



**835 Georgia Avenue
Chattanooga, Tennessee 37402**

March 28, 2011

Dear Shareholder:

We are pleased to invite you to attend our Annual Meeting of Shareholders, which will be held at 6:00 p.m., on Thursday, April 28, 2011, at the Electric Power Board (EPB) Building, 7th Floor Auditorium, located at 10 West Martin Luther King Boulevard in Chattanooga, Tennessee.

As discussed in the accompanying proxy statement, you will be asked at the Annual Meeting to elect the Board of Directors and to ratify the appointment of the auditors of Cornerstone Bancshares, Inc.

Your vote is important. Whether or not you are able to attend, it is important that your shares be represented at the meeting. Accordingly, please sign, date and return the enclosed proxy card at your earliest convenience.

Thank you for your cooperation.

Sincerely,

A handwritten signature in black ink, appearing to read 'W. M. Welborn'.

Wesley M. (Miller) Welborn
Chairman of the Board

A handwritten signature in black ink, appearing to read 'N. F. Hughes'.

Nathaniel F. (Frank) Hughes
President



CORNERSTONE BANCSHARES, INC.

835 Georgia Avenue
Chattanooga, Tennessee 37402

NOTICE OF ANNUAL MEETING OF SHAREHOLDERS

TO BE HELD ON APRIL 28, 2011

Notice is hereby given that the Annual Meeting of Shareholders (the "Shareholders Meeting") of Cornerstone Bancshares, Inc., a Tennessee corporation and bank holding company registered under the Bank Holding Company Act of 1956, as amended (the "Company"), will be held at the EPB Building, 7th Floor Auditorium, 10 W. Martin Luther King, Jr. Blvd, Chattanooga, Tennessee, on Thursday, on April 28, 2011, beginning at 6:00 p.m. local time, for the following purposes:

1. Election of Directors. To elect ten (10) individuals to the Board of Directors.
2. Ratification of Appointment of Independent Registered Public Accounting Firm. To ratify the appointment of Hazlett, Lewis & Bieter, PLLC as the Company's independent registered public accounting firm for the fiscal year ending December 31, 2011.
3. Other Business. To transact such other or further business as may properly come before the Shareholders Meeting or any adjournment or postponement thereof.

Information regarding the matters to be acted upon at the Shareholders Meeting is contained in the Proxy Statement attached to this Notice.

Only shareholders of record at the close of business on March 31, 2011 are entitled to notice of, and to vote at, the Shareholders Meeting or any adjournment(s) thereof.

All shareholders, whether or not they expect to attend the Shareholders Meeting in person, are requested to complete, date, sign and return the enclosed proxy in the accompanying envelope. The proxy may be revoked by the person executing the proxy at any time before it is exercised by filing with the President of the Company an instrument of revocation or a duly executed proxy bearing a later date, or by electing to vote in person at the Shareholders Meeting.

BY ORDER OF THE BOARD OF DIRECTORS

Handwritten signature of Wesley M. Welborn in black ink.

Wesley M. Welborn
Chairman

Handwritten signature of Nathaniel F. Hughes in black ink.

Nathaniel F. Hughes
President

Chattanooga, Tennessee
March 18, 2011

YOU ARE ENCOURAGED TO ATTEND THE SHAREHOLDERS MEETING IN PERSON. IF YOU ARE UNABLE TO ATTEND THE SHAREHOLDERS MEETING, THE BOARD OF DIRECTORS REQUESTS THAT YOU, AT YOUR EARLIEST CONVENIENCE, PLEASE COMPLETE, DATE, SIGN AND RETURN THE ACCOMPANYING PROXY IN THE ENCLOSED REPLY ENVELOPE, WHICH NEEDS NO POSTAGE IF MAILED IN THE UNITED STATES.

**PROXY STATEMENT
FOR
ANNUAL MEETING OF SHAREHOLDERS
OF
CORNERSTONE BANCSHARES, INC.
TO BE HELD ON
APRIL 28, 2011**

SOLICITATION OF PROXIES

This Proxy Statement is being furnished to the shareholders (the "Shareholders") of Cornerstone Bancshares, Inc., a Tennessee corporation (the "Company"), in connection with the solicitation of proxies by the Board of Directors of the Company (the "Board") from holders of the outstanding shares of the Company's common stock, \$1.00 par value per share ("Common Stock"), for use at the annual meeting of the Shareholders to be held at the EPB Building, 7th Floor Auditorium, 10 W. Martin Luther King, Jr. Blvd, Chattanooga, Tennessee, on Thursday, April 28, 2011, beginning at 6:00 p.m. local time, and at any adjournment or postponement thereof (the "Shareholders Meeting"). In order to obtain directions to attend the Shareholders Meeting contact Ms. Charlotte Lindeman at (423) 385-3097.

The Board has fixed the close of business on March 31, 2011 as the record date for the determination of shareholders entitled to notice of, and to vote at, the Shareholders Meeting. Each share of Common Stock entitles the holder thereof to one vote. As of February 28, 2011, there were issued and outstanding **6,500,396** shares of Common Stock.

Proxies for the Shareholders Meeting are hereby being solicited on behalf of the Company. In connection with the solicitation of proxies, the Board has designated Mr. Nathaniel F. Hughes or Doyce G. Payne, M.D. as proxies. Shares represented by all properly executed proxy cards received in time for the meeting (the "Proxy Shares") will be voted at the Shareholders Meeting in accordance with the directions on such proxies. If no directions are specified, the Proxy Shares will be voted (i) "FOR" the election of the ten (10) persons specified as nominees for directors of the Company; (ii) "FOR" the ratification of the Audit Committee's appointment of Hazlett, Lewis & Bieter, PLLC as the Company's independent registered public accounting firm for the fiscal year ending December 31, 2011; and (iii) in the best judgment of the person named in the enclosed proxy in connection with the transaction of such other business as may properly come before the Shareholders Meeting. The Board knows of no other business that will be presented for consideration at the Shareholders Meeting other than the matters described in this Proxy Statement. Should any director nominee named herein become unable or unwilling to serve if elected, it is intended that the Proxy Shares will be voted for the election, in his or her stead, of such other person as the Board may recommend.

The proxy is revocable by you by providing written notice to the President of the Company at any time prior to the exercise of the authority granted thereby or by attending the Shareholders Meeting and electing to vote in person.

This Proxy Statement is dated March 18, 2011 and it and the accompanying notice and form of proxy are first being mailed to the Shareholders on or about March 18, 2011. All costs of preparing, printing, assembling and mailing the form of proxy and the material used in the solicitation will be paid by the Company.

The presence in person or by proxy of the holders of a majority of the shares of Common Stock will constitute a quorum for the transaction of business at the Shareholders Meeting. Votes cast by proxy or in person at the Shareholders Meeting will be counted by the person appointed by the Company to act as election inspector for the meeting. The election inspector will treat Proxy Shares that reflect abstentions as shares that are present and entitled to vote for purposes of determining the presence of a quorum. Abstentions will not be counted as votes for or against any proposal. In those instances where shares are held by brokers who are prohibited from exercising discretionary authority for beneficial owners who have not given voting instructions ("broker non-votes"), those shares will be counted as present for quorum purposes. Broker non-votes will not be counted as votes for or against any proposal.

IMPORTANT NOTICE REGARDING THE AVAILABILITY OF PROXY MATERIALS FOR THE SHAREHOLDER MEETING TO BE HELD ON APRIL 28, 2011: This Proxy Statement and the Company's 2010 Annual Report to Shareholders are available at www.cscbank.com in the Investor Relations area.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

Set forth below is information, as of February 28, 2011, with respect to beneficial ownership by (i) each person who is known to the Company to be the beneficial owner of 5% or more of the outstanding shares of Common Stock, (ii) each director and nominee for director of the Company, (iii) each named executive officer (as such term is defined under Item 402(m)(2) of Regulation S-K, referred to herein collectively as the “named executive officers”) for the fiscal year ended December 31, 2010 (referred to herein as “fiscal 2010”), and (iv) all directors and executive officers of the Company as a group. Unless otherwise indicated below, to the Company’s knowledge, all persons listed below have the sole voting and investment power with respect to their shares of Common Stock (except to the extent that authority is shared by spouses under applicable law).

<u>Name and Address of Beneficial Owner</u>	<u>Description</u>	<u>Amount and Nature of Beneficial Ownership of Common Stock</u>	<u>Percent of Outstanding Common Stock (1)</u>	<u>Amount and Nature of Beneficial Ownership of Series A Convertible Preferred Stock</u>	<u>Percent of Outstanding Series A Convertible Preferred Stock</u>
5% or More Beneficial Owners:					
The Banc Funds Company, L.L.C. 20 North Wacker Drive, Suite 3300 Chicago, IL 60606		407,406 (2)	6.27%		
Directors and Named Executive Officers:					
B. Kenneth Driver	Director	118,994 (3)	1.74%	4,000	2.77%
Karl Fillauer	Director	220,741 (3)(4)	3.23%	4,000	2.77%
David G. Fussell	Director	2,050 (3)	*	2,000	1.38%
Nathaniel F. Hughes	President and Director(5)	223,141 (3)(4)	3.27%	10,000	6.92%
Jerry D. Lee	Executive Vice President, Chief Credit Officer	188,740 (3)(4)(6)	2.76%	*	*
Lawrence D. Levine	Director	35,484 (3)(4)	*	600	*
Frank S. McDonald	Director	16,877 (3)	*	1,000	*
Doyce G. Payne, M.D.	Director	183,793 (3)(4)	2.69%	1,200	*
Gary W. Petty, Jr.	Senior Vice President and Chief Financial Officer	10,617 (3)	*	*	*
Carolyn J. Smith	Senior Vice President and Chief Deposit Officer	23,098 (3)	*	*	*
Robert B. Watson	Executive Vice President and	31,611 (3)	*	1,880	*

	Senior Loan Officer				
Wesley M. Welborn	Chairman and Director	47,323 (3)	*	4,000	2.77%
Billy O. Wiggins	Director	168,977 (3)(4)	2.47%	*	*
Marsha Yessick	Director	119,238 (3)(4)	1.75%		
All directors and executive officers as a group (14 persons)		1,390,683	20.36%	28,680	19.84%

* Signifies less than one percent.

- (1) Unless otherwise indicated, beneficial ownership consists of sole voting and investing power based on 6,500,396 shares issued and outstanding on February 28, 2011.
- (2) This information is based solely upon a Schedule 13G/A filed with the Commission on February 11, 2010 by The Banc Fund Company, L.L.C. (“TBFC”) on behalf of Banc Fund VI L.P. (“BF VI”), an Illinois limited partnership, Banc Fund VII L.P. (“BF VII”), an Illinois limited partnership, and Banc Fund VIII L.P. (“BF VIII”), an Illinois limited partnership, (collectively, the “Reporting Persons”) reporting beneficial ownership of 407,406 shares of the Company’s Common Stock. The general partner of BF VI is MidBanc VI L.P. (“MidBanc VI”), whose principal business is to be a general partner of BF VI. The general partner of BF VII is MidBanc VII L.P. (“MidBanc VII”), whose principal business is to be a general partner of BF VII. The general partner of BF VIII is MidBanc VIII L.P. (“MidBanc VIII”), whose principal business is to be a general partner of BF VIII. MidBanc VI, MidBanc VII, and MidBanc VIII are Illinois limited partnerships. The general partner of MidBanc VI, MidBanc VII, and MidBanc VIII is TBFC, whose principal business is to be a general partner of MidBanc VI, MidBanc VII, and MidBanc VIII. TBFC is an Illinois corporation whose principal shareholder is Charles J. Moore. Mr. Moore has been the manager of the Reporting Persons, since their respective inceptions. As manager, Mr. Moore has voting and dispositive power over the securities of the issuer held by each of those entities. As the controlling member of TBFC, Mr. Moore will control TBFC, and therefore each of the Partnership entities directly and indirectly controlled by TBFC.
- (3) Includes the following numbers of shares subject to purchase pursuant to options that are exercisable or will become exercisable within 60 days of February 28, 2011: Mr. Driver—11,650 shares; Mr. Fillauer—11,650 shares; Mr. Fussell—2,050 shares; Mr. Hughes—94,100 shares; Mr. Lee—90,100 shares; Mr. Levine—11,650 shares; Mr. McDonald—8,650 shares; Dr. Payne—11,650 shares; Mr. Petty—10,000 shares; Ms. Smith—17,000 shares; Mr. Watson—31,200 shares; Mr. Welborn—8,650 shares; Mr. Wiggins—11,650 shares; Ms. Yessick—11,650 shares; and all directors and officers as a group—331,650 shares. Such shares are deemed to be outstanding for the purposes of computing the percentage ownership of the individual holding such shares, but are not deemed outstanding for purposes of computing the percentage of any other person listed above as a beneficial owner.
- (4) Includes shares held by affiliated entities, shares held by spouses, children or other close relatives, and shares held jointly with spouses or as custodians or trustees, as follows: Mr. Fillauer—146,841 shares; Mr. Hughes—3,084 shares; Mr. Lee—41,554 shares; Mr. Levine—21,334 shares; Dr. Payne—67,228 shares; Mr. Wiggins—12,101 shares; and Ms. Yessick—51,429 shares.
- (5) Effective November 12, 2009, Mr. Hughes was appointed to serve as President of the Company.
- (6) Mr. Lee resigned from his positions with the Company and the Bank on January 4, 2011.

PROPOSALS

Item 1. ELECTION OF DIRECTORS

The Company's bylaws provide that the Board shall be comprised of nine to fifteen directors. Currently, the Board is comprised of ten directors.

On January 24, 2011, the Board nominated B. Kenneth Driver, Karl Fillauer, David G. Fussell, Nathaniel F. Hughes, Lawrence D. Levine, Frank S. McDonald, Doyce G. Payne, M.D., Wesley M. Welborn, Billy O. Wiggins and Marsha Yessick to stand for election as directors at the Shareholders Meeting. Should any nominee become unable to serve for any reason, or choose not to serve, the Board may designate a substitute nominee or nominees (in which event the persons named in the enclosed proxy card will vote all valid proxy cards for the election of such substitute nominee or nominees), allow the vacancy or vacancies to remain open until a suitable candidate or candidates are located or by resolution provide for a lesser number of directors.

Each director elected at the Shareholders Meeting will serve until the next Annual Meeting of Shareholders and until his or her successor has been duly elected and qualified or until his or her earlier resignation or removal.

Information about Director Nominees

Set forth below with respect to the nominees for director of the Company is information regarding their business experience during the past five years and other information. In addition, the individual experiences, qualifications, attributes and/or skills of each nominee for director that led to his or her nomination and contribute to the Board's effectiveness as a whole are also discussed below.

Name	Age	Principal Occupation and Qualifications
B. Kenneth Driver	75	Vice Chairman and Co-Chief Executive Officer of Fillauer Companies, Inc., a Chattanooga based prosthetic manufacturer, since 1914. He previously served as President and Chief Operations Officer of Fillauer Companies, Inc. from 1994 to 2007. Since 2007 to present he has served as the Vice Chairman and Vice CEO of the Fillauer Companies. He has been a director of the Company since 1997. Mr. Driver has extensive experience in the matters involved in running a large public company, has served in several capacities from CFO to President and has expertise in finance and accounting, corporate governance, employee matters, and mergers and acquisitions.
Karl Fillauer	63	Chairman and CEO of Fillauer Companies, Inc., a Chattanooga based prosthetic manufacturer, since 1914. He has been a director of the Company since 1997. Mr. Fillauer brings significant executive management experience and insight to the Board and is proficient in matters relating to finance and accounting, corporate governance, employee matters, and mergers and acquisitions.
David G. Fussell	64	Interim Chief Investment Officer (CIO) of Unum Group, a leading worldwide provider of employee benefits insurance. Mr. Fussell was employed by Unum Group and its predecessors for 42 years, including as its Senior Vice President of Investments from 2000 to 2004. He has been a director of the Company since January 2009. As the CIO of a large public company, Mr. Fussell acquired extensive experience in matters relating to finance and accounting, corporate governance, employee matters, mergers and acquisitions, risk assessment, civic affairs, and government relations. His investment background adds material depth to the Company's investment management and risk oversight process. In addition, he also serves on the board of several non-profit organizations.

Name	Age	Principal Occupation and Qualifications
Nathaniel F. Hughes	52	President of the Company and the Company's sole banking subsidiary, Cornerstone Community Bank (the "Bank"), since November 2009. He previously served as President and Chief Financial Officer of the Company and President and Chief Operating Officer of the Bank from June 2004 to November 2009. Prior to this time, Mr. Hughes served as President and Chief Financial Officer of the Company and the Bank from April 2003 to June 2004, and as Executive Vice President and Chief Financial Officer of the Company and the Bank from February 1999 to April 2003. Mr. Hughes has been a director of the Company since April 2003. He has over 25 years experience in the banking and financial services industry, including expertise in finance and accounting. Mr. Hughes possesses extensive knowledge of the Company's business and regulatory environment, including matters affecting public companies. As chief executive, he is intimately involved in the Company's strategic vision and direction and interacts with key executives and constituents within and outside the organization. He also serves on the board of several non-profit organizations.
Lawrence D. Levine	81	Retired insurance executive since 2002. Prior to 2002, he was President of Financial Management Corp., a Chattanooga based insurance and financial management company, for over twenty years. He has been a director of the Company since 1997. As a former small business risk management consultant, Mr. Levine brings an extensive amount of experience concerning the small business market and risk management. In addition, his background assists the Company in human resources management. He also serves on the board of several non-profit organizations.
Frank S. McDonald	59	President of FMA Architects, PLLC, a Chattanooga based architectural firm, for more than twenty-five years. He has been a director of the Company since September 2005. Mr. McDonald's extensive experience in the development and real estate industry assists the Bank's loan origination process and credit risk management. In addition, he has vast experience in board governance and has served as Chairman of several non-profit organizations.
Doyce G. Payne, M.D.	60	Dr. Payne practiced obstetrics and gynecology in the Chattanooga area for more than ten years prior to his retirement in 2004. He has been a director of the Company since 1997. As a resident of Chattanooga, his knowledge of the Chattanooga market fits well with the Company's strategy of focusing on its core banking franchise in Hamilton County. He also serves on the boards of several non-profit organizations.
Wesley M. Welborn	52	Chairman of the Board of Directors of the Company and the Bank since November 2009. Mr. Welborn also has served as President of Welborn & Associates, Inc., a Chattanooga based consulting firm specializing in transportation logistics, for more than ten years. He has been a director of the Company since September 2005. Mr. Welborn has served on the boards of numerous trucking companies and associations. In addition, he served on the board of a publicly traded bank for many years and for two terms as a director of the Federal Reserve Bank of Atlanta's Birmingham Branch. He also serves on the boards of several non-profit organizations.
Billy O. Wiggins	68	President of Checks, Inc., a Chattanooga based specialty check printing company, for more than ten years. He has been a director of the Company since 1997. Mr. Wiggins has expertise in retailing and wholesaling and extensive experience in the matters involved in running a large company, including finance and accounting, corporate governance, employee matters, and mergers and acquisitions.

Name	Age	Principal Occupation and Qualifications
Marsha Yessick	63	Owner of Yessick's Design Center, a Chattanooga based interior design company, for more than thirty years and a current member of the American Society of Interior Designers. She has been a director of the Company since 1997. As the founder and operator of several businesses, Ms. Yessick has developed significant experience in managing and operating businesses of varying sizes. In addition, her background assists the Company in human resources management.

Required Vote

Directors will be elected by a plurality of the votes cast at the Shareholders Meeting at which a quorum is present.

THE BOARD RECOMMENDS A VOTE “FOR” THE ELECTION OF EACH OF THE NOMINEES AS DIRECTORS OF THE COMPANY.

Item 2. RATIFICATION OF APPOINTMENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM FOR FISCAL 2011

The Audit Committee of the Board has appointed Hazlett, Lewis & Bieter, PLLC (“HLB”) to serve as the independent registered public accounting firm for the Company and its subsidiary for the fiscal year ending December 31, 2011 (sometimes referred to herein as “fiscal 2011”). HLB has served as the independent registered public accounting firm for the Company since 1997 and for the Bank since 1996. HLB has advised the Company that neither HLB nor any of its partners have any direct or material interest in the Company and its subsidiary except as the independent registered public accounting firm of the Company and its subsidiary.

The Company is asking the shareholders to ratify the Audit Committee’s appointment for fiscal 2011. In the event the Shareholders fail to ratify the appointment, the Audit Committee will consider it a direction to consider other independent registered public accounting firms after fiscal 2011. A representative of HLB will be present at the Shareholders Meeting and will be given the opportunity to make a statement on behalf of HLB if he or she so desires. The HLB representative is also expected to respond to appropriate questions from the shareholders.

Required Vote

The affirmative vote by holders of a majority of the shares of Common Stock represented at the Shareholders Meeting, at which a quorum is present, is required to ratify the appointment of HLB as the Company’s independent registered public accounting firm for fiscal 2011.

THE BOARD RECOMMENDS A VOTE “FOR” THE RATIFICATION OF THE APPOINTMENT OF HAZLETT, LEWIS & BIETER, PLLC AS THE COMPANY’S INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM FOR THE FISCAL YEAR ENDING DECEMBER 31, 2011.

CORPORATE GOVERNANCE AND THE BOARD OF DIRECTORS

The Company's business is managed by its employees under the direction and oversight of the Board of Directors. Board members are kept informed of the Company's business through discussions with management, materials provided to them by management and their participation in Board and Board Committee meetings.

Board Composition and Director Independence

The Board is currently comprised of ten directors. The directors of the Company are also directors of the Bank. The current Board is comprised of one employee director, Nathaniel F. Hughes, and nine non-employee directors, Messrs. Driver, Fillauer, Fussell, Levine, McDonald, Payne, Welborn and Wiggins and Ms. Yessick. Although the OTC Bulletin Board does not have rules regarding director independence, the Board in its business judgment has determined that each of the non-employee directors is an "independent director," as defined by the listing standards of the Nasdaq Stock Market, Inc. (the "Nasdaq listing standards"). The Board has four standing committees: the Audit Committee, the Asset/Liability Management and Strategic Planning Committee, the Human Resource/Compensation Committee (sometimes referred to herein as the "Compensation Committee") and the Nominating/Board Governance Committee. The Board limits membership on the Audit Committee, the Compensation Committee and the Nominating/Board Governance Committee to independent directors as defined by the Nasdaq listing standards and the rules and regulations of the Securities and Exchange Commission ("SEC"). The standing committees advise the Board on policy origination and plan administrative strategy and assure policy compliance through management reporting from areas under their supervision. Each of these four committees has an identical counterpart which serves the board of the Bank. In addition, the Bank has a Directors Loan Committee (the "Bank's Loan Committee"). The Bank's wholly owned subsidiary, Eagle Financial, Inc. ("Eagle"), has a board of directors comprised of four independent non-management directors and three management directors. The Company's Board selects the non-management directors from the Company's independent directors.

Board Leadership Structure

Currently, the Chairman of the Board is an independent director. The offices of Chairman of the Board and Chief Executive Officer ("CEO") are separated, with Nathaniel F. Hughes holding the position of interim CEO and Wesley M. Welborn being Chairman of the Board. The Company does not have a formal policy with respect to the separation or combination of the offices of Chairman of the Board and CEO. Rather, the Board has the discretion to combine or separate these roles as it deems appropriate from time to time, which provides the Board with necessary flexibility to adjust to changed circumstances. In light of the transition in management in 2009 and the many challenges arising from the difficult economic and regulatory environment, the Board determined that separating the roles of Chairman and CEO would allow the CEO to devote the requisite significant time and focus on managing our business and restoring financial strength. However, under other circumstances, the Board may determine that combining these roles would better serve the Company by enabling one individual to act as a bridge between management and the Board, thereby facilitating their common purpose, and clarifying lines of authority and responsibility. Historically, the Company has not designated a separate lead independent director at times when the offices of Chairman and CEO were combined.

Risk Oversight

Oversight of risk management is a central focus of the Board and its committees. The full Board regularly receives reports both from Board committees and from management with respect to the various risks facing the Company, including the Bank, and oversees planning and responding to them as appropriate. The Audit Committee currently has primary responsibility for oversight of financial risk and for oversight of the Company's risk management processes, including those relating to litigation and regulatory compliance. Under its charter, the Audit Committee is required to discuss the Company's risk assessment and risk management policies and to inquire about any significant risks and exposures and the steps taken to monitor and minimize such risks. The Asset/Liability Management and Strategic Planning Committee actively measures and manages interest rate risk and is responsible for approving the Company's asset/liability management policies and for overseeing the formulation and implementation of strategies to improve balance sheet positioning and earnings. The Human Resource/Compensation Committee is chiefly responsible for compensation-related risks. Under its charter, the Human Resource/Compensation Committee must discuss and review the key business and other risks the Company faces and the relationship of those risks to certain compensation arrangements. The Bank's Loan Committee has primary responsibility for credit risk and the committee's duties include oversight of the Bank's credit risk department. Each of these committees receives regular reports from management concerning areas of risk for which the committee has oversight responsibility. The Bank created a Chief Risk Officer

(“CRO”) who is directly responsible for the Bank’s Audit and Compliance programs and all the employees assigned to those functions. The CRO reports directly to the Audit Committee, which allows the Audit Committee to assist in managing the Bank’s risk.

Code of Conduct

The Company has adopted a Code of Conduct, which contains provisions consistent with the SEC’s description of a code of ethics, which applies to its directors, officers and employees, including its principal executive officers, principal financial officer, principal accounting officer, controller and persons performing similar functions. The purpose of the Code of Conduct is, among other things, to provide written standards that are reasonably designed to deter wrongdoing and to: (1) promote honest and ethical conduct; (2) provide full, fair, accurate, timely and understandable disclosure in reports and documents that the Company files with the SEC and other public communications by the Company; (3) be in compliance with applicable governmental laws, rules and regulations; (4) promptly report any violations of the Code of Conduct; and (5) establish accountability for adherence to the Code of Conduct. Each director is required to read and certify annually that he or she has read, understands and will comply with the Code of Conduct. The Company’s Code of Conduct is available on the Company’s website at www.cscbank.com in the Investor Relations area.

Meetings of the Board of Directors

Because all directors of the Company are also directors of the Bank, the Board of Directors of the Company and the Bank meet concurrently (collectively referred to herein as the “Board”). The Board held twelve meetings during 2010, and all directors attended at least 75% of the aggregate total number of meetings of the Board and meetings of the Board committees on which they served (to the extent held during the period for which the director had been a member of the Board or a member of such Board committees). The Company does not have a policy for director attendance at annual meetings. Five of our then ten directors were present at the Company’s 2010 Annual Meeting of Shareholders.

