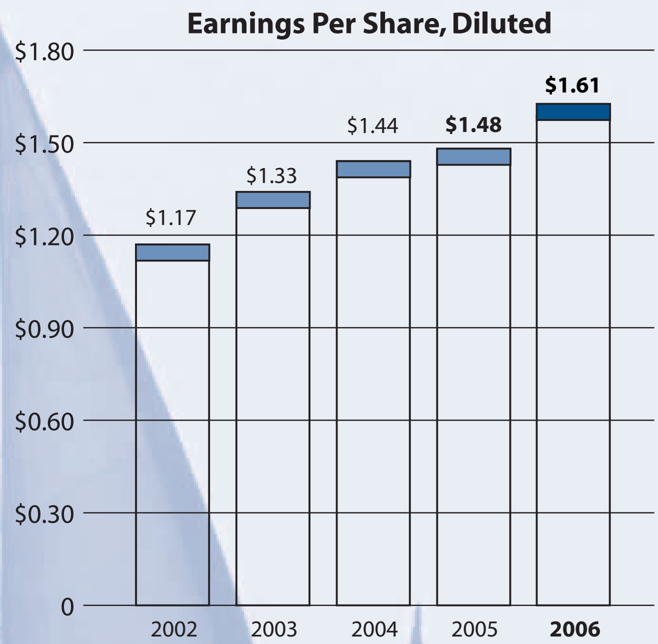
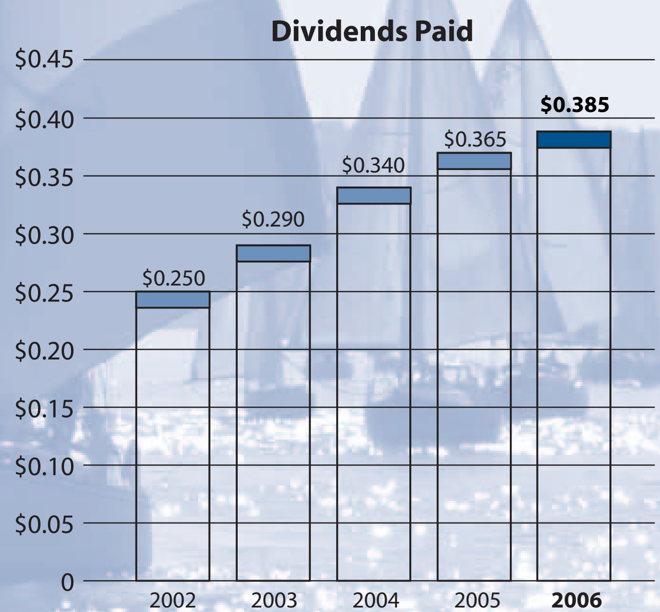
CHESAPEAKE
FINANCIAL SHARES INC.

2006 ANNUAL REPORT

CONTENTS

Chairmans' Letter to Shareholders	1
Select Financial Information	2
Consolidated Financial Statements	
Consolidated balance sheets	3
Consolidated statements of income	4 – 5
Consolidated statements of cash flows	6 – 7
Consolidated statements of changes in shareholders' equity	8 – 9
Notes to consolidated financial statements	10 – 30
Independent Auditor's Report on the Financial Statements	31
Management's Discussion & Analysis of Financial Condition and Results of Operations	32 – 35
Directors and Officers	36





Front Cover: The Turkey Day Regatta held on the Rapphanock River.

DEAR SHAREHOLDER

The year ended on a very sad note as the late **President Gerald R. Ford** was honored in Washington, D.C. as his body lay in state in the Capitol Rotunda. President Ford was the only President of the United States not elected by the people. President Ford's highest ambition, and never realized in an era of Democrat control of Congress, was to become the House Speaker.

In the fall national elections, based on waning popular support for the war in Iraq, the Democrats regained control of both the U.S. Senate and the House of Representatives. As Republican incumbent George Allen was unable to shake the "Macaca" verbal misstep, Democrat "fighting" Jim Webb won by 9,329 votes out of nearly 2.4 million cast. The new senator refused to shake the hand of President Bush at a reception subsequent to the election. Prime Minister Nouri al-Maliki and the new Iraqi government got off to a rough start in a bitterly divided country between the Shiite Muslims, the Arab Sunni Muslims and the Kurds. In addition, Saddam Hussein under Iraqi law was tried, convicted, and on the next to last day of the year hung for "committing crimes against humanity."

As an at-large selection to the NCAA Basketball Tournament, Virginia's George Mason University pranced through the "road to the final four" by defeating Michigan State, North Carolina, Wichita State and Connecticut. Go Patriots!! Locally, *Golf Digest* named the new King Carter Golf Course at Hills Quarter "the Best New Golf Course in the country with green's fees under $75."

As always, it is difficult to look back and know that we will not see many of the people whose names have become household staples. 2006 was no exception as we lost Milton Friedman, advisor to President Reagan, author of *Free to Choose* and viewed by many as the greatest economist of the 20th century, debunking Keynes' theory of a stronger economy by bigger government and more spending; Coretta Scott King, the wife of Martin Luther King, Jr.; Casper Weinberger, Secretary of Defense under President Reagan; Joe Rosenthal, Iwo Jima photographer; the great Hall of Fame golfer Byron Nelson; comedian and star on the Mayberry television series, Don Knotts; along with favorites Dennis Weaver, June Allyson and Red Buttons, and finally music legend James Brown.

On the economic side prices during the year for gas were extremely volatile. Beginning the year around $2.10 per gallon and topping out at $3.04 in August, prices retreated to $2.13 in October. The housing market took a breath this year by slowing from a frantic pace of previous years. Our markets saw a slowdown in sales; however, the market remained fairly steady. Nationally, the slower housing market created a drag on the overall economy as reported by the Federal Reserve in December. Though optimism wavered major investor indexes closed with double-digit gains: The Dow at 12,463.15, up 16.29%; NASDAQ at 2,415.29, up 9.52%; S & P 500 at 1,418.30, up 13.62%; NYSE at 9,139.02, up 17.86; and Richmond Index at 414.51, up 27.62%.

Interest margins continued to be very thin. All commercial banks in our marketplace had difficulty attracting deposits as credit unions continued to expand into the general marketplace opening three large offices at New Town in Williamsburg and three new offices in Gloucester. Because **credit unions pay no taxes** and have no equity investors they are able to offer higher than market rates on deposits and lower than market rates on loans.

In spite of the challenges Chesapeake had a banner year earning a record $3,950,544 or $1.61 per diluted share, up 8.78%; total assets of $418,091,000, up 9.25%; loans of $301,544,000, up 7.08%, and Chesapeake Investment Group assets under management up over 25%. During the year the main banking office in Kilmarnock received a slight facelift with new furniture, carpets, wall coverings and several new working spaces. In addition, due to weather delays completion of the Williamsburg support office on Lafayette Street moved to the first quarter of 2007. The building will provide much needed space for commercial lending officers and staff along with office and sales space for Chesapeake's rapidly growing Merchant Card Services.

We continue to appreciate the support that you, our shareholders, give us. Please review the contents of this report and don't hesitate to call us should you have any questions. We also hope that you can join us for our Annual Shareholder's meeting at 4:00 p.m. on Friday, April 6, 2007, at Rappahannock Westminster-Canterbury in Irvington.

Sincerely,

Douglas D. Monroe, Jr.
Chairman and CEO
Chesapeake Financial Shares, Inc.

Jeffrey M. Szyperski
President, Chesapeake Financial Shares, Inc.,
Chesapeake Bank and Chesapeake Investment Group

SELECTED FINANCIAL INFORMATION

	2006	2005	2004	2003	2002
	(Dollars in thousands except ratios and per share amounts)				
Results of Operations					
Interest income	$ 24,630	$ 20,634	$ 17,629	$ 16,340	$ 15,802
Interest expense	10,365	6,414	4,332	4,668	5,358
Net interest income	14,265	14,220	13,297	11,672	10,444
Provision for loan losses	833	990	1,095	810	1,018
Net interest income after provision for loan losses	13,432	13,230	12,202	10,862	9,426
Noninterest income	11,613	9,866	8,030	7,815	7,110
Noninterest expenses	19,643	18,168	15,478	14,359	12,429
Income before tax	5,402	4,927	4,754	4,318	4,107
Income tax expense	1,451	1,254	1,206	1,034	1,060
Net income	$ 3,951	$ 3,673	$ 3,548	$ 3,284	$ 3,047
Financial Condition					
Total assets	$ 418,091	$ 382,694	$ 363,548	$ 332,424	$ 293,125
Total deposits	358,777	328,535	309,367	289,892	255,672
Net loans	297,202	277,401	261,231	214,951	193,267
Long term debt	11,346	6,445	6,541	1,632	1,720
Trust preferred capital notes	10,310	10,310	10,310	10,310	10,310
Shareholders' equity	30,963	28,570	26,766	24,210	24,091
Average assets	403,833	376,126	346,568	313,106	269,108
Average shareholders' equity	29,090	26,829	23,977	21,833	21,441
Key Financial Ratios					
Return on average assets	0.98%	0.98%	1.02%	1.05%	1.13%.
Return on average equity	13.58%	13.69%	14.80%	15.04%	14.21%
Dividends paid as a percent of net income	23.50%	24.0%	23.0%	20.6%	20.6%
Per Share Data					
Net income, assuming dilution	$ 1.61	$ 1.48	$ 1.44	$ 1.34	$ 1.17
Cash dividends declared	$ 0.385	$ 0.365	$ 0.340	$ 0.290	$ 0.250
Book value	$ 12.97	$ 11.86	$ 11.09	$ 10.16	$ 9.35

**Return on average equity is calculated by dividing net income by average equity for the period excluding accumulated other comprehensive income or loss.*

