CHESAPEAKE FINANCIAL SHARES, INC.

2011 ANNUAL REPORT

CHESAPEAKE
FINANCIAL SHARES, INC.

The Bank began in 1900 with $25,000 in capital and a one branch bank on the shores of the Chesapeake Bay. We are proud to say that, while remaining a small community bank, we have expanded to offer our services to customers in all 50 of the United States.

Chesapeake Bank
Ranked #1 in Virginia and #20 in the nation amongst all community banks by *U.S. Banker*, June 2011

Chesapeake Investment Group
Customized wealth management solutions for individual and institutional clients from coast to coast

Cash Flow
Premier receivables financing provider among community banks nationwide

Chesapeake Payment Systems
Customized merchant processing solutions for 13,000 businesses nationwide

Clear Sky Accounts
Top-rated online bank with competitive rates, exceptional service and customers in all 50 states

You might ask "What's a community bank doing with a map of the United States on its annual report cover?" – a very valid question. Though we are deeply steeped in our local communities and their health, certain aspects of our business have provided us great long-term opportunities outside of our traditional markets. Whether it's technology, a more mobile customer base or a combination, we have been adapting our structure to make sure we're built to last. Rest assured; however, that we will never lose sight of the importance of our local communities to our mutual long-term benefit. "It's All About Community."

In reading through the shareholder letter in last year's annual report, I honestly feel as though I could just say, "Ditto," . . . high unemployment, strong monetary policy efforts from the Fed, reluctance of large and small businesses to invest in either personnel or capital improvements, housing market with continued weakness and concern regarding the sovereign debt of many of the Western European countries. 2011 was very much more of the same. On a bright note; however, the number of bank failures has slowed from 154 failures in 2010 down to 92 failures in 2011. Also, the overall health of the banking industry has improved as reflected in decreased noncurrent loans as well as increased earnings.

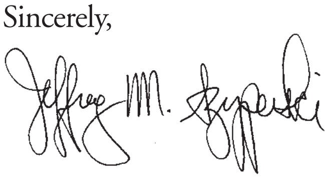
2011 was the first year in which provisions of the new Dodd-Frank Act were being implemented. Without getting overly specific, as this act unfolds over the next several years, it has the ability to materially adversely affect the banking industry, especially community banks. Though many of the current presidential candidates promise a repeal of the Dodd-Frank Act if elected, the current environment does not make that look like a likelihood. 2011 was also marked with goodbyes to many of those who changed the world in which we live: Steve Jobs, Bil Keane ("Family Circus" comic strip), heavyweight fighter Joe Frazier, journalist Andy Rooney, former First Lady Betty Ford, and actor James Arness, just to name a few.

With all that being said, 2011 was the most profitable year in the history of our institution. Our net income for the year was $6,980,708, representing a 28% increase over 2010. Earnings per share increased to $2.16 fully diluted, also representing a 28% increase over 2010. Return on average equity of 15.3% puts us as one of the highest performers in the community bank space. For the fourth consecutive year, *US Banker* magazine has voted Chesapeake Financial Shares one of the "Top 200 Community Banks" in the country based on return on average equity. In the most recent year we moved up to number 20 from 32 in the prior year.

As a shareholder, we want you to know that we are not resting on our laurels. We have an extremely good strategic plan looking into the future in which we hope to parlay the competitive advantages we currently possess. Over time, there is no doubt in our minds that this will reflect in our stock price. Additionally, we began 2012 with a 10% dividend increase to be paid in March of this year. We feel as though focusing on having great employees and appropriately motivating them gives us a competitive advantage which yields the increased earnings and greater shareholder returns.

We want to truly thank you for being a shareholder of Chesapeake Financial Shares. Please take the time to review the contents of this report in detail. Most importantly, however, we hope that you will plan to join us for our Annual Shareholders Meeting on Friday, April 6, 2012 at Rappahannock Westminster-Canterbury in Irvington. We intend to make the 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.

	2011	2010	2009	2008	2007
	(Dollars in thousands except ratios and per share amounts)				
Results of Operations					
Interest income	$ 29,779	$ 30,138	$ 30,543	$ 29,708	$ 28,017
Interest expense	6,962	8,349	11,615	13,245	13,471
Net interest income	22,817	21,789	18,928	16,463	14,546
Provision for loan losses	1,190	2,487	895	400	160
Net interest income after provision for loan losses	21,627	19,302	18,033	16,063	14,386
Noninterest income	13,697	13,841	14,066	15,017	13,484
Noninterest expenses	26,445	26,164	25,860	24,958	21,808
Income before tax	8,879	6,979	6,239	6,122	6,062
Income tax expense	1,898	1,533	1,404	1,521	1,717
Net income	$ 6,981	$ 5,446	$ 4,835	$ 4,601	$ 4,345
Financial Condition					
Total assets	$ 637,953	$ 607,733	$ 586,680	$ 537,952	$ 483,002
Total deposits	543,579	517,743	486,610	427,741	383,214
Net loans	349,798	356,505	360,607	358,917	329,332
Long-term debt	24,235	24,682	42,023	55,135	24,243
Trust preferred capital notes	15,465	15,465	15,465	15,465	25,775
Shareholders' equity	51,225	41,113	35,270	30,552	33,663
Average assets	619,905	602,473	573,048	516,018	447,886
Average shareholders' equity	45,602	40,179	36,788	34,062	31,768
Key Financial Ratios					
Return on average assets	1.13%	0.90%	0.84%	0.89%	0.97%
Return on average equity*	15.3%	13.6%	13.14%	13.51%	13.73%
Dividends paid as a percent of net income	18.5%	21.6%	24.1%	24.9%	24.8%
Per Share Data**					
Net income, assuming dilution	$ 2.160	$ 1.692	$ 1.475	$ 1.333	$ 1.242
Cash dividends declared	$ 0.396	$ 0.358	$ 0.350	$ 0.338	$ 0.292
Book value	$ 15.67	$ 12.58	$ 10.73	$ 9.11	$ 9.93

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

***All per share data has been restated to reflect the 2011 stock split.*

	December 31, 2011	December 31, 2010
Assets		
Cash and due from banks	$ 10,866,615	$ 6,680,096
Interest-bearing deposits in banks	26,554,962	15,982,481
Securities available for sale, at approximate fair value	187,162,678	162,804,936
Restricted stock, at cost	2,932,800	3,631,983
Loans, net of allowance for loan losses of $6,460,625 in 2011 and $6,140,096 in 2010	349,798,245	356,504,722
Premises and equipment, net	16,400,805	16,600,556
Accrued interest receivable	2,939,302	2,742,062
Cash management accounts, net of allowance of $1,053,695 in 2011 and $1,120,675 in 2010	15,770,531	18,515,457
Foreclosed assets	5,331,189	3,149,000
Bank-owned life insurance	9,404,807	8,360,699
Other assets	10,791,276	12,761,102
Total assets	$ 637,953,210	$ 607,733,094
Liabilities and Shareholders' Equity		
Deposits:		
Demand accounts	$ 77,600,120	$ 67,817,627
Savings and interest-bearing demand deposits	236,045,159	229,131,561
Certificates of deposit		
Denominations less than $100,000	134,046,812	121,930,173
Denominations of $100,000 or more	95,887,030	98,863,641
Total deposits	$ 543,579,121	$ 517,743,002
Federal Home Loan Bank advances	—	5,500,000
Trust preferred capital notes	15,465,000	15,465,000
Long-term debt	24,235,439	24,681,763
Accrued interest payable	431,678	475,275
Accrued expenses and other liabilities	3,016,704	2,755,554
Commitments and contingencies	—	—
Total liabilities	$ 586,727,942	$ 566,620,594
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 3,268,390 in 2011 and 2,723,152 in 2010	16,341,950	13,615,760
Common stock, nonvoting, par value $5 per share; authorized 635,000 shares; no shares outstanding	—	—
Additional paid-in capital	—	140,379
Retained earnings	32,167,191	28,987,407
Unearned ESOP shares	(553,600)	(692,000)
Accumulated other comprehensive income (loss)	3,269,727	(939,046)
Total shareholders' equity	$ 51,225,268	$ 41,112,500
Total liabilities and shareholders' equity	$ 637,953,210	$ 607,733,094

