CODORUS VALLEY BANCORP INC
Form 10-K
March 20, 2007
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)
x **Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the fiscal year ended December 31, 2006

or

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from _____________ to _____________.

Commission file Number 0-15536

CODORUS VALLEY BANCORP, INC.

(Exact name of registrant as specified in its charter)

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

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

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

Securities registered pursuant to Section 12(b) of the Act: Common Stock, $2.50 par value

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

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

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

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

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

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

Large accelerated filer o Accelerated filer o Non-accelerated filer x

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

The aggregate market value of Codorus Valley Bancorp, Inc. s voting stock held by non-affiliates was approximately $53,574,424 as of June 30, 2006.

As of February 28, 2007, Codorus Valley Bancorp, Inc. had 3,502,919 shares of common stock outstanding, par value $2.50 per share.

DOCUMENTS INCORPORATED BY REFERENCE

Proxy Statement for the Annual Meeting of Shareholders to be held May 15, 2007	Part III

Codorus Valley Bancorp,Inc.

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PART I

Item 1: Business

Codorus Valley Bancorp, Inc. (Codorus Valley or Corporation) is a Pennsylvania business corporation, incorporated on October 7, 1986. On March 2, 1987, Codorus Valley became a bank holding company, under the Bank Holding Company Act of 1956. PeoplesBank, A Codorus Valley Company (PeoplesBank) is its wholly owned bank subsidiary. SYC Realty Co., Inc. is its wholly owned nonbank subsidiary. Codorus Valley s business consists primarily of managing PeoplesBank, and its principal source of income is dividends received from PeoplesBank. On December 31, 2006, Codorus Valley had total consolidated assets of $548 million, total deposits and other liabilities of $505 million, and total shareholders equity of $43 million.

Bank subsidiary

PeoplesBank, organized in 1934, is a Pennsylvania chartered bank. It is not a member of the Federal Reserve System. PeoplesBank offers a full range of business and consumer banking services through fourteen financial centers located throughout York County, Pennsylvania. It also offers investment, insurance, trust and real estate settlement services. PeoplesBank also operates a loan production office in Towson, Maryland. The Federal Deposit Insurance Corporation insures the deposits of PeoplesBank to the maximum extent provided by law. On December 31, 2006, PeoplesBank had total loans of $407 million and total deposits of $457 million. PeoplesBank s market share of deposits for York County, PA was approximately 7.3 percent as of June 30, 2006, the latest available date.

PeoplesBank is not dependent on deposits or exposed to a loan concentration to a single customer, or a small group of customers. Therefore, losses of a single customer, or small customer group, would not have a material adverse effect on the financial condition of PeoplesBank. At year-end 2006, the largest indebtedness of a single PeoplesBank client was $5,849,000 or 1.4 percent of the total loan portfolio, which was within the regulatory lending limit.

Most of the Corporation s business is with customers in York County, Pennsylvania and northern Maryland. Although this may pose a concentration risk geographically, we believe that the diverse local economy and detailed knowledge of the customer base minimizes this risk. At year-end 2006, the Corporation had one industry concentration that exceeded 10 percent of the total loan portfolio, real estate construction and land development, which was 22.5 percent of the portfolio. Comparatively, at year-end 2005 real estate construction and land development was 20.2 percent of the portfolio, and commercial real estate leasing was 11.0 percent of the portfolio. Commercial leasing pertains to borrowers who lease real estate for business purposes. Loans to borrowers within these industries are usually collateralized by real estate.

Codorus Valley Financial Advisors, Inc. is a wholly owned subsidiary of PeoplesBank that sells non-deposit investment products. Prior to its name change in December 2005, this subsidiary was titled SYC Insurance Services, Inc., which began operations in January 2000. Products sold by Codorus Valley Financial Advisors, Inc. are not FDIC insured, are not obligations of or guaranteed by PeoplesBank and are subject to investment risk including the possible loss of principal.

SYC Settlement Services, Inc. is a wholly owned subsidiary of PeoplesBank that provides real estate settlement services. SYC Settlement began operations in January 1999.

Historically, Codorus Valley Financial Advisors, Inc. and SYC Settlement Services, Inc. have not had a material impact on consolidated operating results.

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Nonbank subsidiaries

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.

On June 20, 1991, SYC Realty was incorporated as a wholly owned subsidiary of Codorus Valley. Codorus Valley created this nonbank subsidiary primarily for the purpose of disposing of selected properties obtained by PeoplesBank in satisfaction of debts previously contracted. SYC Realty commenced business operations in October 1995. To date, the financial impact of this subsidiary s operations on Codorus Valley and PeoplesBank has not been material.

Employees

At year-end 2006, PeoplesBank employed 146 full-time employees and 43 part-time employees, which equated to 168 full-time equivalents. Employees are not covered by a collective bargaining agreement and management considers its relations with employees to be satisfactory.

Segment Reporting

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

Competition

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

Supervision and regulation

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

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

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

The operations of PeoplesBank are subject to federal and state statutes applicable to banks chartered under the banking laws of the Commonwealth of Pennsylvania and whose deposits the Federal Deposit Insurance Corporation (FDIC) insures.

The FDIC is the primary federal regulator of PeoplesBank. It regularly examines banks in such areas as loss allowances, loans, investments, management practices and other aspects of operations. These examinations are designed for the protection of PeoplesBank s depositors rather than Codorus Valley s shareholders. PeoplesBank must furnish annual and quarterly reports to the FDIC.

Federal and state banking laws and regulations govern such things as: the scope of a bank s business, permissible investments, the reserves against deposits a bank must maintain, the types and terms of loans a bank may make and the collateral it may take, the activities of a bank with respect to mergers and consolidations, the establishment of branches, and the sale of nondeposit investment products by the bank and its insurance subsidiary. The Pennsylvania Insurance Department, the Securities and Exchange Commission (SEC) and the National Association of Securities Dealers (NASD) control and supervise the licensing and activities of employees engaged in the sale of nondeposit investment products.

Pennsylvania business and banking laws restrict dividend payments if such payment would render the Corporation insolvent or result in negative net worth, and the Corporation and PeoplesBank are subject to regulatory capital requirements. More information about dividend restrictions and capital requirements can be found in Note 10-Regulatory Matters, to the 2006 financial statements.

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

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

A brief discussion of selected federal agency pronouncements that affect Codorus Valley and/or PeoplesBank follows.

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Sarbanes-Oxley Act of 2002 The Sarbanes-Oxley Act (SOA) was signed into law in July 2002 and applies to all companies, both U.S. and non-U.S, that file periodic reports under the Securities Exchange Act of 1934. The stated goals of the SOA are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws. The SOA is the most far-reaching U.S. securities legislation enacted in some time. The SEC is responsible for establishing rules to implement various provisions of the SOA. The SOA includes very specific disclosure requirements and new corporate governance rules, requires the SEC and securities exchanges to adopt extensive additional disclosure, corporate governance and other related rules and mandates further studies of certain issues by the SEC. The SOA represents significant regulation of the accounting profession, and has greatly impacted state corporate law, such as the relationship between a board of directors and management and between a board of directors and its committees.

Section 404 of the SOA became effective for the year ended December 31, 2004, for companies whose public float (the product of outstanding shares times the share price on a specified date) was above $75 million. For smaller companies, including Codorus Valley, the effective date, after several postponements, is the fiscal year ending on or after December 15, 2007. Section 404 requires publicly held companies to document, test and certify that their internal control systems over financial reporting are effective. Additionally, it presently requires the Corporation s independent auditors to audit and issue an attestation report on management s internal control assessment covering the first fiscal year ending on or after December 15, 2008. Compliance costs associated with Section 404 will increase in the period ahead, but management does not expect these costs to be material.

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

Periodically, various types of federal and state legislation are proposed that could result in additional regulation of, and restrictions on, the business of Codorus Valley and PeoplesBank. It cannot be predicted whether such legislation will be adopted or, if adopted, how such legislation would affect the business of Codorus Valley and its subsidiaries. As a consequence of the extensive regulation of commercial banking activities in the United States of America, Codorus Valley and PeoplesBank s business is particularly susceptible to being affected by federal legislation and regulations that may increase the cost of doing business. Except as specifically described above, management believes that the effect of the provisions of the aforementioned legislation on the liquidity, capital resources, and results of operations of Codorus Valley will not be material. Management is not aware of any other current specific recommendations by regulatory authorities or proposed legislation, which, if they were implemented, would have a material adverse effect upon the liquidity, capital resources or results of operations. However, the general cost of compliance with numerous and multiple federal and state laws and regulations does have, and in the future may have, a negative impact on Codorus Valley s results of operations.

Other information

This Annual Report on Form 10-K is filed with the Securities and Exchange Commission (SEC). Copies of this document and other SEC filings by Codorus Valley Bancorp, Inc. may be obtained electronically at PeoplesBank s website at www.peoplesbanknet.com (select Investor Relations, then select SEC filings), or the SEC s website at www.sec.gov/edgarhp.htm. Copies can also be obtained

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without charge by writing to: Treasurer, Codorus Valley Bancorp, Inc., P.O. Box 2887, York, PA 17405-2887.

Item 1A: Risk Factors

An investment in the Corporation s common stock is subject to risks inherent to the Corporation s business. The material risks and uncertainties that management believes affect the Corporation are described below. Before making investment decisions, carefully consider these risks and uncertainties together with all of the other information included or incorporated by reference in the report. These risks and uncertainties are not the only ones facing the Corporation. Additional risks and uncertainties that management is not aware of or focused on, or currently deems immaterial, or are not controllable by management may also impair the Corporation s business operations. This report is qualified in its entirety by these risk factors.

If any of the following risks occur, the Corporation s financial condition and results of operations could be materially and adversely affected. If this were to happen, the value of the Corporation s common stock could decline significantly, and you could lose all or part of your investment.

Changes in market interest rates may adversely affect our earnings and financial condition.
The Corporation s earnings and cash flows are largely dependent upon its net interest income, which is subject to interest rate risk due to fluctuations in market interest rates. We are unable to predict changes in market interest rates, which are affected by many factors beyond our control, including inflation, unemployment, money supply, and domestic and international events, among others. We attempt to manage interest rate risk, in part, by controlling the mix of interest rate sensitive assets and interest rate sensitive liabilities. However, interest rate risk management is not an exact science. A rapid increase or decrease in market interest rates could adversely affect our financial performance. During 2006, the flat (and sometimes inverted) US treasury yield curve environment that prevailed resulted in a significant increase in funding costs without a commensurate increase in asset yields, which lowered net interest margin. A flat yield curve, a growing reliance on interest rate sensitive funding sources, and competitive pricing pressures can all adversely affect net interest income and margin. In the period ahead, management expects that some or all of these factors could continue to constrain net interest income and margin. Interest rate risk is discussed under Item 7A-Quantitative and qualitative disclosures about market risk, and is incorporated herein by reference.