CONSOLIDATED BALANCE SHEETS

	December 31, 2006 and 2005 2006	2005
Assets		
Cash and due from banks	$ 9,982,958	$ 10,449,268
Securities available for sale, at approximate fair value	66,385,169	53,382,593
Loans, net of allowance for loan losses of $4,342,174 in 2006 and $4,199,745 in 2005	297,201,809	277,401,198
Premises and equipment, net	13,834,788	13,444,092
Accrued interest receivable	1,675,967	1,550,189
Cash management accounts, net	17,249,332	17,708,720
Other assets	11,760,486	8,758,152
Total assets	$ 418,090,509	$ 382,694,212
Liabilities and Shareholders' Equity		
Deposits:		
Demand accounts	$ 66,242,122	$ 67,808,476
Savings and interest bearing demand deposits	137,698,648	124,843,854
Certificates of deposit		
Denominations less than $100,000	91,205,351	86,492,326
Denominations of $100,000 or more	63,631,307	49,390,387
Total deposits	$ 358,777,428	$ 328,535,043
Federal funds purchased	5,001,000	—
Federal Home Loan Bank advances	—	7,000,000
Trust preferred capital notes	10,310,000	10,310,000
Long-term debt	11,345,950	6,445,187
Accrued interest payable	739,232	467,037
Accrued expenses and other liabilities	953,671	1,366,764
Commitments and contingencies	—	—
Total liabilities	$ 387,127,281	$ 354,124,031
Shareholders' equity:		
Preferred stock, par value $1 per share; authorized 50,000 shares; no shares outstanding	$ —	$ —
Common stock, voting, par value $5 per share; authorized 4,800,000 shares; issued and outstanding 2,386,918 in 2006 and 2,408,788 in 2005	11,934,590	12,043,940
Common stock, nonvoting, par value $5 per share; authorized 635,000 shares; no shares outstanding	—	—
Additional paid-in capital	132,151	155,230
Retained earnings	18,275,774	15,636,280
Accumulated other comprehensive income	620,713	734,731
Total shareholders' equity	$ 30,963,228	$ 28,570,181
Total liabilities and shareholders' equity	$ 418,090,509	$ 382,694,212

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31, 2006, 2005 and 2004		
	2006	**2005**	**2004**
Interest Income			
Interest and fees on loans	$ 21,483,909	$ 18,265,073	$ 15,278,375
Interest on federal funds sold	88,340	70,754	12,477
Interest and dividends on securities available for sale:			
Taxable	1,839,746	1,086,965	1,197,367
Nontaxable	1,124,910	1,144,372	1,102,291
Dividends	93,360	66,907	38,836
Total interest and dividend income	$ 24,630,265	$ 20,634,071	$ 17,629,346
Interest Expense			
Savings and interest bearing accounts	$ 2,671,857	$ 1,336,473	$ 775,935
Certificates of deposit			
Denominations less than $100,000	3,645,667	2,466,332	1,762,491
Denominations of $100,000 or more	2,501,850	1,464,482	896,891
Short-term borrowings and FHLB advances	610,042	403,055	340,364
Long-term debt and trust preferred capital notes	936,061	744,090	556,188
Total interest expense	$ 10,365,477	$ 6,414,432	$ 4,331,869
Net interest income	$ 14,264,788	$ 14,219,639	$ 13,297,477
Provision for loan losses	833,333	990,000	1,095,004
Net interest income after provision for loan losses	$ 13,431,455	$ 13,229,639	$ 12,202,473
Noninterest Income			
Trust income	$ 1,604,664	$ 1,312,738	$ 1,307,228
Service charges	1,428,549	1,057,752	992,230
Net gain (loss) on other real estate owned	24,113	—	(144,000)
Net gain on sales of securities available for sale	69,513	111,220	315,189
Net gain on sales of premises and equipment	483,877	—	—
Other income	8,002,680	7,384,008	5,558,897
Total noninterest income	$ 11,613,396	$ 9,865,718	$ 8,029,544

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31, 2006, 2005 and 2004		
	2006	**2005**	**2004**
Noninterest Expenses			
Salaries and benefits	$ 9,967,763	$ 8,917,144	$ 7,666,352
Occupancy expenses	2,768,398	2,624,087	2,156,744
Other expenses	6,906,846	6,627,215	5,654,705
Total noninterest expenses	$ 19,643,007	$ 18,168,446	$ 15,477,801
Income before income taxes	$ 5,401,844	$ 4,926,911	$ 4,754,216
Income tax expense	1,451,300	1,254,397	1,205,892
Net income	$ 3,950,544	$ 3,672,514	$ 3,548,324
Earnings per share, basic	$ 1.64	$ 1.52	$ 1.48
Earnings per share, diluted	$ 1.61	$ 1.48	$ 1.44

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31, 2006, 2005 and 2004 2006	2005	2004
Cash Flows from Operating Activities			
Net income	$ 3,950,544	$ 3,672,514	$ 3,548,324
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	1,208,958	1,094,947	999,334
Provision for loan losses	833,333	990,000	1,095,004
Provision for cash management account losses	200,000	300,000	60,000
Deferred income tax (benefit)	(39,862)	(533,252)	(323,540)
(Accretion) amortization of discounts and premiums, net	(160,215)	352,555	1,297,987
Net (gain) on securities available for sale	(69,513)	(111,220)	(315,189)
Net (gain) loss on other real estate owned	(24,113)	—	144,000
Net (gain) on sales of premises and equipment	(483,877)	—	—
Stock-based compensation	118,000	—	—
Origination of loans available for sale	(17,889,872)	(25,288,899)	(21,432,720)
Proceeds from sale of loans available for sale	17,889,872	25,288,899	22,643,420
Issuance of common stock for services	308,458	176,630	94,706
Changes in other assets and liabilities:			
(Increase) decrease in accrued interest receivable	(125,778)	(112,196)	3,502
(Increase) in other assets	(703,723)	(676,212)	(147,152)
Increase in accrued interest payable	486,634	150,533	20,750
Increase (decrease) in other liabilities	(627,532)	121,823	(148,706)
Net cash provided by operating activities	$ 4,871,314	$ 5,426,122	$ 7,539,720
Cash Flows from Investing Activities			
Purchases of securities available for sale	$ (45,140,421)	$ (22,581,954)	$ (9,680,112)
Proceeds from sales and calls of securities available for sale	18,264,479	3,228,649	2,948,055
Proceeds from maturities of securities available for sale	13,930,339	21,275,225	22,425,392
Proceeds from sale of other real estate	636,113	63,500	40,500
Net (increase) in loans	(23,445,956)	(17,159,935)	(48,585,477)
Net decrease (increase) in cash management accounts	259,388	(1,157,523)	(5,392,095)
Proceeds from sale of premises and equipment	645,305	—	—
Other capital expenditures	(1,761,082)	(5,265,819)	(2,063,780)
Net cash (used in) investing activities	$ (36,611,835)	$ (21,597,857)	$ (40,307,517)

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31, 2006, 2005 and 2004		
	2006	**2005**	**2004**
Cash Flows from Financing Activities			
Net increase (decrease) in short-term borrowings and federal funds purchased	$ (1,999,000)	$ (2,003,000)	$ 4,003,000
Net increase (decrease) in demand accounts, interest-bearing demand accounts and savings accounts	11,288,440	(5,301,807)	22,629,146
Net increase (decrease) in certificates of deposits	18,953,945	24,470,152	(3,154,741)
Net proceeds from issuance of common stock	222,325	311,125	172,650
Repurchase of common stock	(1,164,312)	(995,909)	(12,232)
Cash dividends	(927,950)	(882,654)	(817,387)
Proceeds from issuance of long-term debt	5,000,000	—	5,000,000
Curtailment of long-term debt	(99,237)	(95,370)	(91,669)
Net cash provided by financing activities	$ 31,274,211	$ 15,502,537	$ 27,728,767
Net decrease in cash and cash equivalents	$ (466,310)	$ (669,198)	$ (5,039,030)
Cash and cash equivalents at beginning of year	10,449,268	11,118,466	16,157,496
Cash and cash equivalents at end of year	$ 9,982,958	$ 10,449,268	$ 11,118,466
Supplemental Disclosures of Cash Flow Information			
Cash paid during the year for:			
Interest	$ 10,093,282	$ 6,263,899	$ 4,311,119
Income taxes	$ 1,624,000	$ 1,793,277	$ 1,303,500
Supplemental Schedule of Noncash Investing and Financing Activities			
Unrealized (loss) on securities available for sale	$ (172,754)	$ (723,245)	$ (652,220)
Other real estate acquired in settlement of loans	$ 2,812,012	$ —	$ —

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDER'S EQUITY

Years Ended December 31, 2006, 2005 and 2004

	Common Stock, Voting	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Comprehensive Income	Total
Balance, December 31, 2003	$ 5,961,105	$ 84,943	$16,521,635	$ 1,642,538		$24,210,221
Comprehensive income:						
Net income	—	—	3,548,324	—	$ 3,548,324	3,548,324
Other comprehensive loss:						
Unrealized holding losses on securities available for sale, net of deferred income taxes of $114,591	—	—	—	—	(222,440)	—
Reclassification adjustment, net of income taxes of $107,164	—	—	—	—	(208,025)	—
Other comprehensive loss, net of tax	—	—	—	(430,465)	$ (430,465)	(430,465)
Total comprehensive income	—	—	—	—	$ 3,117,859	—
Exercise of stock options	61,000	111,650	—	—		172,650
Issuance of common stock for services	16,615	78,091	—	—		94,706
Repurchase of common stock	(1,630)	(10,602)	—	—		(12,232)
Cash dividends ($0.34 per share)	—	—	(817,387)	—		(817,387)
Balance, December 31, 2004	$ 6,037,090	$ 264,082	$19,252,572	$ 1,212,073		$26,765,817
Comprehensive income:						
Net income	—	—	3,672,514	—	$3,672,514	3,672,514
Other comprehensive loss:						
Unrealized holding losses on securities available for sale, net of deferred income taxes of $208,088	—	—	—	—	(403,937)	—
Reclassification adjustment, net of income taxes of $37,815	—	—	—	—	(73,405)	—
Other comprehensive loss, net of tax	—	—	—	(477,342)	$ (477,342)	(477,342)
Total comprehensive income	—	—	—	—	$ 3,195,172	—
Exercise of stock options	95,100	216,025	—	—		311,125
Issuance of common stock for services	31,900	144,730	—	—		176,630
Repurchase of common stock	(127,420)	(469,607)	(398,882)	—		(995,909)
Effect of stock split	6,007,270	—	(6,007,270)	—		—
Cash dividends ($0.365 per share)	—	—	(882,654)	—		(882,654)
Balance, December 31, 2005 (forwarded)	$12,043,940	$ 155,230	$15,636,280	$ 734,731		$28,570,181