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

	Years Ended December 31, 2011	2010	2009
Interest and Dividend Income			
Interest and fees on loans	$ 22,002,099	$ 22,579,448	$ 23,002,490
Interest on interest-bearing deposits and federal funds sold	28,754	50,639	128,449
Interest and dividends on securities available for sale:			
Taxable	4,753,795	5,210,962	5,493,777
Nontaxable	2,955,450	2,269,715	1,896,773
Dividends	38,779	27,185	21,668
Total interest and dividend income	$ 29,778,877	$ 30,137,949	$ 30,543,157
Interest Expense			
Savings and interest-bearing accounts	$ 1,258,348	$ 1,684,054	$ 2,079,028
Certificates of deposit			
Denominations less than $100,000	2,409,022	2,638,075	3,983,734
Denominations $100,000 or more	1,677,793	2,013,108	2,903,117
Short-term borrowings and FHLB advances	731,507	1,133,489	1,779,614
Long-term debt and trust preferred capital notes	885,444	880,665	869,941
Total interest expense	$ 6,962,114	$ 8,349,391	$ 11,615,434
Net interest income	$ 22,816,763	$ 21,788,558	$ 18,927,723
Provision for loan losses	1,190,004	2,486,664	895,000
Net interest income after provision for loan losses	$ 21,626,759	$ 19,301,894	$ 18,032,723
Noninterest Income			
Trust income	$ 2,043,994	$ 2,085,671	$ 2,042,834
Service charges	1,438,293	1,566,268	1,717,629
Net (loss) on foreclosed assets	(462,595)	(428,826)	(48,211)
Net gain on sales of securities available for sale	735,630	1,007,466	510,715
Net other-than-temporary impairment losses on investments recognized in earnings (includes total other-than-temporary impairment losses of $1,371,131, $2,529,480 and $975,938, net of $89,594, $1,204,197 and $60,040 recognized in other comprehensive income before taxes)	(1,281,537)	(1,325,643)	(915,898)
Other income	11,223,467	10,936,513	10,758,933
Total noninterest income	$ 13,697,252	$ 13,841,449	$ 14,066,002

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

	Years Ended December 31, 2011	2010	2009
Noninterest Expenses			
Salaries and benefits	$ 13,484,318	$ 12,423,158	$ 12,213,820
Occupancy expenses	3,131,183	3,349,856	3,705,344
Other expenses	9,829,100	10,391,496	9,940,370
Total noninterest expenses	$ 26,444,601	$ 26,164,510	$ 25,859,534
Income before income taxes	$ 8,879,410	$ 6,978,833	$ 6,239,191
Income tax expense	1,898,702	1,532,669	1,404,264
Net income	$ 6,980,708	$ 5,446,164	$ 4,834,927
Earnings per common share, basic	$ 2.17	$ 1.70	$ 1.49
Earnings per common share, diluted	$ 2.16	$ 1.69	$ 1.48

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

	Years Ended December 31, 2011	2010	2009
Cash Flows from Operating Activities			
Net income	$ 6,980,708	$ 5,446,164	$ 4,834,927
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	1,537,627	1,925,445	2,016,233
Provision for loan losses	1,190,004	2,486,664	895,000
Provision for cash management account losses	120,000	249,996	963,000
Deferred income tax (benefit)	(45,602)	(1,121,848)	(629,555)
Amortization (accretion) of discounts, net	1,067,198	574,068	(691,128)
Net (gain) on securities available for sale	(735,630)	(1,007,466)	(510,715)
Net other-than-temporary impairment losses	1,281,537	1,325,643	915,898
Net loss on foreclosed assets	462,595	428,826	48,211
Stock-based compensation	110,000	144,000	108,000
Release of ESOP shares	142,200	135,900	152,300
Origination of loans available for sale	(37,701,855)	(53,175,795)	(64,555,205)
Proceeds from sale of loans available for sale	37,701,855	53,175,795	64,555,205
Issuance of common stock for services	83,134	79,151	100,725
Changes in other assets and liabilities:			
(Increase) in accrued interest receivable	(197,240)	(155,495)	(298,148)
(Increase) in other assets	(1,196,835)	(2,607,482)	(5,376,531)
(Decrease) in accrued interest payable	(43,597)	(107,621)	(216,021)
Increase (decrease) in other liabilities	261,150	550,616	(54,867)
Net cash provided by operating activities	$ 11,017,249	$ 8,346,561	$ 2,257,329
Cash Flows from Investing Activities			
Purchases of securities available for sale	$ (70,543,403)	$ (58,642,174)	$ (83,439,378)
Proceeds from sales and calls of securities available for sale	16,018,448	4,281,720	9,511,037
Proceeds from maturities of securities available for sale	34,931,036	35,870,162	26,868,119
Redemption of restricted stock	699,183	349,800	308,200
Proceeds from sale of foreclosed assets	1,005,116	1,692,400	161,789
Net decrease (increase) in loans	1,866,573	(1,231,052)	(4,000,099)
Net decrease in cash management accounts	2,624,926	5,753,448	6,137,762
Other capital expenditures	(1,337,876)	(289,609)	(2,627,459)
Net cash (used in) investing activities	$ (14,735,997)	$ (12,215,305)	$ (47,080,029)

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

	Years Ended December 31,		
	2011	**2010**	**2009**
Cash Flows from Financing Activities			
Net increase (decrease) in short-term borrowings	$ (5,500,000)	$ 975,000	$ (1,475,000)
Net increase in demand accounts, interest-bearing demand accounts, and savings accounts	16,696,091	30,340,136	77,919,719
Net increase (decrease) in certificates of deposits	9,140,028	793,324	(19,051,268)
Exercise of stock options	84,375	—	—
Repurchase of common stock	(202,254)	(289,848)	(951,167)
Shares acquired for leveraged ESOP	—	—	(968,800)
Cash dividends	(1,294,168)	(1,174,254)	(1,164,777)
Curtailment of long-term debt	(446,324)	(17,341,511)	(13,111,904)
Net cash provided by financing activities	$ 18,477,748	$ 13,302,847	$ 41,196,803
Net increase (decrease) in cash and cash equivalents	$ 14,759,000	$ 9,434,103	$ (3,625,897)
Cash and cash equivalents at beginning of year	22,662,577	13,228,474	16,854,371
Cash and cash equivalents at end of year	$ 37,421,577	$ 22,662,577	$ 13,228,474
Supplemental Disclosures of Cash Flow Information			
Cash paid during the year for:			
Interest	$ 7,005,711	$ 8,457,012	$ 11,831,455
Income taxes	$ 2,651,250	$ 2,673,038	$ 1,305,000
Supplemental Schedule of Noncash Investing and Financing Activities			
Unrealized gain on securities available for sale	$ 6,376,928	$ 2,275,503	$ 3,949,317
Other real estate acquired in settlement of loans	$ 3,649,900	$ 2,847,085	$ 1,415,000

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

Years Ended December 31, 2011, 2010 and 2009

	Common Stock, Voting	Additional Paid-In Capital	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income	Total
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 ($0.35 per share)	—	—	(1,164,777)	—	—		(1,164,777)
Balance, December 31, 2009	$ 13,694,320	$ 131,016	$ 24,715,497	$ (830,400)	$ (2,440,877)		$ 35,269,556
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	—	—	—	—	—	$ 6,947,995	—
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 ($0.36 per share)	—	—	(1,174,254)	—	—		(1,174,254)
Balance, December 31, 2010 (forwarded)	$ 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.

