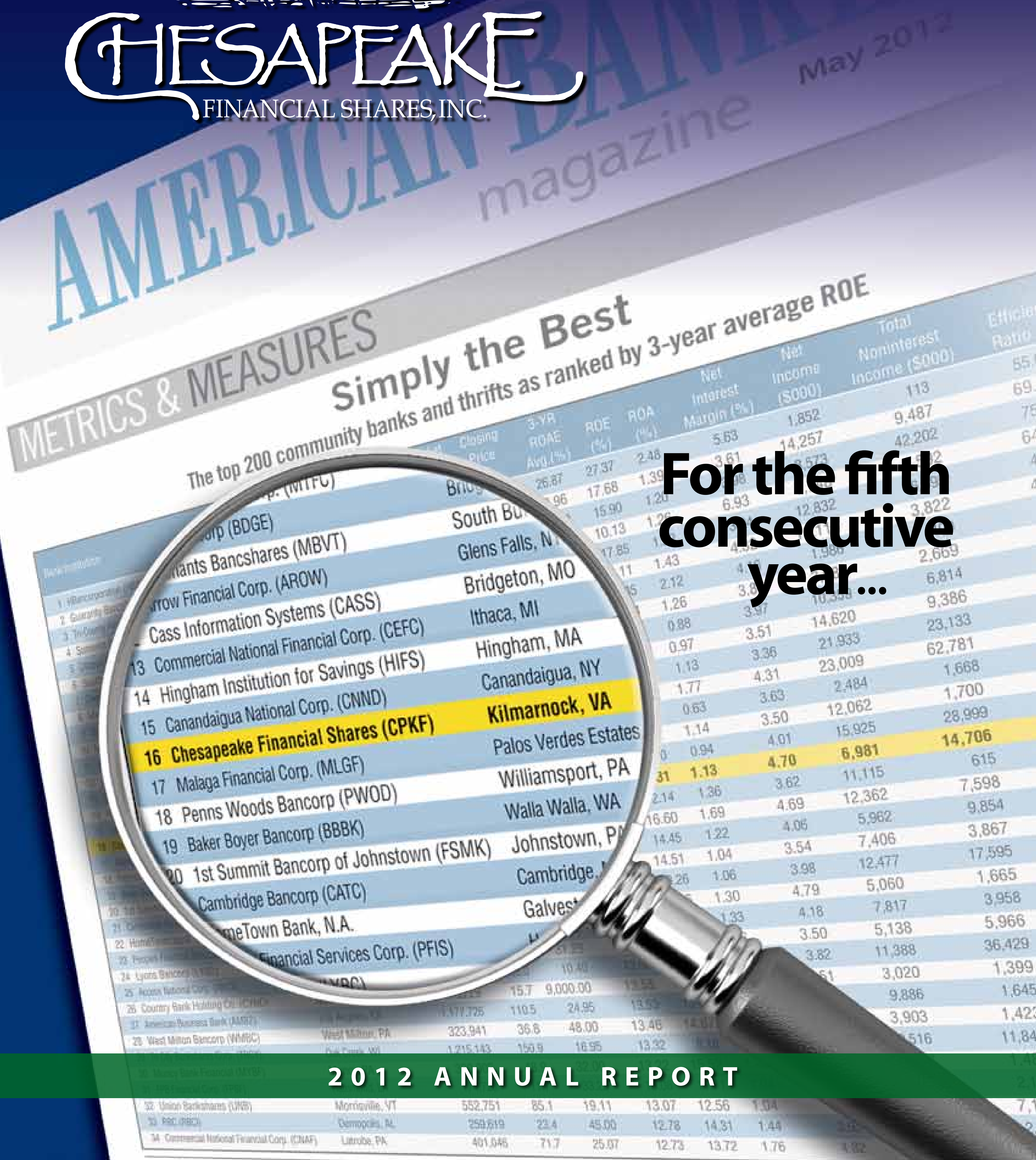
CHESAPEAKE
FINANCIAL SHARES, INC.



For the fifth consecutive year...

2012 ANNUAL REPORT

CHESAPEAKE FINANCIAL SHARES, INC.

CONTENTS

ON THE COVER: For the fifth consecutive year, Chesapeake Financial Shares has made the *American Banker* magazine (formerly *US Banker* magazine) listing of the "Top 200 Community Banks" in the United States. The company ranked at #16 in the nation and #1 in Virginia out of approximately 6,000 community banks in the study. Chesapeake Financial Shares has shown continued improvement from 2008, when Chesapeake broke into the rankings at #148, to the current ranking at #16. The ranking is based on a three-year average of return on average equity (ROAE). The company had a three-year ROAE of 13.40%.

Wow! Five years in a row! I hope you notice the cover of our report reflecting the fact that for the fifth year in a row we've been designated one of the "Top 200 Community Banks" in the country. Our success continues to be based on being great partners with the communities we serve as well as excellent providers of other nonbanking services across the country. Many of the services and delivery channels are changing, and we continue to strive to provide the best of these in a customer-centric manner.

We're currently in the third year of economic recovery, but it hardly feels like it. Continued high unemployment, a stabilized but not really recovering housing market, and an increasing national debt make the current economic environment very uncertain to all financial institutions. With the Federal Reserve currently knee-deep, if not waist-deep, in monetary policy, the prolonged low interest rate environment has a profound effect on bank balance sheets. The banking industry is currently in a position not dissimilar to a retiree – where do we put our excess liquidity? On a positive note, however, the overall health of the banking industry continues to slowly improve.

2012 was marked with goodbyes to many of those who've profoundly changed our world: Andy Griffith, Neil Armstrong, Stephen Covey, Dick Clark, Andy Williams, Earl Scruggs, Letitia Baldrige, and General Norman Schwarzkopf. 2012 once again demonstrated a #1 place showing for the United States in the London Olympics – go USA!

2012 was a record year in earnings for Chesapeake Financial Shares. Our net income for the year was $7,675,951, representing a 10% increase over our 2011 record year. With the return on average equity of 14.87%, we continue to be one of the highest performers in the country. We have maintained good asset quality throughout the last several years and have paid a lot of corporate attention to this.

Though we appreciate where we've been, we continue to put most of our energies into looking forward. The current difficult economic and regulatory environments mandate that of us. Our efforts did yield a total return on our stock in 2012 of over 48%. Our continued efforts toward training and being the employer of choice in each of our communities continue to translate into great customer service and great returns for you as our shareholder.

Thank you for your continued loyalty and 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 5, 2013 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

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

SELECTED FINANCIAL INFORMATION

	2012	2011	2010	2009	2008
	(Dollars in thousands except ratios and per share amounts)				
Results of Operations					
Interest income	$ 28,866	$ 29,779	$ 30,138	$ 30,543	$ 29,708
Interest expense	5,811	6,962	8,349	11,615	13,245
Net interest income	23,055	22,817	21,789	18,928	16,463
Provision for loan losses	600	1,190	2,487	895	400
Net interest income after provision for loan losses	22,455	21,627	19,302	18,033	16,063
Noninterest income	15,417	13,697	13,841	14,066	15,017
Noninterest expenses	28,172	26,445	26,164	25,860	24,958
Income before tax	9,700	8,879	6,979	6,239	6,122
Income tax expense	2,024	1,898	1,533	1,404	1,521
Net income	$ 7,676	$ 6,981	$ 5,446	$ 4,835	$ 4,601
Financial Condition					
Total assets	$ 667,718	$ 637,953	$ 607,733	$ 586,680	$ 537,952
Total deposits	564,234	543,579	517,743	486,610	427,741
Net loans	366,878	349,798	356,505	360,607	358,917
Long-term debt	23,709	24,235	24,682	42,023	55,135
Trust preferred capital notes	15,465	15,465	15,465	15,465	15,465
Shareholders' equity	60,909	51,225	41,113	35,270	30,552
Average assets	643,079	619,905	602,473	573,048	516,018
Average shareholders' equity	51,612	45,602	40,179	36,788	34,062
Key Financial Ratios					
Return on average assets	1.19%	1.13%	0.90%	0.84%	0.89%
Return on average equity*	14.87%	15.3%	13.6%	13.14%	13.51%
Dividends paid as a percent of net income	19.33%	18.5%	21.6%	24.1%	24.9%
Per Share Data**					
Net income, assuming dilution	$ 2.32	$ 2.160	$ 1.692	$ 1.475	$ 1.333
Cash dividends declared	$ 0.45	$ 0.396	$ 0.358	$ 0.350	$ 0.338
Book value	$ 18.80	$ 15.67	$ 12.58	$ 10.73	$ 9.11