The Corporation is subject to credit risk.
The Corporation is subject to credit risk if loan customers do not repay their loans according to the terms of their loans, and the collateral securing the payment of loans is insufficient to assure repayment. The Corporation may experience significant credit losses, which could have a material adverse effect on its operating results. In an economic downturn or recession, our credit risk could increase. Management makes various assumptions and judgments about the collectability of its loan portfolio, including the creditworthiness of its borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of its loans. Credit risk is discussed under the Credit Risk Management and Nonperforming Assets sections of this report, which are incorporated herein by reference.

The Corporation s allowance for possible loan losses may be insufficient.
Management makes significant estimates in determining the allowance for loan losses. Management considers a variety of factors in establishing this estimate such as current economic conditions, diversification of the loan portfolio, delinquency statistics, results of internal loan reviews, financial and managerial strength of borrowers, adequacy of collateral, if collateral dependent, or present value of future cash flows and other relevant factors. Estimates related to the value of collateral also have a significant impact on whether or not management continues to accrue income on delinquent loans and on the amounts at which foreclosed real estate is recorded on the statement of financial condition. In

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addition, bank regulatory agencies periodically review the Corporation s allowance for loan losses and may require an increase in the provision for loan losses or the recognition of further loan charge-offs, based on judgments different from management. Any increases in the allowance for loan losses will result in a decrease in net income, and possibly capital, and may have a material adverse effect on the Corporation s financial condition and results of operations. The adequacy of the allowance is discussed under the Allowance for Loan Losses section of this report and is incorporated herein by reference.

The trading volume in the Corporation s common stock is less than that of other larger financial services companies.
Codorus Valley s common stock is listed on the NASDAQ Global Market under the symbol CVLY. The trading volume in its common stock is less than that of other larger financial companies. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of the Corporation s common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which the Corporation has no control. Given the lower trading volume of the Corporation s common stock, significant sales of the Corporation s common stock, or the expectation of these sales, could cause the Corporation s stock price to languish or fall.

The Corporation is subject to extensive governmental regulation and supervision.
Periodically, federal and state legislation is proposed that could result in additional regulation of, or restrictions on, the business of Codorus

Valley and its subsidiaries. At present, banking regulators are considering modifications to the risk-based capital framework to enhance its risk sensitivity. The proposal is expected to provide a banking organization the ability to elect to adopt the proposed revisions or remain subject to existing risk-based capital rules. In December 2006, banking regulators provided guidance that describes sound risk management practices that are important for an institution, like Codorus Valley, that has strategically decided to concentrate in real estate lending. Other than proposed modifications to the risk-based capital framework, and the recent final ruling on concentrations in commercial real estate lending, management is not aware of any current specific recommendations by regulatory authorities or proposed legislation, which, if they were implemented, would have a material adverse effect upon the liquidity, capital resources, or results of operations. However, the general cost of compliance with numerous and multiple federal and state laws and regulations does have, and in the future may have, a negative impact on Codorus Valley s results of operations. Governmental regulation is discussed in Item I, under the Supervision and Regulation section within this report and is incorporated herein by reference.

Item 1B: Unresolved Staff Comments

Not applicable.

Item 2: Properties

Codorus Valley owns the following property, subject to two liens. A regional financial institution holds a first lien for approximately $1.6 million and Codorus Valley s wholly owned subsidiary PeoplesBank holds a second lien for approximately $1.8 million.

Codorus Valley Corporate Center The Corporate Center is located at 105 Leader Heights Road, York Township, York, PA. This facility serves as the corporate headquarters and is approximately 40,000 square feet. Approximately sixty-seven percent of the leasable space is leased to PeoplesBank and the remaining thirty-three percent is leased to nonaffiliated parties. The Corporate Center is adjacent to PeoplesBank s Data Operations Center and the Leader Heights banking office.

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PeoplesBank owns the following properties without liens:

Glen Rock Office Located at 1 Manchester Street in the borough of Glen Rock, PA. Two bank-owned parking lots are located nearby on Hanover Street and at 7 Manchester Street in the borough of Glen Rock.

Jacobus Office Located at 1 North Main Street in the borough of Jacobus, PA.

Jefferson Office Located at 6 Baltimore Street in Jefferson Borough, PA. A bank-owned parking lot is located nearby at 10 Baltimore Street in Jefferson Borough.

York New Salem Office Located at 320 North Main Street in the borough of York New Salem, PA.

Leader Heights Office This facility serves as both a banking office and data operations center. It is located at 109 Leader Heights Road in York Township, PA.

Cape Horn Office Located at 2587 Cape Horn Road, Red Lion in Windsor Township, PA.

East York Office Located at 2701 Eastern Boulevard, York in Springettsbury Township, PA.

PeoplesBank leases the following properties:

Stewartstown Office Located at 2 Ballast Lane in the borough of Stewartstown, PA. This office is a 1,278 square foot unit of a business complex known as Village Square at Stewartstown. The lease, signed November 29, 1993, is for a twenty-year term with four five-year term renewal options.

South Hanover Office Located at 1400 Baltimore Street, Hanover in Penn Township, PA. This office is a 1,850 square foot unit adjacent to a Rutter s Farm Store and gas station. The capital lease, effective February 1, 2001, is for a fifteen-year term with three five-year term renewal options.

East Market Street Office Located at 48 East Market Street, York City, PA. The office is approximately 685 square feet and located in the lobby entrance of the historic Yorktowne Hotel. The lease, effective February 1, 2006, is for a five-year term with one five-year renewal option.

West Philadelphia Street Office Located within the Susquehanna Commerce Center at 221 W. Philadelphia Street, York City, PA. This office is a 2,814 square foot unit located in the City of York. The lease, effective December 10, 2002, is for an eight-year term with two five-year term renewal options.

Brogue Office Located at 2510 Delta Road in Chanceford Township, PA. This office is a 1,600 square foot portion of a business complex known as Brogue Center. The lease, effective November 5, 2004, is for a five-year term with five five-year term renewal options.

West York Office Located at 1477 Carlisle Road in West Manchester Township, PA. This office is a 2,800 square foot unit. The lease, effective December 1, 2004, is for a ten-year term with three five-year term renewal options.

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New Freedom Office Located at 26 East Main Street, New Freedom Borough, PA. This office is a 1,600 square foot building. The lease, effective September 20, 2004, is for a ten-year term with five-year renewal options.

Towson Loan Production Office Located at 40 West Chesapeake Avenue, Towson, MD. This 266 square foot office space is located on the 6^{th} floor of the 40 West Chesapeake Building and is used as a loan production office (LPO). The lease, effective December 1, 2005, is renewable annually.

All of the above properties are located in York County, Pennsylvania, with the exception of the Towson LPO which is located in Towson, Maryland and, in the opinion of management, are adequate for the business purposes of Codorus Valley and its subsidiaries.

Item 3: Legal proceedings

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

Item 4: Submission of matters to a vote of security holders

No matters were submitted to a vote of security holders during the fourth quarter of 2006.

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PART II

Item 5: Market for Codorus Valley Bancorp, Inc. s common equity, related shareholder matters and issuer purchase of equity securities

Market Information

The shares of Codorus Valley Bancorp, Inc. are traded on the NASDAQ Global Market under the symbol CVLY. Codorus Valley had approximately 939 registered shareholders of record as of December 31, 2006. The following table sets forth high and low sales prices and dividends paid per share for Codorus Valley as reported by NASDAQ during the periods indicated. The sales prices and cash dividends per share listed are adjusted for stock dividends.

	2006			2005		
Quarter	**High**	**Low**	**Dividends per share**	**High**	**Low**	**Dividends per share**
First	$ 19.50	$ 17.25	$ 0.118	$ 17.70	$ 15.98	$ 0.108
Second	19.52	17.61	0.118	17.91	15.96	0.108
Third	19.05	17.86	0.124	18.80	15.43	0.113
Fourth	21.25	18.38	0.129	18.11	16.33	0.118

Codorus Valley has a long history of paying quarterly cash dividends on its common stock. Codorus Valley presently expects to pay future cash dividends at levels comparable with those of prior years. However, the payment of such dividends will depend primarily upon the earnings of its subsidiary, PeoplesBank. Management anticipates that substantially all of the funds available for the payment of dividends by Codorus Valley will be derived from dividends paid to it by PeoplesBank. The payment of cash dividends is also subject to restrictions on dividends and capital requirements as reported in Note 10-Regulatory Matters.

The Corporation maintains various employee, director and shareholder benefit plans that could result in the issuance of its common stock. The information appearing in Note 11-Benefit Plans, and Note 12-Stock-Based Compensation within this report pertains to these plans. Information pertaining to new plans, approved by the Board of Directors and subject to shareholder approval, are included in the 2007 Proxy Statement, which is incorporated herein by reference.

On October 14, 2004, the Corporation issued a press release, which was also filed on Form 8-K, announcing that its Board of Directors authorized the purchase, in open market and privately negotiated transactions, of up to 4.9 percent or approximately 146,000 shares of its then outstanding common stock. As of December 31, 2006, no shares of common stock were acquired under this authorization.

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Shareholder Total Return Performance Graph

The following graph compares the yearly dollar change in the cumulative total shareholder return on Codorus Valley Bancorp, Inc. s common stock against the cumulative total return of the SNL Mid-Atlantic Bank Index and the NASDAQ Composite Index for the period of five fiscal years commencing January 1, 2002, and ending December 31, 2006. The graph shows the cumulative investment return to shareholders based on the assumption that a $100 investment was made on December 31, 2001 in each of Codorus Valley s common stock, the SNL Mid-Atlantic Bank Index and the NASDAQ Composite Index. We computed returns assuming the reinvestment of all dividends. The shareholder return shown on the following graph is not indicative of future performance.