Years Ended December 31, 2011, 2010 and 2009

	Common Stock, Voting	Additional Paid-In Capital	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income	Total
Balance, December 31, 2010							
(brought forward)	$ 13,615,760	$ 140,379	$ 28,987,407	$ (692,000)	$ (939,046)		$ 41,112,500
Comprehensive income:							
Net income	—	—	6,980,708	—	—	$ 6,980,708	6,980,708
Other comprehensive income:							
Unrealized holding gains on securities available for sale, net of deferred income taxes of $1,982,547	—	—	—	—	—	3,848,474	—
Reclassification adjustment, net of income taxes of $185,608	—	—	—	—	—	360,299	—
Other comprehensive income, net of tax	—	—	—	—	4,208,773	4,208,773	4,208,773
Total comprehensive income	—	—	—	—	—	$ 11,189,481	—
Exercise of stock options	44,400	39,975	—	—	—		84,375
Release of ESOP shares	—	—	3,800	138,400	—		142,200
Issuance of common stock for services	36,020	—	47,114	—	—		83,134
Repurchase of common stock	(80,780)	(38,526)	(82,948)	—	—		(202,254)
Stock-based compensation	—	—	110,000	—	—		110,000
Effect of stock split	2,726,550	(141,828)	(2,584,722)	—	—		—
Cash dividends ($ 0.40 per share)	—	—	(1,294,168)	—	—		(1,294,168)
Balance, December 31, 2011	$ 16,341,950	$ —	$ 32,167,191	$ (553,600)	$ 3,269,727		$ 51,225,268

The accompanying notes are an integral part of these 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 29, 2012, the same date on which these consolidated financial statements were issued.

Stock Split

On March 14, 2011, the Board of Directors approved a 6-for-5 stock split of CFS's common stock. All per share information for all periods presented has been retroactively restated to reflect the stock split.

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.

Impairment of securities occurs when the fair value of a security is less than its amortized cost. For debt securities, impairment is considered other-than-temporary and recognized in its entirety in net income if either (a) the intent is to sell the security or (b) it is more likely than not that it will be necessary to sell the security prior to recovery of its amortized cost. If, however, management's intent is not to sell the security and it is not more than likely that management will be required to sell the security before recovery, management must determine what portion of the impairment is attributable to credit loss, which occurs when the amortized cost of the security exceeds the present value of the cash flows expected to be collected from the security. If there is no credit loss, there is no other-than-temporary impairment. If there is a credit loss, other-than-temporary impairment exists and the credit loss must be recognized in net income and the remaining portion of impairment must be recognized in other comprehensive income. For equity securities carried at cost as restricted stock, impairment is considered to be other-than-temporary based on CFS's ability and intent to hold the investment until a recovery of fair value. Other-than-temporary impairment of an equity security results in a write-down that must be included in income. Management regularly reviews each security for other-than-temporary impairment based on criteria that include the extent to which cost exceeds market price, the duration of that market decline, the financial health of and specific prospects for the issuer, the best estimate of the present value of cash flows expected to be collected from debt securities, the intention with regard to holding the security to maturity, and the likelihood that CFS would be required to sell the security before recovery.

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 are 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 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 the 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.

Troubled Debt Restructurings

In situations where, for economic or legal reasons related to a borrower's financial condition, management may grant a concession to the borrower that it would not otherwise consider, the related loan is classified as a troubled debt restructuring (TDR). Management strives to identify borrowers in financial difficulty early and work with them to modify their loan to more affordable terms before the loan reaches nonaccrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance, and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where borrowers are granted new terms that provide for a reduction of either interest or principal, management measures any impairment on the restructuring as noted above for impaired loans.

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 ten to 39 years for buildings and three to seven years for furniture, fixtures, and equipment.

Foreclosed Assets

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

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, the valuation of foreclosed assets, and the fair value of financial instruments.

Earnings Per Common Share

Basic earnings per common share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by CFS relate solely to outstanding stock options and are determined using the treasury stock method. All amounts have been retroactively restated to reflect stock splits.

Cash Management Accounts

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

Share-Based Compensation

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

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

Fair Value of Financial Instruments

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

Trust Company Assets

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

Reclassification

Certain amounts in the 2010 consolidated financial statements have been reclassified to conform to the 2011 presentation.

Recent Accounting Pronouncements

In January 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (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 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. 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, "Receivables (Topic 310) – 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 an entity's exposure to credit losses from lending arrangements. The extensive new disclosures of information as of the end of a reporting period became effective for 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 April 2011, the FASB issued ASU 2011-02, "Receivables (Topic 310) – A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring." The amendments in this ASU clarify the guidance on a creditor's evaluation of whether it has granted a concession to a debtor. They also clarify the guidance on a creditor's evaluation of whether a debtor is experiencing financial difficulty. The amendments in this ASU are effective for annual periods ending on or after December 15, 2012. Early adoption is permitted. A nonpublic entity that elects early adoption should apply the provisions of this ASU retrospectively to restructurings occurring on or after the beginning of the fiscal year of adoption. CFS has adopted ASU 2011-02 and included the required disclosures in its consolidated financial statements.

In April 2011, the FASB issued ASU 2011-03, "Transfers and Servicing (Topic 860) – Reconsideration of Effective Control for Repurchase Agreements." The amendments in this ASU remove from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee and (2) the collateral maintenance implementation guidance related to that criterion. The amendments in this ASU are effective for annual periods beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. CFS is currently assessing the impact that ASU 2011-03 will have on its consolidated financial statements.

In May 2011, the FASB issued ASU 2011-04, "Fair Value Measurement (Topic 820) – Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs." This ASU is the result of joint efforts by the FASB and International Accounting Standards Board (IASB) to develop a single, converged fair value framework on how (not when) to measure fair value and what disclosures to provide about fair value measurements. The ASU is largely consistent with existing fair value measurement principles in U.S. generally accepted accounting principles (GAAP) (Topic 820), with many of the amendments made to eliminate unnecessary wording differences between U.S. GAAP and International Financial Reporting Standards (IFRS). The amendments are effective for annual periods beginning after December 15, 2011 with prospective application. Nonpublic entities may apply the amendments in this ASU early, but no earlier than for interim periods beginning after December 15, 2011. CFS is currently assessing the impact that ASU 2011-04 will have on its consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, "Comprehensive Income (Topic 220) – Presentation of Comprehensive Income." The objective of this ASU is to improve the comparability, consistency, and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income by eliminating the option to present components of other comprehensive income as part of the statement of changes in shareholders' equity. The amendments require that all non-owner changes in shareholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The single statement of comprehensive income should include the components of net income, a total for net income, the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present all the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. The amendments do not change the items that must be reported in other comprehensive income, the option for an entity to present components of other comprehensive income either net of related tax effects or before related tax effects, or the calculation or reporting of earnings per share. The amendments in this ASU should be applied retrospectively. The amendments are effective for fiscal years beginning after December 15, 2012. Early adoption is permitted because compliance with the amendments is already permitted. The amendments do not require transition disclosures. CFS is currently assessing the impact that ASU 2011-05 will have on its consolidated financial statements.

In December 2011, the FASB issued ASU 2011-11, "Balance Sheet (Topic 210) – Disclosures about Offsetting Assets and Liabilities." This ASU requires entities to disclose both gross information and net information about both instruments and transactions eligible for offset in the balance sheet, and instruments and transactions subject to an agreement similar to a master netting arrangement. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. CFS is currently assessing the impact that ASU 2011-11 will have on its consolidated financial statements.

In December 2011, the FASB issued ASU 2011-12, "Comprehensive Income (Topic 220) – Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05." The amendments are being made to allow the Board time to redeliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. While the Board is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU 2011-05. All other requirements in ASU 2011-05 are not affected by ASU 2011-12, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. Nonpublic entities should begin applying these requirements for fiscal years ending after December 15, 2012, and interim and annual periods thereafter. CFS is currently assessing the impact that ASU 2011-12 will have on its consolidated financial statements.