Audit Committee

The Audit Committee selects and engages the Company’s independent registered public accounting firm each year. In accordance with its charter, the Audit Committee, among other things, reviews the Company’s financial statements, the results of internal auditing, financial reporting procedures, reports of regulatory authorities, compliance with internal controls required by the Federal Deposit Insurance Corporation Improvement Act and regularly reports to the Board with respect to all significant matters presented at meetings of the Audit Committee. The charter of the Audit Committee is available on the Company’s website at www.cscbank.com in the Investor Relations area. The Audit Committee is currently comprised of four non-employee directors, Messrs. Levine, Payne, Fussell and McDonald, each of whom is “independent” as defined by the Nasdaq listing standards and the rules and regulations of the SEC. The Audit Committee does not have an “audit committee financial expert,” as defined in applicable SEC rules, because no director on the Board satisfies the criteria of an audit committee financial expert and the Company has not been able to find a suitable board member who is such an expert. The Audit Committee held four meetings for the Company during 2010, each of which was held concurrently with the Bank’s Audit Committee. Prior to the release of quarterly reports in 2010, the Audit Committee or a member of the Audit Committee also reviewed and discussed the interim financial information contained therein with HLB, the Company’s independent registered public accounting firm during fiscal 2010.

Audit Committee Report

Committee Charter

The Audit Committee and the Board have approved and adopted a charter for the Audit Committee, a copy of which is available on the Company’s website at www.cscbank.com in the Investor Relations area. In accordance with the charter, the Audit Committee assists the Board in fulfilling its responsibility for overseeing the accounting, auditing and financial reporting processes of the Company. The responsibilities of the Audit Committee are described in greater detail in its charter.

Auditor Independence

The Audit Committee received from HLB written disclosures and a letter regarding its independence as required by Public Company Accounting Oversight Board Rule 3526, “Communication with Audit Committees Concerning Independence,” describing all relationships between the independent registered public accounting firm and the Company

that might bear on the registered public accounting firm's independence, and discussed this information with HLB. The Audit Committee also reviewed and discussed with management and with HLB the quality and adequacy of the Company's internal controls. The Audit Committee also reviewed with HLB and financial management of the Company the audit plans, audit scope and audit procedures. The discussions with HLB also included the matters required by generally accepted auditing standards, including those described in Statement on Auditing Standards No. 61, as amended, and as adopted by the Public Company Accounting Oversight Board in Rule 3200T. The Audit Committee has also considered, and concluded, that the provision of services by HLB described under the caption "All Other Fees" are compatible with maintaining the independence of HLB.

Review of Audited Financial Statements

The Audit Committee has reviewed the audited financial statements of the Company as of and for the fiscal year ended December 31, 2010 and has discussed the audited financial statements with management and with HLB. Based on all of the foregoing reviews and discussions with management and HLB, the Audit Committee recommended to the Board of Directors that the audited financial statements be included in the Company's Annual Report on Form 10-K for the year ended December 31, 2010, to be filed with the SEC.

The foregoing report is submitted by the following members of the Audit Committee:

Doyce G. Payne, M.D., Chariman
Lawrence D. Levine
Frank S. McDonald
David G. Fussell

The information contained in this report shall not be deemed to be "soliciting material," or to be "filed" with the SEC or subject to Regulation 14A or 14C of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), other than as provided by applicable SEC rules, or to the liabilities of Section 18 of the Exchange Act, except to the extent that the Company specifically requests that the information be treated as soliciting material or specifically incorporates it by reference into a document filed under the Securities Act of 1933, as amended (the "Securities Act"), or the Exchange Act. In addition, such information shall not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the Company specifically incorporates it by reference.

Policies and Procedures for the Approval of Related Person Transactions

The charter of the Audit Committee provides that it must approve all transactions between the Company and related parties, as defined in applicable SEC rules and regulations. In accordance with this responsibility, the Audit Committee on a timely basis reviews and, if appropriate, approves all related party transactions. At any time in which an executive officer, director or nominee for director becomes aware of any contemplated or existing transaction that, in that person's judgment may be a related party transaction, such person is expected to notify the Chairperson of the Audit Committee of the transaction. Generally, the Chairperson of the Audit Committee reviews any reported transaction and may consult with outside legal counsel regarding whether the transaction is, in fact, a related party transaction requiring approval by the Audit Committee. If the transaction is considered to be a related party transaction, then the Audit Committee will review the transaction and, in deciding whether to approve the transaction, will consider the factors it deems appropriate under the circumstances, including, but not limited to, the following:

- The approximate dollar amount involved in the transaction, including the amount payable by or to the related person;
- The nature of the interest of the related person in the transaction;
- Whether the transaction may involve a conflict of interest;
- Whether the transaction involves the provision of goods or services to the Company that are available from unaffiliated third parties and, if so, whether the related party transaction is on terms no less favorable than terms generally available to an unaffiliated third party under the same or similar circumstances; and
- The purpose of the transaction and any potential benefits to the Company.

In addition to the Audit Committee's written responsibility, as mandated by the Audit Committee's charter, to approve related party transactions, the Company also has other written policies and procedures for approving and monitoring related third party transactions.

Audit and Non-Audit Fees

The following table presents the aggregate fees billed to the Company for professional services rendered by HLB for the fiscal years ended December 31, 2009 and December 31, 2010:

<u>Services</u>	<u>2009</u>	<u>2010</u>
Audit Fees (1):	\$ 144,258	\$ 132,569
Audit Related Fees (2):	\$ 18,000	\$ 18,000
Tax Fees (3):	\$ 16,675	\$ 21,259
All Other Fees (4):	\$ 0	\$ 0

- (1) Audit fees consist of services rendered for the audit of the annual financial statements, including required quarterly reviews, statutory and regulatory filings or engagements and services that generally only the independent registered public accounting firm can reasonably be expected to provide.
- (2) Audit-related services are assurance and related services that are reasonably related to the performance of the audit or review of the financial statements or that are traditionally performed by the independent registered public accounting firm and are not included in the "Audit Fees" category.
- (3) Tax fees are for professional services rendered for tax compliance, tax advice and tax planning.
- (4) All other fees are for services other than those in the previous categories such as permitted corporate finance assistance and permitted advisory services.

The charter of the Audit Committee provides that the duties and responsibilities of the Audit Committee include the pre-approval of all services that may be provided to the Company by the independent accountants whether or not related to the audit. In fiscal years 2009 and 2010, the Audit Fees, Audit Related Fees, Tax Fees and All Other Fees were pre-approved by the Audit Committee.

Asset/Liability Management and Strategic Planning Committee

The Asset/Liability Management and Strategic Planning Committee oversees and reviews the Company's investment portfolio, risk management process, development and implementation of the Company's strategic plan and interest risk positions. The current members of this Committee are Messrs. Driver, Fussell, Welborn and Wiggins. The Asset/Liability Management and Strategic Planning Committee held four meetings for the Company during 2010, each of which was held concurrently with an identical committee of the Bank. Ken Driver is the Company's Asset/ Liability Management committee chairman and attended the twelve Management ALCO meetings held during 2010.

Human Resource/Compensation Committee

The Human Resource/Compensation Committee makes recommendations to the Board with respect to the compensation of executive officers and employees of the Company and the Bank. The Human Resource/Compensation Committee administers the Company's 401(k) plan, Employee Stock Ownership Plan ("ESOP"), Statutory-Nonstatutory Stock Option Plan, 2002 Long Term Incentive Plan and 2004 Non-Employee Director Compensation Plan. In addition, the Human Resource/Compensation Committee oversees the Company's employee benefit and salary administration functions. The Board has adopted a written charter for this Committee, which is available on the Company's website at www.cscbank.com in the Investor Relations area. The Human Resource/Compensation Committee is comprised of four independent directors chosen annually by the Board. Messrs. Driver, Fillauer and Levine and Ms. Yessick, who is the Committee Chairperson, constitute the current members of the Human Resource/Compensation Committee. The Human Resource/Compensation Committee held six meetings for the Company during 2010, each of which was held concurrently with an identical committee of the Bank.

Nominating/Board Governance Committee

The Nominating/Board Governance Committee identifies, investigates and recommends prospective directors to the Board with the goal of creating a balance of knowledge, experience and diversity. Candidates for director nominees are reviewed in the context of the current composition of the Board, the operating requirements of the Company and the Bank

and the long-term interests of the Company's shareholders. The Nominating/Board Governance Committee develops and maintains a list of potential candidates for the Board. In assessing candidates for service as an independent director, the Nominating/Board Governance Committee considers: the individual's knowledge and contacts in the communities in which the Company does business; diversity of viewpoints, background, experience and other demographics; ability and willingness to commit adequate time to Board and committee matters; and the fit of the individual's skills and personality with those of other directors and potential directors in building an effective and responsive Board. The Nominating/Board Governance Committee does not set specific, minimum qualifications that nominees must meet in order for the Committee to recommend them for service on the Board, but rather believes that each nominee should be evaluated based on his or her individual merits, taking into account the needs of the Company and the composition of the Board.

As described above diversity, broadly defined to mean diversity of viewpoints, background, experience and other demographics, is one criterion on which the Nominating/Board Governance Committee bases its recommendations of new nominees for director positions. The Board believes that diversity is important to the effective functioning of the Board. More generally, the Board is committed to fostering an environment of non-discrimination and equal opportunity for employees, customers and suppliers and treatment of everyone without discrimination or harassment based on race, color, religion, sex, sexual orientation, gender identity, national origin, age, veteran status or disability. However, neither the Nominating/Board Governance Committee nor the Board has a formal policy with regard to the consideration of diversity in identifying director nominees.

The Nominating/Board Governance Committee also reviews the performance and contribution of independent members of the Board and determines the need for any corporate officer to be considered a candidate for nomination. The Nominating/ Board Governance Committee will not consider nominees for directors recommended by shareholders. The Board has adopted a written charter for the Nominating/Board Governance Committee, which is available on the Company's website at www.cscbank.com in the Investor Relations area. Each member of the Nominating/Board Governance Committee would be deemed independent under the Nasdaq listing standards. Messrs. Fillauer, Driver and Welborn and Ms. Yessick constitute the current members of the Nominating/Board Governance Committee. The Nominating/Board Governance Committee held no meetings during 2010.

Shareholder Communications with Directors

Shareholders are encouraged to communicate with directors either in person or in writing at any time. Communications are not screened and written communications are passed on to the Board for their review and consideration. Written communications should be sent to Cornerstone Bancshares, Inc., Attention: Chairman of the Audit Committee, 6401 Lee Highway, Suite 119, Chattanooga, Tennessee 37421.

EXECUTIVE COMPENSATION

Introduction

The Compensation Committee (the “Committee”) carries out the Board’s overall responsibilities with respect to executive compensation, director compensation and review of the Company’s Chief Executive Officer’s (the “CEO”) performance. The Committee also oversees administration of the Company’s employee benefit plans, including the Company’s 401(k) plan and ESOP. The Committee operates under a written charter (see www.cscbank.com) that is approved annually by the Board. The Committee Chairperson sets the agenda and calendar for the Committee. The Committee has the authority to hire independent consultants to advise the Committee on compensation matters. For fiscal 2010, the Committee did not hire an independent consultant to advise the Committee on compensation matters. The CEO reviews the performance of the other named executive officers and recommends to the Committee compensation packages for each of them.

Total compensation of the Company’s named executive officers is determined primarily by the Company’s size in earning assets, the Company’s financial performance and the individual executive’s performance. In determining what types and levels of total compensation to offer the named executive officers, the Committee follows its written Executive Compensation Policy, including guidelines, using predetermined Company financial parameters for the distribution of the particular components of total compensation to the named executive officers.

Compensation Philosophy

The Company’s overall executive compensation philosophy is to align its compensation program with optimizing shareholder value. To that end, the program is designed to recognize superior operating performance and to attract, retain and motivate the executive talent essential to the Company’s financial success. Consistent with this philosophy, the Committee is guided by the following objectives when administering the Company’s overall compensation program:

- Attract and retain highly qualified executives that portray the Company’s culture and values;
- Motivate executives to provide excellent leadership and achieve the Company’s goals;
- Provide substantial performance-related incentive compensation that is aligned to the Company’s strategies and directly tied to meeting specific Company objectives;
- Strongly link the interests of the executives to the value derived by the Company’s shareholders from owning the Company’s Common Stock; and
- Be fair, ethical, transparent and accountable in setting and disclosing executive compensation.

In furtherance of these objectives, the following considerations underlie the Committee’s determination with respect to the following principal elements of compensation for the named executive officers:

Base Salary – Individual salary determinations should be based upon incumbent qualifications, behaviors, cultural adherence and performance.

Annual Cash Incentives – Executives should have a portion of their total cash compensation at risk, contingent upon meeting Company objectives.

Long-Term Equity-Based Awards – Executives who are critical to the Company’s long-term success should participate in long-term incentive opportunities that link a portion of their total compensation to increasing shareholder value.

Retirement Plans and Other Benefits – Executives should participate in the Company’s benefit programs, such as health insurance, 401(k) plan, ESOP, vacation and life insurance, at a level consistent with policy, prevailing law and current regulation.

Total compensation is intended to correlate to the Company’s ability to grow earning assets, which in turn enhances the Company’s growth in shareholder value. The Committee did not use competitive salary surveys to determine or measure the total compensation of the named executive officers. A portion of each named executive officer’s total compensation consists of cash payments, including base salary and/or annual cash incentive awards. In addition, a portion of each named executive officer’s total compensation consists of equity awards designed to align the

interests of the named executive officers with the interests of the Company's stakeholders, who include shareholders, employees, directors and community interests.

Fiscal 2010 Summary Compensation Table and Narrative

Under rules established by the SEC, the Company is required to provide certain data and information regarding the compensation and benefits awarded to, earned by or paid to all persons who served as principal executive officer of the Company during 2010 and certain other executive officers, including the two other most highly compensated executive officers whose total compensation exceeded \$100,000 (the "named executive officers"). The disclosure requirements include the use of tables and narrative discussion of any material factors necessary to an understanding of the information disclosed in the tables. The summary compensation table below sets forth certain elements of compensation for the named executive officers of the Company and the Bank for the periods indicated.

FISCAL 2010 SUMMARY COMPENSATION TABLE

Name and Principal Position	Year	Salary (\$)	Bonus \$(1)	Stock Awards (\$)	Option Awards \$(2)	Non- equity Incentive Plan Compensation (\$)	Director Fees Earned or Paid in Cash \$(3)	All Other Compens- ation \$(4)	Total (\$)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
Gregory B. Jones(5) Former Chairman & CEO Company & Bank	2010 2009 2008	0 210,000 240,000	0 0 500	0 0 0	0 17,450 14,049	0 0 0	0 7,900 9,480	101,250 30,793 13,815	101,250 266,143 277,844
Nathaniel F. Hughes President Company & Bank	2010 2009 2008	179,200 179,200 179,200	203 250 500	0 0 0	0 11,300 18,955	0 0 0	9,480 9,480 9,480	0 0 10,325	188,883 199,980 217,960
Jerry D. Lee(6) Ex. Vice President Chief Credit Officer Bank	2010 2009 2008	170,700 170,700 170,700	203 250 500	0 0 0	0 11,300 18,955	0 0 0	3,160 9,480 9,480	0 0 9,741	174,063 191,730 209,376
Robert B. Watson Ex. Vice President Sr. Loan Officer Bank	2010 2009 2008	150,000 150,000 146,100	203 250 500	0 0 0	0 11,300 15,610	0 0 0	0 0 0	0 0 7,913	150,203 161,550 170,123
Carolyn J. Smith Sr. Vice President Chief Deposit Officer Bank	2010 2009 2008	110,000 95,500 93,000	217 250 500	0 0 0	0 5,650 6,690	0 0 0	0 0 0	0 0 5,223	110,217 101,400 105,413
Gary W. Petty Jr. Sr. Vice President CFO Company & Bank	2010 2009 2008	115,000 92,500 89,000	217 250 500	0 0 0	0 5,650 6,690	0 0 0	0 0 0	0 0 5,134	115,217 98,400 101,324

- (1) Represents small cash bonuses paid to the entire workforce in connection with the Christmas holiday season.
- (2) The amounts in this column reflect the aggregate grant date fair value of option awards computed in accordance with FASB ASC Topic 718. The fair value of each option award is estimated on the date of grant using the Black-Scholes option-pricing model. No options were awarded based on fiscal 2009 performance. Fiscal 2008 option awards were made on March 1, 2009 with a Black-Scholes value of \$1.13 per share. A more detailed discussion of the assumptions used in the valuation of option awards made in fiscal 2009 based on performance during 2008 may be found in Note 16 of the Notes to the Financial Statements in the Company's Form 10-K for the fiscal year ended December 31, 2010. Options acquired pursuant to option grants must generally be held at least two years before partial vesting is possible.
- (3) The amounts in this column reflect the aggregate amount of cash fees earned or paid to employee directors for attending meetings of the Board and the Bank, as described in greater detail under the section entitled "Director Compensation" below.

- (4) Amounts for fiscal 2008 represent aggregate Company contributions to its 401(k) plan and Employee Stock Ownership Plan (ESOP), which consisted of the following for each named executive officer: Mr. Jones – \$4,827 (401(k)) and \$8,988 (ESOP); Mr. Hughes – \$3,608 (401(k)) and \$6,717 (ESOP); Mr. Lee – \$3,404 (401(k)) and \$6,337 (ESOP); and Mr. Watson – \$2,765 (401(k)) and \$5,148 (ESOP). No such contributions were made for fiscal 2009 and 2010. The fiscal 2009 amount for Mr. Jones represents the aggregate amount of severance payments and continued benefits paid or reimbursed to Mr. Jones with respect to fiscal 2009 under the terms of his separation agreement following his resignation.
- (5) Mr. Jones resigned as Chairman and Chief Executive Officer and as a director of the Company, and was no longer employed by the Company, effective November 12, 2009. See the section entitled “Separation Agreement with Mr. Jones” below for a description of his separation agreement.
- (6) Mr. Lee resigned as Executive Vice President and Chief Credit Officer and was no longer employed by the Company, effective January 4, 2011.

Outstanding Equity Awards at 2010 Fiscal Year-End Table and Narrative

The following table sets forth information concerning outstanding equity based awards for each of the named executive officers as of December 31, 2010. Because the Company has never issued stock appreciation rights, restricted stock awards or other stock awards, the table excludes all columns relating to such awards.

OUTSTANDING EQUITY AWARDS AT 2010 FISCAL YEAR-END

Name	Grant Date	Option Awards (1)		Option Exercise Price (\$)	Option Expiration Date
		Number of Securities Underlying Unexercised Options (2)			
		Exercisable (#)	Unexercisable (#)		
Nathaniel F. Hughes(3)	3/01/2001	20,400		3.250	3/01/2011
	5/01/2002	20,000		3.625	5/01/2012
	3/01/2003	22,000		3.625	3/01/2013
	3/01/2004	26,000		5.438	3/01/2014
	3/01/2005	18,000		9.225	3/01/2015
	3/01/2008	2,550	5,950	7.990	3/01/2018
	3/01/2009	0	10,000	3.650	3/01/2019
Jerry D. Lee(3)	3/01/2001	20,400		3.250	3/01/2011
	5/01/2002	20,000		3.625	5/01/2012
	3/01/2003	22,000		3.625	3/01/2013
	3/01/2004	26,000		5.438	3/01/2014
	3/01/2005	14,000		9.225	3/01/2015
	3/01/2008	2,550	5,950	7.990	3/01/2018
	3/01/2009	0	10,000	3.650	3/01/2019

Name	Grant Date	Option Awards (1)		Option Exercise Price (\$)	Option Expiration Date
		Number of Securities Underlying Unexercised Options (2)			
		Exercisable (#)	Unexercisable (#)		
Robert B. Watson(3)	3/01/2003	8,000		3.625	3/01/2013
	3/01/2004	10,000		5.438	3/01/2014
	3/01/2005	6,000		9.225	3/01/2015
	3/01/2008	2,100	4,900	7.990	3/01/2018
	3/01/2009	0	10,000	3.650	3/01/2019
Carolyn J. Smith(3)	3/01/2001	2,000		3.250	3/01/2011
	5/01/2002	3,200		3.625	5/01/2012
	3/01/2003	4,000		3.625	3/01/2013
	3/01/2004	4,000		5.438	3/01/2014
	3/01/2005	2,500		9.225	3/01/2015
	3/01/2008	900	2,100	7.990	3/01/2018
	3/01/2009	0	5,000	3.650	3/01/2019
Gary W. Petty Jr.(3)	5/01/2002	1,000		3.625	5/01/2012
	3/01/2003	1,600		3.625	3/01/2013
	3/01/2004	2,600		5.438	3/01/2014
	3/01/2005	1,500		9.225	3/01/2015
	3/01/2008	900	2,100	7.990	3/01/2018
	3/01/2009	0	5,000	3.650	3/01/2019

- (1) All employee stock options have been awarded under the Company's Statutory-Nonstatutory Stock Option Plan, which was approved by the shareholders in 1996, and the Company's 2002 Long Term Incentive Plan, which was approved by the shareholders in 2002. All unexercised stock options have been adjusted for the 2-for-1 stock splits of September 2004 and December 2006.
- (2) All employee 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.
- (3) On February 26, 2010, all named executive officers voluntarily forfeited their options for the award years 2006 and 2007, and the shares underlying these options became available for distribution in connection with future awards under the plan.

Agreements or Arrangements Providing for Potential Payments Upon Termination or Change-in-Control

Key Executive Employment Agreements

The Company entered into Key Executive Employment Agreements (the "key executive agreements") with Nathaniel F. Hughes, President and Chief Executive Officer, and Jerry D. Lee, Executive Vice President and Chief Credit Officer, each of which is no longer in effect. The key executive agreements had an initial term of three years. Mr. Hughes key executive agreement was extended, with Board approval, to March 2, 2011. Such agreement was not extended past March 2, 2011 and it expired at that time. It is no longer in full force and effect. Mr. Lee's key executive agreement had an initial term of three years and was extended, with Board approval, to March 2, 2011. Such key executive agreement was terminated on January 4, 2011 with Mr. Lee's resignation of employment. Such agreement is no longer in full force and effect.

Company Equity Plans

Under the terms of the Company's 2002 Long Term Incentive Plan, the vesting of any outstanding stock options and other awards under the plan will be accelerated upon the occurrence of a change of control so that all awards not previously exercisable and vested are fully exercisable and vested. For purposes of this plan, a "change of control" means the happening of any of the following:

- When any "person" (as such term is used in Section 13(d) and 14(d) of the Exchange Act, other than the Company or a subsidiary or any Company employee benefit plan (including its trustee)) is or becomes the "beneficial owner" (as defined in Rule 13d-3 under the Exchange Act) directly or indirectly of securities of the Company representing 51% or more of the combined voting power of the Company's then outstanding securities;
- The occurrence of a transaction requiring shareholder approval for the acquisition of the Company by an entity other than the Company or a subsidiary through purchase of assets, by merger or otherwise; or
- The filing of an application with any regulatory authority having jurisdiction over the ownership of the Company by any "person" (as defined above) to acquire 51% or more of the combined voting power of the Company's then outstanding securities.

Also under the terms of the plan, if the employment of a participant in the plan is terminated for any reason following a change of control, any outstanding stock options or other awards under the plan granted to the participant that are not fully exercisable and vested will become fully exercisable and vested as of the date of such termination and any obligations to pay amounts to the Company or any subsidiary in connection with an award will be terminated as of the date when such termination occurs.

DIRECTOR COMPENSATION

Fees for Board Service

The Company's directors do not receive fees for attendance at meetings of the Board or committees of the Board of the Company. Rather, because these meetings are held concurrently with the meetings of the Board and equivalent committees of the Board of the Bank, meeting fees are paid by the Bank solely with respect to attendance at meetings of the Board and committees of the Board of the Bank. Although employee directors are entitled to receive cash fees for attendance at Board meetings, they are not eligible for Board committee attendance fees or to participate in the Company's annual cash incentive or long-term incentive award programs. In fiscal 2010, each director received \$790 for attendance at each concurrent Board meeting (two paid absences per calendar year are allowed). Each non-employee director (also referred to herein as an "independent director") also received \$240 for attendance at each concurrent Audit Committee meeting and \$210 for attendance at each other Board committee meeting (including concurrent meetings of equivalent Board and Bank committees and meetings of the Bank's Loan Committee), except that the Chairperson of the Audit Committee and of each other Board committee of the Bank received \$290 and \$240, respectively, for attendance at such meetings. The Chairman of the Board also receives cash chairmanship fees (currently, \$100,000 on an annualized basis) for such service of which \$28,838 was allocated to the Bank. Total director fees paid by the Bank for services rendered on behalf of the Bank in 2010 (excluding fees paid for Eagle Board Service) were \$191,813.

In addition, Board members who are also directors of Eagle received \$400 for each Eagle board meeting attended in 2010. Eagle held four board meetings during 2010. There are no other fees or compensation earned for being on Eagle's board and Eagle does not have any standing committees. Total director fees paid by Eagle for services rendered on behalf of Eagle in 2010 were \$4,000.

Director Annual Cash Incentive Awards

The independent directors of the Company are eligible to receive an annual cash incentive award if the Company meets certain financial performance goals set forth in its profit plan, as from time to time amended. These payments may be paid in cash or, at the election of each independent director under the 2004 Non-Employee Director Compensation Plan, in shares of Common Stock. Performance targets are established at the beginning of the fiscal year through the financial budgeting process. Therefore, the independent directors' annual cash incentive awards are determined based on the Company's overall financial performance. The opportunity to earn a cash incentive award payment ranges from 0% to 100% of the average independent directors' compensation received in Board, subsidiary Board and committee fees. The independent directors' cash incentive award pool is further limited to not be greater than the executive officers' cash incentive award pool. Because the Company did not provide any funds for the executive officers' cash incentive award pool in fiscal 2010, the independent directors did not receive any cash incentive awards for fiscal 2010.

Director Long-Term Equity Based Awards

The Company's independent directors are also eligible to participate in the Company's Statutory-Nonstatutory Stock Option Plan and the 2002 Long Term Incentive Plan, each of which was previously approved by the Company and its shareholders. The Compensation Committee establishes, in February of each fiscal year, assuming the achievement of certain financial targets for such fiscal year, the value of the Company's incentive stock options that will be issued the following calendar year. Based on the market value of the incentive stock options issued to all Company employees, the independent directors as a group participate at a level of 15% of the total market value of all stock options granted to both employees and independent directors. The employee grant represents 85% of the total Company grant, while the independent director grant, as a group, represents 15% of the total Company grant. The independent directors did not receive a fiscal 2011 award of non-qualified stock options to date due to reluctance to issue an award given the Company's condition. When awarded, non-qualified stock options issued to independent directors vest 50% on the first anniversary of the grant date and 100% on the second anniversary of the grant date. The Compensation Committee does not support the timing of granting stock options with the release of material non-public information. Instead, the Compensation Committee has chosen March 1 of each year as the grant date of stock options to eliminate any suspicion of timing the stock option grant date. The Compensation Committee has never, and has no plans to ever, time the stock option grant dates to the release of material non-public information for the purpose of affecting the value of executive compensation. The Company has recognized the compensation expense related to the shares subject to these awards.

