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2017 ANNUAL REPORT

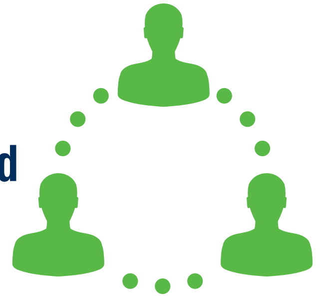
2017 by the Numbers

123

Organizations Served by Our **Volunteers**

83

Employees Volunteered



39 of those held officer positions

$2.17 Earnings Per Share

10.64% Return on Equity

Our customers rated our service **4.72** out of **5** based on 2017 surveys.

Over

5,200

Volunteer Hours in 2017

Top 50 Best Banks to Work For and

TOP 200 Community Banks

(based on three-year average ROE)

2017 designations by

AMERICAN BANKER

Over

19,900

Customers Served

3,624

Small Businesses Served

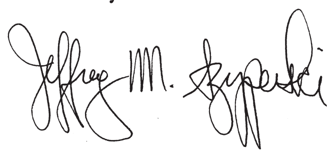
Let's keep this simple – 2017 was a record earnings year for Chesapeake Financial Shares! Additionally, for the tenth year in a row we were recognized by *American Banker* magazine as one of the "Top 200 Community Banks" in the country as well as being on that same periodical's "Best Banks To Work For" list for a fifth straight year. We have a lot to be thankful for.

Our 2017 earnings of $8,948,933 represents a 27.4% increase over 2016 earnings. The increase is primarily due to our strong noninterest income lines of business coupled with an 8% increase in outstanding loans. We are also fortunate to have opened a new branch in the Cedarfield retirement community in Richmond in late 2017. Our stock price also reflected our strong year, appreciating 38.8% in 2017.

2017 also had some notable passings of those who left their mark on our world – Eugene Cernan, Jerry Lewis, Tom Petty, Mary Tyler Moore, Chuck Berry, Bob Taylor (Internet), Jim Nabors, Dick Enberg, and Spencer Johnson *(One Minute Manager)*. The world is a better and changed place because of each of them.

It is always exciting entering a new year knowing the scoreboard gets reset to zero and new challenges await. Please plan on joining us Friday, April 6th at Rappahannock Westminster-Canterbury in Irvington for our Annual Shareholders Meeting. I hope to see you there!

Sincerely,



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

	2017	2016	2015	2014	2013
	(Dollars in thousands except ratios and per share amounts)				
Results of Operations					
Interest income	$ 29,799	$ 27,889	$ 26,801	$ 26,651	$ 27,415
Interest expense	3,777	3,440	3,378	3,533	4,121
Net interest income	26,022	24,449	23,423	23,118	23,294
Provision for loan losses	950	550	241	600	1,133
Net interest income after provision for loan losses	25,072	23,899	23,182	22,518	22,161
Noninterest income	27,423	21,392	20,108	16,219	17,150
Noninterest expense	41,127	37,108	34,405	31,048	30,162
Income before income tax	11,368	8,183	8,885	7,689	9,149
Income tax expense	2,419	1,156	1,481	1,155	1,796
Net income	$ 8,949	$ 7,027	$ 7,404	$ 6,534	$ 7,353
Financial Condition					
Total assets	$ 785,231	$ 720,761	$ 679,058	$ 663,186	$ 662,992
Total deposits	675,458	609,730	565,553	562,721	572,405
Net loans	485,174	448,418	407,405	385,304	374,275
Long-term debt	—	10,078	10,247	10,390	10,527
Short-term debt	10,006	10,873	15,803	—	—
Trust preferred capital notes	5,155	5,155	5,155	10,310	15,465
Shareholders' equity	86,762	77,906	75,957	70,610	61,824
Average assets	774,680	710,007	667,260	661,669	655,170
Average shareholders' equity	84,096	79,296	73,473	62,981	56,790
Key Financial Ratios					
Return on average assets	1.16%	0.99%	1.11%	0.99%	1.12%
Return on average equity*	10.64%	8.86%	10.08%	10.37%	12.95%
Cash dividends paid as a percent of net income	23.09%	28.06%	25.16%	27.41%	22.70%
Per Share Data**					
Net income, assuming dilution	$ 2.17	$ 1.71	$ 1.82	$ 1.62	$ 1.84
Cash dividends declared	$ 0.51	$ 0.49	$ 0.47	$ 0.45	$ 0.425
Book value	$ 21.32	$ 19.34	$ 18.92	$ 17.71	$ 15.63

**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.*

***On July 18, 2014, the Board of Directors approved a 6 for 5 stock split of CFS's common stock payable on or before October 15, 2014. All per share information for all periods presented has been retroactively restated to reflect the stock split.*

	December 31, 2017	December 31, 2016
Assets		
Cash and due from banks	$ 15,873,514	$ 11,360,272
Interest-bearing deposits in banks and federal funds sold	1,757,084	1,450,456
Securities available for sale, at fair value	202,284,752	185,519,078
Other equity investments, at cost	2,300,300	2,689,500
Loans held for sale	1,141,000	405,000
Loans, net of allowance for loan losses of $4,495,279 in 2017 and $5,009,817 in 2016	485,173,646	448,417,820
Cash management accounts, net of allowance of $1,651,474 in 2017 and $1,434,008 in 2016	31,238,724	26,151,356
Premises and equipment, net	17,509,603	18,664,790
Accrued interest receivable	3,287,300	3,059,328
Bank-owned life insurance	14,431,127	14,050,748
Foreclosed assets	3,199,570	1,286,400
Other assets	7,034,210	7,706,032
Total assets	$ 785,230,830	$ 720,760,780
Liabilities and Shareholders' Equity		
Deposits:		
Demand accounts	$ 158,589,012	$ 144,458,129
Savings and interest-bearing demand deposits	309,422,627	278,422,884
Certificates of deposit		
Denominations less than $250,000	164,341,599	165,583,108
Denominations of $250,000 or more	43,104,624	21,266,015
Total deposits	$ 675,457,862	$ 609,730,136
Trust preferred capital notes	5,155,000	5,155,000
Long-term debt	—	10,077,957
Short-term debt	10,006,161	10,872,614
Accrued interest payable	170,698	129,386
Accrued expenses and other liabilities	7,679,087	6,889,784
Total liabilities	$ 698,468,808	$ 642,854,877
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 4,068,675 in 2017 and 4,027,276 in 2016	20,140,995	19,873,415
Common stock, nonvoting, par value $5 per share; authorized 635,000 shares; no shares outstanding	—	—
Additional paid-in capital	1,516,257	1,133,078
Retained earnings	60,062,597	54,323,553
Accumulated other comprehensive income	5,042,173	2,575,857
Total shareholders' equity	$ 86,762,022	$ 77,905,903
Total liabilities and shareholders' equity	$ 785,230,830	$ 720,760,780

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

CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31,	
	2017	**2016**
Interest and Dividend Income		
Interest and fees on loans	$ 23,447,512	$ 21,840,541
Interest on interest-bearing deposits and federal funds sold	5,951	9,953
Interest and dividends on securities available for sale:		
Taxable	1,770,152	1,889,289
Nontaxable	4,436,158	4,015,142
Dividends	138,966	134,450
Total interest and dividend income	$ 29,798,739	$ 27,889,375
Interest Expense		
Savings and interest-bearing accounts	$ 911,068	$ 772,526
Certificates of deposit	2,272,369	2,139,186
Short-term debt	459,228	413,968
Long-term debt and trust preferred capital notes	134,253	114,732
Total interest expense	$ 3,776,918	$ 3,440,412
Net interest income	$ 26,021,821	$ 24,448,963
Provision for loan losses	949,996	549,996
Net interest income after provision for loan losses	$ 25,071,825	$ 23,898,967
Noninterest Income		
Trust income and wealth management	$ 3,613,568	$ 3,457,601
Service charges	1,091,378	1,185,248
Net gain on sales of securities available for sale	73,095	262,418
Other-than-temporary impairment losses on investments	—	(150,550)
Merchant services income	13,300,014	9,668,166
Cash management fee income	3,760,144	3,165,219
Other income	5,584,594	4,213,363
Total noninterest income	$ 27,422,793	$ 21,801,465
Noninterest Expenses		
Salaries and benefits	$ 18,642,179	$ 18,256,451
Occupancy expenses	3,314,724	2,981,479
Net loss on other real estate owned	3,227	383,382
Merchant services expense	9,322,848	6,364,847
Provision for cash management account losses	120,000	99,996
Other expenses	9,723,988	9,431,842
Total noninterest expenses	$ 41,126,966	$ 37,517,997
Income before income taxes	$ 11,367,652	$ 8,182,435
Income tax expense	2,418,719	1,156,035
Net income	$ 8,948,933	$ 7,026,400
Earnings per common share, basic	$ 2.21	$ 1.75
Earnings per common share, diluted	$ 2.17	$ 1.71

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

	Years Ended December 31,	
	2017	**2016**
Net income	$ 8,948,933	$ 7,026,400
Other comprehensive income (loss):		
Unrealized holding gains (losses) on securities available for sale, net of tax (expense) benefit of ($867,946) and $1,522,270	$ 1,684,834	$ (2,954,993)
Reclassification adjustment, net of income tax expense of $24,853 and $38,036	(48,242)	(73,833)
Reclassifiation of accumulated comprehensive loss due to tax rate change	829,724	—
Other comprehensive income (loss), net of tax	$ 2,466,316	$ (3,028,826)
Comprehensive income	$ 11,415,249	$ 3,997,574