**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, 2012	December 31, 2011
Assets		
Cash and due from banks	$ 13,273,355	$ 10,866,615
Interest-bearing deposits in banks	40,867,944	26,554,962
Securities available for sale, at approximate fair value	179,688,335	187,162,678
Restricted stock, at cost	2,591,000	2,932,800
Loans held for sale	1,821,800	511,400
Loans, net of allowance for loan losses of $6,351,789 in 2012 and $6,460,625 in 2011	366,877,868	349,286,845
Premises and equipment, net	15,987,903	16,400,805
Accrued interest receivable	2,849,441	2,939,302
Cash management accounts, net of allowance of $1,136,152 in 2012 and $1,053,695 in 2011	21,374,245	15,770,531
Foreclosed assets, net of allowance of $1,027,196 in 2012 and $611,396 in 2011	4,391,389	5,331,189
Bank-owned life insurance	10,136,957	9,404,807
Other assets	7,857,525	10,791,276
Total assets	$ 667,717,762	$ 637,953,210
Liabilities and Shareholders' Equity		
Deposits:		
Demand accounts	$ 104,164,119	$ 77,600,120
Savings and interest bearing demand deposits	247,598,107	236,045,159
Certificates of deposit		
Denominations less than $100,000	116,051,098	134,046,812
Denominations of $100,000 or more	96,420,631	95,887,030
Total deposits	$ 564,233,955	$ 543,579,121
Trust preferred capital notes	15,465,000	15,465,000
Long-term debt	23,709,080	24,235,439
Accrued interest payable	213,828	431,678
Accrued expenses and other liabilities	3,186,956	3,016,704
Commitments and contingencies	—	—
Total liabilities	$ 606,808,819	$ 586,727,942
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 3,239,370 in 2012 and 3,268,390 in 2011	16,196,850	16,341,950
Common stock, nonvoting, par value $5 per share; authorized 635,000 shares; no shares outstanding	—	—
Additional paid-in capital	—	—
Retained earnings	37,600,101	32,167,191
Unearned ESOP shares	(415,200)	(553,600)
Accumulated other comprehensive income	7,527,192	3,269,727
Total shareholders' equity	$ 60,908,943	$ 51,225,268
Total liabilities and shareholders' equity	$ 667,717,762	$ 637,953,210

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

CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31, 2012	2011
Interest and Dividend Income		
Interest and fees on loans	$21,647,373	$22,002,099
Interest on interest-bearing deposits and federal funds sold	27,671	28,754
Interest and dividends on securities available for sale:		
Taxable	3,657,816	4,753,795
Nontaxable	3,479,428	2,955,450
Dividends	53,822	38,779
Total interest and dividend income	$28,866,110	$29,778,877
Interest Expense		
Savings and interest bearing accounts	$ 892,112	$ 1,258,348
Certificates of deposit		
Denominations less than $100,000	2,035,022	2,409,022
Denominations $100,000 or more	1,459,939	1,677,793
Short-term borrowings and FHLB advances	690,121	731,507
Long-term debt and trust preferred capital notes	733,620	885,444
Total interest expense	$ 5,810,814	$ 6,962,114
Net interest income	$23,055,296	$22,816,763
Provision for loan losses	600,000	1,190,004
Net interest income after provision for loan losses	$22,455,296	$21,626,759
Noninterest Income		
Trust income	$ 2,040,532	$ 2,043,994
Service charges	1,316,544	1,438,293
Net gain on sales of securities available for sale	1,521	735,630
Net other-than-temporary impairment losses on investments recognized in earnings (includes total other-than-temporary impairment losses of $1,591,851 and $1,371,131, net of $739,726 and $89,594 recognized in other comprehensive income before taxes)	(852,125)	(1,281,537)
Other income	12,910,922	11,223,467
Total noninterest income	$15,417,394	$14,159,847
Noninterest Expenses		
Salaries and benefits	$ 14,347,859	$ 13,484,318
Occupancy expenses	3,198,103	3,189,875
Net loss on other real estate owned	421,961	462,595
Other expenses	10,204,601	9,770,408
Total noninterest expenses	$ 28,172,524	$ 26,907,196
Income before income taxes	$ 9,700,166	$ 8,879,410
Income tax expense	2,024,215	1,898,702
Net income	$ 7,675,951	$ 6,980,708
Earnings per common share, basic	$ 2.37	$ 2.17
Earnings per common share, diluted	$ 2.32	$ 2.16

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

	Years Ended December 31, 2012	2011
Net income	$ 7,675,951	$ 6,980,708
Other comprehensive income:		
Unrealized holding gains on securities available for sale (net of tax of $1,904,034 and $1,982,547)	$ 3,696,066	$ 3,848,474
Reclassification adjustment (net of income taxes of $289,205 and $185,609)	561,399	360,299
Other comprehensive income, net of tax	$ 4,257,465	$ 4,208,773
Comprehensive income	$ 11,933,416	$ 11,189,481

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31, 2012	2011
Cash Flows from Operating Activities		
Net income	$ 7,675,951	$ 6,980,708
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,760,876	1,537,627
Provision for loan losses	600,000	1,190,004
Provision for cash management account losses	230,000	120,000
Deferred income tax (benefit)	(47,238)	(45,602)
Amortization (accretion) of premiums (discounts), net	1,555,255	1,067,198
Net (gain) on securities available for sale	(1,521)	(735,630)
Net other-than-temporary impairment losses	852,125	1,281,537
Net loss on other real estate owned	421,961	462,595
Stock-based compensation	100,000	110,000
Release of ESOP shares	173,040	142,200
Origination of loans available for sale	(70,604,643)	(37,701,855)
Proceeds from sale of loans available for sale	70,604,643	37,701,855
Issuance of common stock for services	87,609	83,134
Changes in other assets and liabilities:		
(Increase) decrease in accrued interest receivable	89,861	(197,240)
(Increase) in other assets	(3,656,252)	(1,196,835)
(Decrease) in accrued interest payable	(217,850)	(43,597)
Increase in other liabilities	170,252	261,150
Net cash provided by operating activities	$ 9,794,069	$ 11,017,249
Cash Flows from Investing Activities		
Purchases of securities available for sale	$ (36,289,067)	$ (70,543,403)
Proceeds from sales and calls of securities available for sale	1,577,988	16,018,448
Proceeds from maturities of securities available for sale	47,933,317	34,931,036
Redemption of restricted stock	341,800	699,183
Proceeds from sale of other real estate	539,426	1,005,116
Net (increase) decrease in loans	(18,083,749)	1,866,573
Net (increase) decrease in cash management accounts	(5,373,714)	2,624,926
Other capital expenditures	(1,238,433)	(1,337,876)
Net cash (used in) investing activities	$ (10,592,432)	$ (14,735,997)

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

	Years Ended December 31, 2012	2011
Cash Flows from Financing Activities		
Net (decrease) in short-term borrowings	$ —	$ (5,500,000)
Net increase in demand accounts, interest-bearing demand accounts and savings accounts	38,116,947	16,696,091
Net (decrease) increase in certificates of deposits	(17,462,113)	9,140,028
Exercise of stock options	588,118	84,375
Repurchase of common stock	(1,714,825)	(202,254)
Cash dividends	(1,483,683)	(1,294,168)
Curtailment of long-term debt	(526,359)	(446,324)
Net cash provided by financing activities	$ 17,518,085	$ 18,477,748
Net increase in cash and cash equivalents	$ 16,719,722	$ 14,759,000
Cash and cash equivalents at beginning of year	37,421,577	22,662,577
Cash and cash equivalents at end of year	$ 54,141,299	$ 37,421,577
Supplemental Disclosures of Cash Flow Information		
Cash paid during the year for:		
Interest	$ 6,028,664	$ 7,005,711
Income taxes	$ 1,300,000	$ 2,651,250
Supplemental Schedule of Noncash Investing and Financing Activities		
Unrealized gain on securities available for sale	$ 6,450,704	$ 6,376,928
Other real estate acquired in settlement of loans	$ —	$ 3,649,900