Director Compensation Table

The following table sets forth the compensation earned by the Company's independent directors for services rendered during the fiscal year ended December 31, 2010:

DIRECTOR COMPENSATION FOR FISCAL 2010*

Name	Fees Earned or Paid in Cash \$(1)	Stock Awards (\$)	Option Awards \$(2)	Non-Equity Incentive Plan Compensation (\$)	All Other Compensation (\$)	Total (\$)
B Kenneth Driver	20,510	0	0	0	0	20,510
Karl Fillauer	14,230	0	0	0	0	14,230
David G. Fussell	14,305	0	0	0	0	14,305
Lawrence D. Levine	17,035	0	0	0	0	17,035
Frank S. McDonald	18,775	0	0	0	0	18,775
Doyce G. Payne, M.D.	17,820	0	0	0	0	17,820
Wesley M. Welborn	109,480	0	0	0	0	109,480
Billy O. Wiggins	26,650	0	0	0	0	26,650
Marsha Yessick	15,530	0	0	0	0	15,530

* Nathaniel F. Hughes and Jerry D. Lee are named executive officers in this proxy statement and Messrs. Hughes and Lee were a member of the Board of Directors of the Company during all or part of fiscal 2010. Their director compensation is set forth under "Column (h)" of the "Fiscal 2010 Summary Compensation Table" above and, as a result, has been omitted from this table. Mr. Lee resigned from the Company and Bank on January 4, 2011.

(1) The aggregate amount of director fees for fiscal 2010 includes aggregate meeting fees paid by Eagle for service on its board of directors as follows: Ken Driver \$800; Ms. Yessick \$1,600; Mr. Wiggins \$1,600. In addition, the aggregate amount for Mr. Welborn includes fiscal 2010 chairmanship fees paid to him following his appointment as Chairman of the Board effective November 12, 2009.

(2) For each non-employee director, the aggregate number of shares of Common Stock underlying option awards outstanding (whether or not exercisable) at December 31, 2010, after giving effect to the 2-for-1 stock splits in September 2004 and December 2006, was as follows: Mr. Driver—11,650 shares; Mr. Fillauer—11,650 shares; Mr. Fussell—2,050 shares; Mr. Levine—11,650 shares; Mr. McDonald—8,650 shares; Dr. Payne—11,650 shares; Mr. Welborn—8,650 shares; Mr. Wiggins—11,650 shares; and Ms. Yessick—11,650 shares. Non-qualified stock options are granted to independent directors with an exercise price equal to the market price on the grant date, and vest 50% on the first anniversary of the grant date and 100% on the second anniversary of the grant date.

THE COMPANY'S LONG-TERM EQUITY AND QUALIFIED RETIREMENT PLANS

401(k) Plan

The Company has a 401(k) plan covering employees meeting certain age requirements and service date requirements. The plan is structured such that employees can contribute to the plan on a tax-deductible basis and have their contributions invested in various investment funds offered under the plan. The plan permits, but does not require, the Company to make an employer matching contribution during the plan year. Employer contributions, which when made represent 33% of the first 6% of an employee's salary contributed to the plan, totaled \$0 in 2010.

Employee Stock Ownership Plan

The Company has an Employee Stock Ownership Plan ("ESOP") to which the Company contributes 100% of the contribution toward purchasing the Company's Common Stock, and allocates the contribution among the participants based on regulatory guidelines. The Company has set a maximum guideline of 9% of base pay, including cash incentive performance awards, as a maximum contribution limit. However, the Company will only provide a contribution to the ESOP when the Compensation Committee, upon approval of the Board, recommends a Company contribution. The Company's contribution is determined by the financial performance of the Company on a year-to-year basis, and the

benchmarks are established by the Compensation Committee. Employer contributions are available to all employees who complete more than 1,000 hours of service per year. There are certain age and years-of-service requirements before contributions can be made for the benefit of the employee. The ESOP plan also provides for a three year 100% vesting requirement; therefore, employees terminating employment before their third anniversary date will forfeit their accrued benefit under the ESOP. The forfeiture will be re-allocated among the remaining ESOP participants. The Company contributed \$0 to the ESOP for 2010.

Cornerstone Bancshares, Inc. Statutory-Nonstatutory Stock Option Plan

The Company established the Statutory-Nonstatutory Stock Option Plan during 1996 as a long-term incentive for eligible employees and directors. A total of 820,000 shares, as adjusted for the 2-for-1 stock splits effective September 2004 and December 2006, are available for issuance under the plan, of which 220,000 were allocated as incentive stock options and 600,000 were allocated as nonqualified stock options. The persons eligible to receive incentive stock options under the plan are key Company employees and officers selected by the Compensation Committee. Persons designated by the Compensation Committee who are eligible to receive nonqualified options need not be employees of the Company and generally will be non-management directors of the Company. The nonqualified stock options are issued at the market value of the Company's stock and are exercisable upon vesting. The term of all options issued under the plan is for 10 years. Under the terms of the plan, no further incentive stock options may be awarded. As of December 31, 2010, a total of 71,600 incentive stock options had been exercised, 48,800 outstanding incentive stock options remained exercisable and 99,600 had been forfeited under the terms of the plan. As of December 31, 2010, a total of 595,000 nonqualified stock options had been granted under the plan of which, 526,000 had been exercised and 69,000 remained exercisable and 5,000 nonqualified stock options remained available for future issuance. On February 26, 2010, all independent directors voluntarily forfeited their options for the award years 2006 and 2007, and the shares underlying these options became available for distribution in connection with future awards under the plan.

Cornerstone Bancshares, Inc. 2002 Long Term Incentive Plan

The Company established the 2002 Long Term Incentive Plan (the "Incentive Plan") with shareholder approval in April 2002 as long-term incentive for eligible employees and directors. A total number of 1,200,000 shares, as adjusted for the 2-for-1 stock splits effective September 2004 and December 2006, are available for issuance under the Incentive Plan. The Incentive Plan allows for the issuance of restricted stock, stock appreciation rights, performance awards, non-qualified stock options and incentive stock options. The persons eligible to receive grants under the Incentive Plan are key Company officers, employees and directors selected by the Compensation Committee. The incentive stock options are issued at the market value of the Common Stock and 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. The nonqualified stock options are issued at the market value of the Common Stock and vest 50% on the first anniversary of the grant date and 100% on the second anniversary of the grant date. The term of all grants are determined by the Compensation Committee, but may not exceed ten years. As of December 31, 2010, a total of 516,000 incentive stock options had been issued to Company employees under the Incentive Plan, of which 472,100 remained outstanding. Of the incentive stock options that had been issued as of December 31, 2010, 12,650 had been exercised, 343,350 remained exercisable, 128,750 remained unvested and 271,500 had been forfeited and made available for future issuance under the plan. As of December 31, 2010, a total of 33,300 nonqualified stock options had been issued to Company directors under the Incentive Plan, of which 31,250 remained outstanding. Of the nonqualified stock options that had been issued as of December 31, 2010, none had been exercised, 22,025 remained exercisable, 9,225 remained unvested and 2,050 had been forfeited and made available for future issuance under the plan. The Incentive Plan has 684,000 remaining stock options available for future issuance.

Cornerstone Bancshares, Inc. 2004 Non-Employee Director Compensation Plan

The Company's Board of Directors established the 2004 Non-Employee Director Compensation Plan (the "Director Plan") to provide to non-employee directors the option to receive all or part of their compensation for serving on the Board and on any committee of the Board in shares of Common Stock. The total number of shares that may be issued under the Director Plan may not exceed 80,000, as adjusted for the 2-for-1 stock splits effective September 2004 and December 2006. Shares of Common Stock payable under the Director Plan are issued within forty-five days of the end of the calendar quarter in which they were earned. The number of shares delivered pursuant to the Director Plan is equal the amount of the applicable director compensation divided by the average closing price of the Common Stock for the five trading days immediately preceding the date on which such director compensation was earned.

Equity Compensation Plan Information as of December 31, 2010

Plan category	Number of securities to be issued upon exercise of outstanding options	Weighted average exercise price of outstanding options	Number of securities remaining available for future issuance
Equity compensation plans approved by security holders:	621,150	\$ 6.37	788,600
Equity compensation plans not approved by security holders:	0	\$ 0.00	80,000
Total	621,150	\$ 6.37	868,600

CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Various Company directors, executive officers and their affiliates, including corporations and firms of which they are officers or in which they and/or their families have an ownership interest, are customers of the Company and its subsidiary. These persons, corporations and firms have had transactions in the ordinary course of business with the Company and its subsidiary, including borrowings, all of which, in the opinion of management, were on substantially the same terms including interest rates and collateral as those prevailing at the time for comparable transactions with unaffiliated persons and did not involve more than the normal risk of collectibility or present other unfavorable features. The Company and its subsidiary expect to have such transactions on similar terms with directors, executive officers and their affiliates in the future. The aggregate amount of loans outstanding by the Bank to directors, executive officers and related parties as of December 31, 2010 was approximately \$666,336, which represented 2.6% of the Company's consolidated shareholders' equity on that date.

OTHER MATTERS

Section 16(a) Beneficial Ownership Reporting Compliance

Under 16(a) of the Securities Exchange Act of 1934, as amended, directors and executive officers of the Company and persons who own 10% or more of the Company's Common Stock are required to report to the Securities and Exchange Commission (the "SEC"), within specified due dates, their initial beneficial ownership of the Company's Common Stock and all subsequent changes to their beneficial ownership. Officers, directors and greater than 10% shareholders are required by SEC regulations to furnish the Company with copies of all forms they file in accordance with Section 16(a). Based solely on the Company's review of these reports or on representations or information provided to the Company by the persons required to make such filings, the Company believes that all Section 16(a) filing requirements were complied with during the last fiscal year, with the exception of the following filings: (1) Miller Welborn filed three late reports on Form 4 (a) on February 22, 2010, reporting one late transaction related to the purchase on February 17, 2010 of 5,890 shares of the Company's Common Stock ("common") and the purchase on February 19, 2010 of 67 shares of common. (b) on October 29, 2010, reporting one late transaction related to the purchase on September 1, 2010 of 1,000 shares of the Company's Series A Convertible Preferred Stock ("preferred"). (c) on November 23, 2010, reporting one late transaction related to the purchase on November 17, 2010 of 1,000 shares of common. (2) Lawrence Levine filed four late reports on Form 4 (a) on February 24, 2010, reporting two late transactions related to the sale on February 11, 2010 of 500 shares of the common and the sale on February 17, 2010 of 300 shares of common. (b) on July 2, 2010, reporting one late transaction related to the sale on June 23, 2010 of 750 shares of common. (c) on September 1, 2010, reporting one late transaction related to the sale on August 26, 2010 of 825 shares of common. (d) on February 16, 2010, reporting one late transaction related to the purchase on August 26, 2010 of 600 shares of the preferred. (3) Nathaniel F. Hughes filed two late reports on Form 4 (a) on October 29, 2010, reporting two late transactions related to the purchases on August 31, 2010 of 800 shares of preferred and on September 7, 2010 of 1,000 shares of preferred (b) on February 16, 2011, reporting two late transactions related to the purchase on December 28, 2010 of 2,000 shares of preferred and on December 31, 2010 of 3,000 shares of preferred. (4) Barry Watson filed one late report on Form 4 on October 29, 2010, reporting one late transaction related to the purchases on August 31, 2010 of 1,200 shares of the preferred. (5) Frank McDonald filed one late report on Form 4 on October 29, 2010, reporting one late transaction related to the purchase on September 2, 2010 of 1,000 shares of the preferred. (6) Ken Driver filed one late reports on Form 4 on October 29, 2010, reporting one late transaction related to the purchase on September 22, 2010 of 4,000 shares of the preferred. (7) Doyce

Payne filed one late report on Form 4 on October 29, 2010, reporting one late transaction related to the purchase on August 31, 2010 of 1,200 shares of the preferred. (8) Karl Fillauer filed one late report on Form 4 on October 29, 2010, reporting one late transaction related to the purchase on August 31, 2010 of 2,000 shares of the preferred.

Shareholder Proposals for the 2011 Annual Meeting

Under SEC rules, proposals from the Company's eligible shareholders for presentation for action at the 2012 Annual Meeting of Shareholders must be received by the Company at its principal executive offices no later than November 26, 2011 in order to be considered for inclusion in the Company's proxy statement and proxy relating to the 2012 Annual Meeting of Shareholders.

Available Information

The Company is subject to the informational requirements of the Exchange Act and, in accordance therewith, is required to file reports, proxy statements and other information with the SEC. This information is available on the Internet at the SEC's website at www.sec.gov. Shareholders may also read and copy such reports, proxy statements and other information at the Public Reference Room at 100F Street, N.E., Washington, D.C. 20549. Shareholders may obtain information on the operation of the SEC's Public Reference Room by calling the SEC at 1-800-SEC-0330.

Annual Report on Form 10-K

A copy of the Company's Annual Report on Form 10-K is being mailed with this proxy statement to each shareholder of record.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2010

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For transition period from _____ to _____

Commission file number 000-30497



(Exact Name of Registrant as Specified in its Charter)

Tennessee
(State of Incorporation)

62-1173944

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

835 Georgia Avenue,
Chattanooga, TN 37402
(Address of principal executive offices)(Zip Code)

(423) 385-3000

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, \$1.00 Par Value

Indicate by check mark if Registrant is a well known seasoned issuer, as defined in Rule 405 of the of the Securities Act.

Yes No

Indicate by check mark if Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.

Yes No

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 and 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 whether the Registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files).

Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (229.405 of this chapter) is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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.

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

The aggregate market value of the common stock held by non-affiliates of the Registrant on June 30, 2010 was \$12 million. The market value calculation was determined using the closing sale price of the Registrant's common stock on June 30, 2010, as reported on the OTC Bulletin Board. For purposes of this calculation, the term "affiliate" refers to all directors, executive officers and 10% shareholders of the Registrant. As of the close of business on December 31, 2010 there were 6,500,396 shares of the Registrant's common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Proxy Statement for the 2011 Annual Meeting of Shareholders (the "2011 Proxy Statement") are incorporated by reference into Part III of this Annual Report on Form 10-K to the extent described herein.

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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 7), 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 this Annual Report on Form 10-K, 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.

PART I

ITEM 1. BUSINESS

OVERVIEW

Cornerstone was incorporated on September 19, 1983 under the laws of the State of Tennessee. Cornerstone is a bank holding company registered under the Bank Holding Company Act of 1956, as amended, and was formerly known as East Ridge Bancshares, Inc. It has one wholly-owned subsidiary: Cornerstone Community Bank, a Tennessee banking corporation (the “Bank”), which resulted from the merger of The Bank of East Ridge and Cornerstone Community Bank effective October 15, 1997. The Bank has one wholly-owned subsidiary: Eagle Financial Inc., a Tennessee corporation (“Eagle”), created December 1, 2005 with the assets acquired from Eagle Financial, LLC, a Tennessee limited liability company, and Eagle Funding, LLC, a Nevada limited liability company.

Cornerstone

The primary activity of Cornerstone currently is, and is expected to remain for the foreseeable future, the ownership and operation of the Bank. As a bank holding company, Cornerstone intends to facilitate the Bank's ability to serve its customers' requirements for financial services. The holding company structure also provides flexibility for expansion through the possible acquisition of other financial institutions and the provision of additional banking-related services, as well as certain non-banking services, which a traditional commercial bank may not provide under present laws. The holding company structure also affords additional flexibility in terms of capital formation and financing opportunities. In prior years, Eagle was owned and operated by Cornerstone. However, on June 30, 2009, Eagle was sold to the Bank. This transaction allowed the Bank to consolidate additional capital and improve its regulatory capital position.

While Cornerstone may seek in the future to acquire additional banks or bank holding companies or to engage in other activities appropriate for bank holding companies under appropriate circumstances as permitted by law, Cornerstone currently has no plans, understandings or agreements concerning any other activities other than as described below. The results of operations and financial condition of Cornerstone for the foreseeable future, therefore, will be determined primarily by the results of operations and financial condition of the Bank.

The Bank

The Bank is a Tennessee-chartered commercial bank established in 1985 which has its principal executive offices in Chattanooga, Tennessee. The principal business of the Bank consists of attracting deposits from the general public and investing those funds, together with funds generated from operations and from principal and interest payments on loans, primarily in commercial loans, commercial and residential real estate loans, consumer loans and residential and commercial construction loans. Funds not invested in the loan portfolio are invested by the Bank primarily in obligations of the U.S. Government, U.S. Government agencies, various states and their political subdivisions. In addition to deposits, sources of funds for the Bank loans and other investments include amortization and prepayment of loans, sales of loans or participations in loans, sales of its investment securities and borrowings from other financial institutions. 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.

At December 31, 2010, the Bank had five full-service banking offices located in Hamilton County, Tennessee and one loan production office located in Dalton, Georgia.

Eagle

Eagle's business concentrates on the purchase of accounts receivable from small businesses and commercial loan placement on a conduit basis. The principal sources of Eagle's income are fees derived from the collection of accounts receivable and fees generated from the placement of loans with conduit financial institutions. Eagle's principal expenses are employee compensation and benefits, office expenses and other overhead expenses.

Employees

As of December 31, 2010, Cornerstone had 112 full-time equivalent employees. The employees are not represented by a collective bargaining unit. Cornerstone believes that its relationship with its employees is good.

Competition

All phases of the Bank's banking activities are highly competitive. The Bank competes actively with over 20 commercial banks, as well as finance companies, credit unions, and other financial institutions located in its service area, which includes Hamilton County, Tennessee.

The Bank's deposits totaled approximately \$335 million as of December 31, 2010. The deposit base represents approximately 5% of the deposit base in the Chattanooga, Tennessee Metropolitan Statistical Area (MSA). Three major regional banks represent approximately 70% of the deposits in the Chattanooga, Tennessee MSA. These larger financial institutions have greater resources, higher lending limits than the Bank, and each of the three institutions has over 20 branches in the Chattanooga, Tennessee MSA. There are also several credit unions located in Hamilton County, Tennessee. Credit unions are not subject to the same income tax structure as commercial banks. This advantage enables credit unions to offer competitive rates to potential customers. The Bank also faces competition in certain areas of its business from mortgage banking companies, consumer finance companies, insurance companies, money market mutual funds and investment banking firms, some of which are not subject to the same degree of regulation as the Bank.

The Bank competes for deposits principally by offering depositors a variety of deposit programs with competitive interest rates, quality service and convenient locations and hours. The Bank focuses its resources to seek out and attract small business relationships and take advantage of the Bank's ability to provide flexible service that meets the needs of this customer class. Management feels this market niche is the most promising business area for the future growth of the Bank.

Supervision and Regulation

Cornerstone is a bank holding company within the meaning of the Bank Holding Company Act of 1956, as amended (the "Act"), and is registered with and regulated by the Board of Governors of the Federal Reserve System (the "Federal Reserve Board"). Cornerstone is required to file with the Federal Reserve Board annual reports and such additional information as the Federal Reserve Board may require pursuant to the Act. The Federal Reserve Board may also make examinations of Cornerstone and its subsidiary. Cornerstone is also required to comply with the rules and regulations of the Securities and Exchange Commission (the "Commission") under federal securities laws.

The Bank is a Tennessee-chartered commercial bank and is subject to the supervision and regulation of the Tennessee Department of Financial Institutions (the "TDFI"). In addition, the Bank's deposit accounts are insured up to applicable limits by the Deposit Insurance Fund (the "DIF") of the Federal Deposit Insurance Corporation (the "FDIC") and consequently, the Bank is also subject to regulation and supervision by the FDIC. The Bank is not a member of the Federal Reserve System.

Federal and state banking laws and regulations govern all areas of the operations of Cornerstone and the Bank, including reserves, loans, mortgages, capital, issuance of securities, payment of dividends and establishment of branches. Federal and state banking agencies also have the general authority to limit the dividends paid by insured banks if such payments should be deemed to constitute an unsafe or unsound banking practice. In accordance with and as a result of the exercise of this general authority, the Bank is currently prohibited from paying dividends without prior regulatory approval. The TDFI, FDIC and Federal Reserve Board have the authority to impose penalties, initiate civil and administrative actions and take other steps intended to prevent banks from engaging in unsafe or unsound practices.

FDIC Insurance of Deposit Accounts

Deposits of the Bank are insured by the FDIC to a maximum of \$250,000 for each insured depositor through the DIF. As an insurer, the FDIC issues regulations, conducts examinations and generally supervises the operations of its insured institutions (institutions insured by the FDIC hereinafter are referred to as "insured institutions"). Any insured institution which does not operate in accordance with or conform to FDIC regulations, policies and directives, may be sanctioned for non-compliance. For example, proceedings may be instituted against an insured institution if the institution or any director, officer or employee thereof engages in unsafe and unsound practices, is operating in an unsafe or unsound condition, or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC. If insurance of accounts is terminated by the FDIC, the deposits in the institution will continue to be insured by the FDIC for a period of two years following the date of termination. The FDIC recommends an annual audit by independent accountants and also periodically makes its own examinations of the Bank. The FDIC may revalue assets of an institution, based upon appraisals and other analyses, and require establishment of general or specific reserves in amounts equal to the difference between such reevaluation and the book value of the assets.

On September 15, 1992, the FDIC approved final regulations adopting a risk-related deposit insurance system. The risk-related regulations, which became effective January 1, 1993, resulted in a significant spread between the highest and lowest deposit insurance premiums. Under the risk-related insurance regulations, each insured depository institution is assigned to one of three

risk classifications: "well capitalized," "adequately capitalized," or "under capitalized." Within each risk classification, there are three subgroups. Each insured depository institution is assigned to one of these subgroups within its risk classification based upon supervisory evaluations submitted to the FDIC by the institution's primary federal regulator. The FDIC may terminate its insurance of deposits if it finds that the institution has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC.

Subsequent to the enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), the FDIC issued risk-based bank capital guidelines which went into effect in stages through 1992. In accordance with the FDIC's risk-based standards, an institution's assets and off-balance sheet activities are categorized into one of four risk categories, with either a 0%, 20%, 50%, or 100% amount of capital to be held against these assets. In addition, the guidelines divide capital instruments into Tier 1 (core) capital and Tier 2 (supplementary) capital. The risk-based capital adequacy guidelines require that (i) Tier 1 capital equal or exceed 4% of risk-weighted assets; (ii) Tier 2 capital may not exceed 100% of Tier 1 capital, although certain Tier 2 capital elements are subject to additional limitations; (iii) assets and off-balance sheet items must be weighted according to risk; and (iv) the total capital to risk-weighted assets ratio must be at least 8.0%. The FDIC's current leverage capital requirement requires banks receiving the highest regulatory rating based upon the FDIC's routine examination process, to maintain Tier 1 capital equal to 3.0% of the bank's total assets. The FDIC may determine that an insured institution needs to maintain a higher capital level based on the institution's particular risk profile. The FDIC used this authority under the Action Plans as to the Bank. Specifically, the Action Plans require the Bank to maintain higher capital ratios, for a more detailed discussion please see below under the caption "*Consent Order*". When determining an insured institution's minimum capital level, the FDIC will consider whether the financial history or condition; managerial resources; the future earnings prospects; significant risks from concentrations of credit or nontraditional activities; excessive interest rate risk exposure; or a significant volume of criticized assets poses a risk to the insured institution's capital adequacy.

Certain provisions of the Federal Reserve Act, made applicable to the Bank by Section 18(j) of the Federal Deposit Insurance Act ("FDIA") (12 U.S.C. §1828(j)) and administered with respect to the Bank by the FDIC, establish standards for the terms of, limit the amount of, and establish collateral requirements with respect to any loans or extensions of credit to, and investments in, affiliates by the Bank as well as set arms-length criteria for such transactions and for certain other transactions (including payment by the Bank for services) between the Bank and its affiliates. In addition, related provisions of the Federal Reserve Act and the Federal Reserve regulations (also administered with respect to the Bank by the FDIC) limit the amounts of, and establish required procedures and credit standards with respect to, loans and other extensions of credit to officers, directors and principal shareholders of the Bank and to related interests of such persons.

The FDIC may impose sanctions on any insured bank that does not operate in accordance with FDIC regulations, policies and directives. Proceedings may be instituted against any insured bank or any director, officer or employee of the bank that is believed by the FDIC to be engaged in unsafe or unsound practices, including violation of applicable laws and regulations. The FDIC is also empowered to assess civil penalties against companies or individuals who violate certain federal statutes, orders or regulations. In addition, the FDIC has the authority to terminate insurance of accounts, after notice and hearing, upon a finding by the FDIC that the insured institution is or has engaged in any unsafe or unsound practice that has not been corrected, or is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule or order of, or condition imposed by, the FDIC. Neither Cornerstone nor the Bank knows of any past or current practice, condition or violation that might lead to termination of its deposit insurance.

Although the Bank is not a member of the Federal Reserve System, it is subject to Federal Reserve Board regulations that require the Bank to maintain reserves against its transaction accounts (primarily checking accounts). Because reserves generally must be maintained in cash or in noninterest-bearing accounts, the effect of the reserve requirements is to increase the Bank's cost of funds. The Federal Reserve Board regulations currently require that average daily reserves be maintained against transaction accounts in the amount of 3% of the aggregate of such net transaction accounts up to \$52.6 million, plus 10% of the total in excess of \$52.6 million.

State of Tennessee Supervision and Regulation

As a commercial bank chartered and regulated by the TDFI, the Bank is subject to various state laws and regulations which limit the amount that can be loaned to a single borrower and the borrower's related interests, the types of permissible investments, and geographic and new product expansion, among other things. The Bank must submit an application to, and receive the approval of, the TDFI before opening a new branch office or merging with another financial institution. The Commissioner of the TDFI has the authority to enforce state laws and regulations by ordering a director, officer or employee of the Bank to cease and desist from violating a law or regulation or from engaging in unsafe or unsound banking practices.

Tennessee law contains limitations on the interest rates that may be charged on various types of loans and restrictions on the nature and amount of loans that may be granted and on the type of investments which may be made. The operations of banks

are also affected by various consumer laws and regulations, including those relating to equal credit opportunity and regulation of consumer lending practices. All Tennessee banks, including the Bank, must become and remain insured under the FDIA.

State banks are subject to regulation by the TDFI with regard to capital requirements and the payment of dividends. Tennessee has adopted the provisions of the Federal Reserve Board's Regulation O with respect to restrictions on loans and other extensions of credit to bank "insiders". Further, under Tennessee law, state banks are prohibited from lending to any one person, firm or corporation amounts more than fifteen percent (15%) of the bank's equity capital accounts, except (i) in the case of certain loans secured by negotiable title documents covering readily marketable nonperishable staples, or (ii) with the prior approval of the bank's board of directors or finance committee (however titled), the bank may make a loan to any person, firm or corporation of up to twenty-five percent (25%) of its equity capital accounts. Tennessee law requires that dividends be paid only from retained earnings (or undivided profits) except that dividends may be paid from capital surplus with the prior, written consent of the TDFI. Tennessee laws regulating banks require certain charges against and transfers from an institution's undivided profits account before undivided profits can be made available for the payment of dividends.

Federal Supervision and Regulation

Cornerstone is regularly examined by the Federal Reserve Board, and the Bank is supervised and examined by the FDIC. Cornerstone is required to file with the Federal Reserve Board annual reports and other information regarding its business operations and the business operations of the Bank. Approval of the Federal Reserve Board is required before Cornerstone may acquire, directly or indirectly, ownership or control of the voting shares of any bank, if, after such acquisition, Cornerstone would own or control, directly or indirectly, more than 5% of the voting stock of the bank. In addition, pursuant to the provisions of the Act and the regulations promulgated thereunder, Cornerstone may only engage in, or own or control companies that engage in, activities deemed by the Federal Reserve Board to be so closely related to banking as to be a proper incident thereto.

