

10-Q 1 v194006_10q.htm

**United States Securities and Exchange Commission
Washington, D.C. 20549**

FORM 10-Q

(Mark One)

- QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2010
- TRANSITION REPORT PURSUANT SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from _____ to _____.

Commission File Number: **000-30497**

(Exact name of small business issuer as specified in its charter)

Tennessee
(State or other jurisdiction of incorporation or organization)

62-1173944
(I.R.S. Employer Identification No.)

835 Georgia Avenue Chattanooga, Tennessee
(Address of principal executive offices)

37402
(Zip Code)

423-385-3000
(Registrant's telephone number, including area code)

Not Applicable
(Former name, former address and former fiscal year, if changes since last report)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of July 30, 2010 there were 6,500,396 shares of common stock, \$1.00 par value per share, issued and outstanding.

TABLE OF CONTENTS**PART I – FINANCIAL INFORMATION**

Item 1. Financial Statements (Unaudited)	4
Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations	23
Item 3. Quantitative and Qualitative Disclosures about Market Risk	30
Item 4T.Controls and Procedures	30

PART II – OTHER INFORMATION

Item 1. Legal Proceedings	31
Item 1A. Risk Factors	31
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	31
Item 3. Defaults Upon Senior Securities	31
Item 4. [Removed and Reserved]	31
Item 5. Other Information	31
Item 6. Exhibits	31

FORWARD-LOOKING STATEMENTS

Cornerstone Bancshares, Inc. (“Cornerstone”) may from time to time make written or oral statements, including statements contained in this report (including, without limitation, certain statements in “Management Discussion and Analysis of Financial Condition and Results of Operations” in Item 2), that constitute forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 (the “Exchange Act”). The words “expect,” “anticipate,” “intend,” “consider,” “plan,” “believe,” “seek,” “should,” “estimate,” and similar expressions are intended to identify such forward-looking statements, but other statements may constitute forward-looking statements. These statements should be considered subject to various risks and uncertainties. Such forward-looking statements are made based upon management’s belief as well as assumptions made by, and information currently available to, management pursuant to “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995. Cornerstone’s actual results may differ materially from the results anticipated in forward-looking statements due to a variety of factors. Such factors include, without limitation, those specifically described in Item 1A of Part I of Cornerstone’s Annual Report on Form 10-K for the year ended December 31, 2009, as well as the following: (i) the ability of Cornerstone Community Bank (the “Bank”) to comply with the requirements of the consent order issued by the Federal Deposit Insurance Corporation on April 2, 2010 or the written agreement entered with the Tennessee Department of Financial Institutions on April 8, 2010 (collectively, the “Action Plans”); (ii) the ability of Cornerstone to raise additional capital necessary to retire certain holding company loans and enable the Bank to achieve and maintain the elevated capital levels required under the Action Plans; (iii) unanticipated deterioration in the financial condition of borrowers resulting in significant increases in loan losses and provisions for those losses, (iv) increased competition with other financial institutions, (v) changes in economic conditions in Cornerstone’s market area, (vi) rapid fluctuations or unanticipated changes in interest rates, (vii) the effect on Cornerstone and the financial institutions and banking industry from difficult market conditions, unprecedented volatility and the soundness of other financial institutions, (viii) the -ability of Cornerstone to restructure its loan portfolio to regulatory acceptable levels and composition, (ix) the effect of recent legislative regulatory initiatives, and (x) changes in the legislative and regulatory environment. Many of such factors are beyond Cornerstone’s ability to control or predict, and readers are cautioned not to put undue reliance on such forward-looking statements. Cornerstone does not intend to update or reissue any forward-looking statements contained in this report as a result of new information or other circumstances that may become known to Cornerstone.

Cornerstone Bancshares, Inc. and Subsidiary
Consolidated Balance Sheets

PART I — FINANCIAL INFORMATION

Item 1. Financial Statements

	Unaudited June 30, 2010	December 31, 2009
ASSETS		
Cash and due from banks	\$ 43,690,546	\$ 38,202,205
Securities available for sale	129,610,261	124,415,318
Securities held to maturity	114,705	135,246
Federal Home Loan Bank stock, at cost	2,322,900	2,229,200
Loans, net of allowance for loan losses of \$6,967,292 at June 30, 2010 and \$5,905,054 at December 31, 2009	311,828,256	330,787,382
Bank premises and equipment, net	7,659,025	8,098,059
Accrued interest receivable	1,662,436	1,520,699
Goodwill and amortizable intangibles	2,587,316	2,579,211
Foreclosed assets	9,862,411	10,327,297
Other assets	14,088,466	14,109,769
Total Assets	<u>\$523,426,322</u>	<u>\$ 532,404,386</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing demand deposits	\$ 47,663,569	\$ 41,971,956
Interest-bearing demand deposits	36,802,797	26,533,329
Savings deposits and money market accounts	31,893,781	31,029,587
Time deposits of \$100,000 or more	109,225,781	91,064,094
Time deposits of less than \$100,000	175,062,529	214,143,147
Total deposits	400,648,457	404,742,113
Federal funds purchased and securities sold under agreements to repurchase	24,105,165	26,321,885
Federal Home Loan Bank advances and other borrowings	67,250,000	72,350,000
Accrued interest payable	374,582	351,360
Other liabilities	1,623,449	801,549
Total Liabilities	<u>494,001,653</u>	<u>504,566,907</u>
Stockholders' Equity:		
Preferred stock - no par value; 2,000,000 shares authorized; no shares issued	-	-
Common stock - \$1.00 par value; 20,000,000 shares authorized; 6,709,199 issued in 2010 and 2009; 6,500,396 outstanding in 2010 and 2009	6,500,396	6,500,396
Additional paid-in capital	21,199,992	21,162,686
Retained earnings	786,787	424,854
Accumulated other comprehensive income	937,494	(250,457)
Total Stockholders' Equity	<u>29,424,669</u>	<u>27,837,479</u>
Total Liabilities and Stockholders' Equity	<u>\$523,426,322</u>	<u>\$ 532,404,386</u>

The Notes to Consolidated Financial Statements are an integral part of these statements.

Cornerstone Bancshares, Inc. and Subsidiary
Consolidated Statements of Operations

	Unaudited Three months ended June 30,		Unaudited Six months ended June 30,	
	2010	2009	2010	2009
INTEREST INCOME				
Loans, including fees	\$5,493,946	\$ 6,035,104	\$11,442,192	\$12,477,209
Investment securities	1,216,300	386,065	2,345,579	800,126
Federal funds sold & other earning assets	21,732	6,697	45,393	14,646
Total interest income	<u>6,731,978</u>	<u>6,427,866</u>	<u>13,833,164</u>	<u>13,291,981</u>
INTEREST EXPENSE				
Interest bearing demand accounts	36,019	29,960	66,118	56,154
Money market and savings accounts	63,587	79,889	131,211	169,298
Time deposits of more than \$100,000	588,314	480,917	1,134,340	1,010,094
Time deposits of less than \$100,000	1,030,929	1,388,223	2,168,930	2,854,235
Federal funds purchased and securities sold under agreements to repurchase	32,142	43,880	67,557	97,929
Other borrowings	759,803	768,199	1,539,000	1,474,035
Total interest expense	<u>2,510,794</u>	<u>2,791,068</u>	<u>5,107,156</u>	<u>5,661,745</u>
Net interest income before provision for loan losses	4,221,184	3,636,798	8,726,008	7,630,236
Provision for loan losses	<u>1,465,000</u>	<u>1,633,898</u>	<u>2,480,000</u>	<u>7,358,898</u>
Net interest income after the provision for loan losses	<u>2,756,184</u>	<u>2,002,900</u>	<u>6,246,008</u>	<u>271,338</u>
NONINTEREST INCOME				
Customer service fees	342,126	434,595	684,040	842,738
Net gains / (losses) from sale of loans and other assets	438,886	146,613	386,195	(34,248)
Other noninterest income	29,272	149,083	60,195	184,915
Total noninterest income	<u>810,284</u>	<u>730,291</u>	<u>1,130,430</u>	<u>993,405</u>
NONINTEREST EXPENSE				
Salaries and employee benefits	1,521,216	1,848,452	3,154,560	3,690,127
Net occupancy and equipment expense	368,506	387,897	723,689	796,836
Depository insurance	237,499	279,550	484,836	341,277
Other operating expense	1,476,201	1,257,460	2,556,818	2,237,861
Total noninterest expense	<u>3,603,422</u>	<u>3,773,359</u>	<u>6,919,903</u>	<u>7,066,101</u>
Income / (loss) before provision for income taxes	(36,954)	(1,040,168)	456,535	(5,801,358)
Provision / (benefit) for income taxes	<u>(55,099)</u>	<u>(437,369)</u>	<u>94,602</u>	<u>(2,287,056)</u>
NET INCOME / (LOSS)	<u>\$ 18,145</u>	<u>\$ (602,799)</u>	<u>\$ 361,933</u>	<u>\$ (3,514,302)</u>
EARNINGS / (LOSS) PER COMMON SHARE				
Basic net income / (loss) per common share	\$ -	\$ (0.09)	\$ 0.06	\$ (0.54)
Diluted net income / (loss) per common share	\$ -	\$ (0.09)	\$ 0.06	\$ (0.54)
DIVIDENDS DECLARED PER COMMON SHARE	\$ -	\$ 0.03	\$ -	\$ 0.10

The Notes to Consolidated Financial Statements are an integral part of these statements.

