

CODORUS VALLEY BANCORP INC  
Form 10-Q  
August 08, 2014  
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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-Q**

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

**or**

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

Commission file number: 0-15536

**CODORUS VALLEY BANCORP, INC.**

(Exact name of registrant as specified in its charter)

**Pennsylvania**

(State or other jurisdiction of  
incorporation or organization)

**23-2428543**

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

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

(Address of principal executive offices) (Zip code)

**717-747-1519**

(Registrant's telephone number, including area code)

**Not**

**Applicable**

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

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

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

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for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. On August 1, 2014, 5,493,061 shares of common stock, par value \$2.50, were outstanding.

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Codorus Valley Bancorp, Inc.

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Table of Contents**PART I - FINANCIAL INFORMATION****Item 1. Financial Statements**Codorus Valley Bancorp, Inc.  
Consolidated Balance Sheets  
Unaudited

| <i>(dollars in thousands, except share and per share data)</i>  | <b>June 30,<br/>2014</b> | <b>December 31,<br/>2013</b> |
|---|--------------------------|------------------------------|
| <b>Assets</b>   |                          |                              |
| Interest bearing deposits with banks  | \$ 20,857                | \$ 1,947                     |
| Cash and due from banks   | 15,218                   | 13,115                       |
| Total cash and cash equivalents   | 36,075                   | 15,062                       |
| Securities, available-for-sale  | 226,586                  | 228,741                      |
| Restricted investment in bank stocks, at cost   | 4,710                    | 4,742                        |
| Loans held for sale   | 875                      | 514                          |
| Loans (net of deferred fees of \$2,203 - 2014 and \$1,963 - 2013)   | 887,908                  | 859,384                      |
| Less-allowance for loan losses  | (10,460)                 | (9,975)                      |
| Net loans   | 877,448                  | 849,409                      |
| Premises and equipment, net   | 15,303                   | 14,599                       |
| Other assets  | 39,641                   | 37,574                       |
| <b>Total assets</b>   | <b>\$ 1,200,638</b>      | <b>\$ 1,150,641</b>          |
| <b>Liabilities</b>  |                          |                              |
| <b>Deposits</b>   |                          |                              |
| Noninterest bearing   | \$ 113,207               | \$ 107,921                   |
| Interest bearing  | 855,292                  | 817,382                      |
| Total deposits  | 968,499                  | 925,303                      |
| Short-term borrowings   | 29,971                   | 40,363                       |
| Long-term debt  | 80,451                   | 70,493                       |
| Other liabilities   | 8,036                    | 6,833                        |
| <b>Total liabilities</b>  | <b>1,086,957</b>         | <b>1,042,992</b>             |
| <b>Shareholders equity</b>  |                          |                              |
| 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 June 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: 5,489,784 at June 30, 2014 and 4,800,318 at December 31, 2013                                      | 13,724                   | 12,001                       |
| Additional paid-in capital  | 57,009                   | 45,399                       |
| Retained earnings   | 27,540                   | 23,077                       |
| Accumulated other comprehensive income  | 3,408                    | 2,172                        |
| <b>Total shareholders equity</b>  | <b>113,681</b>           | <b>107,649</b>               |
| <b>Total liabilities and shareholders equity</b>  | <b>\$ 1,200,638</b>      | <b>\$ 1,150,641</b>          |
| See accompanying notes.   |                          |                              |

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Codorus Valley Bancorp, Inc.  
Consolidated Statements of Income  
Unaudited

| <i>(dollars in thousands, except per share data)</i>     | Three months ended<br>June 30, |           | Six months ended<br>June 30, |           |
|--|--------------------------------|-----------|------------------------------|-----------|
|  | 2014                           | 2013      | 2014                         | 2013      |
| <b>Interest income</b>                                   |                                |           |                              |           |
| Loans, including fees                                    | \$ 10,885                      | \$ 10,209 | \$ 21,885                    | \$ 20,277 |
| Investment securities:                                   |                                |           |                              |           |
| Taxable  | 858                            | 621       | 1,697                        | 1,266     |
| Tax-exempt   | 505                            | 612       | 1,046                        | 1,240     |
| Dividends  | 93                             | 3         | 123                          | 9         |
| Other  | 23                             | 28        | 26                           | 42        |
| Total interest income                                    | 12,364                         | 11,473    | 24,777                       | 22,834    |
| <b>Interest expense</b>                                  |                                |           |                              |           |
| Deposits   | 1,741                          | 1,951     | 3,412                        | 3,960     |
| Federal funds purchased and other short-term borrowings  | 37                             | 29        | 73                           | 57        |
| Long-term debt   | 297                            | 192       | 582                          | 364       |
| Total interest expense                                   | 2,075                          | 2,172     | 4,067                        | 4,381     |
| Net interest income                                      | 10,289                         | 9,301     | 20,710                       | 18,453    |
| <b>Provision for loan losses</b>                         | 300                            | 560       | 850                          | 820       |
| Net interest income after provision for loan losses      | 9,989                          | 8,741     | 19,860                       | 17,633    |
| <b>Noninterest income</b>                                |                                |           |                              |           |
| Trust and investment services fees                       | 525                            | 464       | 1,052                        | 937       |
| Income from mutual fund, annuity and insurance sales     | 192                            | 173       | 325                          | 422       |
| Service charges on deposit accounts                      | 760                            | 670       | 1,438                        | 1,304     |
| Income from bank owned life insurance                    | 175                            | 185       | 348                          | 351       |
| Other income   | 164                            | 180       | 303                          | 346       |
| Net gain on sales of loans held for sale                 | 102                            | 322       | 182                          | 641       |
| Gain on sales of securities                              | 0                              | 44        | 0                            | 44        |
| Total noninterest income                                 | 1,918                          | 2,038     | 3,648                        | 4,045     |
| <b>Noninterest expense</b>                               |                                |           |                              |           |
| Personnel  | 4,288                          | 4,115     | 8,604                        | 8,295     |
| Occupancy of premises, net                               | 515                            | 512       | 1,081                        | 1,023     |
| Furniture and equipment                                  | 551                            | 476       | 1,094                        | 970       |
| Postage, stationery and supplies                         | 163                            | 157       | 322                          | 307       |
| Professional and legal                                   | 256                            | 165       | 439                          | 302       |
| Marketing  | 413                            | 254       | 720                          | 400       |
| FDIC insurance   | 173                            | 138       | 362                          | 309       |
| Debit card processing                                    | 193                            | 195       | 393                          | 373       |
| Charitable donations                                     | 32                             | 11        | 769                          | 486       |
| Telephone  | 145                            | 132       | 291                          | 266       |
| External data processing                                 | 233                            | 167       | 435                          | 335       |
| Foreclosed real estate including (gains) losses on sales | 167                            | 74        | 247                          | 137       |
| Other  | 857                            | 761       | 877                          | 1,207     |
| Total noninterest expense                                | 7,986                          | 7,157     | 15,634                       | 14,410    |
| Income before income taxes                               | 3,921                          | 3,622     | 7,874                        | 7,268     |
| <b>Provision for income taxes</b>                        | 1,114                          | 977       | 2,064                        | 1,961     |
| Net income   | 2,807                          | 2,645     | 5,810                        | 5,307     |
| Preferred stock dividends                                | 52                             | 62        | 114                          | 125       |
| Net income available to common shareholders              | \$ 2,755                       | \$ 2,583  | \$ 5,696                     | \$ 5,182  |
| Net income per common share, basic                       | \$ 0.50                        | \$ 0.55   | \$ 1.11                      | \$ 1.10   |
| Net income per common share, diluted                     | \$ 0.49                        | \$ 0.54   | \$ 1.08                      | \$ 1.08   |

See accompanying notes.



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

| <i>(dollars in thousands)</i>   | <b>Three months ended<br/>June 30,</b> |               |
|---|--|---------------|
|   | <b>2014</b>                            | <b>2013</b>   |
| <b>Net income</b>   | \$ 2,807                               | \$ 2,645      |
| <b>Other comprehensive income (loss):</b>   |  |               |
| Securities available for sale:  |  |               |
| Net unrealized holding gains (losses) arising during the period (net of tax expense (benefit) of \$439 and (\$1,283), respectively) | 851                                    | (2,489)       |
| Reclassification adjustment for gains included in net income (net of tax expense of \$0 and \$15, respectively) (a) (b)             | 0                                      | (29)          |
| Net unrealized gains (losses)   | 851                                    | (2,518)       |
| <b>Comprehensive income</b>   | <b>\$ 3,658</b>                        | <b>\$ 127</b> |

| <i>(dollars in thousands)</i>   | <b>Six months ended<br/>June 30,</b> |                 |
|---|--------------------------------------|-----------------|
|   | <b>2014</b>                          | <b>2013</b>     |
| <b>Net income</b>   | \$ 5,810                             | \$ 5,307        |
| <b>Other comprehensive income (loss):</b>   |                                      |                 |
| Securities available for sale:  |                                      |                 |
| Net unrealized holding gains (losses) arising during the period (net of tax expense (benefit) of \$637 and (\$1,500), respectively) | 1,236                                | (2,911)         |
| Reclassification adjustment for gains included in net income (net of tax expense of \$0 and \$15, respectively) (a) (b)             | 0                                    | (29)            |
| Net unrealized gains (losses)   | 1,236                                | (2,940)         |
| <b>Comprehensive income</b>   | <b>\$ 7,046</b>                      | <b>\$ 2,367</b> |

(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

| <i>(dollars in thousands)</i>   | Six months ended<br>June 30, |           |
|---|------------------------------|-----------|
|   | 2014                         | 2013      |
| <b>Cash flows from operating activities</b>                             |                              |           |
| Net income  | \$ 5,810                     | \$ 5,307  |
| Adjustments to reconcile net income to net cash provided by operations: |                              |           |
| Depreciation/amortization   | 873                          | 729       |
| Net amortization of premiums on securities                              | 481                          | 722       |
| Amortization of deferred loan origination fees and costs                | (345)                        | (277)     |
| Provision for loan losses   | 850                          | 820       |
| Provision for losses on foreclosed real estate                          | 50                           | 0         |
| Deferred income tax benefit   | (145)                        | 0         |
| Amortization of investment in real estate partnership                   | 178                          | 161       |
| Increase in cash surrender of bank owned life insurance                 | (348)                        | (351)     |
| Originations of loans held for sale                                     | (9,025)                      | (33,537)  |
| Proceeds from sales of loans held for sale                              | 8,846                        | 36,125    |
| Net gain on sales of loans held for sale                                | (182)                        | (641)     |
| Gain on disposal of premises and equipment                              | (11)                         | 0         |
| Gain on sales of securities, available-for-sale                         | 0                            | (44)      |
| Gain on sales of foreclosed real estate                                 | 0                            | (15)      |
| Stock-based compensation  | 157                          | 157       |
| (Increase) decrease in interest receivable                              | (54)                         | 181       |
| (Decrease) increase in other assets                                     | (1,697)                      | 621       |
| Increase (decrease) in interest payable                                 | 96                           | (79)      |
| Increase in other liabilities   | 1,146                        | 439       |
| Net cash provided by operating activities                               | 6,680                        | 10,318    |
| <b>Cash flows from investing activities</b>                             |                              |           |
| Purchases of securities, available-for-sale                             | (14,841)                     | (14,143)  |
| Maturities, repayments and calls of securities, available-for-sale      | 18,388                       | 20,961    |
| Sales of securities, available-for-sale                                 | 0                            | 927       |
| Redemption (purchase) of restricted investment in bank stock            | 32                           | (230)     |
| Net increase in loans made to customers                                 | (30,114)                     | (31,852)  |
| Purchases of premises and equipment                                     | (1,566)                      | (2,265)   |
| Investment in bank owned life insurance                                 | 0                            | (5,300)   |
| Proceeds from sales of foreclosed real estate                           | 877                          | 207       |
| Net cash used in investing activities                                   | (27,224)                     | (31,695)  |
| <b>Cash flows from financing activities</b>                             |                              |           |
| Net increase in demand and savings deposits                             | 10,903                       | 19,877    |
| Net increase in time deposits   | 32,293                       | 3,666     |
| Net (decrease) increase in short-term borrowings                        | (10,392)                     | 3,774     |
| Proceeds from issuance of long-term debt                                | 10,000                       | 10,000    |
| Repayment of long-term debt   | (42)                         | (282)     |
| Cash dividends paid to preferred shareholder                            | (147)                        | (125)     |
| Cash dividends paid to common shareholders                              | (1,233)                      | (988)     |
| Redemption of preferred stock   | (13,000)                     | 0         |
| Issuance of common stock  | 13,175                       | 514       |
| Net cash provided by financing activities                               | 41,557                       | 36,436    |
| Net increase in cash and cash equivalents                               | 21,013                       | 15,059    |
| Cash and cash equivalents at beginning of year                          | 15,062                       | 49,757    |
| Cash and cash equivalents at end of period                              | \$ 36,075                    | \$ 64,816 |

