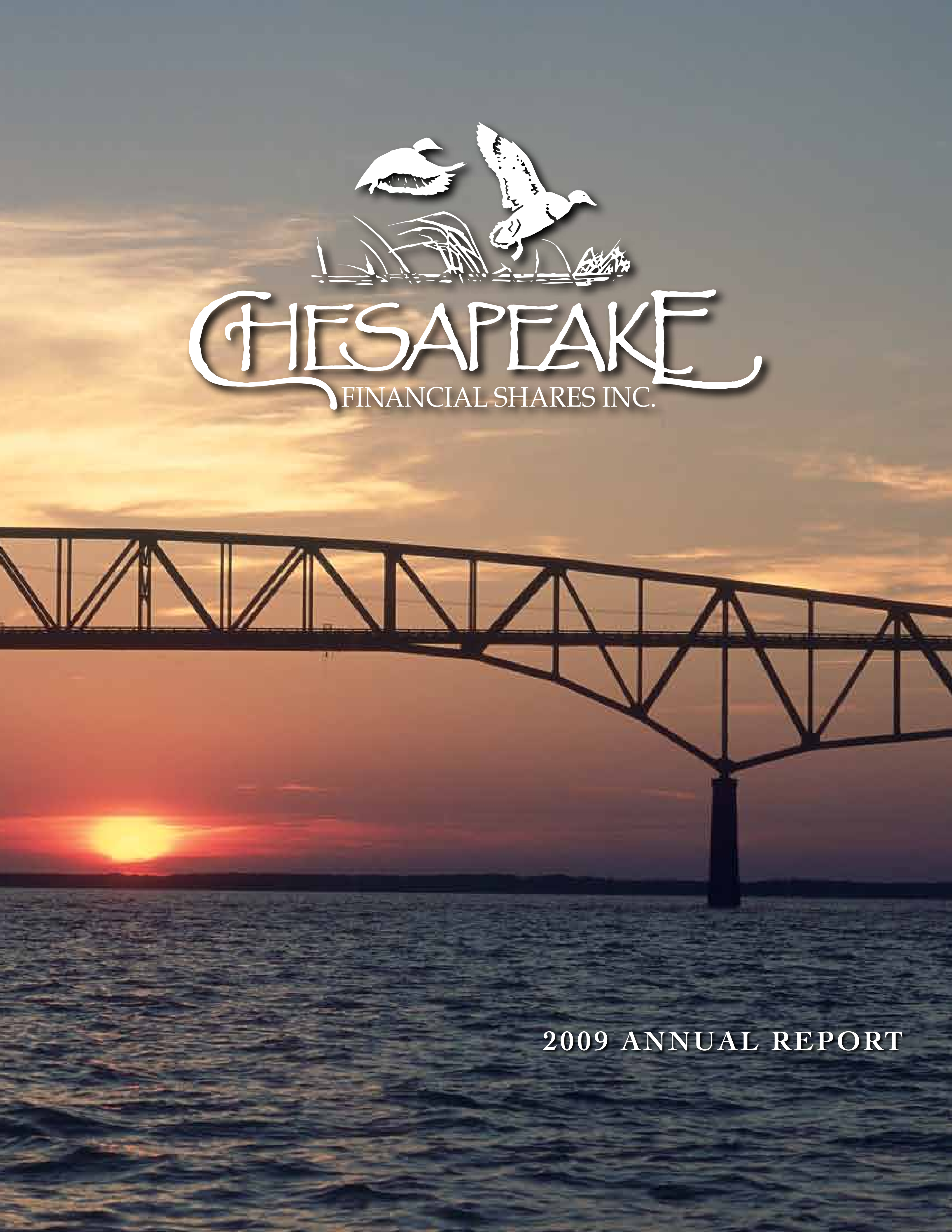
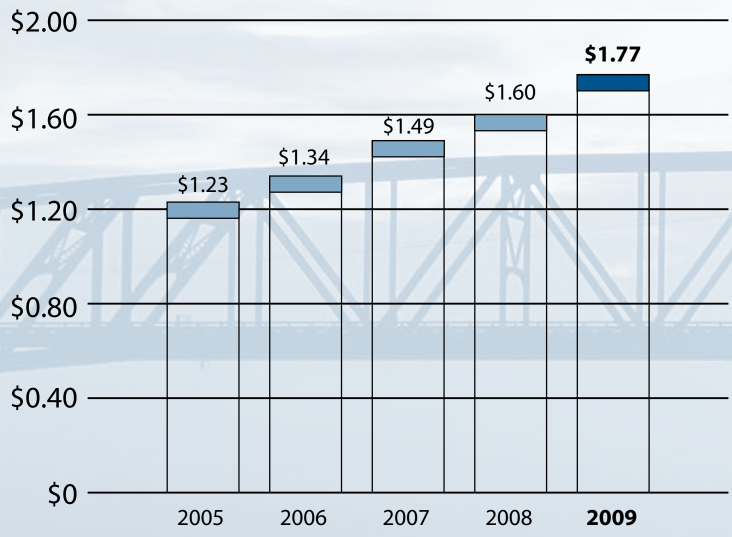


CHESAPEAKE
FINANCIAL SHARES INC.

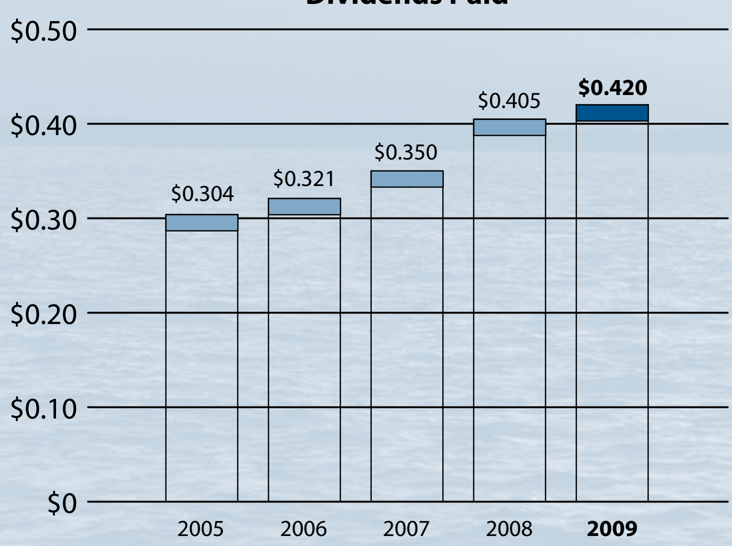
2009 ANNUAL REPORT

CONTENTS

Earnings Per Share, Diluted



Dividends Paid



DEAR SHAREHOLDER

2009 began where 2008 left off. Despite massive amounts of governmental stimulus spending in an effort to jumpstart the economy, both consumers and businesses were appropriately prudent in managing their own financial affairs. Neither consumer nor commercial sector spending were prepared to jump into the fray to fuel an "economic recovery." Diligently watching every dollar and making do with less were clearly the watchwords for 2009. The year culminated with 140 bank failures as compared to just 25 in 2008, with that pace appearing to accelerate going into 2010. The country, and the world for that matter, are in the grips of an economic slowdown which appears will take years to rectify.

In response to the economic collapse in 2008, a lot of "solutions" were brought to the legislative arena in 2009. Though many of them are still in various stages of passage or non-passage, 2009 represented a year of unprecedented regulatory reach into the financial services sector. Though some regulatory reform is needed, much of the legislation falls into the realm of either "too little too late" or "punishing many for the transgressions of a few." Overarching much of the political shadowboxing taking place in Washington was a growing interest in the political process, or more accurately, a populist attempt to reclaim much of the political power from Washington. Though this is happening at many levels and on different fronts, the most notable example of this is the formation and growth of the Tea Party movement. Time will tell whether this is merely a "flash in the pan" or a fundamental tectonic shift in the American political process.

2009 was also marked with goodbyes to many of those who have changed the world in which we live: Paul Harvey, Edward M. Kennedy, Walter Cronkite, Andrew Wyeth, Michael Jackson, Jack Kemp, and Millard Fuller (Habitat for Humanity), to name a few.

Running totally counter to overall results in the financial services industry, Chesapeake Financial Shares was able to post a record year for earnings. Our net income for the year was $4,834,927 representing a 5.1% increase over 2008. Earnings per share increased 10.6% to $1.77 fully diluted. Our return on average equity of 13.14% outperformed almost all within our peer group. In June of 2009 Chesapeake Financial Shares was also voted one of the "Top 200 Community Banks" in the country based on return on average equity, earning the position of #64 on that list.

Though 2009 was an exceptional year for our organization, we are acutely aware of the current economic slowdown and how we must respond to it. We fully understand that long-term shareholder growth is only possible through continued monitoring and intense vigilance of our loan and investment asset quality. We have devoted considerable resources to ensure that we are able to maintain this going forward. We are quite confident that the current strength of our organization provides us a competitive advantage going into 2010 and beyond. This is evidenced by continued outreach for business development in each of our markets as well as strategic investments that will help fuel the longer-term growth of our organization.

