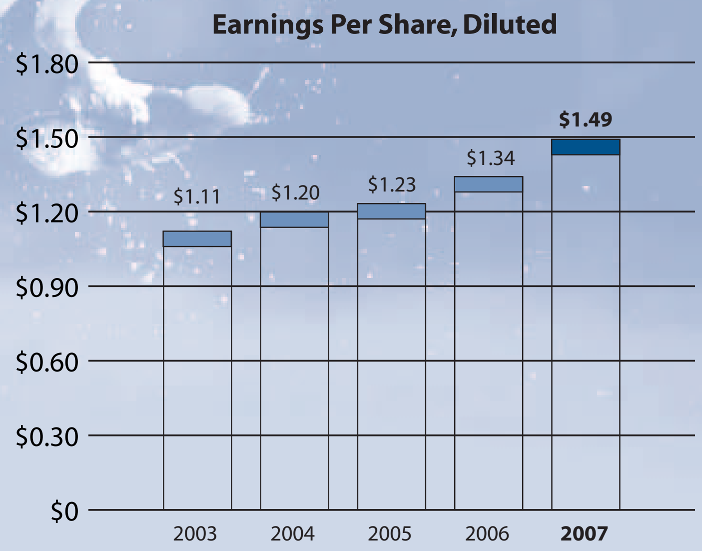
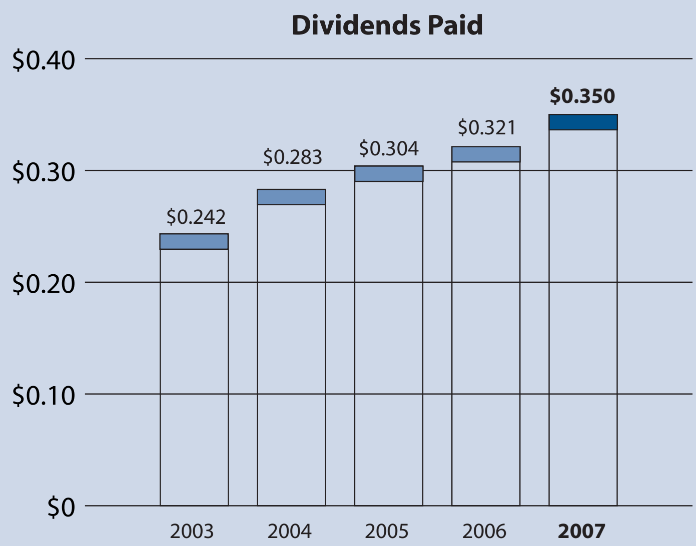
CHESAPEAKE
FINANCIAL SHARES INC.

2007 ANNUAL REPORT

CONTENTS





CHESAPEAKE FINANCIAL SHARES INC.

DEAR SHAREHOLDER

Most Americans were elated as the spring "surge" by our military in Iraq, planned and led by General Petraeus, lowered U. S. Service casualties, diminished the Taliban disruption of provinces, and facilitated returning many of those provinces to Iraq's own military and police for self-supervision. The Democrat leaders on Capitol Hill reluctantly admitted that the "surge" was working. Senator Joe Lieberman (D) fought the Democrat bias to pull our troops out in defeat, and abandon the democratically elected government to give a President Bush perceived political defeat.

2007 was a year of politics. Candidates for the presidential election began their almost two-year campaign early in the year. After many debates, mud fights or love fests over the year, the upcoming primaries will finally be here in early 2008. Obama, Edwards, Clinton, Romney, McCain, Paul, Thompson, and Huckabee are all in the race. In October Jo Ann Davis, 1st District Congresswoman, died of cancer, and Rob Wittman (R) of Montross was elected to take her seat. In a hard fought battle Richard Stuart (R) defeated Albert Pollard (D) to fill John Chichester's 28th District Senatorial seat in the Virginia General Assembly.

Doctor David Nichols who has flown to Tangier Island each Thursday for 28 years was named Country Doctor of the Year. The state-of-the-art Wiley Child Development Center opened on Harris Road on the Virginia Quality Life campus. The Lancaster High School Red Devil Marching Band was selected to perform in the pregame and half time shows at the BCS football championship in New Orleans on January 7, 2008. Homerun hitter Barry Bonds was indicted for lying to Congress. Quarterback Michael Vick was jailed for breeding and illegally sponsoring dog fighting.

We will miss Jo Ann Davis; Art Buchwald; Tom Poston (*Newhart* show); Jerry Falwell (Moral Majority, pastor); Wally Schirra (astronaut); Lady Bird Johnson (1st Lady); Phil Rizzuto (Yankee shortstop, Hall of Famer and sports broadcaster); Merv Griffin (talk show host, *Wheel of Fortune* and *Jeopardy*); Luciano Pavarotti (tenor); and Werner von Trapp (the Trapp Family Singers).

Inflation reached 4% for the year led by fuel and food. The nation faced a subprime-mortgage crisis as many Americans found themselves unable to pay the adjustable rate loans as they repriced and along with many speculators faced foreclosure. After nearly tripling over a decade, housing prices began to tumble. Many individuals and speculators faced foreclosure. Housing starts fell. As a result the real estate market was in a very precarious position. To help manage the financial stumbling block the Federal Reserve cut interest rates three times by a total of 1.00% to 4.25%. In contrast to 2006 the 2007 end of the year markets were reflecting a general pessimism with investor indexes closing up for the year but down in the fourth quarter: the Dow at 13,264.82 up 6.43%; NASDAQ at 2,652.28 up 9.81%; S & P 500 at 1,468.36 up 3.52%; and the NYSE at 9,740.32 up 6.58%.

On a bright note Chesapeake Financial Shares (CFS) had another banner year. Contrary to reported earnings results of banks in the Commonwealth and throughout the nation, CFS earnings were up 10%. Total earnings were a record $4,345,140 or $1.49 per share, up 11.19% and total assets were $483,002,032, up 15.53%. After a 6 for 5 stock split in the form of a 20% stock dividend in November, the CFS stock price settled around $19.50, up approximately 20% for the year. On the other hand the price of most bank stocks was down 25% to 30%. The positive results for CFS were the result of close management of interest margins and a positive contribution to non-interest income by Cash Flow, Chesapeake Payment Systems, and Chesapeake Investment Group.

Chesapeake Investment Group assets under management including trust assets grew by an additional 18% in contrast to the lower growth in the market prices mentioned above. Along with the commercial lending arm of Chesapeake Bank, Chesapeake's high performing Chesapeake Payment Systems (CPS) division moved into their new office on Lafayette Street in Williamsburg. *Virginia Business* magazine published a photo and write-up about Cash Flow. The readers of "Virginia Gazette" in Williamsburg voted Chesapeake Bank the "Best Financial Institution" beating out stiff competition from SunTrust, which usually takes those honors. Additionally, the Williamsburg Chamber of Commerce designated Chesapeake Bank "Corporate Citizen of the Year."