Cornerstone Bancshares, Inc. and Subsidiary
 Consolidated Statement of Changes in Stockholders' Equity - Unaudited
 For the six months ended June 30, 2010

	<u>Comprehensive Income</u>	<u>Common Stock</u>	<u>Additional Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Other Comprehensive Income</u>	<u>Total Stockholders' Equity</u>
BALANCE, December 31, 2009		\$ 6,500,396	\$21,162,686	\$ 424,854	\$ (250,457)	\$ 27,837,479
Employee compensation stock option expense		-	37,306	-	-	37,306
Comprehensive income:						
Net income	\$ 361,933	-	-	361,933	-	361,933
Other comprehensive income, net of tax:						
Unrealized holding gains on securities available for sale, net of reclassification adjustment	<u>1,187,951</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>1,187,951</u>	<u>1,187,951</u>
Total comprehensive income	<u>\$ 1,549,884</u>					
BALANCE, June 30, 2010		<u>\$ 6,500,396</u>	<u>\$21,199,992</u>	<u>\$ 786,787</u>	<u>\$ 937,494</u>	<u>\$ 29,424,669</u>

The Notes to Consolidated Financial Statements are an integral part of these statements.

CORNERSTONE BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Note 1. Presentation of Financial Information

Nature of Business-Cornerstone Bancshares, Inc. ("Cornerstone") is a bank holding company whose primary business is performed by its wholly-owned subsidiary, Cornerstone Community Bank (the "Bank"). The Bank provides a full range of banking services to the Chattanooga, Tennessee market. The Bank has also established a loan production office ("LPO") in Dalton, Georgia to further enhance the Bank's lending markets. The Bank specializes in asset based lending, commercial lending and payment processing. The Bank has a wholly-owned subsidiary, Eagle Financial, Inc. ("Eagle"), which specializes in finance and accounts receivable factoring.

Interim Financial Information (Unaudited)-The financial information in this report for June 30, 2010 and June 30, 2009 has not been audited. The information included herein should be read in conjunction with the annual consolidated financial statements and footnotes thereto included in the 2009 Annual Report to Shareholders which was furnished to each shareholder of Cornerstone in April of 2010. The consolidated financial statements presented herein conform to generally accepted accounting principles and to general industry practices. In the opinion of Cornerstone's management, the accompanying interim financial statements contain all material adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial condition, the results of operations, and cash flows for the interim period. Results for interim periods are not necessarily indicative of the results to be expected for a full year.

Use of Estimates-The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities as of the balance sheet date and the 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 include the determination of the allowance for loan losses.

Consolidation-The accompanying consolidated financial statements include the accounts of Cornerstone the Bank and Eagle. Substantially all intercompany transactions, profits and balances have been eliminated.

Reclassification-Certain amounts in the prior consolidated financial statements have been reclassified to conform to the current period presentation. The reclassifications had no effect on net income or stockholder's equity as previously reported.

Accounting Policies-During interim periods, Cornerstone follows the accounting policies set forth in its Annual Report on Form 10-K for the year ended December 31, 2009 as filed with the Securities and Exchange Commission. Since December 31, 2009, there have been no significant changes in any accounting principles or practices, or in the method of applying any such principles or practices except for the following:

The Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2010-09, Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements in February 2010. This ASU amended the guidance on subsequent events and will no longer require that an SEC filer disclose the date through which subsequent events have been evaluated. The amendment was effective upon issuance. The adoption of ASU 2010-09 does not have a material impact on Cornerstone's financial statements.

The FASB issued ASU No. 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements in January 2010. The new disclosures now required by the amended guidance are:

- (1) The amounts of significant transfers in and/or out of Level 1 and Level 2 fair value measurements and the reasons for the transfers; and
- (2) A reconciliation of the activities in Level 3 fair value measurements on a gross basis.

CORNERSTONE BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

ASU 2010-06 also clarifies the existing disclosure requirements for level of disaggregation and disclosures about inputs and valuation techniques. The new disclosures and clarifications of existing disclosures are effective for annual or interim reporting periods beginning after December 15, 2009, except for the requirement to provide the Level 3 activity for purchases, sales, issuances, and settlements on a gross basis. Those disclosures are effective for fiscal years beginning after December 15, 2010. The adoption of ASU 2010-06 has not and is not expected to have a material impact on Cornerstone's financial statements.

The FASB issued ASU No. 2010-04, Accounting for Various Topics – Technical Corrections to SEC Paragraphs in January 2010. The purpose of this ASU is to make technical corrections to certain guidance issued by the SEC that is included in the FASB Accounting Standards Codification (ASC). Primarily, this ASU changes references to various FASB and AICPA pronouncements to the appropriate ASC paragraph numbers. The adoption of ASU 2010-04 does not have a material impact on Cornerstone's financial statements.

FASB issued ASU No. 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses in July 2010. The purpose of this ASU is to improve transparency in financial reporting by public and nonpublic companies that hold financing receivables, which include loans, lease receivables, and other long-term receivables. The ASU requires companies to provide more information in their disclosures about the credit quality of their financing receivables and the credit reserves held against them. The period end balance disclosures are effective for fiscal years ending after December 15, 2010. The adoption of ASU 2010-20 is not expected to have a material impact on Cornerstone's financial statements.

Going Concern

Cornerstone continues to prepare its consolidated financial statements on a going concern basis. For further information regarding this issue, refer to note 2 "Going Concern Considerations" of Cornerstone's Annual Report on Form 10-K for the year ended December 31, 2009, as filed with the Securities and Exchange Commission on March 30, 2010. The consolidated financial statements and notes thereto are presented in accordance with the instructions for Form 10-K. Furthermore, Cornerstone has submitted its compliance covenant certificate as of June 30, 2010 to Silverton Bridge Bank, N.A., as successor in receivership to Silverton Bank, N.A. ("Silverton"). The June 30, 2010 compliance certificate indicates that certain loan covenants were not met. However, Cornerstone has requested a waiver with respect to the covenant violations. Based upon this request, Cornerstone anticipates that Silverton will waive the covenant violations as of June 30, 2010.

Consent Order

Following the issuance of a written report by the Federal Deposit Insurance Corporation ("FDIC") and the Tennessee Department of Financial Institutions ("TDFI") concerning their joint examination of the Bank in October 2009, the Bank entered a consent order with the FDIC on April 2, 2010 and a written agreement with the TDFI on April 8, 2010, each concerning areas of the Bank's operations identified in the report as warranting improvement and presenting substantially similar plans for making those improvements. The consent order and written agreement, which we collectively refer to as the "Action Plans", convey specific actions needed to address certain findings from the joint examination and to address our current financial condition. The Action Plans contain a list of strict requirements ranging from a capital directive, which requires us to achieve and maintain minimum regulatory capital levels in excess of the statutory minimums to be well-capitalized, to developing a liquidity risk management and contingency funding plan, in connection with which we will be subject to limitations on the maximum interest rates we can pay on deposit accounts. The Action Plans also contain restrictions on future extensions of credit and requires the development of various programs and procedures to improve our asset quality as well as routine reporting on our progress toward compliance with the Action Plans to the Board of Directors, the FDIC and the TDFI. Finally, as of April 2, 2010, the date of the Action Plans, the Bank was deemed to be "adequately capitalized." The adequately capitalized classification is the result of the Bank receiving a formal enforcement action which prohibits a Bank from being classified as "well-capitalized" regardless of its capital ratios. Therefore, the Bank can not be classified as "well capitalized" until the Action Plans are lifted by the FDIC and the TDFI.

CORNERSTONE BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Earnings per Common Share- Basic earnings per share (“EPS”) is computed by dividing income available to common shareholders (numerator) by the weighted average number of common shares outstanding during the period (denominator). Diluted EPS is computed by dividing income available to common shareholders (numerator) by the adjusted weighted average number of shares outstanding (denominator). The adjusted weighted average number of shares outstanding reflects the potential dilution occurring if securities or other contracts to issue common stock were exercised or converted into common stock resulting in the issuance of common stock that share in the earnings of the entity.