We want to truly thank you for being a shareholder of Chesapeake Financial Shares. We hope that you will take the time to review the contents of this report in detail. Additionally, and most importantly, we hope that you will plan on joining us for our Annual Shareholders Meeting on Friday, April 2, at Rappahannock Westminster-Canterbury in Irvington. We look forward to seeing you there.

Sincerely,

Jeffrey M. Szyperski

Jeffrey M. Szyperski
Chairman, CEO & President
Chesapeake Financial Shares, Inc.

SELECTED FINANCIAL INFORMATION

	2009	2008	2007	2006	2005
	(Dollars in thousands except ratios and per share amounts)				
Results of Operations					
Interest income	$ 30,543	$ 29,708	$ 28,017	$ 24,630	$ 20,634
Interest expense	11,615	13,245	13,471	10,365	6,414
Net interest income	18,928	16,463	14,546	14,265	14,220
Provision for loan losses	895	400	160	833	990
Net interest income after provision for loan losses	18,033	16,063	14,386	13,432	13,230
Noninterest income	14,066	15,017	13,484	11,613	9,866
Noninterest expenses	25,860	24,958	21,808	19,643	18,169
Income before tax	6,239	6,122	6,062	5,402	4,927
Income tax expense	1,404	1,521	1,717	1,451	1,254
Net income	$ 4,835	$ 4,601	$ 4,345	$ 3,951	$ 3,673
Financial Condition					
Total assets	$ 586,680	$ 537,952	$ 483,002	$ 418,091	$ 382,694
Total deposits	486,610	427,741	383,214	358,777	328,535
Net loans	360,607	358,917	329,332	297,202	277,401
Long term debt	42,024	55,135	24,243	11,346	6,445
Trust preferred capital notes	15,465	15,465	25,775	10,310	10,310
Shareholders' equity	35,270	30,552	33,663	30,963	28,570
Average assets	573,048	516,018	447,886	403,833	376,126
Average shareholders' equity	36,788	34,062	31,768	29,090	26,829
Key Financial Ratios					
Return on average assets	0.84%	0.89%	0.97%	0.98%	0.98%
Return on average equity	13.14%	13.51%	13.73%	13.58%	13.69%
Dividends paid as a percent of net income	24.1%	24.9%	24.8%	23.5%	24.0%
Per Share Data					
Net income, assuming dilution	$ 1.77	$ 1.60	$ 1.49	$ 1.34	$ 1.23
Cash dividends declared	$ 0.420	$ 0.405	$ 0.350	$ 0.321	$ 0.304
Book value	$ 12.88	$ 10.93	$ 11.91	$ 10.81	$ 9.88

**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, 2009 and 2008	
	2009	**2008**
Assets		
Cash and due from banks	$ 10,836,474	$ 11,149,371
Interest-bearing deposits in banks	2,392,000	—
Federal funds sold	—	5,705,000
Securities available for sale, at approximate fair value	142,931,386	91,635,902
Restricted stock, at cost	3,981,783	4,289,983
Loans, net of allowance for loan losses of $5,165,792 in 2009 and $4,715,574 in 2008	360,607,419	358,917,320
Premises and equipment, net	17,997,786	17,145,122
Accrued interest receivable	2,586,567	2,288,419
Cash management accounts, net of allowance of $1,056,969 in 2009 and $927,734 in 2008	24,518,901	31,619,663
Foreclosed assets	2,423,141	1,218,141
Other assets	18,404,749	13,982,869
Total assets	$ 586,680,206	$ 537,951,790
Liabilities and Shareholders' Equity		
Deposits:		
Demand accounts	$ 62,933,333	$ 62,192,303
Savings and interest bearing demand deposits	203,675,719	126,497,030
Certificates of deposit		
Denominations less than $100,000	123,390,816	138,901,556
Denominations of $100,000 or more	96,609,674	100,150,202
Total deposits	$ 486,609,542	$ 427,741,091
Federal Home Loan Bank advances	3,000,000	6,000,000
Other short-term borrowings	1,525,000	—
Trust preferred capital notes	15,465,000	15,465,000
Long-term debt	42,023,274	55,135,178
Accrued interest payable	582,896	798,917
Accrued expenses and other liabilities	2,204,938	2,259,805
Commitments and contingencies	—	—
Total liabilities	$ 551,410,650	$ 507,399,991
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 2,738,864 in 2009 and 2,795,413 in 2008	13,694,320	13,977,065
Common stock, nonvoting, par value $5 per share; authorized 635,000 shares; no shares outstanding	—	—
Additional paid-in capital	131,016	179,523
Retained earnings	24,715,497	21,442,637
Unearned ESOP shares	(830,400)	—
Accumulated other comprehensive (loss)	(2,440,877)	(5,047,426)
Total shareholders' equity	$ 35,269,556	$ 30,551,799
Total liabilities and shareholders' equity	$ 586,680,206	$ 537,951,790

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

CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31, 2009, 2008 and 2007		
	2009	**2008**	**2007**
Interest and Dividend Income			
Interest and fees on loans	$ 23,002,490	$ 23,877,932	$ 24,179,850
Interest on interest-bearing deposits and federal funds sold	128,449	11,602	70,165
Interest and dividends on securities available for sale:			
Taxable	5,493,777	4,282,768	2,776,632
Nontaxable	1,896,773	1,378,202	878,207
Dividends	21,668	158,074	111,664
Total interest and dividend income	$ 30,543,157	$ 29,708,578	$ 28,016,518
Interest Expense			
Savings and interest bearing accounts	$ 2,079,028	$ 1,863,877	$ 2,881,208
Certificates of deposit			
Denominations less than $100,000	3,983,734	4,576,049	4,500,947
Denominations $100,000 or more	2,903,117	3,611,728	3,532,378
Short-term borrowings and FHLB advances	1,779,614	2,193,272	1,098,348
Long-term debt and trust preferred capital notes	869,941	1,000,360	1,457,988
Total interest expense	$ 11,615,434	$ 13,245,286	$ 13,470,869
Net interest income	$ 18,927,723	$ 16,463,292	$ 14,545,649
Provision for loan losses	895,000	400,000	160,000
Net interest income after provision for loan losses	$ 18,032,723	$ 16,063,292	$ 14,385,649
Noninterest Income			
Trust income	$ 2,042,834	$ 1,989,460	$ 1,836,446
Service charges	1,717,629	1,810,365	1,881,126
Net gain (loss) on other real estate owned	(48,211)	4,000	(167,964)
Net gain on sales of securities available for sale	510,715	106,929	86,761
Net other-than-temporary impairment losses on investments recognized in earnings (includes total other-than-temporary impairment losses of $975,938, net of $60,040 recognized in other comprehensive income before taxes)	(915,898)	—	—
Other income	10,758,933	11,105,801	9,848,104
Total noninterest income	$ 14,066,002	$ 15,016,555	$ 13,484,473

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

CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31, 2009, 2008 and 2007		
	2009	**2008**	**2007**
Noninterest Expenses			
Salaries and benefits	$ 12,213,820	$ 12,161,294	$ 10,825,354
Occupancy expenses	3,705,344	3,360,116	3,147,709
Other expenses	9,940,370	9,436,234	7,834,708
Total noninterest expenses	$ 25,859,534	$ 24,957,644	$ 21,807,771
Income before income taxes	$ 6,239,191	$ 6,122,203	$ 6,062,351
Income tax expense	1,404,264	1,521,296	1,717,211
Net income	$ 4,834,927	$ 4,600,907	$ 4,345,140
Earnings per share, basic	$ 1.78	$ 1.63	$ 1.53
Earnings per share, diluted	$ 1.77	$ 1.60	$ 1.49

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31, 2009, 2008 and 2007		
	2009	**2008**	**2007**
Cash Flows from Operating Activities			
Net income	$ 4,834,927	$ 4,600,907	$ 4,345,140
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	2,016,233	1,780,628	1,540,572
Provision for loan losses	895,000	400,000	160,000
Provision for cash management account losses	963,000	865,000	450,000
Deferred income tax (benefit)	(629,555)	(65,371)	(41,803)
(Accretion) of discounts, net	(691,128)	(365,641)	(208,634)
Net (gain) on securities available for sale	(510,715)	(106,929)	(86,761)
Net other-than-temporary impairment losses	915,898	—	—
Net (gain) loss on other real estate owned	48,211	(4,000)	167,964
Stock-based compensation	108,000	104,000	115,155
Release of ESOP shares	152,300	—	—
Origination of loans available for sale	(64,555,205)	(11,209,549)	(1,119,000)
Proceeds from sale of loans available for sale	64,555,205	11,209,549	1,119,000
Issuance of common stock for services	100,725	103,525	99,049
Changes in other assets and liabilities:			
(Increase) in accrued interest receivable	(298,148)	(356,617)	(255,835)
(Increase) in other assets	(5,376,531)	(689,977)	(1,924,760)
Increase (decrease) in accrued interest payable	(216,021)	(215,952)	275,637
Increase (decrease) in other liabilities	(54,867)	1,167,189	138,945
Net cash provided by operating activities	$ 2,257,329	$ 7,216,762	$ 4,774,669
Cash Flows from Investing Activities			
Purchases of securities available for sale	$ (83,439,378)	$ (47,238,714)	$ (44,989,350)
Proceeds from sales and calls of securities available for sale	9,511,037	6,930,716	10,987,370
Proceeds from maturities of securities available for sale	26,868,119	19,922,640	19,701,181
(Purchase) redemption of restricted stock	308,200	(1,574,183)	(1,200,500)
Proceeds from sale of other real estate	161,789	225,288	1,404,363
Net (increase) in loans	(4,000,099)	(30,281,311)	(32,290,488)
Net decrease (increase) in cash management accounts	6,137,762	(5,540,808)	(9,426,094)
Other capital expenditures	(2,627,459)	(2,796,458)	(3,749,495)
Net cash (used in) investing activities	$ (47,080,029)	$ (60,352,830)	$ (59,563,013)