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

	Years Ended December 31, 2017	2016
Cash Flows from Operating Activities		
Net income	$ 8,948,933	$ 7,026,400
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,807,131	1,672,604
Provision for loan losses	949,996	549,996
Provision for cash management account losses	120,000	99,996
Deferred income tax expense (benefit)	446,245	(198,711)
Amortization of premiums, net	2,024,318	1,533,910
Net gain on securities available for sale	(73,095)	(262,418)
Net other-than-temporary impairment losses	—	150,550
Net loss on other real estate owned	3,227	238,207
Stock-based compensation	478,278	527,503
Origination of loans for sale	(34,180,793)	(33,947,615)
Proceeds from sale of loans	34,142,164	34,746,700
Gain on sale of loans	(697,371)	(626,085)
Changes in other assets and liabilities:		
Increase in accrued interest receivable	(227,972)	(321,653)
Increase in other assets	(990,638)	(497,442)
Increase in accrued interest payable	41,312	25,198
Increase in other liabilities	789,303	651,174
Net cash provided by operating activities	$ 13,581,038	$ 11,368,314
Cash Flows from Investing Activities		
Purchases of securities available for sale	$ (54,290,978)	$ (36,255,894)
Proceeds from sales and calls of securities available for sale	8,713,054	5,731,946
Proceeds from maturities and paydowns of securities available for sale	29,340,711	25,366,081
Redemption (purchase) of equity investments, net	389,200	(12,100)
Proceeds from sale of foreclosed assets	284,773	658,146
Net increase in loans	(39,906,992)	(41,667,494)
Net increase in cash management accounts	(5,207,368)	(1,912,879)
Other capital expenditures	(495,106)	(1,699,144)
Net cash used in investing activities	$ (61,172,706)	$ (49,791,338)

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

	Years Ended December 31,	
	2017	**2016**
Cash Flows from Financing Activities		
Net increase in demand accounts, interest-bearing demand accounts and savings accounts	$ 45,130,625	$ 30,574,980
Net increase in certificates of deposits	20,597,101	13,602,425
Exercise of stock options	590,232	554,816
Repurchase/Surrender of common stock	(895,938)	(1,230,795)
Cash dividends	(2,066,072)	(1,971,607)
Net decrease in short-term debt	(852,000)	(4,951,000)
Curtailment of long-term debt and redemption of trust preferred securities	(10,092,410)	(148,893)
Net cash provided by financing activities	$ 52,411,538	$ 36,429,926
Net increase (decrease) in cash and cash equivalents	$ 4,819,870	$ (1,993,098)
Cash and cash equivalents at beginning of year	12,810,728	14,803,826
Cash and cash equivalents at end of year	$ 17,630,598	$ 12,810,728
Supplemental Disclosures of Cash Flow Information		
Cash paid during the year for:		
Interest	$ 3,735,605	$ 3,415,214
Income taxes	$ 1,983,000	$ 841,000
Supplemental Schedule of Noncash Investing and Financing Activities		
Unrealized gain (loss) on securities available for sale	$ 2,479,685	$ (4,589,132)
Other real estate acquired in settlement of loans	$ 2,201,170	$ 104,261
Issuance of common stock for services	$ 164,094	$ 71,253

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

Years Ended December 31, 2017 and 2016

	Common Stock, Voting	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance, December 31, 2015	$ 19,771,365	$ 834,401	$ 49,746,710	$ 5,604,683	$ 75,957,159
Net income	—	—	7,026,400	—	7,026,400
Other comprehensive loss	—	—	—	(3,028,826)	(3,028,826)
Exercise of stock options	249,120	3 05,696	—	—	554,816
Vesting of restricted stock	150,750	(150,750)	—	—	—
Stock awards surrendered in cashless exercise	(188,490)	(321,774)	(218,937)	—	(729,201)
Issuance of common stock for services	20,300	50,953	—	—	71,253
Repurchase of common stock	(129,630)	(112,951)	(259,013)	—	(501,594)
Stock-based compensation	—	5 27,503	—	—	527,503
Cash dividends ($0.49 per share)	—	—	(1,971,607)	—	(1,971,607)
Balance, December 31, 2016	$ 19,873,415	$ 1,133,078	$ 54,323,553	$ 2,575,857	$ 77,905,903
Net income	—	—	8,948,933	—	8,948,933
Other comprehensive income	—	—	—	1,636,592	1,636,592
Reclassification of stranded AOCI	—	—	(829,724)	829,724	—
Exercise of stock options	271,200	319,032	—	—	590,232
Vesting of restricted stock	138,120	(138,120)	—	—	—
Stock awards surrendered in cashless exercise	(132,090)	(358,166)	(164,235)	—	(654,491)
Issuance of common stock for services	39,070	125,024	—	—	164,094
Repurchase of common stock	(48,720)	(42,869)	(149,858)	—	(241,447)
Stock-based compensation	—	478,278	—	—	478,278
Cash dividends ($0.51 per share)	—	—	(2,066,072)	—	(2,066,072)
Balance, December 31, 2017	$ 20,140,995	$ 1,516,257	$ 60,062,597	$ 5,042,173	$ 86,762,022

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 Wealth Management, Inc. ("CWM"), and CFS Capital Trust II (the "Trust"). The consolidated financial statements include the accounts of CFS and its wholly-owned subsidiaries, except for the Trusts, which is not a consolidated subsidiary of the Company. The subordinated debt payable to the Trust by the Company is reported as a liability of the Company. All significant intercompany accounts have been eliminated.

Subsequent Events

Subsequent events have been considered through February 16, 2018, the same date on which these consolidated financial statements were issued.

Significant Accounting Policies

The accounting and reporting policies of CFS are in accordance with accounting principles generally accepted in the United States of America and conform to general practices within the banking industry. The more significant of these policies are summarized below.

Securities

Debt securities that management has the positive intent and ability to hold to maturity are classified as "held to maturity" and recorded at amortized cost. Trading securities are recorded at fair value with changes in fair value included in earnings. Securities not classified as held to maturity or trading, including equity securities with readily determinable fair values, are classified as "available for sale" and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method. CFS classifies all securities as available for sale.

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, 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 includes 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, James City County, and Richmond 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:

Commercial: Commercial loans include both secured and unsecured loans for working capital, expansion, and other business purposes. Short-term working capital loans are secured by business assets. The Bank also makes term commercial loans secured by equipment and real estate. Lending decisions are based on an evaluation of the financial strength, cash flow, management and credit history of the borrower, and the quality of the collateral securing the loan. With few exceptions, the Bank requires personal guarantees and secondary sources of repayment. Commercial loans generally provide greater yields and re-price more frequently than other types of loans, such as real estate loans.

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.

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, personal bankruptcy or other life events.

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.

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. Generally, the Bank will return a loan to accrual status when all delinquent interest and principal becomes current and remains current for six consecutive months 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 collectability 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 general component of the allowance are made for each segment based on management's assessment of the state of the economy, delinquencies, exceptions to loan underwriting, monitoring policies, various trends, 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 observable 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 time of foreclosure at their fair value net of 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. Due to the passing and subsequent signing of the tax reform bill on December 22, 2017, the deferred tax asset was revalued and reduced against earnings by $394,480 in 2017 to reflect the effect of tax rate reduction.

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, interest bearing deposits, and federal funds sold.

Advertising Costs

CFS follows the policy of charging the production costs of advertising to expense as incurred.

Use of Estimates

In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the valuation of deferred tax assets, other-than-temporary impairments of securities, and the valuation of foreclosed assets.

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 restricted stock, are determined using the treasury stock method.

Cash Management Accounts

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

Stock-Based Compensation

Stock-based compensation accounting requires that the compensation cost relating to stock-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 stock compensation accounting guidance covers a wide range of stock-based compensation arrangements including stock options, restricted share plans, and performance-based awards.

The stock-based compensation accounting guidance requires that compensation cost for all stock awards be calculated and recognized over the employees' service periods, generally defined as the vesting period. Compensation cost is recognized on a straight-line basis over the requisite service period for the award. A Black-Scholes model is used to estimate the fair value of stock options, while the fair value of the Company's common stock at the date of grant is used for restricted awards. There were no options granted in 2016 or 2017.

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 17. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions significantly affect the estimates.

Assets Under Management

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

Recent Accounting Pronouncements

ASU 2014-09:

In May 2014, the Financial Accounting Standards Board ("FASB') issued guidance to change the recognition of revenue from contracts with customers. The core principle of the new guidance is that an entity should recognize revenue to reflect the transfer of goods and services to customers in an amount equal to the consideration the entity receives or expects to receive. The guidance will be effective for the Company for reporting periods beginning after December 15, 2017.

The Company will apply the guidance using a modified retrospective approach. The Company's revenue is comprised of net interest income and noninterest income. The scope of the guidance explicitly excludes net interest income as well as many other revenues for financial assets and liabilities including loans, leases, securities, and derivatives. Accordingly, the majority of our revenues will not be affected. The Company is currently assessing our revenue contracts related to revenue streams that are within the scope of the standard. Our accounting policies will not change materially since the principles of revenue recognition from the ASU are largely consistent with existing guidance and current practices applied by our businesses. We have not identified material changes to the timing or amount of revenue recognition. Based on the updated guidance, we do anticipate changes in our disclosures associated with our revenues. We will provide qualitative disclosures of our performance obligations related to our revenue recognition and we continue to evaluate disaggregation for significant categories of revenue in the scope of the guidance.

ASU 2015-14:

In August 2015, the FASB deferred the effective date of ASU 2014-09, Revenue from Contracts with Customers. As a result of the deferral, the guidance in ASU 2014-09 will be effective for the Company for reporting periods beginning after December 15, 2017. The Company will apply the guidance using a modified retrospective approach. The Company does not expect these amendments to have a material effect on its financial statements.

ASU 2016-01:

In January 2016, the FASB amended the Financial Instruments topic of the Accounting Standards Codification to address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. The amendments will be effective for fiscal years beginning after December 15, 2017, includ¬ing interim periods within those fiscal years. The Company will apply the guidance by means of a cu¬mulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily deter¬minable fair values will be applied prospectively to equity in¬vestments that exist as of the date of adoption of the amendments. The Company does not expect these amendments to have a material effect on its financial statements.

ASU 2016-02:

In February 2016, the FASB amended the Leases topic of the Accounting Standards Codification to revise certain aspects of recognition, measurement, presentation, and disclosure of leasing transactions. The amendments will be effective for fiscal years beginning after December 15, 2018, includ¬ing interim periods within those fiscal years. Early adoption is permitted.

The Company expects to adopt the guidance using the modified retrospective method and practical expedients for transition. The practical expedients allow us to largely account for our existing leases consistent with current guidance except for the incremental balance sheet recognition for lessees. The Company has started an initial evaluation of our leasing contracts and activities. The Company has also started developing our methodology to estimate the right-of-use assets and lease liabilities, which is based on the present value of lease payments (the December 31, 2017 future minimum lease payments were $497,000). The Company does not expect a material change to the timing of expense recognition, but we are early in the implementation process and will continue to evaluate the impact. The Company is evaluating our existing disclosures and may need to provide additional information as a result of adoption of the ASU.