As always, we appreciate your continued support. Please review the contents of this report and don't hesitate to call us should you have any questions. We also hope that you will join us at our Annual Shareholders' Meeting at 4:00 p.m. on Friday, April 4, 2008, 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

	2007	2006	2005	2004	2003
	(Dollars in thousands except ratios and per share amounts)				
Results of Operations					
Interest income	$ 28,017	$ 24,630	$ 20,634	$ 17,629	$ 16,340
Interest expense	13,471	10,365	6,414	4,332	4,668
Net interest income	14,546	14,265	14,220	13,297	11,672
Provision for loan losses	160	833	990	1,095	810
Net interest income after provision for loan losses	14,386	13,432	13,230	12,202	10,862
Noninterest income	13,484	11,613	9,866	8,030	7,815
Noninterest expenses	21,808	19,643	18,168	15,478	14,359
Income before tax	6,062	5,402	4,927	4,754	4,318
Income tax expense	1,717	1,451	1,254	1,206	1,034
Net income	$ 4,345	$ 3,951	$ 3,673	$ 3,548	$ 3,284
Financial Condition					
Total assets	$ 443,002	$ 418,091	$ 382,694	$ 363,548	$ 332,424
Total deposits	383,214	358,777	328,535	309,367	289,892
Net loans	329,332	297,202	277,401	261,231	214,951
Long term debt	24,243	11,346	6,445	6,541	1,632
Trust preferred capital notes	25,775	10,310	10,310	10,310	10,310
Shareholders' equity	33,663	30,963	28,570	26,766	24,210
Average assets	447,886	403,833	376,126	346,568	313,106
Average shareholders' equity	31,768	29,090	26,829	23,977	21,833
Key Financial Ratios					
Return on average assets	0.97%	0.98%	0.98%	1.02%	1.05%
Return on average equity	13.73%	13.58%	13.69%	14.80%	15.04%
Dividends paid as a percent of net income	24.8%	23.5%	24.0%	23.0%	20.6%
Per Share Data					
Net income, assuming dilution	$ 1.49	$ 1.34	$ 1.23	$ 1.20	$ 1.11
Cash dividends declared	$ 0.350	$ 0.321	$ 0.304	$ 0.283	$ 0.242
Book value	$ 11.91	$ 10.81	$ 9.88	$ 9.24	$ 8.47

**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, 2007 and 2006	
	2007	**2006**
Assets		
Cash and due from banks	$ 12,676,152	$ 9,982,958
Federal funds sold	2,272,000	—
Securities available for sale, at approximate fair value	82,460,741	66,385,169
Loans, net of allowance for loan losses of $4,388,538 in 2007 and $4,342,174 in 2006	329,332,297	297,201,809
Premises and equipment, net	16,191,860	13,834,788
Accrued interest receivable	1,931,802	1,675,967
Cash management accounts, net	26,325,426	17,249,332
Other assets	11,811,754	11,760,486
Total assets	$ 483,002,032	$ 418,090,509
Liabilities and Shareholders' Equity		
Deposits:		
Demand accounts	$ 63,432,028	$ 66,242,122
Savings and interest bearing demand deposits	140,784,269	137,698,648
Certificates of deposit		
Denominations less than $100,000	104,559,539	91,205,351
Denominations of $100,000 or more	74,437,917	63,631,307
Total deposits	$ 383,213,753	$ 358,777,428
Federal funds purchased	—	5,001,000
Federal Home Loan Bank advances	14,000,000	—
Trust preferred capital notes	25,775,000	10,310,000
Long-term debt	24,242,673	11,345,950
Accrued interest payable	1,014,869	739,232
Accrued expenses and other liabilities	1,092,616	953,671
Commitments and contingencies	—	—
Total liabilities	$ 449,338,911	$ 387,127,281
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 2,827,474 in 2007 and 2,386,918 in 2006	14,137,370	11,934,590
Common stock, nonvoting, par value $5 per share; authorized 635,000 shares; no shares outstanding	—	—
Additional paid-in capital	173,833	132,151
Retained earnings	18,547,146	18,275,774
Accumulated other comprehensive income	804,772	620,713
Total shareholders' equity	$ 33,663,121	$ 30,963,228
Total liabilities and shareholders' equity	$ 483,002,032	$ 418,090,509

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

CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31, 2007, 2006 and 2005		
	2007	**2006**	**2005**
Interest Income			
Interest and fees on loans	$ 24,179,850	$ 21,483,909	$ 18,265,073
Interest on federal funds sold	70,165	88,340	70,754
Interest and dividends on securities available for sale:			
Taxable	2,776,632	1,839,746	1,086,965
Nontaxable	878,207	1,124,910	1,144,372
Dividends	111,664	93,360	66,907
Total interest and dividend income	$ 28,016,518	$ 24,630,265	$ 20,634,071
Interest Expense			
Savings and interest bearing accounts	$ 2,881,208	$ 2,671,857	$ 1,336,473
Certificates of deposit			
Denominations less than $100,000	4,500,947	3,645,667	2,466,332
Denominations of $100,000 or more	3,532,378	2,501,850	1,464,482
Short-term borrowings and FHLB advances	1,098,348	610,042	403,055
Long-term debt and trust preferred capital notes	1,457,988	936,061	744,090
Total interest expense	$ 13,470,869	$ 10,365,477	$ 6,414,432
Net interest income	$ 14,545,649	$ 14,264,788	$ 14,219,639
Provision for loan losses	160,000	833,333	990,000
Net interest income after provision for loan losses	$ 14,385,649	$ 13,431,455	$ 13,229,639
Noninterest Income			
Trust income	$ 1,836,446	$ 1,604,664	$ 1,312,738
Service charges	1,881,126	1,428,549	1,057,752
Net gain (loss) on other real estate owned	(167,964)	24,113	—
Net gain on sales of securities available for sale	86,761	69,513	111,220
Net gain on sales of premises and equipment	—	483,877	—
Other income	9,848,104	8,002,680	7,384,008
Total noninterest income	$ 13,484,473	$ 11,613,396	$ 9,865,718