The following is a summary of the basic and diluted earnings per share for the three month periods ended June 30, 2010 and 2009.

	Three Months Ended June 30, 2010	2009
Basic earnings / (loss) per share calculation:		
Numerator: Net income / (loss) available to common shareholders	\$ 18,145	\$ (602,799)
Denominator: Weighted avg. common shares outstanding	6,500,396	6,500,396
Effect of dilutive stock options	-	-
Diluted shares	6,500,396	6,500,396
Basic earnings / (loss) per share	<u>\$ -</u>	<u>\$ (0.09)</u>
Diluted earnings / (loss) per share	<u>\$ -</u>	<u>\$ (0.09)</u>

The following is a summary of the basic and diluted earnings per share for the six month periods ended June 30, 2010 and 2009.

	Six Months Ended June 30, 2010	2009
Basic earnings / (loss) per share calculation:		
Numerator: Net income / (loss) available to common shareholders	\$ 361,933	\$ (3,514,302)
Denominator: Weighted avg. common shares outstanding	6,500,396	6,500,396
Effect of dilutive stock options	-	-
Diluted shares	6,500,396	6,500,396
Basic earnings / (loss) per share	<u>\$ 0.06</u>	<u>\$ (0.54)</u>
Diluted earnings / (loss) per share	<u>\$ 0.06</u>	<u>\$ (0.54)</u>

Note 2. Stock Based Compensation

Accounting Policies- Cornerstone, as required by FASB, applies the fair value recognition provisions of ASC 718, Compensation –Stock Compensation. As a result, for the six month period ended June 30, 2010, the compensation cost charged to earnings related to the vested incentive stock options was approximately \$37,000, which had no material impact on earnings per share.

Officer and Employee Plans-Cornerstone has two stock option plans under which officers and employees can be granted incentive stock options or non-qualified stock options to purchase a total of up to 1,420,000 shares of Cornerstone’s common stock. The exercise price for incentive stock options must be not less than 100 percent of the fair market value of the common stock on the date of the grant. The exercise price of the non-qualified stock options may be equal to or more or less than the fair market value of the common stock on the date of the grant. The incentive stock options vest 30% on the second anniversary of the grant date, 60% on the third anniversary of the grant date and 100% on the fourth anniversary of the grant date, and the non-qualified stock options vest 50% on the first anniversary of the grant date and 100% on the second anniversary of the grant date. The options expire ten years from the grant date. At June 30, 2010, the total remaining compensation cost to be recognized on non-vested options is approximately \$226,000. A summary of the status of these stock option plans is presented in the following table:

CORNERSTONE BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

	Number	Weighted Average Exercisable Price	Weighted- Average Contractual Remaining Term (in years)	Aggregate Intrinsic Value
Outstanding at December 31, 2009	799,675	\$ 6.18	4.5 Years	\$ -
Granted	-	-		
Exercised	-	-		
Forfeited	265,600	6.88		
Outstanding at June 30, 2010	<u>534,075</u>	<u>\$ 5.82</u>	4.7 Years	\$ -
Options exercisable at June 30, 2010	<u>389,955</u>	<u>\$ 5.97</u>		

Board of Directors Plan-Cornerstone has a stock option plan under which members of the Board of Directors, at the formation of the Bank, were granted options to purchase a total of up to 600,000 shares of the Bank's common stock. On October 15, 1997, the Bank stock options were converted to Cornerstone stock options. Only non-qualified stock options may be granted under the plan. The exercise price of each option equals the market price of Cornerstone's stock on the date of grant and the maximum term is ten years. Vesting for options granted during 2009, are 50% on the first anniversary of the grant date and 100% on the second anniversary of the grant date. At June 30, 2010, the total remaining compensation cost to be recognized on non-vested options is approximately \$23,000. A summary of the status of this stock option plan is presented in the following table:

	Number	Weighted Average Exercisable Price	Weighted- Average Contractual Remaining Term (in years)	Aggregate Intrinsic Value
Outstanding at December 31, 2009	100,250	\$ 9.42	6.7 Years	\$ -
Granted	-	-		
Exercised	-	-		
Forfeited	-	-		
Outstanding at June 30, 2010	<u>100,250</u>	<u>\$ 9.42</u>	6.2 Years	\$ -
Options exercisable at June 30, 2010	<u>91,025</u>	<u>\$ 10.01</u>		

CORNERSTONE BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Note 3. Securities

The amortized cost and fair value of securities available-for-sale and held-to-maturity at June 30, 2010 and December 31, 2009 are summarized as follows:

	June 30, 2010			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
Debt securities available-for-sale:				
U.S. Government agencies	\$ 4,654,655	\$ 17,052	\$ -	\$ 4,671,707
State and municipal securities	19,051,648	363,343	(72,087)	19,342,904
Mortgage-backed securities:				
Residential mortgage guaranteed by GNMA	63,048,396	1,254,118	(52,798)	64,249,716
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	41,198,541	176,172	(153,188)	41,221,525
Other	126,699	-	(2,290)	124,409
	<u>\$128,079,939</u>	<u>\$ 1,810,685</u>	<u>\$ (280,363)</u>	<u>\$129,610,261</u>
Debt securities held to maturity:				
Mortgage-backed securities:				
Residential mortgage guaranteed by GNMA	<u>\$ 114,705</u>	<u>\$ 3,329</u>	<u>\$ -</u>	<u>\$ 118,034</u>

CORNERSTONE BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

	December 31, 2009			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Debt securities available-for-sale:				
U.S. Government agencies	\$ 4,772,461	\$ 4,703	\$ (3,144)	\$ 4,774,020
State and municipal securities	16,660,518	268,343	(173,221)	16,755,640
Mortgage-backed securities:				
Residential mortgage guaranteed by GNMA	53,207,225	217,897	(698,355)	52,726,767
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	49,956,882	77,852	(74,286)	49,960,448
Other	<u>203,961</u>	<u>-</u>	<u>(5,518)</u>	<u>198,443</u>
	<u>\$124,801,047</u>	<u>\$ 568,795</u>	<u>\$ (954,524)</u>	<u>\$124,415,318</u>
Debt securities held to maturity:				
Mortgage-backed securities:				
Residential mortgage guaranteed by GNMA	<u>\$ 135,246</u>	<u>\$ 1,193</u>	<u>\$ (377)</u>	<u>\$ 136,062</u>

At June 30, 2010, securities with a fair value totaling approximately \$129.5 million were pledged to secure public funds, securities sold under agreements to repurchase, the Federal Home Loan Bank (sometimes referred to herein as "FHLB") as collateral for the Bank's borrowings and serve as collateral for borrowings at the Federal Reserve Discount Window.

The amortized cost and estimated market value of securities at June 30, 2010, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Securities Available for Sale		Securities Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ -	\$ -	\$ -	\$ -
Due from one year to five years	599,264	619,204	-	-
Due from five years to ten years	4,460,566	4,611,101	-	-
Due after ten years	<u>18,646,473</u>	<u>18,784,306</u>	-	-
	23,706,303	24,014,611	-	-
Mortgage-backed securities	<u>104,373,636</u>	<u>105,595,650</u>	<u>114,705</u>	<u>118,034</u>
	<u>\$128,079,939</u>	<u>\$129,610,261</u>	<u>\$ 114,705</u>	<u>\$ 118,034</u>

CORNERSTONE BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

The following tables present the gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities available for sale have been in a continuous unrealized loss position, as of June 30, 2010 and as of December 31, 2009:

	As of June 30, 2010					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Debt securities available for sale:						
State and municipal securities	\$ 5,943,587	\$ (69,418)	\$ 220,218	\$ (2,669)	\$ 6,163,805	\$ (72,087)
Mortgage-backed securities:						
Residential mortgage guaranteed by GNMA	10,617,378	(52,798)	-	-	10,617,378	(52,798)
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	23,144,984	(153,188)	-	-	23,144,984	(153,188)
Other	-	-	124,409	(2,290)	124,409	(2,290)
	<u>\$39,705,949</u>	<u>\$ (275,404)</u>	<u>\$ 344,627</u>	<u>\$ (4,959)</u>	<u>\$40,050,576</u>	<u>\$ (280,363)</u>
	As of December 31, 2009					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Debt securities available for sale:						
U.S. Governmental agencies	\$ 971,400	\$ (3,144)	\$ -	\$ -	\$ 971,400	\$ (3,144)
State and municipal securities	8,222,297	(159,907)	734,848	(13,314)	8,957,145	(173,221)
Mortgage-backed securities:						
Residential mortgage guaranteed by GNMA	40,492,722	(698,343)	5,516	(12)	40,498,238	(698,355)
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	22,538,122	(74,286)	-	-	22,538,122	(74,286)
Other	-	-	198,443	(5,518)	198,443	(5,518)
	<u>\$72,224,541</u>	<u>\$ (935,680)</u>	<u>\$ 938,807</u>	<u>\$ (18,844)</u>	<u>\$73,163,348</u>	<u>\$ (954,524)</u>
Debt securities held to maturity:						
Mortgage-backed securities:						
Residential mortgage guaranteed by GNMA	\$ 48,767	\$ (70)	\$ 25,594	\$ (307)	\$ 74,361	\$ (377)

CORNERSTONE BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Upon acquisition of a security, the Bank determines the appropriate impairment model that is applicable. If the security is a beneficial interest in securitized financial assets, the Bank uses the beneficial interests in securitized financial assets impairment model. If the security is not a beneficial interest in securitized financial assets, the Bank uses the debt and equity securities impairment model. The Bank conducts periodic reviews to evaluate each security to determine whether an other-than-temporary impairment has occurred. The Bank does not have any securities that have been classified as other-than-temporarily-impaired at June 30, 2010 or December 31, 2009.