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31, 2009, 2008 and 2007		
	2009	**2008**	**2007**
Cash Flows from Financing Activities			
Net increase (decrease) in short-term borrowings and federal funds purchased	$ (1,475,000)	$(14,000,000)	$ 8,999,000
Net increase (decrease) in demand accounts, interest-bearing demand accounts and savings accounts	77,919,719	(15,526,964)	275,527
Net increase (decrease) in certificates of deposits	(19,051,268)	60,054,302	24,160,798
Net proceeds from issuance of common stock	—	123,250	232,213
Repurchase of common stock	(951,167)	(1,046,043)	(1,273,858)
Shares acquired for leveraged ESOP	(968,800)	—	—
Cash dividends	(1,164,777)	(1,144,763)	(1,001,865)
Proceeds from issuance of trust preferred capital notes	—	—	15,465,000
Redemption of trust preferred capital notes	—	(10,310,000)	—
Proceeds from issuance of long-term debt	—	37,000,000	13,000,000
Curtailment of long-term debt	(13,111,904)	(107,495)	(103,277)
Net cash provided by financing activities	$ 41,196,803	$ 55,042,287	$ 59,753,538
Net increase (decrease) in cash and cash equivalents	$ (3,625,897)	$ 1,906,219	$ 4,965,194
Cash and cash equivalents at beginning of year	16,854,371	14,948,152	9,982,958
Cash and cash equivalents at end of year	$ 13,228,474	$ 16,854,371	$ 14,948,152
Supplemental Disclosures of Cash Flow Information			
Cash paid during the year for:			
Interest	$ 11,831,455	$ 13,461,238	$ 13,195,232
Income taxes	$ 1,305,000	$ 1,808,000	$ 1,895,000
Supplemental Schedule of Noncash Investing and Financing Activities			
Unrealized gain (loss) on securities available for sale	$ 3,949,317	$ (8,866,967)	$ 278,879
Other real estate acquired in settlement of loans	$ 1,415,000	$ 296,288	$ —

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

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

Years Ended December 31, 2009, 2008 and 2007

	Common Stock, Voting	Additional Paid-In Capital	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income (Loss)	Total
Balance, December 31, 2006	$ 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
Comprehensive loss:							
Net income	—	—	4,600,907	—	—	$ 4,600,907	4,600,907
Other comprehensive loss:							
Unrealized holding losses on securities available for sale, net of deferred income taxes of $2,978,413	—	—	—	—	—	(5,781,625)	—
Reclassification adjustment, net of income taxes of $36,356	—	—	—	—	—	(70,573)	—
Other comprehensive loss, net of tax —	—	—	—	—	(5,852,198)	(5,852,198)	(5,852,198)
Total comprehensive loss	—	—	—	—	—	$ (1,251,291)	—
Exercise of stock options	102,000	21,250	—	—	—		123,250
Issuance of common stock for services	26,545	76,980	—	—	—		103,525
Repurchase of common stock	(288,850)	(196,540)	(560,653)	—	—		(1,046,043)
Stock-based compensation	—	104,000	—	—	—		104,000
Cash dividends ($0.405 per share)	—	—	(1,144,763)	—	—		(1,144,763)
Balance, December 31, 2008 (forwarded)	$ 13,977,065	$ 179,523	$ 21,442,637	$ —	$ (5,047,426)		$ 30,551,799

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

Years Ended December 31, 2009, 2008 and 2007

	Common Stock, Voting	Additional Paid-In Capital	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income (Loss)	Total
Balance, December 31, 2008							
(brought forward)	$ 13,977,065	$ 179,523	$ 21,442,637	$ —	$ (5,047,426)		$ 30,551,799
Comprehensive income:							
Net income	—	—	4,834,927	—	—	$ 4,834,927	4,834,927
Other comprehensive income:							
Unrealized holding gains on securities available for sale, net of deferred income taxes of $1,205,006	—	—	—	—	—	2,339,128	—
Reclassification adjustment, net of income taxes of $137,762	—	—	—	—	—	267,421	—
Other comprehensive income, net of tax	—	—	—	—	2,606,549	2,606,549	2,606,549
Total comprehensive income	—	—	—	—	—	$ 7,441,476	—
Shares acquired for leveraged ESOP	—	—	—	(968,800)	—		(968,800)
Release of ESOP shares	—	13,900	—	138,400	—		152,300
Issuance of common stock for services	29,625	71,100	—	—	—		100,725
Repurchase of common stock	(312,370)	(241,507)	(397,290)	—	—		(951,167)
Stock-based compensation	—	108,000	—	—	—		108,000
Cash dividends ($0.42 per share)	—	—	(1,164,777)	—	—		(1,164,777)
Balance, December 31, 2009	$ 13,694,320	$ 131,016	$ 24,715,497	$ (830,400)	$ (2,440,877)		$ 35,269,556

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” or “Company”) 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.

Subsequent Events

Subsequent events have been considered through February 17, the same date on which these consolidated financial statements were issued.

Significant Accounting Policies

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. All per share information for all periods presented has been retroactively restated to reflect the stock split.

Securities

Debt securities that management has the positive intent and ability to hold to maturity are classified as “held to maturity” and recorded at amortized cost. Trading securities are recorded at fair value with changes in fair value included in earnings. 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. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method. CFS classifies all securities as available for sale.

Effective April 1, 2009, CFS adopted new accounting guidance related to recognition and presentation of other-than-temporary impairment. This recent accounting guidance amends the recognition guidance for other-than-temporary impairments of debt securities and expands the financial statement disclosures for other-than-temporary impairment losses on debt and equity securities. The recent guidance replaced the “intent and ability” indication in prior guidance by specifying that (a) if a company does not have the intent to sell a debt security prior to recovery and (b) it is more likely than not that it will not have to sell the debt security prior to recovery, the security would not be considered other-than-temporarily impaired unless there is a credit loss. When an entity does not intend to sell the security, and it is more likely than not the entity will not have to sell the security before recovery of its cost basis, it will recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income. The credit loss component recognized in earnings is identified as the amount of principal cash flows not expected to be received over the remaining term of the security as projected based on cash flow analyses.

Prior to the adoption of the recent accounting guidance related to other-than-temporary impairment, management considered, in determining whether other-than-temporary impairment existed, (a) the length of time and extent to which the fair value had been less than the cost, (b) the financial condition and near-term prospects of the issuer, and (c) 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.

Federal Home Loan Bank Stock

CFS, as a member of the Federal Home Loan Bank (FHLB) system, is required to maintain an investment in the capital stock of the FHLB. Based on redemption provisions of the FHLB, the stock has no quoted market value and is carried at cost. Management reviews for impairment based on the ultimate recoverability of the cost basis in the FHLB stock.

Loans

The Bank 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 the Bank'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.

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 allocated and general components. The allocated component relates to loans that are classified as impaired. For those loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price less costs to liquidate) 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 charge-off and expected default derived from CFS's loss experience by loan type. Other adjustments may be made to the allowance based on an assessment of internal or external influences on credit quality that are not fully reflected in the historical loss or risk rating data.

A loan is considered impaired when, based on current information and events, it is probable that the Bank 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. Impairment is measured on a loan by loan basis 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.

Premises and Equipment

Land is carried at cost. 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.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (a) the assets have been isolated from CFS – put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership, (b) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (c) CFS does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets.

Income Taxes

CFS accounts for income taxes in accordance with the accounting guidance related to uncertainty in income taxes, which sets out a consistent framework to determine the appropriate level of tax reserves to maintain for uncertain tax positions.

The income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying provisions of the enacted tax law to the taxable income or excess deductions over revenues. CFS determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur.

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained under examination. The term more likely than not means a likelihood of more than fifty percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than fifty percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment. Deferred tax assets are reduced by a valuation allowance if, based on the weight of the evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

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, the valuation of deferred tax assets, other-than-temporary impairments of securities, and the fair value of financial instruments.

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 6-for-5 stock split in 2007.

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.

Share-Based Compensation

Share compensation accounting requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the grant date fair value of the equity or liability instruments issued. The share compensation accounting guidance covers a wide range of share-based compensation arrangements including stock options, restricted share plans, and performance-based awards.

The share compensation accounting guidance requires that compensation cost for all stock awards be calculated and recognized over the employees' service period, generally defined as the vesting period. Compensation cost is recognized on a straight-line basis over the requisite service period for the award. A Black-Scholes model is used to estimate the fair value of stock options.

Fair Value of Financial Instruments

Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully discussed in Note 16. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions significantly affect the estimates.