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDER'S EQUITY

Years Ended December 31, 2006, 2005 and 2004

	Common Stock, Voting	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Comprehensive Income	Total
Balance, December 31, 2005						
(brought forward)	$12,043,940	$ 155,230	$15,636,280	$ 734,731		$28,570,181
Comprehensive income:						
Net income	—	—	3,950,544	—	$3,950,544	3,950,544
Other comprehensive loss:						
Unrealized holding losses on securities available for sale, net of deferred income taxes of $35,102	—	—	—	—	(68,139)	—
Reclassification adjustment, net of income taxes of $ 23,634	—	—	—	—	(45,879)	—
Other comprehensive loss, net of tax	—	—	—	(114,018)	(114,018)	(114,018)
Total comprehensive income	—	—	—	—	$ 3,836,526	—
Exercise of stock options	115,000	107,325	—	—		222,325
Issuance of common stock for services	80,040	228,418	—	—		308,458
Repurchase of common stock	(304,390)	(476,822)	(383,100)	—		(1,164,312)
Stock-based compensation	—	118,000	—	—		118,000
Cash dividends ($0.385 per share)	—	—	(927,950)	—		(927,950)
Balance, December 31, 2006	$11,934,590	$ 132,151	$18,275,774	$ 620,713		$30,963,228

The accompanying notes are an integral part of these consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies

General

Chesapeake Financial Shares, Inc. ("CFS") owns 100% of Chesapeake Bank (the "Bank"), Chesapeake Investment Group, Inc. ("CIG") and CFS Capital Trust I (the "Trust"). Three additional companies, Chesapeake Financial Group, Inc., Chesapeake Insurance Agency, Inc. T/A Chesapeake Investment Services and Chesapeake Trust Company (the "Trust Company") are wholly-owned subsidiaries of CIG. The consolidated financial statements include the accounts of CFS and its wholly-owned subsidiaries. All significant intercompany accounts have been eliminated. FASB Interpretation No. 46R requires that CFS no longer eliminate through consolidation the equity investments in the Trust which approximated $310,000 at December 31, 2006 and 2005. The subordinate debt of the Trust is reflected as a liability of CFS.

The accounting and reporting policies of CFS are in accordance with accounting principles generally accepted in the United States of America and conform to general practices within the banking industry. The more significant of these policies are summarized below.

Stock Split

On October 21, 2005, the Board of Directors of CFS approved a 2-for-1 stock split of CFS's common stock. All per share information for all periods presented has been retroactively restated to reflect the stock split.

Securities

Debt securities that management has the positive intent and ability to hold to maturity are classified as "held to maturity" and recorded at amortized cost. Securities not classified as held to maturity or trading, including equity securities with readily determinable fair values, are classified as "available for sale" and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. CFS classifies all securities as available for sale.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms 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 CFS to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Loans

CFS grants mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio is represented by mortgage loans throughout the Northern Neck, Middle Peninsula, Williamsburg, and James City County areas of Virginia. The ability of CFS's debtors to honor their contracts is dependent upon the real estate and general economic conditions in these areas.

Loans are stated at face value, net of unearned discount and the allowance for loan losses. Interest is computed by methods which result in level rates of return on principal. Nonrefundable loan fees and direct loan origination costs are recognized in operations when received and incurred. The impact of this methodology is not significantly different from recognizing the net of the fees and costs over the contractual life of the related loan.

Loans are placed on nonaccrual status when a loan is specifically determined to be impaired or when principal or interest is delinquent for 90 days or more. Any unpaid interest previously accrued on those loans is reversed from income. Interest income generally is not recognized on specific impaired loans unless the likelihood of further loss is remote. Interest payments received on such loans are applied as a reduction of the loan principal balance. Interest income on other nonaccrual loans is recognized only to the extent of interest payments received.

Mortgage loans held for resale are stated at the lower of cost or market on an individual loan basis. Loan discounts and origination fees received on loans held for resale are deferred until the related loans are sold to third party investors. Gains are recognized at the time of sale.

A loan is considered impaired when, based on current information and events, it is probable that CFS will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, CFS does not separately identify individual consumer and residential loans for impairment disclosures.

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 evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as either 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. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed using both straight-line and accelerated methods over the assets' estimated useful lives. Estimated useful lives range from 10 to 39 years for buildings and 3 to 7 years for furniture, fixtures and equipment.

Foreclosed Properties

Foreclosed properties are recorded at the lower of the outstanding loan balance at the time of foreclosure or the estimated fair value less estimated costs to sell. At foreclosure, any excess of loan balance over the fair value of the property is charged to the allowance for loan losses. Such carrying value is periodically reevaluated and written down if there is an indicated decline in fair value. Costs to bring a property to salable condition are capitalized up to the fair value of the property, while costs to maintain a property in salable condition are expensed as incurred. CFS included $2,720,016 and $520,000 of foreclosed properties in other assets at December 31, 2006 and 2005, respectively.

Trust Company Assets

Securities and other property held by the Trust Company in a fiduciary or agency capacity are not assets of CFS and are not included in the accompanying consolidated financial statements.

Income Taxes

Deferred taxes are provided on a liability method whereby deferred tax assets are recognized for deductible temporary differences, operating loss carryforwards, and tax credit carryforwards. 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 of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

Consolidated Statements of Cash Flows

For purposes of the statement of cash flows, CFS considers cash equivalents to include cash on hand, amounts due from banks and federal funds sold.

Advertising Costs

CFS follows the policy of charging the production costs of advertising to expense as incurred.

Use of Estimates

In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. 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 valuation of deferred tax assets.

Earnings Per Share

Basic earnings per share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflects additional 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 CFS relate solely to outstanding stock options and are determined using the treasury stock method. All amounts have been retroactively restated to reflect the 2-for-1 stock split in 2005.

Defined Benefit Plan

CFS had a noncontributory, defined benefit pension plan for all full-time employees over 18 years of age. Benefits were based upon years of service and the employees' compensation. CFS funded pension costs in accordance with the funding provisions of the Employee Retirement Income Security Act. Refer to Note 7 for a description of the freezing of CFS's defined benefit plan and termination in 2006.

Cash Flow Accounts

CFS purchases trade accounts receivable from customers. These receivables are stated at face value net of discounts and an allowance for losses. CFS retains reserves against these customer balances in the form of deposit accounts to cover unpaid receivables, returns, allowances and other adjustments.

Stock-Based Compensation

At December 31, 2006, CFS had two stock-based employee compensation plans, which are described more fully in Note 8. Beginning January 1, 2006, CFS adopted SFAS No. 123 (revised 2004), "Share-Based Payment" and began to recognize the cost of stock-based payments to employees based on the fair value of those awards at the date of grant. Stock-based compensation is estimated at the date of grant using the Black-Scholes option valuation model for determining fair value. Prior to January 1, 2006, CFS accounted for those plans under the recognition and measurement principles of APB Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations. No stock-based employee compensation cost is reflected in net income for the years ended December 31, 2005 and 2004, as all options granted under those plans had an exercise price at least equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share if CFS had applied fair value recognition provisions to stock-based employee compensation. All per share information for all periods presented has been retroactively restated to reflect the 2-for-1 stock split in 2005.

		Years Ended December 31,	
		2005	**2004**
Net income	As reported	$ 3,672,514	$ 3,548,324
	Pro forma	3,551,136	3,445,928
Earnings per share -	As reported	1.52	1.48
basic	Pro forma	1.47	1.43
Earnings per share -	As reported	1.48	1.44
diluted	Pro forma	1.43	1.40

Recent Accounting Pronouncements

In February 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 155, "Accounting for Certain Hybrid Financial Instruments – an amendment of FASB Statements No. 133 and 140" (SFAS 155). SFAS 155 permits fair value measurement of any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. The Statement also clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133. It establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. SFAS 155 also clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives. SFAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. CFS does not expect the implementation of SFAS 155 to have a material impact on its consolidated financial statements.

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156, "Accounting for Servicing of Financial Assets – an amendment of FASB Statement No. 140" (SFAS 156). SFAS 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into certain servicing contracts. The Statement also requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable. SFAS 156 permits an entity to choose between the amortization and fair value methods for subsequent measurements. At initial adoption, the Statement permits a one-time reclassification of available for sale securities to trading securities by entities with recognized servicing rights. SFAS 156 also requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities. This Statement is effective as of the beginning of an entity's first fiscal year that begins after September 15, 2006. CFS does not expect the implementation of SFAS 156 to have a material impact on its consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements but may change current practice for some entities. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those years. CFS does not expect the implementation of SFAS 157 to have a material impact on its consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, "Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106, and 132(R)" (SFAS 158). SFAS 158 requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. CFS terminated its defined benefit plan during 2006; therefore, the standard will not have a future impact on CFS's consolidated financial statements.

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes: An Interpretation of FASB Statement No. 109" (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with SFAS 109. The Interpretation prescribes a recognition threshold and measurement principles for the financial statement recognition and measurement of tax positions taken or expected to be taken on a tax return that are not certain to be realized. FIN 48 is effective for fiscal years beginning after December 15, 2006. CFS does not expect the implementation of FIN 48 to have a material impact on its consolidated financial statements.

