

CODORUS VALLEY BANCORP INC  
Form 10-K  
March 25, 2008  
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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**FORM 10-K**

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(Mark One)

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

For the fiscal year ended December 31, 2007

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission file Number 0-15536

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**CODORUS VALLEY BANCORP, INC.**

(Exact name of registrant as specified in its charter)

**Pennsylvania**  
(State or other jurisdiction of  
incorporation or organization)

**23-2428543**  
(I.R.S. Employer  
Identification No.)

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

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

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

Title of each class  
**Common Stock, \$2.50 par value**

Name of each exchange on which registered  
**NASDAQ Stock Market LLC**

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

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Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15 (d) of the Act.

Yes  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.  Yes  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.

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company as defined in Rule 12b-2 of the Exchange Act.

Yes  No

The aggregate market value of Codorus Valley Bancorp, Inc.'s voting stock held by non-affiliates was approximately \$63,775,357 as of June 30, 2007.

As of February 26, 2008, Codorus Valley Bancorp, Inc. had 3,742,209 shares of common stock outstanding, par value \$2.50 per share.

## DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates certain information by reference to the registrant's Proxy Statement for the Annual Meeting of Shareholders to be held May 20, 2008

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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, 2007, Codorus Valley had total consolidated assets of \$595 million, total deposits and other liabilities of \$546 million, and total shareholders' equity of \$49 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 operated a loan production office in Towson, Maryland, which it closed in late 2007 due to the opening of the Hunt Valley Office in January 2008. The Hunt Valley Office, the Corporation's fifteenth financial center, is located in the Executive Plaza complex, Hunt Valley, Maryland. The Federal Deposit Insurance Corporation insures the deposits of PeoplesBank to the maximum extent provided by law. On December 31, 2007, PeoplesBank had total loans of \$447 million and total deposits of \$513 million. PeoplesBank's market share of deposits for York County, PA was approximately 8.3 percent as of June 30, 2007, 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, the loss of a single customer, or a small customer group, would not have a material adverse effect on the financial condition of PeoplesBank. At year-end 2007, the largest indebtedness of a single PeoplesBank client was \$6,962,000, or 1.6 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 limited market area 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 2007, the Corporation had two industry concentrations that exceeded 10 percent of the total loan portfolio, real estate

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construction and land development was 18.8 percent and commercial real estate leasing was 11.5 percent. Commercial leasing involves borrowers who lease real estate to commercial tenants. Loans to borrowers within these industries are usually collateralized with real estate. Comparatively, at year-end 2006, only one industry concentration exceeded 10 percent of the total loan portfolio, real estate construction and land development, which was 22.5 percent of the portfolio.

Codorus Valley Financial Advisors, Inc. is a wholly owned subsidiary of PeoplesBank that sells non-deposit investment products. This subsidiary began operations in January 2000 and, prior to a name change in December 2005, operated under the name SYC Insurance Services, Inc. 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.

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

#### **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 2007, PeoplesBank employed 159 full-time employees and 45 part-time employees, which equated to 179 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

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Reserve. The Pennsylvania Department of Banking must also approve certain similar transactions. Pennsylvania law permits Pennsylvania bank holding companies to control an unlimited number of banks.

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

The 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. 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 includes PeoplesBank, 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. The one-time credit offset the new FDIC assessment cost for 2007; however, the credit will be depleted in the first quarter of 2008. Accordingly, PeoplesBank will recognize the assessment at that time. Management's estimate of the FDIC assessment expense, net of the remaining credit, for 2008 is approximately \$239,000.

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 2007 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 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

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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 requirements that affect Codorus Valley and/or PeoplesBank follows.

**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, corporate governance practices, such as the relationship between a board of directors and management and between a board of directors and its committees.

Section 404 of the SOA became effective for the year ended December 31, 2004, for companies whose public float (the product of outstanding shares times the share price on a specified date) was above \$75 million. For smaller companies (nonaccelerated filers), including Codorus Valley, the effective date, after several postponements, was the fiscal year ending on or after December 15, 2007. Section 404 requires publicly held companies to document, test and certify that their internal control systems over financial reporting are effective. In January 2008, the SEC proposed delaying for another year the requirement that nonaccelerated filers provide an auditor's report on their internal control over financial reporting. Compliance costs associated with Section 404 are expected to continue 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

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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](http://www.peoplesbanknet.com) (select Investor Relations, then select SEC filings), or the SEC's website at [www.sec.gov/edgarhp.htm](http://www.sec.gov/edgarhp.htm). Copies can also be obtained without charge by writing to: Treasurer, Codorus Valley Bancorp, Inc., P.O. Box 2887, York, PA 17405-2887.

### **Item 1A: Risk Factors**

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An investment in the Corporation's common stock is subject to risks inherent to the Corporation's business. The most material risks and uncertainties that management believes affect the Corporation are described below. Investors in the Corporation's stock should 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 these events were to occur, the value of the Corporation's common stock could decline significantly, and investors in the Corporation's stock could lose all or part of their 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. Interest rate risk is discussed under Item 7A-Quantitative and qualitative disclosures about market risk.

*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 our 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 our loans. Credit risk is discussed under the Credit Risk Management and Nonperforming Assets sections of this report.

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*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 the 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 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. 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,

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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 a \$1.7 million lien held by its wholly owned subsidiary, PeoplesBank.

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.



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**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.

**Hunt Valley Office** Located at 11350 McCormick Road, Executive Plaza I, Suite 101, Hunt Valley, MD. The 2,455 square foot office space is located in the Executive Plaza complex in Hunt Valley. The lease, effective January 1, 2008, is for a five-year term with a five year renewal option.

**Towson Loan Production Office**-Located at 40 West Chesapeake Avenue, Towson, MD. This 266 square foot office space is located on the 6<sup>th</sup> 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. This lease was terminated at the end of 2007 due to the opening of the Hunt Valley Office described above.

All of the above properties are located in York County, Pennsylvania, with the exception of the Hunt Valley Office and the Towson LPO, which are located in 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 2007.

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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 924 registered shareholders of record as of March 3, 2008. 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.

| Quarter | 2007 |     | 2006 |     |
|---------|------|-----|------|-----|
|         | High | Low | High | Low |

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|        |    |       | Dividends<br>per share |       |    |       | Dividends<br>per share |       |    |       |    |       |
|--------|----|-------|------------------------|-------|----|-------|------------------------|-------|----|-------|----|-------|
| First  | \$ | 19.50 | \$                     | 18.12 | \$ | 0.129 | \$                     | 18.57 | \$ | 16.43 | \$ | 0.112 |
| Second |    | 19.95 |                        | 17.33 |    | 0.129 |                        | 18.59 |    | 16.77 |    | 0.112 |
| Third  |    | 19.49 |                        | 16.50 |    | 0.135 |                        | 18.14 |    | 17.01 |    | 0.118 |
| Fourth |    | 19.00 |                        | 15.00 |    | 0.190 |                        | 20.24 |    | 17.50 |    | 0.122 |

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.

In December 2007, the Board of Directors reaffirmed the Share Repurchase Program (Program), which was authorized in 1995 and extended thereafter to permit the purchase of up to a maximum of 4.9 percent of the outstanding shares of the Corporation's common stock at a price per share no greater than 200 percent of the latest quarterly published book value. For years ended December 31, 2007 and 2006, the Corporation had not acquired any of its common stock under the current Program.

### Securities Authorized for Issuance under Equity Compensation Plans

The following table provides information about options outstanding and securities available for future issuance under the Corporation's 1996 Stock Incentive Plan, 1998 Independent Directors Stock Option Plan, 2000 Stock Incentive Plan, 2001 Employee Stock Bonus Plan, 2007 Long Term Incentive Plan and 2007 Employee Stock Purchase Plan.

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| Plan Category  | Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted-average exercise price of outstanding options, warrants and rights | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in the first column) |
|--|---|---|---|
| Equity compensation plans approved by security holders     | 223,017   | \$ 13.09  | 388,932(1)  |
| Equity compensation plans not approved by security holders |   |   | 13,689(2)   |
| <b>Total</b>   | <b>223,017</b>  | <b>\$ 13.09</b>   | <b>402,621</b>  |

- (1) Includes 175,000 shares available for issuance under the 2007 Employee Stock Purchase Plan.
- (2) Shares available for issuance under the 2001 Employee Stock Bonus Plan. The plan provides for issuance of shares of common stock to employees as performance-based compensation.

### 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, 2003, and ending December 31, 2007. The graph shows the cumulative investment return to shareholders based on the assumption that a \$100 investment was made on December 31, 2002 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.

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The following graph and other information furnished under this Part II Item 5 (d) of this Form 10-K shall not be deemed to be soliciting material or be filed with the Commission or subject to Regulation 14A or 14C, or the liabilities of Section 18 of the Exchange Act of 1934, as amended.

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#### Fiscal Year Ending

| Company/Index/Market         | 12/31/02 | 12/31/03 | 12/31/04 | 12/31/05 | 12/31/06 | 12/31/07 |
|------------------------------|----------|----------|----------|----------|----------|----------|
| Codorus Valley Bancorp, Inc. | 100.00   | 148.43   | 147.35   | 160.06   | 190.12   | 173.02   |
| SNL Mid-Atlantic Bank Index  | 100.00   | 142.18   | 150.59   | 153.26   | 183.94   | 139.10   |
| NASDAQ Composite Index       | 100.00   | 150.36   | 163.00   | 166.58   | 183.68   | 201.91   |

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#### Item 6: Selected financial data

|   | 2007      | 2006      | 2005      | 2004      | 2003      |
|---|-----------|-----------|-----------|-----------|-----------|
| <b>Summary of operations (in thousands)</b> |           |           |           |           |           |
| Interest income                             | \$ 39,169 | \$ 33,319 | \$ 25,572 | \$ 20,469 | \$ 19,964 |
| Interest expense                            | 18,489    | 15,077    | 9,149     | 6,545     | 6,898     |
| Net interest income                         | 20,680    | 18,242    | 16,423    | 13,924    | 13,066    |
| Provision for (recovery of) loan losses     | (554)     | 650       | 775       | 420       | 553       |
| Noninterest income                          | 5,688     | 5,465     | 5,003     | 4,626     | 4,380     |
| Noninterest expense                         | 18,368    | 15,890    | 14,482    | 12,769    | 12,290    |
| Income before income taxes                  | 8,554     | 7,167     | 6,169     | 5,361     | 4,603     |
| Provision for income taxes                  | 2,180     | 1,845     | 1,552     | 1,353     | 1,171     |
| Net income                                  | \$ 6,374  | \$ 5,322  | \$ 4,617  | \$ 4,008  | \$ 3,432  |

#### **Per common share**

*(adjusted for stock dividends)*

|   |           |           |           |           |           |
|---|-----------|-----------|-----------|-----------|-----------|
| Net income, basic                           | \$ 1.72   | \$ 1.45   | \$ 1.27   | \$ 1.11   | \$ 0.95   |
| Net income, diluted                         | \$ 1.69   | \$ 1.42   | \$ 1.24   | \$ 1.08   | \$ 0.94   |
| Cash dividends paid                         | \$ 0.58   | \$ 0.46   | \$ 0.43   | \$ 0.40   | \$ 0.37   |
| Stock dividends distributed                 | 5%        | 10%*      | 5%        | 5%        | 5%        |
| Book value                                  | \$ 12.95  | \$ 11.63  | \$ 10.58  | \$ 9.89   | \$ 9.33   |
| Cash dividend payout ratio                  | 33.8%     | 32.0%     | 33.6%     | 36.3%     | 38.7%     |
| Weighted average shares outstanding         | 3,696,667 | 3,663,692 | 3,648,951 | 3,626,250 | 3,616,015 |
| Weighted average diluted shares outstanding | 3,777,122 | 3,749,572 | 3,721,702 | 3,701,562 | 3,657,217 |

\* includes a special 5% stock dividend

#### **Profitability ratios**

|  |       |       |       |       |       |
|--|-------|-------|-------|-------|-------|
| Return on average shareholders' equity (ROE) | 13.9% | 13.0% | 12.3% | 11.5% | 10.3% |
|--|-------|-------|-------|-------|-------|

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|                                |       |       |       |       |       |
|--------------------------------|-------|-------|-------|-------|-------|
| Return on average assets (ROA) | 1.11% | 1.05% | 1.06% | 1.03% | 0.96% |
| Net interest margin            | 3.97% | 3.97% | 4.16% | 4.01% | 4.13% |
| Efficiency ratio               | 67.4% | 65.1% | 66.1% | 67.6% | 69.9% |

### Capital ratios

|   |       |       |       |       |       |
|---|-------|-------|-------|-------|-------|
| Tier 1 risk-based capital                     | 12.1% | 12.0% | 10.6% | 11.8% | 11.1% |
| Total risk-based capital                      | 12.9% | 12.7% | 11.3% | 12.3% | 11.7% |
| Average shareholders equity to average assets | 8.0%  | 8.1%  | 8.6%  | 9.0%  | 9.3%  |

### Summary of financial condition at year-end (in thousands)

|                       |           |           |           |           |           |
|-----------------------|-----------|-----------|-----------|-----------|-----------|
| Investment securities | \$ 84,369 | \$ 80,926 | \$ 69,664 | \$ 74,140 | \$ 74,069 |
| Loans                 | 447,497   | 407,260   | 369,631   | 300,260   | 262,363   |
| Assets                | 594,607   | 548,212   | 476,052   | 407,671   | 372,547   |
| Deposits              | 511,968   | 456,645   | 385,154   | 329,537   | 304,282   |
| Borrowings            | 30,660    | 45,339    | 49,493    | 39,493    | 31,234    |
| Equity                | 48,415    | 42,786    | 38,729    | 35,982    | 33,789    |

### Other data

|   |            |            |            |            |            |
|---|------------|------------|------------|------------|------------|
| Number of bank offices                                | 14         | 14         | 14         | 12         | 11         |
| Number of employees (full-time equivalents)           | 179        | 168        | 163        | 146        | 143        |
| Wealth Management assets, market value (in thousands) | \$ 320,655 | \$ 259,453 | \$ 213,735 | \$ 180,314 | \$ 137,186 |

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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

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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 21 and 32 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 12. Based on stock options outstanding on December 31, 2007, approximately \$43,000 will be expensed over the weighted average period of 1.3 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 2007, management and the Board of Directors continued to implement a series of initiatives, as guided by the Corporation's long-range strategic plan. Selected accomplishments for 2007 included: creation of the Maryland Banking Group, which involved planning, staffing and site preparation for PeoplesBank's newest financial center that opened in January 2008 in Hunt Valley, MD; restructuring the wealth management division of PeoplesBank to increase sales productivity and operating efficiency; implementing remote deposit capture, which allows business clients to deposit checks directly from their offices; and successfully introducing a new deposit product called the Hometown Spirit CD (or IRA), which results in charitable donations by PeoplesBank to local nonprofit organizations when customers open an account.

Our financial performance was sound in 2007, as described in the Financial Highlights section below, even after removing the impact of favorable non-recurring transactions. Asset quality deteriorated as evidenced by a 2.25 percent nonperforming asset ratio (NPA ratio) at year-end 2007, compared to a 1.09 percent ratio at year-end 2006. Management believes that the two delinquent business loan accounts that elevated the NPA ratio at year-end 2007 are well collateralized by real estate and that all amounts due from these borrowers will ultimately be collected. The Corporation has no loss exposure to subprime lending or investments collateralized by subprime mortgage collateral because it does not participate in the subprime lending market, nor does it invest in securities backed by subprime mortgages.

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 an expected economic slowdown, a possible recession, continued downturn in the real estate markets, and competitive pricing pressures.

#### **Financial Highlights**

The Corporation earned \$6,374,000 or \$1.72 per share (\$1.69 diluted) for 2007, compared to \$5,322,000 or \$1.45 per share (\$1.42 diluted) for 2006, and \$4,617,000 or \$1.27 per share (\$1.24 diluted) for 2005. The \$1,052,000 or 20 percent increase in earnings for 2007 was primarily attributable to a \$2,438,000 or 13 percent increase in net interest income and a \$1,204,000 decrease in loan loss provision, which more than offset a \$2,478,000 or 16 percent increase in noninterest expense. The increase in net interest

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income reflected an increase in interest income from a larger volume of earning assets, principally business and home equity loans, and investment securities. The \$720,000 or 57 percent increase in business loan fees for 2007 also positively contributed. Approximately \$612,000 (\$403,000 after-tax) of the increase in fees from selected business loan accounts, including a recovery of fees from a large delinquent account, was unusually large as to amount. The net interest margin (tax equivalent basis), which was favorably impacted by the increase in loan fees, was 3.97 percent for 2007, the same as 2006. The significant decrease in the loan loss provision reflected the favorable impact of an \$839,000 (\$554,000 after-tax) recovery of loan losses that were incurred by PeoplesBank during 2002-2003. Due to the adequacy of the allowance for loan losses at the time of the recovery, the full amount of the recovery was recorded as a reduction to the loan loss provision. The increase in noninterest expense was due in part to increased personnel costs, including staff additions associated with planned business growth, and increases in performance based compensation and benefits costs. The recognition of a \$437,000 (\$288,000 after-tax) prepayment penalty on the early pay off of a \$5 million Federal Home Loan Bank advance also contributed to the increase in noninterest expense. The advance was due July 2014 and had an above market interest rate of 6.43 percent. The Corporation paid off the advance to reduce interest expense in future periods. At year-end 2007, total assets were \$595 million, an increase of approximately \$46 million, or 8 percent, above year-end 2006.

Comparatively, net income for 2006 increased \$705,000 or 15 percent above 2005, the result of increases in net interest income and noninterest income, which more than offset an increase in noninterest expense. The \$1,819,000 or 11 percent increase in net interest income was primarily the result of an increase in the volume of earning assets, principally business loans. 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. At 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.

Annual cash dividends per share, as adjusted, totaled \$.58 for 2007, compared to \$.46 for 2006. A five percent stock dividend was distributed in 2007. Comparatively, two five percent stock dividends, which included a special five percent stock dividend, were distributed in 2006. Book value per share, as adjusted, was \$12.95 for year-end 2007, compared to \$11.63 for year-end 2006.

Net income as a percentage of average total assets (return on assets or ROA), was 1.11 percent for 2007, compared to 1.05 percent for 2006. Net income as a percentage of average shareholders' equity (return on equity or ROE), was 13.91 percent for 2007, compared to 12.99 percent for 2006.

At December 31, 2007, nonperforming assets as a percentage of total loans and net foreclosed real estate was 2.25 percent, compared to 1.09 percent at year-end 2006. 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 2007 and year-end 2006. 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 its 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, 2007.

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Throughout 2007, 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, 2007.

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

**INCOME STATEMENT ANALYSIS**

**Net Interest Income**

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

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 2007 was \$20,680,000, an increase of \$2,438,000 or 13 percent above 2006. The increase was primarily the result of an increase in the volume of earning assets. Earning assets averaged \$537 million and yielded 7.42 percent (tax equivalent basis) for 2007, compared to \$471 million and 7.17 percent, respectively, for 2006. The \$66 million or 14 percent increase in earning assets was the result of growth in business and home equity loans, investment securities and overnight investment in federal funds sold. The \$720,000 or 57 percent increase in business loan fees for 2007 contributed to the increase in the yield on average assets. Approximately \$612,000 of the increase in fees from selected business loan accounts, including a recovery of fees from a large delinquent account, was unusually large as to amount. Interest bearing liabilities averaged \$481 million at an average rate of 3.84 percent for 2007, compared to \$418 million and 3.60 percent, respectively, for 2006. The \$63 million or 15 percent increase in the average volume of interest bearing liabilities occurred primarily in short-term fixed rate CDs and money market deposits. Current period deposit growth was primarily attributable to rate promotions. Consumer perceptions regarding the greater volatility of capital markets was also a likely contributing factor to overall deposit growth. The cost of servicing long-term corporate debt declined 5 percent in 2007, compared to the preceding year due to a decrease in volume. The Corporation paid off approximately \$6.5 million in above-market rate corporate debt in 2007; however, the effect of this reduction in debt was offset by the full years' impact of adding \$7 million in trust preferred debt in June 2006 as a capital strategy to support planned balance sheet growth. The net interest margin, on a tax equivalent basis, was 3.97 percent for both 2007 and 2006. Excluding the impact of the aforementioned nonrecurring business loan fees, the margin for 2007 would have been 3.86 percent. 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 low interest rate environment and competitive pricing pressures.

Comparatively, 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

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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. Deposit growth for 2006 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. The net interest margin, on a tax equivalent basis, was 3.97 percent for 2006, compared to 4.16 percent for 2005.

**Table 1-Net Interest Income (tax equivalent basis)**

| <i>(dollars in thousands)</i> | <b>2007</b> | <b>2006</b> | <b>2005</b> | <b>2004</b> | <b>2003</b> | <b>5 Year CAGR*</b> |
|-------------------------------|-------------|-------------|-------------|-------------|-------------|---------------------|
| Total interest income         | \$ 39,169   | \$ 33,319   | \$ 25,572   | \$ 20,469   | \$ 19,964   | 13.6%               |
| Tax equivalent adjustment     | 634         | 482         | 257         | 231         | 238         | n/a                 |

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|                                      |            |            |            |            |            |        |
|--------------------------------------|------------|------------|------------|------------|------------|--------|
| Adjusted total interest income       | 39,803     | 33,801     | 25,829     | 20,700     | 20,202     | 13.7%  |
| Total interest expense               | 18,489     | 15,077     | 9,149      | 6,545      | 6,898      | -15.7% |
| Net interest income                  | \$ 21,314  | \$ 18,724  | \$ 16,680  | \$ 14,155  | \$ 13,304  | 12.1%  |
| Average earning assets               | \$ 536,612 | \$ 471,251 | \$ 400,632 | \$ 353,390 | \$ 322,391 | 11.6%  |
| Average interest bearing liabilities | \$ 481,245 | \$ 418,353 | \$ 351,949 | \$ 314,398 | \$ 290,405 | 11.3%  |
| Yield on earning assets              | 7.42%      | 7.17%      | 6.45%      | 5.86%      | 6.27%      |        |
| Rate on interest bearing liabilities | 3.84%      | 3.60%      | 2.60%      | 2.08%      | 2.38%      |        |
| Interest rate spread                 | 3.58%      | 3.57%      | 3.85%      | 3.78%      | 3.89%      |        |
| Net interest margin                  | 3.97%      | 3.97%      | 4.16%      | 4.01%      | 4.13%      |        |

\* Compound annual growth rate (CAGR) is the average annual rate of growth over the five-year period beginning in 2002.

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

| <i>(dollars in thousands)</i>        | 2007 compared to 2006              |           |                        |          |        |
|--------------------------------------|------------------------------------|-----------|------------------------|----------|--------|
|                                      | Year ended<br>December 31,<br>2007 | 2006      | Increase<br>(Decrease) | Volume   | Rate   |
| <b>Interest Income</b>               |                                    |           |                        |          |        |
| Interest bearing deposits with banks | \$ 8                               | \$ 10     | \$ (2)                 | \$ (2)   | \$     |
| Federal funds sold                   | 1,149                              | 521       | 628                    | 659      | (30)   |
| Securities, taxable                  | 2,799                              | 2,699     | 100                    | (96)     | 196    |
| Securities, tax-exempt               | 1,733                              | 1,104     | 629                    | 776      | (147)  |
| Loans, taxable                       | 33,764                             | 29,156    | 4,608                  | 3,162    | 1,446  |
| Loans, tax-exempt                    | 350                                | 311       | 39                     | 67       | (28)   |
| Total interest income                | 39,803                             | 33,801    | 6,002                  | 4,566    | 1,437  |
| <b>Interest Expense</b>              |                                    |           |                        |          |        |
| <b>Interest bearing deposits</b>     |                                    |           |                        |          |        |
| NOW, money market                    | 6,054                              | 4,829     | 1,225                  | 740      | 485    |
| Savings                              | 111                                | 116       | (5)                    | (5)      |        |
| Time deposits less than \$100,000    | 7,083                              | 5,746     | 1,337                  | 964      | 373    |
| Time deposits \$100,000 or more      | 3,169                              | 2,075     | 1,094                  | 918      | 176    |
| Short-term borrowings                |                                    | 133       | (133)                  | (133)    |        |
| Long-term debt                       | 2,072                              | 2,178     | (106)                  | (147)    | 41     |
| Total interest expense               | 18,489                             | 15,077    | 3,412                  | 2,337    | 1,075  |
| Net interest income                  | \$ 21,314                          | \$ 18,724 | \$ 2,590               | \$ 2,229 | \$ 362 |

2006 compared to 2005

Year ended  
December 31, Increase



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(dollars in thousands)

|                                      | 2006             | 2005             | (Decrease)      | Volume          | Rate              |
|--------------------------------------|------------------|------------------|-----------------|-----------------|-------------------|
| <b>Interest Income</b>               |                  |                  |                 |                 |                   |
| 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)              |
| <b>Total interest income</b>         | <b>33,801</b>    | <b>25,829</b>    | <b>7,972</b>    | <b>4,906</b>    | <b>3,066</b>      |
| <b>Interest Expense</b>              |                  |                  |                 |                 |                   |
| 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               |
| <b>Total interest expense</b>        | <b>15,077</b>    | <b>9,149</b>     | <b>5,928</b>    | <b>1,770</b>    | <b>4,158</b>      |
| <b>Net interest income</b>           | <b>\$ 18,724</b> | <b>\$ 16,680</b> | <b>\$ 2,044</b> | <b>\$ 3,136</b> | <b>\$ (1,092)</b> |

Changes which are due to both volume and rate are allocated in proportion to their relationship to the amount of change attributed directly to volume or rate. Taxable loans include net loan fees of \$1,973,000 in 2007, \$1,253,000 in 2006, and \$1,178,000 in 2005.

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

|                                      | 2007            |               |             | 2006            |               |             | 2005            |               |             |
|--------------------------------------|-----------------|---------------|-------------|-----------------|---------------|-------------|-----------------|---------------|-------------|
|                                      | Average Balance | Interest      | Rate        | Average Balance | Interest      | Rate        | Average Balance | Interest      | Rate        |
| <i>(dollars in thousands)</i>        |                 |               |             |                 |               |             |                 |               |             |
| <b>Assets</b>                        |                 |               |             |                 |               |             |                 |               |             |
| Interest bearing deposits with banks | \$ 133          | \$ 8          | 5.71%       | \$ 171          | \$ 10         | 5.85%       | \$ 143          | \$ 5          | 3.50%       |
| Federal funds sold                   | 22,622          | 1,149         | 5.08        | 9,992           | 521           | 5.21        | 3,640           | 130           | 3.57        |
| Investment securities                |                 |               |             |                 |               |             |                 |               |             |
| Taxable                              | 54,066          | 2,799         | 5.18        | 56,061          | 2,699         | 4.81        | 62,615          | 2,530         | 4.04        |
| Tax-exempt                           | 29,669          | 1,733         | 5.84        | 17,420          | 1,104         | 6.34        | 9,734           | 675           | 6.93        |
| <b>Total investment securities</b>   | <b>83,735</b>   | <b>4,532</b>  | <b>5.41</b> | <b>73,481</b>   | <b>3,803</b>  | <b>5.18</b> | <b>72,349</b>   | <b>3,205</b>  | <b>4.43</b> |
| Loans                                |                 |               |             |                 |               |             |                 |               |             |
| Taxable (1)                          | 424,645         | 33,764        | 7.95        | 383,098         | 29,156        | 7.61        | 323,479         | 22,407        | 6.93        |
| Tax-exempt                           | 5,477           | 350           | 6.39        | 4,509           | 311           | 6.90        | 1,021           | 82            | 8.03        |
| <b>Total loans</b>                   | <b>430,122</b>  | <b>34,114</b> | <b>7.93</b> | <b>387,607</b>  | <b>29,467</b> | <b>7.60</b> | <b>324,500</b>  | <b>22,489</b> | <b>6.93</b> |
| <b>Total earning assets</b>          | <b>536,612</b>  | <b>39,803</b> | <b>7.42</b> | <b>471,251</b>  | <b>33,801</b> | <b>7.17</b> | <b>400,632</b>  | <b>25,829</b> | <b>6.45</b> |
| Other assets (2)                     | 38,873          |               |             | 36,575          |               |             | 35,216          |               |             |

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|   |                   |                  |             |                   |                  |             |                   |                  |             |
|---|-------------------|------------------|-------------|-------------------|------------------|-------------|-------------------|------------------|-------------|
| Total assets                                      | \$ 575,485        |                  |             | \$ 507,826        |                  |             | \$ 435,848        |                  |             |
| <b>Liabilities and Shareholders' Equity</b>       |                   |                  |             |                   |                  |             |                   |                  |             |
| <b>Interest bearing deposits</b>                  |                   |                  |             |                   |                  |             |                   |                  |             |
| NOW, money market                                 | \$ 198,008        | \$ 6,054         | 3.06%       | \$ 171,693        | \$ 4,829         | 2.81%       | \$ 140,698        | \$ 1,940         | 1.38%       |
| Savings   | 18,657            | 111              | 0.60        | 19,428            | 116              | 0.60        | 20,709            | 113              | 0.55        |
| Time deposits less than \$100,000                 | 158,789           | 7,083            | 4.46        | 135,968           | 5,746            | 4.23        | 118,328           | 4,040            | 3.41        |
| Time deposits \$100,000 or more                   | 66,061            | 3,169            | 4.80        | 45,795            | 2,075            | 4.53        | 32,105            | 1,162            | 3.62        |
| <b>Total interest bearing deposits</b>            | <b>441,515</b>    | <b>16,417</b>    | <b>3.72</b> | <b>372,884</b>    | <b>12,766</b>    | <b>3.42</b> | <b>311,840</b>    | <b>7,255</b>     | <b>2.33</b> |
| Short-term borrowings                             | 0                 | 0                | 0.00        | 2,857             | 133              | 4.66        | 2,534             | 73               | 2.88        |
| Long-term debt                                    | 39,730            | 2,072            | 5.21        | 42,612            | 2,178            | 5.11        | 37,575            | 1,821            | 4.85        |
| <b>Total interest bearing liabilities</b>         | <b>481,245</b>    | <b>18,489</b>    | <b>3.84</b> | <b>418,353</b>    | <b>15,077</b>    | <b>3.60</b> | <b>351,949</b>    | <b>9,149</b>     | <b>2.60</b> |
| Noninterest bearing deposits                      | 44,942            |                  |             | 45,621            |                  |             | 43,452            |                  |             |
| Other liabilities                                 | 3,477             |                  |             | 2,870             |                  |             | 2,763             |                  |             |
| Shareholders' equity                              | 45,821            |                  |             | 40,982            |                  |             | 37,684            |                  |             |
| <b>Total liabilities and shareholders' equity</b> | <b>\$ 575,485</b> |                  |             | <b>\$ 507,826</b> |                  |             | <b>\$ 435,848</b> |                  |             |
| <b>Net interest income</b>                        |                   | <b>\$ 21,314</b> |             |                   | <b>\$ 18,724</b> |             |                   | <b>\$ 16,680</b> |             |
| Interest rate spread                              |                   |                  | 3.58%       |                   |                  | 3.57%       |                   |                  | 3.85%       |
| Net interest margin                               |                   |                  | 3.97%       |                   |                  | 3.97%       |                   |                  | 4.16%       |

(1) Interest includes net loan fees of \$1,973,000 in 2007, \$1,253,000 in 2006, and \$1,178,000 in 2005.

(2) Average balance includes average nonaccrual loans of \$4,122,253 in 2007, \$3,721,000 in 2006, and \$686,000 in 2005.

### 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 2007, the provision was a \$554,000 credit (recovery), compared to a \$650,000 expense in 2006 and a \$775,000 expense in 2005. In February 2007, PeoplesBank recovered \$839,000 (\$554,000 after-tax), representing its 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 funds substantially reimbursed PeoplesBank for losses that were incurred in 2002 and 2003 that pertained to a group of related equipment leasing contracts that PeoplesBank acquired through a third-party broker. The Bank of New York was escrow agent for payments under those contracts. During the fourth quarter of 2007, the Corporation recorded a \$365,000 loan loss provision due to its concern about a general economic slowdown, or possible

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recession, and continued downturn in the real estate market. The Corporation does not participate in the subprime lending market and, accordingly, it has no loss exposure to subprime lending.

### 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**

| <i>(dollars in thousands)</i>            | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|--|-------------|-------------|-------------|
| Trust and investment services fees       | \$ 1,260    | \$ 1,255    | \$ 1,147    |
| Service charges on deposit accounts      | 1,979       | 1,870       | 1,638       |
| Mutual fund, annuity and insurance sales | 1,506       | 1,349       | 1,156       |
| Income from bank owned life insurance    | 271         | 263         | 269         |
| Other income                             | 431         | 485         | 507         |
| Gain on sales of mortgages               | 248         | 323         | 372         |
| Loss on sales of securities              | (7)         | (80)        | (86)        |
| Total noninterest income                 | \$ 5,688    | \$ 5,465    | \$ 5,003    |

The discussion that follows addresses changes in noninterest income.

**Trust and investment services fees** For 2007, trust fees were flat compared to 2006 partially as a result of a transfer of selected fee based accounts to Codorus Valley Financial Advisors (reference mutual fund, annuity and insurance sales below). For 2006, trust fees increased \$108,000 or 9 percent above 2005 due to business growth.

**Service charges on deposit accounts** For 2007, service charges on deposit accounts increased \$109,000 or 6 percent above 2006. Comparatively, 2006 service charges increased \$232,000 or 14 percent above 2005. The increase for both periods was due largely to an increase in check card (debit card) interchange income in response to increased customer usage. Insufficient funds fees (NSF fees) for the current period were slightly below 2006 due to an internal change in the order of posting transactions and heightened disclosure of NSF fees on checking account statements.

**Mutual fund, annuity and insurance sales** For 2007, income from the sale of mutual funds, annuities and insurance products by Codorus Valley Financial Advisors, a subsidiary of PeoplesBank, increased \$157,000 or 12 percent above 2006 due to an increase in sales, and the transfer of accounts from the trust division as previously described. For 2006, income from this category increased \$193,000 or 17 percent above 2005 due to an increase in sales.

**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 2007, other income decreased \$54,000 or 11 percent compared to 2006, and 2006 decreased \$22,000 or 4 percent compared to 2005. The decrease for both periods was due in part to a decrease in income from real estate settlement services, which resulted from a downturn in the real estate market and competition.

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Year 2006 contained a nonrecurring gain of \$45,000 from the sale of two 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.

**Gain on sales of mortgages** For 2007, gains from the sale of mortgages decreased \$75,000 or 23 percent below 2006, due in part to management's decision to retain a portion of loan production in the portfolio to increase interest income. Comparatively, 2006 gains decreased \$49,000 or 13 percent below 2005. For both periods, mortgage banking operations were adversely affected by a downturn in the residential real estate market.

**Loss 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**

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

**Table 5-Noninterest Expense**

| <i>(dollars in thousands)</i>    | <b>2007</b>      | <b>2006</b>      | <b>2005</b>      |
|----------------------------------|------------------|------------------|------------------|
| Personnel                        | \$ 10,676        | \$ 9,080         | \$ 8,163         |
| Occupancy of premises, net       | 1,333            | 1,368            | 1,311            |
| Furniture and equipment          | 1,324            | 1,350            | 1,241            |
| Postage, stationery and supplies | 449              | 410              | 468              |
| Professional and legal           | 317              | 277              | 326              |
| Marketing and advertising        | 675              | 589              | 698              |
| Other                            | 3,594            | 2,816            | 2,275            |
| <b>Total noninterest expense</b> | <b>\$ 18,368</b> | <b>\$ 15,890</b> | <b>\$ 14,482</b> |

The discussion that follows addresses changes in noninterest expense. Generally, corporate expansion in the form of financial center additions and normal business growth were the principal expense drivers for all three years.

**Personnel** For 2007, personnel expense, comprised of wages, payroll taxes and employee benefits, increased \$1,596,000 or 18 percent above 2006. Comparatively, 2006 increased \$917,000 or 11 percent above 2005. The increases for both periods were due to staff additions associated with planned business growth, and increases in performance based compensation and benefits costs.

**Occupancy of premises, net** For 2007, occupancy of premises expense declined slightly from the prior year due to lower utility and maintenance costs. Comparatively, for 2006 this expense category increased \$57,000 or 4 percent above 2005, which reflected a full year's cost impact of two financial centers that opened in 2005.

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**Furniture and equipment** For 2007, furniture and equipment expense decreased \$26,000 or 2 percent, which was most likely the result of full depreciation of furniture purchased 10 years ago for the corporate center headquarters. Comparatively, 2006 increased \$109,000 or 9 percent above 2005 due in part to financial center expansion and renovation in 2005, the timing of ATM maintenance contracts and a bulk replacement of personal computers.

**Postage, stationery and supplies** For 2007, the postage, stationery and supplies expense category increased \$39,000 or 10 percent above 2006, due primarily to normal business growth. Comparatively, 2006 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.

**Professional and legal** For 2007, professional and legal expense increased \$40,000 or 14 percent above 2006 due to increases in CPA and legal expenses. The increase in CPA expense included review services to enable the company to comply with Section 404 of the Sarbanes-Oxley Act (SOX404). The first quarter of 2006 included a \$35,000 reimbursement of legal expenses to PeoplesBank, which resulted from the settlement of a lawsuit from routine bank business. There was no comparable reimbursement in 2007. Years 2007 and 2006 included consulting expense for assistance with SOX404 compliance, i.e., process documentation and testing, of approximately \$51,000, and \$43,000, respectively. Effective December 31, 2008, and thereafter, the Corporation's public accounting firm is required to audit and opine on the Corporation's controls over financial reporting, although in January 2008 the SEC proposed delaying this requirement for one year. Compliance costs associated with Section 404 are expected to be incurred in the period ahead, but management does not expect these costs to be material.

**Marketing and advertising** For 2007, marketing and advertising expense increased \$86,000 or 15 percent above 2006, due to increased advertising promotions, increases in client incentives and sponsorship costs, and normal business growth. Comparatively, 2006 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.

**Other** For 2007, other expense, which is comprised of many underlying expenses, increased \$778,000 or 28 percent above 2006 due in part to the recognition of a \$437,000 prepayment penalty on the early pay off of a \$5 million Federal Home Loan Bank advance. The Corporation paid off the advance, which was due July 2014 and had an above market interest rate of 6.43 percent, to reduce interest expense in future periods. There was no comparable prepayment penalty in the prior year. Increases in miscellaneous loan expense (loan volume), Pennsylvania shares tax (the prior period tax was reduced by education tax credits), ATM/point-of-sale processing costs (transaction volume, account growth), and normal business growth also contributed to the increase in other expense. Comparably, in 2006 other expense 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. Problem loan and foreclosed real estate carrying costs increased \$192,000 above 2005, due in part to larger portfolio of nonaccrual loans and to the recognition of an unusually large \$151,000 gain from the sale of loan collateral in 2005. Miscellaneous expense for 2006 also included 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.

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In the period ahead, it is probable that noninterest expense will increase as a result of planned franchise expansion, financial center renovations, investment in information technology, 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 includes PeoplesBank, 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. The one-time credit offset the new FDIC assessment cost for 2007; however, the credit will be depleted in the first quarter of 2008. Accordingly, PeoplesBank will recognize the assessment at that time. Management's estimate of the FDIC assessment expense, net of the remaining credit, for 2008 is approximately \$239,000.

**Income Taxes**

The provision for income taxes was \$2,180,000 for 2007, an increase of \$335,000 or 18 percent above 2006 due to a 19 percent increase in pretax income. Comparatively, 2006 increased \$293,000 or 19 percent above 2005 due to a 16 percent increase in pretax income. For 2007, the Corporation recognized \$305,000 in tax benefits, principally tax credits, compared to \$317,000 for 2006 and \$330,000 for 2005 from investments in low-income housing partnerships. For all three years, the Corporation's marginal federal income tax rate was 34 percent, compared to an effective tax rate of approximately 25 percent.

**BALANCE SHEET REVIEW**

**Federal funds sold**

On December 31, 2007, federal funds sold, i.e., overnight investments, were \$25 million, compared to \$24 million for year-end 2006. The level of overnight investment was relatively high for both periods as a result of funds generation from strong deposit growth 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, 2007, the securities available-for-sale portfolio totaled \$81million, which reflected an \$8 million or 11 percent increase from year-end 2006. The increase occurred primarily from the purchase of high quality US agency mortgage-backed bonds and tax-exempt municipal bonds. 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 gains for this portfolio exceeded unrealized losses for year-end 2007 due to declining market interest rates. Table 6 Analysis of Investment Securities shows that the available-for-sale portfolio had a yield of 5.23 percent on December 31, 2007, compared to 4.92 percent on December 31, 2006. The increase in yield reflected higher market

interest rates and an investment focus on municipal bonds and US government agency mortgage-backed securities.

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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, 2007, securities held-to-maturity totaled \$3.4 million, compared to \$7.5 million for year-end 2006. The decrease in the portfolio balance was the result of 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 8.34 percent. As of December 31, 2007, all trust preferred instruments were limited to \$500,000 per issuer and rated investment grade by a national rating service, with one exception, which was not rated. 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, 2007<br>Maturity Distribution |                              |                              |                    |                       | Total            |              |
|-------------------------------|--|------------------------------|------------------------------|--------------------|-----------------------|------------------|--------------|
|                               | One year<br>or less                        | One<br>through<br>five years | Five<br>through<br>ten years | After<br>ten years | No stated<br>maturity | Amount           | Yield(1)     |
| <i>(dollars in thousands)</i> |  |                              |                              |                    |                       |                  |              |
| <b>Available-for-sale</b>     |  |                              |                              |                    |                       |                  |              |
| U.S. agencies(2)              | \$ 11,023                                  | \$ 37,256                    | \$                           | \$                 | \$                    | \$ 48,279        | 4.64%        |
| State and municipal           | 280  | 7,990                        | 17,192                       | 5,277              |                       | 30,739           | 6.14%        |
| Equity securities(3)          |  |                              |                              |                    | 1,471                 | 1,471            | 5.98%        |
| <b>Total</b>                  | <b>\$ 11,303</b>                           | <b>\$ 45,246</b>             | <b>\$ 17,192</b>             | <b>\$ 5,277</b>    | <b>\$ 1,471</b>       | <b>\$ 80,489</b> | <b>5.23%</b> |
| <b>Yield</b>                  | <b>3.88%</b>                               | <b>5.22%</b>                 | <b>5.79%</b>                 | <b>6.20%</b>       | <b>5.98%</b>          | <b>5.23%</b>     |              |
| <b>Held-to-maturity</b>       |  |                              |                              |                    |                       |                  |              |
| Corporate trust preferreds    | \$   | \$                           | \$                           | \$ 3,448           | \$                    | \$ 3,448         | 8.34%        |
| <b>Yield</b>                  | <b>0.00%</b>                               | <b>0.00%</b>                 | <b>0.00%</b>                 | <b>8.34%</b>       | <b>0.00%</b>          | <b>8.34%</b>     |              |

(1) Weighted average yields (tax equivalent basis) were calculated on the amortized cost basis.

(2) U.S. agency mortgage-backed securities are included in the maturity categories based on average expected life.

(3) Equity securities consist of Federal Home Loan Bank stock and Atlantic Central Bankers Bank stock.

## **Loans**

On December 31, 2007, total loans were \$446 million, an increase of approximately \$40 million or 10 percent above year-end 2006. 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 2007, commercial loans increased \$17 million or 5 percent above year-end 2006, while consumer loans increased \$23 million or 24 percent. For 2007, growth in the commercial loan portfolio was constrained by an unusually large volume of loan run-off, while total consumer loans experienced an unusually large increase due to a successful marketing promotion of home equity loans. During 2007, PeoplesBank's mortgage banking staff focused on originating and selling residential

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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, 2007, loans held for sale were \$1.8 million, representing a slight increase above year-end 2006.

**Table 7-Loan Portfolio Composition**

| <i>(dollars in thousands)</i>                   | <b>2007</b>       | <b>%</b>     | <b>2006</b>       | <b>%</b>     | <b>December 31,<br/>2005</b> |              | <b>2004</b>       | <b>%</b>     | <b>2003</b>       | <b>%</b>     |
|---|-------------------|--------------|-------------------|--------------|------------------------------|--------------|-------------------|--------------|-------------------|--------------|
| Commercial, industrial and agricultural         | \$ 243,144        | 54.5         | \$ 218,673        | 53.9         | \$ 207,545                   | 56.4         | \$ 189,658        | 63.5         | \$ 163,676        | 62.9         |
| Real estate - construction and land development | 83,625            | 18.8         | 91,414            | 22.5         | 74,478                       | 20.2         | 35,395            | 11.9         | 28,147            | 10.8         |
| <b>Total commercial related loans</b>           | <b>326,769</b>    | <b>73.3</b>  | <b>310,087</b>    | <b>76.4</b>  | <b>282,023</b>               | <b>76.6</b>  | <b>225,053</b>    | <b>75.4</b>  | <b>191,823</b>    | <b>73.7</b>  |
| Real estate - residential mortgages             | 55,257            | 12.4         | 31,509            | 7.8          | 26,190                       | 7.1          | 24,954            | 8.3          | 25,134            | 9.7          |
| Installment                                     | 63,693            | 14.3         | 63,977            | 15.8         | 59,896                       | 16.3         | 48,664            | 16.3         | 43,249            | 16.6         |
| <b>Total consumer related loans</b>             | <b>118,950</b>    | <b>26.7</b>  | <b>95,486</b>     | <b>23.6</b>  | <b>86,086</b>                | <b>23.4</b>  | <b>73,618</b>     | <b>24.6</b>  | <b>68,383</b>     | <b>26.3</b>  |
| <b>Total loans</b>                              | <b>\$ 445,719</b> | <b>100.0</b> | <b>\$ 405,573</b> | <b>100.0</b> | <b>\$ 368,109</b>            | <b>100.0</b> | <b>\$ 298,671</b> | <b>100.0</b> | <b>\$ 260,206</b> | <b>100.0</b> |

The following table shows that, at December 31, 2007, the commercial loan portfolio was comprised of \$186 million or 57 percent in fixed rate loans and \$141 million or 43 percent in floating or adjustable rate loans. Comparatively, the mix was 58/42 on December 31, 2006. 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**

| <i>(dollars in thousands)</i>                 | <b>December 31, 2007<br/>Maturity Distribution</b> |                      |                         |                   |
|---|--|----------------------|-------------------------|-------------------|
|   | <b>1 year<br/>or less</b>                          | <b>1-5<br/>years</b> | <b>over 5<br/>years</b> | <b>Total</b>      |
| Commercial, industrial and agricultural       | \$ 37,152  | \$ 62,986            | \$ 143,006              | \$ 243,144        |
| Real estate-construction and land development | 57,982   | 21,301               | 4,342                   | 83,625            |
| <b>Total commercial related loans</b>         | <b>\$ 95,134</b>                                   | <b>\$ 84,287</b>     | <b>\$ 147,348</b>       | <b>\$ 326,769</b> |
| Fixed interest rates                          | \$ 12,193  | \$ 51,690            | \$ 121,961              | \$ 185,844        |
| Floating or adjustable interest rates         | 82,941   | 32,597               | 25,387                  | 140,925           |
| <b>Total commercial related loans</b>         | <b>\$ 95,134</b>                                   | <b>\$ 84,287</b>     | <b>\$ 147,348</b>       | <b>\$ 326,769</b> |

**Other Assets**

Included in other assets are PeoplesBank's investments in real estate partnerships and life insurance. On December 31, 2007, the carrying value of investments in two unrelated real estate partnerships totaled \$3.1 million, compared to \$3.6 million at year-end 2006. The purpose of these partnerships is to provide low cost housing to income 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 \$7.8 million on December 31, 2007, which included the impact of a \$249,000 payout for death benefits. Comparatively, the cash surrender value on December 31, 2006, was also \$7.8 million. Additional information about investment in real

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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, 2007, total deposits were \$512 million, an increase of \$55 million or 12 percent above year-end 2006. The increase in deposits occurred primarily within short-term CDs (7-13 month maturities), which were priced competitively. Growth in money market deposits was constrained by a decrease in short-term market interest rates instigated by the Federal Reserve to stimulate the national economy. To increase return, some money market customers re-allocated their funds out of money market deposits and into short-term CDs. In addition to promotions, deposit growth 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 3.72 percent for 2007, compared to 3.42 percent for 2006. A comparative breakdown of deposits is located in Note 8 Deposits. On December 31, 2007, the balance of certificates of deposit \$100,000 and above was \$80 million. Of this total, \$18 million mature within three months, \$17 million mature after three months but within six months, \$21 million mature after six months but within twelve months, and the remaining \$24 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, 2007 and 2006, PeoplesBank had no outstanding short-term borrowings.

Long-term debt is a primary funding source for asset growth. On December 31, 2007, long-term debt was \$30.7 million, compared to \$45.3 million for year-end 2006. The decrease in long-term debt was the result of a \$7 million FHLBP advance that matured in October, in addition to the early payoff of \$6.5 million in borrowings. During 2007, PeoplesBank paid in full a \$5 million Federal Home Loan Bank advance with a 6.43 percent interest rate that matures in 2014. As a result of paying off the advance before its scheduled maturity, PeoplesBank incurred a \$437,000 pre-payment penalty included in other expense. Also during the year, the Corporation paid in full a \$1.5 million mortgage on the corporate center office building with a LIBOR + 150 basis points variable interest rate that matures in 2011 without prepayment penalty. The reduction of debt in 2007 was made with excess liquidity and is expected to lower interest expense in future periods. In 2006, the Corporation 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 \$122 million as of September 30, 2007, the most recent available date. On December 31, 2007, PeoplesBank had approximately \$20 million outstanding on its account with the FHLBP at an average rate of 3.97 percent.

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**Shareholders Equity and Capital Adequacy**

Shareholders' equity or capital enables 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.



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Total shareholders' equity was \$48.4 million on December 31, 2007, compared to \$42.8 million for year-end 2006. The increase in equity was primarily attributable to profitable operations.

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 \$.58 for 2007, which included a special dividend of \$.05 per share solely as a result of the recovery the company realized from loan losses experienced in a prior period. Comparatively, cash dividends totaled \$.46 per share for 2006. 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. The Corporation distributed a 5 percent stock dividend in June of 2007, 2006 and 2005. Additionally, in 2006 the Corporation distributed a special 5 percent stock dividend in December. Distribution of these stock dividends resulted in the issuance of 175,148 additional common shares in 2007, 324,038 shares in 2006 and 149,593 shares in 2005. The weighted average number of shares of common stock outstanding, adjusted for stock dividends, was 3,696,667 for 2007, 3,663,692 for 2006, and 3,648,951 for 2005.

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 were disclosed in the 2007 Proxy Statement, were approved by shareholders at the annual meeting of shareholders held on May 15, 2007.

In December 2007, the Board of Directors reaffirmed the Share Repurchase Program (Program), which was authorized in 1995, and as periodically amended, to permit the purchase of up to a maximum of 4.9 percent of the outstanding shares of the Corporation's common stock at a price per share no greater than 200 percent of the latest quarterly published book value. For years ended December 31, 2007 and 2006, the Corporation had not acquired any of its common stock under the current Program.

As described more fully under Recent Accounting Pronouncements within Note 1 Summary of Significant Accounting Policies, management plans to adopt EITF Issue No. 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split Dollar Life Insurance Arrangements as a cumulative-effect adjustment on January 1, 2008. Accordingly, management anticipates a one time charge to retained earnings of approximately \$713,000 at that time. Recognition of the current liability as an expense through the income statement is expected to approximate \$56,000 for 2008.

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

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million in trust preferred debt securities in June 2006 and \$3.1 million in November 2004 to support business growth, which are included in Tier 1 capital for regulatory capital purposes.

#### **Table 9-Capital Ratios**

| <i>(dollars in thousands)</i>  | Ratios<br>at December 31, |        | Federal<br>Minimum<br>Required | Federal<br>Well<br>Capitalized | Capital *<br>at December 31, |           |
|--|---------------------------|--------|--------------------------------|--------------------------------|------------------------------|-----------|
|  | 2007                      | 2006   |                                |                                | 2007                         | 2006      |
| Tier 1 risk-based capital<br>(as a percentage of risk weighted assets) |                           |        | 4.00%                          | 6.00%                          |                              |           |
| Codorus Valley Bancorp, Inc. (consolidated)                            | 12.14%                    | 11.99% |                                |                                | \$ 57,727                    | \$ 52,587 |

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|   |        |        |           |           |
|---|--------|--------|-----------|-----------|
| PeoplesBank   | 11.39  | 11.12  | 53,759    | 48,130    |
| Total risk-based capital<br>(as a percentage of risk weighted assets) |        |        | 8.00%     | 10.00%    |
| Codorus Valley Bancorp, Inc. (consolidated)                           | 12.86% | 12.71% | \$ 61,161 | \$ 55,713 |
| PeoplesBank   | 12.11  | 11.84  | 57,193    | 51,256    |
| Leverage<br>(Tier 1 capital as a percentage of average total assets)  |        |        | 4.00%     | 5.00%     |
| Codorus Valley Bancorp, Inc. (consolidated)                           | 9.84%  | 9.83%  | \$ 57,727 | \$ 52,587 |
| PeoplesBank   | 9.22   | 9.09   | 53,759    | 48,130    |

\* 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 seven basic policies that guide the lending process and minimize risk. First, the Corporation follows detailed written lending policies and procedures. Second, lending authority is granted commensurate with dollar amount, loan type, level of risk, and loan officer experience. Third, loan review committees function at both the senior lending officer level and the board level to review and approve loans that exceed 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. Sixth, Corporation does not participate in the subprime lending market, nor does it invest in securities backed by subprime mortgages. And seventh, the Corporation does not lend to foreign countries or persons residing therein.

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

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by independent auditors in connection with their annual financial statement audit and are examined periodically by bank regulators.

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 2007, the Corporation had two industry concentrations that exceeded 10 percent of the total loan portfolio, real estate construction and land development was 18.8 percent and commercial real estate leasing was 11.5 percent. Commercial leasing involves borrowers who lease real estate to commercial tenants. Loans to borrowers within these industries are usually collateralized with real estate. Comparatively, at year-end 2006, only one industry concentration exceeded 10 percent of the total loan portfolio, real estate construction and land development, which was 22.5 percent of the portfolio.

### **Nonperforming Assets**

The following table 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

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and related ratios. The paragraphs below explain significant changes in the aforementioned categories for December 31, 2007, compared to December 31, 2006.

**Table 10-Nonperforming Assets**

| <i>(dollars in thousands)</i>  | 2007             | 2006            | December 31,<br>2005 | 2004            | 2003            |
|--|------------------|-----------------|----------------------|-----------------|-----------------|
| Nonaccrual loans   | \$ 9,411         | \$ 4,368        | \$ 1,034             | \$ 622          | \$ 516          |
| Accruing loans that are contractually past due 90 days or more as to principal or interest | 222              | 4               |                      | 19              | 49              |
| Foreclosed real estate, net of allowance   | 403              | 38              | 7                    | 1,535           | 1,326           |
| <b>Total nonperforming assets</b>  | <b>\$ 10,036</b> | <b>\$ 4,410</b> | <b>\$ 1,041</b>      | <b>\$ 2,176</b> | <b>\$ 1,891</b> |
| <b>Ratios</b>  |                  |                 |                      |                 |                 |
| Nonaccrual loans as a % of total year-end loans  | 2.11%            | 1.08%           | 0.28%                | 0.21%           | 0.20%           |
| Nonperforming assets as a % of total year-end loans and net foreclosed real estate         | 2.25%            | 1.09%           | 0.28%                | 0.72%           | 0.72%           |
| Nonperforming assets as a % of total year-end stockholders equity                          | 20.73%           | 10.31%          | 2.69%                | 6.05%           | 5.60%           |
| Allowance for loan losses as a multiple of nonaccrual loans                                | .4x              | .7x             | 2.5x                 | 3.0x            | 3.3x            |

On December 31, 2007, 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, 2007, the nonaccrual loan portfolio was \$9,411,000, compared to \$4,368,000 on December 31, 2006. Most of the portfolio balance at year-end 2007 was attributable to two unrelated

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business loans with outstanding principal balances of \$4,658,000 and \$3,298,000, respectively. In management's judgment, both loans are adequately secured by real estate, which should ensure the ultimate recovery of interest and principal in full. On December 31, 2007, nonaccrual loans were comprised of 11 unrelated accounts ranging in size from \$4,000 to \$4,658,000. For 2007, the gross interest income that would have been recorded if the nonaccrual loans had been current in accordance with their original terms and current throughout the period was approximately \$836,000. The amount of interest income on those nonaccrual loans that was included in net income for 2007 was approximately \$628,000. The interest income recognized on impaired loans, which includes nonaccrual loans, in Note 5-Impaired, Nonaccrual and Past Due Loans is a lesser amount because it includes interest income only from the time the loan was impaired. 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 \$403,000 on December 31, 2007, compared to \$38,000 on December 31, 2006. The current period portfolio contains one property that management is trying to liquidate. The provision expense for foreclosed real estate, due to declines in the fair value of individual assets, was \$0 for 2007 and 2006, and \$17,000 for 2005.

On December 31, 2007, loans contractually past due 90 days or more as to principal or interest totaled \$222,000, compared to \$4,000 on December 31, 2006. At year-end 2007, the delinquency pertained to one business loan account that paid off in full in February 2008.

On December 31, 2007, there were approximately \$7.8 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 are 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 \$1.9 million in potential problem loans on December 31, 2006.

**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, 2007. 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 \$3,434,000 or .77 percent of total loans on December 31, 2007, compared to \$3,126,000 and .77 percent, respectively, on December 31, 2006. The current period allowance was based on management's estimate of the amount necessary to bring the allowance to a level reflective of

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the risk in the loan portfolio and loan growth. Management considered macro-economic factors that could adversely affect the ability of PeoplesBank's loan clients to repay their loans, including a general economic slowdown or possible recession, increases in food and energy costs, rising unemployment and continued downturn in the real estate market. These factors contributed to an increase in the unallocated component in 2007 as noted in Table 12. The \$839,000 recovery in 2007 of prior period commercial loan losses was discussed in the provision for loan loss section of this report. The Corporation does not participate in the subprime lending market and accordingly, it has no loss exposure to subprime lending. Based on its 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, 2007.

**Table 11-Analysis of Allowance for Loan Losses***(dollars in thousands)*

|  | 2007     | 2006     | 2005     | 2004     | 2003     |
|--|----------|----------|----------|----------|----------|
| Balance - beginning of year                                | \$ 3,126 | \$ 2,538 | \$ 1,865 | \$ 1,694 | \$ 1,515 |
| Provision charged (recovery credited) to operating expense | (554)    | 650      | 775      | 420      | 553      |
| Loans charged off  |          |          |          |          |          |
| Commercial   | 7        | 104      | 34       | 336      | 684      |
| Real estate-mortgage                                       | 31       | 27       | 99       | 30       |          |
| Consumer   | 28       | 19       | 80       | 111      | 86       |
| Total loans charged off                                    | 66       | 150      | 213      | 477      | 770      |
| Recoveries   |          |          |          |          |          |
| Commercial   | 886      | 58       | 74       | 216      | 370      |
| Real estate-mortgage                                       | 16       | 3        | 2        | 1        |          |
| Consumer   | 26       | 27       | 35       | 11       | 26       |
| Total recoveries   | 928      | 88       | 111      | 228      | 396      |
| Net (recoveries) charge-offs                               | (862)    | 62       | 102      | 249      | 374      |
| Balance - end of year                                      | \$ 3,434 | \$ 3,126 | \$ 2,538 | \$ 1,865 | \$ 1,694 |

**Ratios**

|   |         |       |       |       |       |
|---|---------|-------|-------|-------|-------|
| Net (recoveries) charge-offs as a % of average total loans                              | (0.20)% | 0.02% | 0.03% | 0.09% | 0.15% |
| Allowance for loan losses as a % of total loans   | 0.77%   | 0.77% | 0.69% | 0.62% | 0.65% |
| Allowance for loan losses as a % of nonaccrual loans and loans past due 90 days or more | 36%     | 71%   | 245%  | 291%  | 300%  |

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**Table of Contents****Table 12-Allocation of Allowance for Loan Losses**

|   | 2007     |               | 2006     |               | December 31, 2005 |               | 2004     |               | 2003     |               |
|---|----------|---------------|----------|---------------|-------------------|---------------|----------|---------------|----------|---------------|
|   | Amount   | % Total Loans | Amount   | % Total Loans | Amount            | % Total Loans | Amount   | % Total Loans | Amount   | % Total Loans |
| <i>(dollars in thousands)</i>                   |          |               |          |               |                   |               |          |               |          |               |
| Commercial, industrial and agricultural         | \$ 1,622 | 54.5          | \$ 1,500 | 53.9          | \$ 1,339          | 56.4          | \$ 1,216 | 63.5          | \$ 1,105 | 62.9          |
| Real estate - construction and land development | 615      | 18.8          | 549      | 22.5          | 439               | 20.2          | 213      | 11.9          | 80       | 10.8          |
| Total commercial related                        | 2,237    | 73.3          | 2,049    | 76.4          | 1,778             | 76.6          | 1,429    | 75.4          | 1,185    | 73.7          |
| Real estate - residential mortgages             | 22       | 12.4          | 22       | 7.8           | 19                | 7.1           | 13       | 8.3           | 15       | 9.7           |
| Installment                                     | 147      | 14.3          | 122      | 15.8          | 141               | 16.3          | 116      | 16.3          | 115      | 16.6          |
| Total consumer related                          | 169      | 26.7          | 144      | 23.6          | 160               | 23.4          | 129      | 24.6          | 130      | 26.3          |
| Unallocated                                     | 1,028    | n/a           | 933      | n/a           | 600               | n/a           | 307      | n/a           | 379      | n/a           |
| Total   | \$ 3,434 | 100.0         | \$ 3,126 | 100.0         | \$ 2,538          | 100.0         | \$ 1,865 | 100.0         | \$ 1,694 | 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.

**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. The Consolidated Statements of Cash Flows present the changes in cash from operating, investing and financing activities. For 2007, management believes that liquidity was more than adequate based on the level of overnight investment, the potential liquidation of an \$81 million portfolio of available-for-sale securities, valued at December 31, 2007, and available credit from the Federal Home Loan Bank of Pittsburgh. On September 30, 2007, the latest available date, available net funding from the FHLBP was approximately \$102 million. The Corporation's loan-to-deposit ratio was 87 percent for year-end 2007, compared to 89 percent for year-end 2006.

*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 \$161 million at December 31, 2007, compared to \$122 million at December 31, 2006. 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

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being drawn and therefore, generally do not present significant liquidity risk to the Corporation or PeoplesBank.

*Contractual Obligations*

The following table presents the amount and timing of payments due under long-term contractual obligations.

**Table 13-Contractual Obligations**

|                               | <b>December 31, 2007</b>      |                             |                      |                      |                              |
|-------------------------------|-------------------------------|-----------------------------|----------------------|----------------------|------------------------------|
|                               | <b>Payments due by period</b> |                             |                      |                      |                              |
| <i>(dollars in thousands)</i> | <b>Total</b>                  | <b>Less than<br/>1 year</b> | <b>1-3<br/>years</b> | <b>3-5<br/>years</b> | <b>More than<br/>5 years</b> |
| Long-term debt                | \$ 30,134                     | \$ 1,125                    | \$ 13,359            | \$ 5,096             | \$ 10,554                    |
| Capital lease                 | 526                           | 40                          | 93                   | 132                  | 261                          |
| Operating leases              | 997                           | 201                         | 386                  | 267                  | 143                          |
| Time deposits                 | 254,140                       | 181,897                     | 66,600               | 5,643                |                              |
| Supplemental retirement plans | 5,825                         |                             |                      | 150                  | 5,675                        |
| Total                         | \$ 291,622                    | \$ 183,263                  | \$ 80,438            | \$ 11,288            | \$ 16,633                    |

**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 2007 was 4.1 percent, compared to 2.5 percent for 2006 and 3.4 percent for 2005.

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 Wall Street Journal Prime rate (prime), LIBOR and short-term US treasury rates. An Asset-Liability Committee (Committee) comprised of members of senior management manages interest

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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 repricable 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 both year-end periods, 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.

The Corporation performed a financial simulation on the balance sheet for December 31, 2007 and 2006. The results of these point-in-time analyses are shown in Table 14. For both periods 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. In response to market interest rates over the past two years, loan clients have shown a preference for longer term fixed rate loans, while deposit clients have shown a preference for money market deposits and short-term CDs. The result has been a gradual shift in the balance sheet to a liability sensitive position. On the December 31, 2007 measurement date, the model projects hypothetical losses even under declining rate scenarios; however, the losses are less than projected by the rising rate scenario. This is due in part to the timing and magnitude of changes in various interest rates forecasted by the forecasting service. For example, the most likely scenario projects prime and federal funds rates to decline by 50 basis points over the next twelve months, while US treasury rates increase 17 to 48 basis points depending on the term. Accordingly, deposit rates tied to the US treasury curve for modeling purposes result in greater interest expense which decreases net income.

Table of Contents**Table 14-Interest Rate Sensitivity**

| Forecasted<br>interest rate<br>scenario | Change in interest<br>rates<br>ramped over 12<br>months<br>(basis points) | Change in<br>net income |       |
|---|---|-------------------------|-------|
|   |   | \$000 s                 | %     |
| <b>at December 31,<br/>2007</b>         |   |                         |       |
| Most likely                             | -50   | (497)                   | (7.7) |
| High                                    | +200  | (580)                   | (8.9) |
| Flat (baseline)                         | 0   | 0                       | 0.0   |
| Low                                     | -200  | (327)                   | (5.0) |
| <b>at December 31,<br/>2006</b>         |   |                         |       |

|                 |      |       |       |
|-----------------|------|-------|-------|
| Most likely     | -75  | (91)  | (1.5) |
| High            | +200 | (300) | (5.0) |
| Flat (baseline) | 0    | 0     | 0.0   |
| Low             | -200 | 78    | 1.3   |

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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**Report of Management's Assessment of  
Internal Controls Over Financial Reporting**

The Corporation carried out an evaluation, under the supervision and with the participation of the Corporation's management, including the Corporation's Chief Executive Officer and Chief Financial Officer, of the effectiveness of its disclosure controls and procedures, as defined in Exchange Act Rules 13a-15(e) and 15d-15(e). Based upon the evaluation, the Corporation's Chief Executive Officer and Chief Financial Officer concluded that, as of December 31, 2007, the Corporation's disclosure controls and procedures are effective. Disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Corporation's reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

The management of the Corporation is responsible for establishing and maintaining adequate internal control over financial reporting. The Corporation's internal control system is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness of future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of the Corporation's internal control over financial reporting as of December 31, 2007, using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework, with an emphasis on Internal Control Over Financial Reporting-Guidance for Smaller Public Companies, also issued by COSO. Based on this assessment, management concluded that, as of December 31, 2007, the Corporation's internal control over financial reporting is effective based on those criteria.

This Annual Report does not include an attestation report of the Corporation's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Corporation's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the Corporation to provide only management's report in this Annual Report.

/s/ Larry J. Miller

Larry J. Miller  
(Principal Executive Officer)  
Vice-Chairman, President  
and Chief Executive Officer

March 11, 2008

/s/ Jann A. Weaver

Jann A. Weaver  
(Principal Financial and Accounting  
Officer) Treasurer, and  
Assistant Secretary

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**Item 8: Financial statements and supplementary data**Codorus Valley Bancorp, Inc.  
**Consolidated Balance Sheets**

|   | <b>December 31,</b> |                   |
|---|---------------------|-------------------|
|   | <b>2007</b>         | <b>2006</b>       |
| <i>(dollars in thousands, except per share data)</i>  |                     |                   |
| <b>Assets</b>   |                     |                   |
| Interest bearing deposits with banks  | \$ 118              | \$ 118            |
| Cash and due from banks   | 13,946              | 11,104            |
| Federal funds sold  | 24,989              | 24,150            |
| <b>Total cash and cash equivalents</b>  | <b>39,053</b>       | <b>35,372</b>     |
| Securities, available-for-sale  | 80,921              | 73,423            |
| Securities, held-to-maturity (fair value \$3,624 for 2007 and \$7,840 for 2006)   | 3,448               | 7,503             |
| Loans held for sale   | 1,778               | 1,687             |
| Loans (net of deferred fees of \$315 in 2007 and \$534 in 2006)   | 445,719             | 405,573           |
| Less-allowance for loan losses  | (3,434)             | (3,126)           |
| <b>Net loans</b>  | <b>442,285</b>      | <b>402,447</b>    |
| Premises and equipment, net   | 10,252              | 10,495            |
| Other assets  | 16,870              | 17,285            |
| <b>Total assets</b>   | <b>\$ 594,607</b>   | <b>\$ 548,212</b> |
| <b>Liabilities</b>  |                     |                   |
| Deposits  |                     |                   |
| Noninterest bearing   | \$ 46,719           | \$ 49,190         |
| Interest bearing  | 465,249             | 407,455           |
| <b>Total deposits</b>   | <b>511,968</b>      | <b>456,645</b>    |
| Long-term debt  | 20,350              | 35,029            |
| Junior subordinated debentures  | 10,310              | 10,310            |
| Other liabilities   | 3,564               | 3,442             |
| <b>Total liabilities</b>  | <b>546,192</b>      | <b>505,426</b>    |
| <b>Shareholders equity</b>  |                     |                   |
| 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; 3,738,950 shares issued and outstanding for 2007 and 3,502,919 for 2006 | 9,347               | 8,757             |
| Additional paid-in capital  | 32,516              | 28,839            |
| Retained earnings   | 6,267               | 5,434             |
| Accumulated other comprehensive income (loss)   | 285                 | (244)             |
| <b>Total shareholders equity</b>  | <b>48,415</b>       | <b>42,786</b>     |
| <b>Total liabilities and shareholders equity</b>  | <b>\$ 594,607</b>   | <b>\$ 548,212</b> |

See accompanying notes.

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Codorus Valley Bancorp, Inc.  
**Consolidated Statements of Income**

|  | Years ended December 31, |               |               |
|--|--------------------------|---------------|---------------|
|  | 2007                     | 2006          | 2005          |
| <i>(dollars in thousands, except per share data)</i>                     |                          |               |               |
| <b>Interest income</b>   |                          |               |               |
| Loans, including fees  | \$ 34,007                | \$ 29,361     | \$ 22,462     |
| Investment securities  |                          |               |               |
| Taxable  | 2,650                    | 2,563         | 2,461         |
| Tax-exempt   | 1,206                    | 729           | 445           |
| Dividends  | 149                      | 136           | 69            |
| Federal funds sold   | 1,149                    | 520           | 130           |
| Other  | 8                        | 10            | 5             |
| <b>Total interest income</b>   | <b>39,169</b>            | <b>33,319</b> | <b>25,572</b> |
| <b>Interest expense</b>  |                          |               |               |
| Deposits   | 16,417                   | 12,766        | 7,255         |
| Federal funds purchased and other short-term borrowings                  |                          | 133           | 73            |
| Long-term debt   | 2,072                    | 2,178         | 1,821         |
| <b>Total interest expense</b>  | <b>18,489</b>            | <b>15,077</b> | <b>9,149</b>  |
| <b>Net interest income</b>   | <b>20,680</b>            | <b>18,242</b> | <b>16,423</b> |
| <b>Provision for (recovery of) loan losses</b>                           | <b>(554)</b>             | <b>650</b>    | <b>775</b>    |
| <b>Net interest income after provision for (recovery of) loan losses</b> | <b>21,234</b>            | <b>17,592</b> | <b>15,648</b> |
| <b>Noninterest income</b>  |                          |               |               |
| Trust and investment services fees                                       | 1,260                    | 1,255         | 1,147         |
| Service charges on deposit accounts                                      | 1,979                    | 1,870         | 1,638         |
| Mutual fund, annuity and insurance sales                                 | 1,506                    | 1,349         | 1,156         |
| Income from bank owned life insurance                                    | 271                      | 263           | 269           |
| Other income   | 431                      | 485           | 507           |
| Gain on sales of mortgages   | 248                      | 323           | 372           |
| Loss on sales of securities  | (7)                      | (80)          | (86)          |
| <b>Total noninterest income</b>  | <b>5,688</b>             | <b>5,465</b>  | <b>5,003</b>  |
| <b>Noninterest expense</b>   |                          |               |               |
| Personnel  | 10,676                   | 9,080         | 8,163         |
| Occupancy of premises, net   | 1,333                    | 1,368         | 1,311         |
| Furniture and equipment  | 1,324                    | 1,350         | 1,241         |
| Postage, stationery and supplies   | 449                      | 410           | 468           |
| Professional and legal   | 317                      | 277           | 326           |
| Marketing and advertising  | 675                      | 589           | 698           |
| Other  | 3,594                    | 2,816         | 2,275         |
| <b>Total noninterest expense</b>   | <b>18,368</b>            | <b>15,890</b> | <b>14,482</b> |
| <b>Income before income taxes</b>  | <b>8,554</b>             | <b>7,167</b>  | <b>6,169</b>  |
| <b>Provision for income taxes</b>  | <b>2,180</b>             | <b>1,845</b>  | <b>1,552</b>  |

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|                               |    |       |    |       |    |       |
|-------------------------------|----|-------|----|-------|----|-------|
| Net income                    | \$ | 6,374 | \$ | 5,322 | \$ | 4,617 |
| Net income per share, basic   | \$ | 1.72  | \$ | 1.45  | \$ | 1.27  |
| Net income per share, diluted | \$ | 1.69  | \$ | 1.42  | \$ | 1.24  |

See accompanying notes.

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

(dollars in thousands)

|   | Years ended December 31, |          |          |
|---|--------------------------|----------|----------|
|   | 2007                     | 2006     | 2005     |
| <b>Cash flows from operating activities</b>                         |                          |          |          |
| Net income  | \$ 6,374                 | \$ 5,322 | \$ 4,617 |
| Adjustments to reconcile net income to cash provided by operations: |                          |          |          |
| Depreciation  | 1,123                    | 1,165    | 1,115    |
| Provision for (recovery of) loan losses                             | (554)                    | 650      | 775      |
| Provision for losses on foreclosed real estate                      |                          |          | 17       |
| Deferred federal income tax benefit                                 | (235)                    | (372)    | (93)     |
| Amortization of investment in real estate partnerships              | 503                      | 484      | 472      |
| Increase in cash surrender value of life insurance investment       | (271)                    | (263)    | (269)    |
| Originations of held for sale mortgages                             | (17,845)                 | (23,249) | (29,402) |
| Proceeds from sales of held for sale mortgages                      | 18,002                   | 23,407   | 29,841   |
| Gain on sales of held for sale mortgages                            | (248)                    | (323)    | (372)    |
| Loss on sales of securities   | 7                        | 80       | 86       |
| Gain on sales of premises and equipment                             |                          | (43)     |          |
| Loss (gain) on sales of foreclosed real estate                      | 2                        | (4)      | (154)    |
| Stock-based compensation expense                                    | 55                       | 54       |          |
| Increase in accrued interest receivable                             | (91)                     | (376)    | (532)    |
| Decrease (increase) in other assets                                 | 361                      | (392)    | 48       |
| (Decrease) increase in accrued interest payable                     | (23)                     | 365      | 149      |
| Increase in other liabilities                                       | 145                      | 464      | 348      |
| Other, net  | 160                      | 190      | 240      |
| Net cash provided by operating activities                           | 7,465                    | 7,159    | 6,886    |
| <b>Cash flows from investing activities</b>                         |                          |          |          |
| Securities, available-for-sale                                      |                          |          |          |
| Purchases   | (23,333)                 | (26,404) | (17,985) |
| Maturities and calls  | 15,195                   | 10,874   | 17,327   |
| Sales   | 961                      | 2,176    | 3,918    |
| Securities, held-to-maturity, calls                                 | 4,172                    | 1,676    |          |
| Net decrease (increase) in restricted investment in bank stock      | 460                      | 520      | (2)      |
| Net increase in loans made to customers                             | (40,080)                 | (37,566) | (69,506) |
| Purchases of premises and equipment                                 | (883)                    | (775)    | (2,174)  |
| Investment in real estate partnership                               |                          |          | (420)    |
| Investment in life insurance  | (7)                      | (7)      | (7)      |
| Investment in nonconsolidated subsidiary                            |                          | (217)    |          |
| Proceeds from life insurance  | 249                      |          |          |
| Purchase of insurance agency assets                                 |                          | (63)     | (60)     |
| Proceeds from sales of premises and equipment                       |                          | 55       |          |
| Proceeds from sales of foreclosed real estate                       | 167                      | 9        | 1,690    |

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|  |           |           |           |
|--|-----------|-----------|-----------|
| Net cash used in investing activities          | (43,099)  | (49,722)  | (67,219)  |
| <b>Cash flows from financing activities</b>    |           |           |           |
| Net increase in demand and savings deposits    | 2,949     | 36,066    | 27,459    |
| Net increase in time deposits                  | 52,374    | 35,425    | 28,158    |
| Net decrease in short-term borrowings          |           | (9,781)   | (3,099)   |
| Proceeds from issuance of long-term debt       |           | 7,217     | 20,500    |
| Repayment of long-term debt                    | (14,679)  | (1,590)   | (7,401)   |
| Dividends paid                                 | (2,155)   | (1,703)   | (1,554)   |
| Issuance of common stock                       | 832       | 229       | 276       |
| Cash paid in lieu of fractional shares         | (6)       | (13)      | (6)       |
| Net cash provided by financing activities      | 39,315    | 65,850    | 64,333    |
| Net increase in cash and cash equivalents      | 3,681     | 23,287    | 4,000     |
| Cash and cash equivalents at beginning of year | 35,372    | 12,085    | 8,085     |
| Cash and cash equivalents at end of year       | \$ 39,053 | \$ 35,372 | \$ 12,085 |

**Supplemental disclosures**

|  |           |           |          |
|--|-----------|-----------|----------|
| Interest paid on deposits and borrowed funds | \$ 18,512 | \$ 14,712 | \$ 9,000 |
| Income taxes paid                            | \$ 1,765  | \$ 1,732  | \$ 1,095 |

See accompanying notes.

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Codorus Valley Bancorp, Inc.

**Consolidated Statements of Changes in Shareholders' Equity**

(dollars in thousands, except per share data)

|   | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total     |
|---|-----------------|----------------------------------|----------------------|--|-----------|
| Balance, December 31, 2004  | \$ 7,481        | \$ 20,293                        | \$ 8,034             | \$ 174   | \$ 35,982 |
| Comprehensive income  |                 |                                  |                      |  |           |
| Net income  |                 |                                  | 4,617                |  | 4,617     |
| Other comprehensive loss, net of tax:   |                 |                                  |                      |  |           |
| Unrealized losses on securities net of reclassification adjustment for gains included in net income |                 |                                  |                      | (586)  | (586)     |
| Total comprehensive income  |                 |                                  |                      |  | 4,031     |
| Cash dividends (\$.43 per share)  |                 |                                  | (1,554)              |  | (1,554)   |
| 5% stock dividend - 149,593 shares at fair value  | 374             | 2,513                            | (2,893)              |  | (6)       |
| Issuance of common stock - 18,638 shares under stock option plan                                    | 47              | 229                              |                      |  | 276       |
| Balance, December 31, 2005  | 7,902           | 23,035                           | 8,204                | (412)  | 38,729    |
| Comprehensive income  |                 |                                  |                      |  |           |
| Net income  |                 |                                  | 5,322                |  | 5,322     |

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|  |          |           |          |        |           |
|--|----------|-----------|----------|--------|-----------|
| Other comprehensive income, net of tax:  |          |           |          |        |           |
| Unrealized gain on securities net of reclassification adjustment for losses included in net income |          |           |          | 168    | 168       |
| Total comprehensive income   |          |           |          |        | 5,490     |
| Cash dividends (\$.46 per share)   |          |           | (1,703)  |        | (1,703)   |
| 5% stock dividend - 157,713 shares at fair value   | 394      | 2,667     | (3,068)  |        | (7)       |
| 5% stock dividend - 166,325 shares at fair value   | 416      | 2,899     | (3,321)  |        | (6)       |
| Stock-based compensation   |          | 54        |          |        | 54        |
| Issuance of common stock - 18,060 shares under stock option plan                                   | 45       | 184       |          |        | 229       |
| Balance, December 31, 2006   |          |           |          |        |           |
|  | 8,757    | 28,839    | 5,434    | (244)  | 42,786    |
| Comprehensive income   |          |           |          |        |           |
| Net income   |          |           | 6,374    |        | 6,374     |
| Other comprehensive income, net of tax:  |          |           |          |        |           |
| Unrealized gain on securities net of reclassification adjustment for losses included in net income |          |           |          | 529    | 529       |
| Total comprehensive income   |          |           |          |        | 6,903     |
| Cash dividends (\$.58 per share)   |          |           | (2,155)  |        | (2,155)   |
| 5% stock dividend - 175,148 shares at fair value   | 438      | 2,942     | (3,386)  |        | (6)       |
| Stock-based compensation   |          | 55        |          |        | 55        |
| Issuance of common stock - 60,883 shares under stock option plan                                   | 152      | 680       |          |        | 832       |
| Balance, December 31, 2007   |          |           |          |        |           |
|  | \$ 9,347 | \$ 32,516 | \$ 6,267 | \$ 285 | \$ 48,415 |

See accompanying notes.

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Codorus Valley Bancorp, Inc.

**Notes to Consolidated Financial Statements**

**NOTE 1-Summary of Significant Accounting Policies**

**Nature of Operations and Basis of Presentation**

Codorus Valley Bancorp, Inc. (Corporation or Codorus Valley) is a one-bank holding company headquartered in York, Pennsylvania that provides a full range of banking services through its subsidiary, PeoplesBank, A Codorus Valley Company (PeoplesBank). PeoplesBank operates two wholly owned subsidiaries, Codorus Valley Financial Advisors, Inc. (formerly SYC Insurance Services, Inc.) which sells nondeposit investment products, and SYC Settlement Services, Inc., which provides real estate settlement services. PeoplesBank operates under a state charter and is subject to regulation by the Pennsylvania Department of Banking and the Federal Deposit Insurance Corporation.

The consolidated financial statements include the accounts of Codorus Valley and its wholly owned bank subsidiary, PeoplesBank, and its wholly owned nonbank subsidiary, SYC Realty Company, Inc. The corporate purpose of SYC Realty, which has been inactive for all reportable periods, is to purchase and sell property acquired through debts previously contracted with an affiliate. All significant intercompany account balances and transactions have been eliminated in consolidation. The accounting and reporting policies of Codorus Valley and subsidiaries conform to accounting principles generally accepted in the United States of America and have been followed on a consistent basis.

**Investment Securities**

The classification of securities is determined at the time of acquisition and is reevaluated at each reporting date. Securities classified as available-for-sale are debt securities, except for investment in restricted stock of the Federal Home Loan Bank and Atlantic Central Bankers Bank which is required as a condition of membership and carried at cost. The Corporation intends to hold debt securities for an indefinite period

of time, but not necessarily to maturity. Any decision to sell a security classified as available-for-sale would be based on various factors, including significant movements in interest rates, changes in maturity mix of assets and liabilities, liquidity needs, regulatory considerations and other factors. Debt securities available-for-sale are carried at fair value, with unrealized gains and losses, net of taxes, reported as a component of accumulated other comprehensive income or loss in shareholders' equity. Premiums and discounts are recognized in interest income using the interest method over the estimated life of the securities. Realized gains and losses from the sale of available-for-sale securities are computed on the basis of specific identification of the adjusted cost of each security and are shown net as a separate line item in the statement of income.

Securities classified as held-to-maturity are those debt securities that the Corporation has both the intent and ability to hold to maturity regardless of changes in market conditions, liquidity needs or general economic conditions. These securities are carried at cost adjusted for amortization of premium and accretion of discount, computed by the interest method over the estimated life of the securities.

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.

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### **Loans Held for Sale**

Loans held for sale are reported at the lower of cost or fair value, as determined in the aggregate. The amount by which cost exceeds fair value, if any, is accounted for as a valuation allowance and is charged to expense in the period of the change.

### **Loans**

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff generally are stated at their outstanding unpaid principal balances adjusted for charge-offs, the allowance for loan losses, and any deferred fees and costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees and costs are generally deferred and recognized as adjustments of interest rate yields, by being amortized to interest income over the terms of the related loans. Determination of a loan's past due status is based on contractual terms. When circumstances indicate that collection of a loan is doubtful, the accrual of interest income is discontinued and unpaid interest previously credited to income is reversed and charged against current income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when management determines that circumstances have improved to the extent that all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

### **Allowance for Loan Losses**

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management's periodic evaluation of the adequacy of the allowance is based on current economic conditions, prior loss experience, adequacy of collateral, risk characteristics of the loan portfolio and other relevant factors. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as additional information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses and reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A loan is considered impaired when, based on current information and events, it is probable that PeoplesBank will be unable to collect all amounts when due according to contractual terms of the loan agreement. Factors considered by management in determining impairment, include: payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. An insignificant delay or shortfall in the amount of payments received would not cause a loan to be rendered impaired. Impairment is measured on an individual

loan basis for business loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous consumer loans are collectively evaluated for impairment using

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loss factors derived in part from historical charge-offs. Accordingly, the Corporation does not separately identify individual consumer and residential loans for impairment disclosure, unless such loans are the subject of a restructuring agreement. Income on impaired loans is recognized under the same policy as disclosed under the heading Loans in this Note.

**Transfers of Financial Assets**

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Corporation, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Corporation does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

**Premises and Equipment**

Land is carried at cost. Premises and equipment are carried at cost less accumulated depreciation. Depreciation expense is calculated principally on the straight-line method over the assets' estimated useful lives. Estimated useful lives are ten to forty years for buildings and improvements, five to ten years for furniture and equipment and three to five years for computer equipment and software. Maintenance and repairs are charged to expense as incurred. The cost of significant improvements to existing assets is capitalized. When facilities are retired or otherwise disposed of, the depreciated cost is removed from the asset accounts and any gain or loss is reflected in the statement of income.

**Foreclosed Real Estate**

Foreclosed real estate, included in other assets, is comprised of property acquired through a foreclosure proceeding, acceptance of a deed-in-lieu of foreclosure, or insubstance foreclosures. Foreclosed real estate is initially recorded at fair value minus estimated costs to sell at the date of foreclosure, establishing a new cost basis. Appraisals are generally used to determine fair value. After foreclosure, management reviews valuations at least quarterly and adjusts the asset to the lower of cost or fair value minus estimated costs to sell. Costs related to the improvement of foreclosed real estate are generally capitalized until the real estate reaches a saleable condition. Revenue and expense from operations and changes in the valuation allowance are included in expense. When a foreclosed real estate asset is ultimately sold, any gain or loss on the sale is included in the income statement as a component of other expense. At year-end 2007, foreclosed real estate, net of allowance, was \$403,000, compared to \$38,000 for year-end 2006.

**Investments in Real Estate Partnerships**

In March 2003, PeoplesBank acquired a 73.47 percent limited partner interest in a real estate joint venture known as Village Court, which was formed to develop, construct, own and operate a 60-unit affordable housing complex located in Dover Township, York County, Pennsylvania. Construction of the housing complex was completed in the fourth quarter of 2004 and the complex was fully leased by December 31, 2004. The investment balance included in other assets was \$1,990,000 at December 31, 2007, compared to \$2,251,000 at December 31, 2006. Additionally, PeoplesBank is a 99.99 percent limited partner in a real estate joint venture known as SMB Properties that rehabilitated and now operates seven buildings in the City of York, Pennsylvania as part of a revitalization initiative. The buildings provide low-income housing to qualified families and to a lesser degree, space for commercial purposes. The investment balance included in other assets was \$1,086,000 at December 31, 2007, compared to \$1,328,000 at December 31, 2006.

Investment and related tax credits are accounted for under the effective yield method of accounting under which tax credits are recognized as they are allocated and the cost of the investment is amortized to provide a constant yield over the period that tax credits are allocated, generally ten years.

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### **Bank Owned Life Insurance**

PeoplesBank invests in bank owned life insurance (BOLI) as a source of funding for employee benefit expenses. BOLI involves the purchasing of life insurance by PeoplesBank on a select group of employees and directors. PeoplesBank is the owner and beneficiary of the policies. This life insurance investment is carried at the cash surrender value of the underlying policies and is included in other assets in the amount of \$7,807,000 at December 31, 2007, compared to \$7,922,000 at December 31, 2006. Income from the increase in cash surrender value of the policies is a separate line item within the noninterest income section of the income statement.

### **Trust and Investment Services Assets**

Assets held by PeoplesBank in a fiduciary or agency capacity for its customers are not included in the consolidated statements of financial condition since these items are not assets of PeoplesBank.

### **Advertising**

Advertising costs are charged to expense when incurred.

### **Income Taxes**

Deferred income taxes are provided on the liability method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance, when in the opinion of management, it is more likely than not that some portion or all the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted through the provision for income taxes for the effects of changes in tax laws and rates on the effective date.

Effective January 1, 2007, the Company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes. The Interpretation provides clarification on accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB No. 109, Accounting for Income Taxes. The Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. As a result of the Company's evaluation of the implementation of FIN 48, no significant income tax uncertainties were identified. Therefore, the Company recognized no adjustment for unrecognized income tax benefits for the year ended December 31, 2007. Our policy is to recognize interest and penalties on unrecognized tax benefits in income taxes expense in the Consolidated Statement of Income. The Company did not recognize any interest and penalties for the year ended December 31, 2007. The tax years subject to examination by the taxing authorities are the years ended December 31, 2006, 2005, 2004 and 2003.

In May 2007, the FASB issued FASB Staff Position ( FSP ) FIN 48-1 Definition of Settlement in FASB Interpretation No. 48 (FSP FIN 48-1). FSP FIN 48-1 provides guidance on how to determine whether a tax position is effectively settled for purpose of recognizing previously unrecognized tax benefits. FSP FIN 48-1 is effective retroactively to January 1, 2007. The implementation of this standard did not have a material impact on our consolidated financial position or results of operation.

### **Use of Estimates**

The preparation of financial statements in conformity with generally accepted accounting principles in the U.S. of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and the evaluation of other than temporary impairment losses of securities.

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### **Per Share Data**

Basic net income per share is calculated as net income divided by the weighted average number of common shares outstanding. Diluted net income per share is calculated as net income divided by the weighted average number of common shares outstanding plus common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Corporation relate solely to outstanding stock options and are determined using the treasury stock method. All share and per share amounts are adjusted for stock dividends that are declared prior to the issuance of the financial statements.



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The computation of net income per share for the years ended December 31, 2007, 2006 and 2005 is provided in the table below. Anti-dilutive options excluded from the computation of earnings per share were 0 for 2007, 0 for 2006, and 53,607 for 2005.

| <i>(in thousands, except per share data)</i>  | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|---|-------------|-------------|-------------|
| Net income                                    | \$ 6,374    | \$ 5,322    | \$ 4,617    |
| Weighted average shares outstanding (basic)   | 3,697       | 3,664       | 3,649       |
| Effect of dilutive stock options              | 80          | 86          | 73          |
| Weighted average shares outstanding (diluted) | 3,777       | 3,750       | 3,722       |
| Basic earnings per share                      | \$ 1.72     | \$ 1.45     | \$ 1.27     |
| Diluted earnings per share                    | \$ 1.69     | \$ 1.42     | \$ 1.24     |

Stock dividends issued by the Board of Directors of Codorus Valley for the years 2005 through 2007 were as follows:

| Stock Dividend | Declaration Date | Record Date | Payable Date |
|----------------|------------------|-------------|--------------|
| 5%             | 4/10/2007        | 4/24/2007   | 6/7/2007     |
| 5%             | 10/10/2006       | 10/24/2006  | 12/7/2006    |
| 5%             | 4/11/2006        | 4/25/2006   | 6/08/2006    |
| 5%             | 4/12/2005        | 4/26/2005   | 6/09/2005    |

### Stock Based Compensation

The Corporation adopted Statement of Financial Accounting Standards No. 123R, Share-Based Payment (Statement 123R) in the first quarter of 2006, using the modified prospective method. Prior to the implementation of FAS 123R, stock options issued under shareholder approved employee and director stock option plans were accounted for under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). Under APB 25, no compensation expense was recognized related to these plans. Stock options are granted at exercise prices not less than the fair value of the common stock on the date of grant. See Note 12 Stock-Based Compensation.

### Cash Flow Information

For purposes of the statements of cash flows, the Corporation considers interest bearing deposits with banks, cash and due from banks, and federal funds sold to be cash and cash equivalents. Noncash items for the years ended December 31, 2007, 2006 and 2005 consisted of the transfer of loans to foreclosed real estate for \$576,000, \$38,000 and \$22,000, respectively.

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### Off-Balance Sheet Financial Instruments

In the ordinary course of business, the Corporation enters into off-balance sheet financial instruments consisting of commitments to extend credit and standby letters of credit. These financial instruments are recorded on the balance sheet when they become a receivable to the Corporation.

### Comprehensive Income

Accounting principles generally accepted in the U.S. of America require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income or loss. The components of other comprehensive income and related tax effects are presented in the following table:

| <i>(dollars in thousands)</i> | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|-------------------------------|-------------|-------------|-------------|
|-------------------------------|-------------|-------------|-------------|

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|   |        |        |          |
|---|--------|--------|----------|
| Unrealized holding gains (losses) arising during the year | \$ 794 | \$ 175 | \$ (974) |
| Reclassification adjustment for losses included in income | 7      | 80     | 86       |
| Net unrealized gains (losses)                             | 801    | 255    | (888)    |
| Tax effect  | (272)  | (87)   | 302      |
| Net of tax amount   | \$ 529 | \$ 168 | \$ (586) |

### 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.

### Reclassification

Certain amounts in the 2006 consolidated financial statements have been reclassified to conform to the 2007 presentation.

### Recent Accounting Pronouncements

In February 2007, the Financial Accounting Standards Board issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be recognized in earnings at each subsequent reporting date. Effective January 1, 2008, the Corporation adopted SFAS No. 159 and has determined that it is immaterial to the consolidated financial statements.

In September 2006, the Financial Accounting Standards Board issued FASB Statement No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value under Generally Accepted Accounting Principles, and expands disclosures about fair value measurements. FASB Statement No. 157 applies to other accounting pronouncements that require or permit fair value measurements. The new guidance is effective for financial statements issued for fiscal years beginning after November 15, 2007, and for interim periods within those fiscal years. Effective January 1, 2008, the Corporation adopted FASB Statement No. 157 and has determined that it is immaterial to the consolidated financial statements.

In December 2007, the FASB issued proposed FASB Staff Position (FSP) 157-b, Effective Date of FASB Statement No. 157, that would permit a one-year deferral in applying the measurement provisions of Statement No. 157 to non-financial assets and non-financial liabilities (non-financial

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items) that are not recognized or disclosed at fair value in an entity's financial statements on a recurring basis (at least annually). Therefore, if the change in fair value of a non-financial item is not required to be recognized or disclosed in the financial statements on an annual basis or more frequently, the effective date of application of Statement 157 to that item is deferred until fiscal years beginning after November 15, 2008 and interim periods within those fiscal years. This deferral does not apply, however, to an entity that applies Statement 157 in interim or annual financial statements before proposed FSP 157-b is finalized. The Company is currently evaluating the impact, if any, that the adoption of FSP 157-b will have on the Company's operating income or net earnings.