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.

Reclassification

Certain amounts in the 2008 consolidated financial statements have been reclassified to conform to the 2009 presentation.

Adoption of New Accounting Standards

In April 2009, the Financial Accounting Standards Board (FASB) issued new guidance impacting FASB Topic 820: *Fair Value Measurements and Disclosures* (Topic 820). This interpretation provides additional guidance for estimating fair value when the volume and level of activity for the asset or liability have significantly decreased. This also includes guidance on identifying circumstances that indicate a transaction is not orderly and requires additional disclosures of valuation inputs and techniques in interim periods and defines the major security types that are required to be disclosed. This guidance was effective for interim and annual periods ending after June 15, 2009, and should be applied prospectively. The additional disclosures required by this guidance are included in Note 16 to these consolidated financial statements.

In April 2009, the FASB issued new guidance impacting FASB Topic 320-10: *Investments – Debt and Equity Securities*. This guidance amends generally accepted accounting principles for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities in the financial statements. This guidance was effective for interim and annual periods ending after June 15, 2009, with earlier adoption permitted for periods ending after March 15, 2009. CFS did not have any cumulative effect adjustment related to the adoption of this guidance and the additional disclosures required are included in the Consolidated Statements of Income and in Note 2 to these consolidated financial statements.

In May 2009, the FASB issued new guidance impacting FASB Topic 855: *Subsequent Events*. This update provides guidance on management's assessment of subsequent events that occur after the balance sheet date through the date that the financial statements are issued. This guidance is generally consistent with current accounting practice. In addition, it requires certain additional disclosures. This guidance was effective for periods ending after June 15, 2009 and the required disclosure is included in Note 1 to these consolidated financial statements.

In August 2009, the FASB issued new guidance impacting Topic 820. This guidance is intended to reduce ambiguity in financial reporting when measuring the fair value of liabilities. This guidance was effective for the first reporting period after issuance and had no impact on CFS's consolidated financial statements.

Accounting Standards Not Yet Effective

In June 2009, the FASB issued new guidance relating to the accounting for transfers of financial assets. The new guidance, which was issued as SFAS No. 166, *Accounting for Transfers of Financial Assets, an amendment to SFAS No. 140)*, was adopted into Codification in December 2009 through the issuance of Accounting Standards Update (ASU) 2009-16. The new standard provides guidance to improve the relevance, representational faithfulness, and comparability of the information that an entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. CFS will adopt the new guidance in 2010 and is evaluating the impact it will have, if any, on its consolidated financial statements.

In September 2009, the FASB issued new guidance impacting Topic 820. This update creates a practical expedient to measure the fair value of an alternative investment that does not have a readily determinable fair value. This guidance also requires certain additional disclosures. This guidance is effective for interim and annual periods ending after December 15, 2009. CFS does not expect the adoption of the new guidance to have a material impact on its consolidated financial statements.

In October 2009, the FASB issued ASU 2009-15, *Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing*. ASU 2009-15 amends Subtopic 470-20 to expand accounting and reporting guidance for own-share lending arrangements issued in contemplation of convertible debt issuance. ASU 2009-15 is effective for fiscal years beginning on or after December 15, 2009 and interim periods within those fiscal years for arrangements outstanding as of the beginning of those fiscal years. CFS does not expect the adoption of ASU 2009-15 to have a material impact on its consolidated financial statements.

In January 2010, the FASB issued ASU No. 2010-01 (ASU 2010-01), *Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash – a consensus of the FASB Emerging Issues Task Force.* ASU 2010-01 clarifies that the stock portion of a distribution to shareholders that allows them to elect to receive cash or stock with a potential limitation on the total amount of cash that all shareholders can elect to receive in the aggregate is considered a share issuance that is reflected in EPS prospectively and is not a stock dividend. ASU 2010-01 is effective for interim and annual periods ending on or after December 15, 2009 and should be applied on a retrospective basis. CFS does not expect the adoption of ASU 2010-01 to have a material impact on its consolidated financial statements.

In January 2010, the FASB issued ASU No. 2010-02, *Consolidation (Topic 810): Accounting and reporting for Decreases in Ownership of a Subsidiary – a Scope Clarification*. ASU 2010-02 amends Subtopic 810-10 to address implementation issues related to changes in ownership provisions including clarifying the scope of the decrease in ownership and additional disclosures. ASU 2010-02 is effective beginning in the period that an entity adopts Statement 160. If an entity has previously adopted Statement 160, ASU 2010-02 is effective beginning in the first interim or annual reporting period ending on or after December 15, 2009 and should be applied retrospectively to the first period Statement 160 was adopted. CFS does not expect the adoption of ASU 2010-02 to have a material impact on its consolidated financial statements.

In January 2010, the FASB issued ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers' disclosures about postretirement benefit plan assets. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. CFS does not expect the adoption of ASU 2010-06 to have a material impact on its consolidated financial statements.

In February 2010, the FASB issued ASU No. 2010-08, *Technical Corrections to Various Topics*. ASU 2010-08 clarifies guidance on embedded derivatives and hedging. ASU 2010-08 is effective for interim and annual periods beginning after December 15, 2009. CFS does not expect the adoption of ASU 2010-08 to have a material impact on its consolidated financial statements.

Note 2. Securities

Amortized cost and fair values of securities available for sale as of December 31, 2009 and 2008, are as follows:

2009	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities of state and political subdivisions	$ 53,242,739	$ 1,600,877	$ (654,449)	$ 54,189,167
Mortgage-backed securities	93,386,945	3,718,509	(8,363,235)	88,742,219
Total	$146,629,684	$ 5,319,386	$ (9,017,684)	$ 142,931,386

2008	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities of state and political subdivisions	$ 33,353,917	$ 1,037,528	$ (1,193,269)	$ 33,198,176
Mortgage-backed securities	65,929,600	657,789	(8,149,663)	58,437,726
Total	$ 99,283,517	$ 1,695,317	$ (9,342,932)	$ 91,635,902

The amortized cost and fair value of securities available for sale as of December 31, 2009, 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	$ 13,254,125	$ 13,277,978
Due after one year through five years	58,614,371	56,736,880
Due after five years through ten years	60,949,775	58,483,423
Due after ten years	13,811,413	14,433,105
Total	$ 146,629,684	$142,931,386

Proceeds from sales and calls of securities available for sale during 2009, 2008 and 2007 were $9,511,037, $6,930,716 and $10,987,370, respectively. Gross realized gains amounted to $576,471, $106,929 and $95,032 in 2009, 2008 and 2007. Gross realized losses amounted to $65,756 and $8,271 in 2009 and 2007, and there were no gross realized losses during 2008. The tax provision applicable to these net realized gains amounted to $173,643, $36,356 and $29,499 in 2009, 2008 and 2007, 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 $85,413,413 and $80,158,025 at December 31, 2009 and 2008, respectively.

Temporarily Impaired Securities

Information pertaining to securities with gross unrealized losses at December 31, 2009 and 2008, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	2009			
	Less Than 12 Months		12 Months or More	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
Securities of state and political subdivisions	$ 10,182,678	$ (174,573)	$ 2,737,087	$ (479,876)
Mortgage-backed securities	15,339,835	(366,471)	17,794,595	(7,996,764)
	$ 25,522,513	$ (541,044)	$ 20,531,682	$ (8,476,640)

	2008			
	Less Than 12 Months		12 Months or More	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
Securities of state and political subdivisions	$ 12,625,353	$ (643,820)	$ 1,636,528	$ (549,449)
Mortgage-backed securities	31,207,364	(6,889,948)	3,644,550	(1,259,715)
	$ 43,832,717	$ (7,533,768)	$ 5,281,078	$ (1,809,164)

Securities of State and Political Subdivisions

CFS's unrealized losses on investments in 21 municipal bonds relates to investments in longer-term securities of municipalities throughout the U.S. The unrealized losses are primarily caused by the trend in interest rates. CFS currently does not believe it is probable that it will be unable to collect all amounts due according to the contractual terms of the investments. Because CFS does not intend to sell the investment and it is not more likely than not that CFS will be required to sell the investment before recovery of its par value, which may be maturity, it does not consider these investments to be other-than-temporarily impaired at December 31, 2009.

Mortgage-Backed Securities

The unrealized losses on CFS's investment in 12 government-sponsored enterprise mortgage-backed securities were caused by interest rate increases. CFS purchased those investments at a discount relative to their face amount, and the contractual cash flows of those investments are guaranteed by an agency of the U.S. government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost bases of CFS's investments. Because the decline in the market value is attributable to changes in interest rates and not credit quality, and because CFS does not intend to sell the investments and it is not more likely than not that CFS will be required to sell the investments before recovery of their amortized cost bases, which may be maturity. CFS does not consider those investments to be other-than-temporarily impaired at December 31, 2009.

The unrealized losses associated with 30 private residential mortgage-backed securities are primarily driven by higher projected collateral losses, wider credit spreads and changes in interest rates. CFS assessed credit impairment using a cash flow model. Based upon our assessment of the expected credit losses of the security given the performance of the underlying collateral compared to our credit enhancement, we expect to recover the entire amortized cost basis of these securities.