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

CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31, 2007, 2006 and 2005		
	2007	**2006**	**2005**
Noninterest Expenses			
Salaries and benefits	$ 10,825,354	$ 9,967,763	$ 8,917,144
Occupancy expenses	3,147,709	2,768,398	2,624,087
Other expenses	7,834,708	6,906,846	6,627,215
Total noninterest expenses	$ 21,807,771	$ 19,643,007	$ 18,168,446
Income before income taxes	$ 6,062,351	$ 5,401,844	$ 4,926,911
Income tax expense	1,717,211	1,451,300	1,254,397
Net income	$ 4,345,140	$ 3,950,544	$ 3,672,514
Earnings per share, basic	$ 1.53	$ 1.37	$ 1.27
Earnings per share, diluted	$ 1.49	$ 1.34	$ 1.23

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31, 2007, 2006 and 2005		
	2007	**2006**	**2005**
Cash Flows from Operating Activities			
Net income	$ 4,345,140	$ 3,950,544	$ 3,672,514
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	1,540,572	1,208,958	1,094,947
Provision for loan losses	160,000	833,333	990,000
Provision for cash management account losses	350,000	200,000	300,000
Deferred income tax (benefit)	(41,803)	(39,862)	(533,252)
(Accretion) amortization of discounts and premiums, net	(208,634)	(160,215)	352,555
Net (gain) on securities available for sale	(86,761)	(69,513)	(111,220)
Net loss (gain) on other real estate owned	167,964	(24,113)	—
Net (gain) on sales of premises and equipment	—	(483,877)	—
Stock-based compensation	115,155	118,000	—
Origination of loans available for sale	(1,119,000)	(17,889,872)	(25,288,899)
Proceeds from sale of loans available for sale	1,119,000	17,889,872	25,288,899
Issuance of common stock for services	99,049	308,458	176,630
Changes in other assets and liabilities:			
(Increase) in accrued interest receivable	(255,835)	(125,778)	(112,196)
(Increase) in other assets	(1,824,760)	(703,723)	(676,212)
Increase in accrued interest payable	275,637	486,634	150,533
Increase (decrease) in other liabilities	138,945	(627,532)	121,823
Net cash provided by operating activities	$ 4,774,669	$ 4,871,314	$ 5,426,122
Cash Flows from Investing Activities			
Purchases of securities available for sale	$ (46,189,850)	$ (45,140,421)	$ (22,581,954)
Proceeds from sales and calls of securities available for sale	10,987,370	18,264,479	3,228,649
Proceeds from maturities of securities available for sale	19,701,181	13,930,339	21,275,225
Proceeds from sale of other real estate	1,404,363	636,113	63,500
Net (increase) in loans	(32,290,488)	(23,445,956)	(17,159,935)
Net (increase) decrease in cash management accounts	(9,426,094)	259,388	(1,157,523)
Proceeds from sale of premises and equipment	—	645,305	—
Other capital expenditures	(3,749,495)	(1,761,082)	(5,265,819)
Net cash (used in) investing activities	$ (59,563,013)	$ (36,611,835)	$ (21,597,857)

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

	Years Ended December 31, 2007, 2006 and 2005		
	2007	**2006**	**2005**
Cash Flows from Financing Activities			
Net increase (decrease) in short-term borrowings and federal funds purchased	$ 8,999,000	$ (1,999,000)	$ (2,003,000)
Net increase (decrease) in demand accounts, interest-bearing demand accounts and savings accounts	275,527	11,288,440	(5,301,807)
Net increase in certificates of deposits	24,160,798	18,953,945	24,470,152
Net proceeds from issuance of common stock	232,213	222,325	311,125
Repurchase of common stock	(1,273,858)	(1,164,312)	(995,909)
Cash dividends	(1,001,865)	(927,950)	(882,654)
Proceeds from issuance of trust preferred capital notes	15,465,000	—	—
Proceeds from issuance of long-term debt	13,000,000	5,000,000	—
Curtailment of long-term debt	(103,277)	(99,237)	(95,370)
Net cash provided by financing activities	$ 59,753,538	$ 31,274,211	$ 15,502,537
Net increase (decrease) in cash and cash equivalents	$ 4,965,194	$ (466,310)	$ (669,198)
Cash and cash equivalents at beginning of year	9,982,958	10,449,268	11,118,466
Cash and cash equivalents at end of year	$ 14,948,152	$ 9,982,958	$ 10,449,268
Supplemental Disclosures of Cash Flow Information			
Cash paid during the year for:			
Interest	$ 13,195,232	$ 10,093,282	$ 6,263,899
Income taxes	$ 1,895,000	$ 1,624,000	$ 1,793,277
Supplemental Schedule of Noncash Investing and Financing Activities			
Unrealized gain (loss) on securities available for sale	$ 278,879	$ (172,754)	$ (723,245)
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 SHAREHOLDERS' EQUITY

Years Ended December 31, 2007, 2006 and 2005

	Common Stock, Voting	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Comprehensive Income	Total
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 ($0.30 per share)	—	—	(882,654)	—		(882,654)
Balance, December 31, 2005	$ 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 ($0.32 per share)	—	—	(927,950)	—		(927,950)
Balance, December 31, 2006 (forwarded)	$ 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.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

Years Ended December 31, 2007, 2006 and 2005

	Common Stock, Voting	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Comprehensive Income	Total
Balance, December 31, 2006						
(brought forward)	$ 11,934,590	$ 132,151	$ 18,275,774	$ 620,713		$ 30,963,228
Comprehensive income:						
Net income	—	—	4,345,140	—	$ 4,345,140	4,345,140
Other comprehensive income:						
Unrealized holding gains on securities available for sale, net of deferred income taxes of $124,319	—	—	—	—	241,321	—
Reclassification adjustment, net of income taxes of $29,499	—	—	—	—	(57,262)	—
Other comprehensive income, net of tax	—	—	—	184,059	184,059	184,059
Total comprehensive income	—	—	—	—	$ 4,529,199	—
Exercise of stock options	120,000	112,213	—	—		232,213
Issuance of common stock for services	31,030	68,019	—	—		99,049
Repurchase of common stock	(321,920)	(253,705)	(698,233)	—		(1,273,858)
Stock-based compensation	—	115,155	—	—		115,155
Effect of stock split	2,373,670	—	(2,373,670)	—		—
Cash dividends ($0.35 per share)	—	—	(1,001,865)	—		(1,001,865)
Balance, December 31, 2007	$ 14,137,370	$ 173,833	$ 18,547,146	$ 804,772		$ 33,663,121

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 (the "Trusts"). 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 Trusts which approximated $775,000 at December 31, 2007 and 2006. The subordinate debt of the Trusts 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 Splits

On July 20, 2007, the Board of Directors approved a 6-for-5 stock split of CFS's common stock. On October 21, 2005, the Board 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 splits.

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 $1,143,141 and $2,720,016 of foreclosed properties in other assets at December 31, 2007 and 2006, 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 and the 6-for-5 stock split in 2007.

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 Management 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, 2007, 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 year ended December 31, 2005, 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 and the 6-for-5 stock split in 2007.