In September 2006, the FASB's Emerging Issues Task Force (EITF) issued EITF Issue No. 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split Dollar Life Insurance Arrangements (EITF 06-4). EITF 06-4 requires the recognition of a liability related to the postretirement benefits covered by an endorsement split-dollar life insurance arrangement. The consensus highlights that the employer (who is also the policyholder) has a liability for the benefit it is providing to its employee. As such, if the policyholder has agreed to maintain the insurance policy in force for the employee's benefit during his or her retirement, then the liability recognized during the employee's active service period should be based on the future cost of insurance to be incurred during the employee's retirement. Alternatively, if the policy holder has agreed to provide the employee with a death benefit, then the liability for the future death benefit should be recognized by following the guidance in SFAS No. 106 or Accounting Principles Board (APB) Opinion No. 12, as appropriate. For transition, an entity can

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choose to apply the guidance using either of the following approaches: (a) a change in accounting principle through retrospective application to all periods presented or (b) a change in accounting principle through a cumulative-effect adjustment to the balance in retained earnings at the beginning of the year of adoption. Implementation is required in fiscal years beginning after December 15, 2007, with early adoption permitted. Management has elected the cumulative-effect adjustment method under EITF Issue No. 06-4 and anticipates a one time charge of approximately \$713,000 to retained earnings on January 1, 2008. Recognition of the current liability as an expense through the income statement is expected to approximate \$56,000 for 2008.

FASB statement No. 141 (R) Business Combinations was issued in December of 2007. This Statement establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. The Statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The guidance will become effective as of the beginning of a company's fiscal year beginning after December 15, 2008.

Staff Accounting Bulletin No. 110 (SAB 110) amends and replaces Question 6 of Section D.2 of Topic 14, Share-Based Payment, of the Staff Accounting Bulletin series. Question 6 of Section D.2 of Topic 14 expresses the views of the staff regarding the use of the simplified method in developing an estimate of expected term of plain vanilla share options and allows usage of the simplified method for share option grants prior to December 31, 2007. SAB 110 allows public companies which do not have historically sufficient experience to provide a reasonable estimate to continue use of the simplified method for estimating the expected term of plain vanilla share option grants after December 31, 2007. Effective January 1, 2008, the Corporation adopted SAB 110 and expects it will not have an impact on its consolidated financial statements.

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In June 2007, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 06-11, Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards (EITF 06-11). EITF 06-11 states that an entity should recognize a realized tax benefit associated with dividends on nonvested equity shares, nonvested equity share units and outstanding equity share options charged to retained earnings as an increase in additional paid in capital. The amount recognized in additional paid in capital should be included in the pool of excess tax benefits available to absorb potential future tax deficiencies on share-based payment awards. EITF 06-11 should be applied prospectively to income tax benefits of dividends on equity-classified share-based payment awards that are declared in fiscal years beginning after December 15, 2007. The Company expects that EITF 06-11 will not have an impact on its consolidated financial statements.

#### **NOTE 2-Restrictions on Cash and Due from Banks**

Cash balances reserved to meet regulatory requirements of the Federal Reserve Bank and balances maintained at other banks for compensating balance requirements averaged approximately \$752,000 for 2007 and \$802,000 for 2006.

#### **NOTE 3-Securities Available-for-Sale and Held-to-Maturity**

A summary of available-for-sale and held-to-maturity securities at December 31 is provided below. Equity securities consist of Federal Home Loan Bank stock and Atlantic Central Bankers Bank stock.

| <i>(dollars in thousands)</i> | Amortized<br>Cost | Gross Unrealized |         | Estimated<br>Fair<br>Value |
|-------------------------------|-------------------|------------------|---------|----------------------------|
|                               |                   | Gains            | Losses  |                            |
| <b>2007</b>                   |                   |                  |         |                            |
| Available-for-sale            |                   |                  |         |                            |
| Debt securities               |                   |                  |         |                            |
| U.S. agency                   | \$ 21,512         | \$ 138           | \$ (28) | \$ 21,622                  |
| State and municipal           | 30,739            | 363              | (130)   | 30,972                     |
| Mortgage-backed, U.S. agency  | 26,767            | 164              | (75)    | 26,856                     |
| Equity securities             | 1,471             |                  |         | 1,471                      |

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|   |           |              |           |            |           |         |           |              |
|---|-----------|--------------|-----------|------------|-----------|---------|-----------|--------------|
| Total available-for-sale                  | \$        | 80,489       | \$        | 665        | \$        | (233)   | \$        | 80,921       |
| <b>Held-to-maturity</b>                   |           |              |           |            |           |         |           |              |
| Debt securities-corporate trust preferred | \$        | 3,448        | \$        | 176        | \$        |         | \$        | 3,624        |
| <b>Total held-to-maturity</b>             | <b>\$</b> | <b>3,448</b> | <b>\$</b> | <b>176</b> | <b>\$</b> | <b></b> | <b>\$</b> | <b>3,624</b> |

**2006**

|   |           |               |           |            |           |              |           |               |
|---|-----------|---------------|-----------|------------|-----------|--------------|-----------|---------------|
| <b>Available-for-sale</b>                 |           |               |           |            |           |              |           |               |
| <b>Debt securities</b>                    |           |               |           |            |           |              |           |               |
| U.S. agency                               | \$        | 32,309        | \$        | 23         | \$        | (400)        | \$        | 31,932        |
| State and municipal                       |           | 27,397        |           | 336        |           | (73)         |           | 27,660        |
| Mortgage-backed, U.S. agency              |           | 12,154        |           | 13         |           | (268)        |           | 11,899        |
| Equity securities                         |           | 1,932         |           |            |           |              |           | 1,932         |
| <b>Total available-for-sale</b>           | <b>\$</b> | <b>73,792</b> | <b>\$</b> | <b>372</b> | <b>\$</b> | <b>(741)</b> | <b>\$</b> | <b>73,423</b> |
| <b>Held-to-maturity</b>                   |           |               |           |            |           |              |           |               |
| Debt securities-corporate trust preferred | \$        | 7,503         | \$        | 337        | \$        |              | \$        | 7,840         |
| <b>Total held-to-maturity</b>             | <b>\$</b> | <b>7,503</b>  | <b>\$</b> | <b>337</b> | <b>\$</b> | <b></b>      | <b>\$</b> | <b>7,840</b>  |

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The amortized cost and estimated fair value of debt securities at December 31, 2007, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities if call options on selected debt issues are exercised in the future. Mortgage-backed securities are included in the maturity categories based on average expected life.

| (dollars in thousands)                 | Available-for-sale |                  | Held-to-maturity |                 |
|--|--------------------|------------------|------------------|-----------------|
|  | Amortized Cost     | Fair Value       | Amortized Cost   | Fair Value      |
| Due in one year or less                | \$ 11,303          | \$ 11,277        | \$               | \$              |
| Due after one year through five years  | 45,246             | 45,632           |                  |                 |
| Due after five years through ten years | 17,192             | 17,368           |                  |                 |
| Due after ten years                    | 5,277              | 5,173            | 3,448            | 3,624           |
| <b>Total debt securities</b>           | <b>\$ 79,018</b>   | <b>\$ 79,450</b> | <b>\$ 3,448</b>  | <b>\$ 3,624</b> |

Gross losses realized from the sale of available-for-sale securities were (\$7,000), (\$80,000), and (\$86,000) for 2007, 2006 and 2005, respectively. Securities, issued by agencies of the federal government, with a carrying value of \$41,961,000 and \$40,875,000 on December 31, 2007 and 2006, respectively, were pledged to secure public and trust deposits.

The table below shows investments gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2007 and 2006.

| (dollars in thousands) | Less than 12 months |                   | 12 months or more |                   | Total      |                   |
|------------------------|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|                        | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |

**2007**

|  |    |       |    |       |    |        |                         |
|--|----|-------|----|-------|----|--------|-------------------------|
| Available-for-sale securities                                  |    |       |    |       |    |        |                         |
| U.S. agency  | \$ |       | \$ | 9,995 | \$ | 28     | \$ 9,995 \$ 28          |
| State and Municipal  |    | 6,553 |    | 98    |    | 2,535  | 32 9,088 130            |
| Mortgage-backed, U.S. agency                                   |    | 1,479 |    | 8     |    | 3,259  | 67 4,738 75             |
| Total temporarily impaired debt securities, available-for-sale |    |       |    |       |    |        |                         |
|  | \$ | 8,032 | \$ | 106   | \$ | 15,789 | \$ 127 \$ 23,821 \$ 233 |

**2006**

|  |    |        |    |    |    |        |                         |
|--|----|--------|----|----|----|--------|-------------------------|
| Available-for-sale securities                                  |    |        |    |    |    |        |                         |
| U.S. agency  | \$ | 750    | \$ | 1  | \$ | 26,712 | \$ 399 \$ 27,462 \$ 400 |
| State and Municipal  |    | 6,741  |    | 55 |    | 1,580  | 18 8,321 73             |
| Mortgage-backed, U.S. agency                                   |    | 2,809  |    | 5  |    | 4,886  | 263 7,695 268           |
| Total temporarily impaired debt securities, available-for-sale |    |        |    |    |    |        |                         |
|  | \$ | 10,300 | \$ | 61 | \$ | 33,178 | \$ 680 \$ 43,478 \$ 741 |

Management believes that unrealized losses at December 31, 2007, were primarily the result of changes in market interest rates and that it has the ability to hold these investments for a time necessary to recover the amortized cost. The \$106,000 unrealized loss within the less than 12 months category was attributable to fifteen different securities issued primarily by municipalities. The \$127,000 unrealized loss in the 12 months or more category relates to twenty securities issued primarily by the following agencies of the federal government: Federal Home Loan Bank (FHLB), Federal Home Loan Mortgage Corporation (FHLMC) and the Federal National Mortgage Association (FNMA). Management believes

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that collection of the contractual principal and interest is probable and therefore, all impairment is considered to be temporary.

**NOTE 4-Loans**

The composition of the loan portfolio at December 31, is as follows:

|   |             |             |
|---|-------------|-------------|
| <i>(dollars in thousands)</i>                   | <b>2007</b> | <b>2006</b> |
| Commercial, industrial and agricultural         | \$ 243,144  | \$ 218,673  |
| Real estate - construction and land development | 83,625      | 91,414      |
| Total commercial related loans                  | 326,769     | 310,087     |
| Real estate - residential mortgages             | 55,257      | 31,509      |
| Installment                                     | 63,693      | 63,977      |
| Total consumer related loans                    | 118,950     | 95,486      |
| Total loans                                     | \$ 445,719  | \$ 405,573  |

Concentrations of credit risk arise when a number of customers are engaged in similar business activities in the same geographic region or have similar economic features that could cause their ability to meet contractual obligations to be similarly affected by changes in economic conditions. Most of the Corporation's business is with customers in York County, Pennsylvania and northern Maryland, specifically Baltimore, Harford and Carroll counties. Although this focus 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 2007, the Corporation had two industry concentrations that exceeded

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10 percent of the total loan portfolio, real estate construction and land development which was 18.8 percent of the portfolio and commercial real estate leasing was 11.5 percent of the portfolio. Comparatively, at year-end 2006, only one industry concentration real estate construction and land development exceeded 10 percent of the total loan portfolio at 22.5 percent of the portfolio. Loans to borrowers within these industries are usually collateralized by real estate.

The principal balance of loans outstanding to directors, executive officers, principal shareholders, and any associates of such persons was \$4,763,000 at December 31, 2007, and \$4,662,000 at December 31, 2006. During 2007, total loan additions were \$2,332,000 and total payments collected were \$2,231,000. Related party loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated persons and do not involve more than normal risk of collection. As of year-end 2007, all loans to this group were current and performing in accordance with contractual terms.

### NOTE 5-Impaired, Nonaccrual and Past Due Loans

Information regarding impaired commercial loans at December 31, is provided below. Commercial loans are predominately real estate collateral dependent; accordingly, impairment is based on the net realizable value of the collateral relative to recorded investment in the loan. The policy for recognizing interest income on impaired loans is provided under Loans within Note 1.

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| <i>(dollars in thousands)</i>                 | <b>2007</b>      | <b>2006</b>     | <b>2005</b>      |
|---|------------------|-----------------|------------------|
| Impaired loans without a related allowance    | \$ 14,246        | \$ 5,272        | \$ 10,273        |
| Impaired loans with a related allowance       | 212              | 530             | 203              |
| <b>Total impaired loans</b>                   | <b>\$ 14,458</b> | <b>\$ 5,802</b> | <b>\$ 10,476</b> |
| Allowance for impaired loans                  | \$ 55            | \$ 90           | \$ 35            |
| Average investment in impaired loans          | 8,195            | 7,632           | 8,308            |
| Interest income recognized on impaired loans: |                  |                 |                  |
| accrual basis                                 | 210              | 165             | 797              |
| cash basis                                    | 47               | 150             | -                |

At December 31, 2007 and 2006, the loan portfolio included nonaccrual loans of \$9,411,000 and \$4,368,000, respectively. Loans contractually past due 90 days or more as to principal or interest, but still accruing interest totaled \$222,000 at December 31, 2007, compared to \$4,000 at December 31, 2006.

### NOTE 6-Analysis of Allowance for Loan Losses

Changes in the allowance for loan losses for each of the three years ended December 31, were as follows:

| <i>(dollars in thousands)</i>                       | <b>2007</b>     | <b>2006</b>     | <b>2005</b>     |
|---|-----------------|-----------------|-----------------|
| Balance at beginning of year                        | \$ 3,126        | \$ 2,538        | \$ 1,865        |
| Provision (recoveries) charged to operating expense | (554)           | 650             | 775             |
| Loans charged off                                   | (66)            | (150)           | (213)           |
| Recoveries  | 928             | 88              | 111             |
| <b>Balance at end of year</b>                       | <b>\$ 3,434</b> | <b>\$ 3,126</b> | <b>\$ 2,538</b> |

As reported on Form 8-K filed by Codorus Valley on February 13, 2007, PeoplesBank recovered \$839,000 representing its portion of a \$12 million restitution fund created in settlement of a claim by the U.S. Department of Justice against the Bank of New York. The funds substantially

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reimbursed PeoplesBank for loan losses that it 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 those contracts. Management recognized this recovery as a credit to the loan loss provision in the first quarter of 2007.

### NOTE 7-Premises and Equipment

A summary of premises and equipment at December 31, is as follows:

| <i>(dollars in thousands)</i>      | <b>2007</b>      | <b>2006</b>      |
|------------------------------------|------------------|------------------|
| Land                               | \$ 1,139         | \$ 1,139         |
| Buildings and improvements         | 11,256           | 10,949           |
| Capitalized leased premises        | 672              | 672              |
| Equipment                          | 8,974            | 8,886            |
|                                    | 22,041           | 21,646           |
| Less-accumulated depreciation      | (11,789)         | (11,151)         |
| <b>Premises and equipment, net</b> | <b>\$ 10,252</b> | <b>\$ 10,495</b> |

PeoplesBank leases certain banking branches under capital and noncancellable operating leases. The terms include various renewal options and provide for rental increases based upon predetermined

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factors. Total lease expenses under operating leases amounted to \$160,000 in 2007, \$163,000 in 2006, and \$137,000 in 2005. At December 31, 2007, future minimum lease payments for these leases and a capital lease are payable as follows:

| <i>(dollars in thousands)</i>                  | <b>Capital<br/>Lease</b> | <b>Operating<br/>Leases</b> |
|--|--------------------------|-----------------------------|
| 2008   | \$ 95                    | \$ 201                      |
| 2009   | 95                       | 199                         |
| 2010   | 95                       | 187                         |
| 2011   | 102                      | 132                         |
| 2012   | 102                      | 135                         |
| Thereafter                                     | 306                      | 143                         |
| <b>Total future minimum lease payments</b>     | <b>795</b>               | <b>\$ 997</b>               |
| Less interest                                  | (269)                    |                             |
| <b>Present value of minimum lease payments</b> | <b>\$ 526</b>            |                             |

### NOTE 8-Deposits

The composition of deposits at December 31, was as follows:

| <i>(dollars in thousands)</i> | <b>2007</b> | <b>2006</b> |
|-------------------------------|-------------|-------------|
| Noninterest bearing demand    | \$ 46,719   | \$ 49,190   |

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|                                   |                   |                   |
|-----------------------------------|-------------------|-------------------|
| NOW                               | 44,086            | 43,864            |
| Money market                      | 148,832           | 144,292           |
| Savings                           | 18,191            | 17,533            |
| Time deposits less than \$100,000 | 173,674           | 145,849           |
| Time deposits \$100,000 or more   | 80,466            | 55,917            |
| <b>Total deposits</b>             | <b>\$ 511,968</b> | <b>\$ 456,645</b> |

Scheduled maturities of time deposits as of December 31, were as follows:

|                               |                   |
|-------------------------------|-------------------|
| <i>(dollars in thousands)</i> | <b>2007</b>       |
| 2008                          | \$ 181,897        |
| 2009                          | 52,939            |
| 2010                          | 13,661            |
| 2011                          | 2,912             |
| 2012                          | 2,731             |
| <b>Total time deposits</b>    | <b>\$ 254,140</b> |

**NOTE 9-Short-term Borrowings and Long-term Debt**

The schedule below provides a summary of short-term borrowings that consist of federal funds purchased and other borrowings. Federal funds purchased from correspondent banks usually mature in one business day. Other short-term borrowings consist of credit available through the Federal Home Loan Bank of Pittsburgh (FHLBP) and the Atlantic Central Bankers Bank (ACBB). Based on the most recent analysis, total credit available from the FHLBP, for both short and long-term credit needs, is approximately \$122 million. As of December 31, 2007, total unused credit with the FHLBP was approximately \$102 million. Obligations to the FHLBP are secured by FHLB stock and qualifying

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collateral, principally the unpledged portion of PeoplesBank's investment securities portfolio and qualifying mortgage loan receivables. The interest rate for short-term borrowings reprices daily based on the federal funds rate or the open repo market depending on the borrowing program. As of December, 31, 2007, the Corporation maintained an unsecured line of credit of \$3 million with ACBB which is renewable annually. No funds were drawn on the ACBB line during 2007.

A summary of aggregate short-term borrowings on December 31, is as follows:

|   |             |             |             |
|---|-------------|-------------|-------------|
| <i>(dollars in thousands)</i>                           | <b>2007</b> | <b>2006</b> | <b>2005</b> |
| Amount outstanding at end of year                       | \$          | \$          | \$ 9,781    |
| Weighted average interest rate at end of year           | 0.00%       | 0.00%       | 4.22%       |
| Maximum amount outstanding at any month-end             | \$          | \$ 16,714   | \$ 12,048   |
| Daily average amount outstanding                        | \$          | \$ 2,857    | \$ 2,534    |
| Approximate weighted average interest rate for the year | 0.00%       | 4.66%       | 2.88%       |

A summary of long-term debt at December 31, is as follows:

|                                  |             |             |
|----------------------------------|-------------|-------------|
| <i>(dollars in thousands)</i>    | <b>2007</b> | <b>2006</b> |
| PeoplesBank obligations to FHLBP |             |             |



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|   |                  |                  |
|---|------------------|------------------|
| Due 2007, 4.68%   | \$               | \$ 7,000         |
| Due 2009, 3.47% convertible quarterly after<br>December 2006  |                  |                  |
|   | 5,000            | 5,000            |
| Due 2010, 4.32%   | 6,000            | 6,000            |
| Due 2011, 4.30%, amortizing   | 4,240            | 4,504            |
| Due 2012, 4.25%, amortizing   | 1,663            | 1,998            |
| Due 2013, 3.46%, amortizing   | 2,921            | 3,403            |
| Due 2014, 6.43%, convertible quarterly after<br>July 2009   |                  | 5,000            |
| Codorus Valley Bancorp, Inc. obligations  |                  |                  |
| Due 2011, floating rate based on 1 month<br>LIBOR plus 1.50%, amortizing                                |                  | 1,562            |
| Due 2034, floating rate based on 3 month<br>LIBOR plus 2.02%, callable quarterly after<br>December 2009 | 3,093            | 3,093            |
| Due 2036 floating rate based on 3 month<br>LIBOR plus 1.54% callable quarterly after<br>July 2011       | 7,217            | 7,217            |
|   | 30,134           | 44,777           |
| Capital lease obligation  | 526              | 562              |
| <b>Total long-term debt</b>   | <b>\$ 30,660</b> | <b>\$ 45,339</b> |

PeoplesBank's obligations to FHLBP are fixed rate and fixed/floating (convertible) rate instruments. The FHLBP has the option on the convertible borrowings to convert the rate to a floating rate after the expiration of a specified period. The floating rate is based on the LIBOR index plus a spread. If the FHLBP elects to exercise the conversion option, PeoplesBank may repay the converted loan, without a prepayment penalty.

To support planned growth, Codorus Valley issued trust preferred debt securities in the amount of \$7,217,000 in June 2006 and \$3,093,000 in November 2004, which are included in Tier 1 capital for regulatory capital purposes. These obligations have a 30-year maturity, but are callable at quarterly intervals after the fifth year. Maturities of total long-term debt over the next five years are as follows:

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\$1,165,000 in 2008, \$6,214,000 in 2009, \$7,238,000 in 2010, \$4,416,000 in 2011, \$812,000 in 2012 and \$10,815,000 thereafter.

**NOTE 10-Regulatory Matters**

The Corporation is subject to restrictions on the payment of dividends to its shareholders pursuant to the Pennsylvania Business Corporation Law of 1988, as amended (BCL). The BCL prohibits dividend payments if such payment would render the Corporation insolvent or result in negative net worth. Federal and state banking regulations place certain restrictions on dividends paid and loans or advances made by PeoplesBank to the Corporation. The amount of total dividends, which may be paid at any date, is generally limited to the retained earnings of PeoplesBank. Furthermore, dividend payments would be prohibited if the effect thereof would cause PeoplesBank's capital to be reduced below applicable minimum capital requirements as discussed below. Loans and advances by PeoplesBank to affiliates, including the Corporation, are limited to 10 percent of PeoplesBank's capital stock and contributed capital on a secured basis.

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

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Quantitative measures established by regulators to ensure capital adequacy require the Corporation and PeoplesBank to maintain minimum ratios to total and tier 1 capital as a percentage of risk-weighted assets, and of tier 1 capital to average assets (leverage ratio) as set forth below. In December 2007, PeoplesBank received the most recent notification from the Federal Deposit Insurance Corporation, which categorized PeoplesBank as well capitalized, as of September 30, 2007, under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes would change PeoplesBank's well capitalized category.

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|  | Actual    |        | Minimum for Capital Adequacy |       | Well Capitalized Minimum* |       |
|--|-----------|--------|------------------------------|-------|---------------------------|-------|
|  | Amount    | Ratio  | Amount                       | Ratio | Amount                    | Ratio |
| <i>(dollars in thousands)</i>                      |           |        |                              |       |                           |       |
| <b>Codorus Valley Bancorp, Inc. (consolidated)</b> |           |        |                              |       |                           |       |
| <b>December 31, 2007</b>                           |           |        |                              |       |                           |       |
| Capital ratios                                     |           |        |                              |       |                           |       |
| Tier 1 risk-based                                  | \$ 57,727 | 12.14% | \$ 19,022                    | 4.0%  | n/a                       | n/a   |
| Total risk-based                                   | 61,161    | 12.86  | 38,043                       | 8.0   | n/a                       | n/a   |
| Leverage   | 57,727    | 9.84   | 23,473                       | 4.0   | n/a                       | n/a   |
| <b>December 31, 2006</b>                           |           |        |                              |       |                           |       |
| Capital ratios                                     |           |        |                              |       |                           |       |
| Tier 1 risk-based                                  | \$ 52,587 | 11.99% | \$ 17,538                    | 4.0%  | n/a                       | n/a   |
| Total risk-based                                   | 55,713    | 12.71  | 35,076                       | 8.0   | n/a                       | n/a   |
| Leverage   | 52,587    | 9.83   | 21,401                       | 4.0   | n/a                       | n/a   |
| <b>PeoplesBank, A Codorus Valley Company</b>       |           |        |                              |       |                           |       |
| <b>December 31, 2007</b>                           |           |        |                              |       |                           |       |
| Capital ratios                                     |           |        |                              |       |                           |       |
| Tier 1 risk-based                                  | \$ 53,759 | 11.39% | \$ 18,885                    | 4.0%  | \$ 28,328                 | 6.0%  |
| Total risk-based                                   | 57,193    | 12.11  | 37,770                       | 8.0   | 47,213                    | 10.0  |
| Leverage   | 53,759    | 9.22   | 23,324                       | 4.0   | 29,155                    | 5.0   |
| <b>December 31, 2006</b>                           |           |        |                              |       |                           |       |
| Capital ratios                                     |           |        |                              |       |                           |       |
| Tier 1 risk-based                                  | \$ 48,130 | 11.12% | \$ 17,316                    | 4.0%  | \$ 25,973                 | 6.0%  |
| Total risk-based                                   | 51,256    | 11.84  | 34,631                       | 8.0   | 43,289                    | 10.0  |
| Leverage   | 48,130    | 9.09   | 21,168                       | 4.0   | 26,460                    | 5.0   |

\* Under prompt corrective action provisions

### **NOTE 11-Benefit Plans**

#### **Defined Contribution Plan**

The Corporation maintains a 401(k) savings and investment plan covering substantially all employees. Under the plan, employees can contribute a percentage of their gross salary. In 2007, 2006, and 2005, the Corporation matched 50 percent of the first 6 percent of an employee's contribution. The Corporation's expense for the 401(k) savings and investment plan was \$154,000 for 2007, \$140,000 for 2006, and \$109,000 for 2005.

#### **Supplemental Benefit Plans**

PeoplesBank maintains supplemental retirement plans for selected executives and supplemental life insurance for executive officers and directors. The supplemental life insurance plans replaced other insurance coverage. The expense associated with these plans was approximately \$217,000 for 2007, \$204,000 for 2006, and \$167,000 for 2005. The accrued liability was \$1,371,000 at December 31, 2007, \$1,154,000 at December 31, 2006, and \$951,000 at December 31, 2005. Investment in bank owned life insurance policies was used to finance the supplemental benefit plans, and provide a tax-exempt return to PeoplesBank.

**Dividend Reinvestment and Stock Purchase Plan**

The Corporation maintains a Dividend Reinvestment and Stock Purchase Plan (Plan). Shareholders of common stock may participate in the Plan, which allows additional shares of common stock to be

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purchased with reinvested dividends at prevailing market prices. For 2007, 2006 and 2005 all shares were purchased from the open market. To the extent that shares are not available in the open market, 204,133 shares of common stock are reserved and available for issuance at December 31, 2007. Open market purchases were made by an independent purchasing agent retained to act as agent for Plan participants, and the purchase price to participants was the actual price paid, excluding brokerage commissions and other expenses which were paid by the Corporation. The Plan also permits participants to make additional voluntary cash payments to purchase shares of the Corporation's common stock.

**NOTE 12-Stock-Based Compensation**

The Corporation adopted Statement of Financial Accounting Standards No. 123(R), Share-Based Payment (Statement 123R) in the first quarter of 2006, using the modified prospective method. Statement 123R requires that the fair value of equity awards to employees be recognized as compensation expense over the period during which an employee is required to provide service in exchange for such award. Compensation expense of \$55,000 net of \$0 tax effect during 2007 and \$54,000 net of \$0 tax effect during 2006 was included in net income and earnings per share. Comparatively, the impact on net income and earnings per share during 2005 that would have occurred if compensation expense would have been recognized based on the estimated fair value of the options on the date of grant is as follows:

| <i>(Dollars in thousands, except per share data)</i>   | <b>2005</b> |
|--|-------------|
| Reported net income  | \$ 4,617    |
| Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects of \$0 | (189)       |
| Pro forma net income   | \$ 4,428    |
| Reported basic earnings per share  | \$ 1.27     |
| Reported diluted earnings per share  | \$ 1.24     |
| Pro forma basic earnings per share   | \$ 1.21     |
| Pro forma diluted earnings per share   | \$ 1.19     |

The Corporation's equity awards are granted from the following plans: a 2000 Stock Incentive Plan (2000 Plan), a 1998 Independent Directors Stock Option Plan (1998 Plan) and a 1996 Stock Incentive Plan (1996 Plan), (collectively the Option Plans), a 2007 Long Term Incentive Plan (LTIP) and a 2007 Employee Stock Purchase Plan (ESPP).

All options available for grant under the 1998 and 1996 Plans have been granted. The 2000 Plan also allows for the granting of stock appreciation rights and restricted stock, none of which have been granted to date at December 31, 2007.

Shares reserved and available for issuance as of December 31, 2007, adjusted for stock dividends declared, were 141,093 for the 2000 Plan, 130,315 for the 1998 Plan, and 38,543 for the 1996 Plan. Shares reserved for future issuance under each plan are subject to adjustment in the event of specified changes in the Corporation's capital structure. Options awarded under these plans to date have been granted with an exercise price equal to the fair value of the stock on the grant date, a minimum vesting

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period of six months and an expiration period of ten years. Upon exercise, the Corporation has historically issued authorized, but unissued, common stock to satisfy the options.

There were no options granted from the 2000 Plan in 2007. The grant-date fair value, adjusted for stock dividends declared, of options granted in 2006 was \$6.62 compared to \$6.22 for 2005. The fair value of the options awarded under the Option Plans is estimated on the date of grant using the Black-Scholes valuation model, which is dependent upon certain assumptions as presented below.

|                          | 2006  | 2005  |
|--------------------------|-------|-------|
| Expected life (in years) | 5.25  | 6.12  |
| Risk-free interest rate  | 5.19% | 3.89% |
| Expected volatility      | 46.4% | 48.3% |
| Expected dividend yield  | 2.7%  | 2.6%  |

The expected life of the options was estimated using one half of the exercise period plus the vesting period and represents the period of time that options granted are expected to be outstanding. The risk-free interest rate is the U.S. Treasury rate commensurate with the expected life of the options on the grant date. Volatility of the Corporation's stock price was based on historical volatility. Dividend yield was based on dividends for the most current year divided by the average market price for the most current year.

A summary of stock options activity from the Option Plans, adjusted for stock dividends declared, is shown below.

|                                  | Options  | Weighted<br>Average<br>Exercise Price<br>Per Share | Weighted<br>Average<br>Remaining<br>Contractual<br>Term | Aggregate<br>Intrinsic<br>Value<br>(\$000) |
|----------------------------------|----------|--|---|--|
| Outstanding at December 31, 2004 | 286,480  | \$ 11.79   | 5.0 years   | \$ 1,175                                   |
| Granted                          | 38,781   | 16.06  |   |  |
| Exercised                        | (21,876) | 10.75  |   |  |
| Outstanding at December 31, 2005 | 303,385  | \$ 12.41   | 4.7 years   | \$ 1,312                                   |
| Granted                          | 551      | 17.14  |   |  |
| Exercised                        | (19,731) | 8.34   |   |  |
| Outstanding at December 31, 2006 | 284,205  | \$ 12.70   | 4.0 years   | \$ 1,884                                   |
| Granted                          |          |  |   |  |
| Exercised                        | (61,188) | 11.31  |   |  |
| Outstanding at December 31, 2007 | 223,017  | \$ 13.09   | 3.6 years   | \$ 879                                     |
| Exercisable at December 31, 2007 | 202,812  | \$ 12.79   | 3.2 years   | \$ 861                                     |

Intrinsic value represents the amount by which the market price of the stock on the measurement date exceeded the exercise price of the option. The intrinsic value of options exercised was \$413,000 for 2007, \$188,000 for 2006, and 119,000 for 2005. Cash received from such exercises during 2007 was \$692,000 and the tax benefit recognized was \$141,000. For 2006 cash received from exercises was \$165,000 and the tax benefit recognized was \$64,000, and for 2005 was \$235,000 and the tax benefit recognized was \$41,000.

As of December 31, 2007, total unrecognized compensation cost related to nonvested options was \$43,000. The cost is expected to be recognized over a weighted average period of 1.3 years.

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During the second quarter of 2007, shareholders approved, and the Corporation adopted the 2007 Long Term Incentive Plan (LTIP), with 175,000 shares reserved for future issuance. No shares of stock were awarded or stock options granted under the LTIP since inception.

Also during the second quarter of 2007, shareholders approved, and the Corporation adopted the 2007 Employee Stock Purchase Plan (ESPP), with 175,000 shares reserved for future issuance. On July 1, 2007, the first offering commenced for the ESPP and, at the end of the offering period, 3,783 shares were purchased from the open market and were reissued to participants.

The Corporation also maintains an Employee Stock Bonus Plan, administered by nonemployee members of the Corporation's Board of Directors, under which the Corporation may issue shares of its common stock to employees as performance based compensation. As of December 31, 2007, 13,689 shares of common stock were reserved for possible issuance under this plan, subject to future adjustment in the event of specified changes in the Corporation's capital structure. Under the Employee Stock Bonus Plan, no shares of stock were issued during 2007, 53 shares were issued during 2006, and no shares of stock were issued during 2005.

### NOTE 13-Income Taxes

The provision for income taxes for the years ended December 31, consists of the following:

| <i>(dollars in thousands)</i>    | 2007            | 2006            | 2005            |
|----------------------------------|-----------------|-----------------|-----------------|
| <b>Current tax provision:</b>    |                 |                 |                 |
| Federal                          | \$ 2,368        | \$ 2,154        | \$ 1,645        |
| State                            | 47              | 63              |                 |
| Deferred tax (benefit) provision | (235)           | (372)           | (93)            |
| <b>Total tax provision</b>       | <b>\$ 2,180</b> | <b>\$ 1,845</b> | <b>\$ 1,552</b> |

The differences between the effective income tax rate and the Federal statutory income tax rate are as follows:

| <i>(dollars in thousands)</i>                  | 2007         | 2006         | 2005         |
|--|--------------|--------------|--------------|
| <b>Statutory tax rate</b>                      | <b>34.0%</b> | <b>34.0%</b> | <b>34.0%</b> |
| <b>Increase (decrease) resulting from:</b>     |              |              |              |
| Tax-exempt interest income                     | (5.8)        | (4.5)        | (2.7)        |
| Low income housing credits                     | (3.6)        | (4.5)        | (5.3)        |
| Disallowed interest                            | 0.9          | 0.6          | 0.2          |
| Bank owned life insurance income               | (1.1)        | (1.3)        | (1.5)        |
| State income taxes, net of federal tax benefit | 0.5          | 0.7          |              |
| Other, net                                     | 0.6          | 0.7          | 0.5          |
| <b>Effective income tax rate</b>               | <b>25.5%</b> | <b>25.7%</b> | <b>25.2%</b> |

The provision for income taxes includes (\$2,000), (\$27,000) and (\$29,000) of applicable income tax benefit related to net investment security losses in 2007, 2006 and 2005, respectively.

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Significant components of the Corporation's deferred tax asset, included in other assets as of December 31, were as follows:

| <i>(dollars in thousands)</i> | 2007 | 2006 |
|-------------------------------|------|------|
|-------------------------------|------|------|

|  |              |              |
|--|--------------|--------------|
| Deferred tax assets                                    |              |              |
| Allowance for loan losses                              | \$ 1,056     | \$ 919       |
| Deferred compensation                                  | 466          | 393          |
| Partnership investment amortization                    | 905          | 734          |
| Net unrealized losses on available-for-sale securities |              | 125          |
| <br>Total deferred tax assets                          | <br>2,427    | <br>2,171    |
| Deferred tax liabilities                               |              |              |
| Deferred loan fees                                     | 333          | 258          |
| Depreciation   | 93           | 189          |
| Net unrealized gains on available-for-sale securities  | 147          |              |
| Other, net   | 778          | 610          |
| <br>Total deferred tax liabilities                     | <br>1,351    | <br>1,057    |
| <br>Net deferred tax asset                             | <br>\$ 1,076 | <br>\$ 1,114 |

**NOTE 14-Commitments to Extend Credit**

In the normal course of business, the Corporation is a party to various financial transactions that are not funded as of the balance sheet date. Off-balance sheet financial instruments, which enable bank customers to meet their financing needs, are comprised mainly of commitments to extend credit and standby letters of credit. Standby letters of credit written are conditional commitments issued by PeoplesBank to guarantee the performance of a customer to a third party. The credit and market risk involved in issuing letters of credit is essentially the same as that involved in extending other loan commitments. To manage these risks the Corporation uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments and requires collateral to support these letters of credit as deemed necessary. Management believes that the proceeds obtained through a liquidation of such collateral would be sufficient to cover the maximum potential amount of future payments required under the corresponding guarantees. The amount of the liability as of December 31, 2007 and 2006, for guarantees under standby letters of credit issued was not material. Normally, commitments to extend credit and letters of credit have fixed expiration dates or termination clauses, have specific rates and are for specific purposes. Many of the commitments are expected to expire without being extended; therefore, total commitment amounts do not necessarily represent future cash requirements.

The following is a summary of outstanding commitments:

| <i>(dollars in thousands)</i>          | December 31, |           |
|--|--------------|-----------|
|  | 2007         | 2006      |
| Commitments to grant loans             |              |           |
| Fixed rate                             | \$ 14,200    | \$ 12,389 |
| Variable rate                          | 39,198       | 16,462    |
| Unfunded commitments of existing loans |              |           |
| Fixed rate                             | \$ 18,046    | \$ 21,696 |
| Variable rate                          | 86,543       | 65,665    |
| Standby letters of credit              | \$ 3,381     | \$ 6,121  |

**NOTE 15-Contingent Liabilities**

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Periodically, the Corporation and its subsidiary bank may be defendants in legal proceedings relating to the conduct of their banking business. Most of such legal proceedings are a normal part of the banking business and, in management's opinion, do not materially affect the financial position or results of operations of the Corporation.

### **NOTE 16-Fair Values of Financial Instruments**

FASB Statement No. 107, *Disclosures About Fair Value of Financial Instruments*, requires disclosure of fair value information about financial instruments, whether or not recognized on the balance sheet, for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value of expected future cash flows or other valuation techniques. These techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. Statement No. 107 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Corporation.

The following methodologies and assumptions were used by Codorus Valley to estimate its fair value disclosures.

*Cash and cash equivalents* The fair value for total cash and cash equivalents is deemed to be the same as the carrying amount.

*Investment securities* Fair values for investment securities are based on quoted market prices. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

*Restricted investment in bank stocks* Fair values for Federal Home Loan Bank and Atlantic Central Bankers Bank stock approximate the carrying values based on the redemption provisions of the respective issuer.

*Loans held for sale* Fair values for loans held for sale are based on quoted market prices.

*Loans, net of allowance* For variable rate and adjustable rate loans that repriced frequently with no significant change in credit risk, fair value is deemed to be the same as the carrying amount. Fair values for all other loans in the portfolio are estimated by discounting estimated future cash flows using comparable current interest rates at which similar loans would be made to borrowers with similar credit risk.

*Interest receivable and payable* The fair values for interest receivable and interest payable approximate their carrying amounts.

*Noninterest bearing demand, NOW, money market and savings deposits* Fair values for noninterest bearing demand, NOW, money market and savings deposits approximate their carrying amounts.

*Time deposits* The fair value for variable rate time deposits is deemed to approximate the carrying amount. The fair value for fixed rate time deposits is estimated by discounting expected future cash flows using rates offered for deposits of similar remaining maturities at the reporting date.

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*Long-term debt and Junior subordinated debentures* The fair value of fixed rate long-term debt is estimated by discounting estimated future cash flows using rates available to Codorus Valley, at the reporting date, for similar types of borrowings. The fair value of variable rate long-term debt approximates carrying amount.

*Off-balance sheet instruments* Fair values for off-balance sheet instruments, such as commitments to extend credit and standby letters of credit, are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. These amounts were not considered to be material at December 31, 2007 and 2006.

The following table summarizes the carrying amounts and fair values of financial instruments at December 31, 2007 and 2006.

2007

2006

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| (dollars in thousands)   | Carrying<br>Amount | Estimated<br>Fair<br>Value | Carrying<br>Amount | Estimated<br>Fair<br>Value |
|--|--------------------|----------------------------|--------------------|----------------------------|
| <b>Financial assets</b>  |                    |                            |                    |                            |
| Cash and equivalents   | \$ 39,053          | \$ 39,053                  | \$ 35,372          | \$ 35,372                  |
| Securities, available-for-sale                                     | 80,921             | 80,921                     | 73,423             | 73,423                     |
| Securities, held-to-maturity                                       | 3,448              | 3,624                      | 7,503              | 7,840                      |
| Loans held for sale  | 1,778              | 1,803                      | 1,687              | 1,714                      |
| Loans, net of allowance  | 442,285            | 440,456                    | 402,447            | 396,770                    |
| Interest receivable  | 2,705              | 2,705                      | 2,614              | 2,614                      |
| <b>Financial liabilities</b>                                       |                    |                            |                    |                            |
| Noninterest bearing demand, NOW, money market and savings deposits | \$ 257,828         | \$ 257,828                 | \$ 254,879         | \$ 254,879                 |
| Time deposits  | 254,140            | 255,231                    | 201,766            | 202,232                    |
| Long-term debt   | 20,350             | 20,191                     | 35,029             | 34,846                     |
| Junior subordinated debentures                                     | 10,310             | 10,310                     | 10,310             | 10,310                     |
| Interest payable   | 838                | 838                        | 861                | 861                        |
| Off-balance sheet instruments                                      |                    |                            |                    |                            |

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**NOTE 17-Condensed Financial Information-Parent Company Only**

**Condensed Balance Sheets**

| (dollars in thousands)                            | December 31,     |                  |
|---|------------------|------------------|
|   | 2007             | 2006             |
| <b>Assets</b>                                     |                  |                  |
| Cash and due from banks                           | \$ 672           | \$ 797           |
| Securities, held-to-maturity                      | 932              | 2,950            |
| Investment in subsidiaries                        | 54,760           | 48,641           |
| Premises and equipment, net                       | 3,700            | 3,834            |
| Other assets                                      | 535              | 406              |
| <b>Total assets</b>                               | <b>\$ 60,599</b> | <b>\$ 56,628</b> |
| <b>Liabilities</b>                                |                  |                  |
| Long-term debt                                    | \$ 10,310        | \$ 11,872        |
| Long-term debt with subsidiary, PeoplesBank       | 1,736            | 1,819            |
| Other liabilities                                 | 138              | 151              |
| <b>Total liabilities</b>                          | <b>12,184</b>    | <b>13,842</b>    |
| <b>Shareholders' equity</b>                       | <b>48,415</b>    | <b>42,786</b>    |
| <b>Total liabilities and shareholders' equity</b> | <b>\$ 60,599</b> | <b>\$ 56,628</b> |

**Condensed Statements of Income**



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|   | Years ended December 31, |                 |                 |
|---|--------------------------|-----------------|-----------------|
|   | 2007                     | 2006            | 2005            |
| <i>(dollars in thousands)</i>   |                          |                 |                 |
| <b>Income</b>   |                          |                 |                 |
| Interest from investment securities   | \$ 240                   | \$ 390          | \$ 327          |
| Dividends from subsidiary, PeoplesBank  | 1,444                    | 1,853           | 1,554           |
| Other   |                          | 26              |                 |
| <b>Total income</b>   | <b>1,684</b>             | <b>2,269</b>    | <b>1,881</b>    |
| <b>Expense</b>  |                          |                 |                 |
| Interest expense on long-term debt  | 910                      | 741             | 405             |
| Occupancy of premises, net  | 65                       | 88              | 92              |
| Other   | 260                      | 222             | 227             |
| <b>Total expense</b>  | <b>1,235</b>             | <b>1,051</b>    | <b>724</b>      |
| <b>Income before applicable income tax benefit and undistributed earnings of subsidiaries</b> | <b>449</b>               | <b>1,218</b>    | <b>1,157</b>    |
| <b>Applicable income tax benefit</b>  | <b>336</b>               | <b>215</b>      | <b>135</b>      |
| <b>Income before undistributed earnings of subsidiaries</b>                                   | <b>785</b>               | <b>1,433</b>    | <b>1,292</b>    |
| <b>Undistributed earnings of subsidiaries</b>   | <b>5,589</b>             | <b>3,889</b>    | <b>3,325</b>    |
| <b>Net income</b>   | <b>\$ 6,374</b>          | <b>\$ 5,322</b> | <b>\$ 4,617</b> |

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**Note 17-Condensed Financial Information-Parent Company Only (continued)**

**Condensed Statements of Cash Flows**

|   | Years ended December 31, |              |              |
|---|--------------------------|--------------|--------------|
|   | 2007                     | 2006         | 2005         |
| <i>(dollars in thousands)</i>   |                          |              |              |
| <b>Cash flows from operating activities</b>                             |                          |              |              |
| Net income  | \$ 6,374                 | \$ 5,322     | \$ 4,617     |
| Adjustments to reconcile net income to net cash provided by operations: |                          |              |              |
| Depreciation  | 156                      | 165          | 171          |
| Undistributed earnings of subsidiaries                                  | (5,589)                  | (3,889)      | (3,325)      |
| Gain on sales of premises and equipment                                 |                          | (26)         |              |
| Other, net  | (161)                    | 6            | (70)         |
| <b>Net cash provided by operating activities</b>                        | <b>780</b>               | <b>1,578</b> | <b>1,393</b> |
| <b>Cash flows from investing activities</b>                             |                          |              |              |
| Calls of securities, held-to-maturity                                   | 2,092                    | 636          |              |
| Additional investment in subsidiary, PeoplesBank                        |                          | (7,000)      |              |
| Investment in nonconsolidated subsidiary                                |                          | (217)        |              |
| Purchases of premises and equipment                                     | (23)                     | (30)         |              |
| Proceeds from sales of premises and equipment                           |                          | 32           |              |

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|  |         |         |         |
|--|---------|---------|---------|
| Net cash provided by (used in) investing activities  | 2,069   | (6,579) |         |
| <b>Cash flows from financing activities</b>          |         |         |         |
| Proceeds from issuance of long-term debt             |         | 7,217   |         |
| Repayments of long-term debt                         | (1,645) | (156)   | (158)   |
| Dividends paid                                       | (2,155) | (1,703) | (1,554) |
| Issuance of common stock                             | 832     | 229     | 276     |
| Cash paid in lieu of fractional shares               | (6)     | (13)    | (6)     |
| Net cash provided by (used in) financing activities  | (2,974) | 5,574   | (1,442) |
| Net increase (decrease) in cash and cash equivalents | (125)   | 573     | (49)    |
| Cash and cash equivalents at beginning of year       | 797     | 224     | 273     |
| Cash and cash equivalents at end of year             | \$ 672  | \$ 797  | \$ 224  |

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**Note 18-Quarterly Results of Operations (Unaudited)**

The following is a summary of the quarterly results of operations for the years ended December 31, 2007 and 2006.

|  | 2007      |           |          |          | 2006     |          |          |          |
|--|-----------|-----------|----------|----------|----------|----------|----------|----------|
|  | Quarter   |           |          |          | Quarter  |          |          |          |
|  | Fourth    | Third     | Second   | First    | Fourth   | Third    | Second   | First    |
| <i>(dollars in thousands,<br/>except per share data)</i> |           |           |          |          |          |          |          |          |
| Interest income  | \$ 10,035 | \$ 10,090 | \$ 9,838 | \$ 9,206 | \$ 8,924 | \$ 8,658 | \$ 7,949 | \$ 7,788 |
| Interest expense   | 4,419     | 4,741     | 4,748    | 4,581    | 4,358    | 4,123    | 3,504    | 3,092    |
| Net interest income                                      | 5,616     | 5,349     | 5,090    | 4,625    | 4,566    | 4,535    | 4,445    | 4,696    |
| Provision for loan losses                                | 365       | (35)      | 35       | (919)    | 150      | 145      | 145      | 210      |
| Noninterest income                                       | 1,446     | 1,399     | 1,375    | 1,227    | 1,374    | 1,237    | 1,416    | 1,195    |
| Gain on sales of mortgages                               | 40        | 51        | 63       | 94       | 113      | 61       | 61       | 88       |
| Noninterest expense (1)                                  | 4,950     | 4,662     | 4,300    | 4,456    | 4,347    | 3,780    | 3,842    | 3,921    |
| Income before taxes and securities<br>loss               | 1,787     | 2,172     | 2,193    | 2,409    | 1,556    | 1,908    | 1,935    | 1,848    |
| Loss on sales of securities                              |           |           | (7)      |          | (80)     |          |          |          |
| Income before income taxes                               | 1,787     | 2,172     | 2,186    | 2,409    | 1,476    | 1,908    | 1,935    | 1,848    |
| Provision for income taxes                               | 450       | 531       | 559      | 640      | 345      | 501      | 512      | 487      |
| Net income   | \$ 1,337  | \$ 1,641  | \$ 1,627 | \$ 1,769 | \$ 1,131 | \$ 1,407 | \$ 1,423 | \$ 1,361 |
| <b>Net income per common share:</b>                      |           |           |          |          |          |          |          |          |
| Basic  | \$ 0.36   | \$ 0.44   | \$ 0.44  | \$ 0.48  | \$ 0.31  | \$ 0.38  | \$ 0.39  | \$ 0.37  |
| Diluted  | \$ 0.35   | \$ 0.43   | \$ 0.43  | \$ 0.47  | \$ 0.30  | \$ 0.38  | \$ 0.38  | \$ 0.36  |

(1) Noninterest expense for the fourth quarter of 2007 increased \$603,000 or 14 percent above the same quarter for 2006. The fourth quarter included an infrequent prepayment penalty expense for \$252,000, which resulted from paying off the remaining \$3 million balance of a Federal Home Loan Bank advance prior to maturity. A \$308,000 or 15 percent increase in wage expense due to staff additions to support business growth also contributed to the increase in noninterest expense for the fourth quarter of 2007.

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**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Shareholders  
Codorus Valley Bancorp, Inc.  
York, Pennsylvania

We have audited the accompanying consolidated balance sheets of Codorus Valley Bancorp, Inc. and subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2007. Codorus Valley Bancorp, Inc.'s management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Codorus Valley Bancorp, Inc. and its subsidiaries as of December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2007 in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 12 to the consolidated financial statements, Codorus Valley Bancorp, Inc. changed its method of accounting for share-based payments in 2006.

Beard Miller Company LLP  
Harrisburg, Pennsylvania  
March 11, 2008

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**Item 9: Changes in and disagreements with accountants on accounting and financial disclosure**

None.

**Item 9A(T): Controls and procedures**

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The Corporation maintains controls and procedures designed to ensure that information required to be disclosed in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC. Based upon their evaluation of those controls and procedures performed as of December 31, 2007, the Chief Executive and Chief Financial Officers of the Corporation concluded that the Corporation's disclosure controls and procedures were adequate. The Chief Executive and Chief Financial Officers are not aware of any changes in internal controls over financial reporting or in other factors that has materially affected these controls subsequent to December 31, 2007, the date of their evaluation.

A Report of Management's Assessment of Internal Control Over Financial Reporting is located on page 38 of this Annual Report.

### **Item 9B: Other Information**

None.

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## **PART III**

### **Item 10: Directors, executive officers and corporate governance of Codorus Valley Bancorp, Inc.**

Information appearing in the Proxy Statement relating to the 2008 Annual Meeting of Shareholders to be held May 20, 2008 (Proxy Statement), under the captions Information about Nominees and Continuing Directors, Executive Officers, and Governance of the Corporation is incorporated by reference in response to this item.

The Corporation has adopted a Code of Business Conduct and Ethics (Code of Ethics) as defined in Item 406 of Regulation S-K. The Code of Ethics was filed as Exhibit 14 to a Form 8-K, filed with the SEC on March 3, 2008, and is incorporated by reference in response to this item. The Code of Ethics is also published on PeoplesBank's website at [www.peoplesbanknet.com](http://www.peoplesbanknet.com), under the Investor Relations tab.

Information regarding Section 16(a) Beneficial Ownership Reporting Compliance follows. Section 16(a) of the Securities Exchange Act of 1934, requires that the Corporation's officers and directors, and persons who own more than 10% of the registered class of the Corporation's equity securities, file reports of ownership and changes in ownership with the SEC. Officers, directors and greater than 10% shareholders are required by SEC regulation to furnish the Corporation with copies of all Section 16(a) forms they file.

Based solely on its review of the copies of Forms 3, 4 and 5 and amendments thereto received by it, or written representations from certain reporting persons that no Form 5 was required for that reporting person, the Corporation believes that during the period from January 1, 2007 through December 31, 2007, its officers and directors were in compliance with all filing requirements applicable to them except for Rodney L. Krebs who filed a Form 4 one day late as disclosed in the 2008 Proxy Statement.

### **Item 11: Executive compensation**

Information appearing in the Proxy Statement, under the captions Executive Compensation, Director Compensation and Compensation Committee Report is incorporated by reference in response to this item.

### **Item 12: Security ownership of certain beneficial owners and management and related shareholder matters**

Information appearing in the Proxy Statement, under the caption Share Ownership, Outstanding Equity Awards at Fiscal Year End and Potential Payments Upon Termination or Change of Control is incorporated by reference in response to this item.

### **Item 13: Certain relationships and related transactions, and director independence**

Information appearing in the Proxy Statement, under the captions Related Person Transactions and Governance of the Corporation is incorporated by reference in response to this item.

**Item 14: Principal accountant fees and services**

Information appearing in the Proxy Statement, under the caption Independent Registered Public Accounting Firm, is incorporated by reference in response to this item.

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**PART IV**

**Item 15: Exhibits and financial statement schedules**

(a) Documents filed as part of this Form 10-K report.

1. Financial Statements

The following consolidated statements of Codorus Valley Bancorp, Inc. are incorporated by reference to Part II, Item 8 hereof:

Report of Independent Registered Public Accounting Firm  
 Consolidated Balance Sheets  
 Consolidated Statements of Income  
 Consolidated Statements of Changes in Shareholders' Equity  
 Consolidated Statements of Cash Flows  
 Notes to Consolidated Financial Statements

2. Financial Statement Schedules

Required financial statement schedules are omitted. This information is either not applicable, not required or is shown in the respective financial statements or in the notes thereto.

3. Exhibits filed as part of 10-K pursuant to Item 601 of Regulation S-K.

| Exhibit<br>Number | Description of Exhibit  |
|-------------------|---|
| 3(i)              | Amended Articles of Incorporation (Incorporated by reference to Exhibit 3(i) to the Registrant's Current Report on Form 8-K, filed with the Commission on October 14, 2005.)  |
| 3(ii)             | Amended By-laws (Incorporated by reference to Exhibit 3(ii) to the Registrant's Current Report on Form 8-K, filed with the Commission on November 15, 2007.)  |
| 4                 | Rights Agreement dated as of November 4, 2005 (Incorporated by reference to Exhibit 4 to the Registrant's Current Report on Form 8-K, filed with the Commission on November 8, 2005.)   |
| 10.1              | 1996 Stock Incentive Plan (Incorporated by reference to Exhibit 99 of Registration Statement No. 333-09277 on Form S-8, filed with the Commission on July 31, 1996.)  |
| 10.2              | Employment Agreement between Codorus Valley Bancorp, Inc., PeoplesBank, A Codorus Valley Company and Larry J. Miller dated December 27, 2005. (Incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K, filed with the Commission on January 3, 2006.)             |
| 10.3              | Change of Control Agreement by and among Codorus Valley Bancorp, Inc., PeoplesBank, A Codorus Valley Company and Jann A. Weaver, dated December 27, 2005. (Incorporated by reference to Exhibit 10.7 to the Registrant's Current Report on Form 8-K, filed with the Commission on January 3, 2006.) |

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- 10.4 Change of Control Agreement by and among Codorus Valley Bancorp, Inc., PeoplesBank, A Codorus Valley Company and Harry R. Swift, dated December 27, 2005. (Incorporated by reference to Exhibit 10.6 to the Registrant's Current Report on Form 8-K, filed with the Commission on January 3, 2006.)
- 10.5 1998 Independent Directors Stock Option Plan (Incorporated by reference to Exhibit 4.3 of Registrant Statement No. 333-61851 on Form S-8, filed with the Commission on August 19, 1998.)
- 10.6 2000 Stock Incentive Plan (Incorporated by reference to Exhibit 4.3 of Registration Statement No. 333-40532 on Form S-8, filed with the Commission on June 30, 2000.)
- 10.7 2001 Employee Stock Bonus Plan (Incorporated by reference to Exhibit 99.1 of Registration Statement No. 333-68410 on Form S-8, filed with the Commission on August 27, 2001.)
- 10.8 Dividend Reinvestment and Stock Purchase Plan (Incorporated by reference to Exhibit 4(a) Registration Statement No. 33-46171 on Amendment No. 4 to Form S-3, filed with the Commission on July 23, 2004.)
- 10.9 Amendment to Salary Continuation Agreement by and among PeoplesBank, A Codorus Valley Company, a wholly owned subsidiary of Codorus Valley Bancorp, Inc. and Larry J. Miller dated December 27, 2005. (Incorporated by reference to Exhibit 10.3 to the Registrant's Current Report on Form 8-K, filed with the Commission on January 3, 2006.)
- 10.10 Amendment to Salary Continuation Agreement by and among PeoplesBank, A Codorus Valley Company, a wholly owned subsidiary of Codorus Valley Bancorp, Inc. and Harry R. Swift dated December 27, 2005. (Incorporated by reference to Exhibit 10.4 to the Registrant's Current Report on Form 8-K, filed with the Commission on January 3, 2006.)
- 10.11 Amendment to Salary Continuation Agreement by and among PeoplesBank, A Codorus Valley Company, a wholly owned subsidiary of Codorus Valley Bancorp, Inc. and Jann A. Weaver dated December 27, 2005. (Incorporated by reference to Exhibit 10.5 to the Registrant's Current Report on Form 8-K, filed with the Commission on January 3, 2006.)
- 10.12 Form of Group Term Replacement Plan, dated December 1, 1998, as amended, including Split Dollar Policy Endorsements pertaining to senior officers of the Corporation's subsidiary, PeoplesBank, A Codorus Valley Company. (Incorporated by reference to Exhibit 10.12 to the Registrant's Annual Report on Form 10-K, filed on March 29, 2005.)
- 10.13 Sample form of Director Group Term Replacement Plan, dated December 1, 1998, including Split Dollar Policy Endorsements pertaining to non-employee directors of the Corporation's subsidiary, PeoplesBank, A Codorus Valley Company. (Incorporated by reference to Exhibit 10.13 to the Registrant's Annual Report on Form 10-K, filed on March 29, 2005.)

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- 10.14 Long Term Nursing Care Agreement between Codorus Valley Bancorp, Inc., PeoplesBank, A Codorus Valley Company and Larry J. Miller, dated December 27, 2005. (Incorporated by reference to Exhibit 10.2 to the Registrant's Current Report on Form 8-K, filed with the Commission on January 3, 2006.)
- 10.15 Codorus Valley Bancorp, Inc. Change in Control and Supplemental Benefit Trust Agreement between Codorus Valley Bancorp, Inc., PeoplesBank, A Codorus Valley Company and Hershey Trust Company, dated January 25, 2006. (Incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K, filed with the Commission on January 27, 2006.)
- 10.16 Amended and Restated Declaration of Trust of CVB Statutory Trust No. 2, dated as of June 28, 2006, among Codorus Valley Bancorp, Inc., as sponsor, the Delaware and institutional trustee named therein, and the

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administrators named therein. (Incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed with the Commission on June 30, 2006.)

- 10.17 Indenture, dated as of June 28, 2006, between Codorus Valley Bancorp, Inc., as issuer, and the trustee named therein, relating to the Junior Subordinated Debt Securities due 2036. (Incorporated by reference to Exhibit 10.2 to the Registrant's Current Report on Form 8-K filed with the Commission on June 30, 2006.)
- 10.18 Guarantee Agreement, dated as of June 28, 2006, between Codorus Valley Bancorp, Inc. and guarantee trustee named therein. (Incorporated by reference to Exhibit 10.3 to the Registrant's Current Report on Form 8-K filed with the Commission on June 30, 2006.)
- 10.19 2007 Long-Term Incentive Plan of Codorus Valley Bancorp, Inc. (Incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K, filed with the Commission on February 20, 2007.)
- 10.20 Leadership Cash Incentive Plan (Incorporated by reference to Exhibit 10.2 to the Registrant's Current Report on Form 8-K, filed with the Commission on February 20, 2007.)
- 14 Code of Ethics (Incorporated by reference to Exhibit 14 to the Registrant's Current Report on Form 8-K, filed with the Commission on March 3, 2008.)
- 21 List of subsidiaries of Codorus Valley Bancorp, Inc.
- 23 Consent of Independent Registered Public Accounting Firm
- 24 Power of Attorney
- 31.1 Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32 Certification of Principal Executive Officer and Principal Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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### **Signatures**

Under the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has caused this report to be signed on its behalf by the authorized undersigned.

Codorus Valley Bancorp, Inc. (Registrant)

/s/ Larry J. Miller

Larry J. Miller, Vice-Chairman,  
President and Chief Executive Officer

Date: March 11, 2008

Under the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature and Capacity

/s/ Rodney L. Krebs

Chairman of the Board of

3/11/08

Rodney L. Krebs

Directors and Director

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|  |   |         |
|--|---|---------|
| /s/ Larry J. Miller  | President, Chief Executive Officer,                     | 3/11/08 |
| Larry J. Miller<br>(Principal Executive Officer)               | Vice-Chairman of the Board of<br>Directors and Director |         |
|  | Director  | 3/11/08 |
| D. Reed Anderson, Esq.   |   |         |
| /s/ MacGregor S. Jones   | Director  | 3/11/08 |
| MacGregor S. Jones   |   |         |
| /s/ William H. Simpson   | Director  | 3/11/08 |
| William H. Simpson   |   |         |
|  | Director  | 3/11/08 |
| Dallas L. Smith  |   |         |
| /s/ Donald H. Warner   | Director  | 3/11/08 |
| Donald H. Warner   |   |         |
| /s/ Michael L. Waugh   | Director  | 3/11/08 |
| Michael L. Waugh   |   |         |
| /s/ Jann A. Weaver   | Treasurer and Assistant Secretary                       | 3/11/08 |
| Jann A. Weaver<br>(Principal Financial and Accounting Officer) |   |         |
| /s/ Harry R. Swift   | Vice President and Secretary                            | 3/11/08 |
| Harry R. Swift, Esq.   |   |         |
| /s/ Diane E. Hill  | Vice President  | 3/11/08 |
| Diane E. Hill  |   |         |

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**Exhibit Index**

| Exhibit<br>Number | Description of Exhibit   | original<br>Form 10-K |
|-------------------|--|-----------------------|
| 3(i)              | Amended Articles of Incorporation (Incorporated by reference to Exhibit 3(i) to the Registrant's Current Report on Form 8-K, filed with the Commission on October 14, 2005.) |                       |
| 3(ii)             |  |                       |



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Amended By-laws (Incorporated by reference to Exhibit 3(ii) to the Registrant's Current Report on Form 8-K, filed with the Commission on November 15, 2007.)

- 4 Rights Agreement dated as of November 4, 2005 (Incorporated by reference to Exhibit 4 of the Registrant's Current Report on Form 8-K, filed with the Commission on November 8, 2005.)
- 10.1 1996 Stock Incentive Plan (Incorporated by reference to Exhibit 99 of Registration Statement No. 333-09277 on Form S-8, filed with the Commission on July 31, 1996.)
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- 10.8 Dividend Reinvestment and Stock Purchase Plan (Incorporated by reference to Exhibit 4(a) Registration Statement No. 33-46171 on Amendment No. 4 to Form S-3, filed with the Commission on July 23, 2004.)
- 10.9 Amendment to Salary Continuation Agreement by and among PeoplesBank, A Codorus Valley Company, a wholly owned subsidiary of Codorus Valley Bancorp, Inc. and Larry J. Miller, dated December 27, 2005. (Incorporated by reference to Exhibit 10.3 to the Registrant's Current Report on Form 8-K, filed with the Commission on January 3, 2006.)
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- 10.13 Sample form Director Group Term Replacement Plan, dated December 1, 1998, including Split Dollar Policy Endorsements pertaining to non-employee directors of the Corporation's subsidiary, PeoplesBank, A Codorus Valley Company. (Incorporated by reference to Exhibit 10.13 to the Registrant's Annual Report on Form 10-K,

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filed with the Commission on March 29, 2005.)

- 10.14 Long Term Nursing Care Agreement between Codorus Valley Bancorp, Inc., PeoplesBank, A Codorus Valley Company and Larry J. Miller, dated December 27, 2005. (Incorporated by reference to Exhibit 10.2 to the Registrant's Current Report on Form 8-K, filed with the Commission on January 3, 2006.)
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- 10.16 Amended and Restated Declaration of Trust of CVB Statutory Trust No. 2, dated as of June 28, 2006, among Codorus Valley Bancorp, Inc., as sponsor, the Delaware and institutional trustee named therein, and the administrators named therein. (Incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed with the Commission on June 30, 2006.)

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|       |  |        |
|-------|--|--------|
| 10.17 | Indenture, dated as of June 28, 2006, between Codorus Valley Bancorp, Inc., as issuer, and the trustee named therein, relating to the Junior Subordinated Debt Securities due 2036. (Incorporated by reference to Exhibit 10.2 to the Registrant's Current Report on Form 8-K filed with the Commission on June 30, 2006.) |        |
| 10.18 | Guarantee Agreement, dated as of June 28, 2006, between Codorus Valley Bancorp, Inc. and guarantee trustee named therein. (Incorporated by reference to Exhibit 10.3 to the Registrant's Current Report on Form 8-K filed with the Commission on June 30, 2006.)   |        |
| 10.19 | 2007 Long-Term Incentive Plan of Codorus Valley Bancorp, Inc. (Incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K, filed with the Commission on February 20, 2007.)  |        |
| 10.20 | Leadership Cash Incentive Plan (Incorporated by reference to Exhibit 10.2 to the Registrant's Current Report on Form 8-K, filed with the Commission on February 20, 2007.)   |        |
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| 21    | List of subsidiaries of the Codorus Valley Bancorp, Inc.   | 77     |
| 23    | Consent of Independent Registered Public Accounting Firm   | 78     |
| 24    | Power of Attorney  | 79- 80 |
| 31.1  | Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   | 81     |
| 31.2  | Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   | 82     |
| 32    | Certification of Principal Executive Officer and Principal Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002   | 83     |

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tockholder (Assumed to be \$10.00 per Share on Common Shares Held prior to Sale) \$10.00 \$9.86 (1.44)% \$9.64 (3.65)%



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|  | Prior to Sale<br>Below<br>NAV | 50% Participation |             | 150% Participation |             |
|--|-------------------------------|-------------------|-------------|--------------------|-------------|
|  |                               | Following<br>Sale | %<br>Change | Following<br>Sale  | %<br>Change |
| Dilution/Accretion per Common Share Held by Stockholder (NAV per Common Share Less Investment per Common Share)                  |                               | \$ (0.19)         |             | \$ 0.03            |             |
| Percentage Dilution/Accretion to Common Stockholder (Dilution/Accretion per Common Share Divided by Investment per Common Share) |                               |                   | (1.92)%     |                    | 0.32%       |

**Impact on New Investors in Common Stock**

Investors who are not currently stockholders, but who participate in an offering below NAV and whose investment per common share is greater than the resulting NAV per share (due to selling compensation and expenses paid by us) will experience an immediate decrease, albeit small, in the NAV of their shares and their NAV per share compared to the price they pay for their shares of common stock. Investors who are not currently stockholders and who participate in an offering below NAV per common share and whose investment per common share is also less than the resulting NAV per common share due to selling compensation and expenses paid by the issuer being significantly less than the discount per common share will experience an immediate increase in the NAV of their shares and their NAV per share compared to the price they pay for their shares of common stock. These investors will experience a disproportionately greater participation in our earnings and assets and their voting power than our increase in assets, potential earning power and voting interests. These investors will, however, be subject to the risk that we may make additional discounted offerings in which such new common stockholder does not participate, in which case such new stockholder will experience dilution as described above in such subsequent offerings. These investors may also experience a decline in the market price of their shares of common stock, which often reflects to some degree announced or potential decreases in NAV per share. This decrease could be more pronounced as the size of the offering and level of discounts increases.

The following chart illustrates the level of dilution or accretion for new investors that would be experienced by a new investor in the same 5%, 10% and 20% discounted offerings as described in the first chart above. The illustration is for a new investor who purchases the same percentage (1%) of the common shares in the offering as the common stockholder in the prior examples held immediately prior to the offering. The prospectus supplement pursuant to which any discounted offering is made will include a chart for this example based on the actual number of common shares in such offering and the actual discount from the most recently determined NAV per common share. It is not possible to predict the level of market price decline that may occur.

|   | Prior to<br>Sale<br>Below NAV | Example 1<br>5% Offering<br>at 5% Discount |             | Example 2<br>10% Offering<br>at 10% Discount |             | Example 3<br>20% Offering<br>at 20% Discount |             |
|---|-------------------------------|--|-------------|--|-------------|--|-------------|
|   |                               | Following<br>Sale                          | %<br>Change | Following<br>Sale                            | %<br>Change | Following<br>Sale                            | %<br>Change |
| <b>Offering Price</b>                   |                               |  |             |  |             |  |             |
| Price per Common Share to Public        |                               | \$ 10.00                                   |             | \$ 9.47                                      |             | \$ 8.42                                      |             |
| Net Proceeds per Common Share to Issuer |                               | \$ 9.50                                    |             | \$ 9.00                                      |             | \$ 8.00                                      |             |
| <b>Decrease to NAV per Common Share</b> |                               |  |             |  |             |  |             |
| Total Common Shares Outstanding         | 1,000,000                     | 1,050,000                                  | 5.00%       | 1,100,000                                    | 10.00%      | 1,200,000                                    | 20.00%      |
| NAV per Common Share                    | \$ 10.00                      | \$ 9.98                                    | (0.20)%     | \$ 9.91                                      | (0.90)%     | \$ 9.67                                      | (3.33)%     |

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|   |                               | Example 1<br>5% Offering<br>at 5% Discount |             | Example 2<br>10% Offering<br>at 10% Discount |             | Example 3<br>20% Offering<br>at 20% Discount |             |
|---|-------------------------------|--|-------------|--|-------------|--|-------------|
|   | Prior to Sale<br>Below<br>NAV | Following<br>Sale                          | %<br>Change | Following<br>Sale                            | %<br>Change | Following<br>Sale                            | %<br>Change |
| <b>Dilution/Accretion to Common Stockholder</b>   |                               |  |             |  |             |  |             |
| Common Shares Held by Stockholder   |                               | 500  |             | 1,000  |             | 2,000  |             |
| Percentage Held by Common Stockholder   | 0.0%                          | 0.05%                                      |             | 0.09%  |             | 0.17%  |             |
| <b>Total Asset Values</b>   |                               |  |             |  |             |  |             |
| Total NAV Held by Common Stockholder  |                               | \$ 4,990                                   |             | \$ 9,910                                     |             | \$ 19,340                                    |             |
| Total Investment by Common Stockholder  |                               | \$ 5,000                                   |             | \$ 9,470                                     |             | \$ 16,840                                    |             |
| Total Dilution/Accretion to Common<br>Stockholder (Total NAV Less Total<br>Investment)  |                               | \$ (10)                                    |             | \$ 440                                       |             | \$ 2,500                                     |             |
| <b>Per Common Share Amounts</b>   |                               |  |             |  |             |  |             |
| NAV Per Common Share Held by Common<br>Stockholder  |                               | \$ 9.98                                    |             | \$ 9.91                                      |             | \$ 9.67                                      |             |
| Investment per Common Share Held by<br>Common Stockholder   |                               | \$ 10.00                                   |             | \$ 9.47                                      |             | \$ 8.42                                      |             |
| Dilution/Accretion per Common Share Held<br>by Stockholder (NAV per Common Share<br>Less Investment per Common Share)                     |                               | \$ (0.02)                                  |             | \$ 0.44                                      |             | \$ 1.25                                      |             |
| Percentage Dilution/Accretion to Common<br>Stockholder (Dilution/Accretion per<br>Common Share Divided by Investment per<br>Common Share) |                               |  | (0.20)%     |  | 4.65%       |  | 14.85%      |

**SENIOR SECURITIES**

Information about our senior securities is shown in the following table for the audited periods as of September 30, 2011, 2010, 2009, 2008, 2007, 2006, 2005, 2004, 2003, 2002 and 2001 and for the unaudited period as of March 31, 2012. The annual information has been derived from our audited financial statement for each respective period, which have been audited by PricewaterhouseCoopers LLP, our independent registered public accounting firm.

| Class and Year                     | Total Amount<br>Outstanding<br>Exclusive of<br>Treasury Securities(1) | Asset Coverage<br>per Unit(2) | Involuntary<br>Liquidating<br>Preference per<br>Unit(3) | Average<br>Market Value<br>per Unit(4) |
|------------------------------------|---|-------------------------------|---|--|
| <b>Revolving Credit Facilities</b> |   |                               |   |  |
| March 31, 2012 (unaudited)         | \$ 65,800,000   | \$ 2,922                      | \$  | N/A                                    |
| September 30, 2011                 | 99,400,000  | 3,144                         |   | N/A                                    |
| September 30, 2010                 | 16,800,000  | 14,187                        |   | N/A                                    |
| September 30, 2009                 | 83,000,000  | 3,963                         |   | N/A                                    |
| September 30, 2008                 | 151,030,000   | 2,792                         |   | N/A                                    |
| September 30, 2007                 | 144,440,000   | 2,524                         |   | N/A                                    |
| September 30, 2006                 | 49,993,000  | 4,435                         |   | N/A                                    |
| September 30, 2005                 | 53,034,000  | 3,849                         |   | N/A                                    |
| September 30, 2004                 | 40,744,000  | 3,452                         |   | N/A                                    |
| September 30, 2003                 |   | N/A                           |   | N/A                                    |
| September 30, 2002                 |   | N/A                           |   | N/A                                    |

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| Class and Year                              | Total Amount<br>Outstanding<br>Exclusive of<br>Treasury Securities(1) | Asset Coverage<br>per Unit(2) | Involuntary<br>Liquidating<br>Preference per<br>Unit(3) | Average<br>Market Value<br>per Unit(4) |
|---|---|-------------------------------|---|--|
| September 30, 2001                          |   | N/A                           |   | N/A                                    |
| <b>Series 2016 Term Preferred Stock (5)</b> |   |                               |   |  |
| March 31, 2012 (unaudited)                  | \$ 38,497,000   | \$ 2,922                      | \$ 25.00  | \$ 25.49                               |
| September 30, 2011                          |   | N/A                           |   | N/A                                    |
| September 30, 2010                          |   | N/A                           |   | N/A                                    |
| September 30, 2009                          |   | N/A                           |   | N/A                                    |
| September 30, 2008                          |   | N/A                           |   | N/A                                    |
| September 30, 2007                          |   | N/A                           |   | N/A                                    |
| September 30, 2006                          |   | N/A                           |   | N/A                                    |
| September 30, 2005                          |   | N/A                           |   | N/A                                    |
| September 30, 2004                          |   | N/A                           |   | N/A                                    |
| September 30, 2003                          |   | N/A                           |   | N/A                                    |
| September 30, 2002                          |   | N/A                           |   | N/A                                    |
| September 30, 2001                          |   | N/A                           |   | N/A                                    |
| <b>Repurchase Agreements</b>                |   |                               |   |  |
| March 31, 2012 (unaudited)                  |   | N/A                           |   | N/A                                    |
| September 30, 2011                          |   | N/A                           |   | N/A                                    |
| September 30, 2010                          |   | N/A                           |   | N/A                                    |
| September 30, 2009                          |   | N/A                           |   | N/A                                    |
| September 30, 2008                          |   | N/A                           |   | N/A                                    |
| September 30, 2007                          |   | N/A                           |   | N/A                                    |
| September 30, 2006                          |   | N/A                           |   | N/A                                    |
| September 30, 2005                          |   | N/A                           |   | N/A                                    |
| September 30, 2004                          | 21,346,000  | 3,452                         |   | N/A                                    |
| September 30, 2003                          | 78,449,000  | 2,667                         |   | N/A                                    |
| September 30, 2002                          | 39,199,000  | 4,333                         |   | N/A                                    |
| September 30, 2001                          |   | N/A                           |   | N/A                                    |

- (1) Total amount of each class of senior securities outstanding at the end of the period presented
- (2) Asset coverage ratio for a class of our senior securities representing indebtedness means the ratio of the value of our total assets, less all liabilities and indebtedness not represented by senior securities, to the aggregate amount of senior securities representing indebtedness and asset coverage ratio for a class of our senior securities that are stock means the ratio of the value of our total assets, less all liabilities and indebtedness not represented by senior securities, to the aggregate amount of senior securities representing indebtedness plus the aggregate involuntary liquidation preference of a class of senior security which is stock. Asset coverage per unit is the asset coverage ratio expressed in terms of dollar amounts per one thousand dollars of indebtedness.
- (3) The amount to which such class of senior security would be entitled upon the involuntary liquidation of the issuer in preference to any security junior to it.
- (4) All senior securities (with the exception of our Series 2016 Term Preferred Stock) are not registered for public trading. Average market value per unit is the average of the last ten days closing prices on the New York Stock Exchange (as our Series 2016 Term Preferred Stock was traded on the New York Stock Exchange during this period). We transferred the listing of our Series 2016 Term Preferred Stock to the NASDAQ effective May 1, 2012.
- (5) In November 2011, we issued 1,539,882 shares of Series 2016 Term Preferred Stock through a public offering and subsequent exercise of an overallotment option. As of March 31, 2012, we had \$38.5 million outstanding of Series 2016 Term Preferred Stock.

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**BUSINESS**

**Overview**

We were incorporated under the General Corporation Laws of the State of Maryland on May 30, 2001 and completed our initial public offering on August 24, 2001. We operate as a closed-end, non-diversified management investment company and we have elected to be treated as a business development company ( BDC ) under the Investment Company Act of 1940, as amended (the 1940 Act ). For federal income tax purposes, we have elected to be treated as a regulated investment company ( RIC ) under Subchapter M of the Internal Revenue Code of 1986, as amended (the Code ). We currently continue to qualify as a RIC for federal income tax purposes and obtain favorable RIC tax treatment by meeting certain requirements, including certain minimum distribution requirements.

We were established to achieve a high level of current income by investing in debt securities, consisting primarily of senior notes and senior subordinated notes, of established private United States ( U.S. ) businesses that are substantially owned by leveraged buyout funds, individual investors or are family-owned businesses, with a particular focus on senior notes. In addition, we may acquire from others existing loans that meet this profile. We also seek to provide our stockholders with long-term capital growth through appreciation in the value of warrants or other equity instruments that we may receive when we make loans.

We seek to invest in small and medium-sized private U.S. businesses that meet certain criteria, including some but not necessarily all of the following: the potential for growth in cash flow, adequate assets for loan collateral, experienced management teams with a significant ownership interest in the borrower, profitable operations based on the borrower's cash flow, reasonable capitalization of the borrower (usually by leveraged buyout funds or venture capital funds) and the potential to realize appreciation and gain liquidity in our equity positions, if any. We anticipate that liquidity in our equity position will be achieved through a merger or acquisition of the borrower, a public offering of the borrower's stock or by exercising our right to require the borrower to repurchase our warrants. However, there can be no assurance that we will always have these rights. We lend to borrowers that need funds to finance growth, restructure their balance sheets or effect a change of control. We invest either by ourselves or jointly with other funds or management of the borrower, depending on the opportunity. If we are participating in an investment with one or more co-investors, our investment is likely to be smaller than if we were to investing alone. Our loans typically range from \$5 million to \$20 million and generally mature in no more than seven years.

We expect that our target portfolio over time will primarily include the following three categories of investments in private U.S. companies:

*Senior Loans.* We seek to invest a portion of our assets in senior notes of borrowers. Using its assets as collateral, the borrower typically uses senior notes to cover a substantial portion of the funding needed to operate. The collateral usually takes the form of first priority liens on the assets of the portfolio company. Senior lenders are exposed to the least risk of all providers of debt because they command a senior position with respect to scheduled interest and principal payments and assets of the borrower. However, unlike senior subordinated lenders, these senior lenders typically do not receive any stock, warrants to purchase stock of the borrowers or other yield enhancements. As such, they generally do not participate in the equity appreciation of the value of the business. Senior notes may include revolving lines of credit, senior term loans, senior syndicated loans and senior last-out tranche loans and generally are at variable interest rates in relation to the London Interbank Offered Rate ( LIBOR ). These loans typically are structured with interest rate floors to protect against declining interest rates.

*Senior Subordinated Loans.* We seek to invest a portion of our assets in senior subordinated notes, which include second lien notes. Holders of senior subordinated notes, which are typically unsecured, are subordinated to the rights of holders of senior debt in their right to receive principal and interest payments or, in the case of last out tranches of senior debt, liquidation proceeds from the borrower. As

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a result, senior subordinated notes are riskier than senior notes. Although such loans are sometimes secured by significant collateral (assets of the borrower), the lender is largely dependent on the borrower's cash flow for repayment. Additionally, lenders may receive warrants to acquire shares of stock in borrowers or other yield enhancements in connection with these loans. Senior subordinated notes include second lien loans and syndicated second lien loans. We typically structure these senior subordinated loans with variable interest rates in relation to the LIBOR with interest rate floors to protect against declining interest rates.

*Junior Subordinated Loans:* We also seek to invest a small portion of our assets in junior subordinated notes, which include mezzanine notes. Holders of junior subordinated notes are subordinated to the rights of the holders of senior debt and senior subordinated debt in their rights to receive principal and interest payments from the borrower and the assets of the borrower. The risk profile of junior subordinated notes is high, which permits the junior subordinated lender to obtain higher variable interest rates and more equity and equity-like compensation.

*Preferred and Common Equity/Equivalents:* While not a primary focus of our investment portfolio strategy, from time to time we also receive yield enhancements in connection with some of our loans, which include warrants to purchase stock or success fees. A portion of our portfolio consists of equity investments that were part of a larger initial investment in a private company. Additionally, we also have equity investments derived from restructurings on some of our investments.

Because the majority of the loans in our portfolio consist of term debt of private companies that typically cannot or will not expend the resources to have their debt securities rated by a credit rating agency, we expect that most, if not all, of the debt securities we acquire will be unrated. Investors should assume that these loans would be rates below what is today considered investment grade quality. Investments rated below investment grade are often referred to as high yield securities or junk bonds and may be considered high risk as compared to investment-grade debt instruments.

**Investment Concentrations**

As of March 31, 2012, our portfolio consisted of loans to 55 companies in 26 states in 23 different industries with an aggregate fair value of \$288.2 million. As of March 31, 2012, there were 24 syndicated investments totaling \$96.7 million at cost and \$96.8 million at fair value, or 25.9% and 33.6% of the total aggregate portfolio, respectively. Since our initial public offering in 2001, we have invested in over 155 different companies, while making over 104 consecutive distributions to common stockholders.

As of March 31, 2012, approximately 62.5% of the aggregate fair value of our portfolio was comprised of senior term debt, 33.2% was senior subordinated term debt and 4.3% was in equity securities. The following table outlines our investments by security type as of March 31, 2012 and September 30, 2011:

| (Dollars in thousands)        | March 31, 2012    |                   | September 30, 2011 |                   |
|-------------------------------|-------------------|-------------------|--------------------|-------------------|
|                               | Cost              | Fair Value        | Cost               | Fair Value        |
| Senior term debt              | \$ 249,904        | \$ 180,000        | \$ 266,491         | \$ 200,145        |
| Senior subordinated term debt | 112,272           | 95,697            | 107,140            | 92,148            |
| Common equity/equivalents     | 6,264             | 11,875            | 7,999              | 10,088            |
| Preferred equity              | 4,520             | 595               | 1,185              | 566               |
| <b>Total investments</b>      | <b>\$ 372,960</b> | <b>\$ 288,167</b> | <b>\$ 382,815</b>  | <b>\$ 302,947</b> |



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Investments at fair value consisted of the following industry classifications at March 31, 2012 and September 30, 2011:

| (Dollars in thousands)                                    | March 31, 2012    |                                 | September 30, 2011 |                                 |
|---|-------------------|---------------------------------|--------------------|---------------------------------|
|   | Fair Value        | Percentage of Total Investments | Fair Value         | Percentage of Total Investments |
| Electronics   | \$ 53,484         | 18.6%                           | \$ 45,752          | 15.1%                           |
| Mining, steel, iron & non-precious metals                 | 32,063            | 11.1                            | 33,734             | 11.1                            |
| Healthcare, education & childcare                         | 30,034            | 10.4                            | 34,106             | 11.3                            |
| Automobile  | 26,725            | 9.3                             | 25,768             | 8.5                             |
| Broadcast (TV & radio)                                    | 20,420            | 7.1                             | 28,194             | 9.3                             |
| Retail stores   | 19,340            | 6.7                             | 19,340             | 6.4                             |
| Aerospace & defense                                       | 15,212            | 5.3                             | 10,003             | 3.3                             |
| Printing & publishing                                     | 12,923            | 4.5                             | 17,623             | 5.8                             |
| Textiles & leather  | 9,801             | 3.4                             | 9,626              | 3.2                             |
| Personal & non-durable consumer products                  | 8,582             | 3.0                             | 6,962              | 2.3                             |
| Personal, food and miscellaneous services                 | 7,915             | 2.7                             | 7,635              | 2.5                             |
| Machinery   | 7,664             | 2.7                             | 8,696              | 2.9                             |
| Beverage, food & tobacco                                  | 7,295             | 2.5                             | 7,332              | 2.4                             |
| Diversified/conglomerate manufacturing                    | 7,251             | 2.5                             | 8,790              | 2.9                             |
| Buildings & real estate                                   | 6,557             | 2.3                             | 10,275             | 3.4                             |
| Leisure, amusement, movies & entertainment                | 6,054             | 2.1                             | 6,607              | 2.2                             |
| Diversified/conglomerate service                          | 3,990             | 1.4                             | 3,810              | 1.3                             |
| Home & office furnishings                                 | 3,952             | 1.4                             | 9,715              | 3.2                             |
| Diversified natural resources, precious metals & minerals | 2,993             | 1.0                             | 3,054              | 1.0                             |
| Other <sup>(A)</sup>                                      | 5,912             | 2.0                             | 5,925              | 1.9                             |
| <b>Total investments</b>                                  | <b>\$ 288,167</b> | <b>100.0%</b>                   | <b>\$ 302,947</b>  | <b>100.0%</b>                   |

<sup>(A)</sup> No individual industry within this category exceeds 1%.

The investments at fair value were included in the following geographic regions of the United States at March 31, 2012 and September 30, 2011:

| (Dollars in thousands)   | March 31, 2012    |                                 | September 30, 2011 |                              |
|--------------------------|-------------------|---------------------------------|--------------------|------------------------------|
|                          | Fair Value        | Percentage of Total Investments | Fair Value         | Percent of Total Investments |
| Midwest                  | \$ 133,425        | 46.3%                           | \$ 144,292         | 47.6%                        |
| West                     | 76,264            | 26.5                            | 70,862             | 23.4                         |
| South                    | 45,234            | 15.7                            | 52,265             | 17.3                         |
| Northeast                | 25,764            | 8.9                             | 28,158             | 9.3                          |
| Other                    | 7,480             | 2.6                             | 7,370              | 2.4                          |
| <b>Total Investments</b> | <b>\$ 288,167</b> | <b>100.0%</b>                   | <b>\$ 302,947</b>  | <b>100.0%</b>                |

The geographic region reflects the location of the headquarters for our portfolio companies. A portfolio company may have a number of other business locations in other geographic regions.

**Our Investment Adviser and Administrator**

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Gladstone Management Corporation (our Adviser ) is our affiliate, investment adviser, and a privately-held company led by a management team which has extensive experience in our lines of business. Our Adviser s affiliate, a privately-held company, Gladstone Administration, LLC (our Administrator ), employs our chief

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financial officer and treasurer, chief accounting officer, chief compliance officer, internal legal counsel and their respective staffs. Excluding our chief financial officer, all of our executive officers serve as directors or executive officers, or both, of the following of our affiliates: Gladstone Commercial Corporation ( Gladstone Commercial ), a publicly-traded real estate investment trust; Gladstone Investment Corporation ( Gladstone Investment ), a publicly-traded BDC and RIC; our Adviser; and our Administrator.

Our Adviser and Administrator also provide investment advisory and administrative services, respectively, to certain of our affiliates, including, but not limited to, Gladstone Commercial; Gladstone Investment; Gladstone Partners Fund, L.P. ( Gladstone Partners ), a private partnership fund formed primarily to co-invest with us and Gladstone Investment; Gladstone Land Corporation, a private agricultural real estate company owned by David Gladstone, our chairman and chief executive officer; and Gladstone Lending Corporation ( Gladstone Lending ), a private corporation that was formed to primarily invest in first and second lien term loans that has filed a registration statement on Form N-2 with the Securities and Exchange Commission (the SEC ), but which has not yet commenced operations. Our Adviser and Administrator may provide investment advisory and administrative services, respectively, to other funds and companies, both public and private.

We have been externally managed by our Adviser pursuant to an investment advisory agreement since October 1, 2004. Our Adviser was organized as a corporation under the laws of the State of Delaware on July 2, 2002, and is a registered investment adviser under the Investment Advisers Act of 1940, as amended. Our Adviser is headquartered in McLean, Virginia, a suburb of Washington, D.C., and also has offices in several other states.

## **Corporate Information**

Our executive offices are located at 1521 Westbranch Drive, Suite 200, McLean, Virginia 22102 and our telephone number is (703) 287-5800. Our corporate website is located at [www.gladstonecapital.com](http://www.gladstonecapital.com). Our website and the information contained therein or connected thereto shall not be deemed to be incorporated into this prospectus or the registration statement of which it forms a part.

## **Our Investment Strategy**

Our strategy is to make loans at favorable interest rates to small and medium-sized businesses. Our Adviser uses the loan referral networks of Mr. David Gladstone, our chairman and chief executive officer, Mr. Terry Brubaker, our vice chairman, chief operating officer and secretary, and Mr. George Stelljes III, our president and chief investment officer, and of its managing directors to identify and make senior and subordinated loans to borrowers that need funds to finance growth, restructure their balance sheets or effect a change of control. We believe that our business strategy will enable us to achieve a high level of current income by investing in debt securities, consisting primarily of senior notes, senior subordinated notes and junior subordinated notes of established private businesses that are backed by leveraged buyout funds, venture capital funds or others. In addition, from time to time we might acquire existing loans that meet this profile from leveraged buyout funds, venture capital funds and others. We also seek to provide our stockholders with long-term capital growth through the appreciation in the value of warrants or other equity instruments that we might receive when we make loans.

We target small and medium-sized private businesses that meet certain criteria, including some but not necessarily all of the following: the potential for growth in cash flow, adequate assets for loan collateral, experienced management teams with a significant ownership interest in the borrower, profitable operations based on the borrower's cash flow, reasonable capitalization of the borrower (usually by leveraged buyout funds or venture capital funds) and the potential to realize appreciation and gain liquidity in our equity position, if any. We may achieve liquidity in an equity position through a merger or acquisition of the borrower, a public offering of the borrower's stock or by exercising our right to require the borrower to repurchase our warrants, although we cannot assure you that we will always have these rights. We can also achieve a similar effect by requiring the borrower to pay us conditional interest, which we refer to as a success fee, upon the occurrence of certain events.

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Success fees are dependent upon the success of the borrower and the occurrence of a triggering event, and are paid in lieu of warrants to purchase common stock of the borrower.

### **Investment Process**

#### ***Overview of Investment and Approval Process***

To originate investments, our Adviser's investment professionals use an extensive referral network comprised primarily of venture capitalists, leveraged buyout funds, investment bankers, attorneys, accountants, commercial bankers and business brokers. Our Adviser's investment professionals review informational packages from these and other sources in search of potential financing opportunities. If a potential opportunity matches our investment objectives, the investment professionals will seek an initial screening of the opportunity from our Adviser's investment committee which is composed of Messrs. Gladstone, Brubaker and Stelljes. If the prospective portfolio company passes this initial screening, the investment professionals conduct a due diligence investigation and create a detailed profile summarizing the prospective portfolio company's historical financial statements, industry and management team and analyzing its conformity to our general investment criteria. The investment professionals then present this profile to our Adviser's investment committee, which must approve each investment. Further, each financing is available for review by the members of our Board of Directors, a majority of whom are not interested persons as defined in Section 2(a)(19) of the 1940 Act.

#### ***Prospective Portfolio Company Characteristics***

We have identified certain characteristics that we believe are important in identifying and investing in prospective portfolio companies. The criteria listed below provide general guidelines for our investment decisions, although not all of these criteria may be met by each portfolio company.

*Value-and-Income Orientation and Positive Cash Flow.* Our investment philosophy places a premium on fundamental analysis from an investor's perspective and has a distinct value-and-income orientation. In seeking value, we focus on companies in which we can invest at relatively low multiples of earnings before interest, taxes, depreciation and amortization ( EBITDA ), and that have positive operating cash flow at the time of investment. In seeking income, we seek to invest in companies that generate relatively stable and high percentage of sales and cash flow to provide some assurance that they will be able to service their debt and pay any required distributions on preferred stock. Typically, we do not expect to invest in start-up companies or companies with speculative business plans.

*Experienced Management.* We generally require that our portfolio companies have experienced management teams. We also require the portfolio companies to have in place proper incentives to induce management to succeed and act in concert with our interests as investors, including having significant equity or other interests in the financial performance of their companies.

*Strong Competitive Position in an Industry.* We seek to invest in target companies that have developed strong market positions within their respective markets and that we believe are well-positioned to capitalize on growth opportunities. We seek companies that demonstrate significant competitive advantages versus their competitors, which we believe will help to protect their market positions and profitability.

*Exit Strategy.* We seek to invest in companies that we believe will provide a stable stream of earnings and cash flow that is sufficient to repay the loans we make to them and to reinvest in their respective businesses. We expect that such internally generated cash flow, which will allow our portfolio companies to pay interest on, and repay the principal of, our investments, will be a key means by which we exit from our investments over time. In addition, we also seek to invest in companies whose business models and expected future cash flows offer attractive possibilities for capital appreciation on any equity interests we may obtain or retain. These capital appreciation possibilities include strategic acquisitions by other industry participants or financial buyers, initial public offerings of common stock, or other capital market transactions.

*Liquidation Value of Assets.* The prospective liquidation value of the assets, if any, collateralizing loans in which we invest is an important factor in our investment analysis. We emphasize both tangible assets, such as accounts



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receivable, inventory, equipment, and real estate and intangible assets, such as intellectual property, customer lists, networks, databases, although the relative weight we place on these assets will vary by company and industry.

### ***Extensive Due Diligence***

Our Adviser conducts what we believe are extensive due diligence investigations of our prospective portfolio companies and investment opportunities. The due diligence investigation may begin with a review of publicly available information and will generally include some or all of the following:

a review of the prospective portfolio company's historical and projected financial information;

visits to the prospective portfolio company's business site(s);

interviews with the prospective portfolio company's management, employees, customers and vendors;

review of loan documents;

background checks on the prospective portfolio company's management team; and

research on the prospective portfolio company's products, services or particular industry.

Upon completion of a due diligence investigation and a decision to proceed with an investment, our Adviser's investment professionals who have primary responsibility for the investment present the investment opportunity to our Adviser's investment committee. The investment committee determines whether to pursue the potential investment. Additional due diligence of a potential investment may be conducted on our behalf by attorneys and independent accountants, as well as other outside advisers, prior to the closing of the investment, as appropriate.