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

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

Years Ended December 31, 2012 and 2011

	Common Stock, Voting	Additional Paid-In Capital	Retained Earnings	Unearned ESOP Shares	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income	Total
Balance, December 31, 2010	$ 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
Comprehensive income:							
Net income	—	—	7,675,951	—	—	$7,675,951	7,675,951
Other comprehensive income:							
Unrealized holding gains on securities available for sale, net of deferred income taxes of $1,904,034	—	—	—	—	—	3,696,066	—
Reclassification adjustment, net of income taxes of $289,205	—	—	—	—	—	561,399	—
Other comprehensive income, net of tax	—	—	—	—	4,257,465	4,257,465	4,257,465
Total comprehensive income	—	—	—	—	—	$ 11,933,416	—
Exercise of stock options	298,800	289,318	—	—	—		588,118
Release of ESOP shares	—	—	34,640	138,400	—		173,040
Issuance of common stock for services	38,425	—	49,184	—	—		87,609
Repurchase of common stock	(482,325)	(289,318)	(943,182)	—	—		(1,714,825)
Stock-based compensation	—	—	100,000	—	—		100,000
Cash dividends ($ 0.45 per share)	—	—	(1,483,683)	—	—		(1,483,683)
Balance, December 31, 2012	$ 16,196,850	$ —	$ 37,600,101	$ (415,200)	$ 7,527,192		$ 60,908,943

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 19, 2013, 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 regards 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 and commercial real estate throughout the Northern Neck, Middle Peninsula, Williamsburg, and James City County areas of Virginia. The ability of the Bank's debtors to honor their contracts is dependent upon the real estate and general economic conditions in these areas.

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

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

The loan portfolio is segmented based on risk characteristics. Particular characteristics associated with each segment are detailed below:

Residential Real Estate: Consumer real estate loans carry risks associated with the continued creditworthiness of the borrower and changes in the value of the collateral.

Consumer – Non Real Estate: Consumer non real estate loans carry risks associated with the continued creditworthiness of the borrower and the value of the collateral, such as automobiles which may depreciate more rapidly than other assets. In addition, these loans may be unsecured. Consumer loans are more likely than real estate loans to be immediately affected in an adverse manner by job loss, divorce, illness or personal bankruptcy.

Commercial – Non Real Estate: Commercial loans not secured by real estate carry risks associated with the successful operation of a business, and the repayments of these loans depend on the profitability and cash flows of the business. Additional risk relates to the value of collateral where depreciation occurs and the valuation is less precise.

Commercial Real Estate: Loans secured by commercial real estate also carry risks associated with the success of the business and ability to generate a positive cash flow sufficient to service debts. Real estate security diminishes risks only to the extent that a market exists for the subject collateral. Some real estate secured construction loans carry risks that a project will not be completed as scheduled and budgeted and that the value of the collateral may, at any point, be less than the principal amount of the loan.

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 becomes 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 are 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 10 to 39 years for buildings and 3 to 7 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 50 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 50 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 consolidated 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-based 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-based 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 2011 consolidated financial statements have been reclassified to conform to the 2012 presentation.

Recent Accounting Pronouncements

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 the first interim or annual period 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. The adoption of the new guidance did not have a material impact on the Company's 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. 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 interim and annual periods beginning after December 15, 2011 with prospective application. Early application is not permitted. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, "Comprehensive Income (Topic 220) – Presentation of Comprehensive Income." The new guidance amends disclosure requirements for the presentation of comprehensive income. The amended guidance eliminates the option to present components of other comprehensive income ("OCI") as part of the statement of changes in shareholders' equity. All changes in OCI must be presented either in a single continuous statement of comprehensive income or in two separate but consecutive financial statements. The guidance does not change the items that must be reported in OCI. The Company adopted this guidance effective 2012, and has elected to present two separate but consecutive financial statements.

In September 2011, the FASB issued ASU 2011-08, "Intangible – Goodwill and Other (Topic 350) – Testing Goodwill for Impairment." The amendments in this ASU permit an entity to first assess qualitative factors related to goodwill to determine whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill test described in Topic 350. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. Under the amendments in this ASU, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. The amendments in this ASU are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted, including for annual and interim goodwill impairment tests performed as of a date before September 15, 2011, if an entity's financial statements for the most recent annual or interim period have not yet been issued. The adoption of the new guidance did not have a material impact on the Company's 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, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The Company does not expect the adoption of ASU 2011-11 to have a material impact on its consolidated financial statements.

In July 2012, the FASB issued ASU 2012-02, "Intangibles – Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment." The amendments in this ASU apply to all entities that have indefinite-lived intangible assets, other than goodwill, reported in their financial statements. The amendments in this ASU provide an entity with the option to make a qualitative assessment about the likelihood that an indefinite-lived intangible asset is impaired to determine whether it should perform a quantitative impairment test. The amendments also enhance the consistency of impairment testing guidance among long-lived asset categories by permitting an entity to assess qualitative factors to determine whether it is necessary to calculate the asset's fair value when testing an indefinite-lived intangible asset for impairment. The amendments are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted. The Company does not expect the adoption of ASU 2012-02 to have a material impact on its consolidated financial statements.

In January 2013, the FASB issued ASU 2013-01, "Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities." The amendments in this ASU clarify the scope for derivatives accounted for in accordance with Topic 815, Derivatives and Hedging, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements and securities borrowing and securities lending transactions that are either offset or subject to netting arrangements. An entity is required to apply the amendments for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. The Company does not expect the adoption of ASU 2013-01 to have a material impact on its consolidated financial statements.

In February 2013, the FASB issued ASU 2013-02, "Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income." The amendments in this ASU require an entity to present (either on the face of the statement where net income is presented or in the notes) the effects on the line items of net income of significant amounts reclassified out of accumulated other comprehensive income. In addition, the amendments require a cross-reference to other disclosures currently required for other reclassification items to be reclassified directly to net income in their entirety in the same reporting period. Companies should apply these amendments for fiscal years, and interim periods within those years, beginning on or after December 15, 2012. The Company is currently assessing the impact that ASU 2011-03 will have on its consolidated financial statements.

Note 2. Securities

Amortized cost and fair values of securities available for sale as of December 31, 2012 and 2011, are as follows:

2012	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities of state and political subdivisions	$ 105,785,931	$ 10,067,815	$ (191,303)	$ 115,662,443
Mortgage-backed securities	62,497,564	2,617,312	(1,088,984)	64,025,892
Total	$ 168,283,495	$ 12,685,127	$(1,280,287)	$ 179,688,335

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

The amortized cost and fair value of securities available for sale as of December 31, 2012, 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	$ 17,132,578	$ 17,472,646
Due after one year through five years	50,299,604	53,498,792
Due after five years through ten years	93,502,009	100,532,746
Due after ten years	7,349,304	8,184,151
Total	$ 168,283,495	$ 179,688,335

Proceeds from sales and calls of securities available for sale during 2012 and 2011 were $1,577,988 and $16,018,448, respectively. Gross realized gains amounted to $1,812 and $785,399 in 2012 and 2011. Gross realized losses amounted to $291 and $49,769 in 2012 and 2011. The tax provision applicable to these net realized gains amounted to $517 and $250,114 in 2012 and 2011, 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 $98,672,851 and $96,863,156 at December 31, 2012 and 2011, respectively.

Temporarily Impaired Securities

Information pertaining to securities with gross unrealized losses at December 31, 2012 and 2011, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	2012			
	Less Than 12 Months		12 Months or More	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
Securities of state and political subdivisions	$ 4,760,699	$ (58,403)	$ 901,028	$ (132,900)
Mortgage-backed securities	5,179,423	(55,257)	14,907,406	(1,033,727)
	$ 9,940,122	$ (113,660)	$ 15,808,434	$ (1,166,627)

	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)

Securities of State and Political Subdivisions

CFS's unrealized losses on investments in 7 municipal bonds relate 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 investments and it is not more likely than not that CFS will be required to sell the investments 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, 2012.

Mortgage-Backed Securities

The unrealized losses on CFS's investment in 15 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, 2012.