		December 31, 2005
Net income	As reported	$ 3,672,514
	Pro forma	3,551,136
Earnings per share - basic	As reported	1.27
	Pro forma	1.23
Earnings per share - diluted	As reported	1.23
	Pro forma	1.19

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (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 rather, provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those years. The FASB has approved a one-year deferral for the implementation of the Statement for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. CFS does not expect the implementation of SFAS 157 to have a material impact on its consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS 159). This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective of this Statement is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The fair value option established by this Statement permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The fair value option may be applied instrument by instrument and is irrevocable. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, with early adoption available in certain circumstances. CFS does not expect the implementation of SFAS 159 to have a material impact on its consolidated financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141(R), "Business Combinations" (SFAS 141(R)). The Standard will significantly change the financial accounting and reporting of business combination transactions. SFAS 141(R) establishes principles for how an acquirer recognizes and measures the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for acquisition dates on or after the beginning of an entity's first year that begins after December 15, 2008. CFS does not expect the implementation of SFAS 141(R) to have a material impact on its consolidated financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, "Noncontrolling Interests in Consolidated Financial Statements an Amendment of ARB No. 51" (SFAS 160). The Standard will significantly change the financial accounting and reporting of noncontrolling (or minority) interests in consolidated financial statements. SFAS 160 is effective as of the beginning of an entity's first fiscal year that begins after December 15, 2008, with early adoption prohibited. CFS does not expect the implementation of SFAS 160 to have a material impact on its 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. The FASB has approved that FIN 48's effective date be deferred to fiscal years beginning after December 15, 2007 for nonpublic enterprises.

In September 2006, the Emerging Issues Task Force (EITF) 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 SFAS 106 (if, in substance, a postretirement benefit plan exists) 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, with early application permitted. CFS is evaluating the effect that EITF 06-4 will have on its consolidated financial statements when implemented.

In November 2006, the EITF issued "Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements" (EITF 06-10). In this Issue, a consensus was reached that an employer should recognize a liability for the postretirement benefit related to a collateral assignment split-dollar life insurance arrangement in accordance with either SFAS 106 or APB Opinion No. 12, as appropriate, if the employer has agreed to maintain a life insurance policy during the employee's retirement or provide the employee with a death benefit based on the substantive agreement with the employee. A consensus also was reached that an employer should recognize and measure an asset based on the nature and substance of the collateral assignment split-dollar life insurance arrangement. The consensuses are effective for fiscal years beginning after December 15, 2007, including interim periods within those fiscal years, with early application permitted. CFS is evaluating the effect that EITF 06-10 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, 2007 and 2006, are as follows:

2007

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities of state and political subdivisions	$ 20,271,610	$ 955,429	$ (40,887)	$ 21,186,152
Mortgage-backed securities	58,253,979	560,290	(255,480)	58,558,789
Preferred stock	50,000	—	—	50,000
Restricted stock	2,665,800	—	—	2,665,800
Total	$ 81,241,389	$ 1,515,719	$ (296,367)	$ 82,460,741

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

Information pertaining to securities with gross unrealized losses at December 31, 2007 and 2006, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

2007

	Less Than 12 Months		12 Months or More	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
Securities of state and political subdivisions	$ 2,557,079	$ (25,613)	$ 307,283	$ (15,274)
Mortgage-backed securities	20,639,532	(235,818)	3,344,641	(19,662)
	$ 23,196,611	$ (261,431)	$ 3,651,924	$ (34,936)

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)

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, 2007 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, 2007, 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	$ 12,734,072	$ 12,760,168
Due after one year through five years	45,729,471	46,195,389
Due after five years through ten years	13,467,921	13,950,055
Due after ten years	6,594,125	6,839,329
Other	2,715,800	2,715,800
Total	$ 81,241,389	$ 82,460,741

Proceeds from sales and calls of securities available for sale during 2007, 2006 and 2005 were $10,987,370, $18,264,479 and $3,228,649, respectively. Gross realized gains amounted to $95,032, $172,067 and $111,220 in 2007, 2006 and 2005. Gross realized losses amounted to $8,271 and $102,554 in 2007 and 2006, and there were no gross realized losses during 2005. The tax provision applicable to these net realized gains amounted to $29,499, $23,634 and $37,815 in 2007, 2006 and 2005, 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 $62,307,663 and $31,399,559 at December 31, 2007 and 2006, respectively.

Note 3. Loans

A summary of the balances of loans follows:

	December 31, 2007	December 31, 2006
Commercial	$ 193,200,806	$ 186,251,924
Real estate mortgage	82,362,880	69,775,020
Real estate construction	30,173,387	14,409,503
Consumer	23,380,959	25,599,087
Participations with other banks	4,073,876	4,356,739
Other	528,927	1,151,710
	$ 333,720,835	$ 301,543,983
Less: Allowance for loan losses	4,388,538	4,342,174
Loans, net	$ 329,332,297	$ 297,201,809

Overdrafts totaling $462,297 and $969,766 at December 31, 2007 and 2006, respectively, were reclassified from deposits to loans.

An analysis of the allowance for loan losses follows:

	December 31, 2007	2006	2005
Balance at beginning of year	$ 4,342,174	$ 4,199,745	$ 3,341,346
Provision for loan losses	160,000	833,333	990,000
Loans charged off	(136,387)	(747,721)	(167,856)
Recoveries on loans previously charged off	22,751	56,817	36,255
Balance at end of year	$ 4,388,538	$ 4,342,174	$ 4,199,745

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

	December 31, 2007	2006	2005
Impaired loans without a valuation allowance	$ 327,075	$ 141,388	$ 71,859
Impaired loans with a valuation allowance	2,803,081	3,191,873	3,407,084
Total impaired loans	$ 3,130,156	$ 3,333,261	$ 3,478,943
Valuation allowance related to impaired loans	$ 614,343	$ 803,282	$ 723,431

	Years Ended December 31, 2007	2006	2005
Average investment in impaired loans	$ 3,231,709	$ 3,406,102	$ 3,481,162
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 $818,185, $453,233 and $216,106 at December 31, 2007, 2006 and 2005, respectively. If interest on these loans had been accrued, such income would have approximated $36,484, $70,051 and $168,125 at December 31, 2007, 2006 and 2005, respectively.

There were no loans 90 days past due and still accruing interest at December 31, 2007, 2006 and 2005.