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 | Treasury Stock | Total      |
|--|-----------------|--------------|----------------------------|-------------------|--|----------------|------------|
| Balance, January 1, 2014   | \$ 25,000       | \$ 12,001    | \$ 45,399                  | \$ 23,077         | \$ 2,172                               | \$ 0           | \$ 107,649 |
| Net income   |                 |              |                            | 5,810             |  |                | 5,810      |
| Other comprehensive income, net of tax                                 |                 |              |                            |                   | 1,236                                  |                | 1,236      |
| Common stock cash dividends (\$0.24 per share)                         |                 |              |                            | (1,233)           |  |                | (1,233)    |
| Preferred stock cash dividends   |                 |              |                            | (114)             |  |                | (114)      |
| Redemption of preferred stock  | (13,000)        |              |                            |                   |  |                | (13,000)   |
| Stock-based compensation including related tax benefit                 |                 |              | 157                        |                   |  |                | 157        |
| Forfeiture of restricted stock   |                 |              | 1                          |                   |  | (1)            | 0          |
| Issuance and reissuance of common stock including related tax benefit: |                 |              |                            |                   |  |                |            |
| 650,000 shares through private placement                               |                 | 1,625        | 10,885                     |                   |  |                | 12,510     |
| 8,706 shares under the dividend reinvestment and stock purchase plan   |                 | 22           | 164                        |                   |  | 1              | 187        |
| 27,104 shares under the stock option plan                              |                 | 67           | 351                        |                   |  |                | 418        |
| 3,613 shares under employee stock purchase plan                        |                 | 9            | 52                         |                   |  |                | 61         |
| Balance, June 30, 2014   | \$ 12,000       | \$ 13,724    | \$ 57,009                  | \$ 27,540         | \$ 3,408                               | \$ 0           | \$ 113,681 |
| Balance, January 1, 2013   | \$ 25,000       | \$ 11,206    | \$ 40,524                  | \$ 18,868         | \$ 5,733                               | \$ 0           | \$ 101,331 |
| Net income   |                 |              |                            | 5,307             |  |                | 5,307      |
| Other comprehensive loss, net of tax                                   |                 |              |                            |                   | (2,940)                                |                | (2,940)    |
| Common stock cash dividends (\$0.21 per share, adjusted)               |                 |              |                            | (988)             |  |                | (988)      |
| Preferred stock cash dividends   |                 |              |                            | (125)             |  |                | (125)      |
| Stock-based compensation including related tax benefit                 |                 |              | 157                        |                   |  |                | 157        |
| Issuance of common stock including related tax benefit:                |                 |              |                            |                   |  |                |            |
| 10,453 shares under the dividend reinvestment and stock purchase plan  |                 | 26           | 151                        |                   |  |                | 177        |
| 23,105 shares under the stock option plan                              |                 | 58           | 226                        |                   |  |                | 284        |
| 4,246 shares under employee stock purchase plan                        |                 | 10           | 43                         |                   |  |                | 53         |
| Balance, June 30, 2013   | \$ 25,000       | \$ 11,300    | \$ 41,101                  | \$ 23,062         | \$ 2,793                               | \$ 0           | \$ 103,256 |

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. (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 six months ended June 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 June 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 June 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 June 30, 2014, foreclosed real estate, net of allowance, was \$4,711,000, compared to \$4,068,000 for December 31, 2013.

*Per Common Share Computations*

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

| <i>(in thousands, except per share data)</i>                                    | Three months ended |          | Six months ended |          |
|---|--------------------|----------|------------------|----------|
|   | June 30,           |          | June 30,         |          |
|   | 2014               | 2013     | 2014             | 2013     |
| Net income available to common shareholders                                     | \$ 2,755           | \$ 2,583 | \$ 5,696         | \$ 5,182 |
| Weighted average shares outstanding (basic)                                     | 5,475              | 4,731    | 5,167            | 4,720    |
| Effect of dilutive stock options  | 101                | 87       | 103              | 87       |
| Weighted average shares outstanding (diluted)                                   | 5,576              | 4,818    | 5,270            | 4,807    |
| Basic earnings per common share   | \$ 0.50            | \$ 0.55  | \$ 1.11          | \$ 1.10  |
| Diluted earnings per common share   | \$ 0.49            | \$ 0.54  | \$ 1.08          | \$ 1.08  |
| Anti-dilutive stock options excluded from the computation of earnings per share | 23                 | 29       | 23               | 29       |

*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>               | Six months ended<br>June 30, |          |
|---|------------------------------|----------|
|   | 2014                         | 2013     |
| Cash paid during the period for:            |                              |          |
| Income taxes                                | \$ 2,285                     | \$ 1,965 |
| Interest                                    | \$ 3,971                     | \$ 4,460 |
| Noncash investing activities:               |                              |          |
| Transfer of loans to foreclosed real estate | \$ 1,570                     | \$ 0     |

*Reclassification*

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

*Recent Accounting Pronouncements*

There were no new accounting pronouncements affecting the Corporation during the reporting period that were not already adopted or that are expected to have a material impact on the Corporation's consolidated financial position or results of operations.

Table of Contents**Note 3-Securities**

A summary of securities available-for-sale at June 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 June 30, 2014, the fair value of the municipal bond portfolio was concentrated in the states of Pennsylvania at 42 percent and Texas at 17 percent.

| <i>(dollars in thousands)</i>            | <b>Amortized<br/>Cost</b> | <b>Gross Unrealized</b> |               | <b>Fair<br/>Value</b> |
|--|---------------------------|-------------------------|---------------|-----------------------|
|  |                           | <b>Gains</b>            | <b>Losses</b> |                       |
| <b>June 30, 2014</b>                     |                           |                         |               |                       |
| Debt securities:                         |                           |                         |               |                       |
| U.S. agency                              | \$ 33,230                 | \$ 665                  | \$ (111)      | \$ 33,784             |
| U.S. agency mortgage-backed, residential | 110,813                   | 2,387                   | (14)          | 113,186               |
| State and municipal                      | 77,379                    | 2,256                   | (19)          | 79,616                |
| Total debt securities                    | \$ 221,422                | \$ 5,308                | \$ (144)      | \$ 226,586            |
| <b>December 31, 2013</b>                 |                           |                         |               |                       |
| 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 June 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>          | <b>Available-for-sale</b> |                       |
|--|---------------------------|-----------------------|
|  | <b>Amortized<br/>Cost</b> | <b>Fair<br/>Value</b> |
| Due in one year or less                | \$ 17,116                 | \$ 17,315             |
| Due after one year through five years  | 135,111                   | 139,078               |
| Due after five years through ten years | 65,376                    | 66,176                |
| Due after ten years                    | 3,819                     | 4,017                 |
| Total debt securities                  | \$ 221,422                | \$ 226,586            |

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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<br>June 30, |       | Six months ended<br>June 30, |       |
|-------------------------------|--------------------------------|-------|------------------------------|-------|
|                               | 2014                           | 2013  | 2014                         | 2013  |
| Realized gains                | \$ 0                           | \$ 44 | \$ 0                         | \$ 44 |
| Realized losses               | 0                              | 0     | 0                            | 0     |
| Net gains                     | \$ 0                           | \$ 44 | \$ 0                         | \$ 44 |

Securities, issued by agencies of the federal government, with a carrying value of \$154,722,000 and \$142,914,000 on June 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 June 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 |
| <b>June 30, 2014</b>   |                     |                   |                   |                   |            |                   |
| Debt securities:   |                     |                   |                   |                   |            |                   |
| U.S. agency  | \$ 0                | \$ 0              | \$ 11,021         | \$ (111)          | \$ 11,021  | \$ (111)          |
| U.S. agency mortgage-backed, residential                       | 0                   | 0                 | 4,415             | (14)              | 4,415      | (14)              |
| State and municipal  | 2,215               | (4)               | 1,697             | (15)              | 3,912      | (19)              |
| Total temporarily impaired debt securities, available-for-sale | \$ 2,215            | \$ (4)            | \$ 17,133         | \$ (140)          | \$ 19,348  | \$ (144)          |
| <b>December 31, 2013</b>                                       |                     |                   |                   |                   |            |                   |
| 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 \$4,000 at June 30, 2014 within the less than 12 months category were attributable to six state and municipal securities. The unrealized losses of \$140,000 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 June 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 June 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 June 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 June 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 June 30, 2014 and 2013.

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

The table below provides the composition of the loan portfolio at June 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.

| <i>(dollars in thousands)</i>    | <b>June 30,<br/>2014</b> | <b>December<br/>31,<br/>2013</b> |
|----------------------------------|--------------------------|----------------------------------|
| Builder & developer              | \$ 106,322               | \$ 106,436                       |
| Commercial real estate investor  | 142,227                  | 141,372                          |
| Residential real estate investor | 88,299                   | 78,400                           |
| Hotel/Motel                      | 77,645                   | 70,324                           |
| Wholesale & retail               | 73,194                   | 75,445                           |
| Manufacturing                    | 35,919                   | 36,872                           |
| Agriculture                      | 40,169                   | 38,041                           |
| Other                            | 177,966                  | 167,325                          |
| Total commercial related loans   | 741,741                  | 714,215                          |
| Residential mortgages            | 30,683                   | 25,695                           |
| Home equity                      | 80,738                   | 80,859                           |
| Other                            | 34,746                   | 38,615                           |
| Total consumer related loans     | 146,167                  | 145,169                          |
| Total loans                      | \$ 887,908               | \$ 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 June 30, 2014 and December 31, 2013.

| <i>(dollars in thousands)</i>    | Pass       | Special<br>Mention | Substandard | Nonaccrual | Total      |
|----------------------------------|------------|--------------------|-------------|------------|------------|
| <b>June 30, 2014</b>             |            |                    |             |            |            |
| Builder & developer              | \$ 95,039  | \$ 4,830           | \$ 4,782    | \$ 1,671   | \$ 106,322 |
| Commercial real estate investor  | 131,357    | 4,227              | 3,403       | 3,240      | 142,227    |
| Residential real estate investor | 84,005     | 2,037              | 270         | 1,987      | 88,299     |
| Hotel/Motel                      | 77,046     | 0                  | 599         | 0          | 77,645     |
| Wholesale & retail               | 71,809     | 850                | 0           | 535        | 73,194     |
| Manufacturing                    | 34,210     | 1,043              | 666         | 0          | 35,919     |
| Agriculture                      | 36,947     | 2,780              | 442         | 0          | 40,169     |
| Other                            | 175,074    | 1,126              | 1,031       | 735        | 177,966    |
| Total commercial related loans   | 705,487    | 16,893             | 11,193      | 8,168      | 741,741    |
| Residential mortgage             | 30,537     | 0                  | 28          | 118        | 30,683     |
| Home equity                      | 80,164     | 390                | 10          | 174        | 80,738     |
| Other                            | 34,057     | 185                | 0           | 504        | 34,746     |
| Total consumer related loans     | 144,758    | 575                | 38          | 796        | 146,167    |
| Total loans                      | \$ 850,245 | \$ 17,468          | \$ 11,231   | \$ 8,964   | \$ 887,908 |
| <b>December 31, 2013</b>         |            |                    |             |            |            |
| 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 June 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>                  | June 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                            | \$ 4,408            | \$ 4,408                 |                   | \$ 3,861            | \$ 3,861                 |                   |
| Commercial real estate investor                | 6,643               | 6,643                    |                   | 7,860               | 7,860                    |                   |
| Residential real estate investor               | 731                 | 731                      |                   | 354                 | 579                      |                   |
| Hotel/Motel                                    | 599                 | 599                      |                   | 0                   | 0                        |                   |
| Wholesale & retail                             | 808                 | 808                      |                   | 1,403               | 1,403                    |                   |
| Manufacturing                                  | 666                 | 666                      |                   | 671                 | 671                      |                   |
| Agriculture                                    | 0                   | 0                        |                   | 0                   | 0                        |                   |
| Other commercial                               | 1,291               | 1,291                    |                   | 1,498               | 1,498                    |                   |
| Residential mortgage                           | 146                 | 172                      |                   | 150                 | 176                      |                   |
| Home equity                                    | 184                 | 184                      |                   | 231                 | 256                      |                   |
| Other consumer                                 | 504                 | 559                      |                   | 594                 | 609                      |                   |
| Total impaired loans with no related allowance | \$ 15,980           | \$ 16,061                |                   | \$ 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                                    | 442                 | 442                      | 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  | \$ 4,488            | \$ 4,488                 | \$ 1,912          | \$ 10,140           | \$ 10,140                | \$ 1,720          |
| Total impaired loans:                          |                     |                          |                   |                     |                          |                   |
| Builder & developer                            | \$ 6,453            | \$ 6,453                 | \$ 953            | \$ 11,594           | \$ 11,594                | \$ 850            |
| Commercial real estate investor                | 6,643               | 6,643                    | 0                 | 7,860               | 7,860                    | 0                 |
| Residential real estate investor               | 2,257               | 2,257                    | 559               | 1,984               | 2,209                    | 650               |
| Hotel/Motel                                    | 599                 | 599                      | 0                 | 0                   | 0                        | 0                 |
| Wholesale & retail                             | 808                 | 808                      | 0                 | 1,403               | 1,403                    | 0                 |
| Manufacturing                                  | 666                 | 666                      | 0                 | 671                 | 671                      | 0                 |
| Agriculture                                    | 442                 | 442                      | 100               | 451                 | 451                      | 100               |
| Other commercial                               | 1,766               | 1,766                    | 300               | 1,824               | 1,824                    | 120               |
| Residential mortgage                           | 146                 | 172                      | 0                 | 150                 | 176                      | 0                 |
| Home equity                                    | 184                 | 184                      | 0                 | 231                 | 256                      | 0                 |
| Other consumer                                 | 504                 | 559                      | 0                 | 594                 | 609                      | 0                 |
| Total impaired loans                           | \$ 20,468           | \$ 20,549                | \$ 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 six months ended June 30, 2014 and 2013.

