

CHESAPEAKE FINANCIAL SHARES INC
Form 10QSB
November 13, 2002
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U. S. Securities and Exchange Commission
Washington, D.C. 20549

FORM 10-QSB

x **QUARTERLY REPORT UNDER SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2002

o **TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT**
For the transition period from _____ to _____

Commission file number 0-18543

CHESAPEAKE FINANCIAL SHARES, INC.

(Exact name of registrant as specified in its charter)

Virginia

54-1210845

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

97 N. Main St., Kilmarnock, VA

22482

(Address of principal executive offices)

(Zip Code)

(804) 435-1181

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report.)

The number of shares outstanding of each of the issuer's classes of common stock as of November 1, 2002.

| Class | Outstanding at November 1, 2002 |
|--|---------------------------------|
| Common Stock, voting, \$5.00 par value | 1,284,198 |
| Common Stock, non-voting, \$5.00 par value | 0 |

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Chesapeake Financial Shares, Inc.
Consolidated Balance Sheets

| | September 30, 2002 | December 31, 2001 |
|---|-----------------------|----------------------|
| | (Unaudited) | |
| ASSETS | | |
| Cash and due from banks | \$ 8,826,353 | \$ 12,298,550 |
| Federal funds sold | 12,000,000 | 7,674,000 |
| Securities available for sale | | |
| U.S. Government agencies (book value of \$20,762,304 -2002 and \$17,700,819-2001) | 21,253,377 | 17,965,367 |
| Obligations of state and political subdivisions (book value of \$16,631,698-2002 and \$15,151,912-2001) | 18,264,699 | 15,655,638 |
| Other Securities (book value \$1,535,395-2002 and \$2,480,027-2001) | 1,800,958 | 2,499,350 |
| Loans | 191,823,684 | 169,015,349 |
| Less: Allowance for loan loss | (2,913,807) | (2,540,577) |
| Net loans | 188,909,877 | 166,474,772 |
| Bank premises and equipment, net | 7,198,046 | 6,985,214 |
| Accrued interest receivable | 1,295,737 | 1,288,705 |
| Business Manager Assets | 16,445,959 | 10,882,704 |
| Other assets | 5,831,617 | 3,279,369 |
| Total assets | \$ 281,826,623 | \$ 245,003,669 |

See accompanying notes to consolidated financial statements.

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PART I. FINANCIAL INFORMATION (cont d)

Item 1. Financial Statements

Chesapeake Financial Shares, Inc.
Consolidated Balance Sheets

| | <u>September 30,</u> <u>2002</u> | <u>December 31,</u> <u>2001</u> |
|--|-------------------------------------|------------------------------------|
| | (Unaudited) | |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Deposits | | |
| Noninterest bearing deposits | \$ 41,148,655 | \$ 33,592,404 |
| Savings and interest bearing deposits | 96,098,404 | 83,345,883 |
| Certificates of deposit | 107,446,522 | 94,879,030 |
| Total deposits | 244,693,581 | 211,817,317 |
| Federal funds purchased and FHLB advances | 10,973,399 | 10,000,000 |
| Accrued interest payable | 224,507 | 255,482 |
| Other liabilities | 1,497,561 | 1,564,010 |
| Note payable | 768,442 | 791,922 |
| Total liabilities | 258,157,490 | 224,428,731 |
| Commitments and contingent liabilities | | |
| Stockholders' equity | | |
| Preferred stock, par value \$1 per share; authorized 50,000 shares; none outstanding | 0 | 0 |
| Common stock, voting, par value \$5 | 6,420,990 | 6,276,990 |
| Common stock, non-voting | 0 | 0 |
| | voting | non-voting |
| | <u>9/30/02</u> | <u>12/31/01</u> |
| | <u>9/30/02</u> | <u>12/31/01</u> |
| Shares auth. | 2,000,000 | 2,000,000 |
| Shares o/s.. | 1,284,198 | 1,255,398 |
| Paid in capital | 310,383 | 229,948 |
| Accumulated other comprehensive income | 1,577,160 | 514,534 |
| Retained earnings | 15,360,600 | 13,553,466 |
| Total stockholders' equity | 23,669,133 | 20,574,938 |
| Total liabilities and stockholders' equity | \$ 281,826,623 | \$ 245,003,669 |

See accompanying notes to consolidated financial statements.