The unrealized losses associated with 20 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 other-than-temporary impairment was recognized in other comprehensive income.

	Available for Sale
Beginning balance as of December 31, 2011	$ 2,689,893
Amount related to the credit loss for which an other-than-temporary impairment was not previously recognized	852,125
Realized losses	(1,442,566)
Ending balance as of December 31, 2012	$ 2,099,452

Note 3. Loans

A summary of the balances of loans by segment follows:

	December 31, 2012	December 31, 2011
Commercial - Non Real Estate	$ 104,737,835	$ 83,418,402
Commercial - Real Estate	166,703,850	160,487,116
Residential Real Estate	88,332,472	100,127,432
Consumer - Non Real Estate	13,455,500	11,714,520
	$ 373,229,657	$ 355,747,470
Less: Allowance for loan losses	6,351,789	6,460,625
Loans, net	$ 366,877,868	$ 349,286,845

Overdrafts totaling $49,947 and $82,189 at December 31, 2012 and 2011, respectively, were reclassified from deposits to loans.

	December 31, 2012	December 31, 2011
Balance at beginning of year	$ 6,460,625	$ 6,140,096
Provision for loan losses	600,000	1,190,004
Loans charged off	(763,771)	(877,616)
Recoveries on loans previously charged off	54,935	8,141
Balance at end of year	$ 6,351,789	$ 6,460,625

An analysis of the allowance for loan losses follows:

	Commercial - Non Real Estate	Commercial - Real Estate	Consumer - Non Real Estate	Residential Real Estate	Unallocated	Total
Year Ended December 31, 2012						
Balance beginning of year	$ 1,423,463	$ 2,723,147	$ 309,448	$ 1,732,912	$ 271,655	$ 6,460,625
Provision for loan losses	1,267,826	(758,538)	179,316	(69,631)	(18,973)	600,000
Loans charged off	(357,274)	(121)	(155,503)	(250,873)	—	(763,771)
Recoveries on loans previously charged off	33,949	—	20,986	—	—	54,935
Total allowance for loan losses	$ 2,367,964	$ 1,964,488	$ 354,247	$ 1,412,408	$ 252,682	$ 6,351,789
Individually evaluated for impairment	$ 1,157,472	$ 682,942	$ 183,791	$ 597,879	$ —	$ 2,622,084
Collectively evaluated for impairment	1,210,492	1,281,546	170,456	814,529	252,682	3,729,705
Total allowance for loan losses	$ 2,367,964	$ 1,964,488	$ 354,247	$ 1,412,408	$ 252,682	$ 6,351,789
Individually evaluated for impairment	$ 6,873,863	$ 7,745,270	$ 291,455	$ 5,397,516	$ —	$ 20,308,104
Collectively evaluated for impairment	97,863,972	158,958,580	13,164,045	82,934,956	—	352,921,553
Total loans	$ 104,737,835	$ 166,703,850	$ 13,455,500	$ 88,332,472	$ —	$ 373,229,657

	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	97,880,384	—	346,095,572
Total loans	$ 83,418,402	$ 160,487,116	$ 11,714,520	$ 100,127,432	$ —	$ 355,747,470

The following is a summary of information pertaining to impaired loans by class at December 31, 2012 and 2011:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2012					
With no related allowance:					
Commercial - Non Real Estate					
Secured	$ 3,295,989	$ 3,295,989		$ 3,404,249	$ 178,135
Unsecured	251,122	251,122		999,036	56,798
Commercial - Real Estate					
Acquisition and development	449,898	449,898		449,949	28,195
Non-owner occupied	—	—		—	—
Owner occupied	2,811,755	2,811,755		2,861,271	61,928
Multifamily	—	—		—	—
Consumer - Non Real Estate					
Installment	8,929	8,929		8,929	847
Revolving	97,973	97,973		98,973	6,259
Other	—	—		—	—
Residential Real Estate					
First Lien 1-4 Family	1,035,490	1,035,490		1,008,721	91,276
Junior Lien 1-4 Family	7,996	7,996		7,998	7,747
Construction	442,000	442,000		438,552	23,951
Land	323,770	323,770		324,870	32,817
Revolving	1,036,645	1,036,645		1,075,218	48,519
With an allowance recorded:					
Commercial - Non Real Estate					
Secured	$ 3,094,946	$ 3,094,946	$ 1,018,617	$ 3,105,529	$ 66,876
Unsecured	231,806	231,806	138,855	245,410	14,542
Commercial - Real Estate					
Acquisition and development	364,527	364,527	189,177	365,956	9,539
Non-owner occupied	3,566,863	3,566,863	354,145	3,977,717	222,195
Owner occupied	552,227	552,227	139,620	558,512	25,547
Multifamily	—	—	—	—	—
Consumer - Non Real Estate					
Installment	84,320	84,320	84,319	87,255	1,911
Revolving	100,233	100,233	99,472	100,796	8,262
Other	—	—	—	—	—
Residential Real Estate					
First Lien 1-4 Family	1,085,103	1,085,103	192,049	1,088,221	45,796
Junior Lien 1-4 Family	230,482	230,482	42,790	230,485	6,141
Construction	694,874	694,874	41,774	694,980	41,208
Land	120,707	120,707	56,396	120,707	—
Revolving	420,449	420,449	264,870	418,681	13,992
Total:					
Commercial - Non Real Estate	$ 6,873,863	$ 6,873,863	$ 1,157,472	$ 7,754,224	$ 316,351
Commercial - Real Estate	7,745,270	7,745,270	682,942	8,213,405	347,404
Consumer - Non Real Estate	291,455	291,455	183,791	295,923	17,280
Residential Real Estate	5,397,516	5,397,516	597,879	5,408,433	311,447
	$ 20,308,104	$ 20,308,104	$ 2,622,084	$ 21,671,985	$ 992,482

	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

Included in impaired loans are troubled debt restructurings. At December 31, 2012 and 2011, $8,592,126 and $7,710,984 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 2012 follows:

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial - Non Real Estate			
Secured	7	$ 3,317,702	$ 3,317,702

No TDRs subsequently defaulted within the first year of modification during 2012.

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

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
Commercial - Real Estate			
Secured 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

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 and Still Accruing	Total Past Due	Nonaccruals	Current	Total Loans
December 31, 2012							
Commercial - Non Real Estate							
Commercial Secured	$ 447,645	$ 172,917	$ —	$ 620,562	$ 1,749,479	$ 94,115,818	$ 96,485,859
Commercial Unsecured	—	39,039	—	39,039	72,097	8,140,840	8,251,976
Commercial Real Estate							
Commercial A&D	—	—	—	—	814,425	24,204,525	25,018,950
Commercial Non-Owner Occupied	—	209,517	—	209,517	—	48,554,906	48,764,423
Commercial Owner Occupied	—	414,598	—	414,598	169,837	84,521,824	85,106,259
Multifamily Commercial	—	—	—	—	—	7,814,218	7,814,218
Consumer - Non Real Estate							
Consumer Installment	97,350	53,971	—	151,321	27,076	7,844,802	8,023,199
Consumer Revolving	—	—	—	—	—	2,206,005	2,206,005
Consumer Other	4,710	—	—	4,710	—	3,221,586	3,226,296
Residential-Real Estate							
First Lien 1-4 Family	773,111	388,511	—	1,161,622	1,686,231	30,079,310	32,927,163
Jr Lien 1-4 Family	4,917	—	—	4,917	372,646	3,164,935	3,542,498
Construction	994,333	—	—	994,333	442,000	3,831,461	5,267,794
Land	187,420	80,209	—	267,629	587,309	8,480,020	9,334,958
Revolving	645,433	—	—	645,433	897,465	35,717,161	37,260,059
Total	$ 3,154,919	$ 1,358,762	$ —	$ 4,513,681	$ 6,818,565	$ 361,897,411	$ 373,229,657