At June 30, 2010 and December 31, 2009, the significant categories of temporarily impaired securities, and management's evaluation of those securities are as follows:

State and municipal securities: At June 30, 2010, 13 investments in obligations of state and municipal securities had unrealized losses. The Bank believes the unrealized losses on those investments were caused by the interest rate environment and does not relate to the underlying credit quality of the issuers. Because the Bank has the intent and ability to hold those investments for a time necessary to recover their amortized cost bases, which may be maturity, the Bank does not consider those investments to be other-than-temporarily impaired at June 30, 2010.

Mortgage-backed securities issued or guaranteed by GNMA: At June 30, 2010, 11 investments in residential mortgage-backed securities issued or guaranteed by GNMA had unrealized losses. This impairment is believed to be caused by the current interest rate environment. The contractual cash flows of those investments are guaranteed or issued by an agency of the U.S. Government. Because the decline in market value is attributable to the current interest rate environment and not credit quality, and because the Bank does not intend to sell the investments and it is not more likely than not that the Bank will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Bank does not deem those investments to be other-than-temporarily impaired at June 30, 2010.

Note 4. Loans and Allowance for Loan Losses

At June 30, 2010 and December 31, 2009, loans are summarized as follows (in thousands):

	June 30, 2010		December 31, 2009	
	Amount	Percent	Amount	Percent
Non-residential real estate				
Owner occupied	\$ 73,124	22.9%	\$ 77,350	23.0%
Non-owner occupied	71,767	22.5%	75,960	22.6%
Multi-family real estate	12,957	4.1%	12,770	3.8%
Construction	5,671	1.8%	7,197	2.1%
Commercial land and lot development	27,604	8.7%	39,767	11.8%
Total non-residential real estate	<u>191,123</u>	<u>60.0%</u>	<u>213,044</u>	<u>63.3%</u>
Residential real estate				
Owner-occupied 1-4 family	46,676	14.6%	47,733	14.2%
Home equity lines	11,012	3.5%	10,473	3.1%
Total residential real estate	<u>57,688</u>	<u>18.1%</u>	<u>58,206</u>	<u>17.3%</u>
Total real estate loans	<u>248,811</u>	<u>78.1%</u>	<u>271,250</u>	<u>80.6%</u>
Commercial	57,618	18.1%	58,476	17.4%
Agricultural and other	8,694	2.7%	2,828	0.8%
Consumer	3,673	1.1%	4,138	1.2%
Total loans, net of unearned fees	<u>\$ 318,796</u>	<u>100.0%</u>	<u>\$ 336,692</u>	<u>100.0%</u>

CORNERSTONE BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

A summary of transactions in the allowance for loan losses for the six months ended June 30, 2010 and year ended December 31, 2009 is as follows (in thousands):

	June 30, 2010	December 31, 2009
Balance, beginning of period	\$ 5,905	\$ 9,618
Loans charged-off	(1,564)	(19,096)
Recoveries of loans previously charged-off	146	484
Provision for loan losses	2,480	14,899
Balance, end of period	<u>\$ 6,967</u>	<u>\$ 5,905</u>

Note 5. Commitments and Contingent Liabilities

Off Balance Sheet Arrangements - In the normal course of business, the Bank has entered into off-balance sheet financial instruments which include commitments to extend credit (i.e., including unfunded lines of credit) and standby letters of credit. Commitments to extend credit are usually the result of lines of credit granted to existing borrowers under agreements that the total outstanding indebtedness will not exceed a specific amount during the term of the indebtedness. Typical borrowers are commercial concerns that use lines of credit to supplement their treasury management functions; thus their total outstanding indebtedness may fluctuate during any time period based on the seasonality of their business and the resultant timing of their cash flows. Other typical lines of credit are related to home equity loans granted to consumers. Commitments to extend credit generally have fixed expiration dates or other termination clauses and may require payment of a fee.

Standby letters of credit are generally issued on behalf of an applicant (our customer) to a specifically named beneficiary and are the result of a particular business arrangement that exists between the applicant and the beneficiary. Standby letters of credit have fixed expiration dates and are usually for terms of two years or less unless terminated beforehand due to criteria specified in the standby letter of credit. A typical arrangement involves the applicant routinely being indebted to the beneficiary for such items as inventory purchases, insurance, utilities, lease guarantees or other third party commercial transactions. The standby letter of credit would permit the beneficiary to obtain payment from the Bank under certain prescribed circumstances. Subsequently, the Bank would then seek reimbursement from the applicant pursuant to the terms of the standby letter of credit.

The Bank follows the same credit policies and underwriting practices when making these commitments as it does for on-balance sheet instruments. Each customer's creditworthiness is evaluated on a case-by-case basis, and the amount of collateral obtained, if any, is based on management's credit evaluation of the customer. Collateral held varies but may include cash, real estate and improvements, marketable securities, accounts receivable, inventory, equipment and personal property.

The contractual amounts of these commitments are not reflected in the consolidated financial statements and would only be reflected if drawn upon. Since many of the commitments are expected to expire without being drawn upon, the contractual amounts do not necessarily represent future cash requirements. However, should the commitments be drawn upon and should customers default on their resulting obligation to, the Bank's maximum exposure to credit loss, without consideration of collateral, is represented by the contractual amount of those instruments.

A summary of the Bank's total contractual amount for all off-balance sheet commitments at June 30, 2010 is as follows:

Commitments to extend credit	\$ 31.1 million
Standby letters of credit	\$ 3.7 million

Various legal claims also arise from time to time in the normal course of business. In the opinion of management, the resolution of claims outstanding at June 30, 2010 will not have a material effect on Cornerstone's consolidated financial statements.

CORNERSTONE BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Note 6. Fair Value Disclosures

Fair Value Measurements:

Cornerstone uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the "Fair Value Measurements and Disclosures" ASC Topic 820, 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. 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.

ASC Topic 820 provides a consistent definition of fair value, which focuses on exit price in an orderly transaction between market participants at the measurement date under current market conditions. If there has been a significant decrease in the 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.

ASC Topic 820 also establishes a three-tier fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value, as follows:

Level 1 - Quoted prices (unadjusted) in active markets for identical assets or liabilities that Cornerstone has the ability to access.

Level 2 - Significant other observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities in active markets, quoted prices in markets that are not active and other inputs that are observable or can be corroborated by observable market data.

Level 3 - Significant unobservable inputs that reflect a company's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

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 Cornerstone in estimating fair value disclosures for financial instruments:

Cash and cash equivalents:

The carrying amounts of cash and cash equivalents approximate fair values based on the short-term nature of the assets.

Securities:

Fair values are estimated using pricing models and discounted cash flows that consider standard input factors such as observable market data, benchmark yields, interest rate volatilities, broker/dealer quotes, and credit spreads. Securities classified as available for sale are reported at fair value utilizing Level 2 inputs.

The carrying value of Federal Home Loan Bank stock approximates fair value based on the redemption provisions of the Federal Home Loan Bank.

CORNERSTONE BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Loans:

For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for fixed-rate loans are estimated using discounted cash flow analyses, using market interest rates for comparable loans. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with ASC Topic 310, "Accounting by Creditors for Impairment of a Loan." The fair value of impaired loans is estimated using several methods including collateral value, liquidation value and discounted cash flows.

Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At June 30, 2010, substantially all of the total impaired loans were evaluated based on the fair value of collateral. In accordance with ASC Topic 820, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, Cornerstone records the impaired loan as nonrecurring Level 2. 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, Cornerstone records the impaired loan as nonrecurring Level 3.

Cash surrender value of life insurance:

The carrying amounts of cash surrender value of life insurance approximate their fair value. The carrying amount is based on information received from the insurance carriers indicating the financial performance of the policies and the amount Cornerstone would receive should the policies be surrendered. Cornerstone reflects these assets within Level 2 of the valuation hierarchy.