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PART I. FINANCIAL INFORMATION (cont d)

Item 1. Financial Statements

Chesapeake Financial Shares, Inc.
Consolidated Statements of Earnings

| | Three Months Ended | |
|---|-----------------------|-----------------------|
| | September 30, 2002 | September 30, 2001 |
| (Unaudited) | | |
| Interest Income | | |
| Interest and fees on loans | \$ 3,419,689 | \$ 3,572,992 |
| Interest on federal funds sold | 29,324 | 62,726 |
| Interest on time deposits with banks | 1,873 | 3,552 |
| Interest on U.S. Agency Obligations | 276,324 | 305,649 |
| Interest on obligations of state and political subs | 229,507 | 222,448 |
| | <u>3,956,717</u> | <u>4,167,367</u> |
| Interest Expense | | |
| Interest on savings and interest bearing deposits | 328,757 | 429,597 |
| Interest on certificates of deposit | 919,786 | 1,330,744 |
| Interest on federal funds purchased | 62,518 | 62,926 |
| Other interest expense | 10,639 | 11,062 |
| | <u>1,321,700</u> | <u>1,834,329</u> |
| Net interest income | 2,635,017 | 2,333,038 |
| Provision for loan losses | 400,001 | 114,499 |
| | <u>2,235,016</u> | <u>2,218,539</u> |
| Noninterest Income | | |
| Income from fiduciary activities | 475,113 | 395,578 |
| Service charges on deposit accounts | 239,657 | 210,339 |
| Merchant card income | 357,185 | 292,260 |
| ATM income | 91,561 | 74,885 |
| Cash Management income | 715,942 | 495,329 |
| Other income | 226,720 | 132,662 |
| | <u>2,106,178</u> | <u>1,601,053</u> |
| Noninterest Expense | | |
| Salaries | 1,144,655 | 1,001,858 |
| Employee benefits | 285,976 | 261,759 |
| Occupancy expenses | 741,072 | 462,927 |
| Merchant card expense | 310,024 | 245,030 |
| ATM expense | 68,864 | 62,883 |
| Cash management expense | 175,397 | 192,543 |
| Other expenses | 553,210 | 653,837 |
| | <u>3,279,198</u> | <u>2,880,837</u> |

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| | | |
|---------------------------------------|------------|------------|
| Income before income taxes | 1,061,996 | 938,755 |
| Income taxes | 242,305 | 247,892 |
| Net income | \$ 819,691 | \$ 690,863 |
| Earnings per share, basic | \$ 0.64 | \$ 0.56 |
| Earnings per share, assuming dilution | \$ 0.62 | \$ 0.54 |
| Dividends per share | \$ 0.12 | \$ 0.11 |

See accompanying notes to consolidated financial statements.

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PART I. FINANCIAL INFORMATION (cont d.)