Note 4. Premises and Equipment

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

	December 31, 2007	2006
Land	$ 3,790,653	$ 3,235,478
Buildings	11,537,047	9,055,977
Furniture, fixtures and improvements	1,771,163	1,264,721
Mechanical equipment	5,995,856	5,006,198
Leasehold improvements	2,354,995	2,354,995
Construction in progress	28,313	1,181,666
	$ 25,478,027	$ 22,099,035
Less accumulated depreciation	9,286,167	8,264,247
	$ 16,191,860	$ 13,834,788

For the years ended December 31, 2007, 2006 and 2005, depreciation expense was $1,392,423, $1,035,246 and $980,449, respectively.

Note 5. Borrowings

CFS's fixed-rate long-term debt of $24,242,673 at December 31, 2007 matures through 2018. $574,019 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. $23,000,000 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 5.36% and mature 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, 2007 for this borrowing was $668,654. Aggregate maturities during the next five years are: 2008, $5,607,495; 2009, $2,111,904; 2010, $13,116,511; 2011, $121,325; and 2012, $126,358.

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, 2007	December 31, 2006
Deferred tax assets:		
Allowance for loan and cash management account losses	$ 1,626,147	$ 1,455,767
Other real estate	26,786	192,157
Deferred compensation	88,856	93,935
Premises and equipment	158,638	108,477
Other	15,529	23,817
	$ 1,915,956	$ 1,874,153
Deferred tax liabilities:		
Securities available for sale	$ 414,580	$ 319,761
Net deferred tax asset	$ 1,501,376	$ 1,554,392

The provision for income taxes charged to operations for the years ended December 31, 2007, 2006 and 2005, consists of the following:

	2007	2006	2005
Current tax expense	$ 1,759,014	$ 1,491,162	$ 1,787,649
Deferred tax (benefit)	(41,803)	(39,862)	(533,252)
	$ 1,717,211	$ 1,451,300	$ 1,254,397

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, 2007, 2006 and 2005, due to the following:

	2007	2006	2005
Computed "expected" tax expense	$ 2,061,199	$ 1,836,627	$ 1,675,150
(Decrease) in income taxes resulting from:			
Tax exempt interest income	(320,542)	(378,541)	(372,727)
Other	(23,446)	(6,786)	(48,026)
	$ 1,717,211	$ 1,451,300	$ 1,254,397

Note 7. Employee Benefit Plans

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 2007 or 2006.

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

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

	2006	2005
Funded Status	$ —	$ (1,988,415)
Unrecognized net actuarial loss	—	1,476,243
Unrecognized net obligation at transition	—	16,274
Unrecognized prior service cost	—	15,745
Accrued benefit cost included in other liabilities at September 30	$ —	$ (480,153)
Contribution made in December	—	305,757
Prepaid (accrued) benefit cost included in other assets (liabilities) at December 31	$ —	$ (174,396)

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

The components of net periodic benefit cost are as follows:

	2005
Service cost	$ 414,335
Interest cost	278,998
Expected return on plan assets	(217,908)
Amortization of prior service cost	2,624
Amortization of net obligation at transition	4,070
Recognized net actuarial loss	58,577
Net periodic benefit cost	$ 540,696

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

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, $270,000 and $150,000 during the years ended December 31, 2007, 2006 and 2005, 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. CFS also makes discretionary contributions to the plan. Total expense related to the plan was $507,204, $491,566 and $218,736 for 2007, 2006 and 2005, respectively.

Note 8. Stock Option Plans

In 1996, CFS adopted an incentive stock option plan that reserved for issuance 252,000 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 156,000 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 $115,155 and $118,000 for the year ended December 31, 2007 and 2006, respectively. No compensation expense was recognized under the plans for the year ended December 31, 2005. No income tax benefit was recognized in the income statement for stock-based compensation arrangements for the years ended December 31, 2007, 2006 and 2005.

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, and the 6-for-5 stock split in 2007.

A summary of the option activity under the plans at December 31, 2007 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	223,440	$ 11.50		
Granted	35,400	16.25		
Exercised	(28,800)	8.06		
Forfeited	(2,400)	6.04		
Outstanding at end of year	227,640	12.73	6.3 years	$ 1,370,393
Options exercisable, end of year	121,200	9.73	3.8 years	1,093,224

The weighted-average grant date fair value of options granted during the years ended December 31, 2007, 2006 and 2005 was $3.03, $3.28 and $4.18, respectively. The total intrinsic value of options exercised during the years ended December 31, 2007 was $235,000.

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,		
	2007	2006	2005
Dividend yield	2.11%	2.13%	1.93%
Expected term	6 years	6 years	10 years
Expected volatility	14.67%	15.55%	16.54%
Risk-free interest rate	4.60%	4.95%	4.57%

As of December 31, 2007, there was $128,850 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 1.75 years.

Note 9. Shareholders' Equity

During 2007, 2006 and 2005, CFS issued 6,206 shares, 6,156 shares and 4,656 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 and the 6-for-5 stock split in 2007.

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, 2007 are as follows:

Year Ending December 31,	
2008	$ 210,423
2009	225,156
2010	243,530
2011	279,905
2012	312,652

Rent expense under operating leases aggregated $247,383, $239,003 and $226,136 for the years ended December 31, 2007, 2006 and 2005, 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, 2007 and 2006, the aggregate amounts of daily average required balances were approximately $1,674,000, and $1,143,000, respectively.

Note 11. Related Party Transactions

Officers, directors and their affiliates had borrowings of $6,672,823 and $5,368,260 at December 31, 2007 and 2006, respectively, with the Bank.

Changes in borrowings during 2007 were as follows:

Balance, December 31, 2006	$ 5,368,260
Additions	3,988,079
Payments	(2,683,516)
Balance, December 31, 2007	$ 6,672,823

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:

	2007	2006	2005
Cash management fees and discount	$ 4,275,417	$ 2,915,253	$ 2,966,205
Merchant discount	3,027,268	2,505,673	2,200,199
ATM fee income	798,245	715,388	610,286
Other (includes no items in excess of 1% of total revenue)	1,747,174	1,866,366	1,607,318
	$ 9,848,104	$ 8,002,680	$ 7,384,008

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

	2007	2006	2005
Advertising	$ 497,669	$ 446,369	$ 354,882
Merchant card	2,249,933	1,914,769	1,674,464
Cash management royalties	311,563	320,509	559,738
Provision for cash management account losses	350,000	200,000	300,000
Legal fees	176,028	215,692	266,701
Delivery and transportation	354,036	357,362	321,223
Stationary and supplies	448,064	442,994	401,588
Other (includes no items in excess of 1% of total revenue)	3,447,415	3,009,151	2,748,619
	$ 7,834,708	$ 6,906,846	$ 6,627,215

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 and the 6-for-5 stock split in 2007.