The Bank and Cornerstone are "affiliated" within the meaning of the Act. Certain provisions of the Act establish standards for the terms of, limit the amount of, and establish collateral requirements with respect to, any loans or extensions of credit to, and investments in, affiliates by the Bank, as well as set arms-length criteria for such transactions and for certain other transactions (including payment by the Bank for services under any contract) between the Bank and its affiliates. In addition, related provisions of the Act and the regulations promulgated under the Act limit the amounts of, and establish required procedures and credit standards with respect to, loans and other extensions of credit to officers, directors, and principal shareholders of the Bank, Cornerstone and any other subsidiary of Cornerstone, and to related interests of such persons.

In addition to the banking regulations imposed on Cornerstone, the offer and sale of securities of Cornerstone, as well as the securities of the Bank, is subject to compliance with applicable federal and state securities laws. Accordingly, any such offering must be registered under both the Securities Act of 1933 (the "Securities Act") and applicable state securities laws or qualify for exemptions from such requirements.

Under Section 106(b) of the 1970 Amendments to the Act (12 U.S.C. § 1972), the Bank is prohibited from extending credit, selling or leasing property or furnishing any service to any customer on the condition or requirement that the customer (i) obtain any additional property, service or credit from Cornerstone, the Bank (other than a loan, discount, deposit, or trust service) or any other subsidiary of Cornerstone; (ii) refrain from obtaining any property, credit or service from any competitor of Cornerstone, the Bank or any subsidiary of Cornerstone; or (iii) provide any credit, property or service to Cornerstone, the Bank (other than those related to and usually provided in connection with a loan, discount, deposit or trust service) or any subsidiary of Cornerstone.

Most bank holding companies are required to give the Federal Reserve Board prior written notice of any purchase or redemption of their outstanding equity securities if the gross consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding 12 months, is equal to 10% or more of the bank holding company's consolidated net worth. The Federal Reserve Board may disapprove such a purchase or redemption if it determines that the proposal constitutes an unsafe or unsound practice that would violate any law, regulation, Federal Reserve Board order or directive or any condition imposed by, or written agreement with, the Federal Reserve Board. The prior notice requirement does not apply to certain "well-capitalized" bank holding companies that meet specified criteria.

In November 1985, the Federal Reserve Board adopted its Policy Statement on Cash Dividends Not Fully Covered by Earnings. The Policy Statement sets forth various guidelines that the Federal Reserve Board believes that a bank holding company should follow in establishing its dividend policy. In general, the Federal Reserve Board stated that bank holding companies should not pay dividends except out of current earnings and unless the prospective rate of earnings retention by the holding company appears consistent with its capital needs, asset quality and overall financial condition.

Legislation Affecting Cornerstone and the Bank

The following information describes certain statutory and regulatory provisions affecting Cornerstone and the Bank and is qualified in its entirety by reference to such statutory and regulatory provisions.

FIRREA and FDICIA

Far-reaching legislation, including FIRREA and the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") have for years impacted the business of banking. FIRREA primarily affected the regulation of savings institutions rather than the regulation of commercial banks and bank holding companies like the Bank and Cornerstone, but did include provisions affecting deposit insurance premiums, acquisitions of thrifts by banks and bank holding companies, liability of commonly controlled depository institutions, receivership and conservatorship rights and procedures and substantially increased penalties for violations of banking statutes, regulations and orders.

FDICIA resulted in extensive changes to the federal banking laws. The primary purpose of FDICIA was to authorize additional borrowings by the FDIC in order to assist in the resolution of failed and failing financial institutions. However, the law also instituted certain changes to the supervisory process and contained various provisions affecting the operations of banks and bank holding companies.

The additional supervisory powers and regulations mandated by FDICIA, include a "prompt corrective action" program based upon five regulatory zones for banks, in which all banks are placed largely based on their capital positions. Regulators are permitted to take increasingly harsh action as a bank's financial condition declines. Regulators are also empowered to place in receivership or require the sale of a bank to another depository institution when a bank's capital leverage ratio reaches two percent. Better capitalized institutions are generally subject to less onerous regulation and supervision than banks with lesser amounts of capital. The FDIC has adopted regulations implementing the prompt corrective action provisions of the FDICIA, which place financial institutions in the following five categories based upon capitalization ratios: (1) a "well capitalized" institution has a total risk-based capital ratio of at least 10%, a Tier 1 risk-based ratio of at least 6% and a leverage ratio of at least 5%; (2) an "adequately capitalized" institution has a total risk-based ratio of at least 8%, a Tier 1 risk-based ratio of at least 4% and a leverage ratio of at least 4%; (3) an "undercapitalized" institution has a total risk-based capital ratio of under 8%, a Tier 1 risk-based capital ratio of under 4% or a leverage ratio of under 4%; (4) a "significantly undercapitalized" institution has a total risk-based capital ratio of under 6%, a Tier 1 risk-based ratio of under 3% or a leverage ratio of under 3%; and (5) a "critically undercapitalized" institution has a leverage ratio of 2% or less. Institutions in any of the three undercapitalized categories would be prohibited from declaring dividends or making capital distributions. The proposed regulations also establish procedures for "downgrading" an institution to a lower capital category based on supervisory factors other than capital. Various other sections of the FDICIA impose substantial audit and reporting requirements and increase the role of independent accountants and outside directors. Set forth below is a list containing certain significant provisions of the FDICIA:

- annual on-site examinations by regulators (except for smaller, well-capitalized banks with high management ratings, which must be examined every 18 months);
- mandated annual independent audits by independent public accountants and an independent audit committee of outside directors for institutions with more than \$500,000,000 in assets;
- new uniform disclosure requirements for interest rates and terms of deposit accounts;
- a requirement that the FDIC establish a risk-based deposit insurance assessment system;
- authorization for the FDIC to impose one or more special assessments on its insured banks to recapitalize the Bank Insurance Fund (now called the Deposit Insurance Fund);
- a requirement that each institution submit to its primary regulators an annual report on its financial condition and management, which report will be available to the public;
- a ban on the acceptance of brokered deposits except by well capitalized institutions and by adequately capitalized institutions with the permission of the FDIC and the regulation of the brokered deposit market by the FDIC;
- restrictions on the activities engaged in by state banks and their subsidiaries as principal, including insurance underwriting, to the same activities permissible for national banks and their subsidiaries unless the state bank is well capitalized and a determination is made by the FDIC that the activities do not pose a significant risk to the insurance fund;
- a review by each regulatory agency of accounting principles applicable to reports or statements required to be filed with federal banking agencies and a mandate to devise uniform requirements for all such filings;
- the institution by each regulatory agency of noncapital safety and soundness standards for each institution it regulates which cover (1) internal controls, (2) loan documentation, (3) credit underwriting, (4) interest rate exposure, (5) asset growth, (6) compensation, fees and benefits paid to employees, officers and directors, (7) operational and managerial standards, and (8) asset quality, earnings and stock valuation standards for preserving a minimum ratio of market value to book value for publicly traded shares (if feasible);
- uniform regulations regarding real estate lending; and

- a review by each regulatory agency of the risk-based capital rules to ensure they take into account adequate interest rate risk, concentration of credit risk, and the risks of non-traditional activities.

Gramm-Leach-Bliley Act

The activities permissible to Cornerstone and the Bank were substantially expanded by the Gramm-Leach-Bliley Act (the “Gramm Act”). The Gramm Act repeals the anti-affiliation provisions of the Glass-Steagall Act to permit the common ownership of commercial banks, investment banks and insurance companies. The Gramm Act amended the Act to permit a financial holding company to engage in any activity and acquire and retain any company that the Federal Reserve Board determines to be (i) financial in nature or incidental to such financial activity, or (ii) complementary to a financial activity and that does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. The Gramm Act also modifies current law relating to financial privacy and community reinvestment. The new financial privacy provisions generally prohibit financial institutions, including the Bank and Cornerstone, from disclosing nonpublic personal financial information to third parties unless customers have the opportunity to “opt out” of the disclosure.

Temporary Liquidity Guarantee Program

On November 21, 2008, the Board of Directors of the FDIC adopted a final rule relating to the Temporary Liquidity Guarantee Program (“TLGP”). The TLGP was announced by the FDIC on October 14, 2008, preceded by the determination of systemic risk by the U.S. Treasury, as an initiative to counter the system-wide crisis in the nation’s financial sector. Under the TLGP, the FDIC will (i) guarantee, through the earlier of maturity or June 30, 2012, certain newly issued senior unsecured debt issued by participating institutions and (ii) provide unlimited FDIC deposit insurance coverage for noninterest bearing transaction deposit accounts, Negotiable Order of Withdrawal Accounts (commonly known as NOW accounts) paying less than 0.5% interest per annum and Interest on Lawyers Trust Accounts (commonly known as IOLTA) held at participating FDIC-insured institutions through December 31, 2009. Such unlimited insurance coverage expired and was not extended under the Dodd-Frank Act (defined below). The \$250,000 deposit insurance coverage limit was scheduled to return to \$100,000 on January 1, 2010, but was extended by congressional action until December 31, 2012 and the NOW and IOLTA accounts are subject to such \$250,000 insurance coverage limit. Coverage under the TLG Program was available for the first 30 days without charge. The fee assessment for coverage of senior unsecured debt ranges from 50 basis points to 100 basis points per annum, depending on the initial maturity of the debt. The fee assessment for deposit insurance coverage is 10 basis points per quarter on amounts in covered accounts exceeding \$250,000. The Bank elected to participate in the unlimited deposit insurance coverage for noninterest bearing transaction deposit accounts, but declined to participate in the senior unsecured debt guarantee coverage.

The Dodd-Frank Act

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”). The impact of the Dodd-Frank Act on the financial services industry will be broad, with enhanced regulatory oversight and compliance, including, among other things, (i) enhanced resolution authority of troubled and failing banks and their holding companies; (ii) increased capital and liquidity requirements; (iii) increased regulatory examination fees; (iv) changes to assessments to be paid to the FDIC for federal deposit insurance; and (v) numerous other provisions designed to improve supervision and oversight of, and strengthening safety and soundness for, the financial services sector. In addition, the Dodd-Frank Act established a new framework for systemic risk and oversight in the industry which has resulted and will continue to result in sweeping changes in the regulation of financial institutions aimed at strengthening safety and soundness for the financial services sector. A summary of certain provisions of the Dodd-Frank Act is set forth below:

- *Increased Capital Standards and Enhanced Supervision.* The federal banking agencies are required to establish minimum leverage and risk-based capital requirements for banks and bank holding companies. These new standards will be no lower than current regulatory capital and leverage standards applicable to insured depository institutions and may, in fact, be higher when established by the agencies. The Dodd-Frank Act also increases regulatory oversight, supervision and examination of banks, bank holding companies and their respective subsidiaries by the appropriate regulatory agency.
- *Federal Deposit Insurance.* The Dodd-Frank Act makes permanent the \$250,000 deposit insurance limit for insured deposits and provides unlimited federal deposit insurance on non-interest bearing transaction accounts at all insured depository institutions until December 31, 2012. The Dodd-Frank Act also changes the assessment base for federal deposit insurance from the amount of insured deposits to consolidated assets less tangible equity, eliminates the ceiling on the size of the DIF and increases the floor of the size of the DIF.
- *The Consumer Financial Protection Bureau (“Bureau”).* The Dodd-Frank Act centralizes responsibility for consumer financial protection by creating a new agency, the Bureau, responsible for implementing, examining and, for large financial institutions, enforcing compliance with federal consumer financial laws. Because the Bank has under \$10

billion in total assets, however, the FDIC will still continue to examine it at the federal level for compliance with such laws.

- *Interest on Demand Deposit Accounts.* The Dodd-Frank Act repeals the prohibition on the payment of interest on demand deposit accounts effective one year after the date of enactment, thereby permitting depository institutions to pay interest on business checking and other accounts.
- *Mortgage Reform.* The Dodd-Frank Act provides for mortgage reform addressing a customer's ability to repay, restricts variable-rate lending by requiring the ability to repay to be determined for variable rate loans by using the maximum rate that will apply during the first five years of a variable-rate loan term, and makes more loans subject to requirement for higher-cost loans, new disclosures and certain other restrictions.

We expect that many of the requirements called for in the Dodd-Frank Act will be implemented over time, and most will be subject to implementing regulations over the course of several years. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank Act will be implemented by the various regulatory agencies and through regulations, the full extent of the impact such requirements will have on financial institutions' operations is unclear. The changes resulting from the Dodd-Frank Act may impact the profitability of our business activities, require changes to certain of our business practices, impose upon us more stringent capital, liquidity and leverage ratio requirements or otherwise adversely affect our business. These changes may also require us to invest significant management attention and resources to evaluate and make necessary changes in order to comply with new statutory and regulatory requirements.

Future Legislation

Legislation is regularly introduced in both the United States Congress and the Tennessee General Assembly that contains wide-ranging proposals for altering the structures, regulations and competitive relationships of the nation's financial institutions. Such legislation may change banking statutes and the operating environment of Cornerstone and/or the Bank in substantial and unpredictable ways and could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance, depending upon whether any of this potential legislation will be enacted and, if enacted, the effect that it or any implementing regulations would have on the financial condition or results of operations of Cornerstone and/or the Bank.

ITEM 1A. RISK FACTORS

Investing in our common stock involves various risks which are particular to Cornerstone, its industry and its market area. Several risk factors regarding investing in our common stock are discussed below. This listing should not be considered as all-inclusive. If any of the following risks were to occur, we may not be able to conduct our business as currently planned and our financial condition or operating results could be negatively impacted. These matters could cause the trading price of our common stock to decline in future periods.

RISKS ASSOCIATED WITH OUR BUSINESS

Cornerstone may face risks with respect to future expansion.

From time to time Cornerstone may engage in additional de novo branch expansion as well as the acquisition of other financial institutions or parts of those institutions. Cornerstone may also consider and enter into new lines of business or offer new products or services. In addition, Cornerstone may receive future inquiries and have discussions regarding an acquisition.

Acquisitions and mergers involve a number of risks, including:

- the time and costs associated with identifying and evaluating potential acquisitions and merger partners;
- inaccuracies in the estimates and judgments used to evaluate credit, operations, management and market risks with respect to the target institution;
- the time and costs of evaluating new markets, hiring experienced local management and opening new offices, and the time lags between these activities and the generation of sufficient assets and deposits to support the costs of the expansion;
- Cornerstone's ability to finance an acquisition and possible dilution to its existing shareholders;
- the diversion of Cornerstone's management's attention to the negotiation of a transaction, and the integration of the operations and personnel of the combining businesses;
- entry into new markets where Cornerstone lacks experience;
- the introduction of new products and services into Cornerstone's business;
- the incurrence and possible impairment of goodwill associated with an acquisition and possible adverse short-term effects on Cornerstone's results of operations; and
- the risk of loss of key employees and customers.

Cornerstone may incur substantial costs to expand. There can be no assurance that integration efforts for any future mergers or acquisitions will be successful. Also, Cornerstone may issue equity securities, including common stock and securities convertible into shares of Cornerstone's common stock in connection with future acquisitions, which could cause ownership and economic dilution to Cornerstone's shareholders. For example, Cornerstone initiated a Series A Preferred Stock Offering during 2010 which is expected to continue through much of 2011. The Series A Preferred Stock is convertible subject to certain terms and conditions into common stock. There is no assurance that, following any future mergers or acquisitions, Cornerstone's integration efforts will be successful or after giving effect to the acquisition, will achieve profits comparable to or better than its historical experience.

The Bank's loan portfolio includes an elevated, although declining level, of residential construction and land development loans, which have a greater credit risk than residential mortgage loans.

The Bank engages in residential construction and land development loans to developers. This type of lending is generally considered to have more complex credit risks than traditional single-family residential lending because the principal is concentrated in a limited number of loans with repayment dependent on the successful operation of the related real estate project. Consequently, these loans are more sensitive to the current adverse conditions in the real estate market and the general economy. These loans are generally less predictable and more difficult to evaluate and monitor and collateral may be difficult to dispose of in a market decline. Furthermore, during adverse general economic conditions, such as are now being experienced in residential real estate construction nationwide, borrowers involved in the residential real estate construction and development business may suffer above normal financial strain. As the residential real estate development and construction market in the Bank's markets has deteriorated, the Bank's borrowers in this segment have begun to experience difficulty repaying their obligations to the Bank. As a result, the Bank's loans to these borrowers have deteriorated and may deteriorate further and may result in additional charge-offs negatively impacting the Bank's (and consequently, Cornerstone's) results of operations. Additionally, to the extent repayment is dependent upon the sale of newly constructed homes or lots, such sales are likely to be at lower prices or at a slower rate than was expected when the loan was made, which may result in such loans being placed on non-accrual status and subject to higher loss estimates even if the borrower keeps interest payments current. These adverse economic and real estate market conditions may lead to further increases in non-performing loans and other real estate owned, increased charge-offs from the disposition of non-performing assets, and increases in provision for loan losses, all of which would negatively impact the Bank's (and, consequently, Cornerstone's) financial condition and results of operations.

If the Bank's asset quality continues to decline or it continues to experience greater loan losses than anticipated, the earnings and overall financial condition of the Bank and Cornerstone will be adversely affected even further.

The assets of Cornerstone and the Bank are primarily comprised of loans. The risk of credit losses on loans varies with, among other things, general economic conditions, the type of loan being made, the creditworthiness of the borrower over the term of the loan and, in the case of a collateralized loan, the value and marketability of the collateral for the loan. While the risk of nonpayment of loans is inherent in banking, the Bank has experienced higher nonpayment levels than it anticipated, which has had a significant adverse effect on its (and, consequently, Cornerstone's) earnings and overall financial condition. Although the Bank has taken actions to prevent further decline, including the creation of a special asset committee to develop and review action plans for minimizing loan losses and the dedication of resources to assist in the collection and recovery process, there can be no assurance that the outcome of such actions will be successful. To minimize the likelihood of a substandard loan portfolio, the Bank assesses the credit worthiness of customers and performs collateral valuations. Management also maintains an allowance for loan losses based upon, among other things, historical experience and an evaluation of economic conditions and regular reviews of delinquencies and loan portfolio quality. Based upon such factors, management makes various assumptions and judgments about the ultimate collectability of the loan portfolio and provides an allowance for loan losses based upon a percentage of the outstanding balances and takes a charge against earnings with respect to specific loans when their ultimate collectability is considered questionable. If management's assumptions and judgments prove to be incorrect and the allowance for loan losses is inadequate to absorb losses, or if regulatory authorities require the Bank to increase its allowance for loan losses as a part of their examination process, additional provision expense would be incurred and the earnings and capital of the Bank and Cornerstone could be significantly and adversely affected. For example, for the fourth quarter of 2010 the Bank was required to fund an additional provision of \$3.2 million for loan losses following a joint examination of the Bank by the FDIC and the TDFI. Moreover, additions to the allowance may be necessary based on changes in economic and real estate market conditions, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of management's control. These additions may require increased provision expense which would negatively impact Cornerstone's results of operations.

Cornerstone has increased levels of other real estate, primarily as a result of foreclosures.

As the Bank has begun to resolve non-performing real estate loans, Cornerstone has increased the level of foreclosed properties, primarily those acquired from builders, residential land developers and commercial properties. Foreclosed real estate expense consists of three types of charges: maintenance and insurance costs, valuation adjustments due to new appraisal values and

gains or losses on disposition. As levels of other real estate increase and also as local real estate values decline, these charges will likely increase, negatively affecting Cornerstone's results of operations.

Liquidity needs could adversely affect Cornerstone's results of operations and financial condition.

Cornerstone relies on dividends from the Bank as its primary source of funds. However, in November 2009, following the conclusion of a joint examination of the Bank by the FDIC and the TDFI, the FDIC placed restrictions on the Bank's ability to pay cash dividends, requiring that the Bank first obtain a non-objection from the FDIC. Furthermore, the majority of the Bank's funds are comprised of customer deposits and loan repayments. While scheduled loan repayments are a relatively stable source of funds, they are subject to the ability of borrowers to repay the loans. The repayment of loans can be adversely affected by a number of factors, including changes in economic conditions, adverse trends or events affecting business industry groups, reductions in real estate values or markets, business closings or lay-offs, inclement weather, natural disasters and international instability. Additionally, deposit levels may be affected by a number of factors, including rates paid by competitors, general interest rate levels, returns available to customers on alternative investments and general economic conditions. Accordingly, Cornerstone currently is, and may from time to time in the future be, required to rely on secondary sources of liquidity to meet withdrawal demands or otherwise fund operations. Alternative sources include advances from the Federal Home Loan Bank and federal funds lines of credit from correspondent banks. While Cornerstone believes that these sources are currently adequate, there can be no assurance they will be sufficient to meet future liquidity demands. Cornerstone may be required to slow or discontinue loan growth, capital expenditures or other investments or liquidate assets if these alternative sources are not adequate.

The Bank has a significant deferred tax asset and cannot assure you that it will be fully realized.

The Bank has net deferred tax assets of \$1.7 million as of December 31, 2010. The Bank did not establish a valuation allowance against its federal net deferred tax assets as of December 31, 2010 because it believes that it is more likely than not that all of these assets will be realized. In evaluating the need for a valuation allowance, the Bank estimated future taxable income based on management prepared forecasts. This process required significant judgment by management about matters that are by nature uncertain. If future events differ significantly from current forecasts, the Bank may need to establish a valuation allowance, which could have a material temporary adverse effect on its results of operations and financial condition.

Competition from financial institutions and other financial service providers may adversely affect Cornerstone's profitability.

The banking business is highly competitive and the Bank experiences competition in each of its markets from many other financial institutions. The Bank competes with other commercial banks, credit unions, savings and loan associations, mortgage banking firms, consumer finance companies, securities brokerage firms, insurance companies, money market funds, and other mutual funds, as well as other community banks and super-regional and national financial institutions that operate offices in the Bank's primary market areas and elsewhere.

Additionally, the Bank faces competition from de novo community banks, including those with senior management who were previously affiliated with other local or regional banks or those controlled by investor groups with strong local business and community ties. These de novo community banks may offer higher deposit rates or lower cost loans in an effort to attract the Bank's customers, and may attempt to hire the Bank's management and employees.

The Bank competes with these other financial institutions both in attracting deposits and in making loans. In addition, the Bank has to attract its customer base from other existing financial institutions and from new residents. The Bank expects competition to increase in the future as a result of legislative, regulatory and technological changes and the continuing trend of consolidation in the financial services industry.

If the Bank's allowance for loan losses is not sufficient to cover actual loan losses, Cornerstone's earnings will decrease.

If loan customers with significant loan balances fail to repay their loans, Cornerstone's earnings and capital levels will suffer. The Bank makes various assumptions and judgments about the probable losses in its loan portfolio, including the creditworthiness of borrowers and the value of any collateral securing the loans. The Bank maintains an allowance for loan losses to cover the estimated probable losses in the loan portfolio. In determining the size of this allowance, management relies on an analysis of the loan portfolio based on volume and types of loans, internal loan grade classifications, trends in classifications, volume and trends in delinquencies, nonaccruals and charge-offs, loss experience by loan categories, national and local economic conditions, industry and peer bank loan quality indications, and other pertinent factors and information. If management's assumptions are inaccurate, the current allowance may not be sufficient to cover potential loan losses, and additional provisions may be necessary which would decrease Cornerstone's earnings.

Certain deposits of the Bank may be volatile and impact its liquidity.

In addition to the traditional core deposits, such as demand deposit accounts, interest checking, money market savings and certificates of deposits, the Bank uses several noncore funding sources, such as Federal Home Loan Bank (FHLB) of Cincinnati advances and certificates of deposit across the United States obtained via the Internet. Management uses these sources of funding to provide liquidity for the ongoing operations and loan demand of the Bank. The availability of these funding sources is subject to broad economic conditions and to investor assessment of Cornerstone's financial strength and, as such, the cost of funds may fluctuate significantly and/or be restricted, thus impacting net interest income, immediate liquidity and/or access to additional liquidity.

To address this risk the Bank adheres to certain internal limits as to the absolute level of funding from these sources. Should the Bank exceed those limitations, management may need to modify growth plans, liquidate certain assets, participate loans to correspondents or execute other actions to allow the Bank to return to an acceptable level of funding within a reasonable amount of time.

Changes in interest rates could adversely affect Cornerstone's results of operations and financial condition.

Changes in interest rates may affect Cornerstone's level of interest income, the primary component of its gross revenue, as well as the level of its interest expense. Interest rates are highly sensitive to many factors that are beyond Cornerstone's control, including general economic conditions and the policies of various governmental and regulatory authorities. Accordingly, changes in interest rates could decrease Cornerstone's net interest income. Changes in the level of interest rates also may negatively affect Cornerstone's ability to originate real estate loans, the value of its assets and the ability to realize gains from the sale of its assets, all of which ultimately affects earnings.

Cornerstone relies heavily on the services of key personnel and the unexpected loss of any of those personnel could adversely affect its operations.

Cornerstone relies on the strategies and management services of Nathaniel F. Hughes. Although Cornerstone entered into an employment agreement with Mr. Hughes, such employment agreement has expired pursuant to its terms and has not been renewed. The loss of his services could have a material adverse effect on Cornerstone's business, results of operations and financial condition. Cornerstone is also dependent on certain other key officers who have important customer relationships or are instrumental to its lending and depository operations. Changes in key personnel and their responsibilities may be disruptive to operations and could have a material adverse effect on Cornerstone's financial condition and earnings. Cornerstone believes that its future results will also depend upon its ability to attract and retain highly skilled and qualified personnel, particularly in those areas where Cornerstone may open new branches.

Cornerstone is subject to Tennessee's anti-takeover statutes and certain charter provisions that could decrease its chances of being acquired even if the acquisition is in the best interest of Cornerstone's shareholders.

As a Tennessee corporation, Cornerstone is subject to various legislative acts that impose restrictions on and require compliance with procedures designed to protect shareholders against unfair or coercive mergers and acquisitions. These statutes may delay or prevent offers to acquire Cornerstone and increase the difficulty of consummating any such offers, even if the acquisition would be in its shareholders' best interests. Cornerstone's charter also contains provisions which may make it difficult for another entity to acquire it without the approval of a majority of the disinterested directors on its board of directors. Secondly, the amount of common stock owned by, and other compensation arrangements with, certain of Cornerstone's officers and directors may make it more difficult to obtain shareholder approval of potential takeovers that they oppose. The common stock and option ownership of Cornerstone's board of directors and management, could make it difficult or expensive to obtain majority support for shareholder proposals or potential acquisition proposals that the board of directors and officers oppose.

The success and growth of Cornerstone's operations will depend on its ability to adapt to technological changes.

The banking industry and the ability to deliver financial services is becoming more dependent on technological advancement, such as the ability to process loan applications over the Internet, accept electronic signatures, provide process status updates instantly, reliable on-line banking capabilities and other customer expected conveniences that are cost efficient to Cornerstone's business processes. As these technologies are improved in the future, Cornerstone may, in order to remain competitive, be required to make significant capital expenditures.

RISK RELATED TO RECENT ECONOMIC, LEGISLATIVE AND REGULATORY EVENTS

Cornerstone's success depends significantly upon economic conditions in the local markets where the Bank operates.