Item 1. Financial Statements

Chesapeake Financial Shares, Inc.
Consolidated Statement of Earnings

| | Nine Months Ended | |
|---|-----------------------|-----------------------|
| | September 30, 2002 | September 30, 2001 |
| | (Unaudited) | |
| Interest Income | | |
| Interest and fees on loans | \$ 10,016,217 | \$ 10,984,671 |
| Interest on federal funds sold | 115,620 | 92,743 |
| Interest on time deposits with banks | 5,948 | 17,815 |
| Interest on U.S. Agency Obligations | 926,390 | 989,697 |
| Interest on obligations of state and political subs | 676,897 | 676,308 |
| | <u>11,741,072</u> | <u>12,761,234</u> |
| Interest Expense | | |
| Interest on savings and interest bearing deposits | 962,083 | 1,340,103 |
| Interest on certificates of deposit | 2,836,470 | 4,329,292 |
| Interest on federal funds purchased | 181,893 | 291,039 |
| Other interest expense | 32,240 | 33,493 |
| | <u>4,012,686</u> | <u>5,993,927</u> |
| Net interest income | 7,728,386 | 6,767,307 |
| Provision for loan losses | 854,501 | 437,165 |
| | <u>6,873,885</u> | <u>6,330,142</u> |
| Noninterest Income | | |
| Income from fiduciary activities | 971,332 | 870,282 |
| Service charges on deposit accounts | 670,688 | 624,539 |
| Security gains (losses) net- | (2,335) | (1,625) |
| Merchant card income | 868,619 | 718,038 |
| ATM income | 243,687 | 199,629 |
| Cash Management income | 1,955,152 | 1,385,375 |
| Other income | 623,692 | 454,049 |
| | <u>5,330,835</u> | <u>4,250,287</u> |
| Noninterest Expense | | |
| Salaries | 3,299,830 | 2,977,367 |
| Employee benefits | 707,755 | 657,664 |
| Occupancy expenses | 1,656,968 | 1,319,815 |
| Merchant card expense | 756,064 | 632,077 |
| ATM expense | 210,468 | 180,527 |
| Cash management expense | 578,748 | 478,305 |
| Other expenses | 1,931,807 | 1,689,998 |
| | <u>11,141,670</u> | <u>9,938,753</u> |

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| | | |
|---------------------------------------|--------------|--------------|
| Total noninterest expense | 9,141,640 | 7,935,753 |
| Income before income taxes | 3,063,080 | 2,644,676 |
| Income taxes | 796,401 | 688,958 |
| Net income | \$ 2,266,679 | \$ 1,955,718 |
| Earnings per share, basic | \$ 1.78 | \$ 1.58 |
| Earnings per share, assuming dilution | \$ 1.74 | \$ 1.54 |
| Dividends per share | \$ 0.36 | \$ 0.33 |

See accompanying notes to consolidated financial statements.

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PART I. FINANCIAL INFORMATION (cont d)

Item 1. Financial Statements

Chesapeake Financial Shares, Inc.
Consolidated Statement of Cash Flows

| | Nine Months Ended | |
|---|-----------------------|-----------------------|
| | September 30, 2002 | September 30, 2001 |
| | (Unaudited) | |
| Cash flows from operating activities: | | |
| Net income | \$ 2,266,679 | \$ 1,955,718 |
| Adjustments to reconcile net income to net cash provided by (used for) operating activities: | | |
| Depreciation and amortization | 882,495 | 748,298 |
| Provision for loan losses | 854,501 | 437,165 |
| Provision for cash management account losses | 210,000 | 210,000 |
| (Accretion) of discount and amortization of premiums, net | 347,547 | 254,693 |
| Net loss on sale of securities | 2,335 | 1,625 |
| Changes in assets and liabilities: | | |
| Decrease (increase) in accrued interest receivable | (7,032) | 53,757 |
| Decrease (increase) in other assets. | (3,099,661) | (456,364) |
| Increase (decrease) in accrued interest payable | (30,975) | (121,337) |
| Increase (decrease) in other liabilities | (66,449) | 684,023 |
| Net cash provided by (used for) operating activities | 1,359,440 | 3,767,578 |
| Cash flows from investing activities: | | |
| Purchases of securities available for sale | (14,237,401) | (2,124,323) |
| Proceeds from sale or call of securities available for sale | 673,524 | 1,038,375 |
| Proceeds from maturities of securities available for sale | 9,625,355 | 2,664,709 |
| Origination of loans available for sale | (20,358,205) | (8,817,380) |
| Proceeds from sale of loans available for sale | 20,358,205 | 8,817,380 |
| Net (increase) decrease in loans outstanding | (23,289,606) | (6,054,984) |
| Net (increase) decrease in business manager assets | (5,773,255) | (1,775,066) |
| Other capital expenditures | (1,095,327) | (614,339) |
| Net cash provided by (used for) investing activities | (34,096,710) | (6,865,628) |
| Cash flows from financing activities: | | |
| Net increase (decrease) in demand accounts, interest bearing demand deposit accounts and savings deposits | 20,308,772 | 16,536,727 |
| Net increase (decrease) in certificates of deposit | 12,567,492 | (4,825,941) |
| Net increase (decrease) in federal funds purchased | 973,399 | (4,500,000) |
| Cash dividends | (459,545) | (410,265) |
| Proceeds from issuance of voting common stock | 224,435 | 119,000 |
| Acquisition of voting common stock | 0 | (9,150) |
| Curtailement of long-term borrowings | (23,480) | (22,226) |
| Net cash provided by (used for) financing activities | 35,591,073 | 6,888,145 |
| Net (decrease) increase in cash and federal funds sold | 853,803 | 3,790,095 |