Foreclosed assets:

Foreclosed assets, consisting of properties obtained through foreclosure or in satisfaction of loans, is initially recorded at fair value, determined on the basis of current appraisals, comparable sales, and other estimates of value obtained principally from independent sources, adjusted for estimated selling costs. At the time of foreclosure, any excess of the loan balance over the fair value of the real estate held as collateral is treated as a charge against the allowance for loan losses. Gains or losses on sale and any subsequent adjustment to the fair value are recorded as a component of foreclosed real estate expense. Foreclosed assets are included in Level 2 of the valuation hierarchy.

Deposits:

The fair value of deposits with no stated maturity, such as noninterest-bearing and interest-bearing demand deposits, savings deposits, and money market accounts, is equal to the amount payable on demand at the reporting date. The carrying amounts of variable-rate, fixed-term certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies market interest rates on comparable instruments to a schedule of aggregated expected monthly maturities on time deposits.

Securities sold under agreements to repurchase:

The estimated fair value of these liabilities approximates their carrying value.

Federal Home Loan Bank advances and other borrowings:

The carrying amounts of FHLB advances and other borrowings approximate their fair value.

Accrued interest:

The carrying amounts of accrued interest approximate fair value.

Commitments to extend credit, letters of credit and lines of credit:

The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates.

CORNERSTONE BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Assets and liabilities recorded at fair value on a recurring basis are as follows.

	Balance as of June 30, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Debt securities available for sale:				
U.S. Government agencies	\$ 4,671,707	\$ -	\$ 4,671,707	\$ -
State and municipal securities	19,342,904	-	19,342,904	-
Mortgage-backed securities:				
Residential mortgage guaranteed by GNMA	64,249,716	-	64,249,716	-
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	41,221,525	-	41,221,525	-
Other	124,409	-	124,409	-
Total securities available for sale	<u>\$129,610,261</u>	<u>\$ -</u>	<u>\$129,610,261</u>	<u>\$ -</u>
Cash surrender value of life insurance	<u>\$ 1,117,349</u>	<u>\$ -</u>	<u>\$ 1,117,349</u>	<u>\$ -</u>

Cornerstone has no assets or liabilities whose fair values are measured on a recurring basis using Level 3 inputs.

Certain assets and liabilities are measured at fair value on a nonrecurring basis, which means the assets and liabilities are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The tables below present information about assets and liabilities on the balance sheet at June 30, 2010 for which a nonrecurring change in fair value was recorded.

	Balance as of June 30, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Impaired loans	\$ 14,608,325	\$ -	\$14,608,325	\$ -
Foreclosed assets	9,862,411	-	9,862,411	-

Loans include impaired loans held for investment for which an allowance for loan losses has been calculated based upon the fair value of the loans at June 30, 2010. Losses derived from Level 2 inputs were calculated by models incorporating significant observable market data.

CORNERSTONE BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

The carrying amount and estimated fair value of Cornerstone's financial instruments at June 30, 2010 and December 31, 2009 are as follows (in thousands):

	June 30, 2010		December 31, 2009	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Assets:				
Cash and cash equivalents	\$ 43,691	\$ 43,691	\$ 38,202	\$ 38,202
Securities	129,725	129,728	124,551	124,551
Federal Home Loan Bank Stock	2,323	2,323	2,229	2,229
Loans, net	311,828	312,276	330,787	331,456
Cash surrender value of life insurance	1,117	1,117	1,101	1,101
Accrued interest receivable	1,662	1,662	1,521	1,521
Liabilities:				
Noninterest-bearing demand deposits	47,664	47,664	41,972	41,972
Interest-bearing demand deposits	36,803	36,803	26,533	26,533
Savings deposits and money market accounts	31,894	31,894	31,030	31,030
Time deposits	284,288	286,834	305,207	307,596
Federal funds purchased and securities sold under agreements to repurchase	24,105	24,105	26,322	26,322
Federal Home Loan Bank advances and other borrowings	67,250	67,250	72,350	72,350
Accrued interest payable	375	375	351	351
Unrecognized financial instruments (net of contract amount):				
Commitments to extend credit	-	-	-	-
Letters of credit	-	-	-	-
Lines of credit	-	-	-	-

Note 7. Other Comprehensive Income

Other comprehensive income consists of unrealized holding gains and losses on securities available for sale. The following is a summary of other comprehensive income for the three and six months ended June 30, 2010 and 2009.

	Three Months Ended June 30,	
	2010	2009
Net Income / (loss)	\$ 18,145	\$ (602,799)
Unrealized holding gains (losses) on securities available for sale, net of reclassification	804,973	(264,205)
Comprehensive income (loss)	\$ 823,118	\$ (867,004)

CORNERSTONE BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

	Six Months Ended	
	June 30,	
	2010	2009
Net Income / (loss)	\$ 361,933	\$ (3,514,302)
Unrealized holding gains (losses) on securities available for sale, net of reclassification	<u>1,187,951</u>	<u>240,544</u>
Comprehensive income (loss)	<u>\$ 1,549,884</u>	<u>\$ (3,273,758)</u>

Cornerstone Bancshares, Inc.
 Net Interest Margin Analysis
 Taxable Equivalent Basis

Three months ended
 June 30

(Amounts in thousands)

Assets	2010			2009		
	Average Balance	Income/Expense	Yield/Rate	Average Balance	Income/Expense	Yield/Rate
Earning assets:						
Loans, net of unearned income	\$ 321,455	\$ 5,494	6.86%	\$ 370,524	\$ 6,035	6.53%
Investment securities	151,220	1,216	3.44%	56,849	386	2.91%
Other earning assets	33,957	22	0.26%	11,089	7	0.24%
Total earning assets	<u>506,632</u>	<u>\$ 6,732</u>	5.39%	<u>438,461</u>	<u>\$ 6,428</u>	5.90%
Allowance for loan losses	(6,797)			(9,326)		
Cash and other assets	29,821			30,509		
TOTAL ASSETS	<u>\$ 529,656</u>			<u>\$ 459,645</u>		
Liabilities and Shareholders' Equity						
Interest bearing liabilities:						
Interest bearing demand deposits	\$ 42,565	\$ 36	0.34%	\$ 31,702	\$ 30	0.38%
Savings deposits	9,090	12	0.51%	8,101	10	0.51%
MMDA's	21,952	52	0.95%	28,754	70	0.97%
Time deposits of \$100,000 or more	89,648	588	2.63%	57,502	481	3.36%
Time deposits of \$100,000 or less	210,072	1,031	1.97%	165,234	1,388	3.37%
Federal funds purchased and securities sold under agreements to repurchase	23,807	32	0.54%	22,479	44	0.78%
Federal Home Loan Bank & other borrowings	69,833	760	4.36%	72,454	768	4.25%
Total interest bearing liabilities	<u>466,966</u>	<u>2,511</u>	2.16%	<u>386,226</u>	<u>2,791</u>	2.90%
Net interest spread		<u>\$ 4,221</u>	3.24%		<u>\$ 3,637</u>	3.01%
Noninterest bearing demand deposits	39,061			42,752		
Accrued expenses and other liabilities	(5,477)			(3,190)		
Shareholders' equity	29,105			33,857		
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	<u>\$ 529,656</u>			<u>\$ 459,645</u>		
Net yield on earning assets			<u>3.41%</u>			<u>3.35%</u>
Taxable equivalent adjustment:						
Loans		0			0	
Investment securities		<u>81</u>			<u>26</u>	
Total adjustment		<u>81</u>			<u>26</u>	

Cornerstone Bancshares, Inc.
 Net Interest Margin Analysis
 Taxable Equivalent Basis

Six months ended
 June 30

(Amounts in thousands)

Assets	2010			2009		
	Average Balance	Income/Expense	Yield/Rate	Average Balance	Income/Expense	Yield/Rate
Earning assets:						
Loans, net of unearned income	\$ 325,715	\$ 11,442	7.08%	\$ 377,095	\$ 12,477	6.67%
Investment securities	143,072	2,346	3.52%	54,976	800	3.12%
Other earning assets	39,927	45	0.23%	12,517	15	0.24%
Total earning assets	508,714	\$ 13,833	5.55%	444,588	\$ 13,292	6.05%
Allowance for loan losses	(6,397)			(9,232)		
Cash and other assets	29,653			29,469		
TOTAL ASSETS	\$ 531,970			\$ 464,825		
Liabilities and Shareholders' Equity						
Interest bearing liabilities:						
Interest bearing demand deposits	\$ 35,277	\$ 66	0.38%	\$ 30,270	\$ 56	0.37%
Savings deposits	8,910	23	0.51%	7,960	20	0.51%
MMDA's	22,830	109	0.96%	30,893	149	0.97%
Time deposits of \$100,000 or more	84,708	1,133	2.70%	58,559	1,010	3.48%
Time deposits of \$100,000 or less	218,649	2,169	2.00%	165,425	2,854	3.48%
Federal funds purchased and securities sold under agreements to repurchase	23,723	68	0.57%	23,509	98	0.84%
Federal Home Loan Bank & other borrowings	71,063	1,539	4.37%	71,946	1,474	4.13%
Total interest bearing liabilities	465,160	5,107	2.21%	388,562	5,661	2.94%
Net interest spread		\$ 8,726	3.33%		\$ 7,631	3.11%
Noninterest bearing demand deposits	43,610			42,907		
Accrued expenses and other liabilities	(5,688)			(2,028)		
Shareholders' equity	28,888			35,384		
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 531,970			\$ 464,825		
Net yield on earning assets			3.52%			3.48%
Taxable equivalent adjustment:						
Loans		0			0	
Investment securities		155			50	
Total adjustment		155			50	

