



CHESAPEAKE
FINANCIAL SHARES INC.

2010 ANNUAL REPORT

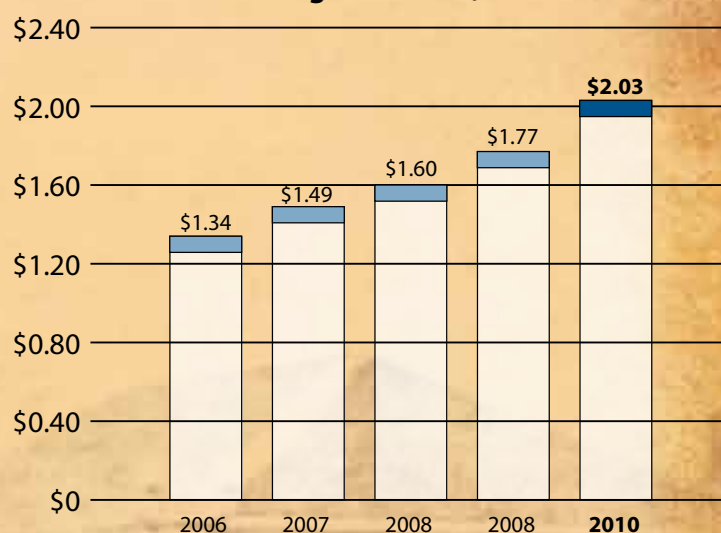
Celebrating **110 years** of service to our customers and the community.



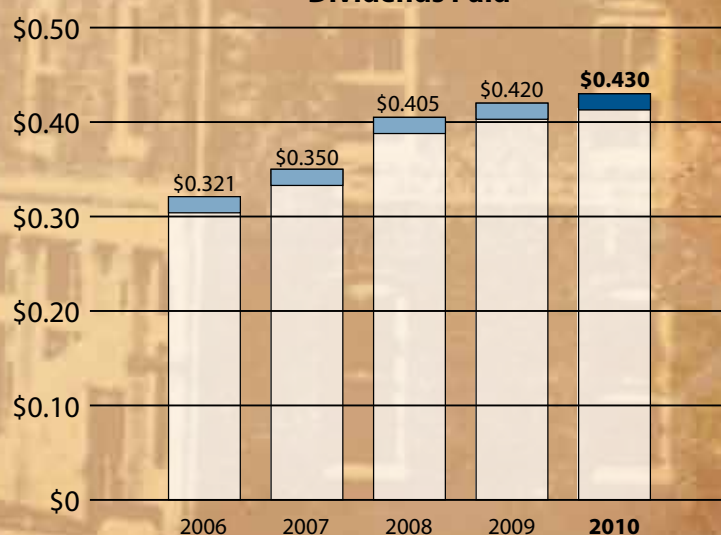
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Earnings Per Share, Diluted



Dividends Paid



Celebrating **110** years of service to our customers and the community.

2010 . . . What a year! Despite efforts to the contrary, the economy continued to struggle through the year much as it had in 2009. High unemployment, despite strong monetary policy efforts from the Fed, was the norm, as was continued cautiousness on the part of both small and large businesses to “put their necks out” with either capital investment or hiring. The housing market showed weakness throughout the year with continued high inventory levels as well as historically low new home starts. A relatively new issue surfaced during the year related to the sovereign debt of many of the Western European countries. The net result was the European Union having to step in to provide backstops to certain countries’ precarious financial positions. In the United States banking sector, there were 154 bank failures during the year as compared to 140 in 2009. Believe it or not, this was relatively good news since it was prognosticated at the beginning of 2010 that there would be approximately 350 such failures.

The real “game changer” during the year was the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act. This 2,319-page bill will give rise to an estimated 200 new pieces of legislation by the time it is fully implemented. To put it in perspective, the Sarbanes-Oxley Act passed in 2002 was only a 61-page bill. Though much of the story has yet to play out, it is anticipated that this will be industry transforming regulation. Of concern is a potential disparate impact on community banks that are less likely to be able to absorb the increased costs associated with the increased regulation. Analysts currently predict that this will most likely accelerate consolidation in the industry as many smaller institutions struggle to provide adequate returns to their shareholders in an already weak economic environment. There is hope; however, the power shift as a result of last November’s elections could prevent some of the more onerous provisions of the law from having a too damaging effect.

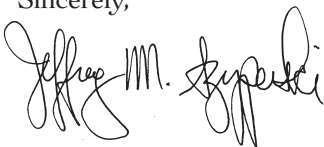
2010 was also marked with goodbyes to many of those who have changed the world in which we live: Teddy Pendergrass, J. D. Salinger, Art Linkletter, John Wooden, Fess Parker, Barbara Billingsley and Edwin Newman, to name a few.

With the above as a backdrop, I am very pleased to say that Chesapeake Financial Shares had the best earnings in our 110-year history. Our net income for the year was \$5,446,164, representing a 12.6% increase over 2009. Earnings per share increased to \$2.03 fully diluted, 14% over 2009. Our return on average equity of 13.57% continued to outperform almost all in our peer group. Again, in the June 2010 issue of *US Banker* magazine, Chesapeake Financial Shares was voted one of the “Top 200 Community Banks” in the country based on return on average equity, earning the position of 32 on that list, up from #64 in the prior year.

Even with such a good report, we want to reaffirm to our shareholders that we are intensely focused on the future. We recognize long-term shareholder growth is why you own our stock, and we’ve made considerable efforts, and we will continue to make considerable efforts, to increase the market value of our stock. I feel that the quality of our employees and our overall corporate culture has no peers, at least in our local market. This is based on knowing what we’ve done organizationally to foster an environment where good, self-motivated employees can flourish and provide the needed financial services to our customers. The formula really is quite simple.

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 1, at Rappahannock Westminster-Canterbury in Irvington. As usual, we want to make our Annual Meeting both an informative and entertaining event. We look forward to seeing you there.

Sincerely,



Jeffrey M. Szyperski

Chairman, CEO & President

Chesapeake Financial Shares, Inc.

SELECTED FINANCIAL INFORMATION

	2010	2009	2008	2007	2006
<i>(Dollars in thousands except ratios and per share amounts)</i>					
Results of Operations					
Interest income	\$ 30,138	\$ 30,543	\$ 29,708	\$ 28,017	\$ 24,630
Interest expense	8,349	11,615	13,245	13,471	10,365
Net interest income	21,789	18,928	16,463	14,546	14,265
Provision for loan losses	2,487	895	400	160	833
Net interest income after provision for loan losses	19,302	18,033	16,063	14,386	13,432
Noninterest income	13,841	14,066	15,017	13,484	11,613
Noninterest expenses	26,164	25,860	24,958	21,808	19,643
Income before tax	6,979	6,239	6,122	6,062	5,402
Income tax expense	1,533	1,404	1,521	1,717	1,451
Net income	\$ 5,446	\$ 4,835	\$ 4,601	\$ 4,345	\$ 3,951
Financial Condition					
Total assets	\$ 607,733	\$ 586,680	\$ 537,952	\$ 483,002	\$ 418,091
Total deposits	517,743	486,610	427,741	383,214	358,777
Net loans	356,505	360,607	358,917	329,332	297,202
Long term debt	24,682	42,023	55,135	24,243	11,346
Trust preferred capital notes	15,465	15,465	15,465	25,775	10,310
Shareholders' equity	41,113	35,270	30,552	33,663	30,963
Average assets	602,473	573,048	516,018	447,886	403,833
Average shareholders' equity	40,179	36,788	34,062	31,768	29,090
Key Financial Ratios					
Return on average assets	0.90%	0.84%	0.89%	0.97%	0.98%
Return on average equity	13.6%	13.14%	13.51%	13.73%	13.58%
Dividends paid as a percent of net income	21.6%	24.1%	24.9%	24.8%	23.5%
Per Share Data					
Net income, assuming dilution	\$ 2.03	\$ 1.77	\$ 1.60	\$ 1.49	\$ 1.34
Cash dividends declared	\$ 0.430	\$ 0.420	\$ 0.405	\$ 0.350	\$ 0.321
Book value	\$ 15.10	\$ 12.88	\$ 10.93	\$ 11.91	\$ 10.81