Note 2. Securities

Amortized cost and fair values of securities available for sale as of December 31, 2011 and 2010, are as follows:

	2011			
	Amortized Cost	**Gross Unrealized Gains**	**Gross Unrealized (Losses)**	**Fair Value**
Securities of state and political subdivisions	$ 91,576,557	$ 6,908,578	$ (391,646)	$ 98,093,489
Mortgage-backed securities	90,631,989	2,815,969	(4,378,769)	89,069,189
Total	$182,208,546	$ 9,724,547	$ (4,770,415)	$187,162,678

	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

The amortized cost and fair value of securities available for sale as of December 31, 2011, 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	$ 20,793,486	$ 20,956,028
Due after one year through five years	60,709,196	63,710,898
Due after five years through ten years	91,217,506	92,920,492
Due after ten years	9,488,358	9,575,260
Total	$ 182,208,546	$ 187,162,678

Proceeds from sales and calls of securities available for sale during 2011, 2010, and 2009 were $16,018,448, $4,281,720, and $9,511,037, respectively. Gross realized gains amounted to $785,399, $1,033,978, and $576,471 in 2011, 2010, and 2009. Gross realized losses amounted to $49,769, $26,512, and $65,756 in 2011, 2010, and 2009. The tax provision applicable to these net realized gains amounted to $250,114, $342,538, and $173,643 in 2011, 2010, and 2009, 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 $96,863,156 and $72,474,164 at December 31, 2011 and 2010, respectively.

Temporarily Impaired Securities

Information pertaining to securities with gross unrealized losses at December 31, 2011 and 2010, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	2011			
	Less Than 12 Months		12 Months or More	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
Securities of state and political subdivisions	$ 4,094,569	$ (17,215)	$ 2,973,632	$ (374,431)
Mortgage-backed securities	27,201,961	(543,956)	10,324,286	(3,834,813)
	$ 31,296,530	$ (561,171)	$ 13,297,918	$ (4,209,244)

	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)

Securities of State and Political Subdivisions

CFS's unrealized losses on investments in ten municipal bonds relates to investments in longer-term securities of municipalities throughout the U.S. The unrealized losses are primarily caused by the trend in interest rates. CFS currently does not believe it is probable that it will be unable to collect all amounts due according to the contractual terms of the investments. Because CFS does not intend to sell the investment and it is not more likely than not that CFS will be required to sell the investment before recovery of its par value, which may be maturity, it does not consider these investments to be other-than-temporarily impaired at December 31, 2011.

Mortgage-Backed Securities

The unrealized losses on CFS's investment in 24 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, 2011.

The unrealized losses associated with 28 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 have appropriately recognized the related other-than-temporary impairment losses in private residential mortgage-backed securities. The remaining unrealized losses are deemed to be related to factors other than credit.

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 possible credit losses recognized in earnings. The beginning balance represents possible credit losses on debt securities at the beginning of the period for which a portion of an OTTI was recognized in other comprehensive income.

	Available for Sale
Beginning balance as of December 31, 2010	$ 2,241,541
Amount related to the credit loss for which an other-than-temporary impairment was not previously recognized	1,281,537
Realized losses	(833,185)
Ending balance as of December 31, 2011	$ 2,689,893

Note 3. Loans

A summary of the balances of loans by segment follows:

	December 31, 2011	December 31, 2010
Commercial–Non Real Estate	$ 83,418,402	$ 83,449,610
Commercial–Real Estate	160,487,116	160,060,380
Residential Real Estate	100,638,832	104,127,756
Consumer–Non Real Estate	11,714,520	15,007,072
	$ 356,258,870	$ 362,644,818
Less: Allowance for loan losses	6,460,625	6,140,096
Loans, net	$ 349,798,245	$ 356,504,722

Overdrafts totaling $82,189 and $125,531 at December 31, 2011 and 2010, respectively, were reclassified from deposits to loans.

An analysis of the allowance for loan losses follows:

	December 31, 2011	December 31, 2010	December 31, 2009
Balance at beginning of year	$ 6,140,096	$ 5,165,792	$ 4,715,574
Provision for loan losses	1,190,004	2,486,664	895,000
Loans charged off	(877,616)	(1,553,131)	(458,972)
Recoveries on loans previously charged off	8,141	40,771	14,190
Balance at end of year	$ 6,460,625	$ 6,140,096	$ 5,165,792

An analysis of the allowance for loan losses by segment follows:

	Commercial - Non Real Estate	Commercial - Real Estate	Consumer - Non Real Estate	Residential Real Estate	Unallocated	Total
Year Ended December 31, 2011						
Balance beginning of year	$ 1,433,501	$ 2,637,110	$ 242,775	$ 1,427,774	$ 398,936	$ 6,140,096
Provision for loan losses	(2,500)	815,496	113,324	390,965	(127,281)	1,190,004
Loans charged off	(8,112)	(729,459)	(54,218)	(85,827)	—	(877,616)
Recoveries on loans previously charged off	574	—	7,567	—	—	8,141
Total allowance for loan losses	$ 1,423,463	$ 2,723,147	$ 309,448	$ 1,732,912	$ 271,655	$ 6,460,625
Individually evaluated for impairment	$ 533,755	$ 350,534	$ 42,402	$ 25,238	$ —	$ 951,929
Collectively evaluated for impairment	889,708	2,372,613	267,046	1,707,674	271,655	5,508,696
Total allowance for loan losses	$ 1,423,463	$ 2,723,147	$ 309,448	$ 1,732,912	$ 271,655	$ 6,460,625
Individually evaluated for impairment	$ 3,315,492	$ 4,030,049	$ 59,309	$ 2,247,048	$ —	$ 9,651,898
Collectively evaluated for impairment	80,102,910	156,457,067	11,655,211	98,391,784	—	346,606,972
Total loans	$ 83,418,402	$ 160,487,116	$ 11,714,520	$ 100,638,832	$ —	$ 356,258,870

	Commercial - Non Real Estate	Commercial - Real Estate	Consumer - Non Real Estate	Residential Real Estate	Unallocated	Total
Year Ended December 31, 2010						
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

The following is a summary of information pertaining to impaired loans by class at December 31, 2011:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2011					
With no related allowance:					
Commercial–Non Real Estate					
Secured	$ 1,490,663	$ 1,490,663	$ —	$ 826,252	$ 40,628
Unsecured	72,907	72,907	—	59,929	1,666
Commercial–Real Estate					
Acquisition and development	—	—	—	—	—
Non-owner occupied	—	—	—	—	—
Owner occupied	499,387	499,387	—	417,077	5,435
Multifamily	—	—	—	—	—
Consumer–Non Real Estate					
Installment	14,199	14,199	—	18,482	850
Revolving	2,261	2,261	—	1,052	—
Other	—	—	—	—	—
Residential Real Estate					
First Lien 1-4 Family	1,149,405	1,149,405	—	841,604	14,424
Junior Lien 1-4 Family	25,241	25,241	—	25,329	876
Construction	—	—	—	—	—
Land	26,522	26,522	—	24,871	41
Revolving	1,020,642	1,020,642	—	991,762	1,929
With an allowance recorded:					
Commercial–Non Real Estate					
Secured	$ 1,719,861	$1,719,861	$501,695	$1,351,320	$48,340
Unsecured	32,061	32,061	32,060	24,055	64
Commercial–Real Estate					
Acquisition and development	367,385	367,385	58,790	276,738	49,517
Non-owner occupied	2,880,977	2,880,977	259,279	2,880,979	124
Owner occupied	282,300	282,300	32,465	219,695	3,607
Multifamily	—	—	—	—	—
Consumer–Non Real Estate					
Installment	33,590	33,590	33,143	25,825	197
Revolving	9,259	9,259	9,259	9,259	—
Other	—	—	—	—	—
Residential Real Estate					
First Lien 1-4 Family	—	—	—	—	—
Junior Lien 1-4 Family	—	—	—	—	—
Construction	—	—	—	—	—
Land	25,238	25,238	25,238	—	—
Revolving	—	—	—	—	—
Total:					
Commercial–Non Real Estate	$ 3,315,492	$ 3,315,492	$ 533,755	$ 2,261,556	$ 90,698
Commercial–Real Estate	4,030,049	4,030,049	350,534	3,794,489	58,683
Consumer–Non Real Estate	59,309	59,309	42,402	54,618	1,047
Residential Real Estate	2,247,048	2,247,048	25,238	1,908,437	17,270
	$ 9,651,898	$ 9,651,898	$ 951,929	$ 8,019,100	$ 167,698

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2010					
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

Included in impaired loans are troubled debt restructurings. At December 31, 2011 and 2010, $7,710,984 and $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.