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Cornerstone is a bank holding company and the parent company of the Bank, a Tennessee banking corporation which operates primarily in and around Chattanooga, Tennessee. The Bank has one wholly owned subsidiary Eagle which is an accounts receivable financing company. The Bank has five full-service banking offices located in Hamilton County, Tennessee, and one loan production office located in Dalton, Georgia. The Bank's business consists primarily of attracting deposits from the general public and, with these and other funds, originating real estate loans, consumer loans, business loans, and residential and commercial construction loans. The principal sources of income for the Bank are interest and fees collected on loans, fees collected on deposit accounts, and interest and dividends collected on other investments. The principal expenses of the Bank are interest paid on deposits, employee compensation and benefits, office expenses, and other overhead expenses. Eagle's principal source of income is revenue received from the purchase of receivables. Expenses are related to employee compensation and benefits and office and overhead expenses.

The following is a discussion of our financial condition at June 30, 2010 and December 31, 2009 and our results of operations for the three and six months ended June 30, 2010 and 2009. The purpose of this discussion is to focus on information about our financial condition and results of operations which is not otherwise apparent from the consolidated financial statements. The following discussion and analysis should be read along with our consolidated financial statements and the related notes included elsewhere herein.

Recent Developments

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") was signed into law. The Dodd-Frank Act contains significant changes to the current bank regulatory structure and requires various federal agencies to adopt a wide array of new implementing rules and regulations. While not yet determinable, the impact of the Dodd-Frank Act and the rules and regulations thereunder may significantly affect our operations and financial stability, increase operating costs and redirect management resources.

Review of Financial Performance

As of June 30, 2010, Cornerstone had total consolidated assets of \$523 million, total loans of \$318.8 million, total deposits of \$400.6 million and stockholders' equity of \$29.4 million. Net income for the three month period ended June 30, 2010 totaled \$18,145. Net income for the six month period ended June 30, 2010 totaled \$361,933.


Results of Operations


Net income for the three months ended June 30, 2010 was \$18,145 or \$0.00 basic earnings per share, compared to a net loss of (\$602,799) or (\$0.09) basic earnings per share, for the same period in 2009. Net Income for the six months ended June 30, 2010 was \$361,933 or \$0.06 basic earnings per share, compared to a net loss of (\$3,514,302) or (\$0.54) basic earnings per share, for the same period in 2009.


The following table presents our results for the three and six months ended June 30, 2010 compared to the three and six months ended June 30, 2009 (amounts in thousands).

	Three months ended June 30,		2010-2009	Dollar Amount Change	Six months ended June 30,		2010-2009	Dollar Amount Change
	2010	2009	Percent Increase (Decrease)		2010	2009	Percent Increase (Decrease)	
Interest income	\$ 6,732	\$ 6,428	4.73 %	\$ 304	\$ 13,833	\$ 13,292	4.07 %	\$ 541
Interest expense	2,511	2,791	(10.03) %	(280)	5,107	5,662	(9.80) %	(555)
Net interest income before provision for loss	4,221	3,637	16.06 %	584	8,726	7,630	14.36 %	1,096
Provision for loan loss	1,465	1,634	(10.34) %	(169)	2,480	7,359	(66.30) %	(4,879)
Net interest income after provision for loan loss	2,756	2,003	37.59 %	753	6,246	271	2204.80 %	5,975
Total noninterest income	810	730	10.96 %	80	1,130	994	13.68 %	136
Total noninterest expense	3,603	3,773	(4.51) %	(170)	6,920	7,066	(2.07) %	(146)
Income / (loss) before income taxes	(37)	(1,040)	96.44 %	1,003	456	(5,801)	107.86 %	6,257
Provision/(benefit)for income taxes	(55)	(437)	87.41 %	382	94	(2,287)	104.11 %	2,381
Net income / (loss)	\$ 18	\$ (603)	102.99 %	621	\$ 362	\$ (3,514)	110.30 %	3,876

Net Interest Income-Net interest income represents the amount by which interest earned on various earning assets exceeds interest paid on deposits and other interest bearing liabilities. Net interest income is also the most significant component of our earnings. For the three months ended June 30, 2010, net interest income before the provision for loan loss, increased \$584 thousand or 16.06% over the same period of 2009. Cornerstone's interest rate spread on a tax equivalent basis (which is the difference between the average yield on earning assets and the average rate paid on interest bearing liabilities) was 3.24% for the three month period ended June 30, 2010 compared to 3.01% for the same period in 2009. The net interest margin on a tax equivalent basis was 3.41% for the three month period ended June 30, 2010 compared to 3.35% for the same period in 2009. Significant items related to the changes in net interest income, net interest yields and rates, and net interest margin are presented below:

 The Bank's net interest margin has been impacted by a change in the Bank's balance sheet mix. The change, implemented by management during 2009 and continuing in 2010, has reduced the Bank's percentage of loans relative to other assets in order to reduce its risk profile. As of June 30, 2010, the Bank's loan to asset ratio was approximately 61% compared to approximately 63% as of December 31, 2009. This level is historically low for the Bank as well as the banking industry. Normal loan to asset ratios for the banking industry typically range from 65% to 75%. Management expects that the Bank's net interest margin will improve once the Bank is able to return to a normal loan to asset ratio.

 The Bank's loan portfolio yield increased to 6.86% for the three months ended June 30, 2010 compared to 6.53% for the quarter ended June 30, 2009. The Bank's loan portfolio yield increased to 7.08% for the six months ended June 30, 2010 compared to 6.67% for the six months ended June 30, 2009. The Bank saw a slight reduction in its non-accrual adjustments to loan interest income in the first six months of 2010 compared to the same time period in 2009.

 For the three month periods ended June 30, 2010, the Bank's investment portfolio yielded 3.44% compared to 2.91% for the same time period in 2009. For the six months ended June 30, 2010, the Bank's investment portfolio yielded 3.52% compared to 3.12% for the same time period in 2009. The Bank increased the amount of its investment portfolio from approximately \$46 million as of June 30, 2009 to approximately \$130 million as of June 30, 2010. The increase provided the Bank needed collateral to guarantee access to funding. The Bank executed a "bar-bell" investment strategy during the fourth quarter of 2009 and first quarter of 2010 to build an investment portfolio sufficient to cover the Bank's collateral requirements which peaked in the first quarter of 2010. Since that time the Bank's collateral requirements have reduced and the Bank is transitioning to a more defensive interest rate sensitivity exposure and is realizing investment gains as it reduces the investment portfolio.




Provision for Loan Losses-The provision for loan losses represents a charge to earnings necessary to establish an allowance for loan losses that, in management's evaluation, should be adequate to provide coverage for the inherent losses on outstanding loans. The provision for loan losses amounted to \$1.5 million for the three months ended June 30, 2010 and \$2.5 million for the six months ended June 30, 2010.

Noninterest Income-Items reported as noninterest income include service charges on checking accounts, insufficient funds charges, automated clearing house ("ACH") processing fees and the Bank's secondary mortgage department earnings. Increases in income derived from service charges and ACH fees are primarily a function of the Bank's growth while fees from the origination of mortgage loans will often reflect market conditions and fluctuate from period to period.

The following table presents the components of noninterest income for the three and six months ended June 30, 2010 and 2009 (dollars in thousands).