Company/Index/Market	12/31/01	12/31/02	Fiscal Year Ending 12/31/03	12/31/04	12/31/05	12/31/06
Codorus Valley Bancorp, Inc.	100.00	121.49	180.33	179.01	194.45	230.97
SNL Mid-Atlantic Bank Index	100.00	76.91	109.35	115.82	117.87	141.46
NASDAQ Composite Index	100.00	69.75	104.88	113.70	116.19	128.12

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Item 6: Selected financial data

	2006	2005	2004	2003	2002
Summary of operations *(in thousands)*					
Interest income	$ 33,319	$ 25,572	$ 20,469	$ 19,964	$ 20,674
Interest expense	15,077	9,149	6,545	6,898	8,907
Net interest income	18,242	16,423	13,924	13,066	11,767
Provision for loan losses	650	775	420	553	515
Noninterest income	5,465	5,003	4,626	4,380	3,534
Noninterest expense	15,890	14,482	12,769	12,290	11,008
Income before income taxes	7,167	6,169	5,361	4,603	3,778
Provision for income taxes	1,845	1,552	1,353	1,171	677
Net income	$ 5,322	$ 4,617	$ 4,008	$ 3,432	$ 3,101
Per common share					
(adjusted for stock dividends)					
Net income, basic	$ 1.53	$ 1.33	$ 1.16	$ 1.00	$ 0.90
Net income, diluted	$ 1.49	$ 1.30	$ 1.14	$ 0.99	$ 0.90
Cash dividends paid	$ 0.49	$ 0.45	$ 0.42	$ 0.39	$ 0.37
Stock dividends distributed	10%*	5%	5%	5%	5%
Book value	$ 12.21	$ 11.11	$ 10.38	$ 9.80	$ 9.36
Cash dividend payout ratio	32.0%	33.6%	36.3%	38.7%	40.7%
Weighted average shares outstanding	3,489,229	3,475,192	3,453,571	3,443,823	3,437,487
Weighted average diluted shares outstanding	3,571,019	3,544,479	3,525,296	3,483,064	3,452,296
* includes a special 5% stock dividend					
Profitability ratios					
Return on average shareholders equity (ROE)	13.0%	12.3%	11.5%	10.3%	10.1%
Return on average assets (ROA)	1.05%	1.06%	1.03%	0.96%	0.91%
Net interest margin	3.97%	4.16%	4.01%	4.13%	3.88%
Efficiency ratio	65.1%	66.1%	67.6%	69.9%	70.7%
Capital ratios					
Tier 1 risk-based capital	12.0%	10.6%	11.8%	11.1%	11.3%
Total risk-based capital	12.7%	11.3%	12.3%	11.7%	11.9%
Average shareholders equity to average assets	8.1%	8.6%	9.0%	9.3%	9.0%

	2006	2005	2004	2003	2002
Summary of financial condition at year-end *(in thousands)*					
Investment securities	$ 80,926	$ 69,664	$ 74,140	$ 74,069	$ 79,723
Loans	407,260	369,631	300,260	262,363	238,546
Assets	548,212	476,052	407,671	372,547	349,897
Deposits	456,645	385,154	329,537	304,282	292,627
Borrowings	45,339	49,493	39,493	31,234	23,253
Equity	42,786	38,729	35,982	33,789	32,223
Other data					
Number of bank offices	14	14	12	11	11
Number of employees (full-time equivalents)	168	163	146	143	163
Wealth Management assets, market value (in thousands)	$ 259,453	$ 213,735	$ 180,314	$ 137,186	$ 113,106

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Item 7: Management s discussion and analysis of financial condition and results of operations

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

Forward-looking statements

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

Shareholders should note that many factors, some of which are discussed elsewhere in this report and in the documents that management incorporates 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 Annual Report. These factors include the following:

- operating, legal and regulatory risks;
- economic, political and competitive forces affecting banking, securities, asset management and credit services businesses; and
- the risk that management s analyses of these risks and forces could be incorrect and/or that the strategies developed to address them could be unsuccessful.

The Corporation undertakes no obligation to publicly revise or update these forward-looking statements to reflect events or circumstances that arise after the date of this report. Readers should carefully review the risk factors described in other documents that Codorus Valley files periodically with the Securities and Exchange Commission.

Critical accounting estimates

Disclosure of Codorus Valley s significant accounting policies is included in Note 1 to the consolidated financial statements of this Annual Report. Some of these policies are particularly sensitive, requiring that significant judgments, estimates and assumptions be made by management. Additional information is contained in Management s Discussion and Analysis for the most sensitive of these issues, including the provision and allowance for loan losses, located on pages 20 and 31 of this report.

Management makes significant estimates in determining the allowance for loan losses. Management considers a variety of factors in establishing this estimate such as current economic conditions, diversification of the loan portfolio, delinquency statistics, results of internal loan reviews, financial and managerial strength of borrowers, adequacy of collateral, if collateral dependent, or present value of future cash flows and other relevant factors. Estimates related to the value of collateral also have a significant impact on whether or not management continues to accrue income on delinquent loans and on the amounts at which foreclosed real estate is recorded on the statement of financial condition.

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Declines in the fair value of available-for-sale and held-to-maturity securities below their cost that are deemed to be other-than-temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers: 1) the length of time and the extent to which the fair value has been less than cost, 2) the financial condition and near-term prospects of the issuer, and 3) the intent and ability of the Corporation to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

The Corporation changed its method of accounting for stock-based compensation in 2006, in accordance with Financial Accounting Statement No. 123(R), which is described in Note 1 under the subheading Recent Accounting Pronouncements. Based on stock options outstanding on December 31, 2006, approximately $76,000 will be expensed over the weighted average period of 1.6 years.

Management discussed the development and selection of critical accounting estimates and related Management Discussion and Analysis disclosure with the Audit Committee. There were no material changes made to the critical accounting estimates during the periods presented within this report.

OVERVIEW

Executive summary

Throughout 2006, management and the Board of Directors (Board) continued to implement a series of initiatives, as guided by the Corporation s long-range strategic plan. Our financial performance was strong in 2006, as described in the Financial Highlights section below, even though our net interest margin was under constant pressure as a result of a flat (and sometimes inverted) US treasury yield curve environment. Asset quality remained sound and capital was increased through profitable operations and the issuance of trust preferred debt to support planned balance sheet growth. Selected accomplishments for 2006 included: opening a loan production office in Towson, MD; opening a limited service banking facility at the Shrewsbury Lutheran Retirement Village in Shrewsbury, PA; enhancing brand awareness through advertising, community sponsorships and special events; offering new financial products, including the popular ultimate money market deposit account; improving sales incentive systems as an important component of our focus on service excellence; implementing multi-factor authentication, which provides greater security to our growing client base that uses our internet banking system; and increased operating efficiency by exchanging check images (as opposed to physical checks) for settlement with other participating banks. Also during the year, management laid the foundation for two important initiatives. The first is to restructure the wealth management business to increase sales effectiveness and improve operating efficiency, and the second is to implement remote deposit capture, which will enable our business clients to process check payments at their place of business. Both of these initiatives are scheduled for implementation in the first half of 2007.

In the period ahead, management will remain focused on profitable balance sheet growth, acquiring and nurturing client relationships, branch office expansion, risk management, and increasing noninterest income. Challenges include a continuation of the flat (and sometimes inverted) US treasury yield curve environment, competitive pricing pressures and a slowing housing market.

Financial Highlights

The Corporation earned $5,322,000 or $1.53 per share ($1.49 diluted) for 2006, compared to $4,617,000 or $1.33 per share ($1.30 diluted) for 2005, and $4,008,000 or $1.16 per share ($1.14 diluted) for 2004. For 2006, the $705,000 or 15 percent increase in net income above 2005 was the result of increases in net interest income and noninterest income, which more than offset an increase in noninterest expense.

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The $1,819,000 or 11 percent increase in net interest income was primarily the result of an increase in earning assets, principally business loans. Earning assets averaged $471 million and yielded 7.17 percent (tax equivalent basis) for 2006, compared to $401 million and 6.45 percent, respectively, for 2005. While net interest income increased, net interest margin decreased due to increased funding costs, which resulted from a flat (and sometimes inverted) US treasury yield curve environment and competitive pricing pressures. The net interest margin was 3.97 percent for 2006, compared to 4.16 percent for 2005. The $462,000 or 9 percent increase in noninterest income was attributable to increases in income from wealth management and deposit services, which resulted from increased sales and business growth. The $1,408,000 or 10 percent increase in noninterest expense was attributable in part to corporate expansion, principally in 2005, planned staff additions and normal business growth. In June 2006, the Corporation achieved a historic financial milestone when total assets exceeded $500 million. By year-end 2006, total assets were $548 million, an increase of approximately $72 million or 15 percent above year-end 2005. Asset growth occurred primarily in business and consumer loans, which were funded by strong deposit growth, principally money market deposits and floating rate CDs. Quarterly earnings for 2006 and 2005 are shown in Note 18-Quarterly Results of Operations.

Comparatively, net income for 2005 increased $609,000 or 15 percent above 2004, the result of increases in net interest income and noninterest income, which more than offset increases in noninterest expense and loan loss provision. The $2,499,000 or 18 percent increase in net interest income was attributable to an increase in the volume and yield on loans, principally business and consumer loans, and loan fees. The net interest margin was 4.16 percent for 2005, compared to 4.01 percent for 2004. The $377,000 or 8 percent increase in noninterest income was attributable to a larger volume of fees and commissions resulting from increased sales and business growth. The $1,713,000 or 13 percent increase in noninterest expense was largely attributable to corporate expansion, which increased personnel, occupancy and marketing expenses. PeoplesBank opened three full service financial centers and renovated three existing financial centers since July 2004. Personnel expense was also impacted by an increase in performance-based compensation and higher health insurance premiums. Marketing expense was impacted by the cost to develop and partially implement a branding initiative for PeoplesBank. The $355,000 or 85 percent increase in the loan loss provision for 2005 was based in part on the significant increase in commercial and commercial real estate loans, which are inherently more risky than other types of loans. Total assets were $476 million on December 31, 2005, an increase of approximately $68 million or 17 percent above December 31, 2004. Asset growth occurred primarily in business and consumer loans, which were funded by growth in deposits and long-term borrowings.

Annual cash dividends per share, as adjusted, were $.49 for 2006, compared to $.45 for 2005. Two 5 percent stock dividends, which included a special 5 percent stock dividend, were distributed in 2006. Comparatively, one 5 percent stock dividend was distributed in 2005. Book value per share, as adjusted, was $12.21 for year-end 2006, compared to $11.11 for year-end 2005.

Net income as a percentage of average shareholders equity (return on equity or ROE), was 13.0 percent for 2006, compared to 12.25 percent for 2005. Net income as a percentage of average total assets (return on assets or ROA), was 1.05 percent for 2006, compared to 1.06 percent for 2005.

At December 31, 2006, nonperforming assets as a percentage of total loans and net foreclosed real estate was 1.09 percent, compared to .28 percent at year-end 2005. Information regarding nonperforming assets is provided in the Risk Management section of this report, including Table 10 Nonperforming Assets. The allowance for loan losses as a percentage of total loans was .77 percent for year-end 2006, compared to .69 percent for year-end 2005. Information regarding the allowance is provided in the Risk Management section of this report, including Tables 11 Analysis of Allowance for Loan Losses and 12 Allocation of Allowance for Loan Losses. Based on a recent evaluation of probable loan losses and the current loan portfolio, management believes that the allowance is adequate to support losses inherent in the portfolio at December 31, 2006.