|  | For the three months ended  |                                     |                            |                             |                                     |                            |
|--|-----------------------------|-------------------------------------|----------------------------|-----------------------------|-------------------------------------|----------------------------|
|  | Average Recorded Investment | June 30, 2014 Total Interest Income | Cash Basis Interest Income | Average Recorded Investment | June 30, 2013 Total Interest Income | Cash Basis Interest Income |
| <i>(dollars in thousands)</i>                  |                             |                                     |                            |                             |                                     |                            |
| Impaired loans with no related allowance:      |                             |                                     |                            |                             |                                     |                            |
| Builder & developer                            | \$ 4,419                    | \$ 67                               | \$ 1                       | \$ 9,211                    | \$ 135                              | \$ 3                       |
| Commercial real estate investor                | 7,229                       | 74                                  | 25                         | 5,702                       | 67                                  | 33                         |
| Residential real estate investor               | 542                         | 2                                   | 0                          | 239                         | 3                                   | 1                          |
| Hotel/Motel                                    | 614                         | 5                                   | 0                          | 0                           | 0                                   | 0                          |
| Wholesale & retail                             | 809                         | 3                                   | 0                          | 2,539                       | 66                                  | 64                         |
| Manufacturing                                  | 667                         | 10                                  | 0                          | 685                         | 11                                  | 0                          |
| Agriculture                                    | 0                           | 0                                   | 0                          | 0                           | 0                                   | 0                          |
| Other commercial                               | 1,149                       | 7                                   | 0                          | 1,667                       | 7                                   | 2                          |
| Residential mortgage                           | 148                         | 2                                   | 2                          | 118                         | 2                                   | 2                          |
| Home equity                                    | 235                         | 2                                   | 2                          | 338                         | 3                                   | 0                          |
| Other consumer                                 | 490                         | 2                                   | 2                          | 642                         | 7                                   | 7                          |
| Total impaired loans with no related allowance | \$ 16,302                   | \$ 174                              | \$ 32                      | \$ 21,141                   | \$ 301                              | \$ 112                     |
| Impaired loans with a related allowance:       |                             |                                     |                            |                             |                                     |                            |
| Builder & developer                            | \$ 3,985                    | \$ 7                                | \$ 0                       | \$ 66                       | \$ 0                                | \$ 0                       |
| Commercial real estate investor                | 0                           | 0                                   | 0                          | 0                           | 0                                   | 0                          |
| Residential real estate investor               | 1,467                       | 2                                   | 0                          | 2,453                       | 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                                    | 445                         | 8                                   | 0                          | 466                         | 8                                   | 0                          |
| Other commercial                               | 337                         | 7                                   | 0                          | 924                         | 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  | \$ 6,234                    | \$ 24                               | \$ 0                       | \$ 3,909                    | \$ 8                                | \$ 0                       |
| Total impaired loans:                          |                             |                                     |                            |                             |                                     |                            |
| Builder & developer                            | \$ 8,404                    | \$ 74                               | \$ 1                       | \$ 9,277                    | \$ 135                              | \$ 3                       |
| Commercial real estate investor                | 7,229                       | 74                                  | 25                         | 5,702                       | 67                                  | 33                         |
| Residential real estate investor               | 2,009                       | 4                                   | 0                          | 2,692                       | 3                                   | 1                          |
| Hotel/Motel                                    | 614                         | 5                                   | 0                          | 0                           | 0                                   | 0                          |
| Wholesale & retail                             | 809                         | 3                                   | 0                          | 2,539                       | 66                                  | 64                         |
| Manufacturing                                  | 667                         | 10                                  | 0                          | 685                         | 11                                  | 0                          |
| Agriculture                                    | 445                         | 8                                   | 0                          | 466                         | 8                                   | 0                          |
| Other commercial                               | 1,486                       | 14                                  | 0                          | 2,591                       | 7                                   | 2                          |
| Residential mortgage                           | 148                         | 2                                   | 2                          | 118                         | 2                                   | 2                          |
| Home equity                                    | 235                         | 2                                   | 2                          | 338                         | 3                                   | 0                          |
| Other consumer                                 | 490                         | 2                                   | 2                          | 642                         | 7                                   | 7                          |
| Total impaired loans                           | \$ 22,536                   | \$ 198                              | \$ 32                      | \$ 25,050                   | \$ 309                              | \$ 112                     |

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|  | For the six months ended          |  |                                  |                                   |  |                                  |
|--|-----------------------------------|--|----------------------------------|-----------------------------------|--|----------------------------------|
|  | Average<br>Recorded<br>Investment | June 30, 2014<br>Total<br>Interest<br>Income | Cash Basis<br>Interest<br>Income | Average<br>Recorded<br>Investment | June 30, 2013<br>Total<br>Interest<br>Income | Cash Basis<br>Interest<br>Income |
| <i>(dollars in thousands)</i>                  |                                   |  |                                  |                                   |  |                                  |
| Impaired loans with no related allowance:      |                                   |  |                                  |                                   |  |                                  |
| Builder & developer                            | \$ 4,233                          | \$ 164                                       | \$ 17                            | \$ 10,211                         | \$ 264                                       | \$ 5                             |
| Commercial real estate investor                | 7,440                             | 150  | 52                               | 5,713                             | 134  | 69                               |
| Residential real estate investor               | 479                               | 5  | 0                                | 184                               | 5  | 2                                |
| Hotel/Motel                                    | 410                               | 10   | 0                                | 0                                 | 0  | 0                                |
| Wholesale & retail                             | 1,007                             | 74   | 68                               | 2,708                             | 43   | 64                               |
| Manufacturing                                  | 669                               | 21   | 0                                | 690                               | 22   | 0                                |
| Agriculture                                    | 0                                 | 0  | 0                                | 0                                 | 0  | 0                                |
| Other commercial                               | 1,266                             | 31   | 21                               | 1,606                             | 6  | 4                                |
| Residential mortgage                           | 148                               | 4  | 3                                | 107                               | 4  | 3                                |
| Home equity                                    | 233                               | 3  | 2                                | 339                               | 6  | 1                                |
| Other consumer                                 | 524                               | 15   | 15                               | 642                               | 13   | 13                               |
| Total impaired loans with no related allowance | \$ 16,409                         | \$ 477                                       | \$ 178                           | \$ 22,200                         | \$ 497                                       | \$ 161                           |
| Impaired loans with a related allowance:       |                                   |  |                                  |                                   |  |                                  |
| Builder & developer                            | \$ 5,234                          | \$ 14  | \$ 0                             | \$ 129                            | \$ 0   | \$ 0                             |
| Commercial real estate investor                | 0                                 | 0  | 0                                | 0                                 | 0  | 0                                |
| Residential real estate investor               | 1,521                             | 2  | 0                                | 2,522                             | (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                                    | 447                               | 16   | 0                                | 468                               | 16   | 0                                |
| Other commercial                               | 333                               | 7  | 0                                | 939                               | 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  | \$ 7,535                          | \$ 39  | \$ 0                             | \$ 4,058                          | \$ 7   | \$ 0                             |
| Total impaired loans:                          |                                   |  |                                  |                                   |  |                                  |
| Builder & developer                            | \$ 9,467                          | \$ 178                                       | \$ 17                            | \$ 10,340                         | \$ 264                                       | \$ 5                             |
| Commercial real estate investor                | 7,440                             | 150  | 52                               | 5,713                             | 134  | 69                               |
| Residential real estate investor               | 2,000                             | 7  | 0                                | 2,706                             | (4)  | 2                                |
| Hotel/Motel                                    | 410                               | 10   | 0                                | 0                                 | 0  | 0                                |
| Wholesale & retail                             | 1,007                             | 74   | 68                               | 2,708                             | 43   | 64                               |
| Manufacturing                                  | 669                               | 21   | 0                                | 690                               | 22   | 0                                |
| Agriculture                                    | 447                               | 16   | 0                                | 468                               | 16   | 0                                |
| Other commercial                               | 1,599                             | 38   | 21                               | 2,545                             | 6  | 4                                |
| Residential mortgage                           | 148                               | 4  | 3                                | 107                               | 4  | 3                                |
| Home equity                                    | 233                               | 3  | 2                                | 339                               | 6  | 1                                |
| Other consumer                                 | 524                               | 15   | 15                               | 642                               | 13   | 13                               |
| Total impaired loans                           | \$ 23,944                         | \$ 516                                       | \$ 178                           | \$ 26,258                         | \$ 504                                       | \$ 161                           |

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 June 30, 2014 and December 31, 2013.

| <i>(dollars in thousands)</i>    | 30-59<br>Days<br>Past Due | 60-89<br>Days<br>Past Due | ≥ 90 Days<br>Past Due<br>and<br>Accruing | Nonaccrual | Total Past<br>Due and<br>Nonaccrual | Current    | Total<br>Loans |
|----------------------------------|---------------------------|---------------------------|--|------------|-------------------------------------|------------|----------------|
| <b>June 30, 2014</b>             |                           |                           |  |            |                                     |            |                |
| Builder & developer              | \$ 0                      | \$ 0                      | \$ 0                                     | \$ 1,671   | \$ 1,671                            | \$ 104,651 | \$ 106,322     |
| Commercial real estate investor  | 0                         | 0                         | 0  | 3,240      | 3,240                               | 138,987    | 142,227        |
| Residential real estate investor | 0                         | 0                         | 0  | 1,987      | 1,987                               | 86,312     | 88,299         |
| Hotel/Motel                      | 0                         | 599                       | 0  | 0          | 599                                 | 77,046     | 77,645         |
| Wholesale & retail               | 0                         | 0                         | 0  | 535        | 535                                 | 72,659     | 73,194         |
| Manufacturing                    | 0                         | 0                         | 0  | 0          | 0                                   | 35,919     | 35,919         |
| Agriculture                      | 0                         | 0                         | 0  | 0          | 0                                   | 40,169     | 40,169         |
| Other                            | 10                        | 129                       | 0  | 735        | 874                                 | 177,092    | 177,966        |
| Total commercial related loans   | 10                        | 728                       | 0  | 8,168      | 8,906                               | 732,835    | 741,741        |
| Residential mortgage             | 0                         | 0                         | 0  | 118        | 118                                 | 30,565     | 30,683         |
| Home equity                      | 100                       | 0                         | 0  | 174        | 274                                 | 80,464     | 80,738         |
| Other                            | 160                       | 0                         | 0  | 504        | 664                                 | 34,082     | 34,746         |
| Total consumer related loans     | 260                       | 0                         | 0  | 796        | 1,056                               | 145,111    | 146,167        |
| Total loans                      | \$ 270                    | \$ 728                    | \$ 0                                     | \$ 8,964   | \$ 9,962                            | \$ 877,946 | \$ 887,908     |
| <b>December 31, 2013</b>         |                           |                           |  |            |                                     |            |                |
| 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     |

*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.

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The table below shows loans whose terms have been modified under TDRs during the three and six months ended June 30, 2014 and 2013. There was no impairment loss recognized on any of these TDRs, and they are all performing under their modified terms. There were no defaults during the three and six months ended June 30, 2014 and 2013 for TDRs entered into for the last 12 months.