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| | | |
|--|---------------|---------------|
| Cash and federal funds sold at beginning of period | 19,972,550 | 8,965,457 |
| Cash and federal funds sold at end of period | \$ 20,826,353 | \$ 12,755,552 |

See accompanying notes to consolidated financial statements.

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Consolidated Statement of Changes in Stockholder's Equity
Chesapeake Financial Shares, Inc.
Nine Months Ended September 30, 2001
(unaudited)

| | Total | Comprehensive Income | Retained Earnings | Accumulated Other Comprehensive Income | Common Stock | Additional Paid-In Capital |
|--|---------------|-------------------------|----------------------|---|-----------------|----------------------------------|
| Beginning balance | \$ 18,330,317 | | \$ 11,473,316 | \$ 554,280 | \$ 6,149,200 | \$ 153,521 |
| Comprehensive Income: | | | | | | |
| Net Income | 1,955,718 | \$ 1,955,718 | 1,955,718 | | | |
| Other comprehensive income, net of tax: | | | | | | |
| Unrealized gain on securities available for sale, net of deferred taxes of \$197,145 | 382,693 | 382,693 | | 382,693 | | |
| Add: reclassification adjustment, net of income taxes of \$552 | 1,073 | 1,073 | | 1,073 | | |
| Total comprehensive income, net of tax: | | \$ 2,339,484 | | | | |
| Acquisition of common stock | (9,150) | | | | (3,000) | (6,150) |
| Issuance of common stock | 119,000 | | | | 93,600 | 25,400 |
| Dividends declared | (410,265) | | (410,265) | | | 0 |
| Ending balance | \$ 20,369,386 | | \$ 13,018,769 | \$ 938,046 | \$ 6,239,800 | \$ 172,771 |

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Consolidated Statement of Changes in Stockholder's Equity
Chesapeake Financial Shares, Inc.
Nine Months Ended September 30, 2002
(unaudited)

| | Total | Comprehensive Income | Retained Earnings | Accumulated Other Comprehensive Income | Common Stock | Additional Paid-In Capital |
|--|---------------|-------------------------|----------------------|---|-----------------|----------------------------------|
| Beginning balance | \$ 20,574,938 | | \$ 13,553,466 | \$ 514,534 | \$ 6,276,990 | \$ 229,948 |
| Comprehensive Income: | | | | | | |
| Net Income | 2,266,679 | \$ 2,266,679 | 2,266,679 | | | |
| Other comprehensive income, net of tax: | | | | | | |
| Unrealized gain on securities available for sale, net of deferred taxes of \$546,620 | 1,061,085 | 1,061,085 | | 1,061,085 | | |
| Add: reclassification adjustment, net of income taxes of \$794 | 1,541 | 1,541 | | 1,541 | | |
| Total comprehensive income, net of tax: | | \$ 3,329,305 | | | | |
| Issuance of common stock | 224,435 | | | | 144,000 | 80,435 |
| Dividends declared | (459,545) | | (459,545) | | | 0 |
| Ending balance | \$ 23,669,133 | | \$ 15,360,600 | \$ 1,577,160 | \$ 6,420,990 | \$ 310,383 |

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PART I. FINANCIAL INFORMATION (cont d.) 9/02-10QSB

Item 1. Financial Statements

Chesapeake Financial Shares, Inc.