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Throughout 2006, the Corporation maintained a capital level well above minimum regulatory quantitative requirements. Currently, there are three federal regulatory definitions of capital that take the form of minimum ratios. Table 9 Capital Ratios, shows that the Corporation and PeoplesBank were well capitalized on December 31, 2006.

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

INCOME STATEMENT ANALYSIS

Net Interest Income

The Corporation s principal source of revenue is net interest income, which is the difference between interest income earned on loans and investment securities, and interest expense incurred on deposits and borrowed funds. Fluctuations in net interest income are caused by changes in interest rates, volumes and the composition or mix of interest rate sensitive assets and liabilities.

For analytical purposes, Tables 1, 2, and 3 are presented on a tax equivalent basis to make it easier to compare taxable and tax-exempt assets. Income from tax-exempt assets, primarily loans to or securities issued by state and local governments, is increased by the amount of federal income taxes which would have been incurred if the income was taxable at the statutory rate of 34 percent. Unless otherwise noted, the discussion that follows is based on interest income and interest expense as reported in the consolidated statements of income, not on a tax equivalent basis.

Net interest income for 2006 was $18,242,000, an increase of $1,819,000 or 11 percent above 2005. The increase was primarily the result of an increase in the volume of earning assets. Earning assets averaged $471 million and yielded 7.17 percent (tax equivalent basis) for 2006, compared to $401 million and 6.45 percent, respectively, for 2005. The $71 million or 18 percent increase in earning assets occurred primarily in business loans and secondarily in consumer loans. Rising market interest rates resulted in increases in yields on variable rate business loans, investment securities and overnight investments, which also contributed to the increase in net interest income. Interest bearing liabilities averaged $418 million at an average rate of 3.60 percent for 2006, compared to $352 million and 2.60 percent, respectively, for 2005. The $66 million or 19 percent increase in the average volume of interest bearing liabilities occurred primarily in money market deposits and floating rate CDs. Current period deposit growth was attributable to several factors including the successful introduction of new money market products, the addition of two financial centers in March 2005, and higher market interest rates, which improved returns for bank depositors. Funding costs also increased as a result of issuing $7.2 million in floating rate trust preferred debt in June 2006, as a capital strategy to support planned balance sheet growth.

A flat yield curve, a growing reliance on interest rate sensitive funding sources, and competitive pricing pressures all contributed to the decrease in net interest margin, which was 3.97 percent (tax equivalent basis) for 2006, compared to 4.16 percent for 2005. Net interest margin is net interest income (tax equivalent basis) as a percentage of average earning assets. In the period ahead, management expects that growth in net interest income will remain constrained by the flat or inverted US treasury yield curve environment and competitive pricing pressures.

Comparatively, net interest income for 2005 was $16,423,000, an increase of $2,499,000 or 18 percent above 2004. The increase was primarily the result of an increase in loan volume, although an increase in loan yields and fees also contributed. Earning assets averaged $401 million and yielded 6.45 percent (tax equivalent basis) for 2005, compared to $353 million and 5.86 percent, respectively, for 2004. The

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$47 million or 13 percent increase in earning assets occurred primarily in business loans and secondarily in consumer loans. Interest bearing liabilities averaged $352 million at an average rate of 2.60 percent for 2005, compared to $314 million and 2.08 percent, respectively, for 2004. The $38 million or 12 percent increase in the average volume of interest bearing liabilities occurred somewhat evenly between long-term debt, interest bearing demand deposits and time deposits. The net interest margin, on a tax equivalent basis, was 4.16 percent for 2005, compared to 4.01 percent for 2004.

Table 1-Net Interest Income (tax equivalent basis)

(dollars in thousands)	**2006**	**2005**	**2004**	**2003**	**2002**	**5 Year CAGR***
Total interest income	$ 33,319	$ 25,572	$ 20,469	$ 19,964	$ 20,674	8.1%
Tax equivalent adjustment	482	257	231	238	277	n/a
Adjusted total interest income	33,801	25,829	20,700	20,202	20,951	8.1%
Total interest expense	15,077	9,149	6,545	6,898	8,907	-6.8%
Net interest income	$ 18,724	$ 16,680	$ 14,155	$ 13,304	$ 12,044	9.3%

(dollars in thousands)	**2006**	**2005**	**2004**	**2003**	**2002**	**5 Year CAGR***
Average earning assets	$ 471,251	$ 400,632	$ 353,390	$ 322,391	$ 310,431	10.4%
Average interest bearing liabilities	$ 418,353	$ 351,949	$ 314,398	$ 290,405	$ 281,062	10.2%
Yield on earning assets	7.17%	6.45%	5.86%	6.27%	6.75%	
Rate on interest bearing liabilities	3.60%	2.60%	2.08%	2.38%	3.17%	
Interest rate spread	3.57%	3.85%	3.78%	3.89%	3.58%	
Net interest margin	3.97%	4.16%	4.01%	4.13%	3.88%	

* Compound annual growth rate (CAGR) is the average annual rate of growth over the five-year period beginning in 2001.

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

	Year ended December 31,		**2006 compared to 2005**		
(dollars in thousands)	**2006**	**2005**	**Increase (Decrease)**	**Volume**	**Rate**
Interest Income					
Interest bearing deposits with banks	$ 10	$ 5	$ 5	$ 1	$ 4
Federal funds sold	521	130	391	227	164
Securities, taxable	2,699	2,530	169	(265)	434
Securities, tax-exempt	1,104	675	429	533	(104)
Loans, taxable	29,156	22,407	6,749	4,130	2,619
Loans, tax-exempt	311	82	229	280	(51)
Total interest income	33,801	25,829	7,972	4,906	3,066
Interest Expense					
Interest bearing deposits					
NOW, money market	4,829	1,940	2,889	427	2,462
Savings	116	113	3	(7)	10
Time deposits less than $100,000	5,746	4,040	1,706	602	1,104
Time deposits $100,000 or more	2,075	1,162	913	495	418
Short-term borrowings	133	73	60	9	51
Long-term debt	2,178	1,821	357	244	113
Total interest expense	15,077	9,149	5,928	1,770	4,158
Net interest income	$ 18,724	$ 16,680	$ 2,044	$ 3,136	$ (1,092)

	Year ended December 31,		**2005 compared to 2004**		
(dollars in thousands)	**2005**	**2004**	**Increase (Decrease)**	**Volume**	**Rate**

	Year ended December 31,		2006 compared to 2005		
Interest Income					
Interest bearing deposits with banks	$ 5	$ 2	$ 3	$	$ 3
Federal funds sold	130	44	86		86
Securities, taxable	2,530	2,412	118	(45)	163
Securities, tax-exempt	675	638	37	78	(41)
Loans, taxable	22,407	17,562	4,845	3,005	1,840
Loans, tax-exempt	82	42	40	5	35
Total interest income	25,829	20,700	5,129	3,043	2,086
Interest Expense					
Interest bearing deposits					
NOW, money market	1,940	827	1,113	64	1,049
Savings	113	71	42	12	30
Time deposits less than $100,000	4,040	3,553	487	125	362
Time deposits $100,000 or more	1,162	857	305	207	98
Short-term borrowings	73	31	42	18	24
Long-term debt	1,821	1,206	615	657	(42)
Total interest expense	9,149	6,545	2,604	1,083	1,521
Net interest income	$ 16,680	$ 14,155	$ 2,525	$ 1,960	$ 565

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. Taxable loans include net loan fees of $1,253,000 in 2006, $1,178,000 in 2005, and $917,000 in 2004.

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Table 3-Average Balances and Interest Rates (tax equivalent basis)

(dollars in thousands)	2006 Average Balance	2006 Interest	2006 Rate	2005 Average Balance	2005 Interest	2005 Rate	2004 Average Balance	2004 Interest	2004 Rate
Assets									
Interest bearing deposits with banks	$ 171	$ 10	5.85%	$ 143	$ 5	3.50%	$ 162	$ 2	1.23%
Federal funds sold	9,992	521	5.21	3,640	130	3.57	3,639	44	1.21
Investment securities									
Taxable	56,061	2,699	4.81	62,615	2,530	4.04	63,806	2,412	3.78
Tax-exempt	17,420	1,104	6.34	9,734	675	6.93	8,668	638	7.36
Total investment securities	73,481	3,803	5.18	72,349	3,205	4.43	72,474	3,050	4.21
Loans									
Taxable (1)	383,098	29,156	7.61	323,479	22,407	6.93	276,211	17,562	6.36
Tax-exempt	4,509	311	6.90	1,021	82	8.03	904	42	4.65
Total loans	387,607	29,467	7.60	324,500	22,489	6.93	277,115	17,604	6.35

	2006			2005			2004		
Total earning assets	471,251	33,801	7.17	400,632	25,829	6.45	353,390	20,700	5.86
Other assets (2)	36,575			35,216			36,006		
Total assets	$ 507,826			$ 435,848			$ 389,396		
Liabilities and Shareholders Equity									
Interest bearing deposits									
NOW, money market	$ 171,693	$ 4,829	2.81%	$ 140,698	$ 1,940	1.38%	$ 130,524	$ 827	0.63%
Savings	19,428	116	0.60	20,709	113	0.55	17,773	71	0.40
Time deposits less than $100,000	135,968	5,746	4.23	118,328	4,040	3.41	114,320	3,553	3.11
Time deposits $100,000 or more	45,795	2,075	4.53	32,105	1,162	3.62	25,848	857	3.32
Total interest bearing deposits	372,884	12,766	3.42	311,840	7,255	2.33	288,465	5,308	1.84
Short-term borrowings	2,857	133	4.66	2,534	73	2.88	1,613	31	1.92
Long-term debt	42,612	2,178	5.11	37,575	1,821	4.85	24,320	1,206	4.96
Total interest bearing liabilities	418,353	15,077	3.60	351,949	9,149	2.60	314,398	6,545	2.08
Noninterest bearing deposits	45,621			43,452			37,205		
Other liabilities	2,870			2,763			2,880		
Shareholders equity	40,982			37,684			34,913		
Total liabilities and shareholders equity	$ 507,826			$ 435,848			$ 389,396		
Net interest income		$ 18,724			$ 16,680			$14,155	
Interest rate spread			3.57%			3.85%			3.78%
Net interest margin			3.97%			4.16%			4.01%

(1) Interest includes net loan fees of $1,253,000 in 2006, $1,178,000 in 2005 and $917,000 in 2004.
(2) Average balance includes average nonaccrual loans of $3,721,000 in 2006, $686,000 in 2005, and $1,022,000 in 2004.