	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due and Still Accruing	Total Past Due	Nonaccruals	Current	Total Loans
December 31, 2011							
Commercial - Non Real Estate							
Commercial Secured	$ 51,829	$ 56,968	$ —	$ 108,797	$ 487,328	$ 71,823,236	$ 72,419,361
Commercial Unsecured	73,804	—	—	73,804	22,158	10,903,079	10,999,041
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	—	—	—	—	326,849	80,896,960	81,223,809
Multifamily Commercial	—	—	—	—	—	8,530,995	8,530,995
Consumer - Non Real Estate							
Consumer Installment	32,620	674,789	—	707,409	42,487	7,615,632	8,365,528
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	1,019,880	32,485,239	33,904,371
Jr Lien 1-4 Family	25,244	145,949	—	171,193	36,890	7,928,918	8,137,001
Construction	—	—	—	—	18,282	5,815,167	5,833,449
Land	—	120,707	—	120,707	—	10,034,486	10,155,193
Revolving	131,837	304,512	—	436,349	468,834	41,192,235	42,097,418
Total	$ 725,113	$ 1,304,515	$ —	$ 2,029,628	$ 2,422,708	$ 351,295,134	$ 355,747,470

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, 2012							
Commercial - Non Real Estate							
Secured	$ 86,015,369	$ 1,975,969	$ 3,079,601	$ 5,093,853	$ 321,067	$ —	$ 96,485,859
Unsecured	7,309,292	128,364	331,391	482,929	—	—	8,251,976
Commercial - Real Estate							
Acquisition and development	21,700,290	804,236	1,700,000	814,424	—	—	25,018,950
Non-owner occupied	36,411,589	5,189,784	3,596,187	3,566,863	—	—	48,764,423
Owner occupied	77,463,768	3,689,540	813,882	3,139,069	—	—	85,106,259
Multifamily	7,814,218	—	—	—	—	—	7,814,218
Consumer - Non Real Estate							
Installment	7,813,545	51,375	65,030	92,535	714	—	8,023,199
Revolving	1,992,988	13,816	995	198,206	—	—	2,206,005
Other	3,226,296	—	—	—	—	—	3,226,296
Residential Real Estate							
First Lien 1-4 Family	29,025,701	943,071	877,657	2,080,734	—	—	32,927,163
Junior Lien 1-4 Family	3,145,759	—	158,261	238,478	—	—	3,542,498
Construction	4,130,919	—	—	1,136,875	—	—	5,267,794
Land	8,405,591	142,058	342,832	323,770	120,707	—	9,334,958
Revolving	33,039,658	2,236,397	487,051	1,274,171	222,782	—	37,260,059
Total	$ 327,494,983	$ 15,174,610	$ 11,452,887	$ 18,441,907	$ 665,270	$ —	$ 373,229,657
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	30,725,878	1,340,819	688,269	1,137,375	12,030	—	33,904,371
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	$ 318,232,728	$ 12,744,317	$ 15,118,527	$ 9,231,638	$ 420,260	$ —	$ 355,747,470

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,	
	2012	**2011**
Land	$ 3,790,653	$ 3,790,653
Buildings	14,573,481	14,037,237
Furniture, fixtures and improvements	1,958,581	1,875,596
Mechanical equipment	5,874,351	5,903,368
Leasehold improvements	4,072,617	4,066,797
	$ 30,269,683	$ 29,673,651
Less accumulated depreciation	14,281,780	13,272,846
	$ 15,987,903	$ 16,400,805

For the years ended December 31, 2012 and 2011, depreciation expense was $1,760,876 and $1,533,847, respectively.

Note 5. Borrowings

CFS's fixed-rate long-term debt of $23,709,080 at December 31, 2012 matures through 2018. $328,798 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. $550,000 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, 2012 for this borrowing was $330,282. Aggregate maturities are: 2013, $13,181,620; 2014, $137,121; 2015, $142,875; 2016, $148,893, 2017, $92,410; and thereafter, $10,006,161.

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, 2012.

Note 6. Income Taxes

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

	December 31, 2012	December 31, 2011
Deferred tax assets:		
Allowance for loan and cash management account losses	$ 2,545,900	$ 2,554,869
Other than temporary impairment of securities	713,814	914,564
Other real estate	360,919	397,489
Deferred compensation	56,396	63,963
Premises and equipment	62,081	—
Other	86,460	37,729
	$ 3,825,570	$ 3,968,614
Deferred tax liabilities:		
Premises and equipment	$ —	$ 190,282
Securities available for sale	3,877,646	1,684,405
	$ 3,877,646	$ 1,874,687
Net deferred tax assets (liabilities)	$ (52,076)	$ 2,093,927

The provision for income taxes charged to operations for the years ended December 31, 2012 and 2011, consists of the following:

	2012	2011
Current tax expense	$ 2,071,453	$ 1,944,304
Deferred tax (benefit)	(47,238)	(45,602)
	$ 2,024,215	$ 1,898,702

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, 2012 and 2011, due to the following:

	2012	2011
Computed "expected" tax expense	$ 3,298,056	$ 3,018,999
(Decrease) in income taxes resulting from:		
Tax exempt income	(1,335,690)	(1,202,533)
Other	61,849	82,236
	$ 2,024,215	$ 1,898,702

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 2009.

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, 2012, 36,000 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 2012). 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 $446,748 and $377,414 for the years ended December 31, 2012 and 2011, respectively (including $173,040 and $142,200 for the years ended December 31, 2012 and 2011 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 $438,114 and $399,583 for 2012 and 2011, 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 187,200 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 $100,000 and $110,000 for the years ended December 31, 2012 and 2011, respectively. No income tax benefit was recognized in the income statement for stock-based compensation arrangements for the years ended December 31, 2012 and 2011.

The stock option plans require that options be granted at an exercise price equal to at least 100% of the fair market value of the common stock on the date of the grant; however, for those individuals who own more than 10% of the stock of CFS, the option price must be at least 110% of the fair market value on the date of grant. Such options are generally not exercisable until three years from the date of issuance and require continuous employment during the period prior to exercise. The options will expire in no more than ten years after the date of grant. All 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, 2012 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	443,148	$ 11.69		
Granted	54,300	13.75		
Exercised	(59,760)	9.78		
Expired	(11,820)	13.33		
Outstanding at end of year	425,868	12.22	5.1 years	$ 1,950,475
Options exercisable, end of year	273,168	12.25	3.3 years	$ 1,251,109

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, 2012. 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, 2012 and 2011 was $2.12 and $1.70, respectively. The total intrinsic value of options exercised during the year ended December 31, 2012 and 2011, was $431,467 and $41,700, respectively.

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,	
	2012	2011
Dividend yield	2.38%	2.30%
Expected term	6 years	6 years
Expected volatility	17.52%	16.85%
Risk-free interest rate	2.72%	2.81%

As of December 31, 2012, there was $134,377 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 2012 and 2011, CFS issued 7,685 shares and 7,204 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, 2012 are as follows:

Year Ending December 31,	
2013	$ 109,250
2014	110,157
2015	92,017
2016	19,867
2017	20,304

Rent expense under operating leases aggregated $371,497 and $365,625 for the years ended December 31, 2012 and 2011, 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, 2012 and 2011, the aggregate amounts of daily average required balances were approximately $1,158,000 and $713,000, respectively.

Note 11. Related Party Transactions

Officers, directors and their affiliates had borrowings of $9,132,825 and $8,978,388 at December 31, 2012 and 2011, respectively, with the Bank.

Changes in borrowings during 2012 were as follows:

Balance, December 31, 2011	$ 8,978,388
Additions	399,145
Payments	(244,708)
Balance, December 31, 2012	$ 9,132,825

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.

Related parties had deposits of $773,955 as of December 31, 2012.

Note 12. Other Income and Expenses

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

	2012	2011
Cash management fees and discount	$ 3,230,692	$ 3,370,780
Merchant discount	5,004,505	4,307,456
ATM fee income	1,114,086	1,111,552
Asset management fees	991,889	898,418
Other (includes no items in excess of 1% of total revenue)	2,569,750	1,535,261
	$ 12,910,922	$ 11,223,467

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

	2012	2011
Advertising	$ 802,787	$ 633,966
Merchant card	2,590,729	2,644,036
Software	900,321	887,455
Provision for cash management account losses	230,000	120,000
Legal fees	226,391	232,669
FDIC assessments	421,815	588,008
Delivery and transportation	245,613	235,187
Stationery and supplies	446,848	381,388
Other (includes no items in excess of 1% of total revenue)	4,340,097	4,047,699
	$ 10,204,601	$ 9,770,408

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.