Information regarding activity in troubled debt restructurings by class during 2011 follows:

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial–Non Real Estate			
Secured	6	$ 1,286,688	$ 1,286,688
Residential Real Estate			
Owner occupied	4	2,112,702	2,112,702
Residential Real Estate			
First Lien 1-4 Family	3	1,193,708	1,193,708
	13	$ 4,593,098	$ 4,593,098

No TDRs subsequently defaulted within the first year of modification during 2011.

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

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, 2011								
Commercial–Non Real Estate								
Commercial Secured	$ 51,829	$ 56,968	$ —	$ 108,797	$ 72,310,564	$ 72,419,361	$ —	$ 487,328
Commercial Unsecured	73,804	—	—	73,804	10,925,237	10,999,041	—	22,158
Commercial Real Estate								
Commercial A&D	—	—	—	—	22,753,530	22,753,530	—	—
Commercial Non-Owner Occupied	—	—	—	—	47,978,782	47,978,782	—	—
Commercial Owner Occupied	—	—	—	—	81,223,809	81,223,809	—	326,849
Multifamily Commercial	—	—	—	—	8,530,995	8,530,995	—	—
Consumer–Non Real Estate								
Consumer Installment	32,620	674,789	—	707,409	7,658,119	8,365,528	—	42,487
Consumer Revolving	9,260	1,590	—	10,850	2,526,583	2,537,433	—	—
Consumer Other	1,267	—	—	1,267	810,292	811,559	—	—
Residential-Real Estate								
First Lien 1-4 Family	399,252	—	—	399,252	34,016,519	34,415,771	—	1,019,880
Jr Lien 1-4 Family	25,244	145,949	—	171,193	7,965,808	8,137,001	—	36,890
Construction	—	—	—	—	5,833,449	5,833,449	—	18,282
Land	—	120,707	—	120,707	10,034,486	10,155,193	—	—
Revolving	131,837	304,512	—	436,349	41,661,069	42,097,418	—	468,834
Total	$ 725,113	$ 1,304,515	$ —	$ 2,029,628	$354,229,241	$356,258,870	$ —	$ 2,422,708

	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	$ —	$ 1,111,225	$ 71,161,157	$ 72,272,382	$ —	$ 1,670,624
Commercial Unsecured	295,860	43,338	—	339,198	10,838,030	11,177,228	—	—
Commercial Real Estate								
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	—	—	—	—	77,723,656	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	42,549	11,265,628	11,308,177	—	151,964
Consumer Revolving	206	1,151	100,956	102,313	3,588,032	3,690,345	—	—
Consumer Other	—	—	—	—	8,550	8,550	—	—
Residential-Real Estate								
First Lien 1-4 Family	1,305,596	173,812	—	1,479,408	37,664,033	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	6,659,473	—	—
Land	—	—	—	—	10,487,174	10,487,174	—	175,297
Revolving	—	70,775	—	70,775	43,383,168	43,453,943	—	124,617
Total	$ 2,271,164	$ 993,466	$ 102,226	$ 3,366,856	$359,277,962	$362,664,818	$ —	$ 4,450,480

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

	Pass	Watch	Special Mention	Substandard	Doubtful	Loss	Total
December 31, 2011							
Commercial–Non Real Estate							
Secured	$ 65,223,099	$ 2,700,202	$ 1,285,536	$ 2,934,504	$ 276,020	$ —	$ 72,419,361
Unsecured	8,713,058	74,207	2,106,808	104,968	—	—	10,999,041
Commercial–Real Estate							
Acquisition and development	17,363,396	2,872,749	2,150,000	367,385	—	—	22,753,530
Non-owner occupied	36,425,862	963,363	7,708,578	2,880,979	—	—	47,978,782
Owner occupied	77,059,524	2,693,733	688,869	781,683	—	—	81,223,809
Multifamily	8,530,995	—	—	—	—	—	8,530,995
Consumer–Non Real Estate							
Installment	8,247,754	52,722	8,004	26,900	30,148	—	8,365,528
Revolving	2,520,223	14,948	—	672	1,590	—	2,537,433
Other	811,559	—	—	—	—	—	811,559
Residential Real Estate							
First Lien 1-4 Family	31,237,278	1,340,819	688,269	1,137,375	12,030	—	34,415,771
Junior Lien 1-4 Family	7,665,687	69,632	376,438	—	25,244	—	8,137,001
Construction	5,138,363	695,086	—	—	—	—	5,833,449
Land	10,027,191	101,480	—	8,240	18,282	—	10,155,193
Revolving	39,780,139	1,165,376	106,025	988,932	56,946	—	42,097,418
Total	$ 318,744,128	$ 12,744,317	$ 15,118,527	$ 9,231,638	$ 420,260	$ —	$ 356,258,870
December 31, 2010							
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.

Note 4. Premises and Equipment

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

	December 31,	
	2011	2010
Land	$ 3,790,653	$ 3,790,653
Buildings	14,037,237	13,315,415
Furniture, fixtures, and improvements	1,875,596	1,984,024
Mechanical equipment	5,903,368	7,293,297
Leasehold improvements	4,066,797	4,069,906
	$ 29,673,651	$ 30,453,295
Less accumulated depreciation	13,272,846	13,852,739
	$ 16,400,805	$ 16,600,556

For the years ended December 31, 2011, 2010 and 2009, depreciation expense was $1,533,847, $1,686,839, and $1,747,837, respectively.

Note 5. Borrowings

CFS's fixed-rate long-term debt of $24,235,439 at December 31, 2011, matures through 2018. $383,367 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. $950,000 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, 2011, for this borrowing was $402,071. Aggregate maturities are: 2012, $126,358; 2013, $12,631,599; 2014, $137,121; 2015, $142,885; 2016, $148,883; and thereafter, $11,048,593.

CFS has unsecured lines of credit with correspondent banks totaling $41,000,000 available for overnight borrowing. No balances were outstanding on these lines at December 31, 2011.

Note 6. Income Taxes

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

	December 31, 2011	December 31, 2010
Deferred tax assets:		
Allowance for loan and cash management account losses	$ 2,554,869	$ 2,379,411
Securities available for sale	—	483,749
Other-than-temporary-impairment of securities	914,564	762,124
Other real estate	397,489	259,837
Deferred compensation	63,963	70,947
Premises and equipment	—	199,395
Other	37,729	61,016
	$ 3,968,614	$ 4,216,479
Deferred tax liabilities:		
Premises and equipment	$ 190,282	$ —
Securities available for sale	1,684,405	—
	$ 1,874,687	$ —
Net deferred tax assets	$ 2,093,927	$ 4,216,479

The provision for income taxes charged to operations for the years ended December 31, 2011, 2010, and 2009, consists of the following:

	2011	2010	2009
Current tax expense	$ 1,944,304	$ 2,654,517	$ 2,033,819
Deferred tax (benefit)	(45,602)	(1,121,848)	(629,555)
	$ 1,898,702	$ 1,532,669	$ 1,404,264

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, 2011, 2010, and 2009, due to the following:

	2011	2010	2009
Computed "expected" tax expense	$ 3,018,999	$ 2,372,803	$ 2,121,325
(Decrease) in income taxes resulting from:			
Tax exempt income	(1,202,533)	(826,663)	(677,203)
Other	82,236	(13,471)	(39,858)
	$ 1,898,702	$ 1,532,669	$ 1,404,264

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 2008.