Provision for Loan Losses

The provision for loan losses is an expense charged to earnings to address estimated losses attributable to uncollectible loans. The provision reflects management s judgment of an appropriate level for the allowance for loan losses. The Risk Management section, including Tables 10 Nonperforming Assets, 11 Analysis of Allowance for Loan Losses, and 12 Allocation of Allowance for Loan Losses, of this report, provides detailed information about the allowance, provision and credit risk. For 2006, the provision expense for loan losses was $650,000, compared to $775,000 for 2005 and $420,000 for 2004. The current period provision was based on management s assessment of overall credit quality, loan growth, particularly commercial and commercial real estate loans, which are inherently more risky than other types of loans, and macro-economic factors. Macro-economic factors included heightened energy costs and market interest rates, and a downturn in the real estate market, which could portend debt service problems for some of our borrowers.

As reported on Form 8-K, filed by Codorus Valley on February 13, 2007, PeoplesBank received a check for approximately $839,000. The check represented PeoplesBank s portion of a $12 million restitution

fund created in settlement of a claim by the United States Department of Justice against the Bank of New York. The check partially reimbursed PeoplesBank for loan losses that were incurred in 2002 and 2003 that pertained to a group of related equipment leasing contracts that PeoplesBank acquired from a third-party broker who designated Bank of New York as escrow agent for payments under these contracts. Management plans to recognize this recovery as a credit to the loan loss provision in the first quarter of 2007.

Noninterest Income

The following table presents the components of total noninterest income for each of the past three years. A key operating strategy is to increase noninterest or fee based income by offering new services, enhancing traditional services and expanding sales into new geographic markets.

Table 4-Noninterest Income

(dollars in thousands)	**2006**	**2005**	**2004**
Trust and investment services fees	$ 1,255	$ 1,147	$ 1,076
Service charges on deposit accounts	1,870	1,638	1,501
Mutual fund, annuity and insurance sales	1,349	1,156	930
Income from bank owned life insurance	263	269	262
Other income	485	507	503
Gain on sales of mortgages	323	372	316
(Loss) gain on sales of securities	(80)	(86)	38
Total noninterest income	$ 5,465	$ 5,003	$ 4,626

The discussion that follows addresses changes in noninterest income.

Trust and investment services fees For 2006, trust fees increased $108,000 or 9 percent above 2005. Comparatively, 2005 trust fees increased $71,000 or 7 percent above 2004. The increase for both periods was attributable to business growth.

Service charges on deposit accounts For 2006, service charges on deposits increased $232,000 or 14 percent above 2005. Comparatively, 2005 service charges increased $137,000 or 9 percent above 2004. The increase for both periods was due to an increase in the volume of transactions and number of accounts. Check card (debit card) interchange income and overdraft fees continued to trend up in response to increased customer usage.

Mutual fund, annuity and insurance sales For 2006, commissions from the sale of mutual funds, annuities and insurance products increased $193,000 or 17 percent above 2005. Comparatively, 2005 commissions increased $226,000 or 24 percent above 2004. The increase for both periods was due to increased sales volume.

Other income Other income is comprised of many fees including, but not limited to: real estate settlement fees, ATM fees (from non-customers using PeoplesBank s ATMs), safe deposit box rental fees, credit card merchant fees, checking supplies fees, wire transfer fees and internet banking fees. For 2006, other income decreased $22,000 or 4 percent below 2005 due primarily to a $34,000 decrease in real estate settlement services, which resulted in part from a downturn in the real estate market and competition. The current period also contained a nonrecurring gain of $45,000 from the sale of two

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small parcels of land, totaling .3 acre, to the local township for a road throughway. One parcel was held by Codorus Valley Bancorp, Inc. and the other was held by its subsidiary, PeoplesBank. Other income for 2005 was approximately the same as 2004.

Gain on sales of mortgages For 2006, gains on sales of mortgages decreased $49,000 or 13 percent below 2005 due to a decline in originations and sales. Mortgage banking operations in the current period was adversely affected by a downturn in the residential real estate market. Comparatively, 2005 gains increased $56,000 or 18 percent above 2004 due to an increase in the volume of mortgage loan originations and sales.

(Loss) gain on sales of securities For 2006 and 2005 the Corporation recognized losses of ($80,000) and ($86,000), respectively, from the sale of securities in connection with an investment swap. A swap entails selling low yielding investments at a loss (investments purchased in a low interest rate environment) and replacing them with higher yielding investments, which increases portfolio yield and interest income in future periods.

Noninterest Expense

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

Table 5-Noninterest Expense

(dollars in thousands)	**2006**	**2005**	**2004**
Personnel	$ 9,080	$ 8,163	$ 7,077
Occupancy of premises, net	1,368	1,311	1,074
Furniture and equipment	1,350	1,241	1,182
Postage, stationery and supplies	410	468	412
Professional and legal	277	326	294
Marketing and advertising	589	698	478
Other	2,816	2,275	2,252
Total noninterest expense	$ 15,890	$ 14,482	$ 12,769

The discussion that follows addresses changes in noninterest expense. Generally, corporate expansion in the form of financial center additions and normal business growth were principal expense drivers for all three years. PeoplesBank opened two financial centers in 2005 and one in 2004. Additionally, several existing financial centers were renovated over the past three years to better serve our cliental.

Personnel For 2006, personnel expense, comprised of wages, payroll taxes and employee benefits, increased $917,000 or 11 percent above 2005 due primarily to planned staff additions to support business growth. Comparatively, 2005 increased $1,086,000 or 15 percent above 2004 due to planned staff additions associated with financial center expansion and increases in performance based compensation and health care insurance premiums.

Occupancy of premises, net For 2006, occupancy of premises expense increased $57,000 or 4 percent above 2005 due in part to a full year s impact of financial center expansion in the prior year. Comparatively, 2005 increased $237,000 or 22 percent above 2004 due to financial center expansion and renovation, and increases in energy expense and real estate taxes.

Furniture and equipment For 2006, furniture and equipment expense increased $109,000 or 9 percent above 2005 due in part to financial center expansion and renovation in the prior period. Current period expense was also impacted by the timing of ATM maintenance contracts and a bulk replacement of personal computers. Comparatively, 2005 increased $59,000 or 5 percent above 2004 due primarily to financial center expansion and renovation.

Postage, stationery and supplies For 2006, postage, stationery and supplies expense category decreased $58,000 or 12 percent below 2005. Stationery and supplies expense for 2005 was higher than normal due to franchise expansion and implementation of a branding initiative (new logo) for PeoplesBank. Comparatively, 2005 increased $56,000 or 14 percent above 2004.

Professional and legal For 2006, professional and legal expense decreased $49,000 or 15 percent below 2005 due to the settlement of two unrelated lawsuits that arose from routine bank business. Both lawsuits were settled by early January 2006, which curtailed further legal expense. One of the lawsuits also resulted in a $35,000 reimbursement to PeoplesBank in 2006 for legal expenses that it incurred in a prior period. While legal expense decreased in the current period the consulting expense component increased $66,000 or 77 percent above 2005 due in part to third party assistance to comply with Section 404 of the Sarbanes-Oxley Act of 2002. Comparatively, 2005 professional and legal expense increased $32,000 or 11 percent above 2004 due primarily to an increase in legal expense from the aforementioned lawsuits.

Marketing and advertising For 2006, marketing and advertising expense decreased $109,000 or 16 percent below 2005. Expense for 2005 was relatively high due to the cost of developing and implementing a strategic branding initiative for PeoplesBank, coupled with costs to promote the addition of two financial centers. Comparatively, 2005 increased $220,000 or 46 percent above 2004 for the reasons previously described.

Other For 2006, other expense, which is comprised of many underlying expenses, increased $541,000 or 24 percent above 2005. The increase was primarily the result of increases in problem loan and foreclosed real estate carrying costs, miscellaneous expense, ATM/point-of-sale processing costs, employee training, Pennsylvania shares tax, and normal business growth. Current period problem loan and foreclosed real estate carrying costs increased $192,000 above 2005, due primarily to the recognition of an unusually large $151,000 gain from the sale of loan collateral in 2005. The level of current period expense also reflected a larger portfolio of nonaccrual loans. Current period miscellaneous expense reflected the recognition of two non-recurring expenses. The first was a $62,000 loss (charge-off) on architectural drawings for a branch office prototype that did not materialize. The second was a $35,000 expense for services to create a manuscript of the history of PeoplesBank, which management plans to use for client appreciation and promotional purposes. Current period ATM/point of sale processing costs increased $53,000 due to an increase in transaction volume, deposit account growth and branch office and ATM expansion. Current period employee training expense increased $46,000 above 2005 due to management s commitment to service quality. Current period Pennsylvania shares tax (before state tax credits from charitable donations) increased $31,000 above 2005 due to normal business growth. The other expense category remained relatively stable for 2005 and 2004.

In the period ahead, it is probable that noninterest expense will increase as a result of planned franchise expansion, financial center renovations and regulatory compliance. Effective January 1, 2007, the Federal Deposit Insurance Corporation (FDIC) created a new risk framework of four risk categories and established assessment rates to coincide with each category. Assessment rates for Risk Category I institutions, which is likely to include PeoplesBank, will range from 5 to 7 basis points. The FDIC also approved a one-time assessment credit for banks in existence on December 31, 1996, that paid a deposit

insurance assessment prior to that date. Management believes that the one-time credit will more than offset the new FDIC assessment cost for 2007.

Income Taxes

The provision for income taxes was $1,845,000 for 2006, an increase of $293,000 or 19 percent above 2005 due to a 16 percent increase in pretax income. Comparatively, 2005 increased $199,000 or 15 percent above 2004 due to a 15 percent increase in pretax income. For 2006, the Corporation recognized $317,000 in tax benefits, principally tax credits, compared to $330,000 for 2005 and $260,000 for 2004 from investments in low-income housing partnerships. The increase in tax credits for 2005 compared to 2004 reflected a full year s impact of investment in a low-income housing development known as Village Court. In June 2004, the Corporation began to recognize pro-rated credits as rental units in this development were constructed and leased to qualified tenants. For all three years, the Corporation s marginal federal income tax rate was 34 percent, compared to an effective tax rate of 26 percent for 2006 and 25 percent for years 2005 and 2004.

BALANCE SHEET REVIEW

Federal funds sold

On December 31, 2006, federal funds sold, i.e., overnight investments, were $24 million, compared to $0 for year-end 2005. The increase in federal funds sold was caused primarily by an increase in liquidity from strong deposit growth throughout the current period as described within the Deposits section of this report.

Investment Securities

The investment securities portfolio is an interest earning asset, second in size to the loan portfolio. Investment securities serve as an important source of revenue and liquidity, and as collateral for public and trust deposits. The investment securities portfolio is managed to comply with the Corporation s Investment Securities Policy, and accounted for in accordance with Financial Accounting Standards Board Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities.