	2007	2006	2005
Weighted average number of common shares, basic	2,846,542	2,895,464	2,902,705
Effect of dilutive stock options	69,652	54,946	83,023
Weighted average number of common shares and dilutive potential common stock used in diluted EPS	2,916,194	2,950,410	2,985,728

Options on approximately 35,460 shares and 44,370 shares were not included in the computation of diluted earnings per share for the years ended December 31, 2007 and 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 year ended December 31, 2005.

Note 14. Time Deposits

Remaining maturities on certificates of deposit are as follows:

2008	$ 147,443,470
2009	22,103,966
2010	8,986,402
2011	283,615
2012	180,003
	$ 178,997,456

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, 2007 and 2006, the following financial instruments were outstanding whose contract amounts represent credit risk:

	Contract Amount	
	2007	**2006**
Commitments to grant loans	$ 8,064,043	$ 4,273,847
Unfunded commitments under lines of credit	82,452,367	78,938,931
Commercial and standby letters of credit	4,427,858	2,670,212

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 $1,998,594 at December 31, 2007.

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, 2007 and 2006, 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:

	2007		2006	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(In Thousands)		*(In Thousands)*	
Financial assets:				
Cash and short-term investments	$ 14,948	$ 14,948	$ 9,983	$ 9,983
Securities	82,461	82,461	66,385	66,385
Loans	329,332	338,122	297,202	295,113
Cash management accounts	26,325	26,325	17,249	17,249
Accrued interest receivable	1,932	1,932	1,676	1,676
Financial liabilities:				
Deposits	$ 383,214	$ 384,770	$ 358,777	$ 358,383
Short-term borrowings	14,000	14,000	5,001	5,001
Long-term debt	50,018	50,346	21,656	21,560
Accrued interest payable	1,015	1,015	739	739

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, 2007 and 2006, that CFS meets all capital adequacy requirements to which it is subject.

As of December 31, 2007, 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, 2007:						
Total Capital (to Risk Weighted Assets):						
Consolidated	$ 62,939	15.5%	$ 32,489	8.0%	N/A	
Chesapeake Bank	$ 46,289	11.5%	$ 32,233	8.0%	$ 40,291	10.0%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	$ 43,811	10.8%	$ 16,245	4.0%	N/A	
Chesapeake Bank	$ 41,248	10.2%	$ 16,116	4.0%	$ 24,174	6.0%
Tier 1 Capital (to Average Assets):						
Consolidated	$ 43,811	9.3%	$ 18,835	4.0%	N/A	
Chesapeake Bank	$ 41,248	8.8%	$ 18,654	4.0%	$ 23,318	5.0%
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%

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, 2007 was 8.53%. The interest rate as of December 31, 2007 was 8.59%. The securities had a mandatory redemption date of January 7, 2033, and were subject to varying call provisions beginning January 7, 2008. The trust preferred capital notes were called and repaid by CFS on January 7, 2008. The principal asset of the Trust was $10.3 million of the Corporation's junior subordinated debt securities with like maturities and like interest rates to Capital Securities.

On July 2, 2007, CFS Capital Trust II, a wholly-owned subsidiary of CFS, was formed for the purpose of issuing redeemable Capital Securities. On July 5, 2007, $15.465 million of trust preferred securities were issued through a pooled underwriting totaling approximately $611 million. The securities have a LIBOR-indexed floating rate of interest. The weighted-average interest rate for the year ended December 31, 2007 was 6.71%. The interest rate as of December 31, 2007 was 6.75%. The securities have a mandatory redemption date of October 1, 2037, and are subject to varying call provisions beginning September 6, 2012. The principal asset of the Trust is $15.465 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, 2007, the amount available for payment of additional dividends without prior regulatory approval from the Bank to the parent company is $11,484,948 or 34.1% of consolidated net assets.

Balance Sheets (Condensed)

	December 31, 2007	December 31, 2006
Assets		
Cash	$ 14,345,651	$ 1,330,089
Investment in subsidiaries	44,852,276	39,411,009
Premises and equipment, net	1,040,176	1,152,467
Other assets	321,027	259,127
Total assets	$ 60,559,130	$ 42,152,692
Liabilities and Shareholders' Equity		
Long-term debt	$ 574,019	$ 615,494
Trust preferred capital notes	25,775,000	10,310,000
Other liabilities	546,990	263,970
Shareholders' equity	33,663,121	30,963,228
Total liabilities and shareholders' equity	$ 60,559,130	$ 42,152,692

Statements of Income (Condensed)

	2007	2006	2005
Income - Dividends from subsidiaries	$ 1,228,102	$ 1,219,775	$ 1,215,249
Other	139,045	196,944	164,870
Total income	$ 1,367,147	$ 1,416,719	$ 1,380,119
Expenses - Interest expense	$ 1,451,018	$ 928,486	$ 735,941
Other expenses	746,494	659,554	545,824
Total expenses	$ 2,197,512	$ 1,588,040	$ 1,281,765
Income (loss) before income taxes and equity in undistributed earnings of subsidiaries	$ (830,365)	$ (171,321)	$ 98,354
Allocated income tax benefit	626,388	405,679	354,515
Income (loss) before equity in undistributed earnings of subsidiaries	$ (203,977)	$ 234,358	$ 452,869
Equity in undistributed earnings of subsidiaries	4,549,117	3,716,186	3,219,645
Net income	$ 4,345,140	$ 3,950,544	$ 3,672,514

Statements of Cash Flows (Condensed)

	2007	2006	2005
Cash Flows from Operating Activities			
Net income	$ 4,345,140	$ 3,950,544	$ 3,672,514
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation	112,291	112,340	109,711
Equity in undistributed earnings of subsidiaries	(4,549,117)	(3,716,186)	(3,219,645)
Issuance of common stock for services	99,049	308,458	176,630
Stock-based compensation	115,155	118,000	—
Changes in other assets and liabilities:			
(Increase) decrease in other assets	(519,991)	464,241	(180,883)
Increase in other liabilities	283,020	15,220	24,597
Net cash provided by (used in) operating activities	$ (114,453)	$ 1,252,617	$ 582,924
Cash Flows from Investing Activities			
Purchases of premises and equipment	$ —	$ (2,069)	$ (376,211)
Investment in subsidiaries	(250,000)	(250,000)	(500,000)
Net cash (used in) investing activities	$ (250,000)	$ (252,069)	$ (876,211)
Cash Flows from Financing Activities			
Dividends paid	$ (1,001,865)	$ (927,950)	$ (882,654)
Curtailment of note payable	(41,475)	(39,260)	(37,164)
Repurchase of common stock	(1,273,858)	(1,164,312)	(995,909)
Proceeds from issuance of trust preferred capital notes	15,465,000	—	—
Net proceeds from issuance of common stock	232,213	222,325	311,125
Net cash provided by (used in) financing activities	$ 13,380,015	$ (1,909,197)	$ (1,604,602)
Net increase (decrease) in cash	$ 13,015,562	$ (908,649)	$ (1,897,889)
Cash at beginning of year	1,330,089	2,238,738	4,136,627
Cash at end of year	$ 14,345,651	$ 1,330,089	$ 2,238,738

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, 2007 and 2006, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for the years ended December 31, 2007, 2006 and 2005. 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, 2007 and 2006, and the results of their operations and their cash flows for the years ended December 31, 2007, 2006 and 2005, in conformity with accounting principles generally accepted in the United States of America.