Substantially all of the Bank's loan and deposit customers live, work and bank in the Chattanooga, Tennessee MSA. As a result, the success of the Bank and, in turn, Cornerstone depends upon a sound local economy to provide opportunities for new business ventures, increased loan demand and the need for deposit services. Cornerstone's profitability is impacted by these local factors as well as general economic conditions and interest rates. For example, Cornerstone's earnings may be negatively impacted by increases in unemployment rates or reductions in population, income levels, deposits and housing starts. Adverse economic conditions in the local markets where the Bank operates may reduce its growth rate and diminish the ability of its customers to service their loan obligations. The prolonged economic downturn has also negatively impacted collateral values or cash flows of borrowing businesses, and as a result the Bank's primary source of repayment could be insufficient to service the debt. In addition, adverse consequences to the Bank (and, consequently, to Cornerstone) as a result of the prolonged economic downturn in its local markets could be compounded by the fact that many of the Bank's commercial and real estate loans are secured by real estate located in those market areas. Significant declines in real estate values in these market areas would mean that the collateral for many of the Bank's loans would provide less security. As a result, the Bank would be more likely to suffer losses on defaulted loans because its ability to fully recover on defaulted loans by selling the real estate collateral would be diminished. Adverse economic conditions in the Bank's local markets, including sustained periods of increased payment delinquencies, foreclosures or losses in the State of Tennessee or the State of Georgia, could impair the Bank's ability to collect loans and could otherwise have a negative effect on the Bank's and Cornerstone's assets, revenues, results of operations and financial condition.

Continuing negative developments in the financial services industry and U.S. and global capital and credit markets may lead to additional regulation and further deterioration of Cornerstone's results of operations and financial condition.

Negative developments in the capital and credit markets during 2009 and 2010 have resulted in uncertainty in the financial markets. It is anticipated that some of the negative economic developments will continue into 2011. Financial institutions across the United States, including the Bank, have experienced deteriorating asset quality. Loan portfolios include impaired loans to businesses struggling to stay in operation or achieve adequate cash flow. A decline in collateral values supporting these loans have also impacted the ability of businesses or consumers to obtain loans or increased financial institutions' losses in the event of foreclosure and liquidation. At the same time financial institutions have experienced concerns regarding liquidity. This concern has increased the competition for deposits in Cornerstone's local market as well as wholesale funding options. These events have impacted Cornerstone's, as well as other bank holding companies', stock prices. The potential impact of these events may be an expansion of existing or creation of new federal or state laws and regulations regarding lending and funding practices, liquidity standards and compliance issues. Continued negative developments or Cornerstone's inability to respond to these new operating and regulatory requirements could further negatively impact Cornerstone's results of operations. The negative consequences could limit Cornerstone's ability to originate new loans or obtain adequate funding or increase costs associated with regulatory compliance. Ultimately, these changes could result in modifications to Cornerstone's existing or future strategic plans, capital requirements, compensation, financial performance and/or stock performance.

Implementation of the various provisions of the Dodd-Frank Act may increase Cornerstone's operating costs or otherwise have a material affect on our business, financial condition or results of operations.

On July 21, 2010, President Obama signed the Dodd-Frank Act. This landmark legislation includes, among other things, (i) the creation of a Financial Services Oversight Counsel to identify emerging systemic risks and improve interagency cooperation; (ii) the elimination of the Office of Thrift Supervision and the transfer of oversight of federally chartered thrift institutions and their holding companies to the Office of the Comptroller of the Currency and the Federal Reserve; (iii) the creation of a Consumer Financial Protection Agency authorized to promulgate and enforce consumer protection regulations relating to financial products that would affect banks and non-bank finance companies; (iv) the establishment of new capital and prudential standards for banks and bank holding companies; (v) the termination of investments by the U.S. Treasury under TARP; (vi) enhanced regulation of financial markets, including the derivatives, securitization and mortgage origination markets; (vii) the elimination of certain proprietary trading and private equity investment activities by banks; (viii) the elimination of barriers to de novo interstate branching by banks; (ix) a permanent increase of the previously implemented temporary increase of FDIC deposit insurance to \$250,000; (x) the authorization of interest-bearing transaction accounts; and (xi) changes in how the FDIC deposit insurance assessments will be calculated and an increase in the minimum designated reserve ratio for the Deposit Insurance Fund. Certain provisions of the legislation are not immediately effective or are subject to required studies and implementing regulations. Further, community banks with less than \$10 billion in assets are exempt from certain provisions of the legislation. Cornerstone cannot predict how this significant new legislation may be interpreted and enforced or how implementing regulations and supervisory policies may affect us. There can be no assurance that these or future reforms will not significantly increase the Bank's compliance or operating costs or otherwise have a significant impact on our business, financial condition and results of operations.

Cornerstone and the Bank are subject to federal and state regulations that impact their operations and financial performance.

Cornerstone and the Bank operate in a highly regulated industry and are subject to examination, supervision and comprehensive regulation by various federal and state agencies, including the Federal Reserve Board, the FDIC and the TDFI. Compliance with the numerous banking regulations is costly and requires investment in human and information technology resources. Certain activities of Cornerstone and/or the Bank, such as the payment of dividends, mergers and acquisitions, investments, loans and interest rates charged, interest rates paid on deposits and locations of offices, are impacted by these regulations. The Bank is also subject to capitalization guidelines established by its regulators, which require it to maintain adequate capital to support its growth.

The laws and regulations applicable to the banking industry are subject to change at any time. Cornerstone cannot predict the events that will result in regulatory changes nor their impact on the banking industry in general and Cornerstone and the Bank in particular. Because government regulation greatly affects the business and financial results of all commercial banks and bank holding companies, the cost of compliance for Cornerstone and the Bank could adversely affect their ability to operate profitably.

The Sarbanes-Oxley Act of 2002, and the related rules and regulations promulgated by the Commission, have increased the scope, complexity and cost of corporate governance, reporting and disclosure practices. As a result, Cornerstone has experienced, and may continue to experience, greater compliance costs.

As of December 31, 2010, the most recent notification from the Federal Deposit Insurance Corporation (FDIC) categorized the Bank as adequately capitalized under the regulatory framework for prompt corrective action.

RISKS ASSOCIATED WITH INVESTMENT IN CORNERSTONE'S COMMON STOCK

The Bank may require additional capital which may not be able to be obtained.

The Bank may require capital from sources other than earnings generation. In November 2009, the FDIC downgraded the Bank's status to an "adequately capitalized" institution, which, among other things, restricts the interest rates payable by the Bank for time deposits. To restore the Bank's status as a "well capitalized" institution, Cornerstone intends to provide capital to the Bank through additional sources, which may include additional equity investments, public or private offerings of common stock (including securities convertible into common stock), preferred stock or trust preferred securities, borrowed funds or any combination of these sources of funds. Cornerstone's ability to access these alternative capital sources may be limited due to regulatory restrictions or the condition of the capital markets. Therefore, Cornerstone's ability to rebuild the Bank's capital reserves may be impaired.

The Series A Convertible Preferred Stock issued during 2010 and 2011 impacts the net income available to our common stockholders and our earnings per common share.

During the 3rd quarter of 2010, Cornerstone initiated a Series A Convertible Preferred Stock (the "Series A Preferred Stock") offering with a stated goal of \$15 million in additional capital. Holders of Series A Preferred Stock have a priority on the receipt of dividends relative to the holders of our common stock. Until, Cornerstone has declared and paid or set aside for full payment of the quarterly dividends on the Series A Preferred Stock for all past dividend periods, Cornerstone may not declare or pay dividends on shares of common stock. The payment of the Series A Preferred Stock dividends will limit the amount of net income available to common stockholders and the amount of dividends to be paid to common stockholders.

Holdings of the Series A Preferred Stock have rights that are senior to those of our common stockholders.

The shares of Series A Preferred Stock that Cornerstone has issued are senior to shares of our common stock. These rights include senior positions with respect to dividend payments and liquidation preference over shares of common stock in the event of dissolution or winding-up.

Conversion of Series A Preferred Stock.

Cornerstone, at its option, at any time on or after July 31, 2015, may cause some or all of the shares of Series A Preferred Stock to be converted into shares of our common stock at the then applicable conversion rate if the closing price of Cornerstone's common stock equals or exceeds 150% of the then applicable conversion price of the Series A Preferred Stock on each of the 30 consecutive trading days immediately preceding the date we give notice of our election to convert.

Cornerstone may issue common stock or other equity securities in the future which could dilute the ownership interest of existing shareholders.

In order to maintain capital at desired or regulatory-required levels or to replace existing capital, Cornerstone may be required to issue shares of common stock, preferred stock or other securities, including securities convertible into, exchangeable for or representing rights to acquire shares of common stock. The sale of these shares may significantly dilute shareholder ownership. New investors in the future may also have rights, preferences and privileges senior to our current shareholders which may adversely impact our current shareholders.

Even though Cornerstone's common stock is currently traded on the OTC Bulletin Board, the trading volume in its common stock has been limited, and the sale of substantial amounts of Cornerstone's common stock in the public market could depress the price.

Cornerstone cannot say with any certainty when a more active and liquid trading market for its common stock will develop or be sustained. Because of this, Cornerstone's shareholders may not be able to sell their shares at the volumes, prices, or times that they desire. Cornerstone cannot predict the effect, if any, that future sales or the availability of common stock will have on the market price. Cornerstone, therefore, can give no assurance that sales of substantial amounts of its common stock in the market, or the potential for large amounts of sales in the market, would not cause the price of its common stock to decline or impair its ability to raise capital through sales of its common stock.

Cornerstone's ability to declare and pay dividends is limited by law and it may be unable to pay future dividends.

Cornerstone derives the majority of its income from dividends on the shares of common stock of the Bank. The ability of the Bank to declare and pay dividends is limited by its obligations to maintain sufficient capital and by other general restrictions on its dividends that are applicable to banks that are regulated by the FDIC and the TDFI. On November 12, 2009, the FDIC placed restrictions on the Bank's ability to pay cash dividends, requiring that the Bank first obtain a non-objection from the FDIC. In addition, the Federal Reserve Board may impose restrictions on Cornerstone's ability to pay dividends on its common stock. As a result, Cornerstone cannot assure its shareholders that it will declare or pay dividends on shares of its common stock in the future.

An investment in Cornerstone's common stock is not an insured deposit.

Cornerstone's common stock is not a bank deposit and, therefore, is not insured against loss by the FDIC, any other deposit insurance fund or by any other public or private entity. Investment in our common stock is inherently risky for the reasons described in this "Risk Factors" section and elsewhere in this report and is subject to the equity market forces like other common stocks. As a result, if you acquire our common stock, you could lose some or all of your investment.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None

ITEM 2. PROPERTIES

As of December 31, 2010, the principal offices of Cornerstone are located at 835 Georgia Avenue, Chattanooga, Tennessee 37402. In addition, the Bank operates five full-service branches and one loan production office that are located at:

Banking Branches	4154 Ringgold Road, East Ridge, Tennessee (owned by the Bank) 5319 Highway 153, Hixson, Tennessee (owned by the Bank) 2280 Gunbarrel Road, Chattanooga, Tennessee (owned by the Bank) 8966 Old Lee Highway, Ooltewah, Tennessee (owned by the Bank) 835 Georgia Avenue, Chattanooga, Tennessee (leased by the Bank)
Loan Production Office	202 West Crawford Street, Dalton, Georgia (leased by the Bank)

The Georgia Avenue facility located in downtown Chattanooga, Tennessee serves as a branch location for the Bank's customers as well as Cornerstone's executive offices. The Bank also owns a vacant building and lot at 103 S. Campbell Station Road Knoxville, Tennessee, which is currently for sale. Cornerstone leases and operates a service center located at 6401 Lee Corners, Suite 119, Chattanooga, Tennessee. to facilitate all of its noncustomer contact functions.

ITEM 3. LEGAL PROCEEDINGS

As of the end of 2010, neither Cornerstone, the Bank nor Eagle was involved in any material litigation. The Bank is periodically involved as a plaintiff or defendant in various legal actions in the ordinary course of its business. Management believes that any claims pending against Cornerstone or its subsidiaries are without merit or that the ultimate liability, if any, resulting from them will not materially affect the Bank's or Eagle's financial condition or Cornerstone's consolidated financial position.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted during the fourth quarter of 2010 to a vote of security holders of Cornerstone through a solicitation of proxies or otherwise.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

On March 11, 2011, Cornerstone had 6,500,396 shares of common stock outstanding. Cornerstone's common stock is quoted on the OTC Bulletin Board under the symbol "CSBQ" but is not listed on a national securities exchange. There are ten market makers who provide a market for Cornerstone's common stock.

There were approximately 550 holders of record of the common stock as of December 31, 2010. This number does not include shareholders with shares in nominee name held by the Depository Trust Company (DTC). As of the end of 2010, there were approximately 3,871,000 shares held in nominee name by DTC. Cornerstone paid quarterly cash dividends in 2009 in the amount of \$0.10 per common share. No cash dividends on common stock were paid in 2010. Cornerstone's board of directors will continue to evaluate the amount of future dividends, if any, after capital needs required for expected growth of assets are reviewed. The payment of dividends is within the discretion of the board of directors, considering Cornerstone's expenses, the maintenance of reasonable capital and risk reserves, and appropriate capitalization requirements for state banks. Currently, the Bank is under a restriction from the FDIC that no dividend can be paid from the Bank to the holding company without prior approval.

Table 1 presents the high and low closing prices of Cornerstone's common stock for the periods indicated, as reported by published sources and cash dividends declared on its common stock for the last two fiscal years. The prices reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions.

TABLE 1

High and Low Common Stock Share Price for Cornerstone			Cash Dividends
2011 Fiscal Year	Low	High	Paid Per Share
First Quarter (through March 11, 2011)	\$1.57	\$1.90	-
2010 Fiscal Year			
First Quarter	\$2.10	\$2.75	-
Second Quarter	\$1.75	\$4.75	-
Third Quarter	\$1.35	\$3.00	-
Fourth Quarter	\$1.58	\$2.00	-
2009 Fiscal Year			
First Quarter	\$3.50	\$6.00	\$0.07
Second Quarter	\$4.00	\$6.00	\$0.03
Third Quarter	\$2.65	\$5.77	-
Fourth Quarter	\$1.95	\$3.71	-

ITEM 6. SELECTED FINANCIAL DATA

Table 2 presents selected financial data for the periods indicated (amounts in thousands, except per share data).

TABLE 2

	At and for the Fiscal Years Ended December 31,				
	2010	2009	2008	2007	2006
Total interest income	\$ 25,211	\$ 26,308	\$ 30,680	\$ 34,784	\$ 29,158
Total interest expense	9,202	11,189	12,698	14,414	10,306
Net interest income	16,009	15,119	17,982	20,370	18,852
Provision for loan losses	7,291	14,899	3,498	10,409	1,106
Net interest income after provision for loan losses	8,718	220	14,484	9,961	17,746
Noninterest income	3,081	2,327	1,887	1,695	2,111
Noninterest expense	18,042	16,062	12,563	10,926	10,718
Income before income taxes	(6,243)	(13,515)	3,808	730	9,139
Income tax (benefit) / expense	(1,535)	(5,336)	1,296	(141)	3,328
Net (loss) income	\$ (4,708)	\$ (8,179)	\$ 2,512	\$ 871	\$ 5,811
Per Common Share Data:					
Net (loss) / income, basic	\$ (0.73)	\$ (1.26)	\$ 0.39	\$ 0.13	\$ 0.87
Net (loss) / income, assuming dilution	\$ (0.73)	\$ (1.26)	\$ 0.38	\$ 0.12	\$ 0.83
Cash dividends paid	\$ —	\$ 0.10	\$ 0.28	\$ 0.22	\$ 0.12
Book value	\$ 3.55	\$ 4.28	\$ 5.78	\$ 5.70	\$ 5.86
Tangible book value(1)	\$ 3.55	\$ 3.89	\$ 5.24	\$ 5.24	\$ 5.40
Financial Condition Data:					
Assets	\$ 441,499	\$ 532,404	\$ 471,803	\$ 444,421	\$ 374,942
Loans, net of unearned interest	\$ 276,115	\$ 330,787	\$ 378,472	\$ 369,883	\$ 305,879
Cash and investments	\$ 133,651	\$ 164,982	\$ 57,286	\$ 51,798	\$ 51,577
Federal funds sold	\$ —	\$ —	\$ 11,025	\$ —	\$ —
Deposits	\$ 335,447	\$ 404,742	\$ 326,583	\$ 313,250	\$ 275,816
FHLB advances and other borrowings	\$ 54,715	\$ 72,350	\$ 71,250	\$ 47,100	\$ 39,500
Federal funds purchased and repurchase agreements	\$ 24,325	\$ 26,322	\$ 35,790	\$ 41,560	\$ 19,249
Shareholders' equity	\$ 25,819	\$ 27,837	\$ 36,502	\$ 36,327	\$ 38,183
Tangible shareholders' equity(1)	\$ 25,782	\$ 25,258	\$ 33,661	\$ 33,386	\$ 35,137
Selected Ratios:					
Interest rate spread	3.24%	2.95%	3.67%	4.51%	5.16%
Net interest margin(2)	3.43%	3.27%	4.16%	5.22%	5.80%
Return on average assets	(0.94)%	(1.69)%	0.55%	0.21%	1.69%
Return on average equity	(15.79)%	(24.34)%	6.71%	2.14%	16.27%
Return on average tangible equity(1)	(15.81)%	(26.36)%	7.26%	2.31%	17.78%
Average equity to average assets	5.95%	6.93%	8.27%	9.86%	10.36%
Dividend payout ratio	N/A	N/A	70.59%	149.71%	13.33%
Ratio of nonperforming assets to total assets	5.99%	3.36%	1.48%	0.40%	0.40%
Ratio of allowance for loan losses to nonperforming loans	66.98%	80.24%	226.23%	791.16%	25.90%
Ratio of allowance for loan losses to total average loans, net of unearned income	2.93%	1.63%	2.49%	3.88%	1.50%

(1) Tangible shareholders' equity is shareholders' equity less goodwill and intangible assets.

(2) Net interest margin is the net yield on interest earning assets and is the difference between the interest yield earned on interest-earning assets less the interest rate paid on interest-bearing liabilities.

GAAP Reconciliation and Management Explanation of Non-GAAP Financial Measures

Certain financial information included in Cornerstone's summary consolidated financial data is determined by methods other than in accordance with U.S. generally accepted accounting principles ("GAAP"). These non-GAAP financial measures are "tangible book value per share," "tangible shareholders' equity," and "return on average tangible equity." Management uses these non-GAAP measures in its analysis of Cornerstone's financial performance.

- “Tangible book value per share” is defined as total equity reduced by recorded preferred stock, goodwill and other intangible assets divided by total common shares outstanding. This measure is important to investors interested in changes from period-to-period in book value per common share exclusive of changes in intangible assets. Goodwill, an intangible asset that is recorded in a purchase business combination, has the effect of increasing total book value while not increasing the tangible assets of a company. For companies such as Cornerstone that have engaged in business combinations, purchase accounting can result in the recording of significant amounts of goodwill related to such transactions.
- “Tangible shareholders’ equity” is shareholders’ equity less goodwill and other intangible assets.
- “Return on average tangible equity” is defined as earnings for the period divided by average equity reduced by average goodwill and other intangible assets.

These disclosures should not be viewed as a substitute for results determined in accordance with GAAP, and are not necessarily comparable to non-GAAP performance measures which may be presented by other companies. Table 3 presents a reconciliation to provide a more detailed analysis of these non-GAAP performance measures:

TABLE 3

	At and for the Fiscal Years Ended December 31,				
	2010	2009	2008	2007	2006
Number of common shares outstanding	6,500,396	6,500,396	6,319,718	6,369,718	6,511,848
Total stockholders’ equity	\$ 25,819,153	\$ 27,837,479	\$ 36,501,509	\$ 36,327,350	\$ 38,183,265
Less: preferred stock	2,727,424	-	-	-	-
Book value	23,091,729	27,837,479	36,501,509	36,327,350	\$ 38,183,265
Book value per common share	\$ 3.55	\$ 4.28	\$ 5.78	\$ 5.70	\$ 5.86
Book value	\$ 23,091,729	\$ 27,837,479	\$ 36,501,509	\$ 36,327,350	\$ 38,183,265
Less: goodwill and other intangible assets	37,317	2,579,211	2,840,773	2,941,798	3,046,287
Tangible book value	23,054,412	25,258,268	33,660,736	33,385,552	35,136,978
Effect of intangible assets per common share	\$ -	\$ 0.39	\$ 0.45	\$ 0.46	\$ 0.46
Tangible book value per common share	\$ 3.55	\$ 3.89	\$ 5.33	\$ 5.24	\$ 5.40
Net (loss) / income	\$ (4,707,521)	\$ (8,178,639)	\$ 2,511,824	\$ 871,152	\$ 5,811,600
Average equity	29,820,000	33,600,000	37,435,000	40,737,000	35,728,000
Return on average equity	(15.79)%	(24.34)%	6.71%	2.14%	16.27%
Average equity	\$ 29,820,000	\$ 33,600,000	\$ 37,435,000	\$ 40,737,000	\$ 35,728,000
Less: goodwill and other intangible assets	37,317	2,579,211	2,840,773	2,941,798	3,046,287
Average tangible equity	\$ 29,782,683	\$ 31,020,789	\$ 34,594,227	\$ 37,795,202	\$ 32,681,713
Effect of intangible assets	(0.02)%	(2.02)%	0.55%	0.17%	1.51%
Return on average tangible equity	(15.81)%	(26.36)%	7.26%	2.31%	17.78%

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward-Looking Statements

Management's discussion and analysis of Cornerstone's operations, prospects, and other matters, may include forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and other provisions of applicable federal and state securities laws. Although Cornerstone believes that the assumptions underlying such forward-looking statements contained in this report are reasonable, any of the assumptions could be inaccurate and, accordingly, there can be no assurance that the forward-looking statements included herein will prove to be accurate. The use of such words as "expect," "anticipate," "forecast," and comparable terms should be understood by the reader to indicate that the statement is "forward-looking" and thus subject to change in a manner that can be unpredictable. Factors that could cause actual results to differ from the results anticipated, but not guaranteed, in this report, include (without limitation) economic and social conditions, competition for loans, mortgages, and other financial services and products, changes in interest rates, unforeseen changes in liquidity, results of operations, and financial conditions affecting Cornerstone's customers, and other risks that cannot be accurately quantified or completely identified. Many factors affecting Cornerstone's financial condition and profitability, including changes in economic conditions, the volatility of interest rates, political events and competition from other providers of financial services simply cannot be predicted. These factors are unpredictable and beyond Cornerstone's control. Earnings may fluctuate from period to period. The purpose of this type of information is to provide readers with information relevant to understanding and assessing the financial condition and results of operations of Cornerstone, and not to predict the future or to guarantee results. Cornerstone is unable to predict the types of circumstances, conditions and factors that can cause anticipated results to change. Cornerstone undertakes no obligation to publish revised forward-looking statements to reflect the occurrence of changes or unanticipated events, circumstances, or results.

Financial Covenant Considerations

Prior to 2009, Cornerstone Community Bank (the "Bank") had a history of profitable operations and sufficient sources of liquidity to meet its funding needs. However, the Bank's parent holding company, Cornerstone Bancshares, Inc. ("Cornerstone"), relies primarily on dividends from the Bank to meet its funding needs. Cornerstone's funding needs as of December 31, 2009 and 2010 primarily consisted of principal and interest payments on two holding company loans totaling approximately \$5.4 million and \$4.7 million, respectively, secured by 100% of the Bank's common stock. In January 2010, the loans were renewed and Cornerstone received a waiver regarding previous covenant violations through December 31, 2009. The uncertainty surrounding the lender's intention to continue granting quarterly waivers of the covenant defaults on the loans through December 31, 2010, combined with the lender's unwillingness to amend the loan covenants, resulted in our independent registered public accounting firm stating in its opinion with regard to our 2009 financial statements substantial doubt about our ability to continue as a going concern. However, on March 29, 2011, Cornerstone received an additional waiver regarding all previous covenant violations in existence through December 31, 2010 and a waiver of any covenant violation that occurs through December 31, 2011. The one year covenant waiver is conditional upon, among other things, Cornerstone's payment in full for the outstanding principal balance in the amount of \$750,000 of one of the two outstanding notes. Therefore, as of April 1, 2011, Cornerstone will be subject to only one outstanding holding company loan. Further, our independent registered public accounting firm has issued an unqualified opinion with regard to our 2010 financial statements without a going concern consideration - *See Our Audited Consolidated Financial Statements in Item 8.*

Management's Discussions 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 Financial, Inc., ("Eagle") 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, office and overhead expenses.

The following is a discussion of Cornerstone's financial condition at December 31, 2010 and December 31, 2009 and Cornerstone's results of operations for each of the three-years ended December 31, 2010, 2009 and 2008. The purpose of this discussion is to focus on information about Cornerstone's 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 Cornerstone's consolidated financial statements and the related notes included elsewhere herein.

Review of Financial Performance

As of December 31, 2010, Cornerstone had total consolidated assets of approximately \$441 million, total loans of approximately \$285 million, total deposits of approximately \$335 million and stockholders' equity of approximately \$26 million. Cornerstone incurred a net loss of \$4.7 million for 2010 compared to a net loss of \$8.2 million for 2009 and net income of \$2.5 million for 2008.

Results of Operations

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 Cornerstone's earnings. For the year ended December 31, 2010, Cornerstone recorded net interest income of approximately \$16,010,000, which resulted in a net interest margin of 3.43%. For the year ended December 31, 2009, Cornerstone recorded net interest income of approximately \$15,119,000, which resulted in a net interest margin of 3.27%. For the year ended December 31, 2008, Cornerstone recorded net interest income of approximately \$17,982,000, which resulted in a net interest margin of 4.16%.

Table 4 presents information with respect to interest income from average interest-earning assets, expressed both in dollars and yields, and interest expense on average interest-bearing liabilities, expressed both in dollars and rates, for the periods indicated. The table includes loan yields, which reflect the amortization of deferred loan origination and commitment fees. Interest income from investment securities includes the accretion of discounts and amortization of premiums.