On December 31, 2006, the securities available-for-sale portfolio totaled $71.5 million, which reflected a $13 million or 23 percent increase from year-end 2005. The increase occurred primarily from the purchase of high quality, tax-exempt municipal bonds with maturities that range from 8 to 20 years. Decisions to purchase or sell securities are based on an assessment of current economic and financial conditions, including the interest rate environment, liquidity and income requirements. Securities available-for-sale are limited to high quality debt instruments as shown in Note 3 Securities Available-for-Sale and Held-to-Maturity. Note 3 shows that unrealized losses for this portfolio exceeded unrealized gains for year-end 2006 due to rising market interest rates. Table 6 Analysis of Investment Securities shows that the available-for-sale portfolio had a yield of 4.92 percent with an average maturity of 4.8 years on December 31, 2006, compared to 4.28 percent and 3.1 years, respectively, on December 31, 2005. The increase in yield reflected higher market interest rates and an investment focus on municipal bonds with relatively longer maturities and higher yields.

Securities classified as held-to-maturity, recorded at amortized cost, reflect management s intent and the Corporation s ability to hold these instruments to maturity. On December 31, 2006, securities held-to-maturity totaled $7.5 million, compared to $9.1 million for year-end 2005. The decrease in the portfolio balance was the result of two bonds being called by issuers exercising their call options. The held-to-

maturity portfolio for both years consisted of fixed rate, long-term preferred stock (trust preferreds) issued by commercial bank holding companies. These trust preferreds are junior subordinated debt, that pays interest semi-annually, are callable in 2007 and thereafter, and mature in years 2026-2028. Table 6 shows that the portfolio has a weighted average yield of 8.59 percent and a weighted average remaining maturity of 19 years as of December 31, 2006. Approximately $4.6 million, held by PeoplesBank, are rated investment grade by a national rating service. The remaining $2.9 million, held by the bank holding company, are either not rated or rated below investment grade, and limited to $500,000 per issuer. In the period ahead, it is probable that more high yielding trust preferred investments will be called by issuers based on the current level of market interest rates. If this occurs, the call will be at a premium; however, reinvestment yields are expected to be much lower.

Table 6-Analysis of Investment Securities (amortized cost basis)

	December 31, 2006 Maturity Distribution						
(dollars in thousands)	**One year or less**	**One through**	**Five through**	**After ten years**	**Total**	**Average maturity**	**Weighted average**

	December 31, 2006 Maturity Distribution						
		five years	ten years				yield(1)
Available-for-sale							
U.S. agencies(2)	$ 11,000	$ 32,007	$ 1,456	$	$ 44,463	2.1 years	4.14%
State and municipal	736	4,509	16,346	5,806	27,397	9.1 years	6.20%
Total	$ 11,736	$ 36,516	$ 17,802	$ 5,806	$ 71,860	4.8 years	4.92%
Percentage of total	16.33%	50.82%	24.77%	8.08%	100.00%		
Weighted average yield	3.54%	4.63%	6.00%	6.78%	4.92%		
Held-to-maturity							
Corporate trust preferreds	$ 524	$	$	$ 6,979	$ 7,503	18.9 years	8.59%
Percentage of total	6.98%	0.00%	0.00%	93.02%	100.00%		
Weighted average yield	11.65%	0.00%	0.00%	8.37%	8.59%		

(1) Yields were based on amortized cost basis. Additionally, yields on tax-exempt obligations were computed on a tax equivalent basis using a 34% tax rate.
(2) U.S. agency mortgage-backed securities are included in the maturity categories based on average expected life.

Loans

On December 31, 2006, total loans were $406 million, an increase of approximately $37 million or 10 percent above year-end 2005. Table 7 presents the composition of total loans on a comparative basis for five year-end periods. The table shows a clear trend of growth and corporate emphasis on commercial lending. At year-end 2006, commercial loans increased $28 million or 10 percent above year-end 2005, while consumer loans increased $9 million or 11 percent. During 2006, PeoplesBank s mortgage banking staff focused on originating and selling residential mortgages without retaining servicing rights. These loans are classified on the balance sheet as loans held for sale and reported at the lower of cost or fair value. On December 31, 2006, loans held for sale were $1.7 million, representing a slight increase above year-end 2005.

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Table 7-Loan Portfolio Composition

	December 31,									
(dollars in thousands)	**2006**	**%**	**2005**	**%**	**2004**	**%**	**2003**	**%**	**2002**	**%**
Commercial, industrial and agricultural	$ 218,673	53.9	$ 207,545	56.4	$ 189,658	63.5	$ 163,676	62.9	$ 161,425	69.0
Real estate construction and land development	91,414	22.5	74,478	20.2	35,395	11.9	28,147	10.8	20,596	8.8
Total commercial	310,087	76.4	282,023	76.6	225,053	75.4	191,823	73.7	182,021	77.8

	December 31,									
related loans										
Real estate residential mortgages	31,509	7.8	26,190	7.1	24,954	8.3	25,134	9.7	24,803	10.6
Installment	63,977	15.8	59,896	16.3	48,664	16.3	43,249	16.6	27,136	11.6
Total consumer related loans	95,486	23.6	86,086	23.4	73,618	24.6	68,383	26.3	51,939	22.2
Total loans	$ 405,573	100.0	$ 368,109	100.0	$ 298,671	100.0	$ 260,206	100.0	$ 233,960	100.0

Table 8 Selected Loan Maturities and Interest Rate Sensitivity shows that, at December 31, 2006, the commercial loan portfolio was comprised of $179 million or 58 percent in fixed rate loans and $131 million or 42 percent in floating or adjustable rate loans. Comparatively, the mix was 56/44 on December 31, 2005. The slight increase in the proportion of fixed rate commercial loans for 2006 was the result of rising market interest rates, as borrowers locked in their financing costs before further rate increases. Floating rate loans reprice periodically with changes in the Wall Street Journal (WSJ) prime rate and LIBOR. Adjustable rate loans reprice at annual intervals based on the US treasury yield curve. Additional loan information can be found in Note 4 Loans, and within the Risk Management section of this report.

Table 8-Selected Loan Maturities and Interest Rate Sensitivity

	December 31, 2006 Maturity Distribution			
(dollars in thousands)	**1 year or less**	**1-5 years**	**over 5 years**	**Total**
Commercial, industrial and agricultural	$ 38,093	$ 43,285	$ 137,295	$ 218,673
Real estate-construction and land development	55,748	27,948	7,718	91,414
Total commercial related loans	$ 93,841	$ 71,233	$ 145,013	$ 310,087
Fixed interest rates	$ 22,367	$ 33,770	$ 122,788	$ 178,925
Floating or adjustable interest rates	71,474	37,463	22,225	131,162
Total commercial related loans	$ 93,841	$ 71,233	$ 145,013	$ 310,087

Other Assets

Included in other assets are PeoplesBank s investments in real estate partnerships and life insurance. On December 31, 2006, the carrying value of investments in two unrelated real estate partnerships totaled $3.6 million, compared to $4.1 million at year-end 2005. The purpose of these partnerships is to provide low cost housing to qualified families. PeoplesBank s role in these real estate partnerships is solely as an investor, whose return is in the form of federal tax credits, which will be realized over a specified number of years. Also included in other assets is an investment in life insurance policies on a select group of employees and directors. This investment is carried at the cash surrender value of the underlying policies. The cash surrender value was approximately $7.9 million on December 31, 2006, compared to approximately $7.7 million on December 31, 2005. Additional information about

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investment in real estate partnerships and bank owned life insurance can be found in Note 1 under the appropriate subheadings.

Funding

Deposits

Deposits are the principal source of funding for earning assets. On December 31, 2006, total deposits were $457 million, an increase of $71 million or 19 percent above year-end 2005. The increase in deposits, which reflected the continuation of a long trend of successful sales efforts, occurred primarily within the money market and CD categories. The increase in money market deposits was primarily the result of a new money market product, which was priced competitively and heavily promoted. CD growth occurred primarily in variable rate CDs, which re-price weekly based on the one year US treasury bond rate. The trend of rising short-term market interest rates, since July 2004, was a factor in overall deposit growth and product selection by bank customers. The increase was also attributable in part to the addition of two financial centers in March of 2005. The average rate paid on interest bearing deposits was 3.42 percent for 2006, compared to 2.33 percent for 2005. A comparative breakdown of deposits is located in Note 8 Deposits. On December 31, 2006, the balance of certificates of deposit $100,000 and above was $56 million. Of this total, $10 million mature in three months, $9 million mature after three months but within six months, $24 million mature after six months but with twelve months, and the remaining $13 million mature beyond twelve months.

Short-term Borrowings and Long-term Debt

In order to meet short-term funding needs, PeoplesBank may borrow from larger correspondent banks in the form of federal funds purchased. It also can use credit available at the Federal Home Loan Bank of Pittsburgh (FHLBP). Interest rates are established daily based on prevailing market conditions for overnight funds. On December 31, 2006, PeoplesBank had no outstanding short-term borrowings, compared to $9.8 million on December 31, 2005. Overnight borrowings for year-end 2005 temporarily funded an increase in commercial loan volume.

Long-term debt is a primary funding source for asset growth. On December 31, 2006, long-term debt was $45.3 million, compared to $39.7 million for year-end 2005. During June 2006, Codorus Valley issued $7.2 million in trust preferred debt securities to provide capital to support planned corporate growth. This obligation has a 30-year maturity, but is callable at quarterly intervals after the fifth year. The interest rate is variable tied to the 3-month LIBOR rate plus 154 basis points. A listing of outstanding long-term debt obligations is provided in Note 9 Short-term Borrowings and Long-term Debt. Generally, funds for the payment of long-term debt come from operations and refinancings.

PeoplesBank s maximum borrowing capacity, as established quarterly by the FHLBP, was approximately $117 million as of September 30, 2006, the most recent available date. On December 31, 2006, PeoplesBank had approximately $33 million outstanding on its account with the FHLBP at an average rate of 4.49 percent.

Shareholders Equity and Capital Adequacy

Shareholders equity, or capital, is a source of funds enabling the Corporation to maintain asset growth and absorb losses. Capital adequacy can be negatively affected by a multitude of factors, including: corporate expansion, balance sheet growth, losses, dividend policy, and regulatory mandates, among others. Total shareholders equity was $42.8 million on December 31, 2006, compared to $38.7 million for year-end 2005. The increase in equity was primarily attributable to profitable operations.

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The Corporation typically pays cash dividends on a quarterly basis. The Board of Directors determines the dividend rate after considering the Corporation s capital requirements, current and projected net income, and other factors. Annual cash dividends per common share totaled $.49 for 2006 and $.45 for 2005. All per share amounts were adjusted for stock dividends.

Periodically, the Corporation distributes stock dividends as an additional means of enhancing long-term shareholder value. For 2006, the Corporation distributed a 5 percent stock dividend in June, followed by a special 5 percent stock dividend in December. Comparatively, the Corporation distributed a 5 percent stock dividend in June of 2005 and 2004. Distribution of these stock dividends resulted in the issuance of 324,038 additional common shares in 2006, 149,593 in 2005 and 141,672 in 2004. The weighted average number of shares of common stock outstanding, adjusted for stock dividends, was 3,489,229 for 2006, 3,475,192 for 2005, and 3,453,571 for 2004.