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

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

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

| <i>(dollars in thousands)</i>     | <b>Builder &amp; developer</b> | <b>Commercial real estate investor</b> | <b>Residential real estate investor</b> | <b>Hotel/ Motel</b> | <b>Wholesale &amp; retail</b> | <b>Manufacturing</b> | <b>Agriculture</b> | <b>Other</b>    | <b>Total commercial related</b> |
|-----------------------------------|--------------------------------|--|---|---------------------|-------------------------------|----------------------|--------------------|-----------------|---------------------------------|
| <b>Allowance for loan losses:</b> |                                |  |   |                     |                               |                      |                    |                 |                                 |
| Balance, April 1, 2014            | \$ 2,195                       | \$ 1,488                               | \$ 1,430                                | \$ 617              | \$ 639                        | \$ 217               | \$ 311             | \$ 1,425        | \$ 8,322                        |
| Charge-offs                       | 0                              | (200)                                  | 0                                       | 0                   | 0                             | 0                    | 0                  | 0               | (200)                           |
| Recoveries                        | 0                              | 0                                      | 190                                     | 0                   | 4                             | 0                    | 0                  | 0               | 194                             |
| Provisions                        | 46                             | 304                                    | (200)                                   | 38                  | (6)                           | (5)                  | 7                  | 88              | 272                             |
| <b>Balance, June 30, 2014</b>     | <b>\$ 2,241</b>                | <b>\$ 1,592</b>                        | <b>\$ 1,420</b>                         | <b>\$ 655</b>       | <b>\$ 637</b>                 | <b>\$ 212</b>        | <b>\$ 318</b>      | <b>\$ 1,513</b> | <b>\$ 8,588</b>                 |
| Balance, April 1, 2013            | \$ 1,534                       | \$ 1,286                               | \$ 1,196                                | \$ 514              | \$ 1,832                      | \$ 224               | \$ 237             | \$ 1,156        | \$ 7,979                        |
| Charge-offs                       | (62)                           | 0                                      | (225)                                   | 0                   | (210)                         | 0                    | 0                  | 0               | (497)                           |
| Recoveries                        | 0                              | 0                                      | 0                                       | 0                   | 18                            | 0                    | 0                  | 0               | 18                              |
| Provisions                        | 104                            | (73)                                   | 210                                     | (9)                 | 216                           | (23)                 | 16                 | (5)             | 436                             |
| <b>Balance, June 30, 2013</b>     | <b>\$ 1,576</b>                | <b>\$ 1,213</b>                        | <b>\$ 1,181</b>                         | <b>\$ 505</b>       | <b>\$ 1,856</b>               | <b>\$ 201</b>        | <b>\$ 253</b>      | <b>\$ 1,151</b> | <b>\$ 7,936</b>                 |

| <i>(dollars in thousands)</i>     | <b>Residential mortgage</b> | <b>Home equity</b> | <b>Other</b>  | <b>Total consumer related</b> | <b>Unallocated</b> | <b>Total</b>     |
|-----------------------------------|-----------------------------|--------------------|---------------|-------------------------------|--------------------|------------------|
| <b>Allowance for loan losses:</b> |                             |                    |               |                               |                    |                  |
| Balance, April 1, 2014            | \$ 59                       | \$ 156             | \$ 318        | \$ 533                        | \$ 1,458           | \$ 10,313        |
| Charge-offs                       | (30)                        | (1)                | (125)         | (156)                         | 0                  | (356)            |
| Recoveries                        | 0                           | 4                  | 5             | 9                             | 0                  | 203              |
| Provisions                        | 32                          | (2)                | 125           | 155                           | (127)              | 300              |
| <b>Balance, June 30, 2014</b>     | <b>\$ 61</b>                | <b>\$ 157</b>      | <b>\$ 323</b> | <b>\$ 541</b>                 | <b>\$ 1,331</b>    | <b>\$ 10,460</b> |
| Balance, April 1, 2013            | \$ 48                       | \$ 315             | \$ 197        | \$ 560                        | \$ 947             | \$ 9,486         |
| Charge-offs                       | (28)                        | 0                  | (101)         | (129)                         | 0                  | (626)            |
| Recoveries                        | 2                           | 6                  | 13            | 21                            | 0                  | 39               |
| Provisions                        | 55                          | (85)               | 167           | 137                           | (13)               | 560              |
| <b>Balance, June 30, 2013</b>     | <b>\$ 77</b>                | <b>\$ 236</b>      | <b>\$ 276</b> | <b>\$ 589</b>                 | <b>\$ 934</b>      | <b>\$ 9,459</b>  |

| <i>(dollars in thousands)</i>     | <b>Builder &amp; developer</b> | <b>Commercial real estate investor</b> | <b>Residential real estate investor</b> | <b>Hotel/ Motel</b> | <b>Wholesale &amp; retail</b> | <b>Manufacturing</b> | <b>Agriculture</b> | <b>Other</b>    | <b>Total commercial related</b> |
|-----------------------------------|--------------------------------|--|---|---------------------|-------------------------------|----------------------|--------------------|-----------------|---------------------------------|
| <b>Allowance for loan losses:</b> |                                |  |   |                     |                               |                      |                    |                 |                                 |
| Balance, January 1, 2014          | \$ 2,073                       | \$ 1,500                               | \$ 1,482                                | \$ 595              | \$ 637                        | \$ 217               | \$ 307             | \$ 1,393        | \$ 8,204                        |
| Charge-offs                       | 0                              | (200)                                  | (91)                                    | 0                   | (34)                          | 0                    | 0                  | 0               | (325)                           |
| Recoveries                        | 0                              | 0                                      | 190                                     | 0                   | 22                            | 0                    | 0                  | 0               | 212                             |
| Provisions                        | 168                            | 292                                    | (161)                                   | 60                  | 12                            | (5)                  | 11                 | 120             | 497                             |
| <b>Balance, June 30, 2014</b>     | <b>\$ 2,241</b>                | <b>\$ 1,592</b>                        | <b>\$ 1,420</b>                         | <b>\$ 655</b>       | <b>\$ 637</b>                 | <b>\$ 212</b>        | <b>\$ 318</b>      | <b>\$ 1,513</b> | <b>\$ 8,588</b>                 |
| Balance, January 1, 2013          | \$ 1,571                       | \$ 1,259                               | \$ 1,195                                | \$ 485              | \$ 1,913                      | \$ 237               | \$ 202             | \$ 1,170        | \$ 8,032                        |
| Charge-offs                       | (62)                           | 0                                      | (225)                                   | 0                   | (210)                         | 0                    | 0                  | 0               | (497)                           |
| Recoveries                        | 0                              | 0                                      | 0                                       | 0                   | 22                            | 0                    | 0                  | 0               | 22                              |
| Provisions                        | 67                             | (46)                                   | 211                                     | 20                  | 131                           | (36)                 | 51                 | (19)            | 379                             |
| <b>Balance, June 30, 2013</b>     | <b>\$ 1,576</b>                | <b>\$ 1,213</b>                        | <b>\$ 1,181</b>                         | <b>\$ 505</b>       | <b>\$ 1,856</b>               | <b>\$ 201</b>        | <b>\$ 253</b>      | <b>\$ 1,151</b> | <b>\$ 7,936</b>                 |

*(dollars in thousands)*

| <b>Other</b> | <b>Unallocated</b> | <b>Total</b> |
|--------------|--------------------|--------------|
|--------------|--------------------|--------------|

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|                                   | Residential<br>mortgage | Home<br>equity | Total<br>consumer<br>related |               |                 |                  |  |
|-----------------------------------|-------------------------|----------------|------------------------------|---------------|-----------------|------------------|--|
| <b>Allowance for loan losses:</b> |                         |                |                              |               |                 |                  |  |
| Balance, January 1, 2014          | \$ 65                   | \$ 237         | \$ 269                       | \$ 571        | \$ 1,200        | \$ 9,975         |  |
| Charge-offs                       | (30)                    | (41)           | (251)                        | (322)         | 0               | (647)            |  |
| Recoveries                        | 4                       | 35             | 31                           | 70            | 0               | 282              |  |
| Provisions                        | 22                      | (74)           | 274                          | 222           | 131             | 850              |  |
| <b>Balance, June 30, 2014</b>     | <b>\$ 61</b>            | <b>\$ 157</b>  | <b>\$ 323</b>                | <b>\$ 541</b> | <b>\$ 1,331</b> | <b>\$ 10,460</b> |  |
| Balance, January 1, 2013          | \$ 124                  | \$ 237         | \$ 238                       | \$ 599        | \$ 671          | \$ 9,302         |  |
| Charge-offs                       | (28)                    | (75)           | (133)                        | (236)         | 0               | (733)            |  |
| Recoveries                        | 2                       | 7              | 39                           | 48            | 0               | 70               |  |
| Provisions                        | (21)                    | 67             | 132                          | 178           | 263             | 820              |  |
| <b>Balance, June 30, 2013</b>     | <b>\$ 77</b>            | <b>\$ 236</b>  | <b>\$ 276</b>                | <b>\$ 589</b> | <b>\$ 934</b>   | <b>\$ 9,459</b>  |  |

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

| <i>(dollars in thousands)</i>         | <b>Builder &amp; developer</b> | <b>Commercial real estate investor</b> | <b>Residential real estate investor</b> | <b>Hotel/ Motel</b> | <b>Wholesale &amp; retail</b> | <b>Manufacturing</b> | <b>Agriculture</b> | <b>Other</b>      | <b>Total commercial related</b> |
|---------------------------------------|--------------------------------|--|---|---------------------|-------------------------------|----------------------|--------------------|-------------------|---------------------------------|
| <b>Allowance for loan losses:</b>     |                                |  |   |                     |                               |                      |                    |                   |                                 |
| Individually evaluated for impairment | \$ 953                         | \$ 0                                   | \$ 559                                  | \$ 0                | \$ 0                          | \$ 0                 | \$ 100             | \$ 300            | \$ 1,912                        |
| Collectively evaluated for impairment | 1,288                          | 1,592                                  | 861                                     | 655                 | 637                           | 212                  | 218                | 1,213             | 6,676                           |
| <b>Balance, June 30, 2014</b>         | <b>\$ 2,241</b>                | <b>\$ 1,592</b>                        | <b>\$ 1,420</b>                         | <b>\$ 655</b>       | <b>\$ 637</b>                 | <b>\$ 212</b>        | <b>\$ 318</b>      | <b>\$ 1,513</b>   | <b>\$ 8,588</b>                 |
| 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                           |
| <b>Balance, December 31, 2013</b>     | <b>\$ 2,073</b>                | <b>\$ 1,500</b>                        | <b>\$ 1,482</b>                         | <b>\$ 595</b>       | <b>\$ 637</b>                 | <b>\$ 217</b>        | <b>\$ 307</b>      | <b>\$ 1,393</b>   | <b>\$ 8,204</b>                 |
| Individually evaluated for impairment | \$ 0                           | \$ 0                                   | \$ 550                                  | \$ 0                | \$ 0                          | \$ 0                 | \$ 100             | \$ 120            | \$ 770                          |
| Collectively evaluated for impairment | 1,576                          | 1,213                                  | 631                                     | 505                 | 1,856                         | 201                  | 153                | 1,031             | 7,166                           |
| <b>Balance, June 30, 2013</b>         | <b>\$ 1,576</b>                | <b>\$ 1,213</b>                        | <b>\$ 1,181</b>                         | <b>\$ 505</b>       | <b>\$ 1,856</b>               | <b>\$ 201</b>        | <b>\$ 253</b>      | <b>\$ 1,151</b>   | <b>\$ 7,936</b>                 |
| <b>Loans:</b>                         |                                |  |   |                     |                               |                      |                    |                   |                                 |
| Individually evaluated for impairment | \$ 6,453                       | \$ 6,643                               | \$ 2,257                                | \$ 599              | \$ 808                        | \$ 666               | \$ 442             | \$ 1,766          | \$ 19,634                       |
| Collectively evaluated for impairment | 99,869                         | 135,584                                | 86,042                                  | 77,046              | 72,386                        | 35,253               | 39,727             | 176,200           | 722,107                         |
| <b>Balance, June 30, 2014</b>         | <b>\$ 106,322</b>              | <b>\$ 142,227</b>                      | <b>\$ 88,299</b>                        | <b>\$ 77,645</b>    | <b>\$ 73,194</b>              | <b>\$ 35,919</b>     | <b>\$ 40,169</b>   | <b>\$ 177,966</b> | <b>\$ 741,741</b>               |
| 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                         |
| <b>Balance, December 31, 2013</b>     | <b>\$ 106,436</b>              | <b>\$ 141,372</b>                      | <b>\$ 78,400</b>                        | <b>\$ 70,324</b>    | <b>\$ 75,445</b>              | <b>\$ 36,872</b>     | <b>\$ 38,041</b>   | <b>\$ 167,325</b> | <b>\$ 714,215</b>               |
| Individually evaluated for impairment | \$ 9,168                       | \$ 5,691                               | \$ 2,571                                | \$ 0                | \$ 2,149                      | \$ 682               | \$ 463             | \$ 2,468          | \$ 23,192                       |
| Collectively evaluated for impairment | 92,743                         | 112,394                                | 67,095                                  | 67,668              | 66,434                        | 33,460               | 30,690             | 140,169           | 610,653                         |
| <b>Balance, June 30, 2013</b>         | <b>\$ 101,911</b>              | <b>\$ 118,085</b>                      | <b>\$ 69,666</b>                        | <b>\$ 67,668</b>    | <b>\$ 68,583</b>              | <b>\$ 34,142</b>     | <b>\$ 31,153</b>   | <b>\$ 142,637</b> | <b>\$ 633,845</b>               |

| <i>(dollars in thousands)</i>         | <b>Residential mortgage</b> | <b>Home equity</b> | <b>Other</b>  | <b>Total consumer related</b> | <b>Unallocated</b> | <b>Total</b>     |
|---------------------------------------|-----------------------------|--------------------|---------------|-------------------------------|--------------------|------------------|
| <b>Allowance for loan losses:</b>     |                             |                    |               |                               |                    |                  |
| Individually evaluated for impairment | \$ 0                        | \$ 0               | \$ 0          | \$ 0                          | \$ 0               | \$ 1,912         |
| Collectively evaluated for impairment | 61                          | 157                | 323           | 541                           | 1,331              | 8,548            |
| <b>Balance, June 30, 2014</b>         | <b>\$ 61</b>                | <b>\$ 157</b>      | <b>\$ 323</b> | <b>\$ 541</b>                 | <b>\$ 1,331</b>    | <b>\$ 10,460</b> |
| Individually evaluated for impairment | \$ 0                        | \$ 0               | \$ 0          | \$ 0                          | \$ 0               | \$ 1,720         |
| Collectively evaluated for impairment | 65                          | 237                | 269           | 571                           | 1,200              | 8,255            |
| <b>Balance, December 31, 2013</b>     | <b>\$ 65</b>                | <b>\$ 237</b>      | <b>\$ 269</b> | <b>\$ 571</b>                 | <b>\$ 1,200</b>    | <b>\$ 9,975</b>  |
| Individually evaluated for impairment | \$ 0                        | \$ 0               | \$ 0          | \$ 0                          | \$ 0               | \$ 770           |

