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

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended September 30, 2012
or
o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from____________to______________
Commission file number: 0-15536

CODORUS VALLEY BANCORP, INC.

(Exact name of registrant as specified in its charter)

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

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

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

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

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

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

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date. On November 1, 2012, 4,461,106 shares of common stock, par value $2.50, were outstanding, which includes the effect of the 5 percent common stock dividend declared October 9, 2012.

Codorus Valley Bancorp, Inc.

Form 10-Q Index

Table of Contents

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

Codorus Valley Bancorp, Inc.
Consolidated Balance Sheets
Unaudited

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

See accompanying notes.

Table of Contents

Codorus Valley Bancorp, Inc.
Consolidated Statements of Income
Unaudited

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

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

See accompanying notes.

Table of Contents

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

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

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

See accompanying notes.

Table of Contents

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

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

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

See accompanying notes.

Table of Contents

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

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

See accompanying notes.

Table of Contents

Notes to Consolidated Financial Statements (Unaudited)

Note 1 Basis of Presentation

The accompanying consolidated balance sheet at December 31, 2011 has been derived from audited financial statements, and the unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information, the instructions to Form 10-Q, and FASB Accounting Standards Codification (ASC) 270. Accordingly, the interim financial statements do not include all of the financial information and notes required by generally accepted accounting principles for complete financial statements. In the opinion of management, the interim consolidated financial statements include all adjustments necessary to present fairly the financial condition and results of operations for the reported periods, and all such adjustments are of a normal and recurring nature.

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

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

The results of operations for the three and nine month periods ended September 30, 2012 are not necessarily indicative of the results to be expected for the full year.

In accordance with FASB ASC 855, the Corporation evaluated the events and transactions that occurred after the balance sheet date of September 30, 2012, and through the date these consolidated financial statements were issued, for items of potential recognition or disclosure.

Note 2 Significant Accounting Policies

Loans

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

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

Table of Contents

Allowance for Loan Losses

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

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

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

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

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

Table of Contents

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

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

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

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

Federal regulatory agencies, as an integral part of their examination process, periodically review the Corporation s allowance for loan losses and may require the Corporation to recognize additions to the allowance based on their judgments about information available to them at the time of their examination, which may not be currently available to the Corporation. Based on a comprehensive analysis of the loan portfolio, the Corporation believes that the level of the allowance for loan losses at September 30, 2012 is adequate.

Table of Contents

Foreclosed Real Estate

Foreclosed real estate, included in other assets, is comprised of property acquired through a foreclosure proceeding or property that is acquired through acceptance of a deed-in-lieu of foreclosure. Foreclosed real estate is initially recorded at fair value minus estimated costs to sell at the date of foreclosure, establishing a new cost basis. Any difference between the carrying value and the new cost basis is charged against the allowance for loan losses. Appraisals are generally used to determine fair value. After foreclosure, management reviews valuations at least quarterly and adjusts the asset to the lower of cost or fair value minus estimated costs to sell through a valuation allowance. Costs related to the improvement of foreclosed real estate are generally capitalized until the real estate reaches a saleable condition subject to fair value limitations. Revenue and expense from operations and changes in the valuation allowance are included in expense. When a foreclosed real estate asset is ultimately sold, any gain or loss on the sale is included in the income statement as a component of noninterest expense. At September 30, 2012, foreclosed real estate, net of allowance, was $4,084,000, compared to $16,243,000 for December 31, 2011. The $12,159,000 or 75 percent decrease was due primarily to the sale of real estate and secondarily to an increase in the allowance for real estate losses for selected properties.

Per Common Share Computations

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

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

Comprehensive Income

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

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.