As disclosed in this report, the Corporation maintains various employee, director and shareholder benefit plans that could result in the issuance of its common stock. Information regarding these plans can be found in Note 11-Benefit Plans and Note 12-Stock-Based Compensation to the consolidated financial statements. On February 20, 2007, the Corporation filed a Form 8-K to disclose the adoption of the 2007 Long-Term Incentive Compensation Plan (LTIP). The LTIP is designed to provide stock-based awards to officers, directors and other key employees. Also in February 2007, the Corporation established the 2007 Employee Stock Purchase Plan to provide eligible employees with a convenient method of purchasing company stock at a discount. Both of these plans, which will be disclosed in the 2007 Proxy Statement, are subject to shareholder approval at the annual meeting of shareholders to be held May 15, 2007.

On October 14, 2004, the Corporation issued a press release, which was also filed on a Form 8-K, announcing that its Board of Directors authorized the purchase, in open market and privately negotiated transactions, of up to 4.9 percent or approximately 146,000 shares of its then outstanding common stock. As of December 31, 2006, the Corporation had not acquired any of its common stock under the authorization reported in October 2004.

The Corporation and PeoplesBank are subject to various regulatory capital requirements administered by banking regulators that involve quantitative guidelines and qualitative judgments. Quantitative measures established by regulators pertain to minimum capital ratios, as set forth in Table 9. Table 9 provides a comparison of the Corporation s and PeoplesBank s risk-based capital ratios and leverage ratios to the minimum regulatory requirement for the periods indicated. The Corporation issued $7.2 million in trust preferred debt securities in June 2006 and $3.1 million in November 2004, which are included in Tier 1 capital for regulatory capital purposes, to support business growth.

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Table 9-Capital Ratios

(dollars in thousands)	**Ratios at December 31, 2006**	**2005**	**Federal Minimum Required**	**Federal Well Capitalized**	**Capital * at December 31, 2006**	**2005**
Tier 1 risk-based capital			4.00%	6.00%		
(as a percentage of risk weighted assets)						
Codorus Valley Bancorp, Inc. (consolidated)	11.99%	10.61%			$ 52,587	$ 41,658
PeoplesBank	11.12	9.62			48,130	37,201
Total risk-based capital			8.00%	10.00%		
(as a percentage of risk weighted assets)						
Codorus Valley Bancorp, Inc. (consolidated)	12.71%	11.26%			$ 55,713	$ 44,196
PeoplesBank	11.84	10.28			51,256	39,739
Leverage			4.00%	5.00%		
(Tier 1 capital as a percentage of average total assets)						
Codorus Valley Bancorp, Inc. (consolidated)	9.83%	9.57%			$ 52,587	$ 41,658
PeoplesBank	9.09	8.66			48,130	37,201

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

Risk Management

The Corporation s Risk Management Committee (Committee) meets at least quarterly and includes members of senior management and an independent director. The objective of the Committee is to identify and manage risk inherent in the operations of the Corporation and its affiliates. The Committee s risk review is broad in scope and includes the following risks: credit, interest rate, liquidity, price, transaction, compliance, strategic and reputation. A primary responsibility of the Committee is to develop, implement and monitor compliance with formal risk management policies and procedures.

Credit Risk Management

The Corporation emphasizes the management of credit risk. To support this objective a sound lending policy framework has been established. This framework includes six basic policies that guide the lending process and minimize risk. First, the Corporation follows detailed written lending policies and procedures. Second, lending authority is granted commensurate with dollar amount, loan type, level of risk, and loan officer experience. Third, loan review committees function at both the senior lending officer level and the board level to review and approve loans that exceed preestablished dollar thresholds and/or meet other criteria. Fourth, the Corporation directly lends mainly within its primary geographical market area, York County, Pennsylvania and northern Maryland. Although this focus may pose a geographical concentration risk, the diverse local economy and employee knowledge of customers minimizes this risk. Fifth, the loan portfolio is diversified to prevent dependency upon a single customer or small group of related customers. And sixth, the Corporation does not lend to foreign countries or persons residing therein.

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

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One component of the internal credit risk review is the identification and management of industry concentrations, defined as greater than 10 percent of the total loan portfolio. At year-end 2006, the Corporation had one industry concentration that exceeded 10 percent of the total loan portfolio, real estate construction and land development, which was 22.5 percent of the portfolio. Comparatively, at year-end 2005, real estate construction and land development was 20.2 percent of the portfolio, and commercial real estate leasing was 11.0 percent of the portfolio. Commercial leasing pertains to borrowers who lease real estate for business purposes. Loans to borrowers within these industries are usually collateralized by real estate.

Nonperforming Assets

Table 10 Nonperforming Assets, presents asset categories posing the greatest risk of loss. Management generally places a loan on nonaccrual status and ceases accruing interest income 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, are contractually past due, but well collateralized and in the process of collection. The final category, foreclosed real estate, is real estate acquired to satisfy debts owed to PeoplesBank. Table 10 also provides a summary of nonperforming assets and related ratios. The paragraphs below explain significant changes in the aforementioned categories for December 31, 2006, compared to December 31, 2005.

Table 10-Nonperforming Assets

			December 31,		
(dollars in thousands)	**2006**	**2005**	**2004**	**2003**	**2002**
Nonaccrual loans	$ 4,368	$ 1,034	$ 622	$ 516	$ 5,051
Accruing loans that are contractually past due 90 days or more as to principal or interest	4		19	49	453
Foreclosed real estate, net of allowance	38	7	1,535	1,326	465
Total nonperforming assets	$ 4,410	$ 1,041	$ 2,176	$ 1,891	$ 5,969
Ratios					
Nonaccrual loans as a % of total year-end loans	1.08%	0.28%	0.21%	0.20%	2.16%
Nonperforming assets as a % of total year-end loans and net foreclosed real estate	1.09%	0.28%	0.72%	0.72%	2.55%
Nonperforming assets as a % of total year-end stockholders equity	10.31%	2.69%	6.05%	5.60%	18.52%

	December 31,				
Allowance for loan losses as a multiple of nonaccrual loans	.7x	2.5x	3.0x	3.3x	.3x

On December 31, 2006, nonaccrual loans consisted of collateralized business and mortgage loans, and consumer loans. The Corporation recognizes interest income on a cash basis for nonaccrual loans. On December 31, 2006, the nonaccrual loan portfolio was $4,368,000, compared to $1,034,000 on December 31, 2005. The $3,334,000 increase was attributable to the addition of two unrelated business loans with outstanding principal balances at year-end 2006 of $2,624,000 and $530,000, respectively. In management s judgment, the $2,624,000 loan, which has matured, is adequately secured both by collateral (based on a recent independent appraisal), and personal guarantees, which should ensure the

ultimate recovery of interest and principal in full. The net realizable value of the collateral for the $530,000 loan was deemed insufficient. Accordingly, management has established a $90,000 loss allowance for this account. On December 31, 2006, nonaccrual loans were comprised of 19 unrelated accounts ranging in size from $1,000 to $2,624,000. Management and the Board of Directors evaluate the adequacy of the allowance for loan losses at least quarterly. 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.

Foreclosed real estate, net of allowance, was $38,000 on December 31, 2006, compared to $7,000 on December 31, 2005. The increase was attributable to the acquisition of a property in satisfaction of a delinquent mortgage loan. In January 2007, this property was sold resulting in a principal loss of approximately $1,800. The provision expense for foreclosed real estate, due to declines in the fair value of individual assets, was $0 for 2006, compared to $17,000 for 2005 and $19,000 for 2004.

On December 31, 2006, there were approximately $1.9 million in potential problem loans closely monitored by management. Potential problem loans consist of loans for which management has doubts as to the ability of the borrower to comply with present repayment terms, and which were not disclosed in Table 10. A loss allowance is established for those potential problem loans that in management s judgment were inadequately collateralized. Comparatively, management was monitoring approximately $10 million in potential problem loans on December 31, 2005.

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 at December 31, 2006. 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. In analyzing the adequacy of the allowance, management considers the results of internal and external credit reviews, past loss experience, changes in the size and composition of the loan portfolio, adequacy of collateral, general economic conditions and the local business outlook. All of these factors are susceptible to significant change. Determining the level of the allowance for probable loan losses at any given period is difficult, particularly during deteriorating or uncertain economic periods. Management must make estimates using assumptions and information which are often subjective and fluid. Table 11 presents an analysis of the activity in the allowance for loan losses over a five-year period. Table 12 presents an allocation of the allowance for loan losses by major loan category. The unallocated component of the allowance for loan losses represents probable losses inherent in the portfolio that are not fully captured in the allocated allowance analyses, such as: industry concentrations, imprecision in the loan risk evaluation process and current economic factors.

The allowance was $3,126,000 or .77 percent of total loans on December 31, 2006, compared to $2,538,000 and .69 percent, respectively, on December 31, 2005. The $588,000 or 23 percent increase in the allowance was based on management s estimate to bring the allowance to a level reflective of risk in the portfolio, loan growth, and macro-economic factors such as the heightened level of energy costs and interest rates, and a downturn in the real estate market. These factors contributed to an increase in the unallocated component in 2006 as noted in Table 12. Based on a recent evaluation of probable loan losses in the current portfolio, management believes that the allowance is adequate to support losses inherent in the loan portfolio on December 31, 2006.