ASU 2016-08:

In March 2016, the FASB amended the Revenue from Contracts with Customers topic of the Accounting Standards Codification to clarify the implementation guidance on principal versus agent considerations and address how an entity should assess whether it is the principal or the agent in contracts that include three or more parties. The amendments will be effective for the Company for reporting periods beginning after December 15, 2017. The Company does not expect these amendments to have a material effect on its financial statements.

ASU 2016-10:

In April 2016, the FASB amended the Revenue from Contracts with Customers topic of the Accounting Standards Codification to clarify guidance related to identifying performance obligations and accounting for licenses of intellectual property. The amendments will be effective for the Company for reporting periods beginning after December 15, 2017. The Company does not expect these amendments to have a material effect on its financial statements.

ASU 2016-12:

In May 2016, the FASB amended the Revenue from Contracts with Customers topic of the Accounting Standards Codification to clarify guidance related to collectability, noncash consideration, presentation of sales tax, and transition. The amendments will be effective for the Company for reporting periods beginning after December 15, 2017. The Company does not expect these amendments to have a material effect on its financial statements.

ASU 2016-13:

In June 2016, the FASB issued guidance to change the accounting for credit losses and modify the impairment model for certain debt securities. The amendments will be effective for the Company for reporting periods beginning after December 15, 2020. Early adoption is permitted for all organizations for periods beginning after December 15, 2018.

The Company will apply the amendments to the ASU through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption. While early adoption is permitted beginning in first quarter 2019, the Company does not expect to elect that option. The Company is evaluating the impact of the ASU on our consolidated financial statements. The Company expects the ASU will have no material impact on the recorded allowance for loan losses given the change to estimated losses over the contractual life of the loans adjusted for expected prepayments. In addition to our allowance for loan losses, the Company will also record an allowance for credit losses on debt securities instead of applying the impairment model currently utilized. The amount of the adjustments will be impacted by each portfolio's composition and credit quality at the adoption date as well as economic conditions and forecasts at that time.

ASU 2016-15:

In August 2016, the FASB amended the Statement of Cash Flows topic of the Accounting Standards Codification to clarify how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments will be effective for the Company for fiscal years beginning after December 15, 2017 including interim periods within those fiscal years. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

ASU 2016-16:

In October 2016, the FASB amended the Income Taxes topic of the Accounting Standards Codification to modify the accounting for intra-entity transfers of assets other than inventory. The amendments will be effective for the Company for fiscal years beginning after December 15, 2017 including interim periods within those fiscal years. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

ASU 2016-18:

In November 2016, the FASB amended the Statement of Cash Flows topic of the Accounting Standards Codification to clarify how restricted cash is presented and classified in the statement of cash flows. The amendments will be effective for the Company for fiscal years beginning after December 15, 2017 including interim periods within those fiscal years. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

ASU 2016-20:

In December 2016, the FASB issued technical corrections and improvements to the Revenue from Contracts with Customers Topic. These corrections make a limited number of revisions to several pieces of the revenue recognition standard issued in 2014. The effective date and transition requirements for the technical corrections will be effective for the Company for reporting periods beginning after December 15, 2017. The Company will apply the guidance using a full retrospective approach. The Company does not expect these amendments to have a material effect on its financial statements.

ASU 2017-01:

In January 2017, the FASB issued guidance to clarify the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The amendment to the Business Combinations Topic is intended to address concerns that the existing definition of a business has been applied too broadly and has resulted in many transactions being recorded as business acquisitions that in substance are more akin to asset acquisitions. The guidance will be effective for the Company for reporting periods beginning after December 15, 2017. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

ASU 2017-05:

In February 2017, the FASB amended the Other Income Topic of the Accounting Standards Codification to clarify the scope of the guidance on nonfinancial asset derecognition as well as the accounting for partial sales of nonfinancial assets. The amendments conform the derecognition guidance on nonfinancial assets with the model for transactions in the new revenue standard. The amendments will be effective for the Company for reporting periods beginning after December 15, 2017. The Company does not expect these amendments to have a material effect on its financial statements.

ASU 2017-08:

In March 2017, the FASB amended the requirements in the Receivables—Nonrefundable Fees and Other Costs Topic of the Accounting Standards Codification related to the amortization period for certain purchased callable debt securities held at a premium. The amendments shorten the amortization period for the premium to the earliest call date. The amendments will be effective for the Company for interim and annual periods beginning after December 15, 2018. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

ASU 2017-09:

In May 2017, the FASB amended the requirements in the Compensation—Stock Compensation Topic of the Accounting Standards Codification related to changes to the terms or conditions of a share-based payment award. The amendments provide guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting. The amendments will be effective for the Company for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

ASU 2018-02:

In February 2018, the FASB issued Income Statement – Reporting Comprehensive Income (Topic 220) which requires companies to reclassify the stranded effects in other comprehensive income to retained earnings as a result of the change in the tax rates under the Tax Cuts and Jobs Act. The Company has opted to early adopt this pronouncement by retrospective application to each period in which the effect of the change in the tax rate under the Tax Cuts and Jobs Act is recognized. The impact of this ASU was a reclassification from other comprehensive income to retained earnings is $829,724.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's financial position, results of operations or cash flows.

Reclassification

Certain items for prior years have been reclassified to conform to the current year presentation. Such reclassifications had no effect on net income, total assets or shareholders' equity as previously reported.

Note 2. Securities

Amortized cost and fair values of securities available for sale as of December 31, 2017 and 2016, are as follows:

2017				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities of state and political subdivisions	$ 136,143,821	$ 5,178,863	$ (101,145)	$ 141,221,539
Mortgage-backed securities	59,758,433	1,576,735	(271,955)	61,063,213
Total	$ 195,902,254	$ 6,755,598	$ (373,100)	$ 202,284,752

2016				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities of state and political subdivisions	$ 126,457,719	$ 3,887,998	$ (1,340,225)	$ 129,005,492
Mortgage-backed securities	54,658,546	1,642,320	(290,033)	56,010,833
Other domestic debt securities	500,000	2,753	—	502,753
Total	$ 181,616,265	$ 5,533,071	$ (1,630,258)	$ 185,519,078

The amortized cost and fair value of securities available for sale as of December 31, 2017, 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	$ 23,508,035	$ 23,698,378
Due after one year through five years	85,083,557	87,585,713
Due after five years through ten years	76,874,093	80,082,731
Due after ten years	10,436,569	10,917,930
Total	$ 195,902,254	$ 202,284,752

Proceeds from sales and calls of securities available for sale during 2017 and 2016 were $8,713,054 and $5,731,946, respectively. Gross realized gains amounted to $365,007 and $272,890 in 2017 and 2016. Gross realized losses amounted to $291,912 and $10,472 in 2017 and 2016, respectively. The tax provision applicable to these net realized gains amounted to $24,853 and $38,036 in 2017 and 2016, respectively.

The amortized cost of securities pledged to secure public deposits, borrowings from the Federal Home Loan Bank, fiduciary powers and for other purposes required or permitted by law amounted to $99,323,686 and $104,399,760 at December 31, 2017 and 2016, respectively.

Temporarily Impaired Securities

Information pertaining to securities with gross unrealized losses at December 31, 2017 and 2016, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	2017				
	Less Than 12 Months		12 Months or More		
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Total
Securities of state and political subdivisions	$ 4,986,523	$ 21,319	$ 3,775,699	$ 79,826	$ 8,863,367
Mortgage-backed securities	20,612,646	211,116	4,938,956	60,839	25,823,557
	$ 25,599,169	$ 232,435	$ 8,714,655	$ 140,665	$ 34,686,924

	2016				
	Less Than 12 Months		12 Months or More		
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Total
Securities of state and political subdivisions	$ 33,368,939	$ 1,340,225	$ —	$ —	$ 34,709,164
Mortgage-backed securities	17,106,660	146,946	10,759,470	143,087	28,156,163
	$ 50,475,599	$ 1,487,171	$ 10,759,470	$ 143,087	$ 62,865,327

Securities of State and Political Subdivisions

CFS's unrealized losses on investments in 10 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, 2017.

Mortgage-Backed Securities

The unrealized losses on CFS's investment in 20 government-sponsored enterprise mortgage-backed securities were caused by interest rate movements. CFS purchased those investments at a premium 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. CFS does not consider these investments to be other-than-temporarily impaired at December 31, 2017 due to the following:

- The decline in the market value is attributable to changes in interest rates and not credit quality;
- CFS does not intend to sell the investments;
- 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.

The unrealized losses associated with 22 private-label 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 the Company's assessment of the expected credit losses of the security given the performance of the underlying collateral, CFS has appropriately recognized the related other-than-temporary impairment losses in these private-label residential mortgage-backed securities during prior years. 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 management's OTTI analysis are private-label 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 an OTTI write-down or loss, CFS records the expected credit portion of the 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, 2016	$ 3,469,119
Amount related to the credit loss for which an other-than-temporary impairment was not previously recognized	—
Realized losses	—
Ending balance as of December 31, 2017	$ 3,469,119

Note 3. Loans

A summary of the balances of loans by segment follows:

	December 31,	
	2017	2016
Commercial	$ 154,459,502	$ 136,939,451
Commercial - Real Estate	231,974,724	214,116,057
Consumer - Non Real Estate	11,813,154	9,806,510
Residential - Real Estate	91,421,545	92,565,619
	$ 489,668,925	$ 453,427,637
Less: Allowance for loan losses	(4,495,279)	(5,009,817)
Loans, net	$ 485,173,646	$ 448,417,820

Overdrafts totaling $970,342 and $595,875 at December 31, 2017 and 2016, respectively, were reclassified from deposits to Consumer – Non Real Estate loans.