We also rely on the long-term relationships that our Adviser's investment professionals have with venture capitalists, leveraged buyout funds, investment bankers, commercial bankers, private equity sponsors, and business brokers. In addition, the extensive direct experience of our executive officers and managing directors in the operations of and providing debt and equity capital to small and medium-sized private businesses plays a significant role in our investment evaluation and assessment of risk.

### ***Investment Structure***

Once we have determined that a prospective acquisition, buyout or recapitalization meets our standards and investment criteria, we work with the management of that company and other capital providers to structure the transaction in a way that we believe will provide us with the greatest opportunity to maximize our return on the investment, while appropriately incentivizing company management. As discussed above, the capital classes through which we typically structure a deal include subordinated and mezzanine debt, senior secured debt and preferred and common equity. Through our risk management process, we seek to limit the downside risk of our investments by:

making investments with an expected total return (including both interest and potential equity appreciation) that we believe compensates us for the credit risk of the investment;

seeking collateral or superior positions in the portfolio company's capital structure where possible;

incorporating put rights and call protection into the investment structure where possible; and

negotiating covenants in connection with our investments that afford our portfolio companies as much flexibility as possible in managing their businesses, consistent with the preservation of our capital.

We expect to hold most of our investments in subordinated debt, mezzanine debt or equity interests until maturity or repayment, but may sell our investments earlier if a liquidity event takes place, such as the sale or recapitalization of a portfolio company or, in the case of an equity investment in a company, its initial public offering.

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### ***Hedging Strategies***

Although it has not yet happened, nor do we expect it to happen in the near future, if one of our portfolio companies goes public, we may undertake hedging strategies with regard to any equity interests that we may have in that company. We may mitigate risks associated with the volatility of publicly-traded securities by, for example, selling securities short or writing or buying call or put options. Hedging against a decline in the value of such investments in public companies would not eliminate fluctuations in the values of such investments or prevent losses if the values of such investments decline, but would establish or enhance a hedging strategy to seek to protect our investment in such securities. Therefore, by engaging in hedging transactions, we seek to moderate the decline in the value of our hedged investments in public companies. However, such hedging transactions would also limit our opportunity to gain from an increase in the value of our investment in the public company. In the future, we may enter into hedging transactions, such as interest rate cap agreements, in connection with the borrowings that we make under our line of credit. We currently do not hold any interest rate cap agreements, although we have done so in the past. Hedging strategies can pose risks to us and our stockholders; however we believe that such activities are manageable because they will be limited to only a portion of our portfolio.

Section 12(a)(3) of the 1940 Act prohibits us from effecting a short sale of any security in contravention of such rules and regulations or orders as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors . . . However, to date, the SEC has not promulgated regulations under this statute. It is possible that such regulations could be promulgated in the future in a way that would require us to change any hedging strategies that we may adopt. In addition, our ability to engage in short sales may be limited by the 1940 Act's leverage limitations. We will only engage in hedging activities in compliance with applicable laws and regulations.

### ***Competitive Advantages***

A large number of entities compete with us and make the types of investments that we seek to make in small and medium-sized privately-owned businesses. Such competitors include private equity funds, leveraged buyout funds, venture capital funds, investment banks and other equity and non-equity based investment funds, and other financing sources, including traditional financial services companies such as commercial banks. Many of our competitors are substantially larger than we are and have considerably greater funding sources that are not available to us. In addition, certain of our competitors may have higher risk tolerances or different risk assessments, which could allow them to consider a wider variety of investments, establish more relationships and build their market shares. Furthermore, many of these competitors are not subject to the regulatory restrictions that the 1940 Act imposes on us as a BDC. However, we believe that we have the following competitive advantages over other providers of financing to small and mid-sized businesses.

### ***Management Expertise***

David Gladstone, our chairman and chief executive officer, is also the chairman and chief executive officer of our Adviser and certain of its affiliated companies, (the Gladstone Companies), and has been involved in all aspects of the Gladstone Companies' investment activities, including serving as a member of our Adviser's investment committee. Terry Lee Brubaker is our vice chairman, chief operating officer and secretary, and has substantial experience in acquisitions and operations of companies. George Stelljes III is our president and chief investment officer and has extensive experience in leveraged finance. Messrs. Gladstone, Brubaker and Stelljes have principal management responsibility for our Adviser constituting the majority of its senior executive officers. These individuals dedicate a significant portion of their time to managing our investment portfolio. Our senior management has extensive experience providing capital to small and mid-sized companies and has worked together for more than 10 years. In addition, we have access to the resources and expertise of our Adviser's investment professionals and supporting staff who possess a broad range of transactional, financial, managerial and investment skills.



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### ***Increased Access to Investment Opportunities Developed Through Proprietary Research Capability and an Extensive Network of Contacts***

Our Adviser seeks to identify potential investments both through active origination and due diligence and through its dialogue with numerous management teams, members of the financial community and potential corporate partners with whom our Adviser's investment professionals have long-term relationships. We believe that our Adviser's investment professionals have developed a broad network of contacts within the investment, commercial banking, private equity and investment management communities, and that their reputation in investment management enables us to identify well-positioned prospective portfolio companies which provide attractive investment opportunities. Additionally, our Adviser expects to generate information from its professionals' network of accountants, consultants, lawyers and management teams of portfolio companies and other companies.

### ***Disciplined, Value and Income-Oriented Investment Philosophy with a Focus on Preservation of Capital***

In making its investment decisions, our Adviser focuses on the risk and reward profile of each prospective portfolio company, seeking to minimize the risk of capital loss without foregoing the potential for capital appreciation. We expect our Adviser to use the same value and income-oriented investment philosophy that its professionals use in the management of the other Gladstone Companies and to commit resources to management of downside exposure. Our Adviser's approach seeks to reduce our risk in investments by using some or all of the following approaches:

focusing on companies with good market positions and good cash flow;

investing in businesses with experienced and established management teams;

engaging in extensive due diligence from the perspective of a long-term investor;

investing at low price-to-cash flow multiples; and

adopting flexible transaction structures by drawing on the experience of the investment professionals of our Adviser and its affiliates.

### ***Longer Investment Horizon with Attractive Publicly-traded Model***

Unlike private equity and venture capital funds that are typically organized as finite-life partnerships, we are not subject to standard periodic capital return requirements. The partnership agreements of most private equity and venture capital funds typically provide that these funds may only invest investors' capital once and must return all capital and realized gains to investors within a finite time period, often seven to ten years. These provisions often force private equity and venture capital funds to seek returns on their investments by causing their portfolio companies to pursue mergers, public equity offerings, or other liquidity events more quickly than might otherwise be optimal or desirable, potentially resulting in both a lower overall return to investors and an adverse impact on their portfolio companies. We believe that our flexibility to make investments with a long-term view and without the capital return requirements of traditional private investment vehicles provides us with the opportunity to achieve greater long-term returns on invested capital.

### ***Flexible Transaction Structuring***

We believe our management team's broad expertise and its ability to draw upon many years of combined experience enables our Adviser to identify, assess, and structure investments successfully across all levels of a company's capital structure and manage potential risk and return at all stages of the economic cycle. We are not subject to many of the regulatory limitations that govern traditional lending institutions such as banks. As a result, we are flexible in selecting and structuring investments, adjusting investment criteria and transaction structures, and, in some cases, the types of securities in which we invest. We believe that this approach enables our Adviser to identify attractive investment opportunities that will continue to generate current income and



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capital gain potential throughout the economic cycle, including during turbulent periods in the capital markets. One example of our flexibility is our ability to exchange our publicly-traded stock for the stock of an acquisition target in a tax-free reorganization under the Code. After completing an acquisition in such an exchange, we can restructure the capital of the small company to include senior and subordinated debt.

### ***Leverage***

For the purpose of making investments and to take advantage of favorable interest rates, we may issue senior securities up to the maximum amount permitted by the 1940 Act. The 1940 Act currently permits us to issue senior securities representing indebtedness and senior securities that are stock, to which we refer collectively as Senior Securities, in amounts such that our asset coverage, as defined in Section 18(h) of the 1940 Act, is at least 200% immediately after each issuance of Senior Securities. We may also incur indebtedness to repurchase our common stock. As a result of incurring indebtedness generally (for example, through our Credit Facility) or issuing senior securities representing indebtedness, we are exposed to the risks of leverage. Although borrowing money for investments increases the potential for gain, it also increases the risk of a loss. A decrease in the value of our investments will have a greater impact on the value of our common stock to the extent that we have borrowed money to make investments. There is a possibility that the costs of borrowing could exceed the income we receive on the investments we make with such borrowed funds.

Our Board of Directors is authorized to provide for the issuance of Senior Securities with such preferences, powers, rights and privileges as it deems appropriate, subject to the requirements of the 1940 Act. See Regulation as a BDC Asset Coverage for a discussion of our leveraging constraints.

In addition, our ability to pay dividends or distributions (other than dividends payable in our stock) to holders of any class of our capital stock would be restricted if our senior securities representing indebtedness fail to have an asset coverage of at least 200% (measured at the time of declaration of such distribution and accounting for such distribution). The 1940 Act does not apply this limitation to privately arranged debt that is not intended to be publicly distributed, unless this limitation is specifically negotiated by the lender. In addition, our ability to pay dividends or distributions (other than dividends payable in our common stock) to our common stockholders would be restricted if our senior securities that are stock fail to have an asset coverage of at least 200% (measured at the time of declaration of such distribution and accounting for such distribution). If the value of our assets declines, we might be unable to satisfy these asset coverage requirements. To satisfy the 200% asset coverage requirement in the event that we are seeking to pay a distribution, we might either have to (i) liquidate a portion of our loan portfolio to repay a portion of our indebtedness or (ii) issue common stock. This may occur at a time when a sale of a portfolio asset may be disadvantageous, or when we have limited access to capital markets on agreeable terms. In addition, any amounts that we use to service our indebtedness or for offering expenses will not be available for distributions to our stockholders. If we are unable to regain asset coverage through these methods, we may be forced to suspend the payment of such dividends.

In November 2011, we completed a public offering of an aggregate of approximately 1.5 million shares of 7.125% Series 2016 Term Preferred Stock, par value \$0.001 per share, at a public offering price of \$25.00 per share. The Series 2016 Term Preferred Stock has an aggregate liquidation preference of \$38.5 million, which we have recorded as a liability in accordance with the U.S. generally accepted accounting principles and as such will affect our asset coverage, exposing us to additional leverage risks. For a further discussion of the terms of our Series 2016 Term Preferred Stock, see Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources.

### **Ongoing Relationships with and Monitoring of Portfolio Companies**

Our Adviser's investment professionals actively oversee each investment by continuously evaluating the portfolio company's performance and working collaboratively with the portfolio company's management to identify and incorporate best resources and practices that help us achieve our investment expectations.

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### ***Monitoring***

Our Adviser's investment professionals monitor the financial performance, trends, and changing risks of each portfolio company on an ongoing basis to determine if each company is performing within expectations and to guide the portfolio company's management in taking the appropriate courses of action. Our Adviser employs various methods of evaluating and monitoring the performance of our investments in portfolio companies, which may include the following:

Monthly analysis of financial and operating performance;

Assessment of the portfolio company's performance against its business plan and our investment expectations;

Assessment of the investment's risks;

Participation in the portfolio company's board of directors or management meetings;

Assessment of portfolio company management, sponsor, governance and strategic direction;

Assessment of the portfolio company's industry and competitive environment; and

Review and assessment of the portfolio company's operating outlook and financial projections.

### ***Relationship Management***

Our Adviser's investment professionals interact with various parties involved with a portfolio company, or investment, by actively engaging with internal and external constituents, including:

Management;

Boards of directors;

Financial sponsors;

Capital partners; and

Advisers and consultants.

### ***Managerial Assistance and Services***

As a BDC, we make available significant managerial assistance to our portfolio companies and may provide other services to such portfolio companies. Neither we nor our Adviser currently receives fees in connection with the managerial assistance we make available. At times, our

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Adviser provides other services to certain of our portfolio companies and it receives fees for these other services with 50% of certain of these fees, and 100% of others, credited against the base management fee that we would otherwise be required to pay to our Adviser.

In April 2011, Gladstone Securities started providing other services (such as investment banking and due diligence services) to certain of our portfolio companies. The fees the portfolio companies paid to Gladstone Securities do not impact the overall fees we pay to our Adviser or the overall fees credited against the base management fee.

### ***Valuation Process***

The following is a general description of the steps we take each quarter to determine the value of our investment portfolio. We value our investments in accordance with the requirements of the 1940 Act. We value securities for which market quotations are readily available at their market value. We value all other securities and assets at fair value as determined in good faith by our Board of Directors. In determining the value of our investments, our Adviser has established an investment valuation policy (the Policy). The Policy has been

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approved by our Board of Directors and each quarter the Board of Directors reviews whether our Adviser has applied the Policy consistently and votes whether or not to accept the recommended valuation of our investment portfolio. Due to the uncertainty inherent in the valuation process, such estimates of fair value may differ significantly from the values that would have been obtained had a ready market for the securities existed. Investments for which market quotations are readily available are recorded in our financial statements at such market quotations. With respect to any investments for which market quotations are not readily available, we perform the following valuation process each quarter:

Our quarterly valuation process begins with each portfolio company or investment being initially assessed by our Adviser's investment professionals responsible for the investment, using the Policy.

Preliminary valuation conclusions are then discussed with our management, and documented, along with any independent opinions of value provided by Standard & Poor's Securities Evaluations, Inc. (SPSE), for review by our Board of Directors.

Our Board of Directors reviews this documentation and discusses the information provided by our management, and the opinions of value provided by SPSE to arrive at a determination that the Policy has been followed for determining the aggregate fair value of our portfolio of investments.

Our valuation policies, procedures and processes are more fully described under *Management's Discussion and Analysis of Financial Condition and Results of Operations*, *Critical Accounting Policies*, and *Investment Valuation*.

### **Investment Advisory and Management Agreements**

We are externally managed pursuant to contractual arrangements with our Adviser under which our Adviser and Administrator employ all of our personnel and pay our payroll, benefits and general expenses directly. In 2004, we entered into an investment advisory agreement with our Adviser (as amended, the *Advisory Agreement*), which is controlled by our chairman and chief executive officer. In accordance with the *Advisory Agreement*, we pay the Adviser fees as compensation for its services, consisting of a base management fee and an incentive fee. On July 12, 2011, our Board of Directors approved the renewal of the *Advisory Agreement* through August 31, 2012.

#### ***Base Management Fee***

The base management fee is computed and payable quarterly and is assessed at an annual rate of 2.0% computed on the basis of the value of our average gross assets at the end of the two most recently completed quarters, which are total assets, including investments made with proceeds of borrowings, less any uninvested cash or cash equivalents resulting from borrowings. Overall, the base management fee cannot exceed 2.0% of total assets (as reduced by cash and cash equivalents pledged to creditors) during any given fiscal year. In addition, the following three items are potential adjustments to the base management fee calculation.

#### ***Loan Servicing Fees***

Our Adviser also services the loans held by our wholly-owned subsidiary, Business Loan, in return for which our Adviser generally receives a 1.5% annual fee based on the monthly aggregate outstanding balance of loans pledged under our line of credit. Since we own these loans, all loan servicing fees paid to our Adviser are treated as reductions directly against the 2.0% base management fee under the *Advisory Agreement*.

#### ***Portfolio Company Fees***

Under the *Advisory Agreement*, our Adviser has also provided and continues to provide managerial assistance and other services to our portfolio companies and may receive fees for services other than managerial assistance with 50% of certain of these fees, and 100% of others, credited against the base management fee that we would otherwise be required to pay to our Adviser.



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*Senior Syndicated Loan Fee Waiver*

Our Board of Directors accepted an unconditional and irrevocable voluntary waiver from the Adviser to reduce the annual 2.0% base management fee on senior syndicated loan participations to 0.5%, to the extent that proceeds resulting from borrowings were used to purchase such syndicated loan participations, for the years ended September 30, 2011, 2010 and 2009 and also for the six months ended March 31, 2012 and 2011.

***Incentive Fee***

The incentive fee consists of two parts: an income-based incentive fee and a capital gains-based incentive fee. The income-based incentive fee rewards the Adviser if our quarterly net investment income (before giving effect to any incentive fee) exceeds 1.75% of our net assets (the hurdle rate ). We will pay the Adviser an income-based incentive fee with respect to our pre-incentive fee net investment income in each calendar quarter as follows:

no incentive fee in any calendar quarter in which our pre-incentive fee net investment income does not exceed the hurdle rate (7% annualized);

100% of our pre-incentive fee net investment income with respect to that portion of such pre-incentive fee net investment income, if any, that exceeds the hurdle rate but is less than 2.1875% in any calendar quarter (8.75% annualized); and

20% of the amount of our pre-incentive fee net investment income, if any, that exceeds 2.1875% in any calendar quarter (8.75% annualized).

***Quarterly Incentive Fee Based on Net Investment Income***

Pre-incentive fee net investment income

(expressed as a percentage of the value of net assets)

Percentage of pre-incentive fee net investment income

allocated to income-based portion of incentive fee

The second part of the incentive fee is a capital gains-based incentive fee that is determined and payable in arrears as of the end of each fiscal year (or upon termination of the Advisory Agreement, as of the termination date), and equals 20% of our realized capital gains as of the end of the fiscal year. In determining the capital gains-based incentive fee payable to our Adviser, we calculate the cumulative aggregate realized capital gains and cumulative aggregate realized capital losses since our inception, and the aggregate unrealized capital depreciation as of the date of the calculation, as applicable, with respect to each of the investments in our portfolio. For this purpose, cumulative aggregate realized capital gains, if any, equals the sum of the differences between the net sales price of each investment, when sold, and the original cost of such investment since our inception. Cumulative aggregate realized capital losses equals the sum of the amounts by which the net sales price of each investment, when sold, is less than the original cost of such investment since our inception. Aggregate unrealized capital depreciation equals the sum of the difference, if negative, between the valuation of each investment as of the applicable calculation date and the original cost of such investment. At the end of the applicable year, the amount of capital gains that serves as the basis for our calculation of the capital gains-based incentive fee equals the cumulative aggregate realized capital gains less cumulative aggregate realized capital losses, less aggregate unrealized capital depreciation, with respect to our portfolio of investments. If this number



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is positive at the end of such year, then the capital gains-based incentive fee for such year equals 20% of such amount, less the aggregate amount of any capital gains-based incentive fees paid in respect of our portfolio in all prior years. We have not incurred capital gains-based incentive fees from inception through September 30, 2011, as cumulative unrealized capital depreciation has exceeded cumulative realized capital gains net of cumulative realized capital losses.

Additionally, in accordance with accounting principles generally accepted in the U.S. ( GAAP ), we have not accrued a capital gains-based incentive fee since inception. This GAAP accrual is calculated using the aggregate cumulative realized capital gains and losses and aggregate cumulative unrealized capital depreciation included in the calculation of the capital gains-based incentive fee plus the aggregate cumulative unrealized capital appreciation. If such amount is positive at the end of a period, then GAAP requires us to record a capital gains-based incentive fee equal to 20% of such amount, less the aggregate amount of actual capital gains-based incentive fees paid in all prior years. If such amount is negative, then there is no accrual for such year. GAAP requires that the capital gains-based incentive fee accrual consider the cumulative aggregate unrealized capital appreciation in the calculation, as a capital gains-based incentive fee would be payable if such unrealized capital appreciation were realized. In such instances, however, there could be no assurance that any such unrealized capital appreciation would be realized in the future.

Our Board of Directors accepted an unconditional and irrevocable voluntary waiver from the Adviser to reduce the income-based incentive fee to the extent net investment income did not cover 100% of the distributions to stockholders for the fiscal years ended September 30, 2011, 2010 and 2009. For the years ended September 30, 2011, 2010 and 2009, these credits totaled approximately \$21,000, \$165,000 and \$3,326,000, respectively.

### ***Administration Agreement***

In 2004, we entered into an administration agreement with our Administrator (as amended, the Administration Agreement ), whereby we pay separately for administrative services. The Administration Agreement provides for quarterly payments equal to our allocable portion of our Administrator's overhead expenses in performing its obligations under the Administration Agreement, including, but not limited to, rent and salaries and benefits expenses of our chief financial officer, chief accounting officer, chief compliance officer, internal counsel and their respective staffs. Our allocable portion of expenses is generally derived by multiplying our Administrator's total allocable expenses by the percentage of our total assets at the beginning of the quarter in comparison to the total assets at the beginning of the quarter of all companies managed by the Adviser under similar agreements. On July 12, 2011, our Board of Directors approved the renewal of the Administration Agreement through August 31, 2012.

### ***Code of Ethics***

We, our Adviser and our Administrator have each adopted a code of ethics and business conduct applicable to our officers, directors and all employees of our Adviser and our Administrator that complies with the guidelines set forth in Item 406 of Regulation S-K of the Securities Act. As required by the 1940 Act, this code establishes procedures for personal investments, restricts certain transactions by our personnel and requires the reporting of certain transactions and holdings by our personnel. A copy of this code is available for review, free of charge, at our website at [www.gladstonecapital.com](http://www.gladstonecapital.com). We intend to provide any required disclosure of any amendments to or waivers of the provisions of this code by posting information regarding any such amendment or waiver to our website within four days of its effectiveness.

**Table of Contents****Compliance Policies and Procedures**

We and our Adviser have adopted and implemented written policies and procedures reasonably designed to prevent violation of the federal securities laws, and our Board of Directors is required to review these compliance policies and procedures annually to assess their adequacy and the effectiveness of their implementation. We have designated a chief compliance officer, John Dellafiora, Jr., who also serves as chief compliance officer for our Adviser.

**Competition**

A large number of entities compete with us and make the types of investments that we seek to make in small and medium-sized privately-owned businesses. Such competitors include private equity funds, leveraged buyout funds, venture capital funds, investment banks and other equity and non-equity based investment funds, and other financing sources, including traditional financial services companies such as commercial banks. Many of our competitors are substantially larger than we are and have considerably greater funding sources that are not available to us. In addition, certain of our competitors may have higher risk tolerances or different risk assessments, which could allow them to consider a wider variety of investments, establish more relationships and build their market shares. Furthermore, many of these competitors are not subject to the regulatory restrictions that the 1940 Act imposes on us as a business development company. There is no assurance that the competitive pressures we face will not have a material adverse effect on our business, financial condition and results of operations. In addition, because of this competition, we may not be able to take advantage of attractive investment opportunities from time to time and there can be no assurance that we will be able to identify and make investments that satisfy our investment objective or that we will be able to meet our investment goals. Recently we have seen an increase in our competition such that terms and rates for proposed loans have been reduced. However, we believe that our extensive loan referral network and flexible transaction structuring enable us to compete effectively for opportunities in the current market environment.

**Staffing**

We do not currently have any employees and do not expect to have any employees in the foreseeable future. Currently, services necessary for our business are provided by individuals who are employees of our Adviser and our Administrator pursuant to the terms of the Advisory Agreement and the Administration Agreement, respectively. Excluding our chief financial officer, each of our executive officers is an employee or officer, or both, of our Adviser and our Administrator. No employee of our Adviser or our Administrator will dedicate all of his or her time to us. However, we expect that 25-30 full time employees of our Adviser and our Administrator will spend substantial time on our matters during the remainder of calendar year 2011 and all of calendar year 2012. To the extent we acquire more investments, we anticipate that the number of employees of our Adviser and our Administrator who devote time to our matters will increase.

As of May 31, 2012, our Adviser and our Administrator collectively had 56 full-time employees. A breakdown of these employees is summarized by functional area in the table below:

| <b>Number of Individuals</b> | <b>Functional Area</b>  |
|------------------------------|---|
| 9                            | Executive Management  |
| 33                           | Investment Management, Portfolio Management and Due Diligence               |
| 14                           | Administration, Accounting, Compliance, Human Resources, Legal and Treasury |

**Properties**

We do not own any real estate or other physical properties materially important to our operations. Our Adviser is the current leaseholder of all properties in which we operate. We occupy these premises pursuant to our Advisory and Administration Agreements with our Adviser and Administrator, respectively. Our Adviser and Administrator are both headquartered in McLean, Virginia and our Adviser also has offices in several other states.

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**Legal Proceedings**

We are not currently subject to any material legal proceedings, nor, to our knowledge, is any material legal proceeding threatened against us.

**Table of Contents****PORTFOLIO COMPANIES**

The following table sets forth certain information as of March 31, 2012, regarding each portfolio company in which we had a debt or equity security as of such date. All such investments have been made in accordance with our investment policies and procedures described in this prospectus.

(Dollars in thousands)

| Company   | Industry  | Investment   | % of Class Held on Fully Diluted Basis | Cost                     | Fair Value        |
|---|---|--|--|--------------------------|-------------------|
| <b>NON-CONTROL/NON-AFFILIATE INVESTMENTS</b>  |   |  |  |                          |                   |
| <b>Non-syndicated Loans:</b>  |   |  |  |                          |                   |
| Access Television Network, Inc. 2600 Michelson Drive, Ste 1650 Irvine, California 91612 | Service-cable airtime (infomercials)              | Senior Term Debt   |  | \$ 903                   | \$                |
| Allison Publications, LLC 4311 Oak Lawn, Suite 100 Dallas, Texas 75219                  | Service-publisher of consumer oriented Magazines  | Senior Term Debt   |  | 8,171                    | 7,674             |
| BAS Broadcasting 905 West State St. Fremont, OH 43420                                   | Service-radio station operator                    | Senior Term Debt   |  | 7,465                    | 4,106             |
| Chinese Yellow Pages Company 9550 Flair Drive Suite 200 El Monte, CA 91731              | Service-publisher of Chinese language directories | Line of Credit Senior Term Debt  |  | 450<br>78                | 270<br>47         |
| CMI Acquisition, LLC 4211 E. 43rd St. Place Kearney, NE 68848                           | Service-recycling                                 | Senior Subordinated Term Debt  |  | 14,265                   | 14,194            |
| FedCap Partners, LLC 11951 Freedom Drive, 13th Fl Reston, VA 20190                      | Private equity fund                               | Class A Membership Units Uncalled Capital Commitment                             | 6.7%                                   | 1,200                    | 1,153             |
| GFRC Holdings, LLC 3615 Miller Park Dr. Garland, TX 75042                               | Manufacturing-glass-fiber reinforced concrete     | Senior Term Debt<br>Senior Subordinated Term Debt                                |  | 5,324<br>6,598           | 2,928<br>3,629    |
| Heartland Communications Group 909 North Railroad Eagle River, WI 54521                 | Service-radio station operator                    | Line of Credit<br>Line of Credit<br>Senior Term Debt<br>Common Stock<br>Warrants |  | 100<br>45<br>4,325<br>66 | 35<br>16<br>1,520 |
|   |   |  | 8.8%                                   |                          |                   |

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| <b>Company</b>   | <b>Industry</b>  | <b>Investment</b>  | <b>% of Class Held on Fully Diluted Basis</b> | <b>Cost</b>                              | <b>Fair Value</b>                        |
|--|--|--|---|--|--|
| International Junior Golf Training<br>Acquisition Company  | Service-golf training  | Line of Credit<br>Senior Term Debt<br>Senior Term Debt   |   | \$ 2,125<br>661                          | \$ 1,424<br>443                          |
| 58 Hospital Center Common Hilton Head,<br>SC 29926   |  |  |   | 2,500                                    | 1,675                                    |
| Legend Communications of Wyoming,<br>LLC<br><br>6805 Douglas Legum Dr, Ste 100<br>Elkridge, MD 21075 | Service-operator of radio<br>stations  | Senior Term Debt   |   | 9,203                                    | 4,785                                    |
| North American Aircraft Services, LLC<br><br>11502 Jones Maltsberger<br>San Antonio, TX 78216        | Service - repairs and<br>maintains aircraft<br><br>fuel tanks and fuel systems | Line of Credit<br>Senior Term Debt<br>Senior Subordinated<br>Term Debt<br>Senior Subordinated<br>Term Debt<br>Common Stock<br>Warrants |   | 1,250<br>4,767<br>4,750<br>2,820<br>350  | 1,238<br>4,719<br>4,703<br>2,792<br>608  |
| Northstar Broadband, LLC<br>3660 East Covington Ave suite C<br>Post Falls, ID 83854                  | Service-cable TV franchise<br>owner  | Senior Term Debt   |   | 44                                       | 42                                       |
| Ohana Media Group<br>833 Gambell Street<br>Anchorage, AK 99501                                       | Service - AM/FM radio<br>broadcast   | Senior Term Debt   |   | 1,590                                    | 1,447                                    |
| Precision Acquisition Group<br><br>Holdings, Inc.<br>435 Burt Street<br>Sistersville, WV 26175       | Manufacturing-consumable<br><br>components for the Aluminum<br><br>industry    | Equipment Note<br>Senior Term Debt<br>Senior Term Debt   |   | 1,000<br>4,125<br>4,053                  | 835<br>3,444<br>3,384                    |
| PROFIT Systems Acquisition Co.<br>422 E. Vermijo Ave, Suite 100<br>Colorado Springs, CO 80903        | Service-design and develop<br>ERP<br><br>Software                              | Line of Credit<br><br>Senior Term Debt   |   | <br>2,850                                | <br>2,708                                |
| Reliable Biopharmaceutical Holdings, Inc.<br>1945 Walton Rd.<br>St. Louis, MO 63114                  | Manufacturing-pharmaceutical<br>and<br><br>biochemical intermediates           | Line of Credit<br>Mortgage Note<br>Senior Term Debt<br>Senior Subordinated<br>Term Debt<br>Common Stock<br>Warrants                    |   | 3,500<br>7,121<br>11,513<br>6,000<br>209 | 3,316<br>6,747<br>10,908<br>5,685<br>736 |

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| Company   | Industry   | Investment   | % of Class Held on Fully Diluted Basis | Cost                    | Fair Value              |
|---|--|--|--|-------------------------|-------------------------|
| Saunders & Associates<br>2520 East Rose Garden Ln.<br>Phoenix, AZ 85050   | Manufacturing-equipment provider for frequency control devices | Line of Credit<br>Senior Term Debt   |  | \$<br>8,947             | \$<br>8,052             |
| Sunburst Media - Louisiana, LLC<br>300 Crescent Court, Suite 850<br>Dallas, Texas 75201                         | Service-radio station operator                                 | Senior Term Debt   |  | 6,000                   | 2,400                   |
| Thibaut Acquisition Co.<br>480 Frelinghuysen Avenue<br>Newark, NJ 07114   | Service-design and distribute wall covering                    | Line of Credit<br>Senior Term Debt<br>Senior Term Debt                             |  | 750<br>287<br>3,000     | 737<br>282<br>2,933     |
| Westlake Hardware, Inc.<br>14000 Marshall Dr.<br>Lenexa, KS 66215   | Retail-hardware and variety                                    | Senior Subordinated Term Debt<br>Senior Subordinated Term Debt                     |  | 12,000<br>8,000         | 11,640<br>7,700         |
| Westland Technologies, Inc.<br>107 S Riverside Dr<br>Modesto, CA 95354  | Service-diversified conglomerate                               | Line of Credit<br>Senior Term Debt<br>Senior Term Debt<br>Common Stock<br>Warrants |  | 1,850<br>4,000<br>350   | 1,804<br>3,900<br>279   |
| Winchester Electronics<br>62 Barnes Industrial Road<br>North Wallingford, CT 06492                              | Manufacturing-high bandwidth connectors and cables             | Senior Term Debt<br>Senior Term Debt<br>Senior Subordinated Term Debt              |  | 1,250<br>1,669<br>9,750 | 1,244<br>1,656<br>9,628 |
| <b>Subtotal Non-syndicated loans</b>  |  |  |  | \$ 177,274              | \$ 149,466              |
| <b>Syndicated Loans:</b>  |  |  |  |                         |                         |
| Airvana Network Solutions, Inc.<br>19 Alpha Road,<br>Chelmsford, MA 01824                                       | Service-telecommunications                                     | Senior Term Debt   |  | \$ 3,827                | \$ 3,732                |
| Allied Security Holdings, LLC<br>161 Washington Street<br>Eight Tower Bridge, Suite 600<br>Conshocken, PA 19428 | Service-contract security officer providers                    | Senior Subordinated Term Debt  |  | 991                     | 1,003                   |

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| <b>Company</b>  | <b>Industry</b>   | <b>Investment</b>             | <b>% of Class Held on Fully Diluted Basis</b> | <b>Cost</b> | <b>Fair Value</b> |
|---|---|-------------------------------|---|-------------|-------------------|
| Allied Specialty Vehicles, Inc.<br>2778 N. Forsyth Road<br>Winter Park, FL 32792            | Manufacturing-specialty vehicles  | Senior Term Debt              |   | \$ 9,735    | \$ 9,702          |
| Ameriqua Group, LLC<br>18200 Highway 41 North<br>Evansville, IN 47725                       | Manufacturing-production and distribution of food products                      | Senior Term Debt              |   | 7,319       | 7,295             |
| Applied Systems, Inc.<br>200 Applied Parkway,<br>University Park, IL 60466                  | Software for property & casualty insurance industry                             | Senior Subordinated Term Debt |   | 992         | 998               |
| Ascend Learning, LLC<br>7500 West 160th Street,<br>Stillwell, KS 66085                      | Service-technology-based learning solutions                                     | Senior Subordinated Term Debt |   | 974         | 1,010             |
| Attachmate Corporate<br>1500 Dexter Ave N<br>Seattle, WA 98109                              | Service-develops, implements and supports software                              | Senior Subordinated Term Debt |   | 3,965       | 3,990             |
| Autoparts Holdings Limited<br>39 Old Ridgebury Rd<br>Danbury, CT 06810                      | Supplier to the light and heavy-duty vehicle after market for replacement parts | Senior Term Debt              |   | 995         | 983               |
| Blue Coat Systems, Inc.<br>420 North Mary Avenue<br>Sunnyvale, CA 94086                     | Provider of Internet security and network Acceleration appliances               | Senior Subordinated Term Debt |   | 8,497       | 8,542             |
| Covad Communications Group, Inc.<br>2220 O Toole Avenue,<br>San Jose, CA 95131              | Service-telecommunications  | Senior Term Debt              |   | 1,722       | 1,741             |
| Global Brass and Copper, Inc.<br>1901 North Roselle Road, Suite 824<br>Schaumburg, IL 60195 | Manufacturing - steel wool products and metal fibers                            | Senior Term Debt              |   | 2,886       | 2,993             |
| HGI Holding, Inc<br>1810 Summit Commerce Park<br>Twinsburg, OH 44087                        | Service - distributor of disposable medical products                            | Senior Term Debt              |   | 1,725       | 1,757             |
| Hubbard Radio, LLC<br>3415 University Ave<br>St. Paul, MN 55114                             | Service-radio station operator  | Senior Subordinated Term Debt |   | 495         | 506               |
| Keypoint Government Solutions, Inc<br>1750 Foxtrail Drive<br>Loveland, CO 80538             | Service-security consulting services  | Senior Term Debt              |   | 6,884       | 6,912             |
| Mood Media Corporation<br>99 Sante Drive,<br>Concord, ON, Canada L4K 3C4                    | Service-media and marketing solutions   | Senior Term Debt              |   | 7,926       | 7,480             |

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| <b>Company</b>  | <b>Industry</b>   | <b>Investment</b>       | <b>% of Class Held on Fully Diluted Basis</b> | <b>Cost</b>    | <b>Fair Value</b> |
|---|---|-------------------------|---|----------------|-------------------|
| National Surgical Hospitals, Inc.<br>250 South Wacker Drive, Suite 500<br>Chicago, IL 60606               | Service-physician-partnered surgical facilities                     | Senior Term Debt        |   | \$ 1,652       | \$ 1,631          |
| Sensus USA, Inc.<br>8601 Six Forks Road<br>Raleigh, NC 27615  | Service-provider of utility Communication services                  | Senior Term Debt        |   | 495            | 496               |
| Springs Window Fashions, LLC<br>7549 Graber Road<br>Middleton, WI 53562                                   | Manufacturing-window coverings                                      | Senior Term Debt        |   | 6,843          | 6,825             |
| SRAM, LLC<br>1333 N. Kingsbury, 4th Floor<br>Chicago, Illinois 60622                                      | Manufacturing-premium bicycle components                            | Senior Term Debt        |   | 2,477          | 2,512             |
| Targus Group International, Inc.<br>1211 North Miller Street<br>Anaheim, CA 92806                         | Manufacturing-carrying cases and accessories for notebook computers | Senior Term Debt        |   | 9,752          | 9,801             |
| Ulterra Drilling Technologies, LP<br>420 Throckmorton St, Suite 1110<br>Fort Worth, TX 76102              | Manufacturing-oil field drill bits and slick- slip reduction tools  | Senior Term Debt        |   | 1,891          | 1,915             |
| Vision Solutions, Inc.<br>15300 Barranca Parkway<br>Irvine, California 92618                              | Service-provider of information availability software               | Senior Term Debt        |   | 10,921         | 10,670            |
| Wall Street Systems Holdings, Inc.<br>1290 Avenue of the Americas<br>New York, NY 10104                   | Service-software provider   | Senior Term Debt        |   | 2,972          | 3,007             |
| WP Evenflo Group Holdings, Inc.<br>707 Crossroads Court<br>Vandalia, OH 45377                             | Manufacturing-infant and juvenile Products                          | Senior Term Debt        |   | 277            | 270               |
|   |   | Senior Preferred Equity | 0.9%  | 333            | 440               |
|   |   | Junior Preferred Equity | 4.4%  | 111            | 155               |
|   |   | Common Stock            | 0.8%  |                | 403               |
|   |   |                         |   | 96,657         | 96,769            |
| <b>Subtotal - Syndicated loans</b>  |   |                         |   |                |                   |
| <b>Total Non-Control/Non-Affiliate Investments (represented 85.4% of total investments at fair value)</b> |   |                         |   | <b>273,931</b> | <b>246,235</b>    |



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| Company   | Industry   | Investment                    | % of Class Held on Fully Diluted Basis | Cost     | Fair Value |
|---|--|-------------------------------|--|----------|------------|
| <b>CONTROL INVESTMENTS</b>  |  |                               |  |          |            |
| BERTL, Inc.<br>200 Craig Road<br>Manalapan, NJ 07726  | Service-web-based evaluator of imaging products  | Line of Credit                |  | \$ 1,358 | \$         |
|   |  | Common Stock                  | 88.3%                                  | 424      |            |
| Defiance Integrated Technologies, Inc.<br>1090 Perry Street<br>Defiance, OH 43512             | Manufacturing-trucking parts                     | Senior Term Debt              |  | 7,345    | 7,345      |
|   |  | Common Stock                  | 58.7%                                  | 1        | 8,696      |
| Kansas Cable Holdings, Inc.<br>PO Box 67235<br>Topeka, KS 66667                               | Service - cable, internet, voice provider        | Line of Credit                |  | 662      | 5          |
|   |  | Senior Term Debt              |  | 1,444    | 11         |
|   |  | Senior Term Debt              |  | 1,000    | 8          |
|   |  | Common Stock                  | 100.0%                                 |          |            |
| Lindmark Acquisition, LLC<br>306 Lindmark Ave<br>Purcell, OK 73080                            | Service-advertising                              | Senior Subordinated Term Debt |  | 10,000   | 1,300      |
|   |  | Senior Subordinated Term Debt |  | 2,000    | 260        |
|   |  | Senior Subordinated Term Debt |  | 1,909    | 248        |
|   |  | Common Stock                  | 100.0%                                 | 317      |            |
| LocalTel, LLC<br>360 Merrimack Street, Suite 216<br>Lawrence, MA 01843                        | Service-yellow pages publishing                  | Line of credit                |  | 2,218    | 559        |
|   |  | Line of Credit                |  | 1,170    |            |
|   |  | Senior Term Debt              |  | 325      |            |
|   |  | Senior Term Debt              |  | 2,688    |            |
|   |  | Senior Term Debt              |  | 2,750    |            |
|   |  | Common Stock                  | 40.0%                                  |          |            |
| Midwest Metal Distribution, Inc.<br>6270 Van Buren Road<br>Clinton, OH 44216                  | Distribution-aluminum sheets and stainless steel | Senior Subordinated Term Debt |  | 18,267   | 17,870     |
|   |  | Common Stock                  | 70.1%                                  | 138      |            |
| Sunshine Media Holdings<br>735 Broad St, Suite 708<br>Chattanooga, TN 37402                   | Service-publisher regional B2B                   | Line of credit                |  | 1,502    | 225        |
|   |  | Senior Term Debt              |  | 16,948   | 2,542      |
|   |  | Senior Term Debt              |  | 10,700   | 1,605      |
|   | trade magazines                                  | Junior Preferred Equity       | 91.6%                                  | 4,075    |            |
|   |  | Common Stock                  | 28.8%                                  | 740      |            |
| U.S. Healthcare Communications, Inc.<br>318 Cleveland Ave., Unit 1<br>Highland Park, NJ 08904 | Service-magazine publisher/operator              | Line of credit                |  | 269      |            |
|   |  | Line of credit                |  | 450      |            |
|   |  | Common Stock                  | 100.0%                                 | 2,470    |            |

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| Company   | Industry                        | Investment  | % of Class Held on Fully Diluted Basis | Cost                         | Fair Value           |
|---|---------------------------------|---|--|------------------------------|----------------------|
| Viapack, Inc.<br>1224 S. Hamilton St<br>Dalton, GA 30720                                | Manufacturing-polyethylene film | Line of Credit<br>Senior Real Estate<br>Term Debt<br>Senior Term Debt<br>Preferred Equity | 98.3%                                  | \$ 3,334<br><br>600<br>3,925 | 534<br><br>96<br>628 |
| <b>Total Control Investments (represented 14.6% of total investments at fair value)</b> |                                 |   |  | <b>99,029</b>                | <b>41,932</b>        |
| <b>Total Investments</b>  |                                 |   |  | <b>\$ 372,960</b>            | <b>\$ 288,167</b>    |

**Significant Portfolio Companies**

Set forth below is a brief description of each portfolio company in which we have made an investment that currently represents greater than 5% of our total assets at fair value (excluding cash pledged to creditors). Because of the relative size of our investments in these companies, we are exposed to a greater degree to the risks associated with these companies.

**CMI Acquisition, LLC**

We currently hold a senior subordinated term loan, having a fair value of \$14.2 million as of March 31, 2012, of CMI Acquisition, LLC, which we refer to as CMI. The principal amount of the loan is \$14.3 million, and the loan matures on December 31, 2016.

CMI is a full services scrap metals recycler and automobile shredder. CMI services mainly customers in Nebraska and surrounding states, within a close radius of its plants. Because of the relative size of this investment, we are significantly exposed to the risks associated with CMI's business. CMI is exposed to risks related to the volatility of scrap steel prices specifically and the cyclical nature of the steel and automobile industries in general. CMI is also exposed to environmental risks similar to companies in this type of industry.

CMI's principal executive offices are located at 3440 1<sup>st</sup> Street East, Columbus, NE 68601.

**Defiance Integrated Technologies, Inc.**

We currently hold investments, having an aggregate fair value of \$16.0 million as of March 31, 2012, in Defiance Integrated Technologies, Inc. and its subsidiaries, which we refer to collectively as Defiance. Our investments in Defiance consist of a senior term loan with a principal amount outstanding of \$7.3 million, maturing April 15, 2013, and 15,500 shares of its common stock, which we purchased for \$775.

Defiance is a leading manufacturer of axle nut and washer systems for heavy (Class 8) trucks and trailers in North America. Through an acquisition, Defiance expanded into the light truck and auto market segments. Their product offering includes a wheel bearing retainer nut, used primarily on light trucks, and brake cable tension limiters.

Because of the relative size of this investment, we are significantly exposed to the risks associated with Defiance's business. Defiance has been affected by the overall U.S. recession, specifically light and heavy duty truck production volume. There is risk in these markets as they are directly impacted by the consumer and industrial goods demand. Defiance, similar to other entities in these markets, is also exposed to the risk of increased raw material prices and manufacturing costs. In addition, Defiance's financial results are correlated

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with the operations and production levels of the large domestic auto makers. In order to overcome these risks, Defiance will need to continue to diversify its revenue sources and maintain control over its costs.

One of our Adviser's managing directors, Lud Kimbrough, and one of our Adviser's directors, Michael Beckett, are directors on Defiance's board. The principal executive offices of Defiance are located at 1090 Perry Street, Defiance, Ohio 43512.

### **Francis Drilling Fluids, Ltd.**

We currently hold a subordinated term loan in Francis Drilling Fluids, Ltd., having a value of \$15.0 million. In addition we have a \$1.0 million equity co-investment in the company. The loan matures on November 4, 2017.

FDF provides a logistics network of warehousing, transportation and energy field services that focus on fracturing materials required for high-pressure, fracture stimulation for horizontal oil and natural gas drilling. FDF offers customers a one-stop alternative for all of their drilling fluids, storage and transportation of hydraulic fracturing materials, equipment rental and cleaning service needs during every stage of the drilling process. Due to the relative size of this investment, we are significantly exposed to the risks associated with FDF's business. FDF is exposed to risks related to the worldwide demand for oil and natural gas as well as environmental regulations similar to other companies in this industry.

FDF's principal executive offices are located at 240 Jasmine Road, Crowley, LA 70526.

### **Midwest Metal Distribution, Inc.**

We currently hold investments, having an aggregate fair value of \$17.9 million as of March 31, 2012, in Midwest Metal Distribution, Inc., which we refer to as Midwest Metal. Our investments in Midwest Metal consist of a senior subordinated term loan with a principal amount outstanding of \$18.3 million, maturing July 31, 2013 and 501 shares of common stock, which we purchased for \$0.1 million.

Midwest Metal is a metal service center that supplies custom cut aluminum sheet, plate, bar/extrusions, angle as well as stainless steel. Midwest Metal has focused on serving customers in the Midwest and Great Lakes region that require small batches of custom cut metal, and Just-in-time (JIT) delivery service at competitive prices.

Because of the relative size of this investment, we are significantly exposed to the risks associated with Midwest Metal's business. Midwest Metal is exposed to commodity price risk in aluminum and stainless steel, which historically have been substantially more volatile during the past three years than in previous historical periods. Additionally, despite a diversified customer base, a significant percentage of sales are to customers in the auto industry, which has historically been volatile and has undergone significant changes during the recent recession. To overcome these risks, Midwest Metal management will need to execute on offering competitively priced metal enhanced by high value-added processing with a quick turnaround.

Our vice chairman and chief operating officer, Terry Lee Brubaker, one of our Adviser's managing directors, Lud Kimbrough, and one of our Adviser's associates, Christopher Lee, are directors of Midwest Metal. The principal executive offices of Midwest Metal are located at 6270 Van Buren Road, Clinton, Ohio 44216.

### **Reliable Biopharmaceutical Holdings, Inc.**

We currently hold investments, having an aggregate fair value of \$27.4 million as of March 31, 2012, in Reliable Biopharmaceutical Holdings, Inc. and its subsidiaries, which we refer to collectively as Reliable. Our investments in Reliable consist of a senior term last out tranche loan with a principal amount outstanding of \$11.5 million, a senior subordinated term loan with a principal amount outstanding of \$6.0 million, a mortgage

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note with a principal amount outstanding of \$7.1 million, a revolving credit facility of \$4.0 million, of which \$0.7 million is currently undrawn, and a warrant to purchase 764 shares of common stock, which we purchased for \$0.2 million. Each of the notes has a maturity date of December 22, 2014 and the revolving credit facility has a maturity date of January 30, 2013. Reliable, based in St. Louis, Missouri, develops and manufactures active pharmaceutical ingredients and high purity processing chemicals used in the manufacture of pharmaceuticals and biological products. Reliable's products are the active ingredients for leading generic injectable drugs that treat cancer, heart disease, hypertension, anxiety and other serious illnesses.

Because of the relative size of this investment, we are significantly exposed to the risks associated with Reliable's business. In particular, Reliable is subject to regulation and approvals by the Food & Drug Administration, or FDA. Should Reliable fail to comply with FDA regulations, it could have a material adverse impact on Reliable and the value of our investment in Reliable.

Reliable's principal executive offices are located at 1945 Walton Road, St. Louis, Missouri 63114.

### **Westlake Hardware, Inc.**

We currently hold investments, having an aggregate fair value of \$19.3 million as of March 31, 2012, in Westlake Hardware, Inc., which we refer to as Westlake. Our investments in Westlake consist of a senior subordinated term loan with a principal amount outstanding of \$12.0 million and a senior subordinated term last out tranche loan with a principal amount outstanding of \$8.0 million, both maturing on January 6, 2014.

Westlake is a business with a 100-year history as a retailer of home hardware. Westlake is the largest member of the ACE Hardware Corporation buying cooperative. Westlake operates more than 85 retail locations, averaging 20,000 square feet each, in seven Midwestern states that sell a variety of products and services to predominantly do-it-yourself, or DIY, customers and some professionals. Westlake has a strong brand name in the Midwest, gained by providing customers quality products, a broad selection and superior service in a neighborhood retail setting.

Because of the relative size of this investment, we are significantly exposed to the risks associated with Westlake's business. Big-box retailers dominate the home improvement market and have impacted Westlake's revenue growth historically. There is a risk that they may change strategy and compete with stores like Westlake with smaller stores similar to Westlake. In fact, Big-box retailers have been doing this during the economic downturn, but Westlake has had some success repositioning itself as offering more knowledgeable staff (older and more experienced with more training) who can offer guidance on a range of home repairs and projects. Westlake plans on growing through infill store growth and positioning itself as the neighborhood store. Slowdown in the economy could reduce personal incomes, leading to lower retail hardware purchases if customers defer repairs.

The principal executive offices of Westlake are located at 14000 Marshall Drive, Lenexa, Kansas 66215.

**Table of Contents****MANAGEMENT**

Our business and affairs are managed under the direction of our Board of Directors. Our Board of Directors currently consists of nine members, five of whom are not considered to be interested persons of Gladstone Capital as defined in Section 2(a)(19) of the 1940 Act. We refer to these individuals as our independent directors. Our Board of Directors elects our officers, who serve at the discretion of the Board of Directors.

**Board of Directors**

Under our articles of incorporation, our directors are divided into three classes. Each class consists, as nearly as possible, of one-third of the total number of directors, and each class has a three year term. Holders of our common stock and preferred stock vote together as a class for the election of directors, except that the holders of our term preferred stock have the sole right to elect two of our directors. At each annual meeting of our stockholders, the successors to the class of directors whose term expires at such meeting will be elected to hold office for a term expiring at the annual meeting of stockholders held in the third year following the year of their election. Each director will hold office for the term to which he or she is elected and until his or her successor is duly elected and qualifies. Information regarding our Board of Directors is as follows (the address for each director is c/o Gladstone Capital Corporation, 1521 Westbranch Drive, Suite 200, McLean, Virginia 22102):

| Name                         | Age | Position   | Director Since | Expiration of Term |
|------------------------------|-----|--|----------------|--------------------|
| <b>Interested Directors</b>  |     |  |                |                    |
| David Gladstone              | 70  | Chairman of the Board and Chief Executive Officer(1)(2)              | 2001           | 2013               |
| Terry L. Brubaker            | 68  | Vice Chairman, Chief Operating Officer, Secretary and Director(1)(2) | 2001           | 2015               |
| George Stelljes III          | 50  | President, Chief Investment Officer and Director(1)                  | 2003           | 2014               |
| David A. R. Dullum           | 64  | Executive Vice President, Director(1)                                | 2001           | 2015               |
| <b>Independent Directors</b> |     |  |                |                    |
| Anthony W. Parker            | 66  | Director(2)(3)(6)  | 2001           | 2014               |
| Michela A. English           | 62  | Director(3)(6)   | 2002           | 2014               |
| Paul W. Adelgren             | 69  | Director(4)(5)(6)  | 2003           | 2013               |
| John H. Outland              | 66  | Director(4)(5)(6)  | 2003           | 2013               |
| John Reilly                  | 69  | Director(3)(6)   | 2011           | 2015               |

- (1) Interested person as defined in Section 2(a)(19) of the 1940 Act due to the director's position as our officer and/or employment by our Adviser.
- (2) Member of the executive committee.
- (3) Member of the audit committee.
- (4) Member of the ethics, nominating, and corporate governance committee.
- (5) Member of the compensation committee.
- (6) Each independent director serves as an alternate member of each committee for which they do not serve as a regular member. Messrs. Adelgren and Outland serve as alternate members of the audit committee; Messrs. Parker and Reilly and Ms. English serve as alternates on the compensation committee; and Messrs. Parker and Reilly and Ms. English serve as alternates on the ethics, nominating and corporate governance committee. Alternate members of the committees serve and participate in meetings of the committees only in the event of an absence of a regular member of the committee.

The biographical information for each of our directors, includes all of the public company directorships held by such directors for the past five years.

**Table of Contents*****Independent Directors (in alphabetical order)***

*Paul W. Adelgren.* Mr. Adelgren has served as a director since January 2003. Mr. Adelgren has also served as a director of Gladstone Commercial since August 2003 and a director of Gladstone Investment since June 2005. From 1997 to the present, Mr. Adelgren has served as the pastor of Missionary Alliance Church. From 1991 to 1997, Mr. Adelgren was pastor of New Life Alliance Church. From 1988 to 1991, Mr. Adelgren was vice president – finance and materials for Williams & Watts, Inc., a logistics management and procurement business located in Fairfield, NJ. Prior to joining Williams & Watts, Mr. Adelgren served in the United States Navy, where he served in a number of capacities, including as the director of the Strategic Submarine Support Department, as an executive officer at the Naval Supply Center, and as the director of the Joint Uniform Military Pay System. He is a retired Navy Captain. Mr. Adelgren holds an MBA from Harvard Business School and a BA from the University of Kansas. Mr. Adelgren was selected to serve as an independent director on our Board due to his strength and experience in ethics, which also led to his appointment to the chairmanship of our Ethics, Nominating & Corporate Governance Committee, as well as his past service on our Board since 2003.

*Michela A. English.* Ms. English has served as director since June 2002. Ms. English is President and CEO of Fight for Children, a non-profit charitable organization focused on providing high quality education and health care services to underserved youth in Washington, D.C. Ms. English has also been a director of Gladstone Commercial since August 2003, and a director of Gladstone Investment since June 2005. From March 1996 to March 2004, Ms. English held several positions with Discovery Communications, Inc., including president of Discovery Consumer Products, president of Discovery Enterprises Worldwide and president of Discovery.com. From 1991 to 1996, Ms. English served as senior vice president of the National Geographic Society and was a member of the National Geographic Society’s Board of Trustees and Education Foundation Board. Prior to 1991, Ms. English served as vice president, corporate planning and business development for Marriott Corporation and as a senior engagement manager for McKinsey & Company. Ms. English currently serves as director of the Educational Testing Service (ETS), as a director of D.C. Preparatory Academy, a director of the District of Columbia Public Education Fund, a director of the National Women’s Health Resource Center, a trustee of the Corcoran Museum of Art, a director of the Society for Science and the Public and as a member of the Virginia Institute of Marine Science Council. Ms. English is an emeritus member of the board of Sweet Briar College. Ms. English holds a Bachelor of Arts in International Affairs from Sweet Briar College and a Master of Public and Private Management degree from Yale University’s School of Management. Ms. English was selected to serve as an independent director on our Board due to her greater than twenty years of senior management experience at various corporations and non-profit organizations as well as her past service on our Board since 2002.

*John H. Outland.* Mr. Outland has served as a director since December 2003. Mr. Outland has also served as a director of Gladstone Commercial since December 2003 and of Gladstone Investment since June 2005. From March 2004 to June 2006, he served as vice president of Genworth Financial, Inc. From 2002 to March 2004, Mr. Outland served as a managing director for 1789 Capital Advisors, where he provided market and transaction structure analysis and advice on a consulting basis for multifamily commercial mortgage purchase programs. From 1999 to 2001, Mr. Outland served as vice president of mortgage-backed securities at Financial Guaranty Insurance Company where he was team leader for bond insurance transactions, responsible for sourcing business, coordinating credit, loan files, due diligence and legal review processes, and negotiating structure and business issues. From 1993 to 1999, Mr. Outland was senior vice president for Citicorp Mortgage Securities, Inc., where he securitized non-conforming mortgage product. From 1989 to 1993, Mr. Outland was vice president of real estate and mortgage finance for Nomura Securities International, Inc., where he performed due diligence on and negotiated the financing of commercial mortgage packages in preparation for securitization. Mr. Outland holds an MBA from Harvard Business School and a bachelor’s degree in Chemical Engineering from Georgia Institute of Technology. Mr. Outland was selected to serve as an independent director on our Board due to his more than twenty years of experience in the real estate and mortgage industry as well as his past service on our Board since 2003.

*Anthony W. Parker.* Mr. Parker has served as a director since August 2001. Mr. Parker has also served as a director of Gladstone Commercial since August 2003 and as a director of Gladstone Investment since June 2005.

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In January 2011, Mr. Parker was elected as treasurer of the Republican National Committee. In 1997 Mr. Parker founded Parker Tide Corp., formerly known as Snell Professional Corp. Parker Tide Corp. is a government contracting company providing mission critical solutions to the Federal government. From 1992 to 1996, Mr. Parker was chairman of, and a 50 percent stockholder of, Capitol Resource Funding, Inc., or CRF, a commercial finance company. Mr. Parker practiced corporate and tax law for over 15 years: from 1980 to 1983, he practiced at Verner, Liipfert, Bernhard & McPherson and from 1983 to 1992, in private practice. From 1973 to 1977, Mr. Parker served as executive assistant to the administrator of the U.S. Small Business Administration. Mr. Parker received his J.D. and Masters in Tax Law from Georgetown Law Center and his undergraduate degree from Harvard College. Mr. Parker was selected to serve as an independent director on our Board due to his expertise and wealth of experience in the field of corporate taxation as well as his past service on our Board since our inception. Mr. Parker's knowledge of corporate tax was instrumental in his appointment to the chairmanship of our Audit Committee.

*John Reilly.* Mr. Reilly has served as a director since January 2011. Mr. Reilly has also served as a director of Gladstone Investment and Gladstone Commercial since January 2011. From 1987 until the present, Mr. Reilly has served as president of Reilly Investment Corporation, where he provides advisory services to public and private companies, and financing and joint venture development. From March 1976 until April 1984 he served as principal stockholder, president and chief executive officer of Reilly Mortgage Group, Inc., where he provided origination and construction lending and permanent loan placement of commercial real estate loans for institutional investors. In 1988, Mr. Reilly assumed the role of chairman. In 1992, Stonehurst Ventures, L.P., purchased Reilly Mortgage Group, at which time he then assumed the role of executive director until 1994. From 1971 to 1976, Mr. Reilly served as vice president of Walker & Dunlop, Inc. where he provided services for commercial loan originations, joint ventures, HUD programs and secondary marketing. From 1967 to 1969, Mr. Reilly served as a research engineer for Crane Company, and from 1964 to 1967 he served as a supply officer in the United States Navy. Mr. Reilly also has served as a member of the board of directors of Beekman Helix India since 2009, and has served as co-chairman of the board of directors for Community Preservation and Development Corporation since 2006. He has also served as a member of the board of Victory Housing since 2005 and has served as the chairman of the advisory board of the Snite Museum of Art at the University of Notre Dame since 1996. Mr. Reilly has held a D.C. real estate broker license since 1973. Mr. Reilly is a graduate of Mortgage Bankers School I, II and II and Income School I and II. Mr. Reilly holds an MBA from Harvard Business School and a Bachelor of Arts and a Bachelor of Science in Mathematical Engineering from the University of Notre Dame. Mr. Reilly was selected to serve as an independent director on our Board due to his expertise and wealth of experience in the real estate and mortgage industry.

***Interested Directors***

*David Gladstone.* Mr. Gladstone is our founder and has served as our chief executive officer and chairman of our Board of Directors since our inception. Mr. Gladstone is also the founder of our Adviser and has served as its chief executive officer and chairman of its board of directors since its inception. Mr. Gladstone also founded and serves as the chief executive officer and chairman of the boards of directors of our affiliates, Gladstone Investment and Gladstone Commercial. Prior to founding the Gladstone Companies, Mr. Gladstone served as either chairman or vice chairman of the board of directors of American Capital Strategies, Ltd., a publicly traded leveraged buyout fund and mezzanine debt finance company, from June 1997 to August 2001. From 1974 to February 1997, Mr. Gladstone held various positions, including chairman and chief executive officer, with Allied Capital Corporation (a mezzanine debt lender), Allied Capital Corporation II (a subordinated debt lender), Allied Capital Lending Corporation (a small business lending company), Allied Capital Commercial Corporation (a real estate investment company), and Allied Capital Advisers, Inc., a registered investment adviser that managed the Allied companies. The Allied companies were the largest group of publicly-traded mezzanine debt funds in the United States and were managers of two private venture capital limited partnerships (Allied Venture Partnership and Allied Technology Partnership) and a private REIT (Business Mortgage Investors). From 1992 to 1997, Mr. Gladstone served as a director, president and chief executive officer of Business Mortgage Investors, a privately held mortgage REIT managed by Allied Capital Advisers, which invested in loans to small and

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medium-sized businesses. Mr. Gladstone is also a past director of Capital Automotive REIT, a real estate investment trust that purchases and net leases real estate to automobile dealerships. Mr. Gladstone served as a director of The Riggs National Corporation (the parent of Riggs Bank) from 1993 to May 1997 and of Riggs Bank from 1991 to 1993. He has served as a trustee of The George Washington University and currently is a trustee emeritus. He is a past member of the Listings and Hearings Committee of the National Association of Securities Dealers, Inc. He is a past member of the advisory committee to the Women's Growth Capital Fund, a venture capital firm that finances women-owned small businesses. Mr. Gladstone was the founder and managing member of The Capital Investors, LLC, a group of angel investors, and is currently a member emeritus. He is also the past chairman and past owner of Coastal Berry Company, LLC, a large strawberry farming operation in California. He is also the chairman and owner of Gladstone Land Corporation, a privately held company that has substantial farmland holdings in agriculture real estate in California. Mr. Gladstone holds an MBA from the Harvard Business School, an MA from American University and a BA from the University of Virginia. Mr. Gladstone has co-authored two books on financing for small and medium-sized businesses, *Venture Capital Handbook* and *Venture Capital Investing*. Mr. Gladstone was selected to serve as a director on our Board due to the fact that he is our founder and has greater than thirty years of experience in the industry, including his service as our chairman and chief executive since our inception.

*Terry Lee Brubaker.* Mr. Brubaker has been our chief operating officer, secretary and a director since our inception. He also served as our president from May 2001 through April 2004, when he assumed the duties of vice chairman. Mr. Brubaker has also served as a director of our Adviser since its inception. He also served as president of our Adviser from its inception through February 2006, when he assumed the duties of vice chairman, chief operating officer and secretary. He has served as vice chairman, chief operating officer, secretary and as a director of Gladstone Investment since its inception. Mr. Brubaker has also served chief operating officer, secretary and as a director of Gladstone Commercial since February 2003, and as president from February 2003 through July 2007, when he assumed the duties of vice chairman. In March 1999, Mr. Brubaker founded and, until May 1, 2003, served as chairman of Heads Up Systems, a company providing process industries with leading edge technology. From 1996 to 1999, Mr. Brubaker served as vice president of the paper group for the American Forest & Paper Association. From 1992 to 1995, Mr. Brubaker served as president of Interstate Resources, a pulp and paper company. From 1991 to 1992, Mr. Brubaker served as president of IRI, a radiation measurement equipment manufacturer. From 1981 to 1991, Mr. Brubaker held several management positions at James River Corporation, a forest and paper company, including vice president of strategic planning from 1981 to 1982, group vice president of the Groveton Group and Premium Printing Papers from 1982 to 1990, and vice president of human resources development in 1991. From 1976 to 1981, Mr. Brubaker was strategic planning manager and marketing manager of white papers at Boise Cascade. Previously, Mr. Brubaker was a senior engagement manager at McKinsey & Company from 1972 to 1976. Prior to 1972, Mr. Brubaker was a U.S. Navy fighter pilot. Mr. Brubaker holds an MBA from the Harvard Business School and a BSE from Princeton University. Mr. Brubaker was selected to serve as a director on our Board due to his more than thirty years of experience in various mid-level and senior management positions at several corporations as well as his past service on our Board since our inception.

*George Stelljes III.* Mr. Stelljes has served as our chief investment officer since September 2002 and a director from August 2001 to September 2002, and then rejoined the Board of Directors in July 2003. He also served as our executive vice president from September 2002 through April 2004, when he assumed the duties of president. Mr. Stelljes has served as our Adviser's chief investment officer and a director of our Adviser since May 2003. He also served as executive vice president of our Adviser until February 2006, when he assumed the duties of president. Mr. Stelljes has served as Gladstone Investment's chief investment officer and a director since inception. Mr. Stelljes also served as Gladstone Investment's president from inception through April 2008, when he became a vice chairman. Mr. Stelljes has served as chief investment officer of Gladstone Commercial since February 2003 and as a director since July 2007. He became a co-vice chairman of Gladstone Commercial in June 2012. He also served as executive vice president of Gladstone Commercial from February 2003 through July 2007, when he assumed the duties of president through June 1, 2012. Prior to joining Gladstone Mr. Stelljes



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served as a managing member of St. John's Capital, a vehicle used to make private equity investments. From 1999 to 2001, Mr. Stelljes was a co-founder and managing member of Camden Partners and Cahill Warnock & Company, private equity firms which finance high growth companies in the communications, education, healthcare, and business services sectors. From 1997 to 1999, Mr. Stelljes was a managing director and partner of Columbia Capital, a venture capital firm focused on investments in communications and information technology. From 1989 to 1997, Mr. Stelljes held various positions, including executive vice president and principal, with the Allied companies. Mr. Stelljes serves as a general partner and investment committee member of Patriot Capital and Patriot Capital II, private equity funds, and serves on the board of Intrepid Capital Management, a money management firm. He is also a former board member and regional president of the National Association of Small Business Investment Companies. Mr. Stelljes holds an MBA from the University of Virginia and a BA in Economics from Vanderbilt University. Mr. Stelljes was selected to serve as a director on our Board due to his more than twenty years of experience in the investment analysis, management, and advisory industries as well as his past service on our Board since 2003.

*David A. R. Dullum.* Mr. Dullum has served as a director since August 2001. Mr. Dullum has been a senior managing director of our Adviser since February 2008, a director of Gladstone Commercial since August 2003, and a director of Gladstone Investment since June 2005 and has served as Gladstone Investment's president since April 2008. Additionally, Mr. Dullum has served as our Executive Vice President since October 2010. From 1995 through June 2009, Mr. Dullum was a partner of New England Partners, a venture capital firm focused on investments in small and medium-sized business in the Mid-Atlantic and New England regions. From May 2005 to May 2008, Mr. Dullum served as the President and a director of Harbor Acquisition Corporation, an operating business with emphasis in the consumer and industrial sectors. From 1976 to 1990, Mr. Dullum was a managing general partner of Frontenac Company, a Chicago-based venture capital firm. Mr. Dullum holds an MBA from Stanford Graduate School of Business and a BME from the Georgia Institute of Technology. Mr. Dullum was selected to serve as a director on our Board due to his more than thirty years of experience in various areas of the investment industry as well as his past service on our Board since our inception.

**Executive Officers Who Are Not Directors**

Information regarding our executive officers who are not directors is as follows (the address for each executive officer is c/o Gladstone Capital Corporation, 1521 Westbranch Drive, Suite 200, McLean, Virginia 22102):

| <b>Name</b>      | <b>Age</b> | <b>Position</b>                       |
|------------------|------------|---------------------------------------|
| David Watson     | 36         | Chief Financial Officer and Treasurer |
| Melissa Morrison | 39         | Chief Accounting Officer              |

*David Watson.* Mr. Watson has served as our chief financial officer since January 2011 and has served as the chief financial officer of Gladstone Investment since January 2010. He also assumed treasurer responsibilities in January 2012 for both Gladstone Capital and Gladstone Investment. Prior to joining our company, from July 2007 until January 2010, Mr. Watson was Director of Portfolio Accounting of MCG Capital Corporation. Mr. Watson was employed by Capital Advisory Services, LLC, which subsequently joined Navigant Consulting, Inc., where he held various positions providing finance and accounting consulting services from 2001 to 2007. Prior to that, Mr. Watson was an auditor at Deloitte and Touche. He received a BS from Washington and Lee University, an MBA from the University of Maryland's Smith School of Business, and is a licensed CPA in the Commonwealth of Virginia.

*Melissa Morrison.* Ms. Morrison has served as our Chief Accounting Officer since November 2011. From September 2007 to September 2011, Ms. Morrison served in various positions providing accounting and finance services including accounting and sales finance controller roles to Tandberg, Inc., which was subsequently acquired by Cisco Systems, Inc. in April 2010. Prior to September 2007, Ms. Morrison worked at PRA International, Inc. and Ericsson NetQual Inc. in accounting manager and assistant controller positions, respectively. Her career began as an auditor at PricewaterhouseCoopers, LLC. She received a BBA from The College of William and Mary and is a licensed CPA in the Commonwealth of Virginia.

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### **Employment Agreements**

We are not a party to any employment agreements. Messrs. Gladstone, Brubaker and Stelljes have entered into employment agreements with our Adviser, whereby they are direct employees of our Adviser. The employment agreement of Mr. Stelljes provides for his nomination to serve as our chief investment officer.

### **Director Independence**

As required under NASDAQ listing standards, our Board of Directors annually determines each director's independence, and continually assesses the independence of each of the directors throughout the year. The NASDAQ listing standards provide that a director of a business development company is considered to be independent if he or she is not an interested person of ours, as defined in Section 2(a)(19) of the 1940 Act. Section 2(a)(19) of the 1940 Act defines an interested person to include, among other things, any person who has, or within the last two years had, a material business or professional relationship with us.

Consistent with these considerations, after review of all relevant transactions or relationships between each director, or any of his or her family members, and us, our senior management and our independent auditors, the Board has affirmatively determined that the following five directors are independent directors within the meaning of the applicable NASDAQ listing standards: Messrs. Adelgren, Outland, Parker and Reilly and Ms. English. In making this determination, the Board found that none of these directors had a material or other disqualifying relationship with us. Mr. Gladstone, the chairman of our Board of Directors and chief executive officer, Mr. Brubaker, our vice chairman, chief operating officer and secretary, Mr. Stelljes, our president and chief investment officer, and Mr. Dullum, a senior managing director of our Adviser, are not independent directors by virtue of their positions as our officers or as officers of our Adviser or their employment by our Adviser.

### **Corporate Leadership Structure**

Since our inception, Mr. Gladstone has served as chairman of our Board and our chief executive officer. Our Board believes that our chief executive officer is best situated to serve as chairman because he is the director most familiar with our business and industry, and most capable of effectively identifying strategic priorities and leading the discussion and execution of strategy. In addition, Mr. Adelgren, one of our independent directors, serves as the lead director for all meetings of our independent directors held in executive session. The lead director has the responsibility of presiding at all executive sessions of our Board, consulting with the chairman and chief executive officer on Board and committee meeting agendas, acting as a liaison between management and the independent directors and facilitating teamwork and communication between the independent directors and management.

Our Board believes the combined role of chairman and chief executive officer, together with an independent Lead Director, is in the best interest of stockholders because it provides the appropriate balance between strategic development and independent oversight of risk management. In coming to this conclusion, the Board considered the importance of having an interested chairperson that is familiar with our day-to-day management activities, our portfolio companies and the operations of our Adviser. The Board concluded that the combined role enhances, among other things, the Board's understanding of our investment portfolio, business, finances and risk management efforts. In addition, the Board believes that Mr. Gladstone's employment by the Adviser better allows for the efficient mobilization of the Adviser's resources at the Board's behest and on its behalf.

### **Committees of Our Board of Directors**

*Executive Committee.* Membership of our executive committee is comprised of Messrs. Gladstone, Brubaker and Parker. The executive committee has the authority to exercise all powers of our Board of Directors except for actions that must be taken by a majority of independent directors or the full Board of Directors under the Maryland General Corporation Law, including electing our chairman and president. Mr. Gladstone serves as chairman of the executive committee. The executive committee did not meet during the last fiscal year.

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*Audit Committee.* The Audit Committee of our Board oversees our corporate accounting and financial reporting process. For this purpose, the Audit Committee performs several functions. The Audit Committee evaluates the performance of and assesses the qualifications of the independent registered public accounting firm; determines and approves the engagement of the independent registered public accounting firm; determines whether to retain or terminate the existing independent registered public accounting firm or to appoint and engage a new independent registered public accounting firm; reviews and approves the retention of the independent registered public accounting firm to perform any proposed permissible non-audit services; monitors the rotation of partners of the independent registered public accounting firm on our audit engagement team as required by law; confers with management and the independent registered public accounting firm regarding the effectiveness of internal controls over financial reporting; establishes procedures, as required under applicable law, for the receipt, retention and treatment of complaints received by us regarding accounting, internal accounting controls or auditing matters and the confidential and anonymous submission by employees of concerns regarding questionable accounting or auditing matters; and meets to review our annual audited financial statements and quarterly financial statements with management and the independent registered public accounting firm, including reviewing our disclosures under Management's Discussion and Analysis of Financial Condition and Results of Operations. During the fiscal year ended September 30, 2011, the Audit Committee was comprised of Messrs. Parker, Gerard Mead (a former director) and Ms. English and, following his appointment to the Board in January 2011, Mr. Reilly. Mr. Mead's service on the Audit Committee ceased upon the conclusion of his term as a director at our 2012 annual meeting of stockholders, and the Audit Committee is currently comprised of Messrs. Parker (Chairman) and Reilly and Ms. English. Messrs. Adलगren and Outland serve as alternate members of the Audit Committee. Alternate members of the Audit Committee serve and participate in meetings of the Audit Committee only in the event of an absence of a regular member of the Audit Committee. The Audit Committee met eight times during the last fiscal year. The Audit Committee has adopted a written charter that is available to stockholders on our website at [www.gladstonecapital.com](http://www.gladstonecapital.com).

*Compensation Committee.* The Compensation Committee operates pursuant to a written charter that is available to stockholders on our website at [www.gladstonecapital.com](http://www.gladstonecapital.com). The Compensation Committee conducts periodic reviews of the Advisory Agreement and the Administration Agreement to evaluate whether the fees paid to our Adviser and our Administrator under the agreements are in the best interests of us and our stockholders. The committee considers in such periodic reviews, among other things, whether the salaries and bonuses paid to our executive officers by our Adviser and our Administrator are consistent with our compensation philosophies, whether the performance of our Adviser and our Administrator are reasonable in relation to the nature and quality of services performed and whether the provisions of the Advisory and Administration Agreements are being satisfactorily performed. The Compensation Committee also reviews with management our Compensation Discussion and Analysis and to consider whether to recommend that it be included in proxy statements and other filings. During the fiscal year ended September 30, 2011, the Compensation Committee was comprised of Messrs. Adलगren, Outland and Mead and Ms. English. Mr. Mead's service on the Compensation Committee ceased upon the conclusion of his term as a director at our 2012 annual meeting of stockholders, and the Compensation Committee is currently comprised of Messrs. Outland (Chairman) and Adलगren, with Messrs. Parker and Reilly, and Ms. English serving as alternate members. Alternate members of the Compensation Committee serve and participate in meetings of the Compensation Committee only in the event of an absence of a regular member of the Compensation Committee. The Compensation Committee met four times during the last fiscal year. The Compensation Committee has adopted a written charter that is available to stockholders on our website at [www.gladstonecapital.com](http://www.gladstonecapital.com).

*Ethics, Nominating and Corporate Governance Committee.* The Ethics, Nominating and Corporate Governance Committee of our Board is responsible for identifying, reviewing and evaluating candidates to serve as our directors (consistent with criteria approved by our Board), reviewing and evaluating incumbent directors, recommending to our Board for selection candidates for election to our Board, making recommendations to our Board regarding the membership of the committees of our Board, assessing the performance of our Board, and developing our corporate governance principles. Our Ethics, Nominating and Corporate Governance Committee charter can be found on our website at [www.gladstonecapital.com](http://www.gladstonecapital.com). The Ethics Committee is currently comprised

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of Messrs. Adelgren (Chairman) and Outland, with Messrs. Parker, and Reilly, and Ms. English serving as alternate members. Each member of the Ethics, Nominating and Corporate Governance Committee is independent (as independence is currently defined in Rule 5605(a)(2) of the NASDAQ listing standards). The Ethics, Nominating and Corporate Governance Committee met four times during the last fiscal year. The Ethics, Nominating and Corporate Governance Committee has adopted a written charter that is available to stockholders on our website at [www.gladstonecapital.com](http://www.gladstonecapital.com).

*Qualifications for Director Candidates.* The Ethics, Nominating and Corporate Governance Committee believes that candidates for director should have certain minimum qualifications, including being able to read and understand basic financial statements, being over 21 years of age and having the highest personal integrity and ethics. The Ethics, Nominating and Corporate Governance Committee also considers such factors as possessing relevant expertise upon which to be able to offer advice and guidance to management, having sufficient time to devote to our affairs, demonstrated excellence in his or her field, having the ability to exercise sound business judgment and having the commitment to rigorously represent the long-term interests of our stockholders. However, the Ethics, Nominating and Corporate Governance Committee retains the right to modify these qualifications from time to time. Candidates for director nominees are reviewed in the context of the current composition of our Board, our operating requirements and the long-term interests of our stockholders.

Though we have no formal policy addressing diversity, the Ethics, Nominating and Corporate Governance Committee and Board believe that diversity is an important attribute of directors and that our Board should be the culmination of an array of backgrounds and experiences and be capable of articulating a variety of viewpoints. Accordingly, the Ethics, Nominating and Corporate Governance Committee considers in its review of director nominees factors such as values, disciplines, ethics, age, gender, race, culture, expertise, background and skills, all in the context of an assessment of the perceived needs of us and our Board at that point in time in order to maintain a balance of knowledge, experience and capability.

In the case of incumbent directors whose terms of office are set to expire, the Ethics, Nominating and Corporate Governance Committee reviews such directors' overall service to us during their term, including the number of meetings attended, level of participation, quality of performance, and any other relationships and transactions that might impair such directors' independence. In the case of new director candidates, the Ethics, Nominating and Corporate Governance Committee also determines whether such new nominee must be independent for NASDAQ purposes, which determination is based upon applicable NASDAQ listing standards, applicable SEC rules and regulations and the advice of counsel, if necessary. The Ethics, Nominating and Corporate Governance Committee then uses its network of contacts to compile a list of potential candidates, but may also engage, if it deems appropriate, a professional search firm. The Ethics, Nominating and Corporate Governance Committee conducts any appropriate and necessary inquiries into the backgrounds and qualifications of possible candidates after considering the function and needs of our Board. The Ethics, Nominating and Corporate Governance Committee meets to discuss and consider such candidates' qualifications and then selects a nominee for recommendation to our Board by majority vote. To date, the Ethics, Nominating and Corporate Governance Committee has not paid a fee to any third party to assist in the process of identifying or evaluating director candidates.

Nominations made by stockholders must be made by written notice (setting forth the information required by our bylaws) received by the secretary of our company at least 120 days in advance of an annual meeting or within 10 days of the date on which notice of a special meeting for the election of directors is first given to our stockholders.

*Meetings.* During the fiscal year ended September 31, 2011, each member of our Board of Directors attended 75% or more of the aggregate of the meetings of our Board of Directors and of the committees on which he or she served.

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### **Oversight of Risk Management**

Since September 2007, Jack Dellafiora has served as our chief compliance officer and, in that position, Mr. Dellafiora directly oversees our enterprise risk management function and reports to our chief executive officer, the Audit Committee and our Board in this capacity. In fulfilling his risk management responsibilities, Mr. Dellafiora works closely with our internal counsel and other members of senior management including, among others, our chief executive officer, chief financial officer, chief accounting officer, chief investment officer and chief operating officer.

Our Board, in its entirety, plays an active role in overseeing management of our risks. Our Board regularly reviews information regarding our credit, liquidity and operations, as well as the risks associated with each. Each committee of our Board plays a distinct role with respect to overseeing management of our risks:

**Audit Committee:** Our Audit Committee oversees the management of enterprise risks. To this end, our Audit Committee meets at least annually (i) to discuss our risk management guidelines, policies and exposures and (ii) with our independent registered public accounting firm to review our internal control environment and other risk exposures.

**Compensation Committee:** Our Compensation Committee oversees the management of risks relating to the fees paid to our Adviser and Administrator under the Advisory Agreement and the Administration Agreement, respectively. In fulfillment of this duty, the Compensation Committee meets at least annually to review these agreements. In addition, the Compensation Committee reviews the performance of our Adviser to determine whether the compensation paid to our executive officers was reasonable in relation to the nature and quality of services performed and whether the provisions of the Advisory Agreement were being satisfactorily performed.

**Ethics, Nominating and Corporate Governance Committee:** Our Ethics, Nominating and Corporate Governance Committee manages risks associated with the independence of our Board and potential conflicts of interest.

While each committee is responsible for evaluating certain risks and overseeing the management of such risks, the committees each report to our Board on a regular basis to apprise our Board regarding the status of remediation efforts of known risks and of any new risks that may have arisen since the previous report.

### **Summary of Compensation**

#### ***Executive Compensation***

None of our executive officers receive direct compensation from us. We do not currently have any employees and do not expect to have any employees in the foreseeable future. The services necessary for the operation of our business are provided to us by our officers and the other employees of our Adviser and Administrator, pursuant to the terms of the Advisory and Administration Agreements, respectively.

Mr. Gladstone, our chairman and chief executive officer, Mr. Brubaker, our vice chairman, chief operating officer and secretary, and Mr. Stelljes, our president and chief investment officer, are all employees of and compensated directly by our Adviser. Our chief financial officer and our treasurer are employees of our Administrator. Under the Administration Agreement, we reimbursed our Administrator for our allocable portion of the salaries of Mr. Gerson, our former treasurer, Mr. Watson, our current chief financial officer and treasurer, and Mr. Gray, our former chief financial officer. For the year ended September 30, 2011, our allocable portion of Mr. Watson's compensation paid by our Administrator was \$43,889 of his salary, \$15,073 of his bonus, and \$7,517 of the cost of his benefits. During that same year our allocable portion of Mr. Gray's compensation paid by our Administrator was \$16,951 of his salary, \$692 of his bonus, and \$1,582 of the cost of his benefits. For the year ended September 30, 2010, our allocable portion of Mr. Gray's compensation paid by our Administrator was: \$46,748 of Mr. Gray's salary, \$6,167 of his bonus, and \$5,883 of the cost of his benefits. For the year ended September 30, 2009, our allocable portion of Mr. Gray's compensation paid by our Administrator was: \$50,161 of Mr. Gray's salary, \$6,692 of his bonus, and \$8,483 of the cost of his benefits.

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The following table shows, for the fiscal year ended September 30, 2011, compensation awarded to or paid to our directors who are not executive officers, which we refer to as our non-employee directors, for all services rendered to us during this period. No compensation is paid to directors who are our executive officers for their service on the Board of Directors. We do not issue stock options and therefore have no information to report relating to stock option grants and exercises for our directors.

| Name               | Aggregate<br>Compensation<br>from Fund<br>(\$) | Total<br>Compensation<br>from Fund and<br>Fund<br>Complex<br>Paid to<br>Directors \$(1) |
|--------------------|--|---|
| Paul W. Adalgren   | \$ 33,000                                      | \$ 99,000   |
| John Reilly (2)    | \$ 22,000                                      | \$ 73,000   |
| Michela A. English | \$ 31,000                                      | \$ 95,000   |
| Gerard Mead        | \$ 35,000                                      | \$ 107,000  |
| John H. Outland    | \$ 33,000                                      | \$ 99,250   |
| Anthony W. Parker  | \$ 34,000                                      | \$ 104,000  |

- (1) Includes compensation the director received from Gladstone Investment, as part of our Fund Complex. Also includes compensation the director received from Gladstone Commercial, our affiliate and a real estate investment trust, although not part of our Fund Complex.
- (2) Mr. Reilly joined the Board of Directors in January 2011. Accordingly, the amounts in the table above reflect compensation paid to Mr. Reilly for the portion of the year during which he served as a director.

As compensation for serving on our Board of Directors, each of our independent directors receives an annual fee of \$20,000, an additional \$1,000 for each Board of Directors meeting attended, and an additional \$1,000 for each committee meeting attended if such committee meeting takes place on a day other than when the full Board of Directors meets. In addition, the chairperson of the Audit Committee receives an annual fee of \$3,000, and the chairpersons of each of the Compensation and Ethics, Nominating and Corporate Governance committees receive annual fees of \$1,000 for their additional services in these capacities. During the fiscal year ended September 30, 2011, we paid total cash compensation of \$188,000 to our non-employee directors. We also reimburse our directors for their reasonable out-of-pocket expenses incurred in attending Board of Directors and committee meetings.

We do not pay any compensation to directors who also serve as our officers, or as officers or directors of our Adviser or our Administrator, in consideration for their service to us. Our Board of Directors may change the compensation of our independent directors in its discretion. None of our independent directors received any compensation from us during the fiscal year ended September 30, 2011 other than for Board of Directors or committee service and meeting fees.

**Certain Transactions*****Investment Advisory and Management Agreement******Management Services***

Our Adviser is a Delaware corporation registered as an investment adviser under the Investment Advisers Act of 1940, as amended. Subject to the overall supervision of our Board of Directors, our Adviser provides investment advisory and management services to us. Under the terms of our Advisory Agreement, our Adviser has investment discretion with respect to our capital and, in that regard:

determines the composition of our portfolio, the nature and timing of the changes to our portfolio, and the manner of implementing such changes;

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identifies, evaluates, and negotiates the structure of the investments we make (including performing due diligence on our prospective portfolio companies);

closes and monitors the investments we make; and

makes available on our behalf, and provides if requested, managerial assistance to our portfolio companies.

Our Adviser's services under the Advisory Agreement are not exclusive, and it is free to furnish similar services to other entities so long as its services to us are not impaired.

### *Portfolio Management*

Our Adviser takes a team approach to portfolio management; however, the following persons are primarily responsible for the day-to-day management of our portfolio and comprise our Adviser's investment committee: David Gladstone, Terry Lee Brubaker and George Stelljes III, whom we refer to collectively as the Portfolio Managers. Our investment decisions are made on our behalf by the investment committee of our Adviser by unanimous decision.

Mr. Gladstone has served as the chairman and the chief executive officer of our Adviser, since he founded the Adviser in 2002, along with Mr. Brubaker and Mr. Stelljes. Mr. Brubaker has served as the vice chairman, chief operating officer and secretary of our Adviser since 2002. Mr. Stelljes has served as the president and chief investment officer of our Adviser since 2002. For more complete biographical information on Messrs. Gladstone, Brubaker and Stelljes, please see Management Interested Directors.

The Portfolio Managers are all officers or directors, or both, of our Adviser and our Administrator. David Gladstone is the controlling stockholder of our Adviser, which is the sole member of our Administrator. Although we believe that the terms of the Advisory Agreement are no less favorable to us than those that could be obtained from unaffiliated third parties in arms-length transactions, our Adviser and its officers and its directors have a material interest in the terms of this agreement. Based on an analysis of publicly available information, the Board believes that the terms and the fees payable under the Advisory Agreement are similar to those of the agreements between other business development companies that do not maintain equity incentive plans and their external investment advisers.

Our Adviser provides investment advisory services to other investment funds in the Gladstone Companies. As such, the Portfolio Managers also are primarily responsible for the day-to-day management of the portfolios of other pooled investment vehicles in the Gladstone Companies that are managed by our Adviser. As of the date hereof, Messrs. Gladstone, Brubaker, and Stelljes are primarily responsible for the day-to-day management of the portfolios of Gladstone Investment, another publicly-traded business development company, Gladstone Commercial, a publicly-traded real estate investment trust, and Gladstone Land Corporation, a private company controlled by Mr. Gladstone that owns farmland in California. As of September 30, 2011, our Adviser had an aggregate of approximately \$1.0 billion in total assets under management.

### *Possible Conflicts of Interest*

Our Portfolio Managers provide investment advisory services and serve as officers, directors or principals of certain of the other Gladstone Companies, which operate in the same or a related line of business as we do. Accordingly, they have corresponding obligations to investors in those entities. For example, Mr. Gladstone, our chairman and chief executive officer, is chairman of the board and chief executive officer of our Adviser, Gladstone Investment, Gladstone Commercial, and Gladstone Land with management responsibilities for the other members of the Gladstone Companies, other than Gladstone Securities, where he sits on the board of managers as an outside non-employee manager. In addition, Mr. Brubaker, our vice chairman, chief operating officer and secretary, is vice chairman, chief operating officer and secretary of our Adviser, Gladstone Investment and Gladstone Commercial, and Mr. Stelljes, our president and chief investment officer, is president



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and chief investment officer of our Adviser, Gladstone Lending and Gladstone Land, vice chairman and chief investment officer of Gladstone Commercial and vice chairman and chief investment officer of Gladstone Investment. Moreover, we may establish other investment vehicles which from time to time may have potentially overlapping investment objectives with those of Gladstone Investment and accordingly may invest in, whether principally or secondarily, asset classes similar to those targeted by us. While the Adviser generally has broad authority to make investments on behalf of the investment vehicles that it advises, our Adviser has adopted investment allocation procedures to address these potential conflicts and intends to direct investment opportunities to the member of the Gladstone Companies with the investment strategy that most closely fits the investment opportunity. Nevertheless, the Portfolio Managers may face conflicts in the allocation of investment opportunities to other entities managed by our Adviser. As a result, it is possible that certain investment opportunities may not be available to other members of the Gladstone Companies or investment funds managed by our Adviser. When the officers of the Adviser identify an investment, they will be forced to choose which investment fund should make the investment in accordance with their investment allocation procedures.

Our affiliate, Gladstone Commercial, may lease property to portfolio companies that we do not control under certain circumstances. We may pursue such transactions only if (i) the portfolio company is not controlled by us or any of our affiliates, (ii) the portfolio company satisfies the tenant underwriting criteria that meets the lease underwriting criteria of Gladstone Commercial, and (iii) the transaction is approved by a majority of our independent directors and a majority of the independent directors of Gladstone Commercial. We expect that any such negotiations between Gladstone Commercial and our portfolio companies would result in lease terms consistent with the terms that the portfolio companies would be likely to receive were they not portfolio companies of ours. Additionally, we may make simultaneous investments in senior syndicated loans with our affiliate, Gladstone Investment. In this regard, our Adviser has adopted allocation procedures designed to ensure fair and equitable allocations of such investments.

### *Portfolio Manager Compensation*

The Portfolio Managers receive compensation from our Adviser in the form of a base salary plus a bonus. Each of the Portfolio Managers' base salaries is determined by a review of salary surveys for persons with comparable experience who are serving in comparable capacities in the industry. Each Portfolio Manager's base salary is set and reviewed yearly. Like all employees of the Adviser, a Portfolio Manager's bonus is tied to the performance of the Adviser and the entities that it advises. A Portfolio Manager's bonus increases or decreases when the Adviser's income increases or decreases. The Adviser's income, in turn, is directly tied to the management and performance fees earned in managing its investment funds, including Gladstone Capital. Pursuant to the Advisory Agreement, the Adviser receives an incentive fee based on net investment income in excess of the hurdle rates and capital gains as set out in the Advisory Agreement.

All compensation of the Portfolio Managers from the Adviser takes the form of cash. The Portfolio Managers are also portfolio managers for other members of the Gladstone Companies, one of which (Gladstone Commercial) previously had a stock option plan through which the Portfolio Managers have previously received options to purchase stock of those entities. Gladstone Commercial terminated its stock option plan effective December 31, 2006. We also previously had a stock option plan, but it was terminated effective September 30, 2006. These plan terminations were effected in connection with the implementation of new advisory agreements between each of us and Gladstone Commercial with our Adviser, which have been approved by our respective stockholders. All outstanding, unexercised options under our plan were terminated effective September 30, 2006, and all outstanding, unexercised options under the Gladstone Commercial plan were terminated effective December 31, 2006.

### *Investment Advisory and Management Agreement and Administration Agreement*

We are externally managed pursuant to contractual arrangements with our Adviser, under which our Adviser has directly employed our personnel and paid our payroll, benefits, and general expenses directly. The management services and fees in effect under the Advisory Agreement are described below. In addition, we pay

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our direct expenses including, but not limited to, directors' fees, legal and accounting fees and stockholder related expenses under the Advisory Agreement.

The principal executive office of each of the Adviser and the Administrator is located at 1521 Westbranch Drive, Suite 200, McLean, Virginia 22102.

*Management services and fees under the Advisory Agreement*

Under the Advisory Agreement, we pay our Adviser an annual base management fee of 2% of our average gross assets, which is defined as total assets, including investments made with proceeds of borrowings, less any uninvested cash or cash equivalents resulting from borrowings, valued at the end of the two most recently completed calendar quarters, and appropriately adjusted for any share issuances or repurchases during the current calendar quarter.

We also pay our Adviser a two-part incentive fee under the Advisory Agreement. The first part of the incentive fee is an income-based incentive fee which rewards our Adviser if our quarterly net investment income (before giving effect to any incentive fee) exceeds the hurdle rate. We pay our Adviser an income-based incentive fee with respect to our pre-incentive fee net investment income in each calendar quarter as follows:

no incentive fee in any calendar quarter in which our pre-incentive fee net investment income does not exceed the hurdle rate (7% annualized);

100% of our pre-incentive fee net investment income with respect to that portion of such pre-incentive fee net investment income, if any, that exceeds the hurdle rate but is less than 2.1875% in any calendar quarter (8.75% annualized); and

20% of the amount of our pre-incentive fee net investment income, if any, that exceeds 2.1875% in any calendar quarter (8.75% annualized).

***Quarterly Incentive Fee Based on Net Investment Income***

Pre-incentive fee net investment income (expressed as a percentage of the value of net assets)

Percentage of pre-incentive fee net investment income

allocated to income-based portion of incentive fee

The second part of the incentive fee is a capital gains-based incentive fee that is determined and payable in arrears as of the end of each fiscal year (or upon termination of the Advisory Agreement, as of the termination date), equals 20% of our realized capital gains as of the end of the fiscal year. In determining the capital gains-based incentive fee payable to our Adviser, we calculate the cumulative aggregate realized capital gains and cumulative aggregate realized capital losses since our inception, and the aggregate unrealized capital depreciation as of the date of the calculation, as applicable, with respect to each of the investments in our portfolio. For this purpose, cumulative aggregate realized capital gains, if any, equals the sum of the differences between the net sales price of each investment, when sold, and the original cost of such investment since our inception. Cumulative aggregate realized capital losses equals the sum of the amounts by which the net sales price of each investment, when sold, is less than the original cost of such investment since our inception. Aggregate unrealized capital depreciation equals the sum of the difference, if negative, between the valuation of each investment as of the applicable calculation date and the original cost of such investment. At the end of the applicable year, the



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amount of capital gains that serves as the basis for our calculation of the capital gains-based incentive fee equals the cumulative aggregate realized capital gains less cumulative aggregate realized capital losses, less aggregate unrealized capital depreciation, with respect to our portfolio of investments. If this number is positive at the end of such year, then the capital gains-based incentive fee for such year equals 20% of such amount, less the aggregate amount of any capital gains-based incentive fees paid in respect of our portfolio in all prior years.

Beginning in April 2006, our Board of Directors has accepted from the Adviser unconditional and irrevocable voluntary waivers on a quarterly basis to reduce the annual 2.0% base management fee on senior syndicated loan participations to 0.5%, to the extent that proceeds resulting from borrowings were used to purchase such syndicated loan participations. These waivers were applied through March 31, 2012.