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Table 11-Analysis of Allowance for Loan Losses

(dollars in thousands)	2006	2005	2004	2003	2002
Balance beginning of year	$ 2,538	$ 1,865	$ 1,694	$ 1,515	$ 1,898
Provision charged to operating expense	650	775	420	553	515
Loans charged off					
Commercial	104	34	336	684	1,100
Real estate-mortgage	27	99	30		7
Consumer	19	80	111	86	78
Total loans charged off	150	213	477	770	1,185
Recoveries					
Commercial	58	74	216	370	274
Real estate-mortgage	3	2	1		
Consumer	27	35	11	26	13
Total recoveries	88	111	228	396	287
Net charge-offs	62	102	249	374	898
Balance end of year	$ 3,126	$ 2,538	$ 1,865	$ 1,694	$ 1,515
Ratios					
Net charge-offs as a % of average total loans	0.02%	0.03%	0.09%	0.15%	0.39%
Allowance for loan losses as a % of total loans	0.77%	0.69%	0.62%	0.65%	0.65%
Allowance for loan losses as a % of nonaccrual loans and loans past due 90 days or more	71%	245%	291%	300%	28%

Table 12-Allocation of Allowance for Loan Losses

	December 31,									
	2006		2005		2004		2003		2002	
(dollars in thousands)	Amount	% Total Loans	Amount	% Total Loans	Amount	% Total Loans	Amount	% Total Loans	Amount	% Total Loans
Commercial, industrial and agricultural	$ 1,500	53.9	$ 1,339	56.4	$ 1,216	63.5	$ 1,105	62.9	$ 906	69.0
Real estate construction and land development	549	22.5	439	20.2	213	11.9	80	10.8	61	8.8
Total commercial related	2,049	76.4	1,778	76.6	1,429	75.4	1,185	73.7	967	77.8
Real estate residential mortgages	22	7.8	19	7.1	13	8.3	15	9.7	16	10.6
Installment	122	15.8	141	16.3	116	16.3	115	16.6	70	11.6
Total consumer related	144	23.6	160	23.4	129	24.6	130	26.3	86	22.2
Unallocated	933	n/a	600	n/a	307	n/a	379	n/a	462	n/a

	December 31,									
Total	$ 3,126	100.0	$ 2,538	100.0	$ 1,865	100.0	$ 1,694	100.0	$ 1,515	100.0

Note: The specific allocation for any particular loan category may be reallocated in the future as risk perceptions change. Furthermore, the portion allocated to each loan category is not the total amount available for future losses that might occur within such categories since the total allowance is a general allowance applicable to the entire loan portfolio.

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Liquidity

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. Retained earnings from profitable operations are another source of liquidity. The Consolidated Statements of Cash Flows present the changes in cash from operating, investing and financing activities. For 2006, management believes that liquidity was more than adequate based on the level of overnight investment, the potential liquidation of a $71 million portfolio of available-for-sale securities, valued at December 31, 2006, and available credit from the Federal Home Loan Bank of Pittsburgh. On September 30, 2006, the latest available date, available funding from the FHLBP was approximately $84 million. The Corporation s loan-to-deposit ratio was 89 percent for year-end 2006, compared to 96 percent for year-end 2005. The decrease in this ratio was the result of strong deposit growth. Management believes that the addition of two financial centers in March of 2005 will continue to provide liquidity in the form of new deposits.

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 mainly of unfunded loans and letters of credit made under the same standards as on-balance sheet instruments. Financial instruments with off-balance sheet risk are disclosed in Note 14-Commitments to Extend Credit of this report and totaled $122 million at December 31, 2006, compared to $120 million at December 31, 2005. 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 and therefore, generally do not present significant liquidity risk to the Corporation or PeoplesBank.

Contractual Obligations

Table 13 Contractual Obligations, presents the amount and timing of payments due under long-term contractual obligations.

Table 13-Contractual Obligations

		December 31, 2006 Payments due by period			
(dollars in thousands)	**Total**	**Less than 1 year**	**1-3 years**	**3-5 years**	**More than 5 years**
Long-term debt	$ 44,777	$ 8,162	$ 7,478	$ 12,839	$ 16,298
Capital lease	890	95	190	197	408
Operating leases	927	157	319	226	225
Time deposits	201,766	142,721	43,292	15,753	
Total	$ 248,360	$ 151,135	$ 51,279	$ 29,015	$ 16,931

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Impact of Inflation and Changing Prices

The majority of assets and liabilities of a financial institution are monetary in nature and therefore differ greatly from most commercial and industrial companies that have significant investments in fixed assets or inventories. However, inflation may impact the growth of total assets in the banking industry and the resulting need to increase equity capital at higher than normal rates in order to maintain an appropriate equity-to-assets ratio. Inflation may also significantly affect noninterest expenses, which tend to rise during periods of general inflation. The level of inflation can be measured by the change in the Consumer Price Index (CPI) for all urban consumers (December vs. December). The change in the CPI for 2006 was 2.5 percent, compared to 3.4 percent for 2005 and 3.3 percent for 2004.

Management believes that the most significant impact on financial results is the Corporation s ability to react to changes in market interest rates. As discussed below in the Market Risk Management section, management strives to structure the balance sheet to increase net interest income by managing interest rate sensitive assets and liabilities to reprice in response to changes in market interest rates. Additionally, management is focused on increasing fee income, an income component that is less sensitive to changes in market interest rates.

Item 7A: Quantitative and qualitative disclosures about market risk

Market Risk Management

In the normal course of conducting business, the Corporation is exposed to market risk, principally interest rate risk, through the operations of its banking subsidiary, PeoplesBank. Interest rate risk arises from market driven fluctuations in interest rates that may affect cash flows, income, expense and the values of financial instruments. PeoplesBank is particularly vulnerable to changes in short-term interest rates such as the prime rate and LIBOR. An Asset-Liability Committee (Committee) comprised of members of senior management manages interest rate risk. The Committee s objective is to maximize net interest income within acceptable levels of liquidity and interest rate risk and within capital adequacy constraints. PeoplesBank is not subject to foreign currency or commodity price risk and it does not own any trading assets.

The Committee manages interest rate risk primarily through sensitivity analysis. Asset-liability management simulation software (ALM model) is used to model and measure the potential loss in future net income based on hypothetical changes in interest rates. Interest rate forecasts are supplied by a national forecasting service and integrated with the ALM model. The Corporation s policy limit for the maximum negative impact on net income is 10 percent over a twelve-month period. This policy limit is tested on a quarterly basis by measuring the change in net income from a baseline scenario where interest rates are held constant, to a high rate scenario (gradual 200 basis point increase in prime and fed funds rates), a low rate scenario (gradual 200 basis point decrease in prime and fed funds rates) and a most likely scenario (defined by a forecasting service) over the future twelve-month period. Important ALM modeling assumptions include: the use of a static balance sheet and contractual cash flows; varying levels of prepayments for loans and mortgage-backed securities; stability of noninterest income and expense; reinvestment of repriceable cash flows in the same type of asset or liability; and constant product rate spreads, determined at the balance sheet date, over the twelve-month measurement period. The ALM model also includes significant balance sheet characteristics such as rate caps and floors. For year-end 2006, management presumed that in all scenarios trust preferred investment securities, which are callable at a premium, would be called by the issuers due to the relatively high coupon rate and would result in a one time increase in interest income.

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The Corporation performed a financial simulation on the balance sheet for December 31, 2006 and 2005. The results of these point-in-time analyses are shown in Table 14. For year-end 2006, the ALM model portrayed a balance sheet that was liability sensitive. Liability sensitivity means that deposits and debt are likely to re-price to a greater and faster degree than the loans and investments that they fund. This suggests that net income may increase if market interest rates, particularly short-term rates, decrease. Conversely, net income would be expected to decrease if market interest rates increase. From June 2004 through June 2006, short-term market interest rates have systematically increased in response to economic tightening by the Federal Reserve, while long-term interest rates remained relatively stable, or in some cases declined slightly. During the flat (slightly inverted) US treasury yield curve environment that prevailed in 2006 many loan clients showed a preference for fixed rate loans to lock in rates, while deposit clients preferred variable or floating rate deposit products with short maturities. The result was a gradual shift in the balance sheet to a liability sensitive position for year-end 2006, compared to a more neutral interest rate risk position for year-end 2005.

Table 14-Interest Rate Sensitivity

Forecasted interest rate scenario	Change in interest rates ramped over 12 months (basis points)	Change in net income $000 s	%
	at December 31, 2006		
Most likely	-75	(91)	(1.5)
High	+200	(300)	(5.0)
Flat (baseline)	0	0	0.0
Low	-200	78	1.3
	at December 31, 2005		
Most likely	+50	(1)	0.0
High	+200	2	0.0
Flat (baseline)	0	0	0.0
Low	-200	39	0.7

Measurement of interest rate risk requires many assumptions. These assumptions are inherently uncertain and, as a result, the model cannot precisely estimate net interest income or precisely predict the impact of higher or lower rates on net income. Actual results may differ from simulated results due to many factors including: timing of cash flows, magnitude and frequency of interest rate changes, customer behavior, changes in market conditions, and management strategies.

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Item 8: Financial statements and supplementary data

Codorus Valley Bancorp, Inc.
Consolidated Balance Sheets

(dollars in thousands, except per share data)	**December 31,** 2006	2005
Assets		
Interest bearing deposits with banks	$ 118	$ 126
Cash and due from banks	11,104	11,959
Federal funds sold	24,150	
Total cash and cash equivalents	35,372	12,085
Securities, available-for-sale	71,491	58,111
Securities, held-to-maturity (fair value $7,840 for 2006 and $9,686 for 2005)	7,503	9,101
Restricted investment in bank stocks, at cost	1,932	2,452
Loans held for sale	1,687	1,522
Loans (net of deferred fees of $534 in 2006 and $537 in 2005)	405,573	368,109
Less-allowance for loan losses	(3,126)	(2,538)
Net loans	402,447	365,571
Premises and equipment, net	10,495	10,962

	December 31,	
Other assets	17,285	16,248
Total assets	$ 548,212	$ 476,052
Liabilities		
Deposits		
Noninterest bearing	$ 49,190	$ 49,369
Interest bearing	407,455	335,785
Total deposits	456,645	385,154
Short-term borrowings		9,781
Long-term debt	35,029	36,619
Junior subordinated debentures	10,310	3,093
Other liabilities	3,442	2,676
Total liabilities	505,426	437,323
Shareholders equity		
Preferred stock, par value $2.50 per share; 1,000,000 shares authorized; 0 shares issued and outstanding		
Common stock, par value $2.50 per share; 10,000,000 shares authorized; 3,502,919 shares issued and outstanding for 2006 and 3,160,821 for 2005	8,757	7,902
Additional paid-in capital	28,839	23,035
Retained earnings	5,434	8,204
Accumulated other comprehensive loss	(244)	(412)
Total shareholders equity	42,786	38,729
Total liabilities and shareholders equity	$ 548,212	$ 476,052

See accompanying notes.

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Codorus Valley Bancorp, Inc.
Consolidated Statements of Income

	Years ended December 31,		
(dollars in thousands, except per share data)	**2006**	**2005**	**2004**
Interest income			
Loans, including fees	$ 29,361	$ 22,462	$ 17,590
Investment securities			
Taxable	2,563	2,461	2,377
Tax-exempt	729	445	421
Dividends	136	69	35
Other	530	135	46
Total interest income	33,319	25,572	20,469

	Years ended December 31,		
Interest expense			
Deposits	12,766	7,255	5,308
Federal funds purchased and other short-term borrowings	133	73	31
Long-term debt	2,178	1,821	1,206
Total interest expense	15,077	9,149	6,545
Net interest income	18,242	16,423	13,924
Provision for loan losses	650	775	420
Net interest income after provision for loan losses	17,592	15,648	13,504
Noninterest income			
Trust and investment services fees	1,255	1,147	1,076
Service charges on deposit accounts	1,870	1,	