The unrealized loss positions at December 31, 2008 were directly related to interest rate movements. Bonds with an unrealized loss position of twelve months or more included five mortgage-backed securities and four municipal bonds. Bonds with an unrealized loss position less than twelve months in duration included 41 mortgage-backed securities and 24 municipal bonds. Management continuously monitors the mortgage-backed securities portfolio for potential permanent impairment. Analytical tools used include robust credit risk analysis. CFS strives to maintain exposure only to securities that have credit support in excess of original issue levels. Generally, it is CFS's intent to hold the securities for a time necessary to recover the amortized cost unless prudent business decisions warrant otherwise.

Other-Than-Temporary Impairment

CFS routinely conducts periodic reviews to identify and evaluate each investment security to determine whether an other-than-temporary impairment has occurred. Economic models are also used to determine whether an other-than-temporary impairment has occurred on these securities. While all securities are considered, the securities primarily impacted by other-than-temporary impairment testing are private-label mortgage-backed securities. For each private-label mortgage-backed security in the investment portfolio (including but not limited to those whose fair value is less than their amortized cost basis), an extensive, regular review is conducted to determine if an other-than-temporary impairment has occurred. Various inputs to the economic models are used to determine if an unrealized loss is other-than-temporary. The most significant inputs are the following:

- Default rate
- Severity
- Geographic concentration
- Prepayment speeds
- Housing depreciation
- Collateral type
- Credit support
- Book value
- Credit ratings

Other inputs may include the actual collateral attributes and other performance indicators of the underlying asset.

To determine if the unrealized loss for private-label mortgage-backed securities is other-than-temporary, CFS projects total estimated defaults of the underlying assets (mortgages) and multiplies that calculated amount by an estimate of realizable value upon sale in the marketplace (severity) in order to determine the projected collateral loss. CFS also evaluates the current credit enhancement underlying the bond to determine the impact on cash flows. If CFS determines that a given mortgage-backed security position will be subject to a write-down or loss, CFS records the expected credit loss as a charge to earnings.

The following roll forward reflects the amount related to credit losses recognized in earnings. The beginning balance represents credit losses on debt securities at the beginning of the period for which a portion of an other-than-temporary impairment was recognized in other comprehensive income.

	Available for Sale
Beginning balance as of December 31, 2008	$ —
Amount related to the credit loss for which an other-than-temporary impairment was not previously recognized	915,898
Ending balance as of December 31, 2009	$ 915,898

Note 3. Loans

A summary of the balances of loans follows:

	December 31, 2009	December 31, 2008
Commercial	$ 222,847,109	$ 213,966,393
Real estate mortgage	95,966,137	95,157,530
Real estate construction	23,691,749	29,570,243
Consumer	19,513,200	21,042,442
Participations with other banks	3,665,708	3,746,521
Other	89,308	149,765
	$ 365,773,211	$ 363,632,894
Less: Allowance for loan losses	5,165,792	4,715,574
Loans, net	$ 360,607,419	$ 358,917,320

Overdrafts totaling $94,921 and $190,419 at December 31, 2009 and 2008, respectively, were reclassified from deposits to loans.

An analysis of the allowance for loan losses follows:

	December 31, 2009	December 31, 2008	December 31, 2007
Balance at beginning of year	$ 4,715,574	$ 4,388,538	$ 4,342,174
Provision for loan losses	895,000	400,000	160,000
Loans charged off	(458,972)	(319,957)	(136,387)
Recoveries on loans previously charged off	14,190	246,993	22,751
Balance at end of year	$ 5,165,792	$ 4,715,574	$ 4,388,538

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

	December 31, 2009	December 31, 2008	December 31, 2007
Impaired loans without a valuation allowance	$ 1,664,726	$ 2,524,428	$ 327,075
Impaired loans with a valuation allowance	7,194,431	—	2,803,081
Total impaired loans	$ 8,859,157	$ 2,524,428	$ 3,130,156
Valuation allowance related to impaired loans	$ 2,292,983	$ —	$ 614,343

	Years Ended December 31, 2009	2008	2007
Average investment in impaired loans	$ 2,907,487	$ 2,629,682	$ 3,231,709
Interest income recognized	—	—	—

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

Nonaccrual loans excluded from impaired loan disclosure amounted to $1,013,611, $138,254 and, $818,185 at December 31, 2009, 2008 and 2007, respectively. If interest on these loans had been accrued, such income would have approximated $78,794, $10,723 and $36,484 at December 31, 2009, 2008 and 2007, respectively.

There were no loans 90 days past due and still accruing interest at December 31, 2009, 2008 and 2007.

Note 4. Premises and Equipment

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

	December 31, 2009	December 31, 2008
Land	$ 3,790,653	$ 3,790,653
Buildings	13,272,452	11,585,176
Furniture, fixtures and improvements	1,985,243	1,825,733
Mechanical equipment	7,202,567	6,924,759
Leasehold improvements	4,063,371	3,020,307
Construction in progress	73,293	770,466
	$ 30,387,579	$ 27,917,094
Less accumulated depreciation	12,389,793	10,771,972
	$ 17,997,786	$ 17,145,122

For the years ended December 31, 2009, 2008 and 2007, depreciation expense was $1,747,837, $1,582,941 and $1,392,423, respectively.

Note 5. Borrowings

CFS's fixed-rate long-term debt of $42,023,274 at December 31, 2009 matures through 2018. $483,919 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. $41,000,000 of the long-term debt consists of fixed-rate credits from the Federal Home Loan Bank (FHLB). These credits have rates ranging from 2.06% to 4.89% and mature through 2018. 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, 2009 for this borrowing was $539,355. Aggregate maturities during the next five years are: 2010, $10,116,509; 2011, $5,621,089; 2012, $126,111; 2013, $12,631,336; and 2014, $137,121.

CFS has unsecured lines of credit with correspondent banks totaling $33,000,000 available for overnight borrowing and a line of credit of $5,000,000 secured by CFS stock with $1,525,000 outstanding at December 31, 2009 with an interest rate of 2.75%.

Note 6. Income Taxes

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

	December 31, 2009	December 31, 2008
Deferred tax assets:		
Allowance for loan and cash management account losses	$ 1,959,550	$ 1,726,838
Securities available for sale	1,257,426	2,600,189
Other than temporary impairment of securities	311,405	—
Other real estate	64,927	40,539
Deferred compensation	77,398	83,355
Premises and equipment	170,811	126,949
Other	26,791	3,646
	$ 3,868,308	$ 4,581,516

The provision for income taxes charged to operations for the years ended December 31, 2009, 2008 and 2007, consists of the following:

	2009	2008	2007
Current tax expense	$ 2,033,819	$ 1,586,667	$ 1,759,014
Deferred tax (benefit)	(629,555)	(65,371)	(41,803)
	$ 1,404,264	$ 1,521,296	$ 1,717,211

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, 2009, 2008 and 2007, due to the following:

	2009	2008	2007
Computed "expected" tax expense	$ 2,121,325	$ 2,081,549	$ 2,061,199
(Decrease) in income taxes resulting from:			
Tax exempt interest income	(677,203)	(541,854)	(320,542)
Other	(39,858)	(18,399)	(23,446)
	$ 1,404,264	$ 1,521,296	$ 1,717,211

CFS, on a consolidated basis, files income tax returns in the U.S. federal jurisdiction and the Commonwealth of Virginia. With few exceptions, CFS is no longer subject to U.S. federal or state income tax examinations by tax authorities for years before 2006.

Note 7. Employee Benefit Plans

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

CFS sponsors a leveraged employee stock ownership plan (ESOP) that generally covers full-time employees who have completed one calendar year of service. CFS makes annual contributions to the ESOP equal to the ESOP's debt service and certain additional contributions at the discretion of the board of directors. The ESOP is internally leveraged through a loan from the Bank to the ESOP. Certain ESOP shares are pledged as collateral for its debt. As the debt is repaid, shares are released from collateral and allocated to active employees, based on the proportion of debt service paid in the year. Shares pledged as collateral are deducted from shareholders' equity as unearned ESOP shares in the accompanying consolidated balance sheets. At December 31, 2009, 60,000 shares remained as collateral securing the note payable.

The note payable referred to in the preceding paragraph requires annual principal payments plus interest at the prime interest rate adjusted annually (5.50% during 2009). Future principal payments of $138,300 are due annually through 2015.

As shares are released from collateral, CFS reports compensation expense equal to the current market price of the shares and the shares become outstanding for earnings per share computations. Dividends on allocated ESOP shares are recorded as a reduction of retained earnings. Dividends on unallocated ESOP shares are recorded as a reduction of debt and accrued interest. ESOP compensation expense was $416,312, $299,928 and $270,000 for the years ended December 31, 2009, 2008 and 2007, respectively (including $152,300 for the year ended December 31, 2009 related to the release of ESOP shares).

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 $559,724, $566,610 and $507,204 for 2009, 2008 and 2007, 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 $108,000, $104,000 and $115,155 for the years ended December 31, 2009, 2008 and 2007, respectively. No income tax benefit was recognized in the income statement for stock-based compensation arrangements for the years ended December 31, 2009, 2008 and 2007.

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 6-for-5 stock split in 2007.