	2012	2011
Weighted average number of common shares, basic	3,242,343	3,210,161
Effect of dilutive stock options	63,304	25,402
Weighted average number of common shares and dilutive potential common stock used in diluted EPS	3,305,647	3,235,563

There were no antidilutive options for the year ended December 31, 2012. Options on approximately 259,649 average shares were not included in the computation of diluted earnings per share for the year ended December 31, 2011 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:

2013	$ 128,735,923
2014	24,327,941
2015	13,797,943
2016	7,982,162
2017	5,238,760
Thereafter	32,389,000
	$ 212,471,729

The Bank obtains certain deposits through the efforts of third-party brokers. At December 31, 2012 and 2011, brokered deposits totaled $32,389,000 and $30,063,000, 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, 2012 and 2011, the following financial instruments were outstanding whose contract amounts represent credit risk:

	Contract Amount	
	2012	**2011**
	(in thousands)	
Commitments to grant loans	$ 15,381	$ 8,780
Unfunded commitments under lines of credit	93,631	95,339
Commercial and standby letters of credit	1,361	1,308

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 $2,491,000 at December 31, 2012.

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

Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data (Level 2). If the inputs used to provide the evaluation for certain securities are unobservable and/or there is little, if any, market activity then the security would fall to the lowest level of the hierarchy (Level 3).

The Company's investment portfolio is primarily valued using fair value measurements that are considered to be Level 2. The Company has contracted with a third party portfolio accounting service vendor for valuation of its securities portfolio. The vendor's primary source for security valuation is Interactive Data Corporation ("IDC"), which evaluates securities based on market data. IDC utilizes evaluated pricing models that vary by asset class and include available trade, bid, and other market information. Generally, the methodology includes broker quotes, proprietary modes, vast descriptive terms and conditions databases, as well as extensive quality control programs.

The vendor utilizes proprietary valuation matrices for valuing all municipals securities. The initial curves for determining the price, movement, and yield relationships within the municipal matrices are derived from industry benchmark curves or sourced from a municipal trading desk. The securities are further broken down according to issuer, credit support, state of issuance and rating to incorporate additional spreads to the industry benchmark curves.

The Company uses Bloomberg Valuation Service, an independent information source that draws on quantitative models and market data contributed from over 4,000 market participants, to validate third party valuations. Any material differences between valuation sources are researched by further analyzing the various inputs that are utilized by each pricing source.

Loans Receivable

Fair values for 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.

Bank Owned Life Insurance

The carrying value of bank owned life insurance is based on cash surrender value and approximates fair value.

Deposit Liabilities

The fair values disclosed for demand deposits (for example, interest and noninterest checking, 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, if any, approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies market interest rates on comparable instruments to a schedule of aggregated expected monthly maturities on time deposits.

Short-Term Borrowings

The carrying amounts of federal funds purchased and other short-term borrowings maturing within ninety days approximate their fair values. Fair values of other short-term borrowings are estimated using discounted cash flow analyses based on current market rates and similar types of borrowing arrangements.

Long-Term Borrowings

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

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Off-Balance Sheet Credit-Related Instruments

Fair values for off-balance-sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into 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, 2012 and 2011:

		Fair Value Measurements at December 31, 2012, 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	$115,662	$ —	$115,662	$ —
Mortgage-backed securities	64,026	—	37,880	26,146

		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

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, 2012:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)					
		Total Realized/Unrealized Gains (Losses) Included in				
	Balance as of January 1, 2012	**Net Income**	**Other Comprehensive Income**	**Purchases, Sales, Issuances, and Settlements, Net**	**Transfers in and/or out of Level 3**	**Balance as of December 31, 2012**
			(in thousands)			
Mortgage-backed securities	$ 27,147	$ (852)	$ (614)	$ 465	$ —	$ 26,146

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, 2012 and 2011, for which a nonrecurring change in fair value has been recorded:

	Fair Value Measurements at December 31, 2012, 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	$ —	$ —	$ 7,924
Foreclosed assets	—	—	4,391

	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	—	—	5,331

	Fair Value Measurements at December 31, 2012			
	Fair Value	Valuation Techniques	Unobservable Inputs	Weighted Average
Assets				
Commercial -				
Non Real Estate	$ 2,169	Market comparables	Discount applied to market comparables [1]	16-100%
Commercial -				
Real Estate	3,801	Market comparables	Discount applied to market comparables [1]	6-52%
Residential Real Estate	1,954	Market comparables	Discount applied to market comparables [1]	6-100%
Consumer -				
Non Real Estate	—	Market comparables	Discount applied to market comparables [1]	20-100%
Total Impaired Loans	$ 7,924			
Other Real Estate Owned	$ 4,391			
Total	$ 12,315			

[1] A discount percentage is applied based on age of independent appraisals, current market conditions, and experience within the local market.

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 agreements will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority or market valuation approach is based on an appraisal, of one year or less, conducted by an independent, licensed appraiser 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 property is more than one year old and not solely based on observable market comparables or management determines the fair value of the collateral is further impaired below the appraised value, then a Level 3 valuation is considered to measure the fair value. The value of business equipment is based upon an outside appraisal, of one year or less, if deemed significant, or the net book value on the applicable business' 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 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

Fair values of other real estate owned ("OREO") are carried at the lower of carrying value or fair value less selling costs. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the foreclosed asset as Level 2 valuation. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the foreclosed asset as Level 3 valuation. 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 (dollars in thousands):

		Fair Value Measurements at December 31, 2012			
	Carrying Value	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Total Fair Value Balance
Financial assets:					
Cash and short-term investments	$ 54,141	$ 54,141			$ 54,141
Securities available for sale	179,688		153,542	26,146	179,688
Restricted stock	2,591			2,591	2,591
Loans, net	366,878		365,860	7,924	373,784
Cash management accounts	21,374		21,374		21,374
Accrued interest receivable	2,849		2,849		2,849
Bank-owned life insurance	10,137		10,137		10,137
Financial liabilities:					
Deposits	$564,234		$ 550,843		$ 550,843
Short-term borrowings	12,500		12,500		12,500
Long-term debt	11,209		12,506		12,506
Accrued interest payable	214		214		214

	2011	
	Carrying Amount	Fair Value
	(In Thousands)	
Financial assets:		
Cash and short-term investments	$ 37,422	$ 37,422
Securities	187,163	187,163
Restricted stock	2,933	2,933
Loans	349,798	349,584
Cash management accounts	15,771	15,771
Accrued interest receivable	2,939	2,939
Bank-owned life insurance	9,405	9,405
Financial liabilities:		
Deposits	$ 543,579	$ 547,600
Short-term borrowings	—	—
Long-term debt	39,700	41,018
Accrued interest payable	432	432

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, 2012 and 2011, that CFS meets all capital adequacy requirements to which it is subject.

As of December 31, 2012, 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, 2012:						
Total Capital (to Risk Weighted Assets):						
Consolidated	$ 74,706	14.8%	$ 40,376	8.0%	N/A	
Chesapeake Bank	$ 71,183	14.2%	$ 40,031	8.0%	$50,039	10.0%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	$ 68,383	13.6%	$ 20,188	4.0%	N/A	
Chesapeake Bank	$ 64,913	13.0%	$ 20,016	4.0%	$30,023	6.0%
Tier 1 Capital (to Average Assets):						
Consolidated	$ 68,383	10.5%	$ 26,034	4.0%	N/A	
Chesapeake Bank	$ 64,913	10.2%	$ 25,590	4.0%	$31,988	5.0%
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%

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, 2012 was 4.33%. The interest rate as of December 31, 2012 was 1.74%. The securities have a mandatory redemption date of October 1, 2037, and are subject to varying call provisions beginning September 6, 2012. The principal asset of the Trust is $15.465 million of the CFS's junior subordinated debt securities with like maturities and like interest rates to the capital securities.

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

The obligations of CFS with respect to the issuance of the capital securities constitute a full and unconditional guarantee by 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, 2012, the amount available for payment of additional dividends without prior regulatory approval from the Bank to the parent company is $14,160,504 or 23.25% of consolidated net assets.