When our Adviser receives fees from our portfolio companies, such as investment banking fees, structuring fees or executive recruiting services fees, 50% or 100% of certain of these fees will be credited against the base management fee that we would otherwise be required to pay to our Adviser.

We pay our direct expenses including, but not limited to, directors' fees, legal and accounting fees, stockholder-related expenses, and directors and officers insurance under the Advisory Agreement.

During the fiscal years ended September 30, 2011, 2010 and 2009, we incurred total fees of approximately \$6.3 million, \$4.1 million and \$1.7 million, respectively, to our Adviser under the Advisory Agreement.

### *Duration and Termination*

Unless terminated earlier as described below, the Advisory Agreement will remain in effect from year to year if approved annually by our Board of Directors or by the affirmative vote of the holders of a majority of our outstanding voting securities, including, in either case, approval by a majority of our directors who are not interested persons. On July 12, 2011, we renewed the Advisory Agreement through August 31, 2012. The Advisory Agreement will automatically terminate in the event of its assignment. The Advisory Agreement may be terminated by either party without penalty upon 60 days' written notice to the other. See Risk Factors We are dependent upon our key management personnel and the key management personnel of our Adviser, particularly David Gladstone, George Stelljes III and Terry Lee Brubaker, and on the continued operations of our Adviser, for our future success.

### *Administration Agreement*

Pursuant to the Administration Agreement, our Administrator furnishes us with clerical, bookkeeping and record keeping services and our Administrator also performs, or oversees the performance of, our required administrative services, which include, among other things, being responsible for the financial records which we are required to maintain and preparing reports to our stockholders and reports filed with the SEC. In addition, our Administrator assists us in determining and publishing our net asset value, oversees the preparation and filing of our tax returns, the printing and dissemination of reports to our stockholders, and generally oversees the payment of our expenses and the performance of administrative and professional services rendered to us by others. Payments under the Administration Agreement are generally equal to an amount based upon our allocable portion of our Administrator's overhead in performing its obligations under the Administration Agreement, including rent and our allocable portion of the salaries and benefits expenses of our chief financial officer, chief accounting officer, chief compliance officer, internal counsel and their respective staffs. On July 12, 2011, we renewed the Administration Agreement through August 31, 2012.

During the fiscal years ended September 30, 2011, 2010 and 2009, we incurred total fees of approximately \$0.7 million, \$0.8 million and \$0.9 million, respectively, to our Administrator under the Administration Agreement.

Based on an analysis of publicly available information, the Board believes that the terms and the fees payable under the Advisory and Administration Agreements are similar to those of the agreements between other

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business development companies that do not maintain equity incentive plans and their external investment advisers. David Gladstone, Terry Lee Brubaker and George Stelljes III are all officers or directors, or both, of our Adviser and our Administrator. David Gladstone is the controlling stockholder of our Adviser. Although we believe that the terms of the Advisory and Administration Agreements are no less favorable to us than those that could be obtained from unaffiliated third parties in arms length transactions, our Adviser and its officers and its directors have a material interest in the terms of these agreements.

### *Consulting Services Agreements*

As a business development company, we make available significant managerial assistance to our portfolio companies and provide other services to such portfolio companies. Neither we nor our Adviser currently receives fees in connection with managerial assistance. Our Adviser provides other services to our portfolio companies and receives fees for these other services.

On October 25, 2010, our Adviser received a payment of \$277,015 from Lindmark Acquisition, LLC, or Lindmark, a wholly-owned portfolio company of ours which we own through one of our wholly-owned subsidiaries, Lindmark Holdings Corp., in connection with the performance of certain consulting services rendered from March 18, 2009 through March 31, 2010 pursuant to that certain Consulting Agreement between our Adviser and Lindmark, effective October 10, 2010 and that certain Engagement Letter Agreement between our Adviser and Lindmark Outdoor Advertising, LLC, dated November 19, 2009. Beginning with April 1, 2010, Lindmark has received current invoices and has remitted payment for such in a timely manner. Payments for services rendered beginning April 1, 2010 and ending September 30, 2010 totaled \$40,000. Payments for services rendered during the year ended September 30, 2011 totaled \$8,698.

On October 29, 2010, our Adviser received a payment of \$213,191 from BERTL, Inc., or Bertl, one of our wholly-owned portfolio companies, in connection with the performance of certain consulting services rendered from March 19, 2009 through June 30, 2010 pursuant to that certain Engagement Letter Agreement, dated March 19, 2009 between Bertl and our Adviser. Beginning with the quarter ended September 30, 2010, Bertl has received current quarterly invoices from our Adviser for the provision of such services and has paid current through the quarter ended September 30, 2010. Payments for services rendered during the year ended September 30, 2010 totaled \$7,800.

### *Loan Servicing Agreement*

Our Adviser services the loans pledged under our credit facility pursuant to a loan servicing agreement with our wholly-owned subsidiary, Business Loan, in return for a 1.5% annual fee, based on the monthly aggregate outstanding loan balance of the loans pledged under our credit facility. Loan servicing fees paid to our Adviser under this agreement directly reduce the amount of fees payable under the Advisory Agreement. Loan servicing fees of approximately \$3.4 million, \$3.4 million and \$5.6 million were incurred for the fiscal years ended September 30, 2011, 2010 and 2009, respectively, all of which were directly credited against the amount of the base management fee due to our Adviser under the Advisory Agreement.

## **Loans**

At September 30, 2010, we had a loan outstanding in the principal amount of \$5,900,010 to Mr. Gladstone, which was due and payable in cash on August 23, 2010 and, because the loan was not repaid on its due date, it is currently in default. During the fiscal year ended September 30, 2011, Mr. Gladstone repaid a total of \$3,151,006 of the principal balance. As a result, the remaining principal balance on the loan as of September 30, 2011 and March 31, 2012 was \$2,749,004. In connection with Mr. Gladstone's payments during the fiscal year ended September 30, 2011, we released our first priority security interest on 210,000 shares of Mr. Gladstone's pledged shares on this loan, leaving a balance of 183,334 shares owned by Mr. Gladstone pledged as collateral for the loan as of September 30, 2011. This loan was originally extended in connection with the exercise of stock options by Mr. Gladstone under our former Amended and Restated 2001 Equity Incentive Plan, as amended, or

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the 2001 Plan, which was terminated on September 30, 2006, and the loan was made on terms available to all eligible participants under the 2001 Plan. The loan is evidenced by a full recourse promissory note secured by the shares of common stock purchased upon the exercise of the options as well as additional collateral. The interest rate on the loan is 4.9% per annum, plus an additional 2.0% per annum for periods following the date of default. Interest is due quarterly and Mr. Gladstone has made each of his quarterly interest payments to date. The Sarbanes-Oxley Act of 2002 prohibits us from making loans to our executive officers, although certain loans outstanding prior to July 30, 2002, including the promissory note we received from Mr. Gladstone, were expressly exempted from this prohibition. In addition, this loan meets the requirements set forth in Section 57(j) of the 1940 Act.

Also at September 30, 2010, we had two loans outstanding in the principal amounts of \$275,010 and \$474,990, respectively, to Laura Gladstone, a managing director of ours and the daughter of Mr. Gladstone. The outstanding principal amount of the \$275,010 loan was originally due on August 23, 2010 and, because the loan was not repaid on its due date, it is now in default. During the fiscal year ended September 30, 2011, Ms. Gladstone repaid \$75,000 of the principal balance of that loan. As a result, the remaining principal balance on this loan as of September 30, 2011 and March 31, 2012 was \$200,010. The outstanding principal amount of the \$474,990 loan is due on July 13, 2015 and no principal payments have been made as of March 31, 2012. Both of the loans were issued in connection with the exercise of stock options under the 2001 Plan by Ms. Gladstone, and were made on terms available to all eligible participants under the 2001 Plan. These loans are evidenced by full recourse promissory notes and are secured by the shares of common stock purchased upon the exercise of the options as well as additional collateral. The loans are collateralized by a first security interest in 18,334 and 31,666 of Ms. Gladstone's pledged shares, respectively. To date, we have not released our security interest in any of the shares pledged on these loans. The interest rate on the \$200,010 loan is 4.9% per annum, plus an additional 2.0% per annum for periods following the date of default. The interest rate on the \$474,990 loan is 8.26% per annum. Interest on the loans is due quarterly and Ms. Gladstone has made each of her quarterly interest payments to date with respect to both loans. These loans meet the requirements set forth in Section 57(j) of the 1940 Act. Mr. Gladstone has not received, nor will he receive in the future, any direct or indirect benefit from these loans.

On September 7, 2010, each of Mr. Gladstone and Ms. Gladstone executed a redemption agreement with us, each of which provides that, pursuant to the terms and conditions thereof, we will automatically accept and retire the shares of our common stock pledged as collateral for their loans in partial or full satisfaction, as applicable, of Mr. Gladstone's or Ms. Gladstone's obligations to us under the loans that are in default at such time, if ever, that the trading price of our common stock reaches \$15 per share. In entering into the redemption agreements, we reserved all of our existing rights under the promissory notes and related pledge agreements, including but not limited to the ability to foreclose on the shares of common stock pledged as collateral for the loans, or additional pledged collateral, at any time.

**Indemnification**

In our articles of incorporation and bylaws, we have agreed to indemnify certain officers and directors by providing, among other things, that we will indemnify such officer or director, under the circumstances and to the extent provided for therein, for expenses, damages, judgments, fines and settlements he or she may be required to pay in actions or proceedings which he or she is or may be made a party by reason of his or her position as our director, officer or other agent, to the fullest extent permitted under Maryland law and our bylaws. Notwithstanding the foregoing, the indemnification provisions shall not protect any officer or director from liability to us or our stockholders as a result of any action that would constitute willful misfeasance, bad faith or gross negligence in the performance of such officer's or director's duties, or reckless disregard of his or her obligations and duties.

Each of the Advisory and Administration Agreements provide that, absent willful misfeasance, bad faith or gross negligence in the performance of their duties or by reason of the reckless disregard of their duties and obligations (as the same may be determined in accordance with the 1940 Act and any interpretations or guidance by the SEC or its staff thereunder), our Adviser, our Administrator and their respective officers, managers, agents, employees, controlling persons, members and any other person or entity affiliated with them are entitled to indemnification from us for any damages, liabilities, costs and expenses (including reasonable attorneys' fees and amounts reasonably paid in settlement) arising from the rendering of our Adviser's or Administrator's services under the Advisory or Administration Agreements or otherwise as an investment adviser of ours.

**Table of Contents****CONTROL PERSONS AND PRINCIPAL STOCKHOLDERS**

The following table sets forth, as of May 14, 2012 (unless otherwise indicated), the beneficial ownership of each current director, each of the executive officers, the executive officers and directors as a group and each stockholder known to our management to own beneficially more than 5% of the outstanding shares of common stock. To our knowledge, no person beneficially owns more than 5% of our Series 2016 Term Preferred Stock. Except as otherwise noted, the address of the individuals below is c/o Gladstone Capital Corporation, 1521 Westbranch Drive, Suite 200, McLean, VA 22102.

| Name and Address   | Number of Shares | Percent of Total | Beneficial Ownership(1)   |   |
|--|------------------|------------------|---|---|
|  |                  |                  | Dollar Range of Equity Securities of the Company Owned by Directors and Executive Officers(2) | Aggregate Dollar Range of Equity Securities of all Funds Overseen by Directors and Executive Officers in Family of Investment Companies(2)(3) |
| <b>Executive Officers and Directors:</b>                     |                  |                  |   |   |
| David Gladstone  | 1,155,039        | 5.5%             | Over \$100,000  | Over \$100,000  |
| Terry Lee Brubaker(4)  | 198,442          | 1.0%             | Over \$100,000  | Over \$100,000  |
| George Stelljes III  | 16,958           | *                | Over \$100,000  | Over \$100,000  |
| David Watson   | 100              | *                | \$1 - \$10,000  | \$10,001 - \$50,000   |
| Melissa Morrison   | 125              | *                | \$1 - \$10,000  | \$1 - \$10,000  |
| Anthony W. Parker  | 7,020            | *                | \$50,001 - \$100,000  | Over \$100,000  |
| David A.R. Dullum(5)   | 4,000            | *                | \$10,001 - \$50,000   | Over \$100,000  |
| Michela A. English   | 2,500            | *                | \$10,001 - \$50,000   | \$50,001 - \$100,000  |
| Paul W. Adelgren   | 4,504            | *                | \$10,001 - \$50,000   | Over \$100,000  |
| John H. Outland  | 1,441            | *                | \$10,001 - \$50,000   | \$50,001 - \$100,000  |
| John Reilly  | 3,400            | *                | \$10,001 - \$50,000   | Over \$100,000  |
| All executive officers and directors as a group (11 persons) | 1,393,529        | 6.6%             | N/A   | N/A   |

\* Less than 1%

- (1) This table is based upon information supplied by officers, directors and principal stockholders. Unless otherwise indicated in the footnotes to this table and subject to community property laws where applicable, we believe that each of the stockholders named in this table has sole voting and sole investment power with respect to the shares indicated as beneficially owned. Applicable percentages are based on 21,000,160 shares outstanding on May 14, 2012.
- (2) Ownership calculated in accordance with Rule 16a-1(a)(2) of the Exchange Act. The dollar range of our equity securities beneficially owned is calculated by multiplying the closing price of our common stock as reported on the NASDAQ as of May 14, 2012, times the number of shares beneficially owned.
- (3) Each of our directors and executive officers, (other than Ms. Morrison) is also a director or executive officer, or both, of Gladstone Investment Corporation, our affiliate and a business development company, and/or Gladstone Commercial Corporation, our affiliate and a real estate investment trust, each of which is also externally managed by our Adviser.
- (4) Includes 75,114 shares owned by Mr. Brubaker's spouse with respect to which Mr. Brubaker disclaims beneficial ownership.
- (5) Includes 2,000 shares owned by Mr. Dullum's spouse with respect to which Mr. Dullum disclaims beneficial ownership.

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**DIVIDEND REINVESTMENT PLAN**

We have adopted a dividend reinvestment plan that provides for reinvestment of our distributions on behalf of our common stockholders upon their election as provided below. As a result, if our Board of Directors authorizes, and we declare, a cash dividend, then our common stockholders who have opted in to our dividend reinvestment plan will not receive cash dividends but, instead, such cash dividends will automatically be reinvested in additional shares of our common stock.

Pursuant to our dividend reinvestment plan, if your shares of our common stock are registered in your own name you can have all distributions reinvested in additional shares of our common stock by Computershare Shareholder Services LLC, the plan agent, if you enroll in the dividend reinvestment plan by delivering an authorization form to the plan agent prior to the corresponding dividend declaration date. The plan agent will effect purchases of our common stock under the dividend reinvestment plan in the open market. If you do not elect to participate in the dividend reinvestment plan, you will receive all distributions in cash paid by check mailed directly to you (or if you hold your shares in street or other nominee name, then to your nominee) as of the relevant record date, by the plan agent, as our dividend disbursing agent. If your shares are held in the name of a broker or nominee or if you are transferring such an account to a new broker or nominee, you should contact the broker or nominee to determine whether and how they may participate in the dividend reinvestment plan.

The plan agent serves as agent for the holders of our common stock in administering the dividend reinvestment plan. After we declare a dividend, the plan agent will, as agent for the participants, receive the cash payment and use it to buy common stock on the NASDAQ or elsewhere for the participants' accounts. The price of the shares will be the average market price at which such shares were purchased by the plan agent.

Participants in the dividend reinvestment plan may withdraw from the dividend reinvestment plan upon written notice to the plan agent. Such withdrawal will be effective immediately if received not less than ten days prior to a dividend record date; otherwise, it will be effective the day after the related dividend distribution date. When a participant withdraws from the dividend reinvestment plan or upon termination of the dividend reinvestment plan as provided below, certificates for whole shares of common stock credited to his or her account under the dividend reinvestment plan will be issued and a cash payment will be made for any fractional share of common stock credited to such account.

The plan agent will maintain each participant's account in the dividend reinvestment plan and will furnish monthly written confirmations of all transactions in such account, including information needed by the stockholder for personal and tax records. Common stock in the account of each dividend reinvestment plan participant will be held by the plan agent in non-certificated form in the name of such participant. Proxy materials relating to our stockholders' meetings will include those shares purchased as well as shares held pursuant to the dividend reinvestment plan.

In the case of participants who beneficially own shares of common stock that are held in the name of banks, brokers or other nominees, the plan agent will administer the dividend reinvestment plan on the basis of the number of shares of common stock certified from time to time by the record holders as the amount held for the account of such beneficial owners. Shares of our common stock may be purchased by the plan agent through any of the underwriters, acting as broker or dealer.

We pay the plan agent's fees for the handling or reinvestment of dividends and other distributions. Each participant in the dividend reinvestment plan pays a pro rata share of brokerage commissions incurred with respect to the plan agent's open market purchases in connection with the reinvestment of distributions. There are no other charges to participants for reinvesting distributions.

Distributions are taxable whether paid in cash or reinvested in additional shares, and the reinvestment of distributions pursuant to the dividend reinvestment plan will not relieve participants of any U.S. federal income tax or state income tax that may be payable or required to be withheld on such distributions. For more information regarding taxes that our stockholders may be required to pay, see Material U.S. Federal Income Tax Considerations.



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Experience under the dividend reinvestment plan may indicate that changes are desirable. Accordingly, we reserve the right to amend or terminate the dividend reinvestment plan as applied to any distribution paid subsequent to written notice of the change sent to participants in the dividend reinvestment plan at least 90 days before the record date for the distribution. The dividend reinvestment plan also may be amended or terminated by the plan agent with our prior written consent, on at least 90 days written notice to participants in the dividend reinvestment plan. All correspondence concerning the reinvestment plan should be directed to the plan agent, Computershare Shareholder Services LLC, by mail at 480 Washington Boulevard, Jersey City, NJ 07310 or by phone at 866-214-7543.

**MATERIAL U.S. FEDERAL INCOME TAX CONSIDERATIONS**

**Regulated Investment Company Status**

In order to maintain our qualification for treatment as a RIC under Subchapter M of the Code, we generally must distribute to our stockholders, for each taxable year, at least 90% of our investment company taxable income, which is generally our ordinary income plus short-term capital gains. We refer to this as the annual distribution requirement. We must also meet several additional requirements, including:

*Business Development Company Status.* At all times during each taxable year, we must maintain our status as a business development company;

*Income source requirements.* At least 90% of our gross income for each taxable year must be from dividends, interest, payments with respect to securities loans, gains from sales or other dispositions of securities or other income derived with respect to our business of investing in securities, and net income derived from an interest in a qualified publicly traded partnership; and

*Asset diversification requirements.* As of the close of each quarter of our taxable year: (1) at least 50% of the value of our assets must consist of cash, cash items, U.S. government securities, the securities of other regulated investment companies and other securities to the extent that (a) we do not hold more than 10% of the outstanding voting securities of an issuer of such other securities and (b) such other securities of any one issuer do not represent more than 5% of our total assets, and (2) no more than 25% of the value of our total assets may be invested in the securities of one issuer (other than U.S. government securities or the securities of other regulated investment companies), or of two or more issuers that are controlled by us and are engaged in the same or similar or related trades or businesses or in the securities of one or more qualified publicly traded partnerships.

*Failure to Qualify as a RIC.* If we are unable to qualify for treatment as a RIC, we will be subject to tax on all of our taxable income at regular corporate rates. We would not be able to deduct distributions to stockholders, nor would we be required to make such distributions. Distributions would be taxable to our stockholders as dividend income to the extent of our current and accumulated earnings and profits. Subject to certain limitations under the Code, corporate distributees would be eligible for the dividends received deduction. Distributions in excess of our current and accumulated earnings and profits would be treated first as a return of capital to the extent of the stockholder's tax basis, and then as a gain realized from the sale or exchange of property. If we fail to meet the RIC requirements for more than two consecutive years and then seek to requalify as a RIC, we would be required to recognize a gain to the extent of any unrealized appreciation on our assets unless we make a special election to pay corporate-level tax on any such unrealized appreciation recognized during the succeeding 10-year period. Absent such special election, any gain we recognized would be deemed distributed to our stockholders as a taxable distribution.

*Qualification as a RIC.* If we qualify as a RIC and distribute to stockholders each year in a timely manner at least 90% of our investment company taxable income, we will not be subject to federal income tax on the portion of our taxable income and gains we distribute to stockholders. We would, however, be subject to a 4%

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nondeductible federal excise tax if we do not distribute, actually or on a deemed basis, 98% of our ordinary income and 98.2% of our capital gain net income. The excise tax would apply only to the amount by which 98% of our ordinary income or 98.2% of our capital gain net income exceeds the amount of income we distribute, actually or on a deemed basis, to stockholders. We will be subject to regular corporate income tax, currently at rates up to 35%, on any undistributed income, including both ordinary income and capital gains. We intend to retain some or all of our capital gains, but to designate the retained amount as a deemed distribution. In that case, among other consequences, we will pay tax on the retained amount, each stockholder will be required to include its share of the deemed distribution in income as if it had been actually distributed to the stockholder and the stockholder will be entitled to claim a credit or refund equal to its allocable share of the tax we pay on the retained capital gain. The amount of the deemed distribution net of such tax will be added to the stockholder's cost basis for its common stock. Since we expect to pay tax on any retained capital gains at our regular corporate capital gain tax rate, and since that rate is in excess of the maximum rate currently payable by individuals on long-term capital gains, the amount of tax that individual stockholders will be treated as having paid will exceed the tax they owe on the capital gain dividend and such excess may be claimed as a credit or refund against the stockholder's other tax obligations. A stockholder that is not subject to U.S. federal income tax or tax on long-term capital gains would be required to file a U.S. federal income tax return on the appropriate form in order to claim a refund for the taxes we paid. We will also be subject to alternative minimum tax, but any tax preference items would be apportioned between us and our stockholders in the same proportion that distributions, other than capital gain dividends, paid to each stockholder bear to our taxable income determined without regard to the dividends paid deduction.

From time to time, we acquire debt obligations that are issued at a discount, which may include loans we make that are accompanied by warrants, that bear interest at rates that are not either fixed rates or certain qualified variable rates or that are not unconditionally payable at least annually over the life of the obligation. In such cases, we are required to include in taxable income each year a portion of the original issue discount, or OID, that accrues over the life of the obligation. Such OID is included in our investment company taxable income even though we receive no cash corresponding to such discount amount. As a result, we may be required to make additional distributions corresponding to such OID amounts in order to satisfy the annual distribution requirement and to continue to qualify as a RIC or to avoid the 4% excise tax. This could mean that we may be required to sell temporary investments or other assets to meet the RIC distribution requirements.

**Taxation of Our U.S. Stockholders**

*Distributions.* For any period during which we qualify for treatment as a RIC for federal income tax purposes, distributions to our stockholders attributable to our investment company taxable income generally will be taxable as ordinary income to stockholders to the extent of our current or accumulated earnings and profits. Any distributions in excess of our earnings and profits will first be treated as a return of capital to the extent of the stockholder's adjusted basis in his or her shares of common stock and thereafter as gain from the sale of shares of our common stock. Distributions of our long-term capital gains, designated by us as such, will be taxable to stockholders as long-term capital gains regardless of the stockholder's holding period for its common stock and whether the distributions are paid in cash or invested in additional common stock. Corporate stockholders are generally eligible for the 70% dividends received deduction with respect to ordinary income, but not with respect to capital gain dividends to the extent such amount designated by us does not exceed the dividends received by us from domestic corporations. Any dividend declared by us in October, November or December of any calendar year, payable to stockholders of record on a specified date in such a month and actually paid during January of the following year, will be treated as if it were paid by us and received by the stockholders on December 31 of the previous year. In addition, we may elect to relate a dividend back to the prior taxable year if we (1) declare such dividend prior to the 15<sup>th</sup> day of the 9<sup>th</sup> month following the close of that taxable year, or any applicable extended due date of our tax return for such prior taxable year (2) make the election in that tax return, and (3) distribute such amount in the 12-month period following the close of the taxable year but not later than our first payment of the same type of dividend following such declaration. Any such election will not alter the general rule that a stockholder will be treated as receiving a dividend in the taxable year in which the dividend is made, subject to the October, November, December rule described above.

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In general, the tax rates applicable to our dividends other than dividends designated as capital gain dividends will be the standard ordinary income tax rates, and not the lower federal income tax rate applicable to qualified dividend income. If we distribute dividends that are attributable to actual dividend income received by us that is eligible to be, and is, designated by us as qualified dividend income, such dividends would be eligible for such lower federal income tax rate. For this purpose, qualified dividend income means dividends received by us from United States corporations and qualifying foreign corporations, provided that both we and the stockholder recipient of our dividends satisfy certain holding period and other requirements in respect of our shares (in the case of our stockholder) and the stock of such corporations (in our case). However, we do not anticipate receiving or distributing a significant amount of qualified dividend income.

If a stockholder participates in our dividend reinvestment plan, any dividends reinvested under the plan will be taxable to the stockholder to the same extent, and with the same character, as if the stockholder had received the dividend in cash. The stockholder will have an adjusted basis in the additional common shares purchased through the plan equal to the amount of the reinvested dividend. The additional shares will have a new holding period commencing on the day following the day on which the shares are credited to the stockholder's account.

*Sale of Our Shares.* A U.S. stockholder generally will recognize taxable gain or loss if the U.S. stockholder sells or otherwise disposes of his, her or its shares of our common stock. Any gain arising from such sale or disposition generally will be treated as long-term capital gain or loss if the U.S. stockholder has held his, her or its shares for more than one year. Otherwise, it will be classified as short-term capital gain or loss. However, any capital loss arising from the sale or disposition of shares of our common stock held for six months or less will be treated as long-term capital loss to the extent of the amount of capital gain dividends received, or undistributed capital gain deemed received, with respect to such shares. Under the tax laws in effect as of the date of this prospectus, individual U.S. stockholders are subject to a maximum federal income tax rate of 15% on their net capital gain (*i.e.*, the excess of realized net long-term capital gain over realized net short-term capital loss for a taxable year) including any long-term capital gain derived from an investment in our shares. Such rate is lower than the maximum rate on ordinary income currently payable by individuals. Corporate U.S. stockholders currently are subject to federal income tax on net capital gain at the same rates applied to their ordinary income (currently up to a maximum of 35%). Capital losses are subject to limitations on use for both corporate and non-corporate stockholders.

*Backup Withholding.* We may be required to withhold federal income tax, or backup withholding, currently at a rate of 28%, from all taxable dividends to any non-corporate U.S. stockholder (1) who fails to furnish us with a correct taxpayer identification number or a certificate that such stockholder is exempt from backup withholding, or (2) with respect to whom the Internal Revenue Service, or IRS, notifies us that such stockholder has failed to properly report certain interest and dividend income to the IRS and to respond to notices to that effect. An individual's taxpayer identification number is generally his or her social security number. Any amount withheld under backup withholding is allowed as a credit against the U.S. stockholder's federal income tax liability, provided that proper information is provided to the IRS.

### **REGULATION AS A BUSINESS DEVELOPMENT COMPANY**

We are a closed-end, non-diversified management investment company that has elected to be regulated as a business development company under Section 54 of the 1940 Act. As such, we are subject to regulation under the 1940 Act. The 1940 Act contains prohibitions and restrictions relating to transactions between business development companies and their affiliates, principal underwriters and affiliates of those affiliates or underwriters and requires that a majority of the directors be persons other than interested persons, as defined in the 1940 Act. In addition, the 1940 Act provides that we may not change the nature of our business so as to cease to be, or to withdraw our election as, a business development company unless approved by a majority of our outstanding voting securities, as defined in the 1940 Act.

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We intend to conduct our business so as to retain our status as a business development company. A business development company may use capital provided by public stockholders and from other sources to invest in long-term private investments in businesses. A business development company provides stockholders the ability to retain the liquidity of a publicly traded stock while sharing in the possible benefits, if any, of investing in primarily privately owned companies. In general, a business development company must have been organized and have its principal place of business in the United States and must be operated for the purpose of making certain types of investments in assets described in Sections 55(a)(1)-(3) of the 1940 Act.

### **Qualifying Assets**

Under the 1940 Act, a business development company may not acquire any asset other than assets of the type listed in Section 55(a) of the 1940 Act, which are referred to as qualifying assets, unless, at the time the acquisition is made, qualifying assets, other than assets defined in Section 55(a)(7) ( operating assets ), which includes certain interests in furniture, equipment, real estate, or leasehold improvements, represent at least 70% of the company's total assets, exclusive of operating assets. The types of qualifying assets in which we may invest under the 1940 Act include, but are not limited to, the following:

(1) Securities purchased in transactions not involving any public offering from the issuer of such securities, which issuer is an eligible portfolio company. An eligible portfolio company is generally defined in the 1940 Act as any issuer which:

(a) is organized under the laws of, and has its principal place of business in, any state or states in the United States;

(b) is not an investment company (other than a small business investment company wholly owned by the business development company) or otherwise excluded from the definition of investment company; and

(c) satisfies one of the following:

(i) it does not have any class of securities with respect to which a broker or dealer may extend margin credit;

(ii) it is controlled by the business development company, alone or as part of a group, and the business development company in fact exercises a controlling influence over the management or policies of the portfolio company and, as a result of such control, has an affiliated person who is a director of the portfolio company;

(iii) it has total assets of not more than \$4 million and capital and surplus of not less than \$2 million;

(iv) it does not have any class of securities listed on a national securities exchange; or

(v) it has a class of securities listed on a national securities exchange, with an aggregate market value of outstanding voting and non-voting equity of less than \$250 million.

(2) Securities received in exchange for or distributed on or with respect to securities described in (1) above, or pursuant to the exercise of options, warrants or rights relating to such securities.

(3) Cash, cash items, government securities or high quality debt securities maturing in one year or less from the time of investment.

### **Asset Coverage**

Pursuant to Section 61(a)(2) of the 1940 Act, we are permitted, under specified conditions, to issue multiple classes of senior securities representing indebtedness. However, pursuant to Section 18(c) of the 1940 Act, we are permitted to issue only one class of senior securities that is stock. In either case, we may only issue such Senior Securities if such class of Senior Securities, after such issuance, has an asset coverage, as defined in Section 18(h) of the 1940 Act, of at least 200%.

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In addition, our ability to pay dividends or distributions (other than dividends payable in our stock) to holders of any class of our capital stock would be restricted if our senior securities representing indebtedness fail to have an asset coverage of at least 200% (measured at the time of declaration of such distribution and accounting for such distribution). The 1940 Act does not apply this limitation to privately arranged debt that is not intended to be publicly distributed, unless this limitation is specifically negotiated by the lender. In addition, our ability to pay dividends or distributions (other than dividends payable in our common stock) to our common stockholders would be restricted if our senior securities that are stock fail to have an asset coverage of at least 200% (measured at the time of declaration of such distribution and accounting for such distribution). If the value of our assets declines, we might be unable to satisfy these asset coverage requirements. To satisfy the 200% asset coverage requirement in the event that we are seeking to pay a distribution, we might either have to (i) liquidate a portion of our loan portfolio to repay a portion of our indebtedness or (ii) issue common stock. This may occur at a time when a sale of a portfolio asset may be disadvantageous, or when we have limited access to capital markets on agreeable terms. In addition, any amounts that we use to service our indebtedness or for offering expenses will not be available for distributions to our stockholders. If we are unable to regain asset coverage through these methods, we may be forced to suspend the payment of such dividends.

## **Significant Managerial Assistance**

A business development company generally must make available significant managerial assistance to issuers of its portfolio securities that the business development company counts as a qualifying asset for the 70% test described above. Making available significant managerial assistance means, among other things, any arrangement whereby the business development company, through its directors, officers or employees, offers to provide, and, if accepted, does so provide, significant guidance and counsel concerning the management, operations or business objectives and policies of a portfolio company. Significant managerial assistance also may include the exercise of a controlling influence over the management and policies of the portfolio company. However, with respect to certain, but not all such securities, where the business development company purchases such securities in conjunction with one or more other persons acting together, one of the other persons in the group may make available such managerial assistance, or the business development company may exercise such control jointly.

## **Investment Policies**

We seek to achieve a high level of current income and capital gains through investments in debt securities and preferred and common stock that we acquired in connection with buyout and other recapitalizations. The following investment policies may not be changed without the approval of our Board of Directors:

We will at all times conduct our business so as to retain our status as a business development company. In order to retain that status we must continue to meet the definition of business development company contained in the 1940 Act, which requires us, among other things, to be operated for the purpose of investing in certain categories of qualifying assets. In addition, we may not acquire any assets (other than operating assets or qualifying assets) if, after giving effect to such acquisition, the value of our qualifying assets, less our operating assets, is less than 70% of the value of our total assets (excluding our operating assets). We anticipate that the securities we seek to acquire, as well as temporary investments, will generally be qualifying assets.

We will at all times endeavor to conduct our business so as to retain our status as a regulated investment company under the Code. In order to do so, we must meet income source, asset diversification and annual distribution requirements. We may issue senior securities, such as debt or preferred stock, to the extent permitted by the 1940 Act for the purpose of making investments, to fund share repurchases, or for temporary emergency or other purposes.

With the exception of our policy to conduct our business as a business development company, these policies are not fundamental and may be changed without stockholder approval.

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**Pending Exemptive Application**

On November 22, 2005, the Securities and Exchange Commission granted us exemptive relief that permits us to engage in limited co-investment transactions with an affiliated private investment pool (the Current Order ). Under the terms of the Current Order, Gladstone Capital, or Gladstone Investment, or any future formed BDC or closed-end management investment company that is advised by our Adviser, may co-invest with Gladstone Partners.

We have filed a new exemptive application with the SEC. The relief sought by the exemptive application, if granted by the SEC, would supersede the Current Order and would permit us, under certain circumstances, to co-invest with Gladstone Investment, Gladstone Partners, Gladstone Lending, any BDC or closed-end management investment company that is advised by our Adviser, (or sub-advised by our Adviser if it also controls the fund), or any combination of the foregoing. We have received comments from the SEC and have filed a second revised and restated exemptive application with the SEC. There are no assurances that the SEC will grant our exemptive request.

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**DESCRIPTION OF OUR SECURITIES**

Our authorized capital stock consists of 50,000,000 shares of capital stock, \$0.001 par value per share, all of which is currently designated as common stock 46,000,000 or term preferred stock 4,000,000. Under our articles of incorporation, our Board of Directors is authorized to classify and reclassify any unissued shares of capital stock without requiring stockholder approval. The following summary description of our capital stock is not necessarily complete and is subject to, and qualified in its entirety by, our articles of incorporation. Please review our articles of incorporation for a more detailed description of the provisions summarized below.

**Common Stock**

As of the date hereof, we have 21,000,160 shares of common stock outstanding. All shares of our common stock have equal rights as to earnings, assets, dividends and voting privileges and, when issued, will be duly authorized, validly issued, fully paid and nonassessable. Distributions may be paid to the holders of our common stock if, as and when declared by our Board of Directors out of funds legally available. Shares of our common stock have no preemptive, conversion or redemption rights and are freely transferable, except where their transfer is restricted by federal and state securities laws. In the event of our liquidation, dissolution or winding up, each share of our common stock is entitled to share ratably in all of our assets that are legally available for distribution after we pay all debts and other liabilities and subject to any preferential rights of holders of our preferred stock, if any is outstanding at the time. Each share of our common stock is entitled to one vote and does not have cumulative voting rights, which means that holders of a majority of such shares, if they so choose, could elect all of the directors, and holders of less than a majority of such shares would, in that case, be unable to elect any director. Our common stock is listed on the NASDAQ under the ticker symbol GLAD.

**Preferred Stock**

Our articles of incorporation give the Board of Directors the authority, without further action by stockholders, to issue shares of preferred stock in one or more series and to fix the rights, preferences, privileges, qualifications and restrictions granted to or imposed upon such preferred stock, including dividend rights, conversion rights, voting rights, rights and terms of redemption, and liquidation preference, any or all of which may be greater than the rights of the common stock. Thus, the Board of Directors could authorize the issuance of shares of preferred stock with terms and conditions which could have the effect of delaying, deferring or preventing a transaction or a change in control that might involve a premium price for holders of our common stock or otherwise be in their best interest. The issuance of preferred stock could adversely affect the voting power of holders of common stock and reduce the likelihood that such holders will receive dividend payments and payments upon liquidation, and could also decrease the market price of our common stock.

You should note, however, that any issuance of preferred stock must comply with the requirements of the 1940 Act. The 1940 Act requires, among other things, that (1) immediately after issuance and before any dividend or other distribution is made with respect to our common stock and before any purchase of common stock is made, such preferred stock together with all other Senior Securities must not exceed an amount equal to 50% of our total assets after deducting the amount of such dividend, distribution or purchase price, as the case may be, and (2) the holders of shares of preferred stock, if any are issued, must be entitled as a class to elect two directors at all times and to elect a majority of the directors if dividends on such preferred stock are in arrears by two years or more. Certain matters under the 1940 Act require the separate vote of the holders of any issued and outstanding preferred stock. If we offer preferred stock under this prospectus, we will issue an appropriate prospectus supplement. You should read that prospectus supplement for a description of the preferred stock, including, but not limited to, whether there will be an arrearage in the payment of dividends or sinking fund installments, if any, restrictions with respect to the declaration of dividends, requirements in connection with the maintenance of any ratio or assets, or creation or maintenance of reserves, or provisions for permitting or restricting the issuance of additional securities.

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### *Term Preferred Stock*

Of the 4,000,000 shares of our capital stock designated as term preferred stock, 1,610,000 of such shares are designated as 7.125% Series 2016 Term Preferred Shares, which we refer to as the Series 2016 Term Preferred Stock. As of the date hereof, we have 1,539,882 shares of Series 2016 Term Preferred Stock outstanding. Our Series 2016 Term Preferred Shares are listed on the NASDAQ under the symbol GLADP.

The following is a summary of the material terms of the Series 2016 Term Preferred Stock. The following summary is qualified in its entirety by reference to the Articles Supplementary Establishing and Fixing the Rights and Preferences of the Term Preferred Shares, including Appendix A thereto relating to the Series 2016 Term Preferred Stock, which are filed as an exhibit to the registration statement of which this prospectus is a part:

### **Dividend Rights**

The holders of Series 2016 Term Preferred Stock are entitled to monthly dividends in the amount of 7.125% per annum on the stated liquidation preference of Series 2016 Term Preferred Stock, or \$0.1484375 per share, and we are prohibited from issuing dividends or making distributions to the holders of our common stock while any shares of Series 2016 Term Preferred Stock are outstanding, unless all accrued and unpaid dividends on the Series 2016 Term Preferred Stock are paid in their entirety. In the event that we fail to pay dividends on the 2016 Series Term Preferred Stock when required, the dividend rate on the 2016 Series Term Preferred Stock will increase to 9.125% per annum until such default is cured.

### **Voting Rights**

The holders of the Series 2016 Term Preferred Stock are entitled to one vote per share and do not have cumulative voting. The holders of the Series 2016 Term Preferred Stock generally vote together with the holders of our common stock, except that the holders of the Series 2016 Term Preferred Stock have the right to elect two of our directors. Furthermore, during any period that we owe accumulated dividends, whether or not earned or declared, on our Series 2016 Term Preferred Shares equal to at least two full years of dividends, the holders of Series 2016 Term Preferred Stock will have the right to elect a majority of our Board of Directors.

### **Liquidation Rights**

The Series 2016 Term Preferred Stock has a liquidation preference over our common stock equal to \$25 per share, plus all accrued but unpaid dividends in the event of a dissolution, liquidation or winding up of our affairs.

### **Redemption**

The Series 2016 Term Preferred Stock has a mandatory term redemption date of December 31, 2016, however, if we fail to maintain asset coverage as required by the 1940 Act, of at least 200%, we will be required to redeem a portion of the Series 2016 Term Preferred Stock to enable us to meet the required asset coverage. We also have the option to redeem such shares at any time on or after December 31, 2012, subject to the requirement to pay an optional redemption premium on the amount of shares redeemed if we optionally redeem such shares before December 31, 2014. In the event that we fail to redeem the Series 2016 Term Preferred Stock when due, the dividend rate will increase to 9.125% per annum until such shares are redeemed.

### **Subscription Rights**

#### ***General***

We may issue subscription rights to our stockholders to purchase common stock or preferred stock. Subscription rights may be issued independently or together with any other offered security and may or may not be transferable by the person purchasing or receiving the subscription rights. In connection with any



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subscription rights offering to our stockholders, we may enter into a standby underwriting arrangement with one or more underwriters pursuant to which such underwriters would purchase any offered securities remaining unsubscribed after such subscription rights offering to the extent permissible under applicable law. In connection with a subscription rights offering to our stockholders, we would distribute certificates evidencing the subscription rights and a prospectus supplement to our stockholders on the record date that we set for receiving subscription rights in such subscription rights offering.

The applicable prospectus supplement would describe the following terms of subscription rights in respect of which this prospectus is being delivered:

the period of time the offering would remain open (which in no event would be less than fifteen business days);

the title of such subscription rights;

the exercise price for such subscription rights;

the ratio of the offering (which in no event would exceed one new share of common stock for each three rights held);

the number of such subscription rights issued to each stockholder;

the extent to which such subscription rights are transferable;

if applicable, a discussion of the material U.S. federal income tax considerations applicable to the issuance or exercise of such subscription rights;

the date on which the right to exercise such subscription rights shall commence, and the date on which such rights shall expire (subject to any extension);

the extent to which such subscription rights include an over-subscription privilege with respect to unsubscribed securities;

if applicable, the material terms of any standby underwriting or other purchase arrangement that we may enter into in connection with the subscription rights offering; and

any other terms of such subscription rights, including terms, procedures and limitations relating to the exchange and exercise of such subscription rights.

### ***Exercise of Subscription Rights***

Each subscription right would entitle the holder of the subscription right to purchase for cash such amount of shares of common stock, or preferred stock, at such exercise price as shall in each case be set forth in, or be determinable as set forth in, the prospectus supplement relating to the subscription rights offered thereby. Subscription rights may be exercised at any time up to the close of business on the expiration date for such subscription rights set forth in the prospectus supplement. After the close of business on the expiration date, all unexercised subscription rights would become void.

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Subscription rights may be exercised as set forth in the prospectus supplement relating to the subscription rights offered thereby. Upon receipt of payment and the subscription rights certificate properly completed and duly executed at the corporate trust office of the subscription rights agent or any other office indicated in the prospectus supplement we will forward, as soon as practicable, the shares of common stock, or preferred stock, purchasable upon such exercise. We may determine to offer any unsubscribed offered securities directly to persons other than stockholders, to or through agents, underwriters or dealers or through a combination of such methods, including pursuant to standby underwriting arrangements, as set forth in the applicable prospectus supplement.

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### **Warrants**

The following is a general description of the terms of the warrants we may issue from time to time. Particular terms of any warrants we offer will be described in the prospectus supplement relating to such warrants.

We may issue warrants to purchase shares of our common stock. Such warrants may be issued independently or together with shares of common stock or other equity or debt securities and may be attached or separate from such securities. We will issue each series of warrants under a separate warrant agreement to be entered into between us and a warrant agent. The warrant agent will act solely as our agent and will not assume any obligation or relationship of agency for or with holders or beneficial owners of warrants.

A prospectus supplement will describe the particular terms of any series of warrants we may issue, including the following:

the title of such warrants;

the aggregate number of such warrants;

the price or prices at which such warrants will be issued;

the currency or currencies, including composite currencies, in which the price of such warrants may be payable;

if applicable, the designation and terms of the securities with which the warrants are issued and the number of warrants issued with each such security or each principal amount of such security;

the number of shares of common stock purchasable upon exercise of one warrant and the price at which and the currency or currencies, including composite currencies, in which these shares may be purchased upon such exercise;

the date on which the right to exercise such warrants shall commence and the date on which such right will expire;

whether such warrants will be issued in registered form or bearer form;

if applicable, the minimum or maximum amount of such warrants which may be exercised at any one time;

if applicable, the date on and after which such warrants and the related securities will be separately transferable;

information with respect to book-entry procedures, if any;

the terms of the securities issuable upon exercise of the warrants;

if applicable, a discussion of certain U.S. federal income tax considerations; and

any other terms of such warrants, including terms, procedures and limitations relating to the exchange and exercise of such warrants. We and the warrant agent may amend or supplement the warrant agreement for a series of warrants without the consent of the holders of the warrants issued thereunder to effect changes that are not inconsistent with the provisions of the warrants and that do not materially and adversely affect the interests of the holders of the warrants.

Prior to exercising their warrants, holders of warrants will not have any of the rights of holders of the securities purchasable upon such exercise, including the right to receive dividends, if any, or payments upon our liquidation, dissolution or winding up or to exercise any voting rights.

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Under the 1940 Act, we may generally only offer warrants (except for warrants expiring not later than 120 days after issuance and issued exclusively and ratably to a class of our security holders) on the condition that (1) the warrants expire by their terms within ten years; (2) the exercise or conversion price is not less than the current market value of the securities underlying the warrants at the date of issuance; (3) our stockholders authorize the proposal to issue such warrants (our stockholders approved such a proposal to issue long-term rights, including warrants, in connection with our 2008 annual meeting of stockholders) and a required majority of our Board of Directors approves such issuance on the basis that the issuance is in the best interests of Gladstone Capital and our stockholders; and (4) if the warrants are accompanied by other securities, the warrants are not separately transferable unless no class of such warrants and the securities accompanying them has been publicly distributed. A required majority of our Board of Directors is a vote of both a majority of our directors who have no financial interest in the transaction and a majority of the directors who are not interested persons of the company. The 1940 Act also provides that the amount of our voting securities that would result from the exercise of all outstanding warrants, options and subscription rights at the time of issuance may not exceed 25% of our outstanding voting securities.

## **Debt Securities**

Any debt securities that we issue may be senior or subordinated in priority of payment. If we offer debt securities under this prospectus, we will provide a prospectus supplement that describes the ranking, whether senior or subordinated, the specific designation, the aggregate principal amount, the purchase price, the maturity, the redemption terms, the interest rate or manner of calculating the interest rate, the time of payment of interest, if any, the terms for any conversion or exchange, including the terms relating to the adjustment of any conversion or exchange mechanism, the listing, if any, on a securities exchange, the name and address of the trustee and any other specific terms of the debt securities.

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**CERTAIN PROVISIONS OF MARYLAND LAW AND OF OUR  
ARTICLES OF INCORPORATION AND BYLAWS**

*Our articles of incorporation and bylaws and the Maryland General Corporation Law contain certain provisions that could make more difficult the acquisition of us by means of a tender offer, a proxy contest or otherwise. These provisions are expected to discourage certain types of coercive takeover practices and inadequate takeover bids and to encourage persons seeking to acquire control of us to negotiate first with our Board of Directors. We believe that the benefits of these provisions outweigh the potential disadvantages of discouraging such proposals because, among other things, negotiation of such proposals might result in an improvement of their terms. The description set forth below is intended as a summary only and is qualified in its entirety by reference to our articles of incorporation and bylaws, as amended, which are filed as exhibits to the registration statement of which this prospectus is a part.*

**Classified Board of Directors**

In accordance with our bylaws, our Board of Directors is divided into three classes of directors serving staggered three-year terms. Under the Maryland General Corporation Law, each class must consist as nearly as possible of one-third of the directors then elected to our Board of Directors and our board is currently divided into three classes, all of which have three directors. A classified board may render more difficult a change in control of us or removal of our incumbent management. We believe, however, that the longer time required to elect a majority of a classified board of directors will help to ensure continuity and stability of our management and policies.

Our classified board could have the effect of making the replacement of incumbent directors more time consuming and difficult. Because our directors may only be removed for cause, at least two annual meetings of stockholders, instead of one, will generally be required to effect a change in a majority of our Board of Directors. Thus, our classified board could increase the likelihood that incumbent directors will retain their positions. The staggered terms of directors may delay, defer or prevent a tender offer or an attempt to change control of us or another transaction that might involve a premium price for our common stock that might be in the best interest of our stockholders.

**Number of Directors; Removal; Vacancies**

Our articles of incorporation provide that the number of directors will be determined pursuant to our bylaws and our bylaws provide that a majority of our entire Board of Directors may at any time increase or decrease the number of directors. In addition, our bylaws provide that the number of directors shall not be increased by 50% or more in any 12-month period without the approval of at least 66<sup>2</sup>/3% of the members of our Board of Directors then in office. Our bylaws provide that any vacancies will be filled by the vote of a majority of the remaining directors, even if less than a quorum, and the directors so appointed shall hold office until the next annual meeting of stockholders and until their successors are elected and qualified. Accordingly, our Board of Directors could temporarily prevent any stockholder from enlarging the Board of Directors and filling the new directorships with such stockholder's own nominees.

Our bylaws also provide that, except as may be required by law or our articles of incorporation, our directors may only be removed for cause and only by the affirmative vote of 75% of the voting power of all of the shares of our capital stock then entitled to vote generally in the election of directors, voting together as a single class.

**Stockholder Approval Requirements**

Maryland General Corporation Law provides that stockholder action can be taken only at an annual or special meeting of stockholders or by unanimous written consent in lieu of a meeting. These provisions may have the effect of delaying consideration of a stockholder proposal until the next annual meeting.

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### **Advance Notice Provisions for Stockholder Nominations and Stockholder Proposals**

Our bylaws establish an advance notice procedure for stockholders to make nominations of candidates for election as directors or to bring other business before an annual meeting of our stockholders, which we refer to as the stockholder notice procedure.

The stockholder notice procedure provides that (1) only persons who are nominated by, or at the direction of, the Board of Directors, or by a stockholder who has given timely written notice containing specified information to our secretary prior to the meeting at which directors are to be elected, will be eligible for election as directors and (2) at an annual meeting only such business may be conducted as has been brought before the meeting by, or at the direction of, our Board of Directors or by a stockholder who has given timely written notice to our secretary of such stockholder's intention to bring such business before the meeting. Except for stockholder proposals submitted in accordance with the federal proxy rules as to which the requirements specified therein shall control, notice of stockholder nominations or business to be conducted at an annual meeting must be received by us prior to the first anniversary of the previous year's annual meeting. If we call a special meeting of stockholders for the purpose of electing directors, stockholder nominations must be received by us not earlier than the 90th day prior to such meeting and not later than the later of the 60th day prior to such meeting or the 10th day following the day on which notice of the date of a special meeting of stockholders was given.

The purpose of requiring stockholders to give us advance notice of nominations and other business is to afford our Board of Directors a meaningful opportunity to consider the qualifications of the proposed nominees and the advisability of the other proposed business and, to the extent deemed necessary or desirable by the Board of Directors, to inform stockholders and make recommendations about such qualifications or business, as well as to provide a more orderly procedure for conducting meetings of stockholders. Although our bylaws do not give our Board of Directors any power to disapprove stockholder nominations for the election of directors or proposals for action, they may have the effect of precluding a contest for the election of directors or the consideration of stockholder proposals if proper procedures are not followed and of discouraging or deterring a third party from conducting a solicitation of proxies to elect its own slate of directors or to approve its own proposal without regard to whether consideration of such nominees or proposals might be harmful or beneficial to us and our stockholders.

### **Authority to Issue Preferred Stock without Stockholder Approval**

Our articles of incorporation permit our Board of Directors to issue up to 50,000,000 shares of capital stock. In addition, our Board of Directors, without any action by our stockholders, may amend our articles of incorporation from time to time to increase or decrease the aggregate number of shares or the number of shares of any class or series of stock that we have authority to issue. Our Board of Directors may classify or reclassify any unissued common stock or preferred stock and establish the preferences, conversion or other rights, voting powers, restrictions, limitations as to distributions, qualifications and terms or conditions of redemption of any such stock. Thus, our Board of Directors could authorize the issuance of preferred stock with terms and conditions that could have a priority as to distributions and amounts payable upon liquidation over the rights of the holders of our common stock.

### **Amendment of Articles of Incorporation and Bylaws**

Our articles of incorporation may be amended, altered, changed or repealed, subject to the resolutions providing for any class or series of preferred stock, only by the affirmative vote of both a majority of the members of our Board of Directors then in office and a majority of the voting power of all of the shares of our capital stock entitled to vote generally in the election of directors, voting together as a single class.

Our articles of incorporation also provide that the bylaws may be adopted, amended, altered, changed or repealed by the affirmative vote of the majority of our Board of Directors then in office. Any action taken by our

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stockholders with respect to adopting, amending, altering, changing or repealing our bylaws may be taken only by the affirmative vote of the holders of at least 75% of the voting power of all of the shares of our capital stock then entitled to vote generally in the election of directors, voting together as a single class.

These provisions are intended to make it more difficult for stockholders to circumvent certain other provisions contained in our articles of incorporation and bylaws, such as those that provide for the classification of our Board of Directors. These provisions, however, also will make it more difficult for stockholders to amend the articles of incorporation or bylaws without the approval of the Board of Directors, even if a majority of the stockholders deems such amendment to be in the best interests of all stockholders.

### **Limitation on Liability of Directors**

We have adopted provisions in our articles of incorporation, which, to the fullest extent permitted by Maryland law and as limited by the 1940 Act, limit the liability of our directors and officers for monetary damages. Under our articles of incorporation we shall indemnify (1) our directors and officers to the fullest extent permitted by the General Laws of the State of Maryland as limited by the 1940 Act or any valid rule, regulation or order of the SEC thereunder, including the advance of expenses under the procedures and to the fullest extent permitted by law and (2) other employees and agents to such extent as shall be authorized by our Board of Directors or our bylaws and be permitted by law. The effect of these provisions is to eliminate our rights and the rights of our stockholders (through stockholders' derivative suits on our behalf) to recover monetary damages against one of our directors or officers for breach of the fiduciary duty of care as a director or officer (including breaches resulting from negligent or grossly negligent behavior) except to the extent this limitation is not permitted under applicable law, including the 1940 Act. These provisions do not limit or eliminate our rights or the rights of any of our stockholders to seek non-monetary relief such as an injunction or rescission in the event one of our directors or officers breaches his or her duty of care. These provisions also will not alter the liability of our directors or officers under federal securities laws.

### **SHARE REPURCHASES**

Shares of closed-end investment companies frequently trade at discounts to net asset value. We cannot predict whether our shares will trade above, at or below net asset value. The market price of our common stock is determined by, among other things, the supply and demand for our shares, our investment performance and investor perception of our overall attractiveness as an investment as compared with alternative investments. Our Board of Directors has authorized our officers, in their discretion and subject to compliance with the 1940 Act and other applicable law, to purchase on the open market or in privately negotiated transactions, outstanding shares of our common stock in the event that our shares trade at a discount to net asset value. We cannot assure you that we will ever conduct any open market purchases and if we do conduct open market purchases, we may terminate them at any time.

In addition, if our shares publicly trade for a substantial period of time at a substantial discount to our then current net asset value per share, our Board of Directors will consider authorizing periodic repurchases of our shares or other actions designed to eliminate the discount. Our Board of Directors would consider all relevant factors in determining whether to take any such actions, including the effect of such actions on our status as a RIC under the Code and the availability of cash to finance these repurchases in view of the restrictions on our ability to borrow. We cannot assure you that any share repurchases will be made or that if made, they will reduce or eliminate market discount. Should we make any such repurchases in the future, we expect that we would make them at prices at or below the then current net asset value per share. Any such repurchase would cause our total assets to decrease, which may have the effect of increasing our expense ratio. We may borrow money to finance the repurchase of shares subject to the limitations described in this prospectus. Any interest on such borrowing for this purpose would reduce our net income.



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**PLAN OF DISTRIBUTION**

We may sell the Securities through underwriters or dealers, directly to one or more purchasers, including existing stockholders in a rights offering, or through agents or through a combination of any such methods of sale. In the case of a rights offering, the applicable prospectus supplement will set forth the number of shares of our common stock issuable upon the exercise of each right and the other terms of such rights offering. Any underwriter or agent involved in the offer and sale of the Securities will also be named in the applicable prospectus supplement.

The distribution of the Securities may be effected from time to time in one or more transactions at a fixed price or prices, which may be changed, in at the market offerings within the meaning of Rule 415(a)(4) of the Securities Act, at prevailing market prices at the time of sale, at prices related to such prevailing market prices, or at negotiated prices, provided, however, that in the case of our common stock, the offering price per share less any underwriting commissions or discounts must equal or exceed the net asset value per share of our common stock except (i) in connection with a rights offering to our existing stockholders, (ii) with the consent of the majority of our common stockholders, or (iii) under such other circumstances as the SEC may permit.

In connection with the sale of the Securities, underwriters or agents may receive compensation from us or from purchasers of the Securities, for whom they may act as agents, in the form of discounts, concessions or commissions. Underwriters may sell the Securities to or through dealers and such dealers may receive compensation in the form of discounts, concessions or commissions from the underwriters and/or commissions from the purchasers for whom they may act as agents. Underwriters, dealers and agents that participate in the distribution of the Securities may be deemed to be underwriters under the Securities Act, and any discounts and commissions they receive from us and any profit realized by them on the resale of the Securities may be deemed to be underwriting discounts and commissions under the Securities Act. Any such underwriter or agent will be identified and any such compensation received from us will be described in the applicable prospectus supplement. The maximum commission or discount to be received by any Financial Industry Regulatory Authority, or FINRA, member or independent broker-dealer will not exceed 10%.

We may enter into derivative transactions with third parties, or sell securities not covered by this prospectus to third parties in privately negotiated transactions. If the applicable prospectus supplement indicates, in connection with those derivatives, the third parties may sell Securities covered by this prospectus and the applicable prospectus supplement, including in short sale transactions. If so, the third party may use securities pledged by us or borrowed from us or others to settle those sales or to close out any related open borrowings of stock, and may use securities received from us in settlement of those derivatives to close out any related open borrowings of stock. The third parties in such sale transactions will be underwriters and, if not identified in this prospectus, will be identified in the applicable prospectus supplement (or a post-effective amendment).

Any of our common stock sold pursuant to a prospectus supplement will be listed on the NASDAQ, or another exchange on which our common stock is traded.

Under agreements into which we may enter, underwriters, dealers and agents who participate in the distribution of the Securities may be entitled to indemnification by us against certain liabilities, including liabilities under the Securities Act. Underwriters, dealers and agents may engage in transactions with, or perform services for, us in the ordinary course of business.

If so indicated in the applicable prospectus supplement, we will authorize underwriters or other persons acting as our agents to solicit offers by certain institutions to purchase the Securities from us pursuant to contracts providing for payment and delivery on a future date. Institutions with which such contracts may be made include commercial and savings banks, insurance companies, pension funds, investment companies,

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educational and charitable institutions and others, but in all cases such institutions must be approved by us. The obligations of any purchaser under any such contract will be subject to the condition that the purchase of the Securities shall not at the time of delivery be prohibited under the laws of the jurisdiction to which such purchaser is subject. The underwriters and such other agents will not have any responsibility in respect of the validity or performance of such contracts. Such contracts will be subject only to those conditions set forth in the prospectus supplement, and the prospectus supplement will set forth the commission payable for solicitation of such contracts.

In order to comply with the securities laws of certain states, if applicable, the Securities offered hereby will be sold in such jurisdictions only through registered or licensed brokers or dealers. In addition, in certain states, the Securities may not be sold unless they have been registered or qualified for sale in the applicable state or an exemption from the registration or qualification requirement is available and is complied with.

### **CUSTODIAN, TRANSFER AND DIVIDEND PAYING AGENT AND REGISTRAR**

Our securities are held under a custodian agreement with The Bank of New York Mellon Corp. The address of the custodian is: 500 Ross Street, Suite 935, Pittsburgh, PA 15262. Our assets are held under bank custodianship in compliance with the 1940 Act. Securities held through our wholly-owned subsidiary, Business Loan, are held under a custodian agreement with The Bank of New York Mellon Corp., which acts as collateral custodian pursuant to Business Loan's credit facility with Key Equipment Finance Inc. and certain other parties. The address of the collateral custodian is 500 Ross Street, Suite 935, Pittsburgh, PA 15262. Computershare Shareholder Services LLC acts as our transfer and dividend paying agent and registrar. The principal business address of Computershare Shareholder Services LLC is 480 Washington Boulevard, Jersey City, New Jersey 07310, telephone number 866-214-7543. Computershare Shareholder Services LLC also maintains an internet website at <http://www.bnymellon.com/shareowner/equityaccess.com>.

### **BROKERAGE ALLOCATION AND OTHER PRACTICES**

Since we generally acquire and dispose of our investments in privately negotiated transactions, we will infrequently use securities brokers or dealers in the normal course of our business. Subject to policies established by our Board of Directors, our Adviser will be primarily responsible for the execution of transactions involving publicly traded securities and the allocation of brokerage commissions in respect thereof, if any. In the event that our Adviser executes such transactions, we do not expect our Adviser to execute transactions through any particular broker or dealer, but we would expect our Adviser to seek to obtain the best net results for us, taking into account such factors as price (including the applicable brokerage commission or dealer spread), size of order, difficulty of execution, and operational facilities of the firm and the firm's risk and skill in positioning blocks of securities. While we expect that our Adviser generally will seek reasonably competitive trade execution costs, we will not necessarily pay the lowest spread or commission available. Subject to applicable legal requirements, our Adviser may select a broker based partly upon brokerage or research services provided to us, our Adviser and any of its other clients. In return for such services, we may pay a higher commission than other brokers would charge if our Adviser determines in good faith that such commission is reasonable in relation to the value of the brokerage and research services provided by such broker or dealer viewed in terms either of the particular transaction or our Adviser's overall responsibilities with respect to all of our Adviser's clients.

### **PROXY VOTING POLICIES AND PROCEDURES**

We have delegated our proxy voting responsibility to our Adviser. The proxy voting policies and procedures of our Adviser are set out below. The guidelines are reviewed periodically by our Adviser and our directors who are not interested persons, and, accordingly, are subject to change.

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### **Introduction**

As an investment adviser registered under the Advisers Act, our Adviser has a fiduciary duty to act solely in our best interests. As part of this duty, our Adviser recognizes that it must vote our securities in a timely manner free of conflicts of interest and in our best interests.

Our Adviser's policies and procedures for voting proxies for its investment advisory clients are intended to comply with Section 206 of, and Rule 206(4)-6 under, the Advisers Act.

### **Proxy Policies**

Our Adviser votes proxies relating to our portfolio securities in what it perceives to be the best interest of our stockholders. Our Adviser reviews on a case-by-case basis each proposal submitted to a stockholder vote to determine its effect on the portfolio securities we hold. In most cases our Adviser will vote in favor of proposals that our Adviser believes are likely to increase the value of the portfolio securities we hold. Although our Adviser will generally vote against proposals that may have a negative effect on our portfolio securities, our Adviser may vote for such a proposal if there exist compelling long-term reasons to do so.

Our proxy voting decisions are made by our Adviser's portfolio managers. To ensure that our Adviser's vote is not the product of a conflict of interest, our Adviser requires that (1) anyone involved in the decision-making process disclose to our Adviser's investment committee any potential conflict that he or she is aware of and any contact that he or she has had with any interested party regarding a proxy vote; and (2) employees involved in the decision-making process or vote administration are prohibited from revealing how our Adviser intends to vote on a proposal in order to reduce any attempted influence from interested parties. Where conflicts of interest may be present, our Adviser will disclose such conflicts to us, including our independent directors and may request guidance from us on how to vote such proxies.

### **Proxy Voting Records**

You may obtain information without charge about how the Adviser voted proxies by making a written request for proxy voting information to:

Michael LiCalsi, Internal Counsel

c/o Gladstone Capital Corporation

1521 Westbranch Dr.

McLean, VA 22102

## **LEGAL MATTERS**

The legality of securities offered hereby will be passed upon for us by Cooley LLP, Reston, Virginia. Certain legal matters will be passed upon for the underwriters, if any, by the counsel named in the accompanying prospectus supplement.

## **EXPERTS**

The financial statements as of September 30, 2011 and September 30, 2010 and for each of the three years in the period ended September 30, 2011 and management's assessment of the effectiveness of internal control over financial reporting (which is included in Management's Report on Internal Control over Financial Reporting) as of September 30, 2011 included in this prospectus have been so included in reliance on the report of PricewaterhouseCoopers LLP, an independent registered public accounting firm, given on the authority of said firm as experts in auditing and accounting.

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**GLADSTONE CAPITAL CORPORATION**

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**Report of Management on Internal Controls**

To the Stockholders and Board of Directors of Gladstone Capital Corporation:

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934. Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and include those policies and procedures that: (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect our transactions and the dispositions of our assets; (2) provide reasonable assurance that our transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with appropriate authorizations; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on our financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Under the supervision and with the participation of our management, we assessed the effectiveness of our internal control over financial reporting as of September 30, 2011, using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control Integrated Framework. Based on its assessment, management has concluded that our internal control over financial reporting was effective as of September 30, 2011.

The effectiveness of the Company's internal control over financial reporting as of September 30, 2011 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which appears herein.

November 14, 2011

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**Report of Independent Registered Public Accounting Firm**

To the Stockholders and Board of Directors of Gladstone Capital Corporation:

In our opinion, the accompanying consolidated statements of assets and liabilities, including the consolidated schedules of investments, and the related consolidated statements of operations, changes in net assets and cash flows present fairly, in all material respects, the financial position of Gladstone Capital Corporation and its subsidiaries (the Company) at September 30, 2011 and 2010, and the results of their operations and their cash flows for each of the three years in the period ended September 30, 2011 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of September 30, 2011, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements and financial statement schedule, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express opinions on these financial statements, on the financial statement schedule, and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. Our procedures included confirmation of securities at September 30, 2011, by correspondence with the custodian, and where replies were not received, we performed other auditing procedures. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

Philadelphia, PA

November 14, 2011

**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONSOLIDATED STATEMENTS OF ASSETS AND LIABILITIES****(DOLLAR AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA)**

|   | September 30,     |            |
|---|-------------------|------------|
|   | 2011              | 2010       |
| <b>ASSETS</b>   |                   |            |
| Investments at fair value:  |                   |            |
| Non-Control/Non-Affiliate investments (Cost of <b>\$288,266</b> and \$244,140, respectively)  | <b>\$ 257,302</b> | \$ 223,737 |
| Control investments (Cost of <b>\$94,549</b> and \$54,076, respectively)  | <b>45,645</b>     | 33,372     |
| Total investments (Cost of <b>\$382,815</b> and \$298,216, respectively)  | <b>302,947</b>    | 257,109    |
| Cash  | <b>6,732</b>      | 7,734      |
| Interest receivable investments in debt securities  | <b>3,066</b>      | 2,648      |
| Interest receivable employees <sup>(A)</sup>  |                   | 104        |
| Due from custodian  | <b>2,547</b>      | 255        |
| Deferred financing fees   | <b>650</b>        | 1,266      |
| Prepaid assets  | <b>996</b>        | 799        |
| Other assets  | <b>686</b>        | 603        |
| <b>TOTAL ASSETS</b>   | <b>\$ 317,624</b> | \$ 270,518 |
| <b>LIABILITIES</b>  |                   |            |
| Borrowings at fair value (Cost of <b>\$99,400</b> and \$16,800, respectively)   | <b>\$ 100,012</b> | \$ 17,940  |
| Accounts payable and accrued expenses   | <b>513</b>        | 752        |
| Interest payable  | <b>289</b>        | 693        |
| Fee due to Administrator <sup>(A)</sup>   | <b>194</b>        | 267        |
| Fees due to Adviser <sup>(A)</sup>  | <b>1,760</b>      | 673        |
| Other liabilities   | <b>1,135</b>      | 947        |
| <b>TOTAL LIABILITIES</b>  | <b>103,903</b>    | 21,272     |
| <b>NET ASSETS</b>   | <b>\$ 213,721</b> | \$ 249,246 |
| <b>ANALYSIS OF NET ASSETS</b>   |                   |            |
| Common stock, \$0.001 par value, 50,000,000 shares authorized and 21,039,242 shares issued and outstanding at September 30, 2011 and 2010 | <b>\$ 21</b>      | \$ 21      |
| Capital in excess of par value  | <b>326,913</b>    | 326,935    |
| Notes receivable employees <sup>(A)</sup>   | <b>(3,858)</b>    | (7,103)    |
| Cumulative net unrealized depreciation on investments   | <b>(79,867)</b>   | (41,108)   |
| Cumulative net unrealized appreciation on borrowings  | <b>(612)</b>      | (1,140)    |
| Underdistributed (overdistributed) net investment income  | <b>108</b>        | (1,103)    |
| Accumulated net realized losses   | <b>(28,984)</b>   | (27,256)   |
| <b>TOTAL NET ASSETS</b>   | <b>\$ 213,721</b> | \$ 249,246 |
| <b>NET ASSETS PER COMMON SHARE</b>  | <b>\$ 10.16</b>   | \$ 11.85   |

<sup>(A)</sup> Refer to Note 4 *Related Party Transactions* for additional information.

*THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.*

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**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONSOLIDATED STATEMENTS OF OPERATIONS****(DOLLAR AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA)**

|  | 2011               | Year ended September 30,<br>2010 | 2009            |
|--|--------------------|----------------------------------|-----------------|
| <b>INVESTMENT INCOME</b>   |                    |                                  |                 |
| Interest income  |                    |                                  |                 |
| Non-Control/Non-Affiliate investments                                  | \$ 27,497          | \$ 29,938                        | \$ 40,747       |
| Control investments  | 5,139              | 2,645                            | 933             |
| Cash   | 1                  | 1                                | 11              |
| Notes receivable from employees <sup>(A)</sup>                         | 431                | 437                              | 468             |
| <b>Total interest income</b>   | <b>33,068</b>      | <b>33,021</b>                    | <b>42,159</b>   |
| Other income   |                    |                                  |                 |
| Non-Control/Non-Affiliate investments                                  | 1,518              | 2,518                            | 459             |
| Control investments  | 625                |                                  |                 |
| <b>Total investment income</b>   | <b>35,211</b>      | <b>35,539</b>                    | <b>42,618</b>   |
| <b>EXPENSES</b>  |                    |                                  |                 |
| Loan servicing fee <sup>(A)</sup>                                      | 3,355              | 3,412                            | 5,620           |
| Base management fee <sup>(A)</sup>                                     | 2,376              | 2,673                            | 2,005           |
| Incentive fee <sup>(A)</sup>   | 4,598              | 1,823                            | 3,326           |
| Administration fee <sup>(A)</sup>                                      | 729                | 807                              | 872             |
| Interest expense   | 2,676              | 4,390                            | 7,949           |
| Amortization of deferred financing fees                                | 1,420              | 1,490                            | 2,778           |
| Professional fees  | 1,118              | 2,101                            | 1,586           |
| Compensation expense <sup>(A)</sup>                                    |                    | 245                              |                 |
| Other expenses   | 1,170              | 1,259                            | 1,131           |
| Expenses before credits from Adviser                                   | 17,442             | 18,200                           | 25,267          |
| Credit to fees from Adviser <sup>(A)</sup>                             | (643)              | (420)                            | (3,680)         |
| <b>Total expenses net of credits to fees</b>                           | <b>16,799</b>      | <b>17,780</b>                    | <b>21,587</b>   |
| <b>NET INVESTMENT INCOME</b>   | <b>18,412</b>      | <b>17,759</b>                    | <b>21,031</b>   |
| <b>REALIZED AND UNREALIZED (LOSS) GAIN</b>                             |                    |                                  |                 |
| Net realized loss on investments                                       | (1,280)            | (2,893)                          | (26,411)        |
| Net unrealized (depreciation) appreciation on investments              | (38,759)           | 2,317                            | 9,513           |
| Realized loss on settlement of derivative                              |                    |                                  | (304)           |
| Net unrealized appreciation on derivative                              |                    |                                  | 304             |
| Net unrealized depreciation (appreciation) on borrowings               | 528                | (789)                            | (350)           |
| <b>Net loss on investments, derivative and borrowings</b>              | <b>(39,511)</b>    | <b>(1,365)</b>                   | <b>(17,248)</b> |
| <b>NET (DECREASE) INCREASE IN NET ASSETS RESULTING FROM OPERATIONS</b> | <b>\$ (21,099)</b> | <b>\$ 16,394</b>                 | <b>\$ 3,783</b> |

NET (DECREASE) INCREASE IN NET ASSETS RESULTING FROM  
OPERATIONS PER COMMON SHARE

|                   |           |         |         |
|-------------------|-----------|---------|---------|
| Basic and Diluted | \$ (1.00) | \$ 0.78 | \$ 0.18 |
|-------------------|-----------|---------|---------|

WEIGHTED AVERAGE SHARES OF COMMON STOCK  
OUTSTANDING

|                   |            |            |            |
|-------------------|------------|------------|------------|
| Basic and Diluted | 21,039,242 | 21,060,351 | 21,087,574 |
|-------------------|------------|------------|------------|

<sup>(A)</sup> Refer to Note 4 *Related Party Transactions* for additional information.

*THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.*

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**GLADSTONE CAPITAL CORPORATION**  
**CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS**  
**(DOLLAR AMOUNTS IN THOUSANDS)**

|  | Year ended September 30, |            |            |
|--|--------------------------|------------|------------|
|  | 2011                     | 2010       | 2009       |
| <i>Operations:</i>   |                          |            |            |
| Net investment income  | \$ 18,412                | \$ 17,759  | \$ 21,031  |
| Net loss on sale of investments  | (1,280)                  | (2,893)    | (26,411)   |
| Net unrealized (depreciation) appreciation on investments                      | (38,759)                 | 2,317      | 9,513      |
| Realized loss on settlement of derivative                                      |                          |            | (304)      |
| Net unrealized appreciation on derivative                                      |                          |            | 304        |
| Net unrealized depreciation (appreciation) on borrowings                       | 528                      | (789)      | (350)      |
| Net (decrease) increase in net assets from operations                          | (21,099)                 | 16,394     | 3,783      |
| <i>Distributions to stockholders from:</i>                                     |                          |            |            |
| Net investment income  | (17,672)                 | (16,907)   | (20,795)   |
| Long term capital gains  |                          |            | (27)       |
| Return of capital  |                          | (783)      | (5,748)    |
| Net decrease in net assets from distributions to stockholders                  | (17,672)                 | (17,690)   | (26,570)   |
| <i>Capital share transactions:</i>   |                          |            |            |
| Shelf offering costs   |                          | (28)       | (41)       |
| Repayment of principal on employee notes                                       | 3,246                    | 1,400      | 6          |
| Conversion of former employee stock option loans from recourse to non-recourse |                          | (420)      |            |
| Reclassification of principal on employee note                                 |                          | 514        | 150        |
| Net increase in net assets from capital share transactions                     | 3,246                    | 1,466      | 115        |
| Total (decrease) increase in net assets  | (35,525)                 | 170        | (22,672)   |
| Net assets at beginning of year  | 249,246                  | 249,076    | 271,748    |
| Net assets at end of year  | \$ 213,721               | \$ 249,246 | \$ 249,076 |

*THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.*

**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONSOLIDATED STATEMENTS OF CASH FLOWS****(DOLLAR AMOUNTS IN THOUSANDS)**

|  | Year ended September 30, |                 |                 |
|--|--------------------------|-----------------|-----------------|
|  | 2011                     | 2010            | 2009            |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>  |                          |                 |                 |
| Net (decrease) increase in net assets resulting from operations  | \$ (21,099)              | \$ 16,394       | \$ 3,783        |
| Adjustments to reconcile net (decrease) increase in net assets resulting from operations to net cash (used in) provided by operating activities: |                          |                 |                 |
| Purchase of investments  | (136,254)                | (22,530)        | (24,911)        |
| Principal repayments on investments  | 45,835                   | 82,515          | 47,490          |
| Proceeds from sale of investments  | 4,167                    | 3,119           | 49,203          |
| Repayment of paid in kind interest   |                          | 51              |                 |
| Increase in investment balance due to paid in kind interest  | (12)                     | (67)            | (166)           |
| Increase in investment balance due to transferred interest   | (204)                    | (1,230)         | (1,455)         |
| Net change in premiums, discounts and amortization   | 1,467                    | 711             | (95)            |
| (Decrease) increase in loan impairment treated as contra-investment  | (715)                    | 715             |                 |
| Net realized loss on investments   | 1,119                    | 2,893           | 26,411          |
| Net unrealized depreciation (appreciation) on investments  | 38,759                   | (2,317)         | (9,513)         |
| Realized loss on settlement of derivative  |                          |                 | 304             |
| Net unrealized appreciation on derivative  |                          |                 | (304)           |
| Net unrealized (depreciation) appreciation on borrowings   | (528)                    | 789             | 350             |
| Amortization of deferred financing fees  | 1,420                    | 1,490           | 2,778           |
| Change in compensation expense from non-recourse notes   |                          | 245             |                 |
| (Increase) decrease in interest receivable   | (314)                    | 382             | 546             |
| (Increase) decrease in funds due from custodian  | (2,292)                  | 2,804           | 1,485           |
| Increase in prepaid assets   | (196)                    | (459)           | (35)            |
| (Increase) decrease in other assets  | (83)                     | 1,304           | (914)           |
| (Decrease) increase in accounts payable and accrued expenses   | (239)                    | (375)           | 539             |
| (Decrease) increase in interest payable  | (404)                    | 315             | (268)           |
| Increase (decrease) in fees due to Adviser <sup>(A)</sup>  | 1,087                    | (161)           | 377             |
| (Decrease) increase in fee due to Administrator <sup>(A)</sup>   | (73)                     | 51              | (31)            |
| Increase (decrease) in other liabilities   | 187                      | (138)           | (53)            |
| Net cash (used in) provided by operating activities  | (68,372)                 | 86,501          | 95,521          |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>  |                          |                 |                 |
| Shelf offering costs   |                          | (28)            | (41)            |
| Borrowings   | 120,100                  | 24,900          | 48,800          |
| Repayments   | (37,500)                 | (91,100)        | (116,830)       |
| Distributions paid   | (17,672)                 | (17,690)        | (26,570)        |
| Receipt of principal on notes receivable employees <sup>(A)</sup>  | 3,246                    | 1,400           | 6               |
| Deferred financing fees  | (804)                    | (1,525)         | (2,103)         |
| Net cash provided by (used in) financing activities  | 67,370                   | (84,043)        | (96,738)        |
| <b>NET (DECREASE) INCREASE IN CASH</b>   | <b>(1,002)</b>           | <b>2,458</b>    | <b>(1,217)</b>  |
| <b>CASH, BEGINNING OF YEAR</b>   | <b>7,734</b>             | <b>5,276</b>    | <b>6,493</b>    |
| <b>CASH, END OF YEAR</b>   | <b>\$ 6,732</b>          | <b>\$ 7,734</b> | <b>\$ 5,276</b> |

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|   |                 |                 |                 |
|---|-----------------|-----------------|-----------------|
| <b>CASH PAID DURING PERIOD FOR INTEREST</b>                   | <b>\$ 3,080</b> | <b>\$ 4,075</b> | <b>\$ 8,278</b> |
| <b>NON-CASH FINANCING ACTIVITIES</b>                          |                 |                 |                 |
| Reclassification of principal on employee note <sup>(A)</sup> | \$              | \$ 515          | \$ 150          |
| Cancellation of employee note receivable <sup>(A)</sup>       |                 | 420             |                 |

(A) Refer to Note 4 *Related Party Transactions* for additional information.

*THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.*

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**Table of Contents**

**GLADSTONE CAPITAL CORPORATION**  
**CONSOLIDATED SCHEDULE OF INVESTMENTS**

**SEPTEMBER 30, 2011**

**(DOLLAR AMOUNTS IN THOUSANDS)**

| Company <sup>(A)</sup>                                 | Industry   | Investment <sup>(B)</sup>   | Principal | Cost   | Fair Value |
|--|--|---|-----------|--------|------------|
| <b>NON-CONTROL/NON-AFFILIATE INVESTMENTS</b>           |  |   |           |        |            |
| Non-syndicated Loans:                                  |  |   |           |        |            |
| Access Television Network, Inc.                        | Service-cable airtime (infomercials)               | Senior Term Debt (14.0%, Due 2/2011) <sup>(D) (H)</sup>                                   | \$ 903    | \$ 903 | \$ 45      |
| Allison Publications, LLC                              | Service-publisher of consumer oriented magazines   | Senior Term Debt (10.5%, Due 9/2012) <sup>(D)</sup>                                       | 8,463     | 8,478  | 7,861      |
| BAS Broadcasting                                       | Service-radio station operator                     | Senior Term Debt (11.5%, Due 7/2013) <sup>(D)</sup>                                       | 7,465     | 7,465  | 6,233      |
| Chinese Yellow Pages Company                           | Service-publisher of Chinese language directories  | Line of Credit, \$250 available (7.3%, Due 11/2011) <sup>(D)</sup>                        | 450       | 450    | 338        |
|  |  | Senior Term Debt (7.3%, Due 11/2011) <sup>(D)</sup>                                       | 168       | 168    | 126        |
| CMI Acquisition, LLC                                   | Service-recycling                                  | Senior Subordinated Term Debt (13.0%, Due 12/2016) <sup>(D)</sup>                         | 14,265    | 14,265 | 14,336     |
| FedCap Partners, LLC                                   | Private equity fund                                | Class A Membership Units (80 units) <sup>(G)</sup><br>Uncalled Capital Commitment (\$800) |           | 1,200  | 1,153      |
| GFRC Holdings, LLC                                     | Manufacturing-glass-fiber reinforced directories   | Senior Term Debt (11.5%, Due 12/2012) <sup>(D)</sup>                                      | 5,617     | 5,617  | 4,719      |
|  |  | Senior Subordinated Term Debt (14.0%, Due 12/2012) <sup>(C) (D)</sup>                     | 6,615     | 6,615  | 5,557      |
| Global Materials Technologies, Inc.                    | Manufacturing-steel wool products and metal fibers | Senior Term Debt (13.0%, Due 6/2012) <sup>(C) (D)</sup>                                   | 2,635     | 2,635  | 2,212      |
| Heartland Communications Group                         | Service-radio station operator                     | Line of Credit, \$0 available (5.0%, Due 3/2013) <sup>(D)</sup>                           | 100       | 100    | 41         |
|  |  | Line of Credit, \$0 available (10.0%, Due 3/2013) <sup>(D)</sup>                          | 100       | 100    | 41         |
|  |  | Senior Term Debt (5.0%, Due 3/2013) <sup>(D)</sup>  | 4,342     | 4,316  | 1,780      |
|  |  | Common Stock Warrants (8.8% ownership) <sup>(F) (G)</sup>                                 |           | 66     |            |
| International Junior Golf Training Acquisition Company | Service-golf training                              | Line of Credit, \$0 available (11.0%, Due 5/2012) <sup>(D)</sup>                          | 1,500     | 1,500  | 1,275      |
|  |  | Senior Term Debt (10.5%, Due 5/2012) <sup>(D)</sup>                                       | 861       | 861    | 732        |

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|   |       |       |       |
|---|-------|-------|-------|
| Senior Term Debt (12.5%,<br>Due 5/2012) <sup>(C)(D)</sup> | 2,500 | 2,500 | 2,125 |
|---|-------|-------|-------|

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**GLADSTONE CAPITAL CORPORATION**  
**CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)**

**AS OF SEPTEMBER 30, 2011**

**(DOLLAR AMOUNTS IN THOUSANDS)**

| Company <sup>(A)</sup>                        | Industry  | Investment <sup>(B)</sup>   | Principal | Cost   | Fair Value |  |
|---|---|---|-----------|--------|------------|--|
| KMBQ Corporation <sup>(1)</sup>               | Service-AM/FM radio broadcaster   | Line of Credit, \$42 available<br>(12.3%, Due 7/2010) <sup>(D)(H)</sup>   | \$ 162    | \$ 158 | \$ 76      |  |
|   |   | Senior Term Debt (12.3%, Due<br>7/2010) <sup>(D)(H)</sup>                 | 2,081     | 2,038  | 984        |  |
| Legend Communications of<br>Wyoming, LLC      | Service-operator of radio stations                                      | Senior Term Debt (12.0%, Due<br>6/2013) <sup>(D)</sup>                    | 9,745     | 9,745  | 5,408      |  |
|   |   | Senior Term Debt (16.0%, Due<br>7/2011) <sup>(D)</sup>                    | 220       | 220    | 123        |  |
| Newhall Holdings, Inc.                        | Service-distributor of personal care<br>products and supplements        | Line of Credit, \$0 available<br>(8.0%, Due 12/2012) <sup>(D)(H)</sup>    | 1,985     | 1,985  | 98         |  |
|   |   | Senior Term Debt (8.5%, Due<br>12/2012) <sup>(D)(H)</sup>                 | 1,870     | 1,870  | 94         |  |
|   |   | Senior Term Debt (3.5%, Due<br>12/2012) <sup>(C)(D)(H)</sup>              | 2,000     | 2,000  | 100        |  |
|   |   | Senior Term Debt (3.5%, Due<br>12/2012) <sup>(C)(D)(H)</sup>              | 4,648     | 4,648  | 232        |  |
|   |   | Preferred Equity (1,000,000<br>shares) <sup>(F)(G)(H)</sup>               |           |        |            |  |
|   |   | Common Stock (688,500<br>shares) <sup>(F)(G)</sup>                        |           |        |            |  |
| North American Aircraft Services<br>LLC       | Service - repairs and maintains<br>aircraft fuel tanks and fuel systems | Line of Credit, \$1,500<br>available (6.5%, Due 8/2012)<br><sup>(D)</sup> | 500       | 500    | 500        |  |
|   |   | Senior Term Debt (7.5%, Due<br>8/2016) <sup>(D)</sup>                     | 3,250     | 3,250  | 3,250      |  |
|   |   | Senior Subordinated Term<br>Debt (11.8%, Due 8/2016) <sup>(D)</sup>       | 4,750     | 4,750  | 4,750      |  |
|   |   | Common Stock Warrants<br>(4.8% ownership) <sup>(F)(G)</sup>               |           | 350    | 350        |  |
| Northern Contours, Inc.                       | Manufacturing-veneer and laminate<br>components                         | Senior Subordinated Term<br>Debt (13.0%, Due 9/2012) <sup>(D)</sup>       | 6,128     | 6,128  | 5,684      |  |
| Northstar Broadband, LLC                      | Service-cable TV franchise owner  | Senior Term Debt (0.7%, Due<br>12/2012) <sup>(D)</sup>                    | 80        | 70     | 64         |  |
| Precision Acquisition Group<br>Holdings, Inc. | Manufacturing-consumable<br>components<br><br>for the Aluminum industry | Equipment Note (13.0%, Due<br>11/2011) <sup>(D)</sup>                     | 1,000     | 1,000  | 948        |  |
|   |   | Senior Term Debt (13.0%, Due<br>11/2011) <sup>(D)</sup>                   | 4,125     | 4,125  | 3,908      |  |
|   |   | Senior Term Debt (13.0%, Due<br>11/2011) <sup>(C)(D)</sup>                | 4,053     | 4,053  | 3,840      |  |



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|                                |   |  |       |       |       |
|--------------------------------|---|--|-------|-------|-------|
| PROFIT Systems Acquisition Co. | Service-design and develop ERP software | Line of Credit, \$350 available (11.3%, Due 7/2012) <sup>(D)</sup><br>Senior Term Debt (10.5%, Due 7/2014) <sup>(C)(D)</sup> | 3,150 | 3,150 | 3,024 |
|--------------------------------|---|--|-------|-------|-------|

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**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)****AS OF SEPTEMBER 30, 2011****(DOLLAR AMOUNTS IN THOUSANDS)**

| <b>Company<sup>(A)</sup></b>              | <b>Industry</b>  | <b>Investment<sup>(B)</sup></b>                                      | <b>Principal</b> | <b>Cost</b> | <b>Fair Value</b> |
|---|--|--|------------------|-------------|-------------------|
| RCS Management Holding Co.                | Service-healthcare supplies                                    | Senior Term Debt (9.5%, Due 1/2013) <sup>(D)</sup>                   | \$ 1,438         | \$ 1,438    | \$ 1,367          |
|   |  | Senior Term Debt (11.5%, Due 1/2013) <sup>(C)(D)</sup>               | 3,060            | 3,060       | 2,907             |
| Reliable Biopharmaceutical Holdings, Inc. | Manufacturing-pharmaceutical and biochemical intermediates     | Line of Credit, \$2,800 available (9.0%, Due 1/2013) <sup>(D)</sup>  | 1,200            | 1,200       | 1,176             |
|   |  | Mortgage Note (9.5%, Due 12/2014) <sup>(D)</sup>                     | 7,168            | 7,168       | 7,025             |
|   |  | Senior Term Debt (12.0%, Due 12/2014) <sup>(C)(D)</sup>              | 11,573           | 11,573      | 10,906            |
|   |  | Senior Subordinated Term Debt (12.5%, Due 12/2014) <sup>(D)</sup>    | 6,000            | 6,000       | 5,655             |
|   |  | Common Stock Warrants (764 shares) <sup>(F)(G)</sup>                 |                  | 209         | 534               |
| Saunders & Associates                     | Manufacturing-equipment provider for frequency control devices | Line of Credit, \$2,500 available (11.3%, Due 5/2013) <sup>(D)</sup> |                  |             |                   |
|   |  | Senior Term Debt (11.3%, Due 5/2013) <sup>(D)</sup>                  | 8,947            | 8,947       | 8,913             |
| Sunburst Media - Louisiana, LLC           | Service-radio station operator                                 | Senior Term Debt (10.5%, Due 12/2011) <sup>(D)</sup>                 | 6,100            | 6,103       | 3,964             |
| Thibaut Acquisition Co.                   | Service-design and distribute wall covering                    | Line of Credit, \$400 available (9.0%, Due 1/2014) <sup>(D)</sup>    | 600              | 600         | 585               |
|   |  | Senior Term Debt (8.5%, Due 1/2014) <sup>(D)</sup>                   | 550              | 550         | 536               |
|   |  | Senior Term Debt (12.0%, Due 1/2014) <sup>(C)(D)</sup>               | 3,000            | 3,000       | 2,910             |
| Westlake Hardware, Inc.                   | Retail-hardware and variety                                    | Senior Subordinated Term Debt (12.3%, Due 1/2014) <sup>(D)</sup>     | 12,000           | 12,000      | 11,640            |
|   |  | Senior Subordinated Term Debt (13.5%, Due 1/2014) <sup>(D)</sup>     | 8,000            | 8,000       | 7,700             |
| Westland Technologies, Inc.               | Service-diversified conglomerate                               | Line of Credit, \$1,000 available (6.5%, Due 4/2012) <sup>(D)</sup>  |                  |             |                   |
|   |  | Senior Term Debt (7.5%, Due 4/2016) <sup>(D)</sup>                   | 2,000            | 2,000       | 1,995             |
|   |  | Senior Term Debt (12.5%, Due 4/2016) <sup>(D)</sup>                  | 4,000            | 4,000       | 3,990             |

|   |     |     |
|---|-----|-----|
| Common Stock Warrants<br>(77,287 shares) <sup>(F)</sup> (G) | 350 | 307 |
|---|-----|-----|

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**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)****AS OF SEPTEMBER 30, 2011****(DOLLAR AMOUNTS IN THOUSANDS)**

| <b>Company<sup>(A)</sup></b>         | <b>Industry</b>   | <b>Investment<sup>(B)</sup></b>                                   | <b>Principal</b> | <b>Cost</b> | <b>Fair Value</b> |
|--------------------------------------|---|---|------------------|-------------|-------------------|
| Winchester Electronics               | Manufacturing-high bandwidth connectors and cables                              | Senior Term Debt (5.2%, Due 5/2012) <sup>(D)</sup>                | \$ 1,250         | \$ 1,250    | \$ 1,238          |
|                                      |   | Senior Term Debt (5.7%, Due 5/2013) <sup>(D)</sup>                | 1,677            | 1,677       | 1,656             |
|                                      |   | Senior Subordinated Term Debt (14.0%, Due 6/2013) <sup>(D)</sup>  | 9,800            | 9,800       | 9,628             |
| <i>Subtotal Non-syndicated loans</i> |   |   |                  | \$ 196,204  | \$ 166,639        |
| <b>Syndicated Loans:</b>             |   |   |                  |             |                   |
| Airvana Network Solutions, Inc.      | Service-telecommunications  | Senior Term Debt (10.0%, Due 3/2015) <sup>(E)</sup>               | \$ 6,048         | \$ 5,912    | \$ 6,048          |
| Allied Security Holdings, LLC        | Service-contract security officer providers                                     | Senior Subordinated Term Debt (8.5%, Due 2/2018) <sup>(E)</sup>   | 1,000            | 991         | 965               |
| Allied Specialty Vehicles, Inc.      | Manufacturing-specialty vehicles  | Senior Term Debt (9.5%, Due 2/2016) <sup>(E)</sup>                | 9,950            | 9,767       | 9,751             |
| Ameriquel Group, LLC                 | Manufacturing-production and distribution of food products                      | Senior Term Debt (9.0%, Due 3/2016) <sup>(E)</sup>                | 7,481            | 7,344       | 7,332             |
| Applied Systems, Inc.                | Software for property & casualty insurance industry                             | Senior Subordinated Term Debt (9.3%, Due 6/2017) <sup>(E)</sup>   | 1,000            | 991         | 990               |
| Ascend Learning, LLC                 | Service-technology-based learning solutions                                     | Senior Subordinated Term Debt (11.5%, Due 12/2017) <sup>(E)</sup> | 1,000            | 972         | 980               |
| Attachmate Corporate                 | Service-develops, implements and supports software                              | Senior Subordinated Term Debt (9.5%, Due 2/2017) <sup>(E)</sup>   | 4,000            | 3,962       | 3,810             |
| Autoparts Holdings Limited           | Supplier to the light and heavy-duty vehicle after market for replacement parts | Senior Term Debt (10.5%, Due 1/2018) <sup>(E)</sup>               | 1,000            | 995         | 978               |
| Covad Communications Group, Inc.     | Service-telecommunications  | Senior Term Debt (12.0%, Due 11/2015) <sup>(E)</sup>              | 1,850            | 1,818       | 1,795             |
| Ernest Health, Inc.                  | Service-post-acute care services  | Senior Term Debt (10.3%, Due 5/2017) <sup>(E)</sup>               | 2,000            | 1,971       | 1,930             |
| Global Brass and Copper, Inc.        | Manufacturing - steel wool products and metal fibers                            | Senior Term Debt (10.3%, Due 8/2015) <sup>(E)</sup>               | 2,969            | 2,893       | 3,054             |
| HGI Holding, Inc                     | Service - distributor of disposable medical products                            | Senior Term Debt (6.8%, Due 10/2016) <sup>(E)</sup>               | 1,757            | 1,723       | 1,687             |



**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)****AS OF SEPTEMBER 30, 2011****(DOLLAR AMOUNTS IN THOUSANDS)**

| <b>Company<sup>(A)</sup></b>  | <b>Industry</b>   | <b>Investment<sup>(B)</sup></b>                                 | <b>Principal</b> | <b>Cost</b>       | <b>Fair Value</b> |
|---|---|---|------------------|-------------------|-------------------|
| Hubbard Radio, LLC  | Service-radio station operator                                      | Senior Subordinated Term Debt (8.8%, Due 4/2018) <sup>(E)</sup> | \$ 500           | \$ 495            | \$ 488            |
| Keypoint Government Solutions, Inc.   | Service-security consulting services                                | Senior Term Debt (10.0%, Due 12/2015) <sup>(E)</sup>            | 6,948            | 6,916             | 6,670             |
| Mood Media Corporation  | Service-media and marketing solutions                               | Senior Term Debt (10.3%, Due 11/2018) <sup>(E)</sup>            | 8,000            | 7,923             | 7,370             |
| National Surgical Hospitals, Inc.   | Service-physician-partnered surgical facilities                     | Senior Term Debt (8.3%, Due 2/2017) <sup>(E)</sup>              | 1,694            | 1,658             | 1,627             |
| Sensus USA, Inc.  | Service-provider of utility communication services                  | Senior Term Debt (8.5%, Due 5/2018) <sup>(E)</sup>              | 500              | 495               | 483               |
| Springs Window Fashions, LLC  | Manufacturing-window coverings                                      | Senior Term Debt (11.3%, Due 11/2017) <sup>(E)</sup>            | 5,000            | 4,855             | 4,750             |
| SRAM, LLC   | Manufacturing-premium bicycle components                            | Senior Term Debt (8.5%, Due 12/2018) <sup>(E)</sup>             | 2,500            | 2,476             | 2,475             |
| Targus Group International, Inc.  | Manufacturing-carrying cases and accessories for notebook computers | Senior Term Debt (11.0%, Due 5/2016) <sup>(E)</sup>             | 9,975            | 9,785             | 9,626             |
| Ulterra Drilling Technologies, LP   | Manufacturing-oil field drill bits and slick-slip reduction tools   | Senior Term Debt (9.5%, Due 6/2016) <sup>(E)</sup>              | 1,975            | 1,937             | 1,916             |
| Vision Solutions, Inc.  | Service-provider of information availability software               | Senior Term Debt (9.5%, Due 7/2017) <sup>(E)</sup>              | 11,000           | 10,915            | 10,560            |
| Wall Street Systems Holdings, Inc.  | Service-software provider   | Senior Term Debt (9.0%, Due 6/2018) <sup>(E)</sup>              | 3,000            | 2,971             | 2,880             |
| WP Evenflo Group Holdings Inc.  | Manufacturing-infant and juvenile products                          | Senior Term Debt (8.0%, Due 2/2013) <sup>(E)</sup>              | 1,853            | 1,853             | 1,723             |
|   |   | Senior Preferred Equity (333.3 shares) <sup>(F)(G)</sup>        |                  | 333               | 419               |
|   |   | Junior Preferred Equity (111.1 shares) <sup>(F)(G)</sup>        |                  | 111               | 146               |
|   |   | Common Stock (1,874 shares) <sup>(F)(G)</sup>                   |                  |                   | 210               |
| <i>Subtotal - Syndicated loans</i>  |   |   |                  | \$ 92,062         | \$ 90,663         |
| <b>Total Non-Control/Non-Affiliate Investments (represented 84.9% of total investments at fair value)</b> |   |   |                  | <b>\$ 288,266</b> | <b>\$ 257,302</b> |



**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)****AS OF SEPTEMBER 30, 2011****(DOLLAR AMOUNTS IN THOUSANDS)**

| <b>Company<sup>(A)</sup></b>               | <b>Industry</b>                                 | <b>Investment<sup>(B)</sup></b>   | <b>Principal</b>                        | <b>Cost</b>                             | <b>Fair Value</b>   |
|--|---|---|---|---|---------------------|
| <b>CONTROL INVESTMENTS</b>                 |   |   |   |   |                     |
| BERTL, Inc.                                | Service-web-based evaluator of imaging products | Line of Credit, \$6 available (6.4%, Due 10/2011) <sup>(F) (H)</sup><br>Common Stock (100 shares) <sup>(F) (G)</sup>  | \$ 1,427                                | \$ 1,355<br>424                         | \$                  |
| Defiance Integrated Technologies, Inc.     | Manufacturing-trucking parts                    | Senior Term Debt (11.0%, Due 4/2013) <sup>(C) (F)</sup><br>Common Stock (15,500 shares) <sup>(F) (G)</sup>  | 7,505                                   | 7,505<br>1                              | 7,505<br>7,534      |
| Kansas Cable Holdings, Inc. <sup>(J)</sup> | Service - cable, internet, voice provider       | Line of Credit, \$179 available (10.0%, Due 10/2012) <sup>(H)</sup><br>Senior Term Debt (10.0%, Due 10/2012) <sup>(F) (H)</sup><br>Senior Term Debt (10.0%, Due 10/2012) <sup>(F) (H)</sup><br>Common Stock (100 shares) <sup>(F) (G)</sup>   | 346<br>1,500<br>1,039                   | 337<br>1,444<br>1,000                   | 14<br>60<br>42      |
| Lindmark Acquisition, LLC                  | Service-advertising                             | Senior Subordinated Term Debt (11.0%, Due 10/2012) <sup>(D) (H)</sup><br>Senior Subordinated Term Debt (13.0%, Due 10/2012) <sup>(D) (H)</sup><br>Senior Subordinated Term Debt (13.0%, Due Upon Demand) <sup>(D) (H)</sup><br>Common Stock (100 shares) <sup>(F) (G)</sup>   | 10,000<br>2,000<br>1,908                | 10,000<br>2,000<br>1,908<br>317         | 2,000<br>400<br>383 |
| LocalTel, LLC <sup>(K)</sup>               | Service-yellow pages publishing                 | Line of credit, \$2 available (10.0%, Due 12/2011) <sup>(F) (H)</sup><br>Line of Credit, \$1,830 available (4.7%, Due 6/2012) <sup>(F) (H)</sup><br>Senior Term Debt (12.5%, Due 2/2012) <sup>(F) (H)</sup><br>Senior Term Debt (8.5%, Due 6/2012) <sup>(F) (H)</sup><br>Senior Term Debt (10.5%, Due 6/2012) <sup>(C) (F) (H)</sup><br>Common Stock Warrants (4,000 shares) <sup>(F) (G)</sup> | 1,848<br>1,170<br>325<br>2,688<br>2,750 | 1,848<br>1,170<br>325<br>2,688<br>2,750 | 734                 |





**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)****AS OF SEPTEMBER 30, 2011****(DOLLAR AMOUNTS IN THOUSANDS)**

| <b>Company<sup>(A)</sup></b>            | <b>Industry</b>                                  | <b>Investment<sup>(B)</sup></b>   | <b>Principal</b>  | <b>Cost</b>       | <b>Fair Value</b> |
|---|--|---|-------------------|-------------------|-------------------|
| Midwest Metal Distribution, Inc.        | Distribution-aluminum sheets and stainless steel | Senior Subordinated Term Debt (12.0%, Due 7/2013) <sup>(D)</sup>                        | \$ 18,281         | \$ 18,262         | \$ 17,184         |
|   |  | Common Stock (501 shares) <sup>(F)(G)</sup>   |                   | 138               |                   |
| Sunshine Media Holdings <sup>(L)</sup>  | Service-publisher regional B2B trade magazines   | Line of credit, \$1,100 available (10.5%, Due 8/2014) <sup>(D)</sup>                    | 900               | 900               | 270               |
|   |  | Senior Term Debt (10.5%, Due 5/2016) <sup>(D)</sup>                                     | 16,948            | 16,948            | 5,084             |
|   |  | Senior Term Debt (5.0%, Due 5/2016) <sup>(C)(D)</sup>                                   | 10,700            | 10,700            | 3,210             |
|   |  | Junior Preferred Equity (6,689 shares) <sup>(F)(G)</sup>                                |                   | 2,475             |                   |
|   |  | Common Stock (934 shares) <sup>(F)(G)</sup>   |                   | 740               |                   |
| U.S. Healthcare Communications, Inc.    | Service-magazine publisher/operator              | Line of credit, \$131 available (6.0%, Due 12/2010) <sup>(F)(H)</sup>                   | 269               | 269               |                   |
|   |  | Line of credit, \$0 available (6.0%, Due 12/2010) <sup>(F)(H)</sup>                     | 450               | 450               |                   |
|   |  | Common Stock (100 shares) <sup>(F)(G)</sup>   |                   | 2,470             |                   |
| Viapack, Inc. <sup>(M)</sup>            | Manufacturing-polyethylene film                  | Line of Credit, \$900 available (10.0%, Due 3/2013) <sup>(D)</sup>                      | 1,600             | 1,600             | 320               |
|   |  | Senior Real Estate Term Debt (10.0%, Due 3/2014) <sup>(D)</sup>                         | 600               | 600               | 120               |
|   |  | Senior Term Debt (13.0%, Due 3/2014) <sup>(C)(D)</sup>                                  | 3,925             | 3,925             | 785               |
|   |  | Preferred Equity (100 shares) <sup>(F)(G)</sup>   |                   |                   |                   |
|   |  | <b>Total Control Investments (represented 15.1% of total investments at fair value)</b> |                   |                   | <b>\$ 94,549</b>  |
| <b>Total Investments <sup>(N)</sup></b> |  |   | <b>\$ 382,815</b> | <b>\$ 302,947</b> |                   |

<sup>(A)</sup> Certain of the securities listed in the above chart are issued by affiliate(s) of the indicated portfolio company.