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, 2011, 48,000 shares (as adjusted for the stock split) 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 2011). 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 $377,414, $357,115, and $377,470 for the years ended December 31, 2011, 2010, and 2009, respectively (including $142,200, $135,900, and $152,300 for the years ended December 31, 2011, 2010, and 2009 related to the release of ESOP shares).

401(k) Plan

CFS has adopted a contributory 401(k) plan that covers substantially all employees. Under the plan, employees may elect to defer up to 100% of their salary, subject to Internal Revenue Service limits. CFS will make a matching contribution of 100% of the first 3% and 50% of the second 3% of the employee's salary deferred. CFS may also make a discretionary contribution to the plan. Total expense related to the plan was $399,583, $398,482, and $559,724 for 2011, 2010, and 2009, respectively.

Note 8. Stock Option Plans

In 1996, CFS adopted an incentive stock option plan that reserved for issuance 302,400 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 374,400 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 $110,000, $144,000, and $108,000 for the years ended December 31, 2011, 2010, and 2009, respectively. No income tax benefit was recognized in the income statement for stock-based compensation arrangements for the years ended December 31, 2011, 2010 and 2009.

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

A summary of the option activity under the plans at December 31, 2011, 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	398,088	$ 11.69		
Granted	55,140	11.04		
Exercised	(10,080)	8.37		
Outstanding at end of year	443,148	11.69	5.2 years	$ 287,215
Options exercisable, end of year	286,488	11.69	3.5 years	$ 276,091

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, 2011. 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, 2011, 2010, and 2009 was $1.70, $1.98, and $1.96, respectively. The total intrinsic value of options exercised during the year ended December 31, 2011, was $41,700. No options were exercised during the years ended December 31, 2010 and 2009.

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

	Years Ended December 31,		
	2011	2010	2009
Dividend yield	2.30%	2.20%	2.09%
Expected term	6 years	6 years	6 years
Expected volatility	16.85%	17.37%	17.39%
Risk-free interest rate	2.81%	3.20%	2.48%

As of December 31, 2011, there was $122,292 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 2011, 2010, and 2009, CFS issued 7,204 shares, 6,587 shares, and 7,110 shares, respectively, of common stock to its directors for partial compensation. Share amounts have been adjusted for stock splits.

Note 10. Commitments and Contingencies

CFS leases certain facilities and equipment under operating leases which expire at various dates through 2016. 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, 2011, are as follows:

Year Ending December 31,	
2012	$105,792
2013	92,712
2014	93,230
2015	93,762
2016	94,306

Rent expense under operating leases aggregated $365,625, $358,243, and $353,782 for the years ended December 31, 2011, 2010, and 2009, 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, 2011 and 2010, the aggregate amounts of daily average required balances were approximately $713,000 and $1,462,000, respectively.

Note 11. Related Party Transactions

Officers, directors, and their affiliates had borrowings of $8,978,388 and $10,235,742 at December 31, 2011 and 2010, respectively, with the Bank.

Changes in borrowings during 2011 were as follows:

Balance, December 31, 2010	$ 10,235,742
Additions	63,966
Payments	(1,321,320)
Balance, December 31, 2011	$ 8,978,388

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:

	2011	2010	2009
Cash management fees and discount	$ 3,370,780	$ 3,603,281	$ 4,129,052
Merchant discount	4,307,456	4,004,493	3,462,331
ATM fee income	1,111,552	1,014,375	881,092
Asset management fees	898,418	812,147	730,981
Other (includes no items in excess of 1% of total revenue)	1,535,261	1,502,217	1,555,477
	$ 11,223,467	$ 10,936,513	$ 10,758,933

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

	2011	2010	2009
Advertising	$ 633,966	$ 677,460	$ 694,943
Merchant card	2,644,036	2,971,729	2,547,131
Software	887,455	916,368	810,037
Provision for cash management account losses	120,000	249,996	963,000
Legal fees	232,669	392,906	240,419
FDIC assessments	588,008	970,695	845,770
Delivery and transportation	235,187	235,933	337,406
Stationery and supplies	381,388	380,351	407,916
Other (includes no items in excess of 1% of total revenue)	4,106,391	3,596,058	3,093,748
	$ 9,829,100	$ 10,391,496	$ 9,940,370

Note 13. Earnings Per Common Share

The following data shows the amounts used in computing earnings per common 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.

	2011	2010	2009
Weighted average number of common shares, basic	3,210,161	3,208,537	3,251,317
Effect of dilutive stock options	25,402	15,936	20,513
Weighted average number of common shares and dilutive potential common stock used in diluted EPS	3,235,563	3,224,473	3,271,830

Options on approximately 259,649 average shares, 263,718 average shares, and 155,646 average shares were not included in the computation of diluted earnings per share for the years ended December 31, 2011, 2010, and 2009 because the exercise price of those options exceeded the average market price of the common shares.

Note 14. Time Deposits

Remaining maturities on certificates of deposit are as follows:

2012	$ 152,522,843
2013	25,947,114
2014	10,821,690
2015	7,757,093
2016	7,772,102
Thereafter	25,113,000
	$ 229,933,842

The Bank obtains certain deposits through the efforts of third-party brokers. At December 31, 2011 and 2010, brokered deposits totaled $30,063,000 and $10,000,000, respectively, and were included in certificates of deposit on the consolidated balance sheets.

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, 2011 and 2010, the following financial instruments were outstanding whose contract amounts represent credit risk:

	Contract Amount	
	2011	**2010**
	(in thousands)	
Commitments to grant loans	$ 8,780	$ 7,664
Unfunded commitments under lines of credit	95,339	95,686
Commercial and standby letters of credit	1,308	1,169

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 $3,300,000 at December 31, 2011.

Note 16. Fair Value of Assets and Liabilities

Determination of Fair Value

CFS uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. The fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are not quoted market prices for CFS's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

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

Fair Value Hierarchy

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

Level 1 - Valuation is based on quoted prices in active markets for identical assets and liabilities and generally includes 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.

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 in to account the remaining terms of the agreements and the counterparties' credit standing.

Assets Measured at Fair Value on a Recurring Basis

The following table presents the balances of financial assets measured at fair value on a recurring basis as of December 31, 2011 and 2010:

		Fair Value Measurements at December 31, 2011, Using		
Description	**Carrying Value**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
		(in thousands)		
Assets:				
Securities of state and political subdivisions	$ 98,093	$ —	$ 98,093	$ —
Mortgage-backed securities	89,069	—	61,922	27,147

		Fair Value Measurements at December 31, 2010, Using		
Description	**Carrying Value**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
		(in thousands)		
Assets:				
Securities of state and political subdivisions	$ 76,175	$ —	$ 76,175	$ —
Mortgage-backed securities	86,630	—	51,805	34,825

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, 2011:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)					
		Total Realized/Unrealized Gains (Losses) Included in				
	Balance as of January 1, 2011	Net Income	Other Comprehensive Income	Purchases, Sales, Issuances, and Settlements, Net	Transfers in and/or out of Level 3	Balance as of December 31, 2011
			(in thousands)			
Mortgage-backed securities	$ 34,825	$ (1,282)	$ (894)	$ (5,502)	$ —	$ 27,147

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, 2011 and 2010, for which a nonrecurring change in fair value has been recorded:

	Fair Value Measurements at December 31, 2011, 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	$ —	$ —	$ 4,399
Foreclosed assets	—	1,067	4,264

	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	$ —	$ —	$ 3,115
Foreclosed assets	—	—	3,149

Impaired Loans

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on expected cash flows, the observable market price of the loan or the fair value of the collateral. Fair value is typically measured based on the value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The majority of the collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Bank using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business's financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans with specific reserves allocated to the allowance for loan losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the consolidated statements of income.

Foreclosed Assets

Loans are transferred to foreclosed assets when the collateral securing them is foreclosed on. The measurement of loss associated with foreclosed assets is based on the fair value of the collateral compared to the unpaid loan balance and anticipated costs to sell the property. If there is a contract for the sale of a property, and management reasonably believes the contract will be executed, fair value is based on the sale price in that contract (Level 1). Lacking such a contract, the value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Bank using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of foreclosed assets is over two years old, then the fair value is considered Level 3. Any fair value adjustments are recorded in the period incurred and expensed against current earnings.