Balance Sheets (Condensed)

	December 31,	
	2012	2011
Assets		
Cash	$ 672,097	$ 532,168
Investment in subsidiaries	74,156,170	65,179,804
Premises and equipment, net	2,257,650	2,400,602
Other assets	1,041,870	1,061,234
Total assets	$ 78,127,787	$ 69,173,808
Liabilities and Shareholders' Equity		
Borrowings	$ 1,293,998	$ 1,886,967
Trust preferred capital notes	15,465,000	15,465,000
Other liabilities	459,846	596,573
Shareholders' equity	60,908,943	51,225,268
Total liabilities and shareholders' equity	$ 78,127,787	$ 69,173,808

Statements of Income (Condensed)

	2012	2011
Income - Dividends from subsidiaries	$ 3,868,203	$ 2,369,879
Other	313,215	299,181
Total income	$ 4,181,418	$ 2,669,059
Expenses - Interest expense	$ 760,940	$ 919,650
Other expenses	829,525	774,215
Total expenses	$ 1,590,465	$ 1,693,865
Income before income taxes and equity in undistributed earnings of subsidiaries	$ 2,590,953	$ 975,195
Allocated income tax benefit	370,014	408,743
Income before equity in undistributed earnings of subsidiaries	$ 2,960,967	$ 1,383,938
Equity in undistributed earnings of subsidiaries	4,714,984	5,596,770
Net income	$ 7,675,951	$ 6,980,708

Statements of Cash Flows (Condensed)

	2012	2011
Cash Flows from Operating Activities		
Net income	$ 7,675,951	$ 6,980,708
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	211,051	207,157
Equity in undistributed earnings of subsidiaries	(4,714,984)	(5,596,770)
Issuance of common stock for services	87,609	83,134
Stock-based compensation	100,000	110,000
Release of ESOP shares	173,040	142,200
Changes in other assets and liabilities:		
(Increase) decrease in other assets	15,447	52,247
Increase (decrease) in other liabilities	(136,727)	(113,097)
Net cash provided by operating activities	$ 3,411,387	$ 1,865,579
Cash Flows from Investing Activities		
Purchases of premises and equipment	$ (68,099)	$ (49,113)
Net cash (used in) investing activities	$ (68,099)	$ (49,113)
Cash Flows from Financing Activities		
Dividends paid	$ (1,483,683)	$(1,294,168)
Curtailment of borrowings	(592,969)	(515,055)
Repurchase of common stock	(1,714,825)	(202,254)
Exercise of stock options	588,118	84,375
Net cash provided by (used in) financing activities	$ (3,203,359)	$(1,927,102)
Net increase (decrease) in cash	$ 139,929	$ (110,636)
Cash at beginning of year	532,168	642,804
Cash at end of year	$ 672,097	$ 532,168

Yount Hyde & Barbour
Certified Public Accountants
and Consultants

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

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Chesapeake Financial Shares, Inc. and its Subsidiaries which comprise the consolidated balance sheets as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for the years then ended and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

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 its Subsidiaries as of December 31, 2012 and 2011, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Winchester, Virginia
February 19, 2013

Yount, Hyde & Barbour, P.C.

Financial Overview: Chesapeake Financial Shares, Inc. posted another record year for earnings in 2012. The return on average equity in 2012 was 14.9% and return on average assets was 1.2% compared to 15.3% and 1.1%, respectively, in 2011. At the end of 2012, Chesapeake Financial Shares, Inc. (CFS) had total assets of $668 million, representing a 4.7% increase over the December 31, 2011 balance of $638 million. The Company ended the year with total gross loans of $373.2 million, and total deposits of $564.2 million, up 4.9% and up 3.8%, respectively.

The current economic environment continued to cause soft loan demand coupled with competitive pricing pressures. Despite the pressures mentioned, loan volume was up $17.6 million for 2012 which brought the average annual loan growth rate for the last five years to 2.4%. 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 an adequate level of 1.7%. The deposit growth of 3.8% for 2012 brought the average annual deposit growth rate for the last five years to 8.1%. 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 2012 were $7,675,951 or $2.32 per share (fully diluted) compared to $6,980,708 or $2.16 per share in 2011, an increase of $695,243. The 10% increase in net income resulted from a 3.8% increase or $828,537 in net interest income after provision for loan losses. There was also an 8.9% increase or $1,257,547 in noninterest income and noninterest expense increased by 4.7% or $1,265,328 in 2012 over 2011. The provision for Other Than Temporary Impairment (OTTI) decreased by $429,412, or 33.5%, net of realized losses. Merchant Services income increased by $697,049 or 16% in 2012, while Cash Management fees were down $140,088 or 4.2% for the year.

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. Noninterest expense increased by 1% or $280,091 in 2011 over 2010.

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 $373.3, $355.7, and $361.4 million for 2012, 2011, and 2010, respectively, representing an increase of 4.9% for 2012 from 2011, a decrease 1.8% for 2011 from 2010, and a decrease of 0.9% for 2010 from 2009. The commercial portfolio including real estate and non real estate combined was up 11.3% or $27.5 million and the consumer and residential real estate portfolios were down a combined 9% or $10.8 million from 2011.

On December 31, 2012, the loan portfolio consisted of 72.7% commercial loans, 23.7% single-family residential and residential construction loans, and 3.6% consumer and other loans. The commercial loans consisted principally of business loans such as owner-occupied commercial development, retail, builders/contractors, medical, service and professional, hospitality, non-profits, marine industry, and a small portion of agricultural and seafood loans.

Total nonperforming assets consisted of nonaccrual loans, restructured loans, repossessed and foreclosed properties, and Other Real Estate Owned. Nonperforming assets were $19,805,554 at December 31, 2012, which represented an increase from $15,539,881 at December 31, 2011. Past due loans over thirty days were 3% of total loans at December 31, 2012. A significant portion of the nonperforming asset total is attributable to a group of loans that are included as a result of a reclassification of these credits based on the identification of some weakness. The total included in the 2012 year-end number is $8,592,126. Any potential loss related to these loans has been incorporated in the allowance for loan losses.

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

The fair market value of the portfolio was $7,527,192 more than book value, net of the tax effect, at December 31, 2012, and was more than book value by $3,269,727, net of the tax effect, at December 31, 2011. 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 $179.7 million, down $7.5 million from the $187.2 million on December 31, 2011. Investments in securities of state and political subdivisions increased by $17.6 million or 17.9%. Investments in mortgage backed securities decreased by $25 million or 28.1%.

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 nonaccrual status and over ninety days past due are considered in this evaluation as well as other loans, which may be a potential loss. The status of nonaccrual and past due loans varies from quarter to quarter based on seasonality, local economic conditions, and the cash flow of customers.

The allowance for loan losses was $6,351,789 or 1.70% of gross loans less unearned discounts at year-end. This ratio was 1.81% on December 31, 2011, and 1.69% in 2010. The table below represents the provision for loan losses taken in years 2010 through 2012 as well as loans charged off and subsequent recoveries.

	2012	2011	2010
Provision for Loan Losses	600,000	1,190,004	2,486,664
Loans Charged Off	763,771	877,616	1,553,131
Recoveries	54,935	8,141	40,771

Management and the Board of Directors believe that the total allowance at year-end was adequate relative to current levels of risk in the portfolio. However, continued loan growth or increases in specific problem loans may warrant additional provisions in the future.

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

Deposits totaled $564.2, $543.6, and $517.7 million for 2012, 2011, and 2010, respectively, and represented an increase of 3.8% for 2012 over 2011 and 5% for 2011 over 2010. The below table represents a breakdown of total deposits.

	2012	2011	Change	Percent Change
Demand Deposits (non interest bearing)	104,164,119	77,600,120	26,563,999	34.2%
Savings & Interest Bearing Deposits	247,598,107	236,045,159	11,552,948	4.9%
Certificates of Deposit	212,471,729	229,933,842	(17,462,113)	-7.6%
Total Deposits	564,233,955	543,579,121	20,654,834	3.8%

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 certificate of deposit accounts. Through the use of Clear Sky, the Company has been able to attract deposits from all 50 states. At December 31, 2012, Clear Sky deposits totaled $44.1 million.