<sup>(B)</sup> Percentage represents interest rates in effect at September 30, 2011, and due date represents the contractual maturity date.

<sup>(C)</sup> Last Out Tranche ( LOT ) of senior debt, meaning if the portfolio company is liquidated, the holder of the LOT is paid after the senior debt.

<sup>(D)</sup> Fair value was primarily based on opinions of value submitted by Standard & Poor's Securities Evaluations, Inc.

<sup>(E)</sup> Security valued based on the indicative bid price on or near September 30, 2011, offered by the respective syndication agent's trading desk or secondary desk.

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**GLADSTONE CAPITAL CORPORATION**

**CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)**

**AS OF SEPTEMBER 30, 2011**

**(DOLLAR AMOUNTS IN THOUSANDS)**

- (F) Fair value was primarily based on the total enterprise value of the portfolio company using a liquidity waterfall approach. The Company also considered discounted cash flow methodologies.
- (G) Security is non-income producing.
- (H) Debt security is on non-accrual status.
- (I) In November 2011, the Company invested \$1.6 million in Ohana Media Group ( Ohana ) in order for it to purchase certain of KMBQ Corporation s ( KMBQ ) assets out of receivership. In connection with this transaction, the Company recorded a partial realized loss in the quarter ending December 31, 2011. Ohana replaces KMBQ on the Company s *Schedule of Investments* as a Non-Control/Non-Affiliate portfolio Company in the quarter ending December 31, 2011.
- (J) In August 2011, the Company restructured its loan to SCI Cable, Inc. ( SCI ) through a UCC Article 9 sale, resulting in a new control entity, Kansas Cable Holdings, Inc., obtaining certain of the assets of SCI. This resulted in a realized loss of \$1.3 million. Kansas Cable Holdings, Inc. replaces SCI on the accompanying *Schedule of Investments* and remains on non-accrual status as of the date of this filing.
- (K) Subsequent to September 30, 2011, the Company entered into an allonge to its revolving promissory note with LocalTel, LLC whereby the maximum principal amount was increased by \$0.5 million and the maturity date was changed from December 31, 2011 to June 15, 2012.
- (L) In January 2011, the Company purchased common stock for \$1.5 million from existing shareholders of Sunshine Media Holdings, which resulted in the Company attaining a controlling interest. This purchase resulted in reclassifying the investment from Non-Control/Non-Affiliate to Control during the quarter ended March 31, 2011. Additionally, the Company has extended \$1.3 million through revolver draws since January 2011 to Sunshine Media Holdings through September 30, 2011.
- (M) In July 2011, the Company increased its investment in Viapack, Inc., by adding a line of credit facility and also purchasing preferred equity in Viapack, Inc.; thereby giving the Company a controlling interest. This purchase resulted in reclassifying the investment from Non-Control/Non-Affiliate to Control during the quarter ended September 30, 2011.
- (N) Cumulative gross unrealized depreciation for federal income tax purposes is \$88,670; cumulative gross unrealized appreciation for federal income tax purposes is \$8,566. Cumulative net unrealized depreciation is \$80,104 based on a tax cost of \$383,052.

*THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.*

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**GLADSTONE CAPITAL CORPORATION**  
**CONSOLIDATED SCHEDULE OF INVESTMENTS**

**SEPTEMBER 30, 2010**

**(DOLLAR AMOUNTS IN THOUSANDS)**

| Company <sup>(A)</sup>                       | Industry   | Investment <sup>(B)</sup>   | Principal      | Cost           | Fair Value     |
|--|--|---|----------------|----------------|----------------|
| <b>NON-CONTROL/NON-AFFILIATE INVESTMENTS</b> |  |   |                |                |                |
| Non-syndicated Loans:                        |  |   |                |                |                |
| Access Television Network, Inc.              | Service-cable airtime (infomercials)               | Senior Term Debt (14.0%, Due 12/2011) <sup>(E)</sup>  | \$ 963         | \$ 963         | \$ 809         |
| Allison Publications, LLC                    | Service-publisher of consumer oriented magazines   | Senior Term Debt (10.5%, Due 9/2012) <sup>(E)</sup><br>Senior Term Debt (13.0%, Due 12/2010) <sup>(E)</sup>   | 9,064<br>65    | 9,094<br>65    | 8,543<br>64    |
| BAS Broadcasting                             | Service-radio station operator                     | Senior Term Debt (11.5%, Due 7/2013) <sup>(E)</sup>   | 7,465          | 7,465          | 6,644          |
| Chinese Yellow Pages Company                 | Service-publisher of Chinese language directories  | Line of Credit, \$250 available (7.3%, Due 11/2010) <sup>(E)</sup><br>Senior Term Debt (7.3%, Due 11/2010) <sup>(E)</sup>   | 450<br>333     | 450<br>333     | 428<br>317     |
| CMI Acquisition, LLC                         | Service-recycling                                  | Senior Subordinated Term Debt (10.3%, Due 11/2012) <sup>(E)</sup>   | 5,972          | 5,972          | 5,868          |
| FedCap Partners, LLC                         | Private equity fund                                | Class A Membership Units <sup>(H)</sup> (80 units)<br>Uncalled Capital Commitment (\$1,600)   |                | 400            | 400            |
| Finn Corporation                             | Manufacturing-landscape equipment                  | Common Stock Warrants (33,000 shares) <sup>(G)(H)</sup>   |                | 37             | 284            |
| GFRC Holdings LLC                            | Manufacturing-glass-fiber reinforced concrete      | Senior Term Debt (11.5%, Due 12/2012) <sup>(E)</sup><br>Senior Subordinated Term Debt (14.0%, Due 12/2012) <sup>(C)(E)</sup>  | 6,111<br>6,632 | 6,111<br>6,632 | 6,004<br>6,450 |
| Global Materials Technologies, Inc.          | Manufacturing-steel wool products and metal fibers | Senior Term Debt (13.0%, Due 6/2012) <sup>(C)(E)</sup>  | 3,560          | 3,560          | 2,937          |
| Heartland Communications Group               | Service-radio station operator                     | Line of Credit, \$100 available (8.5%, Due 3/2013)<br>Line of Credit, \$100 available (8.5%, Due 3/2013)<br>Senior Term Debt (8.5%, Due 3/2013) <sup>(E)</sup><br>Common Stock Warrants (8.75%) <sup>(G)(H)</sup> | 4,342          | 4,301<br>66    | 2,519          |



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**GLADSTONE CAPITAL CORPORATION**  
**CONSOLIDATED SCHEDULE OF INVESTMENTS**

**SEPTEMBER 30, 2010**

**(DOLLAR AMOUNTS IN THOUSANDS)**

| Company <sup>(A)</sup>                                 | Industry  | Investment <sup>(B)</sup>  | Principal | Cost     | Fair Value |
|--|---|--|-----------|----------|------------|
| Interfilm Holdings, Inc.                               | Service-slitter and distributor of plastic films              | Senior Term Debt (12.3%, Due 10/2012) <sup>(E)</sup>   | \$ 2,400  | \$ 2,400 | \$ 2,382   |
| International Junior Golf Training Acquisition Company | Service-golf training   | Line of Credit, \$1,500 available (9.0%, Due 5/2011) <sup>(E)</sup><br>Senior Term Debt (8.5%, Due 5/2012) <sup>(E)</sup><br>Senior Term Debt (10.5%, Due 5/2012) <sup>(C) (E)</sup>   | 1,557     | 1,557    | 1,537      |
| KMBQ Corporation                                       | Service-AM/FM radio broadcaster                               | Line of Credit, \$39 available (12.3%, Due 7/2010) <sup>(E) (I)</sup><br>Senior Term Debt (12.3%, Due 7/2010) <sup>(E) (I)</sup>   | 161       | 161      | 16         |
| Legend Communications of Wyoming LLC                   | Service-operator of radio stations                            | Senior Term Debt (12.0%, Due 6/2013) <sup>(E)</sup>  | 9,880     | 9,880    | 6,422      |
| Newhall Holdings, Inc.                                 | Service-distributor of personal care products and supplements | Line of Credit, \$0 available (5.0%, Due 12/2012) <sup>(E)</sup><br>Senior Term Debt (5.0%, Due 12/2012) <sup>(E)</sup><br>Senior Term Debt (5.0%, Due 12/2012) <sup>(C) (E)</sup><br>Preferred Equity (1,000,000 shares) <sup>(G) (H)</sup><br>Common Stock (688,500 shares) <sup>(G) (H)</sup> | 1,350     | 1,350    | 1,269      |
| Northern Contours, Inc.                                | Manufacturing-veneer and laminate components                  | Senior Subordinated Term Debt (13.0%, Due 9/2012) <sup>(E)</sup>   | 6,301     | 6,301    | 5,765      |
| Northstar Broadband, LLC                               | Service-cable TV franchise owner                              | Senior Term Debt (0.7%, Due 12/2012) <sup>(E)</sup>  | 135       | 117      | 102        |
| Pinnacle Treatment Centers, Inc.                       | Service-Addiction treatment centers                           | Line of Credit, \$350 available (12.0%, Due 10/2010) <sup>(E)</sup><br>Senior Term Debt (10.5%, Due 12/2011) <sup>(E)</sup><br>Senior Term Debt (10.5%, Due 12/2011) <sup>(C) (E)</sup>  | 150       | 150      | 150        |
| Precision Acquisition Group Holdings, Inc.             | Manufacturing-consumable components for the Aluminum industry | Equipment Note (13.0%, Due 10/2010) <sup>(E)</sup><br>Senior Term Debt (13.0%, Due 10/2010) <sup>(E)</sup>   | 1,000     | 1,000    | 950        |
|  |   |  | 4,125     | 4,125    | 3,919      |

|  |       |       |       |
|--|-------|-------|-------|
| Senior Term Debt (13.0%, Due<br>10/2010) <sup>(C)</sup> <sup>(E)</sup> | 4,053 | 4,053 | 3,850 |
|--|-------|-------|-------|

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**GLADSTONE CAPITAL CORPORATION**  
**CONSOLIDATED SCHEDULE OF INVESTMENTS**

**SEPTEMBER 30, 2010**

**(DOLLAR AMOUNTS IN THOUSANDS)**

| Company <sup>(A)</sup>                    | Industry   | Investment <sup>(B)</sup>  | Principal | Cost   | Fair Value |
|---|--|--|-----------|--------|------------|
| PROFITSystems Acquisition Co.             | Service-design and develop ERP software  | Line of Credit, \$350 available (4.5%, Due 7/2011)                   | \$        | \$     | \$         |
|   |  | Senior Term Debt (8.5%, Due 7/2011) <sup>(E)</sup>                   | 1,000     | 1,000  | 940        |
|   |  | Senior Term Debt (10.5%, Due 7/2011) <sup>(C) (E)</sup>              | 2,900     | 2,900  | 2,697      |
| RCS Management Holding Co.                | Service-healthcare supplies  | Senior Term Debt (9.5%, Due 1/2011) <sup>(C) (E)</sup>               | 1,937     | 1,937  | 1,918      |
|   |  | Senior Term Debt (11.5%, Due 1/2011) <sup>(D) (E)</sup>              | 3,060     | 3,060  | 3,029      |
| Reliable Biopharmaceutical Holdings, Inc. | Manufacturing-pharmaceutical and   | Line of Credit, \$3,800 available (9.0%, Due 10/2010) <sup>(E)</sup> | 1,200     | 1,200  | 1,188      |
|   |  | biochemical intermediates  |           |        |            |
|   | Mortgage Note (9.5%, Due 10/2014) <sup>(E)</sup>   | 7,256  | 7,255     | 7,201  |            |
|   | Senior Term Debt (9.0%, Due 10/2012) <sup>(E)</sup>  | 1,080  | 1,080     | 1,069  |            |
|   | Senior Term Debt (11.0%, Due 10/2012) <sup>(C) (E)</sup>   | 11,693   | 11,693    | 11,386 |            |
|   | Senior Subordinated Term Debt (12.0%, Due 10/2013) <sup>(E)</sup><br>Common Stock Warrants (764 shares) <sup>(G) (H)</sup> | 6,000  | 6,000     | 5,730  |            |
|   |  |  |           | 209    |            |
| Saunders & Associates                     | Manufacturing-equipment provider for frequency control devices   | Senior Term Debt (9.8%, Due 5/2013) <sup>(E)</sup>                   | 8,947     | 8,947  | 8,935      |
| SCI Cable, Inc.                           | Service-cable, internet, voice provider  | Senior Term Debt (10.0%, Due 10/2012) <sup>(E) (I)</sup>             | 1,165     | 450    | 140        |
|   |  | Senior Term Debt (10.0%, Due 10/2012) <sup>(E) (I)</sup>             | 2,931     | 2,931  | 352        |
| Sunburst Media - Louisiana, LLC           | Service-radio station operator   | Senior Term Debt (10.5%, Due 6/2011) <sup>(E)</sup>                  | 6,375     | 6,391  | 5,100      |
| Sunshine Media Holdings                   | Service-publisher regional B2B trade magazines   | Line of credit, \$401 available (10.5%, Due 2/2011) <sup>(E)</sup>   | 1,599     | 1,599  | 1,499      |
|   |  | Senior Term Debt (10.5%, Due 5/2012) <sup>(E)</sup>                  | 16,948    | 16,948 | 15,889     |
|   |  | Senior Term Debt (13.3%, Due 5/2012) <sup>(C) (E)</sup>              | 10,700    | 10,700 | 9,898      |



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**GLADSTONE CAPITAL CORPORATION**  
**CONSOLIDATED SCHEDULE OF INVESTMENTS**

**SEPTEMBER 30, 2010**

**(DOLLAR AMOUNTS IN THOUSANDS)**

| Company <sup>(A)</sup>                      | Industry   | Investment <sup>(B)</sup>  | Principal | Cost      | Fair Value |
|---|--|--|-----------|-----------|------------|
| Thibaut Acquisition Co.                     | Service-design and distribute wall covering        | Line of Credit, \$0 available (9.0%, Due 1/2011) <sup>(E)</sup>  | \$ 1,000  | \$ 1,000  | \$ 970     |
|   |  | Senior Term Debt (8.5%, Due 1/2011) <sup>(E)</sup>               | 1,075     | 1,075     | 1,043      |
|   |  | Senior Term Debt (12.0%, Due 1/2011) <sup>(C) (E)</sup>          | 3,000     | 3,000     | 2,888      |
| Viapack, Inc.                               | Manufacturing-polyethylene film                    | Senior Real Estate Term Debt (10.0%, Due 3/2011) <sup>(E)</sup>  | 675       | 675       | 672        |
|   |  | Senior Term Debt (13.0%, Due 3/2011) <sup>(C) (E)</sup>          | 4,005     | 4,005     | 3,990      |
| Westlake Hardware, Inc.                     | Retail-hardware and variety                        | Senior Subordinated Term Debt (12.3%, Due 1/2014) <sup>(E)</sup> | 12,000    | 12,000    | 11,820     |
|   |  | Senior Subordinated Term Debt (13.5%, Due 1/2014) <sup>(E)</sup> | 8,000     | 8,000     | 7,800      |
| Winchester Electronics                      | Manufacturing-high bandwidth connectors and cables | Senior Term Debt (5.3%, Due 5/2012) <sup>(E)</sup>               | 1,250     | 1,250     | 1,244      |
|   |  | Senior Term Debt (6.0%, Due 5/2013) <sup>(E)</sup>               | 1,686     | 1,686     | 1,661      |
|   |  | Senior Subordinated Term Debt (14.0%, Due 6/2013) <sup>(E)</sup> | 9,875     | 9,875     | 9,603      |
| <i>Subtotal - Non-syndicated loans</i>      |  |  |           | \$225,798 | \$206,326  |
| Syndicated Loans:                           |  |  |           |           |            |
| Airvana Network Solutions, Inc              | Service-telecommunications                         | Senior Term Debt (11.0%, Due 8/2014) <sup>(F)</sup>              | 9,056     | 8,858     | 8,942      |
| Puerto Rico Cable Acquisition Company, Inc. | Service-telecommunications                         | Senior Subordinated Term Debt (7.9%, Due 1/2012) <sup>(F)</sup>  | 7,141     | 7,159     | 6,427      |
| WP Evenflo Group Holdings Inc.              | Manufacturing-infant and juvenile products         | Senior Term Debt (8.0%, Due 2/2013) <sup>(F)</sup>               | 1,881     | 1,881     | 1,655      |
|   |  | Senior Preferred Equity (333.3 shares) <sup>(G) (H)</sup>        |           | 333       | 379        |
|   |  | Junior Preferred Equity (111.1 shares) <sup>(G) (H)</sup>        |           | 111       | 8          |
|   |  | Common Stock (1,873.95 shares) <sup>(G) (H)</sup>                |           |           |            |
| <i>Subtotal - Syndicated loans</i>          |  |  |           | \$ 18,342 | \$ 17,411  |

|   |                   |                   |
|---|-------------------|-------------------|
| <b>Total Non-Control/Non-Affiliate Investments (represented 87% of total investments at fair value)</b> | <b>\$ 244,140</b> | <b>\$ 223,737</b> |
|---|-------------------|-------------------|

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**GLADSTONE CAPITAL CORPORATION**  
**CONSOLIDATED SCHEDULE OF INVESTMENTS**

**SEPTEMBER 30, 2010**

**(DOLLAR AMOUNTS IN THOUSANDS)**

| Company <sup>(A)</sup>                 | Industry   | Investment <sup>(B)</sup>   | Principal                               | Cost                                    | Fair Value            |
|--|--|---|---|---|-----------------------|
| <b>CONTROL INVESTMENTS</b>             |  |   |   |   |                       |
| BERTL, Inc.                            | Service-web-based evaluator of imaging products  | Line of Credit, \$345 available (6.5%, Due 10/2010) <sup>(G) (I)</sup><br>Common Stock (100 shares) <sup>(G) (H)</sup>  | \$ 1,276                                | \$ 1,319<br>424                         | \$                    |
| Defiance Integrated Technologies, Inc. | Manufacturing-trucking parts                     | Senior Term Debt (11.0%, Due 4/2013) <sup>(C) (E)</sup><br>Common Stock (15,500 shares) <sup>(G) (H)</sup><br>Guaranty (\$250)  | 8,325                                   | 8,325<br>1                              | 8,325<br>1,543        |
| Lindmark Acquisition, LLC              | Service-advertising                              | Senior Subordinated Term Debt (11.0%, Due 10/2012) <sup>(E) (I)</sup><br>Senior Subordinated Term Debt (13.0%, Due 12/2010) <sup>(E) (I)</sup><br>Senior Subordinated Term Debt (13.0%, Due Upon Demand) <sup>(E) (I)</sup><br>Common Stock (100 shares) <sup>(G) (H)</sup>   | 10,000<br>2,000<br>1,794                | 10,000<br>2,000<br>1,794<br>1           | 5,000<br>1,000<br>897 |
| LocalTel, LLC                          | Service-yellow pages publishing                  | Line of credit, \$152 available (10.0%, Due 12/2010) <sup>(G) (I)</sup><br>Line of Credit, \$1,830 available (4.8%, Due 6/2011) <sup>(G) (I)</sup><br>Senior Term Debt (12.5%, Due 2/2012) <sup>(G) (I)</sup><br>Senior Term Debt (8.5%, Due 6/2011) <sup>(G) (I)</sup><br>Senior Term Debt (10.5%, Due 6/2011) <sup>(C) (G) (I)</sup><br>Common Stock Warrants (4,000 shares) <sup>(G) (H)</sup> | 1,698<br>1,170<br>325<br>2,688<br>2,750 | 1,698<br>1,170<br>325<br>2,688<br>2,750 | 1,063                 |
| Midwest Metal Distribution, Inc.       | Distribution-aluminum sheets and stainless steel | Senior Subordinated Term Debt (12.0%, Due 7/2013) <sup>(E)</sup><br>Common Stock (501 shares) <sup>(G) (H)</sup>  | 18,281                                  | 18,254<br>138                           | 15,539                |

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**GLADSTONE CAPITAL CORPORATION**  
**CONSOLIDATED SCHEDULE OF INVESTMENTS**

**SEPTEMBER 30, 2010**

**(DOLLAR AMOUNTS IN THOUSANDS)**

| Company <sup>(A)</sup>  | Industry                            | Investment <sup>(B)</sup>  | Principal | Cost              | Fair Value        |
|---|-------------------------------------|--|-----------|-------------------|-------------------|
| U.S. Healthcare Communications, Inc.  | Service-magazine publisher/operator | Line of credit, \$131 available (6.0%, Due 12/2010) <sup>(G) (I)</sup> | \$ 269    | \$ 269            | \$ 5              |
|   |                                     | Line of credit, \$0 available (6.0%, Due 12/2010) <sup>(G) (I)</sup>   | 450       | 450               |                   |
|   |                                     | Common Stock (100 shares) <sup>(G) (H)</sup>                           |           | 2,470             |                   |
| <b>Total Control Investments (represented 13% of total investments at fair value)</b> |                                     |  |           | <b>\$ 54,076</b>  | <b>\$ 33,372</b>  |
| <b>Total Investments <sup>(J)</sup></b>   |                                     |  |           | <b>\$ 298,216</b> | <b>\$ 257,109</b> |

(A) Certain of the securities listed in the chart above are issued by affiliate(s) of the indicated portfolio company.

(B) Percentage represents interest rates in effect at September 30, 2010, and due date represents the contractual maturity date.

(C) LOT of senior debt, meaning if the portfolio company is liquidated, the holder of the LOT is paid after the senior debt.

(D) LOT of senior debt, meaning if the portfolio company is liquidated, the holder of the LOT is paid after the senior debt; however, the debt is also junior to another LOT.

(E) Fair value was primarily based on opinions of value submitted by Standard & Poor's Securities Evaluations, Inc.

(F) Security valued based on the indicative bid price on or near September 30, 2010, offered by the respective syndication agent's trading desk or secondary desk.

(G) Fair value was primarily based on the total enterprise value of the portfolio company using a liquidity waterfall approach. The Company also considered discounted cash flow methodologies.

(H) Security is non-income producing.

(I) Debt security is on non-accrual status.

(J) Aggregate gross unrealized depreciation for federal income tax purposes is \$1,919; aggregate gross unrealized appreciation for federal income tax purposes is \$43,023. Net unrealized depreciation is \$41,104 based on a tax cost of \$298,186.

*THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.*

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**GLADSTONE CAPITAL CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2011**

**(DOLLAR AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA AND AS OTHERWISE INDICATED)**

**NOTE 1. ORGANIZATION**

Gladstone Capital Corporation (the Company) was incorporated under the General Corporation Laws of the State of Maryland on May 30, 2001 and completed an initial public offering on August 23, 2001. The Company is a closed-end, non-diversified management investment company that has elected to be treated as a business development company (BDC) under the Investment Company Act of 1940, as amended (the 1940 Act). In addition, the Company has elected to be treated for tax purposes as a regulated investment company (RIC) under the Internal Revenue Code of 1986, as amended (the Code). The Company's investment objectives are to achieve a high level of current income by investing in debt securities, consisting primarily of senior notes, senior subordinated notes and junior subordinated notes, of established private businesses that are substantially owned by leveraged buyout funds, individual investors or are family-owned businesses, with a particular focus on senior notes. In addition, the Company may acquire from others existing loans that meet this profile.

Gladstone Business Loan, LLC (Business Loan), a wholly-owned subsidiary of the Company, was established on February 3, 2003 for the sole purpose of owning the Company's portfolio of investments in connection with its line of credit.

Gladstone Financial Corporation (Gladstone Financial), a wholly-owned subsidiary of the Company, was established on November 21, 2006 for the purpose of holding a license to operate as a Specialized Small Business Investment Company. Gladstone Financial (previously known as Gladstone SSBIC Corporation) acquired this license in February 2007. The license enables the Company, through this subsidiary, to make investments in accordance with the United States Small Business Administration guidelines for specialized small business investment companies.

The financial statements of the subsidiaries are consolidated with those of the Company.

The Company is externally managed by Gladstone Management Corporation (the Adviser), an unconsolidated affiliate of the Company.

**NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

*Basis of Presentation*

These *Consolidated Financial Statements* and the accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America and conform to Regulation S-X under the Securities Exchange Act of 1934, as amended. Management believes it has made all necessary adjustments so that the *Consolidated Financial Statements* are presented fairly and that all such adjustments are of a normal recurring nature. The accompanying *Consolidated Financial Statements* include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

*Reclassifications*

Certain amounts in the prior year's financial statements have been reclassified to conform to the presentation for the year ended September 30, 2011 with no effect to net (decrease) increase in net assets resulting from operations.

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### *Consolidation*

Under Article 6 of Regulation S-X under the Securities Act of 1933, as amended, and the authoritative accounting guidance provided by the AICPA Audit and Accounting Guide for Investment Companies, the Company is not permitted to consolidate any subsidiary or other entity that is not an investment company, (including those in which the Company has a controlling interest).

### *Use of Estimates*

Preparing financial statements requires management to make estimates and assumptions that affect the amounts reported in the *Consolidated Financial Statements* and accompanying notes. Actual results may differ from those estimates.

### *Cash*

Cash is carried at cost, which approximates fair value. The Company places its cash with financial institutions, and at times, cash held in checking accounts may exceed the Federal Deposit Insurance Corporation insured limit. The Company seeks to mitigate this risk by depositing funds with major financial institutions.

### *Classification of Investments*

In accordance with the federal securities laws, the Company classifies portfolio investments on its *Consolidated Statements of Assets and Liabilities*, its *Consolidated Statements of Operations* and its *Consolidated Schedules of Investments* into the following categories:

**Control Investments** Control investments are generally those in which the Company owns more than 25% of the voting securities or has greater than 50% representation on the board of directors;

**Affiliate Investments** Affiliate investments are generally those in which the Company owns between 5% and 25% of the voting securities and has less than 50% representation on the board of directors, or is otherwise deemed to be an affiliate of the Company under the 1940 Act; and

**Non-Control/Non-Affiliate Investments** Non-Control/Non-Affiliate investments are generally those in which the Company owns less than 5% of the voting securities.

### *Investment Valuation Policy*

The Company carries its investments at fair value to the extent that market quotations are readily available and reliable, and otherwise at fair value, as determined in good faith by its Board of Directors. In determining the fair value of the Company's investments, the Adviser has established an investment valuation policy (the Policy). The Policy has been approved by the Company's Board of Directors, and each quarter the Board of Directors reviews whether the Adviser has applied the Policy consistently and votes whether or not to accept the recommended valuation of the Company's investment portfolio.

The Company uses generally accepted valuation techniques to value its portfolio unless the Company has specific information about the value of an investment to determine otherwise. From time to time, the Company may accept an appraisal of a business in which the Company holds securities. These appraisals are expensive and occur infrequently but provide a third-party valuation opinion that may differ in results, techniques and scopes used to value the Company's investments. When these specific third-party appraisals are engaged or accepted, the Company uses estimates of value provided by such appraisals and its own assumptions, including estimated remaining life, current market yield and interest rate spreads of similar securities as of the measurement date, to value the investment the Company has in that business.

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The Policy, summarized below, applies to publicly-traded securities, securities for which a limited market exists, and securities for which no market exists.

**Publicly-traded securities:** The Company determines the value of publicly-traded securities based on the closing price for the security on the exchange or securities market on which it is listed and primarily traded on the valuation date. To the extent that the Company owns restricted securities that are not freely tradable, but for which a public market otherwise exists, the Company will use the market value of that security adjusted for any decrease in value resulting from the restrictive feature.

**Securities for which a limited market exists:** The Company values securities that are not traded on an established secondary securities market, but for which a limited market for the security exists, such as certain participations in, or assignments of, syndicated loans, at the quoted bid price. In valuing these assets, the Company assesses trading activity in an asset class and evaluates variances in prices and other market insights to determine if any available quote prices are reliable. If the Company concludes that quotes based on active markets or trading activity may be relied upon, firm bid prices are requested; however, if a firm bid price is unavailable, the Company bases the value of the security upon the indicative bid price ( IBP ) offered by the respective originating syndication agent's trading desk, or secondary desk, on or near the valuation date. To the extent that the Company uses the IBP as a basis for valuing the security, the Adviser may take further steps to consider additional information to validate that price in accordance with the Policy.

In the event these limited markets become illiquid such that market prices are no longer readily available, the Company will value its syndicated loans using alternative methods, such as estimated net present values of the future cash flows or discounted cash flows ( DCF ). The use of a DCF methodology follows that prescribed by the Financial Accounting Standards Board ( FASB ) Accounting Standards Codification ( ASC ) 820, Fair Value Measurements and Disclosures, which provides guidance on the use of a reporting entity's own assumptions about future cash flows and risk-adjusted discount rates when relevant observable inputs, such as quotes in active markets, are not available. When relevant observable market data does not exist, the alternative outlined in ASC 820 is the valuation of investments based on DCF. For the purposes of using DCF to provide fair value estimates, the Company considers multiple inputs such as a risk-adjusted discount rate that incorporates adjustments that market participants would make both for nonperformance and liquidity risks. As such, the Company develops a modified discount rate approach that incorporates risk premiums including, among others, increased probability of default, or higher loss given default or increased liquidity risk. The DCF valuations applied to the syndicated loans provide an estimate of what the Company believes a market participant would pay to purchase a syndicated loan in an active market, thereby establishing a fair value. The Company will apply the DCF methodology in illiquid markets until quoted prices are available or are deemed reliable based on trading activity.

As of September 30, 2011, the Company determined that the indicative bid prices were reliable indicators of fair value. However, because of the private nature of this marketplace (meaning actual transactions are not publicly reported), the Company determined that these valuation inputs were classified as Level 3 within the fair value hierarchy as defined in ASC 820.

**Securities for which no market exists:** The valuation methodology for securities for which no market exists falls into three categories: (A) portfolio investments comprised solely of debt securities; (B) portfolio investments in controlled companies comprised of a bundle of securities, which can include debt and equity securities; (C) portfolio investments in non-controlled companies comprised of a bundle of investments, which can include debt and equity securities; and (D) portfolio investments comprised of non-publicly-traded non-control equity securities of other funds.

**(A) Portfolio investments comprised solely of debt securities:** Debt securities that are not publicly-traded on an established securities market, or for which a limited market does not exist ( Non-Public Debt Securities ), and that are issued by portfolio companies where the Company has no equity or equity-like

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securities, are fair valued in accordance with the terms of the Policy, which utilizes opinions of value submitted to the Company by Standard & Poor's Securities Evaluations, Inc. ( SPSE ). The Company may also submit paid in kind ( PIK ) interest to SPSE for its evaluation when it is determined that PIK interest is likely to be received.

**(B) Portfolio investments in controlled companies comprised of a bundle of investments, which can include debt and equity securities:**

The fair value of these investments is determined based on the total enterprise value ( TEV ) of the portfolio company, or issuer, utilizing a liquidity waterfall approach under ASC 820 for the Company's Non-Public Debt Securities and equity or equity-like securities (e.g. preferred equity, common equity, or other equity-like securities) that are purchased together as part of a package, where the Company has control or could gain control through an option or warrant security; both the debt and equity securities of the portfolio investment would exit in the mergers and acquisition market as the principal market, generally through a sale or recapitalization of the portfolio company. In accordance with ASC 820, the Company applies the in-use premise of value which assumes the debt and equity securities are sold together. Under this liquidity waterfall approach, the Company first calculates the TEV of the issuer by incorporating some or all of the following factors to determine the TEV of the issuer:

the issuer's ability to make payments;

the earnings of the issuer;

recent sales to third parties of similar securities;

the comparison to publicly-traded securities; and

DCF or other pertinent factors.

In gathering the sales to third parties of similar securities, the Company may reference industry statistics and use outside experts. Once the Company has estimated the TEV of the issuer, the Company will subtract the value of all the debt securities of the issuer, which are valued at the contractual principal balance. Fair values of these debt securities are discounted for any shortfall of TEV over the total debt outstanding for the issuer. Once the values for all outstanding senior securities (which include the debt securities) have been subtracted from the TEV of the issuer, the remaining amount, if any, is used to determine the value of the issuer's equity or equity-like securities. If, in the Adviser's judgment, the liquidity waterfall approach does not accurately reflect the value of the debt component, the Adviser may recommend that the Company use a valuation by SPSE, or if that is unavailable, a DCF valuation technique.

**(C) Portfolio investments in non-controlled companies comprised of a bundle of investments, which can include debt and equity securities:**

The Company values Non-Public Debt Securities that are purchased together with equity or equity-like securities from the same portfolio company, or issuer, for which the Company does not control or cannot gain control as of the measurement date, using a hypothetical secondary market as the Company's principal market. In accordance with ASC 820, the Company determines its fair value of these debt securities of non-control investments assuming the sale of an individual debt security using the in-exchange premise of value. As such, the Company estimates the fair value of the debt component using estimates of value provided by SPSE and its own assumptions in the absence of observable market data, including synthetic credit ratings, estimated remaining life, current market yield and interest rate spreads of similar securities as of the measurement date. Subsequent to June 30, 2009, for equity or equity-like securities of investments for which the Company does not control or cannot gain control as of the measurement date, the Company estimates the fair value of the equity using the in-exchange premise of value based on factors such as the overall value of the issuer, the relative fair value of other units of account including debt, or other relative value approaches. Consideration is also given to capital structure and other contractual obligations that may impact the fair value of the equity. Further, the Company may utilize comparable values of similar companies, recent investments and indices with similar structures and risk characteristics or its own assumptions in the absence of other observable market data and may also employ DCF valuation techniques.





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**(D) Portfolio investments comprised of non-publicly-traded non-control equity securities of other funds:** The Company values any uninvested capital of the non-control fund at par value and values any invested capital at the value provided by the non-control fund. Due to the uncertainty inherent in the valuation process, such estimates of fair value may differ significantly from the values that would have been obtained had a ready market for the securities existed, and the differences could be material. Additionally, changes in the market environment and other events that may occur over the life of the investments may cause the gains or losses ultimately realized on these investments to be different than the valuations currently assigned. There is no single standard for determining fair value in good faith, as fair value depends upon circumstances of each individual case. In general, fair value is the amount that the Company might reasonably expect to receive upon the current sale of the security in an orderly transaction between market participants at the measurement date.

Refer to Note 3 for additional information regarding fair value measurements and the Company's application of ASC 820.

*Interest Income Recognition*

Interest income, adjusted for amortization of premiums and acquisition costs, the accretion of discounts and the amortization of amendment fees, is recorded on the accrual basis to the extent that such amounts are expected to be collected. Generally, when a loan becomes 90 days or more past due or if the Company's qualitative assessment indicates that the debtor is unable to service its debt or other obligations, the Company will place the loan on non-accrual status and cease recognizing interest income on that loan until the borrower has demonstrated the ability and intent to pay contractual amounts due. However, the Company remains contractually entitled to this interest. Interest payments received on non-accrual loans may be recognized as income or applied to the cost basis, depending upon management's judgment. Non-accrual loans are restored to accrual status when past due principal and interest are paid and, in management's judgment, are likely to remain current, or due to a restructuring such that the interest income is deemed to be collectible. At September 30, 2011, three Non-Control/Non-Affiliate investment and five Control investments were on non-accrual with an aggregate cost basis of approximately \$41.1 million, or 11.0% of the cost basis of all debt investments in the Company's portfolio, and an aggregate fair value of approximately \$5.3 million, or 1.8% of the fair value of all debt investments in the Company's portfolio. At September 30, 2010, two Non-Control/Non-Affiliate investments and four Control investments were on non-accrual with an aggregate cost basis of approximately \$29.9 million, or 10.2% of the cost basis of all debt investments in the Company's portfolio, and an aggregate fair value of approximately \$8.7 million, or 3.4% of the fair value of all debt investments in the Company's portfolio.

As of September 30, 2011, the Company had 27 original issue discount (OID) loans, primarily from the syndicated loans in its portfolio. The Company recorded OID income of \$0.2 million, \$21, and \$0.2 million for the fiscal years ended September 30, 2011, 2010 and 2009, respectively. The unamortized balance of OID investments as of September 30, 2011 and 2010 totaled \$1.5 million and \$0.3 million, respectively.

During the quarter ended June 30, 2011, our PIK investment was restructured and the PIK interest component was eliminated, therefore as of September 30, 2011, the Company had no investments that bore PIK interest. The PIK interest, computed at the contractual rate specified in each loan agreement, is added to the principal balance of the loan and recorded as income. To maintain the Company's status as a RIC, this non-cash source of income must be paid out to stockholders in the form of distributions, even though the Company has not yet collected the cash. The Company recorded PIK income of \$12, \$67 and \$166 for the fiscal years ended September 30, 2011, 2010 and 2009, respectively.

The Company also transfers past due interest to the principal balance as stipulated in certain loan amendments with portfolio companies. The Company transferred past due interest to the principal balance of \$0.2 million,

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\$1.2 million and \$1.5 million for the fiscal years ended September 30, 2011, 2010 and 2009, respectively. For the fiscal year ended September 30, 2010, the Company also rolled over past due interest to a portfolio company's principal balance of \$0.7 million, and then recorded an adjustment against that principal balance as a contra-investment since the loan was on non-accrual and the collectability of the additional principal was uncertain. As a result of a restructure, the Company reversed this contra-investment amount of \$0.7 million during 2011. These adjustments had no net impact to the *Consolidated Statements of Operations*.

### *Other Income*

Success fees are recorded upon receipt. Success fees are contractually due upon a change of control in a portfolio company and are recorded in other income in the *Consolidated Statements of Operations*. The Company recorded \$1.0 million of success fees during the year ended September 30, 2011, which resulted primarily from the exits of Pinnacle Treatment Centers, Inc. and Interfilm Holdings, Inc. and the prepayment of success fees from Westlake Hardware, Inc. During the year ended September 30, 2010, the Company received \$1.9 million in success fees from the exits of ActivStyle Acquisition Co., Anitox Acquisition Co., Saunders & Associates, Visual Edge Technology, Inc., Tulsa Welding School and the prepayment of success fees from Doe & Ingalls Management LLC and Northern Contours, Inc. During the year ended September 30, 2009, the Company received \$0.4 million in success fees from the prepayment of success fees from ActivStyle Acquisition Co. and Interfilm Holdings, Inc. and the exit from It's Just Lunch.

In addition, we received \$1.0 million from two legal settlements related to portfolio companies during the year ended September 30, 2011, that were recorded in other income.

### *Realized Gain or Loss and Unrealized Appreciation or Depreciation of Portfolio Investments*

Gains or losses on the sale of investments are calculated by using the specific identification method. Realized gain or loss is recognized at the trade date, typically when an investment is disposed of and is computed as the difference between the Company's cost basis in the investment at the disposition date and the net proceeds received from such disposition. Unrealized appreciation or depreciation displays the difference between the fair value of the investment and the cost basis of such investment. The Company must determine the fair value of each individual investment on a quarterly basis and record changes in fair value as unrealized appreciation or depreciation in its *Consolidated Statement of Operations*.

### *Costs Related to Shelf Registration Statements*

Costs related to shelf registration statement filings are recorded as prepaid assets. These expenses are charged as a reduction of capital upon issuance of securities; or upon expiration of the registration statement, charged to shelf offering expense, in accordance with ASC 946-20, Investment Company Activities.

### *Deferred Financing Fees*

Costs associated with the Company's line of credit are deferred and amortized over the life of the line of credit. These costs are amortized in the *Consolidated Statement of Operations* as amortization of deferred financing fees using the straight line method which approximates the effective interest method.

### *Related Party Costs*

The Company has entered into an investment advisory and management agreement (the *Advisory Agreement*) with the Adviser, which is controlled by the Company's chairman and chief executive officer. In accordance with the *Advisory Agreement*, the Company pays the Adviser fees as compensation for its services, consisting of a base management fee and an incentive fee. The Company has entered into an administration agreement (the *Administration Agreement*) with Gladstone Administration, LLC (the *Administrator*) whereby it pays

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separately for administrative services. These fees are accrued when the services are performed and generally paid one month in arrears. Refer to Note 4 for additional information regarding these related party costs and agreements.

### *Federal Income Taxes*

The Company intends to continue to qualify for treatment as a RIC under subchapter M of the Code, which generally allows it to avoid paying corporate income taxes on any income or gains that it distributes to the Company's stockholders. The Company has distributed and intends to continue to distribute sufficient distributions to eliminate taxable income. The Company may also be subject to federal excise tax if it does not distribute at least 98% of its ordinary income and 98% of its capital gain net income in a calendar year. Under the RIC Modernization Act, for excise tax years beginning January 1, 2011, the minimum distribution requirement for capital gains income has been raised to 98.2%.

ASC 740, *Income Taxes* requires the evaluation of tax positions taken or expected to be taken in the course of preparing the Company's tax returns to determine whether the tax positions are more-likely-than-not of being sustained by the applicable tax authorities. Tax positions not deemed to satisfy the more-likely-than-not threshold would be recorded as a tax benefit or expense in the current year. The Company has evaluated the implications of ASC 740, for all open tax years and in all major tax jurisdictions, and determined that there is no material impact on the *Consolidated Financial Statements*. The Company's federal tax returns for fiscal year 2009, 2010 and 2011 remain subject to examination by the Internal Revenue Service.

### *Distributions*

Distributions to stockholders are recorded on the ex-distribution date. The Company is required to pay out at least 90% of its ordinary income and short-term capital gains for each taxable year as a distribution to its stockholders in order to maintain its status as a RIC under Subtitle A, Chapter 1 of Subchapter M of the Code. It is the policy of the Company to pay out as a distribution up to 100% of those amounts. The amount to be paid out as a distribution is determined by the Board of Directors each quarter and is based on the annual earnings estimated by the management of the Company. Based on that estimate, a distribution is declared each quarter and is paid out monthly over the course of the respective quarter. At year-end, the Company elected to treat a portion of the first distribution paid after year-end as having been paid in the prior year, in accordance with Section 855(a) of the Code. Additionally, at year-end the Company may pay a bonus distribution, in addition to the monthly distributions, to ensure that it has paid out at least 90% of its ordinary income and short-term capital gains for the year. The Company typically retains long-term capital gains, if any, and does not pay them out as distributions. If the Company decides to retain long-term capital gains, the portion of the retained capital gains will be subject to a 35% tax.

### *Recent Accounting Pronouncements*

In May 2011, the FASB issued Accounting Standards Update No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*, (ASU 2011-04) which results in a consistent definition of fair value and common requirements for measurement of and disclosure about fair value between accounting principles generally accepted in the United States (GAAP) and IFRS. ASU 2011-04 is effective for interim and annual periods beginning after December 15, 2011. The adoption of ASU 2011-04 is not expected to materially impact the Company's financial statements.

**Table of Contents****NOTE 3. INVESTMENTS**

ASC 820 defines fair value, establishes a framework for measuring fair value and expands disclosures about assets and liabilities measured at fair value. ASC 820 provides a consistent definition of fair value that focuses on exit price in the principal, or most advantageous, market and prioritizes, within a measurement of fair value, the use of market-based inputs over entity-specific inputs. ASC 820 also establishes the following three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date.

Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets;

Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument. Level 2 inputs are in those markets for which there are few transactions, the prices are not current, little public information exists or instances where prices vary substantially over time or among brokered market makers; and

Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement. Unobservable inputs are those inputs that reflect the Company's own assumptions that market participants would use to price the asset or liability based upon the best available information.

As of September 30, 2011 and 2010, all of the Company's investments were valued using Level 3 inputs. The Company transfers investments in and out of Level 1, 2 and 3 securities as of the beginning balance sheet date, based on changes in the use of observable and unobservable inputs utilized to perform the valuation for the period. During the years ended September 30, 2011 and 2010, there were no transfers in or out of Level 1, 2 or 3.

The following tables present the investments carried at fair value as of September 30, 2011 and 2010, by caption on the accompanying *Consolidated Statements of Assets and Liabilities*, all of which are valued using level 3 inputs:

|  | <b>Level 3 Investments</b>                               |                   |
|--|--|-------------------|
|  | <b>Total Fair Value Reported in</b>                      |                   |
|  | <i>Consolidated Statements of Assets and Liabilities</i> |                   |
|  | <b>As of September 30,</b>                               |                   |
|  | <b>2011</b>  | <b>2010</b>       |
| <b>Non-Control/Non-Affiliate Investments</b> |  |                   |
| Senior Term Loans                            | \$ 182,002   | \$ 163,203        |
| Senior Subordinated Term Loans               | 72,182   | 59,463            |
| Preferred Equity                             | 566  | 387               |
| Common Equity/Equivalents                    | 2,552  | 684               |
| Total Non-Control/Non-Affiliate Investments  | \$ 257,302   | \$ 223,737        |
| <b>Control Investments</b>                   |  |                   |
| Senior Term Loans                            | \$ 18,143  | \$ 9,393          |
| Senior Subordinated Term Loans               | 19,966   | 22,436            |
| Common Equity/Equivalents                    | 7,536  | 1,543             |
| Total Control Investments                    | \$ 45,645  | \$ 33,372         |
| <b>Total Investments at Fair Value</b>       | <b>\$ 302,947</b>  | <b>\$ 257,109</b> |



**Table of Contents***Changes in Level 3 Fair Value Measurements*

The following tables provide a roll-forward in the changes in fair value during the year ended September 30, 2011 and 2010 for all investments for which the Company determines fair value using unobservable (Level 3) factors. When a determination is made to classify a financial instrument within Level 3 of the valuation hierarchy, the determination is based upon the significance of the unobservable factors to the overall fair value measurement. However, Level 3 financial instruments typically include, in addition to the unobservable or Level 3 components, observable components (that is, components that are actively quoted and can be validated to external sources). Accordingly, the gains and losses in the tables below include changes in fair value due in part to observable factors that are part of the valuation methodology.

**Fair value measurements using significant unobservable data inputs (Level 3)****Fiscal Year 2011:**

|   | Non-Control/<br>Non-Affiliate<br>Investments | Control<br>Investments | Total      |
|---|--|------------------------|------------|
| <b>Year ended September 30, 2011:</b>                               |  |                        |            |
| Fair value as of September 30, 2010                                 | \$ 223,737                                   | \$ 33,372              | \$ 257,109 |
| Total gains or losses   |  |                        |            |
| Realized losses <sup>(a)</sup>                                      | (1,119)                                      |                        | (1,119)    |
| Reversal of prior period depreciation on realization <sup>(b)</sup> | 3,969  |                        | 3,969      |
| Unrealized depreciation <sup>(b)</sup>                              | (25,332)                                     | (17,396)               | (42,728)   |
| New investments, repayments and settlements <sup>(c)</sup>          |  |                        |            |
| Issuances/New investments   | 125,895                                      | 10,575                 | 136,470    |
| Settlements/Repayments  | (43,054)                                     | (3,533)                | (46,587)   |
| Sales   | (3,427)                                      | (740)                  | (4,167)    |
| Transfers   | (23,367)                                     | 23,367                 |            |
| Fair value as of September 30, 2011                                 | \$ 257,302                                   | \$ 45,645              | \$ 302,947 |

|  | Senior<br>Term<br>Loans | Senior<br>Subordinated<br>Term Loans | Preferred<br>Equity | Common<br>Equity/<br>Equivalents | Total      |
|--|-------------------------|--------------------------------------|---------------------|----------------------------------|------------|
| <b>Year ended September 30, 2011:</b>  |                         |                                      |                     |                                  |            |
| Fair value as of September 30, 2010  | \$ 172,596              | \$ 81,899                            | \$ 386              | \$ 2,228                         | \$ 257,109 |
| Total gains or losses  |                         |                                      |                     |                                  |            |
| Realized losses <sup>(a)</sup>   | (1,105)                 | (14)                                 |                     |                                  | (1,119)    |
| Reversal of prior period depreciation (appreciation) on realization <sup>(b)</sup> | 3,485                   | 731                                  |                     | (247)                            | 3,969      |
| Unrealized (depreciation) appreciation <sup>(b)</sup>                              | (42,381)                | (3,639)                              | (2,295)             | 5,587                            | (42,728)   |
| New investments, repayments, and settlements, net <sup>(c)</sup>                   |                         |                                      |                     |                                  |            |
| Issuances/New investments  | 110,041                 | 20,657                               | 2,475               | 3,297                            | 136,470    |
| Settlements/Repayments   | (39,101)                | (7,486)                              |                     |                                  | (46,587)   |
| Sales  | (3,390)                 |                                      |                     | (777)                            | (4,167)    |
| Fair value as of September 30, 2011  | \$ 200,145              | \$ 92,148                            | \$ 566              | \$ 10,088                        | \$ 302,947 |





**Table of Contents****Fiscal Year 2010:**

|   | <b>Non-Control/<br/>Non-Affiliate<br/>Investments</b> | <b>Control<br/>Investments</b> | <b>Total</b> |
|---|---|--------------------------------|--------------|
| <b>Year ended September 30, 2010:</b>                               |   |                                |              |
| Fair value as of September 30, 2009                                 | \$ 286,997  | \$ 33,972                      | \$ 320,969   |
| Total gains or losses   |   |                                |              |
| Realized losses <sup>(a)</sup>                                      | (28)  | (2,865)                        | (2,893)      |
| Reversal of prior period depreciation on realization <sup>(b)</sup> | 3,546   | 2,865                          | 6,411        |
| Unrealized appreciation (depreciation) <sup>(b)</sup>               | 1,098   | (5,192)                        | (4,094)      |
| New investments, repayments and settlements <sup>(c)</sup>          |   |                                |              |
| Issuances/New investments   | 17,774  | 4,627                          | 22,401       |
| Settlements/Repayments  | (82,531)  | (35)                           | (82,566)     |
| Sales   | (3,119)   |                                | (3,119)      |
| Fair value as of September 30, 2010                                 | \$ 223,737  | \$ 33,372                      | \$ 257,109   |

|  | <b>Senior<br/>Term<br/>Loans</b> | <b>Senior<br/>Subordinated<br/>Term Loans</b> | <b>Preferred<br/>Equity</b> | <b>Common<br/>Equity/<br/>Equivalents</b> | <b>Total</b> |
|--|----------------------------------|---|-----------------------------|---|--------------|
| <b>Year ended September 30, 2010:</b>  |                                  |   |                             |   |              |
| Fair value as of September 30, 2009  | \$ 212,290                       | \$ 105,794                                    | \$                          | \$ 2,885                                  | \$ 320,969   |
| Total gains or losses  |                                  |   |                             |   |              |
| Realized (losses) gains <sup>(a)</sup>   | (2,104)                          | (571)   | (1,584)                     | 1,366                                     | (2,893)      |
| Reversal of prior period depreciation (appreciation) on realization <sup>(b)</sup> | 3,453                            | 1,620   | 1,584                       | (246)                                     | 6,411        |
| Unrealized (depreciation) appreciation <sup>(b)</sup>                              | (3,016)                          | (758)   | 386                         | (706)                                     | (4,094)      |
| New investments, repayments, and settlements, net <sup>(c)</sup>                   |                                  |   |                             |   |              |
| Issuances/New investments  | 19,551                           | 2,355   |                             | 495                                       | 22,401       |
| Settlements/Repayments   | (56,653)                         | (24,347)                                      |                             | (1,566)                                   | (82,566)     |
| Sales  | (925)                            | (2,194)                                       |                             |   | (3,119)      |
| Fair value as of September 30, 2010  | \$ 172,596                       | \$ 81,899                                     | \$ 386                      | \$ 2,228                                  | \$ 257,109   |

(a) Included in net realized loss on investments on the accompanying *Consolidated Statements of Operations* for the years ended September 30, 2011 and 2010.

(b) Included in net unrealized (depreciation) appreciation on investments on the accompanying *Consolidated Statements of Operations* for the years ended September 30, 2011 and 2010.

(c) Includes increases in the cost basis of investments resulting from new portfolio investments, the amortization of discounts, premiums and closing fees as well as decreases in the cost basis of investments resulting from principal repayments or sales.

*Non-Control/Non-Affiliate Investments*

As of September 30, 2011 and 2010, the Company held 50 and 33 Non-Control/Non-Affiliate investments in the aggregate of approximately \$257.3 million and \$223.7 million, at fair value, respectively. During the year ended September 30, 2011, \$95.7 million was funded to 23 new Non-Control/Non-Affiliate syndicate loans, and \$15.2 million was funded to two new Non-Control/Non-Affiliate non-syndicate investments. Additionally, \$14.8 million was funded to existing Non-Control/Non-Affiliate portfolio companies. During year ended September 30, 2011, the Company received principal payoffs, at par, on four Non-Control/Non-Affiliate investments, for which the Company received aggregate

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payments of \$25.8 million and sold one Non-Control/Non-Affiliate investment for \$37. As of September 30, 2011, the Company had a total of 50 Non-Control/Non-Affiliate investments, 24 of which were syndicated loans.

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**Table of Contents***Control Investments*

As of September 30, 2011 and 2010, the Company held nine and six Control investments in the aggregate of approximately \$45.6 million and \$33.4 million, at fair value, respectively. During the year ended September 30, 2011, \$10.6 million was funded to six Control investments. The Company did not exit any Control investments during the year ended September 30, 2011. During the year ended September 30, 2011, three existing Non-Control/Non-Affiliate investments were restructured into Control investments.

*Sunshine Media Holdings ( Sunshine Media )*: In January 2011, the Company purchased a controlling interest in common stock from existing shareholders of Sunshine Media. Sunshine Media is a publisher of regional B2B trade magazines.

*Viapack, Inc. ( Viapack )*: In July, 2011, the Company purchased a controlling interest in the equity securities of Viapack. Viapack is a manufacturer of polyethylene film.

*Kansas Cable Holdings, Inc. ( Kansas Cable )*: In August 2011, the Company restructured its loan to SCI Cable, Inc. ( SCI ) through a UCC Article 9 sale, resulting in a new control entity, Kansas Cable, obtaining certain of the assets of SCI. This resulted in a realized loss of \$1.3 million. Kansas Cable replaces SCI on the Schedule of Investments and remains on non-accrual status. Kansas Cable is a provider of cable, internet and voice services.

*Investment Concentrations*

As of September 30, 2011, the Company's portfolio consisted of loans to 59 companies in 27 states in 23 different industries with a fair value of \$302.9 million. Year over year, the Company's investment concentration as a percentage of fair value and of cost has changed only slightly. During 2011, the Company decided based on favorable syndicate loan marketplace conditions to invest in a significant number of senior syndicated loans. New syndicated loan investments totaled 23 at a cost of \$95.7 million during 2011. As of September 30, 2011, there were 24 syndicated investments totaling \$92.1 million at cost and \$90.7 million at fair value, or 24.0% and 29.9% of the total aggregate portfolio, respectively.

The following table outlines the Company's investments by security type as of September 30, 2011 and 2010:

|                               | September 30, 2011 |               |                   |               | September 30, 2010 |               |                   |               |
|-------------------------------|--------------------|---------------|-------------------|---------------|--------------------|---------------|-------------------|---------------|
|                               | Cost               | Fair Value    | Cost              | Fair Value    | Cost               | Fair Value    | Cost              | Fair Value    |
| Senior term debt              | \$ 266,491         | 69.6%         | \$ 200,145        | 66.1%         | \$ 200,041         | 67.1%         | \$ 172,596        | 67.1%         |
| Senior subordinated term debt | 107,140            | 28.0          | 92,148            | 30.4          | 93,987             | 31.5          | 81,899            | 31.8          |
| Common equity/equivalents     | 7,999              | 2.1           | 10,088            | 3.3           | 3,744              | 1.3           | 2,227             | 0.9           |
| Preferred equity              | 1,185              | 0.3           | 566               | 0.2           | 444                | 0.1           | 387               | 0.2           |
| <b>Total investments</b>      | <b>\$ 382,815</b>  | <b>100.0%</b> | <b>\$ 302,947</b> | <b>100.0%</b> | <b>\$ 298,216</b>  | <b>100.0%</b> | <b>\$ 257,109</b> | <b>100.0%</b> |

The 5 largest investments at fair value as of September 30, 2011 totaled \$91.2 million, or 30.1% of the total aggregated portfolio as compared to the 5 largest investments at fair value as of September 30, 2010 totaling \$101.5 million, or 39.4% of the total aggregated portfolio.

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Investments at fair value consisted of the following industry classifications at September 30, 2011 and 2010:

| Industry Classification                                   | September 30, 2011 |                                 | September 30, 2010 |                                 |
|---|--------------------|---------------------------------|--------------------|---------------------------------|
|   | Fair Value         | Percentage of Total Investments | Fair Value         | Percentage of Total Investments |
| Electronics   | \$ 45,752          | 15.1%                           | \$ 25,080          | 9.8%                            |
| Healthcare, education & childcare                         | 34,106             | 11.3                            | 41,098             | 16.0                            |
| Mining, steel, iron & non-precious metals                 | 33,734             | 11.1                            | 24,343             | 9.5                             |
| Broadcast (TV & radio)                                    | 28,194             | 9.3                             | 44,562             | 17.3                            |
| Automobile  | 25,768             | 8.5                             | 9,868              | 3.8                             |
| Retail stores   | 19,340             | 6.4                             | 19,620             | 7.6                             |
| Printing & publishing                                     | 17,623             | 5.8                             | 37,705             | 14.7                            |
| Buildings & real estate                                   | 10,275             | 3.4                             | 12,454             | 4.8                             |
| Aerospace & defense                                       | 10,003             | 3.3                             | 400                | 0.2                             |
| Home & office furnishings                                 | 9,715              | 3.2                             | 10,666             | 4.1                             |
| Textiles & leather  | 9,626              | 3.2                             |                    |                                 |
| Diversified/conglomerate manufacturing                    | 8,790              | 2.9                             | 2,042              | 0.8                             |
| Machinery   | 8,696              | 2.9                             | 8,719              | 3.4                             |
| Personal, food and miscellaneous services                 | 7,635              | 2.5                             |                    |                                 |
| Beverage, food & tobacco                                  | 7,332              | 2.4                             |                    |                                 |
| Personal & non-durable consumer products                  | 6,962              | 2.3                             | 9,230              | 3.6                             |
| Leisure, amusement, movies & entertainment                | 6,607              | 2.2                             | 3,994              | 1.6                             |
| Diversified/conglomerate service                          | 3,810              | 1.3                             |                    |                                 |
| Diversified natural resources, precious metals & minerals | 3,054              | 1.0                             |                    |                                 |
| Oil & gas   | 1,916              | 0.6                             |                    |                                 |
| Telecommunications  | 1,794              | 0.6                             |                    |                                 |
| Chemicals, plastics & rubber                              | 1,225              | 0.4                             | 7,044              | 2.7                             |
| Insurance   | 990                | 0.3                             |                    |                                 |
| Farming & agriculture                                     |                    |                                 | 284                | 0.1                             |
| <b>Total investments</b>                                  | <b>\$ 302,947</b>  | <b>100.0%</b>                   | <b>\$ 257,109</b>  | <b>100.0%</b>                   |

Eight new industries were invested in during the year ended September 30, 2011, as the Company made 25 new investments during the year in total. This brings the net total industries invested in up to 23 from 16 for the year ended September 30, 2010.

The investments at fair value were included in the following geographic regions of the United States at September 30, 2011 and September 30, 2010:

| Geographic Region        | September 30, 2011 |                              | September 30, 2010 |                                 |
|--------------------------|--------------------|------------------------------|--------------------|---------------------------------|
|                          | Fair Value         | Percent of Total Investments | Fair Value         | Percentage of Total Investments |
| Midwest                  | \$ 144,292         | 47.6%                        | \$ 109,299         | 42.5%                           |
| West                     | 70,862             | 23.4                         | 59,684             | 23.2                            |
| South                    | 52,265             | 17.3                         | 44,704             | 17.4                            |
| Northeast                | 28,158             | 9.3                          | 36,995             | 14.4                            |
| Other                    | 7,370              | 2.4                          | 6,427              | 2.5                             |
| <b>Total Investments</b> | <b>\$ 302,947</b>  | <b>100.0%</b>                | <b>\$ 257,109</b>  | <b>100.0%</b>                   |

The geographic region indicates the location of the headquarters for the Company's portfolio companies. A portfolio company may have a number of other business locations in other geographic regions.



**Table of Contents***Investment Principal Repayment*

The following table summarizes the contractual principal repayment and maturity of the Company's investment portfolio by fiscal year, assuming no voluntary prepayments, at September 30, 2011:

| <b>Fiscal year ending September 30,</b>                            | <b>Amount</b>     |
|--|-------------------|
| 2012   | \$ 60,817         |
| 2013   | 131,377           |
| 2014   | 35,172            |
| 2015   | 32,272            |
| 2016   | 72,363            |
| 2017 and thereafter  | 43,868            |
| <b>Total contractual repayments</b>                                | <b>\$ 375,869</b> |
| Investments in equity securities                                   | 9,184             |
| Adjustments to cost basis on debt securities                       | (2,238)           |
| <b>Total cost basis of investments held at September 30, 2011:</b> | <b>\$ 382,815</b> |

*Receivables from Portfolio Companies*

Receivables from portfolio companies represent non-recurring costs incurred on behalf of such portfolio companies and are included in other assets on the *Consolidated Statements of Assets and Liabilities*. The Company maintains an allowance for uncollectible receivables from portfolio companies, which is determined based on historical experience and management's expectations of future losses. The Company charges the accounts receivable to the established provision when collection efforts have been exhausted and the receivables are deemed uncollectible. As of September 30, 2011 and 2010, the Company had gross receivables from portfolio companies of \$0.8 million. The allowance for uncollectible receivables was \$0.4 million for September 30, 2011 and \$0.3 million for September 30, 2010. In addition, the Company recorded an allowance for uncollectible interest receivable of \$65 as of September 30, 2011. No allowance for uncollectible interest receivable was recorded as of September 30, 2010.

**NOTE 4. RELATED PARTY TRANSACTIONS***Loans to Former Employees*

The Company has outstanding loans to certain employees of the Adviser, each of whom was a joint employee of the Adviser (or the Company's previous adviser, Gladstone Capital Advisers, Inc.) and the Company at the time the loans were originally provided. The loans were for the exercise of options granted under the Amended and Restated 2001 Equity Incentive Plan, which has since been terminated. The loans require the quarterly payment of interest at the market rate in effect at the date of issuance, have varying terms not exceeding ten years and have been recorded as a reduction of net assets. The loans are evidenced by full recourse notes that are due upon maturity or 60 days following termination of employment, and the shares of common stock purchased with the proceeds of the loan were posted as collateral. The Company received \$3.2 million and \$1.4 million of principal repayments during the years ended September 30, 2011 and 2010, respectively. The Company recognized interest income from all employee loans of \$0.4 million, \$0.4 million and \$0.5 million for the years ended September 30, 2011, 2010 and 2009. Refer to Note 7, *Common Stock Transactions* for additional information related to these transactions.

During the year ended September 30, 2010, \$0.5 million of an employee stock option loan to a former employee of the Adviser was transferred from notes receivable—employees to other assets in connection with the termination of her employment with the Adviser and the later amendment of the loan. The interest on the loan from the time the employee's employment ended with the Adviser is included in other income on the accompanying *Consolidated Statement of Operations*.

**Table of Contents***Compensation Expense*

During the year ended September 30, 2010, the employee stock option loans of two former employees were converted from recourse to non-recourse loans. In connection with these conversions, the Company repurchased and retired the shares of common stock pledged as collateral for the loans, which shares had previously been acquired upon the exercise of the stock options in consideration for the issuance of the loans. The repurchases were accounted for as treasury stock transactions at the fair value of the shares, based on the trading price of the Company's common stock on the date of the transactions, totaling \$0.4 million. Since the value of the stock option loans totaled \$0.6 million, the Company recorded non-cash compensation expense of \$0.2 million during the year ended September 30, 2010.

*Investment Advisory and Management Agreement*

The Company has entered into an investment advisory agreement with the Adviser (the *Advisory Agreement*), which is controlled by the Company's chairman and chief executive officer. In accordance with the *Advisory Agreement*, the Company pays the Adviser certain fees as compensation for its services, such fees consisting of a base management fee and an incentive fee. On July 12, 2011, the Board of Directors approved the renewal of the *Advisory Agreement* through August 31, 2012.

The following table summarizes the management fees, incentive fees and associated credits reflected in the accompanying *Consolidated Statements of Operations*:

|  | Year Ended September 30, |                   |                   |
|--|--------------------------|-------------------|-------------------|
|  | 2011                     | 2010              | 2009              |
| <b>Average total assets subject to base management fee <sup>(A)</sup></b>                                  | <b>\$ 286,550</b>        | <b>\$ 304,250</b> | <b>\$ 381,250</b> |
| Multiplied by annual base management fee of 2.0%   | <b>2.0%</b>              | <b>2.0%</b>       | <b>2.0%</b>       |
| <b>Gross base management fee</b>   | <b>5,731</b>             | <b>6,085</b>      | <b>7,625</b>      |
| Reduction for loan servicing fees <sup>(B)</sup>   | <b>(3,355)</b>           | <b>(3,412)</b>    | <b>(5,620)</b>    |
| <b>Base management fee <sup>(B)</sup></b>  | <b>2,376</b>             | <b>2,673</b>      | <b>2,005</b>      |
| Credit for fees received by Adviser from the portfolio companies   | <b>(239)</b>             | <b>(213)</b>      | <b>(89)</b>       |
| Fee reduction for the voluntary, irrevocable waiver of 2% fee on senior syndicated loans to 0.5% per annum | <b>(383)</b>             | <b>(42)</b>       | <b>(265)</b>      |
| <b>Net base management fee</b>   | <b>\$ 1,754</b>          | <b>\$ 2,418</b>   | <b>\$ 1,651</b>   |
| <b>Gross incentive fee <sup>(B)</sup></b>  | <b>\$ 4,598</b>          | <b>\$ 1,823</b>   | <b>\$ 3,326</b>   |
| Credit from voluntary, irrevocable waiver issued by Adviser's board of directors                           | <b>(21)</b>              | <b>(165)</b>      | <b>(3,326)</b>    |
| <b>Net incentive fee</b>   | <b>\$ 4,577</b>          | <b>\$ 1,658</b>   | <b>\$</b>         |
| Credit for fees received by Adviser from the portfolio companies   | <b>\$ (239)</b>          | <b>\$ (213)</b>   | <b>\$ (89)</b>    |
| Fee reduction for the voluntary, irrevocable waiver of 2% fee on senior syndicated loans to 0.5% per annum | <b>(383)</b>             | <b>(42)</b>       | <b>(265)</b>      |
| Incentive fee credit   | <b>(21)</b>              | <b>(165)</b>      | <b>(3,326)</b>    |
| <b>Credit to base management and incentive fees from Adviser <sup>(B)</sup></b>                            | <b>\$ (643)</b>          | <b>\$ (420)</b>   | <b>\$ (3,680)</b> |

<sup>(A)</sup> Average total assets subject to the base management fee is defined as total assets, including investments made with proceeds of borrowings, less any uninvested cash and cash equivalents resulting from borrowings, valued at the end of the four most recently completed quarters and appropriately adjusted for any share issuances or repurchases during the applicable year.

<sup>(B)</sup> Reflected as a line item in the *Consolidated Statements of Operations*.





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### **Base Management Fee**

The base management fee is payable quarterly and assessed at a rate of 2.0%, computed on the basis of the value of the Company's average gross assets at the end of the two most recently completed quarters, which are total assets, including investments made with proceeds of borrowings, less any uninvested cash or cash equivalents resulted from borrowings. In addition, the following three items are adjustments to the base management fee calculation:

#### *Loan Servicing Fees*

The Adviser also services the loans held by Business Loan, in return for which it generally receives a 1.5% annual fee based on the monthly aggregate outstanding balance of loans pledged under the Company's line of credit. Since the Company owns these loans, all loan servicing fees paid to the Adviser are treated as reductions directly against the 2.0% base management fee under the Advisory Agreement.

#### *Senior Syndicated Loan Fee Waiver*

The Company's Board of Directors accepted an unconditional and irrevocable voluntary waiver from the Adviser to reduce the annual 2.0% base management fee on senior syndicated loan participations to 0.5%, to the extent that proceeds resulting from borrowings were used to purchase such syndicated loan participations, for the years ended September 30, 2011 and 2010.

#### *Portfolio Company Fees*

Under the Advisory Agreement, the Adviser has also provided, and continues to provide, managerial assistance and other services to the Company's portfolio companies and may receive fees for services other than managerial assistance with 50% of certain of these fees, and 100% of others, credited against the base management fee that the Company would otherwise be required to pay to the Adviser.

### **Incentive Fee**

The incentive fee consists of two parts: an income-based incentive fee and a capital gains incentive fee. The income-based incentive fee rewards the Adviser if the Company's quarterly net investment income (before giving effect to any incentive fee) exceeds 1.75% of the Company's net assets (the hurdle rate). The Company will pay the Adviser an income-based incentive fee with respect to the Company's pre-incentive fee net investment income in each calendar quarter as follows:

no incentive fee in any calendar quarter in which the Company's pre-incentive fee net investment income does not exceed the hurdle rate (7% annualized);

100% of the Company's pre-incentive fee net investment income with respect to that portion of such pre-incentive fee net investment income, if any, that exceeds the hurdle rate but is less than 2.1875% in any calendar quarter (8.75% annualized); and

20% of the amount of the Company's pre-incentive fee net investment income, if any, that exceeds 2.1875% in any calendar quarter (8.75% annualized).

The Company's Board of Directors accepted an unconditional and irrevocable voluntary waiver from the Adviser to reduce the income-based incentive fee to the extent net investment income did not 100% cover distributions to stockholders for the years ended September 30, 2011 and 2010.

The second part of the incentive fee is a capital gains-based incentive fee that is determined and payable in arrears as of the end of each fiscal year (or upon termination of the Advisory Agreement, as of the termination date) and equals 20% of the Company's realized capital gains as of the end of the fiscal year. In determining the



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capital gains-based incentive fee payable to the Adviser, the Company will calculate the cumulative aggregate realized capital gains and cumulative aggregate realized capital losses since the Company's inception, and the aggregate unrealized capital depreciation as of the date of the calculation, as applicable, with respect to each of the investments in the Company's portfolio. For this purpose, cumulative aggregate realized capital gains, if any, equals the sum of the differences between the net sales price of each investment, when sold, and the original cost of such investment since the Company's inception. Cumulative aggregate realized capital losses equals the sum of the amounts by which the net sales price of each investment, when sold, is less than the original cost of such investment since the Company's inception. Aggregate unrealized capital depreciation equals the sum of the difference, if negative, between the valuation of each investment as of the applicable calculation date and the original cost of such investment. At the end of the applicable year, the amount of capital gains that serves as the basis for the Company's calculation of the capital gains-based incentive fee equals the cumulative aggregate realized capital gains less cumulative aggregate realized capital losses, less aggregate unrealized capital depreciation, with respect to the Company's portfolio of investments. If this number is positive at the end of such year, then the capital gains-based incentive fee for such year equals 20% of such amount, less the aggregate amount of any capital gains-based incentive fees paid in respect of the Company's portfolio in all prior years. No capital gains-based incentive fee had been recorded for the Company from inception through September 30, 2011, as cumulative unrealized capital depreciation exceeded cumulative realized capital gains net of cumulative realized capital losses.

Additionally, in accordance with GAAP, the Company did not accrue a capital gains-based incentive fee for the year ended September 30, 2011. This GAAP accrual is calculated using the aggregate cumulative realized capital gains and losses and aggregate cumulative unrealized capital depreciation included in the calculation of the capital gains-based incentive fee plus the aggregate cumulative unrealized capital appreciation. If such amount is positive at the end of a relevant period, then GAAP requires the Company to record a capital gains-based incentive fee equal to 20% of such amount, less the aggregate amount of actual capital gains-based incentive fees paid in all prior years. If such amount is negative, then there is no accrual for such year. GAAP requires that the capital gains-based incentive fee accrual consider the cumulative aggregate unrealized capital appreciation in the calculation, as a capital gains-based incentive fee would be payable if such unrealized capital appreciation were realized. There can be no assurance that such unrealized capital appreciation will be realized in the future.

As a BDC, the Company makes available significant managerial assistance to its portfolio companies and provides other services to such portfolio companies. Although, neither the Company nor its Adviser currently receives fees in connection with managerial assistance, the Adviser provides other services to the Company's portfolio companies and receives fees for these other services. For example, certain of the Company's portfolio companies contract directly with our Adviser for the provision of consulting services.

*Administration Agreement*

The Company has entered into an administration agreement (the "Administration Agreement") with Gladstone Administration, LLC (the "Administrator"), an affiliate of the Adviser, whereby it pays separately for administrative services. The Administration Agreement provides for payments equal to the Company's allocable portion of its Administrator's overhead expenses in performing its obligations under the Administration Agreement, including, but not limited to, rent and the salaries and benefits expenses of the Company's chief financial officer, chief compliance officer, treasurer, internal legal counsel and their respective staffs. The Company's allocable portion of administrative expenses is generally derived by multiplying the Administrator's total allocable expenses by the percentage of the Company's total assets at the beginning of the quarter in comparison to the total assets at the beginning of the quarter of all companies managed by the Adviser under similar agreements. On July 12, 2011, the Board of Directors approved the renewal of the Administration Agreement through August 31, 2012.

**Table of Contents***Related Party Fees Due*

Amounts due to related parties on the accompanying *Consolidated Statements of Assets and Liabilities* were as follows:

|                                     | As of September 30, |        |
|-------------------------------------|---------------------|--------|
|                                     | 2011                | 2010   |
| Base management fee due to Adviser  | \$ 330              | \$ 319 |
| Incentive fee due to Adviser        | 1,203               | 158    |
| Loan servicing fee due to Adviser   | 227                 | 196    |
| <b>Total fees due to Adviser</b>    | <b>1,760</b>        | 673    |
| Fee due to Administrator            | 194                 | 267    |
| <b>Total related party fees due</b> | <b>\$ 1,954</b>     | \$ 940 |

**NOTE 5. BORROWINGS***Line of Credit*

On March 15, 2010, the Company, through its wholly-owned subsidiary, Business Loan, entered into a fourth amended and restated credit agreement which provided for a \$127.0 million revolving line of credit arranged by Key Equipment Finance Inc. ( Keybank ) as administrative agent (the Credit Facility ). Branch Banking and Trust Company ( BB&T ) and ING Capital LLC ( ING ) also joined the Credit Facility as committed lenders. Subject to certain terms and conditions, the Credit Facility may be expanded up to \$202.0 million through the addition of other committed lenders to the facility. On November 22, 2010 (the Amendment Date ), the Company amended its Credit Facility. Prior to the Amendment Date, advances under the Credit Facility bore interest at a 30-day London Interbank Offered Rate ( LIBOR ) subject to a minimum rate of 2.0%, plus 4.5% per annum, with a commitment fee of 0.5% per annum on undrawn amounts. As of the Amendment Date, advances under the Credit Facility bear interest at a 30-day LIBOR or commercial paper rate (subject to a minimum rate of 1.5%), plus 3.75% per annum, with a commitment fee of 0.5% per annum on undrawn amounts when the facility is drawn more than 50% and 1.0% per annum on undrawn amounts when the facility is drawn less than 50%. In addition, effective as of the Amendment Date, the Company is no longer obligated to pay an annual minimum earnings shortfall fee to the committed lenders, which was calculated as the difference between the weighted average of borrowings outstanding under the Credit Facility and 50.0% of the commitment amount of the Credit Facility, multiplied by 4.5% per annum, less commitment fees paid during the year. During the quarter ended December 31, 2010, the Company reversed the projected annual minimum earnings shortfall fee of \$0.6 million that had been accrued as of September 30, 2010. The Company paid a \$0.7 million fee in connection with the November 2010 amendment. On August 9, 2011, ING, increased its commitment by \$10 million, bring the total revolving line of credit to \$137.0 million. All other terms of the existing line of credit remained the same.

The Credit Facility matures on March 15, 2012, and, if the facility is not renewed or extended by this date, all unpaid principal and interest will be due and payable on March 15, 2013. In addition, if the Credit Facility is not renewed on or before March 15, 2012, the Company will be required to use all principal collections from its loans to pay outstanding principal on the Credit Facility.

The following tables summarize noteworthy information related to the Credit Facility:

|                        | As of September 30, |            |
|------------------------|---------------------|------------|
|                        | 2011                | 2010       |
| Commitment amount      | \$ 137,000          | \$ 127,000 |
| Borrowings outstanding | 99,400              | 16,800     |
| Availability           | 24,700              | 81,000     |

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|   | Year Ended September 30, |           |
|---|--------------------------|-----------|
|   | 2011                     | 2010      |
| Weighted average borrowings outstanding | \$ 49,169                | \$ 47,918 |
| Effective interest rate <sup>(A)</sup>  | 6.00%                    | 7.0%      |
| Commitment fees incurred                | \$ 648                   | \$ 393    |

<sup>(A)</sup> Excludes the impact of deferred financing fees.

Interest is payable monthly during the term of the Credit Facility. Available borrowings are subject to various constraints imposed under the Credit Facility, based on the aggregate loan balance pledged by Business Loan, which varies as loans are added and repaid, regardless of whether such repayments are prepayments or made as contractually required.

The administrative agent also requires that any interest or principal payments on pledged loans be remitted directly by the borrower into a lockbox account with Keybank as custodian. Keybank, who also serves as the trustee of the account, generally remits the collected funds to the Company once a month.

The Credit Facility contains covenants that require Business Loan to maintain its status as a separate legal entity, prohibit certain significant corporate transactions (such as mergers, consolidations, liquidations or dissolutions), and restrict material changes to the Company's credit and collection policies. The Credit Facility also limits payments on distributions to the aggregate net investment income for each of the twelve month periods ended September 30, 2011 and 2010. Business Loan is also subject to certain limitations on the type of loan investments it can apply toward availability credit in the borrowing base, including restrictions on geographic concentrations, sector concentrations, loan size, dividend payout, payment frequency and status, average life and lien property. The Credit Facility further requires Business Loan to comply with other financial and operational covenants, which obligate Business Loan to, among other things, maintain certain financial ratios, including asset and interest coverage and a minimum number of obligors required in the borrowing base of the credit agreement. Additionally, the Company is subject to a performance guaranty that requires it to maintain (i) a minimum net of \$200.0 million plus 50.0% of all equity and subordinated debt raised after May 15, 2009, (ii) asset coverage with respect to senior securities representing indebtedness of at least 200%, in accordance with Section 18 of the 1940 Act and (iii) its status as a BDC under the 1940 Act and as a RIC under the Code. The facility requires a minimum of 20 obligors in the borrowing base and as of September 30, 2011, Business Loan had 42 obligors. As of September 30, 2011, the Company was in compliance with all of the facility covenants.

*Fair Value*

The Company elected to apply ASC 825, Financial Instruments, specifically for the Credit Facility, which was consistent with its application of ASC 820 to its investments. The Company estimates the fair value of the Credit Facility using estimates of value provided by an independent third party and its own assumptions in the absence of observable market data, including estimated remaining life, credit party risk, current market yield and interest rate spreads of similar securities as of the measurement date. As of September 30, 2011 and 2010, all of the Company's borrowings were valued using Level 3 inputs.

The following tables present the Credit Facility carried at fair value as of September 30, 2011 and 2010, by caption on the accompanying *Consolidated Statements of Assets and Liabilities* for Level 3 of the hierarchy established by ASC 820 and a roll-forward in the changes in fair value of the Credit Facility during the years ended September 30, 2011 and 2010:

|                 | Level 3 Borrowings under Credit Facility<br>Total Fair Value Reported in<br><i>Consolidated Statements of Assets and Liabilities</i><br>As of September 30, |           |
|-----------------|---|-----------|
|                 | 2011  | 2010      |
| Credit Facility | \$ 100,012  | \$ 17,940 |

**Table of Contents****Total Fair value Reported in Consolidated Statements of Assets and Liabilities**

|   | Years Ended September 30, |                  |
|---|---------------------------|------------------|
|   | 2011                      | 2010             |
| Fair value as of September 30, 2010 and 2009, respectively        | \$ 17,940                 | \$ 83,350        |
| Net unrealized (depreciation) appreciation <sup>(A)</sup>         | (528)                     | 790              |
| Borrowings  | 120,100                   | 24,900           |
| Repayments  | (37,500)                  | (91,100)         |
| <b>Fair value as of September 30, 2011 and 2010, respectively</b> | <b>\$ 100,012</b>         | <b>\$ 17,940</b> |

<sup>(A)</sup> Included in cumulative net unrealized appreciation on borrowings on the accompanying *Consolidated Statements of Assets and Liabilities* for the year ended September 30, 2011 and 2010.

The fair value of the collateral under the Credit Facility was approximately \$256.9 million and \$212.6 million at September 30, 2011 and 2010, respectively.

**NOTE 6. INTEREST RATE CAP AGREEMENT**

Pursuant to its previous revolving credit facility, the Company had an interest rate cap agreement, with an initial notional amount of \$35.0 million at a cost of \$0.3 million that effectively limited the interest rate on a portion of the borrowings under the line of credit. The interest rate cap agreement expired in February 2009.

The Company recorded changes in the fair market value of the interest rate cap agreement monthly based on the current market valuation at month end as unrealized depreciation or appreciation on derivative on the Company's *Consolidated Statement of Operations*. The agreement provided that the Company's floating interest rate or cost of funds on a portion of the portfolio's borrowings would be capped at 5% when the LIBOR was in excess of 5%. During the year ended September 30, 2009, the Company recorded \$0.3 million of loss from the interest rate cap agreement, recorded as a realized loss on the settlement of derivative on the Company's *Consolidated Statement of Operations*.

**NOTE 7. COMMON STOCK TRANSACTIONS**

On October 20, 2009, the Company filed a registration statement on Form N-2 (File No. 333-162592) that was amended on December 9, 2009 and which the Securities and Exchange Commission (SEC) declared effective on January 28, 2010, and the Company filed post-effective amendments to such registration statement on April 7, 2011, June 15, 2011, and July 13, 2011, which were declared effective by the SEC on July 15, 2011. Such registration statement permits the Company to issue, through one or more transactions, up to an aggregate of \$300.0 million in securities, consisting of common stock, preferred stock, subscription rights, debt securities and warrants to purchase common stock, including through a combined offering of such securities.

On May 17, 2010, the Company and the Adviser entered into an equity distribution agreement (the Agreement) with BB&T Capital Markets, a division of Scott & Stringfellow, LLC (the Agent), under which the Company may, from time to time, issue and sell through the Agent, as sales agent, up to 2.0 million shares (the Shares) of the Company's common stock, par value \$0.001 per share, based upon instructions from the Company (including, at a minimum, the number of shares to be offered, the time period during which sales are requested to be made, any limitation on the number of shares that may be sold in any one day and any minimum price below which sales may not be made). Sales of Shares through the Agent, if any, will be executed by means of either ordinary brokers' transactions on the NASDAQ Global Select Market in accordance with Rule 153 under the Securities Act of 1933, as amended, or such other sales of the Shares as shall be agreed by the

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Company and the Agent. The compensation payable to the Agent for sales of Shares with respect to which the Agent acts as sales agent shall be equal to 2.0% of the gross sales price of the Shares for amounts of Shares sold pursuant to the Agreement. To date, the Company has not issued any shares pursuant to this Agreement.

The following table is a summary of all outstanding notes issued to employees of the Adviser for the exercise of stock options:

| Issue Date | Number of Options Exercised | Strike Price of Options Exercised | Amount of Promissory Note Issued to Employees | Outstanding Balance of Employee Loans at 9/30/11 | Maturity Date | Interest Rate on Note |
|------------|-----------------------------|-----------------------------------|---|--|---------------|-----------------------|
| Aug-01     | 393,334                     | 15.00                             | \$ 5,900 <sup>(A)</sup>                       | \$ 2,749   | Aug-10        | 4.90% <sup>(B)</sup>  |
| Aug-01     | 18,334                      | 15.00                             | 275 <sup>(A)</sup>                            | 200  | Aug-10        | 4.90 <sup>(B)</sup>   |
| Aug-01     | 18,334                      | 15.00                             | 275   | 236  | Aug-11        | 4.90 <sup>(C)</sup>   |
| Sep-04     | 13,332                      | 15.00                             | 200   | 198  | Sep-13        | 5.00                  |
| Jul-06     | 13,332                      | 15.00                             | 200   | 200  | Jul-15        | 8.26                  |
| Jul-06     | 18,334                      | 15.00                             | 275   | 275  | Jul-15        | 8.26                  |
|            | <b>475,000</b>              |                                   | <b>\$ 7,125</b>                               | <b>\$ 3,858</b>                                  |               |                       |

<sup>(A)</sup> On September 7, 2010, the Company entered into redemption agreements (the Redemption Agreements) with David Gladstone, the Company's Chairman and Chief Executive Officer, and Laura Gladstone, the daughter of Mr. Gladstone, in connection with the maturity of secured promissory notes executed by Mr. Gladstone and Ms. Gladstone in favor of the Company on August 23, 2001, in the principal amounts of \$5.9 million and \$0.3 million, respectively (collectively, the Notes). Mr. and Ms. Gladstone executed the Notes in payment of the exercise price of certain stock options (the Options) to acquire shares of the Company's common stock. Concurrently with the execution of the Notes, the Company and Mr. and Ms. Gladstone entered into stock pledge agreements (collectively, the Pledge Agreements), pursuant to which Mr. and Ms. Gladstone granted to the Company a first priority security interest in the Pledged Collateral (as defined in the respective Pledge Agreements), which included 393,334 and 18,334 shares, respectively, of the Company's common stock that Mr. and Ms. Gladstone acquired pursuant to the exercise of the Options (collectively, the Pledged Shares). An event of default was triggered under the Notes by virtue of Mr. and Ms. Gladstone's failure to repay the amounts outstanding under the Notes within five business days of August 23, 2010. The Redemption Agreements provide that, pursuant to the terms and conditions thereof, the Company will automatically accept and retire the Pledged Shares in partial or full satisfaction, as applicable, of Mr. and Ms. Gladstone's obligations to the Company under the Notes at such time, if ever, that the trading price of the Company's common stock reaches \$15 per share. In entering into the Redemption Agreements, the Company reserved all of its existing rights under the Notes and the Pledge Agreements, including, but not limited to, the ability to foreclose on the Pledged Collateral at any time. On March 30, 2011, June 27, 2011 and September 26, 2011, Mr. Gladstone paid down in the aggregate \$3.2 million of the principal balance of his Note, leaving a principal balance of \$2.7 million outstanding as of September 30, 2011. In connection with these payments, the Company released its first priority security interest on 210,000 shares of Mr. Gladstone's Pledged Shares, leaving a balance of 183,334 shares in Pledged Collateral from Mr. Gladstone as of September 30, 2011. On September 28, 2011, Ms. Gladstone paid down \$0.1 million of the principal balance of her 2001 Note, leaving a principal balance of \$0.2 million outstanding on this Note as of September 30, 2011. The principal balances under her 2006 Notes remain unchanged at an aggregate balance of \$0.5 million as of September 30, 2011.