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|                                       |       |        |        |        |        |          |
|---------------------------------------|-------|--------|--------|--------|--------|----------|
| Collectively evaluated for impairment | 77    | 236    | 276    | 589    | 934    | 8,689    |
| <b>Balance, June 30, 2013</b>         | \$ 77 | \$ 236 | \$ 276 | \$ 589 | \$ 934 | \$ 9,459 |

**Loans:**

|                                       |           |           |           |            |            |
|---------------------------------------|-----------|-----------|-----------|------------|------------|
| Individually evaluated for impairment | \$ 146    | \$ 184    | \$ 504    | \$ 834     | \$ 20,468  |
| Collectively evaluated for impairment | 30,537    | 80,554    | 34,242    | 145,333    | 867,440    |
| <b>Balance, June 30, 2014</b>         | \$ 30,683 | \$ 80,738 | \$ 34,746 | \$ 146,167 | \$ 887,908 |

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

|                                       |           |           |           |            |            |
|---------------------------------------|-----------|-----------|-----------|------------|------------|
| Individually evaluated for impairment | \$ 152    | \$ 397    | \$ 667    | \$ 1,216   | \$ 24,408  |
| Collectively evaluated for impairment | 24,276    | 71,169    | 38,094    | 133,539    | 744,192    |
| <b>Balance, June 30, 2013</b>         | \$ 24,428 | \$ 71,566 | \$ 38,761 | \$ 134,755 | \$ 768,600 |

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Table of Contents**Note 7 Deposits**

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

| <i>(dollars in thousands)</i>     | <b>June 30,<br/>2014</b> | <b>December 31,<br/>2013</b> |
|-----------------------------------|--------------------------|------------------------------|
| Noninterest bearing demand        | \$ 113,207               | \$ 107,921                   |
| NOW                               | 88,654                   | 83,949                       |
| Money market                      | 291,377                  | 292,870                      |
| Savings                           | 41,927                   | 39,522                       |
| Time deposits less than \$100,000 | 246,394                  | 230,641                      |
| Time deposits \$100,000 or more   | 186,940                  | 170,400                      |
| Total deposits                    | \$ 968,499               | \$ 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 June 30, 2014, the balance of securities sold under agreements to repurchase was \$29,971,000 compared to \$24,597,000 at December 31, 2013. At June 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 June 30, 2014 and December 31, 2013.

| <i>(dollars in thousands)</i>  | <b>June 30,<br/>2014</b> | <b>December 31,<br/>2013</b> |
|--|--------------------------|------------------------------|
| 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   | 141                      | 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   | \$ 80,451                | \$ 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.

Table of Contents**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.

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

| <i>(dollars in thousands)</i>                      | Actual     |        | Minimum for<br>Capital Adequacy |       | Well Capitalized<br>Minimum* |       |
|--|------------|--------|---------------------------------|-------|------------------------------|-------|
|  | Amount     | Ratio  | Amount                          | Ratio | Amount                       | Ratio |
| <b>Codorus Valley Bancorp, Inc. (consolidated)</b> |            |        |                                 |       |                              |       |
| <b>at June 30, 2014</b>                            |            |        |                                 |       |                              |       |
| Capital ratios:                                    |            |        |                                 |       |                              |       |
| Tier 1 risk based                                  | \$ 120,273 | 12.90% | \$ 37,292                       | 4.00% | n/a                          | n/a   |
| Total risk based                                   | 130,733    | 14.02  | 74,584                          | 8.00  | n/a                          | n/a   |
| Leverage   | 120,273    | 10.04  | 47,919                          | 4.00  | n/a                          | n/a   |
| <b>at December 31, 2013</b>                        |            |        |                                 |       |                              |       |
| 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   |
| <b>PeoplesBank, A Codorus Valley Company</b>       |            |        |                                 |       |                              |       |
| <b>at June 30, 2014</b>                            |            |        |                                 |       |                              |       |
| Capital ratios:                                    |            |        |                                 |       |                              |       |
| Tier 1 risk based                                  | \$ 116,666 | 12.56% | \$ 37,166                       | 4.00% | \$ 55,748                    | 6.00% |
| Total risk based                                   | 127,126    | 13.68  | 74,331                          | 8.00  | 92,914                       | 10.00 |
| Leverage   | 116,666    | 9.76   | 47,793                          | 4.00  | 59,742                       | 5.00  |
| <b>at December 31, 2013</b>                        |            |        |                                 |       |                              |       |
| 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.





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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.

### *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 June 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 six months ended June 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. 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 \$25,350,000 of standby letters of credit outstanding on June 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 June 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.

Table of Contents**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.

| <i>(dollars in thousands)</i>            | <b>Total</b> | <b>(Level 1)<br/>Quoted Prices in<br/>Active Markets for<br/>Identical Assets</b> | <b>Fair Value Measurements<br/>(Level 2)<br/>Significant Other<br/>Observable<br/>Inputs</b> | <b>(Level 3)<br/>Significant Other<br/>Unobservable<br/>Inputs</b> |
|--|--------------|---|--|--|
| <b>June 30, 2014</b>                     |              |   |  |  |
| Securities available-for-sale:           |              |   |  |  |
| U.S. agency                              | \$ 33,784    | \$ 0  | \$ 33,784  | \$ 0   |
| U.S. agency mortgage-backed, residential | 113,186      | 0   | 113,186  | 0  |
| State and municipal                      | 79,616       | 0   | 79,616   | 0  |
| <b>December 31, 2013</b>                 |              |   |  |  |
| 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 June 30, 2014, the fair value of impaired loans with a valuation allowance or charge-off was of \$2,803,000, which is net of valuation allowances of \$1,912,000 and charge-offs of \$81,000. 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 June 30, 2014, the fair value of foreclosed real estate with a valuation allowance or charge-off was \$2,915,000, which is net of valuation allowances of \$3,878,000. 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)<br>Quoted Prices in<br>Active Markets for<br>Identical Assets | (Level 2)<br>Significant Other<br>Observable<br>Inputs | (Level 3)<br>Significant Other<br>Unobservable<br>Inputs |
| <b>June 30, 2014</b>          |          |   |  |  |
| Impaired loans                | \$ 2,803 | \$ 0  | \$ 0   | \$ 2,803   |
| Foreclosed real estate        | 2,915    | 0   | 0  | 2,915  |
| <b>December 31, 2013</b>      |          |   |  |  |
| 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<br>Estimate | Quantitative Information about Level 3 Fair Value Measurements |                       |                  | Weighted<br>Average |
|-------------------------------|------------------------|--|-----------------------|------------------|---------------------|
|                               |                        | Valuation<br>Techniques  | Unobservable<br>Input | Range            |                     |
| <b>June 30, 2014</b>          |                        |  |                       |                  |                     |
| Impaired loans                | \$ 2,803               | Appraisal (1)  | Appraisal adjustments | 10% - 41%<br>(2) | 22%                 |
| Foreclosed real estate        | 2,915                  | Appraisal (1)  | Appraisal adjustments | 8% - 66%<br>(2)  | 45%                 |
| <b>December 31, 2013</b>      |                        |  |                       |                  |                     |
| Impaired loans                | \$ 8,669               | Appraisal (1)  | Appraisal adjustments | 13% - 27%<br>(2) | 19%                 |
| Foreclosed real estate        | 3,098                  | Appraisal (1)  | Appraisal adjustments | 8% - 67%<br>(2)  | 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 June 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 June 30, 2014 and December 31, 2013.

|                                      | Carrying<br>Amount | Estimated<br>Fair Value | Fair Value Estimates  |   |   |
|--------------------------------------|--------------------|-------------------------|---|---|---|
|                                      |                    |                         | (Level 1)<br>Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets | (Level 2)<br>Significant<br>Other<br>Observable<br>Inputs | (Level 3)<br>Significant<br>Other<br>Unobservable<br>Inputs |
| <i>(dollars in thousands)</i>        |                    |                         |   |   |   |
| <b>June 30, 2014</b>                 |                    |                         |   |   |   |
| Financial assets                     |                    |                         |   |   |   |
| Cash and cash equivalents            | \$ 36,075          | \$ 36,075               | \$ 36,075   | \$ 0  | \$ 0  |
| Securities available-for-sale        | 226,586            | 226,586                 | 0   | 226,586   | 0   |
| Restricted investment in bank stocks | 4,710              | 4,710                   | 0   | 4,710   | 0   |
| Loans held for sale                  | 875                | 895                     | 0   | 895   | 0   |
| Loans, net                           | 877,448            | 892,753                 | 0   | 0   | 892,753   |
| Interest receivable                  | 3,637              | 3,637                   | 0   | 3,637   | 0   |
| Financial liabilities                |                    |                         |   |   |   |
| Deposits                             | \$ 968,499         | \$ 970,616              | \$ 0  | \$ 970,616  | \$ 0  |
| Short-term borrowings                | 29,971             | 29,971                  | 0   | 29,971  | 0   |
| Long-term debt                       | 80,451             | 78,228                  | 0   | 70,555  | 7,673   |
| Interest payable                     | 487                | 487                     | 0   | 487   | 0   |
| Off-balance sheet instruments        | 0                  | 0                       | 0   | 0   | 0   |
| <b>December 31, 2013</b>             |                    |                         |   |   |   |
| 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.

| <i>(dollars in thousands)</i> |        | <b>Gross<br/>Amounts of<br/>Recognized<br/>Liabilities</b> | <b>Gross<br/>Amounts<br/>Offset in the<br/>Statements of<br/>Condition</b> | <b>Net Amounts<br/>of Liabilities<br/>Presented in<br/>the Statements<br/>of Condition</b> | <b>Gross amounts Not Offset in<br/>the Statements of Condition</b> | <b>Cash<br/>Collateral<br/>Pledged</b> | <b>Net<br/>Amount</b> |
|-------------------------------|--------|--|--|--|--|--|-----------------------|
| <b>June 30, 2014</b>          |        |  |  |  |  |  |                       |
| Repurchase Agreements         | (1) \$ | 29,971 \$  | 0 \$   | 29,971 \$  | (29,971) \$  | 0 \$                                   | 0                     |
| <b>December 31, 2013</b>      |        |  |  |  |  |  |                       |
| Repurchase Agreements         | (1) \$ | 24,597 \$  | 0 \$   | 24,597 \$  | (24,597) \$  | 0 \$                                   | 0                     |

(1) As of June 30, 2014 and December 31, 2013, the fair value of securities pledged in connection with repurchase agreements was \$34,596,000 and \$29,299,000, respectively.

**Note 15 Subsequent Events**

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.

Consummation of the Merger is subject to certain terms and conditions, including, but not limited to, receipt of various regulatory approvals and approval by Madison's shareholders.

It is expected that the acquisition will be completed in the fourth quarter of 2014 or 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.

#### **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.



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

**FINANCIAL HIGHLIGHTS**

The Corporation earned net income available to common shareholders (earnings) totaling \$2,755,000 for the quarter ended June 30, 2014, compared to \$2,583,000 for the quarter ended June 30, 2013. The \$172,000 or 7 percent increase in earnings was primarily the result of an increase in net interest income and a decrease in the provision for loan losses, which more than offset an increase in noninterest expense, a decrease in noninterest income, and an increase in the provision for income taxes, as described below.

Net interest income increased \$988,000 or 11 percent for the second quarter of 2014, compared to the second 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 second quarter of 2014 decreased \$260,000 or 46 percent compared to the second quarter of 2013. Net charge-offs in the second quarter of 2014 were \$153,000, compared to \$587,000 for the second quarter of 2013. The Corporation realized a recovery of \$190,000 of a previous partial charge-off of an impaired commercial loan due to updated collateral appraisals resulting in a favorable fair value adjustment prior to the asset being transferred to foreclosed real estate.

The \$120,000 or 6 percent decrease in total noninterest income for the second quarter of 2014, compared to the second quarter of 2013, was primarily the result of a substantial decrease in net gain from sales of loans held for sale (i.e. residential mortgage loans), reflecting a sharp decrease in refinancing demand and elevated mortgage market interest rates.

The \$829,000 or 12 percent increase in noninterest expense for the second quarter of 2014, compared to the second quarter of 2013, was driven by increases in personnel, marketing, foreclosed real estate, and professional and legal expenses. Personnel expense increased \$173,000 or 4 percent as a result of expanding the banking franchise in the third quarter of 2013, and normal business growth. Marketing expense increased \$159,000 or 63 percent primarily as a result of non-recurring costs to promote PeoplesBank's 150<sup>th</sup> year in business anniversary. Foreclosed real estate expenses increased \$93,000 or 126 percent as a result of increased holding costs and valuation adjustments based upon updated appraisals for selected properties. The \$91,000 or 55 percent increase in professional and legal expense was due primarily to an increase in consulting expense, which supported various corporate initiatives, and normal business growth.

The \$137,000 or 14 percent increase in the provision for income taxes for the second quarter of 2014, compared to the second quarter of 2013, was primarily the result of a higher level of pretax earnings, and a decrease in the amount of tax-exempt income for the second quarter of 2014 as compared to the same period in 2013.