The following tables represent an analysis of the allowance for loan losses by segment:

	Commercial	Commercial - Real Estate	Consumer - Non Real Estate	Residential - Real Estate	Unallocated	Total
Year Ended December 31, 2017						
Balance beginning of year	$ 1,313,832	$ 2,678,330	$ 166,130	$ 757,193	$ 94,332	$ 5,009,817
Provision (recovery) for loan losses	(135,089)	1,115,282	173,075	(108,940)	(94,332)	949,996
Charge-offs	(105,290)	(1,249,241)	(222,965)	(49,583)	—	(1,627,079)
Recoveries	29,555	—	52,739	80,251	—	162,545
Total allowance for loan losses	$ 1,103,008	$ 2,544,371	$ 168,979	$ 678,921	$ —	$ 4,495,279
Individually evaluated for impairment	$ —	$ 541,112	$ 16,597	$ —	$ —	$ 557,709
Collectively evaluated for impairment	1,103,008	2,003,259	152,382	678,921	—	3,937,570
Total allowance for loan losses	$ 1,103,008	$ 2,544,371	$ 168,979	$ 678,921	$ —	$ 4,495,279
Individually evaluated for impairment	$ 4,166,675	$ 7,533,791	$ 16,597	$ 1,309,871	$ —	$ 13,026,934
Collectively evaluated for impairment	150,292,827	224,440,933	11,796,557	90,111,674	—	476,641,991
Total loans	$ 154,459,502	$ 231,974,724	$ 11,813,154	$ 91,421,545	$ —	$ 489,668,925

	Commercial	Commercial - Real Estate	Consumer - Non Real Estate	Residential - Real Estate	Unallocated	Total
Year Ended December 31, 2016						
Balance beginning of year	$ 2,205,066	$ 2,319,509	$ 115,924	$ 847,569	$ —	$ 5,488,068
Provision (recovery) for loan losses	380,845	358,821	123,291	(7,293)	94,332	949,996
Charge-offs	(1,443,382)	—	(147,473)	(145,170)	—	(1,736,025)
Recoveries	171,303	—	74,388	62,087	—	307,778
Total allowance for loan losses	$ 1,313,832	$ 2,678,330	$ 166,130	$ 757,193	$ 94,332	$ 5,009,817
Individually evaluated for impairment	$ 64,010	$ 1,428,935	$ 101,897	$ —	$ —	$ 1,594,842
Collectively evaluated for impairment	1,249,822	1,249,395	64,233	757,193	94,332	3,414,975
Total allowance for loan losses	$ 1,313,832	$ 2,678,330	$ 166,130	$ 757,193	$ 94,332	$ 5,009,817
Individually evaluated for impairment	$ 4,817,564	$ 5,896,122	$ 101,897	$ 743,746	$ —	$ 11,559,329
Collectively evaluated for impairment	132,121,887	208,219,935	9,704,613	91,821,873	—	441,868,308
Total loans	$ 136,939,451	$ 214,116,057	$ 9,806,510	$ 92,565,619	$ —	$ 453,427,637

During 2016, the Company elected to reclass $400,000 from the cash management reserve provision to the Company's loan loss provision. During 2013, the Company elected to move a large, non-performing cash management account to the loan portfolio based on modifications to the account and to aid in collections of the account. A portion of this cash management account was subsequently charged off in 2015 and 2016, with these charge-offs being applied to the Allowance for Loan Losses. Based on the nature of this account, the Company felt that these charge-offs were more applicable to the cash management reserve, and as a result, determined that the reclass for $400,000 was reasonable in order to properly reflect the level of risk within both the loan portfolio and the cash management portfolio.

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2017					
With no related allowance:					
Commercial					
Secured	$ 4,166,675	$ 4,166,675	$ —	$ 4,258,870	$ 231,760
Commercial - Real Estate					
Acquisition and development	721,340	721,340	—	574,799	10,820
Non-owner occupied	2,136,975	2,136,975	—	1,501,517	42,256
Owner occupied	1,021,430	1,021,430	—	1,147,789	69,718
Multifamily	—	—	—	254,637	—
Residential - Real Estate					
First lien 1-4 family	324,831	324,831	—	541,997	27,425
Land	332,129	332,129	—	338,838	9,377
Revolving	652,911	652,911	—	630,114	36,099
With an allowance recorded:					
Commercial					
Secured	$ —	$ —	$ —	$ 253,082	$ —
Commercial - Real Estate					
Non-owner occupied	3,254,713	3,254,713	491,112	3,187,002	130,188
Owner occupied	399,333	399,333	50,000	—	22,684
Consumer - Non Real Estate					
Installment	16,597	16,597	16,597	58,367	195
Total:					
Commercial	$ 4,166,675	$ 4,166,675	$ —	$ 4,511,952	$ 231,760
Commercial - Real Estate	7,533,791	7,533,791	541,112	6,665,744	275,666
Consumer - Non Real Estate	16,597	16,597	16,597	58,367	195
Residential - Real Estate	1,309,871	1,309,871	—	1,510,949	72,901
	$ 13,026,934	$ 13,026,934	$ 557,709	$ 12,747,012	$ 580,522

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2016					
With no related allowance:					
Commercial					
Secured	$ 4,751,465	$ 4,751,465	$ —	$ 1,869,783	$ 225,783
Commercial - Real Estate					
Acquisition and development	—	—	—	217,009	—
Owner occupied	960,572	960,572	—	877,795	54,517
Consumer - Non Real Estate					
Installment	—	—	—	20,487	—
Residential - Real Estate					
First lien 1-4 family	95,161	95,161	—	236,641	9,594
Land	346,664	346,664	—	288,298	11,668
Revolving	301,921	301,921	—	185,545	17,970
With an allowance recorded:					
Commercial					
Secured	$ 66,099	$ 66,099	$ 64,010	$ 613,417	$ 3,835
Unsecured	—	—	—	86,059	—
Commercial - Real Estate					
Non-owner occupied	4,935,550	4,935,550	1,428,935	5,016,222	101,164
Owner occupied	—	—	—	259,792	—
Consumer - Non Real Estate					
Installment	101,897	101,897	101,897	124,055	1,728
Revolving	—	—	—	640	—
Residential - Real Estate					
First lien 1-4 family	—	—	—	56,618	—
Revolving	—	—	—	291,910	—
Total:					
Commercial	$ 4,817,564	$ 4,817,564	$ 64,010	$ 2,569,259	$ 229,618
Commercial - Real Estate	5,896,122	5,896,122	1,428,935	6,370,818	155,681
Consumer - Non Real Estate	101,897	101,897	101,897	145,182	1,728
Residential - Real Estate	743,746	743,746	—	1,059,012	39,232
	$ 11,559,329	$ 11,559,329	$ 1,594,842	$ 10,144,271	$ 426,259

Included in impaired loans are troubled debt restructurings. At December 31, 2017 and 2016, $927,318 and $6,122,312 in loans were classified as 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.

There were no loans modified in a troubled debt restructuring during 2017.

Information regarding loans modified as troubled debt restructurings by class during 2016 are as follows:

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Residential - Real Estate			
Land	1	$ 193,929	$ 193,929

There were no troubled debt restructurings that subsequently defaulted (more than 90 days past due or charge-off) within the first year of modification during 2017 and 2016.

At December 31, 2017, no additional funds were committed to be advanced in connection with impaired loans.

The Bank's 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.

The Bank's credit quality information, which is based on internal risk grades is as follows:

	Pass	Watch	Special Mention	Substandard	Doubtful	Total
December 31, 2017						
Commercial						
Secured	$ 135,601,691	$ 6,150,293	$ 664,839	$ 4,100,161	$ —	$ 146,516,984
Unsecured	7,801,500	100,000	41,018	—	—	7,942,518
Commercial - Real Estate						
Acquisition and development	15,482,578	—	—	721,340	—	16,203,918
Non-owner occupied	100,187,729	4,834,469	432,337	5,391,688	—	110,846,223
Owner occupied	88,461,899	110,567	2,987,248	778,665	—	92,338,379
Multifamily	12,070,932	515,272	—	—	—	12,586,204
Consumer - Non Real Estate						
Installment	7,608,503	—	—	85,078	16,597	7,710,178
Revolving	3,132,634	—	—	—	—	3,132,634
Other	970,342	—	—	—	—	970,342
Residential - Real Estate						
First lien 1-4 family	33,790,696	309,641	475,018	249,285	—	34,824,640
Junior lien 1-4 family	9,127,568	9,221	—	—	—	9,136,789
Construction	11,852,435	—	—	—	—	11,852,435
Land	6,606,856	21,697	54,854	350,820	—	7,034,227
Revolving	27,536,857	249,036	205,648	581,913	—	28,573,454
Total	$ 460,232,220	$ 12,300,196	$ 4,860,962	$ 12,258,950	$ 16,597	$ 489,668,925
December 31, 2016						
Commercial						
Secured	$ 112,509,181	$ 735,557	$ 3,943,134	$ 4,031,622	$ —	$ 121,219,494
Unsecured	15,695,148	—	24,809	—	—	15,719,957
Commercial - Real Estate						
Acquisition and development	19,906,463	721,340	13,208	—	—	20,641,011
Non-owner occupied	87,473,478	6,691,003	1,262,356	—	2,599,240	98,026,077
Owner occupied	77,094,794	196,266	2,092,238	960,572	—	80,343,870
Multifamily	12,575,233	—	2,529,866	—	—	15,105,099
Consumer - Non Real Estate						
Installment	6,968,910	—	282,641	149,444	117,945	7,518,940
Revolving	1,690,694	—	—	1,000	—	1,691,694
Other	595,876	—	—	—	—	595,876
Residential - Real Estate						
First lien 1-4 family	36,508,739	155,011	395,112	282,519	—	37,341,381
Junior lien 1-4 family	8,080,512	27,303	7,780	—	—	8,115,595
Construction	8,892,266	—	—	—	—	8,892,266
Land	6,455,232	28,560	22,598	370,962	—	6,877,352
Revolving	30,237,929	202,330	397,599	501,167	—	31,339,025
Total	$ 424,684,455	$ 8,757,370	$ 10,971,341	$ 6,297,286	$ 2,717,185	$ 453,427,637