In September 2006, the Emerging Issues Task Force issued EITF 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements." This consensus concludes that for a split-dollar life insurance arrangement within the scope of this Issue, an employer should recognize a liability for future benefits in accordance with FASB Statement No. 106 (if, in substance, a postretirement benefit plan exits) or APB Opinion No. 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee. The consensus is effective for fiscal years beginning after December 15, 2007. CFS is currently evaluating the effect that EITF No. 06-4 will have on its consolidated financial statements when implemented.

In September 2006, The Emerging Issues Task Force issued EITF 06-5, "Accounting for Purchases of Life Insurance- Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4 ." This consensus concludes that a policyholder should consider any additional amounts included in the contractual terms of the insurance policy other than the cash surrender value in determining the amount that could be realized under the insurance contract. A consensus also was reached that a policyholder should determine the amount that could be realized under the life insurance contract assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy). The consensuses are effective for fiscal years beginning after December 15, 2006. CFS is currently evaluating the effect that EITF No. 06-5 will have on its consolidated financial statements when implemented.

Note 2. Securities

Amortized cost and fair values of securities available for sale as of December 31, 2006 and 2005, are as follows:

2006	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities of state and political subdivisions	$ 18,121,593	$ 1,050,173	$ (4,295)	$ 19,167,471
Mortgage-backed securities	45,807,802	130,125	(235,529)	45,702,398
Preferred stock	50,000	—	—	50,000
Restricted stock	1,465,300	—	—	1,465,300
Total	$ 65,444,695	$ 1,180,298	$ (239,824)	$ 66,385,169

2005	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities of U.S. government and federal agencies	$ 1,987,245	$ —	$ (51,587)	$ 1,935,658
Securities of state and political subdivisions	23,967,901	1,174,325	(52,122)	25,090,104
Mortgage-backed securities	24,747,818	137,517	(94,904)	24,790,431
Preferred stock	50,000	—	—	50,000
Restricted stock	1,516,400	—	—	1,516,400
Total	$ 52,269,364	$ 1,311,842	$ (198,613)	$ 53,382,593

Information pertaining to securities with gross unrealized losses at December 31, 2006 and 2005, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

2006	Less Than 12 Months		12 Months or More	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
Securities of state and political subdivisions	$ 648,859	$ (4,295)	$ —	$ —
Mortgage-backed securities	21,061,126	(170,660)	7,828,911	(64,869)
	$ 21,709,985	$ (174,955)	$ 7,828,911	$ (64,869)

	2005			
	Less Than 12 Months		12 Months or More	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
Securities of U.S. government and federal agencies	$ —	$ —	$ 1,935,658	$ (51,587)
Securities of state and political subdivisions	3,488,441	(52,122)	—	—
Mortgage-backed securities	11,542,515	(94,904)	—	—
	$ 15,030,956	$ (147,026)	$ 1,935,658	$ (51,587)

Management evaluates securities for other-than-temporary impairment annually, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (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 CFS to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

The unrealized loss positions at December 31, 2006 were directly related to interest rate movements as there is minimal credit risk exposure in these investments. All securities are investment grade or better. Bonds with an unrealized loss position of twelve months or more included ten mortgage-backed securities. Bonds with an unrealized loss position less than twelve months in duration included 24 mortgage-backed securities and one municipal bond. Generally, it is CFS's intent to hold the securities in the previous table for a time necessary to recover the amortized cost unless prudent business decisions warrant otherwise.

The amortized cost and fair value of securities available for sale as of December 31, 2006, by contractual maturity are shown below. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations without penalties.

	Amortized Cost	Fair Value
Due in one year or less	$ 14,852,599	$ 14,840,328
Due after one year through five years	37,020,271	37,341,998
Due after five years through ten years	7,548,497	7,774,437
Due after ten years	4,508,028	4,913,106
Other	1,515,300	1,515,300
Total	$ 65,444,695	$ 66,385,169

Proceeds from sales and calls of securities available for sale during 2006, 2005 and 2004 were $18,264,479, $3,228,649 and $2,948,055, respectively. Gross realized gains amounted to $172,067, $111,220 and $315,189 in 2006, 2005 and 2004. Gross realized losses amounted to $102,554 in 2006 and there were no gross realized losses during 2005 or 2004. The tax provision applicable to these net realized gains amounted to $23,634, $37,815 and $107,164 in 2006, 2005 and 2004, respectively.

The amortized cost of securities pledged to secure public deposits, borrowings from the Federal Reserve Bank, fiduciary powers and for other purposes required or permitted by law amounted to $31,399,559 and $35,759,481 at December 31, 2006 and 2005, respectively.

Note 3. Loans

A summary of the balances of loans follows:

	December 31, 2006	December 31, 2005
Commercial	$ 186,251,924	$ 170,789,743
Real estate mortgage	69,775,020	64,110,219
Real estate construction	14,409,503	16,134,937
Consumer	25,599,087	22,695,031
Participations with other banks	4,356,739	7,597,916
Other	1,151,710	273,097
	$ 301,543,983	$ 281,600,943
Less: Allowance for loan losses	4,342,174	4,199,745
Loans, net	$ 297,201,809	$ 277,401,198

Overdrafts totaling $969,766 and $277,098 at December 31, 2006 and 2005, respectively, were reclassified from deposits to loans.

An analysis of the allowance for loan losses follows:

	December 31, 2006	December 31, 2005	December 31, 2004
Balance at beginning of year	$ 4,199,745	$ 3,341,346	$ 2,631,043
Provision for loan losses	833,333	990,000	1,095,004
Loans charged off	(747,721)	(167,856)	(554,604)
Recoveries on loans previously charged off	56,817	36,255	169,903
Balance at end of year	$ 4,342,174	$ 4,199,745	$ 3,341,346

The following is a summary of information pertaining to impaired loans:

	December 31, 2006	December 31, 2005	December 31, 2004
Impaired loans without a valuation allowance	$ 141,388	$ 71,859	$ 114,834
Impaired loans with a valuation allowance	3,191,873	3,407,084	—
Total impaired loans	$ 3,333,261	$ 3,478,943	$ 114,834
Valuation allowance related to impaired loans	$ 803,282	$ 723,431	$ —

	Years Ended December 31, 2006	2005	2004
Average investment in impaired loans	$ 3,406,102	$ 3,481,162	$ 114,834
Interest income recognized	—	—	—

No additional funds are committed to be advanced in connection with impaired loans.

Nonaccrual loans excluded from impaired loan disclosure under SFAS No. 114 amounted to $453,233, $216,106 and $163,669 at December 31, 2006, 2005 and 2004, respectively. If interest on these loans had been accrued, such income would have approximated $70,051, $168,125 and $7,486 at December 31, 2006, 2005 and 2004, respectively.

There were no loans 90 days past due and still accruing interest at December 31, 2006, 2005 and 2004.

Note 4. Premises and Equipment

A summary of the cost and accumulated depreciation of premises and equipment follows:

	December 31,	
	2006	2005
Land	$ 3,235,478	$ 3,235,478
Buildings	9,055,977	9,346,112
Furniture, fixtures and improvements	1,264,721	1,428,267
Mechanical equipment	5,006,198	4,836,183
Leasehold improvements	2,354,995	2,354,995
Construction in progress	1,181,666	—
	$ 22,099,035	$ 21,201,035
Less accumulated depreciation	8,264,247	7,756,943
	$ 13,834,788	$ 13,444,092

For the years ended December 31, 2006, 2005 and 2004, depreciation expense was $1,035,246, $980,449 and $863,251, respectively.

Note 5. Borrowings

CFS's fixed-rate long-term debt of $11,345,950 at December 31, 2006 matures through 2018. $615,494 of the long-term debt is secured by a deed of trust on property located in Lancaster County, Virginia with a carrying value of approximately $675,000. $10,000,000 of the long-term debt consists of fixed-rate credits from the Federal Home Loan Bank (FHLB). These credits have rates ranging from 3.45% to 5.30% and matures through 2013. The remainder of the long-term debt is an advance from the FHLB's EDGE Project. CFS borrowed $1,000,000 at 1.00% to fund a local non-profit project. The remaining balance at December 31, 2006 for this borrowing was $730,456. Aggregate maturities during the next five years are: 2007, $5,103,279; 2008, $2,607,495; 2009, $111,903; 2010, $116,510; and 2011, $121,325.

CFS has unsecured lines of credit with correspondent banks totaling $23,500,000 available for overnight borrowing and an undrawn line of credit of $4,000,000 secured by CFS stock.

Note 6. Income Taxes

The components of the net deferred tax asset, included in other assets, are as follows:

	December 31,	
	2006	2005
Deferred tax assets:		
Allowance for loan and cash management account losses	$ 1,455,767	$ 1,418,427
Other real estate	192,157	181,218
Deferred compensation	93,935	98,624
Accrued pension expense	- -	80,921
Premises and equipment	108,477	—
Other	23,817	59,785
	$ 1,874,153	$ 1,838,975
Deferred tax liabilities:		
Securities available for sale	$ 319,761	$ 378,498
Premises and equipment	—	4,684
	319,761	383,182
Net deferred tax asset	$ 1,554,392	$ 1,455,793

The provision for income taxes charged to operations for the years ended December 31, 2006, 2005 and 2004, consists of the following:

	2006	2005	2004
Current tax expense	$ 1,491,162	$ 1,787,649	$ 1,529,432
Deferred tax (benefit)	(39,862)	(533,252)	(323,540)
	$ 1,451,300	$ 1,254,397	$ 1,205,892

The income tax provision differs from the amount of income tax determined by applying the U.S. federal income tax rate to pretax income for the years ended December 31, 2006, 2005 and 2004, due to the following:

	2006	2005	2004
Computed "expected" tax expense	$ 1,836,627	$ 1,675,150	$ 1,616,433
(Decrease) in income taxes resulting from:			
Tax exempt interest income	(378,541)	(372,727)	(366,831)
Other	(6,786)	(48,026)	(43,710)
	$ 1,451,300	$ 1,254,397	$ 1,205,892

Note 7. Employee Benefit Plans

Pension Plan

Effective December 31, 2005, CFS approved the freezing and termination of its defined benefit pension plan. The plan was terminated effective January 31, 2006 after receiving final approval from the Pension Benefit Guaranty Corporation and making distributions in the form of lump-sum cash payments to plan participants and purchasing nonparticipating annuity contracts. Plan assets at December 31, 2005 were sufficient to fund the termination. CFS recognized a gain of $174,396 upon termination of the plan. This gain is included in other income on the consolidated statements of income. No net periodic benefit cost was recognized in 2006.