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The schedule below presents selected performance metrics for second quarter of 2014 and 2013. Earnings per common share reflect an adjustment for the 5 percent common stock dividend distributed on December 10, 2013.

|  | Three months ended |         |
|--|--------------------|---------|
|  | June 30,           |         |
|  | 2014               | 2013    |
| Basic earnings per common share            | \$ 0.50            | \$ 0.55 |
| Diluted earnings per common share          | \$ 0.49            | \$ 0.54 |
| Cash dividend payout ratio                 | 23.8%              | 19.2%   |
| Return on average assets                   | 0.93%              | 0.98%   |
| Return on average equity                   | 9.63%              | 10.13%  |
| Net interest margin (tax equivalent basis) | 3.73%              | 3.79%   |
| Net overhead ratio                         | 2.02%              | 1.91%   |
| Efficiency ratio                           | 63.21%             | 60.86%  |
| Average equity to average assets           | 9.71%              | 9.67%   |

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

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

Net interest income for the three month period ended June 30, 2014, was \$10,289,000, an increase of \$988,000 or 11 percent above the second quarter of 2013. The increase was due primarily to increased interest income from a higher 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 3.73 percent for the second quarter of 2014, compared to 3.79 percent for the same period in 2013.

Interest income for the second quarter of 2014 totaled \$12,364,000, an increase of \$891,000 or 8 percent above the second 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 4.46 percent (tax equivalent basis) for the second quarter of 2014, compared to \$1.02 billion and 4.65 percent, respectively, for the second quarter of 2013. While the volume of earning assets increased, its effect on interest income was muted by lower loan yields, a reflection of the continuing low interest rate environment.

Interest expense for the second quarter of 2014 totaled \$2,075,000, a decrease of \$97,000 or 4 percent below the second quarter of 2013. The decrease in total interest expense was driven primarily by a general decrease in deposit rates, due to the 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 \$537 million for the second quarter of 2014, a \$43 million or 9 percent increase above the average volume for the second 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 \$105,000 or 55 percent due to an increase in the average volume of borrowings. Long-term debt averaged \$80 million for the second quarter of 2014, compared to a \$41 million average for the second 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 June 30, |           |                |                    |          |                |
|---|-----------------------------|-----------|----------------|--------------------|----------|----------------|
|   | 2014                        |           |                | 2013               |          |                |
|   | Average<br>Balance          | Interest  | Yield/<br>Rate | Average<br>Balance | Interest | Yield/<br>Rate |
| <b>Assets</b>                               |                             |           |                |                    |          |                |
| Interest bearing deposits with banks        | \$ 36,740                   | \$ 23     | 0.25%          | \$ 44,315          | \$ 28    | 0.25%          |
| <b>Investment securities:</b>               |                             |           |                |                    |          |                |
| Taxable                                     | 149,407                     | 951       | 2.55           | 120,860            | 624      | 2.07           |
| Tax-exempt                                  | 76,918                      | 752       | 3.92           | 92,784             | 908      | 3.93           |
| Total investment securities                 | 226,325                     | 1,703     | 3.02           | 213,644            | 1,532    | 2.88           |
| <b>Loans:</b>                               |                             |           |                |                    |          |                |
| Taxable (1)                                 | 859,412                     | 10,737    | 5.01           | 751,554            | 10,105   | 5.39           |
| Tax-exempt                                  | 18,096                      | 221       | 4.90           | 11,111             | 155      | 5.60           |
| Total loans                                 | 877,508                     | 10,958    | 5.01           | 762,665            | 10,260   | 5.40           |
| Total earning assets                        | 1,140,573                   | 12,684    | 4.46           | 1,020,624          | 11,820   | 4.65           |
| Other assets (2)                            | 60,447                      |           |                | 58,939             |          |                |
| Total assets                                | \$ 1,201,020                |           |                | \$ 1,079,563       |          |                |
| <b>Liabilities and Shareholders' Equity</b> |                             |           |                |                    |          |                |
| <b>Deposits:</b>                            |                             |           |                |                    |          |                |
| Interest bearing demand                     | \$ 381,758                  | \$ 329    | 0.35%          | \$ 363,182         | \$ 337   | 0.37%          |
| Savings                                     | 41,236                      | 20        | 0.19           | 38,194             | 24       | 0.25           |
| Time  | 430,927                     | 1,392     | 1.30           | 410,682            | 1,590    | 1.55           |
| Total interest bearing deposits             | 853,921                     | 1,741     | 0.82           | 812,058            | 1,951    | 0.96           |
| Short-term borrowings                       | 27,176                      | 37        | 0.55           | 21,051             | 29       | 0.55           |
| Long-term debt                              | 80,463                      | 297       | 1.48           | 40,569             | 192      | 1.90           |
| Total interest bearing liabilities          | 961,560                     | 2,075     | 0.87           | 873,678            | 2,172    | 1.00           |
| Noninterest bearing deposits                | 114,409                     |           |                | 93,442             |          |                |
| Other liabilities                           | 8,454                       |           |                | 8,001              |          |                |
| Shareholders' equity                        | 116,597                     |           |                | 104,442            |          |                |
| Total liabilities and shareholders' equity  | \$ 1,201,020                |           |                | \$ 1,079,563       |          |                |
| Net interest income (tax equivalent basis)  |                             | \$ 10,609 |                |                    | \$ 9,648 |                |
| Net interest margin (3)                     |                             |           | 3.73%          |                    |          | 3.79%          |
| Tax equivalent adjustment                   |                             | (320)     |                |                    | (347)    |                |
| Net interest income                         |                             | \$ 10,289 |                |                    | \$ 9,301 |                |

- (1) Average balance includes average nonaccrual loans of \$12,001,000 for 2014 and \$11,726,000 for 2013. Interest includes net loan fees of \$362,000 for 2014 and \$393,000 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>        | <b>Three months ended<br/>June 30,<br/>2014 vs. 2013</b> |                 |               |
|--------------------------------------|--|-----------------|---------------|
|                                      | <b>Volume</b>  | <b>Rate</b>     | <b>Net</b>    |
| <b>Interest Income</b>               |  |                 |               |
| Interest bearing deposits with banks | \$ (5)   | \$ 0            | \$ (5)        |
| <b>Investment securities:</b>        |  |                 |               |
| Taxable                              | 145  | 182             | 327           |
| Tax-exempt                           | (155)  | (1)             | (156)         |
| <b>Loans:</b>                        |  |                 |               |
| Taxable                              | 1,499  | (867)           | 632           |
| Tax-exempt                           | 97   | (31)            | 66            |
| <b>Total interest income</b>         | <b>1,581</b>   | <b>(717)</b>    | <b>864</b>    |
| <b>Interest Expense</b>              |  |                 |               |
| <b>Deposits:</b>                     |  |                 |               |
| Interest bearing demand              | 21   | (29)            | (8)           |
| Savings                              | 1  | (5)             | (4)           |
| Time                                 | 78   | (276)           | (198)         |
| Short-term borrowings                | 9  | (1)             | 8             |
| Long-term debt                       | 185  | (80)            | 105           |
| <b>Total interest expense</b>        | <b>294</b>   | <b>(391)</b>    | <b>(97)</b>   |
| <b>Net interest income</b>           | <b>\$ 1,287</b>  | <b>\$ (326)</b> | <b>\$ 961</b> |

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 \$300,000 for the three month period ended June 30, 2014, a decrease of \$260,000 or 46 percent below the provision of \$560,000 for the second quarter of 2013. The decrease in the provision was consistent with a decrease in net charge-offs in the second quarter of 2014, which totaled \$153,000. The current quarter benefited from a recovery of \$190,000 from a previous partial charge-off of an impaired commercial loan due to updated collateral appraisals resulting in a favorable fair value adjustment prior to the asset being transferred to foreclosed real estate. Comparatively, net charge-offs totaled \$587,000 for the second quarter 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 55.

Table of Contents**Noninterest income**

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

*Table 3 - Noninterest income*

| <i>(dollars in thousands)</i>                        | Three months ended |                  | Change                    |       |
|--|--------------------|------------------|---------------------------|-------|
|  | 2014               | June 30,<br>2013 | Increase (Decrease)<br>\$ | %     |
| Trust and investment services fees                   | \$ 525             | \$ 464           | \$ 61                     | 13%   |
| Income from mutual fund, annuity and insurance sales | 192                | 173              | 19                        | 11    |
| Service charges on deposit accounts                  | 760                | 670              | 90                        | 13    |
| Income from bank owned life insurance                | 175                | 185              | (10)                      | (5)   |
| Other income   | 164                | 180              | (16)                      | (9)   |
| Net gain on sales of loans held for sale             | 102                | 322              | (220)                     | (68)  |
| Gain on sales of securities                          | 0                  | 44               | (44)                      | (100) |
| Total noninterest income                             | \$ 1,918           | \$ 2,038         | \$ (120)                  | (6)%  |

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

**Trust and investment services fees** The \$61,000 or 13 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 \$90,000 or 13 percent increase in service charge income was due primarily to increases in overdraft fees and debit card revenue.

**Net gain on sales of loans held for sale** The \$220,000 or 68 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.

Table of Contents**Noninterest expense**

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

*Table 4 - Noninterest expense*

| <i>(dollars in thousands)</i>                            | <b>Three months ended</b> |                          | <b>Change</b>              |          |
|--|---------------------------|--------------------------|----------------------------|----------|
|  | <b>2014</b>               | <b>June 30,<br/>2013</b> | <b>Increase (Decrease)</b> |          |
|  |                           |                          | <b>\$</b>                  | <b>%</b> |
| Personnel  | \$ 4,288                  | \$ 4,115                 | \$ 173                     | 4%       |
| Occupancy of premises, net                               | 515                       | 512                      | 3                          | 1        |
| Furniture and equipment                                  | 551                       | 476                      | 75                         | 16       |
| Postage, stationery and supplies                         | 163                       | 157                      | 6                          | 4        |
| Professional and legal                                   | 256                       | 165                      | 91                         | 55       |
| Marketing  | 413                       | 254                      | 159                        | 63       |
| FDIC insurance   | 173                       | 138                      | 35                         | 25       |
| Debit card processing                                    | 193                       | 195                      | (2)                        | (1)      |
| Charitable donations                                     | 32                        | 11                       | 21                         | 191      |
| Telephone  | 145                       | 132                      | 13                         | 10       |
| External data processing                                 | 233                       | 167                      | 66                         | 40       |
| Foreclosed real estate including (gains) losses on sales | 167                       | 74                       | 93                         | 126      |
| Other  | 857                       | 761                      | 96                         | 13       |
| Total noninterest expense                                | \$ 7,986                  | \$ 7,157                 | \$ 829                     | 12%      |

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

**Personnel** The \$173,000 or 4 percent increase in personnel expense was due largely to an increase in wage expense resulting from planned staff additions that occurred in the first half of 2014 and throughout the year 2013 that affect the current period (e.g. franchise expansion), and normal business growth.

**Furniture and equipment** The \$75,000 or 16 percent increase in furniture and equipment was due primarily to additions related to franchise/office expansion, and normal business growth, which included increases in depreciation expense on computer hardware and software.

**Professional and legal** The \$91,000 or 55 percent increase in professional and legal expense was due primarily to an increase in consulting expense, which supported various corporate initiatives, and normal business growth.

**Marketing** The \$159,000 or 63 percent increase in marketing expense was primarily the result of non-recurring costs to promote PeoplesBank's 150<sup>th</sup> year in business anniversary.

**External data processing** The \$66,000 or 40 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. Increases in the services offered to our client base and increases in transaction volume from normal business growth also contributed to the increase in this expense category.

**Foreclosed real estate** The \$93,000 or 126 percent increase in foreclosed real estate expenses was a result of holding costs incurred including real estate taxes, property maintenance, and valuation adjustments based upon updated appraisals.

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### **Provision for income taxes**

The provision for income tax for the second quarter of 2014 was \$1,114,000, compared to \$977,000 for the second quarter of 2013. The \$137,000 or 14 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 second 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 28 percent for the second quarter of 2014, compared to 27 percent for the second quarter 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 second quarter of 2014 totaled \$52,000 compared to \$62,000 for the second quarter of 2013. Though an annualized dividend rate of 1 percent applied to both periods, the amount of preferred stock dividends for the second 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.

### **Six months ended June 30, 2014, compared to six months ended June 30, 2013**

### **FINANCIAL HIGHLIGHTS**

The Corporation earned net income available to common shareholders (earnings) totaling \$5,696,000 for the first six months of 2014, compared to \$5,182,000 for the same period of 2013. The \$514,000 or 10 percent increase in earnings was primarily the result of an increase in net interest income, which more than offset an increase in noninterest expense and a decrease in noninterest income as described below.

Net interest income increased \$2,257,000 or 12 percent for the first six months of 2014, compared to the same period 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 average balance of interest-earning assets for the first six months of 2014 increased \$111 million or 11 percent compared to the same period of 2013.

The provision for loan losses for the first six months of 2014 was \$850,000, which was required to support growth in the commercial loan portfolio and maintain the adequacy of the allowance for loan losses. The provision was 4% higher compared to the first six months of 2013. Net charge-offs for the first six months of 2014 were \$365,000, which benefited from a \$190,000 recovery from a previous partial charge-off of an impaired commercial loan due to updated collateral appraisals resulting in a favorable fair value adjustment prior to the asset being transferred to foreclosed real estate. Comparatively, net charge-offs totaled \$663,000 for the same period of 2013.