<sup>(B)</sup> An event of default was triggered under these Notes by virtue of Mr. and Ms. Gladstone's failure to repay the amounts outstanding within five business days of August 23, 2010. As such, the Company charges a default rate of an additional 2% per annum under these Notes for all periods following default.

<sup>(C)</sup> An event of default was triggered under the Note by virtue of an employee's failure to repay the amounts outstanding within five business days of August 23, 2011. As such, the Company charges a default rate of an additional 2% per annum under the Note for all periods following default.

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In accordance with ASC 505, Equity, receivables from employees for the issuance of capital stock to employees prior to the receipt of cash payment should be reflected in the balance sheet as a reduction to stockholders' equity. Therefore, these recourse notes were recorded as loans to employees and are included in the equity section of the accompanying *Consolidated Statements of Assets and Liabilities*. As of September 30, 2011, the Company determined that these notes were still recourse.

**NOTE 8. NET (DECREASE) INCREASE IN NET ASSETS RESULTING FROM OPERATIONS PER SHARE**

The following table sets forth the computation of basic and diluted net (decrease) increase in net assets resulting from operations per share for the fiscal years ended September 30, 2011, 2010 and 2009:

|   | 2011        | Year Ended September 30,<br>2010 | 2009       |
|---|-------------|----------------------------------|------------|
| Numerator for basic and diluted net (decrease) increase in net assets resulting from operations per share | \$ (21,099) | \$ 16,394                        | \$ 3,783   |
| Denominator for basic and diluted shares  | 21,039,242  | 21,060,351                       | 21,087,574 |
| Basic and diluted net (decrease) increase in net assets resulting from operations per common share        | \$ (1.00)   | \$ 0.78                          | \$ 0.18    |

**NOTE 9. DISTRIBUTIONS***Distributions*

The Company is required to pay out as a distribution 90% of its ordinary income and short-term capital gains for each taxable year in order to maintain its status as a RIC under Subtitle A, Chapter 1 of Subchapter M of the Code. It is the policy of the Company to pay out as a distribution up to 100% of those amounts. The amount to be paid out as a distribution is determined by the Board of Directors each quarter and is based on the annual earnings estimated by the management of the Company. Based on that estimate, three monthly distributions are declared each quarter. At year-end the Company may pay a bonus distribution, in addition to the monthly distributions, to ensure that it has paid out at least 90% of its ordinary income and realized net short-term capital gains for the year. Long-term capital gains are composed of prepayment fees and gains from the sale of securities held for one year or more. Additionally, success fees, prior to January 1, 2011, were treated as long-term capital gains. Starting January 1, 2011, the tax characterization of the success fee amount was and will be treated as ordinary income. The approved change in accounting method does not require the Company to retroactively change the capital gains treatment of the success fees received prior to January 1, 2011. As a result, the Company will be required to distribute such amounts to its stockholders in order to maintain RIC status for success fees the Company receives after January 1, 2011.



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The Company may decide to retain long-term capital gains from the sale of securities, if any, and not pay them out as distributions, however, the Board of Directors may decide to declare and pay out capital gains during any fiscal year. If the Company decides to retain long-term capital gains, the portion of the retained capital gains will be subject to a 35% tax. The tax characteristics of all distributions will be reported to stockholders on Form 1099 at the end of each calendar year. The following table lists the per share distributions paid for the fiscal years ended September 30, 2011 and 2010:

| Fiscal Year          | Declaration Date     | Record Date        | Payment Date       | Distribution per Share |         |
|----------------------|----------------------|--------------------|--------------------|------------------------|---------|
| 2011                 | October 5, 2010      | October 21, 2010   | October 29, 2010   | \$ 0.07                |         |
|                      | October 5, 2010      | November 19, 2010  | November 30, 2010  | 0.07                   |         |
|                      | October 5, 2010      | December 23, 2010  | December 31, 2010  | 0.07                   |         |
|                      | January 11, 2011     | January 21, 2011   | January 31, 2011   | 0.07                   |         |
|                      | January 11, 2011     | February 21, 2011  | February 28, 2011  | 0.07                   |         |
|                      | January 11, 2011     | March 21, 2011     | March 31, 2011     | 0.07                   |         |
|                      | April 12, 2011       | April 22, 2011     | April 29, 2011     | 0.07                   |         |
|                      | April 12, 2011       | May 20, 2011       | May 31, 2011       | 0.07                   |         |
|                      | April 12, 2011       | June 20, 2011      | June 30, 2011      | 0.07                   |         |
|                      | July 12, 2011        | July 22, 2011      | July 29, 2011      | 0.07                   |         |
|                      | July 12, 2011        | August 19, 2011    | August 31, 2011    | 0.07                   |         |
|                      | July 12, 2011        | September 22, 2011 | September 30, 2011 | 0.07                   |         |
|                      | <b>Annual Total:</b> |                    |                    |                        | \$ 0.84 |
|                      | 2010                 | October 6, 2009    | October 22, 2009   | October 30, 2009       | \$ 0.07 |
| October 6, 2009      |                      | November 19, 2009  | November 30, 2009  | 0.07                   |         |
| October 6, 2009      |                      | December 22, 2009  | December 31, 2009  | 0.07                   |         |
| January 12, 2010     |                      | January 21, 2010   | January 29, 2010   | 0.07                   |         |
| January 12, 2010     |                      | February 18, 2010  | February 26, 2010  | 0.07                   |         |
| January 12, 2010     |                      | March 23, 2010     | March 31, 2010     | 0.07                   |         |
| April 7, 2010        |                      | April 22, 2010     | April 30, 2010     | 0.07                   |         |
| April 7, 2010        |                      | May 20, 2010       | May 28, 2010       | 0.07                   |         |
| April 7, 2010        |                      | June 22, 2010      | June 30, 2010      | 0.07                   |         |
| July 7, 2010         |                      | July 22, 2010      | July 30, 2010      | 0.07                   |         |
| July 7, 2010         |                      | August 23, 2010    | August 31, 2010    | 0.07                   |         |
| July 7, 2010         |                      | September 22, 2010 | September 30, 2010 | 0.07                   |         |
| <b>Annual Total:</b> |                      |                    |                    | \$ 0.84                |         |

Aggregate distributions declared and paid for the 2011 and 2010 fiscal years were both approximately \$17.7 million, which were declared based on an estimate of net investment income for each fiscal year.

**Distribution of Income and Gains**

Net investment income of the Company is declared and distributed to stockholders monthly. Net realized gains from investment transactions, in excess of available capital loss carryforwards, would be taxable to the Company if not distributed, and, therefore, generally will be distributed at least annually.

The timing and characterization of certain income and capital gains distributions are determined annually in accordance with federal tax regulations which may differ from GAAP. These differences primarily relate to items recognized as income for financial statement purposes and realized gains for tax purposes. As a result, net investment income and net realized gain (loss) on investment transactions for a reporting period may differ significantly from distributions during such period. Accordingly, the Company may periodically make



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reclassifications among certain of its capital accounts without impacting the net asset value of the Company. Additionally, the following tables also include these adjustments for the years ended September 30, 2011 and 2010, respectively.

The Company's components of net assets on a tax-basis were as follows:

|  | Year Ended September 30, |                       |
|--|--------------------------|-----------------------|
|  | 2011                     | 2010                  |
| Common stock                               | \$ 21                    | \$ 21                 |
| Paid in capital                            | 326,913                  | 326,935               |
| Notes receivable - employees               | (3,858)                  | (7,103)               |
| Net unrealized depreciation on investments | (80,104)                 | (41,800)              |
| Net unrealized appreciation on borrowings  | (612)                    | (1,140)               |
| Underdistributed ordinary income           | 679                      |                       |
| Capital loss carryforward                  | (27,255)                 | (26,354)              |
| Post-October tax loss                      | (1,649)                  | (901)                 |
| Other temporary differences                | (414)                    | (412)                 |
| <br>Net Assets                             | <br><b>\$ 213,721</b>    | <br><b>\$ 249,246</b> |

The Company intends to retain realized gains to the extent of available capital loss carryforwards. As of September 30, 2011 the Company had \$26.4 million and \$0.9 million of capital loss carryforwards that expire in 2018 and 2019, respectively.

For the years ended September 30, 2011 and 2010, the Company recorded the following adjustments to reflect tax character. Reclassifications between income and gains primarily relate to the character of prepayment and success fees and accrued interest written off for GAAP purposes.

|                                       | Year Ended September 30, |            |
|---------------------------------------|--------------------------|------------|
|                                       | 2011                     | 2010       |
| Overdistributed net investment income | \$ 472                   | \$ (1,172) |
| Accumulated Net Realized Losses       | (450)                    | 1,992      |
| Paid-in-capital                       | (22)                     | (820)      |

The tax character of distributions paid to stockholders by the Company is summarized as follows:

|                                | Year Ended September 30, |                      |                      |
|--------------------------------|--------------------------|----------------------|----------------------|
|                                | 2011                     | 2010                 | 2009                 |
| Distributions from:            |                          |                      |                      |
| Ordinary Income                | \$ 17,672                | \$ 16,907            | \$ 20,795            |
| Long Term Capital Gains        |                          |                      | 27                   |
| Return of Capital              |                          | 783                  | 5,748                |
| <br><b>Total Distributions</b> | <br><b>\$ 17,672</b>     | <br><b>\$ 17,690</b> | <br><b>\$ 26,570</b> |

**NOTE 10. FEDERAL AND STATE INCOME TAXES**

The Company intends to continue to qualify for treatment as a RIC under subchapter M of the Code. As a RIC, the Company will not be subject to federal income tax on the portion of its taxable income and gains distributed to stockholders. To qualify as a RIC, the Company is required to distribute at least 90% of its investment company taxable income, as defined by the Code. The Company intends to distribute a minimum of 90% of its ordinary income, and, as a result, no income tax provisions have been recorded. The Company may, but does not intend to, pay out a return of capital. The Company may also be subject to federal excise tax if it does not



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distribute at least 98% of its ordinary income in any calendar year and 98% of its capital gain net income in any calendar year. Under the RIC Modernization Act, for excise tax years beginning January 1, 2011, the minimum distribution requirement for capital gains income has been raised to 98.2%. The Company must also meet the asset diversification threshold under the Code's rules applicable to a RIC.

Additionally, under the RIC Modernization Act, the Company will be permitted to carry forward capital losses incurred in taxable years beginning after September 30, 2011, for an unlimited period. However, any losses incurred during those future taxable years will be required to be utilized prior to the losses incurred in pre-enactment taxable years, which carry an expiration date. As a result of this ordering rule, pre-enactment capital loss carryforwards may be more likely to expire unused. Additionally, post-enactment capital loss carryforwards will retain their character as either short-term or long-term capital losses rather than being considered all short-term as permitted under the previous regulation.

### **NOTE 11. COMMITMENTS AND CONTINGENCIES**

#### *Legal Proceedings*

The Company is party to certain legal proceedings incidental to the normal course of its business, including the enforcement of the Company's rights under contracts with its portfolio companies. The Company is required to establish reserves for litigation matters where those matters present loss contingencies that are both probable and estimable. When loss contingencies are not both probable and estimable, the Company does not establish reserves. Based on current knowledge, the Company does not believe that loss contingencies, if any, arising from pending investigations, litigation or regulatory matters will have a material adverse effect on the Company's financial condition or results of operation.

#### *Financial Commitments and Obligations*

At September 30, 2011, the Company was not party to any signed commitments for potential investments. However, the Company has certain lines of credit and capital commitments with its portfolio companies that have not been fully drawn or called, respectively, as of September 30, 2011 and 2010. Since these commitments have expiration dates and the Company expects many will never be fully drawn or called, the total commitment amounts do not necessarily represent future cash requirements.

In addition to the lines of credit and capital commitments with portfolio companies, the Company also extends certain guaranties on behalf of some of its portfolio companies during the normal course of business. In July 2009, the Company executed a guaranty (the "Guaranty") of a line of credit agreement between Comerica Bank and Defiance Integrated Technologies, Inc. ("Defiance"), one of its Control investments. Pursuant to the Guaranty, if Defiance had a payment default, the Guaranty was callable once the bank reduced its claim by using commercially reasonable efforts to collect through disposition of the Defiance collateral. The Guaranty was limited to \$0.3 million plus interest on that amount accrued from the date demand payment was made under the Guaranty, and all costs incurred by the bank in its collection efforts. On March 1, 2011, the Company and Comerica Bank terminated the Guaranty.

The Company estimated the fair value of its unused line of credit and uncalled capital commitments as of September 30, 2011 and 2010 to be minimal; and therefore, they are not recorded on the accompanying *Consolidated Statements of Assets and Liabilities*. As of September 30, 2011, there were no outstanding guaranties.

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The following table summarizes the notional dollar balances of unused line of credit commitments, uncalled capital commitments and guaranties as of September 30, 2011 and 2010:

|                                   | As of September 30, |                  |
|-----------------------------------|---------------------|------------------|
|                                   | 2011                | 2010             |
| Unused line of credit commitments | \$ 12,990           | \$ 9,304         |
| Uncalled capital commitment       | 800                 | 1,600            |
| Guaranties                        |                     | 250              |
| <b>Total</b>                      | <b>\$ 13,790</b>    | <b>\$ 11,154</b> |

The following table shows the Company's contractual obligations as of September 30, 2011:

| Contractual Obligations <sup>(A)</sup> | Payments Due by Period |           |           |               | Total     |
|--|------------------------|-----------|-----------|---------------|-----------|
|  | Less than<br>1 Year    | 1-3 Years | 4-5 Years | After 5 Years |           |
| Credit Facility <sup>(B)</sup>         | \$ 99,400              | \$        | \$        | \$            | \$ 99,400 |

<sup>(A)</sup> Excludes the unused or uncalled commitments to extend credit or capital to the Company's portfolio companies for an aggregate amount of \$13.8 million, as discussed above.

<sup>(B)</sup> Principal balance of borrowings under the Credit Facility, based on the contractual maturity due to the revolving nature of the facility.

**Table of Contents****NOTE 12. FINANCIAL HIGHLIGHTS**

| Per Share Data <sup>(A)</sup>                             | Year Ended September 30, |          |          |          |          |
|---|--------------------------|----------|----------|----------|----------|
|   | 2011                     | 2010     | 2009     | 2008     | 2007     |
| Net asset value at beginning of period                    | \$ 11.85                 | \$ 11.81 | \$ 12.89 | \$ 14.97 | \$ 14.02 |
| <i>Income from investment operations</i>                  |                          |          |          |          |          |
| <sup>(B)</sup>  |                          |          |          |          |          |
| Net investment income                                     | 0.88                     | 0.84     | 1.00     | 1.35     | 1.69     |
| Net realized loss on the sale of investments              | (0.06)                   | (0.14)   | (1.25)   | (0.04)   |          |
| Realized loss on settlement of derivative                 |                          |          | (0.01)   |          |          |
| Net unrealized appreciation on derivative                 |                          |          | 0.01     |          |          |
| Net unrealized (depreciation) appreciation on investments | (1.84)                   | 0.11     | 0.45     | (2.39)   | (0.56)   |
| Net unrealized appreciation (depreciation) on borrowings  | 0.02                     | (0.03)   | (0.02)   |          |          |
| Total from investment operations                          | (1.00)                   | 0.78     | 0.18     | (1.08)   | 1.13     |
| <i>Distributions to stockholders from</i>                 |                          |          |          |          |          |
| <sup>(B)(C)</sup>   |                          |          |          |          |          |
| Taxable ordinary income                                   | (0.84)                   | (0.80)   | (0.99)   | (1.31)   | (1.48)   |
| Long term capital gains                                   |                          |          |          | (0.01)   |          |
| Return on capital   |                          | (0.04)   | (0.27)   | (0.36)   | (0.20)   |
| Total distributions                                       | (0.84)                   | (0.84)   | (1.26)   | (1.68)   | (1.68)   |
| <i>Capital share transactions</i>                         |                          |          |          |          |          |
| Issuance of common stock under shelf offering             |                          |          |          | 0.72     | 1.55     |
| Offering costs  |                          |          |          | (0.04)   | (0.05)   |
| Repayment of principal on notes receivable                | 0.15                     | 0.07     |          |          | 0.06     |
| Conversion of recourse to non-recourse notes              |                          | (0.02)   |          |          |          |
| Reclassification of principal on employee note            |                          | 0.02     |          |          |          |
| Stock surrendered to settle withholding tax obligation    |                          |          |          |          | (0.06)   |
| Anti-dilutive effect of common stock reduction            |                          | 0.03     |          |          |          |
| Total from capital share transactions                     | 0.15                     | 0.10     |          | 0.68     | 1.50     |
| Net asset value at end of period                          | \$ 10.16                 | \$ 11.85 | \$ 11.81 | \$ 12.89 | \$ 14.97 |
|   | \$ 11.27                 | \$ 8.93  | \$ 15.24 | \$ 19.52 | \$ 22.01 |

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Per share market value at beginning  
of period

|  |                   |            |            |            |            |
|--|-------------------|------------|------------|------------|------------|
| Per share market value at end of<br>period   | <b>6.86</b>       | 11.27      | 8.93       | 15.24      | 19.52      |
| Total return <sup>(D)</sup>                  | <b>(33.77)%</b>   | 37.46%     | (30.94)%   | (13.90)%   | (4.40)%    |
| Common stock outstanding at end<br>of period | <b>21,039,242</b> | 21,039,242 | 21,087,574 | 21,087,574 | 14,762,574 |

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|  | Year Ended September 30, |            |            |            |            |
|--|--------------------------|------------|------------|------------|------------|
|  | 2011                     | 2010       | 2009       | 2008       | 2007       |
| <b>Statement of Assets and Liabilities Data</b>            |                          |            |            |            |            |
| Net assets at end of period                                | \$ 213,721               | \$ 249,246 | \$ 249,076 | \$ 271,748 | \$ 220,959 |
| Average net assets <sup>(E)</sup>                          | 235,901                  | 249,968    | 253,316    | 284,304    | 189,732    |
| <b>Senior Securities Data</b>                              |                          |            |            |            |            |
| Borrowing, at fair value                                   | \$ 100,012               | \$ 17,940  | \$ 83,350  | \$ 151,030 | \$ 144,440 |
| Asset coverage ratio <sup>(F)(G)</sup>                     | 314%                     | 1,419%     | 396%       | 279%       | 252%       |
| Average coverage per unit <sup>(G)</sup>                   | \$ 3,144                 | \$ 14,187  | \$ 3,963   | \$ 2,792   | \$ 2,524   |
| <b>Ratios/Supplemental Data</b>                            |                          |            |            |            |            |
| Ratio of expenses to average net assets <sup>(H)</sup>     | 7.39%                    | 7.28%      | 9.97%      | 9.34%      | 10.75%     |
| Ratio of net expenses to average net assets <sup>(I)</sup> | 7.12                     | 7.11       | 8.52       | 6.74       | 7.60       |
| Ratio of net investment income to average net assets       | 7.81                     | 7.10       | 8.30       | 9.34       | 11.73      |

(A) Based on actual shares outstanding at the end of the corresponding period.

(B) Based on weighted average basic per share data.

(C) Distributions are determined based on taxable income calculated in accordance with income tax regulations which may differ from amounts determined under U.S. GAAP.

(D) Total return equals the change in the ending market value of the Company's common stock from the beginning of the period taking into account distributions reinvested in accordance with the terms of the Company's distribution reinvestment plan. Total return does not take into account distributions that may be characterized as a return of capital. For further information on the estimated character of the Company's distributions please refer to Note 9.

(E) Average net assets are computed using the average of the balance of net assets at the end of each month of the reporting period.

(F) As a BDC, the Company is generally required to maintain a ratio of at least 200% of total consolidated assets, less all liabilities and indebtedness not represented by senior securities, to total borrowings and guaranty commitments.

(G) Asset coverage ratio is the ratio of the carrying value of the Company's total consolidated assets, less all liabilities and indebtedness not represented by senior securities, to the aggregate amount of senior securities representing indebtedness (including interest payable and guaranties). Asset coverage per unit is the asset coverage ratio expressed in terms of dollar amounts per one thousand dollars of indebtedness.

(H) Ratio of expenses to average net assets is computed using expenses before credits from Adviser to the base management and incentive fees and including income tax expense.

(I) Ratio of net expenses to average net assets is computed using total expenses net of credits from Adviser to the base management and incentive fees and including income tax expense.

**NOTE 13. SELECTED QUARTERLY DATA (UNAUDITED)**

|   | Year Ended September 30, 2011   |                              |                             |                                  |
|---|---------------------------------|------------------------------|-----------------------------|----------------------------------|
|   | Quarter Ended December 31, 2010 | Quarter Ended March 31, 2011 | Quarter Ended June 30, 2011 | Quarter Ended September 30, 2011 |
| Total Investment Income   | \$ 8,006                        | \$ 8,398                     | \$ 8,980                    | \$ 9,827                         |
| Net Investment Income   | 4,637                           | 4,428                        | 4,534                       | 4,813                            |
| Net Increase (Decrease) in Net Assets Resulting From Operations   | 2,132                           | (8,381)                      | (14,310)                    | (540)                            |
| Net Increase (Decrease) in Net Assets Resulting From Operations per Weighted Average Common Share (Basic and Diluted) | \$ 0.10                         | \$ (0.40)                    | \$ (0.68)                   | \$ (0.03)                        |

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|  | Year Ended September 30, 2010            |  |   |  |
|--|--|--|---|--|
|  | Quarter<br>Ended<br>December 31,<br>2009 | Quarter<br>Ended<br>March<br>31,<br>2010 | Quarter<br>Ended<br>June<br>30,<br>2010 | Quarter<br>Ended<br>September<br>30,<br>2010 |
| Total Investment Income  | \$ 9,804                                 | \$ 9,814                                 | \$ 7,969                                | \$ 7,952                                     |
| Net Investment Income  | 4,428                                    | 4,474                                    | 4,429                                   | 4,428  |
| Net Increase (Decrease) in Net Assets Resulting From Operations  | 6,326                                    | 7,980                                    | (1,748)                                 | 3,836  |
| Net Increase (Decrease) in Net Assets Resulting From Operations per<br>Weighted Average Common Share (Basic and Diluted) | \$ 0.30                                  | \$ 0.38                                  | \$ (0.08)                               | \$ 0.18                                      |

**NOTE 14. SUBSEQUENT EVENTS***Portfolio Activity*

Subsequent to September 30, 2011, the Company extended \$3.6 million in revolver draws and investments. The Company also had \$3.9 million in scheduled and unscheduled loan repayments. Of significance, in November 2011, the Company invested \$1.6 million in Ohana Media Group ( Ohana ) in order for it to purchase certain of KMBQ Corporation's ( KMBQ ) assets out of receivership. In connection with this transaction, the Company recorded a partial realized loss in the quarter ending December 31, 2011. Ohana replaces KMBQ on the Company's *Schedule of Investments* as a Non-Control/Non-Affiliate portfolio Company in the quarter ending December 31, 2011.

*Distributions*

On October 11, 2011, the Company's Board of Directors declared the following monthly cash distributions to stockholders:

| Record Date       | Payment Date      | Distribution<br>per Share |
|-------------------|-------------------|---------------------------|
| October 21, 2011  | October 31, 2011  | \$ 0.07                   |
| November 17, 2011 | November 30, 2011 | \$ 0.07                   |
| December 21, 2011 | December 30, 2011 | \$ 0.07                   |

*Preferred Stock Offering*

On October 31, 2011, the Company filed a Prospectus Supplement (to Prospectus dated July 15, 2011) with the SEC pursuant to Rule 497 under the Securities Act of 1933, as amended, which contains a description of the offering of 7.125% Series 2016 Term Preferred Stock ( Term Preferred Stock ), par value \$0.001 per share of the Company. Under this Prospectus Supplement, the Company can issue up to 1.4 million of Term Preferred Stock at an offering price of \$25.00 per share. The shares will have a redemption date of December 31, 2016 with an overallotment option of 15% and will be traded under the ticker symbol of GLADPRA on the New York Stock Exchange. The Term Preferred Stock will not be convertible into the Company's common stock or any other security of the Company. At the time of issuance, any term preferred stock, including the Term Preferred Stock, will be fully paid and non-assessable and will have no preemptive, conversion, or exchange rights or rights to cumulative voting. The Term Preferred Stock will rank equally with shares of all of the Company's other preferred stock that might be issued in the future, as to payment of dividends and the distribution of the Company's assets upon dissolution, liquidation or winding up of affairs. The Term Preferred Stock is, and all other preferred stock that the Company may issue in the future will be, senior as to dividends and distributions to the Company's Common Stock. The Company may issue additional series of term preferred stock or other preferred stock in the future. Monthly dividends will be paid on the Term Preferred Stock at an annual rate of 7.125% of the \$25.00 liquidation preference per share, or \$1.7813 per Term Preferred Stock per year.

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commencing on December 30, 2011. As of October 31, 2011, the Company had incurred \$1.9 million in offering costs in relation to this transaction. On November 4, 2011, the Company completed the offering of its Term Preferred Stock for gross proceeds of \$35.0 million. Net proceeds of the offering, after deducting underwriting discounts and estimated offering expenses borne by the Company, were approximately \$33.0 million and were used to repay a portion of outstanding borrowings under the Credit Facility. In connection with the offering, the Company also granted the underwriters an option, exercisable on or before November 27, 2011, to purchase an additional 210,000 shares of Term Preferred Stock solely to cover over-allotments, if any. On November 14, 2011, the underwriters notified the Company of their intent to exercise their option to purchase an additional 139,882 shares of the Company's Term Preferred Stock.

The Company is required to redeem all of the outstanding Term Preferred Stock on December 31, 2016 at a redemption price equal to \$25.00 per share plus an amount equal to accumulated but unpaid dividends, if any, to the date of redemption. The Company cannot effect any amendment, alteration or repeal of its obligation to redeem all of the Term Preferred Stock on December 31, 2016 without the prior unanimous consent of the holders of Term Preferred Stock. If the Company fails to maintain an asset coverage ratio of at least 200% (as described in the Prospectus Supplement), it will redeem a portion of the outstanding Term Preferred Stock in an amount at least equal to the lesser of (1) the minimum number of shares of Term Preferred Stock necessary to cause the Company to meet its required asset coverage ratio and (2) the maximum number of Term Preferred Stock that the Company can redeem out of cash legally available for such redemption. At any time on or after December 31, 2012, at the Company's sole option, it may redeem the Term Preferred Stock at a redemption price per share equal to the sum of the \$25.00 liquidation preference per share plus (i) an initial premium of 1.00% of the liquidation preference (with such premium declining by 0.50% on the first and second anniversaries such that on December 31, 2014, no premium will be payable in connection with any such optional redemption) and (ii) an amount equal to accumulated but unpaid dividends, if any, on the Term Preferred Stock.

**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF ASSETS AND LIABILITIES****(DOLLAR AMOUNTS IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)****(UNAUDITED)**

|   | March 31,<br>2012 | September 30,<br>2011 |
|---|-------------------|-----------------------|
| <b>ASSETS</b>   |                   |                       |
| Investments at fair value   |                   |                       |
| Non-Control/Non-Affiliate investments (Cost of <b>\$273,931</b> and \$288,266, respectively)  | <b>\$ 246,235</b> | \$ 257,302            |
| Control investments (Cost of <b>\$99,029</b> and \$94,549, respectively)  | <b>41,932</b>     | 45,645                |
| Total investments at fair value (Cost of <b>\$372,960</b> and \$382,815, respectively)  | <b>288,167</b>    | 302,947               |
| Cash  | <b>7,693</b>      | 6,732                 |
| Restricted cash   | <b>1,225</b>      |                       |
| Interest receivable investments in debt securities  | <b>3,055</b>      | 3,066                 |
| Interest receivable employees <sup>(A)</sup>  | <b>62</b>         |                       |
| Due from custodian  | <b>6,530</b>      | 2,547                 |
| Deferred financing fees   | <b>3,476</b>      | 650                   |
| Other assets  | <b>1,103</b>      | 1,682                 |
| <b>TOTAL ASSETS</b>   | <b>\$ 311,311</b> | \$ 317,624            |
| <b>LIABILITIES</b>  |                   |                       |
| Borrowings at fair value (Cost of <b>\$65,800</b> and \$99,400, respectively)   | <b>\$ 65,800</b>  | \$ 100,012            |
| Mandatorily redeemable preferred stock, \$0.001 par value per share, \$25 liquidation preference per share; <b>4,000,000</b> and no shares authorized; <b>1,539,882</b> and no shares issued and outstanding at March 31, 2012 and September 30, 2011, respectively | <b>38,497</b>     |                       |
| Accounts payable and accrued expenses   | <b>495</b>        | 513                   |
| Interest payable  | <b>226</b>        | 289                   |
| Fees due to Adviser <sup>(A)</sup>  | <b>2,063</b>      | 1,760                 |
| Fee due to Administrator <sup>(A)</sup>   | <b>211</b>        | 194                   |
| Other liabilities   | <b>2,017</b>      | 1,135                 |
| <b>TOTAL LIABILITIES</b>  | <b>\$ 109,309</b> | \$ 103,903            |
| Commitments and contingencies <sup>(B)</sup>  |                   |                       |
| <b>NET ASSETS</b>   | <b>\$ 202,002</b> | \$ 213,721            |
| <b>ANALYSIS OF NET ASSETS</b>   |                   |                       |
| Common stock, \$0.001 par value per share, <b>46,000,000</b> and 50,000,000 shares authorized; <b>21,000,160</b> and 21,039,242 shares issued and outstanding at March 31, 2012 and September 30, 2011, respectively  | <b>\$ 21</b>      | \$ 21                 |
| Capital in excess of par value  | <b>326,578</b>    | 326,913               |
| Notes receivable from employees <sup>(A)</sup>  | <b>(3,522)</b>    | (3,858)               |
| Cumulative net unrealized depreciation of investments   | <b>(84,793)</b>   | (79,867)              |
| Cumulative net unrealized appreciation of borrowings  |                   | (612)                 |
| Net investment income in excess of distributions  | <b>108</b>        | 108                   |
| Accumulated net realized losses   | <b>(36,390)</b>   | (28,984)              |

|  |                   |                   |
|--|-------------------|-------------------|
| <b>TOTAL NET ASSETS</b>                                  | <b>\$ 202,002</b> | <b>\$ 213,721</b> |
| <b>NET ASSET VALUE PER COMMON SHARE AT END OF PERIOD</b> | <b>\$ 9.62</b>    | <b>\$ 10.16</b>   |

(A) Refer to Note 4 *Related Party Transactions* for additional information.

(B) Refer to Note 10 *Commitments and Contingencies* for additional information.

*THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONDENSED CONSOLIDATED*

*FINANCIAL STATEMENTS.*

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**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(DOLLAR AMOUNTS IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)****(UNAUDITED)**

|  | Three Months Ended<br>March 31, |              | Six Months Ended<br>March 31, |               |
|--|---------------------------------|--------------|-------------------------------|---------------|
|  | 2012                            | 2011         | 2012                          | 2011          |
| <b>INVESTMENT INCOME</b>                                   |                                 |              |                               |               |
| Interest income  |                                 |              |                               |               |
| Non-Control/Non-Affiliate investments                      | \$ 7,840                        | \$ 5,754     | \$ 15,729                     | \$ 12,680     |
| Control investments  | 1,051                           | 1,414        | 2,410                         | 2,211         |
| Cash   |                                 |              | 6                             |               |
| Notes receivable from employees <sup>(A)</sup>             | 63                              | 122          | 130                           | 244           |
| <b>Total interest income</b>                               | <b>8,954</b>                    | <b>7,290</b> | <b>18,275</b>                 | <b>15,135</b> |
| Other income   |                                 |              |                               |               |
| Non-Control/Non-Affiliate investments                      | 2,042                           | 483          | 2,042                         | 645           |
| Control investments  |                                 | 625          |                               | 625           |
| <b>Total other income</b>                                  | <b>2,042</b>                    | <b>1,108</b> | <b>2,042</b>                  | <b>1,270</b>  |
| <b>Total investment income</b>                             | <b>10,996</b>                   | <b>8,398</b> | <b>20,317</b>                 | <b>16,405</b> |
| <b>EXPENSES</b>  |                                 |              |                               |               |
| Base management fee <sup>(A)</sup>                         | 1,538                           | 1,365        | 3,094                         | 2,712         |
| Incentive fee <sup>(A)</sup>                               | 1,304                           | 1,102        | 2,339                         | 2,261         |
| Administration fee <sup>(A)</sup>                          | 209                             | 175          | 404                           | 361           |
| Interest expense on borrowings                             | 999                             | 478          | 2,138                         | 358           |
| Dividend expense on mandatorily redeemable preferred stock | 686                             |              | 1,120                         |               |
| Amortization of deferred financing fees                    | 277                             | 368          | 734                           | 664           |
| Professional fees  | 362                             | 201          | 655                           | 534           |
| Other general and administrative expenses                  | 528                             | 383          | 773                           | 603           |
| <b>Expenses before credits from Adviser</b>                | <b>5,903</b>                    | <b>4,072</b> | <b>11,257</b>                 | <b>7,493</b>  |
| Credits to fees from Adviser <sup>(A)</sup>                | (123)                           | (102)        | (574)                         | (154)         |
| <b>Total expenses net of credits</b>                       | <b>5,780</b>                    | <b>3,970</b> | <b>10,683</b>                 | <b>7,339</b>  |
| <b>NET INVESTMENT INCOME</b>                               | <b>5,216</b>                    | <b>4,428</b> | <b>9,634</b>                  | <b>9,066</b>  |
| <b>REALIZED AND UNREALIZED GAIN (LOSS)</b>                 |                                 |              |                               |               |
| Net realized gain (loss):                                  |                                 |              |                               |               |
| Non-Control/Non-Affiliate investments                      | 37                              | 161          | (8,212)                       | 161           |
| Control investments  |                                 | (156)        |                               | (156)         |
| <b>Total net realized gain (loss)</b>                      | <b>37</b>                       | <b>5</b>     | <b>(8,212)</b>                | <b>5</b>      |
| Net unrealized (depreciation) appreciation:                |                                 |              |                               |               |
| Non-Control/Non-Affiliate investments                      | (3,351)                         | (3,020)      | 3,267                         | (8,062)       |

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|  |                   |            |                   |            |
|--|-------------------|------------|-------------------|------------|
| Control investments  | <b>(3,818)</b>    | (10,049)   | <b>(8,193)</b>    | (7,952)    |
| Borrowings   | <b>313</b>        | 255        | <b>612</b>        | 693        |
| Net unrealized depreciation  | <b>(6,856)</b>    | (12,814)   | <b>(4,314)</b>    | (15,321)   |
| Net realized and unrealized loss                                       | <b>(6,819)</b>    | (12,809)   | <b>(12,526)</b>   | (15,316)   |
| NET DECREASE IN NET ASSETS RESULTING FROM OPERATIONS                   | <b>\$ (1,603)</b> | \$ (8,381) | <b>\$ (2,892)</b> | \$ (6,250) |
| NET DECREASE IN NET ASSETS RESULTING FROM OPERATIONS PER COMMON SHARE: |                   |            |                   |            |
| Basic and Diluted  | <b>\$ (0.08)</b>  | \$ (0.40)  | <b>\$ (0.14)</b>  | \$ (0.30)  |
| WEIGHTED AVERAGE SHARES OF COMMON STOCK OUTSTANDING:                   |                   |            |                   |            |
| Basic and Diluted  | <b>21,005,402</b> | 21,039,242 | <b>21,022,087</b> | 21,039,242 |

<sup>(A)</sup> Refer to Note 4 *Related Party Transactions* for additional information.

*THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS.*

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**GLADSTONE CAPITAL CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS**  
**(DOLLAR AMOUNTS IN THOUSANDS)**  
**(UNAUDITED)**

|  | Six Months Ended March 31, |            |
|--|----------------------------|------------|
|  | 2012                       | 2011       |
| <i>Operations:</i>   |                            |            |
| Net investment income  | \$ 9,634                   | \$ 9,066   |
| Net realized (loss) gain on investments                                      | (8,212)                    | 5          |
| Net unrealized depreciation of investments                                   | (4,926)                    | (16,014)   |
| Net unrealized depreciation of borrowings                                    | 612                        | 693        |
| Net decrease in net assets resulting from operations                         | (2,892)                    | (6,250)    |
| <i>Distributions:</i>  |                            |            |
| Distributions to common stockholders   | (8,830)                    | (8,836)    |
| <i>Capital transactions:</i>   |                            |            |
| Stock redemption for repayment of principal on employee notes <sup>(A)</sup> | (332)                      |            |
| Repayment of principal on employee notes <sup>(A)</sup>                      | 335                        | 1,055      |
| Net increase in net assets from capital transactions                         | 3                          | 1,055      |
| Total decrease in net assets   | (11,719)                   | (14,031)   |
| Net assets at beginning of period  | 213,721                    | 249,246    |
| Net assets at end of period  | \$ 202,002                 | \$ 235,215 |

<sup>(A)</sup> Refer to Note 4 *Related Party Transactions* for additional information.

*THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS.*



**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(DOLLAR AMOUNTS IN THOUSANDS, EXCEPT SHARE AMOUNTS)****(UNAUDITED)**

|   | <b>Six Months Ended March 31,</b> |                 |
|---|-----------------------------------|-----------------|
|   | <b>2012</b>                       | <b>2011</b>     |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>   |                                   |                 |
| Net decrease in net assets resulting from operations  | \$ (2,892)                        | \$ (6,250)      |
| Adjustments to reconcile net decrease in net assets resulting from operations to net cash provided by (used in) operating activities: |                                   |                 |
| Purchase of investments   | (29,609)                          | (52,424)        |
| Principal repayments on investments   | 24,760                            | 35,227          |
| Proceeds from sale of investments   | 6,459                             | 777             |
| Increase in investment balance due to paid-in-kind interest   |                                   | (8)             |
| Increase in investment balance due to transferred interest  |                                   | (204)           |
| Net change in premiums, discounts and amortization  | (119)                             | 776             |
| Net realized loss (gain) on investments   | 8,363                             | (163)           |
| Net unrealized depreciation of investments  | 4,926                             | 16,014          |
| Net unrealized depreciation of borrowings   | (612)                             | (693)           |
| Increase in restricted cash   | (1,225)                           |                 |
| Amortization of deferred financing fees   | 734                               | 664             |
| (Increase) decrease in interest receivable  | (51)                              | 251             |
| Increase in due from custodian  | (3,983)                           | (1,024)         |
| Decrease (increase) in other assets   | 579                               | (9)             |
| Decrease in accounts payable and accrued expenses   | (18)                              | (296)           |
| Decrease in interest payable  | (63)                              | (573)           |
| Increase in fees due to Adviser <sup>(A)</sup>  | 303                               | 1,118           |
| Increase (decrease) in fee due to Administrator <sup>(A)</sup>  | 17                                | (92)            |
| Increase in other liabilities   | 882                               | 186             |
| <b>Net cash provided by (used in) operating activities</b>  | <b>8,451</b>                      | <b>(6,723)</b>  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>   |                                   |                 |
| Proceeds from borrowings  | 32,900                            | 50,800          |
| Repayments on borrowings  | (66,500)                          | (34,400)        |
| Proceeds from issuance of mandatorily redeemable preferred stock  | 38,497                            |                 |
| Deferred financing fees   | (3,560)                           | (759)           |
| Distributions paid to common stockholders   | (8,830)                           | (8,836)         |
| Receipt of principal on employee notes  | 3                                 | 1,055           |
| <b>Net cash (used in) provided by financing activities</b>  | <b>(7,490)</b>                    | <b>7,860</b>    |
| <b>NET INCREASE IN CASH</b>   | <b>961</b>                        | <b>1,137</b>    |
| <b>CASH, BEGINNING OF PERIOD</b>  | <b>6,732</b>                      | <b>7,734</b>    |
| <b>CASH, END OF PERIOD</b>  | <b>\$ 7,693</b>                   | <b>\$ 8,871</b> |

|   |           |            |           |
|---|-----------|------------|-----------|
| <b>NON-CASH ACTIVITIES</b> <sup>(B)</sup> | <b>\$</b> | <b>332</b> | <b>\$</b> |
|---|-----------|------------|-----------|

<sup>(A)</sup> Refer to Note 4 *Related Party Transactions* for additional information.

<sup>(B)</sup> Redemption of 39,082 shares of common stock to reduce the principal balance of an employee loan by \$332. Refer to Note 7 *Common Stock* for additional information.

*THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONDENSED CONSOLIDATED*

*FINANCIAL STATEMENTS.*

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**GLADSTONE CAPITAL CORPORATION**  
**CONDENSED CONSOLIDATED SCHEDULE OF INVESTMENTS**

AS OF MARCH 31, 2012

(DOLLAR AMOUNTS IN THOUSANDS)

(UNAUDITED)

| Company <sup>(A)</sup>                                 | Industry  | Investment <sup>(B)</sup>  | Principal | Cost   | Fair Value |
|--|---|--|-----------|--------|------------|
| <b>NON-CONTROL/NON-AFFILIATE INVESTMENTS:</b>          |   |  |           |        |            |
| <b>Non-syndicated Loans:</b>                           |   |  |           |        |            |
| Access Television Network, Inc.                        | Service-cable airtime (infomercials)              | Senior Term Debt (14.0%, Due 2/2011) <sup>(D)(H)</sup>             | \$ 903    | \$ 903 | \$         |
| Allison Publications, LLC                              | Service-publisher of consumer oriented Magazines  | Senior Term Debt (10.5%, Due 9/2012) <sup>(D)</sup>                | 8,164     | 8,171  | 7,674      |
| BAS Broadcasting                                       | Service-radio station operator                    | Senior Term Debt (11.5%, Due 7/2013) <sup>(D)</sup>                | 7,465     | 7,465  | 4,106      |
| Chinese Yellow Pages Company                           | Service-publisher of Chinese language directories | Line of Credit, \$0 available (7.3%, Due 11/2012) <sup>(D)</sup>   | 450       | 450    | 270        |
|  |   | Senior Term Debt (7.3%, Due 11/2012) <sup>(D)</sup>                | 78        | 78     | 47         |
|  |   |  |           | 528    | 317        |
| CMI Acquisition, LLC                                   | Service-recycling                                 | Senior Subordinated Term Debt (14.0%, Due 12/2016) <sup>(D)</sup>  | 14,265    | 14,265 | 14,194     |
| FedCap Partners, LLC                                   | Private equity fund                               | Class A Membership Units (80 units) <sup>(G)</sup>                 |           | 1,200  | 1,153      |
|  |   | Uncalled Capital Commitment (\$800)                                |           |        |            |
| GFRC Holdings, LLC                                     | Manufacturing-glass-fiber reinforced concrete     | Senior Term Debt (11.5%, Due 12/2013) <sup>(D)</sup>               | 5,324     | 5,324  | 2,928      |
|  |   | Senior Subordinated Term Debt (14.0%, Due 12/2013) <sup>(D)</sup>  | 6,598     | 6,598  | 3,629      |
|  |   |  |           | 11,922 | 6,557      |
| Heartland Communications Group                         | Service-radio station operator                    | Line of Credit, \$0 available (5.0%, Due 3/2013) <sup>(D)</sup>    | 100       | 100    | 35         |
|  |   | Line of Credit, \$55 available (10.0%, Due 3/2013) <sup>(D)</sup>  | 45        | 45     | 16         |
|  |   | Senior Term Debt (5.0%, Due 3/2013) <sup>(D)</sup>                 | 4,342     | 4,325  | 1,520      |
|  |   | Common Stock Warrants (8.8% ownership) <sup>(F)(G)</sup>           |           | 66     |            |
|  |   |  |           | 4,536  | 1,571      |
| International Junior Golf Training Acquisition Company | Service-golf training                             | Line of Credit, \$125 available (11.0%, Due 5/2014) <sup>(D)</sup> | 2,125     | 2,125  | 1,424      |
|  |   | Senior Term Debt (10.5%, Due 5/2014) <sup>(D)</sup>                | 661       | 661    | 443        |

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|   |       |       |       |
|---|-------|-------|-------|
| Senior Term Debt (12.5%, Due<br>5/2014) <sup>(C)(D)</sup> | 2,500 | 2,500 | 1,675 |
|   |       | 5,286 | 3,542 |

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**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONDENSED CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)****AS OF MARCH 31, 2012****(DOLLAR AMOUNTS IN THOUSANDS)****(UNAUDITED)**

| <b>Company<sup>(A)</sup></b>                              | <b>Industry</b>  | <b>Investment<sup>(B)</sup></b>                                    | <b>Principal</b> | <b>Cost</b> | <b>Fair Value</b> |
|---|--|--|------------------|-------------|-------------------|
| <b>NON-CONTROL/NON-AFFILIATE INVESTMENTS (Continued):</b> |  |  |                  |             |                   |
| Legend Communications of Wyoming, LLC                     | Service-operator of radio stations                                   | Senior Term Debt (12.0%, Due 6/2013) <sup>(D)</sup>                | \$ 9,203         | \$ 9,203    | \$ 4,785          |
| North American Aircraft Services, LLC                     | Service - repairs and maintains aircraft fuel tanks and fuel systems | Line of Credit, \$750 available (6.5%, Due 8/2012) <sup>(D)</sup>  | 1,250            | 1,250       | 1,238             |
|   |  | Senior Term Debt (7.5%, Due 8/2016) <sup>(D)</sup>                 | 4,767            | 4,767       | 4,719             |
|   |  | Senior Subordinated Term Debt (11.8%, Due 8/2016) <sup>(D)</sup>   | 4,750            | 4,750       | 4,703             |
|   |  | Senior Subordinated Term Debt (12.5%, Due 8/2016) <sup>(D)</sup>   | 2,820            | 2,820       | 2,792             |
|   |  | Common Stock Warrants (5.8% ownership) <sup>(F)(G)</sup>           |                  | 350         | 608               |
|   |  |  |                  | 13,937      | 14,060            |
| Northstar Broadband, LLC                                  | Service-cable TV franchise owner                                     | Senior Term Debt (0.7%, Due 12/2012) <sup>(D)</sup>                | 50               | 44          | 42                |
| Ohana Media Group   | Service AM/FM radio broadcast  | Senior Term Debt (10.0%, Due 10/2016) <sup>(D)</sup>               | 1,590            | 1,590       | 1,447             |
| Precision Acquisition Group Holdings, Inc.                | Manufacturing-consumable components for the Aluminum industry        | Equipment Note (13.0%, Due 3/2013) <sup>(D)</sup>                  | 1,000            | 1,000       | 835               |
|   |  | Senior Term Debt (13.0%, Due 3/2013) <sup>(D)</sup>                | 4,125            | 4,125       | 3,444             |
|   |  | Senior Term Debt (13.0%, Due 3/2013) <sup>(C)(D)</sup>             | 4,053            | 4,053       | 3,384             |
|   |  |  |                  |             | 9,178             |
| PROFIT Systems Acquisition Co.                            | Service-design and develop ERP Software                              | Line of Credit, \$350 available (11.3%, Due 7/2012) <sup>(D)</sup> |                  |             |                   |
|   |  | Senior Term Debt (10.5%, Due 7/2014) <sup>(C)(D)</sup>             | 2,850            | 2,850       | 2,708             |
|   |  |  |                  | 2,850       | 2,708             |
| Reliable Biopharmaceutical Holdings, Inc.                 | Manufacturing-pharmaceutical and biochemical intermediates           | Line of Credit, \$500 available (9.0%, Due 1/2013) <sup>(D)</sup>  | 3,500            | 3,500       | 3,316             |
|   |  | Mortgage Note (9.5%, Due 12/2014) <sup>(D)</sup>                   | 7,121            | 7,121       | 6,747             |
|   |  | Senior Term Debt (12.0%, Due 12/2014) <sup>(C)(D)</sup>            | 11,513           | 11,513      | 10,908            |
|   |  |  | 6,000            | 6,000       | 5,685             |

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|   |        |        |
|---|--------|--------|
| Senior Subordinated Term Debt (12.5%, Due 12/2014) <sup>(D)</sup> |        |        |
| Common Stock Warrants (764 shares) <sup>(F)(G)</sup>              | 209    | 736    |
|   | 28,343 | 27,392 |

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**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONDENSED CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)****AS OF MARCH 31, 2012****(DOLLAR AMOUNTS IN THOUSANDS)****(UNAUDITED)**

| <b>Company<sup>(A)</sup></b>                              | <b>Industry</b>  | <b>Investment<sup>(B)</sup></b>   | <b>Principal</b>        | <b>Cost</b>             | <b>Fair Value</b>       |
|---|--|---|-------------------------|-------------------------|-------------------------|
| <b>NON-CONTROL/NON-AFFILIATE INVESTMENTS (Continued):</b> |  |   |                         |                         |                         |
| Saunders & Associates                                     | Manufacturing-equipment provider for frequency control devices | Line of Credit, \$2,500 available (11.3%, Due 5/2013) <sup>(D)</sup><br>Senior Term Debt (11.3%, Due 5/2013) <sup>(D)</sup>   | \$<br>8,947             | \$<br>8,947             | \$<br>8,052             |
|   |  |   |                         | 8,947                   | 8,052                   |
| Sunburst Media - Louisiana, LLC                           | Service-radio station operator                                 | Senior Term Debt (10.5%, Due 1/2012) <sup>(D)</sup>   | 6,000                   | 6,000                   | 2,400                   |
| Thibaut Acquisition Co.                                   | Service-design and distribute wall Covering                    | Line of Credit, \$250 available (9.0%, Due 1/2014) <sup>(D)</sup><br>Senior Term Debt (8.5%, Due 1/2014) <sup>(D)</sup><br>Senior Term Debt (12.0%, Due 1/2014) <sup>(C)(D)</sup>   | 750<br>287<br>3,000     | 750<br>287<br>3,000     | 737<br>282<br>2,933     |
|   |  |   |                         | 4,037                   | 3,952                   |
| Westlake Hardware, Inc.                                   | Retail-hardware and variety                                    | Senior Subordinated Term Debt (12.3%, Due 1/2014) <sup>(D)</sup><br>Senior Subordinated Term Debt (13.5%, Due 1/2014) <sup>(D)</sup>  | 12,000<br>8,000         | 12,000<br>8,000         | 11,640<br>7,700         |
|   |  |   |                         | 20,000                  | 19,340                  |
| Westland Technologies, Inc.                               | Service-diversified conglomerate                               | Line of Credit, \$1,000 available (6.5%, Due 4/2012) <sup>(D)</sup><br>Senior Term Debt (7.5%, Due 4/2016) <sup>(D)</sup><br>Senior Term Debt (12.5%, Due 4/2016) <sup>(D)</sup><br>Common Stock Warrants (77,287 shares) <sup>(F)(G)</sup> | 1,850<br>4,000          | 1,850<br>4,000          | 1,804<br>3,900          |
|   |  |   |                         | 350                     | 279                     |
|   |  |   |                         | 6,200                   | 5,983                   |
| Winchester Electronics                                    | Manufacturing-high bandwidth connectors and cables             | Senior Term Debt (6.5%, Due 5/2013) <sup>(D)</sup><br>Senior Term Debt (7.0%, Due 5/2013) <sup>(D)</sup><br>Senior Subordinated Term Debt (13.5%, Due 6/2013) <sup>(D)</sup>  | 1,250<br>1,669<br>9,750 | 1,250<br>1,669<br>9,750 | 1,244<br>1,656<br>9,628 |

|                                      |            |            |
|--------------------------------------|------------|------------|
|                                      | 12,669     | 12,528     |
| <i>Subtotal Non-syndicated loans</i> | \$ 177,274 | \$ 149,466 |

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**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONDENSED CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)**

AS OF MARCH 31, 2012

(DOLLAR AMOUNTS IN THOUSANDS)

(UNAUDITED)

| Company <sup>(A)</sup>                                    | Industry  | Investment <sup>(B)</sup>   | Principal | Cost     | Fair Value |
|---|---|---|-----------|----------|------------|
| <b>NON-CONTROL/NON-AFFILIATE INVESTMENTS (Continued):</b> |   |   |           |          |            |
| <b>Syndicated Loans:</b>                                  |   |   |           |          |            |
| Airvana Network Solutions, Inc.                           | Service-telecommunications  | Senior Term Debt (10.0%, Due 3/2015) <sup>(E)</sup>               | \$ 3,928  | \$ 3,827 | \$ 3,732   |
| Allied Security Holdings, LLC                             | Service-contract security officer providers                                     | Senior Subordinated Term Debt (8.5%, Due 2/2018) <sup>(E)</sup>   | 1,000     | 991      | 1,003      |
| Allied Specialty Vehicles, Inc.                           | Manufacturing-specialty vehicles  | Senior Term Debt (9.5%, Due 2/2016) <sup>(E)</sup>                | 9,900     | 9,735    | 9,702      |
| Ameriquel Group, LLC                                      | Manufacturing-production and distribution of food products                      | Senior Term Debt (9.0%, Due 3/2016) <sup>(E)</sup>                | 7,444     | 7,319    | 7,295      |
| Applied Systems, Inc.                                     | Software for property & casualty insurance industry                             | Senior Subordinated Term Debt (9.3%, Due 6/2017) <sup>(E)</sup>   | 1,000     | 992      | 998        |
| Ascend Learning, LLC                                      | Service-technology-based learning solutions                                     | Senior Subordinated Term Debt (11.5%, Due 12/2017) <sup>(E)</sup> | 1,000     | 974      | 1,010      |
| Attachmate Corporate                                      | Service-develops, implements and supports software                              | Senior Subordinated Term Debt (9.5%, Due 2/2017) <sup>(E)</sup>   | 4,000     | 3,965    | 3,990      |
| Autoparts Holdings Limited                                | Supplier to the light and heavy-duty vehicle after market for replacement parts | Senior Term Debt (10.5%, Due 1/2018) <sup>(E)</sup>               | 1,000     | 995      | 983        |
| Blue Coat Systems, Inc.                                   | Provider of internet security and network acceleration appliances               | Senior Subordinated Term Debt (11.5%, Due 8/2018) <sup>(E)</sup>  | 8,500     | 8,497    | 8,542      |
| Covad Communications Group, Inc.                          | Service-telecommunications  | Senior Term Debt (12.0%, Due 11/2015) <sup>(E)</sup>              | 1,750     | 1,722    | 1,741      |
| Global Brass and Copper, Inc.                             | Manufacturing - steel wool products and metal fibers                            | Senior Term Debt (10.3%, Due 8/2015) <sup>(E)</sup>               | 2,953     | 2,886    | 2,993      |
| HGI Holding, Inc  | Service - distributor of disposable medical products                            | Senior Term Debt (6.8%, Due 10/2016) <sup>(E)</sup>               | 1,757     | 1,725    | 1,757      |
| Hubbard Radio, LLC  | Service-radio station operator  | Senior Subordinated Term Debt (8.8%, Due 4/2018) <sup>(E)</sup>   | 500       | 495      | 506        |
| Keypoint Government Solutions, Inc.                       | Service-security consulting services  | Senior Term Debt (10.0%, Due 12/2015) <sup>(E)</sup>              | 6,912     | 6,884    | 6,912      |
| Mood Media Corporation                                    | Service-media and marketing solutions   | Senior Term Debt (10.3%, Due 11/2018) <sup>(E)</sup>              | 8,000     | 7,926    | 7,480      |
| National Surgical Hospitals, Inc.                         | Service-physician-partnered surgical facilities                                 | Senior Term Debt (8.3%, Due 2/2017) <sup>(E)</sup>                | 1,686     | 1,652    | 1,631      |

**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONDENSED CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)****AS OF MARCH 31, 2012****(DOLLAR AMOUNTS IN THOUSANDS)****(UNAUDITED)**

| <b>Company<sup>(A)</sup></b>  | <b>Industry</b>   | <b>Investment<sup>(B)</sup></b>   | <b>Principal</b> | <b>Cost</b>       | <b>Fair Value</b> |
|---|---|---|------------------|-------------------|-------------------|
| <b>NON-CONTROL/NON-AFFILIATE INVESTMENTS (Continued):</b>   |   |   |                  |                   |                   |
| Sensus USA, Inc.  | Service-provider of utility communication Services                  | Senior Term Debt (8.5%, Due 5/2018) <sup>(E)</sup>  | \$ 500           | \$ 495            | \$ 496            |
| Springs Window Fashions, LLC  | Manufacturing-window coverings                                      | Senior Term Debt (11.3%, Due 11/2017) <sup>(E)</sup>  | 7,000            | 6,843             | 6,825             |
| SRAM, LLC   | Manufacturing-premium bicycle components                            | Senior Term Debt (8.5%, Due 12/2018) <sup>(E)</sup>   | 2,500            | 2,477             | 2,512             |
| Targus Group International, Inc.  | Manufacturing-carrying cases and accessories for notebook computers | Senior Term Debt (11.0%, Due 5/2016) <sup>(E)</sup>   | 9,925            | 9,752             | 9,801             |
| Ulterra Drilling Technologies, LP   | Manufacturing-oil field drill bits and slick-slip reduction tools   | Senior Term Debt (9.5%, Due 6/2016) <sup>(E)</sup>  | 1,925            | 1,891             | 1,915             |
| Vision Solutions, Inc.  | Service-provider of information availability software               | Senior Term Debt (9.5%, Due 7/2017) <sup>(E)</sup>  | 11,000           | 10,921            | 10,670            |
| Wall Street Systems Holdings, Inc.  | Service-software provider   | Senior Term Debt (9.0%, Due 6/2018) <sup>(E)</sup>  | 3,000            | 2,972             | 3,007             |
| WP Evenflo Group Holdings, Inc.   | Manufacturing-infant and juvenile Products                          | Senior Term Debt (8.0%, Due 2/2013) <sup>(E)</sup>  | 277              | 277               | 270               |
|   |   | Senior Preferred Equity (333 shares) <sup>(F)(G)</sup>  |                  | 333               | 440               |
|   |   | Junior Preferred Equity (111 shares) <sup>(F)(G)</sup>  |                  | 111               | 155               |
|   |   | Common Stock (1,874 shares) <sup>(F)(G)</sup>   |                  |                   | 403               |
|   |   |   |                  | 721               | 1,268             |
| <b>Subtotal Syndicated loans</b>  |   |   |                  | \$ 96,657         | \$ 96,769         |
| <b>Total Non-Control/Non-Affiliate Investments (represented 85.4% of total investments at fair value)</b> |   |   |                  | <b>\$ 273,931</b> | <b>\$ 246,235</b> |
| <b>CONTROL INVESTMENTS:</b>   |   |   |                  |                   |                   |
| BERTL, Inc.   | Service-web-based evaluator of imaging products                     | Line of Credit, \$69 available (6.5%, Due 4/2012) <sup>(F)(H)(I)</sup><br>Common Stock (100 shares) <sup>(F)(G)</sup> | 1,358            | 1,358             |                   |
|   |   |   |                  | 424               |                   |
|   |   |   |                  | 1,782             |                   |
| Defiance Integrated Technologies, Inc.  | Manufacturing-trucking parts  | Senior Term Debt (11.0%, Due 4/2013) <sup>(C)(F)</sup>  | 7,345            | 7,345             | 7,345             |

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|                             |   |  |     |       |        |
|-----------------------------|---|--|-----|-------|--------|
|                             |   | Common Stock (15,500 shares) <sup>(F)(G)</sup>                         |     | 1     | 8,696  |
|                             |   |  |     | 7,346 | 16,041 |
| Kansas Cable Holdings, Inc. | Service - cable, internet, voice provider | Line of Credit, \$153 available (10.0%, Due 10/2012) <sup>(D)(H)</sup> | 672 | 662   | 5      |

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**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONDENSED CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)****AS OF MARCH 31, 2012****(DOLLAR AMOUNTS IN THOUSANDS)****(UNAUDITED)**

| <b>Company<sup>(A)</sup></b>            | <b>Industry</b>                                  | <b>Investment<sup>(B)</sup></b>  | <b>Principal</b> | <b>Cost</b> | <b>Fair Value</b> |
|---|--|--|------------------|-------------|-------------------|
| <b>CONTROL INVESTMENTS (Continued):</b> |  |  |                  |             |                   |
|   |  | Senior Term Debt (10.0%, Due 10/2012) <sup>(D)(H)</sup>                  | \$ 1,500         | \$ 1,444    | \$ 11             |
|   |  | Senior Term Debt (10.0%, Due 10/2012) <sup>(D)(H)</sup>                  | 1,039            | 1,000       | 8                 |
|   |  | Common Stock (100 shares) <sup>(F)(G)</sup>                              |                  |             |                   |
|   |  |  |                  | 3,106       | 24                |
| Lindmark Acquisition, LLC               | Service-advertising                              | Senior Subordinated Term Debt (11.0%, Due 10/2012) <sup>(D)(H)</sup>     | 10,000           | 10,000      | 1,300             |
|   |  | Senior Subordinated Term Debt (13.0%, Due 10/2012) <sup>(D)(H)</sup>     | 2,000            | 2,000       | 260               |
|   |  | Senior Subordinated Term Debt (13.0%, Due Upon Demand) <sup>(D)(H)</sup> | 1,909            | 1,909       | 248               |
|   |  | Common Stock (100 shares) <sup>(F)(G)</sup>                              |                  | 317         |                   |
|   |  |  |                  | 14,226      | 1,808             |
| LocalTel, LLC                           | Service-yellow pages publishing                  | Line of credit, \$132 available (10.0%, Due 6/2012) <sup>(F)(H)</sup>    | 2,218            | 2,218       | 559               |
|   |  | Line of Credit, \$1,830 available (4.7%, Due 6/2012) <sup>(F)(H)</sup>   | 1,170            | 1,170       |                   |
|   |  | Senior Term Debt (12.5%, Due 2/2012) <sup>(F)(H)</sup>                   | 325              | 325         |                   |
|   |  | Senior Term Debt (8.5%, Due 6/2012) <sup>(F)(H)</sup>                    | 2,688            | 2,688       |                   |
|   |  | Senior Term Debt (10.5%, Due 6/2012) <sup>(C)(F)(H)</sup>                | 2,750            | 2,750       |                   |
|   |  | Common Stock Warrants (4,000 shares) <sup>(F)(G)</sup>                   |                  |             |                   |
|   |  |  |                  | 9,151       | 559               |
| Midwest Metal Distribution, Inc.        | Distribution-aluminum sheets and stainless steel | Senior Subordinated Term Debt (12.0%, Due 7/2013) <sup>(D)</sup>         | 18,281           | 18,267      | 17,870            |
|   |  | Common Stock (501 shares) <sup>(F)(G)</sup>                              |                  | 138         |                   |
|   |  |  |                  | 18,405      | 17,870            |

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|                         |  |   |        |        |       |
|-------------------------|--|---|--------|--------|-------|
| Sunshine Media Holdings | Service-publisher regional B2B trade magazines | Line of credit, \$498 available (4.8%, Due 8/2014) <sup>(D)</sup> | 1,502  | 1,502  | 225   |
|                         |  | Senior Term Debt (4.8%, Due 5/2016) <sup>(D)</sup>                | 16,948 | 16,948 | 2,542 |
|                         |  | Senior Term Debt (5.5%, Due 5/2016) <sup>(C)(D)(H)</sup>          | 10,700 | 10,700 | 1,605 |
|                         |  | Junior Preferred Equity (11,013 shares) <sup>(F)(G)</sup>         |        | 4,075  |       |
|                         |  | Common Stock (934 shares) <sup>(F)(G)</sup>                       |        | 740    |       |
|                         |  |   |        | 33,965 | 4,372 |

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**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONDENSED CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)**

AS OF MARCH 31, 2012

(DOLLAR AMOUNTS IN THOUSANDS)

(UNAUDITED)

| Company <sup>(A)</sup>  | Industry                            | Investment <sup>(B)</sup>   | Principal | Cost              | Fair Value        |
|---|-------------------------------------|---|-----------|-------------------|-------------------|
| <b>CONTROL INVESTMENTS (Continued):</b>   |                                     |   |           |                   |                   |
| U.S. Healthcare Communications, Inc.  | Service-magazine publisher/operator | Line of credit, \$131 available (6.0%, Due 12/2010) <sup>(F)(H)</sup> | \$ 269    | \$ 269            | \$                |
|   |                                     | Line of credit, \$0 available (6.0%, Due 12/2010) <sup>(F)(H)</sup>   | 450       | 450               |                   |
|   |                                     | Common Stock (100 shares) <sup>(F)(G)</sup>                           |           | 2,470             |                   |
|   |                                     |   |           | 3,189             |                   |
| Viapack, Inc.   | Manufacturing-polyethylene film     | Line of Credit, \$466 available (6.5%, Due 3/2013) <sup>(D)</sup>     | 3,334     | 3,334             | 534               |
|   |                                     | Senior Real Estate Term Debt (5.0%, Due 3/2014) <sup>(D)</sup>        | 600       | 600               | 96                |
|   |                                     | Senior Term Debt (6.2%, Due 3/2014) <sup>(C)(D)(H)</sup>              | 3,925     | 3,925             | 628               |
|   |                                     | Preferred Equity (100 shares) <sup>(F)(G)</sup>                       |           |                   |                   |
|   |                                     | Guarantee (\$600)   |           |                   |                   |
|   |                                     |   |           | 7,859             | 1,258             |
| <b>Total Control Investments (represented 14.6% of total investments at fair value)</b> |                                     |   |           | <b>\$ 99,029</b>  | <b>\$ 41,932</b>  |
| <b>Total Investments</b>  |                                     |   |           | <b>\$ 372,960</b> | <b>\$ 288,167</b> |

<sup>(A)</sup> Certain of the securities listed in the above schedule are issued by affiliate(s) of the indicated portfolio company.

<sup>(B)</sup> Percentage represents interest rates in effect at March 31, 2012, and due date represents the contractual maturity date.

<sup>(C)</sup> Last Out Tranche ( LOT ) of senior debt, meaning if the portfolio company is liquidated, the holder of the LOT is paid after the senior debt.

<sup>(D)</sup> Fair value was primarily based on opinions of value submitted by Standard & Poor's Securities Evaluations, Inc.

<sup>(E)</sup> Security valued based on the indicative bid price on or near March 31, 2012, offered by the respective syndication agent's trading desk or secondary desk.

<sup>(F)</sup> Fair value was primarily based on the total enterprise value of the portfolio company using a liquidity waterfall approach. We also considered discounted cash flow methodologies.

<sup>(G)</sup> Security is non-income producing.

<sup>(H)</sup> Debt security is on non-accrual status.

<sup>(I)</sup> In April 2012, we amended the terms of the security extending the maturity date.

*THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS.*

**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONDENSED CONSOLIDATED SCHEDULE OF INVESTMENTS****SEPTEMBER 30, 2011****(DOLLAR AMOUNTS IN THOUSANDS)**

| <b>Company<sup>(A)</sup></b>                  | <b>Industry</b>                                    | <b>Investment<sup>(B)</sup></b>                                    | <b>Principal</b> | <b>Cost</b> | <b>Fair Value</b> |
|---|--|--|------------------|-------------|-------------------|
| <b>NON-CONTROL/NON-AFFILIATE INVESTMENTS:</b> |  |  |                  |             |                   |
| <b>Non-syndicated Loans:</b>                  |  |  |                  |             |                   |
| Access Television Network, Inc.               | Service-cable airtime (infomercials)               | Senior Term Debt (14.0%, Due 2/2011) <sup>(D)(H)</sup>             | \$ 903           | \$ 903      | \$ 45             |
| Allison Publications, LLC                     | Service-publisher of consumer oriented magazines   | Senior Term Debt (10.5%, Due 9/2012) <sup>(D)</sup>                | 8,463            | 8,478       | 7,861             |
| BAS Broadcasting                              | Service-radio station operator                     | Senior Term Debt (11.5%, Due 7/2013) <sup>(D)</sup>                | 7,465            | 7,465       | 6,233             |
| Chinese Yellow Pages Company                  | Service-publisher of Chinese language directories  | Line of Credit, \$250 available (7.3%, Due 11/2011) <sup>(D)</sup> | 450              | 450         | 338               |
|   |  | Senior Term Debt (7.3%, Due 11/2011) <sup>(D)</sup>                | 168              | 168         | 126               |
|   |  |  |                  | 618         | 464               |
| CMI Acquisition, LLC                          | Service-recycling                                  | Senior Subordinated Term Debt (13.0%, Due 12/2016) <sup>(D)</sup>  | 14,265           | 14,265      | 14,336            |
| FedCap Partners, LLC                          | Private equity fund                                | Class A Membership Units (80 units) <sup>(G)</sup>                 |                  | 1,200       | 1,153             |
|   |  | Uncalled Capital Commitment (\$800)                                |                  |             |                   |
| GFRC Holdings, LLC                            | Manufacturing-glass-fiber reinforced concrete      | Senior Term Debt (11.5%, Due 12/2012) <sup>(D)</sup>               | 5,617            | 5,617       | 4,719             |
|   |  | Senior Subordinated Term Debt (14.0%, Due 12/2012) <sup>(D)</sup>  | 6,615            | 6,615       | 5,557             |
|   |  |  |                  | 12,232      | 10,276            |
| Global Materials Technologies, Inc.           | Manufacturing-steel wool products and metal fibers | Senior Term Debt (13.0%, Due 6/2012) <sup>(C)(D)</sup>             | 2,635            | 2,635       | 2,212             |
| Heartland Communications Group                | Service-radio station operator                     | Line of Credit, \$0 available (5.0%, Due 3/2013) <sup>(D)</sup>    | 100              | 100         | 41                |
|   |  | Line of Credit, \$0 available (10.0%, Due 3/2013) <sup>(D)</sup>   | 100              | 100         | 41                |
|   |  | Senior Term Debt (5.0%, Due 3/2013) <sup>(D)</sup>                 | 4,342            | 4,316       | 1,780             |
|   |  | Common Stock Warrants (8.8% ownership) <sup>(F)(G)</sup>           |                  | 66          |                   |
|   |  |  |                  | 4,582       | 1,862             |
|   | Service-golf training                              |  | 1,500            | 1,500       | 1,275             |

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|  |  |       |       |       |
|--|--|-------|-------|-------|
| International Junior Golf Training Acquisition Company | Line of Credit, \$0 available (11.0%, Due 5/2012) <sup>(D)</sup> |       |       |       |
|  | Senior Term Debt (10.5%, Due 5/2012) <sup>(D)</sup>              | 861   | 861   | 732   |
|  | Senior Term Debt (12.5%, Due 5/2012) <sup>(C)(D)</sup>           | 2,500 | 2,500 | 2,125 |
|  |  |       | 4,861 | 4,132 |

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**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONDENSED CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)****AS OF SEPTEMBER 30, 2011****(DOLLAR AMOUNTS IN THOUSANDS)**

| <b>Company<sup>(A)</sup></b>                              | <b>Industry</b>  | <b>Investment<sup>(B)</sup></b>                                      | <b>Principal</b> | <b>Cost</b> | <b>Fair Value</b> |  |
|---|--|--|------------------|-------------|-------------------|--|
| <b>NON-CONTROL/NON-AFFILIATE INVESTMENTS (Continued):</b> |  |  |                  |             |                   |  |
| KMBQ Corporation  | Service-AM/FM radio broadcaster                                      | Line of Credit, \$42 available (12.3%, Due 7/2010) <sup>(D)(H)</sup> | \$ 162           | \$ 158      | \$ 76             |  |
|   |  | Senior Term Debt (12.3%, Due 7/2010) <sup>(D)(H)</sup>               | 2,081            | 2,038       | 984               |  |
|   |  |  |                  | 2,196       | 1,060             |  |
| Legend Communications of Wyoming, LLC                     | Service-operator of radio stations                                   | Senior Term Debt (12.0%, Due 6/2013) <sup>(D)</sup>                  | 9,745            | 9,745       | 5,408             |  |
|   |  | Senior Term Debt (16.0%, Due 7/2011) <sup>(D)</sup>                  | 220              | 220         | 123               |  |
|   |  |  |                  | 9,965       | 5,531             |  |
| Newhall Holdings, Inc.                                    | Service-distributor of personal care products and supplements        | Line of Credit, \$0 available (8.0%, Due 12/2012) <sup>(D)(H)</sup>  | 1,985            | 1,985       | 98                |  |
|   |  | Senior Term Debt (8.5%, Due 12/2012) <sup>(D)(H)</sup>               | 1,870            | 1,870       | 94                |  |
|   |  | Senior Term Debt (3.5%, Due 12/2012) <sup>(C)(D)(H)</sup>            | 2,000            | 2,000       | 100               |  |
|   |  | Senior Term Debt (3.5%, Due 12/2012) <sup>(C)(D)(H)</sup>            | 4,648            | 4,648       | 232               |  |
|   |  | Preferred Equity (1,000,000 shares) <sup>(F)(G)(H)</sup>             |                  |             |                   |  |
|   |  | Common Stock (688,500 shares) <sup>(F)(G)</sup>                      |                  |             |                   |  |
|   |  |  |                  | 10,503      | 524               |  |
| North American Aircraft Services LLC                      | Service - repairs and maintains aircraft fuel tanks and fuel systems | Line of Credit, \$1,500 available (6.5%, Due 8/2012) <sup>(D)</sup>  | 500              | 500         | 500               |  |
|   |  | Senior Term Debt (7.5%, Due 8/2016) <sup>(D)</sup>                   | 3,250            | 3,250       | 3,250             |  |
|   |  | Senior Subordinated Term Debt (11.8%, Due 8/2016) <sup>(D)</sup>     | 4,750            | 4,750       | 4,750             |  |
|   |  | Common Stock Warrants (4.8% ownership) <sup>(F)(G)</sup>             |                  | 350         | 350               |  |
|   |  |  | 8,850            | 8,850       |                   |  |
| Northern Contours, Inc.                                   | Manufacturing-veneer and laminate components                         | Senior Subordinated Term Debt (13.0%, Due 9/2012) <sup>(D)</sup>     | 6,128            | 6,128       | 5,684             |  |
| Northstar Broadband, LLC                                  | Service-cable TV franchise owner                                     | Senior Term Debt (0.7%, Due 12/2012) <sup>(D)</sup>                  | 80               | 70          | 64                |  |

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|  |   |   |       |       |       |
|--|---|---|-------|-------|-------|
| Precision Acquisition Group Holdings, Inc. | Manufacturing-consumable components for the aluminum industry | Equipment Note (13.0%, Due 11/2011) <sup>(D)</sup>      | 1,000 | 1,000 | 948   |
|  |   | Senior Term Debt (13.0%, Due 11/2011) <sup>(D)</sup>    | 4,125 | 4,125 | 3,908 |
|  |   | Senior Term Debt (13.0%, Due 11/2011) <sup>(C)(D)</sup> | 4,053 | 4,053 | 3,840 |
|  |   |   |       | 9,178 | 8,696 |

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**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONDENSED CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)****AS OF SEPTEMBER 30, 2011****(DOLLAR AMOUNTS IN THOUSANDS)**

| <b>Company<sup>(A)</sup></b>                              | <b>Industry</b>  | <b>Investment<sup>(B)</sup></b>                                      | <b>Principal</b> | <b>Cost</b> | <b>Fair Value</b> |
|---|--|--|------------------|-------------|-------------------|
| <b>NON-CONTROL/NON-AFFILIATE INVESTMENTS (Continued):</b> |  |  |                  |             |                   |
| PROFIT Systems Acquisition Co.                            | Service-design and develop ERP software                        | Line of Credit, \$350 available (11.25%, Due 7/2012) <sup>(D)</sup>  | \$               | \$          | \$                |
|   |  | Senior Term Debt (10.5%, Due 7/2014) <sup>(C)(D)</sup>               | 3,150            | 3,150       | 3,024             |
|   |  |  |                  | 3,150       | 3,024             |
| RCS Management Holding Co.                                | Service-healthcare supplies                                    | Senior Term Debt (9.5%, Due 1/2013) <sup>(D)</sup>                   | 1,438            | 1,438       | 1,367             |
|   |  | Senior Term Debt (11.5%, Due 1/2013) <sup>(C)(D)</sup>               | 3,060            | 3,060       | 2,907             |
|   |  |  |                  | 4,498       | 4,274             |
| Reliable Biopharmaceutical Holdings, Inc.                 | Manufacturing-pharmaceutical and biochemical intermediates     | Line of Credit, \$2,800 available (9.0%, Due 1/2013) <sup>(D)</sup>  | 1,200            | 1,200       | 1,176             |
|   |  | Mortgage Note (9.5%, Due 12/2014) <sup>(D)</sup>                     | 7,168            | 7,168       | 7,025             |
|   |  | Senior Term Debt (12.0%, Due 12/2014) <sup>(C)(D)</sup>              | 11,573           | 11,573      | 10,906            |
|   |  | Senior Subordinated Term Debt (12.5%, Due 12/2014) <sup>(D)</sup>    | 6,000            | 6,000       | 5,655             |
|   |  | Common Stock Warrants (764 shares) <sup>(F)(G)</sup>                 |                  | 209         | 534               |
|   |  |  |                  | 26,150      | 25,296            |
| Saunders & Associates                                     | Manufacturing-equipment provider for frequency control devices | Line of Credit, \$2,500 available (11.3%, Due 5/2013) <sup>(D)</sup> |                  |             |                   |
|   |  | Senior Term Debt (11.3%, Due 5/2013) <sup>(D)</sup>                  | 8,947            | 8,947       | 8,913             |
|   |  |  |                  | 8,947       | 8,913             |
| Sunburst Media - Louisiana, LLC                           | Service-radio station operator                                 | Senior Term Debt (10.5%, Due 12/2011) <sup>(D)</sup>                 | 6,100            | 6,103       | 3,964             |
| Thibaut Acquisition Co.                                   | Service-design and distribute wall covering                    | Line of Credit, \$400 available (9.0%, Due 1/2014) <sup>(D)</sup>    | 600              | 600         | 585               |
|   |  | Senior Term Debt (8.5%, Due 1/2014) <sup>(D)</sup>                   | 550              | 550         | 536               |
|   |  | Senior Term Debt (12.0%, Due 1/2014) <sup>(C)(D)</sup>               | 3,000            | 3,000       | 2,910             |

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|                         |                             |  |        |        |        |
|-------------------------|-----------------------------|--|--------|--------|--------|
|                         |                             |  |        | 4,150  | 4,031  |
| Westlake Hardware, Inc. | Retail-hardware and variety | Senior Subordinated Term Debt (12.3%, Due 1/2014) <sup>(D)</sup> | 12,000 | 12,000 | 11,640 |
|                         |                             | Senior Subordinated Term Debt (13.5%, Due 1/2014) <sup>(D)</sup> | 8,000  | 8,000  | 7,700  |
|                         |                             |  |        | 20,000 | 19,340 |

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**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONDENSED CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)****AS OF SEPTEMBER 30, 2011****(DOLLAR AMOUNTS IN THOUSANDS)**

| <b>Company<sup>(A)</sup></b>                              | <b>Industry</b>  | <b>Investment<sup>(B)</sup></b>                                     | <b>Principal</b> | <b>Cost</b> | <b>Fair Value</b> |
|---|--|---|------------------|-------------|-------------------|
| <b>NON-CONTROL/NON-AFFILIATE INVESTMENTS (Continued):</b> |  |   |                  |             |                   |
| Westland Technologies, Inc.                               | Service-diversified conglomerate                           | Line of Credit, \$1,000 available (6.5%, Due 4/2012) <sup>(D)</sup> | \$               | \$          | \$                |
|   |  | Senior Term Debt (7.5%, Due 4/2016) <sup>(D)</sup>                  | 2,000            | 2,000       | 1,995             |
|   |  | Senior Term Debt (12.5%, Due 4/2016) <sup>(D)</sup>                 | 4,000            | 4,000       | 3,990             |
|   |  | Common Stock Warrants (77,287 shares) <sup>(F)(G)</sup>             |                  | 350         | 307               |
|   |  |   |                  | 6,350       | 6,292             |
| Winchester Electronics                                    | Manufacturing-high bandwidth connectors and cables         | Senior Term Debt (5.2%, Due 5/2012) <sup>(D)</sup>                  | 1,250            | 1,250       | 1,238             |
|   |  | Senior Term Debt (5.7%, Due 5/2013) <sup>(D)</sup>                  | 1,677            | 1,677       | 1,656             |
|   |  | Senior Subordinated Term Debt (14.0%, Due 6/2013) <sup>(D)</sup>    | 9,800            | 9,800       | 9,628             |
|   |  |   |                  | 12,727      | 12,522            |
| <b>Subtotal Non-syndicated loans</b>                      |  |   |                  | \$ 196,204  | \$ 166,639        |
| <b>Syndicated Loans:</b>                                  |  |   |                  |             |                   |
| Airvana Network Solutions, Inc.                           | Service-telecommunications                                 | Senior Term Debt (10.0%, Due 3/2015) <sup>(E)</sup>                 | 6,048            | 5,912       | 6,048             |
| Allied Security Holdings, LLC                             | Service-contract security officer providers                | Senior Subordinated Term Debt (8.5%, Due 2/2018) <sup>(E)</sup>     | 1,000            | 991         | 965               |
| Allied Specialty Vehicles, Inc.                           | Manufacturing-specialty vehicles                           | Senior Term Debt (9.5%, Due 2/2016) <sup>(E)</sup>                  | 9,950            | 9,767       | 9,751             |
| Ameriquel Group, LLC                                      | Manufacturing-production and distribution of food products | Senior Term Debt (9.0%, Due 3/2016) <sup>(E)</sup>                  | 7,481            | 7,344       | 7,332             |
| Applied Systems, Inc.                                     | Software for property & casualty insurance industry        | Senior Subordinated Term Debt (9.3%, Due 6/2017) <sup>(E)</sup>     | 1,000            | 991         | 990               |
| Ascend Learning, LLC                                      | Service-technology-based learning solutions                | Senior Subordinated Term Debt (11.53%, Due 12/2017) <sup>(E)</sup>  | 1,000            | 972         | 980               |
| Attachmate Corporate                                      |  |   | 4,000            | 3,962       | 3,810             |

|  |   |
|--|---|
| Service-develops, implements and supports software | Senior Subordinated Term Debt (9.5%, Due 2/2017) <sup>(E)</sup> |
|--|---|

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**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONDENSED CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)****AS OF SEPTEMBER 30, 2011****(DOLLAR AMOUNTS IN THOUSANDS)**

| <b>Company<sup>(A)</sup></b>                              | <b>Industry</b>   | <b>Investment<sup>(B)</sup></b>                                 | <b>Principal</b> | <b>Cost</b> | <b>Fair Value</b> |
|---|---|---|------------------|-------------|-------------------|
| <b>NON-CONTROL/NON-AFFILIATE INVESTMENTS (Continued):</b> |   |   |                  |             |                   |
| Autoparts Holdings Limited                                | Supplier to the light and heavy-duty vehicle after market for replacement parts | Senior Term Debt (10.5%, Due 1/2018) <sup>(E)</sup>             | \$ 1,000         | \$ 995      | \$ 978            |
| Covad Communications Group, Inc.                          | Service-telecommunications  | Senior Term Debt (12.0%, Due 11/2015) <sup>(E)</sup>            | 1,850            | 1,818       | 1,795             |
| Ernest Health, Inc.                                       | Service-post-acute care services  | Senior Term Debt (10.3%, Due 5/2017) <sup>(E)</sup>             | 2,000            | 1,971       | 1,930             |
| Global Brass and Copper, Inc.                             | Manufacturing - steel wool products and metal fibers                            | Senior Term Debt (10.3%, Due 8/2015) <sup>(E)</sup>             | 2,969            | 2,893       | 3,054             |
| HGI Holding, Inc  | Service - distributor of disposable medical products                            | Senior Term Debt (6.8%, Due 10/2016) <sup>(E)</sup>             | 1,757            | 1,723       | 1,687             |
| Hubbard Radio, LLC  | Service-radio station operator  | Senior Subordinated Term Debt (8.8%, Due 4/2018) <sup>(E)</sup> | 500              | 495         | 488               |
| Keypoint Government Solutions, Inc.                       | Service-security consulting services  | Senior Term Debt (10.0%, Due 12/2015) <sup>(E)</sup>            | 6,948            | 6,916       | 6,670             |
| Mood Media Corporation                                    | Service-media and marketing solutions   | Senior Term Debt (10.3%, Due 11/2018) <sup>(E)</sup>            | 8,000            | 7,923       | 7,370             |
| National Surgical Hospitals, Inc.                         | Service-physician-partnered surgical facilities                                 | Senior Term Debt (8.3%, Due 2/2017) <sup>(E)</sup>              | 1,694            | 1,658       | 1,627             |
| Sensus USA, Inc.  | Service-provider of utility communication services                              | Senior Term Debt (8.5%, Due 5/2018) <sup>(E)</sup>              | 500              | 495         | 483               |
| Springs Window Fashions, LLC                              | Manufacturing-window coverings  | Senior Term Debt (11.3%, Due 11/2017) <sup>(E)</sup>            | 5,000            | 4,855       | 4,750             |
| SRAM, LLC   | Manufacturing-premium bicycle components  | Senior Term Debt (8.5%, Due 12/2018) <sup>(E)</sup>             | 2,500            | 2,476       | 2,475             |
| Targus Group International, Inc.                          | Manufacturing-carrying cases and accessories for notebook computers             | Senior Term Debt (11.0%, Due 5/2016) <sup>(E)</sup>             | 9,975            | 9,785       | 9,626             |
| Ulterra Drilling Technologies, LP                         | Manufacturing-oil field drill bits and slick-slip reduction tools               | Senior Term Debt (9.5%, Due 6/2016) <sup>(E)</sup>              | 1,975            | 1,937       | 1,916             |
| Vision Solutions, Inc.                                    | Service-provider of information availability software                           | Senior Term Debt (9.5%, Due 7/2017) <sup>(E)</sup>              | 11,000           | 10,915      | 10,560            |
| Wall Street Systems Holdings, Inc.                        | Service-software provider   | Senior Term Debt (9.0%, Due 6/2018) <sup>(E)</sup>              | 3,000            | 2,971       | 2,880             |
| WP Evenflo Group Holdings Inc.                            |   |   | 1,853            | 1,853       | 1,723             |

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|  |  |     |     |
|--|--|-----|-----|
| Manufacturing-infant and juvenile products | Senior Term Debt (8.0%, Due 2/2013) <sup>(E)</sup>     |     |     |
|  | Senior Preferred Equity (333 shares) <sup>(F)(G)</sup> | 333 | 419 |

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**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONDENSED CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)****AS OF SEPTEMBER 30, 2011****(DOLLAR AMOUNTS IN THOUSANDS)**

| <b>Company<sup>(A)</sup></b>  | <b>Industry</b>                                 | <b>Investment<sup>(B)</sup></b>  | <b>Principal</b> | <b>Cost</b> | <b>Fair Value</b> |
|---|---|--|------------------|-------------|-------------------|
| <b>NON-CONTROL/NON-AFFILIATE INVESTMENTS (Continued):</b>   |   |  |                  |             |                   |
|   |   | Junior Preferred Equity (111 shares) <sup>(F)(G)</sup>                   |                  | \$ 111      | \$ 146            |
|   |   | Common Stock (1,874 shares) <sup>(F)(G)</sup>                            |                  |             | 210               |
|   |   |  |                  | 2,297       | 2,498             |
| <b>Subtotal Syndicated loans</b>  |   |  |                  | \$ 92,062   | \$ 90,663         |
| <b>Total Non-Control/Non-Affiliate Investments (represented 84.9% of total investments at fair value)</b> |   |  |                  | \$ 288,266  | \$ 257,302        |
| <b>CONTROL INVESTMENTS:</b>   |   |  |                  |             |                   |
| BERTL, Inc.   | Service-web-based evaluator of imaging products | Line of Credit, \$6 available (6.4%, Due 10/2011) <sup>(F)(H)</sup>      | 1,427            | 1,355       |                   |
|   |   | Common Stock (100 shares) <sup>(F)(G)</sup>                              |                  | 424         |                   |
|   |   |  |                  | 1779        |                   |
| Defiance Integrated Technologies, Inc.  | Manufacturing-trucking parts                    | Senior Term Debt (11.0%, Due 4/2013) <sup>(C)(F)</sup>                   | 7,505            | 7,505       | 7,505             |
|   |   | Common Stock (15,500 shares) <sup>(F)(G)</sup>                           |                  | 1           | 7,534             |
|   |   |  |                  | 7,506       | 15,039            |
| Kansas Cable Holdings, Inc.   | Service-cable, internet, voice provider         | Line of Credit, \$179 available (10.0%, Due 10/2012) <sup>(D)(H)</sup>   | 346              | 337         | 14                |
|   |   | Senior Term Debt (10.0%, Due 10/2012) <sup>(D)(H)</sup>                  | 1,500            | 1,444       | 60                |
|   |   | Senior Term Debt (10.0%, Due 10/2012) <sup>(D)(H)</sup>                  | 1,039            | 1,000       | 42                |
|   |   | Common Stock (100 shares) <sup>(F)(G)</sup>                              |                  |             |                   |
|   |   |  |                  | 2,781       | 116               |
| Lindmark Acquisition, LLC   | Service-advertising                             | Senior Subordinated Term Debt (11.0%, Due 10/2012) <sup>(D)(H)</sup>     | 10,000           | 10,000      | 2,000             |
|   |   | Senior Subordinated Term Debt (13.0%, Due 10/2012) <sup>(D)(H)</sup>     | 2,000            | 2,000       | 400               |
|   |   | Senior Subordinated Term Debt (13.0%, Due Upon Demand) <sup>(D)(H)</sup> | 1,908            | 1,908       | 383               |
|   |   | Common Stock (100 shares) <sup>(F)(G)</sup>                              |                  | 317         |                   |
|   |   |  |                  | 14,225      | 2,783             |

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|               |                                 |   |       |       |     |
|---------------|---------------------------------|---|-------|-------|-----|
| LocalTel, LLC | Service-yellow pages publishing | Line of credit, \$2 available<br>(10.0%, Due 12/2011) <sup>(F)(H)</sup> | 1,848 | 1,848 | 734 |
|---------------|---------------------------------|---|-------|-------|-----|

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**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONDENSED CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)****AS OF SEPTEMBER 30, 2011****(DOLLAR AMOUNTS IN THOUSANDS)**

| <b>Company<sup>(A)</sup></b>            | <b>Industry</b>                                  | <b>Investment<sup>(B)</sup></b>  | <b>Principal</b> | <b>Cost</b> | <b>Fair Value</b> |
|---|--|--|------------------|-------------|-------------------|
| <b>CONTROL INVESTMENTS (Continued):</b> |  |  |                  |             |                   |
|   |  | Line of Credit, \$1,830 available (4.7%, Due 6/2012) <sup>(F)(H)</sup> | \$ 1,170         | \$ 1,170    | \$                |
|   |  | Senior Term Debt (12.5%, Due 2/2012) <sup>(F)(H)</sup>                 | 325              | 325         |                   |
|   |  | Senior Term Debt (8.5%, Due 6/2012) <sup>(F)(H)</sup>                  | 2,688            | 2,688       |                   |
|   |  | Senior Term Debt (10.5%, Due 6/2012) <sup>(C)(F)(H)</sup>              | 2,750            | 2,750       |                   |
|   |  | Common Stock Warrants (4,000 shares) <sup>(F)(G)</sup>                 |                  |             |                   |
|   |  |  |                  | 8,781       | 734               |
| Midwest Metal Distribution, Inc.        | Distribution-aluminum sheets and stainless steel | Senior Subordinated Term Debt (12.0%, Due 7/2013) <sup>(D)</sup>       | 18,281           | 18,262      | 17,184            |
|   |  | Common Stock (501 shares) <sup>(F)(G)</sup>                            |                  | 138         |                   |
|   |  |  |                  | 18,400      | 17,184            |
| Sunshine Media Holdings                 | Service-publisher regional B2B trade magazines   | Line of credit, \$1,100 available (10.5%, Due 8/2014) <sup>(D)</sup>   | 900              | 900         | 270               |
|   |  | Senior Term Debt (10.5%, Due 5/2016) <sup>(D)</sup>                    | 16,948           | 16,948      | 5,084             |
|   |  | Senior Term Debt (5.0%, Due 5/2016) <sup>(C)(D)</sup>                  | 10,700           | 10,700      | 3,210             |
|   |  | Junior Preferred Equity (6,689 shares) <sup>(F)(G)</sup>               |                  | 2,475       |                   |
|   |  | Common Stock (934 shares) <sup>(F)(G)</sup>                            |                  | 740         |                   |
|   |  |  |                  | 31,763      | 8,564             |
| U.S. Healthcare Communications, Inc.    | Service-magazine publisher/operator              | Line of credit, \$131 available (6.0%, Due 12/2010) <sup>(F)(H)</sup>  | 269              | 269         |                   |
|   |  | Line of credit, \$0 available (6.0%, Due 12/2010) <sup>(F)(H)</sup>    | 450              | 450         |                   |
|   |  | Common Stock (100 shares) <sup>(F)(G)</sup>                            |                  | 2,470       |                   |
|   |  |  |                  | 3,189       |                   |
| Viapack, Inc.                           | Manufacturing-polyethylene film                  | Line of Credit, \$900 available (10.0%, Due 3/2013) <sup>(D)</sup>     | 1,600            | 1,600       | 320               |

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|  |       |       |     |
|--|-------|-------|-----|
| Senior Real Estate Term Debt<br>(10.0%, Due 3/2014) <sup>(D)</sup> | 600   | 600   | 120 |
| Senior Term Debt (13.0%, Due<br>3/2014) <sup>(C)(D)</sup>          | 3,925 | 3,925 | 785 |

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**Table of Contents****GLADSTONE CAPITAL CORPORATION****CONDENSED CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)****AS OF SEPTEMBER 30, 2011****(DOLLAR AMOUNTS IN THOUSANDS)**

| <b>Company<sup>(A)</sup></b>  | <b>Industry</b> | <b>Investment<sup>(B)</sup></b>                 | <b>Principal</b> | <b>Cost</b>       | <b>Fair Value</b> |
|---|-----------------|---|------------------|-------------------|-------------------|
| <b>CONTROL INVESTMENTS (Continued):</b>   |                 |   |                  |                   |                   |
|   |                 | Preferred Equity (100 shares) <sup>(F)(G)</sup> |                  | \$                | \$                |
|   |                 |   |                  | 6,125             | 1,225             |
| <b>Total Control Investments (represented 15.1% of total investments at fair value)</b> |                 |   |                  | <b>\$ 94,549</b>  | <b>\$ 45,645</b>  |
| <b>Total Investments<sup>(I)</sup></b>  |                 |   |                  | <b>\$ 382,815</b> | <b>\$ 302,947</b> |

(A) Certain of the securities listed in the above schedule are issued by affiliate(s) of the indicated portfolio company.

(B) Percentage represents interest rates in effect at September 30, 2011, and due date represents the contractual maturity date.

(C) Last Out Tranche ( LOT ) of senior debt, meaning if the portfolio company is liquidated, the holder of the LOT is paid after the senior debt.

(D) Fair value was primarily based on opinions of value submitted by Standard & Poor's Securities Evaluations, Inc.

(E) Security valued based on the indicative bid price on or near September 30, 2011, offered by the respective syndication agent's trading desk or secondary desk.

(F) Fair value was primarily based on the total enterprise value of the portfolio company using a liquidity waterfall approach. We also considered discounted cash flow methodologies.

(G) Security is non-income producing.

(H) Debt security is on non-accrual status.

(I) For the year ended September 30, 2011, cumulative gross unrealized depreciation for federal income tax purposes is \$88,670 and cumulative gross unrealized appreciation for federal income tax purposes is \$8,566. For the year ended September 30, 2011, cumulative net unrealized depreciation is \$80,104 based on a tax cost of \$383,052.

*THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS.*

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**GLADSTONE CAPITAL CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**MARCH 31, 2012**

**(DOLLAR AMOUNTS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA AND AS OTHERWISE INDICATED)**

**NOTE 1. ORGANIZATION**

Gladstone Capital Corporation was incorporated under the General Corporation Laws of the State of Maryland on May 30, 2001 and completed an initial public offering on August 23, 2001. The terms we, our, and us all refer to Gladstone Capital Corporation and its consolidated subsidiaries. We are a closed-end, non-diversified management investment company that has elected to be treated as a business development company ( BDC ) under the Investment Company Act of 1940, as amended (the 1940 Act ). In addition, we have elected to be treated for tax purposes as a regulated investment company ( RIC ) under the Internal Revenue Code of 1986, as amended (the Code ). Our investment objective is to achieve a high level of current income by investing in debt securities, consisting primarily of senior notes, senior subordinated notes and junior subordinated notes, with a particular focus on senior notes, of established private businesses in the United States ( U.S ) that are substantially owned by leveraged buyout funds, individual investors or are family-owned businesses. In addition, we may acquire existing loans that meet this profile from other funds.

Gladstone Business Loan, LLC ( Business Loan ), a wholly-owned subsidiary of ours, was established on February 3, 2003 for the sole purpose of owning our portfolio of investments in connection with our line of credit.

Gladstone Financial Corporation ( Gladstone Financial ), a wholly-owned subsidiary of ours, was established on November 21, 2006 for the purpose of holding a license to operate as a Specialized Small Business Investment Company. Gladstone Financial (previously known as Gladstone SSBIC Corporation) acquired this license in February 2007. The license enables us, through this subsidiary, to make investments in accordance with the United States Small Business Administration guidelines for specialized small business investment companies.

The financial statements of the subsidiaries are consolidated with those of ours.

We are externally managed by Gladstone Management Corporation (the Adviser ), an affiliate of ours.

**NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

*Unaudited Interim Financial Statements and Basis of Presentation*

We prepare our interim financial statements in accordance with accounting principles generally accepted in the U.S. ( GAAP ) for interim financial information and pursuant to the requirements for reporting on Form 10-Q and Article 10 of Regulation S-X under the Securities Act of 1933, as amended (the Securities Act ). Accordingly, certain disclosures accompanying annual financial statements prepared in accordance with GAAP are omitted. The accompanying condensed consolidated financial statements include our accounts and those of our wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated. Under Article 6 of Regulation S-X under the Securities Act, and the authoritative accounting guidance provided by the AICPA Audit and Accounting Guide for Investment Companies, we are not permitted to consolidate any portfolio company investments, including those in which we have a controlling interest. In our opinion, all adjustments, consisting solely of normal recurring accruals, necessary for the fair statement of financial statements for the interim periods have been included. The results of operations for the three and six months ended March 31, 2012, are not necessarily indicative of results that ultimately may be achieved for the year. The interim financial statements and notes thereto should be read in conjunction with the financial statements and notes thereto included in our annual report on Form 10-K for the fiscal year ended September 30, 2011, as filed with the Securities and Exchange Commission (the SEC ) on November 14, 2011.

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Our fiscal year-end *Condensed Consolidated Statement of Assets and Liabilities* was derived from audited financial statements, but does not include all disclosures required by GAAP.

### *Reclassifications*

Certain amounts in the prior period's financial statements have been reclassified to conform to the presentation for the three and six month periods ended March 31, 2012, with no effect to net decrease in net assets resulting from operations.

### *Investment Valuation Policy*

We carry our investments at fair value to the extent that market quotations are readily available and reliable and otherwise at fair value as determined in good faith by our board of directors (the *Board of Directors*). In determining the fair value of our investments, the Adviser has established an investment valuation policy (the *Policy*). The Policy has been approved by our Board of Directors, and each quarter our Board of Directors reviews whether the Adviser has applied the Policy consistently and votes whether to accept the recommended valuation of our investment portfolio. Such determination of fair values may involve subjective judgments and estimates.

We use generally accepted valuation techniques to value our portfolio unless we have specific information about the value of an investment to determine otherwise. From time to time, we may accept an appraisal of a business in which we hold securities. These appraisals are expensive and occur infrequently, but provide a third-party valuation opinion that may differ in results, techniques and scope used to value our investments. When we obtain these specific third-party appraisals, we use estimates of value provided by such appraisals and our own assumptions, including estimated remaining life, current market yield and interest rate spreads of similar securities as of the measurement date, to value our investments.

The Policy, summarized below, applies to publicly traded securities, securities for which a limited market exists and securities for which no market exists.

**Publicly traded securities:** We determine the value of publicly traded securities based on the closing price for the security on the exchange or securities market on which it is listed and primarily traded on the valuation date. To the extent that we own restricted securities that are not freely tradable, but for which a public market otherwise exists, we will use the market value of that security adjusted for any decrease in value resulting from the restrictive feature.

**Securities for which a limited market exists:** We value securities that are not traded on an established secondary securities market, but for which a limited market for the security exists, such as certain participations in, or assignments of, syndicated loans, at the quoted bid price, which are non-binding. In valuing these assets, we assess trading activity in an asset class and evaluate variances in prices and other market insights to determine if any available quoted prices are reliable. In general, if we conclude that quotes based on active markets or trading activity may be relied upon, firm bid prices are requested; however, if firm bid prices are unavailable, we base the value of the security upon the indicative bid price ( *IBP* ) offered by the respective originating syndication agent's trading desk, or secondary desk, on or near the valuation date. To the extent that we use the *IBP* as a basis for valuing the security, the Adviser may take further steps to consider additional information to validate that price in accordance with the Policy.

In the event these limited markets become illiquid to a degree that market prices are no longer readily available, we will value our syndicated loans using alternative methods, such as estimated net present values of the future cash flows or discounted cash flows ( *DCF* ). The use of a *DCF* methodology follows that prescribed by the Financial Accounting Standards Board ( *FASB* ) Accounting Standards Codification ( *ASC* ) 820, *Fair Value Measurements and Disclosures*, which provides guidance on the use of a reporting entity's own assumptions

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about future cash flows and risk-adjusted discount rates when relevant observable inputs, such as quotes in active markets, are not available. When relevant observable market data does not exist, an alternative outlined in ASC 820 is the valuation of investments based on DCF. For the purposes of using DCF to provide fair value estimates, we consider multiple inputs, such as a risk-adjusted discount rate that incorporates adjustments that market participants would make, both for nonperformance and liquidity risks. As such, we develop a modified discount rate approach that incorporates risk premiums including, among other things, increased probability of default, higher loss given default or increased liquidity risk. The DCF valuations applied to the syndicated loans provide an estimate of what we believe a market participant would pay to purchase a syndicated loan in an active market, thereby establishing a fair value. We will apply the DCF methodology in illiquid markets until quoted prices are available or are deemed reliable based on trading activity.

As of March 31, 2012 and September 30, 2011, we determined that the indicative bid prices were reliable indicators of fair value for our syndicate investments. However, because of the private nature of this marketplace (meaning actual transactions are not publicly reported); we determined that these valuation inputs were classified as Level 3 within the fair value hierarchy as defined in ASC 820.

**Securities for which no market exists:** The valuation methodology for securities for which no market exists falls into four categories: (A) portfolio investments comprised solely of debt securities; (B) portfolio investments in controlled companies comprised of a bundle of securities, which can include debt and equity securities; (C) portfolio investments in non-controlled companies comprised of a bundle of investments, which can include debt and equity securities; and (D) portfolio investments comprised of non-publicly traded, non-control equity securities of other funds.

**(A) Portfolio investments comprised solely of debt securities:** Debt securities that are not publicly traded on an established securities market, or for which a limited market does not exist ( Non-Public Debt Securities ), and that are issued by portfolio companies in which we have no equity or equity-like securities, are fair valued utilizing opinions of value submitted to us by Standard & Poor's Securities Evaluations, Inc. ( SPSE ). We may also submit paid-in-kind ( PIK ) interest to SPSE for its evaluation when it is determined that PIK interest is likely to be received.

**(B) Portfolio investments in controlled companies comprised of a bundle of investments, which can include debt and equity securities:** The fair value of these investments is determined based on the total enterprise value ( TEV ) of the portfolio company, or issuer, utilizing a liquidity waterfall approach under ASC 820 for our Non-Public Debt Securities and equity or equity-like securities (e.g., preferred equity, common equity or other equity-like securities) that are purchased together as part of a package, where we have control or could gain control through an option or warrant security; both the debt and equity securities of the portfolio investment would exit in the mergers and acquisitions market as the principal market, generally through a sale of the portfolio company. We manage our risk related to these investments at the aggregated issuer level and generally exit the debt and equity securities together. Applying the liquidity waterfall approach to all of the investments of an issuer, we first calculate the TEV of the issuer by incorporating some or all of the following factors:

the issuer's ability to make payments;

the earnings of the issuer;

recent sales to third parties of similar securities;

the comparison to publicly traded securities; and

DCF or other pertinent factors.

In gathering the sales to third parties of similar securities, we may reference industry statistics and use outside experts. TEV is only an estimate of value and may not be the value received in an actual sale. Once we have estimated the TEV of the issuer, we will subtract the value of all the debt securities of the issuer, which are valued at the contractual principal balance. Fair values of these debt securities are discounted for





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any shortfall of TEV over the total debt outstanding for the issuer. Once the values for all outstanding senior securities, which include all the debt securities, have been subtracted from the TEV of the issuer, the remaining amount, if any, is used to determine the value of the issuer's equity or equity-like securities. If, in the Adviser's judgment, the liquidity waterfall approach does not accurately reflect the value of the debt component, the Adviser may recommend that we use a valuation by SPSE, or, if that is unavailable, a DCF valuation technique.

**(C) Portfolio investments in non-controlled companies comprised of a bundle of investments, which can include debt and equity securities:** We value Non-Public Debt Securities that are purchased together with equity or equity-like securities from the same portfolio company, or issuer, for which we do not control or cannot gain control as of the measurement date, using a hypothetical secondary market as our principal market. In accordance with ASC 820 (as amended by the FASB's Accounting Standards Update No. 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards (IFRS), (ASU 2011-04)), we have defined our unit of account at the investment level (either debt or equity) and as such determine our fair value of these non-control investments assuming the sale of an individual security using the standalone premise of value. As such, we estimate the fair value of the debt component using estimates of value provided by SPSE and our own assumptions in the absence of observable market data, including synthetic credit ratings, estimated remaining life, current market yield and interest rate spreads of similar securities as of the measurement date. For equity or equity-like securities of investments for which we do not control or cannot gain control as of the measurement date, we estimate the fair value of the equity based on factors such as the overall value of the issuer, the relative fair value of other units of account, including debt, or other relative value approaches. Consideration is also given to capital structure and other contractual obligations that may impact the fair value of the equity. Furthermore, we may utilize comparable values of similar companies, recent investments and indices with similar structures and risk characteristics or DCF valuation techniques and, in the absence of other observable market data, our own assumptions.

**(D) Portfolio investments comprised of non-publicly traded, non-control equity securities of other funds:** We generally value any uninvested capital of the non-control fund at par value and values any invested capital at the value provided by the non-control fund. Due to the uncertainty inherent in the valuation process, such estimates of fair value may differ significantly and materially from the values that would have been obtained had a ready market for the securities existed. Additionally, changes in the market environment and other events that may occur over the life of the investments may cause the gains or losses ultimately realized on these investments to be different than the valuations currently assigned. There is no single standard for determining fair value in good faith, as fair value depends upon circumstances of each individual case. In general, fair value is the amount that we might reasonably expect to receive upon the current sale of the security in an orderly transaction between market participants at the measurement date.

Refer to Note 3 *Investments* for additional information regarding fair value measurements and our application of ASC 820.

*Interest Income Recognition*

Interest income, adjusted for amortization of premiums and acquisition costs, the accretion of discounts and the amortization of amendment fees, is recorded on the accrual basis to the extent that such amounts are expected to be collected. Generally, when a loan becomes 90 days or more past due, or if our qualitative assessment indicates that the debtor is unable to service its debt or other obligations, we will place the loan on non-accrual status and cease recognizing interest income on that loan until the borrower has demonstrated the ability and intent to pay contractual amounts due. However, we remain contractually entitled to this interest. Interest payments received on non-accrual loans may be recognized as income or applied to the cost basis, depending upon management's judgment. Generally, non-accrual loans are restored to accrual status when past due principal and interest are

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paid and, in management's judgment, are likely to remain current, or due to a restructuring such that the interest income is deemed to be collectable. At March 31, 2012, eight portfolio companies were either fully or partially on non-accrual with an aggregate debt cost basis of \$43.8 million, or 12.1% of the cost basis of all debt investments in our portfolio, and an aggregate fair value of \$4.6 million, or 1.7% of the fair value of all debt investments in our portfolio. At September 30, 2011, eight portfolio companies were on non-accrual with an aggregate debt cost basis of \$41.1 million, or 11.0% of the cost basis of all debt investments in our portfolio, and an aggregate fair value of \$5.3 million, or 1.8% of the fair value of all debt investments in our portfolio.

As of March 31, 2012 and September 30, 2011, we had 27 original issue discount (OID) loans, primarily from the syndicated loans in our portfolio. We recorded OID income of \$74 and \$0.2 million for the three and six months ended March 31, 2012, respectively, as compared to \$29 and \$53 for the three and six months ended March 31, 2011. The unamortized balance of OID investments as of March 31, 2012 and September 30, 2011 totaled \$1.4 million and \$1.5 million, respectively.

As of March 31, 2012 and September 30, 2011, we had no investments that bore PIK interest. PIK interest, computed at the contractual rate specified in a loan agreement, is added to the principal balance of a loan and recorded as income. To maintain our status as a RIC, this non-cash source of income must be paid out to common stockholders in the form of distributions, even though we have not yet collected the cash. We recorded no PIK income during the three and six months ended March 31, 2012, respectively, as compared to \$4 and \$8 for the three and six months ended March 31, 2011, respectively.

We also transfer past due interest to the principal balance as stipulated in certain loan amendments with portfolio companies. There were no such transfers during the three and six months ended March 31, 2012. We transferred past due interest to the principal balance of \$0.2 million for both the three and six months ended March 31, 2011, respectively.

*Other Income Recognition*

We record success fees upon receipt. Success fees are typically contractually due upon a change of control in a portfolio company and are recorded in other income in our accompanying *Condensed Consolidated Statements of Operations*. We recorded \$2.0 million of success fees during the six months ended March 31, 2012, which resulted from our exit of Global Materials Technologies, Inc and RCS Management Holding Co. We recorded \$0.6 million of success fees during the six months ended March 31, 2011, which resulted from our exits of Pinnacle Treatment Centers, Inc. and Interfilm Holdings, Inc.

*Recent Accounting Pronouncements*

In May 2011, the FASB issued ASU 2011-04 which results in a consistent definition of fair value and common requirements for measurement of and disclosure about fair value between GAAP and IFRS. ASU 2011-04 is effective for interim and annual periods beginning after December 15, 2011, and as such we have adopted this ASU beginning with our quarter ended March 31, 2012. We have increased our disclosures related to Level 3 fair value measurement, in addition to other required disclosures. There were no related impacts on our financial position or results of operations.

**NOTE 3. INVESTMENTS**

ASC 820 defines fair value, establishes a framework for measuring fair value and expands disclosures about assets and liabilities measured at fair value. ASC 820 provides a consistent definition of fair value that focuses on exit price in the principal, or most advantageous, market and prioritizes, within a measurement of fair value, the use of market-based inputs over entity-specific inputs. ASC 820 also establishes the following three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date.

*Level 1* inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets;

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Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active or inactive markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument. Level 2 inputs are in those markets for which there are few transactions, the prices are not current, little public information exists or instances where prices vary substantially over time or among brokered market makers; and

Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement. Unobservable inputs are those inputs that reflect assumptions that market participants would use when pricing the asset or liability and can include our own assumptions based upon the best available information.

We transfer investments in and out of Level 1, 2 and 3 securities as of the beginning balance sheet date, based on changes in the use of observable and unobservable inputs utilized to perform the valuation for the period. During the six months ended March 31, 2012 and 2011, there were no transfers in or out of Level 3.

The following table presents the investments carried at fair value as of March 31, 2012 and September 30, 2011, by caption on our accompanying *Condensed Consolidated Statements of Assets and Liabilities* and by security type, all of which are valued using Level 3 inputs:

|   | <b>Total Recurring Fair Value<br/>Measurements Reported in <i>Condensed<br/>Consolidated Statements of Assets and<br/>Liabilities</i> Using Significant<br/>Unobservable Inputs (Level 3)</b> |                       |
|---|---|-----------------------|
|   | March 31, 2012  | September 30, 2011    |
| <b>Non-Control/Non-Affiliate Investments</b>    |   |                       |
| Senior term debt                                | \$ 166,442  | \$ 182,002            |
| Senior subordinated term debt                   | 76,019  | 72,182                |
| Preferred equity                                | 595   | 566                   |
| Common equity/equivalents                       | 3,179   | 2,552                 |
| <br>Total Non-Control/Non-Affiliate Investments | <br>\$ 246,235  | <br>\$ 257,302        |
| <b>Control Investments</b>                      |   |                       |
| Senior term debt                                | \$ 13,558   | \$ 18,143             |
| Senior subordinated term debt                   | 19,678  | 19,966                |
| Common equity/equivalents                       | 8,696   | 7,536                 |
| <br>Total Control Investments                   | <br>\$ 41,932   | <br>\$ 45,645         |
| <br><b>Total Investments at Fair Value</b>      | <br><b>\$ 288,167</b>   | <br><b>\$ 302,947</b> |

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In accordance with ASU 2011-04, the following table provides quantitative information about our Level 3 fair value measurements of our investments as of March 31, 2012. In addition to the techniques and inputs noted in the table below, according to our valuation policy we may also use other valuation techniques and methodologies when determining our fair value measurements. The below table is not intended to be all-inclusive, but rather provides information on the significant Level 3 inputs as they relate to our fair value measurements. The weighted average calculations in the table below are based on the principal balances for all debt related calculations and on the cost basis for all equity related calculations for the particular input.

|   | <b>Quantitative Information about Level 3 Fair Value Measurements</b> |  |  |  |
|---|---|--|--|--|
|   | <b>Fair Value as of<br/>March 31,<br/>2012</b>                        | <b>Valuation<br/>Techniques/<br/>Methodologies</b> | <b>Unobservable<br/>Input</b>                        | <b>Range / Weighted<br/>Average</b>                  |
| Non-syndicated debt only investments            | <b>\$ 99,306</b>  | SPSE <sup>(A)</sup>                                | EBITDA <sup>(B)</sup><br>Risk Ratings <sup>(C)</sup> | (\$310) - \$14,058 / \$4,976<br>2.0 - 10.0 / 6.3     |
| Syndicated debt only investments                | <b>95,503</b>   | Market Quotes                                      | IBP <sup>(D)</sup>                                   | 93.5% - 101.4% / 98.3%                               |
| Bundled debt and equity investments             | <b>92,205</b>   | SPSE <sup>(A)</sup>                                | EBITDA <sup>(B)</sup><br>Risk Ratings <sup>(C)</sup> | (\$1,595) - \$6,406 /<br>\$3,087<br>3.0 - 6.0 / 4.6  |
|   |   | TEV  | EBITDA multiples <sup>(B)</sup>                      | 4.6 - 9.7 / 5.9<br>(\$1,595) -<br>\$25,026 / \$2,921 |
| Other Investments                               | <b>1,153</b>  |  |  |  |
| <b>Total Fair Value for Level 3 Investments</b> | <b>\$ 288,167</b>   |  |  |  |

- <sup>(A)</sup> SPSE makes an independent assessment of the data we submit to them (which includes the financial and operational performance, as well as our internally assessed risk ratings of the portfolio companies – see footnote (C) below) and its own independent data to form an opinion as to what they consider to be the market values for our securities. With regard to its work, SPSE has stated that the data submitted to us is regarded as proprietary in nature.
- <sup>(B)</sup> Earnings before interest expense, taxes, depreciation and amortization ( EBITDA ) is an unobservable input which is generally based on the most recently available trailing twelve month financial statements submitted to us from the portfolio companies. EBITDA multiples, indexed in accordance with our valuation policy, represent our estimation of where market participants might price these investments. For our bundled debt and equity investments, the EBITDA and EBITDA multiples impact the TEV fair value determination and the value of the issuer's debt, equity, or equity-like securities are valued in accordance with our liquidity waterfall approach.
- <sup>(C)</sup> As part of our valuation procedures, we risk rate all of our investments in debt securities. We use the Nationally Recognized Statistical Rating Organization's risk rating system for generally all of syndicated loans and a proprietary risk rating system for all other debt securities. Our risk rating system uses a scale of 0 to 10, with 10 being the lowest probability of default. The risk rating system covers both qualitative and quantitative aspects of the portfolio company business and the securities we hold.
- <sup>(D)</sup> We generally base the value of our syndicated debt securities on the IBP offered by the respective originating syndication agent's trading desk, or secondary desk, on or near the valuation date. These bid prices are non-binding and are generally based on the underlying company performance and security characteristics, as well as other market conditions and credit risk factors.

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In general, included in the internally assessed TEV model used to value our proprietary debt and equity investments, the significant unobservable inputs are the portfolio company's EBITDA and EBITDA multiples. All other factors holding constant, increases (decreases) in the EBITDA and/or the EBITDA multiples inputs would result in a higher (lower) fair value measurement. Per our valuation policy, we generally use an indexed EBITDA multiple. EBITDA and EBITDA multiple inputs do not have to directionally correlate since EBITDA is a company performance metric and EBITDA multiples can be influenced by market, industry, size and other factors.

*Changes in Level 3 Fair Value Measurements of Investments*

The following tables provide the changes in fair value, broken out by security type, during the three and six-month periods ending March 31, 2012 and 2011 for all investments for which we determine fair value using unobservable (Level 3) factors. When a determination is made to classify a financial instrument within Level 3 of the valuation hierarchy, such determination is based upon the significance of the unobservable factors to the overall fair value measurement. However, Level 3 financial instruments typically include, in addition to the unobservable, or Level 3, inputs, observable inputs (that is, components that are actively quoted and can be validated to external sources). In these cases, we categorize all of the inputs as the lowest level input within the hierarchy. Accordingly, the gains and losses in the tables below include changes in fair value, due in part to observable factors that are part of the valuation methodology.

**Fair Value Measurements Using Significant Unobservable Inputs (Level 3)****Periods ended March 31, 2012:**

|   | Senior<br>Term<br>Debt | Senior<br>Subordinated<br>Term Debt | Preferred<br>Equity | Common<br>Equity/<br>Equivalents | Total             |
|---|------------------------|-------------------------------------|---------------------|----------------------------------|-------------------|
| <b>Three months ended March 31, 2012:</b>                               |                        |                                     |                     |                                  |                   |
| Fair value as of December 31, 2011                                      | \$ 192,821             | \$ 88,004                           | \$ 581              | \$ 11,440                        | \$ 292,846        |
| Total gains or losses   |                        |                                     |                     |                                  |                   |
| Net realized gain <sup>(a)</sup>  | 37                     |                                     |                     |                                  | 37                |
| Net unrealized (depreciation) appreciation <sup>(b)</sup>               | (6,292)                | (784)                               | (986)               | 435                              | (7,627)           |
| Reversal of prior period net depreciation on realization <sup>(b)</sup> | 458                    |                                     |                     |                                  | 458               |
| New investments, repayments and settlements <sup>(c)</sup>              |                        |                                     |                     |                                  |                   |
| Issuances/originations  | 8,858                  | 8,500                               | 1,000               |                                  | 18,358            |
| Settlements/repayments  | (13,912)               | (23)                                |                     |                                  | (13,935)          |
| Sales   | (1,970)                |                                     |                     |                                  | (1,970)           |
| <b>Fair value as of March 31, 2012</b>                                  | <b>\$ 180,000</b>      | <b>\$ 95,697</b>                    | <b>\$ 595</b>       | <b>\$ 11,875</b>                 | <b>\$ 288,167</b> |

|   | Senior<br>Term<br>Debt | Senior<br>Subordinated<br>Term Debt | Preferred<br>Equity | Common<br>Equity/<br>Equivalents | Total             |
|---|------------------------|-------------------------------------|---------------------|----------------------------------|-------------------|
| <b>Six months ended March 31, 2012:</b>                                 |                        |                                     |                     |                                  |                   |
| Fair value as of September 30, 2011                                     | \$ 200,145             | \$ 92,148                           | \$ 566              | \$ 10,088                        | \$ 302,947        |
| Total gains or losses   |                        |                                     |                     |                                  |                   |
| Net realized loss <sup>(a)</sup>  | (8,363)                |                                     |                     |                                  | (8,363)           |
| Net unrealized (depreciation) appreciation <sup>(b)</sup>               | (15,128)               | (2,028)                             | (1,572)             | 1,787                            | (16,941)          |
| Reversal of prior period net depreciation on realization <sup>(b)</sup> | 11,571                 | 444                                 |                     |                                  | 12,015            |
| New investments, repayments and settlements <sup>(c)</sup>              |                        |                                     |                     |                                  |                   |
| Issuances/originations  | 16,688                 | 11,320                              | 1,601               |                                  | 29,609            |
| Settlements/repayments  | (18,454)               | (6,187)                             |                     |                                  | (24,641)          |
| Sales   | (6,459)                |                                     |                     |                                  | (6,459)           |
| <b>Fair value as of March 31, 2012</b>                                  | <b>\$ 180,000</b>      | <b>\$ 95,697</b>                    | <b>\$ 595</b>       | <b>\$ 11,875</b>                 | <b>\$ 288,167</b> |



**Table of Contents****Periods ended March 31, 2011:**

|  | Senior<br>Term<br>Debt | Senior<br>Subordinated<br>Term Debt | Preferred<br>Equity | Common<br>Equity/<br>Equivalents | Total             |
|--|------------------------|-------------------------------------|---------------------|----------------------------------|-------------------|
| <b>Three months ended March 31, 2011:</b>  |                        |                                     |                     |                                  |                   |
| Fair value as of December 31, 2010   | \$ 169,882             | \$ 76,999                           | \$ 523              | \$ 5,101                         | \$ 252,505        |
| Total gains or losses  |                        |                                     |                     |                                  |                   |
| Net realized gain (loss) <sup>(a)</sup>  | 177                    | (14)                                |                     |                                  | 163               |
| Net unrealized (depreciation) appreciation <sup>(b)</sup>                              | (11,268)               | (1,364)                             | (361)               | 134                              | (12,859)          |
| Reversal of prior period net appreciation on realization <sup>(b)</sup>                | (210)                  |                                     |                     |                                  | (210)             |
| New investments, repayments and settlements <sup>(c)</sup>                             |                        |                                     |                     |                                  |                   |
| Issuances/originations   | 37,544                 | 1,038                               | 375                 | 1,880                            | 40,837            |
| Settlements/repayments   | (22,523)               | (60)                                |                     |                                  | (22,583)          |
| Sales  |                        |                                     |                     | (740)                            | (740)             |
| <b>Fair value as of March 31, 2011</b>   | <b>\$ 173,602</b>      | <b>\$ 76,599</b>                    | <b>\$ 537</b>       | <b>\$ 6,375</b>                  | <b>\$ 257,113</b> |
| <b>Six months ended March 31, 2011:</b>  |                        |                                     |                     |                                  |                   |
| Fair value as of September 30, 2010  | \$ 172,596             | \$ 81,899                           | \$ 386              | \$ 2,228                         | \$ 257,109        |
| Total gains or losses  |                        |                                     |                     |                                  |                   |
| Net realized gain (loss) <sup>(a)</sup>  | 177                    | (14)                                |                     |                                  | 163               |
| Net unrealized (depreciation) appreciation <sup>(b)</sup>                              | (17,218)               | (1,839)                             | (224)               | 2,974                            | (16,307)          |
| Reversal of prior period net (appreciation) depreciation on realization <sup>(b)</sup> | (191)                  | 731                                 |                     | (247)                            | 293               |
| <b>Six months ended March 31, 2011:</b>  |                        |                                     |                     |                                  |                   |
| New investments, repayments and settlements <sup>(c)</sup>                             |                        |                                     |                     |                                  |                   |
| Issuances/originations   | 46,942                 | 3,122                               | 375                 | 2,197                            | 52,636            |
| Settlements/repayments   | (28,704)               | (7,300)                             |                     |                                  | (36,004)          |
| Sales  |                        |                                     |                     | (777)                            | (777)             |
| <b>Fair value as of March 31, 2011</b>   | <b>\$ 173,602</b>      | <b>\$ 76,599</b>                    | <b>\$ 537</b>       | <b>\$ 6,375</b>                  | <b>\$ 257,113</b> |

(a) Included in net realized gain (loss) on Non-Control/Non-Affiliate and Control investments on our accompanying *Condensed Consolidated Statements of Operations* for the three and six months ended March 31, 2012 and 2011.

(b) Included in net unrealized depreciation on Non-Control/Non-Affiliate and Control investments on our accompanying *Condensed Consolidated Statements of Operations* for the three and six months ended March 31, 2012 and 2011.

(c) Includes increases in the cost basis of investments resulting from new portfolio investments, the amortization of discounts, premiums and closing fees as well as decreases in the cost basis of investments resulting from principal repayments or sales.

*Non-Control/Non-Affiliate Investments*

As of March 31, 2012 and September 30, 2011, we held 46 and 50 Non-Control/Non-Affiliate investments in the aggregate fair value of \$246.2 million and \$257.3 million, respectively. Of these, we had a total of 24 syndicate loans in the aggregate fair value of \$96.8 million and \$90.7 million, as of March 31, 2012 and September 30, 2011, respectively. During the six months ended March 31, 2012, we added two new Non-Control/Non-Affiliate





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investments, with an aggregate fair value of \$10.0 million at March 31, 2012, and four Non-Control/Non-Affiliate investments paid off early, for which we received aggregate principal payments of \$14.9 million. Additionally, we funded \$11.4 million to existing Non-Control/Non-Affiliate portfolio companies during the six months ended March 31, 2012. The following sales and restructures of Non-Control/Non-Affiliate investments occurred during the six months ended March 31, 2012:

*KMBQ Corporation* In November 2011, we invested \$1.6 million in Ohana Media Group ( Ohana ) to facilitate its purchase of certain of KMBQ Corporation's ( KMBQ ) assets out of receivership. In connection with this transaction, we received net proceeds of \$1.2 million and recorded a realized loss during the three months ended December 31, 2011 totaling \$1.0 million. Ohana replaced KMBQ on our *Condensed Consolidated Schedule of Investments* as a Non-Control/Non-Affiliate investment at December 31, 2011.

Newhall Holdings, Inc. In December 2011, we sold our investments in Newhall Holdings, Inc. ( Newhall ) for net proceeds of \$3.3 million, which resulted in a realized loss of \$7.4 million recorded in the three months ended December 31, 2011.

*Control Investments*

As of March 31, 2012 and September 30, 2011, we held nine Control investments in the aggregate fair value of \$41.9 million and \$45.6 million, respectively. During the six months ended March 31, 2012, five Control investments made draws on their lines of credit, totaling \$4.6 million. We did not exit any Control investments during the six months ended March 31, 2012. The following restructures of Control investments occurred during the six months ended March 31, 2012:

*Sunshine Media Holdings* Effective October 1, 2011, we restructured Sunshine Media Holdings ( Sunshine ) by reducing the interest rates on its line of credit, senior term debt and LOT senior term debt to preserve capital at the portfolio company to further enable Sunshine to invest in new and existing initiatives. In addition, we funded \$1.6 million through additional preferred equity investments and \$2.1 million through additional line of credit draws to Sunshine for the six months ended March 31, 2012. We placed our investment in Sunshine's LOT senior term debt on non-accrual status effective January 1, 2012.

Viapack, Inc. Effective January 1, 2012, we restructured our investment in Viapack, Inc. ( Viapack ), by reducing the interest rates on its line of credit, senior real estate term debt and senior term debt to preserve capital at the portfolio company to enable it to invest in existing initiatives. In addition, we funded \$1.8 million to Viapack through additional draws on its line of credit for the six months ended March 31, 2012. We placed our investment in Viapack's LOT senior term debt on non-accrual status effective January 1, 2012.

*Investment Concentrations*

As of March 31, 2012, our investment portfolio consisted of loans to 55 companies located in 26 states across 23 different industries with an aggregate fair value of \$288.2 million. As of March 31, 2012, there were 24 syndicated investments totaling \$96.7 million at cost and \$96.8 million at fair value, or 25.9% and 33.6% of the total aggregate portfolio, respectively.

The following table outlines our investments by security type as of March 31, 2012 and September 30, 2011:

|                               | March 31, 2012    |               |                   |               | September 30, 2011 |               |                   |               |
|-------------------------------|-------------------|---------------|-------------------|---------------|--------------------|---------------|-------------------|---------------|
|                               | Cost              |               | Fair Value        |               | Cost               |               | Fair Value        |               |
| Senior term debt              | \$ 249,904        | 67.0%         | \$ 180,000        | 62.5%         | \$ 266,491         | 69.6%         | \$ 200,145        | 66.1%         |
| Senior subordinated term debt | 112,272           | 30.1          | 95,697            | 33.2          | 107,140            | 28.0          | 92,148            | 30.4          |
| Common equity/equivalents     | 6,264             | 1.7           | 11,875            | 4.1           | 7,999              | 2.1           | 10,088            | 3.3           |
| Preferred equity              | 4,520             | 1.2           | 595               | 0.2           | 1,185              | 0.3           | 566               | 0.2           |
| <b>Total investments</b>      | <b>\$ 372,960</b> | <b>100.0%</b> | <b>\$ 288,167</b> | <b>100.0%</b> | <b>\$ 382,815</b>  | <b>100.0%</b> | <b>\$ 302,947</b> | <b>100.0%</b> |



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Investments at fair value consisted of the following industry classifications at March 31, 2012 and September 30, 2011:

| Industry Classification                                   | March 31, 2012    |                                 | September 30, 2011 |                                 |
|---|-------------------|---------------------------------|--------------------|---------------------------------|
|   | Fair Value        | Percentage of Total Investments | Fair Value         | Percentage of Total Investments |
| Electronics   | \$ 53,484         | 18.6%                           | \$ 45,752          | 15.1%                           |
| Mining, steel, iron & non-precious metals                 | 32,063            | 11.1                            | 33,734             | 11.1                            |
| Healthcare, education & childcare                         | 30,034            | 10.4                            | 34,106             | 11.3                            |
| Automobile  | 26,725            | 9.3                             | 25,768             | 8.5                             |
| Broadcast (TV & radio)                                    | 20,420            | 7.1                             | 28,194             | 9.3                             |
| Retail stores   | 19,340            | 6.7                             | 19,340             | 6.4                             |
| Aerospace & defense                                       | 15,212            | 5.3                             | 10,003             | 3.3                             |
| Printing & publishing                                     | 12,923            | 4.5                             | 17,623             | 5.8                             |
| Textiles & leather  | 9,801             | 3.4                             | 9,626              | 3.2                             |
| Personal & non-durable consumer products                  | 8,582             | 3.0                             | 6,962              | 2.3                             |
| Personal, food and miscellaneous services                 | 7,915             | 2.7                             | 7,635              | 2.5                             |
| Machinery   | 7,664             | 2.7                             | 8,696              | 2.9                             |
| Beverage, food & tobacco                                  | 7,295             | 2.5                             | 7,332              | 2.4                             |
| Diversified/conglomerate manufacturing                    | 7,251             | 2.5                             | 8,790              | 2.9                             |
| Buildings & real estate                                   | 6,557             | 2.3                             | 10,275             | 3.4                             |
| Leisure, amusement, movies & entertainment                | 6,054             | 2.1                             | 6,607              | 2.2                             |
| Diversified/conglomerate service                          | 3,990             | 1.4                             | 3,810              | 1.3                             |
| Home & office furnishings                                 | 3,952             | 1.4                             | 9,715              | 3.2                             |
| Diversified natural resources, precious metals & minerals | 2,993             | 1.0                             | 3,054              | 1.0                             |
| Other <sup>(A)</sup>                                      | 5,912             | 2.0                             | 5,925              | 1.9                             |
| <b>Total investments</b>                                  | <b>\$ 288,167</b> | <b>100.0%</b>                   | <b>\$ 302,947</b>  | <b>100.0%</b>                   |

(A) No individual industry within this category exceeds 1%.

The investments at fair value were included in the following geographic regions of the U.S. at March 31, 2012 and September 30, 2011:

| Geographic Region        | March 31, 2012    |                              | September 30, 2011 |                                 |
|--------------------------|-------------------|------------------------------|--------------------|---------------------------------|
|                          | Fair Value        | Percent of Total Investments | Fair Value         | Percentage of Total Investments |
| Midwest                  | \$ 133,425        | 46.3%                        | \$ 144,292         | 47.6%                           |
| West                     | 76,264            | 26.5                         | 70,862             | 23.4                            |
| South                    | 45,234            | 15.7                         | 52,265             | 17.3                            |
| Northeast                | 25,764            | 8.9                          | 28,158             | 9.3                             |
| Other non U.S.           | 7,480             | 2.6                          | 7,370              | 2.4                             |
| <b>Total Investments</b> | <b>\$ 288,167</b> | <b>100.0%</b>                | <b>\$ 302,947</b>  | <b>100.0%</b>                   |

The geographic region reflects the location of the headquarters of our portfolio companies. A portfolio company may have a number of other business locations in other geographic regions.



**Table of Contents***Investment Principal Repayments*

The following table summarizes the contractual principal repayments and maturity of our investment portfolio by fiscal year, assuming no voluntary prepayments, at March 31, 2012:

|  | <b>Amount</b>     |
|--|-------------------|
| For the remaining six months ending September 30: 2012         | \$ 30,816         |
| For the fiscal year ending September 30:                       |                   |
| 2013   | 106,242           |
| 2014   | 51,190            |
| 2015   | 31,517            |
| 2016   | 75,867            |
| Thereafter   | 67,925            |
| <b>Total contractual repayments</b>                            | <b>\$ 363,557</b> |
| Investments in equity securities                               | 10,784            |
| Adjustments to cost basis on debt securities                   | (1,381)           |
| <b>Total cost basis of investments held at March 31, 2012:</b> | <b>\$ 372,960</b> |

*Receivables from Portfolio Companies*

Receivables from portfolio companies represent non-recurring costs that we incurred on behalf of portfolio companies and are included in other assets on our accompanying *Condensed Consolidated Statements of Assets and Liabilities*. We maintain an allowance for uncollectible receivables from portfolio companies, which is determined based on historical experience and management's expectations of future losses. We charge the accounts receivable to the established provision when collection efforts have been exhausted and the receivables are deemed uncollectible. As of March 31, 2012 and September 30, 2011, we had gross receivables from portfolio companies of \$0.6 million. The allowance for uncollectible receivables was \$0.3 million and \$0.4 million as of March 31, 2012 and September 30, 2011, respectively. In addition, we recorded an allowance for uncollectible interest receivable of \$21 and \$65 as of March 31, 2012 and September 30, 2011, respectively.

**NOTE 4. RELATED PARTY TRANSACTIONS***Loans to Former Employees*

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We have outstanding loans to certain employees of the Adviser, each of whom was a joint employee of the Adviser (or our previous adviser, Gladstone Capital Advisers, Inc.) and us at the time the loans were originally provided. The loans were extended to such employees to allow them to exercise options granted under the Amended and Restated 2001 Equity Incentive Plan, which has since been terminated. The loans require the quarterly payment of interest at the market rate in effect at the date of issuance, have varying terms not exceeding ten years and have been recorded as a reduction of net assets. The loans are evidenced by full recourse notes that are due upon maturity or 60 days following termination of employment, and the shares of common stock purchased with the proceeds of the loans are posted as collateral. We received \$3 and \$1.1 million of principal repayments during the six months ended March 31, 2012 and 2011, respectively. Additionally, one employee redeemed 39,082 common shares (20,000 in December 2011 and 19,082 in January 2012) to pay off \$0.3 million of principal on his outstanding loans during the six months ended March 31, 2012. We recognized interest income from all employee loans of \$0.1 million for the three and six months ended March 31, 2012, respectively, and \$0.1 million and \$0.2 million for the three and six months ended March 31, 2011, respectively. Refer to Note 7 *Common Stock* for additional information related to these transactions.

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**Table of Contents***Investment Advisory and Management Agreement*

We entered into an investment advisory and management agreement with the Adviser (the *Advisory Agreement*), which is controlled by our chairman and chief executive officer. In accordance with the *Advisory Agreement*, we pay the Adviser certain fees as compensation for its services, such fees consisting of a base management fee and an incentive fee. On July 12, 2011, our Board of Directors approved the renewal of the *Advisory Agreement* through August 31, 2012.

The following table summarizes the management fees, incentive fees and associated credits reflected in our accompanying *Condensed Consolidated Statements of Operations*:

|  | Three Months Ended<br>March 31, |                   | Six Months Ended<br>March 31 |                   |
|--|---------------------------------|-------------------|------------------------------|-------------------|
|  | 2012                            | 2011              | 2012                         | 2011              |
| <b>Average total assets subject to base management fee <sup>(A)</sup></b>                                    | <b>\$ 307,600</b>               | <b>\$ 273,000</b> | <b>\$ 309,400</b>            | <b>\$ 271,200</b> |
| Multiplied by prorated annual base management fee of 2.0%  | <b>0.5%</b>                     | 0.5%              | <b>1.0%</b>                  | 1.0%              |
| <b>Gross base management fee <sup>(B)</sup></b>  | <b>\$ 1,538</b>                 | <b>\$ 1,365</b>   | <b>\$ 3,094</b>              | <b>\$ 2,712</b>   |
| Reduction for loan servicing fees  | <b>(864)</b>                    | (757)             | <b>(1,823)</b>               | (1,599)           |
| <b>Base management fee</b>   | <b>674</b>                      | 608               | <b>1,271</b>                 | 1,113             |
| Credit for fees received by Adviser from the portfolio companies   | <b>(5)</b>                      |                   | <b>(53)</b>                  |                   |
| Fee reduction for the voluntary, irrevocable waiver of 2.0% fee on senior syndicated loans to 0.5% per annum | <b>(118)</b>                    | (81)              | <b>(243)</b>                 | (133)             |
| <b>Net base management fee</b>   | <b>\$ 551</b>                   | <b>\$ 527</b>     | <b>\$ 975</b>                | <b>\$ 980</b>     |
| <b>Incentive fee <sup>(B)</sup></b>  | <b>1,304</b>                    | 1,102             | <b>2,339</b>                 | 2,261             |
| Credit from voluntary, irrevocable waiver issued by Adviser's board of directors                             |                                 | (21)              | <b>(278)</b>                 | (21)              |
| <b>Net incentive fee</b>   | <b>\$ 1,304</b>                 | <b>\$ 1,081</b>   | <b>\$ 2,061</b>              | <b>\$ 2,240</b>   |
| Credit for fees received by Adviser from the portfolio companies   | <b>(5)</b>                      |                   | <b>(53)</b>                  |                   |
| Fee reduction for the voluntary, irrevocable waiver of 2.0% fee on senior syndicated loans to 0.5% per annum | <b>(118)</b>                    | (81)              | <b>(243)</b>                 | (133)             |
| Incentive fee credit   |                                 | (21)              | <b>(278)</b>                 | (21)              |
| <b>Credit to base management and incentive fees from Adviser <sup>(B)</sup></b>                              | <b>\$ (123)</b>                 | <b>\$ (102)</b>   | <b>\$ (574)</b>              | <b>\$ (154)</b>   |

<sup>(A)</sup> Average total assets subject to the base management fee is defined as total assets, including investments made with proceeds of borrowings, less any uninvested cash and cash equivalents resulting from borrowings, valued at the end of the applicable quarters within the respective periods and appropriately adjusted for any share issuances or repurchases during the periods.

<sup>(B)</sup> Reflected as a line item on our *Condensed Consolidated Statements of Operations*.



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### **Base Management Fee**

The base management fee is payable quarterly and assessed at an annual rate of 2.0%, computed on the basis of the value of our average total assets at the end of the two most recently completed quarters, which are total assets, including investments made with proceeds of borrowings, less any cash or cash equivalents resulting from borrowings and appropriately adjusted for any share issuances or repurchases during the periods. In addition, the following three items are adjustments to the base management fee calculation.

#### *Loan Servicing Fees*

The Adviser also services the loans held by Business Loan, in return for which it receives a 1.5% annual fee, based on the monthly aggregate outstanding balance of loans pledged under our line of credit. Since we own these loans, all loan servicing fees paid to the Adviser are treated as reductions directly against the 2.0% base management fee under the Advisory Agreement.

#### *Senior Syndicated Loan Fee Waiver*

Our Board of Directors accepted an unconditional and irrevocable voluntary waiver from the Adviser to reduce the annual 2.0% base management fee on senior syndicated loan participations to 0.5%, to the extent that proceeds resulting from borrowings were used to purchase such senior syndicated loan participations, for the six months ended March 31, 2012 and 2011.

#### *Portfolio Company Fees*

Under the Advisory Agreement, the Adviser has also provided, and continues to provide, managerial assistance and other services to our portfolio companies and may receive fees for services other than managerial assistance. 50% of certain of these fees, and 100% of other fees are credited against the base management fee that we would otherwise be required to pay to the Adviser.

### **Incentive Fee**

The incentive fee consists of two parts: an income-based incentive fee and a capital gains-based incentive fee. The income-based incentive fee rewards the Adviser if our quarterly net investment income (before giving effect to any incentive fee) exceeds 1.75% of our net assets (the hurdle rate ). We will pay the Adviser an income-based incentive fee with respect to our pre-incentive fee net investment income in each calendar quarter as follows:

no incentive fee in any calendar quarter in which our pre-incentive fee net investment income does not exceed the hurdle rate (7.0% annualized);

100% of our pre-incentive fee net investment income with respect to that portion of such pre-incentive fee net investment income, if any, that exceeds the hurdle rate but is less than 2.1875% in any calendar quarter (8.75% annualized); and

20% of the amount of our pre-incentive fee net investment income, if any, that exceeds 2.1875% in any calendar quarter (8.75% annualized).

Our Board of Directors accepted an unconditional and irrevocable voluntary waiver from the Adviser to reduce the income-based incentive fee to the extent net investment income did not cover all distributions to common stockholders for the six months ended March 31, 2012 and 2011.

The second part of the incentive fee is a capital gains-based incentive fee that will be determined and payable in arrears as of the end of each fiscal year (or upon termination of the Advisory Agreement, as of the termination date) and equals 20% of our realized capital gains as of the end of the fiscal year. In determining the capital gains-based incentive fee payable to the Adviser, we will calculate the cumulative aggregate realized capital gains and cumulative aggregate realized capital losses since our inception, and the aggregate unrealized capital depreciation as of

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the date of the calculation, as applicable, with respect to each of the investments in our portfolio. For this purpose, cumulative aggregate realized capital gains, if any, equals the sum of the differences

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between the net sales price of each investment, when sold, and the original cost of such investment since our inception. Cumulative aggregate realized capital losses equals the sum of the amounts by which the net sales price of each investment, when sold, is less than the original cost of such investment since our inception. Aggregate unrealized capital depreciation equals the sum of the difference, if negative, between the valuation of each investment as of the applicable calculation date and the original cost of such investment. At the end of the applicable year, the amount of capital gains that serves as the basis for our calculation of the capital gains-based incentive fee equals the cumulative aggregate realized capital gains less cumulative aggregate realized capital losses, less aggregate unrealized capital depreciation, with respect to our portfolio of investments. If this number is positive at the end of such year, then the capital gains-based incentive fee for such year equals 20% of such amount, less the aggregate amount of any capital gains-based incentive fees paid in respect of our portfolio in all prior years. No capital gains-based incentive fee has been recorded since our inception through March 31, 2012, as cumulative unrealized capital depreciation has exceeded cumulative realized capital gains net of cumulative realized capital losses.

Additionally, in accordance with GAAP, we did not accrue a capital gains-based incentive fee. This GAAP accrual is calculated using the aggregate cumulative realized capital gains and losses and aggregate cumulative unrealized capital depreciation included in the calculation of the capital gains-based incentive fee plus the aggregate cumulative unrealized capital appreciation. If such amount is positive at the end of a relevant period, then GAAP requires us to record a capital gains-based incentive fee equal to 20% of such amount, less the aggregate amount of actual capital gains-based incentive fees paid in all prior years. If such amount is negative, then there is no accrual for such year. GAAP requires that the capital gains-based incentive fee accrual consider the cumulative aggregate unrealized capital appreciation in the calculation, as a capital gains-based incentive fee would be payable if such unrealized capital appreciation were realized. There can be no assurance that such unrealized capital appreciation will be realized in the future. No GAAP accrual for a capital gains-based incentive fee has been recorded since our inception through March 31, 2012.

As a BDC, we make available significant managerial assistance to our portfolio companies and provide other services to such portfolio companies. Although neither we nor our Adviser receive fees in connection with managerial assistance, the Adviser provides other services to our portfolio companies and receives fees for these other services.

### *Administration Agreement*

We have entered into an administration agreement (the Administration Agreement) with Gladstone Administration, LLC (the Administrator), an affiliate of the Adviser, whereby we pay separately for administrative services. The Administration Agreement provides for payments equal to our allocable portion of the Administrator's overhead expenses in performing its obligations under the Administration Agreement, including, but not limited to, rent and the salaries and benefits expenses of our chief financial officer and treasurer, chief compliance officer, internal counsel and their respective staffs. Our allocable portion of administrative expenses is generally derived by multiplying the Administrator's total allocable expenses by the percentage of our total assets at the beginning of the quarter in comparison to the total assets at the beginning of the quarter of all companies managed by the Adviser under similar agreements. On July 12, 2011, our Board of Directors approved the renewal of the Administration Agreement through August 31, 2012.

**Table of Contents***Related Party Fees Due*

Amounts due to related parties on our accompanying *Condensed Consolidated Statements of Assets and Liabilities* were as follows:

|                                     | As of March 31, 2012 | As of September 30, 2011 |
|-------------------------------------|----------------------|--------------------------|
| Base management fee due to Adviser  | \$ 551               | \$ 330                   |
| Incentive fee due to Adviser        | 1,304                | 1,203                    |
| Loan servicing fee due to Adviser   | 208                  | 227                      |
| <b>Total fees due to Adviser</b>    | <b>2,063</b>         | 1,760                    |
| Fee due to Administrator            | 211                  | 194                      |
| <b>Total related party fees due</b> | <b>\$ 2,274</b>      | <b>\$ 1,954</b>          |

**NOTE 5. BORROWINGS***Line of Credit*

On January 19, 2012, we, through our wholly-owned subsidiary, Business Loan, entered into Amendment No. 3 to the fourth amended and restated credit agreement (the *Credit Facility*), to extend the maturity date of our \$137.0 million revolving line of credit from March 15, 2012 to January 18, 2015 (the *Maturity Date*). Our Credit Facility was arranged by Key Equipment Finance Inc. ( *Keybank* ) as administrative agent. Branch Banking and Trust Company ( *BB&T* ) and ING Capital LLC ( *ING* ) also joined our Credit Facility as committed lenders. Subject to certain terms and conditions, our Credit Facility may be expanded to a maximum of \$237.0 million through the addition of other committed lenders to the facility. If our Credit Facility is not renewed or extended by the Maturity Date, all principal and interest will be due and payable on or before January 18, 2016 (one year after the Maturity Date). The interest rates on advances under our Credit Facility remain unchanged and generally bear interest at a 30-day London Interbank Offered Rate ( *LIBOR* ) (subject to a minimum rate of 1.5%), plus 3.75% per annum, with a commitment fee of 0.5% per annum on undrawn amounts when our facility is drawn more than 50% and 1.0% per annum on undrawn amounts when our facility is drawn less than 50%. We incurred fees of \$1.4 million in January 2012 in connection with this amendment.

The following tables summarize noteworthy information related to our Credit Facility at cost:

|                                       | March 31, 2012 | September 30, 2011 |
|---------------------------------------|----------------|--------------------|
| Commitment amount                     | \$ 137,000     | \$ 137,000         |
| Borrowings outstanding <sup>(A)</sup> | 65,800         | 99,400             |
| Availability                          | 54,200         | 24,700             |

|   | For the Three Months<br>Ended March 31, |           | For the Six Months<br>Ended March 31, |           |
|---|---|-----------|---------------------------------------|-----------|
|   | 2012                                    | 2011      | 2012                                  | 2011      |
| Weighted average borrowings outstanding | \$ 62,018                               | \$ 14,464 | \$ 68,174                             | \$ 17,203 |
| Effective interest rate <sup>(B)</sup>  | 6.2%                                    | 6.3%      | 6.1%                                  | 6.5%      |
| Commitment (unused) fees incurred       | \$ 177                                  | \$ 277    | \$ 318                                | \$ 461    |

<sup>(A)</sup> The March 31, 2012 balance decreased significantly as compared to the September 30, 2011 balance due to repayments with the proceeds from our Term Preferred Stock offering in November 2011.

<sup>(B)</sup> Excludes the impact of deferred financing fees.

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Interest is payable monthly during the term of our Credit Facility. Available borrowings are subject to various constraints imposed under our Credit Facility, based on the aggregate loan balance pledged by Business Loan, which varies as loans are added and repaid, regardless of whether such repayments are prepayments or made as

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contractually required. The administrative agent also requires that any interest or principal payments on pledged loans be remitted directly by the borrower into a lockbox account with Keybank as custodian. Keybank, who also serves as the trustee of the account, generally remits the collected funds to us monthly.

Our Credit Facility contains covenants that require Business Loan to maintain its status as a separate legal entity, prohibit certain significant corporate transactions (such as mergers, consolidations, liquidations or dissolutions), and restrict material changes to our credit and collection policies. Our Credit Facility also limits payments on distributions to aggregate net investment income for each of the twelve month periods ending September 30, 2012, 2013, 2014 and 2015. Business Loan is also subject to certain limitations on the type of loan investments it can apply as collateral towards the borrowing base in order to receive additional borrowing availability under our Credit Facility, including restrictions on geographic concentrations, sector concentrations, loan size, dividend payout, payment frequency and status, average life and lien property. Our Credit Facility further requires Business Loan to comply with other financial and operational covenants, which obligate Business Loan to, among other things, maintain certain financial ratios, including asset and interest coverage and a minimum number of obligors required in the borrowing base of the credit agreement. Additionally, we are subject to a performance guaranty that requires us to maintain (i) a minimum net worth of \$190.0 million plus 50.0% of all equity and subordinated debt raised after January 19, 2012, (ii) asset coverage with respect to senior securities representing indebtedness of at least 200%, in accordance with Section 18 of the 1940 Act and (iii) our status as a BDC under the 1940 Act and as a RIC under the Code. The facility requires a minimum of 20 obligors in the borrowing base and as of March 31, 2012, Business Loan had 37 obligors. As of March 31, 2012, we were in compliance with all of the facility covenants.

*Fair Value*

We elected to apply ASC 825, Financial Instruments, specifically for our Credit Facility, which was consistent with our application of ASC 820 to our investments. Generally, we estimate the fair value of our Credit Facility using estimates of value provided by an independent third party and our own assumptions in the absence of observable market data, including estimated remaining life, counterparty credit risk, current market yield and interest rate spreads of similar securities as of the measurement date. However, as the renewal of our Credit Facility occurred during the three months ended March 31, 2012, cost was determined to approximate fair value as of March 31, 2012. At both March 31, 2012 and September 30, 2011, our Credit Facility was valued using Level 3 inputs.

The following tables present our Credit Facility carried at fair value as of March 31, 2012 and September 30, 2011, by caption on our accompanying *Condensed Consolidated Statements of Assets and Liabilities* for Level 3 of the hierarchy established by ASC 820 and the changes in fair value of our Credit Facility during the three and six months ended March 31, 2012 and 2011:

|                   | <b>Total Recurring Fair Value Measurement Reported in<br/>Condensed Consolidated Statements of<br/>Assets and Liabilities Using Significant Unobservable<br/>Inputs (Level 3)</b> |                               |
|-------------------|---|-------------------------------|
|                   | <b>March 31,<br/>2012</b>   | <b>September 30,<br/>2011</b> |
| <b>Borrowings</b> | <b>\$ 65,800</b>  | <b>\$ 100,012</b>             |

**Table of Contents****Total Fair value Reported in Condensed Consolidated Statements of Assets and Liabilities**

|   | <b>Three Months Ended March 31,</b> |             |
|---|-------------------------------------|-------------|
|   | <b>2012</b>                         | <b>2011</b> |
| Fair value as of December 31, 2011 and 2010, respectively     | <b>\$ 57,213</b>                    | \$ 25,301   |
| Net unrealized depreciation <sup>(A)</sup>                    | <b>(313)</b>                        | (255)       |
| Borrowings  | <b>21,900</b>                       | 40,800      |
| Repayments  | <b>(13,000)</b>                     | (32,200)    |
| <b>Fair value as of March 31, 2012 and 2011, respectively</b> | <b>\$ 65,800</b>                    | \$ 33,646   |

|   | <b>Six Months Ended March 31,</b> |             |
|---|-----------------------------------|-------------|
|   | <b>2012</b>                       | <b>2011</b> |
| Fair value as of September 30, 2011 and 2010, respectively    | <b>\$ 100,012</b>                 | \$ 17,940   |
| Net unrealized depreciation <sup>(A)</sup>                    | <b>(612)</b>                      | (694)       |
| Borrowings  | <b>32,900</b>                     | 50,800      |
| Repayments  | <b>(66,500)</b>                   | (34,400)    |
| <b>Fair value as of March 31, 2012 and 2011, respectively</b> | <b>\$ 65,800</b>                  | \$ 33,646   |

<sup>(A)</sup> Included in net unrealized depreciation on borrowings on our accompanying *Condensed Consolidated Statements of Operations* for the three and six months ended March 31, 2012 and 2011.

The fair value of the collateral under our Credit Facility was \$239.0 million and \$256.9 million at March 31, 2012 and September 30, 2011, respectively.

**NOTE 6. MANDATORILY REDEEMABLE PREFERRED STOCK**

In November 2011, we completed a public offering of 1.5 million shares of 7.125% Series 2016 Term Preferred Stock, par value \$0.001 per share ( Term Preferred Stock ), at a public offering price of \$25.00 per share. Gross proceeds totaled \$38.5 million and net proceeds, after deducting underwriting discounts and offering expenses borne by us, were \$36.3 million and were used to repay a portion of outstanding borrowings under the Credit Facility. We incurred \$2.2 million in total offering costs related to these transactions, which have been recorded as deferred financing fees on our *Condensed Consolidated Statements of Assets and Liabilities* and will be amortized over the redemption period ending December 31, 2016.

The shares have a redemption date of December 31, 2016 and are traded under the ticker symbol of GLAD PRA on the New York Stock Exchange ( NYSE ). The Term Preferred Stock is not convertible into our common stock or any other security. The Term Preferred Stock provides for a fixed dividend equal to 7.125% per year, payable monthly (which equates to approximately \$2.7 million per year). We are required to redeem all of the outstanding Term Preferred Stock on December 31, 2016 for cash at a redemption price equal to \$25.00 per share plus an amount equal to accumulated but unpaid dividends, if any, to the date of redemption. In addition, there are two other potential redemption triggers: 1) if we fail to maintain an asset coverage ratio of at least 200%, we are required to redeem a portion of the outstanding Term Preferred Stock or otherwise cure the ratio redemption trigger and 2) at our sole option, at any time on or after December 31, 2012, we may redeem the Term Preferred Stock. See Note 12 *Subsequent Events* for discussion of the transfer of the listing of our Term Preferred Stock from the NYSE to the NASDAQ Global Select Market ( NASDAQ ).

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Our Board of Directors declared the following monthly distributions to preferred stockholders for the six months ended March 31, 2012:

| Fiscal Year                             | Time Period                    | Declaration Date | Record Date       | Payment Date      | Distribution per Term Preferred Share |
|---|--------------------------------|------------------|-------------------|-------------------|---------------------------------------|
| 2012                                    | November 4 - 30 <sup>(A)</sup> | December 6, 2011 | December 16, 2011 | December 30, 2011 | \$ 0.13359375                         |
|   | December 1 - 31                | December 6, 2011 | December 16, 2011 | December 30, 2011 | <b>0.14843750</b>                     |
|   | January 1 - 31                 | January 10, 2012 | January 23, 2012  | January 21, 2012  | <b>0.14843750</b>                     |
|   | February 1 - 29                | January 10, 2012 | February 21, 2012 | February 29, 2012 | <b>0.14843750</b>                     |
|   | March 1 - 31                   | January 10, 2012 | March 22, 2012    | March 30, 2012    | <b>0.14843750</b>                     |
| <b>Six Months Ended March 31, 2012:</b> |                                |                  |                   |                   | <b>\$ 0.72734375</b>                  |

<sup>(A)</sup> November 2011 was prorated from the time the Term Preferred Stock was issued and outstanding as per our final prospectus supplement dated October 28, 2011.

In accordance with ASC 480, Distinguishing Liabilities from Equity, mandatorily redeemable financial instruments should be classified as liabilities in the balance sheet and therefore the related dividend payments are treated as dividend expense on our statement of operations as of the ex-dividend date.

**NOTE 7. COMMON STOCK***Registration Statement*

On October 20, 2009, we filed a registration statement on Form N-2 (File No. 333-162592) that was amended on December 9, 2009 and which the SEC declared effective on January 28, 2010, and we filed post-effective amendments to such registration statement on April 7, 2011, June 15, 2011, and July 13, 2011, which were declared effective by the SEC on July 15, 2011. We filed a post-effective amendment to such registration statement on March 6, 2012, which has not yet been declared effective. The registration statement permits us to issue, through one or more transactions, up to an aggregate of \$300.0 million in securities, consisting of common stock, preferred stock, subscription rights, debt securities and warrants to purchase common stock, including through a combined offering of such securities.

On May 17, 2010, together with the Advisor, we entered into an equity distribution agreement (the Agreement) with BB&T Capital Markets, a division of Scott & Stringfellow, LLC (the Agent), under which we may, from time to time, issue and sell through the Agent, as sales agent, up to 2.0 million shares (the Shares) of our common stock, par value \$0.001 per share, based upon instructions from us (including, at a minimum, the number of Shares to be offered, the time period during which sales are requested to be made, any limitation on the number of Shares that may be sold in any one day and any minimum price below which sales may not be made). Sales of Shares through the Agent, if any, will be executed by means of either ordinary brokers' transactions on NASDAQ in accordance with Rule 153 under the Securities Act of 1933, as amended, or such other sales of the Shares as shall be agreed by us and the Agent. The compensation payable to the Agent for sales of Shares with respect to which the Agent acts as sales agent shall be equal to 2.0% of the gross sales price of the Shares sold pursuant to the Agreement. To date, we have not issued any shares pursuant to this Agreement.

During the quarter ended December 31, 2011, pursuant to the terms of our articles of incorporation, as amended, our Board of Directors approved reclassifying 4.0 million shares of common stock to shares of preferred stock.



**Table of Contents***Employee Notes*

The following table is a summary of all outstanding notes issued to employees of the Adviser for the exercise of stock options:

| Issue Date | Original Number of Options Exercised | Strike Price of Options Exercised | Original Amount of Promissory Note Issued to Employees | Outstanding Balance of Employee Loans at March 31, 2012 | Maturity Date | Original Interest Rate on Note |
|------------|--------------------------------------|-----------------------------------|--|---|---------------|--------------------------------|
| Aug-01     | 393,334                              | 15.00                             | \$ 5,900 <sup>(A)</sup>                                | \$ 2,749  | Aug-10        | 4.90% <sup>(B)</sup>           |
| Aug-01     | 18,334                               | 15.00                             | 275 <sup>(A)</sup>                                     | 200   | Aug-10        | 4.90 <sup>(B)</sup>            |
| Aug-01     | 18,334                               | 15.00                             | 275 <sup>(C)</sup>                                     |   | Aug-11        | 4.90                           |
| Sep-04     | 13,332                               | 15.00                             | 200 <sup>(C)</sup>                                     | 98  | Sep-13        | 5.00                           |
| Jul-06     | 13,332                               | 15.00                             | 200  | 200   | Jul-15        | 8.26                           |
| Jul-06     | 18,334                               | 15.00                             | 275  | 275   | Jul-15        | 8.26                           |
|            | <b>475,000</b>                       |                                   | <b>\$ 7,125</b>  | <b>\$ 3,522</b>   |               |                                |

- <sup>(A)</sup> On September 7, 2010, we entered into redemption agreements (the Redemption Agreements) with David Gladstone, our Chairman and Chief Executive Officer, and Laura Gladstone, the daughter of Mr. Gladstone and an officer of the Adviser, and one of our Managing Directors, in connection with the maturity of secured promissory notes executed by Mr. Gladstone and Ms. Gladstone in favor of us on August 23, 2001, in the principal amounts of \$5.9 million and \$0.3 million, respectively (collectively, the Notes). Mr. and Ms. Gladstone executed the Notes to facilitate their payment of the exercise price of certain stock options (the Options) to acquire shares of our common stock. Concurrently with the execution of the Notes, we, together with Mr. and Ms. Gladstone entered into stock pledge agreements (collectively, the Pledge Agreements), pursuant to which Mr. and Ms. Gladstone granted to us a first priority security interest in the Pledged Collateral (as defined in the respective Pledge Agreements), which included 393,334 and 18,334 shares, respectively, of our common stock that Mr. and Ms. Gladstone acquired pursuant to the exercise of the Options (collectively, the Pledged Shares). An event of default was triggered under the Notes by virtue of Mr. and Ms. Gladstone's failure to repay the amounts outstanding under the Notes within five business days of August 23, 2010. The Redemption Agreements provide that, pursuant to the terms and conditions thereof, we will automatically accept and retire the Pledged Shares in partial or full satisfaction, as applicable, of Mr. and Ms. Gladstone's obligations to us under the Notes at such time, if ever, that the trading price of our common stock reaches \$15 per share. In entering into the Redemption Agreements, we reserved all of our existing rights under the Notes and the Pledge Agreements, including, but not limited to, the ability to foreclose on the Pledged Collateral at any time. On March 30, 2011, June 27, 2011 and September 26, 2011, Mr. Gladstone paid down an aggregate of \$3.2 million of the principal balance of his note, leaving a principal balance of \$2.7 million outstanding as of March 31, 2012. In connection with these payments, we released our first priority security interest on 210,000 common shares of Mr. Gladstone's Pledged Shares, leaving a balance of 183,334 common shares in Pledged Collateral from Mr. Gladstone as of March 31, 2012. On September 28, 2011, Ms. Gladstone paid down \$0.1 million of the principal balance of her 2001 note, leaving a principal balance of \$0.2 million outstanding on this note as of March 31, 2012. The principal balances under her 2006 notes remain unchanged at an aggregate balance of \$0.5 million as of March 31, 2012.
- <sup>(B)</sup> An event of default was triggered under these Notes by virtue of Mr. and Ms. Gladstone's failure to repay the amounts outstanding within five business days of August 23, 2010. As such, we charged a default rate of an additional 2% per annum under these Notes for all periods following default.
- <sup>(C)</sup> On December 20, 2011, we entered into an amended and restated redemption agreement with an employee of the Adviser in connection with the maturity of a secured promissory note executed by the employee in favor of us on August 23, 2001, in the principal amount of \$0.3 million. Pursuant to the redemption agreement, on December 29, 2011, we redeemed 20,000 shares of our common stock that had been pledged as collateral on the employee note, resulting in a reduction of \$0.2 million on the employee note, leaving a principal balance of \$0.1 million as of December 31, 2011. On January 26, 2012, we redeemed an additional

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19,082 shares of our common stock that had been pledged as collateral on the employee note, resulting in the employee's defaulted loan being fully paid off and a reduction of \$0.1 million on the employee's other note, leaving a remaining principal balance thereon of \$0.1 million as of March 31, 2012.

In accordance with ASC 505, Equity, receivables from employees for the issuance of capital stock to employees prior to the receipt of cash payment should be reflected in the balance sheet as a reduction to stockholders' equity. Therefore, these recourse notes were recorded as loans to employees and are included in the equity section of our accompanying *Condensed Consolidated Statements of Assets and Liabilities*. As of March 31, 2012, we determined that these notes were still recourse.

**NOTE 8. NET DECREASE IN NET ASSETS RESULTING FROM OPERATIONS PER COMMON SHARE**

The following table sets forth the computation of basic and diluted net decrease in net assets resulting from operations per weighted average common share for the three and six months ended March 31, 2012 and 2011:

|   | Three Months Ended March 31, |            | Six Months Ended March 31, |            |
|---|------------------------------|------------|----------------------------|------------|
|   | 2012                         | 2011       | 2012                       | 2011       |
| Numerator for basic and diluted net decrease in net assets resulting from operations per common share | \$ (1,603)                   | \$ (8,381) | \$ (2,892)                 | \$ (6,250) |
| Denominator for basic and diluted weighted average common shares                                      | 21,005,402                   | 21,039,242 | 21,022,087                 | 21,039,242 |
| Basic and diluted net decrease in net assets resulting from operations per common share               | \$ (0.08)                    | \$ (0.40)  | \$ (0.14)                  | \$ (0.30)  |

**NOTE 9. DISTRIBUTIONS TO COMMON STOCKHOLDERS**

Our Board of Directors declared the following monthly distributions to common stockholders for the six months ended March 31, 2012 and 2011:

| Fiscal Year                             | Declaration Date | Record Date       | Payment Date      | Distribution per Common Share |
|---|------------------|-------------------|-------------------|-------------------------------|
| 2012                                    | October 11, 2011 | October 21, 2011  | October 31, 2011  | \$ 0.07                       |
|   | October 11, 2011 | November 17, 2011 | November 30, 2011 | 0.07                          |
|   | October 11, 2011 | December 21, 2011 | December 30, 2011 | 0.07                          |
|   | January 10, 2012 | January 23, 2012  | January 31, 2012  | 0.07                          |
|   | January 10, 2012 | February 21, 2012 | February 29, 2012 | 0.07                          |
|   | January 10, 2012 | March 22, 2012    | March 30, 2012    | 0.07                          |
| <b>Six Months Ended March 31, 2012:</b> |                  |                   |                   | <b>\$ 0.42</b>                |
| 2011                                    | October 5, 2010  | October 21, 2010  | October 29, 2010  | \$ 0.07                       |
|   | October 5, 2010  | November 19, 2010 | November 30, 2010 | 0.07                          |
|   | October 5, 2010  | December 23, 2010 | December 31, 2010 | 0.07                          |
|   | January 11, 2011 | January 21, 2011  | January 31, 2011  | 0.07                          |
|   | January 11, 2011 | February 21, 2011 | February 28, 2011 | 0.07                          |
|   | January 11, 2011 | March 21, 2011    | March 31, 2011    | 0.07                          |
| <b>Six Months Ended March 31, 2011:</b> |                  |                   |                   | <b>\$ 0.42</b>                |

Aggregate common distributions declared and paid for the six months ended March 31, 2012 and 2011 were each approximately \$8.8 million, which were declared based on estimates of net investment income for the respective

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fiscal years. The characterization of the common distributions declared and paid for the fiscal year ended September 30, 2012 will be determined at year end and cannot be determined at this time. For the fiscal year ended September 30, 2011, taxable income available for common distributions exceeded distributions declared and paid, and, in accordance with Section 855(a) of the Code, we elected to treat a portion of the first common distribution paid in fiscal year 2012 as having been paid in the prior year.

**NOTE 10. COMMITMENTS AND CONTINGENCIES***Legal Proceedings*

We are party to certain legal proceedings incidental to the normal course of our business, including the enforcement of our rights under contracts with our portfolio companies. We are required to establish reserves for litigation matters where those matters present loss contingencies that are both probable and estimable. When loss contingencies are not both probable and estimable, we do not establish reserves. Based on current knowledge, we do not believe that loss contingencies, if any, arising from pending investigations, litigation or regulatory matters will have a material adverse effect on our financial condition or results of operation.

*Escrow Holdbacks*

From time to time, we will enter into arrangements as it relates to exits of certain investments whereby specific amounts of the proceeds are held in escrow in order to be used to satisfy potential obligations as stipulated in the sales agreements. We record escrow amounts in restricted cash on our accompanying *Condensed Consolidated Statements of Assets and Liabilities*. We establish a contingent liability against the escrow amounts if we determine that it is probable and estimable that a portion of the escrow amounts will not be ultimately received at the end of the escrow period. The aggregate contingent liability amount recorded against the escrow amounts was \$1.2 million and \$0 as of March 31, 2012 and September 30, 2011, respectively, and is located in other liabilities on our accompanying *Condensed Consolidated Statements of Assets and Liabilities*.

*Financial Commitments and Obligations*

We have lines of credit and capital commitments with certain of our portfolio companies that have not been fully drawn or called. Since these commitments have expiration dates and we expect many will never be fully drawn or called, the total commitment amounts do not necessarily represent future cash requirements.

In addition to the lines of credit and capital commitments with portfolio companies, we also extend certain guarantees on behalf of some of our portfolio companies during the normal course of business. In January 2012, we executed a guarantee for one of our Control investments, Viapack, to irrevocably and unconditionally guarantee payment and performance of Viapack's obligations regarding purchase agreements and expenses to one of its vendors. This guarantee is limited to a maximum of \$0.6 million and terminates within 30 days written notice not to extend further credit. As of September 30, 2011, we were not party to any signed guarantees.

We estimated the fair value of our unused line of credit commitments, uncalled capital commitment and guarantee as of March 31, 2012 and September 30, 2011 to be minimal; and therefore, they are not recorded on our accompanying *Condensed Consolidated Statements of Assets and Liabilities*. The following table summarizes the dollar balances of unused line of credit commitments, uncalled capital commitment and guarantee as of March 31, 2012 and September 30, 2011:

|                                   | As of March 31,<br>2012 | As of September 30,<br>2011 |
|-----------------------------------|-------------------------|-----------------------------|
| Unused line of credit commitments | \$ 8,810                | \$ 12,990                   |
| Uncalled capital commitment       | 800                     | 800                         |
| Guarantee                         | 600                     |                             |
| <b>Total</b>                      | <b>\$ 10,210</b>        | <b>\$ 13,790</b>            |

**Table of Contents****NOTE 11. FINANCIAL HIGHLIGHTS**

|  | Three Months Ended<br>March 31, |            | Six Months Ended<br>March 31, |            |
|--|---------------------------------|------------|-------------------------------|------------|
|  | 2012                            | 2011       | 2012                          | 2011       |
| <b>Per Common Share Data <sup>(A)</sup></b>  |                                 |            |                               |            |
| Net asset value at beginning of period   | \$ 9.90                         | \$ 11.74   | \$ 10.16                      | \$ 11.85   |
| Net investment income <sup>(B)</sup>   | 0.25                            | 0.21       | 0.45                          | 0.43       |
| Net realized loss on investments <sup>(B)</sup>                                    |                                 |            | (0.39)                        |            |
| Net unrealized depreciation of investments <sup>(B)</sup>                          | (0.34)                          | (0.62)     | (0.23)                        | (0.76)     |
| Net unrealized depreciation of borrowings <sup>(B)</sup>                           | 0.01                            | 0.01       | 0.03                          | 0.03       |
| Distributions to common stockholders from net investment income <sup>(B) (C)</sup> | (0.21)                          | (0.21)     | (0.42)                        | (0.42)     |
| Repayment of principal on employee notes   | 0.01                            | 0.05       | 0.02                          | 0.05       |
| Stock redemption for repayment on employee notes                                   | (0.01)                          |            | (0.02)                        |            |
| Other, net <sup>(D)</sup>  | 0.01                            |            | 0.02                          |            |
| Net asset value at end of period   | \$ 9.62                         | \$ 11.18   | \$ 9.62                       | \$ 11.18   |
| Per common share market value at beginning of period                               | \$ 7.63                         | \$ 11.52   | \$ 6.86                       | \$ 11.27   |
| Per common share market value at end of period                                     | 8.11                            | 11.31      | 8.11                          | 11.31      |
| Total return <sup>(E)</sup>  | 8.93%                           | 1.86%      | 24.46%                        | 4.12%      |
| Common shares outstanding at end of period   | 21,000,160                      | 21,039,242 | 21,000,160                    | 21,039,242 |
| <b>Statement of Assets and Liabilities Data:</b>                                   |                                 |            |                               |            |
| Net assets at end of period  | \$ 202,002                      | \$ 235,215 | \$ 202,002                    | \$ 235,215 |
| Average net assets <sup>(F)</sup>  | 207,018                         | 252,457    | 208,995                       | 249,985    |
| <b>Senior Securities Data:</b>   |                                 |            |                               |            |
| Borrowings under Credit Facility, at cost  | 65,800                          | 33,200     | 65,800                        | 33,200     |
| Mandatorily redeemable preferred stock   | 38,497                          |            | 38,497                        |            |
| Asset coverage ratio <sup>(G) (H)</sup>  | 292%                            | 807%       | 292%                          | 807%       |
| Asset coverage per unit <sup>(H)</sup>   | \$ 2,922                        | \$ 8,073   | \$ 2,922                      | \$ 8,073   |
| <b>Ratios/Supplemental Data:</b>   |                                 |            |                               |            |
| Ratio of expenses to average net assets-annualized <sup>(I)</sup>                  | 11.41%                          | 6.45%      | 10.77%                        | 6.00%      |
| Ratio of net expenses to average net assets-annualized <sup>(J)</sup>              | 11.17                           | 6.29       | 10.22                         | 5.87       |
| Ratio of net investment income to average net assets-annualized                    | 10.08                           | 7.02       | 9.22                          | 7.25       |

(A) Based on actual shares outstanding at the end of the corresponding period.

(B) Based on weighted average basic per share data.

(C) Distributions are determined based on taxable income calculated in accordance with income tax regulations which may differ from amounts determined under GAAP.

(D) Represents the impact of the different share amounts (weighted average shares outstanding during the period and shares outstanding at the end of the period) in the per share data calculations and rounding impacts.

(E) Total return equals the change in the ending market value of our common stock from the beginning of the period, taking into account distributions reinvested in accordance with the terms of our dividend reinvestment plan. Total return does not take into account distributions that may be characterized as a return of capital. For further information on the estimated character of our distributions to common stockholders, please refer to Note 9 *Distributions to Common Stockholders*. Total return is not annualized.



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- (F) Average net assets are computed using the average of the balance of net assets at the end of each month of the reporting period.
- (G) As a BDC, we are generally required to maintain a ratio of at least 200% of total assets, less all liabilities and indebtedness not represented by senior securities, to total borrowings and guaranty commitments. Our mandatorily redeemable preferred stock is characterized as borrowings for the asset coverage ratio.
- (H) Asset coverage ratio is the ratio of the carrying value of our total consolidated assets, less all liabilities and indebtedness not represented by senior securities, to the aggregate amount of senior securities representing indebtedness (including interest payable and guarantees). Asset coverage per unit is the asset coverage ratio expressed in terms of dollar amounts per one thousand dollars of indebtedness.
- (I) Ratio of expenses to average net assets is computed using expenses before credits from the Adviser to the base management and incentive fees and including income tax expense.
- (J) Ratio of net expenses to average net assets is computed using total expenses net of credits from the Adviser to the base management and incentive fees and including income tax expense.

**NOTE 12. SUBSEQUENT EVENTS***Distributions*

In April 2012, our Board of Directors declared the following monthly cash distributions to common and preferred stockholders:

| <b>Record Date</b>           | <b>Payment Date</b> | <b>Distribution per Common Share</b> | <b>Distribution per Term Preferred Share</b> |
|------------------------------|---------------------|--------------------------------------|--|
| April 20, 2012               | April 30, 2012      | \$ 0.07                              | \$ 0.1484375                                 |
| May 18, 2012                 | May 31, 2012        | 0.07                                 | 0.1484375                                    |
| June 20, 2012                | June 29, 2012       | 0.07                                 | 0.1484375                                    |
| <b>Total for the Quarter</b> |                     | <b>\$ 0.21</b>                       | <b>\$ 0.4453125</b>                          |

*Investment Activity*

Subsequent to March 31, 2012, we extended an aggregate amount of approximately \$0.7 million to 4 existing portfolio companies in revolver draws and received scheduled repayments of \$1.8 million from 16 portfolio companies.

*Term Preferred Stock Listing*

On May 1, 2012, we transferred our listing of Term Preferred Stock from the NYSE to NASDAQ. The new trading symbol on NASDAQ for the Term Preferred Stock is GLADP.

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**The information in this prospectus supplement is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus supplement is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.**

Filed Pursuant to Rule 497

Registration Statement No. 333-162592

## PROSPECTUS SUPPLEMENT

(To Prospectus dated , 201 )

**Shares of Common Stock**

We are offering for sale shares of our common stock. Our common stock is traded on The NASDAQ Global Select Market under the symbol GLAD. The last reported sale price for our common stock on , was \$ per share. The net asset value per share of our common stock at the close of business on , 201 was \$ per share.

|  | Per Share | Total (1) |
|--|-----------|-----------|
| Public offering price                  | \$        | \$        |
| Underwriting discounts and commissions | \$        | \$        |
| Proceeds, before expenses, to us       | \$        | \$        |

(1) The aggregate expenses of the offering are estimated to be \$ , which represents approximately \$ per share. The underwriters may also purchase up to an additional shares of common stock from us at the public offering price, less underwriting discounts and commissions, to cover over-allotments, if any, within 30 days after the date of this prospectus supplement. If the over-allotment option is exercised in full, our total proceeds, before expenses, would be \$ and the total underwriting discounts and commissions would be \$ . The common shares will be ready for delivery on or about , .

You should read this prospectus supplement and the accompanying prospectus before deciding whether to invest in our common stock and you should retain them for future reference. Additional information about us, including our annual, quarterly and current reports, has been filed with the Securities and Exchange Commission. This information is available free of charge on our corporate website at <http://www.gladstoneinvestment.com>.

**An investment in our common stock involves certain risks, including, among other things, risks relating to investments in securities of small, private and developing businesses. We describe some of these risks in the section entitled Risk Factors, which begins on page S-4 of this prospectus supplement and page 8 of the accompanying prospectus. Shares of closed-end investment companies frequently trade at a discount to their net asset value and this may increase the risk of loss of purchasers of our common stock. You should carefully consider these risks together with all of the other information contained in this prospectus supplement and the accompanying prospectus before making a decision to purchase our common stock.**

**The common stock being offered has not been approved or disapproved by the Securities and Exchange Commission or any state securities commission nor has the Securities and Exchange Commission or any state**



**securities commission passed upon the accuracy or adequacy of this prospectus supplement or the accompanying prospectus. Any representation to the contrary is a criminal offense.**

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We have not authorized any dealer, salesman or other person to give any information or to make any representation other than those contained in this prospectus supplement or the accompanying prospectus. You must not rely upon any information or representation not contained in this prospectus supplement or the accompanying prospectus as if we had authorized it. This prospectus supplement and the accompanying prospectus do not constitute an offer to sell or a solicitation of any offer to buy any security other than the registered securities to which they relate, nor do they constitute an offer to sell or a solicitation of an offer to buy any securities in any jurisdiction to any person to whom it is unlawful to make such an offer or solicitation in such jurisdiction. The information contained in this prospectus supplement and any accompanying prospectus is accurate as of the dates on their respective covers only. Our business, financial condition, results of operations and prospects may have changed since such dates.

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**Table of Contents****SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

All statements contained in this prospectus supplement or the accompanying prospectus, other than historical facts, may constitute forward-looking statements. These statements may relate to, among other things, future events or our future performance or financial condition. In some cases, you can identify forward-looking statements by terminology such as may, might, believe, will, provided, anticipate, future growth, plan, intend, expect, should, would, if, seek, possible, potential, likely or the negative of such terms or comparable forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others: (1) further adverse changes in the economy and the capital markets; (2) risks associated with negotiation and consummation of pending and future transactions; (3) the loss of one or more of our executive officers, in particular David Gladstone, Terry Lee Brubaker or George Stelljes III ; (4) changes in our business strategy; (5) availability, terms and deployment of capital; (6) changes in our industry, interest rates, exchange rates or the general economy; (7) the degree and nature of our competition; and (8) those factors described in the Risk Factors sections of this prospectus supplement and the accompanying prospectus. We caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, after the date of this prospectus supplement. The forward-looking statements contained in this prospectus supplement or the accompanying prospectus are excluded from the safe harbor protection provided by the Private Securities Litigation Reform Act of 1995 and Section 27A of the Securities Act.

**FEES AND EXPENSES**

The following table is intended to assist you in understanding the costs and expenses that an investor in this offering will bear directly or indirectly. We caution you that some of the percentages indicated in the table below are estimates and may vary. Except where the context suggests otherwise, whenever this prospectus contains a reference to fees or expenses paid by us or Gladstone Investment, or that we will pay fees or expenses, stockholders will indirectly bear such fees or expenses as investors in Gladstone Investment. The following percentages were calculated based on actual expenses incurred in the year ended , and average net assets for the quarter ended , .

**Stockholder Transaction Expenses:**

|  |      |
|--|------|
| Sales load (as a percentage of offering price) | [ ]% |
|--|------|

|  |     |
|--|-----|
| Dividend reinvestment plan expenses(1) | [ ] |
|--|-----|

**Annual expenses (as a percentage of net assets attributable to common stock):**

|                    |      |
|--------------------|------|
| Management fees(2) | [ ]% |
|--------------------|------|

|   |      |
|---|------|
| Incentive fees payable under investment advisory and management agreement (20% of realized capital gains and 20% of pre-incentive fee net investment income)(3) | [ ]% |
|---|------|

|  |      |
|--|------|
| Interest payments on borrowed funds(4) | [ ]% |
|--|------|

|                   |      |
|-------------------|------|
| Other expenses(5) | [ ]% |
|-------------------|------|

|                              |      |
|------------------------------|------|
| Total annual expenses (2)(5) | [ ]% |
|------------------------------|------|

- (1) The expenses of the reinvestment plan are included in stock record expenses, a component of Other expenses. We do not have a cash purchase plan. The participants in the dividend reinvestment plan will bear a pro rata share of brokerage commissions incurred with respect to open market purchases, if any. See Dividend Reinvestment Plan in the accompanying prospectus for information on the dividend reinvestment plan.
- (2) Our annual base management fee is 2% (0.5% quarterly) of our average gross assets, which are defined as total assets of Gladstone Investment, including investments made with proceeds of borrowings, less any

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- uninvested cash or cash equivalents resulting from borrowings. For the fiscal year ended \_\_\_\_\_, \_\_\_\_\_, our Adviser voluntarily agreed to waive the annual base management fee of 2% to [ ]% for those senior syndicated loans that we purchase using borrowings from our credit facility. However, because we held no senior syndicated loans purchased using borrowings under our credit facility during the quarter ended \_\_\_\_\_, \_\_\_\_\_, the waiver did not impact our expenses for that period, as reflected in the table above. See Management Certain Transactions Investment Advisory and Management Agreement in the accompanying prospectus and footnote 3 below.
- (3) The incentive fee consists of two parts: an income-based fee and a capital gains-based fee. The income-based fee is payable quarterly in arrears, and equals 20% of the excess, if any, of our pre-incentive fee net investment income that exceeds a 1.75% quarterly ([ ]% annualized) hurdle rate of our net assets, subject to a catch-up provision measured as of the end of each calendar quarter. The catch-up provision requires us to pay 100% of our pre-incentive fee net investment income with respect to that portion of such income, if any, that exceeds the hurdle rate but is less than 125% of the quarterly hurdle rate (or 2.1875%) in any calendar quarter (8.75% annualized). The catch-up provision is meant to provide our Adviser with 20% of our pre-incentive fee net investment income as if a hurdle rate did not apply when our pre-incentive fee net investment income exceeds 125% of the quarterly hurdle rate in any calendar quarter (8.75% annualized). The income-based incentive fee is computed and paid on income that may include interest that is accrued but not yet received in cash. Our pre-incentive fee net investment income used to calculate this part of the income-based incentive fee is also included in the amount of our gross assets used to calculate the 2% base management fee (see footnote 2 above). The capital gains-based incentive fee equals 20% of our net realized capital gains since our inception, if any, computed net of all realized capital losses and unrealized capital depreciation since our inception, less any prior payments, and is payable at the end of each fiscal year.
- Examples of how the incentive fee would be calculated are as follows:

Assuming pre-incentive fee net investment income of 0.55%, there would be no income-based incentive fee because such income would not exceed the hurdle rate of 1.75%.

Assuming pre-incentive fee net investment income of 2.00%, the income-based incentive fee would be as follows:

$$= 100\% \times (2.00\% - 1.75\%)$$

$$= 0.25\%$$

Assuming pre-incentive fee net investment income of 2.30%, the income-based incentive fee would be as follows:

$$= (100\% \times ( \text{catch-up} : 2.1875\% - 1.75\% )) + (20\% \times (2.30\% - 2.1875\% ))$$

$$= (100\% \times 0.4375\%) + (20\% \times 0.1125\%)$$

$$= 0.4375\% + 0.0225\%$$

$$= 0.46\%$$

Assuming net realized capital gains of 6% and realized capital losses and unrealized capital depreciation of 1%, the capital gains-based incentive fee would be as follows:

$$= 20\% \times (6\% - 1\%)$$

$$= 20\% \times 5\%$$

$$= 1\%$$

For a more detailed discussion of the calculation of the two-part incentive fee, see Management Certain Transactions Investment Advisory and Management Agreement in the accompanying prospectus.



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- (4) Includes deferred financing costs. We entered into a revolving credit facility, effective \_\_\_\_\_, \_\_\_\_\_, under which our borrowing capacity is \$[ ] million. We have drawn down on this credit facility and we expect to borrow additional funds in the future up to an amount so that our asset coverage, as defined in the 1940 Act, is at least 200% after each issuance of our senior securities. Assuming that we borrowed \$[ ] million at an interest rate of [ ]% plus an additional fee related to borrowings of [ ]%, for an aggregate rate of [ ]%, interest payments and amortization of deferred financing costs on borrowed funds would have been [ ]% of our average net assets for the quarter ended \_\_\_\_\_, \_\_\_\_\_.
- (5) Includes our overhead expenses, including payments under the administration agreement based on our projected allocable portion of overhead and other expenses incurred by our Administrator in performing its obligations under the administration agreement. See Management Certain Transactions Administration Agreement in the accompanying prospectus.

**Example**

The following example demonstrates the projected dollar amount of total cumulative expenses that would be incurred over various periods with respect to a hypothetical investment in our common stock. In calculating the following expense amounts, we have assumed that our annual operating expenses would remain at the levels set forth in the table above.

|   | 1 Year | 3 Years | 5 Years | 10 Years |
|---|--------|---------|---------|----------|
| You would pay the following expenses on a \$1,000 investment, assuming a 5% annual return | \$ [ ] | \$ [ ]  | \$ [ ]  | \$ [ ]   |

While the example assumes, as required by the SEC, a 5% annual return, our performance will vary and may result in a return greater or less than 5%. Additionally, we have assumed that the entire amount of such 5% annual return would constitute ordinary income as we have not historically realized positive capital gains (computed net of all realized capital losses) on our investments. Because the assumed 5% annual return is significantly below the hurdle rate of 7% (annualized) that we must achieve under the investment advisory and management agreement to trigger the payment of an income-based incentive fee, we have assumed, for purposes of the above example, that no income-based incentive fee would be payable if we realized a 5% annual return on our investments. Additionally, because the capital gains-based incentive fee is calculated on a cumulative basis (computed net of all realized capital losses and unrealized capital depreciation) and because of the significant capital losses realized to date, we have assumed that we will not trigger the payment of any capital gains-based incentive fee in any of the indicated time periods. If we achieve sufficient returns on our investments, including through the realization of capital gains, to trigger an incentive fee of a material amount, our expenses on a \$1,000 investment, assuming a 5% annual return, consisting entirely of capital gains would be \$[ ] for 1 year, \$[ ] for 3 years, \$[ ] for 5 years and \$[ ] for 10 years. In addition, while the example assumes reinvestment of all dividends and distributions at net asset value, participants in our dividend reinvestment plan will receive a number of shares of our common stock, determined by dividing the total dollar amount of the dividend payable to a participant by the market price per share of our common stock at the close of trading on the valuation date for the dividend. See Dividend Reinvestment Plan in the accompanying prospectus for additional information regarding our dividend reinvestment plan.

This example and the expenses in the table above should not be considered a representation of our future expenses, and actual expenses (including the cost of debt, incentive fees, if any, and other expenses) may be greater or less than those shown.

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**RISK FACTORS**

[To be provided.]

**USE OF PROCEEDS**

We intend to use the net proceeds from this offering first to pay down existing short-term debt, then to make investments in small and mid-sized businesses in accordance with our investment objectives, with any remaining proceeds to be used for other general corporate purposes. Indebtedness under our credit line facility currently accrues interest at the rate of approximately [ ]% and matures on [ ], [ ]. We anticipate that substantially all of the net proceeds of this offering will be utilized in the manner described above within three months of the completion of the offering. Pending such utilization, we intend to invest the net proceeds of this offering primarily in cash, cash equivalents, U.S. government securities, and other high-quality debt investments that mature in one year or less from the date of investment, consistent with the requirements for continued qualification as a RIC for federal income tax purposes.

**FINANCIAL HIGHLIGHTS**

[To be provided.]

**PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS**

We currently intend to distribute in the form of cash dividends, a minimum of 90% of our ordinary income and short-term capital gains, if any, on a quarterly basis to our stockholders in the form of monthly dividends. We intend to retain long-term capital gains and treat them as deemed distributions for tax purposes. We report the estimated tax characteristics of each distribution when declared while the actual tax characteristics of distributions are reported annually to each stockholder on Form 1099-DIV. There is no assurance that we will achieve investment results or maintain a tax status that will permit any specified level of cash distributions or year-to-year increases in cash distributions. At the option of a holder of record of common stock, all cash distributions can be reinvested automatically under our dividend reinvestment plan in additional whole and fractional shares. A stockholder whose shares are held in the name of a broker or other nominee should contact the broker or nominee regarding participation in our dividend reinvestment plan on the stockholder's behalf. See Risk Factors We will be subject to corporate-level tax if we are unable to satisfy Code requirements for RIC qualification; Dividend Reinvestment Plan; and Material U.S. Federal Income Tax Considerations in the accompanying prospectus.

Our common stock is quoted on The NASDAQ Global Select Market under the symbol GLAD. Our common stock has historically traded at prices both above and below its net asset value. There can be no assurance, however, that any premium to net asset value will be attained or maintained. As of [ ], [ ], we had [ ] stockholders of record.

**PLAN OF DISTRIBUTION**

[To be provided.]

**LEGAL MATTERS**

The legality of securities offered hereby will be passed upon for us by Cooley LLP, Reston, Virginia. [Certain legal matters will be passed upon for the underwriters by [ ].]

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**Gladstone Capital Corporation**

**Shares of Common Stock**

**PROSPECTUS SUPPLEMENT**

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**The information in this prospectus supplement is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus supplement is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.**

Filed Pursuant to Rule 497

Registration Statement No. 333-162592

PROSPECTUS SUPPLEMENT

(To Prospectus dated , 201 )

**Shares**

**% Series [ ] Preferred Stock**

**Liquidation Preference \$ per share**

We are offering for sale shares of our Series Preferred Stock. Our common stock is traded on The NASDAQ Global Select Market under the symbol GLAD. The last reported sale price for our common stock on , was \$ per share. The net asset value per share of our common stock at the close of business on , 201 was \$ per share. There currently is no market for the preferred stock. We applied to list the preferred stock on [ ]. The expected trading symbol for the preferred stock is [ ].

|  | Per Share | Total (1) |
|--|-----------|-----------|
| Public offering price                  | \$        | \$        |
| Underwriting discounts and commissions | \$        | \$        |
| Proceeds, before expenses, to us       | \$        | \$        |

(1) The aggregate expenses of the offering are estimated to be \$ , which represents approximately \$ per share. The Underwriters are expected to deliver the Series Preferred Stock in book-entry form through the Depositary Trust Company on or about .