TABLE 4

**Yields Earned on Average Earning Assets and
Rates Paid on Average Interest Bearing Liabilities**
Years Ended December 31,

(In thousands)	2010			2009			2008		
	Average Balance	Interest Income/Expense(1)	Yield/Rate	Average Balance	Interest Income/Expense(1)	Yield/Rate	Average Balance	Interest Income/Expense(1)	Yield/Rate
ASSETS									
Interest-earning assets:									
Loans(1)(2)	\$ 311,407	\$ 21,498	6.90%	\$ 363,146	\$ 24,402	6.72%	\$ 385,957	\$ 28,661	7.43%
Investment securities(3)	128,795	3,633	3.06%	63,854	1,840	3.10%	47,096	1,996	4.36%
Other earning assets	36,319	80	0.22%	40,085	66	0.16%	869	23	2.70%
Total interest-earning assets	476,521	25,211	5.36%	467,085	26,308	5.66%	433,922	30,680	7.08%
Allowance for loan losses	(6,454)			(8,088)			(8,496)		
Cash and other assets	31,277			25,672			27,179		
Total assets	<u>\$ 501,344</u>			<u>\$ 484,669</u>			<u>\$ 452,605</u>		
TOTAL LIABILITIES AND EQUITY									
Interest-bearing liabilities:									
Deposits:									
NOW accounts	\$ 32,338	111	0.34%	\$ 27,864	\$ 98	0.35%	\$ 30,106	\$ 211	0.70%
Money market / savings	32,240	269	0.83%	35,269	303	0.86%	51,600	826	1.60%
Time deposits	281,251	5,839	2.08%	256,551	7,608	2.97%	190,221	8,262	4.34%
Total interest-bearing deposits	345,829	6,219	1.80%	319,684	8,009	2.51%	271,927	9,299	3.42%
Federal funds purchased	197	1	0.51%	-	-	-	12,952	339	2.62%
Securities sold under agreement to repurchase	22,519	126	0.56%	21,624	174	0.80%	18,580	261	1.41%
Other borrowings	66,208	2,856	4.31%	72,150	3,006	4.17%	68,578	2,799	4.08%
Total interest-bearing									
Liabilities	434,753	9,202	2.12%	413,458	11,189	2.71%	372,037	12,698	3.41%
Net interest spread			<u>3.24%</u>			<u>2.95%</u>			<u>3.67%</u>
Other liabilities:									
Demand deposits	39,104			40,816			42,915		
Accrued interest payable and other liabilities	(2,333)			(3,205)			218		
Stockholders' equity	29,820			33,600			37,435		
Total liabilities and stockholders' equity	<u>\$ 501,344</u>			<u>\$ 484,669</u>			<u>\$ 452,605</u>		
Net interest margin		<u>\$ 16,009</u>	<u>3.43%</u>		<u>\$ 15,119</u>	<u>3.27%</u>		<u>\$ 17,982</u>	<u>4.16%</u>

- (1) Interest income on loans includes amortization of deferred loan fees and other discounts of \$46 thousand, \$78 thousand and \$227 thousand for the fiscal years ended December 31, 2010, 2009 and 2008, respectively.
- (2) Nonperforming loans are included in the computation of average loan balances, and interest income on such loans is recognized on a cash basis.
- (3) Yields on securities are calculated on a fully tax equivalent basis.

Other matters related to the changes in net interest income, net interest yields and rates, and net interest margin are presented below:

☐ The net interest margin increased 16 basis points from 3.27% as of December 31, 2009 to 3.43% as of December 31, 2010. The increase in net interest margin can be attributed primarily to a change in the yield earned on the Bank's loan portfolio and a decrease in interest expense paid on certificates of deposit. The yield on the Bank's loan portfolio increased from 6.72% as of December 31, 2009 to 6.90% as of December 31, 2010. While the yield on loans actually increased, the total amount of interest income on loans was negatively affected by a reduction of the average loans outstanding for 2010. This decrease was partially offset by an increase in interest income realized on the Bank's security portfolio. Next, the Bank experienced a decrease in the interest rates on certificates of deposit accounts. This decrease is seen in the decline in rate from 2.97% as of December 31, 2009 compared to 2.08% as of December 31, 2010.

☐ As of December 31, 2010, the Bank's investment portfolio resulted in a yield of 3.06% compared to 3.10% as of December 31, 2009. The Bank's investment portfolio is used primarily for pledging purposes with the State of Tennessee Collateral Pool, Federal Reserve Bank discount window, to secure repurchase agreements and to provide additional collateral to the Federal Home Loan Bank to secure the Bank's fixed rate term advances. As of December 31, 2010, the Bank's securities portfolio was invested approximately 77% in Government National Mortgage Association (GNMA) securities, approximately 19% in municipal general obligation securities and 4% in agency-backed securities.

☐ The Bank's primary source of funding during 2010 came from certificates of deposit of which approximately 40% came from Internet deposits that allowed the Bank to have longer term maturities at a lower cost than the Chattanooga, TN market could provide. The rates of certificates of deposit decreased sharply in 2010 to 2.08% compared to 2.97% in 2009.

Tables 5 and 6 present the changes in interest income and interest expense that are attributable to three factors:

- (i) A change in volume or amount of an asset or liability.
- (ii) A change in interest rates.
- (iii) A change caused by the combination of changes in asset or deposit mix.

The tables describe the extent to which changes in interest rates and changes in volume of interest-earning assets and interest-bearing liabilities have affected Cornerstone's interest income and expense during the periods indicated. For each category of interest-earning assets and interest-bearing liabilities, information is provided as to changes attributable to change in volume (change in volume multiplied by current rate) and change in rates (change in rate multiplied by current volume). The remaining difference has been allocated to mix.

TABLE 5

INTEREST INCOME AND EXPENSE ANALYSIS

(In Thousands)	Year Ended December 31, 2010 Compared to 2009			
	Volume	Rate	Mix	Net Change
Interest income:				
Loans (1)(2)	\$ (3,570)	\$ 561	\$ 105	\$ (2,904)
Investment securities	1,987	(52)	(142)	1,793
Other earning assets	(8)	22	0	14
Total interest income				(1,097)
Interest expense:				
NOW accounts	15	(3)	1	13
Money market and savings accounts	(26)	-	(8)	(34)
Time deposits	514	(2,503)	220	(1,769)
Other borrowings	(256)	93	13	(150)
Federal funds purchased	(1)	-	2	1
Securities sold under agreement to repurchase	7	(54)	(1)	(48)
Total interest expense				(1,987)
Change in net interest income (expense)				\$ 890

(1) Loan amounts include non-accruing loans.

(2) Interest income includes the portion of loan fees recognized in the respective periods.

TABLE 6

INTEREST INCOME AND EXPENSE ANALYSIS

(In Thousands)	Year Ended December 31, 2009 Compared to 2008			
	Volume	Rate	Mix	Net Change
Interest income:				
Loans (1)(2)	\$ (1,533)	\$ (2,578)	\$ (148)	\$ (4,259)
Investment securities	520	(805)	129	(156)
Other earning assets	63	(1,018)	998	43
Total interest income				(4,372)
Interest expense:				
NOW accounts	(8)	(98)	(7)	(113)
Money market and savings accounts	(140)	(261)	(122)	(523)
Time deposits, \$100,000 and over	73	(911)	516	(322)
Time deposits, less than \$100,000	1,897	(2,594)	365	(332)
Other borrowings	146	14	47	207
Federal funds purchased	-	-	(339)	(339)
Securities sold under agreement to repurchase	32	(80)	(39)	(87)
Total interest expense				(1,509)
Change in net interest income (expense)				\$ (2,863)

(1) Loan amounts include non-accruing loans.

(2) Interest income includes the portion of loan fees recognized in the respective periods.

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 \$7.3 million for the year ended December 31, 2010 compared to \$14.9 million for the year ended December 31, 2009. Cornerstone's policies and procedures used to estimate the allowance for loan losses, as well as the resultant provision for loan losses, are considered adequate by management and are periodically reviewed by regulators. However, there are factors beyond Cornerstone's control, such as conditions in the local and national economy which may (and, for 2009 and 2010, in fact did) negatively impact Cornerstone's asset quality. The measurements are

approximations which may require additional provisions to loan losses based upon changing circumstances or when additional information becomes available or known. Other matters relating to the changes in provision for loan losses are presented below:

☐ Cornerstone’s provision for loan losses during 2010, was needed to address multiple credits that continued to deteriorate as a result of the prolonged economic downturn. The large provision for the fourth quarter of 2010 was primarily designated for unimpaired credits in the Bank’s loan portfolio. During the fourth quarter of 2010, management changed its methodology for estimating the allowance for loan and lease losses. First, the Bank revised several specific loan impairments to account for appraisals that were older than one year. The second change in methodology was a reduction in the number of years included in the Bank’s historical loss look-back period. These changes in methodology resulted in an additional \$3.2 million in provision expense during the fourth quarter of 2010. Management believes that these changes in estimate are appropriate and consistent with generally accepted accounting principles and interagency policy statements published by the Bank’s regulatory agencies.

☐ To address the problem credits within the Bank’s loan portfolio a Special Asset Committee was created during 2008. This committee has instructed the Bank’s loan review department to identify potential problem loans as quickly as possible. This committee is also responsible for developing and reviewing action plans that identify possible strategies to minimize the Bank’s losses. The early detection and proactive resolution process serves to assist customers with the severe economic environment while potentially minimizing losses. During 2010, the Bank dedicated additional human resources to the Special Asset department to assist in the collection and recovery process.

Non Interest Income-Items reported as non interest 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.

Table 7 presents the components of non interest income for the years ended December 31, 2010, 2009 and 2008 (in thousands).

TABLE 7

	2010	2009	2008
Customer service fees	\$ 1,273	\$ 1,630	\$ 1,727
Other noninterest income	90	97	102
Net gain from sale of securities	1,698	400	-
Net gain from sale of loans & other assets	20	200	58
Total noninterest income	<u>\$ 3,081</u>	<u>\$ 2,327</u>	<u>\$ 1,887</u>

Significant matters relating to the changes to non interest income are presented below:

☐ The Bank experienced a material decrease in its customer service fees from 2009 to 2010. The primary reason for this decrease was the decision by management and the board of directors to exit the payroll processor Automated Clearing House payments (“ACH”) line of business. The Bank elected to exit this line of business to reduce its risk profile and reduce the strain on the Bank’s liquidity due to the high amount of cash balances that the Bank was required to maintain at the Federal Reserve Bank of Atlanta. Exiting the line of business resulted in a significant reduction in the Bank’s commercial analysis fee income and ACH income. However, management believes this decision was appropriate given its current asset quality and liquidity needs.

☐ The Bank realized approximately \$1.7 million of security gains during 2010 as management elected to restructure its investment portfolio. The goal of the restructure was to maintain high credit quality investments while enabling the Bank to decrease its interest rate risk. To accomplish this goal, management selected several fixed rate GNMA mortgage-backed securities to sell. Once the sale transaction was complete, the Bank’s investment committee purchased LIBOR based floating rate GNMA collateralized mortgage obligations. Management also believes that the restructuring was needed due to the acceleration of prepayment speeds, during 2010, associated with the fixed rate GNMA securities.

Non Interest Expense-Items reported as non interest expense include salaries and employee benefits, occupancy and equipment expense, depository insurance, impairment of goodwill, net foreclosed assets and other operating expenses.

Table 8 presents the components of non interest expense for the years ended December 31, 2010, 2009 and 2008 (in thousands).

TABLE 8

	2010	2009	2008
Salaries and employee benefits	\$ 6,195	\$ 6,970	\$ 7,140
Net occupancy and equipment expense	1,501	1,548	1,520
Depository insurance	1,288	1,199	321
Impairment of goodwill	2,541	-	-
Foreclosed assets, net	2,790	2,571	219
Other operating expenses	3,727	3,774	3,362
Total noninterest expense	<u>\$ 18,042</u>	<u>\$ 16,062</u>	<u>\$ 12,563</u>

Significant matters relating to the changes to non interest expense are presented below:

☐ Salary expense decreased 11.1% from 2009 to 2010. The reduction is resulted from the Bank's reduced employee benefits, management's election not to replace certain staff positions if an employee decided to leave the Bank and the conclusion of payments owed to Gregory B. Jones in May of 2010.

☐ The Bank experienced an increase in regulatory insurance cost during 2010 as its average deposits increased over 2009 average amounts. Management anticipates regulatory insurance to decrease slightly in 2011 as average deposits decline.

☐ Cornerstone's goodwill was determined to be completely impaired due to the company's substandard performance and the decline in value of community banks, particularly in the Southeastern portion of the United States. The write-off of the holding company's goodwill is a one time expense to earnings. However, the write-off of goodwill will not negatively affect Cornerstone's capital ratios since the calculation of capital ratios requires that any goodwill be excluded before the calculation is performed.

☐ The Bank continued to see elevated foreclosed asset expenses as the amount of other real estate owned increased during 2010. Examples of expenses associated with foreclosed assets include property taxes, property maintenance and insurance. However, the foreclosed asset expense was slightly offset by rental income generated from the properties. These expenses were higher in 2010 than in 2009 due to an increase in the number of properties. Additionally, net losses from the sale of foreclosed assets are reflected in foreclosed assets expense. Management anticipates a decrease in its foreclosed asset expenses as more of the Bank's properties become income producing and as the general economy stabilizes.

Income Tax Expense

☐ The difference between Cornerstone's expected income tax expense, computed by multiplying income before income taxes by statutory income tax rates, and actual income tax expense, is primarily attributable to new market tax credits for federal and state purposes, tax exempt loans and tax exempt securities and the write-off of goodwill.

Financial Condition

Overview-Cornerstone's consolidated balance sheet reflects significant changes over the last two years. Total assets decreased approximately \$91 million or 17.1% from \$532 million as of December 31, 2009 to \$441 million as of December 31, 2010. During 2010, total loans decreased \$52 million or 15.4% from approximately \$337 million as of December 31, 2009 to approximately \$285 million as of December 31, 2010. The reduction in loans was a result of the Bank's collection process, and an increase in the Bank's loan underwriting requirements. Finally, stockholders' equity decreased to approximately \$26 million as of December 31, 2010 from approximately \$28 million as of December 31, 2009.

Investments-The Bank's investment portfolio totaled \$110.7 million or 25.1% of total assets as of December 31, 2010, compared to a total of \$126.8 million or 23.8% of total assets as of December 31, 2009. The decrease was a result of the Bank reducing its FHLB borrowings by \$17 million, thereby reducing the need for the security collateral.

The portfolio is accounted for in two classifications: "Held to Maturity" and "Available for Sale". The Bank also has an investment in Federal Home Loan Bank stock. The objective of the Bank's investment policy is to invest funds not otherwise needed to meet the loan demand of the Bank's market area and to meet the following five objectives: Gap Management, Liquidity, Pledging, Return, and Local Community Support. In doing so, the Bank uses the portfolio to provide structure and

liquidity that the loan portfolio cannot. The management investment committee balances the market and credit risks against the potential investment return, ensures investments are compatible with the pledge requirements of the Bank's deposit of public funds, maintains compliance with regulatory investment requirements, and assists various public entities with their financing needs. The management investment committee is authorized to execute security transactions for the investment portfolio based on the decisions of the Directors Asset Liability Committee of the Board of Directors ("ALCO"). All investment transactions occurring since the previous ALCO meeting are reviewed by the ALCO at its next quarterly meeting, in addition to the entire portfolio. The investment policy allows portfolio holdings to include short-term securities purchased to provide the Bank's needed liquidity and longer-term securities purchased to generate stable income for the Bank during periods of interest rate fluctuations.

Table 9 presents the carrying value of the Bank's investments at the dates indicated. Available for sale securities are carried at fair market value and securities held to maturity are held at their book value (amounts in thousands).

TABLE 9

Investment Portfolio
Years Ended December 31,

	2010	2009	2008
Securities available for sale:			
U.S. Government agency obligations	\$ 4,587	\$ 4,774	\$ 8,252
Mortgage-backed securities	82,927	102,885	31,182
State & political subdivisions tax-exempt	20,736	16,756	4,623
Totals	<u>\$ 108,250</u>	<u>\$ 124,415</u>	<u>\$ 44,057</u>
Securities held to maturity:			
Mortgage-backed securities	\$ 96	\$ 135	\$ 169
Totals	<u>\$ 96</u>	<u>\$ 135</u>	<u>\$ 169</u>
Federal Home Loan Bank stock, at cost	<u>2,323</u>	<u>2,229</u>	<u>2,188</u>
Total Investments	<u>\$ 110,669</u>	<u>\$ 126,779</u>	<u>\$ 46,414</u>

During 2010, the Bank's Asset-Liability Committee elected to decrease the amount of fixed rate GNMA mortgage backed securities and increase its GNMA LIBOR based collateralized mortgage obligations. The change was made in order to reduce the Bank's overall interest rate risk profile. The change did not reduce the portfolio's high credit quality, which is needed to provide collateral for the Bank's funding purposes. The Bank also increased its municipal security holdings to take advantage of the large credit risk spread over U.S. Treasury securities. Management anticipates the general level of security holdings to decrease during 2011 as the Bank's collateral requirements decrease.

A second objective of the security portfolio is to provide adequate collateral to satisfy pledging requirements with the State of Tennessee collateral pool, repurchase agreements, correspondent banks and the Federal Reserve discount window. As of December 31, 2010, the Bank's borrowing capacity with the Federal Reserve discount window was approximately \$10 million. The Bank also secured availability with a correspondent bank of approximately \$4 million as of December 31, 2010.

During 2009, the Federal Home Loan Bank ("FHLB") notified the Bank that as a result of the decline in the Bank's loan asset quality, additional collateral was required to secure the Bank's fixed rate term advances. As of December 31, 2010, the Bank had pledged securities with a market value of approximately \$50 million to the FHLB.

For December 31, 2010, tables 10 and 11 present the book value of the Bank's investments, the weighted average yields on the Bank's investments and the periods to maturity of the Bank's investments for the "Securities Available for Sale" and the "Securities Held to Maturity," respectively. Tables 12 and 13 present this information for December 31, 2009.

TABLE 10 (amounts in thousands)

Weighted Average Yields on the Available For Sale Investments
Periods of Maturity from December 31, 2010

	Less than 1 year		1 to 5 years		5 to 10 years		Over 10 years	
	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)
Securities available for sale:								
U.S. Government agencies	\$ -	-	\$ -	-	\$ -	-	\$ 4,571	1.08%
Mortgage-backed securities (2)	4,932	1.45%	3	6.94%	30	5.42%	78,358	1.53%
Tax-exempt municipal bonds	-	-	599	6.31%	4,456	5.30%	15,814	5.58%
Totals	\$ 4,932	1.45%	\$ 602	6.31%	\$ 4,486	5.30%	\$ 98,743	2.16%

Total Securities Available for Sale

\$ 108,763 **2.28%**

- (1) The weighted average yields on tax-exempt securities have been computed on a tax-equivalent basis.
(2) Mortgages are allocated by maturity and not amortized.

TABLE 11 (amounts in thousands)

Weighted Average Yields on the Held to Maturity Investments
Periods of Maturity from December 31, 2010

	Less than 1 year		1 to 5 years		5 to 10 years		Over 10 years	
	Amount	Weighted Avg. Yield(1)	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)
Securities held to maturity:								
Mortgage-backed securities (2)	\$ -	-	\$ -	-	\$ 20	2.53%	\$ 75	3.57%
Totals	\$ -	-	\$ -	-	\$ 20	2.53%	\$ 75	3.57%

Total Securities Held to Maturity

\$ 95 **3.35%**

Federal Home Loan Bank stock, at cost

\$ 2,323 **4.35%**

Total Investments

\$ 111,181 **2.32%**

- (1) The weighted average yields on tax-exempt securities have been computed on a tax-equivalent basis.
(2) Mortgages are allocated by maturity and not amortized.

TABLE 12 (amounts in thousands)

Weighted Average Yields on the Available For Sale Investments
Periods of Maturity from December 31, 2009

	Less than 1 year		1 to 5 years		5 to 10 years		Over 10 years	
	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)
Securities available for sale:								
U.S. Government agencies	\$ -	-	\$ -	-	\$ -	-	\$ 4,772	1.15%
Mortgage-backed securities (2)	-	-	-	-	39	5.68%	103,329	3.01%
Tax-exempt municipal bonds	-	-	599	6.31%	2,468	5.62%	13,594	5.77%
Totals	\$ -	-	\$ 599	6.31%	\$ 2,507	5.62%	\$ 121,695	3.25%

Total Securities Available for Sale

\$ 124,801 **3.31%**

- (1) The weighted average yields on tax-exempt securities have been computed on a tax-equivalent basis.
(2) Mortgages are allocated by maturity and not amortized.

TABLE 13 (amounts in thousands)

Weighted Average Yields on the Held to Maturity Investments
Periods of Maturity from December 31, 2009

	Less than 1 year		1 to 5 years		5 to 10 years		Over 10 years	
	Amount	Weighted Avg. Yield(1)	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)
Securities held to maturity:								
Mortgage-backed securities (2)	\$ 1	6.43%	\$ -	-	\$ 23	3.45%	\$ 111	4.47%
Totals	\$ 1	6.43%	\$ -	-	\$ 23	3.45%	\$ 111	4.47%
 Total Securities Held to Maturity	 \$ 135	 4.31%						
 Federal Home Loan Bank stock, at cost	 \$ 2,229	 4.58%						
 Total Investments	 \$ 127,165	 3.33%						

- (1) The weighted average yields on tax-exempt securities have been computed on a tax-equivalent basis.
(2) Mortgages are allocated by maturity and not amortized.

Lending-All lending activities of the Bank are under the direct supervision and control of the Directors Loan Committee (DLC). The DLC is comprised of three members of management and five independent directors that serve only in a director capacity and are not employees of the Bank. Also present at meetings of the committee are the loan review officer and other lending officers as required. All lending activities of Eagle are under the direct supervision and control of its Board of Directors which is comprised of both management and independent directors. These oversight committees enforce loan authorizations for each officer, make lending decisions on loans exceeding such limits, review and oversee problem credits, and determine the allocation of funds for each lending category.

At December 31, 2010 and 2009, Cornerstone's net loan portfolio constituted approximately 62.5% and 62.1% of Cornerstone's total assets, respectively.

Table 14 presents the composition of the Cornerstone's loan portfolio at the indicated dates.

TABLE 14

Loan Portfolio Composition
Years Ended December 31,

(In thousands)	2010		2009		2008		2007		2006	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Commercial, financial and agricultural	\$ 51,160	17.94%	\$ 60,560	17.99%	\$ 83,140	21.42%	\$ 98,065	25.57%	\$ 98,542	31.77%
Real estate – construction	29,848	10.46%	47,651	14.15%	70,456	18.15%	76,832	20.03%	57,606	18.57%
Real estate – mortgage	71,878	25.20%	70,976	21.08%	72,737	18.74%	64,585	16.84%	48,700	15.70%
Real estate – commercial	129,031	45.23%	153,310	45.53%	155,728	40.13%	138,074	35.99%	99,197	31.98%
Consumer loans	3,330	1.17%	4,195	1.25%	6,029	1.56%	6,037	1.57%	6,092	1.98%
Total loans	\$ 285,247	100.00%	\$ 336,692	100.00%	\$ 388,090	100.00%	\$ 383,593	100.00%	\$ 310,137	100.00%

Significant matters relating to the changes in the loan portfolio composition are presented below:

During 2010, the Bank's total loans outstanding decreased by 15.4%. The decrease occurred primarily in three loan categories. First, the real estate construction category decreased by 37.4% followed by real estate commercial which decreased by 15.8% and finally the commercial, financial and agricultural category decreased by 15.5%. The Bank anticipates that the amount of total loans outstanding will stabilize during 2011. The Bank's primary focus for new loan growth is concentrated in attracting owner-occupied commercial and residential loans and commercial and industrial loans.

Table 15 presents the scheduled maturities of the loans in Cornerstone's loan portfolio as of December 31, 2010 based on their contractual terms to maturity. Overdrafts are reported as due in less than one year. Loans unpaid at maturity are renegotiated based on current market rates and terms.

TABLE 15

Loans Maturing
Year-end balance as of December 31, 2010

(In thousands)	Less than One Year	1 to 5 Years	Over 5 Years	Total
Commercial, financial and agricultural	\$ 28,323	\$ 20,589	\$ 2,248	\$ 51,160
Real estate – construction	21,084	7,711	1,053	29,848
Real estate – mortgage	21,121	34,041	16,716	71,878
Real estate – commercial	41,606	63,115	24,310	129,031
Consumer	1,185	2,145	-	3,330
Total Loans	<u>\$ 113,319</u>	<u>\$ 127,601</u>	<u>\$ 44,327</u>	<u>\$ 285,247</u>

Types of Loans

Commercial Loans-The Bank's commercial loan portfolio is comprised of commercial, industrial, and non-farm non-residential loans, hereinafter referred to as commercial loans (excluding commercial construction loans). These installment loans and lines of credit are extended to individuals, partnerships and corporations for a variety of business purposes, such as accounts receivable and inventory financing, equipment financing, business expansion and working capital. The following is a list of terms imbedded in the Bank's commercial loan portfolio:

- ▣ The terms of the Bank's commercial loans generally range from 90 days to a 15 year amortization with a five year balloon.
- ▣ Commercial loans are generally tied to the prime index and adjust according with changes in the prime rate. The Bank also extends fixed interest rate loans when appropriate to match the borrower's needs.
- ▣ Loans secured by marketable equipment are required to be amortized over a period not to exceed 60 months.
- ▣ Generally, loans secured by current assets such as inventory or accounts receivable are structured as revolving lines of credit with annual maturities.
- ▣ Loans secured by chattel, mortgages and accounts receivable may not exceed 85% of their market value.
- ▣ Loans secured by listed stocks, municipal bonds and mutual funds may not exceed 70% of their market value.
- ▣ Unsecured short-term loans and lines of credit must meet criteria set by the Bank's Loan Committee. Current financial statements support all commercial loans, and such financial statements are updated annually.
- ▣ Substantially all of the Bank's commercial loans are secured and are guaranteed by the principals of the borrower.

Real Estate: Construction Loans-The Bank makes residential construction loans to owner-occupants and to persons building residential properties for resale. The Bank has two main areas of construction loans: one is to residential real estate developers for speculative or custom single-family residential properties, and the other is to custom commercial construction projects with guaranteed takeout provisions. Construction loans are usually variable rate loans made for terms of one year or less, but extensions are permitted if construction has continued satisfactorily, the loan is current and other circumstances warrant the extension. Construction loans are limited to 80% of the appraised value of the lot and the completed value of the proposed structure.

Construction financing generally is considered to involve a higher degree of credit risk than permanent mortgage financing of residential properties, and this additional risk usually is reflected in higher interest rates. The higher risk of loss on construction loans is attributable in large part to the fact that loan funds are estimated and advanced upon the security of the project under construction, which is of uncertain value prior to the completion of construction. Moreover, because of the uncertainties inherent in estimating construction costs, delays arising from labor problems, material shortages and other unpredictable contingencies, it is relatively difficult to accurately evaluate the total loan funds required to complete a project and to accurately evaluate the related loan-to-value ratios. If the estimates of construction costs and the saleability of the property upon completion of the project prove to be inaccurate, the Bank may be required to advance funds beyond the amount originally committed to permit completion of the project. If the estimate of value proves to be inaccurate, the Bank may be confronted, at or prior to the maturity of the loan, with a project with a value that is insufficient to assure full repayment.

The Bank's underwriting criteria are designed to evaluate and minimize the risk of each construction loan. Among other items, the Bank considers evidence of the availability of permanent financing or a take-out commitment to the borrower, the financial strength and reputation of the borrower, an independent appraisal and review of cost estimates, market conditions, and, if applicable, the amount of the borrower's equity in the project, pre-construction sale or leasing information and cash flow projections of the borrower.