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

	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Nonaccruals	Current	Total Loans
December 31, 2017							
Commercial							
Secured	$ 8,099	$ 9,995	$ —	$ 18,094	$ 282,905	$ 146,215,985	$ 146,516,984
Unsecured	—	—	—	—	36,272	7,906,246	7,942,518
Commercial Real Estate							
Acquisition and development	—	—	—	—	721,340	15,482,578	16,203,918
Non-owner occupied	125,602	—	—	125,602	2,011,373	108,709,248	110,846,223
Owen occupied	—	—	—	—	755,832	91,582,547	92,338,379
Multifamily	—	—	—	—	—	12,586,204	12,586,204
Consumer - Non Real Estate							
Installment	2,634	3,624	—	6,258	16,597	7,687,323	7,710,178
Revolving	—	—	—	—	—	3,132,634	3,132,634
Other	12,914	—	—	12,914	—	957,428	970,342
Residential - Real Estate							
First lien 1-4 family	—	—	—	—	690,860	34,133,780	34,824,640
Junior lien 1-4 family	—	—	—	—	9,221	9,127,568	9,136,789
Construction	—	—	—	—	—	11,852,435	11,852,435
Land	—	—	—	—	427,371	6,606,856	7,034,227
Revolving	32,428	19,785	—	52,213	217,893	28,303,348	28,573,454
Total	$ 181,677	$ 33,404	$ —	$ 215,081	$ 5,169,664	$ 484,284,180	$ 489,668,925
December 31, 2016							
Commercial							
Secured	$ —	$ 9,993	$ —	$ 9,993	$ 1,255,786	$ 119,953,715	$ 121,219,494
Unsecured	12,955	4,921	—	17,876	—	15,702,081	15,719,957
Commercial Real Estate							
Acquisition and development	—	—	—	—	13,208	20,627,803	20,641,011
Non-owner occupied	—	—	—	—	2,599,240	95,426,837	98,026,077
Owen occupied	53,898	—	—	53,898	958,499	79,331,473	80,343,870
Multifamily	—	—	—	—	—	15,105,099	15,105,099
Consumer - Non Real Estate							
Installment	9,009	14,544	—	23,553	62,453	7,432,934	7,518,940
Revolving	—	—	—	—	—	1,691,694	1,691,694
Other	9,390	—	—	9,390	—	586,486	595,876
Residential - Real Estate							
First lien 1-4 family	30,973	—	—	30,973	524,202	36,786,206	37,341,381
Junior lien 1-4 family	—	—	—	—	18,896	8,096,699	8,115,595
Construction	—	—	—	—	—	8,892,266	8,892,266
Land	—	—	—	—	408,151	6,469,201	6,877,352
Revolving	—	5,237	—	5,237	476,246	30,857,542	31,339,025
Total	$ 116,225	$ 34,695	$ —	$ 150,920	$ 6,316,681	$ 446,960,036	$ 453,427,637

There were no loans 90+ days past due and still accruing at December 31, 2017 and 2016, respectively.

Note 4. Premises and Equipment

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

	December 31,	
	2017	2016
Land	$ 4,612,979	$ 4,645,478
Buildings	19,202,044	19,195,930
Furniture, fixtures and improvements	2,300,149	2,109,410
Equipment	6,969,232	6,853,652
Leasehold improvements	4,061,024	4,024,904
	$ 37,145,428	$ 36,829,374
Less accumulated depreciation	(19,635,825)	(18,164,584)
Total	$ 17,509,603	$ 18,664,790

For the years ended December 31, 2017 and 2016, depreciation expense was $1,650,293 and $1,477,530, respectively.

Note 5. Time Deposits

Remaining maturities on certificates of deposit are as follows:

2018	$ 123,801,001
2019	39,781,836
2020	5,465,786
2021	10,255,073
2022	14,043,527
Thereafter	14,099,000
	$ 207,446,223

The Bank obtains certain deposits through the efforts of third-party brokers. At December 31, 2017 and 2016, brokered deposits totaled $37,209,000 and $37,735,000, respectively, and were included in certificates of deposit on the consolidated balance sheets.

Note 6. Trust Preferred Capital Notes

On July 2, 2007, CFS Capital Trust II, was formed by the Company for the purpose of issuing redeemable capital securities. Trust II is not a consolidated subsidiary of the Company. On July 5, 2007, $15.465 million of trust preferred securities which have a LIBOR-indexed floating rate of interest were issued. The weighted-average interest rate for the year ended December 31, 2017 was 2.57%. The interest rate as of December 31, 2017 was 2.72%. The securities have a mandatory redemption date of October 1, 2037, and became subject to varying call provisions beginning on September 6, 2012.

In August 2014, CFS was notified that $5.0 million of the $15.0 million in trust preferred securities of Trust II would be auctioned off as part of a larger pooled collateralized debt obligation liquidation. CFS placed a bid of $3.9 million for the securities which was accepted by the trustee and the transaction closed on September 5, 2014. Because the accepted bid of $3.9 million was less than the $5.0 million carrying value, CFS recognized a gain of $1.1 million related to this transaction, when these securities were redeemed.

In January 2015, CFS was notified that $5.0 million of the $10.0 million remaining in trust preferred securities of Trust II would be auctioned off as part of a larger pooled collateralized debt obligation liquidation. CFS placed bids totaling $3.9 million for the securities which were accepted by the trustee and the transactions closed on February 5, 2015 and February 13, 2015. Because the accepted bids of $3.9 million were less than the $5.0 million carrying value, CFS recognized a gain of $1.1 million related to the transactions, when these securities were redeemed.

As of December 31, 2017, $5.0 million in preferred stock and $155,000 in common stock of Trust II was still outstanding.

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 7. Borrowings

The Bank has lines of credit with the FHLB that can equal up to 3% of total assets of the Bank. As of December 31, 2017, loans with a carrying value of $22,639,571 and securities with an amortized cost of $13,508,671 were pledged to the FHLB as collateral for borrowings. The FHLB lines of credit totaled $195 million with approximately $185 million available at December 31, 2017. Additional loans are available that can be pledged as collateral for future borrowings from the FHLB above the current lendable collateral value.

As of December 31, 2017, the Bank had fixed-rate, short-term borrowings of $10.0 million outstanding with the FHLB. The interest rates on short-term advances from the FHLB ranged from 3.21% to 3.435% with a weighted average interest rate of 3.32% as of December 31, 2017. The Bank also maintains an additional secured line of credit with another correspondent bank totaling $20.0 million, of which there was no outstanding balance as of December 31, 2017.

In addition to the available credit from the FHLB, the Bank also has unsecured lines of credit with correspondent banks totaling $46.5 million available for overnight borrowings and a line of credit secured by 400,000 shares of Chesapeake Bank common stock with a correspondent bank totaling $5.0 million available for borrowing as of December 31, 2017. There were no outstanding balances on these lines of credit as of December 31, 2017 and 2016.

Note 8. Income Taxes

The Tax Cuts and Jobs Act (TCJA) was signed into law by the President on Friday December 22, 2017. The TCJA includes the reduction in the corporate tax rate from a top rate of 34% to a flat rate of 21%, changes in business deductions, and many international provisions.

The company recognized the income tax effects of the 2017 Tax Act in its 2017 financial statements in accordance with Staff Accounting Bulletin No. 118, which provides guidance for the application of ASC Topic 740, Income Taxes, in the reporting period in which the 2017 Tax Act was signed into law. As such, the company's financial results reflect the income tax effects of the 2017 Tax Act for which the accounting under ASC Topic 740 is complete and provisional amounts for those specific income tax effects of the 2017 Tax Act for which the accounting under ASC Topic 740 is incomplete but a reasonable estimate could be determined. The Company did not identify items for which the income tax effects of the 2017 Tax Act have not been completed and a reasonable estimate could not be determined as of December 31, 2017.

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, 2017 and 2016, due to the following:

	December 31,	
	2017	2016
Income tax at federal statutory rate	$ 3,865,001	$ 2,782,028
(Decrease) increase in income taxes resulting from:		
Tax exempt income	(1,617,267)	(1,478,208)
Remeasurement of deferred taxes under TCJA	394,480	—
Other	(223,495)	(147,785)
Total	$ 2,418,719	$ 1,156,035

The provision for income taxes charged to operations for the years ended December 31, 2017 and 2016, consists of the following:

	2017	2016
Current tax expense	$ 1,972,474	$ 1,354,746
Deferred tax expense (benefit)	446,245	(198,711)
Total	$ 2,418,719	$ 1,156,035

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

	December 31,	
	2017	2016
Deferred tax assets:		
Allowance for loan and cash management account losses	$ 1,290,819	$ 2,190,901
Other real estate	146,625	237,392
Deferred compensation	72,162	19,420
Premises and equipment	361,201	319,336
Restricted stock	64,013	104,010
AMT tax credit carryforward	384,155	647,302
Other	39,252	115,836
	$ 2,358,227	$ 3,634,197
Deferred tax liabilities:		
Securities available for sale	$ 1,340,324	$ 1,326,956
Net deferred tax assets	$ 1,017,903	$ 2,307,241

CFS, on a consolidated basis, files income tax returns in the U.S. federal jurisdiction, the Commonwealth of Virginia and other states where income is generated. With few exceptions, CFS is no longer subject to U.S. federal or state income tax examinations by tax authorities for years before 2014.

The Company measures deferred tax assets and liabilities using enacted tax rates that will apply in the years in which the temporary differences are expected to be recovered or paid. Accordingly, the company's deferred tax assets and liabilities were remeasured to reflect the reduction in the U.S. corporate income tax rate from 34 percent to 21 percent, resulting in a $394,480 increase in income tax expense for the year ended December 31, 2017 and a corresponding $394,480 decrease in net deferred tax assets as of December 31, 2017.

The Company has analyzed the tax positions taken or expected to be taken in its tax returns and concluded it has no liability related to uncertain tax positions.

Note 9. Employee Benefit Plans

Deferred Compensation Agreements

CFS has a deferred compensation agreement providing for monthly payments to an officer of the Company 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. The liability remaining is $23,628 and $57,117 for years ended December 31, 2017 and 2016, respectively.

CFS funded the deferred compensation commitment through life insurance policies on the officer. The officer is currently receiving benefits under this plan. CFS recorded income of $97,402 and $107,840 for years ended December 31, 2017 and 2016, respectively, for increasing cash value of these policies.

Employee Stock Ownership Plan

CFS sponsors an 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 at the discretion of the Board of Directors.

ESOP compensation expense was $300,000 for the years ended December 31, 2017 and 2016.

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 $523,245 and $501,073 for 2017 and 2016, respectively.

Note 10. Stock Option Plans

On April 1, 2005, CFS's shareholders approved a stock incentive plan under which options or restricted stock may be granted to certain key employees. The plan reserved 224,640 shares of voting common stock for issuance and expired on January 21, 2015. There was no compensation cost charged to income for those plans related to stock options for 2017.

On April 4, 2014, CFS's shareholders approved a stock incentive plan under which options or restricted stock may be granted to certain key employees. The plan originally reserved 420,000 shares of voting common stock for issuance and expires on January 16, 2024. There was no compensation cost charged to income for those plans related to stock options for 2017.

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. The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option-pricing model. 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. There were no options granted during the years ended December 31, 2017 and 2016.