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

Reclassification

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

Recent Accounting Pronouncements

The FASB issued ASU No. 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S GAAP and IFRSs. This Update amends FASB ASC Topic 820, Fair Value Measurements, to bring U.S. GAAP for fair value measurements in line with International Accounting Standards. The Update clarifies existing guidance for items such as: the application of the highest and best use concept to non-financial assets and liabilities; the application of fair value measurement to financial instruments classified in a reporting entity s stockholder s equity; and disclosure requirements regarding quantitative information about unobservable inputs used in the fair value measurements of level 3 assets. The Update also creates an exception to Topic 820 for entities which carry financial instruments within a portfolio or group, under which the entity is now permitted to base the price used for fair valuation upon a price that would be received to sell the net asset position or transfer a net liability position in an orderly transaction. The Update also allows for the application of premiums and discounts in a fair value measurement if the financial instrument is categorized in level 2 or 3 of the fair value hierarchy. Lastly, the ASU contains new disclosure requirements regarding fair value amounts categorized as level 3 in the fair value hierarchy such as: disclosure of the valuation process used; effects of and relationships between unobservable inputs; usage of nonfinancial assets for purposes other than their highest and best use when that is the basis of the disclosed fair value; and categorization by level of items disclosed at fair value, but not measured at fair value for financial statement purposes. The Corporation adopted the provisions of ASU No. 2011-04 effective January 1, 2012. The fair value measurement provisions of ASU No. 2011-04 had no impact on the Corporation s consolidated financial statements. See Note 13 to the consolidated financial statements for enhanced disclosures required by ASU No. 2011-04.

Table of Contents

In November 2008, the Securities and Exchange Commission (SEC) released a proposed roadmap regarding the potential use by U.S. issuers of financial statements prepared in accordance with International Financial Reporting Standards (IFRS). IFRS is a comprehensive series of accounting standards published by the International Accounting Standards Board (IASB). On July 13, 2012, the SEC published their final report on IFRS, which included an analysis of the issues related to possible incorporation of IFRS into the U.S. financial reporting regime. The SEC report was designed to inform the SEC commissioners for when they would come to decide whether, and if so, how, IFRS should be applied to the U.S. The next step for the SEC is to develop a recommendation on IFRS, but no timetable has been disclosed for completing this work. The Corporation will continue to monitor the development of the potential implementation of IFRS.

Note 3 Securities

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

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

Table of Contents

The amortized cost and estimated fair value of debt securities at September 30, 2012 by contractual maturity are shown below. Actual maturities may differ from contractual maturities if call options on select debt issues are exercised in the future. Mortgage-backed securities are included in the maturity categories based on average expected life.

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

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

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

Securities, issued by agencies of the federal government, with a carrying value of $149,657,000 and $136,827,000 on September 30, 2012 and December 31, 2011, respectively, were pledged to secure public and trust deposits, repurchase agreements, other short-term borrowings and Federal Home Loan Bank debt.

The table below shows gross unrealized losses and fair value, aggregated by investment category and length of time, for securities that have been in a continuous unrealized loss position, at September 30, 2012 and December 31, 2011.

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

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

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

Table of Contents

The Corporation believes that unrealized losses at September 30, 2012 were primarily the result of changes in market interest rates and that it has the ability to hold these investments for a time necessary to recover the amortized cost. Through September 30, 2012, the Corporation has collected all interest and principal on its investment securities as scheduled. The Corporation believes that collection of the contractual principal and interest is probable and, therefore, all impairment is considered to be temporary.

Note 4 Restricted Investment in Bank Stocks

Restricted stock, which represents required investments in the common stock of correspondent banks, is carried at cost and, as of September 30, 2012 and December 31, 2011, consisted primarily of the common stock of the Federal Home Loan Bank of Pittsburgh (FHLBP) and, to a lesser degree, Atlantic Central Bankers Bank (ACBB). Under the FHLBP s Capital Plan, PeoplesBank is required to maintain a minimum member stock investment, both as a condition of becoming and remaining a member and as a condition of obtaining borrowings from the FHLBP. The FHLBP uses a formula to determine the minimum stock investment, which is based on the volume of loans outstanding, unused borrowing capacity and other factors.

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

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

Table of Contents

Note 5 Loans

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

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

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

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

Table of Contents

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

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

Table of Contents

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

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

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

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