Yount, Hyde & Barbour, P.C.

Winchester, Virginia
February 28, 2008

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

Financial Overview: Chesapeake Financial Shares, Inc (CFS). had a return on average equity in 2007 of 13.7% and a return on average assets of 0.96% compared to 13.6% and 0.98%, respectively, in 2006. Total assets at year-end were $483 million, representing a 15.5% increase over the December 31, 2006 balance of $418.1 million. The Company ended the year with total gross loans of $333.7 million, and total deposits of $383.2 million, up 10.7% and 6.8%, respectively. Asset quality remained strong with net allowance for loan losses to gross loans of 1.3%, and loans over thirty days delinquent at 1.8% 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 2007 were $4,345,140 or $1.49 per share (fully diluted) compared to $3,950,544 or $1.34 per share in 2006, an increase of $394,596. The 10.0% increase in net income resulted from a 16.1% increase or $1,871,077 in noninterest income. Noninterest expense increased by 11.0% or $2,164,764 in 2007 over 2006. All noninterest income items were up in 2007. Cash Flow Services income increased by $1,360,164 or 46.7% in 2007. Merchant Card income increased by 20.8% or $521,595 in 2007. Total noninterest expense was up for the year due primarily to normal increases in operating expenses, however there was a significant increase of 27.1% in Cash Flow expenses.

Earnings for 2006 were $3,950,544 or $1.34 per share (fully diluted) compared to $3,672,514 or $1.23 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 $2,720,645 or 17.6% 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.

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 $333.7, $301.5 and $281.6 million for 2007, 2006, and 2005, respectively, representing an increase of 10.7% for 2007 over 2006, 7.1% for 2006 over 2005, and 6.4% for 2005 over 2004. The increase in 2007 was primarily in commercial loans, up 3.7% or $6.9 million, real estate mortgage, up 18.0% or $12.6 million, and real estate construction loans, up 109.4% or $15.8 million. Participations with other banks decreased $282.9 thousand or 6.5% as did consumer loans, down 8.7% or $2.2 million. All other loans decreased $622.8 thousand or 54.1%.

On December 31, 2007, the loan portfolio consisted of 57.9% commercial loans, 33.7% single-family residential and residential construction loans, and 7% 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 $2,219,861 at December 31, 2007, which represented a decrease from $3,173,248 at December 31, 2006. Past due loans over thirty days were 1.8% of total loans at December 31, 2007. 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 CFS'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 CFS 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 $804,772, net of the tax effect, at December 31, 2007, and by $620,713, net of the tax effect, at December 31, 2006. 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 $82.5 million, up $16.1 million from the $66.4 million on December 31, 2006. Investments in mortgage-backed securities increased from the 2006 levels of $45.7 million to $58.6 million or 28.2%. Investments in securities of state and political subdivisions increased by $2.0 million or 10.5%.

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 allowance for loan losses was $4,388,538 or 1.3% of gross loans less unearned discounts at year-end. This ratio was 1.4% on December 31, 2006, and 1.5% in 2005. The 2007 provision was $160,000. There was a provision of $833,333 in 2006 compared to the 2005 provision of $990,000. Loans charged off totaled $136,387 in 2007, $747,721 in 2006, and $167,856 in 2005. Recoveries for the same periods were $22,751, $56,817, and $36,255, 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: CFS 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 CFS's liabilities and account for the greatest portion of interest expense.

Deposits totaled $383.2, $358.8, and $328.5 million for 2007, 2006, and 2005, respectively, and represented an increase of 6.8% for 2007 over 2006 and an increase of 9.2% for 2006 over 2005. There was a 15.6% increase in certificates of deposit during 2007 while noninterest bearing deposits decreased by $2.8 million or 4.2% from $66.2 million on December 31, 2006. Savings and interest bearing demand deposit balances increased during 2007 by 2.2% or $3.1 million to $140.8 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 $14.5, $14.3, and $14.2 million for 2007, 2006, and 2005, respectively, representing an increase of 2% for 2007 over 2006, 0.3% for 2006 over 2005, and 6.9% for 2005 over 2004. Loan demand was strong this year with total gross loans up 10.7% or $32.2 million for 2007 over 2006. Total interest expense was $13.5, $10.4, and $6.4 million for 2007, 2006 and 2005, respectively. On a tax equivalent annualized basis, the net interest margin was 4.1%, 4.2% and 4.8% for 2007, 2006 and 2005, respectively. The Bank's margins have been very stable and generally above peer through numerous rate cycles. The decline in the margin in 2007 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, 2007 noninterest income was $13.5 million, a 16.1% increase over the 2006 amount of $11.6 million, which was a 17.7% increase over the 2005 amount of $9.9 million. The increase in 2007 was due to the increases in service charges on deposit accounts of $453 thousand or 31.7%, Merchant Card income of $522 thousand or 20.8%, fiduciary income of $232 thousand or 14.4%, Cash Flow income of $1.4 million, or 46.7%, and ATM income of $83 thousand or 11.6%. Other income was actually down due to the gain on the sale of the old Hayes office of $483 thousand in 2006.

Noninterest Expenses: Total noninterest expenses increased 11% or $2.2 million in 2007 over 2006. In 2006, total noninterest expenses increased 8.1% over 2005 and increased 17.4% in 2005 over 2004. The increase in 2007 was due to an increase in salaries and benefits of 8.6% or $858 thousand, occupancy expenses increased 13.7% or $380 thousand, Cash Flow expenses increased 27.1% or $141 thousand, and merchant card expenses were up $335 thousand or 17.5%. Other expenses increased 10.1% or $452 thousand.

Liquidity, Interest Rate Sensitivity, and Inflation: The objectives of the CFS'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 CFS, 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 CFS'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, 2007, approximately 36.7% of the total invested portfolio dollars matured or were repricing within one year as compared to 36.1% on December 31, 2006. The Bank's loan portfolio was liquid with 59.3% of all loan dollars maturing or repricing within one year. This loan liquidity ratio was 58.7% on December 31, 2006.

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 $101 million, secured and unsecured. The Bank and CFS have access to additional secured borrowing for $4 million.