	Three months ended		2010-	Six months ended		2010-
	June 30,		2009	June 30,		2009
	2010	2009	Percent Increase (Decrease)	2010	2009	Percent Increase (Decrease)
Service charges on deposit accounts	\$ 342	\$ 435	(21.38)%	\$ 684	\$ 843	(18.86)%
Net gains / (losses) on sale of loans and other assets	(179)	(247)	27.53%	(254)	(428)	40.65%
Realized gains on sale of securities	618	394	56.85%	640	394	62.44%
Other noninterest income	29	149	(80.54)%	60	185	(67.57)%
Total noninterest income	<u>\$ 810</u>	<u>\$ 731</u>	<u>10.81%</u>	<u>\$ 1,130</u>	<u>\$ 994</u>	<u>13.68%</u>

Significant matters relating to the changes in noninterest income are presented below:

-  The Bank has seen a decrease in its service charges on deposit accounts during 2010 due to a reduction in customer overdraft charges.
-  The Bank realized approximately \$618 thousand of security gains during the second quarter of 2010 as the Bank reduced its security portfolio. The Bank sold fixed rate Ginnie Mae mortgages.
-  The Bank continues to experience losses on its other real estate portfolio but at a slower rate than 2009 due to a stabilization of commercial real estate prices in the Chattanooga, Tennessee MSA.


Noninterest Expense-Items reported as noninterest expense include salaries and employee benefits, occupancy and equipment expense, depository insurance and other operating expense.


The following table presents the components of noninterest expense for the three and six months ended June 30, 2010 and 2009 (dollars in thousands).

	Three months ended		2010-	Six months ended		2010-
	June 30,		2009	June 30,		2009
	2010	2009	Percent Increase / (Decrease)	2010	2009	Percent Increase / (Decrease)
Salaries and employee benefits	\$ 1,521	\$ 1,848	(17.69)%	\$ 3,155	\$ 3,690	(14.50)%
Occupancy and equipment expense	369	388	(4.90)%	723	797	(9.28)%
OREO & repossessed asset expense	515	108	376.85%	629	183	243.72%
FDIC depository insurance (a)	237	280	(15.36)%	485	341	42.23%
Other operating expense	961	1,149	(16.36)%	1,928	2,055	(6.18)%
Total noninterest expense	<u>\$ 3,603</u>	<u>\$ 3,773</u>	<u>(4.51)%</u>	<u>\$ 6,920</u>	<u>\$ 7,066</u>	<u>(2.07)%</u>

(a) The amounts listed for 2009 include a FDIC special assessment fee of approximately \$213 thousand that was accrued during the second quarter of 2009 and paid during the third quarter of 2009.

Significant matters relating to the changes to noninterest expense are presented below:

 During the second quarter of 2010, the Bank paid approximately \$237,000 in insurance assessments to the Federal Deposit Insurance Corporation. The Bank has seen a material increase in its ongoing insurance assessment due to its higher risk profile. The Bank was not required to prefund the FDIC three year assessment and is paying as incurred.

 As of June 30, 2010, Cornerstone had incurred the following expenses related to other real estate: other real estate expense, which includes real estate taxes and maintenance, of approximately \$507 thousand, other real estate legal expense of approximately \$69 thousand and repossessed asset expense of approximately \$53 thousand. Management expects these costs to continue throughout 2010 as property is transferred into other real estate, maintained by the Bank for a period of time and finally sold.

Financial Condition

Overview-Cornerstone's consolidated assets totaled \$532.4 million as of December 31, 2009. As of June 30, 2010, total consolidated assets had decreased \$9.0 million or 1.69% to \$523.4 million. The Bank's loan portfolio totaled \$318.8 million as of June 30, 2010.

Liabilities as of June 30, 2010 and December 31, 2009 totaled approximately \$494.0 million and \$504.6 million, respectively. The change in liabilities is primarily attributable to decreases in the Bank's certificate of deposit accounts and reduction of FHLB advances of \$5 million.


Stockholders' equity as of June 30, 2010 and December 31, 2009 totaled approximately \$29.4 million and \$27.8 million, respectively.

Securities-The Bank's investment portfolio, primarily consisting of Ginnie Mae Agency, mortgage-backed securities and municipal securities, amounted to \$129.7 million as of June 30, 2010 compared to \$124.6 million as of December 31, 2009. The primary purpose of the Bank's investment portfolio is to provide liquidity, satisfy pledging requirements, collateralize the Bank's repurchase accounts and secure the Bank's FHLB borrowings.

Loans-The composition of loans at June 30, 2010 and at December 31, 2009 and the percentage (%) of each classification to total loans are summarized in the following table (dollars in thousands):

	June 30, 2010		December 31, 2009	
	Amount	Percent	Amount	Percent
Non-residential real estate				
Owner occupied	\$ 73,124	22.9%	\$ 77,350	23.0%
Non-owner occupied	71,767	22.5%	75,960	22.6%
Multi-family real estate	12,957	4.1%	12,770	3.8%
Construction	5,671	1.8%	7,197	2.1%
Commercial land and lot development	27,604	8.7%	39,767	11.8%
Total non-residential real estate	191,123	60.0%	213,044	63.3%
Residential real estate				
Owner-occupied 1-4 family	46,676	14.6%	47,733	14.2%
Home equity lines	11,012	3.5%	10,473	3.1%
Total residential real estate	57,688	18.1%	58,206	17.3%
Total real estate loans	248,811	78.1%	271,250	80.6%
Commercial	57,618	18.1%	58,476	17.4%
Agricultural and other	8,694	2.7%	2,828	0.8%
Consumer	3,673	1.1%	4,138	1.2%
Total loans, net of unearned fees	<u>\$ 318,796</u>	<u>100.0%</u>	<u>\$ 336,692</u>	<u>100.0%</u>

Allowance for Loan Losses-The allowance for loan losses represents Cornerstone's assessment of the risks associated with extending credit and its evaluation of the quality of the loan portfolio. Management analyzes the loan portfolio to determine the adequacy of the allowance for loan losses and the appropriate provisions required to maintain a level considered adequate to absorb anticipated loan losses. The Bank uses a risk based approach to calculate the appropriate loan loss allowance in accordance with guidance issued by the Federal Financial Institutions Examination Council. Although the Bank performs prudent credit underwriting, no assurances can be given that adverse economic circumstances will not result in increased losses in the loan portfolio and require greater provisions for possible loan losses in the future.

 During the second quarter of 2010, the Bank experienced a continued decline in loan quality. Currently, the Bank believes that it has established an allowance for loan losses that adequately accounts for the Bank's identified loan impairment. However, additional provision to the loan loss allowance may be needed in future quarters if the Bank's loan portfolio continues to deteriorate.

The following is a summary of changes in the allowance for loan losses for the six months ended June 30, 2010 and for the year ended December 31, 2009 and the ratio of the allowance for loan losses to total loans as of the end of each period (dollars in thousands):


	June 30, 2010	December 31, 2009
Balance, beginning of period	\$ 5,905	\$ 9,618
Loans charged-off	(1,564)	(19,096)
Recoveries of loans previously charged-off	146	484
Provision for loan losses	2,480	14,899
Balance, end of period	<u>\$ 6,967</u>	<u>\$ 5,905</u>
Total loans	\$318,796	\$ 336,692
Ratio of allowance for loan losses to loans outstanding at the end of the period	2.19%	1.75%
Ratio of net charge-offs to total loans outstanding for the period	0.44%	5.53%

Non-Performing Assets-The specific economic and credit risks associated with the Bank's loan portfolio include, but are not limited to, a general downturn in the economy which could affect employment rates in our market area, general real estate market deterioration, interest rate fluctuations, deteriorated or non-existent collateral, title defects, inaccurate appraisals, financial deterioration of borrowers, fraud, and violation of laws and regulations.

The Bank attempts to reduce these economic and credit risks by adherence to a lending policy approved by the Bank's board of directors. The Bank's lending policy establishes loan to value limits, collateral perfection, credit underwriting criteria and other acceptable lending standards. The Bank classifies loans that are ninety (90) days past due and still accruing interest, renegotiated loans, non-accrual loans, foreclosures and repossessed property as non-performing assets. The Bank's policy is to categorize a loan on non-accrual status when payment of principal or interest is contractually ninety (90) or more days past due. At the time the loan is categorized as non-accrual the interest previously accrued but not collected may be reversed and charged against current earnings.

The following is a summary of changes in the Bank's impaired loans for the six months ended June 30, 2010 and for the year ended December 31, 2009:

	<u>June 30, 2010</u>	<u>December 31, 2009</u>
Impaired loans without a valuation allowance	\$ 11,367,057	\$ 7,138,077
Impaired loans with a valuation allowance	18,506,604	23,956,594
Total impaired loans	<u>\$ 29,873,661</u>	<u>\$ 31,094,671</u>
Valuation allowance related to impaired loans	<u>\$ 3,898,279</u>	<u>\$ 2,145,383</u>
Loans past due over 90 days still on accrual	\$ -	\$ -
Loans on nonaccrual	13,030,024	7,359,542
Total nonperforming loans	<u>\$ 13,030,024</u>	<u>\$ 7,359,542</u>
	Six Months	
	Ended	Year Ended
	<u>June 30, 2010</u>	<u>December 31, 2009</u>
Average investment in impaired loans	\$ 32,635,242	\$ 28,555,483
Interest income recognized on impaired loans	\$ 1,254,701	\$ 2,900,652

 The Bank's loan portfolio has experienced a general deterioration in loan quality as the Chattanooga, Tennessee Metropolitan Statistical Area endures the current economic recession. The number and dollar amount of impaired loans increased during the second quarter of 2010 as the Bank continued to systematically review its loan portfolio to proactively identify possible impaired loans. Management anticipates that its loan asset quality will not improve until the economy recovers from the current economic recession.