*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, 2010 and 2009

	2010	2009
Assets		
Cash and due from banks	\$ 19,869,577	\$ 10,836,474
Interest-bearing deposits in banks	2,793,000	2,392,000
Securities available for sale, at approximate fair value	162,804,936	142,931,386
Restricted stock, at cost	3,631,983	3,981,783
Loans, net of allowance for loan losses of \$6,140,096 in 2010 and \$5,165,792 in 2009	356,504,722	360,607,419
Premises and equipment, net	16,600,556	17,997,786
Accrued interest receivable	2,742,062	2,586,567
Cash management accounts, net of allowance of \$1,120,675 in 2010 and \$1,056,969 in 2009	18,515,457	24,518,901
Foreclosed assets	3,149,000	2,423,141
Other assets	21,121,801	18,404,749
Total assets	\$ 607,733,094	\$ 586,680,206
Liabilities and Shareholders' Equity		
Deposits:		
Demand accounts	\$ 67,817,627	\$ 62,933,333
Savings and interest-bearing demand deposits	229,131,561	203,675,719
Certificates of deposit		
Denominations less than \$100,000	121,930,173	123,390,816
Denominations of \$100,000 or more	98,863,641	96,609,674
Total deposits	\$ 517,743,002	\$ 486,609,542
Federal Home Loan Bank advances	5,500,000	3,000,000
Other short-term borrowings	—	1,525,000
Trust preferred capital notes	15,465,000	15,465,000
Long-term debt	24,681,763	42,023,274
Accrued interest payable	475,275	582,896
Accrued expenses and other liabilities	2,755,554	2,204,938
Commitments and contingencies	—	—
Total liabilities	\$ 566,620,594	\$ 551,410,650
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 2,723,152 in 2010 and 2,738,864 in 2009	13,615,760	13,694,320
Common stock, nonvoting, par value \$5 per share; authorized 635,000 shares; no shares outstanding	—	—
Additional paid-in capital	140,379	131,016
Retained earnings	28,987,407	24,715,497
Unearned ESOP shares	(692,000)	(830,400)
Accumulated other comprehensive (loss)	(939,046)	(2,440,877)
Total shareholders' equity	\$ 41,112,500	\$ 35,269,556
Total liabilities and shareholders' equity	\$ 607,733,094	\$ 586,680,206

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

CONSOLIDATED STATEMENTS OF INCOME

	<i>Years Ended December 31, 2010, 2009, and 2008</i>		
	2010	2009	2008
Interest and Dividend Income			
Interest and fees on loans	\$22,579,448	\$23,002,490	\$23,877,932
Interest on interest-bearing deposits and federal funds sold	50,639	128,449	11,602
Interest and dividends on securities available for sale:			
Taxable	5,210,962	5,493,777	4,282,768
Nontaxable	2,269,715	1,896,773	1,378,202
Dividends	27,185	21,668	158,074
Total interest and dividend income	\$30,137,949	\$30,543,157	\$29,708,578
Interest Expense			
Savings and interest bearing accounts	\$ 1,684,054	\$ 2,079,028	\$ 1,863,877
Certificates of deposit			
Denominations less than \$100,000	2,638,075	3,983,734	4,576,049
Denominations \$100,000 or more	2,013,108	2,903,117	3,611,728
Short-term borrowings and FHLB advances	1,133,489	1,779,614	2,193,272
Long-term debt and trust preferred capital notes	880,665	869,941	1,000,360
Total interest expense	\$ 8,349,391	\$11,615,434	\$13,245,286
Net interest income	\$21,788,558	\$18,927,723	\$16,463,292
Provision for loan losses	2,486,664	895,000	400,000
Net interest income after provision for loan losses	\$19,301,894	\$18,032,723	\$16,063,292
Noninterest Income			
Trust income	\$ 2,085,671	\$ 2,042,834	\$ 1,989,460
Service charges	1,566,268	1,717,629	1,810,365
Net gain (loss) on other real estate owned	(428,826)	(48,211)	4,000
Net gain on sales of securities available for sale	1,007,466	510,715	106,929
Net other-than-temporary impairment losses on investments recognized in earnings (includes total other-than-temporary impairment losses of \$2,529,840 and \$975,938, net of \$1,204,197 and \$60,040 recognized in other comprehensive income before taxes)	(1,325,643)	(915,898)	—
Other income	10,936,513	10,758,933	11,105,801
Total noninterest income	\$13,841,449	\$14,066,002	\$15,016,555

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

CONSOLIDATED STATEMENTS OF INCOME

Years Ended December 31, 2010, 2009, and 2008

	2010	2009	2008
Noninterest Expenses			
Salaries and benefits	\$ 12,423,158	\$ 12,213,820	\$ 12,161,294
Occupancy expenses	3,349,856	3,705,344	3,360,116
Other expenses	10,391,496	9,940,370	9,436,234
Total noninterest expenses	\$ 26,164,510	\$ 25,859,534	\$ 24,957,644
Income before income taxes	\$ 6,978,833	\$ 6,239,191	\$ 6,122,203
Income tax expense	1,532,669	1,404,264	1,521,296
Net income	\$ 5,446,164	\$ 4,834,927	\$ 4,600,907
Earnings per share, basic	\$ 2.04	\$ 1.78	\$ 1.63
Earnings per share, diluted	\$ 2.03	\$ 1.77	\$ 1.60

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years Ended December 31, 2010, 2009, and 2008

	2010	2009	2008
Cash Flows from Operating Activities			
Net income	\$ 5,446,164	\$ 4,834,927	\$ 4,600,907
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	1,925,445	2,016,233	1,780,628
Provision for loan losses	2,486,664	895,000	400,000
Provision for cash management account losses	249,996	963,000	865,000
Deferred income tax (benefit)	(1,121,848)	(629,555)	(65,371)
Amortization (accretion) of discounts, net	574,068	(691,128)	(365,641)
Net (gain) on securities available for sale	(1,007,466)	(510,715)	(106,929)
Net other-than-temporary impairment losses	1,325,643	915,898	—
Net (gain) loss on other real estate owned	428,826	48,211	(4,000)
Stock-based compensation	144,000	108,000	104,000
Release of ESOP shares	135,900	152,300	—
Origination of loans available for sale	(53,175,795)	(64,555,205)	(11,209,549)
Proceeds from sale of loans available for sale	53,175,795	64,555,205	11,209,549
Issuance of common stock for services	79,151	100,725	103,525
Changes in other assets and liabilities:			
(Increase) in accrued interest receivable	(155,495)	(298,148)	(356,617)
(Increase) in other assets	(2,607,482)	(5,376,531)	(689,977)
(Decrease) in accrued interest payable	(107,621)	(216,021)	(215,952)
Increase (decrease) in other liabilities	550,616	(54,867)	1,167,189
Net cash provided by operating activities	\$ 8,346,561	\$ 2,257,329	\$ 7,216,762
Cash Flows from Investing Activities			
Purchases of securities available for sale	\$ (58,642,174)	\$ (83,439,378)	\$ (47,238,714)
Proceeds from sales and calls of securities available for sale	4,281,720	9,511,037	6,930,716
Proceeds from maturities of securities available for sale	35,870,162	26,868,119	19,922,640
(Purchase) redemption of restricted stock	349,800	308,200	(1,574,183)
Proceeds from sale of other real estate	1,692,400	161,789	225,288
Net (increase) in loans	(1,231,052)	(4,000,099)	(30,281,311)
Net decrease (increase) in cash management accounts	5,753,448	6,137,762	(5,540,808)
Other capital expenditures	(289,609)	(2,627,459)	(2,796,458)
Net cash (used in) investing activities	\$ (12,215,305)	\$ (47,080,029)	\$ (60,352,830)