You should read this prospectus supplement and the accompanying prospectus before deciding whether to invest in our preferred stock and you should retain them for future reference. Additional information about us, including our annual, quarterly and current reports, has been filed with the Securities and Exchange Commission. This information is available free of charge on our corporate website at <http://www.gladstoneinvestment.com>.

**An investment in our preferred stock involves certain risks, including, among other things, risks relating to investments in securities of small, private and developing businesses. We describe some of these risks in the section entitled Risk Factors, which begins on page P-2 of this prospectus supplement and page 8 of the accompanying prospectus. Shares of closed-end investment companies frequently trade at a discount to their net asset value and this may increase the risk of loss of purchasers of our preferred stock. You should carefully consider these risks together with all of the other information contained in this prospectus supplement and the accompanying**

prospectus before making a decision to purchase our preferred stock.

**The preferred stock being offered has not been approved or disapproved by the Securities and Exchange Commission or any state securities commission nor has the Securities and Exchange Commission or any state securities commission passed upon the accuracy or adequacy of this prospectus supplement or the accompanying prospectus. Any representation to the contrary is a criminal offense.**

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We have not authorized any dealer, salesman or other person to give any information or to make any representation other than those contained in this prospectus supplement or the accompanying prospectus. You must not rely upon any information or representation not contained in this prospectus supplement or the accompanying prospectus as if we had authorized it. This prospectus supplement and the accompanying prospectus do not constitute an offer to sell or a solicitation of any offer to buy any security other than the registered securities to which they relate, nor do they constitute an offer to sell or a solicitation of an offer to buy any securities in any jurisdiction to any person to whom it is unlawful to make such an offer or solicitation in such jurisdiction. The information contained in this prospectus supplement and any accompanying prospectus is accurate as of the dates on their respective covers only. Our business, financial condition, results of operations and prospects may have changed since such dates.

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**SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

All statements contained in this prospectus supplement or the accompanying prospectus, other than historical facts, may constitute forward-looking statements. These statements may relate to, among other things, future events or our future performance or financial condition. In some cases, you can identify forward-looking statements by terminology such as may, might, believe, will, provided, anticipate, future growth, plan, intend, expect, should, would, if, seek, possible, potential, likely or the negative of such terms or comparable forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others: (1) further adverse changes in the economy and the capital markets; (2) risks associated with negotiation and consummation of pending and future transactions; (3) the loss of one or more of our executive officers, in particular David Gladstone, Terry Lee Brubaker or George Stelljes III ; (4) changes in our business strategy; (5) availability, terms and deployment of capital; (6) changes in our industry, interest rates, exchange rates or the general economy; (7) the degree and nature of our competition; and (8) those factors described in the Risk Factors sections of this prospectus supplement and the accompanying prospectus. We caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, after the date of this prospectus supplement. The forward-looking statements contained in this prospectus supplement or the accompanying prospectus are excluded from the safe harbor protection provided by the Private Securities Litigation Reform Act of 1995 and Section 27A of the Securities Act.

**TERMS OF THE SERIES [ ] PREFERRED STOCK**

|                         |   |
|-------------------------|---|
| Dividend Rate           | The dividend rate will be _____ %.  |
| Dividend Payment Rate   | [Dividends will be paid when, as and if declared on _____, _____, _____, and _____, commencing _____.] The payment date for the initial dividend period will be _____.] |
| Regular Dividend Period | Regular dividend periods will be _____ days.  |
| Liquidation Preference  | \$ _____ per share  |
| Non-Call Period         | The shares may not be called for redemption at the option of the Company prior to _____.  |
| Stock Exchange Listing  |   |

**RISK FACTORS**

[To be provided.]

**USE OF PROCEEDS**

We intend to use the net proceeds from this offering first to pay down existing short-term debt, then to make investments in small and mid-sized businesses in accordance with our investment objectives, with any remaining proceeds to be used for other general corporate purposes. Indebtedness under our credit line facility currently accrues interest at the rate of approximately [ ]% and matures on \_\_\_\_\_, \_\_\_\_\_. We anticipate that substantially all of the net proceeds of this

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offering will be utilized in the manner described above within three months of the completion of the offering. Pending such utilization, we intend to invest the net proceeds of this offering primarily in cash, cash equivalents, U.S. government securities, and other high-quality debt investments that mature in one year or less from the date of investment, consistent with the requirements for continued qualification as a RIC for federal income tax purposes.

**CAPITALIZATION**

[To be provided.]

**ASSET COVERAGE RATIO**

[To be provided.]

**SPECIAL CHARACTERISTICS AND RISKS OF THE SERIES [ ] PREFERRED STOCK**

[To be provided.]

**DESCRIPTION OF THE SERIES [ ] PREFERRED STOCK**

[To be provided.]

**TAXATION**

[To be provided.]

**UNDERWRITING**

[To be provided.]

**LEGAL MATTERS**

The legality of securities offered hereby will be passed upon for us by Cooley LLP, Reston, Virginia. [Certain legal matters will be passed upon for the underwriters by .]

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**Gladstone Capital Corporation**

**Shares**

**% Series [ ] Preferred Stock**

**(Liquidation Preference \$ per share)**

**PROSPECTUS SUPPLEMENT**

**, 201**

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**The information in this prospectus supplement is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus supplement is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.**

Filed Pursuant to Rule 497

Registration Statement No. 333-162592

PROSPECTUS SUPPLEMENT

(To Prospectus dated \_\_\_\_\_, 201 )

**Rights for Shares**

**Subscription Rights for Common Stock**

Gladstone Capital Corporation, referred to as we, us, our or the Company, is issuing subscription rights, or Rights, to our common stockholders to purchase additional shares of common stock.

We were primarily established for the purpose of investing in subordinated loans, mezzanine debt, preferred stock and warrants to purchase common stock of small and medium-sized companies in connection with buyouts and other recapitalizations. When we invest in buyouts we do so with the management team of the portfolio companies and with other buyout funds. We also sometimes invest in senior secured loans, common stock and, to a much lesser extent, senior and subordinated syndicated loans. Our investment objective is to generate both current income and capital gains through these debt and equity instruments. We operate as a closed-end, non-diversified management investment company and have elected to be treated as a business development company, or BDC, under the Investment Company Act of 1940, as amended, which we refer to as the 1940 Act. Our investment adviser is Gladstone Management Corporation, referred to as Adviser.

Our common stock is traded on The NASDAQ Global Select Market under the symbol GLAD. The last reported sale price for our common stock on \_\_\_\_\_, \_\_\_\_\_ was \$ \_\_\_\_\_ per share. The net asset value per share of our common stock at the close of business on \_\_\_\_\_, 201 \_\_\_\_\_ was \$ \_\_\_\_\_ per share.

You should read this prospectus supplement and the accompanying prospectus before deciding whether to invest in our Rights and you should retain them for future reference. Additional information about us, including our annual, quarterly and current reports, has been filed with the Securities and Exchange Commission. This information is available free of charge on our corporate website at <http://www.gladstoneinvestment.com>.

**Investing in common stock through Rights involves certain risks that are described in the Risk Factors section beginning on page R-5 of this prospectus supplement and page 8 of the accompanying prospectus.**

**Stockholders who do not exercise their rights may, at the completion of the offering, own a smaller proportional interest in the Company than if they exercised their rights. As a result of the offering you may experience dilution or accretion of the aggregate net asset value of your shares of common stock depending upon whether the Company's net asset value per share of common stock is above or below the subscription price on the expiration date.**

**The Rights being offered have not been approved or disapproved by the Securities and Exchange Commission or any state securities commission nor has the Securities and Exchange Commission or any state securities commission passed upon the accuracy or adequacy of this prospectus supplement or the accompanying prospectus. Any representation to the contrary is a criminal offense.**



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|  | Per Share | Total |
|--|-----------|-------|
| Subscription price of Common Stock to shareholders exercising Rights | \$        | \$    |
| Underwriting discounts and commissions                               | \$        | \$    |
| Proceeds, before expenses, to us (1)                                 | \$        | \$    |

(1) The aggregate expenses of the offering are estimated to be \$ .  
 The common stock is expected to be ready for delivery in book-entry form through the Depository Trust Company on or about , 201 . If  
 the offer is extended, the common stock is expected to be ready for delivery in book-entry form through the Depository Trust Company on or  
 about , 201 .

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We have not authorized any dealer, salesman or other person to give any information or to make any representation other than those contained in this prospectus supplement or the accompanying prospectus. You must not rely upon any information or representation not contained in this prospectus supplement or the accompanying prospectus as if we had authorized it. This prospectus supplement and the accompanying prospectus do not constitute an offer to sell or a solicitation of any offer to buy any security other than the registered securities to which they relate, nor do they constitute an offer to sell or a solicitation of an offer to buy any securities in any jurisdiction to any person to whom it is unlawful to make such an offer or solicitation in such jurisdiction. The information contained in this prospectus supplement and any accompanying prospectus is accurate as of the dates on their respective covers only. Our business, financial condition, results of operations and prospects may have changed since such dates.

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**Table of Contents****SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

All statements contained in this prospectus supplement or the accompanying prospectus, other than historical facts, may constitute forward-looking statements. These statements may relate to, among other things, future events or our future performance or financial condition. In some cases, you can identify forward-looking statements by terminology such as may, might, believe, will, provided, anticipate, future, growth, plan, intend, expect, should, would, if, seek, possible, potential, likely or the negative of such terms or comparable forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others: (1) further adverse changes in the economy and the capital markets; (2) risks associated with negotiation and consummation of pending and future transactions; (3) the loss of one or more of our executive officers, in particular David Gladstone, Terry Lee Brubaker or George Stelljes III ; (4) changes in our business strategy; (5) availability, terms and deployment of capital; (6) changes in our industry, interest rates, exchange rates or the general economy; (7) the degree and nature of our competition; and (8) those factors described in the Risk Factors sections of this prospectus supplement and the accompanying prospectus. We caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, after the date of this prospectus supplement. The forward-looking statements contained in this prospectus supplement or the accompanying prospectus are excluded from the safe harbor protection provided by the Private Securities Litigation Reform Act of 1995 and Section 27A of the Securities Act.

**SUMMARY OF THE TERMS OF THE RIGHTS OFFERING**

|   |   |
|---|---|
| <b>Terms of the Offer</b>                                     | [To be provided.]   |
| <b>Amount Available for Primary Subscription</b>              | [\$ ]   |
| <b>Title</b>  | Subscription Rights for common stock  |
| <b>Subscription Price</b>                                     | Rights may be exercised at a price of \$ per share of common stock (the Subscription Price ). See Description of the Rights Offering.   |
| <b>Record Date</b>  | Rights will be issued to holders of record of the Company s common stock on , 201 (the Record Date ). See Description of the Rights Offering.   |
| <b>Number of Rights Issued</b>                                | Rights will be issued in respect of each share of common stock of the Company outstanding on the Record Date. See Description of the Rights Offering.   |
| <b>Number of Rights Required to Purchase One Common Share</b> | A holder of Rights may purchase share of common stock of the Company for every Rights exercised. The number of Rights to be issued to a stockholder on the Record Date will be rounded up to the nearest number of Rights evenly divisible by . See Description of the Rights Offering. |
| <b>Over-Subscription Privilege</b>                            | [To be provided.]   |
| <b>Transfer of Rights</b>                                     | [To be provided.]   |
| <b>Subscription Period</b>                                    | The Rights may be exercised at any time after issuance and prior to expiration of the Rights, which will be 5:00 PM Eastern Time on , 201 (the Expiration Date ) (the Subscription Period ). See Description of the Rights Offering.  |
| <b>Offer Expenses</b>   | The expenses of the Offer are expected to be approximately \$[ ]. See Use of Proceeds.  |

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**Sale of Rights**

[To be provided.]

**Use of Proceeds**

The Company estimates the net proceeds of the Offer to be approximately \$[ ]. This figure is based on the Subscription Price per share of \$ and assumes all new shares of common stock offered are sold and that the expenses related to the Offer estimated at approximately \$[ ] are paid.

The Company intends to use the net proceeds from this offering first to pay down existing short-term debt, then to make investments in small and mid-sized businesses in accordance with our investment objectives, with any remaining proceeds to be used for other general corporate purposes. We anticipate that substantially all of the net proceeds of this offering will be utilized in the manner described above within three months of the completion of the offering. Pending such utilization, we intend to invest the net proceeds of this offering primarily in cash, cash equivalents, U.S. government securities, and other high-quality debt investments that mature in one year or less from the date of investment, consistent with the requirements for continued qualification as a RIC for federal income tax purposes. See Use of Proceeds.

**Rights Agent**

[To be provided.]

**Table of Contents****DESCRIPTION OF THE RIGHTS OFFERING**

[To be provided.]

**FEES AND EXPENSES**

The following table is intended to assist you in understanding the costs and expenses that an investor in this offering will bear directly or indirectly. We caution you that some of the percentages indicated in the table below are estimates and may vary. Except where the context suggests otherwise, whenever this prospectus contains a reference to fees or expenses paid by us or Gladstone Investment, or that we will pay fees or expenses, stockholders will indirectly bear such fees or expenses as investors in Gladstone Investment. The following percentages were calculated based on actual expenses incurred in the year ended \_\_\_\_\_, \_\_\_\_\_ and average net assets for the quarter ended \_\_\_\_\_, \_\_\_\_\_.

|   |       |
|---|-------|
| <b>Stockholder Transaction Expenses:</b>  |       |
| Sales load (as a percentage of offering price)  | [ ] % |
| Dividend reinvestment plan expenses(1)  | [ ] % |
| <b>Annual expenses (as a percentage of net assets attributable to common stock):</b>  |       |
| Management fees(2)  | [ ] % |
| Incentive fees payable under investment advisory and management agreement (20% of realized capital gains and 20% of pre-incentive fee net investment income)(3) | [ ] % |
| Interest payments on borrowed funds(4)  | [ ] % |
| Other expenses(5)   | [ ] % |
| Total annual expenses (2)(5)  | [ ] % |

- (1) The expenses of the reinvestment plan are included in stock record expenses, a component of Other expenses. We do not have a cash purchase plan. The participants in the dividend reinvestment plan will bear a pro rata share of brokerage commissions incurred with respect to open market purchases, if any. See Dividend Reinvestment Plan in the accompanying prospectus for information on the dividend reinvestment plan.
- (2) Our annual base management fee is 2% (0.5% quarterly) of our average gross assets, which are defined as total assets of Gladstone Investment, including investments made with proceeds of borrowings, less any uninvested cash or cash equivalents resulting from borrowings. For the fiscal year ended \_\_\_\_\_, \_\_\_\_\_, our Adviser voluntarily agreed to waive the annual base management fee of 2% to [ ]% for those senior syndicated loans that we purchase using borrowings from our credit facility. However, because we held no senior syndicated loans purchased using borrowings under our credit facility during the quarter ended \_\_\_\_\_, \_\_\_\_\_, the waiver did not impact our expenses for that period, as reflected in the table above. See Management Certain Transactions Investment Advisory and Management Agreement in the accompanying prospectus and footnote 3 below.
- (3) The incentive fee consists of two parts: an income-based fee and a capital gains-based fee. The income-based fee is payable quarterly in arrears, and equals 20% of the excess, if any, of our pre-incentive fee net investment income that exceeds a 1.75% quarterly ([ ]% annualized) hurdle rate of our net assets, subject to a catch-up provision measured as of the end of each calendar quarter. The catch-up provision requires us to pay 100% of our pre-incentive fee net investment income with respect to that portion of such income, if any, that exceeds the hurdle rate but is less than 125% of the quarterly hurdle rate (or 2.1875%) in any calendar quarter (8.75% annualized). The catch-up provision is meant to provide our Adviser with 20% of our pre-incentive fee net investment income as if a hurdle rate did not apply when our pre-incentive fee net investment income exceeds 125% of the quarterly hurdle rate in any calendar quarter (8.75% annualized). The income-based incentive fee is computed and paid on income that may include interest that is accrued but not yet received in cash. Our pre-incentive fee net investment income used to calculate this part of the income-based incentive fee is also included in the amount of our gross assets used to calculate the 2% base

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management fee (see footnote 2 above). The capital gains-based incentive fee equals 20% of our net realized capital gains since our inception, if any, computed net of all realized capital losses and unrealized capital depreciation since our inception, less any prior payments, and is payable at the end of each fiscal year.

Examples of how the incentive fee would be calculated are as follows:

Assuming pre-incentive fee net investment income of 0.55%, there would be no income-based incentive fee because such income would not exceed the hurdle rate of 1.75%.

Assuming pre-incentive fee net investment income of 2.00%, the income-based incentive fee would be as follows:

$$= 100\% \times (2.00\% - 1.75\%)$$

$$= 0.25\%$$

Assuming pre-incentive fee net investment income of 2.30%, the income-based incentive fee would be as follows:

$$= (100\% \times (2.30\% - 1.75\%)) + (20\% \times (2.30\% - 2.1875\%))$$

$$= (100\% \times 0.55\%) + (20\% \times 0.1125\%)$$

$$= 0.55\% + 0.0225\%$$

$$= 0.5725\%$$

Assuming net realized capital gains of 6% and realized capital losses and unrealized capital depreciation of 1%, the capital gains-based incentive fee would be as follows:

$$= 20\% \times (6\% - 1\%)$$

$$= 20\% \times 5\%$$

$$= 1\%$$

For a more detailed discussion of the calculation of the two-part incentive fee, see [Management Certain Transactions Investment Advisory and Management Agreement](#) in the accompanying prospectus.

- (4) Includes deferred financing costs. We entered into a revolving credit facility, effective \_\_\_\_\_, \_\_\_\_\_, under which our borrowing capacity is \$[ ] million. We have drawn down on this credit facility and we expect to borrow additional funds in the future up to an amount so that our asset coverage, as defined in the 1940 Act, is at least 200% after each issuance of our senior securities. Assuming that we borrowed \$[ ] million at an interest rate of [ ]% plus an additional fee related to borrowings of [ ]%, for an aggregate rate of [ ]%, interest payments and amortization of deferred financing costs on borrowed funds would have been [ ]% of our average net assets for the quarter ended \_\_\_\_\_.
- (5) Includes our overhead expenses, including payments under the administration agreement based on our projected allocable portion of overhead and other expenses incurred by our Administrator in performing its obligations under the administration agreement. See [Management Certain Transactions Administration Agreement](#) in the accompanying prospectus.

**Table of Contents****Example**

The following example demonstrates the projected dollar amount of total cumulative expenses that would be incurred over various periods with respect to a hypothetical investment in our common stock. In calculating the following expense amounts, we have assumed that our annual operating expenses would remain at the levels set forth in the table above.

|   | 1 Year | 3 Years | 5 Years | 10 Years |
|---|--------|---------|---------|----------|
| You would pay the following expenses on a \$1,000 investment, assuming a 5% annual return | \$ [ ] | \$ [ ]  | \$ [ ]  | \$ [ ]   |

While the example assumes, as required by the SEC, a 5% annual return, our performance will vary and may result in a return greater or less than 5%. Additionally, we have assumed that the entire amount of such 5% annual return would constitute ordinary income as we have not historically realized positive capital gains (computed net of all realized capital losses) on our investments. Because the assumed 5% annual return is significantly below the hurdle rate of 7% (annualized) that we must achieve under the investment advisory and management agreement to trigger the payment of an income-based incentive fee, we have assumed, for purposes of the above example, that no income-based incentive fee would be payable if we realized a 5% annual return on our investments. Additionally, because the capital gains-based incentive fee is calculated on a cumulative basis (computed net of all realized capital losses and unrealized capital depreciation) and because of the significant capital losses realized to date, we have assumed that we will not trigger the payment of any capital gains-based incentive fee in any of the indicated time periods. If we achieve sufficient returns on our investments, including through the realization of capital gains, to trigger an incentive fee of a material amount, our expenses on a \$1,000 investment, assuming a 5% annual return, consisting entirely of capital gains would be \$[ ] for 1 year, \$[ ] for 3 years, \$[ ] for 5 years and \$[ ] for 10 years. In addition, while the example assumes reinvestment of all dividends and distributions at net asset value, participants in our dividend reinvestment plan will receive a number of shares of our common stock, determined by dividing the total dollar amount of the dividend payable to a participant by the market price per share of our common stock at the close of trading on the valuation date for the dividend. See Dividend Reinvestment Plan in the accompanying prospectus for additional information regarding our dividend reinvestment plan.

This example and the expenses in the table above should not be considered a representation of our future expenses, and actual expenses (including the cost of debt, incentive fees, if any, and other expenses) may be greater or less than those shown.

**RISK FACTORS**

[To be provided.]

**USE OF PROCEEDS**

We intend to use the net proceeds from this offering first to pay down existing short-term debt, then to make investments in small and mid-sized businesses in accordance with our investment objectives, with any remaining proceeds to be used for other general corporate purposes. Indebtedness under our credit line facility currently accrues interest at the rate of approximately [ ]% and matures on , . We anticipate that substantially all of the net proceeds of this offering will be utilized in the manner described above within three months of the completion of the offering. Pending such utilization, we intend to invest the net proceeds of this offering primarily in cash, cash equivalents, U.S. government securities, and other high-quality debt investments that mature in one year or less from the date of investment, consistent with the requirements for continued qualification as a RIC for federal income tax purposes.



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**CAPITALIZATION**

[To be provided.]

**PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS**

We currently intend to distribute in the form of cash dividends, a minimum of 90% of our ordinary income and short-term capital gains, if any, on a quarterly basis to our stockholders in the form of monthly dividends. We intend to retain long-term capital gains and treat them as deemed distributions for tax purposes. We report the estimated tax characteristics of each distribution when declared while the actual tax characteristics of distributions are reported annually to each stockholder on Form 1099-DIV. There is no assurance that we will achieve investment results or maintain a tax status that will permit any specified level of cash distributions or year-to-year increases in cash distributions. At the option of a holder of record of common stock, all cash distributions can be reinvested automatically under our dividend reinvestment plan in additional whole and fractional shares. A stockholder whose shares are held in the name of a broker or other nominee should contact the broker or nominee regarding participation in our dividend reinvestment plan on the stockholder's behalf. See Risk Factors We will be subject to corporate-level tax if we are unable to satisfy Code requirements for RIC qualification; Dividend Reinvestment Plan; and Material U.S. Federal Income Tax Considerations in the accompanying prospectus.

Our common stock is quoted on The NASDAQ Global Select Market under the symbol GLAD. Our common stock has historically traded at prices both above and below its net asset value. There can be no assurance, however, that any premium to net asset value will be attained or maintained. As of , , we had [ ] stockholders of record.

**TAXATION**

[To be provided.]

**LEGAL MATTERS**

The legality of securities offered hereby will be passed upon for us by Cooley LLP, Reston, Virginia. [Certain legal matters will be passed upon for the underwriters by .]

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**Gladstone Capital Corporation**  
**Shares of Common Stock**  
**Issuable Upon Exercise of Rights to**  
**Subscribe for Such Shares of Common Stock**  
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**The information in this prospectus supplement is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus supplement is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.**

Filed Pursuant to Rule 497

Registration Statement No. 333-162592

PROSPECTUS SUPPLEMENT

(To Prospectus dated [ ], 201 [ ]) )

**Rights for                      Shares**  
**Subscription Rights for                      % Series [ ] Preferred Stock**

Gladstone Capital Corporation, referred to as we, us, our or the Company, is issuing subscription rights, or Rights, to our common stockholders to purchase shares of [ ] % Series [ ] Preferred Stock, referred to as the Series [ ] Preferred Stock.

We were primarily established for the purpose of investing in subordinated loans, mezzanine debt, preferred stock and warrants to purchase common stock of small and medium-sized companies in connection with buyouts and other recapitalizations. When we invest in buyouts we do so with the management team of the portfolio companies and with other buyout funds. We also sometimes invest in senior secured loans, common stock and, to a much lesser extent, senior and subordinated syndicated loans. Our investment objective is to generate both current income and capital gains through these debt and equity instruments. We operate as a closed-end, non-diversified management investment company and have elected to be treated as a business development company, or BDC, under the Investment Company Act of 1940, as amended, which we refer to as the 1940 Act. Our investment adviser is Gladstone Management Corporation, referred to as Adviser.

Our common stock is traded on The NASDAQ Global Select Market under the symbol GLAD. The last reported sale price for our common stock on [ ], [ ] was \$ [ ] per share. The net asset value of our common shares at the close of business on [ ], 201 [ ] was \$ [ ] per share. There currently is no market for the preferred stock. We applied to list the preferred stock on [ ]. The expected trading symbol for the preferred stock is [ ].

You should read this prospectus supplement and the accompanying prospectus before deciding whether to invest in our Rights and you should retain them for future reference. Additional information about us, including our annual, quarterly and current reports, has been filed with the Securities and Exchange Commission. This information is available free of charge on our corporate website at <http://www.gladstoneinvestment.com>.

**Investing in preferred stock through Rights involves certain risks that are described in the Risk Factors section beginning on page PR-3 of this prospectus supplement and page 8 of the accompanying prospectus.**

**The Rights being offered have not been approved or disapproved by the Securities and Exchange Commission or any state securities commission nor has the Securities and Exchange Commission or any state securities commission passed upon the accuracy or adequacy of this prospectus. Any representation to the contrary is a criminal offense.**

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|   | Per Share | Total |
|---|-----------|-------|
| Subscription price of Preferred Stock to shareholders exercising Rights | \$        | \$    |
| Underwriting discounts and commissions                                  | \$        | \$    |
| Proceeds, before expenses, to us (1)                                    | \$        | \$    |

(1) The aggregate expenses of the offering are estimated to be \$[ ].  
 The preferred stock is expected to be ready for delivery in book-entry form through the Depository Trust Company on or about , 201 .  
 If the offer is extended, the preferred stock is expected to be ready for delivery in book-entry form through the Depository Trust Company on or about , 201 .

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We have not authorized any dealer, salesman or other person to give any information or to make any representation other than those contained in this prospectus supplement or the accompanying prospectus. You must not rely upon any information or representation not contained in this prospectus supplement or the accompanying prospectus as if we had authorized it. This prospectus supplement and the accompanying prospectus do not constitute an offer to sell or a solicitation of any offer to buy any security other than the registered securities to which they relate, nor do they constitute an offer to sell or a solicitation of an offer to buy any securities in any jurisdiction to any person to whom it is unlawful to make such an offer or solicitation in such jurisdiction. The information contained in this prospectus supplement and any accompanying prospectus is accurate as of the dates on their respective covers only. Our business, financial condition, results of operations and prospects may have changed since such dates.

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All statements contained in this prospectus supplement or the accompanying prospectus, other than historical facts, may constitute forward-looking statements. These statements may relate to, among other things, future events or our future performance or financial condition. In some cases, you can identify forward-looking statements by terminology such as may, might, believe, will, provided, anticipate, future growth, plan, intend, expect, should, would, if, seek, possible, potential, likely or the negative of such terms or comparable forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others: (1) further adverse changes in the economy and the capital markets; (2) risks associated with negotiation and consummation of pending and future transactions; (3) the loss of one or more of our executive officers, in particular David Gladstone, Terry Lee Brubaker or George Stelljes III ; (4) changes in our business strategy; (5) availability, terms and deployment of capital; (6) changes in our industry, interest rates, exchange rates or the general economy; (7) the degree and nature of our competition; and (8) those factors described in the Risk Factors sections of this prospectus supplement and the accompanying prospectus. We caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, after the date of this prospectus supplement. The forward-looking statements contained in this prospectus supplement or the accompanying prospectus are excluded from the safe harbor protection provided by the Private Securities Litigation Reform Act of 1995 and Section 27A of the Securities Act.

**SUMMARY OF THE TERMS OF THE RIGHTS OFFERING**

|  |  |
|--|--|
| <b>Terms of the Offer</b>  | [To be provided.]  |
| <b>Amount Available for Primary Subscription</b>                 | \$(        )   |
| <b>Title</b>   | Subscription Rights for Series [        ] preferred stock  |
| <b>Exercise Price</b>  | Rights may be exercised at a price of \$        per share of common stock (the Subscription Price ). See Description of the Rights Offering.   |
| <b>Record Date</b>   | Rights will be issued to holders of record of the Company's common stock on        , 201        (the Record Date ). See Description of the Rights Offering.  |
| <b>Number of Rights Issued</b>                                   | Rights will be issued in respect of each share of preferred stock of the Company outstanding on the Record Date. See Description of the Rights Offering.   |
| <b>Number of Rights Required to Purchase One Preferred Share</b> | A holder of Rights may purchase        share of common stock of the Company for every        Rights exercised. The number of Rights to be issued to a stockholder on the Record Date will be rounded up to the nearest number of Rights evenly divisible by        . See Description of the Rights Offering. |
| <b>Over-Subscription Privilege</b>                               | [To be provided.]  |
| <b>Transfer of Rights</b>  | [To be provided.]  |
| <b>Exercise Period</b>   | The Rights may be exercised at any time after issuance and prior to expiration of the Rights, which will be 5:00 PM Eastern Time on        , 201        (the Expiration Date ) (the Subscription Period ). See Description of the Rights Offering.   |

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**USE OF PROCEEDS**

We intend to use the net proceeds from this offering first to pay down existing short-term debt, then to make investments in small and mid-sized businesses in accordance with our investment objectives, with any remaining proceeds to be used for other general corporate purposes. Indebtedness under our credit line facility currently accrues interest at the rate of approximately [ ]% and matures on , . We anticipate that substantially all of the net proceeds of this offering will be utilized in the manner described above within three months of the completion of the offering. Pending such utilization, we intend to invest the net proceeds of this offering primarily in cash, cash equivalents, U.S. government securities, and other high-quality debt investments that mature in one year or less from the date of investment, consistent with the requirements for continued qualification as a RIC for federal income tax purposes.

**CAPITALIZATION**

[To be provided.]

**ASSET COVERAGE RATIO**

[To be provided.]

**TAXATION**

[To be provided.]

**UNDERWRITING**

[To be provided.]

**LEGAL MATTERS**

The legality of securities offered hereby will be passed upon for us by Cooley LLP, Reston, Virginia. [Certain legal matters will be passed upon for the underwriters by .]

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**Gladstone Capital Corporation**  
**Shares of      % Series [   ] Preferred Stock**  
**Issuable Upon Exercise of Rights to**  
**Subscribe for Such Shares of Preferred Stock**  
**PROSPECTUS SUPPLEMENT**  
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**The information in this prospectus supplement is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus supplement is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.**

Filed Pursuant to Rule 497

Registration Statement No. 333-162592

PROSPECTUS SUPPLEMENT

(To Prospectus dated , 201 )

% Notes due ,

We are offering promissory notes in an aggregate principal amount of \$ , which we refer to as the Notes in this prospectus supplement. Our common stock is traded on The NASDAQ Global Select Market under the symbol GLAD. The last reported sale price for our common stock on , was \$ per share. The net asset value per share of our common stock at the close of business on , 201 was \$ per share.

You should read this prospectus supplement and the accompanying prospectus before deciding whether to invest in our Notes and you should retain them for future reference. Additional information about us, including our annual, quarterly and current reports, has been filed with the Securities and Exchange Commission. This information is available free of charge on our corporate website at <http://www.gladstoneinvestment.com>.

**An investment in our Notes involves certain risks, including, among other things, risks relating to investments in securities of small, private and developing businesses. We describe some of these risks in the section entitled Risk Factors, which begins on page N-2 of this prospectus supplement and page 8 of the accompanying prospectus. Shares of closed-end investment companies frequently trade at a discount to their net asset value and this may increase the risk of loss of purchasers of our Notes. You should carefully consider these risks together with all of the other information contained in this prospectus supplement and the accompanying prospectus before making a decision to purchase our Notes.**

**The Notes do not represent a deposit or obligation of, and are not guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board or any other government agency.**

|   | Per Note | Total |
|---|----------|-------|
| Public offering price                           | \$       | \$    |
| Sales load                                      | \$       | \$    |
| Proceeds to us (before expenses) <sup>(1)</sup> | \$       | \$    |

(1) Does not include offering expenses payable to us estimated to be \$ .  
The Notes will be ready for delivery on or about , 201 .



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We have not authorized any dealer, salesman or other person to give any information or to make any representation other than those contained in this prospectus supplement or the accompanying prospectus. You must not rely upon any information or representation not contained in this prospectus supplement or the accompanying prospectus as if we had authorized it. This prospectus supplement and the accompanying prospectus do not constitute an offer to sell or a solicitation of any offer to buy any security other than the registered securities to which they relate, nor do they constitute an offer to sell or a solicitation of an offer to buy any securities in any jurisdiction to any person to whom it is unlawful to make such an offer or solicitation in such jurisdiction. The information contained in this prospectus supplement and any accompanying prospectus is accurate as of the dates on their respective covers only. Our business, financial condition, results of operations and prospects may have changed since such dates.

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**Table of Contents****SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

All statements contained in this prospectus supplement or the accompanying prospectus, other than historical facts, may constitute forward-looking statements. These statements may relate to, among other things, future events or our future performance or financial condition. In some cases, you can identify forward-looking statements by terminology such as may, might, believe, will, provided, anticipate, future, growth, plan, intend, expect, should, would, if, seek, possible, potential, likely or the negative of such terms or comparable forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others: (1) further adverse changes in the economy and the capital markets; (2) risks associated with negotiation and consummation of pending and future transactions; (3) the loss of one or more of our executive officers, in particular David Gladstone, Terry Lee Brubaker or George Stelljes III ; (4) changes in our business strategy; (5) availability, terms and deployment of capital; (6) changes in our industry, interest rates, exchange rates or the general economy; (7) the degree and nature of our competition; and (8) those factors described in the Risk Factors sections of this prospectus supplement and the accompanying prospectus. We caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, after the date of this prospectus supplement. The forward-looking statements contained in this prospectus supplement or the accompanying prospectus are excluded from the safe harbor protection provided by the Private Securities Litigation Reform Act of 1995 and Section 27A of the Securities Act.

**TERMS OF THE NOTES**

|                          |  |
|--------------------------|--|
| Principal Amount         | The principal amount of the Notes is \$ _____ in the aggregate.                |
| Maturity                 | The principal amount of the Notes will become due and payable on _____, _____. |
| Interest Rate            | The interest rate will be _____ %.   |
| Frequency of payment     | Interest will be paid commencing _____.  |
| Prepayment Protections   | [To be provided.]  |
| Conversion               | [To be provided.]  |
| [Stock Exchange Listing] | [To be provided.]  |
| Rating                   | It is a condition of issuance that the notes be rated [ ] by [ ].              |

**RISK FACTORS**

[To be provided.]

**USE OF PROCEEDS**

We intend to use the net proceeds from this offering first to pay down existing short-term debt, then to make investments in small and mid-sized businesses in accordance with our investment objectives, with any remaining proceeds to be used for other general corporate purposes. Indebtedness under our credit line facility currently accrues interest at the rate of approximately [ ]% and matures on \_\_\_\_\_, \_\_\_\_\_. We anticipate that substantially all of

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the net proceeds of this offering will be utilized in the manner described above within three months of the completion of the offering. Pending such utilization, we intend to invest the net proceeds of this offering primarily in cash, cash equivalents, U.S. government securities, and other high-quality debt investments that mature in one year or less from the date of investment, consistent with the requirements for continued qualification as a RIC for federal income tax purposes.

**CAPITALIZATION**

[To be provided.]

**ASSET COVERAGE RATIO**

[To be provided.]

**TAXATION**

[To be provided.]

**UNDERWRITING**

[To be provided.]

**LEGAL MATTERS**

The legality of securities offered hereby will be passed upon for us by Cooley LLP, Reston, Virginia. [Certain legal matters will be passed upon for the underwriters by .]



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**Gladstone Capital Corporation**

**% Notes due ,**

**PROSPECTUS SUPPLEMENT**

**, 201**

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**The information in this prospectus supplement is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus supplement is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.**

Filed Pursuant to Rule 497

Registration Statement No. 333-162592

PROSPECTUS SUPPLEMENT

(To Prospectus dated , 201 )

**Warrants for Common Stock**

We are offering for sale warrants to purchase shares of common stock of the Company, which we refer to as Common Warrants, at an exercise price equal to \$ per whole share. No fractional Common Warrants will be issued. Our common stock is traded on The NASDAQ Global Select Market under the symbol GLAD. The last reported sale price for our common stock on , was \$ per share. The net asset value per share of our common stock at the close of business on , 201 was \$ per share.

Currently, no public market exists for the Common Warrants offered by this prospectus supplement. It is anticipated that the Common Warrants will be quoted on promptly after the date of this prospectus supplement.

|  | Per Warrant | Total (1) |
|--|-------------|-----------|
| Public offering price                  | \$          | \$        |
| Underwriting discounts and commissions | \$          | \$        |
| Proceeds, before expenses, to us       | \$          | \$        |

(1) The aggregate expenses of the offering are estimated to be \$ .  
The Underwriters are expected to deliver the Common Warrants in book-entry form through the Depository Trust Company on or about ,

You should read this prospectus supplement and the accompanying prospectus before deciding whether to invest in our Common Warrants and you should retain them for future reference. Additional information about us, including our annual, quarterly and current reports, has been filed with the Securities and Exchange Commission. This information is available free of charge on our corporate website at <http://www.gladstoneinvestment.com>.

**An investment in our Common Warrants involves certain risks, including, among other things, risks relating to investments in securities of small, private and developing businesses. We describe some of these risks in the section entitled Risk Factors, which begins on page W-4 of this prospectus supplement and page 8 of the accompanying prospectus. Shares of closed-end investment companies frequently trade at a discount to their net asset value and this may increase the risk of loss of purchasers of our Common Warrants. You should carefully consider these risks together with all of the other information contained in this prospectus supplement and the accompanying prospectus before making a decision to purchase our Common Warrants.**

**The Common Warrants being offered have not been approved or disapproved by the Securities and Exchange Commission or any state securities commission nor has the Securities and Exchange Commission or any state securities commission passed upon the accuracy or adequacy of this prospectus supplement or the accompanying prospectus. Any representation to the contrary is a criminal offense.**



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We have not authorized any dealer, salesman or other person to give any information or to make any representation other than those contained in this prospectus supplement or the accompanying prospectus. You must not rely upon any information or representation not contained in this prospectus supplement or the accompanying prospectus as if we had authorized it. This prospectus supplement and the accompanying prospectus do not constitute an offer to sell or a solicitation of any offer to buy any security other than the registered securities to which they relate, nor do they constitute an offer to sell or a solicitation of an offer to buy any securities in any jurisdiction to any person to whom it is unlawful to make such an offer or solicitation in such jurisdiction. The information contained in this prospectus supplement and any accompanying prospectus is accurate as of the dates on their respective covers only. Our business, financial condition, results of operations and prospects may have changed since such dates.

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**Table of Contents****SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

All statements contained in this prospectus supplement or the accompanying prospectus, other than historical facts, may constitute forward-looking statements. These statements may relate to, among other things, future events or our future performance or financial condition. In some cases, you can identify forward-looking statements by terminology such as may, might, believe, will, provided, anticipate, future growth, plan, intend, expect, should, would, if, seek, possible, potential, likely or the negative of such terms or comparable forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others: (1) further adverse changes in the economy and the capital markets; (2) risks associated with negotiation and consummation of pending and future transactions; (3) the loss of one or more of our executive officers, in particular David Gladstone, Terry Lee Brubaker or George Stelljes III ; (4) changes in our business strategy; (5) availability, terms and deployment of capital; (6) changes in our industry, interest rates, exchange rates or the general economy; (7) the degree and nature of our competition; and (8) those factors described in the Risk Factors sections of this prospectus supplement and the accompanying prospectus. We caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, after the date of this prospectus supplement. The forward-looking statements contained in this prospectus supplement or the accompanying prospectus are excluded from the safe harbor protection provided by the Private Securities Litigation Reform Act of 1995 and Section 27A of the Securities Act.

**TERMS OF THE WARRANTS**

|                          |   |
|--------------------------|---|
| Exercise Price           | Each Common Warrant will be exercisable at an exercise price of \$ _____ per whole share of common stock of the Company.  |
| Exercise Period          | The Common Warrants will be exercisable until the date that is _____ years from the original date of issuance, or the Exercise Period. The rights represented by the Common Warrants may be exercised in whole or in part at any time during the Exercise Period. |
| [Stock Exchange Listing] | [To be provided.]   |
| [Non-Call Period]        | The Common Warrants may not be called for redemption at the option of the Company prior to _____.]  |
| No Stockholder Rights    | The Common Warrants do not entitle the holder to any voting rights or other rights as a stockholder of the Company.   |

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**Table of Contents****FEES AND EXPENSES**

The following table is intended to assist you in understanding the costs and expenses that an investor in this offering will bear directly or indirectly. We caution you that some of the percentages indicated in the table below are estimates and may vary. Except where the context suggests otherwise, whenever this prospectus contains a reference to fees or expenses paid by us or Gladstone Investment, or that we will pay fees or expenses, stockholders will indirectly bear such fees or expenses as investors in Gladstone Investment. The following percentages were calculated based on actual expenses incurred in the year ended , and average net assets for the quarter ended , .

|   |      |
|---|------|
| <b>Stockholder Transaction Expenses:</b>  |      |
| Sales load (as a percentage of offering price)  | [ ]% |
| Dividend reinvestment plan expenses(1)  | [ ]  |
| <b>Annual expenses (as a percentage of net assets attributable to common stock):</b>  |      |
| Management fees(2)  | [ ]% |
| Incentive fees payable under investment advisory and management agreement (20% of realized capital gains and 20% of pre-incentive fee net investment income)(3) | [ ]% |
| Interest payments on borrowed funds(4)  | [ ]% |
| Other expenses(5)   | [ ]% |
| Total annual expenses (2)(5)  | [ ]% |

- (1) The expenses of the reinvestment plan are included in stock record expenses, a component of Other expenses. We do not have a cash purchase plan. The participants in the dividend reinvestment plan will bear a pro rata share of brokerage commissions incurred with respect to open market purchases, if any. See Dividend Reinvestment Plan in the accompanying prospectus for information on the dividend reinvestment plan.
- (2) Our annual base management fee is 2% (0.5% quarterly) of our average gross assets, which are defined as total assets of Gladstone Investment, including investments made with proceeds of borrowings, less any uninvested cash or cash equivalents resulting from borrowings. For the fiscal year ended , , our Adviser voluntarily agreed to waive the annual base management fee of 2% to [ ]% for those senior syndicated loans that we purchase using borrowings from our credit facility. However, because we held no senior syndicated loans purchased using borrowings under our credit facility during the quarter ended , , the waiver did not impact our expenses for that period, as reflected in the table above. See Management Certain Transactions Investment Advisory and Management Agreement in the accompanying prospectus and footnote 3 below.
- (3) The incentive fee consists of two parts: an income-based fee and a capital gains-based fee. The income-based fee is payable quarterly in arrears, and equals 20% of the excess, if any, of our pre-incentive fee net investment income that exceeds a 1.75% quarterly ([ ]% annualized) hurdle rate of our net assets, subject to a catch-up provision measured as of the end of each calendar quarter. The catch-up provision requires us to pay 100% of our pre-incentive fee net investment income with respect to that portion of such income, if any, that exceeds the hurdle rate but is less than 125% of the quarterly hurdle rate (or 2.1875%) in any calendar quarter (8.75% annualized). The catch-up provision is meant to provide our Adviser with 20% of our pre-incentive fee net investment income as if a hurdle rate did not apply when our pre-incentive fee net investment income exceeds 125% of the quarterly hurdle rate in any calendar quarter (8.75% annualized). The income-based incentive fee is computed and paid on income that may include interest that is accrued but not yet received in cash. Our pre-incentive fee net investment income used to calculate this part of the income-based incentive fee is also included in the amount of our gross assets used to calculate the 2% base management fee (see footnote 2 above). The capital gains-based incentive fee equals 20% of our net realized capital gains since our inception, if any, computed net of all realized capital losses and unrealized capital depreciation since our inception, less any prior payments, and is payable at the end of each fiscal year.

Examples of how the incentive fee would be calculated are as follows:

Assuming pre-incentive fee net investment income of 0.55%, there would be no income-based incentive fee because such income would not exceed the hurdle rate of 1.75%.

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Assuming pre-incentive fee net investment income of 2.00%, the income-based incentive fee would be as follows:  
 $= 100\% \times (2.00\% - 1.75\%)$   
 $= 0.25\%$

Assuming pre-incentive fee net investment income of 2.30%, the income-based incentive fee would be as follows:  
 $= (100\% \times (2.30\% - 1.75\%)) + (20\% \times (2.30\% - 2.1875\%))$   
 $= (100\% \times 0.4375\%) + (20\% \times 0.1125\%)$   
 $= 0.4375\% + 0.0225\%$   
 $= 0.46\%$

Assuming net realized capital gains of 6% and realized capital losses and unrealized capital depreciation of 1%, the capital gains-based incentive fee would be as follows:  
 $= 20\% \times (6\% - 1\%)$   
 $= 20\% \times 5\%$   
 $= 1\%$

For a more detailed discussion of the calculation of the two-part incentive fee, see Management Certain Transactions Investment Advisory and Management Agreement in the accompanying prospectus.

- (4) Includes deferred financing costs. We entered into a revolving credit facility, effective [redacted], under which our borrowing capacity is \$[redacted] million. We have drawn down on this credit facility and we expect to borrow additional funds in the future up to an amount so that our asset coverage, as defined in the 1940 Act, is at least 200% after each issuance of our senior securities. Assuming that we borrowed \$[redacted] million at an interest rate of [redacted]% plus an additional fee related to borrowings of [redacted]%, for an aggregate rate of [redacted]%, interest payments and amortization of deferred financing costs on borrowed funds would have been [redacted]% of our average net assets for the quarter ended [redacted].
- (5) Includes our overhead expenses, including payments under the administration agreement based on our projected allocable portion of overhead and other expenses incurred by our Administrator in performing its obligations under the administration agreement. See Management Certain Transactions Administration Agreement in the accompanying prospectus.

**Example**

The following example demonstrates the projected dollar amount of total cumulative expenses that would be incurred over various periods with respect to a hypothetical investment in our common stock. In calculating the following expense amounts, we have assumed that our annual operating expenses would remain at the levels set forth in the table above.

|   | 1 Year       | 3 Years      | 5 Years      | 10 Years     |
|---|--------------|--------------|--------------|--------------|
| You would pay the following expenses on a \$1,000 investment, assuming a 5% annual return | \$[redacted] | \$[redacted] | \$[redacted] | \$[redacted] |

While the example assumes, as required by the SEC, a 5% annual return, our performance will vary and may result in a return greater or less than 5%. Additionally, we have assumed that the entire amount of such 5% annual return would constitute ordinary income as we have not historically realized positive capital gains (computed net of all realized capital losses) on our investments. Because the assumed 5% annual



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return is significantly below the hurdle rate of 7% (annualized) that we must achieve under the investment advisory and management agreement to trigger the payment of an income-based incentive fee, we have assumed, for purposes

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of the above example, that no income-based incentive fee would be payable if we realized a 5% annual return on our investments. Additionally, because the capital gains-based incentive fee is calculated on a cumulative basis (computed net of all realized capital losses and unrealized capital depreciation) and because of the significant capital losses realized to date, we have assumed that we will not trigger the payment of any capital gains-based incentive fee in any of the indicated time periods. If we achieve sufficient returns on our investments, including through the realization of capital gains, to trigger an incentive fee of a material amount, our expenses on a \$1,000 investment, assuming a 5% annual return, consisting entirely of capital gains would be \$[ ] for 1 year, \$[ ] for 3 years, \$[ ] for 5 years and \$[ ] for 10 years. In addition, while the example assumes reinvestment of all dividends and distributions at net asset value, participants in our dividend reinvestment plan will receive a number of shares of our common stock, determined by dividing the total dollar amount of the dividend payable to a participant by the market price per share of our common stock at the close of trading on the valuation date for the dividend. See Dividend Reinvestment Plan in the accompanying prospectus for additional information regarding our dividend reinvestment plan.

This example and the expenses in the table above should not be considered a representation of our future expenses, and actual expenses (including the cost of debt, incentive fees, if any, and other expenses) may be greater or less than those shown.

**RISK FACTORS**

[To be provided.]

**USE OF PROCEEDS**

We intend to use the net proceeds from this offering first to pay down existing short-term debt, then to make investments in small and mid-sized businesses in accordance with our investment objectives, with any remaining proceeds to be used for other general corporate purposes. Indebtedness under our credit line facility currently accrues interest at the rate of approximately [ ]% and matures on , . We anticipate that substantially all of the net proceeds of this offering will be utilized in the manner described above within three months of the completion of the offering. Pending such utilization, we intend to invest the net proceeds of this offering primarily in cash, cash equivalents, U.S. government securities, and other high-quality debt investments that mature in one year or less from the date of investment, consistent with the requirements for continued qualification as a RIC for federal income tax purposes.

**CAPITALIZATION**

[To be provided.]

**PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS**

We currently intend to distribute in the form of cash dividends, a minimum of 90% of our ordinary income and short-term capital gains, if any, on a quarterly basis to our stockholders in the form of monthly dividends. We intend to retain long-term capital gains and treat them as deemed distributions for tax purposes. We report the estimated tax characteristics of each distribution when declared while the actual tax characteristics of distributions are reported annually to each stockholder on Form 1099 DIV. There is no assurance that we will achieve investment results or maintain a tax status that will permit any specified level of cash distributions or year-to-year increases in cash distributions. At the option of a holder of record of common stock, all cash distributions can be reinvested automatically under our dividend reinvestment plan in additional whole and fractional shares. A stockholder whose shares are held in the name of a broker or other nominee should contact the broker or nominee regarding participation in our dividend reinvestment plan on the stockholder's behalf. See Risk Factors We will be subject to corporate-level tax if we are unable to satisfy Code requirements for RIC qualification; Dividend Reinvestment Plan; and Material U.S. Federal Income Tax Considerations in the accompanying prospectus.

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Our common stock is quoted on The NASDAQ Global Select Market under the symbol GLAD. Our common stock has historically traded at prices both above and below its net asset value. There can be no assurance, however, that any premium to net asset value will be attained or maintained. As of \_\_\_\_\_, we had [ ] stockholders of record.

**DESCRIPTION OF THE WARRANTS**

[To be provided.]

**TAXATION**

[To be provided.]

**UNDERWRITING**

[To be provided.]

**LEGAL MATTERS**

The legality of securities offered hereby will be passed upon for us by Cooley LLP, Reston, Virginia. [Certain legal matters will be passed upon for the underwriters by \_\_\_\_\_.]

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**Gladstone Capital Corporation**

**Warrants for Common Stock**

**PROSPECTUS SUPPLEMENT**

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**The information in this prospectus supplement is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus supplement is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.**

Filed Pursuant to Rule 497

Registration Statement No. 333-162592

## PROSPECTUS SUPPLEMENT

(To Prospectus dated , 201 )

**Warrants for Series [ ] Preferred Stock**

We are offering for sale warrants to purchase shares of Series [ ] Preferred Stock of the Company, which we refer to as Preferred Warrants, at an exercise price equal to \$ per whole share. No fractional Preferred Warrants will be issued. Our common stock is traded on The NASDAQ Global Select Market under the symbol GLAD. The last reported sale price for our common stock on , was \$ per share. The net asset value per share of our common stock at the close of business on , 201 was \$ per share. Our preferred stock is traded on [ ] under the symbol [ ]. The last reported sale of our preferred stock on , 201 was \$ per share.

Currently, no public market exists for the Preferred Warrants offered by this prospectus supplement. It is anticipated that the Preferred Warrants will be quoted on promptly after the date of this prospectus supplement.

|  | Per Warrant | Total (1) |
|--|-------------|-----------|
| Public offering price                  | \$          | \$        |
| Underwriting discounts and commissions | \$          | \$        |
| Proceeds, before expenses, to us       | \$          | \$        |

(1) The aggregate expenses of the offering are estimated to be \$ .  
The Underwriters are expected to deliver the Preferred Warrants in book-entry form through the Depository Trust Company on or about , .

You should read this prospectus supplement and the accompanying prospectus before deciding whether to invest in our Preferred Warrants and you should retain them for future reference. Additional information about us, including our annual, quarterly and current reports, has been filed with the Securities and Exchange Commission. This information is available free of charge on our corporate website at <http://www.gladstoneinvestment.com>.

**An investment in our Preferred Warrants involves certain risks, including, among other things, risks relating to investments in securities of small, private and developing businesses. We describe some of these risks in the section entitled Risk Factors, which begins on page PR-2 of this prospectus supplement and page 8 of the accompanying prospectus. Shares of closed-end investment companies frequently trade at a discount to their net asset value and this may increase the risk of loss of purchasers of our Preferred Warrants. You should**

**carefully consider these risks together with all of the other information contained in this prospectus supplement and the accompanying prospectus before making a decision to purchase our Preferred Warrants.**

**The Preferred Warrants being offered have not been approved or disapproved by the Securities and Exchange Commission or any state securities commission nor has the Securities and Exchange Commission or any state securities commission passed upon the accuracy or adequacy of this prospectus. Any representation to the contrary is a criminal offense.**

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We have not authorized any dealer, salesman or other person to give any information or to make any representation other than those contained in this prospectus supplement or the accompanying prospectus. You must not rely upon any information or representation not contained in this prospectus supplement or the accompanying prospectus as if we had authorized it. This prospectus supplement and the accompanying prospectus do not constitute an offer to sell or a solicitation of any offer to buy any security other than the registered securities to which they relate, nor do they constitute an offer to sell or a solicitation of an offer to buy any securities in any jurisdiction to any person to whom it is unlawful to make such an offer or solicitation in such jurisdiction. The information contained in this prospectus supplement and any accompanying prospectus is accurate as of the dates on their respective covers only. Our business, financial condition, results of operations and prospects may have changed since such dates.

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**Table of Contents****SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

All statements contained in this prospectus supplement or the accompanying prospectus, other than historical facts, may constitute forward-looking statements. These statements may relate to, among other things, future events or our future performance or financial condition. In some cases, you can identify forward-looking statements by terminology such as may, might, believe, will, provided, anticipate, future growth, plan, intend, expect, should, would, if, seek, possible, potential, likely or the negative of such terms or comparable forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others: (1) further adverse changes in the economy and the capital markets; (2) risks associated with negotiation and consummation of pending and future transactions; (3) the loss of one or more of our executive officers, in particular David Gladstone, Terry Lee Brubaker or George Stelljes III ; (4) changes in our business strategy; (5) availability, terms and deployment of capital; (6) changes in our industry, interest rates, exchange rates or the general economy; (7) the degree and nature of our competition; and (8) those factors described in the Risk Factors sections of this prospectus supplement and the accompanying prospectus. We caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, after the date of this prospectus supplement. The forward-looking statements contained in this prospectus supplement or the accompanying prospectus are excluded from the safe harbor protection provided by the Private Securities Litigation Reform Act of 1995 and Section 27A of the Securities Act.

**TERMS OF THE WARRANTS**

|                          |  |
|--------------------------|--|
| Exercise Price           | Each Preferred Warrant will be exercisable at an exercise price of \$ _____ per whole share of Series [ ] Preferred Stock of the Company.  |
| Exercise Period          | The Preferred Warrants will be exercisable until the date that is _____ years from the original date of issuance, or the Exercise Period. The rights represented by the warrant may be exercised in whole or in part at any time during the Exercise Period. |
| [Stock Exchange Listing] | [To be provided.]  |
| [Non-Call Period]        | The Preferred Warrants may not be called for redemption at the option of the Company prior to _____.]  |
| No Stockholder Rights    | The Preferred Warrants do not entitle the holder to any voting rights or other rights as a stockholder of the Company.   |

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**TERMS OF THE SERIES [ ] PREFERRED STOCK**

|                         |   |
|-------------------------|---|
| Dividend Rate           | The dividend rate will be %.  |
| Dividend Payment Rate   | [Dividends will be paid when, as and if declared on , , and , commencing .] The payment date for the initial dividend period will be .] |
| Regular Dividend Period | Regular dividend periods will be days.  |
| Liquidation Preference  | \$ per share  |
| Non-Call Period         | The shares may not be called for redemption at the option of the Company prior to .   |
| Stock Exchange Listing  |   |

**RISK FACTORS**

[To be provided.]

**USE OF PROCEEDS**

We intend to use the net proceeds from this offering first to pay down existing short-term debt, then to make investments in small and mid-sized businesses in accordance with our investment objectives, with any remaining proceeds to be used for other general corporate purposes. Indebtedness under our credit line facility currently accrues interest at the rate of approximately [ ]% and matures on , . We anticipate that substantially all of the net proceeds of this offering will be utilized in the manner described above within three months of the completion of the offering. Pending such utilization, we intend to invest the net proceeds of this offering primarily in cash, cash equivalents, U.S. government securities, and other high-quality debt investments that mature in one year or less from the date of investment, consistent with the requirements for continued qualification as a RIC for federal income tax purposes.

**CAPITALIZATION**

[To be provided.]

**DESCRIPTION OF THE WARRANTS**

[To be provided.]

**TAXATION**

[To be provided.]

**UNDERWRITING**

[To be provided.]

**LEGAL MATTERS**

The legality of securities offered hereby will be passed upon for us by Cooley LLP, Reston, Virginia. [Certain legal matters will be passed upon for the underwriters by .]



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**Gladstone Capital Corporation**

**Warrants for Series [ ] Preferred Stock**

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**Table of Contents****Part C OTHER INFORMATION****Item 25. Financial Statements and Exhibits****1. Financial Statements**

The following financial statements of Gladstone Capital Corporation (the Company or the Registrant ) are included in the Registration Statement in Part A: Information Required in a Prospectus:

**GLADSTONE CAPITAL CORPORATION****INDEX TO CONSOLIDATED FINANCIAL STATEMENTS****Audited Consolidated Financial Statements**

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**2. Exhibits****Exhibit**

| <b>Number</b> | <b>Description</b>  |
|---------------|---|
| 2.a.1         | Articles of Amendment and Restatement of the Articles of Incorporation, incorporated by reference to Exhibit a.2 to Pre-Effective Amendment No. 1 to the Registration Statement on Form N-2 (File No. 333-63700), filed July 27, 2001.  |
| 2.a.2         | Articles Supplementary Establishing and Fixing the Rights and Preferences of the Term Preferred Shares, including Appendix A thereto relating to the Term Preferred Shares, 7.125% Series 2016 (previously filed on October 31, 2011 with Post-Effective Amendment No. 5 to this Registration Statement). |
| 2.b.1         | By-laws, incorporated by reference to Exhibit b to Pre-Effective Amendment No. 1 to the Registration Statement on Form N-2 (File No. 333-63700), filed July 27, 2001.   |
| 2.b.2         | Amendment to By-laws, incorporated by reference to Exhibit 3.3 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended December 31, 2003 (File No. 814-00237), filed February 17, 2004.   |

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|       |  |
|-------|--|
| 2.b.3 | Second Amendment to By-laws, incorporated by reference to Exhibit 99.1 to the Registrant's Current Report on Form 8-K (File No. 814-00237), filed July 10, 2007.   |
| 2.b.4 | Third Amendment to Bylaws, incorporated by reference to Exhibit 99.1 to the Registrant's Current Report on Form 8-K (File No. 814-00237), filed June 10, 2011.   |
| 2.c   | Not applicable.  |
| 2.d.1 | Form of Direct Registration Transaction Advice for the Registrant's common stock, par value \$0.001 per share, incorporated by reference to Exhibit d to Pre-Effective Amendment No. 1 to the Registration Statement on Form N-2 (File No. 333-63700), filed July 27, 2001.  |
| 2.d.2 | Specimen Stock Certificate, incorporated by reference to Exhibit d.2 to Pre-Effective Amendment No. 3 to the Registration Statement on Form N-2 (File No. 333-63700), filed August 23, 2001.   |
| 2.d.3 | Form of Senior Indenture (previously filed on October 20, 2009 with this Registration Statement).  |
| 2.d.4 | Form of Subordinated Indenture (previously filed on October 20, 2009 with this Registration Statement).  |
| 2.d.5 | Specimen 7.125% Series 2016 Term Preferred stock certificate (previously filed on October 31, 2011 with Post-Effective Amendment No. 5 to this Registration Statement).  |
| 2.e   | Dividend Reinvestment Plan, incorporated by reference to Exhibit 2.e to Pre-Effective Amendment No. 1 to the Registration Statement on Form N-2 (File No. 333-63700), filed July 27, 2001.   |
| 2.f   | Not applicable.  |
| 2.g.1 | Amended and Restated Investment Advisory and Management Agreement between Gladstone Capital Corporation and Gladstone Management Corporation, dated as of October 1, 2006 incorporated by reference to Exhibit 99.1 to the Registrant's Current Report on Form 8-K (File No. 814-00237), filed October 5, 2006 (renewed on July 7, 2010).  |
| 2.h.1 | Equity Distribution Agreement, dated as of May 17, 2010, by and among Gladstone Capital Corporation, Gladstone Management Corporation and BB&T Capital Markets, a division of Scott & Stringfellow, LLC (previously filed on May 17, 2010 with Post-Effective Amendment No. 1 to this Registration Statement).   |
| 2.i   | Not applicable.  |
| 2.j   | Custodian Agreement between Gladstone Capital Corporation and The Bank of New York, dated as of May 5, 2006, incorporated by reference to Exhibit 10.3 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 (File No. 814-00237), filed August 1, 2006.   |
| 2.k.1 | Promissory Note of David Gladstone in favor of the Company, dated August 23, 2001, incorporated by reference to Exhibit 10.4 to the Registrant's Quarterly Report on Form 10-Q for the period ended June 30, 2001, filed October 4, 2001.  |
| 2.k.2 | Redemption Agreement, dated as of September 7, 2010, between Gladstone Capital Corporation and David Gladstone, incorporated by reference to Exhibit 10.10 to the Registrant's Annual Report on Form 10-K (File No. 814-00237), filed November 22, 2010.   |
| 2.k.3 | Third Amended and Restated Credit Agreement dated as of May 15, 2009 by and among Gladstone Business Loan, LLC as Borrower, Gladstone Management Corporation as Servicer, the Committed Lenders named therein, the CP Lenders named therein, the Managing Agents named therein, and Key Equipment Finance Inc. as Administrative Agent, incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K (File No. 814-00237), filed May 19, 2009. |
| 2.k.4 | Administration Agreement between Gladstone Capital Corporation and Gladstone Administration, LLC, dated as of October 1, 2006 incorporated by reference to Exhibit 99.1 to the Registrant's Current Report on Form 8-K (File No. 814-00237), filed October 5, 2006 (renewed on July 7, 2010).  |

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- 2.k.5 Fourth Amended and Restated Credit Agreement dated as of March 15, 2010 by and among Gladstone Business Loan, LLC as Borrower, Gladstone Management Corporation as Servicer, the Lenders named therein, the Managing Agents named therein, and Key Equipment Finance Inc. as Administrative Agent, incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K (File No. 814-00237), filed March 16, 2010.
- 2.k.6 Amendment No. 1 to Fourth Amended and Restated Credit Agreement dated as of November 22, 2010 by and among Gladstone Business Loan, LLC as Borrower, Gladstone Management Corporation as Servicer, the Committed Lenders named therein, the Managing Agents named therein, and Key Equipment Finance Inc. as Administrative Agent, incorporated by reference to Exhibit 10.8 to the Registrant's Annual Report on Form 10-K (File No. 814-00237), filed November 22, 2010.
- 2.l Opinion of Cooley Godward Kronish LLP (previously filed on October 20, 2009 with this Registration Statement).
- 2.m Not applicable.
- 2.n.1 Consent of Independent Registered Public Accounting Firm.
- 2.n.2 Consent of Cooley Godward Kronish LLP (included in Exhibit 2.1) (previously filed on October 20, 2009 with this Registration Statement).
- 2.n.3 Report of Independent Registered Public Accounting Firm on Financial Statement Schedule (previously filed on March 6, 2012 with Post-Effective Amendment No. 6 to this Registration Statement).
- 2.o Not applicable.
- 2.p Subscription Agreement dated May 30, 2001, incorporated by reference to incorporated by reference to Exhibit p to the Registration Statement on Form N-2 (File No. 333-63700), filed June 22, 2001.
- 2.q Not applicable.
- 2.r Code of Ethics and Business Conduct, incorporated by reference to Exhibit 14.1 to the Registrant's Current Report on Form 8-K (File No. 814-00237), filed October 12, 2005.
- 2.s.1 Power of Attorney (included in the signature page of the original filing of this Registration Statement, filed on October 20, 2009).
- 2.s.2 Power of Attorney (previously filed on April 7, 2011 with Post Effective Amendment No. 2 to this Registration Statement).

**Item 26. Marketing Arrangements**

The information contained under the heading "Plan of Distribution" on page 143 of the prospectus is incorporated herein by reference, and any information concerning any underwriters will be contained in the accompanying prospectus supplement, if any.

**Item 27. Other Expenses of Issuance and Distribution**

|                              |             |
|------------------------------|-------------|
| Commission registration fee  | \$ 16,740   |
| FINRA fee                    | 30,500      |
| Accounting fees and expenses | 75,000*     |
| Printing and engraving       | 150,000*    |
| Legal fees and expenses      | 300,000*    |
| Total                        | \$ 572,240* |

\* These amounts are estimates.

All of the expenses set forth above shall be borne by the Registrant.

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**Item 28. *Persons Controlled by or Under Common Control***

Gladstone Capital Advisers, Inc., a Delaware corporation and wholly-owned subsidiary of the Registrant.

U.S. Healthcare Communications, Inc., a Delaware corporation and wholly-owned subsidiary of the Registrant.

USHC Legal Inc., a New Jersey corporation and wholly-owned subsidiary of the Registrant.

Gladstone Business Loan, LLC, a Delaware limited liability company and wholly-owned subsidiary of the Registrant.

Gladstone Financial Corporation, a Delaware corporation and wholly-owned subsidiary of the Registrant.

BERTL, Inc., a Delaware corporation controlled by the Registrant through 29% common stock ownership.

LYP Holdings Corp., a Delaware corporation controlled by the Registrant.

LocalTel, LLC, a Delaware limited liability company controlled by LYP Holdings Corp., through 57% ownership.

LYP, LLC, a Delaware limited liability company controlled by LYP Holdings Corp., through 100% ownership.

Lindmark Acquisition, LLC a Delaware limited liability company controlled by Lindmark Holdings Corp., through 50% ownership.

Lindmark Holdings Corp., a Delaware corporation controlled by the Registrant.

Defiance Integrated Technologies, Inc., a Delaware corporation controlled by the Registrant, through 58% ownership.

1090 Perry Acquisition Corp., a Delaware corporation controlled by Defiance Integrated Technologies, Inc., through 100% ownership.

JBM Tool & Die, Inc., a Delaware corporation controlled by Defiance Integrated Technologies, Inc., through 100% ownership.

Pro Shear Corporation, a Delaware corporation controlled by Defiance Integrated Technologies, Inc., through 100% ownership.

Midwest Metal Distribution, Inc., a Delaware corporation controlled by Gladstone Metal, LLC through 70% ownership.

Gladstone Metal, LLC, a Delaware limited liability company controlled by the Registrant.

Kansas Cable Holdings, Inc., a Delaware corporation controlled by the Registrant through 100% ownership.

Sunshine Media Group, Inc., a Delaware corporation controlled by the Registrant through 50% ownership.

Publication Holdings, Inc., a Delaware corporation controlled by the Registrant through 100% ownership.

Georgia Film Holdings, LLC, a Delaware limited liability company controlled by the Registrant through 100% ownership.



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Gladstone Investment Corporation, a Delaware corporation controlled by the Registrant's officers and directors.

Gladstone Business Investment, LLC, a Delaware limited liability company and wholly-owned subsidiary of Gladstone Investment Corporation.

Gladstone Investment Advisers, Inc., a Delaware corporation and wholly-owned subsidiary of Gladstone Investment Corporation ..

ACME Cryogenics Inc., a Pennsylvania corporation controlled by Gladstone Investment Corporation through 53% ownership.

CCE Investment Corp., a Delaware corporation and wholly-owned subsidiary of Gladstone Investment Corporation.

Mustang Eagle Partnership, LLC, a Delaware limited liability company and wholly-owned subsidiary of CCE Investment Corp.

Country Club Enterprises, LLC, a Massachusetts limited liability company, controlled by Mustang Eagle Partnership, LLC through 52% ownership.

ASH Holdings Corp., a Delaware corporation and wholly-owned subsidiary of Gladstone Investment Corporation.

Auto Safety House, LLC, a Delaware limited liability company, controlled by ASH Holdings, Corp. through 74% ownership.

Galaxy Tool Holding Corporation, a Delaware corporation controlled by Gladstone Investment Corporation through 60% ownership.

Mathey Investments, Inc., a Oklahoma corporation controlled by the Gladstone Investment Corporation through 97% ownership.

Tread Corporation, a Delaware corporation controlled by Gladstone Investment Corporation through 51% ownership.

Neville Limited, a Delaware corporation controlled by Gladstone Investment Corporation through 100% stock ownership.

Quench Holdings Corp., a Delaware corporation controlled by Gladstone Investment Corporation.

Precision Southeast Holdings, Inc., a Delaware corporation controlled by Gladstone Investment Corporation through 91% stock ownership.

SBS Industries Holdings, Inc., a Delaware corporation controlled by the Registrant through 85% ownership.

SBS Industries, LLC, a Delaware limited liability company controlled by SBS Industries Holdings, Inc. through 100% ownership.

Venyu Solutions, Inc, a Louisiana corporation controlled by Venyu Holdings, LLC through 100% ownership.

Venyu Holdings, LLC, a Delaware limited liability company controlled by Venyu Investments, LLC though 60% ownership.

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Venyu Investments, LLC, a Delaware limited liability company controlled by Gladstone Investment Corporation through 100% ownership.

MRP Holdings Corp., a Delaware corporation controlled by Gladstone Investment Corporation through 30% ownership.

Gladstone SOG Investments, Inc., a Delaware corporation and wholly-owned subsidiary of the Registrant.

SOG Investment I LLC, a Delaware limited liability company controlled by Gladstone SOG Investments, Inc. through 100% ownership.

GAIN CTG Holdings, Inc., a Delaware corporation controlled by the Registrant through 100% ownership.

Gladstone Commercial Corporation, a Maryland corporation controlled by the Registrant's officers and directors.

GCLP Business Trust I, a Massachusetts business trust controlled by Gladstone Commercial Corporation.

GCLP Business Trust II, a Massachusetts business trust controlled by Gladstone Commercial Partners, LLC.

Gladstone Commercial Partners, LLC, a Delaware limited liability company and wholly-owned subsidiary of Gladstone Commercial Corporation.

Gladstone Commercial Advisers, Inc., a Delaware corporation and wholly-owned subsidiary of Gladstone Commercial Corporation.

First Park Ten COCO San Antonio GP LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

First Park Ten COCO San Antonio LP, a Delaware limited partnership controlled by its general partner, First Park Ten COCO San Antonio GP LLC.

COCO04 Austin TX GP LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

COCO04 Austin TX LP, a Delaware limited partnership controlled by its general partner, COCO04 Austin TX GP LLC.

Pocono PA GCC, LP, a Delaware limited partnership controlled by its general partner, Pocono PA GCC GP LLC.

Gladstone Commercial Limited Partnership, a Delaware limited partnership controlled by its general partner GCLP Business Trust II.

GCC Acquisition Holdings LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

SLEE Grand Prairie LP, a Delaware limited partnership controlled by its general partner, GCC Acquisition Holdings, Inc.

EE 208 South Rogers Lane, Raleigh, NC LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

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Gladstone Commercial Lending LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

260 Springside Drive Akron OH LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

Little Arch04 Charlotte NC Member LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

Little Arch Charlotte NC LLC, a Delaware limited liability company controlled by its sole member, Little Arch04 Charlotte NC Member LLC.

CMI04 Canton NC LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

OB Midway NC Gladstone Commercial LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

GCC Granby LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

Granby Property Trust, a Delaware statutory trust controlled by its grantor, GCC Granby LLC.

GCC Dorval LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

Dorval Property Trust, a Delaware statutory trust controlled by its grantor, GCC Dorval LLC.

3094174 Nova Scotia Company, a Nova Scotia corporation controlled by its sole stockholder, Gladstone Commercial Limited Partnership.

3094175 Nova Scotia Company, a Nova Scotia corporation controlled by its sole stockholder, Gladstone Commercial Limited Partnership.

WMI05 Columbus OH LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

2525 N Woodlawn Vstrm Wichita KS LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

Corning Big Flats LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

OB Crenshaw SPE GP LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

OB Crenshaw GCC LP, a Delaware limited partnership controlled by its general partner, OB Crenshaw SPE GP LLC.

HMBF05 Newburyport MA LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

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YorkTC05 Eatontown NJ LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

STI05 Franklin NJ LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

AFL05 Duncan SC Member LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

AFL05 Duncan SC LLC, a Delaware limited liability company controlled by its sole member, AFL05 Duncan SC Member LLC.

MSI05-3 LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

WMI05 Hazelwood MO LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

CI05 Clintonville WI LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

PZ05 Maple Heights OH LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

YCC06 South Hadley MA LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

NW05 Richmond VA LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

SVMCM05 Toledo OH LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

ACI06 Champaign IL LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

UC06 Roseville MN LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

TCI06 Burnsville MN LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

RC06 Menomonee Falls WI LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

SJMH06 Baytown TX GP LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

SJMH06 Baytown TX LP, a Delaware limited partnership controlled by its general partner, SJMH06 Baytown TX GP LLC.

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NJT06 Sterling Heights MI LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

CMS06-3 LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

MPI06 Mason OH LLC, a Delaware limited liability company, controlled by its manager, Gladstone Commercial Limited Partnership.

GSM LLC, a Delaware limited liability company, controlled by its manager, Gladstone Commercial Limited Partnership.

AC07 Lawrenceville GA LLC, a Delaware limited liability company, controlled by its manager, Gladstone Commercial Limited Partnership.

EE07 Raleigh NC GP LLC, a Delaware limited liability company, controlled by its manager, Gladstone Commercial Limited Partnership.

EE07 Raleigh NC, L.P., a Delaware limited partnership, controlled by its general partner, EE07 Raleigh NC GP LLC.

WPI07 Tulsa OK LLC, a Delaware limited liability company, controlled by its manager, Gladstone Commercial Limited Partnership.

APML07 Hialeah FL LLC, a Delaware limited liability company, controlled by its manager, Gladstone Commercial Limited Partnership.

EI07 Tewksbury MA LLC, a Delaware limited liability company, controlled by its manager, Gladstone Commercial Limited Partnership.

GBI07 Syracuse NY LLC, a Delaware limited liability company, controlled by its manager, Gladstone Commercial Limited Partnership.

CDLCI07 Mason OH LLC, a Delaware limited liability company, controlled by its manager, Gladstone Commercial Limited Partnership.

FTCH107 Grand Rapids MI LLC, a Delaware limited liability company, controlled by its manager, Gladstone Commercial Limited Partnership.

DBP107 Bolingbrook IL LLC, a Delaware limited liability company, controlled by its manager, Gladstone Commercial Limited Partnership.

Pocono PA GCC GP LLC, a Delaware limited liability company, controlled by its manager, Gladstone Commercial Limited Partnership.

RCOG07 Georgia LLC, a Delaware limited liability company, controlled by its manager Gladstone Commercial Limited Partnership.

C08 Fridley MN LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

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SRFF08 Reading PA GP LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

SRFF08 Reading PA, L.P., a Delaware limited partnership controlled by its general partner, SRFF08 Reading PA GP LLC.

OS08 Winchester VA LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

RB08 Concord OH LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

RPT08 Pineville NC GP LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

RPT08 Pineville NC L.P., a Delaware limited partnership controlled by its general partner, RPT08 Pineville NC GP LLC.

FMCT08 Chalfont PA GP LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

FMCT08 Chalfont PA, L.P., a Delaware limited partnership controlled by its general partner, FMCT08 Chalfont PA GP LLC.

D08 Marietta OH LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

ELF08 Florida LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

SCC10 Orange City IA LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

TMC11 Springfield MO LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

FS11 Hickory NC GP LLC, a Delaware limited liability company controlled by its manager Gladstone Commercial Limited Partnership.

FS11 Hickory NC, LP, a Delaware limited partnership controlled by its general partner, FS11 Hickory NC GP LLC.

AFR11 Parsippany NJ LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

Hemingway at Boston Heights, LLC, a Ohio limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

WEC11 Dartmouth MA LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

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WC11 Springfield MO LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

CBP11 Green Tree PA GP LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

CBP11 Green Tree PA, L.P., a Delaware limited partnership controlled by its general partner, CBP11 Green Tree PA GP LLC.

IPA12 Ashburn VA LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

PNA11 Boston Heights OH LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

ABC12 Ottumwa IA LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

CVG12 New Albany OH LLC, a Delaware limited liability company controlled by its manager, Gladstone Commercial Limited Partnership.

Gladstone Land Corporation, a Maryland corporation controlled by David Gladstone through indirect 100% stock ownership.

Gladstone Land Partners, LLC, a Delaware limited liability company controlled by its manager, Gladstone Land Corporation.

Gladstone Land Advisers, Inc., a Delaware corporation and wholly-owned subsidiary of Gladstone Land Corporation.

Gladstone Land Limited Partnership, a Delaware limited partnership controlled by its general partner, Gladstone Land Partners, LLC.

San Andreas Road Watsonville LLC, a California limited liability company controlled by its manager, Gladstone Land Limited Partnership.

West Gonzales Road Oxnard LLC, a California limited liability company controlled by its manager, Gladstone Land Limited Partnership.

West Beach Street Watsonville, LLC, a California limited liability company controlled by its manager, Gladstone Land Limited Partnership.

Dalton Lane Watsonville, LLC, a California limited liability company controlled by its manager, Gladstone Land Limited Partnership.

Keysville Road Plant City, LLC, a Florida limited liability company controlled by its manager, Gladstone Land Limited Partnership.

Carlton Lake Road Plant City, LLC, a Florida limited liability company controlled by its manager, Gladstone Land Limited Partnership.

Gladstone Holding Corporation, a Delaware corporation controlled by David Gladstone through 100% indirect stock ownership.

Gladstone Management Corporation, a Delaware corporation controlled by Gladstone Holding Corporation, through 100% ownership.

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Gladstone Administration, LLC, a Delaware limited liability company and wholly-owned subsidiary of Gladstone Holding Corporation.

Gladstone Securities, LLC, a Connecticut limited liability company controlled by its member, Gladstone Holding Corporation.

Gladstone General Partner, LLC, a Delaware limited liability company controlled by its manager, Gladstone Management Corporation.

Gladstone Participation Fund LLC, a Delaware limited liability company controlled by Gladstone General Partner, LLC.

Gladstone Partners Fund, LP, a Delaware limited partnership controlled by its general partner, Gladstone Management Corporation.

Gladstone Lending Corporation, a Maryland corporation controlled by David Gladstone through 100% indirect stock ownership.

**Item 29. Number of Holders of Securities**

The following table sets forth the approximate number of record holders of our common stock at May 31, 2012.

| Title of Class                            | Number of<br>Record<br>Holders |
|---|--------------------------------|
| Common Stock, par value \$0.001 per share | 63                             |

**Item 30. Indemnification**

Subject to the Investment Company Act of 1940, as amended (the 1940 Act ) or any valid rule, regulation or order of the Securities and Exchange Commission ( SEC ) thereunder, our articles of incorporation and bylaws provide that we will indemnify any person who was or is a party or is threatened to be made a party to any threatened action, suit or proceeding whether civil, criminal, administrative or investigative, by reason of the fact that he is or was our director or officer, or is or was serving at our request as a director, officer, partner or trustee of another corporation, real estate investment trust, partnership, joint venture, trust, employee benefit plan or other enterprise to the maximum extent permitted by Section 2-418 of the Annotated Code of Maryland, Corporations and Associations (the Maryland Law ). The 1940 Act provides that a company may not indemnify any director or officer against liability to it or its security holders to which he or she might otherwise be subject by reason of his or her willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his or her office unless a determination is made by final decision of a court, by vote of a majority of a quorum of directors who are disinterested, non-party directors or by independent legal counsel that the liability for which indemnification is sought did not arise out of the foregoing conduct. In addition to any indemnification to which our directors and officers are entitled pursuant to our articles of incorporation and bylaws and Maryland Law, our articles of incorporation and bylaws permit us to indemnify our other employees and agents to the fullest extent permitted by Maryland Law, whether such employees or agents are serving us or, at our request, any other entity.

In addition, the investment advisory and management agreement between us and our investment adviser, Gladstone Management Corporation (the Adviser ), as well as the administration agreement between us and our administrator Gladstone Administration, LLC (the Administrator ), each provide that, absent willful misfeasance, bad faith, or gross negligence in the performance of their respective duties or by reason of the reckless disregard of their respective duties and obligations, our Adviser or our Administrator, as applicable, and their respective officers, managers, partners, agents, employees, controlling persons, members, and any other person or entity affiliated with it are entitled to indemnification from us for any damages, liabilities, costs, and



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expenses (including reasonable attorneys' fees and amounts reasonably paid in settlement) arising from the rendering of our Adviser's services under the investment advisory and management agreement or otherwise as our investment adviser, or the rendering of our Administrator's services under the administration agreement, as applicable.

### **Item 31. *Business and Other Connections of Investment Adviser***

A description of any other business, profession, vocation or employment of a substantial nature in which our Adviser, and each director or executive officer of our Adviser, is or has been during the past two fiscal years, engaged in for his or her own account or in the capacity of director, officer, employee, partner or trustee, is set forth in Part A of this Registration Statement in the section entitled "Management." Additional information regarding our Adviser and its officers and directors is set forth in its Form ADV, as filed with the SEC, and is incorporated herein by reference.

### **Item 32. *Location of Accounts and Records***

All accounts, books or other documents required to be maintained by Section 31(a) of the 1940 Act and the rules thereunder are maintained at the offices of:

- (1) the Registrant, Gladstone Capital Corporation, 1521 Westbranch Drive, Suite 200, McLean, VA 22102;
- (2) the Transfer Agent, Computershare Shareholder Services LLC, 480 Washington Boulevard, Jersey City, NJ 07310;
- (3) the Adviser, Gladstone Management Corporation, 1521 Westbranch Drive, Suite 200, McLean, VA 22102;
- (4) the Custodian, The Bank of New York Mellon Corp., 500 Ross Street, Suite 935, Pittsburgh, PA 15262; and
- (5) the Collateral Custodian, The Bank of New York Mellon Corp., 500 Ross Street, Suite 935, Pittsburgh, PA 15262.

### **Item 33. *Management Services***

Not applicable.

### **Item 34. *Undertakings***

1. We hereby undertake to suspend the offering of shares until the prospectus is amended if, subsequent to the effective date of this registration statement, our net asset value declines more than ten percent from our net asset value as of the effective date of this registration statement.
2. We hereby undertake:
  - (a) to file, during any period in which offers or sales are being made, a post-effective amendment to this registration statement;
  - (i) to include any prospectus required by Section 10(a)(3) of the Securities Act of 1933, as amended, or the Securities Act;

- (ii) to reflect in the prospectus any facts or events arising after the effective date of this registration statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the registration statement; and

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- (iii) to include any material information with respect to the plan of distribution not previously disclosed in the registration statement or any material change to such information in the registration statement;
- (b) that, for the purpose of determining any liability under the Securities Act, each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of those securities at that time shall be deemed to be the initial bona fide offering thereof;
- (c) to remove from registration by means of a post-effective amendment any of the securities being registered which remain unsold at the termination of the offering; and
- (d) that, for the purpose of determining liability under the Securities Act to any purchaser, if the Registrant is subject to Rule 430C: Each prospectus filed pursuant to Rule 497(b), (c), (d) or (e) under the Securities Act as part of a registration statement relating to an offering, other than prospectuses filed in reliance on Rule 430A under the Securities Act, shall be deemed to be part of and included in the registration statement as of the date it is first used after effectiveness. Provided, however, that no statement made in a registration statement or prospectus that is part of the registration statement or made in a document incorporated or deemed incorporated by reference into the registration statement or prospectus that is part of the registration statement will, as to a purchaser with a time of contract of sale prior to such first use, supersede or modify any statement that was made in the registration statement or prospectus that was part of the registration statement or made in any such document immediately prior to such date of first use;
- (e) that for the purpose of determining liability of the Registrant under the Securities Act to any purchaser in the initial distribution of securities: The undersigned Registrant undertakes that in a primary offering of securities of the undersigned Registrant pursuant to this registration statement, regardless of the underwriting method used to sell the securities to the purchaser, if the securities are offered or sold to such purchaser by means of any of the following communications, the undersigned Registrant will be a seller to the purchaser and will be considered to offer or sell such securities to the purchaser:
  - (i) any preliminary prospectus or prospectus of the undersigned Registrant relating to the offering required to be filed pursuant to Rule 497 under the Securities Act;
  - (ii) the portion of any advertisement pursuant to Rule 482 under the Securities Act relating to the offering containing material information about the undersigned Registrant or its securities provided by or on behalf of the undersigned Registrant; and
  - (iii) any other communication that is an offer in the offering made by the undersigned Registrant to the purchaser;
- (f) to file a post-effective amendment to the registration statement, and to suspend any offers or sales pursuant the registration statement until such post-effective amendment has been declared effective under the Securities Act, in the event the shares of the Registrant are trading below its net asset value and either (i) the Registrant receives, or has been advised by its independent registered accounting firm that it will receive, an audit report reflecting substantial doubt regarding the Registrant's ability to continue as a going concern or (ii) the Registrant has concluded that a material adverse change has occurred in its financial position or results of operations that has caused the financial statements and other disclosures on the basis of which the offering would be made to be materially misleading;
- (g) to file a post-effective amendment to the registration statement in respect of any one or more offerings of the Registrant's shares (including warrants and/or rights to purchase the shares) below net asset value that will result in greater than 15%

dilution, in the aggregate, to existing net asset value per share;

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(h) to file a post-effective amendment to the registration statement in connection with any rights offering and

(i) to file a post-effective amendment to the registration statement in connection with any combined offering of securities.

3. We hereby undertake that:

(a) for the purpose of determining any liability under the Securities Act, the information omitted from the form of prospectus filed as part of this registration statement in reliance upon Rule 430A and contained in a form of prospectus filed by us under Rule 497(h) under the Securities Act shall be deemed to be part of this registration statement as of the time it was declared effective; and

(b) for the purpose of determining any liability under the Securities Act, each post-effective amendment that contains a form of prospectus shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of the securities at that time shall be deemed to be the initial bona fide offering thereof.

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**SIGNATURES**

Pursuant to the requirements of the Securities Act of 1933, as amended, and the Investment Company Act of 1940, as amended, the Registrant has duly caused this Post-Effective Amendment No. 7 to the Registration Statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of McLean and Commonwealth of Virginia, on the 1<sup>st</sup> day of June 2012.

GLADSTONE CAPITAL CORPORATION

By: /s/ DAVID GLADSTONE  
David Gladstone  
*Chairman of the Board and Chief Executive Officer*

Pursuant to the requirements of the Securities Act of 1933, as amended, this Post-Effective Amendment No. 7 to the Registration Statement has been signed below by the following persons in the capacities indicated on June 1, 2012:

By: /s/ DAVID GLADSTONE  
David Gladstone  
*Chief Executive Officer and Chairman of the Board  
of Directors (principal executive officer)*

By: /s/ DAVID WATSON  
David Watson  
*Chief Financial Officer and Treasurer (principal  
financial and accounting officer)*

By: \*  
Terry L. Brubaker  
*Vice Chairman, Chief Operating Officer, Secretary  
and Director*

By: \*  
George Stelljes III  
*President, Chief Investment Officer and Director*

By: \*  
David A. R. Dullum  
*Director*

By: \*  
Anthony W. Parker  
*Director*

By: \*  
Michela A. English  
*Director*

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By: \*  
Paul W. Adelgren  
*Director*

By: \*  
John H. Outland  
*Director*

By: \*  
Jack Reilly  
*Director*

\*By: /s/ DAVID GLADSTONE  
David Gladstone  
*(attorney-in-fact)*

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**Table of Contents****Exhibits**

| <b>Exhibit</b> | <b>Description</b>  |
|----------------|---|
| <b>Number</b>  | <b>Description</b>  |
| 2.a.1          | Articles of Amendment and Restatement of the Articles of Incorporation, incorporated by reference to Exhibit a.2 to Pre-Effective Amendment No. 1 to the Registration Statement on Form N-2 (File No. 333-63700), filed July 27, 2001.  |
| 2.a.2          | Articles Supplementary Establishing and Fixing the Rights and Preferences of the Term Preferred Shares, including Appendix A thereto relating to the Term Preferred Shares, 7.125% Series 2016 (previously filed on October 31, 2011 with Post-Effective Amendment No. 5 to this Registration Statement).                                 |
| 2.b.1          | By-laws, incorporated by reference to Exhibit b to Pre-Effective Amendment No. 1 to the Registration Statement on Form N-2 (File No. 333-63700), filed July 27, 2001.   |
| 2.b.2          | Amendment to Bylaws, incorporated by reference to Exhibit 3.3 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended December 31, 2003 (File No. 814-00237), filed February 17, 2004.  |
| 2.b.3          | Second Amendment to Bylaws, incorporated by reference to Exhibit 99.1 to the Registrant's Current Report on Form 8-K (File No. 814-00237), filed July 10, 2007.   |
| 2.b.4          | Third Amendment to Bylaws, incorporated by reference to Exhibit 99.1 to the Registrant's Current Report on Form 8-K (File No. 814-00237), filed June 10, 2011.  |
| 2.c            | Not applicable.   |
| 2.d.1          | Form of Direct Registration Transaction Advice for the Registrant's common stock, par value \$0.001 per share, incorporated by reference to Exhibit d to Pre-Effective Amendment No. 1 to the Registration Statement on Form N-2 (File No. 333-63700), filed July 27, 2001.   |
| 2.d.2          | Specimen Stock Certificate, incorporated by reference to Exhibit d.2 to Pre-Effective Amendment No. 3 to the Registration Statement on Form N-2 (File No. 333-63700), filed August 23, 2001.  |
| 2.d.3          | Form of Senior Indenture (previously filed on October 20, 2009 with this Registration Statement).   |
| 2.d.4          | Form of Subordinated Indenture (previously filed on October 20, 2009 with this Registration Statement).   |
| 2.d.5          | Specimen 7.125% Series 2016 Term Preferred stock certificate (previously filed on October 31, 2011 with Post-Effective Amendment No. 5 to this Registration Statement).   |
| 2.e            | Dividend Reinvestment Plan, incorporated by reference to Exhibit 2.e to Pre-Effective Amendment No. 1 to the Registration Statement on Form N-2 (File No. 333-63700), filed July 27, 2001.  |
| 2.f            | Not applicable.   |
| 2.g.1          | Amended and Restated Investment Advisory and Management Agreement between Gladstone Capital Corporation and Gladstone Management Corporation, dated as of October 1, 2006 incorporated by reference to Exhibit 99.1 to the Registrant's Current Report on Form 8-K (File No. 814-00237), filed October 5, 2006 (renewed on July 7, 2010). |
| 2.h.1          | Equity Distribution Agreement, dated as of May 17, 2010, by and among Gladstone Capital Corporation, Gladstone Management Corporation and BB&T Capital Markets, a division of Scott & Stringfellow, LLC (previously filed on May 17, 2010 with Post-Effective Amendment No. 1 to this Registration Statement).                            |
| 2.i            | Not applicable.   |
| 2.j            | Custodian Agreement between Gladstone Capital Corporation and The Bank of New York, dated as of May 5, 2006, incorporated by reference to Exhibit 10.3 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 (File No. 814-00237), filed August 1, 2006.  |



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- 2.k.1 Promissory Note of David Gladstone in favor of the Company, dated August 23, 2001, incorporated by reference to Exhibit 10.4 to the Registrant's Quarterly Report on Form 10-Q for the period ended June 30, 2001, filed October 4, 2001.
- 2.k.2 Redemption Agreement, dated as of September 7, 2010, between Gladstone Capital Corporation and David Gladstone, incorporated by reference to Exhibit 10.10 to the Registrant's Annual Report on Form 10-K (File No. 814-00237), filed November 22, 2010.
- 2.k.3 Third Amended and Restated Credit Agreement dated as of May 15, 2009 by and among Gladstone Business Loan, LLC as Borrower, Gladstone Management Corporation as Servicer, the Committed Lenders named therein, the CP Lenders named therein, the Managing Agents named therein, and Key Equipment Finance Inc. as Administrative Agent, incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K (File No. 814-00237), filed May 19, 2009.
- 2.k.4 Administration Agreement between Gladstone Capital Corporation and Gladstone Administration, LLC, dated as of October 1, 2006 incorporated by reference to Exhibit 99.1 to the Registrant's Current Report on Form 8-K (File No. 814-00237), filed October 5, 2006 (renewed on July 7, 2010).
- 2.k.5 Fourth Amended and Restated Credit Agreement dated as of March 15, 2010 by and among Gladstone Business Loan, LLC as Borrower, Gladstone Management Corporation as Servicer, the Lenders named therein, the Managing Agents named therein, and Key Equipment Finance Inc. as Administrative Agent, incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K (File No. 814-00237), filed March 16, 2010.
- 2.k.6 Amendment No. 1 to Fourth Amended and Restated Credit Agreement dated as of November 22, 2010 by and among Gladstone Business Loan, LLC as Borrower, Gladstone Management Corporation as Servicer, the Committed Lenders named therein, the Managing Agents named therein, and Key Equipment Finance Inc. as Administrative Agent, incorporated by reference to Exhibit 10.8 to the Registrant's Annual Report on Form 10-K (File No. 814-00237), filed November 22, 2010.
- 2.l Opinion of Cooley Godward Kronish LLP (previously filed on October 20, 2009 with this Registration Statement).
- 2.m Not applicable.
- 2.n.1 Consent of Independent Registered Public Accounting Firm.
- 2.n.2 Consent of Cooley Godward Kronish LLP (included in Exhibit 2.1) (previously filed on October 20, 2009 with this Registration Statement).
- 2.n.3 Report of Independent Registered Public Accounting Firm on Financial Statement Schedule (previously filed on March 6, 2012 with Post-Effective Amendment No. 6 to this Registration Statement).
- 2.o Not applicable.
- 2.p Subscription Agreement dated May 30, 2001, incorporated by reference to incorporated by reference to Exhibit p to the Registration Statement on Form N-2 (File No. 333-63700), filed June 22, 2001.
- 2.q Not applicable.
- 2.r Code of Ethics and Business Conduct, incorporated by reference to Exhibit 14.1 to the Registrant's Current Report on Form 8-K (File No. 814-00237), filed October 12, 2005.
- 2.s.1 Power of Attorney (included in the signature page of the original filing of this Registration Statement, filed on October 20, 2009).
- 2.s.2 Power of Attorney (previously filed on April 7, 2011 with Post-Effective Amendment No. 2 to this Registration Statement).