The following table summarizes Cornerstone's non-performing assets for the six months ended June 30, 2010 and for the year ended December 31, 2009 (amounts in thousands):

	<u>June 30, 2010</u>	<u>December 31, 2009</u>
Non-accrual loans	\$ 13,030	\$ 7,360
Reposessed assets	350	217
Foreclosed properties	9,862	10,327
Total non-performing assets	<u>\$ 23,242</u>	<u>\$ 17,904</u>
Total loans outstanding	\$318,796	\$ 336,692
Allowance for loan losses	6,967	5,905
Ratio of nonperforming assets to total loans outstanding at the end of the period	<u>7.29%</u>	<u>5.32%</u>
Ratio of nonperforming assets to total allowance for loan losses at the end of the period	<u>333.61%</u>	<u>303.20%</u>

Non-accrual loans increased to approximately \$13 million as of June 30, 2010 up from approximately \$8.5 million as of March 31, 2010 and approximately \$7.3 million as of December 31, 2009. The increase is concentrated in one loan relationship of approximately \$7 million. The relationship is in bankruptcy and the courts are presently making payments on several pieces of income producing commercial real estate. Since the end of the second quarter of 2010, the Bank has recovered \$1.2 million with no loss from one of its non-accrual loans and expects to close the sale of a non-accrual loan in the amount of \$1.5 million with no loss. The Bank has seen an increased interest in its OREO holdings and currently has \$2 million under contract to close during the third quarter of 2010.

Deposits and Other Borrowings-The Bank's deposits consist of noninterest bearing demand deposits, interest bearing demand accounts, savings and money market accounts, and time deposits. The Bank has agreements with some customers to sell certain of its securities under agreements to repurchase the security the following day. The Bank has also obtained advances from the FHLB.

The following table presents the Bank's deposits and other borrowings as either core funding or non-core funding. Core funding consists of all deposits except for time deposits issued in denominations of \$100,000 or greater. All other funding is classified as non-core (amounts in thousands).

	June 30, 2010		December 31, 2009	
	Amount	Percent	Amount	Percent
Core funding:				
Noninterest bearing demand deposits	\$ 47,664	9.8%	\$ 41,972	8.4%
Interest bearing demand deposits	36,803	7.6%	26,533	5.3%
Savings & money market accounts	31,894	6.5%	31,030	6.2%
Time deposits under \$100,000	175,063	36.0%	214,143	43.0%
Total core funding	291,424	59.9%	313,678	62.9%
Non-core funding:				
Brokered deposits	\$ -	0.0%	\$ 5,852	1.2%
Time deposit accounts greater than \$100,000	109,226	22.4%	85,212	17.1%
Fed funds purchased and securities sold under agreements to repurchase	24,105	5.0%	26,322	5.3%
Federal Home Loan Bank advances	62,000	12.7%	67,000	13.5%
Total non-core funding	195,331	40.1%	184,386	37.1%
Total	\$ 486,755	100.0%	\$ 498,064	100.0%


Federal funds purchased are lines of credit established with other financial institutions that allow the Bank to meet short term funding requirements. These lines can be used as frequently as daily with large variations in balances depending upon the Bank's immediate funding requirements. As of June 30, 2010, the Bank had established \$13 million in available federal funds lines.

FHLB borrowings are secured by certain qualifying residential mortgage loans and, pursuant to a blanket lien, all qualifying commercial mortgage loans. The FHLB is further secured with pledged securities with a market value of approximately \$57 million as of June 30, 2010. Management believes that FHLB borrowings provide an additional source of funding at lower interest rates than alternative sources. The borrowings are structured as either term loans with call and put options after a stated conversion date or an overnight borrowing arrangement.

Capital Resources-At June 30, 2010 and December 31, 2009, Cornerstone's stockholders' equity amounted to \$29.4 million and \$27.8 million, respectively.

Cornerstone's stockholders' equity increased \$0.8 million during the second quarter of 2010. The increase in equity can be attributed to Cornerstone's second quarter 2010 earnings of approximately \$18,000 and an unrealized gain on securities available for sale of approximately \$805,000. Following is a summary of the Bank's capital ratios as of June 30, 2010:


Tier 1 leverage ratio of 5.78% to average assets.
Tier 1 capital ratio of 9.21% to risk weighted assets.
Total risk based capital ratio of 10.48% to risk weighted assets.

 Cornerstone had total outstanding borrowings of \$5.3 million from Silverton Bridge Bank as of June 30, 2010. Cornerstone is currently seeking a waiver from Silverton for its covenant violations as of June 30, 2010.

Market and Liquidity Risk Management

Interest Rate Sensitivity

The Bank's Asset Liability Management Committee ("ALCO") is responsible for making decisions regarding liquidity and funding solutions based upon approved liquidity, loan, capital and investment policies. The ALCO committee must consider interest rate sensitivity and liquidity risk management when rendering a decision on funding solutions and loan pricing. The following is a brief discussion of one of the primary tools used by the ALCO committee to perform its responsibilities:

 Gap analysis is a technique of asset-liability management that can be used to assess interest rate risk or liquidity risk. The Bank has developed a gap analysis to assist the ALCO committee in its decision making. The analysis provides the committee information regarding the interest rate-sensitivity of the Bank. The interest rate-sensitivity is the difference between the interest-earning assets and interest-bearing liabilities scheduled to mature or reprice within a stated time period. The gap is considered positive when the amount of interest rate-sensitive assets exceeds the amount of interest rate-sensitive liabilities. Conversely, the gap is considered negative when the amount of interest rate-sensitive liabilities exceeds the amount of interest rate-sensitive assets. The gap position coupled with interest rate movements will result in either an increase or decrease in net interest income depending upon the Bank's position and the nature of the movement.

Liquidity Risk Management

Liquidity is measured by the Bank's ability to raise cash at a reasonable cost or with a minimum of loss. These funds are used primarily to fund loans and satisfy deposit withdrawals. Several factors must be considered by management when attempting to minimize liquidity risk. Examples include changes in interest rates, competition, loan demand, and general economic conditions. Minimizing liquidity risk is a responsibility of the ALCO committee and is reviewed by the Bank's regulatory agencies on a regular basis.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

A comprehensive qualitative and quantitative analysis regarding market risk was disclosed in Cornerstone's Form 10-K for the year ended December 31, 2009. No material changes in the assumptions used in preparing, or results obtained from, the model have occurred since December 31, 2009.

Item 4T. Controls and Procedures

Under the supervision and with the participation of management, including Cornerstone's Chief Executive Officer, Cornerstone has evaluated the effectiveness of its disclosure controls and procedures (as such term is defined in Rules 13a-15 (e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as of June 30, 2010 (the "Evaluation Date"). Based on such evaluation, such officers have concluded that, as of the Evaluation Date, Cornerstone's disclosure controls and procedures were effective in alerting them on a timely basis to material information relating to Cornerstone (including its consolidated subsidiaries) required to be included in Cornerstone's periodic filings under the Exchange Act.

There were no changes in Cornerstone's internal control over financial reporting during Cornerstone's fiscal quarter ended June 30, 2010 that have materially affected, or are reasonably likely to materially affect, Cornerstone's internal control over financial reporting.

PART II. OTHER INFORMATION**Item 1. Legal Proceedings**

There are various claims and lawsuits in which the Bank is periodically involved incidental to the Bank's business. In the opinion of management, no material loss is expected from any of such pending claims or lawsuits.

Item 1A. Risk Factors

Cornerstone, as a smaller reporting company, is not required to provide the information required by this Item.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

Item 3. Defaults Upon Senior Securities

None

Item 4. [Removed and Reserved]**Item 5. Other Information**

None

Item 6. Exhibits

<u>Exhibit Number</u>	<u>Description</u>
31	Certifications under Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certifications under Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Cornerstone Bancshares, Inc.

Date: August 13, 2010

/s/ Nathaniel F. Hughes
Nathaniel F. Hughes,
President and Chief Executive Officer
(principal executive officer)

Date: August 13, 2010

/s/ Gary W. Petty, Jr.
Gary W. Petty, Jr.
Senior Vice President and Chief Financial Officer
(principal financial officer and accounting officer)

EXHIBIT INDEX

<u>Exhibit Number</u>	<u>Description</u>
31	Certifications under Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certifications under Section 906 of the Sarbanes-Oxley Act of 2002.