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years Ended December 31, 2010, 2009, and 2008

	2010	2009	2008
Cash Flows from Financing Activities			
Net increase (decrease) in short-term borrowings	\$ 975,000	\$ (1,475,000)	\$ (14,000,000)
Net increase (decrease) in demand accounts, interest-bearing demand accounts and savings accounts	30,340,136	77,919,719	(15,526,964)
Net increase (decrease) in certificates of deposits	793,324	(19,051,268)	60,054,302
Net proceeds from issuance of common stock	—	—	123,250
Repurchase of common stock	(289,848)	(951,167)	(1,046,043)
Shares acquired for leveraged ESOP	—	(968,800)	—
Cash dividends	(1,174,254)	(1,164,777)	(1,144,763)
Redemption of trust preferred capital notes	—	—	(10,310,000)
Proceeds from issuance of long-term debt	—	—	37,000,000
Curtailment of long-term debt	(17,341,511)	(13,111,904)	(107,495)
Net cash provided by financing activities	\$ 13,302,847	\$ 41,196,803	\$ 55,042,287
Net increase (decrease) in cash and cash equivalents	\$ 9,434,103	\$ (3,625,897)	\$ 1,906,219
Cash and cash equivalents at beginning of year	13,228,474	16,854,371	14,948,152
Cash and cash equivalents at end of year	\$ 22,662,577	\$ 13,228,474	\$ 16,854,371
Supplemental Disclosures of Cash Flow Information			
Cash paid during the year for:			
Interest	\$ 8,457,012	\$ 11,831,455	\$ 13,461,238
Income taxes	\$ 2,673,038	\$ 1,305,000	\$ 1,808,000
Supplemental Schedule of Noncash Investing and Financing Activities			
Unrealized gain (loss) on securities available for sale	\$ 2,275,503	\$ 3,949,317	\$ (8,866,967)
Other real estate acquired in settlement of loans	\$ 2,847,085	\$ 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, 2010, 2009, and 2008

	Common Stock, Voting	Additional Paid-In Capital	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income (Loss)	Total
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	\$ 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 (forwarded)	\$ 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.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

Years Ended December 31, 2010, 2009, and 2008

	Common Stock, Voting	Additional Paid-In Capital	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income (Loss)	Total
Balance, December 31, 2009 (brought forward)	\$ 13,694,320	\$ 131,016	\$ 24,715,497	\$ (830,400)	\$ (2,440,877)		\$ 35,269,556
Comprehensive income:							
Net income	—		5,446,164	—	—	\$ 5,446,164	5,446,164
Other comprehensive income:							
Unrealized holding gains on securities available for sale, net of deferred income taxes of \$665,491	—	—	—	—	—	1,291,834	—
Reclassification adjustment, net of income taxes of \$108,180	—	—	—	—	—	209,997	—
Other comprehensive income, net of tax	—	—	—	—	1,501,831	1,501,831	1,501,831
Total comprehensive income	—	—	—	—	—	<u>\$ 6,947,995</u>	—
Release of ESOP shares	—	(2,500)	—	138,400	—		135,900
Issuance of common stock for services	27,445	51,706	—	—	—		79,151
Repurchase of common stock	(106,005)	(183,843)	—	—	—		(289,848)
Stock-based compensation	—	144,000	—	—	—		144,000
Cash dividends (\$0.43 per share)	—	—	(1,174,254)	—	—		(1,174,254)
Balance, December 31, 2010	\$ 13,615,760	\$ 140,379	\$ 28,987,407	\$ (692,000)	\$ (939,046)		\$ 41,112,500

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 21, 2011, 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.

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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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.

The Bank's recorded investments in 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.

The Bank analyzes its loan portfolio by segment. Segments are based on the level at which the allowance for loan losses is calculated and monitored. The Bank's loan segments are commercial – non real estate, commercial – real estate, consumer – non real estate, and residential real estate. The Bank further segregates each segment of the loan portfolio into classes based on how each loan was initially recorded. Classes are a level of detail that appropriately exhibits the risks inherent in the loan portfolio.

Loans of each class 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. Generally the Bank will return a loan to accrual status when all delinquent interest and principal become current under the terms of the loan agreement or the loan is well-secured and in the process of collection.

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. Loans of each segment are fully or partially charged off against the allowance when the Bank deems the amount to be uncollectible. General conditions for charge-off include repayment schedules that are deemed to be protracted beyond a reasonable timeframe, the loan has been classified as a loss either internally or by regulators, or the loan is 180 days past due unless well secured and in the process of collection. 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

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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 by segment 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. Adjustments to the historical charge-off factors are made for each segment based on management's assessment of the state of economy, delinquencies, exceptions to loan underwriting/monitoring policies, and local unemployment. There were no significant changes to the Bank's allowance methodology during the current year.

A loan in each class 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 three to seven 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 the 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

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

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position will be realized or sustained under examination. The term more likely than not means a likelihood of more than 50%; 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 50% 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.

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.

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.

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

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calculated and recognized over the employees' service periods, 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 2009 consolidated financial statements have been reclassified to conform to the 2010 presentation.

Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (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 the Accounting Standards Codification (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. ASU 2009-16 was effective for transfers on or after January 1, 2010. The adoption of the new guidance did not have a material impact on CFS's consolidated financial statements.

In January 2010, the FASB issued ASU 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. The adoption of the new guidance did not have a material impact on CFS's consolidated financial statements.

In July 2010, the FASB issued ASU 2010-20, "Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses." The new disclosure guidance significantly expands the existing requirements and will lead to greater transparency into a company's exposure to credit losses from lending arrangements. The extensive new disclosures of information as of the end of a reporting period will become effective for both interim and annual reporting periods ending on or after December 15, 2010. Specific disclosures regarding activity that occurred before the issuance of the ASU, such as the allowance roll forward and modification disclosures, will be required for periods beginning on or after December 15, 2010. CFS has included the required disclosures in its consolidated financial statements.

In January 2011, the FASB issued ASU 2011-01, "Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20." The amendments in this ASU temporarily delay the effective date of the disclosures about troubled debt restructurings in ASU 2010-20 for public entities. The delay is intended to allow the FASB time to complete its deliberations on what constitutes a troubled debt

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

restructuring. The effective date of the new disclosures about troubled debt restructurings for public entities and the guidance for determining what constitutes a troubled debt restructuring will then be coordinated. Currently, that guidance is anticipated to be effective for interim and annual periods ending after June 15, 2011.

In December 2010, the FASB issued ASU 2010-29, "Disclosure of Supplementary Pro Forma Information for Business Combinations." The guidance requires pro forma disclosure for business combinations that occurred in the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period. If comparative financial statements are presented, the pro forma information should be reported as though the acquisition date for all business combinations that occurred during the current year had been as of the beginning of the comparable prior annual reporting period. ASU 2010-29 is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010. Early adoption is permitted. The adoption of the new guidance is not expected to have a material impact on CFS's consolidated financial statements.