A summary of the option activity under the plans at December 31, 2009 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	247,140	$13.89		
Granted	39,900	14.92		
Exercised	—	—		
Outstanding at end of year	287,040	14.03	6.0 years	$369,900
Options exercisable, end of year	171,840	12.80	4.4 years	369,900

The weighted-average grant date fair value of options granted during the years ended December 31, 2009, 2008 and 2007 was $2.35, $2.95 and $3.03, respectively. The total intrinsic value of options exercised during the year ended December 31, 2008 was $242,000. No options were exercised during the year ended December 31, 2009.

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,		
	2009	2008	2007
Dividend yield	2.09%	2.04%	2.11%
Expected term	6 years	6 years	6 years
Expected volatility	17.39%	17.60%	14.67%
Risk-free interest rate	2.48%	3.28%	4.60%

As of December 31, 2009, there was $128,355 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 2009, 2008 and 2007, CFS issued 5,925 shares, 5,309 shares and 6,206 shares, respectively, of common stock to its directors for partial compensation. All information has been retroactively restated to reflect 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 2014. 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, 2009 are as follows:

Year Ending December 31,	
2010	$ 82,175
2011	94,753
2012	95,247
2013	95,754
2014	96,274

Rent expense under operating leases aggregated $353,782, $316,118 and $247,383 for the years ended December 31, 2009, 2008 and 2007, 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, 2009 and 2008, the aggregate amounts of daily average required balances were approximately $1,511,000 and $1,317,000, respectively.

Note 11. Related Party Transactions

Officers, directors and their affiliates had borrowings of $23,892,574 and $22,564,135 at December 31, 2009 and 2008, respectively, with the Bank.

Changes in borrowings during 2009 were as follows:

Balance, December 31, 2008	$ 22,564,135
Additions	1,527,690
Payments	(199,251)
Balance, December 31, 2009	$ 23,892,574

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:

	2009	2008	2007
Cash management fees and discount	$ 4,129,052	$ 5,029,630	$ 4,275,417
Merchant discount	3,462,331	3,088,190	3,027,268
ATM fee income	881,092	845,767	798,245
Asset management fees	730,981	609,338	545,328
Other (includes no items in excess of 1% of total revenue)	1,555,477	1,532,876	1,201,846
	$ 10,758,933	$ 11,105,801	$ 9,848,104

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

	2009	2008	2007
Advertising	$ 694,943	$ 707,388	$ 497,669
Merchant card	2,547,131	2,337,442	2,249,933
Cash management royalties	4,790	219,244	311,563
Software	810,037	748,560	645,031
Provision for cash management account losses	963,000	865,000	450,000
Legal fees	240,419	284,485	176,028
FDIC assessments	845,770	274,837	43,009
Delivery and transportation	337,406	374,853	354,036
Stationary and supplies	407,916	458,465	448,064
Other (includes no items in excess of 1% of total revenue)	3,088,958	3,165,960	2,659,375
	$ 9,940,370	$ 9,436,234	$ 7,834,708

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 6-for-5 stock split in 2007.

	2009	2008	2007
Weighted average number of common shares, basic	2,709,431	2,820,240	2,846,542
Effect of dilutive stock options	17,094	47,628	69,652
Weighted average number of common shares and dilutive potential common stock used in diluted EPS	2,726,525	2,867,868	2,916,194

Options on approximately 129,705 shares and 35,460 shares were not included in the computation of diluted earnings per share for the years ended December 31, 2009 and 2007 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, 2008.

Note 14. Time Deposits

Remaining maturities on certificates of deposit are as follows:

2010	$ 176,164,746
2011	28,417,013
2012	12,559,962
2013	572,755
2014	2,286,014
	$ 220,000,490

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

The Bank 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.

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

At December 31, 2009 and 2008, the following financial instruments were outstanding whose contract amounts represent credit risk:

	Contract Amount	
	2009	2008
Commitments to grant loans	$ 12,107,109	$ 9,422,900
Unfunded commitments under lines of credit	118,259,473	107,314,333
Commercial and standby letters of credit	1,147,997	1,148,733

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 the Bank, 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 the Bank is committed. The amount of collateral obtained, if it is deemed necessary by the Bank, is based on management's credit evaluation of the customer.

Commercial and standby letters of credit are conditional commitments issued by the Bank 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. The Bank 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 $1,054,000 at December 31, 2009.

Note 16. Fair Value of Assets and Liabilities

Determination of Fair Value

CFS uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. The fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are not 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.

Fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

Fair Value Hierarchy

In accordance with this guidance, CFS groups its financial assets and financial liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

Level 1 - Valuation is based on quoted prices in active markets for identical assets and liabilities generally include debt and equity securities that are traded in an active exchange market. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2 - Valuation is based on inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.

Level 3 - Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

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

Cash and Cash Equivalents and Interest-Bearing Deposits in Banks

The carrying amounts of cash and short-term instruments approximate fair values based on the short-term nature of the assets.

Securities

Where quoted prices are available in an active market, CFS classifies the securities within level 1 of the valuation hierarchy. Securities are defined as both long and short positions. Level 1 securities include highly-liquid government bonds and exchange-traded equities.

If quoted market prices are not available, CFS estimates fair values using pricing models and discounted cash flows that consider standard input factors such as observable market data, benchmark yields, interest rate volatilities, broker/dealer quotes, and credit spreads. Examples of such instruments, which would generally be classified within level 2 of the valuation hierarchy, include U.S. government agency obligations, corporate bonds, and other securities. Mortgage-backed securities are included in level 2 if observable inputs are available. In certain cases where there is limited activity or less transparency around inputs to the valuation, CFS classifies those securities in level 3. The carrying value of restricted stock approximates fair value based on the redemption provisions of the respective entity.

Loans Receivable

For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for certain mortgage loans (for example, one-to-four family residential), credit card loans, and other consumer loans are based on quoted market prices of similar loans sold in conjunction with securitization transactions, adjusted for differences in loan characteristics. Fair values for other loans (for example, commercial real estate and investment property mortgage loans, commercial and industrial loans) are estimated using discounted cash flow analyses, using market interest rates for comparable loans. Fair values for nonperforming loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

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.

Deposit Liabilities

The fair values disclosed for demand deposits (for example, interest and noninterest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). The carrying amounts of variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies market interest rates on comparable instruments to a schedule of aggregated expected monthly maturities on time deposits.

Short-Term Borrowings

The carrying amounts of federal funds purchased 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 current market rates and similar types of borrowing arrangements.

Long-Term Borrowings

Current market rates for debt with similar terms, and remaining maturities are used to estimate fair value of existing debt. Fair value of long-term debt is based on quoted market prices or dealer quotes for the identical liability when traded as an asset in an active market. If a quoted market price is not available, an expected present value technique is used to estimate fair value.

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Off-Balance Sheet Credit-Related Instruments

Fair values for off-balance-sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking in to account the remaining terms of the agreements and the counterparties' credit standing.

Assets Measured at Fair Value on a Recurring Basis

The following table presents the balances of financial assets measured at fair value on a recurring basis as of December 31, 2009:

		Fair Value Measurements at December 31, 2009 Using		
Description	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(in thousands)		
Assets:				
Available for sale securities	$ 142,931	$ —	$ 98,240	$ 44,691

The following table presents the changes in level 3 assets that are measured at fair value on a recurring basis for the year ended December 31, 2009:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)					
		Total Realized/Unrealized Gains (Losses) Included in				
	Balance as of January 1, 2009	Net Income	Other Comprehensive Income	Purchases, Sales, Issuances, and Settlements, Net	Transfers in and/or Out of Level 3	Balance as of December 31, 2009
			(in thousands)			
Securities available for sale	$ —	$ (916)	$ (60)	$ —	$ 45,667	$ 44,691

Assets Measured at Fair Value on a Nonrecurring Basis

Under certain circumstances, CFS makes adjustments to fair value for our assets and liabilities although they are not measured at fair value on an ongoing basis. The following table presents assets carried on the consolidated balance sheet by caption and by level in the fair value hierarchy at December 31, 2009, for which a nonrecurring change in fair value has been recorded:

	Fair Value Measurements Using *(in thousands)*		
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans	$ —	$ —	$ 4,901

In accordance with the provisions of the loan impairment guidance, individual loans with a carrying amount of $7,194,431 were written down to their fair value of $4,901,448. Loans applicable to write downs of impaired loans are estimated using the present value of expected cash flows or the appraised value of the underlying collateral discounted as necessary due to management's estimates of changes in economic conditions.

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

	2009		2008	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(In Thousands)		*(In Thousands)*	
Financial assets:				
Cash and short-term investments	$ 13,228	$ 13,228	$ 16,854	$ 16,854
Securities	142,931	142,931	91,636	91,636
Restricted stock	3,982	3,982	4,290	4,290
Loans	360,607	359,912	358,917	377,445
Cash management accounts	24,519	24,519	31,620	31,620
Accrued interest receivable	2,587	2,587	2,288	2,288
Financial liabilities:				
Deposits	$ 486,610	$ 486,794	$ 427,741	$ 435,538
Short-term borrowings	4,525	4,525	6,000	6,000
Long-term debt	57,488	52,232	70,600	73,192
Accrued interest payable	583	583	799	799

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 and the Bank are 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, 2009 and 2008, that CFS meets all capital adequacy requirements to which it is subject.