As of December 31, 2007, the Bank held $37,247 in repossessed assets and $1,143,141 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 CFS is dictated by the ability to produce capital. The adequacy of CFS's capital is reviewed by management on an ongoing basis with reference to the size, composition and quality of CFS'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, 2007, the Company had ratios of Tier 1 risk based capital to risk weighted assets of 10.8%, total risk based capital to risk weighted assets of 15.51%, and Tier 1 leverage capital of 9.3%. At December 31, 2006, these ratios were 11.1%, 12.5% and 9.6%, respectively. At December 31, 2007, these ratios for the bank were 10.2%, 11.5% and 8.8%, respectively, well above the regulatory minimums and exceeded the requirements for FDIC's "well capitalized" designation. As of December 31, 2007, the Company's primary capital to asset ratio was 9.1%.

Dividend and Market Information: The Company's stock trades on the "OTC" (Over The Counter) market under the symbol "CPKF". There was a 6-for-5 stock split in the form of a 20% stock dividend with a record date of October 15, 2007 and all per share information for all periods presented has been retroactively restated. The Company raised its dividend to $0.35 per share in 2007, an increase of $0.03 over 2006. This increase followed a $0.017 per share dividend increase from $0.304 in 2005 to $0.321 in 2006. 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 2007 from $15.50 to $20.50, and during 2006, from $14.17 to $15.92. 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, 2007, there were 2,827,474 shares of Company's common stock outstanding held by approximately 236 holders of record.

DIRECTORS AND OFFICERS

Chesapeake Financial Shares, Inc. — Directors

Douglas D. Monroe, Jr.
Chairman of the Board and
Chief Executive Officer

Jeffrey M. Szyperski
President

Eugene S. Hudnall, Jr.
Owner and Operator
Kilmarnock Mini Storage

Thomas E. Kellum
Vice President
W. Ellery Kellum, Inc.

Katherine W. Monroe
Shareholder

Bruce P. Robertson
President
Shirley Pewter Shop and
The Pink Cabana, Inc.

William F. Shumadine, Jr.
Former President of
Central Fidelity Bank

Robert J. Singley
Partner
RJS & Associates, Inc.

Thomas G. Tingle, AIA
President
Guernsey Tingle Architects

Chesapeake Bank — Directors

Jeffrey M. Szyperski
Chairman of the Board, President and
Chief Executive Officer

David E. Bush, CPA, CFP
Member
Witt Mares Eggleston Smith, PLC

Charles C. Chase, II
President, Chase Properties, Inc.

James M. Holmes, Jr.
President
Chesapeake Health Services

Eugene S. Hudnall, Jr.
Owner and Operator
Kilmarnock Mini Storage

Thomas E. Kellum
Vice President
W. Ellery Kellum, Inc.

Douglas D. Monroe, Jr.
Chairman Emeritus
Chesapeake Bank

Albert C. Pollard
President
Pollard Properties, Inc.

Thomas G. Tingle, AIA
President
Guernsey Tingle Architects

Harry M. Ward
Director
Insurance Pool for the Virginia
School Boards Association and
Legislative Services

Corporate Officers

Douglas D. Monroe, Jr.
Jeffrey M. Szyperski
Marshall N. Warner
John H. Hunt, II
John K. O'Shaughnessy
Larry T. Lawrence
J. Mark Monroe
Gegory V. Powell
Trudy M. Quinto
Dianne D. Hall
Kathleen S. Banks
Steven D. Callis
Robert G. Castleman
Pamela D. Chapman
Sherri L. Clowser
Melissa A. Crawford
Melissa A. Denison
Bryan D. Edmonds
Tucker K. Edmonds
Mark J. Eggleston
Rebecca A. Foster
Julie Williams George
Carlie H. Gill
David W. Homard
Catherine B. Jackson
Ryan C. Kent
Suzanne D. Keyser
Cecelia G. Klink
Jean H. Light
Roberta R. LeDoux
Patricia R. Lewis
W. J. McLachlan
P. Kim Miller
Paula A. Milsted
Catherine D. Mise
Johanna M. Northstein
Tracy R. Pastella
Ann Marie Pruitt
Carol C. Rakes
Thomas H. Richardson
Kristie K. Smith
Sandra L. Smith
Betty Sue Spence
Teresa W. Stewart
Paul L. Wegkamp, Jr.
Kevin S. Wood

Chesapeake Investment Group, Inc. — Directors

Jeffrey M. Szyperski, President
Leland T. James
Douglas D. Monroe, Jr.
William F. Shumadine, Jr.
Marshall N. Warner

Chesapeake Trust Company, Inc. — Directors

Gregory V. Powell, President
John H. Hunt, II
Ted M. Kattmann
John K. O'Shaughnessy
Jeffrey M. Szyperski
Marshall N. Warner

Chesapeake Financial Group, Inc. — Directors

J. Mark Monroe, President
John H. Hunt, II
Douglas D. Monroe, Jr.
John K. O'Shaughnessy
Jeffrey M. Szyperski
Marshall N. Warner

Chesapeake Investment Services — Directors

Trudy M. Quinto, President
John H. Hunt, II
Douglas D. Monroe, Jr.
John K. O'Shaughnessy
Jeffrey M. Szyperski
Marshall N. Warner

Chesapeake Bank — Business Advisory Boards

Peninsula
David E. Bush, CPA, CFP
Vincent A. Campana
Catherine B. Chaplain
J. Terry Deaver
Perry M. DePue
Patrick G. Duffeler
Vernon M. Geddy, III, Esq.
Bruce P. Robertson
John M. Sadler, Esq.
Thomas G. Tingle, AIA

Northen Neck
Martin L. Bowling
Stuart A. Bunting
James N. Carter, Jr.
Sandra H. Hargett
Susan F. Hill
Joseph P. Hudnall
Thomas E. Kellum
William R. Lee
Michael A. Lynch
Samuel E. Monroe, II
W. Bruce Sanders
Matson C. Terry, II, Esq.

Middle Peninsula
Dr. Layton H. Beverage
Nancy H. Dykeman, CPA
Elwood G. Everington
J. Scott Finney
Joseph K. Moorman
Harvey B. Morgan
David A. Morris, D.D.S.
David W. Muffelman, M.D.
Guy R. A. Sorensen
J. V. White
J. Stephen Wiseman

CHESAPEAKE
FINANCIAL SHARES INC.

Chesapeake Financial Shares, Inc.

Chesapeake Bank

Chesapeake Investment Group

P.O. Box 1419 • Kilmarnock, Virginia 22482 • 804-435-1181
www.chesbank.com • Ticker Symbol CPKF
To purchase CPKF please call 888-653-9088, Chesapeake Investment Group
www.chesvest.com