The following tables provide a reconciliation of the changes in the plan's benefit obligations and fair value of assets over the three-year period ending December 31, 2006, computed as of September 30 of each respective year:

	2006	2005	2004
Change in Benefit Obligation			
Benefit obligation, beginning	$ 5,446,897	$ 4,661,787	$ 3,683,968
Termination adjustment	(1,682,658)	—	—
Service cost	—	414,335	341,403
Interest cost	271,320	278,998	238,690
Actuarial loss	—	139,631	436,388
Benefits paid	—	(47,854)	(38,662)
Termination of plan	(4,035,559)	—	—
Benefit obligation, ending	$ —	$ 5,446,897	$ 4,661,787
Change in Plan Assets			
Fair value of plan assets, beginning	$ 3,458,482	$ 2,495,894	$ 1,902,733
Actual return on plan assets	271,320	460,442	281,823
Employer contributions	305,757	550,000	350,000
Benefits paid	—	(47,854)	(38,662)
Termination of plan - distributions	(4,035,559)	—	—
Fair value of plan assets, ending	$ —	$ 3,458,482	$ 2,495,894

	2006	2005	2004
Funded Status	$ —	$ (1,988,415)	$ (2,165,893)
Unrecognized net actuarial loss	—	1,476,243	1,637,723
Unrecognized net obligation at transition	—	16,274	20,344
Unrecognized prior service cost	—	15,745	18,369
Accrued benefit cost included in other liabilities at September 30	$ —	$ (480,153)	$ (489,457)
Contribution made in December	—	305,757	550,000
Prepaid (accrued) benefit cost included in other assets (liabilities) at December 31	$ —	$ (174,396)	$ 60,543

The accumulated benefit obligation for the defined benefit pension plan was $2,986,413 and $2,382,619 at December 31, 2005 and 2004, respectively.

The components of net periodic benefit cost are as follows:

	2005	2004
Service cost	$ 414,335	$ 341,403
Interest cost	278,998	238,690
Expected return on plan assets	(217,908)	(169,627)
Amortization of prior service cost	2,624	2,624
Amortization of net obligation at transition	4,070	4,070
Recognized net actuarial loss	58,577	49,744
Net periodic benefit cost	$ 540,696	$ 466,904

The weighted-average assumptions used in the measurement of CFS's benefit obligation and net periodic benefit cost are shown in the following table:

	2005	2004
Benefit Obligation		
Discount rate	5.75%	6.00%
Expected return on plan assets	8.50%	8.50%
Rate of compensation increase	5.00%	5.00%
Periodic Benefit Cost		
Discount rate	6.00%	6.50%
Expected return on plan assets	8.50%	8.50%
Rate of compensation increase	5.00%	5.00%

Long-Term Rate of Return

The plan sponsor selects the expected long-term rate of return on assets assumption in consultation with their investment advisors and actuary. This rate is intended to reflect the average rate of earnings expected to be earned on the funds invested to provide plan benefits. Historical performance is reviewed with respect to real rates of return (net of inflation) for the major asset classes held or anticipated to be held by the trust, and for the trust itself. Undue weight is not given to recent experience that may not continue over the measurement period, with higher significance placed on current forecasts of future long-term economic conditions.

Because assets are held in a qualified trust, anticipated returns are not reduced for taxes. Further, solely for this purpose, the plan is assumed to continue in force and not terminate during the period which assets are invested. However, consideration is given to the potential impact of current and future investment policy, cash flow into and out of the trust, and expenses (both investment and non-investment) typically paid from plan assets to the extent such expenses are not explicitly estimated within periodic cost.

Asset Allocation

The pension plan's weighted-average asset allocation at September 30, 2005 by asset category is as follows:

	2005
Mutual funds - fixed income	19%
Mutual funds - equity	81%
	100%

The trust fund is sufficiently diversified to maintain a reasonable level of risk without imprudently sacrificing return with a targeted asset allocation of 25% fixed income and 75% equities. The investment manager selects investment fund managers with demonstrated experience and expertise and funds with demonstrated historical performance for the implementation of the plan's investment strategy. The investment manager will consider both actively and passively managed investment strategies and will allocate funds across the classes to develop an efficient investment structure.

It is the responsibility of the trustee to administer the investments of the trust within reasonable costs, being careful to avoid sacrificing quality. These costs include, but are not limited to, management and custodial fees, consulting fees, transaction costs and other administrative costs chargeable to the trust.

Deferred Compensation Agreements

CFS has a deferred compensation agreement providing for monthly payments to an officer commencing at retirement. The liability under this agreement was accrued over the officer's period of employment such that the present value of the monthly payments was accrued by retirement date. CFS funded the deferred compensation commitment through life insurance policies on the officer. The officer is currently receiving benefits under this plan.

Employee Stock Ownership Plan

Generally, full-time employees who have completed one calendar year of service are eligible. Contributions each year are at the discretion of the Board of Directors, within certain limitations prescribed by Federal tax regulations. CFS made cash contributions to the plan of $270,000, $150,000 and $30,000 during the years ended December 31, 2006, 2005 and 2004, respectively. These contributions are included in salaries and benefits in the accompanying income statements. An employee's proportional ownership in the plan assets vests on an increasing scale over 7 years, or sooner under certain circumstances. The plan intends to invest contributions received in shares of CFS common stock. Dividends paid on shares held by the plan are charged to retained earnings. All shares held by the plan are treated as outstanding in computing CFS's earnings per share.

401(k) Plan

CFS has adopted a contributory 401(k) plan that covers substantially all employees. Under the plan, employees may elect to defer up to 100% of their salary, subject to Internal Revenue Service limits. CFS will make a matching contribution of 100% of the first 3% and 50% of the second 3% of the employee's salary deferred. Total expense related to the plan was $491,566, $218,736 and $181,760 for 2006, 2005 and 2004, respectively.

Note 8. Stock Option Plans

In 1996, CFS adopted an incentive stock option plan that reserved for issuance 210,000 shares of CFS's voting common stock. The plan's expiration date was March 31, 2006. On April 1, 2005, CFS's shareholders approved an incentive stock option plan under which options may be granted to certain key employees. The plan reserves 130,000 shares of voting common stock for issuance as options and expires on January 21, 2015. The compensation cost that has been charged against income for those plans was $118,000 for the year ended December 31, 2006. No compensation expense was recognized under the plans for the years ended December 31, 2005 and 2004. No income tax benefit was recognized in the income statement for stock-based compensation arrangements for the years ended December 31, 2006, 2005 and 2004.

The stock option plans require that options be granted at an exercise price equal to at least 100% of the fair market value of the common stock on the date of the grant; however, for those individuals who own more than 10% of the stock of CFS, the option price must be at least 110% of the fair market value on the date of grant. Such options are generally not exercisable until three years from the date of issuance and require continuous employment during the period prior to exercise. The options will expire in no more than ten years after the date of grant. All information for all periods presented has been retroactively restated to reflect the 2-for-1 stock split in 2005.

A summary of the option activity under the plans at December 31, 2006 and changes during the year then ended are as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at beginning of year	179,700	$ 12.33		
Granted	29,500	19.50		
Exercised	(23,000)	9.67		
Forfeited	–			
Outstanding at end of year	186,200	13.80	5.9 years	$ 986,680
Options exercisable, end of year	94,000	10.18	3.6 years	838,480

The weighted-average grant date fair value of options granted during the years ended December 31, 2006, 2005 and 2004 was $3.93, $5.02 and $3.65, respectively. The total intrinsic value of options exercised during the years ended December 31, 2006 was $223,500.

The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option-pricing model with the assumptions noted in the following table. Expected volatility is based on the historic volatility of CFS's stock price over the expected life of the options. The expected term is estimated as the average of the contractual life and vesting schedule for the respective options. The risk-free interest rate is the U.S. Treasury zero-coupon issue with a remaining term equal to the expected term of the options granted. The dividend yield is estimated as the ratio of CFS's historical dividends paid per share of common stock to the stock price on the date of grant.

	Years Ended December 31,		
	2006	2005	2004
Dividend yield	2.13%	1.93%	1.94%
Expected term	6 years	10 years	10 years
Expected volatility	15.55%	16.54%	14.74%
Risk-free interest rate	4.95%	4.57%	4.78%

As of December 31, 2006, there was $137,000 of total unrecognized compensation cost related to nonvested stock-based compensation arrangements granted under the plans. That cost is expected to be recognized over a weighted average period of 1.9 years.

Note 9. Shareholders' Equity

During 2006, 2005 and 2004, CFS issued 5,130 shares, 3,880 shares and 6,646 shares, respectively, of common stock to its directors for partial compensation. All information has been retroactively restated to reflect the 2-for-1 stock split in 2005.

Note 10. Commitments and Contingencies

CFS leases certain facilities and equipment under operating leases which expire at various dates through 2010. These leases generally contain renewal options and require CFS to pay taxes, insurance, maintenance and other expenses in addition to the minimum normal rentals.

Minimum rental payments under these operating lease agreements as of December 31, 2006 are as follows:

Year Ending December 31,	
2007	$ 156,692
2008	163,354
2009	172,518
2010	184,626
2011	189,333

Rent expense under operating leases aggregated $239,003, $226,136 and $109,621 for the years ended December 31, 2006, 2005 and 2004, respectively.