Note 2. Securities

Amortized cost and fair values of securities available for sale as of December 31, 2010 and 2009, are as follows:

	2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities of state and political subdivisions	\$ 76,699,524	\$ 1,198,509	\$ (1,723,256)	\$ 76,174,777
Mortgage-backed securities	87,528,207	3,880,049	(4,778,097)	86,630,159
Total	\$ 164,227,731	\$ 5,078,558	\$ (6,501,353)	\$ 162,804,936

	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

The amortized cost and fair value of securities available for sale as of December 31, 2010, 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	\$ 19,760,566	\$ 20,157,108
Due after one year through five years	54,481,850	54,859,742
Due after five years through ten years	65,675,519	64,485,165
Due after ten years	24,309,796	23,302,921
Total	\$ 164,227,731	\$ 162,804,936

Proceeds from sales and calls of securities available for sale during 2010, 2009, and 2008 were \$4,281,720, \$9,511,037, and \$6,930,716, respectively. Gross realized gains amounted to \$1,033,978, \$576,471, and \$106,929 in 2010, 2009, and 2008. Gross realized losses amounted to \$26,512 and \$65,756 in 2010 and 2009, and there were no gross realized losses during 2008. The tax provision applicable to these net realized gains amounted to

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

\$342,538, \$173,643, and \$36,356 in 2010, 2009, and 2008, 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 \$72,474,164 and \$85,413,413 at December 31, 2010 and 2009, respectively.

Temporarily Impaired Securities

Information pertaining to securities with gross unrealized losses at December 31, 2010 and 2009, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	2010			
	Less Than 12 Months		12 Months or More	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
Securities of state and political subdivisions	\$ 36,827,934	\$ (1,233,323)	\$ 2,077,493	\$ (489,933)
Mortgage-backed securities	9,510,146	(141,934)	14,775,972	(4,636,163)
	\$ 46,338,080	\$ (1,375,257)	\$ 16,853,465	\$ (5,126,096)

	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)

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 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, 2010.

Mortgage-Backed Securities

The unrealized losses on CFS's investment in government-sponsored enterprise mortgage-backed securities were caused by interest rate movements. 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 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, 2010.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The unrealized losses associated with 23 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 an economic cash flow model. Based upon our assessment of the expected credit losses of the security given the performance of the underlying collateral, we expect to experience minimal losses in private residential mortgage-backed securities.

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 the 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 (OTTI) has occurred. The initial indicator of OTTI is a decline in market value (unrealized loss) below the amount recorded for an investment as well as the severity and duration of the decline. If the decline in fair value is below amortized cost, CFS recognizes OTTI if (1) CFS has the intent to sell the security, (2) it is more likely than not that CFS will be required to sell the security before recovery of its amortized cost basis, or (3) CFS does not expect to recover the entire amortized cost of the security. While all securities are considered, the securities primarily impacted by OTTI analysis are private residential mortgage-backed securities. CFS uses economic models to aid in its determination of OTTI. Various inputs into the economic models are used to determine if OTTI exists. The most significant inputs in determining OTTI are:

- Length of time and extent to which fair value has been less than amortized cost,
- Cause of the decline such as interest rates or adverse conditions in the market,
- Payment structure of the security,
- Credit performance of the underlying collateral, including delinquency rates, nonperforming collateral/defaults, severities of losses, collateral values, and expected credit losses,
- Current rating of security, and
- Independent analysts reports and forecasts.

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

If CFS determines that a given security is subject to OTTI write-down or loss, CFS records the expected credit portion loss as a charge to earnings. The measurement of the credit loss component is equal to the difference between the security's cost basis and the present value of its expected future cash flows, using the economic models, discounted at the security's purchase yield assumption. The remaining non-credit portion is recorded in other comprehensive income.

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, 2009	\$ 915,898
Amount related to the credit loss for which an other-than-temporary impairment was not previously recognized	1,325,643
Ending balance as of December 31, 2010	\$ 2,241,541

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Note 3. Loans

A summary of the balances of loans by segment follows:

	December 31,	
	2010	2009
Commercial - Non Real Estate	\$ 83,449,610	\$ 83,471,526
Commercial - Real Estate	160,060,380	161,007,329
Residential Real Estate	104,127,756	106,037,537
Consumer - Non Real Estate	15,007,072	15,256,819
	\$ 362,644,818	\$ 365,773,211
Less: Allowance for loan losses	6,140,096	5,165,792
Loans, net	\$ 356,504,722	\$ 360,607,419

Overdrafts totaling \$125,531 and \$94,921 at December 31, 2010 and 2009, respectively, were reclassified from deposits to loans.

An analysis of the allowance for loan losses follows:

	December 31,		
	2010	2009	2008
Balance at beginning of year	\$ 5,165,792	\$ 4,715,574	\$ 4,388,538
Provision for loan losses	2,486,664	895,000	400,000
Loans charged off	(1,553,131)	(458,972)	(319,957)
Recoveries on loans previously charged off	40,771	14,190	246,993
Balance at end of year	\$ 6,140,096	\$ 5,165,792	\$ 4,715,574

An analysis of the allowance for loan losses by segment at December 31, 2010, follows:

	Commercial - Non Real Estate	Commercial - Real Estate	Consumer - Non Real Estate	Residential Real Estate	Unallocated	Total
Individually evaluated for impairment	\$ 83,398	\$ 442,441	\$ 35,000	\$ 102,251	\$ —	\$ 663,090
Collectively evaluated for impairment	1,350,103	2,194,669	207,775	1,325,523	398,936	5,477,006
Total allowance for loan losses	\$ 1,433,501	\$ 2,637,110	\$ 242,775	\$ 1,427,774	\$ 398,936	\$ 6,140,096
Individually evaluated for impairment	\$ 3,635,235	\$ 3,256,854	\$ 117,652	\$ 2,331,511	\$ —	\$ 9,341,252
Collectively evaluated for impairment	79,814,375	156,803,526	14,889,420	101,796,245	—	353,303,566
Total loans	\$ 83,449,610	\$ 160,060,380	\$ 15,007,072	\$ 104,127,756	\$ —	\$ 362,644,818

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The following is a summary of information pertaining to impaired loans by class at December 31, 2010:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance:					
Commercial - Non Real Estate					
Secured	\$ 2,677,520	\$ 2,677,520	\$ —	\$ 669,380	\$ 110,792
Unsecured	24,194	24,194	—	481,831	6,397
Commercial - Real Estate					
Acquisition and development	—	—	—	—	—
Non-owner occupied	—	—	—	—	—
Owner occupied	674,781	674,781	—	2,267,626	94,699
Multifamily	—	—	—	—	—
Consumer - Non Real Estate					
Installment	18,162	18,162	—	18,132	5,560
Revolving	501	501	—	125	—
Other	—	—	—	—	—
Residential Real Estate					
First Lien 1-4 Family	818,876	818,876	—	1,979,726	129,725
Junior Lien 1-4 Family	43,525	43,525	—	10,881	—
Construction	695,091	695,091	—	173,773	3,338
Land	28,277	28,277	—	7,069	—
Revolving	582,116	582,116	—	145,529	—
With an allowance recorded:					
Commercial - Non Real Estate					
Secured	\$ 933,521	\$ 933,521	\$ 83,398	\$ 430,534	\$ 37,826
Unsecured	—	—	—	—	—
Commercial - Real Estate					
Acquisition and development	372,133	372,133	70,408	93,033	—
Non-owner occupied	1,908,049	1,908,049	322,033	477,012	—
Owner occupied	301,891	301,891	50,000	1,067,794	50,901
Multifamily	—	—	—	—	—
Consumer - Non Real Estate					
Installment	98,989	98,989	35,000	28,530	3,931
Revolving	—	—	—	—	—
Other	—	—	—	—	—
Residential Real Estate					
First Lien 1-4 Family	163,626	163,626	102,251	121,539	9,193
Junior Lien 1-4 Family	—	—	—	—	—
Construction	—	—	—	—	—
Land	—	—	—	—	—
Revolving	—	—	—	—	—
Total:					
Commercial - Non Real Estate	\$ 3,635,235	\$ 3,635,235	\$ 83,398	\$ 1,581,745	\$ 155,015
Commercial - Real Estate	3,256,854	3,256,854	442,441	3,905,465	145,600
Consumer - Non Real Estate	117,652	117,652	35,000	46,787	9,491
Residential Real Estate	2,331,511	2,331,511	102,251	2,438,517	142,256
	\$ 9,341,252	\$ 9,341,252	\$ 663,090	\$ 7,972,514	\$ 452,362