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

	2011		2010	
	Carrying Amount	**Fair Value**	**Carrying Amount**	**Fair Value**
	(In Thousands)		*(In Thousands)*	
Financial assets:				
Cash and short-term investments	$ 37,422	$ 37,422	$ 22,663	$ 22,663
Securities	187,163	187,163	162,805	162,805
Restricted stock	2,933	2,933	3,632	3,632
Loans	349,798	349,584	365,505	358,102
Cash management accounts	15,771	15,771	18,515	18,515
Accrued interest receivable	2,939	2,939	2,742	2,742
Financial liabilities:				
Deposits	$ 543,579	$ 547,600	$ 517,743	$ 504,070
Short-term borrowings	—	—	5,500	5,500
Long-term debt	39,700	41,018	40,147	40,686
Accrued interest payable	432	432	475	475

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

Note 17. Minimum Regulatory Capital Requirements

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

Quantitative measures established by regulation to ensure capital adequacy require financial institutions to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets, and of Tier 1 capital to average assets. Management believes, as of December 31, 2011 and 2010, that CFS meets all capital adequacy requirements to which it is subject.

As of December 31, 2011, 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, 2011:						
Total Capital (to Risk-Weighted Assets):						
Consolidated	$ 69,430	13.4%	$ 41,358	8.0%	N/A	
Chesapeake Bank	$ 66,592	13.0%	$ 41,002	8.0%	$ 51,253	10.0%
Tier 1 Capital (to Risk-Weighted Assets):						
Consolidated	$ 62,955	12.2%	$ 20,679	4.0%	N/A	
Chesapeake Bank	$ 60,172	11.7%	$ 20,501	4.0%	$ 30,752	6.0%
Tier 1 Capital (to Average Assets):						
Consolidated	$ 62,955	9.9%	$ 25,388	4.0%	N/A	
Chesapeake Bank	$ 60,172	9.6%	$ 25,102	4.0%	$ 31,378	5.0%
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%

Note 18. Trust Preferred Capital Notes

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, 2011, was 5.13%. The interest rate as of December 31, 2011, was 5.15%. 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, 2011, the amount available for payment of additional dividends without prior regulatory approval from the Bank to the parent company is $13,977,368 or 27.3% of consolidated net assets.

Balance Sheets (Condensed)

	December 31, 2011	December 31, 2010
Assets		
Cash	$ 532,168	$ 642,804
Investment in subsidiaries	65,179,804	55,374,278
Premises and equipment, net	2,400,602	2,558,646
Other assets	1,061,234	1,113,464
Total assets	$ 69,173,808	$ 59,689,192
Liabilities and Shareholders' Equity		
Borrowings	$ 1,886,967	$ 2,402,022
Trust preferred capital notes	15,465,000	15,465,000
Other liabilities	596,573	709,670
Shareholders' equity	51,225,268	41,112,500
Total liabilities and shareholders' equity	$ 69,173,808	$ 59,689,192

Statements of Income (Condensed)

	2011	2010	2009
Income–Dividends from subsidiaries	$ 2,369,879	$ 2,309,954	$ 1,326,230
Other	299,181	840,636	111,998
Total income	$ 2,669,059	$ 3,150,590	$ 1,438,228
Expenses–Interest expense	$ 919,650	$ 921,923	$ 918,271
Other expenses	774,215	752,375	687,347
Total expenses	$ 1,693,865	$ 1,674,298	$ 1,605,618
Income (loss) before income taxes and equity in undistributed earnings of subsidiaries	$ 975,195	$ 1,476,292	$ (167,390)
Allocated income tax benefit	408,743	212,629	378,962
Income before equity in undistributed earnings of subsidiaries	$ 1,383,938	$ 1,688,921	$ 211,572
Equity in undistributed earnings of subsidiaries	5,596,770	3,757,243	4,623,355
Net income	$ 6,980,708	$ 5,446,164	$ 4,834,927

Statements of Cash Flows (Condensed)

	2011	2010	2009
Cash Flows from Operating Activities			
Net income	$ 6,980,708	$ 5,446,164	$ 4,834,927
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	207,157	230,295	173,317
Equity in undistributed earnings of subsidiaries	(5,596,770)	(3,757,243)	(4,623,355)
Issuance of common stock for services	83,134	79,151	100,725
Stock-based compensation	110,000	144,000	108,000
Release of ESOP shares	142,200	135,900	152,300
Changes in other assets and liabilities:			
(Increase) decrease in other assets	52,247	(42,981)	357,706
Increase (decrease) in other liabilities	(113,097)	50,052	(52,250)
Net cash provided by operating activities	$ 1,865,579	$ 2,285,338	$ 1,051,370
Cash Flows from Investing Activities			
Purchases of premises and equipment	$ (49,113)	$ (9,856)	$(1,901,787)
Investment in subsidiaries	—	—	(350,000)
Net cash (used in) investing activities	$ (49,113)	$ (9,856)	$(2,251,787)
Cash Flows from Financing Activities			
Dividends paid	$ (1,294,168)	$ (1,174,254)	$(1,164,777)
Curtailment of borrowings	(515,055)	(437,297)	(259,686)
Proceeds from borrowings	—	—	2,568,800
Repurchase of common stock	(202,254)	(289,848)	(951,167)
Shares acquired for leveraged ESOP	—	—	(968,800)
Exercise of stock options	84,375	—	—
Net cash (used in) financing activities	$ (1,927,102)	$ (1,901,399)	$ (775,630)
Net increase (decrease) in cash	$ (110,636)	$ 374,083	$(1,976,047)
Cash at beginning of year	642,804	268,721	2,244,768
Cash at end of year	$ 532,168	$ 642,804	$ 268,721

Yount Hyde & Barbour
Certified Public Accountants
and Consultants

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

We have audited the accompanying consolidated balance sheets of Chesapeake Financial Shares, Inc. and Subsidiaries as of December 31, 2011 and 2010, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for the years ended December 31, 2011, 2010, and 2009. 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, 2011 and 2010, and the results of their operations and their cash flows for the years ended December 31, 2011, 2010, and 2009 in conformity with accounting principles generally accepted in the United States of America.

Yount, Hyde & Barbour, P.C.

Winchester, Virginia
February 29, 2012

Financial Overview: Chesapeake Financial Shares, Inc. (CFS) posted another record year for earnings in 2011. The return on average equity in 2011 was 15.3% and return on average assets was 1.13% compared to 13.6% and 0.90%, respectively, in 2010. At the end of 2011, CFS had total assets of $638 million, representing a 5% increase over the December 31, 2010, balance of $607.7 million. The Company ended the year with total gross loans of $356.3 million, and total deposits of $543.6 million, down 1.8% and up 5%, respectively.

The current economic environment continued to cause declining loan demand coupled with solid deposit generation. Loan volume was down $6.4 million for 2011 which brought the average annual loan growth rate for the last five years to 3.4%. 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 1.81%. The deposit growth of 5% for 2011 brought the average annual deposit growth rate for the last five years to 9.1%. The Holding Company and the Bank continued to maintain their "well capitalized" status, the highest ranking available from the Federal Deposit Insurance Corporation (FDIC).

Summary of Results of Operations: Earnings for 2011 were $6,980,708 or $2.16 per share (fully diluted) compared to $5,446,164 or $1.69 per share in 2010, an increase of $1,534,544. The 28.2% increase in net income resulted from a 12% increase or $2,324,865 in net interest income after provision for loan losses. There was a 1% decrease or $144,197 in noninterest income and noninterest expense increased by only 1% or $280,091 in 2011 over 2010. The provision for Other-Than-Temporary-Impairment (OTTI) increased by $448,352, or 20%, net of realized losses. Merchant Services income increased by $302,963 or 7.6% in 2011 while Cash Management fees were down $232,501 or 6.5% for the year.