Notes to Consolidated Financial Statements (unaudited)

1. Chesapeake Financial Shares, Inc. (CFS) is a Virginia based financial services holding company which traces its roots to a national bank founded in Irvington, Virginia in 1900. The Company has two operating subsidiaries, Chesapeake Bank (the Bank), which constitutes the majority of its business activity, and Chesapeake Investment Group, Inc., an entity that has as its subsidiaries, Chesapeake Financial Group, Inc., Chesapeake Insurance Agency, Inc., d/b/a Chesapeake Investment Services, and Chesapeake Trust Company, Inc. Chesapeake Bank also is the 100% owner of CNB Properties, Inc. The consolidated financial statements include the accounts of CFS and its wholly owned subsidiaries. All significant intercompany accounts have been eliminated.

2. The accounting and reporting policies of the registrant conform to accounting principles generally accepted in the United States of America and to the general practices within the banking industry. The interim financial statements have not been audited; however, in the opinion of management, all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the consolidated financial statements have been included.

The results of operations for the three and nine months ended September 30, 2002 are not necessarily indicative of the results expected for the full year. These financial statements should be read in conjunction with the financial statements and the footnotes included in the registrant's 2001 Annual Report to Shareholders.

3. The following data shows the amounts used in computing earnings per share and the effect on the weighted average number of shares of potential dilutive common stock. The potential common stock will not have a significant impact on net income.

| | September 30, 2002 | September 30, 2001 |
|--|-----------------------|-----------------------|
| Weighted average number of common shares, basic | 1,275,505 | 1,241,171 |
| Effect of dilutive stock options | 24,274 | 30,718 |
| Weighted number of common shares and dilutive potential common stock used in diluted EPS | 1,299,779 | 1,271,889 |

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PART I. - FINANCIAL INFORMATION (cont. d.) 9/02-10QSB

Item 2. Management's Discussion and Analysis or Plan of Operation

Chesapeake Financial Shares, Inc.

(Unaudited)

A. Critical Accounting Policies

The financial condition and results of operations presented in the Consolidated Financial Statements, accompanying notes to the Consolidated Financial Statements, selected financial data appearing elsewhere within this report, and management's discussion and analysis are, to a large degree, dependent upon Chesapeake Financial Shares' accounting policies. The selection and application of these policies involve judgments, estimates and uncertainties that are susceptible to change.

Presented below are discussions of those accounting policies that management believes are the most important (Critical Accounting Policies) to the portrayal and understanding of Chesapeake's financial condition and results of operations. These Critical Accounting Policies require management's most difficult, subjective and complex judgments about matters that are inherently uncertain. In the event that different assumptions or conditions were to prevail, and depending upon the severity of such changes, the possibility of materially different financial conditions or results of operations is a reasonable likelihood.

Allowance for Loan Loss - Chesapeake Bank's management maintains an allowance for loan loss that they feel represents a conservative estimate of potential losses in the Bank's loan portfolio. The methodology incorporates subjective factors into the evaluation of the adequacy of the ALLL such as:

- The effect of volume and trends in delinquencies and nonaccrual loans.
- The effect of trends in portfolio volume, maturity, and composition.
- An estimate of loss on all significant loans and assessment of underwriting and lending policies and procedures including those for charge off, collection and recovery.
- Experience, ability and depth of lending management and staff.
- The effect of national and local economic conditions and downturns in specific industries.
- Concentrations of credit that might affect loss experience across one or more components of the portfolio.
- The results of any independent reviews of the portfolio.

The lookback period for losses and recoveries was changed in 2001 from a 24-month history to a 15-month history in order to arrive at more accurate historical factors which reflect the effects of current economic conditions on the loan portfolio.

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PART I. - FINANCIAL INFORMATION (cont d.) 9/02-10QSB

Item 2. Management's Discussion and Analysis or Plan of Operation

Chesapeake Financial Shares, Inc.