A summary of the option activity under the plans at December 31, 2017 and changes during the year then ended are as follows:

	Shares	Exercise Price	Contractual Term	Intrinsic Value
Outstanding at December 31, 2016	180,840	$ 10.88		
Granted	—			
Exercised	(54,240)	10.88		
Expired	—	—		
Forfeited	—	—		
Outstanding at December 31, 2017	126,600	$ 10.88	2.6	$ 2,421,052
Options exercisable, end of year	126,600	$ 10.88	2.6	$ 2,421,052

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, 2017. This amount changes based on changes in the market value of CFS's stock.

The total intrinsic value of options exercised during the year ended December 31, 2017 and 2016 was $760,752 and $405,247, respectively. As of December 31, 2017 and December 31, 2016 there are no unrecognized compensation costs related to nonvested stock options granted under the plans.

Restricted Stock

The Company grants shares of restricted stock to key employees. These awards help align the interests of these employees with the interests of the shareholders of the Company by providing economic value directly related to increases in the value of the Company's common stock. The value of the stock awarded is established as the fair market value of the stock at the time of grant. The Company recognizes expense, equal to the total value of such awards, ratably over the vesting period of the stock grants. Restricted stock vests over 36 months based on the term of the award.

Nonvested restricted stock activity for the year ended December 31, 2017 is summarized in the following table:

	Shares	Weighted Average Grant Date Value
Nonvested at December 31, 2016	52,593	$ 16.82
Granted	16,525	25.25
Vested	(27,624)	16.38
Expired and Forfeited	(1,018)	19.98
Nonvested at December 31, 2017	40,476	$ 20.52

At December 31, 2017, there were no unrecognized compensation costs related to nonvested restricted stock granted under the 2005 Plan. At December 31, 2017, there was $553,412 in unrecognized compensation cost related to nonvested restricted stock granted under the 2014 Plan. This cost is expected to be recognized over the next 28 months. Stock based compensation expense for nonvested restricted stock totaled $478,278 and $527,503 during 2017 and 2016, respectively.

Note 11. Shareholders' Equity

During 2017 and 2016, CFS issued 7,814 shares and 4,060 shares, respectively, of common stock to its directors for partial compensation. Also, during 2017 and 2016, the Company purchased and retired 9,744 and 32,399, respectively of common stock.

Note 12. Commitments and Contingencies

CFS leases certain facilities and equipment under operating leases which expire at various dates through 2023. 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, 2017 are as follows:

Year Ending December 31,	
2018	$ 147,590
2019	132,354
2020	132,221
2021	47,750
2022	19,930
Thereafter	17,508
Total	$ 497,353

Rent expense under operating leases totaled $134,301 and $131,396 for the years ended December 31, 2017 and 2016, respectively.

Note 13. Related Party Transactions

Officers, directors and their affiliates had borrowings of $5,442,929 and $2,760,103 at December 31, 2017 and 2016, respectively, with the Bank.

Changes in borrowings during 2017 were as follows:

Balance, December 31, 2016	$ 2,760,103
Additions	3,174,060
Payments	(491,234)
Balance, December 31, 2017	$ 5,442,929

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 $4,044,347 and $3,318,317 as of December 31, 2017 and 2016, respectively.

Note 14. Other Income and Expenses

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

	2017	2016
Pair off fee income	$ 697,371	$ 626,085
Mortgage servicing fee income	562,216	546,424
ATM fee income	1,400,737	1,282,271
Other	2,924,270	1,349,005
Total	$ 5,584,594	$ 3,803,785

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

	2017	2016
Advertising	$ 818,348	$ 965,550
Software	1,522,452	1,171,639
Legal fees	368,620	443,729
FDIC assessments	277,487	353,884
Delivery and transportation	243,547	222,098
Stationery and supplies	368,927	360,436
Other	6,124,607	5,914,506
Total	$ 9,723,988	$ 9,431,842

Note 15. 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. Shares related to unvested restricted stock grants are included in the weighted average number of common shares outstanding because the holders participate in non-refundable dividends and have voting rights during the vesting period.

	2017	2016
Weighted average number of common shares, basic	4,048,910	4,022,143
Effect of dilutive stock options	83,005	88,883
Weighted average number of common shares and dilutive potential common stock used in diluted EPS	4,131,915	4,111,026

There were no antidilutive options for the years ended December 31, 2017 and 2016.

Note 16. 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, 2017 and 2016, the following financial instruments were outstanding whose contract amounts represent credit risk:

	Contract Amount	
	2017	2016
	(in thousands)	
Commitments to grant loans	$ 6,043	$ 10,019
Unfunded commitments under lines of credit	140,983	133,627
Commercial and standby letters of credit	2,424	3,093
Cash managment unfunded commitments	24,285	26,290

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The commitments for lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Bank, is based on management's credit evaluation of the customer.

Unfunded commitments under commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit usually do not contain a specified maturity date and may not be drawn upon to the total extent to which the Bank is committed. The amount of collateral obtained, if it is deemed necessary by the Bank, is based on management's credit evaluation of the customer.

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral supporting those commitments, if deemed necessary.

CFS maintains its cash accounts in several correspondent banks. The total amount by which cash on deposit in those banks exceeds the federally insured limits is approximately $3,076,566 at December 31, 2017.

Note 17. 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 municipal 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 Held For Sale

Loans held for sale include mortgage loans and are carried at the lower of cost or market value. The fair values of mortgage loans held for sale are based on current market rates from investors within the secondary market for loans with similar characteristics. Carrying value approximates fair value.

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.

Deposits

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 Debt

The carrying amounts of short-term debt maturing within 90 days approximate their fair values. Fair values of short-term debt is estimated using discounted cash flow analyses based on current market rates and similar types of borrowing arrangements.

Long-Term Debt

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 standings.

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, 2017 and 2016:

		Fair Value Measurements at December 31, 2017 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	$ 141,222	$ —	$ 141,222	$ —
Mortgage-backed securities	61,063	—	54,920	6,143

		Fair Value Measurements at December 31, 2016 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	$ 129,005	$ —	$ 129,005	$ —
Mortgage-backed securities	56,011	—	48,267	7,744
Other domestic debt securities	503	—	503	—

The following tables present the changes in Level 3 assets that are measured at fair value on a recurring basis for the years ended December 31, 2017 and 2016:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)					
		Total Realized/Unrealized Gains (Losses) Included in				
	Balance as of January 1, 2017	Net Income	Other Comprehensive Income	Purchases, Sales, Issuances, and Settlements, Net	Transfers in and/or Out of Level 3	Balance as of December 31, 2017
	(in thousands)					
Mortgage-backed securities	$ 7,744	$ —	$ (1,601)	$ —	$ —	$ 6,143

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)					
		Total Realized/Unrealized Gains (Losses) Included in				
	Balance as of January 1, 2016	Net Income	Other Comprehensive Income	Purchases, Sales, Issuances, and Settlements, Net	Transfers in and/or Out of Level 3	Balance as of December 31, 2016
	(in thousands)					
Mortgage-backed securities	$ 7,921	$ (151)	$ 1,340	$ (1,366)	$ –	$ 7,744

Assets Measured at Fair Value on a Nonrecurring Basis

Under certain circumstances, CFS makes adjustments to the fair value of certain assets and liabilities although they are not measured at fair value on a recurring 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, 2017 and 2016, for which a nonrecurring change in fair value has been recorded:

	Fair Value Measurements at December 31, 2017 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	$ –	$ –	$ 12,469
Other real estate owned	–	–	3,200

	Fair Value Measurements at December 31, 2016 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	$ –	$ –	$ 9,964
Other real estate owned	–	–	1,286

Fair Value Measurements at December 31, 2017				
	Fair Value	Valuation Techniques	Unobservable Inputs	Weighted Average
Assets				
Commercial	$ 4,166	Market comparables	Discount applied to market comparables [1]	100.0%
Commercial - Real Estate	6,993	Market comparables	Discount applied to market comparables [1]	93.0%
Residential - Real Estate	1,310	Market comparables	Discount applied to market comparables [1]	100.0%
Consumer - Non Real Estate	—	Market comparables	Discount applied to market comparables [1]	0.0%
Total Impaired Loans	$ 12,469			
Other Real Estate Owned	$ 3,200	Market comparables	Discount applied to market comparables [1]	85.0%
Total	$ 15,669			

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

Fair Value Measurements at December 31, 2016				
	Fair Value	Valuation Techniques	Unobservable Inputs	Weighted Average
Assets				
Commercial	$ 4,754	Market comparables	Discount applied to market comparables [1]	99.0%
Commercial - Real Estate	4,467	Market comparables	Discount applied to market comparables [1]	76.0%
Residential - Real Estate	743	Market comparables	Discount applied to market comparables [1]	100.0%
Consumer - Non Real Estate	—	Market comparables	Discount applied to market comparables [1]	0.0%
Total Impaired Loans	$ 9,964			
Other Real Estate Owned	$ 1,286	Market comparables	Discount applied to market comparables [1]	87.0%
Total	$ 11,250			

[1] A discount percentage is applied based on age of independent appraisals, selling costs, 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 of the Company's collateral is real estate. The value of real estate is determined utilizing an income or market valuation approach 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's financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans 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 as a foreclosed asset expense on the consolidated statements of income.

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

		Fair Value Measurements at December 31, 2017			
	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
Financial assets:			(in thousands)		
Cash and short-term investments	$ 17,631	$ 17,631	$ —	$ —	$ 17,631
Securities available for sale	202,285	—	196,142	6,143	202,285
Other equity securities	2,300	—	—	2,300	2,300
Loans, net	485,174	—	479,501	12,469	491,970
Cash management accounts, net	31,239	—	31,239	—	31,239
Accrued interest receivable	3,287	—	3,287	—	3,287
Financial liabilities:					
Deposits	$ 675,458	$ —	$ 673,989	$ —	$ 673,989
Trust preferred capital notes	5,155	—	4,055	—	4,055
Short-term debt	10,006	—	10,070	—	10,070
Accrued interest payable	171	—	171	—	171

		Fair Value Measurements at December 31, 2016			
	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
Financial assets:			(in thousands)		
Cash and short-term investments	$ 12,810	$ 12,810	$ —	$ —	$ 12,810
Securities available for sale	185,519	—	177,775	7,744	185,519
Other equity securities	2,690	—	—	2,690	2,690
Loans, net	448,418	—	446,968	9,964	456,932
Cash management accounts, net	26,151	—	26,151	—	26,151
Accrued interest receivable	3,059	—	3,059	—	3,059
Financial liabilities:					
Deposits	$ 609,730	$ —	$ 608,478	$ —	$ 608,478
Trust preferred capital notes	5,155	—	4,055	—	4,055
Long-term debt	10,078	—	10,351	—	10,351
Short-term debt	10,873	—	10,866	—	10,866
Accrued interest payable	129	—	129	—	129

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 18. 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.