Real Estate: Mortgage Loans-Real estate mortgage loans include all one to four family residential loans secured by real estate for purposes other than construction or acquisition and development. All real estate loans are held in the Bank's loan portfolio except for loans that are designated as loans held for sale. The loans held for sale are qualified by the Federal National Mortgage Association and have been pre-approved by an underwriting specialist prior to closing. The remainder of the Bank's mortgage loans are home equity loans and are made at fixed interest rates for terms of one to three years with balloon payment provisions and amortized over a 10 to 15 year period. The Bank's experience indicates that real estate loans normally remain outstanding for much shorter periods (seven years on average) than their stated maturity because the borrowers repay the loans in full either upon the sale of the secured property or upon the refinancing of the original loan.

In the case of owner occupied single-family residences, real estate loans are made for up to 95% of the value of the property securing the loan, based upon an appraisal if the loan amount is over \$100,000. When the loan is secured by real estate containing a non-owner occupied dwelling of one to four family units, loans generally are made for up to 80% of the value, based upon an appraisal if the loan amount is over \$100,000. The Bank also requires title insurance to insure the priority of the property lien on its real estate loans over \$50,000 and requires fire and casualty insurance on all of its loans.

The real estate loans originated by the Bank contain a "due-on-sale" clause, which provides that the Bank may declare the unpaid balance of the loan immediately due and payable upon the sale of the mortgaged property. Such clauses are an important means of reducing the average loan life and increasing the yield on existing fixed-rate real estate loans, and it is the Bank's policy to enforce due-on-sale clauses.

Real Estate: Commercial-Commercial real estate mortgage loans include all one to four family residential loans secured by real estate for purposes other than construction or acquisition and development. All real estate loans are held in the Bank's loan portfolio except for loans that have been participated to correspondent banks. The Bank will sell these participations if a loan exceeds the Bank's legal lending limit or as is deemed appropriate by the Director's Loan Committee. Commercial real estate mortgage loans are a combination of properties that are leased out or used for a primary place of a business the Bank has a relationship with. Most of the commercial real estate loans have fixed interest rates for terms of one to three years with balloon payment provisions and are amortized over a 10 to 15 year period, but whenever possible the Bank will seek a variable rate loan which would be tied to the New York prime rate and adjusted monthly. The Bank's experience indicates that real estate loans normally remain outstanding for much shorter periods (seven years on average) than their stated maturity because the borrowers repay the loans in full either upon the sale of the secured property or upon the refinancing of the original loan. Commercial real estate loans are made for up to 85% of the value of the property securing the loan, based upon an appraisal if the loan amount is over \$100,000. The Bank also requires title insurance to insure the priority of the property lien on its real estate loans over \$50,000 and requires fire and casualty insurance on all of its loans.

Consumer Loans-These loans consist of consumer installment loans and consumer credit card balances. The Bank makes both secured and unsecured consumer loans for a variety of personal and household purposes. Most of the Bank's consumer loans are automobile loans, boat loans, property improvement loans and loans to depositors on the security of their certificates of deposit. These loans are generally made for terms of up to five years at fixed interest rates. The Bank considers consumer loans to involve a relatively high credit risk compared to real estate loans. Consumer loans, therefore, generally yield a relatively high return to the Bank and provide a relatively short maturity. The Bank believes that the generally higher yields and the shorter terms available on various types of consumer loans tend to offset the relatively higher risk associated with such loans, and contribute to a profitable spread between the Bank's average yield on earning assets and the Bank's cost of funds.

Lending Commitments-Commitments under standby letters of credit and undisbursed loan commitments totaled approximately \$32 million as of December 31, 2010 compared to approximately \$46 million as of December 31, 2009. This number includes all lines of credit that have not been fully drawn and loan commitments in the same status.

Origination, Purchase and Sale of Loans

The Bank originates the majority of its loans in Hamilton County, Tennessee. However, the Bank also originates loans in Marion, Sequatchie and Bradley Counties in Tennessee, and Dade, Walker, Whitfield and Catoosa Counties in Georgia, each of which is within 150 miles of Chattanooga, Tennessee. Eagle markets to staffing companies in the United States. Loans are originated by 14 relationship managers who operate from the Bank's offices in Chattanooga, Tennessee and from the loan production office in Dalton, Georgia. These relationship managers actively solicit loan applications from existing customers, local manufacturers and retailers, builders, real estate developers, real estate agents and others. The Bank also receives numerous loan applications as a result of customer referrals and walk-ins to its offices.

Upon receipt of a loan application and all required supporting information from a prospective borrower, the Bank obtains a credit report and verifies specific information relating to the loan applicant's employment, income and creditworthiness. For significant extensions of credit in which real estate will secure the proposed loan, a certified appraisal of the real estate is undertaken by an independent appraiser approved by the Bank. The Bank's relationship managers then analyze the credit

worthiness of the borrower and the value of any collateral involved.

The Bank's loan approval process is intended to be conservative but also responsive to customer needs. Loans are approved in accordance with the Bank's written loan policy, which provides for several tiers of approval authority, based on a borrower's aggregate debt with the Bank. The Bank's legal lending limit is 25% of the Bank's qualifying equity for secured loans and 15% for unsecured loans.

The Bank has in the past purchased and sold commercial loan participations with correspondent banks and will continue the practice when management feels the action would be in the best interest of shareholders. The purchase of loan participations allows the Bank to expand its loan portfolio and increase profitability while still maintaining the high credit standards, which are applied to all extensions of credit made by the Bank. The sale of loan participations allows the Bank to make larger loans and retain a servicing fee for its labor, which it otherwise would be unable to make due to capital or other funding considerations.

Loan Fee Income

In addition to interest earned on loans, the Bank receives origination fees for making loans, commitment fees for making certain loans, and other fees for miscellaneous loan-related services. Such fee income varies with the volume of loans made, prepaid or sold, and the rates of fees vary from time to time depending on the supply of funds and competitive conditions.

Commitment fees are charged by the Bank to the borrower for certain loans and are calculated as a percentage of the principal amount of the loan. These fees normally are deducted from the proceeds of the loan and generally range from 0.5% to 2.0% of the principal amount, depending on the type and volume of loans made and market conditions such as the demand for loans, the availability of money and general economic conditions. The Bank complies with Accounting Standard Codification Topic 310, "Receivables," and amortizes all significant loan fees over the life of the loan. The Bank also receives miscellaneous fee income from late payment charges, overdraft fees, property inspection fees, and miscellaneous services related to its existing loans.

Problem Loans and Allowance for Loan Losses

Problem Loans-In originating loans, Cornerstone recognizes that it will experience credit losses and that the risk of loss will vary with, among other things, the type of loan being made, the creditworthiness of the borrower over the term of the loan and, in the case of a secured loan, the quality of the security for the loan. Cornerstone has instituted measures at the Bank and Eagle which are designed to reduce the risk of, and monitor exposure to, credit losses.

The Bank's loan portfolio is systematically reviewed by the Bank's management, internal auditors, external auditors, and State and Federal regulators to ensure that the Bank's larger loan relationships are being maintained within the loan policy guidelines, and remain properly underwritten. Input from all the above sources is used by the Bank to take corrective actions as necessary. As discussed below, each of the Bank's loans is assigned a rating in accordance with the Bank's internal loan rating system. All past due loans are reviewed by the Bank's senior lending officers and all past due loans over \$25,000 are reviewed monthly by the Director's Loan Committee. All loans classified as substandard or doubtful, as well as any "special mention" loans (defined in the following paragraph), are placed on the Bank's watch list and reviewed at least monthly by the Director's Loan Committee. In addition, all loans to a particular borrower are reviewed, regardless of classification, each time such borrower requests a renewal or extension of any loan or requests an additional loan. All lines of credit are reviewed annually prior to renewal. Such reviews include, but are not limited to, the ability of the borrower to repay the loan, a re-assessment of the borrower's financial condition, the value of any collateral and the estimated potential loss to the Bank, if any.

The Bank's internal problem loan rating system establishes three classifications for problem assets: substandard, doubtful and loss. Additionally, in connection with regulatory examinations of the Bank, Federal and State examiners have authority to identify problem assets and, if appropriate, require the Bank to classify them. Substandard assets have one or more defined weaknesses and are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Doubtful assets have the weaknesses of substandard assets with the additional characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. An asset classified as loss is considered uncollectible and of such little value that continuance as an asset of the Bank is not warranted. Consequently, such assets are charged-off in the month they are classified as loss. Federal regulations also designate a "special mention" category, described as assets which do not currently expose the Bank to a sufficient degree of risk to warrant classification but do possess credit deficiencies or potential weaknesses deserving management's close attention.

Assets classified as substandard or doubtful require the Bank to establish general or specific allowances for loan losses. If an asset or portion thereof is classified as loss, the Bank must either establish specific allowances for loan losses in the amount of 100% of the portion of the asset classified as loss or charge off such amount. General loss allowances established to cover

possible losses related to assets classified as substandard or doubtful may be included, up to certain limits, in determining the Bank's regulatory capital, while specific valuation allowances for loan losses do not qualify as regulatory capital.

The Bank's collection procedures provide that when a loan becomes between 15 days and 30 days delinquent, the borrower is contacted by mail and payment is requested. If the delinquency continues, subsequent efforts are made to contact and request payment from the delinquent borrower. Most loan delinquencies are cured within 60 days and no legal action is required. In certain circumstances, the Bank, for a fee, may modify the loan, grant a limited moratorium on loan payments or revise the payment schedule to enable the borrower to restructure his or her financial affairs. Generally, the Bank stops accruing interest and any accrued non collected interest will be reversed in accordance with GAAP on delinquent loans when payment is in arrears for 90 days or when collection otherwise becomes doubtful. If the delinquency exceeds 120 days and is not cured through the Bank's normal collection procedures or through a restructuring, the Bank will institute measures to enforce its remedies resulting from the default, including commencing a foreclosure, repossession or collection action. In certain cases, the Bank will consider accepting a voluntary conveyance of collateral in lieu of foreclosure or repossession. Real property acquired by the Bank as a result of foreclosure or by deed in lieu of foreclosure is classified as foreclosed assets until it is sold and is carried at the lower of cost or fair value less estimated costs to dispose. Accounting standards define fair value as the amount that is expected to be received in a current sale between a willing buyer and seller other than in a forced or liquidation sale. Fair values at foreclosure are based on appraisals. Losses arising from the acquisition of foreclosed properties are charged against the allowance for loan losses. Subsequent write-downs are provided by a charge to income through losses on other real estate in the period in which the need arises.

Allowance for Loan Losses-The allowance or reserve for possible loan losses is a means of absorbing future losses, which could be incurred from the current loan portfolio. The Bank maintains an allowance for possible loan losses, and management adjusts the general allowances quarterly by charges to income in response to changes to outstanding loan balances.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. A loan or portion thereof is charged off against the allowance when management has determined that losses on such loans are probable. Recoveries on any loans charged-off in prior fiscal periods are credited to the allowance. It is the opinion of the Bank's management that the balance in the allowance for loan losses as of December 31, 2010 is adequate to absorb possible losses from loans currently in the portfolio.

Table 16 presents the Bank's internal watchlist for loans classified as doubtful as of December 31, 2010 and 2009. Table 17 presents the Bank's internal watchlist for loans classified as substandard as of December 31, 2010 and 2009.

TABLE 16

Internal Watchlist Composition-Doubtful

(In thousands)	December 31, 2010		December 31, 2009	
	Amount	Impairment	Amount	Impairment
Commercial and industrial	\$ -	\$ -	\$ 1,350	\$ -
Construction and development	-	-	-	-
Single family real estate	-	-	-	-
Multi-family real estate	-	-	-	-
Owner occupied commercial real estate	-	-	-	-
Non-owner occupied commercial real estate	-	-	-	-
Consumer	-	-	-	-
Totals	\$ -	\$ -	\$ 1,350	\$ -

TABLE 17

Internal Watchlist Composition-Substandard

(In thousands)	December 31, 2010		December 31, 2009	
	Amount	Impairment	Amount	Impairment
Commercial and industrial	\$ 1,792	\$ 337	\$ 2,578	\$ 216
Construction and development	3,326	60	13,727	93
Single family real estate	10,896	1,020	6,498	689
Multi-family real estate	7,222	1,400	2,820	52
Owner occupied commercial real estate	6,016	741	6,038	131
Non-owner occupied commercial real estate	6,034	165	6,150	159
Consumer	61	17	100	6
Totals	\$ 35,347	\$ 3,740	\$ 37,911	\$ 1,346

☐ The information listed in tables 16 and 17 reflect the amount of the Bank's loans net of any partial charge-off amount that has been previously recorded.

☐ The Bank has seen an improvement in its asset quality as substandard loans have decreased by approximately 6.8%. The decrease in construction and development loans from approximately \$14 million as of December 31, 2009 to approximately \$3 million as of December 31, 2010 is primarily from the Bank recognizing the properties into other real estate owned. Currently, the Bank is in the process of trying to sell individual lots or large tracts of real estate to reduce the other real estate owned inventory. Management believes the Bank is well positioned for continued improvement in asset quality. The Bank's impairment amount of \$3.7 million as of December 31, 2010 compared to \$1.4 million as of December 31, 2009 is primarily the result of management adjusting the specific impairment on several large loans as reliable cash flow information has been obtained or more recent appraisals have been received.

☐ During the fourth quarter of 2010, the Bank revised its appraisal policy to require all loans graded substandard or worse to have annual appraisals on all real estate pledged as collateral with a value of \$250,000 or greater. These appraisals are used by management to determine appropriate real estate values and access if any impairment exists.

Table 18 presents Cornerstone's allocation of the allowance for loan losses as of December 31, 2010, 2009, 2008, 2007 and 2006.

TABLE 18

Allowance for Loan Losses
Years Ended December 31,

(In thousands)	2010		2009		2008	
	Amount	Percent of loans by category to total loans	Amount	Percent of loans by category to total loans	Amount	Percent of loans by category to total loans
Balance at end of period applicable to						
Commercial, financial and agricultural	\$ 925	17.94%	\$ 1,607	17.99%	\$ 4,955	21.42%
Real estate – construction	3,238	10.46%	595	14.15%	1,433	18.15%
Real estate – mortgage	3,111	25.20%	1,861	21.08%	1,532	18.74%
Real estate – commercial	1,793	45.23%	1,768	45.53%	1,376	40.13%
Consumer	65	1.17%	74	1.25%	322	1.56%
Totals	\$ 9,132	100.00%	\$ 5,905	100.00%	\$ 9,618	100.00%

(In thousands) Balance at end of period applicable to	2007		2006	
	Amount	Percent of loans by category to total loans	Amount	Percent of loans by category to total loans
Commercial, financial and agricultural	\$ 9,482	25.57%	\$ 1,686	31.77%
Real estate – construction	2,447	20.03%	1,581	18.57%
Real estate – mortgage	101	16.84%	77	15.70%
Real estate – commercial	1,434	35.99%	703	31.98%
Consumer	246	1.57%	211	1.98%
Totals	\$ 13,710	100.00%	\$ 4,258	100.00%

In recent years, Cornerstone has refined its allowance for loan and leases losses (“ALLL”) to include measurements such as environmental factors for growth, environmental factors for real estate values, historical metrics and specific loan products with increased levels of risk, such as asset based lending. During the fourth quarter of 2010, management elected to further revise its ALLL estimate. Specifically, two material changes to this estimation process were incorporated. First, the Bank revised several specific loan impairments to account for appraisals that were older than one year. Second, the Bank changed its historical loss look-back period from five years to one year. Management believes these changes are consistent with generally accepted accounting principles and interagency policy statements published by the Bank’s regulatory agencies. These changes resulted in a higher ALLL calculation and required an additional \$3.2 million in provision expense during the fourth quarter of 2010 bringing the total ALLL balance as of December 31, 2010 to \$9.1 million.

The Bank’s \$9.1 million ALLL is comprised of two components. The first component is derived from a review of the Bank’s loan portfolio with a risk grade of substandard or worse. These loans are reviewed to determine if the loan is impaired and what amount of impairment, if any, exists. The second component involves a general reserve for all other loans in the Bank’s portfolio to address possible losses that have not been identified in the Bank’s loan review process. As of December 31, 2010, the Bank has assigned approximately \$3.7 million to address specific impairments for loans the Bank has identified as substandard or worse. The remaining \$5.4 million is allocated to the remaining loan portfolio.

Table 19 presents Cornerstone's delinquent and non-performing assets as of December 31, 2010 and 2009.

TABLE 19

Delinquent and Non-Performing Assets
Actual for Years Ended December 31,

(In thousands)	2010	2009
Accruing loans that are contractually past due 90-days or more:		
Commercial, financial and agricultural	\$ 0	\$ 0
Real estate – construction	0	0
Real estate – mortgage	0	0
Real estate – commercial	0	0
Consumer	0	0
Total Loans	\$ 0	\$ 0
Non-accruing loans 90-days or more:		
Commercial, financial and agricultural	\$ 75	\$ 1,498
Real estate – construction	-	2,770
Real estate – mortgage	5,114	842
Real estate – commercial	8,426	2,250
Consumer	18	0
Total Loans	\$ 13,633	\$ 7,360
Total Foreclosed Assets	\$ 12,809	\$ 10,544
Total Loans	\$ 285,247	\$ 336,692

Ratio of non-performing assets to total loans	9.27%	5.32%
Ratio of delinquent (30-days or more) but accruing loans to:		
Total loans	0.81%	1.80%
Total assets	0.52%	1.20%

As the United States enters the third year of the current economic downturn the Bank's problem loans have evolved from construction and development loans to income producing commercial and residential properties. Typically, the construction and development loans resulted in a high loss percentage due to the completion status or marketability of the real estate project. Management believes the income producing commercial and residential properties that comprise the majority of the Bank's non-accrual loans will experience smaller losses as a percentage of the total loan.

The Bank has seen a significant decline in the level of past due loans as of December 31, 2010. As a result, management believes that the Bank will see a general decline in the non-accrual balances during 2011 as the present non-accruals transition to other real estate and are either sold or turned into income producing properties.

In addition to the Bank's loan rating system for problem assets described above (see "Problem Loans," above), the Bank has established a loan rating system for all categories of loans which assists management and the Board of Directors in determining the adequacy of the Bank's allowance for loan losses. Each loan in the Bank's portfolio is assigned a rating which is reviewed by management periodically to ensure its continued suitability. An exception is made in the case of (i) monthly installment loans which are grouped together by delinquency status such as over 10, 30, 60, or 90 days past due and (ii) problem assets which are rated as substandard, doubtful, or loss as discussed above. All other loans are assigned a rating of excellent, good, or average.

The Bank has developed an internal loan watchlist that identifies classified loans and assists management to monitor their potential risk to Bank earnings. As of December 31, 2010, the Bank had no loans graded as doubtful, approximately \$35 million in loans graded substandard and approximately \$33 million graded as special mention.

Table 20 presents Cornerstone's loan loss experience for the periods indicated.

TABLE 20

(in thousands)	Loan Loss Reserve Analysis Years Ending December 31,				
	2010	2009	2008	2007	2006
Average loans	\$ 311,407	\$ 363,146	\$ 385,957	\$ 353,278	\$ 284,105
Allowance for possible loan losses,					
Beginning of the period	\$ 5,905	\$ 9,618	\$ 13,710	\$ 4,258	\$ 3,545
Charge-offs for the period:					
Commercial, financial and agricultural	433	10,811	6,991	737	307
Real estate – construction	1,260	6,005	434	84	0
Real estate – mortgage	562	692	193	0	104
Real estate – commercial	2,309	1,248	210	180	0
Consumer	114	340	151	74	70
Total charge-offs	4,688	19,096	7,979	1,075	481
Recoveries for the period:					
Commercial, financial and agricultural	282	358	362	114	66
Real estate – construction	19	4	14	0	0
Real estate – mortgage	54	64	1	4	7
Real estate – commercial	213	43	0	0	0
Consumer	56	15	12	0	15
Total recoveries	624	484	389	118	88
Net charge-offs for the period	4,064	18,612	7,590	957	393

Provision for loan losses	7,291	14,899	3,498	10,409	1,106
Adjustments	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Allowance for possible loan losses, end of period	<u>\$ 9,132</u>	<u>\$ 5,905</u>	<u>\$ 9,618</u>	<u>\$ 13,710</u>	<u>\$ 4,258</u>
Ratio of allowance for loan losses to total average loans outstanding	<u>2.93%</u>	<u>1.63%</u>	<u>2.49%</u>	<u>3.88%</u>	<u>1.50%</u>
Ratio of net charge-offs during the period to average loans outstanding during the period	<u>1.31%</u>	<u>5.13%</u>	<u>1.97%</u>	<u>0.27%</u>	<u>0.14%</u>

Intangibles-Cornerstone follows the provisions of Accounting Standards Codification Topic 350, "Intangibles-Goodwill and Other," concerning approximately \$2.5 million in goodwill created by the merger with the Bank of East Ridge. Goodwill is tested annually for impairment. If the carrying value of goodwill exceeds the implied fair value, a write-down is recorded. No impairment loss was recognized in years prior to 2010. However, in 2010, management's annual impairment analysis revealed that the goodwill was fully impaired. Therefore, as of December 31, 2010 the goodwill recorded on the holding company's balance sheet was wrote-off through noninterest expense.

In December, 2005, Cornerstone completed the purchase of Eagle Financial, Inc. and recorded an intangible asset of \$848,916. Prior to June 2009, Eagle amortized a portion of the intangible each month. However, on June 30, 2009 the Bank purchased Eagle from the holding company. The transaction resulted in a write-off of the remaining intangible balance of approximately \$229 thousand based on an appraisal of the business performed in conjunction with that transaction.

Sources of Funds


Overview-Time, money market, savings and demand deposits are the major source of the Bank's funds for lending and other investment purposes. All deposits are held by the Bank. In addition, the Bank obtains funds from loan principal repayments and proceeds from sales of loan participations and investment securities. Loan repayments are a relatively stable source of funds, while deposit inflows and outflows and sales of loan participations and investment securities are significantly influenced by prevailing interest rates, economic conditions and the Bank's asset and liability management strategies. Borrowings are used on either a short-term basis to compensate for reductions in the availability of other sources of funds or on a longer-term basis to reduce interest rate risk.

Table 21 presents the Bank's core vs. non-core funding as of December 31, 2010 and 2009.

TABLE 21

Core and Non-Core Funding

(In thousands)	December 31, 2010		December 31, 2009	
	Amount	Percent	Amount	Percent
Core funding:				
Noninterest-bearing demand deposits	\$ 28,980	7.1%	\$ 41,972	8.4%
Interest-bearing demand deposits	24,834	6.1%	26,533	5.3%
Savings & money market accounts	34,042	8.3%	31,030	6.2%
Time deposits under \$100,000	133,626	32.6%	214,143	43.0%
Total core funding	<u>221,482</u>	<u>54.1%</u>	<u>313,678</u>	<u>62.9%</u>
Non-core funding:				
Brokered deposits	-	0.0%	5,852	1.2%
Time deposits greater than \$100,000	113,965	27.8%	85,212	17.1%
Securities sold under agreements to repurchase	24,325	5.9%	26,322	5.3%
Federal Home Loan Bank advances	50,000	12.2%	67,000	13.5%
Total non-core funding	<u>188,290</u>	<u>45.9%</u>	<u>184,386</u>	<u>37.1%</u>
Total	<u>\$ 409,772</u>	<u>100.0%</u>	<u>\$ 498,064</u>	<u>100.0%</u>

 During 2010, the Bank's total funding decreased from \$498 million as of December 31, 2009 to \$410 million as of

December 31, 2010. First, the decrease in the Bank's time deposits was a result of the decline in outstanding loans. Second, the decline in noninterest-bearing demand deposits resulted from the Bank exiting the payroll processor ACH line of business as previously discussed. Finally, the Bank reduced its Federal Home Loan Bank advances by \$17 million during 2010 as the advances matured. The Bank is contractually obligated to pay off \$10 million of Federal Home Loan Bank advances in 2011.

Deposits-The Bank offers several types of deposit accounts, with the principal differences relating to the minimum balances required, the time period the funds must remain on deposit and the interest rate. Deposits are obtained primarily from the Bank's Chattanooga, Tennessee MSA. The Bank does advertise for deposits outside of this area and has had moderate success attracting deposits from credit unions around the United States. The Bank does not rely upon any single person or group of related persons for a material portion of its deposits. A principal source of deposits for the Bank consists of short-term money market and other accounts, which are highly responsive to changes in market interest rates. Accordingly, the Bank, like all financial institutions, is subject to short-term fluctuations in deposits in response to customer actions due to changing short-term market interest rates. The ability of the Bank to attract and maintain deposits and the Bank's cost of funds has been and will continue to be significantly affected by money market conditions.

Table 22 presents the composition of deposits for the Bank, excluding accrued interest payable, by type for the years ended December 31, 2010, 2009 and 2008 (in thousands).

TABLE 22

Deposit Composition
Years Ended December 31,

(In thousands)	2010	2009	2008
Demand deposits	\$ 28,980	\$ 41,972	\$ 40,078
NOW deposits	24,834	26,533	26,909
Savings & money market deposits	34,042	31,030	35,848
Time deposits \$100,000 and over	113,965	91,064	59,057
Time deposits under \$100,000	133,626	214,143	164,692
Total Deposits	<u>\$ 335,447</u>	<u>\$ 404,742</u>	<u>\$ 326,584</u>

On October 3, 2008, the Emergency Economic Stabilization Act of 2008 ("EESA") became law. The EESA enabled the FDIC to temporarily increase the amount of FDIC deposit insurance coverage from \$100,000 to \$250,000 per qualified depositor through December 31, 2013. Also during the fourth quarter of 2008, the FDIC's Temporary Liquidity Guarantee Program ("TLGP") extended unlimited deposit insurance coverage for noninterest-bearing transaction accounts at participating FDIC insured banks. The FDIC also offered coverage regarding debt obligation coverage. These services were offered by the FDIC with a fee structure for each product. The Bank chose to accept the unlimited transaction account coverage but refused the debt obligation coverage. The TLGP currently has an expiration date of December 31, 2011.

Time deposits annual percentage yields decreased materially throughout 2010, which allowed the Bank to increase its deposit base at a lower cost of funds than incurred in 2009. In November 2009, the FDIC downgraded the Bank to "adequately capitalized" status, thereby restricting the interest rates payable by the Bank for time deposits. However, as of March 2011, the restriction has not impacted the Bank's liquidity.