Earnings for 2010 were $5,446,164 or $1.69 per share (fully diluted) compared to $4,834,927 or $1.48 per share in 2009, an increase of $611,237. The 12.6% increase in net income resulted from a 15.1% increase or $2,860,835 in net interest income. Noninterest expense increased by 1.2% or $304,976 in 2010 over 2009.

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 $356.3, $362.6, and $365.8 million for 2011, 2010, and 2009, respectively, representing a decrease of 1.8% for 2011 from 2010, a decrease of 0.9% for 2010 from 2009 and an increase of 0.6% for 2009 over 2008. The commercial portfolio including real estate and non-real estate combined was up 0.2% or $395,528 and the consumer and residential real estate portfolios were down a combined 5.7% or $6.8 million from 2010.

On December 31, 2011, the loan portfolio consisted of 68.5% commercial loans, 28.2% single-family residential and residential construction loans, and 3.3% 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 $15,539,881 at December 31, 2011, which represented a decrease from $15,591,528 at December 31, 2010. Past due loans over 30 days were 1.3% of total loans at December 31, 2011. 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 as troubled debt restructurings based on the identification of some weakness. The total included in the 2011 year end number is $7,710,984. 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 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 $3,269,727 more than book value, net of the tax effect, at December 31, 2011, and was less than book value by $939,046, net of the tax effect, at December 31, 2010. 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 $187.2 million, up $24.4 million from the $162.8 million on December 31, 2010. Investments in securities of state and political subdivisions increased by $22.0 million or 28.8%. Investments in mortgage-backed securities increased by $2.4 million or 2.8%.

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 nonaccrual and past due loans varies from quarter to quarter based on seasonality, local economic conditions, and the cash flow of customers.

The allowance for loan losses was $6,460,625 or 1.81% of gross loans less unearned discounts at year-end. This ratio was 1.69% on December 31, 2010, and 1.41% in 2009. The table below represents the provision for loan losses taken in years 2009 through 2011 as well as loans charged off and subsequent recoveries.

	2011	2010	2009
Provision for Loan Losses	1,190,004	2,486,664	895,000
Loans Charged Off	877,616	1,553,131	458,972
Recoveries	8,141	40,771	14,190

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, 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 $543.6, $517.7, and $486.6 million for 2011, 2010, and 2009, respectively, and represented an increase of 5% for 2011 over 2010, and an increase of 6.4% for 2010 over 2009. The below table represents a breakdown of total deposits.

	2011	2010	Change	Percent Change
Demand Deposits (non-interest bearing)	$ 77,600,120	$ 67,817,627	$ 9,782,493	14.4%
Savings & Interest Bearing Deposits	236,045,159	229,131,561	6,913,598	3.0%
Certificates of Deposit	229,933,842	220,793,814	9,140,028	4.1%
Total Deposits	$ 543,579,121	$ 517,743,002	$ 25,836,119	5.0%

The Company has been able to attract and retain deposits through its Clear Sky internet banking branch. Clear Sky offers internet-based retail checking, savings, and certificates of deposit accounts. Through the use of Clear Sky, the Company has been able to attract deposits from all 50 states. At December 31, 2011, Clear Sky deposits totaled $51.7 million.

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

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

Net interest income totaled $22.8, $21.8, and $18.9 million for 2011, 2010, and 2009, respectively, representing an increase of 4.7% for 2011 over 2010, 15.1% for 2010 over 2009, and 15.0% for 2009 over 2008. Loan demand was mild this year with total gross loans down 1.8% or $6.4 million for 2011 from 2010. Total interest expense was $7.0, $8.3, and $11.6 million for 2011, 2010, and 2009, respectively. On a tax equivalent annualized basis, the net interest margin was 4.7%, 4.4% and 4.1% for 2011, 2010, and 2009, 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 net interest income was due in large part to a continued low rate environment as it relates to deposit costs and funding alternatives.

Noninterest Income: For the year ended December 31, 2011, noninterest income was $15 million excluding a charge of $1,281,537 for OTTI investments. This represents a slight decrease in noninterest income of $188,303 for the year. Changes in noninterest income categories are highlighted below.

	2011	2010	Change	Percent Change
Merchant Discount Income	$ 4,307,456	$ 4,004,493	$ 302,963	7.6%
ATM Fee Income	1,111,552	1,014,375	97,177	9.6%
Asset Management Fees	898,418	812,147	86,271	10.6%
Other Income	1,535,261	1,502,217	33,044	2.2%
Gains on Sale of Securities	735,630	1,007,466	(271,836)	-27.0%
Cash Management Fees	3,370,780	3,603,281	(232,501)	-6.5%
Service Charge Income	1,438,293	1,566,268	(127,975)	-8.2%
Fiduciary Income	2,043,994	2,085,671	(41,677)	-2.0%
Net Losses on Foreclosed Assets	(462,595)	(428,826)	(33,769)	-7.9%

While noninterest income was down slightly in 2011, it still represented 32% of the total gross revenue for the Company. Sources of noninterest income include the Company's merchant processing services (Chesapeake Payment Systems), accounts receivable financing (Cash Flow), wealth management and trust services (Chesapeake Investment Group), and mortgage origination sold to a secondary market. Through its mortgage origination, the Company retains servicing rights to its $177.5 million Federal Home Loan Mortgage Corporation loan portfolio.

Noninterest Expenses: Total noninterest expenses increased 1.1% or $280,091 in 2011 over 2010. In 2010, total noninterest expenses increased 1.2% over 2009. Occupancy expenses decreased $218,673 or 6.5% while salary and benefit costs increased by $1,061,160 or 8.5%. The decrease in 2011 other expenses of $$562,396 or 5.4% is explained in the table below.

	2011	2010	Change	Percent Change
FDIC Insurance Premiums	$ 588,008	$ 970,695	$ (382,687)	-39.4%
Merchant Card Expenses	2,644,036	2,971,729	(327,693)	-11.0%
Legal Fees	232,669	392,906	(160,237)	-40.8%
Provision for Cash Management Losses	120,000	249,996	(129,996)	-52.0%

The decreases in expenses above were offset by an increase in all other expenses of $438,217 or 4.6%.

Liquidity, Interest Rate Sensitivity, and Inflation: The objectives of CFS's liquidity management policy include 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, 2011, approximately 39.6% of total assets matured or were repricing within one year as compared to 41.2% on December 31, 2010. The Bank's loan portfolio was liquid with 54.1% of all loan dollars maturing or repricing within one year. The loan liquidity ratio was 53.2% on December 31, 2010.

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 $94.9 million, secured and unsecured. The Bank and CFS have access to additional secured borrowing for $4.05 million.

As of December 31, 2011, the Bank held $75,000 in repossessed assets and $5,331,189 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").

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, 2011, the Company had ratios of Tier 1 risk-based capital to risk-weighted assets of 12.2%, total risk-based capital to risk-weighted assets of 13.4%, and Tier 1 leverage capital of 9.9%. At December 31, 2010, these ratios were 12.1%, 13.5% and 9.2%, respectively. At December 31, 2009, these ratios for the bank were 10.1%, 11.7%, and 8.7%, respectively, well above the regulatory minimums and exceeded the requirements for FDIC's "well capitalized" designation.

Dividend and Market Information: The Company's stock trades on the "OTC" (Over the Counter) market under the symbol "CPKF." The Company has increased its dividend payment annually for the past twenty years. The Company raised its dividend to $0.396 per share in 2011, an increase of $0.038 over 2010. This increase followed a $0.008 per share dividend increase from $0.35 in 2009 to $0.358 in 2010. 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 2011 ranged from $10.80 to $14.15, and during 2010, from $10.42 to $12.08. Such transactions may not be representative of all transactions during the indicated periods, of the fair value of the stock at the time of such transactions, due to the infrequency of trades and the limited market for the stock. Management attributes the Company's ability to maintain stable share prices, during hard economic times, to its record earnings over the past several years. At December 31, 2011, there were 3,268,390 shares of Company's common stock outstanding held by approximately 218 holders of record.

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