The final rules implementing Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective for the Company on January 1, 2015 with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. The net unrealized gain or loss on available for sale securities is not included in computing regulatory capital. Management believes as of December 31, 2017, the Company and Bank meet all capital adequacy requirements to which they are subject.

When fully phased in on January 1, 2019, the Basel III Capital Rules will require the Company and the Bank to maintain (i) a minimum ratio of Common Equity Tier 1 capital to risk-weighted assets of at least 4.5%, plus a 2.5% "capital conservation buffer" (which is added to the 4.5% Common Equity Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum ratio of Common Equity Tier 1 capital to risk-weighted assets of at least 7.0% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of total capital (that is, Tier 1 plus Tier 2) to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation) and (iv) a minimum leverage ratio of 4.0%, calculated as the ratio of Tier 1 capital to average quarterly assets.

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2017:						
Total Capital (to Risk-Weighted Assets):						
Consolidated	$ 92,483	15.4%	$ 48,135	8.0%	N/A	
Chesapeake Bank	$ 88,045	14.7%	$ 47,821	8.0%	$ 59,777	10.0%
Tier 1 Capital (to Risk-Weighted Assets):						
Consolidated	$ 86,336	14.3%	$ 36,101	6.0%	N/A	
Chesapeake Bank	$ 81,898	13.7%	$ 35,866	6.0%	$ 47,821	8.0%
Tier 1 Capital (to Average Assets):						
Consolidated	$ 86,336	11.1%	$ 31,159	4.0%	N/A	
Chesapeake Bank	$ 81,898	10.6%	$ 30,938	4.0%	$ 38,672	5.0%
Common Equity Tier 1 Capital (to Risk-Weighted Assets)						
Consolidated	$ 81,413	13.5%	$ 27,076	4.5%	N/A	
Chesapeake Bank	$ 81,898	13.7%	$ 26,899	4.5%	$ 38,855	6.5%
As of December 31, 2016:						
Total Capital (to Risk-Weighted Assets):						
Consolidated	$ 85,200	15.1%	$ 45,245	8.0%	N/A	
Chesapeake Bank	$ 81,552	14.5%	$ 44,939	8.0%	$ 56,173	10.0%
Tier 1 Capital (to Risk-Weighted Assets):						
Consolidated	$ 78,756	13.9%	$ 33,933	6.0%	N/A	
Chesapeake Bank	$ 75,108	13.4%	$ 33,704	6.0%	$ 44,939	8.0%
Tier 1 Capital (to Average Assets):						
Consolidated	$ 78,756	11.0%	$ 28,731	4.0%	N/A	
Chesapeake Bank	$ 75,108	10.5%	$ 28,490	4.0%	$ 35,612	5.0%
Common Equity Tier 1 Capital (to Risk-Weighted Assets)						
Consolidated	$ 78,756	13.1%	$ 25,450	4.5%	N/A	
Chesapeake Bank	$ 75,108	13.4%	$ 25,278	4.5%	$ 36,513	6.5%

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, 2017 and 2016 the aggregate amounts of daily average required balances were approximately $1,982,000 and $1,846,000, respectively. These reserve requirements were covered by internal holdings.

Note 19. Accumulated Other Comprehensive Income

Changes in each component of accumulated other comprehensive income for the years ended December 31, 2017 and 2016 were as follows:

	Net Unrealized Gains (Losses) on Securities, Net
Balance at December 31, 2016	$ 2,575,857
Unrealized gains on securities available for sale, net of tax expense of ($867,946)	1,684,834
Reclassification adjustment, net of tax expense of $24,853	(48,242)
Reclassification of stranded AOCI	829,724
Balance at December 31, 2017	$ 5,042,173
Balance at December 31, 2015	$ 5,604,683
Unrealized losses on securities available for sale, net of tax benefit of $1,522,269	(2,954,993)
Reclassification adjustment, net of tax expense of $38,035	(73,833)
Balance at December 31, 2016	$ 2,575,857

Details regarding reclassifications out of accumulated other comprehensive income for the years ended December 31, 2017 and 2016 were as follows:

Reclassifications Out of Accumulated Other Comprehensive Income for the Year Ended December 31, 2017:

Details about AOCI Components	Amount Reclassified from AOCI	Affected Line Item in the Consolidated Income Statement
Realized gain on sale of securities	$ 73,095	Net gain on sales of securities available for sale
Income tax expense	(24,853)	Income tax expense
Stranded AOCI	829,724	Retained earnings
Total reclassifications	$ 877,966	Net of tax

Reclassifications Out of Accumulated Other Comprehensive Income for the Year Ended December 31, 2016:

Details about AOCI Components	Amount Reclassified from AOCI	Affected Line Item in the Consolidated Income Statement
Realized gain on sale of securities	$ 262,418	Net gain on sales of securities available for sale
Other-than-temporary impairment on securities	(150,550)	Net other-than-temporary impairment losses on investments
Income tax expense	(38,035)	Income tax expense
Total reclassifications	$ 73,833	Net of tax

Note 20. 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, 2017, the amount available for payment of additional dividends without prior regulatory approval from the Bank to the parent company is $13,761,752 or 15.86% of consolidated net assets.

Balance Sheets (Condensed)

	December 31,	
	2017	2016
Assets		
Cash	$ 910,903	$ 769,051
Investment in subsidiaries	88,736,612	79,957,307
Premises and equipment, net	1,688,370	1,838,972
Other assets	1,023,011	1,090,270
Total assets	$ 92,358,896	$ 83,655,600
Liabilities and Shareholders' Equity		
Borrowings	$ 6,161	$ 77,957
Trust preferred capital notes	5,155,000	5,155,000
Other liabilities	435,713	516,740
Shareholders' equity	86,762,022	77,905,903
Total liabilities and shareholders' equity	$ 92,358,896	$ 83,655,600

Statements of Income (Condensed)

	2017	2016
Income: Dividends from subsidiaries	$ 2,403,843	$ 1,703,058
Other	697,300	709,307
Total income	$ 3,101,143	$ 2,412,365
Expenses: Interest expense	$ 136,749	$ 114,153
Other expenses	1,361,594	1,318,329
Total expenses	$ 1,498,343	$ 1,432,482
Income before income taxes and equity in undistributed earnings of subsidiaries	$ 1,602,800	$ 979,883
Allocated income tax expense	203,227	273,762
Income before equity in undistributed earnings of subsidiaries	$ 1,806,027	$ 1,253,645
Equity in undistributed earnings of subsidiaries	7,142,906	5,772,755
Net income	$ 8,948,933	$ 7,026,400

Statements of Cash Flows (Condensed)

	2017	2016
Cash Flows from Operating Activities		
Net income	$ 8,948,933	$ 7,026,400
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	150,602	154,206
Equity in distributed earnings of subsidiaries	(7,142,906)	(5,772,755)
Stock-based compensation	478,278	527,503
Changes in other assets and liabilities:		
Decrease in other assets	231,544	115,894
(Decrease) increase in other liabilities	(81,025)	51,541
Net cash provided by operating activities	$ 2,585,426	$ 2,102,789
Cash Flows from Investing Activities		
Purchases of premises and equipment	$ —	$ (140,533)
Net cash used in investing activities	$ —	$ (140,533)
Cash Flows from Financing Activities		
Dividends paid	$ (2,066,072)	$ (1,971,607)
Curtailment of borrowings	(71,796)	(67,962)
Repurchase of common stock	(895,938)	(1,230,795)
Exercise of stock options	590,232	554,816
Net cash used in financing activities	$ (2,443,574)	(2,715,548)
Net increase (decrease) in cash	$ 141,852	$ (753,292)
Cash at beginning of year	769,051	1,522,343
Cash at end of year	$ 910,903	$ 769,051

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 Subsidiaries, which comprise the consolidated balance sheets as of December 31, 2017 and 2016, 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 consolidated financial statements (collectively, the financial statements).

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these 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 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 financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the 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 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 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 financial statements referred to above present fairly, in all material respects, the financial position of Chesapeake Financial Shares, Inc. and Subsidiaries as of December 31, 2017 and 2016, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Elliott Davis PLLC

Raleigh, North Carolina
February 16, 2018

Financial Overview: Chesapeake Financial Shares, Inc. (CFS or the Company) posted earnings of $8,948,933 for 2017. The return on average equity in 2017 was 10.6% and return on average assets was 1.6% compared to 8.9% and 1.0%, respectively, in 2016. At December 31, 2017, CFS had total assets of $785.2 million which was up 8.9% when compared to December 31, 2016. The Company ended 2017 with total gross loans of $489.7 million, and total deposits of $675.4 million, up 8.0% and 10.8%, respectively.

The current economic environment continued to cause competitive pricing pressures on loans. Despite the pressures mentioned, loan volume was up $36.2 million for 2017 which brought the average annual loan growth rate for the last five years to 5.6%. Total past due and nonaccrual loans decreased by $1,082,847 from December 31, 2016 to December 31, 2017. The loan loss reserve to gross loans less unearned discounts remained at an adequate level at December 31, 2017 of 0.92%. The deposit increase of 10.8% for 2017 brought the average annual deposit growth rate for the last five years to 3.8%.

Summary of Results of Operations: Earnings for 2017 were $8,948,933 or $2.17 per share (fully diluted) compared to $7,026,400 or $1.71 per share in 2016, an increase of $1,922,533. The 27.4% increase in net income resulted primarily due to increases in the net interest margin and growth in merchant card processing and cash management lines of business. Net interest income before the provision for loan losses was up 6.4% from 2016. There was a 27.3% increase or $5,880,354 in noninterest income excluding other than temporary impairment (OTTI), and noninterest expense increased by 10.8% or $4,018,534 in 2017 over 2016. The loss for OTTI decreased by $150,550, or 100%. Merchant services income and cash management fee income increased from the 2016 levels by $3,613,568 and $594,925 or 39.6% and 18.8%, respectively. Also, trust income and wealth management fees increased $155,967 in 2017 over 2016 or 4.5%. In addition to these factors, management also recognized gains on the sale of investment securities of $73,095.