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Included in impaired loans are troubled debt restructurings. At December 31, 2010, \$7,386,028 in loans were modified in troubled debt restructurings where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a reduction in the loan's interest rate, payment extensions, or other actions intended to maximize collection.

The following is a summary of information pertaining to impaired loans at December 31, 2009 and 2008:

	2009	2008
Impaired loans without a valuation allowance	\$ 1,664,726	\$ 2,524,428
Impaired loans with a valuation allowance	7,194,431	—
Total impaired loans	\$ 8,859,157	\$ 2,524,428
Valuation allowance related to impaired loans	\$ 2,292,983	\$ —

	2009	2008
Average investment in impaired loans	\$ 2,907,487	\$ 2,629,682
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 and \$138,254 at December 31, 2009 and 2008, respectively. If interest on these loans had been accrued, such income would have approximated \$78,794 and \$10,723 at December 31, 2009 and 2008, respectively.

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

The following is a summary of information pertaining to nonaccrual and past due loans by class:

	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	90-Days Past Due and Still Accruing	Nonaccruals
December 31, 2010								
Commercial - Non Real Estate								
Commercial Secured	\$ 587,331	\$ 523,894	\$ —	\$ 24,487,329	\$ 47,785,053	\$ 72,272,382	\$ —	\$ 1,670,624
Commercial Unsecured	295,860	43,338	—	339,198	10,838,030	11,177,228	—	—
Commercial Real Estate (CRE)								
Commercial A&D	—	169,566	—	169,566	28,915,645	29,085,211	—	—
Commercial Non-Owner Occupied	—	—	—	—	49,434,458	49,434,458	—	—
Commercial Owner Occupied	—	—	—	97,526	77,626,130	77,723,656	—	1,207,563
Multifamily Commercial	—	—	—	—	3,817,055	3,817,055	—	—
Consumer - Non Real Estate								
Consumer Installment	30,349	10,930	1,270	51,315	11,256,862	11,308,177	—	151,964
Consumer Revolving	206	1,151	100,956	103,121	3,587,224	3,690,345	—	—
Consumer Other	—	—	—	—	8,550	8,550	—	—
Residential-Real Estate								
First Lien 1-4 Family	1,305,596	173,812	—	1,404,121	37,739,320	39,143,441	—	1,085,187
Jr Lien 1-4 Family	51,822	—	—	51,822	4,351,903	4,403,725	—	35,228
Construction	—	—	—	—	6,639,473	6,639,473	—	—
Land	—	—	—	274,330	10,212,844	10,487,174	—	175,297
Revolving	—	70,775	—	589,897	42,864,046	43,453,943	—	124,617
Total	\$ 2,271,164	\$ 993,466	\$ 102,226	\$ 27,568,225	\$335,076,593	\$362,644,818	\$ —	\$ 4,450,480

A loan is considered past due when a payment of principal and/or interest is due but not paid.

The Bank's credit quality information follows. Information is based on internal risk ratings by class of loans.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	Pass	Watch	Special Mention	Substandard	Doubtful	Loss	Total
Commercial - Non Real Estate							
Secured	\$ 64,794,919	\$ 1,678,229	\$ 2,188,834	\$ 3,408,312	\$ 202,088	\$ —	\$ 72,272,382
Unsecured	8,685,488	455,000	2,012,546	24,194	—	—	11,177,228
Commercial - Real Estate							
Acquisition and development	22,099,825	6,078,470	534,783	372,133	—	—	29,085,211
Non-owner occupied	36,877,809	6,290,388	4,358,213	—	1,908,048	—	49,434,458
Owner occupied	69,459,815	6,983,301	303,868	976,672	—	—	77,723,656
Multifamily	3,817,055	—	—	—	—	—	3,817,055
Consumer - Non Real Estate							
Installment	11,103,546	70,311	17,169	117,151	—	—	11,308,177
Revolving	2,838,733	—	851,111	501	—	—	3,690,345
Other	8,550	—	—	—	—	—	8,550
Residential Real Estate							
First Lien 1-4 Family	36,432,608	976,383	751,423	888,052	94,975	—	39,143,441
Junior Lien 1-4 Family	4,352,372	33,739	—	17,614	—	—	4,403,725
Construction	5,378,359	—	566,023	695,091	—	—	6,639,473
Land	10,329,566	54,032	75,299	28,277	—	—	10,487,174
Revolving	42,392,096	312,792	166,939	582,116	—	—	43,453,943
Total	\$ 318,570,741	\$ 22,932,645	\$ 11,826,208	\$ 7,110,113	\$ 2,205,111	\$ —	\$ 362,644,818

Internal risk rating definitions are:

Pass/Watch: These include satisfactory loans which may have elements of risk that the Bank has chosen to monitor formally. The objective of monitoring is to assure that no weaknesses develop in these loans.

Special Mention: These loans have a potential weakness that requires management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Bank's credit position at some future date. These credits do not expose the Bank to sufficient risk to warrant further adverse classification.

Substandard: A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified as such must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Doubtful: Loans classified doubtful have all the weaknesses inherent in a substandard asset with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loss: Loans classified loss are considered uncollectible and of such little value that their continuance as a bankable asset is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be received in the future.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 4. Premises and Equipment

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

	December 31,	
	2010	2009
Land	\$ 3,790,653	\$ 3,790,653
Buildings	13,315,415	13,272,452
Furniture, fixtures, and improvements	1,984,024	1,985,243
Mechanical equipment	7,293,297	7,202,567
Leasehold improvements	4,069,906	4,063,371
Construction in progress	—	73,293
	\$ 30,453,295	\$ 30,387,579
Less accumulated depreciation	13,852,739	12,389,793
	\$ 16,600,556	\$ 17,997,786

For the years ended December 31, 2010, 2009, and 2008, depreciation expense was \$1,686,839, \$1,747,837, and \$1,582,941, respectively.

Note 5. Borrowings

CFS's fixed-rate long-term debt of \$24,681,763 at December 31, 2010, matures through 2018. \$435,022 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. \$22,500,000 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 4.76% and mature through 2018. \$1,275,000 of the long-term debt consists of a 4.50% fixed-rate borrowing secured by CFS stock from a line of credit totaling \$5,000,000. 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, 2010, for this borrowing was \$471,742. Aggregate maturities during the next five years are: 2011, \$121,089; 2012, \$126,111; 2013, \$12,631,336; 2014, \$137,121; and 2015, \$142,885.