(Unaudited)

B. Summary - liquidity and capital resources

Sufficient short-term assets are maintained at Chesapeake Financial Shares to meet cash needs anticipated by management. Management's primary sources of liquidity continue to be federal funds sold, short term borrowings from Federal Home Loan Bank Atlanta, securities maturing within one year, and principal payments from mortgage securities. The repayment and sale of loans also provides liquidity. The total of federal funds sold, securities maturing within one year, and estimated principal payments on mortgage-backed securities within one year at September 30, 2002 was approximately \$21,910,000, compared to \$10,705,000 one year ago and \$15,205,000 at December 31, 2001.

The liquidity ratio at September 30, 2002 was 20.1%, compared with 19.2% one year ago. This ratio is arrived at by dividing net liquid assets (sum of total Cash and Due from Banks, including Federal Reserve, unpledged and over pledged portions of Investment Securities at market value, and federal funds sold less reserves required at the Federal Reserve Bank) by net liabilities (total liabilities excluding valuation reserves and capital). Management has found in the past that 18% represents a sufficient level of liquidity to meet cash needs. Lower asset liquidity ratios have been expected as management has positioned the Company to be more liability liquid to meet the demand for changing needs for deposit and loan funding.

Management believes capital is adequate to meet current needs. Unencumbered capital (total capital net of accumulated other comprehensive income less intangibles plus reserves) as a percent of total adjusted assets (total assets net of accumulated other comprehensive income less intangibles plus reserves) was 8.8% at September 30, 2002 and 9.2% at December 31, 2001, for CFS.

Chesapeake Financial Shares and Chesapeake Bank must have a ratio of Tier 1 capital (common equity, retained earnings less certain goodwill) to risk-adjusted assets of at least 4.0%. Minimums for total risk based and tier one leverage are 8% and 4%, respectively. At September 30, 2002 and December 31, 2001 the consolidated ratio of Tier 1 risk-based capital to risk-adjusted assets was 9.6% and 9.4%, respectively. Total risk based capital to risk weighted assets was 10.8% and 10.6% at September 30, 2002 and December 31, 2001, respectively. Tier one leverage capital was 8.0% and 7.7% at September 30, 2002 and December 31, 2001, respectively.

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PART I. - FINANCIAL INFORMATION (cont d.) 902-10QSB

Item 2. Management's Discussion and Analysis or Plan of Operation

Chesapeake Financial Shares, Inc.

(Unaudited)

C. Results of operations:

Earnings Summary:

Net income was \$2,266,679 for the nine months ended September 30, 2002, compared with net income of \$1,955,718 for the same period in 2001. On a fully diluted per share basis, the net income was \$1.78 for the first nine months of 2002. Fully diluted earnings per share for the first nine months of 2001 were \$1.58. Net interest income before provision increased \$961,079 or 14.2% and noninterest income increased \$1,080,548 or 25.4%. The Company experienced a net increase in noninterest expense (which includes other expense) of \$1,205,887 or 15.2%.

Net Interest Income:

Chesapeake Financial Shares' results of operation are significantly affected by its ability to manage effectively the interest rate sensitivity and maturity of its interest-earning assets and interest-bearing liabilities. At September 30, 2002, the Company's interest-earning assets exceeded its interest-bearing liabilities by approximately \$43.5 million, compared with \$34.7 million excess one year ago.

Net interest margins are 4.69% at September 30, 2002 compared to 4.73% at September 30, 2001. Margins have generally improved since the spreads were most narrow for Chesapeake in 2000. In the falling rate environment and steepening of the yield curve in 2001, management expected margins to improve slightly with higher priced deposits maturing in this lower rate environment. This has been somewhat offset by loans and investments repricing in the lower rate environment as well. The Bank's sustained margin levels of 4.5% to 4.7% continue to be 20-30 basis points better than several Virginia community banks.