As a member of the Federal Reserve System, the Bank is required to maintain certain average reserve balances. For the final weekly reporting period in the years ended December 31, 2006 and 2005, the aggregate amounts of daily average required balances were approximately $1,143,000 and $1,414,000, respectively.

Note 11. Related Party Transactions

Officers, directors and their affiliates had borrowings of $5,368,260 and $5,290,002 at December 31, 2006 and 2005, respectively, with the Bank.

Changes in borrowings during 2006 were as follows:

Balance, December 31, 2005	$ 5,290,002
Additions	1,775,256
Payments	(1,696,998)
Balance, December 31, 2006	$ 5,368,260

These transactions occurred in the ordinary course of business on substantially the same terms as those prevailing at the time for comparable transactions with unrelated persons.

Note 12. Other Income and Expenses

The principal components of "Other Income" in the consolidated statements of income are:

	2006	2005	2004
Cash Flow fees and discount	$ 2,915,253	$ 2,966,205	$ 2,185,908
Merchant discount	2,505,673	2,200,199	1,761,941
ATM fee income	715,388	610,286	503,948
Other (includes no items in excess of 1% of total revenue)	1,866,366	1,607,318	1,107,100
	$ 8,002,680	$ 7,384,008	$ 5,558,897

The principal components of "Other Expenses" in the consolidated statements of income are:

	2006	2005	2004
Advertising	$ 446,369	$ 354,882	$ 304,526
Merchant card	1,914,769	1,674,464	1,291,403
Cash Flow royalties	320,509	559,738	353,243
Provision for Cash Flow account losses	200,000	300,000	60,000
Legal fees	215,692	266,701	444,414
Delivery and transportation	357,362	321,223	294,996
Stationary and supplies	442,994	401,588	395,562
Other (includes no items in excess of 1% of total revenue)	3,009,151	2,748,619	2,510,561
	$ 6,906,846	$ 6,627,215	$ 5,654,705

Note 13. Earnings Per Share

The following data shows the amounts used in computing earnings per share and the effect on the weighted average number of shares of dilutive potential common stock. The potential common stock did not have an impact on net income. All information for all periods presented has been retroactively restated to reflect the 2-for-1 stock split in 2005.

	2006	2005	2004
Weighted average number of common shares, basic	2,412,887	2,418,921	2,401,818
Effect of dilutive stock options	45,788	69,186	66,548
Weighted average number of common shares and dilutive potential common stock used in diluted EPS	2,458,675	2,488,107	2,468,366

Options on approximately 36,975 shares were not included in the computation of diluted earnings per share for the year ended December 31, 2006 because the exercise price of those options exceeded the average market price of the common shares. No shares were excluded from the computation of diluted earnings per share for the years ended December 31, 2005 and 2004.

Note 14. Time Deposits

Remaining maturities on certificates of deposit are as follows:

2007	$ 115,131,140
2008	23,578,529
2009	10,653,437
2010	218,207
2011	5,255,345
	$ 154,836,658

Note 15. Financial Instruments With Off-Balance-Sheet Risk

CFS is a party to credit related financial instruments with off-balance-sheet risk in the normal course of business to meet the financial needs of its customers. These financial instruments include commitments to extend credit, standby letters of credit and commercial letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets.

CFS's exposure to credit loss is represented by the contractual amount of these commitments. CFS follows the same credit policies in making commitments as it does for on-balance-sheet instruments.

At December 31, 2006 and 2005, the following financial instruments were outstanding whose contract amounts represent credit risk:

	Contract Amount	
	2006	**2005**
Commitments to grant loans	$ 4,273,847	$ 2,627,793
Unfunded commitments under lines of credit	78,938,931	82,440,087
Commercial and standby letters of credit	2,670,212	2,068,435

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The commitments for equity lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by CFS, is based on management's credit evaluation of the customer.

Unfunded commitments under commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit usually do not contain a specified maturity date and may not be drawn upon to the total extent to which CFS is committed. The amount of collateral obtained, if it is deemed necessary by CFS, is based on management's credit evaluation of the customer.

Commercial and standby letters of credit are conditional commitments issued by CFS to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. CFS generally holds collateral supporting those commitments, if deemed necessary.

CFS maintains its cash accounts in several correspondent banks. The total amount by which cash on deposit in those banks exceeds the federally insured limits is approximately $1,159,000 at December 31, 2006.

Note 16. Fair Value of Financial Instruments and Interest Rate Risk

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for CFS's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. SFAS No. 107 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of CFS.

The following methods and assumptions were used by CFS in estimating fair value disclosures for financial instruments:

Cash, short-term investments and federal funds sold: The carrying amounts of cash and short-term instruments approximate fair values.

Securities: Fair values for securities, excluding restricted stock, are based on quoted market prices. The carrying value of restricted stock approximates fair value based on the redemption provisions of the respective entity.

Loans: For certain homogeneous categories of loans, such as some residential mortgages, and other consumer loans, fair value is estimated using the quoted market prices for securities backed by similar loans, adjusted for differences in loan characteristics. The fair value of other types of loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

Cash management accounts: The carrying value of cash management accounts approximates their fair value. The future cash flows from these accounts are short-term in nature (less than 90 days) and the rate of return approximates current market rates.

Deposits: The fair value of demand deposits, savings accounts and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities.

Short-term borrowings: The carrying amounts of federal funds purchased, borrowings under repurchase agreements, and other short-term borrowings maturing within ninety days approximate their fair values. Fair values of other short-term borrowings are estimated using discounted cash flow analyses based on CFS's current incremental borrowing rates for similar types of borrowing arrangements.

Long-term debt: The fair value of CFS's long-term borrowings are estimated using discounted cash flow analyses based on CFS's current incremental borrowing rates for similar types of borrowing arrangements.

Accrued interest: The carrying amounts of accrued interest approximate fair value.

Off-balance-sheet instruments: Fair values for off-balance-sheet, credit-related financial instruments 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. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of standby letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At December 31, 2006 and 2005, the fair values of loan commitments and standby letters of credit were deemed immaterial.

The estimated fair values, and related carrying or notional amounts, of CFS's financial instruments are as follows:

	2006		2005	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(In Thousands)		*(In Thousands)*	
Financial assets:				
Cash and short-term investments	$ 9,983	$ 9,983	$ 10,449	$ 10,449
Securities	66,385	66,385	53,383	53,383
Loans	297,202	295,113	277,401	271,210
Cash management accounts	17,249	17,249	17,709	17,709
Accrued interest receivable	1,676	1,676	1,550	1,550
Financial liabilities:				
Deposits	$ 358,777	$ 358,383	$ 328,535	$ 326,810
Short-term borrowings	5,001	5,001	7,000	7,000
Long-term debt	21,656	21,560	16,755	16,580
Accrued interest payable	739	739	467	467

CFS assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair values of CFS's financial instruments will change when interest rate levels change and that change may be either favorable or unfavorable to CFS. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities and attempts to minimize interest rate risk by adjusting terms of new loans and deposits and by investing in securities with terms that mitigate CFS's overall interest rate risk.

Note 17. Minimum Regulatory Capital Requirements

CFS is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on CFS's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, financial institutions must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. A financial institution's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies

Quantitative measures established by regulation to ensure capital adequacy require financial institutions to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets, and of Tier 1 capital to average assets. Management believes, as of December 31, 2006 and 2005, that CFS meets all capital adequacy requirements to which it is subject.

As of December 31, 2006, the most recent notification from the Federal Reserve Bank categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

CFS's actual capital amounts and ratios are also presented in the table.

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
			(Amount in Thousands)			
As of December 31, 2006:						
Total Capital (to Risk Weighted Assets):						
Consolidated	$ 44,723	12.5%	$ 28,623	8.0%	N/A	
Chesapeake Bank	$ 41,038	11.5%	$ 28,548	8.0%	$ 35,685	10.0%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	$ 39,835	11.1%	$ 14,355	4.0%	N/A	
Chesapeake Bank	$ 36,588	10.3%	$ 14,209	4.0%	$ 21,314	6.0%
Tier 1 Capital (to Average Assets):						
Consolidated	$ 39,835	9.6%	$ 16,598	4.0%	N/A	
Chesapeake Bank	$ 36,588	8.9%	$ 16,444	4.0%	$ 20,555	5.0%
As of December 31, 2005:						
Total Capital (to Risk Weighted Assets):						
Consolidated	$ 42,067	12.5%	$ 27,036	8.0%	N/A	
Chesapeake Bank	$ 36,866	11.0%	$ 26,802	8.0%	$ 33,503	10.0%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	$ 37,113	11.0%	$ 13,518	4.0%	N/A	
Chesapeake Bank	$ 32,670	9.8%	$ 13,401	4.0%	$ 20,102	6.0%
Tier 1 Capital (to Average Assets):						
Consolidated	$ 37,113	9.6%	$ 15,441	4.0%	N/A	
Chesapeake Bank	$ 32,670	8.6%	$ 15,217	4.0%	$ 19,021	5.0%

Note 18. Trust Preferred Capital Notes

On December 6, 2002, CFS Capital Trust I, a wholly-owned subsidiary of CFS, was formed for the purpose of issuing redeemable Capital Securities. On December 19, 2002, $10.3 million of trust preferred securities were issued through a pooled underwriting totaling approximately $340 million. The securities have a LIBOR-indexed floating rate of interest. The weighted-average interest rate for the year ended December 31, 2006 was 8.47%. The interest rate as of December 31, 2006 was 8.72%. The securities have a mandatory redemption date of January 7, 2033, and are subject to varying call provisions beginning January 7, 2008. The principal asset of the Trust is $10.3 million of the Corporation's junior subordinated debt securities with like maturities and like interest rates to Capital Securities.