CFS has unsecured lines of credit with correspondent banks totaling \$33,000,000 available for overnight borrowing. No balances were outstanding on these lines at December 31, 2010.

Note 6. Income Taxes

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

	December 31,	
	2010	2009
Deferred tax assets:		
Allowance for loan and cash management account losses	\$ 2,379,411	\$ 1,959,550
Securities available for sale	483,749	1,257,426
Other-than-temporary impairment of securities	762,124	311,405
Other real estate	259,837	64,927
Deferred compensation	70,947	77,398
Premises and equipment	199,395	170,811
Other	61,016	26,791
	\$ 4,216,479	\$ 3,868,308

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The provision for income taxes charged to operations for the years ended December 31, 2010, 2009, and 2008, consists of the following:

	2010	2009	2008
Current tax expense	\$ 2,654,517	\$ 2,033,819	\$ 1,586,667
Deferred tax (benefit)	(1,121,848)	(629,555)	(65,371)
	\$ 1,532,669	\$ 1,404,264	\$ 1,521,296

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, 2010, 2009, and 2008, due to the following:

	2010	2009	2008
Computed "expected" tax expense	\$ 2,372,803	\$ 2,121,325	\$ 2,081,549
(Decrease) in income taxes resulting from:			
Tax exempt interest income	(826,663)	(677,203)	(541,854)
Other	(13,471)	(39,858)	(18,399)
	\$ 1,532,669	\$ 1,404,264	\$ 1,521,296

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 2007.

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, 2010, 50,000 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 2010). Future principal payments of \$138,400 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 \$357,115, \$377,470, and \$299,928 for the years ended December 31, 2010, 2009, and 2008, respectively (including \$135,900 for the year ended December 31, 2010, related to the release of ESOP shares).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 \$398,482, \$559,724, and \$566,610 for 2010, 2009, and 2008, 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 \$144,000, \$108,000, and \$104,000 for the years ended December 31, 2010, 2009, and 2008, respectively. No income tax benefit was recognized in the income statement for stock-based compensation arrangements for the years ended December 31, 2010, 2009, and 2008.

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.

A summary of the option activity under the plans at December 31, 2010, 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	287,040	\$ 14.03		
Granted	44,700	14.00		
Exercised	—	—		
Outstanding at end of year	331,740	14.03	5.6 years	\$ 304,000
Options exercisable, end of year	207,240	13.39	3.9 years	304,000

Aggregate intrinsic value of stock options represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all the option holders exercised their options on December 31, 2010. This amount changes based on changes in the market value of CFS's stock.

The weighted-average grant date fair value of options granted during the years ended December 31, 2010, 2009, and 2008 was \$2.38, \$2.35, and \$2.95, respectively. The total intrinsic value of options exercised during the year ended December 31, 2008, was \$242,000. No options were exercised during the years ended December 31, 2010 and 2009.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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,		
	2010	2009	2008
Dividend yield	2.20%	2.09%	2.04%
Expected term	6 years	6 years	6 years
Expected volatility	17.37%	17.39%	17.60%
Risk-free interest rate	3.20%	2.48%	3.28%

As of December 31, 2010, there was \$128,268 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 2010, 2009, and 2008, CFS issued 5,489 shares, 5,925 shares, and 5,309 shares, respectively, of common stock to its directors for partial compensation.

Note 10. Commitments and Contingencies

CFS leases certain facilities and equipment under operating leases which expire at various dates through 2015. 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, 2010, are as follows:

Year Ending December 31,	
2011	\$ 91,713
2012	92,206
2013	92,712
2014	93,230
2015	93,762

Rent expense under operating leases aggregated \$358,243, \$353,782, and \$316,118 for the years ended December 31, 2010, 2009, and 2008, 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, 2010 and 2009, the aggregate amounts of daily average required balances were approximately \$1,462,000 and \$1,511,000, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 11. Related Party Transactions

Officers, directors, and their affiliates had borrowings of \$10,235,742 and \$11,045,066 at December 31, 2010 and 2009, respectively, with the Bank.

Changes in borrowings during 2010 were as follows:

Balance, December 31, 2009	\$ 11,045,066
Additions	392,863
Payments	(1,202,187)
Balance, December 31, 2010	\$ 10,235,742

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:

	2010	2009	2008
Cash management fees and discount	\$ 3,603,281	\$ 4,129,052	\$ 5,029,630
Merchant discount	4,004,493	3,462,331	3,088,190
ATM fee income	1,014,375	881,092	845,767
Asset management fees	812,147	730,981	609,338
Other (includes no items in excess of 1% of total revenue)	1,502,217	1,555,477	1,532,876
	\$ 10,936,513	\$ 10,758,933	\$ 11,105,801

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

	2010	2009	2008
Advertising	\$ 677,460	\$ 694,943	\$ 707,388
Merchant card	2,971,729	2,547,131	2,337,442
Cash management royalties	—	4,790	219,244
Software	916,368	810,037	748,560
Provision for cash management account losses	249,996	963,000	865,000
Legal fees	392,906	240,419	284,485
FDIC assessments	970,695	845,770	274,837
Delivery and transportation	235,933	337,406	374,853
Stationery and supplies	380,351	407,916	458,465
Other (includes no items in excess of 1% of total revenue)	3,596,058	3,088,958	3,165,960
	\$ 10,391,496	\$ 9,940,370	\$ 9,436,234

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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.

	2010	2009	2008
Weighted average number of common shares, basic	2,673,781	2,709,431	2,820,240
Effect of dilutive stock options	13,280	17,094	47,628
Weighted average number of common shares and dilutive potential common stock used in diluted EPS	2,687,061	2,726,525	2,867,868

Options on approximately 219,765 shares and 129,705 shares were not included in the computation of diluted earnings per share for the years ended December 31, 2010 and 2009 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:

2011	\$ 141,953,811
2012	38,668,272
2013	20,090,695
2014	2,894,772
2015	7,186,264
Thereafter	10,000,000
	<u>\$ 220,793,814</u>

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, 2010 and 2009, the following financial instruments were outstanding whose contract amounts represent credit risk:

	Contract Amount	
	2010	2009
Commitments to grant loans	\$ 7,663,950	\$ 12,107,109
Unfunded commitments under lines of credit	95,686,157	118,259,473
Commercial and standby letters of credit	1,168,800	1,147,997

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 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 \$1,434,000 at December 31, 2010.

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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 and 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.

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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 90 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 into account the remaining terms of the agreements and the counterparties' credit standing.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

	2010		2009	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	<i>(In Thousands)</i>		<i>(In Thousands)</i>	
Financial assets:				
Cash and short-term investments	\$ 22,663	\$ 22,663	\$ 13,228	\$ 13,228
Securities	162,805	162,805	142,931	142,931
Restricted stock	3,632	3,632	3,982	3,982
Loans	365,505	358,102	360,607	359,912
Cash management accounts	18,515	18,515	24,519	24,519
Accrued interest receivable	2,742	2,742	2,587	2,587
Financial liabilities:				
Deposits	\$ 517,743	\$ 504,070	\$ 486,610	\$ 486,794
Short-term borrowings	5,500	5,500	4,525	4,525
Long-term debt	40,147	40,686	57,488	52,232
Accrued interest payable	475	475	583	583

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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2010 and 2009:

Description	Carrying Value	Fair Value Measurements at December 31, 2010, Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(in thousands)		

Assets:

Securities of state and political subdivisions	\$ 76,175	\$ —	\$ 76,175	\$ —
Mortgage-backed securities	86,630	—	51,805	34,825

Description	Carrying Value	Fair Value Measurements at December 31, 2009, Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(in thousands)				

Assets:

Securities of state and political subdivisions	\$ 54,189	\$ —	\$ 54,189	\$ —
Mortgage-backed securities	88,742	—	44,051	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, 2010:

Fair Value Measurements Using Significant Unobservable Inputs (Level 3)						
	Balance as of January 1, 2010	Total Realized/Unrealized Gains (Losses) Included in		Purchases, Sales, Issuances, and Settlements, Net	Transfers in and/or Out of Level 3	Balance as of December 31, 2010
		Net Income	Other Comprehensive Income			
<i>(in thousands)</i>						
Mortgage-backed securities	\$ 44,691	\$ (1,326)	\$ (1,204)	\$ (7,336)	\$ —	\$ 34,825

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2010 and 2009, for which a nonrecurring change in fair value has been recorded:

Fair Value Measurements at December 31, 2010, 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	\$ —	\$ —	\$ 6,893
Other real estate owned	—	—	3,149

Fair Value Measurements at December 31, 2009, 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
Other real estate owned	—	—	2,423

Impaired Loans

The fair value of impaired loans is 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.