There continues to be reasonable growth in deposits in all trade areas of the bank and total deposits increased 15.5% since December 31, 2001 and 18.9% from one year ago. Noninterest bearing deposits and savings and interest bearing deposits are up 30.8% and 24.4%, respectively, over the same time last year. Total certificates of deposit have increased 10.7% from one year ago, and are up 13.2% from December 31, 2001. Deposits have been easier to obtain with the instability of the equity markets and the bank had a promotion for noninterest bearing deposits during the second quarter. The bank relocated the Gloucester Winn-Dixie office to a new building in January and the bank continues to experience substantial deposit growth in that market.

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PART I. - FINANCIAL INFORMATION (cont d.) 902-10QSB

Item 2. Management's Discussion and Analysis or Plan of Operation

Chesapeake Financial Shares, Inc.

(Unaudited)

Provision for Loan Losses:

The loan loss provision 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 portfolio. Management makes a quarterly evaluation as to the adequacy of the current loan loss allowance. Management's detailed analysis as of September 30, 2002 supports the adequacy of the current loan loss level of \$2.9 million.

The loan loss allowance was 1.5% of gross loans as of September 30, 2002 and December 31, 2001.

Noninterest Income:

Noninterest income is up 25.4% or \$1,080,548 from the same period last year. Chesapeake Bank's Cash Management product generated \$1,955,152 in gross revenue for the first nine months ended September 30, 2002, compared to the same period last year of \$1,385,275. Managed assets in the Cash Management program were \$17,070,508 at September 30, 2002, and \$11,199,573 at September 30, 2001. Merchant Card income was up 21.0%, or \$150,581, from one year ago due to an increased client base.

The Other Income category was \$623,692, up 37.4%, or \$169,643 from one year ago.

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PART I. - FINANCIAL INFORMATION (cont d.) 902-10QSB

Item 2. Management's Discussion and Analysis or Plan of Operation

Chesapeake Financial Shares, Inc.

(Unaudited)

Noninterest Expenses:

Employee salary expense amounted to \$3,299,830 and \$2,977,367 for the nine months ended September 30, 2002 and 2001, respectively. Benefits expense is up 7.6% or \$50,091 from September 30, 2001. These increases are directly related to new hires and increases for existing staff. Other expenses were up \$241,809 or 14.3% from the same period one year ago due to general increases in business activity.

Cash management expense was \$578,748 for the nine months ended September 30, 2002, up 21.0% from the same period one year ago. This increase is mainly due to increased business activity.

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PART I. - FINANCIAL INFORMATION (cont d.) 902-10QSB

Item 2. Management's Discussion and Analysis or Plan of Operation

Chesapeake Financial Shares, Inc.

(Unaudited)

Assets and Loans:

At September 30, 2002, Chesapeake Financial Shares had total assets of \$ 281.8 million, up 15.0% from \$245.0 million at December 31, 2001 and up 20.4% from \$234.0 million of one year ago. Management has budgeted for a 10.6% growth in total assets for 2002.

Total loans (gross) at September 30, 2002 were \$191.8 million, representing an increase of 13.5% from December 31, 2001, when loans were \$169.0 million. Chesapeake Bank's loan quality is good as the following table shows. Management is confident that no serious delinquency trends are developing.

| | 9/30/02 | 12/31/01 |
|---|-------------------|-------------------|
| Nonaccrual loans | \$ 800,288 | \$ 822,264 |
| 90 days past due | 164 | 21,551 |
| Restructured loans | 0 | 0 |
| Totals | \$ 800,452 | \$ 843,815 |
| Impaired loans with a valuation allowance | \$ 199,698 | \$ 552,104 |
| Valuation allowance related to impaired loans | \$ 179,133 | \$ 350,000 |

Management is also confident there will be no significant loss incurred as the Bank is well secured on these assets.

Charged off loans through September 30, 2002, amounted to \$510,615 and charged off loans through September 30, 2001, were \$26,759. Recoveries through September 30, 2002 were \$49,029 as compared to \$13,019 as of September 30, 2001.