The \$397,000 or 10 percent decrease in total noninterest income for the first six months of 2014, compared to the same period of 2013, was primarily the result of a substantial decrease in net gain from the sales of residential mortgage loans, reflecting a sharp decrease in refinancing demand and higher mortgage market interest rates. Additionally, a decrease in income from the sale of mutual fund, annuity, and insurance products resulted from the lingering impact of staff turnover in 2013, and the unusually severe weather affecting sales activities in early 2014.

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The \$1,224,000 or 8 percent increase in noninterest expense for the first six months of 2014, compared to the same period of 2013, was driven by increases in several areas including personnel, furniture and equipment, marketing, charitable donations, external data processing, foreclosed real estate expenses, and professional and legal expenses. Personnel expense increased \$309,000 and furniture and equipment expenses increased \$124,000 as a result of expanding the banking franchise in the third quarter of 2013, and normal business growth. Marketing expense increased \$320,000 primarily as a result of non-recurring costs to promote PeoplesBank's 150<sup>th</sup> year in business anniversary. An increase in charitable contributions of \$283,000 reflects increased donations to nonprofit organizations that qualify for state tax credits, which reduce future tax liabilities and effectively lower the overall cost of the donation. Foreclosed real estate expenses increased \$110,000 related to holding costs and valuation adjustments based upon updated appraisals. Professional and legal expense increased \$137,000 due primarily to increases in consulting expenses which supported various corporate initiatives, and increased professional services associated with normal business growth. An increase in external data processing of \$100,000 reflects increased reliance on outsourcing transaction processing to specialized vendors, increases in the services offered to our client base, and increases in transaction volume from normal business growth.

The \$103,000 or 5 percent increase in the provision for income taxes for the first six 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 six months of 2014 and 2013. Earnings per common share reflect an adjustment for the 5 percent common stock dividend distributed on December 10, 2013.

|  | Six months ended |         |
|--|------------------|---------|
|  | June 30,         |         |
|  | 2014             | 2013    |
| Basic earnings per common share            | \$ 1.11          | \$ 1.10 |
| Diluted earnings per common share          | \$ 1.08          | \$ 1.08 |
| Cash dividend payout ratio                 | 21.7%            | 19.1%   |
| Return on average assets                   | 0.99%            | 0.99%   |
| Return on average equity                   | 10.21%           | 10.26%  |
| Net interest margin (tax equivalent basis) | 3.85%            | 3.83%   |
| Net overhead ratio                         | 2.03%            | 1.95%   |
| Efficiency ratio                           | 61.98%           | 61.64%  |
| Average equity to average assets           | 9.65%            | 9.70%   |

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

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

Net interest income for the six-month period ended June 30, 2014, was \$20,710,000, an increase of \$2,257,000 or 12 percent above the same period of 2013. The increase was due primarily to increased interest income from a higher average volume of interest-earning assets. 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 3.85 percent for the first six months of 2014 compared to 3.83 percent for the same period in 2013.



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Interest income for the first six months totaled \$24,777,000, an increase of \$1,943,000 or 9 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 \$1.12 billion and yielded 4.58 percent (tax equivalent basis) for the first six months of 2014, compared to \$1.01 billion and 4.70 percent, respectively, for the first six months of 2013. While the volume of earning assets increased, its effect on interest income was muted by lower asset yields, a reflection of the continuing low interest rate environment.

Interest expense for the first six months of 2014 totaled \$4,067,000, a decrease of \$314,000 or 7 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 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 \$536 million for the six-month period ending June 30, 2014, a \$47 million or 10 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 \$218,000 or 60 percent due to an increase in average borrowings. Long-term debt averaged \$79 million for the first six months of 2014, compared to a \$37 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>                     | 2014               |           |                | Six months ended June 30, |           |                | 2013               |          |                |  |
|---|--------------------|-----------|----------------|---------------------------|-----------|----------------|--------------------|----------|----------------|--|
|   | Average<br>Balance | Interest  | Yield/<br>Rate | Average<br>Balance        | Interest  | Yield/<br>Rate | Average<br>Balance | Interest | Yield/<br>Rate |  |
| <b>Assets</b>                                     |                    |           |                |                           |           |                |                    |          |                |  |
| Interest bearing deposits with banks              | \$ 20,775          | \$ 26     | 0.25%          | \$ 33,543                 | \$ 42     | 0.25%          |                    |          |                |  |
| <b>Investment securities:</b>                     |                    |           |                |                           |           |                |                    |          |                |  |
| Taxable   | 146,972            | 1,820     | 2.50           | 124,327                   | 1,275     | 2.07           |                    |          |                |  |
| Tax-exempt  | 79,698             | 1,557     | 3.94           | 93,908                    | 1,840     | 3.95           |                    |          |                |  |
| Total investment securities                       | 226,670            | 3,377     | 3.00           | 218,235                   | 3,115     | 2.88           |                    |          |                |  |
| <b>Loans:</b>                                     |                    |           |                |                           |           |                |                    |          |                |  |
| Taxable (1)                                       | 854,894            | 21,597    | 5.09           | 746,601                   | 20,072    | 5.42           |                    |          |                |  |
| Tax-exempt  | 17,438             | 431       | 4.98           | 10,874                    | 306       | 5.67           |                    |          |                |  |
| Total loans                                       | 872,332            | 22,028    | 5.09           | 757,475                   | 20,378    | 5.43           |                    |          |                |  |
| Total earning assets                              | 1,119,777          | 25,431    | 4.58           | 1,009,253                 | 23,535    | 4.70           |                    |          |                |  |
| Other assets (2)                                  | 59,218             |           |                | 57,607                    |           |                |                    |          |                |  |
| Total assets                                      | \$ 1,178,995       |           |                | \$ 1,066,860              |           |                |                    |          |                |  |
| <b>Liabilities and Shareholders' Equity</b>       |                    |           |                |                           |           |                |                    |          |                |  |
| <b>Deposits:</b>                                  |                    |           |                |                           |           |                |                    |          |                |  |
| Interest bearing demand                           | \$ 385,605         | \$ 695    | 0.36%          | \$ 364,209                | \$ 671    | 0.37%          |                    |          |                |  |
| Savings   | 40,474             | 45        | 0.22           | 36,967                    | 46        | 0.25           |                    |          |                |  |
| Time  | 414,636            | 2,672     | 1.30           | 408,478                   | 3,243     | 1.60           |                    |          |                |  |
| Total interest bearing deposits                   | 840,715            | 3,412     | 0.82           | 809,654                   | 3,960     | 0.99           |                    |          |                |  |
| Short-term borrowings                             | 27,722             | 73        | 0.53           | 20,592                    | 57        | 0.56           |                    |          |                |  |
| Long-term debt                                    | 78,650             | 582       | 1.49           | 37,387                    | 364       | 1.96           |                    |          |                |  |
| Total interest bearing liabilities                | 947,087            | 4,067     | 0.87           | 867,633                   | 4,381     | 1.02           |                    |          |                |  |
| Noninterest bearing deposits                      | 109,967            |           |                | 88,363                    |           |                |                    |          |                |  |
| Other liabilities                                 | 8,137              |           |                | 7,377                     |           |                |                    |          |                |  |
| Shareholders' equity                              | 113,804            |           |                | 103,487                   |           |                |                    |          |                |  |
| Total liabilities and shareholders' equity        | \$ 1,178,995       |           |                | \$ 1,066,860              |           |                |                    |          |                |  |
| <b>Net interest income (tax equivalent basis)</b> |                    |           |                |                           |           |                |                    |          |                |  |
| Net interest income (tax equivalent basis)        |                    | \$ 21,364 |                |                           | \$ 19,154 |                |                    |          |                |  |
| Net interest margin (3)                           |                    |           | 3.85%          |                           |           | 3.83%          |                    |          |                |  |
| Tax equivalent adjustment                         |                    | (654)     |                |                           | (701)     |                |                    |          |                |  |
| Net interest income                               |                    | \$ 20,710 |                |                           | \$ 18,453 |                |                    |          |                |  |

- (1) Average balance includes average nonaccrual loans of \$13,030,000 for 2014 and \$10,249,000 for 2013. Interest includes net loan fees of \$821,000 for 2014 and \$721,000 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>        | Six months ended<br>June 30,<br>2014 vs. 2013 |  |          |
|--------------------------------------|---|--|----------|
|                                      | Volume  | Increase (decrease) due to change in<br>Rate | Net      |
| Interest Income                      |   |  |          |
| Interest bearing deposits with banks | \$ (16)                                       | \$ 0   | \$ (16)  |
| Investment securities:               |   |  |          |
| Taxable                              | 224   | 321  | 545      |
| Tax-exempt                           | (278)   | (5)  | (283)    |
| Loans:                               |   |  |          |
| Taxable                              | 3,116   | (1,591)                                      | 1,525    |
| Tax-exempt                           | 185   | (60)   | 125      |
| Total interest income                | 3,231   | (1,335)                                      | 1,896    |
| Interest Expense                     |   |  |          |
| Deposits:                            |   |  |          |
| Interest bearing demand              | 47  | (23)   | 24       |
| Savings                              | 4   | (5)  | (1)      |
| Time                                 | 49  | (620)  | (571)    |
| Short-term borrowings                | 15  | 1  | 16       |
| Long-term debt                       | 398   | (180)  | 218      |
| Total interest expense               | 513   | (827)  | (314)    |
| Net interest income                  | \$ 2,718                                      | \$ (508)                                     | \$ 2,210 |

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 six months of 2014 was \$850,000, which was required to support growth in the commercial loan portfolio and maintain the adequacy of the allowance for loan losses. The provision was 4% higher compared to the first six months of 2013. Net charge-offs for the first six months of 2014 were \$365,000, which benefited from a \$190,000 recovery from a previous partial charge-off of an impaired commercial loan due to updated collateral appraisals resulting in a favorable fair value adjustment prior to the asset being transferred to foreclosed real estate. Comparatively, net charge-offs totaled \$663,000 for the same period 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 55.

Table of Contents**Noninterest income**

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

*Table 7 - Noninterest income*

| <i>(dollars in thousands)</i>                        | Six months ended<br>June 30, |          | Change                    |       |
|--|------------------------------|----------|---------------------------|-------|
|  | 2014                         | 2013     | Increase (Decrease)<br>\$ | %     |
| Trust and investment services fees                   | \$ 1,052                     | \$ 937   | \$ 115                    | 12%   |
| Income from mutual fund, annuity and insurance sales | 325                          | 422      | (97)                      | (23)  |
| Service charges on deposit accounts                  | 1,438                        | 1,304    | 134                       | 10    |
| Income from bank owned life insurance                | 348                          | 351      | (3)                       | (1)   |
| Other income   | 303                          | 346      | (43)                      | (12)  |
| Net gain on sales of loans held for sale             | 182                          | 641      | (459)                     | (72)  |
| Gain on sales of securities                          | 0                            | 44       | (44)                      | (100) |
| Total noninterest income                             | \$ 3,648                     | \$ 4,045 | \$ (397)                  | (10)% |

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

**Trust and investment services fees** The \$115,000 or 12 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 \$97,000 or 23 percent decrease in income from the sale of mutual fund, annuity and insurance products by Codorus Valley Financial Advisors (CVFA), a subsidiary of PeoplesBank, was a result of the lingering impact of the resignation of three registered representatives who left CVFA in 2013. Also, the level of sales early in 2014 was adversely affected by the unusually severe winter weather.

**Service charges on deposit accounts** The \$134,000 or 10 percent increase in service charge income was due primarily to increases in debit card revenue and overdraft fees.

**Income from bank owned life insurance (BOLI)** Income from BOLI in the first six months of 2014, compared to the same period in 2013, was relatively flat as low market interest rates depressed yields.

**Other income** The \$43,000 or 12 percent decrease in other income was due primarily to a decrease in income from settlement services, which has been adversely affected by the decrease in mortgage banking activity.

**Net gain on sales of loans held for sale** The \$459,000 or 72 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.

Table of Contents**Noninterest expense**

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

*Table 8 - Noninterest expense*

| <i>(dollars in thousands)</i>                            | Six months ended |                  | Change                    |      |
|--|------------------|------------------|---------------------------|------|
|  | 2014             | June 30,<br>2013 | Increase (Decrease)<br>\$ | %    |
| Personnel  | \$ 8,604         | \$ 8,295         | \$ 309                    | 4%   |
| Occupancy of premises, net                               | 1,081            | 1,023            | 58                        | 6    |
| Furniture and equipment                                  | 1,094            | 970              | 124                       | 13   |
| Postage, stationery and supplies                         | 322              | 307              | 15                        | 5    |
| Professional and legal                                   | 439              | 302              | 137                       | 45   |
| Marketing and advertising                                | 720              | 400              | 320                       | 80   |
| FDIC insurance   | 362              | 309              | 53                        | 17   |
| Debit card processing                                    | 393              | 373              | 20                        | 5    |
| Charitable donations                                     | 769              | 486              | 283                       | 58   |
| Telephone  | 291              | 266              | 25                        | 9    |
| External data processing                                 | 435              | 335              | 100                       | 30   |
| Foreclosed real estate including (gains) losses on sales | 247              | 137              | 110                       | 80   |
| Other  | 877              | 1,207            | (330)                     | (27) |
| Total noninterest expense                                | \$ 15,634        | \$ 14,410        | \$ 1,224                  | 8%   |

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

**Personnel** The \$309,000 or 4 percent increase in personnel expense was due largely to an increase in wage expense resulting from planned staff additions that occurred in the first six months of 2014 and throughout the year 2013 that affect the current period (e.g., franchise expansion), and normal business growth.