Other Real Estate Owned

Other real estate owned is measured at fair value less cost to sell.

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, 2010 and 2009, that CFS meets all capital adequacy requirements to which it is subject.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

As of December 31, 2010, 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 and Chesapeake Bank'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, 2010:						
Total Capital (to Risk-Weighted Assets):						
Consolidated	\$ 62,872	13.5%	\$ 37,142	8.0%	N/A	
Chesapeake Bank	\$ 60,147	13.1%	\$ 36,770	8.0%	\$ 45,962	10.0%
Tier 1 Capital (to Risk-Weighted Assets):						
Consolidated	\$ 56,054	12.1%	\$ 18,571	4.0%	N/A	
Chesapeake Bank	\$ 54,595	11.9%	\$ 18,385	4.0%	\$ 27,577	6.0%
Tier 1 Capital (to Average Assets):						
Consolidated	\$ 56,054	9.2%	\$ 24,257	4.0%	N/A	
Chesapeake Bank	\$ 54,595	9.0%	\$ 24,314	4.0%	\$ 30,393	5.0%
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%

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 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, 2010, was 5.12%. The interest rate as of December 31, 2010, was 5.12%. 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 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 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, 2010, the amount available for payment of additional dividends without prior regulatory approval from the Bank to the parent company is \$12,891,804 or 31.4% of consolidated net assets.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Balance Sheets (Condensed)

	December 31,	
	2010	2009
Assets		
Cash	\$ 642,804	\$ 268,721
Investment in subsidiaries	55,374,278	50,115,200
Premises and equipment, net	2,558,646	2,779,085
Other assets	1,113,464	1,070,487
Total assets	\$ 59,689,192	\$ 54,233,493
Liabilities and Shareholders' Equity		
Borrowings	\$ 2,402,022	\$ 2,839,319
Trust preferred capital notes	15,465,000	15,465,000
Other liabilities	709,670	659,618
Shareholders' equity	41,112,500	35,269,556
Total liabilities and shareholders' equity	\$ 59,689,192	\$ 54,233,493

Statements of Income (Condensed)

	2010	2009	2008
Income - Dividends from subsidiaries	\$ 2,309,954	\$ 1,326,230	\$ 1,221,553
Other	840,636	111,998	115,967
Total income	\$ 3,150,590	\$ 1,438,228	\$ 1,337,520
Expenses - Interest expense	\$ 921,923	\$ 918,271	\$ 994,017
Other expenses	752,375	687,347	738,307
Total expenses	\$ 1,674,298	\$ 1,605,618	\$ 1,732,324
Income (loss) before income taxes and equity in undistributed earnings of subsidiaries	\$ 1,476,292	\$ (167,390)	\$ (394,804)
Allocated income tax benefit	212,629	378,962	484,505
Income before equity in undistributed earnings of subsidiaries	\$ 1,688,921	\$ 211,572	\$ 89,701
Equity in undistributed earnings of subsidiaries	3,757,243	4,623,355	4,511,206
Net income	\$ 5,446,164	\$ 4,834,927	\$ 4,600,907

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Statements of Cash Flows (Condensed)

	2010	2009	2008
Cash Flows from Operating Activities			
Net income	\$ 5,446,164	\$ 4,834,927	\$ 4,600,907
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	230,295	173,317	119,429
Equity in undistributed earnings of subsidiaries	(3,757,243)	(4,623,355)	(4,511,206)
Issuance of common stock for services	79,151	100,725	103,525
Stock-based compensation	144,000	108,000	104,000
Release of ESOP shares	135,900	152,300	—
Changes in other assets and liabilities:			
(Increase) decrease in other assets	(42,981)	357,706	(131,178)
Increase (decrease) in other liabilities	50,052	(52,250)	164,878
Net cash provided by operating activities	\$ 2,285,338	\$ 1,051,370	\$ 450,355
Cash Flows from Investing Activities			
Purchases of premises and equipment	\$ (9,856)	\$ (1,901,787)	\$ (129,868)
Investment in subsidiaries	—	(350,000)	—
Net cash (used in) investing activities	\$ (9,856)	\$ (2,251,787)	\$ (129,868)
Cash Flows from Financing Activities			
Dividends paid	\$ (1,174,254)	\$ (1,164,777)	\$ (1,144,763)
Curtailment of borrowings	(437,297)	(259,686)	(43,814)
Proceeds from borrowings	—	2,568,800	—
Repurchase of common stock	(289,848)	(951,167)	(1,046,043)
Shares acquired for leveraged ESOP	—	(968,800)	—
Redemption of trust preferred capital notes	—	—	(10,310,000)
Net proceeds from issuance of common stock	—	—	123,250
Net cash (used in) financing activities	\$ (1,901,399)	\$ (775,630)	\$ (12,421,370)
Net increase (decrease) in cash	\$ 374,083	\$ (1,976,047)	\$ (12,100,883)
Cash at beginning of year	268,721	2,244,768	14,345,651
Cash at end of year	\$ 642,804	\$ 268,721	\$ 2,244,768

INDEPENDENT AUDITOR'S REPORT



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, 2010 and 2009, and the related consolidated statements of income, changes in shareholders' equity and cash flows for the years ended December 31, 2010, 2009 and 2008. 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, 2010 and 2009, and the results of their operations and their cash flows for the years ended December 31, 2010, 2009 and 2008 in conformity with accounting principles generally accepted in the United States of America.

Yount, Hyde & Barbour, P.C.

Winchester, Virginia
February 21, 2011

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 2010. The return on average equity in 2010 was 13.6% and return on average assets was 0.90% compared to 13.1% and 0.84%, respectively, in 2009. At the end of 2010, CFS had total assets of \$607.7 million, representing a 3.6% increase over the December 31, 2009, balance of \$586.7 million. The Company ended the year with total gross loans of \$362.6 million, and total deposits of \$517.7 million, down 0.8% and up 6.4%, respectively.

Loan volume was down \$3.1 million for 2010, bringing the average annual loan growth rate for the last five years to 6.7%. Asset quality was maintained during the year with past due loans relatively low and the net allowance for loan losses to gross loans less unearned discounts remaining at adequate levels of 1.69%. The deposit growth of 6.4% for 2010 brought the average annual deposit growth rate for the last five years to 9.5%. 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 2010 were \$5,446,164 or \$2.03 per share (fully diluted) compared to \$4,834,927 or \$1.77 per share in 2009, an increase of \$611,237. The 12.6% increase in net income resulted from a 7.0% increase or \$1,269,170 in net interest income after provision for loan losses. There was a 1.6% decrease or \$224,553 in noninterest income, and noninterest expense increased by only 1.2% or \$304,976 in 2010 over 2009. The provision for Other Than Temporary Impairment (OTTI) increased \$409,745 or 44.7% for 2010 over 2009. Merchant Services income increased by \$542,162 or 15.7% in 2010 while cash management fees were down \$525,771 or 12.7% for the year.