As of December 31, 2009, 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
As of December 31, 2009:						
Total Capital (to Risk Weighted Assets):						
Consolidated	$ 58,934	11.7%	$ 40,196	8.0%	N/A	
Chesapeake Bank	$ 56,666	11.4%	$ 39,833	8.0%	$ 49,791	10.0%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	$ 50,545	10.1%	$ 20,098	4.0%	N/A	
Chesapeake Bank	$ 50,753	10.2%	$ 19,916	4.0%	$ 29,875	6.0%
Tier 1 Capital (to Average Assets):						
Consolidated	$ 50,545	8.7%	$ 23,822	4.0%	N/A	
Chesapeake Bank	$ 50,753	8.7%	$ 23,243	4.0%	$ 29,053	5.0%
As of December 31, 2008:						
Total Capital (to Risk Weighted Assets):						
Consolidated	$ 56,184	12.5%	$ 35,980	8.0%	N/A	
Chesapeake Bank	$ 51,606	11.6%	$ 35,734	8.0%	$ 44,668	10.0%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	$ 47,465	10.6%	$ 17,990	4.0%	N/A	
Chesapeake Bank	$ 46,021	10.3%	$ 17,867	4.0%	$ 26,801	6.0%
Tier 1 Capital (to Average Assets):						
Consolidated	$ 47,465	8.9%	$ 21,274	4.0%	N/A	
Chesapeake Bank	$ 46,021	8.7%	$ 21,094	4.0%	$ 26,367	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 had a LIBOR-indexed floating rate of interest. 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 CFS's junior subordinated debt securities with like maturities and like interest rates to the 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, 2009 was 5.33%. The interest rate as of December 31, 2009 was 5.13%. 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 CFS's junior subordinated debt securities with like maturities and like interest rates to the 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 CFS 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, 2009, the amount available for payment of additional dividends without prior regulatory approval from the Bank to the parent company is $13,683,678 or 38.8% of consolidated net assets.

Balance Sheets (Condensed)

	December 31, 2009	December 31, 2008
Assets		
Cash	$ 268,721	$ 2,244,768
Investment in subsidiaries	50,115,200	42,714,101
Premises and equipment, net	2,779,085	1,050,615
Other assets	1,070,487	1,249,388
Total assets	$ 54,233,493	$ 47,258,872
Liabilities and Shareholders' Equity		
Borrowings	$ 2,839,319	$ 530,205
Trust preferred capital notes	15,465,000	15,465,000
Other liabilities	659,618	711,868
Shareholders' equity	35,269,556	30,551,799
Total liabilities and shareholders' equity	$ 54,233,493	$ 47,258,872

Statements of Income (Condensed)

	2009	2008	2007
Income - Dividends from subsidiaries	$ 1,326,230	$ 1,221,553	$ 1,228,102
Other	111,998	115,967	139,045
Total income	$ 1,438,228	$ 1,337,520	$ 1,367,147
Expenses - Interest expense	$ 918,271	$ 994,017	$ 1,451,018
Other expenses	687,347	738,307	746,494
Total expenses	$ 1,605,618	$ 1,732,324	$ 2,197,512
(Loss) before income taxes and equity in undistributed earnings of subsidiaries	$ (167,390)	$ (394,804)	$ (830,365)
Allocated income tax benefit	378,962	484,505	626,388
Income (loss) before equity in undistributed earnings of subsidiaries	$ 211,572	$ 89,701	$ (203,977)
Equity in undistributed earnings of subsidiaries	4,623,355	4,511,206	4,549,117
Net income	$ 4,834,927	$ 4,600,907	$ 4,345,140

Statements of Cash Flows (Condensed)

	2009	2008	2007
Cash Flows from Operating Activities			
Net income	$ 4,834,927	$ 4,600,907	$ 4,345,140
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation	173,317	119,429	112,291
Equity in undistributed earnings of subsidiaries	(4,623,355)	(4,511,206)	(4,549,117)
Issuance of common stock for services	100,725	103,525	99,049
Stock-based compensation	108,000	104,000	115,155
Release of ESOP shares	152,300	—	—
Changes in other assets and liabilities:			
(Increase) decrease in other assets	357,706	(131,178)	(519,991)
Increase (decrease) in other liabilities	(52,250)	164,878	283,020
Net cash provided by (used in) operating activities	$ 1,051,370	$ 450,355	$ (114,453)
Cash Flows from Investing Activities			
Purchases of premises and equipment	$ (1,901,787)	$ (129,868)	$ —
Investment in subsidiaries	(350,000)	—	(250,000)
Net cash (used in) investing activities	$ (2,251,787)	$ (129,868)	$ (250,000)
Cash Flows from Financing Activities			
Dividends paid	$ (1,164,777)	$ (1,144,763)	$ (1,001,865)
Curtailment of borrowings	(259,686)	(43,814)	(41,475)
Proceeds from borrowings	2,568,800	—	—
Repurchase of common stock	(951,167)	(1,046,043)	(1,273,858)
Shares acquired for leveraged ESOP	(968,800)	—	—
Redemption of trust preferred capital notes	—	(10,310,000)	—
Proceeds from issuance of trust preferred capital notes	—	—	15,465,000
Net proceeds from issuance of common stock	—	123,250	232,213
Net cash provided by (used in) financing activities	$ (775,630)	$ (12,421,370)	$ 13,380,015
Net increase (decrease) in cash	$ (1,976,047)	$ (12,100,883)	$ 13,015,562
Cash at beginning of year	2,244,768	14,345,651	1,330,089
Cash at end of year	$ 268,721	$ 2,244,768	$ 14,345,651

INDEPENDENT AUDITOR'S REPORT

Yount Hyde & Barbour
Certified Public Accountants
and Consultants

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

We have audited the accompanying consolidated balance sheets of Chesapeake Financial Shares, Inc. and Subsidiaries as of December 31, 2009 and 2008, and the related consolidated statements of income, changes in shareholders' equity and cash flows for the years ended December 31, 2009, 2008 and 2007. These financial statements are the responsibility of the Company'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, 2009 and 2008, and the results of their operations and their cash flows for the years ended December 31, 2009, 2008 and 2007 in conformity with accounting principles generally accepted in the United States of America.

Yount, Hyde & Barbour, P.C.

Winchester, Virginia
February 17, 2010

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

Financial Overview: Chesapeake Financial Shares, Inc. posted another record year for earnings in 2009. The return on average equity in 2009 was 13.1% and return on average assets was 0.84% compared to 13.5% and 0.89%, respectively, in 2008. At the end of 2009, Chesapeake Financial Shares, Inc. (CFS) had total assets of $586.7 million, representing a 9.1% increase over the December 31, 2008 balance of $538.0 million. The Company ended the year with total gross loans of $365.8 million, and total deposits of $486.6 million, up 0.6% and 13.8%, respectively.

The loan growth of 0.6% for 2009 brought the average annual loan growth rate for the last five years to 6.7%. Asset quality was maintained during this growth period with past due loans relatively low and the net allowance for loan losses to gross loans less unearned discounts remaining at adequate levels of 1.41%. The deposit growth of 13.8% for 2009 brought the average annual deposit growth rate for the last five years to 12.1%. 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 2009 were $4,834,927 or $1.77 per share (fully diluted) compared to $4,600,907 or $1.60 per share in 2008, an increase of $234,020. The 5.1% increase in net income resulted from a 15.0% increase or $2,464,431 in net interest income. Noninterest expense increased by 3.6% or $901,890 in 2009 over 2008. This increase was dominated by the $570,933 increase in FDIC insurance premiums in 2009. Noninterest income was down $950,553 or 6.3% and that decrease was dominated by a $915,898 charge to income for Other Than Temporary Impairment related to the securities portfolio.

Earnings for 2008 were $4,600,907 or $1.60 per share (fully diluted) compared to $4,345,140 or $1.49 per share in 2007, an increase of $255,767. The 5.9% increase in net income resulted from an 11.4% increase or $1,532,082 in noninterest income. Noninterest expense increased by 14.4% or $3,149,873 in 2008 over 2007. All noninterest income items were up in 2008. Cash Flow Services income increased by $754,213 or 17.6% in 2008. Total noninterest expense was up for the year due primarily to normal increases in operating expense however there was a significant increase of 12.3% in salaries and benefits.

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 $365.8, $363.6 and $333.7 million for 2009, 2008, and 2007, respectively, representing an increase of 0.6% for 2009 over 2008, 9.0% for 2008 over 2007, and 10.7% for 2007 over 2006. The increase in 2009 was in the commercial loan portfolio, up 4.2% or $8.9 million over 2008. The real estate mortgage/construction portfolios combined were down 4.1% on $5.1 million and the consumer and all other loan categories were down a combined 6.7% on $1.6 million from 2008.

On December 31, 2009, the loan portfolio consisted of 61.0% commercial loans, 32.6% single-family residential and residential construction loans, and 6.4% consumer and other 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 consisted of nonaccrual loans, restructured loans, repossessed and foreclosed properties, and Other Real Estate Owned. Nonperforming assets were $5,281,213 at December 31, 2009, which represented an increase from $1,378,784 at December 31, 2008. Past due loans over thirty days were 1.7% of total loans at December 31, 2009. 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.