The Trust Preferred Securities may be included in Tier 1 capital for regulatory capital adequacy determination purposes up to 25% of Tier 1 capital after its inclusion. The portion of the Trust Preferred not considered as Tier 1 capital may be included in Tier 2 capital.

The obligations of CFS with respect to the issuance of the Capital Securities constitute a full and unconditional guarantee by the Corporation of the Trust's obligations with respect to the Capital Securities.

Subject to certain exceptions and limitations, CFS may elect from time to time to defer interest payments on the junior subordinated debt securities, which would result in a deferral of distribution payments on the related Capital Securities.

Note 19. Condensed Parent Company Financial Statements

The following parent company accounting policies should be read in conjunction with the related condensed balance sheets, statements of income, and statements of cash flows.

Investments in subsidiaries are accounted for using the equity method of accounting. The parent company and its subsidiaries file a consolidated federal income tax return. The subsidiaries' individual tax provisions and liabilities are stated as if they filed separate returns and any benefits or detriments of filing the consolidated tax return are absorbed by the parent company.

The parent company's principal assets are its investments in its wholly-owned subsidiaries. Dividends from the Bank are the primary source of funds for the parent company. The payment of dividends by the Bank is restricted by various statutory limitations. Banking regulations also prohibit extensions of credit by the Bank to the parent company unless appropriately secured by assets. As of December 31, 2006, the amount available for payment of additional dividends without prior regulatory approval from the Bank to the parent company is $9,951,962 or 32.1% of consolidated net assets.

Balance Sheets *(Condensed)*

	December 31,	
	2006	2005
Assets		
Cash	$ 1,330,089	$ 2,238,738
Investment in subsidiaries	39,411,009	35,564,783
Premises and equipment, net	1,152,467	1,262,738
Other assets	259,127	717,426
Total assets	$ 42,152,692	$ 39,783,685
Liabilities and Shareholders' Equity		
Long-term debt	$ 615,494	$ 654,754
Trust preferred capital notes	10,310,000	10,310,000
Other liabilities	263,970	248,750
Shareholders' equity	30,963,228	28,570,181
Total liabilities and shareholders' equity	$ 42,152,692	$ 39,783,685

Statements of Income *(Condensed)*

	2006	2005	2004
Income - Dividends from subsidiaries	$ 1,219,775	$ 1,215,249	$ 1,210,943
Other	196,944	164,870	113,778
Total income	$ 1,416,719	$ 1,380,119	$ 1,324,721
Expenses - Interest expense	$ 928,486	$ 735,941	$ 547,414
Other expenses	659,554	545,824	558,877
Total expenses	$ 1,588,040	$ 1,281,765	$ 1,106,291
Income (loss) before income taxes and equity in undistributed earnings of subsidiaries	$ (171,321)	$ 98,354	$ 218,430
Allocated income tax benefit	405,679	354,515	313,763
Income before equity in undistributed earnings of subsidiaries	$ 234,358	$ 452,869	$ 532,193
Equity in undistributed earnings of subsidiaries	3,716,186	3,219,645	3,016,131
Net income	$ 3,950,544	$ 3,672,514	$ 3,548,324

Statements of Cash Flows *(Condensed)*

	2006	2005	2004
Cash Flows from Operating Activities			
Net income	$ 3,950,544	$ 3,672,514	$ 3,548,324
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	112,340	109,711	59,715
Equity in undistributed earnings of subsidiaries	(3,716,186)	(3,219,645)	(3,016,131)
Issuance of common stock for services	308,458	176,630	94,706
Stock-based compensation	118,000	—	—
Changes in other assets and liabilities:			
(Increase) decrease in other assets	464,241	(180,883)	66,019
Increase in other liabilities	15,220	24,597	19,229
Net cash provided by operating activities	$ 1,252,617	$ 582,924	$ 771,862
Cash Flows from Investing Activities			
Purchases of premises and equipment	$ (2,069)	$ (376,211)	$ (309,344)
Investment in subsidiaries	(250,000)	(500,000)	—
Net cash (used in) investing activities	$ (252,069)	$ (876,211)	$ (309,344)
Cash Flows from Financing Activities			
Dividends paid	$ (927,950)	$ (882,654)	$ (817,387)
Curtailment of note payable	(39,260)	(37,164)	(35,180)
Repurchase of common stock	(1,164,312)	(995,909)	(12,232)
Net proceeds from issuance of common stock	222,325	311,125	172,650
Net cash (used in) financing activities	$ (1,909,197)	$ (1,604,602)	$ (692,149)
Net (decrease) in cash	$ (908,649)	$ (1,897,889)	$ (229,631)
Cash at beginning of year	2,238,738	4,136,627	4,366,258
Cash at end of year	$ 1,330,089	$ 2,238,738	$ 4,136,627

YHB

To the Board of Directors and Shareholders
Chesapeake Financial Shares, Inc. and Subsidiaries
Kilmarnock, Virginia

We have audited the accompanying consolidated balance sheets of Chesapeake Financial Shares, Inc. and Subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for the years ended December 31, 2006, 2005 and 2004. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 financial position of Chesapeake Financial Shares, Inc. and Subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for the years ended December 31, 2006, 2005 and 2004, in conformity with accounting principles generally accepted in the United States of America.

As noted in Note 1 to the consolidated financial statements, the Corporation changed its method of accounting for stock-based compensation to adopt Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment."

Yount, Hyde & Barbour, P.C.

Winchester, Virginia
February 19, 2007

Financial Overview: Chesapeake Financial Shares, Inc. had a return on average equity in 2006 of 13.6% and a return on average assets of 0.98% compared to 13.7% and 0.98%, respectively, in 2005. Total assets at year-end were $418.1 million, representing a 9.3% increase over the December 31, 2005 balance of $382.7 million. The Company ended the year with total gross loans of $301.5 million, and total deposits of $358.8 million, up 7.1% and 9.2%, respectively. Asset quality remained strong with net allowance for loan losses to gross loans of 1.4%, and loans over thirty days delinquent at 0.83% of total loans. The Holding Company and the Bank continued to maintain their "well capitalized" status, the highest ranking available from the Federal Deposit Insurance Corporation (FDIC).

Summary of Results of Operations: Earnings for 2006 were $3,950,544 or $1.61 per share (fully diluted) compared to $3,672,514 or $1.48 per share in 2005, an increase of $278,030. The 7.6% increase in net income resulted from a 17.7% increase or $1,747,678 in noninterest income. Noninterest expense increased by only 8.1% or $1,474,561 in 2006 over 2005. In 2005 noninterest expense was up $2,690,645 or 17.4% over the prior year. All noninterest income items were up in 2006 except Cash Flow Services. There was also a significant gain on sale of premises and equipment of $483,877. Total noninterest expense was up for the year due primarily to normal increases in operating expenses, however there was a significant decrease in Cash Flow expenses and a small decrease in ATM expenses.

Earnings for 2005 were $3,672,514 or $1.48 per share (fully diluted) compared to $3,548,324 or $1.44 per share in 2004, an increase of $124,190. The 3.5% increase in net income resulted from an 8.4% increase or $1,027,166 in net interest income after provision for loan losses. Noninterest expense increased by 17.4% or $2,690,645 in 2005 over 2004. In 2004 noninterest expense was up $1,118,537 or 7.8% over the prior year. Income from Cash Flow Services was up $780,297 or 35.7% over the prior year, while Merchant Card and ATM income were up 24.9% and 21.1%, respectively, and Other Income was up $1,825,111, or 32.8%. Fiduciary income was flat for the year, service charges were up $65,522 or 6.6%, and there was a net gain on securities sold of $111,220. Total noninterest expense was up 17.4% or $2,690,645 for the year.

Assets: Loan Portfolio: The loan portfolio is the largest component of earning assets for the Company and accounts for the greatest portion of total interest income. The gross loan portfolio totaled $301.5, $281.6 and $264.6 million for 2006, 2005, and 2004, respectively, representing an increase of 7.1% for 2006 over 2005, 6.4% for 2005 over 2004, and 21.6% for 2004 over 2003. The increase in 2006 was primarily in commercial loans, up 9.1% or $15.4 million, real estate mortgage, up 8.8% or $5.6 million, and consumer loans, up 12.8% or $2.9 million. Participations with other banks decreased $3.2 million or 42.7% as did the real estate construction loans, down 10.7% or $1,725,434. All other loans increased $878.6 thousand.

On December 31, 2006, the loan portfolio consisted of 62% commercial loans, 27.9% single-family residential and residential construction loans, and 8.5% consumer loans. The commercial loans consisted principally of business loans such as owner-occupied commercial development, retail, builders/contractors, medical, service and professional, hospitality, non-profits, marine industry, and a small portion of agricultural and seafood loans.

Total nonperforming assets consist of nonaccrual loans, restructured loans, repossessed and foreclosed properties, and Other Real Estate Owned. Nonperforming assets were $6,506,510 at December 31, 2006, which represented an increase from $4,234,378 at December 31, 2005. Past due loans over thirty days were 0.8% of total loans at December 31, 2006. A significant portion of the nonperforming asset total is attributable to a group of residential construction loans in one of the Bank's markets. Any potential loss related to these loans has been incorporated in the allowance for loan losses.

Investment Securities: All of the Company's securities are classified as securities available for sale. Securities may be classified as investment securities (held to maturity) when management has the intent and the Company has the ability at the time of purchase to hold the securities to maturity. Investment securities are carried at cost adjusted for amortization of premiums and accretion of discounts. Securities available for sale include securities that may be sold in response to changes in market interest rates, changes in the securities option or credit risk, increases in loan demand, general liquidity needs and other similar factors. Securities available for sale are carried at fair market value. Deposit growth, overnight and term borrowing, and investment portfolio liquidity provided funding for the increases in the loan portfolio.

The fair market value of the portfolio exceeded book value by $620,713, net of the tax effect, at December 31, 2006, and by $734,731, net of the tax effect, at December 31, 2005. This is within risk limits established by the Board and the Asset/Liability Management Committee.