Earnings for 2016 were $7,026,400 or $1.71 per share (fully diluted) compared to $7,404,340 or $1.82 per share in 2015, a decrease of $377,940. The 5.1% decrease in net income resulted largely due to a $1.1 million gain (pre-tax) taken on the retirement of the Company's trust preferred debt in 2015.

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 $489.7 million, $453.4 million, and $412.9 million as of December 31, 2017, 2016, and 2015, respectively, representing an increase of 8.0% at December 31, 2017 compared to December 31, 2016, 9.8% for 2016 from December 31, 2015, and 5.4% for December 31, 2015 to December 31, 2014. Commercial (including real estate and non-real estate combined) and consumer loan balances were up 10.1% or $35.3 million and 20.5% or $2.0 million, respectively. Residential loan balances were down 1.2% or $1.1 million.

On December 31, 2017, the loan portfolio consisted of 78.9% commercial loans, 18.7% single-family residential and residential construction loans, and 2.4% consumer and other loans. Commercial loans consisted primarily of business loans such as owner-occupied commercial development, retail, builders/contractors, medical, service and professional, hospitality, nonprofits, marine industry, and a small portion of agricultural and seafood loans.

Total nonperforming assets consisted of nonaccrual loans, performing restructured loans, repossessed and foreclosed properties, and other real estate owned. Nonperforming assets were $9,090,822 at December 31, 2017, which represented a 16.9% decrease from $10,936,961 at December 31, 2016. Past due loans over thirty days, excluding nonaccrual, totaled $215,081 at December 31, 2017. Nonaccrual loans were $5.2 million or 1.1% of total loans at December 31, 2017. 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. Any potential loss related to these loans has been incorporated in the allowance for loan losses.

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

The fair market value of the portfolio was $4,212,449 greater than amortized cost, net of the tax effect, at December 31, 2017, and was $2,575,857 more than amortized cost, net of the tax effect, at December 31, 2016. This is within risk limits established by the Board of Directors and the Asset/Liability Management Committee.

At December 31, 2017, total securities at fair market value were $202.3 million, up $16.8 million from $185.5 million on December 31, 2016. Investments in securities of state and political subdivisions increased by $12.2 million or 9.5%. Investments in mortgage-backed securities increased by $5.1 million or 9.0%. Other domestic debt securities declined by $502,753 or 100%.

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. Loans in a nonaccrual status and over 90 days past due are considered in this evaluation as well as other loans, which may be a potential loss. The status of nonaccrual and past due loans varies from quarter to quarter based on seasonality, local economic conditions, and the cash flow of customers. A general reserve is established for nonspecifically reserved loans.

The allowance for loan losses was $4,495,279 or 0.92% of gross loans less unearned discounts at December 31, 2017. This ratio was 1.1% on December 31, 2016, and 1.33% at December 31, 2015. The table below represents the provision for loan losses taken in years 2016 and 2017 as well as loans charged off and subsequent recoveries.

	2017	2016
Provision for loan losses	$ 949,996	$ 549,996
Loans charged off	1,627,079	1,736,026
Recoveries	162,545	307,778

Management and the Board of Directors believe that the total allowance at December 31, 2017 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 $675.4 million, $609.7 million, and $565.6 million, as of December 31, 2017, 2016, and 2015, respectively, and represented an increase of 10.8% for December 31, 2017 to December 31, 2016 and 7.8% for December 31, 2016 to December 31, 2015. The below table represents a breakdown of total deposits.

	2017	2016	Change	Percent Change
Demand deposits (noninterest bearing)	$ 158,589,012	$ 144,458,129	$ 14,130,883	9.8%
Savings & interest bearing deposits	309,422,627	278,422,884	30,999,743	11.1%
Certificates of deposit	207,446,223	186,849,123	20,597,100	11.0%
Total deposits	$ 675,457,862	$ 609,730,136	$ 65,727,726	10.78%

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 of Directors.

Net interest income totaled $26.0 million and $24.4 million, for 2017 and 2016, respectively, representing an increase of 6.4% for 2017 over 2016 and 4.4% for 2016 over 2015. Loan balances increased this year with total gross loans up 8% or $36.2 million for 2017 from 2016. Total interest expense was $3.8 million, $3.4 million, and $3.4 million for 2017, 2016, and 2015, respectively. On a consolidated tax equivalent annualized basis, the 2017 net interest margin was 4.3%. Margins have been well above peer through numerous rate cycles and through the recent recession.

Noninterest Income: For the year ended December 31, 2017, noninterest income was $27.4 million. This represents an increase in noninterest income of $5,880,356 for the year, excluding OTTI. Most of this increase is attributable to merchant discount income. Changes in noninterest income categories are highlighted below.

	2017	2016	Change	Percent Change
Other income	$ 4,183,856	$ 2,521,515	$ 1,662,341	65.9%
Merchant services income	13,300,014	9,668,166	3,631,848	37.6%
Cash management fee income	3,760,144	3,165,219	594,925	18.8%
ATM fee income	1,400,737	1,282,271	118,466	9.2%
Trust income and wealth management	3,613,568	3,457,601	155,967	4.5%
Service charge income	1,091,378	1,185,248	(93,870)	-7.9%
Gains on sale of securities	73,095	262,418	(189,323)	-72.1%
Total noninterest income	$ 27,422,792	$ 21,542,438	$ 5,880,354	27.3%

Noninterest income represented 47.9% 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 Wealth Management) and mortgage origination sold to a secondary market.

Noninterest Expenses: Total noninterest expenses increased 10.8%, or $4.0 million in 2017 over 2016. In 2016, total noninterest expenses increased 7.9% or $2.7 million over 2015. In 2017, the Company opened its fifth branch in a retirement community. These communities have proven to be a good source of deposits and asset gathering for the Company's wealth management and trust company. Salary and benefit costs increased by $765,306 million or 4.2% as a result of new hires and normal salary increases. Also, the Company realized increased merchant card expense as a result of higher processing volume in 2017. Below is a breakdown of other expenses for 2017 over 2016.

	2017	2016	Change	Percent Change
Merchant services expense	$ 9,322,848	$ 6,364,847	$ 2,958,001	46.5%
Provision for cash management account losses	120,000	99,996	20,004	20.0%
Delivery and transportation	243,547	222,098	21,449	9.7%
Software	1,522,452	1,171,639	350,813	29.9%
Miscellaneous other	6,124,607	5,914,506	210,101	3.6%
Stationery and supplies	368,927	360,436	8,491	2.4%
Advertising	818,348	965,550	(147,202)	-15.2%
Legal fees	368,620	443,729	(75,109)	-16.9%
FDIC assessments	277,487	353,884	(76,397)	-21.6%
Total other noninterest expenses	$ 19,166,836	$ 15,896,685	$ 3,270,151	20.6%

Liquidity, Interest Rate Sensitivity, and Inflation: The objectives of CFS's liquidity management policy include providing adequate funds to meet the needs of depositors and borrowers at all times, as well as providing funds to meet the basic needs for ongoing operations of CFS, and to allow funding of longer-term investment opportunities and regulatory requirements. The objective of providing adequate funding should be accomplished at reasonable costs and on a timely basis. Management considers CFS's liquidity to be adequate.

The Bank's primary sources of asset liquidity continue to be federal funds purchased, time deposits with other banks, securities maturing within one year, loan curtailments, and short-term borrowings.

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 $96.5 million, secured and unsecured. CFS has access to additional secured borrowing of $5.0 million.

As of December 31, 2017, the Bank held $3,199,570 in other real estate owned. These assets are being actively marketed through real estate channels and represent near term secondary sources of liquidity. The Company was able to dispose of one other real estate owned property during 2017.

Since the assets and liabilities of a bank are primarily monetary in nature (payable in fixed, determinable amounts), the performance of a bank is affected more by changes in interest rates than by inflation. Interest rates generally increase as the rate of inflation increases, but the magnitude of the change in rates may not be the same. Interest rate sensitivity refers to the difference between assets and liabilities subject to repricing, maturity, or volatility during a specified period. Management’s objective in controlling interest rate sensitivity is to reprice loans and deposits and make investments that will maintain a profitable net interest margin (see “Net Interest Income”).

While the effect of inflation is normally not as significant as its influence on those businesses that have large investments in plant and inventories, it does have an effect. There are normally corresponding increases in the money supply, and banks will normally experience above average growth in assets, loans and deposits. Also, general increases in the prices of goods and services will result in increased operating expenses.

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

Regulators have adopted minimum capital standards. The final rules implementing Basel Committee on Banking Supervision’s capital guidelines for U.S. banks (Basel III rules) became effective for the Company on January 1, 2015 with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. The net unrealized gain or loss on available for sale securities is not included in computing regulatory capital. Management believes as of December 31, 2017, the Company and Bank meet all capital adequacy requirements to which they are subject.

When fully phased in on January 1, 2019, the Basel III Capital Rules will require the Company and the Bank to maintain (i) a minimum ratio of Common Equity Tier 1 capital to risk-weighted assets of at least 4.5%, plus a 2.5% "capital conservation buffer" (which is added to the 4.5% Common Equity Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum ratio of Common Equity Tier 1 capital to risk-weighted assets of at least 7.0% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of total capital (that is, Tier 1 plus Tier 2) to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation) and (iv) a minimum leverage ratio of 4.0%, calculated as the ratio of Tier 1 capital to average quarterly assets.

The table below represents CFS's capital ratios as of December 31, 2017 and December 31, 2016.

	2017	2016
Total capital to risk-weighted assets	15.4%	15.3%
Tier 1 capital to risk-weighted assets	14.3%	14.2%
Tier 1 captial to average assets	11.1%	11.1%
Common equity tier 1 capital to risk-weighted assets	13.5%	13.3%

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 $0.51 per share in 2017, an increase of $0.02 over 2016. 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 2017 ranged from $20.50 to $30.00, and during 2016, from $17.251 to $22.51. 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 earnings over the past several years. At December 31, 2017, there were 4,068,675 shares of the Company's common stock outstanding held by approximately 219 holders of record. The Board of Directors of CFS approved the purchase and retirement of up to 12,500 shares of CFS stock in 2017 of which 9,744 shares were executed upon.

Income Taxes: The Company took a charge against earnings of $394,480 for the reduction of deferred tax assets as a result of the "Tax Cuts and Jobs Act" being signed into law on December 22, 2017.

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