Concentrations of credit in loans are compiled quarterly by management and reviewed with the Board of Director's Loan Review Committee. There have been no material changes in the concentrations of credit within the past three months that would warrant above average additions to the allowance. The Bank's only concentrations of credit greater than 60% of capital are individual consumer (224% of capital) and residential real estate (65% of total capital). Bank management feels that the current levels are consistent with the objectives of the Bank and do not represent unwarranted risk.

The Bank currently has no assets carried as Other Real Estate Owned (OREO). Repossessed assets total \$20,423.

Deposits:

Deposits were \$ 244.7 million at September 30, 2002 and \$211.8 million at December 31, 2001. Deposits were \$205.8 million at September 30, 2001. The Bank's mix of deposit dollars has changed from September 30, 2001 with net increases in all categories. It is management's opinion that this trend will continue in the current interest rate environment.

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PART I. - FINANCIAL INFORMATION (cont d.) 902-10QSB

Item 3. Controls and Procedures

Chesapeake Financial Shares, Inc.

Within the 90 days prior to the date of this report, the Company has carried out an evaluation, under the supervision and with the participation of the company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company's periodic SEC filings. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect internal controls subsequent to the date the Company carried out its evaluation.

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PART II. - OTHER INFORMATION 9/02-10QSB

Chesapeake Financial Shares, Inc.

Item 1. - Legal Proceedings

None to report

Item 2. - Changes in Securities

None to report.

Item 3. Default Upon Senior Securities

None to report.

Item 4. - Submission of Matters to a Vote of Security Holders

None to Report.

Item 5. Other Information

CFS filed a Report on Form 8-K on September 13, 2002 that included a copy of its news release, dated September 3, 2002 and a letter to shareholders announcing the company's proposed plan to engage in a going private transaction which, if approved by shareholders, would result in approximately 73,300 shares, representing approximately 5.7% of CFS' outstanding shares, being converted into the right to receive from CFS \$27.00 in cash per share.

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PART II. - OTHER INFORMATION 9/02-10QSB

Chesapeake Financial Shares, Inc.

| | | |
|---------|---|--|
| Item 6. | Exhibits and Reports on Form 8-K | |
| (a) | Exhibit 2 Plan of acquisition, reorganization, arrangement, liquidation or succession | N/A |
| | Exhibit 4 Instruments defining the rights of security holders, including indentures | N/A (1) |
| | Exhibit 10 Material contracts | N/A (1) |
| | Exhibit 11 Statement re: computation of earnings per share | See Part 1, Item 1, Note 3 of this Form 10-QSB |
| | Exhibit 15 Letter re: unaudited interim financial information {TALK TO YHB} | N/A |
| | Exhibit 18 Letter re: change in accounting principles | N/A |
| | Exhibit 19 Report furnished to security holders | N/A |
| | Exhibit 22 Published report regarding matters submitted to vote of security holders | N/A |
| | Exhibit 23 Consents of experts and counsel | N/A |
| | Exhibit 24 Power of attorney | N/A |
| | Exhibit 27 Financial data schedule | N/A |
| | Exhibit 99 Certification of CEO and CFO | Attached |
| (b) | Reports on Form 8-K. CFS filed a Report on Form 8-K on September 13, 2002 that included a copy of its news release, dated September 3, 2002 and a letter to shareholders announcing the company's proposed plan to engage in a going private transaction which, if approved by shareholders, would result in approximately 73,300 shares, representing approximately 5.7% of CFS' outstanding shares, being converted into the right to receive from CFS \$27.00 in cash per share. | |

(1) Incorporated by reference to previously filed Registration Statement on Form S-18, Registration No: 33-27825, dated May 15, 1989, as amended.

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SIGNATURES

Chesapeake Financial Shares, Inc.

SEC 10-QSB 6/02

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CHESAPEAKE FINANCIAL SHARES, INC.

(Registrant)

11/08/02

(Date)

/s/ DOUGLAS D. MONROE, JR.

(Signature)

Douglas D. Monroe, Jr.
Chairman and Chief Executive Officer

11/08/02

(Date)

/s/ JOHN H. HUNT, II

(Signature)

John H. Hunt, II
Secretary and Chief Financial Officer

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