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

A large number of variables interact to affect net interest income. Included are variables such as changes in the mix and volume of earning assets and interest bearing liabilities, market interest rates, and the statutory federal tax rate. It is management's ongoing 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 $23.1, $22.8, and $21.8 million for 2012, 2011, and 2010, respectively, representing an increase of 1% increase for 2012 over 2011, 4.7% for 2011 over 2010, and 15.1% for 2010 over 2009. Loan balances increased this year with total gross loans up 4.9% or $17.5 million for 2012 from 2011. Total interest expense was $5.8, $7.0, and $8.3 million for 2012, 2011, and 2010, respectively. On a tax equivalent annualized basis, the net interest margin was 4.6%, 4.7%, and 4.4% for 2012, 2011, and 2010, respectively. The Bank's margins have been very stable and well above peer through numerous rate cycles and through the recent recession.

Noninterest Income: For the year ended December 31, 2012 noninterest income was $16.3 million excluding a charge of $852,125 for Other Than Temporary Impairment (OTTI) of investments. This represents an increase in noninterest income of $828,135 for the year. Changes in noninterest income categories are highlighted below.

	2012	2011	Change	Percent Change
Merchant Discount Income	5,004,505	4,307,456	697,049	16.2%
ATM Fee Income	1,114,086	1,111,552	2,534	0.2%
Asset Management Fees	991,889	898,418	93,471	10.4%
Other Income	2,569,750	1,535,261	1,034,489	67.4%
Gains on Sale of Securities	1,521	735,630	(734,109)	-99.8%
Cash Management Fees	3,230,692	3,370,780	(140,088)	-4.2%
Service Charge Income	1,316,544	1,438,293	(121,749)	-8.5%
Fiduciary Income	2,040,532	2,043,994	(3,462)	-0.2%
Total Noninterest Income	16,269,519	15,441,384	828,135	5.4%

Noninterest income represented 36% 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 $207.1 million Federal Home Loan Mortgage Corporation loan portfolio.

Noninterest Expenses: Total noninterest expenses increased 4.7%% or $1,265,328 in 2012 over 2011. In 2011, total noninterest expenses increased 1.1% over 2010. Occupancy expenses only increased $8,228 over 2011, while salary and benefit costs increased by $863,541 or 6.4%. Below is a breakdown of other expenses for 2012 over 2011.

	2012	2011	Change	Percent Change
Advertising	802,787	633,966	168,821	26.6%
Software	900,321	887,455	12,866	1.4%
Provision for cash management account losses	230,000	120,000	110,000	91.7%
Delivery and transportation	245,613	235,187	10,426	4.4%
Stationery and supplies	446,848	381,388	65,460	17.2%
Miscellaneous other	4,340,097	4,047,699	292,398	7.2%

The increases in expenses above were offset by a decrease in merchant card, legal and FDIC assessment expenses of $225,778 in 2012 over 2011.

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, 2012, approximately 45.2% of total assets matured or were repricing within one year as compared to 39.6% on December 31, 2011. The Bank's loan portfolio was liquid with 55.6% of all loan dollars maturing or repricing within one year. The loan liquidity ratio was 54.1% on December 31, 2011.

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 $71.2 million, secured and unsecured. The Bank and CFS have access to additional secured borrowings of $4.45 million.

As of December 31, 2012, the Bank held $3,474 in repossessed assets and $4,391,389 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 is its influence on those businesses that have large investments in plant and inventories, it does have an effect. There are normally corresponding increases in the money supply, and banks will normally experience above-average growth in assets, loans and deposits. Also, general increases in the prices of goods and services will result in increased operating expenses.

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

Federal regulators have adopted minimum capital standards. Specifically, the guidelines categorize assets and off balance sheet items into four risk-weighted categories. The minimum ratio of qualifying total capital to risk-weighted assets is 8%. For CFS, Tier 1 capital is composed of common equity and retained earnings. Tier 1 capital to risk-weighted assets and Tier 1 capital to average assets (called leveraged capital) must be 4%. On December 31, 2012, the Company had ratios of Tier 1 risk-based capital to risk-weighted assets of 13.6%, total risk-based capital to risk-weighted assets of 14.8%, and Tier 1 leverage capital of 10.5%. At December 31, 2011, these ratios were 12.2%, 13.4% and 9.9%, respectively. At December 31, 2010, these ratios for the Bank were 12.1%, 13.5% and 9.20%, respectively, well above the regulatory minimums and exceeded the requirements for the FDIC's "well capitalized" designation.

Dividend and Market Information: The Company's stock trades on the "OTC" (Over the Counter) market under the symbol "CPKF". The Company has increased its dividend payment annually for more than twenty years. The Company raised its dividend to $0.45 per share in 2012, an increase of $0.054 over 2011. This increase followed a $0.038 per share dividend increase from $0.358 in 2010 to $0.396 in 2011. 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 2012 ranged from $11.12 to $18.70, and during 2011, from $10.80 to $14.15. 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. In 2012 CFS bought and retired 80,976 shares in a tender offer. At December 31, 2012, there were 3,239,370 shares of the Company's common stock outstanding held by approximately 214 holders of record.

Chesapeake Financial Shares, Inc. — Directors

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

Douglas D. Monroe, Jr.
Vice Chairman

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

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

Katherine W. Monroe
Shareholder

Bruce P. Robertson
Retired CEO
Shirley Pewter Shops, Inc.

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

Robert J. Singley, Sr.
President
RJS & Associates, Inc.

Thomas G. Tingle, AIA
President
Guernsey Tingle Architects

Chesapeake Bank — Directors

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

David E. Bush, CPA, CFP, PFS
Managing Director
Witt Mares Financial Vision, LLC

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

James M. Holmes, Jr.
President
Chesapeake Health Services

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

Douglas D. Monroe, Jr.
Chairman Emeritus
Chesapeake Bank

Thomas G. Tingle, AIA
President
Guernsey Tingle Architects

Harry M. Ward
Retired Superintendent of Schools
Mathews County Public Schools

Corporate Officers

Jeffrey M. Szyperski
Marshall N. Warner
John H. Hunt II
John K. O'Shaughnessy
J. Mark Monroe
John M. Sadler
Dianne D. Hall
Francis Bell III
Bryan D. Edmonds
Patricia R. Lewis
Paula A. Milsted
Steven D. Callis
Melissa A. Denison
Mark J. Eggleston
Rebecca A. Foster
Trudy M. Quinto
Jean H. Light
Robert G. Castleman
W. J. McLachlan
Thomas H. Richardson
Betty Sue Spence
Suzanne D. Keyser
Tracy R. Pastella
Donald J. Seeterlin
Kevin S. Wood
Pamela D. Chapman
Melissa A. Crawford
Anjillette S. Eamigh
Cecelia G. Klink
Melissa D. Loudermilk
Catherine D. Mise
Donna M. Mitchell
Amy E. Mitchem
Vickie M. Noel
Johanna M. Northstein
Diana N. Rock
Christopher M. Sikes
Kristie K. Smith
Sandra L. Smith
Catherine W. Snowden
Teresa W. Stewart
Sherry T. Williams
Tucker K. Edmonds
Lisa M. McCullen
Sherri L. Clowser
Ryan C. Kent
Roberta R. LeDoux
Ann Marie Pruitt
Anita B. Pritchett
Sherry M. Vanlandingham

Chesapeake Investment Group, Inc. — Directors

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

Chesapeake Trust Company, Inc. — Directors

John M. Sadler, President
John H. Hunt II
Ted M. Kattmann
J. Mark Monroe
John K. O'Shaughnessy
Jeffrey M. Szyperski
Marshall N. Warner

Chesapeake Financial Group, Inc. — Directors

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

Chesapeake Investment Services — Directors

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

Chesapeake Bank — Business Advisory Boards

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

Northern Neck
Stuart A. Bunting
Fred E. Burke, Jr.
James N. Carter, Jr.
Sandra H. Hargett
S. Lynn Haynie
Susan F. Hill
Joseph P. Hudnall
Thomas E. Kellum
William R. Lee
Samuel E. Monroe II
W. Bruce Sanders
Matson C. Terry II, Esq.

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

CHESAPEAKE FINANCIAL SHARES, INC.

Chesapeake Financial Shares, Inc.

Chesapeake Bank

Chesapeake Investment Group

P.O. Box 1419 • Kilmarnock, Virginia 22482 • 804-435-1181
www.chesapeakefinancialshares.com • Ticker Symbol CPKF