At year-end, total securities at fair market value were $66.4 million, up $13 million from the $53.4 million on December 31, 2005. Investments in mortgage-backed securities increased from the 2005 levels of $24.8 million to $45.7 million or 84.3%. Investments in securities of state and political subdivisions decreased by $5,922,633 or 23.6%.

Asset Quality-Provision/Allowance for Loan Losses: The provision for loan losses is a charge against earnings necessary to maintain the allowance for loan losses at a level consistent with management's evaluation of the credit quality and risk adverseness of the loan portfolio. The allowance for loan losses represents management's estimate of the amount adequate to provide for potential losses inherent in the loan portfolio. To achieve this goal, the loan loss provision must be sufficient to cover loans charged off plus any growth in the loan portfolio. In determining the adequacy of the allowance for loan losses, management uses a methodology, which specifically identifies and reserves for higher risk loans. A general reserve is established for non-specifically reserved loans. Loans in a non-accrual status and over ninety days past due are considered in this evaluation as well as other loans, which may be a potential loss. The status of nonaccrual and past due loans varies from quarter to quarter based on seasonality, local economic conditions, and the cash flow of customers.

The net allowance for loan losses was $4,342,174 or 1.4% of gross loans less unearned discounts at year-end. The 2006 provision was $833,333. This ratio was also 1.5% on December 31, 2005, and 1.3% in 2004. There was a provision of $990,000 in 2005 compared to the 2004 provision of $1,095,004. Loans charged off totaled $747,721 in 2006, $167,856 in 2005, and $554,604 in 2004. Recoveries for the same periods were $56,817, $36,255, and $169,903, respectively. Management and the Board of Directors believe that the total allowance at year-end was adequate relative to current levels of risk in the portfolio. However, continued loan growth may warrant additional provisions in the future.

Liabilities: Deposits: The Company depends on deposits to fund most of its lending activities, generate fee income opportunities, and create a market for other financial service products. Deposits are also the largest component of the Company's liabilities and account for the greatest portion of interest expense.

Deposits totaled $358.8, $328.5, and $309.4 million for 2006, 2005, and 2004, respectively, and represented an increase of 9.2% for 2006 over 2005 and an increase of 6.2% for 2005 over 2004. There was a 13.9% increase in certificates of deposit during 2006 while noninterest bearing deposits decreased by $1.5 million or 2.3% from $67.8 million on December 31, 2005. Savings and interest bearing demand deposit balances increased during 2006 by 10.3% or $12.8 million to $137.7 million.

Net Interest Income: The principal source of earnings for CFS is net interest income. Net interest income is the difference between interest plus fees generated by earning assets and interest expense paid to fund those assets. As such, net interest income represents the gross profit from the Bank's lending, investment, and funding activities.

A large number of variables interact to affect net interest income. Included are variables such as changes in the mix and volume of earning assets and interest bearing liabilities, market interest rates, and the statutory Federal tax rate. It is management's on-going policy to maximize net interest income through the development of balance sheet and pricing strategies while maintaining appropriate risk levels as set by the board.

Net interest income totaled $14.3, $14.2, and $13.3 million for 2006, 2005, and 2004, respectively, representing an increase of 0.3% for 2006 over 2005, 6.9% for 2005 over 2004, and 13.9% for 2004 over 2003. Loan demand was strong this year with gross total loans up 7.1% or $19.9 million for 2006 over 2005. Total interest expense was $10.4, $6.4, and $4.3 million for 2006, 2005 and 2004, respectively. On a tax equivalent annualized basis, the net interest margin was 4.2%, 4.8% and 4.7% for 2006, 2005 and 2004, respectively. The Bank's margins have been very stable and generally above peer through numerous rate cycles. The decline in the margin in 2006 was consistent with decreased margins in the industry. This is due to the tremendous competition for deposits in an inverse yield curve environment and deposit competition from credit unions expanding trade areas.

Noninterest Income: For the year ended December 31, 2006 noninterest income was $11.6 million, a 17.7% increase over the 2005 amount of $9.9 million, which was a 22.9% increase over the 2004 amount of $8.0 million. The increase in 2006 was due, in part, to a gain on the sale of the old Hayes office of $483,877. The category still had a substantial increase of $1,263,801, or 12.8%, without the gain. This was due to the increases in service charges on deposit accounts of $370,797 or 35.1%, Merchant Card income of $305,474 or 13.9%, fiduciary income of $291,926 or 22.2%, other income of $254,048, or 16.1%, and ATM income of $105,102 or 17.2%. Income from Cash Flow Services was actually down slightly, as was the gain on securities sold from the previous year.

Noninterest Expenses: Total noninterest expenses increased 8.1% or $1,474,561 in 2006 over 2005. In 2005, total noninterest expenses increased 17.4% over 2004 and increased 7.7% in 2004 over 2003. The 2006 increase was mitigated by a significant decrease in Cash Flow expenses for the year of $339,229, a 39.5% reduction due primarily to a change in software provider. ATM expenses were also down slightly. There was an increase in salaries and benefits of 11.8% or $1,050,619. Other expenses were up $260,532 or 9.5% while merchant card expenses were up $240,305 or 14.4%. Occupancy expenses were up 5.5% or $144,311.

Liquidity, Interest Rate Sensitivity, and Inflation: The objectives of the Company's liquidity management policy includes providing adequate funds to meet the needs of depositors and borrowers at all times, as well as providing funds to meet the basic needs for ongoing operations of the Company, and to allow funding of longer-term investment opportunities and regulatory requirements. The objective of providing adequate funding should be accomplished at reasonable costs and on a timely basis. Management considers the Company's liquidity to be adequate.

The Bank's primary sources of asset liquidity continue to be federal funds purchased, time deposits with other banks, securities maturing within one year, loan curtailments, and short-term borrowings. On December 31, 2006, approximately 36.1% of the total invested portfolio dollars matured or were repricing within one year as compared to 22.2% on December 31, 2005. The Bank's loan portfolio was liquid with 58.7% of all loan dollars maturing or repricing within one year. This loan liquidity ratio was 57.4% on December 31, 2005.

Other sources of asset liquidity include the normal amortization and prepayment of loans, sale of loans, and proceeds from the sale of repossessed assets and other real estate owned. The sale of loans through the secondary market operation enhances the liquidity position by providing both fixed and adjustable rate long-term mortgage options to our client base. Mortgage loans held for resale are stated at the lower of cost or market (or contract value), however, due to the quick turning of these assets, seldom do these loans represent more than 1% of total assets.

Bank management maintains overnight borrowing relationships with correspondent banks for up to $23,500,000, secured and unsecured. The Bank and CFS have access to additional secured borrowing for $4,000,000.

As of December 31, 2006, the Bank held no repossessed assets and $2,720,016 in other real estate owned. These assets are being actively marketed through real estate channels and a near term secondary sources of liquidity. The Bank should realize no loss on disposal of these assets.

Since the assets and liabilities of a bank are primarily monetary in nature (payable in fixed, determinable amounts), the performance of a bank is affected more by changes in interest rates than by inflation. Interest rates generally increase as the rate of inflation increases, but the magnitude of the change in rates may not be the same. Interest rate sensitivity refers to the difference between assets and liabilities subject to repricing, maturity, or volatility during a specified period. Management's objective in controlling interest rate sensitivity is to reprice loans and deposits and make investments that will maintain a profitable net interest margin (see "Net Interest Income").

While the effect of inflation is normally not as significant as is its influence on those businesses that have large investments in plant and inventories, it does have an effect. There are normally corresponding increases in the money supply, and banks will normally experience above average growth in assets, loans and deposits. Also, general increases in the prices of goods and services will result in increased operating expenses.

Shareholders' Equity: Capital represents funds, earned or obtained, over which management can exercise greater control in comparison with deposits and borrowed funds. Future growth and expansion of the Company is dictated by the ability to produce capital. The adequacy of the Company's capital is reviewed by management on an ongoing basis with reference to the size, composition and quality of the Company's asset and liability levels and consistent with regulatory requirements and industry standards. Management seeks to maintain a capital structure that assures an adequate level to support anticipated asset growth and absorb potential losses.

Federal regulators have adopted minimum capital standards. Specifically, the guidelines categorize assets and off balance sheet items into four risk weighted categories. The minimum ratio of qualifying total capital to risk weighted assets is 8%. For CFS, Tier 1 capital is composed of common equity and retained earnings. Tier 1 capital to risk weighted assets and Tier 1 capital to average assets (called leveraged capital) must be 4%. On December 31, 2006, the Company had ratios of Tier 1 risk based capital to risk weighted assets of 11.1%, total risk based capital to risk weighted assets of 12.5%, and Tier 1 leverage capital of 9.6%. At December 31, 2005, these ratios were 11.0%, 12.5% and 9.6%, respectively. At December 31, 2006, these ratios for the bank were 10.3%, 11.5% and 8.9%, respectively, well above the regulatory minimums and exceeded the requirements for FDIC's "well capitalized" designation. As of December 31, 2006, the Company's primary capital to asset ratio was 8.2%.

Dividend and Market Information: The Company's stock trades on the "OTC" (Over The Counter) market under the symbol "CPKF". There was a 2-for-1 stock split with a record date of November 15, 2005 and all per share information for all periods presented has been retroactively restated. The Company raised its dividend to $0.385 per share in 2006, an increase of $0.02 over 2005. This increase followed a $0.025 per share dividend increase from $0.34 in 2004 to $0.365 in 2005. Trades in the Company's common stock occurred infrequently and generally involved a relatively small number of shares. Based on information available, the selling price for the Company's common stock ranged during 2006 from $19.25 to $18.60, and during 2005, from $21.00 to $18.93. Such transactions may not be representative of all transactions during the indicated periods, of the fair value of the stock at the time of such transactions, due to the infrequency of trades and the limited market for the stock. At December 31, 2006, there were 2,386,918 shares of Company's common stock outstanding held by approximately 242 holders of record.

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