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.

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 \$362.6, \$365.8, and \$363.6 million for 2010, 2009, and 2008, respectively, representing a decrease of 0.9% for 2010 from 2009, an increase of 0.6% for 2009 over 2008, and 9.0% for 2008 over 2007. The commercial portfolio, including real estate and non-real estate combined, was down 1.7% or \$4.0 million, and the consumer and residential real estate portfolios were down a combined 0.1% or \$165,120 from 2009. Loan participations and all other loans as a group were up 28.8% or \$1.1 million.

On December 31, 2010, the loan portfolio consisted of 65.5% commercial loans, 33.1% single-family residential and residential construction loans, and 1.3% 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, and repossessed and foreclosed properties. Nonperforming assets were \$15,591,528 at December 31, 2010, which represented an increase from \$5,281,213 at December 31, 2009. Past due loans over 30 days were 2.2% of total loans at December 31, 2010. A significant portion of the nonperforming asset total is attributable to a group of loans that are included as a result of a reclassification of these credits based on the identification of some weakness. The total included in the 2010 year end number is \$7,386,027. There were no such loans identified at year-end 2009. Any potential loss related to these loans has been incorporated in the allowance for loan losses.

Investment Securities: All of 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

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

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 \$939,046 less than book value, net of the tax effect, at December 31, 2010, and was less than book value by \$939,046, net of the tax effect, at December 31, 2009. 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 \$162.8 million, up \$19.9 million from the \$142.9 million on December 31, 2009. Investments in securities of state and political subdivisions increased by \$22.0 million or 40.6%. Investments in mortgage-backed securities decreased by \$2.1 million or 2.4%.

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 90 days past due are considered in this evaluation as well as other loans, which may be a potential loss. The status of non-accrual 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 \$6,140,096 or 1.69% of gross loans less unearned discounts at year-end. This ratio was 1.41% on December 31, 2009, and 1.30% in 2008. The 2010 provision was \$2,486,664. There was a provision of \$895,000 in 2009 compared to the 2008 provision of \$400,000. Loans charged off totaled \$1,553,131 in 2010, \$458,972 in 2009, and \$319,957 in 2008. Recoveries for the same periods were \$40,771, \$14,190, and \$246,993, respectively. Management and the Board of Directors believe 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 \$517.7, \$486.6, and \$427.7 million for 2010, 2009, and 2008, respectively, and represented an increase of 6.4% for 2010 over 2009 and an increase of 13.8% for 2009 over 2008. There was a 0.4% increase in certificates of deposit during 2010, while demand (noninterest bearing) deposits increased by \$4.9 million or 7.8% from \$62.9 million on December 31, 2009. Savings and interest bearing demand deposit balances increased during 2010 by 12.5% or \$25.5 million to \$229.1 million.

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

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

Net interest income totaled \$21.8, \$18.9, and \$16.5 million for 2010, 2009, and 2008, respectively, representing an increase of 15.1% for 2010 over 2009, 15.0% for 2009 over 2008, and 13.8% for 2008 over 2007.

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

Loan demand was mild this year with total gross loans down 0.9% or \$3.1 million for 2010 from 2009. Total interest expense was \$8.3, \$11.6, and \$13.2 million for 2010, 2009, and 2008, respectively. On a tax equivalent annualized basis, the net interest margin was 4.4%, 4.1%, and 4.0% for 2010, 2009, and 2008, respectively. The Bank's margins have been very stable and well above peer through numerous rate cycles and through the recent recession. The increase in the margin in 2010 was due to the lower cost of funding alternatives provided by the internet banking products and a decrease in total interest and dividend income of only \$405,209 or 1.3% from 2009.

Noninterest Income: For the year ended December 31, 2010, noninterest income was \$15.2 million excluding a charge of \$1,325,643 for OTTI of investments. This represents essentially an increase in noninterest income of \$185,192 for the year. The 2009 amount of \$15.0 million excluding a charge of \$915,898 for OTTI was essentially no change from the 2008 amount. Increases in the gain on sale of securities of \$496,751 or 97.3%, merchant discount income of \$542,162 or 15.7%, ATM fee income of \$133,283 or 15.1%, asset management fees of \$81,166 or 11.1%, and fiduciary income of \$42,837 or 2.1% was offset by decreases in cash management fees of \$525,744 or 12.7%, and service charge income of \$151,361 or 8.8%. Other income was down 1.7% or \$177,580.

Noninterest Expenses: Total noninterest expenses increased 1.2% or \$304,976 in 2010 over 2009. In 2009, total noninterest expenses increased 3.6% over 2008. Occupancy expenses decreased \$355,488 or 9.6%, and salary and benefit costs were up only \$209,338 or 1.7%. The increase in 2010 other expenses category of \$451,126 or 4.5%, was due primarily to increases in merchant card expenses of \$424,598 or 16.7%, and all other expenses of \$507,100 or 16.4%, offset by a reduction in the provision for cash management losses of \$713,004 or 74.0%, and reductions in delivery and transportation of \$101,473 or 30.1%.

Liquidity, Interest Rate Sensitivity, and Inflation: The objectives of 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, 2010, approximately 41.2% of total assets matured or were repricing within one year as compared to 47.2% on December 31, 2009. The Bank's loan portfolio was liquid with 53.2% of all loan dollars maturing or repricing within one year. The loan liquidity ratio was 56.3% on December 31, 2009.

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 \$86.5 million, secured and unsecured. CFS has access to additional secured borrowing for \$3.725 million.

As of December 31, 2010, the Bank held \$606,021 in repossessed assets and \$3,149,000 in other real estate owned. These assets are being actively marketed through real estate channels and represent 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").

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

While the effect of inflation is normally not as significant as 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, 2010, the Company had ratios of Tier 1 risk-based capital to risk-weighted assets of 12.1%, total risk-based capital to risk-weighted assets of 13.5%, and Tier 1 leverage capital of 9.2%. At December 31, 2009, these ratios were 10.1%, 11.7% and 8.7%, respectively. At December 31, 2008, these ratios for CFS were 10.6%, 12.5%, and 8.9%, respectively, well above the regulatory minimums and exceeded the requirements for the FDIC's "well capitalized" designation.

Dividend and Market Information: The Company's stock trades on the Over the Counter market under the symbol "CPKF." The Company raised its dividend to \$0.430 per share in 2010, an increase of \$0.010 over 2009. This increase followed a \$0.015 per share dividend increase from \$0.405 in 2008 to \$0.420 in 2009. 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 2010 ranged from \$13.50 to \$14.50, and during 2009, from \$14.00 to \$18.00. Such transactions may not be representative of all transactions during the indicated periods or 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, 2010, there were 2,723,152 shares of Company's common stock outstanding held by approximately 235 holders of record.

DIRECTORS AND OFFICERS

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Chairman of the Board,
Chief Executive Officer and President

Douglas D. Monroe, Jr.
Vice Chairman

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

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

Katherine W. Monroe
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Retired CEO
Shirley Pewter Shops, Inc.

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

Robert J. Singley, Sr.
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Chief Executive Officer and President

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Managing Director
Witt Mares Financial Vision, LLC

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