The fair market value of the portfolio was $2,440,877 less than book value, net of the tax effect, at December 31, 2009, and was less than book value by $5,047,426, net of the tax effect, at December 31, 2008. 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 $142.9 million, up $51.3 million from the $91.6 million on December 31, 2008. Investments in securities of state and political subdivisions increased by $21.0 million or 63.2%. Investments in mortgage backed securities increased by $30.3 million or 51.9%.

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 and recognition of specific loan impairments. 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 $5,165,792 or 1.41% of gross loans less unearned discounts at year-end. This ratio was 1.30% on December 31, 2008, and 1.32% in 2007. The 2009 provision was $895,000. There was a provision of $400,000 in 2008 compared to the 2007 provision of $160,000. Loans charged off totaled $458,972 in 2009, $319,957 in 2008, and $136,387 in 2007. Recoveries for the same periods were $14,190, $246,993, and $22,751, 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 or increases in specific problem loans 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 $486.6, $427.7, and $383.2 million for 2009, 2008, and 2007, respectively, and represented an increase of 13.8% for 2009 over 2008 and an increase of 11.6% for 2008 over 2007. There was an 8.0% decrease in certificates of deposit during 2009, while demand (noninterest bearing) deposits increased by $0.7 million or 1.2% from $62.2 million on December 31, 2008. Savings and interest bearing demand deposit balances increased during 2009 by 61.0% or $77.2 million to $203.7 million. The increase in savings balances was due primarily to the launch of an internet-based account offering called Clear Sky (www.clearskyaccounts.com).

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 $18.9, $16.5, and $14.5 million for 2009, 2008, and 2007, respectively, representing an increase of 15.0% for 2009 over 2008, 13.8% for 2008 over 2007, and 2.0% for 2007 over 2006.

Loan demand was mild this year with total gross loans up only 0.6% or $2.1 million for 2009 over 2008. Total interest expense was $11.6, $13.2, and $13.5 million for 2009, 2008 and 2007, respectively. On a tax equivalent annualized basis, the net interest margin was 4.1%, 4.0% and 4.1% for 2009, 2008 and 2007, respectively. The Bank's margins have been very stable and generally above peer through numerous rate cycles. The increase in the margin in 2009 was due to the lower cost of funding alternatives provided by the internet banking products and an increase in total interest income of $834,579 or 2.8% over 2008.

Noninterest Income: For the year ended December 31, 2009 non interest income was $15.0 million excluding a charge of $915,898 for Other Than Temporary Impairment of investments. This represents essentially no decrease ($34,655) in noninterest income for the year. The 2008 amount of $15.0 million was an 11.4% increase over the 2007 amount of $13.5 million. Increases in the gain on sale of securities of $403,786, or 377.6%, merchant discount income of $374,141, or 12.1%, asset management fees of $121,643, or 20%, fiduciary income of $53 thousand, or 2.7%, and ATM income of $35 thousand, or 4.2% was offset by a decreases in cash management fees of $900,578, or 17.9% and service charge income of $92,736, or 5.1%. Other income was up 1.5% or $22.6 thousand dollars.

Noninterest Expenses: Total noninterest expenses increased 3.6% or $0.9 million in 2009 over 2008. In 2008, total noninterest expenses increased 14.4% over 2007 and increased 11.0% in 2007 over 2006. The increase in 2009 was due to an increase in FDIC insurance premiums of $570,933, or 207.7%, occupancy expenses of $345,228, or 10.1% and merchant card expenses of $209,689, or 9.0%. Cash management royalty expense was down $214,454 or 97.8% due to having fully depreciated fees from a terminated relationship. It should be noted that salaries and benefits expense increased only 0.4% or $52,526 during the year.

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, 2009, approximately 47.2% of total assets matured or were repricing within one year as compared to 52.7% on December 31, 2008. The Bank's loan portfolio was liquid with 56.3% of all loan dollars maturing or repricing within one year. The loan liquidity ratio was 50.7% on December 31, 2008.

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 $99.3 million, secured and unsecured. The Bank and CFS have access to additional secured borrowing for $3.5 million.

As of December 31, 2009, the Bank held $9,363 in repossessed assets and $2,423,141 in other real estate owned. These assets are being actively marketed through real estate channels and represent 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, 2009, the Company had ratios of Tier 1 risk based capital to risk weighted assets of 10.1%, total risk based capital to risk weighted assets of 11.7%, and Tier 1 leverage capital of 8.7%. At December 31, 2008, these ratios were 10.6%, 12.5% and 8.9%, respectively. At December 31, 2009, these ratios for the bank were 10.2%, 11.4% and 8.7%, respectively, well above the regulatory minimums and exceeded the requirements for FDIC’s “well capitalized” designation.

Dividend and Market Information: The Company’s stock trades on the “OTC” (Over the Counter) market under the symbol “CPKF”. The Company raised its dividend to $0.420 per share in 2009, an increase of $0.015 over 2008. This increase followed a $0.055 per share dividend increase from $0.350 in 2007 to $0.405 in 2008. 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 during 2009 ranged from $14.00 to $18.00, and during 2008, from $15.05 to $19.99. 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. Management attributes the Company’s ability to maintain stable share prices, during hard economic times, to its record earnings over the past several years. At December 31, 2009, there were 2,738,864 shares of Company’s common stock outstanding held by approximately 230 holders of record.

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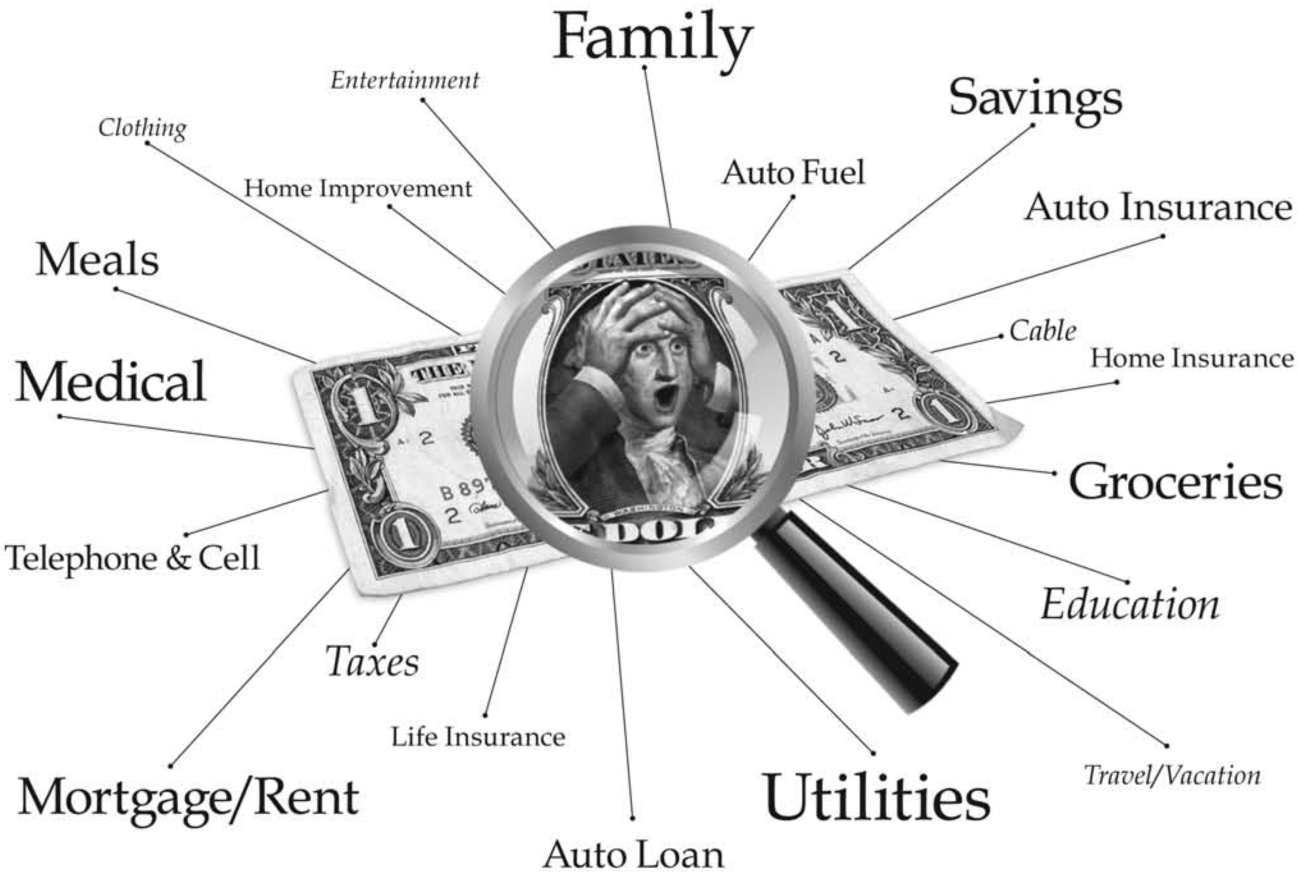

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