**Furniture and equipment** The \$124,000 or 13 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, which includes depreciation expense on computer hardware and software.

**Professional and legal** The \$137,000 or 45 percent increase in professional and legal expense was due primarily to increases in consulting expenses which supported various corporate initiatives, and increased professional services associated with normal business growth.

**Marketing** The \$320,000 or 80 percent increase in marketing expense was primarily the result of non-recurring costs to promote PeoplesBank's 150<sup>th</sup> year in business anniversary.

**Charitable donations** The \$283,000 or 58 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 \$100,000 or 30 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. Increases in the services offered to our client base and increases in transaction volume from normal business growth also contributed to the increase in this expense category.

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**Foreclosed real estate** The \$110,000 or 80 percent increase in foreclosed real estate expenses was a result of holding costs incurred including real estate taxes, property maintenance, and valuation adjustments based upon updated appraisals.

**Other** The \$330,000 or 27 percent decrease in other expense was primarily attributable to a \$342,000 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.

### **Provision for income taxes**

The provision for income tax for the first six months of 2014 was \$2,064,000, compared to \$1,961,000 for the same period of 2013. The \$103,000 or 5 percent increase in the provision for income taxes was primarily the result of higher pretax earnings. For both periods, the Corporation's statutory federal income tax rate was 34 percent. The Corporation's effective income tax rate was 26 percent for the first six months of 2014, compared to 27 percent for the first six 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 six months of 2014 totaled \$114,000 compared to \$125,000 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 half 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 June 30, 2014, interest bearing deposits with banks totaled \$21 million, compared to \$2 million at year-end 2013. The increase was the result of funds generated from an increase in interest bearing deposits, and the proceeds from a \$10 million borrowing from the Federal Home Loan Bank of Pittsburgh, which outpaced the deployment of funds to the loan and investment security portfolios.

### **Securities available-for-sale**

On June 30, 2014, the fair value of securities available-for-sale totaled \$227 million, which represented a slight 1 percent decrease compared to the \$229 million value at year-end 2013. During the second quarter of 2014, cash inflows from U.S. agency mortgage-backed securities and state and municipal bond maturities (or bond calls) temporarily exceeded 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.

### **Loans**

On June 30, 2014, total loans, net of deferred fees, totaled \$888 million, which was \$29 million or 3 percent higher than the level at year-end 2013. The increase in volume was due primarily to increases in commercial loans within the residential real estate investor and hotel/motel sectors, and additional loan growth in other industries (e.g., agriculture, professional services and finance). The composition of the Corporation's loan portfolio is provided in Note 5 - Loans.

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### **Deposits**

On June 30, 2014, deposits totaled \$968 million, which represented a \$43 million or 5 percent increase compared to the level at year-end 2013. Of the increase in total deposits, \$32 million was attributable to growth in time deposits, which reflected a special rate promotion to celebrate PeoplesBank's 150<sup>th</sup> anniversary. Additional increases in the demand (both interest and non-interest bearing) and savings categories also contributed to the increase in deposits. The composition of the Corporation's deposit portfolio is provided in Note 7 Deposits.

### **Long-term debt**

On June 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. The advance has a 38-month bullet maturity and a low fixed interest rate. 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 \$114 million on June 30, 2014, an increase of approximately \$6 million or 6 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 six 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.

#### *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.

The net proceeds from the private placement, 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. Department of the 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 six month periods ended June 30, 2014 and 2013, accrued dividends equated to an annualized dividend rate of 1 percent on the preferred stock outstanding.

#### *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 July 8, 2014, payable on August 12, 2014, to shareholders of record at the close of business on July 22, 2014. This dividend follows \$0.12 per common share cash dividends paid in May and February 2014.

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 June 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 banking organizations. 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:

|   | 2015 | 2016   | As of January 1:<br>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 making dividend payments or discretionary bonus payments 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 4 calendar quarters preceding the current calendar quarter, net of any distributions and associated tax effects not already reflected in net income. A summary of payout restrictions based on the capital conservation buffer is as follows:

| <b>Capital Conservation Buffer</b><br>(as a % of risk-weighted assets) | <b>Maximum Payout</b><br>(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 June 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>  | June 30,<br>2014 | December 31,<br>2013 |
|--|------------------|----------------------|
| Nonaccrual loans   | \$ 6,842         | \$ 13,231            |
| Nonaccrual loans, troubled debt restructurings                                       | 2,122            | 2,069                |
| Total nonperforming loans  | 8,964            | 15,300               |
| Foreclosed real estate, net of allowance   | 4,711            | 4,068                |
| Total nonperforming assets   | \$ 13,675        | \$ 19,368            |
| Accruing troubled debt restructurings  | \$ 2,186         | \$ 3,342             |
| Total period-end loans, net of deferred fees   | \$ 887,908       | \$ 859,384           |
| Allowance for loan losses (ALL)  | \$ 10,460        | \$ 9,975             |
| ALL as a % of total period-end loans   | 1.18%            | 1.16%                |
| Annualized net charge-offs as a % of average total loans                             | 0.08%            | 0.10%                |
| ALL as a % of nonperforming loans  | 116.69%          | 65.20%               |
| Nonperforming loans as a % of total period-end loans                                 | 1.01%            | 1.78%                |
| Nonperforming assets as a % of total period-end loans and net foreclosed real estate | 1.53%            | 2.24%                |
| Nonperforming assets as a % of total period-end assets                               | 1.14%            | 1.68%                |
| Nonperforming assets as a % of total period-end shareholders' equity                 | 12.03%           | 17.99%               |

The current level of nonperforming assets has decreased by approximately \$5.7 million or 29 percent when compared to year-end 2013. The decrease was primarily the result of (i) a \$3.9 million payment received on a nonaccrual loan in the second quarter of 2014, (ii) the \$1.05 million payoff of a nonaccrual commercial loan in the first quarter of 2014, and (iii) an approximate \$0.5 million recovery from the sale of a foreclosed property in the first quarter of 2014. Generally, we remain concerned about prolonged low economic growth or weakening economic conditions and the corresponding effects it has on our commercial borrowers.

*Nonaccrual loans*

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

As of June 30, 2014, the nonperforming loan portfolio balance totaled \$8,964,000, compared to \$15,300,000 at year-end 2013. The decrease was primarily the result of a \$3.9 million payment received on a nonaccrual commercial loan, a \$1.05 million payoff of a nonaccrual commercial loan and reclassifications to foreclosed real estate totaling \$1.6 million. For both periods the portfolio balance was comprised primarily of collateralized commercial loans. On June 30, 2014, the nonaccrual loan portfolio was comprised of twenty-two unrelated loan relationships with outstanding principal balances ranging in size from \$21,200 to \$2,002,000. Four unrelated commercial relationships, which represent 71 percent of the nonperforming loan portfolio balance, are described below.

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Loan no. 1 At June 30, 2014, the outstanding principal balance of the loan relationship was \$1,595,000 after a significant principal payment of \$3,879,000 was received during the second quarter of 2014 from proceeds of the sale of the largest commercial property securing the loan. The remaining balance is collateralized by various smaller commercial properties, some with multiple 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. 2 At June 30, 2014, the outstanding principal balance of the loan relationship was \$2,002,000, collateralized by commercial rental properties whose rents are assigned to PeoplesBank. Based on a recent appraisal of the primary real estate collateralizing the relationship, we believe that the loans are adequately collateralized. The borrower is presently operating under a troubled debt restructuring agreement.

Loan no. 3 At June 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.

Loan no. 4 At June 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*

On June 30, 2014, foreclosed real estate, net of allowance, totaled \$4,711,000, compared to \$4,068,000 at December 31, 2013. On June 30, 2014, the portfolio was comprised of nine unrelated accounts ranging in size from \$51,000 to \$1,179,000, net of related allowance. If a valuation allowance for probable loss has been established for a particular property, it is so noted in the property description below. Further valuation allowances may be required on any foreclosed property as additional information becomes available or conditions change. Foreclosed real estate is included in the other assets category on the Corporation's balance sheet. Four unrelated foreclosed real estate properties, which represent 81% of the foreclosed real estate portfolio balance, net of allowance, are described below.

Property no. 1 The carrying amount of this property at June 30, 2014 was \$1,179,000, which is net of a \$2,119,000 valuation allowance based on an independent appraisal, as adjusted for improvements, less estimated selling costs. The property is comprised of 266 acres of unimproved land that is zoned for residential development. Management is working towards a sale of the property.

Property no. 2 The carrying amount of this property at June 30, 2014 was \$1,088,000, which is net of a \$1,627,000 valuation allowance. The property is comprised of 134 approved residential building lots. Of this total, 28 lots are improved. Management is evaluating its disposition options with regard to this property.

Property no. 3 The carrying amount of this property at June 30, 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.

Property no. 4 The carrying amount of this residential property at June 30, 2014 was \$648,000, which is net of a \$132,000 valuation allowance. The property is presently listed for sale.

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*Allowance for loan losses*

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

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

The following table presents an analysis of the activity in the allowance for loan losses for the six months ended June 30, 2014 and 2013. The \$1,001,000 or 11 percent increase in the allowance from June 30, 2013 to June 30, 2014, generally supported the \$119 million or 16 percent increase in loans, net of deferred fees. The provision for loan losses for the first six months of 2014 was \$850,000 or 4 percent higher compared to the provision of \$820,000 for the first six months of 2013. The increased provision was required to support the larger commercial loan portfolio and maintain the adequacy of the allowance for loan losses. Net charge-offs for the first six months of 2014 were \$365,000 compared to \$663,000 of net charge-offs for the same period of 2013. The Corporation realized a recovery in 2014 of \$190,000 of a previous partial charge-off of an impaired commercial loan due to updated collateral appraisals 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 weakness in economic and business conditions, and the level of unemployment and 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. Based on a comprehensive analysis of the loan portfolio, we believe that the allowance for loan losses was adequate at June 30, 2014.

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

| <i>(dollars in thousands)</i>                              | <b>2014</b> | <b>2013</b> |
|--|-------------|-------------|
| Balance-January 1,   | \$ 9,975    | \$ 9,302    |
| Provision charged to operating expense                     | 850         | 820         |
| Loans charged off:   |             |             |
| Commercial, financial and agricultural                     | 325         | 497         |
| Real estate - residential mortgages                        | 30          | 28          |
| Consumer and home equity                                   | 292         | 208         |
| Total loans charged off                                    | 647         | 733         |
| Recoveries:  |             |             |
| Commercial, financial and agricultural                     | 212         | 22          |
| Real estate - residential mortgages                        | 4           | 2           |
| Consumer and home equity                                   | 66          | 46          |
| Total recoveries   | 282         | 70          |
| Net charge-offs  | 365         | 663         |
| Balance-June 30,   | \$ 10,460   | \$ 9,459    |
| <b>Ratios:</b>   |             |             |
| Allowance for loan losses as a % of total period-end loans | 1.18%       | 1.23%       |
| Annualized net charge-offs as a % of average total loans   | 0.08%       | 0.18%       |
| Allowance for loan losses as a % of nonperforming loans    | 116.69%     | 85.00%      |

**Liquidity risk management**

Maintaining adequate liquidity provides the Corporation with the ability to meet financial obligations to depositors, loan customers, employees, and shareholders on a timely and cost effective basis in the normal course of business. Additionally, it provides funds for growth and business opportunities as they arise. Liquidity is generated from transactions relating to both the Corporation's assets and liabilities. The primary sources of asset liquidity are scheduled investment security maturities and cash inflows, funds received from customer loan payments, and asset sales. The primary sources of liability liquidity are deposit growth, short-term borrowings and long-term debt. The Consolidated Statements of Cash Flows, included in this report, present the changes in cash from operating, investing and financing activities. At June 30, 2014, we believe that liquidity was adequate based upon the potential liquidation of unpledged available-for-sale securities with a fair value totaling approximately \$70 million and available credit from the Federal Home Loan Bank of Pittsburgh totaling approximately \$272 million. The Corporation's loan-to-deposit ratio was 92 percent at June 30, 2014, compared to 93 percent at 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 June 30, 2014, totaled \$287 million and consisted of \$204 million in unfunded commitments under existing loan facilities, \$58 million to grant new loans and \$25 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.

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

Not applicable to smaller reporting companies.

### **Item 4. Controls and Procedures**

The Corporation carried out an evaluation, under the supervision and with the participation of the Corporation's management, including the Corporation's Chief Executive Officer and Chief Financial Officer, of the effectiveness of its disclosure controls and procedures, as defined in Exchange Act Rules 13a-15(e) and 15d-15(e). Based upon the evaluation, the Corporation's Chief Executive Officer and Chief Financial Officer concluded that, as of June 30, 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.

There has been no change in the Corporation's internal control over financial reporting that occurred during the quarter ended June 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 six month period ended June 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.

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**Item 5. Other information**

None

**Item 6. Exhibits**

| Exhibit<br>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 June 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)

August 8, 2014  
Date

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

August 8, 2014  
Date

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

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