Table 23 presents a breakdown by category of the average amount of deposits and the average rate paid on deposits for the periods indicated:

TABLE 23

Average Amount and Average Rate Paid on Deposits
Years Ending December 31,

(In thousands)	2010		2009		2008	
	Amount	Rate	Amount	Rate	Amount	Rate
Demand deposits	\$ 39,104		\$ 40,816		\$ 42,915	
NOW deposits	32,338	0.34%	27,864	0.35%	30,106	0.70%
Savings & money market deposits	32,240	0.83%	35,269	0.86%	51,600	1.60%
Time deposits	281,251	2.08%	256,551	2.97%	190,221	4.34%
Total Deposits	<u>\$ 384,933</u>	<u>1.80%</u>	<u>\$ 360,500</u>	<u>2.51%</u>	<u>\$ 314,842</u>	<u>3.42%</u>

Borrowings-The Bank joined the Federal Home Loan Bank of Cincinnati in October 2000. The Federal Home Loan Bank (the "FHLB") allows the Bank to borrow funds on a contractual basis many times at rates lower than the costs of local certificates of deposit. In addition, the FHLB has the ability to provide structured advances that best reduce or leverage the interest rate risk of the Bank. During 2010, the Bank reduced its FHLB borrowings by \$17 million. The reduction lowered the amount owed to the FHLB as of December 31, 2010, to \$50 million. The FHLB offers multiple products to assist banks in their funding needs. The advances from the FHLB as of December 31, 2010 are structured as an obligation with a fixed rate with the majority of loans incorporating an optional conversion to a floating rate after a stated period of time. The loans have maturities ranging from May 2011 to January 2017. As of December 31, 2010, the interest rates on these loans ranged from 3.52% to 4.66%. The Bank has one Federal Funds line of credit available with correspondent banks with a total availability of \$4 million as of December 31, 2010. In addition, the Bank has the right to borrow from the Federal Reserve Bank, if necessary, to supplement its supply of funds available for lending and to meet deposit withdrawal requirements. As of December 31, 2010, Cornerstone had two loans totaling approximately \$4.7 million priced at New York Prime Rate plus 300 basis points with a floor of 6.25%. The loans were established to insert capital infusions to the Bank to fund growth or retire treasury stock, if any, as needed. See Note 10 of our audited consolidated financial statements for additional information.

Capital

Capital Resources-Stockholder's average equity for 2010 and 2009 totaled \$29.8 million and \$33.6 million, respectively. As of December 31, 2010, Cornerstone's actual stockholder equity totaled \$25.8 million compared to \$27.8 million as of December 31, 2009. As of December 31, 2010, the number of shares of Series A Preferred Stock outstanding is 114,540. No shares of Series A Preferred Stock was outstanding as of December 31, 2009. The number of common shares outstanding remained unchanged at 6,500,396 as of December 31, 2010 compared to December 31, 2009.

Capital Adequacy-Capital adequacy refers to the level of capital required to sustain asset growth and to absorb losses. The objective of Cornerstone's management is to maintain a level of capitalization that is sufficient to take advantage of profitable growth opportunities while meeting regulatory requirements. This is achieved by improving profitability by effectively allocating resources to more profitable business, improving asset quality, strengthening service quality, and streamlining costs. The primary measures used by management to monitor the results of these efforts are the ratios of actual equity to average assets and actual equity to risk-adjusted assets.

The FDIC has adopted capital guidelines governing the activities of banks. These guidelines require the maintenance of an amount of capital based on risk-adjusted assets so that categories of assets with potentially higher credit risk will require more capital backing than assets with lower risk. In addition, banks are required to maintain capital to support, on a risk-adjusted basis, certain off-balance sheet activities such as loan commitments. The capital guidelines classify capital into two tiers, referred to as Tier I and Tier II. Under risk-based capital requirements, total capital consists of Tier I capital, which is generally common shareholder's equity less goodwill, and Tier II, which is primarily Tier I capital plus a portion of the loan loss allowance. In determining risk-based capital requirements, assets are assigned risk-weights of 0% to 100%, depending primarily on the regulatory assigned levels of credit risk associated with such assets. Off-balance sheet items are considered in the calculation of risk-adjusted assets through conversion factors established by regulators. The framework for calculating risk-based capital requires banks to meet the regulatory minimums of 4% Tier I and 8% total risk based capital. In 1990, regulators added a leverage computation to the capital requirements, comparing Tier I capital to total average assets less goodwill.

The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") established five capital categories for banks. Under the regulation defining these five capital categories, each bank is classified into one of the five categories based on its level of risk-based capital as measured by Tier I capital, total risk-based capital, and Tier I leverage ratios and its supervisory ratings. Table 24 lists the five categories of capital and each of the minimum requirements for the three risk-based ratios.

TABLE 24

Minimum Requirements for Risk-Based Capital Ratios

	Total Risk-Based Capital Ratio	Tier I Risk-Based Capital Ratio	Leverage Ratio
Well capitalized	10% or above	6% or above	5% or above
Adequately capitalized	8% or above	4% or above	4% or above
Under Capitalized	Less than 8%	Less than 4%	Less than 4%
Significantly undercapitalized	Less than 6%	Less than 3%	Less than 3%
Critically undercapitalized			2% or less

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 consent order, 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. As of December 31, 2010 the Bank’s capital ratios were as follows:

Tier 1 leverage ratio	5.75%
Tier 1 risk-based capital ratio	8.80%
Total risk-based capital ratio	10.06%

Liquidity-Of primary importance to depositors, creditors and regulators is the ability to have readily available funds sufficient to repay fully maturing liabilities. Cornerstone’s liquidity, represented by cash and cash equivalents, is a result of its operating, investing and financing activities. In order to ensure funds are available at all times, Cornerstone devotes resources to projecting on a monthly basis the amount of funds accessible. Liquidity requirements can also be met through short-term borrowing or the disposition of short-term assets, which are generally matched to correspond to the maturity of liabilities.

The Bank’s liquidity target is measured by adding net cash, short-term and marketable securities not pledged and dividing this number by total deposits and short-term liabilities not secured by assets pledged. The Bank’s liquidity ratio at December 31, 2010 was 12.0% compared to 9.1% at December 31, 2009. The Bank is not subject to any specific liquidity requirements imposed by regulatory orders. The Bank is subject however, to general FDIC guidelines which are concerned with funding sources and dependence on noncore deposits and does not require a specific minimum level of liquidity. Management believes its liquidity ratios and funding sources meet or exceed these guidelines.

Cornerstone’s liquidity is dependent on dividends from its subsidiary and capital contributions from its stockholders. Currently, the holding company’s expenses are tied to debt service on two holding company loans totaling \$4.7 million and shareholder and related Securities and Exchange Commission required filings expense. The Bank is presently restricted from passing up any dividends to the holding company unless the Bank receives prior approval from the FDIC.

Management does not know of any other trends, demands, commitments, events or uncertainties that will result in or are reasonably likely to result in liquidity increasing or decreasing in any material manner.

Table 25 presents the average loan to deposit ratios, a liquidity measure, for periods indicated:

TABLE 25

	<u>December 31, 2010</u>	<u>December 31, 2009</u>
Average loans to average deposits	80.90%	100.73%

Off-Balance Sheet Arrangements

Cornerstone does not have any off-balance sheet arrangements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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 must consider interest rate sensitivity and liquidity risk management when rendering a decision on funding solutions and loan pricing. To assist in this process the Bank has contracted with an independent third party to prepare quarterly reports that summarize several key asset-liability measurements. In addition, the third party will also provide recommendations to the Bank's ALCO regarding future balance sheet structure, earnings and liquidity strategies. The following is a brief discussion of the primary tools used by the ALCO to perform its responsibilities:

Earnings at Risk Model

The Bank uses an earnings at risk model to analyze interest rate risk. Forecasted levels of earning assets, interest-bearing liabilities, and off-balance sheet financial instruments are combined with ALCO forecasts of interest rates for the next 12 months and are combined with other factors in order to produce various earnings simulations.

At December 31, 2010, the Bank's earnings at risk model demonstrated that the Bank was within its policy limits for a 200 or 300 basis point change in interest rates. The policy limits have been established by the Directors ALCO committee and are calculated and reported quarterly.

Economic Value of Equity

The Bank's economic value of equity model measures the extent that estimated economic values of the Bank's assets and liabilities will change as a result of interest rate changes. Economic values are determined by discounting expected cash flows from assets and liabilities, which establishes a base case economic value of equity.

As of December 31, 2010, the Bank's economic value of equity model demonstrated that the Bank was within its policy limits for a 200 or 300 basis point change in interest rates. The policy limits have been established by the Directors ALCO committee and are calculated and reported quarterly.

Liquidity Analysis

The Bank uses a liquidity analysis model to examine the current liquidity position and analyze the potential sources of coverage in the event of a liquidity crisis. The following is a brief description of the key measurements contained in the analysis:

Regular Liquidity Position-This is a measurement used to capture the ability of an institution to cover its current debt obligations.

As of December 31, 2010, the Bank's regular liquidity measurements indicated that the liquidity position was within policy limits. The policy limits have been established by the Directors ALCO committee and are calculated and reported quarterly.

Basic Surplus-The basic surplus ratio is used to determine the number of times non-obligated assets could be used to meet immediate liquidity needs.

As of December 31, 2010, the Bank's basic surplus measurement indicated that the Bank was within policy limits. The policy limits have been established by the Directors ALCO committee and are calculated and reported quarterly.

Dependency Ratio-The dependency ratio determines the reliance on short-term liabilities.

As of December 31, 2010, the Bank's dependency ratio measurement indicated that the current position was within policy limits. The policy limits have been established by the Directors ALCO committee and are calculated and reported quarterly.

Leverage Analysis


The leverage analysis examines the potential of the institution to absorb additional debt. The key measurements included in this analysis are the Bank's tier 1 capital, leverage and total capital ratios.

Balance Sheet Analytics

Balance sheet analytics involve an in depth examination of the balance sheet structure, including diversification of structure and most recent pricing practices. This review uses trend analysis to compare previous balance sheet positions. The

analysis enables the ALCO to review significant changes in the Bank's loan and security portfolios as well as the Bank's deposit composition.

Like any forecasting technique, interest rate simulation modeling is based on a large number of assumptions. In this case, the assumptions relate primarily to loan and deposit growth, asset and liability prepayments, interest rates and balance sheet management strategies. Management believes that both individually and in the aggregate the assumptions are reasonable. Nevertheless, the simulation modeling process produces only a sophisticated estimate, not a precise calculation of exposure.

 The majority of the Bank's loans are indexed to the Prime rate as published in *The Wall Street Journal*. These variable rate loans contain a provision stating that an interest rate floor ranging from 4.0% to 7.5% exists. Almost all of the Bank's variable rate loans have repriced to the interest rate floors. The Bank's interest rate model estimates the most likely rate adjustment scenario.

Impact of Inflation and Changing Price- The financial statements and related financial data presented herein have been prepared in accordance with U.S. generally accepted accounting principles, which require the measurement of the financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time and due to inflation. Management is primarily concerned with two inflationary factors: The first, and most common, factor is the general impact of inflation on the operations of Cornerstone and is reflected in increased operating costs. The second, and more material to the Bank's profitability, factor is interest rate adjustments by the Federal Reserve and the general fixed income market in reaction to inflation. In other words, interest rate risk, unlike most industrial companies, substantially impacts Cornerstone because virtually all of the assets and liabilities of Cornerstone are monetary in nature. As a result, interest rates may have a more significant impact on Cornerstone's performance than the effects of general levels of inflation. Interest rate fluctuations do not necessarily move in the same direction or in the same magnitude as the price of goods and services and each issue must be dealt with independently.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

Consolidated Financial Statements and Footnotes

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MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of Cornerstone is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) or 15d-15(f) promulgated under the Exchange Act as a process designed by, or under the supervision of, Cornerstone's principal executive and principal financial officers and effected by Cornerstone's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of Cornerstone's assets;
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that Cornerstone's receipts and expenditures are being made only in accordance with authorizations of Cornerstone's management and directors; and
- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of Cornerstone's assets that could have a material effect on the financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Cornerstone's management has assessed the effectiveness of internal controls over financial reporting as of December 31, 2010. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in "Internal Control-Integrated Framework."

Based on this assessment management believes that, as of December 31, 2010, Cornerstone's internal control over financial reporting was effective based on those criteria.

This annual report does not include an attestation report of Cornerstone's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by Cornerstone's registered public accounting firm pursuant to transitional rules of the Securities and Exchange Commission that permit Cornerstone to provide only management's report in this annual report.

Report of Independent Registered Public Accounting Firm

To the Stockholders and
Board of Directors
Cornerstone Bancshares, Inc.
Chattanooga, Tennessee

We have audited the accompanying consolidated balance sheets of Cornerstone Bancshares, Inc. and subsidiary (Company) as of December 31, 2010 and 2009, and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2010. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Cornerstone Bancshares, Inc. and subsidiary as of December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2010, in conformity with United States generally accepted accounting principles.

/s/ HAZLETT, LEWIS & BIETER, PLLC

Chattanooga, Tennessee
March 30, 2011

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

December 31, 2010 and 2009

	2010	2009
ASSETS		
Cash and due from banks	\$ 1,490,030	\$ 1,420,502
Interest-bearing deposits at other financial institutions	<u>21,491,922</u>	<u>36,781,703</u>
Total cash and cash equivalents	22,981,952	38,202,205
Securities available for sale	108,250,434	124,415,318
Securities held to maturity (fair value approximates \$98,388 at 2010 and \$136,062 at 2009)	95,702	135,246
Federal Home Loan Bank stock, at cost	2,322,900	2,229,200
Loans, net of allowance for loan losses of \$9,132,171 in 2010 and \$5,905,054 in 2009	276,114,617	330,787,382
Bank premises and equipment, net	8,047,370	8,098,059
Accrued interest receivable	1,326,480	1,520,699
Goodwill	-	2,541,476
Foreclosed assets	12,808,838	10,327,297
Other assets	<u>9,551,121</u>	<u>14,147,504</u>
Total assets	<u>\$ 441,499,414</u>	<u>\$ 532,404,386</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing demand deposits	\$ 28,980,043	\$ 41,971,956
Interest-bearing demand deposits	24,834,214	26,533,329
Savings deposits and money market accounts	34,041,672	31,029,587
Time deposits	<u>247,591,161</u>	<u>305,207,241</u>
Total deposits	335,447,090	404,742,113
Accrued interest payable	176,761	351,360
Federal funds purchased and securities sold under agreements to repurchase	24,325,372	26,321,885
Federal Home Loan Bank advances and other borrowings	54,715,000	72,350,000
Other liabilities	<u>1,016,038</u>	<u>801,549</u>
Total liabilities	<u>415,680,261</u>	<u>504,566,907</u>
Stockholders' equity:		
Preferred stock - no par value; 2,000,000 shares authorized; 114,540 shares issued and outstanding in 2010	2,727,424	-
Common stock - \$1.00 par value; 20,000,000 shares authorized in 2010 and 10,000,000 shares authorized in 2009; 6,709,199 shares issued in 2010 and 2009; 6,500,396 shares outstanding in 2010 and 2009	6,500,396	6,500,396
Additional paid-in capital	21,237,298	21,162,686
Retained (deficit) earnings	(4,317,130)	424,854
Accumulated other comprehensive income	<u>(328,835)</u>	<u>(250,457)</u>
Total stockholders' equity	<u>25,819,153</u>	<u>27,837,479</u>
Total liabilities and stockholders' equity	<u>\$ 441,499,414</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
Years Ended December 31, 2010, 2009 and 2008

	2010	2009	2008
INTEREST INCOME			
Loans, including fees	\$21,498,120	\$24,402,101	\$28,660,491
Securities and interest-bearing deposits at other financial institutions	3,633,367	1,895,228	1,996,228
Federal funds sold	79,941	11,098	23,455
Total interest income	<u>25,211,428</u>	<u>26,308,427</u>	<u>30,680,174</u>
INTEREST EXPENSE			
Time deposits	5,838,571	7,608,747	8,262,157
Other deposits	379,810	400,395	1,037,191
Federal funds purchased and securities sold under agreements to repurchase	127,308	173,648	600,163
Federal Home Loan Bank advances and other borrowings	<u>2,856,125</u>	<u>3,006,593</u>	<u>2,798,563</u>
Total interest expense	<u>9,201,814</u>	<u>11,189,383</u>	<u>12,698,074</u>
Net interest income before provision for loan losses	16,009,614	15,119,044	17,982,100
Provision for loan losses	<u>7,291,000</u>	<u>14,898,898</u>	<u>3,498,000</u>
Net interest income after provision for loan losses	<u>8,718,614</u>	<u>220,146</u>	<u>14,484,100</u>
NONINTEREST INCOME			
Customer service fees	1,272,893	1,630,387	1,726,681
Other noninterest income	90,268	96,839	102,455
Net gains (losses) from sale of securities	1,698,136	399,754	-
Net gains (losses) from sale of loans and other assets	<u>19,632</u>	<u>200,082</u>	<u>57,828</u>
Total noninterest income	<u>3,080,929</u>	<u>2,327,062</u>	<u>1,886,964</u>
NONINTEREST EXPENSES			
Salaries and employee benefits	6,194,504	6,970,282	7,139,594
Net occupancy and equipment expense	1,501,504	1,547,630	1,520,378
Depository insurance	1,287,676	1,198,937	321,164
Impairment of goodwill	2,541,476	-	-
Foreclosed assets, net	2,789,708	2,570,584	219,135
Other operating expenses	<u>3,727,493</u>	<u>3,774,454</u>	<u>3,362,427</u>
Total noninterest expenses	<u>18,042,361</u>	<u>16,061,887</u>	<u>12,562,698</u>
(Loss) income before income tax expense (benefit)	(6,242,818)	(13,514,679)	3,808,366
Income tax (benefit) expense	<u>(1,535,297)</u>	<u>(5,336,040)</u>	<u>1,296,542</u>
Net (loss) income	(4,707,521)	(8,178,639)	2,511,824
Preferred stock dividends	<u>34,463</u>	<u>-</u>	<u>-</u>
Net (loss) income available to common stockholders	<u>\$ (4,741,984)</u>	<u>\$ (8,178,639)</u>	<u>\$ 2,511,824</u>
EARNINGS (LOSS) PER COMMON SHARE			
Basic	\$ (0.73)	\$ (1.26)	\$ 0.39
Diluted	<u>(0.73)</u>	<u>(1.26)</u>	<u>0.38</u>

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
 CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
 Years Ended December 31, 2010, 2009 and 2008

	Comprehensive Income	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total Stockholders' Equity
BALANCE, December 31, 2007	\$ 6,369,718	\$ 20,532,787	\$ 9,317,878	\$ 106,967	\$ 36,327,350	
Issuance of common stock	22,000	60,500	-	-	82,500	
Stock compensation expense	-	279,400	-	-	279,400	
Dividends - \$0.28 per common share	-	-	(1,773,022)	-	(1,773,022)	
Repurchase of common stock	(72,000)	(561,049)	-	-	(633,049)	
Comprehensive income:						
Net income	\$ 2,511,824	-	2,511,824	-	2,511,824	
Other comprehensive income, net of tax:						
Unrealized holding gains (losses) on securities available for sale, net of reclassification adjustment	(293,494)	-	-	(293,494)	(293,494)	
Total comprehensive income	\$ 2,218,330	-	-	-	(293,494)	
BALANCE, December 31, 2008	6,319,718	20,311,638	10,056,680	(186,527)	36,501,509	
Stock compensation expense	-	216,600	-	-	216,600	
Dividends - \$0.10 per common share	-	-	(638,061)	-	(638,061)	
Common stock dividends	180,678	634,448	(815,126)	-	-	
Comprehensive loss:						
Net loss	\$ (8,178,639)	-	(8,178,639)	-	(8,178,639)	
Other comprehensive income, net of tax:						
Unrealized holding gains (losses) on securities available for sale, net of reclassification adjustment	(63,930)	-	-	(63,930)	(63,930)	
Total comprehensive loss	\$ (8,242,569)	-	-	-	(63,930)	
BALANCE, December 31, 2009	\$ 6,500,396	\$ 21,162,686	\$ 424,854	\$ (250,457)	\$ 27,837,479	

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

(continued on next page)

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Years Ended December 31, 2010, 2009 and 2008

(continued from previous page)

	Comprehensive Income	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income	Total Stockholders' Equity
BALANCE, December 31, 2009	\$ -	-	\$ 6,500,396	\$ 21,162,686	\$ 424,854	\$ (250,457)	\$ 27,837,479
Stock compensation expense	-	-	-	74,612	-	-	74,612
Issuance of Series A Convertible Preferred Stock	-	2,727,424	-	-	-	-	2,727,424
Preferred stock dividends paid	-	-	-	-	(34,463)	-	(34,463)
Comprehensive loss: Net loss	\$ (4,707,521)	-	-	-	(4,707,521)	-	(4,707,521)
Other comprehensive income, net of tax: Unrealized holding gains (losses) on securities available for sale, net of reclassification adjustment	(78,378)	-	-	-	-	(78,378)	(78,378)
Total comprehensive loss	\$ (4,785,899)	-	-	-	-	-	-
BALANCE, December 31, 2010	\$ -	\$ 2,727,424	\$ 6,500,396	\$ 21,237,298	\$ (4,317,130)	\$ (328,835)	\$ 25,819,153

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS
Years Ended December 31, 2010, 2009 and 2008

	2010	2009	2008
CASH FLOWS FROM OPERATING ACTIVITIES			
Net (loss) income	\$ (4,707,521)	\$ (8,178,639)	\$ 2,511,824
Adjustments to reconcile net (loss) income to net cash provided by operating activities:			
Depreciation and amortization	555,235	958,438	694,499
Impairment of goodwill	2,541,476	-	-
Provision for loan losses	7,291,000	14,898,898	3,498,000
Stock compensation expense	74,612	216,600	279,400
Gain on sales of securities	(1,698,136)	(399,754)	-
Loss (gain) on sales of foreclosed assets, loans, and other assets	1,448,508	1,627,168	(57,828)
Deferred income taxes	(1,012,915)	1,301,148	3,302,186
Changes in other operating assets and liabilities:			
Net change in loans held for sale	(43,500)	582,000	(112,000)
Accrued interest receivable	194,219	250,392	636,886
Accrued interest payable	(174,599)	(118,226)	253,500
Other assets and liabilities	5,641,354	(5,089,681)	(7,509,166)
Net cash provided by operating activities	<u>10,109,733</u>	<u>6,048,344</u>	<u>3,497,301</u>
CASH FLOWS FROM INVESTING ACTIVITIES			
Proceeds from security transactions:			
Securities available for sale	127,818,220	36,851,917	23,596,577
Securities held to maturity	40,111	33,532	30,594
Purchase of securities available for sale	(110,123,951)	(117,340,105)	(33,350,455)
Purchase of Federal Home Loan Bank stock	(93,700)	(41,700)	(275,900)
Loan originations and principal collections, net	37,003,774	18,247,178	(14,691,368)
Purchase of bank premises and equipment	(835,007)	(310,113)	(2,589,553)
Proceeds from sale of other real estate and other assets	<u>7,094,142</u>	<u>4,119,884</u>	<u>1,357,027</u>
Net cash provided by (used in) investing activities	<u>60,903,589</u>	<u>(58,439,407)</u>	<u>(25,923,078)</u>
CASH FLOWS FROM FINANCING ACTIVITIES			
Net (decrease) increase in deposits	(69,295,023)	78,158,890	13,333,498
Decrease in federal funds purchased and securities sold under agreements to repurchase	(1,996,513)	(9,468,361)	(5,770,109)
Proceeds from Federal Home Loan Bank advances	-	-	20,000,000
Repayment of Federal Home Loan Bank advances	(17,000,000)	-	-
Net (repayments) borrowings of other borrowings	(635,000)	1,100,000	4,150,000
Purchase of common stock	-	-	(633,049)
Payment of dividends	(34,463)	(1,094,651)	(1,773,022)
Issuance of preferred stock	2,727,424	-	-
Issuance of common stock	<u>-</u>	<u>-</u>	<u>82,500</u>
Net cash (used in) provided by financing activities	<u>(86,233,575)</u>	<u>68,695,878</u>	<u>29,389,818</u>
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(15,220,253)	16,304,815	6,964,041
CASH AND CASH EQUIVALENTS, beginning of year	<u>38,202,205</u>	<u>21,897,390</u>	<u>14,933,349</u>
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 22,981,952</u>	<u>\$ 38,202,205</u>	<u>\$21,897,390</u>
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION			
Cash paid during the period for interest	\$ 9,376,413	\$ 11,307,609	\$12,444,574
Cash paid during the period for taxes	<u>500,000</u>	<u>180,350</u>	<u>738,886</u>
NONCASH INVESTING AND FINANCING ACTIVITIES			
Acquisition of real estate through foreclosure	<u>\$ 10,645,773</u>	<u>\$ 14,156,244</u>	<u>\$ 2,915,414</u>

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2010, 2009 and 2008

Note 1. Summary of Significant Accounting Policies

The accounting and reporting policies of Cornerstone Bancshares, Inc. and subsidiary (Cornerstone) conform with United States generally accepted accounting principles (GAAP) and practices within the banking industry. The Financial Accounting Standards Board (FASB) has adopted the FASB Accounting Standards Codification (ASC) as the single source of authoritative nongovernmental GAAP. Rules and interpretive releases of the Securities and Exchange Commission (SEC) are also sources of authoritative GAAP for SEC registrants. The policies that materially affect financial position and results of operations are summarized as follows:

Nature of operations:

Cornerstone is a bank-holding company which owns all of the outstanding common stock of Cornerstone Community Bank (the Bank). The Bank provides a variety of financial services through five full service branch locations in Chattanooga, Tennessee and a loan production office in Dalton, Georgia. The Bank's primary deposit products are demand deposits, savings accounts, and certificates of deposit. Its primary lending products are commercial loans, real estate loans, and installment loans. In addition, the Bank owns Eagle Financial, Inc. (Eagle) which is a finance and factoring company located in Chattanooga, Tennessee.

Principles of consolidation:

The consolidated financial statements include the accounts of Cornerstone, the Bank and Eagle. All material intercompany accounts and transactions have been eliminated in consolidation.

Goodwill:

Goodwill represents the excess of the cost of Cornerstone's 1997 purchase of the net assets of the Bank of East Ridge over the underlying fair value of such net assets at the date of acquisition. Cornerstone applies the provisions of ASC Topic 350, "Intangibles-Goodwill and Other," which requires that goodwill and other intangible assets deemed to have an indefinite life not be amortized. Goodwill is tested annually for impairment. If the carrying value of goodwill exceeds the fair value, a write-down is recorded. See Note 7 for further discussion regarding goodwill.

Use of estimates:

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

During 2010, management modified the application of its historical loss ratios relating to allowance for loan losses from a five-year historical loss ratio to a one-year historical loss ratio. Management determined that using one-year historical net charge-off percentages within their general reserve more accurately reflects current trends of losses inherent in the general loan portfolio. The impact on the consolidated financial statements was an increase to provision for loan losses and related allowance for loan losses of approximately \$2,000,000.

Significant group concentrations of credit risk:

Most of Cornerstone's activities are with customers located in middle and eastern Tennessee. The types of securities that Cornerstone invests in are included in Note 4. The types of lending Cornerstone engages in are included in Note 5. Cornerstone does not have any significant concentrations to any one industry or customer.

Commercial real estate, including commercial construction loans, represented 52 percent of the loan portfolio at December 31, 2010, and 57 percent of the loan portfolio at December 31, 2009.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 1. Summary of Significant Accounting Policies (continued)

Securities:

Debt securities are classified as held to maturity when the Bank has the intent and ability to hold the securities to maturity. Securities held to maturity are carried at amortized cost. The amortization of premiums and accretion of discounts are recognized in interest income using methods approximating the interest method over the period to maturity.

Debt securities not classified as held to maturity are classified as available for sale. Securities available for sale are carried at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Realized gains and losses on securities available for sale are included in other income and, when applicable, are reported as a reclassification adjustment, net of tax, in other comprehensive income. Gains and losses on sales of securities are determined using the specific-identification method. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities.

The Bank conducts a regular assessment of its securities portfolio to determine whether any are other-than-temporarily impaired. In estimating other-than-temporary impairment losses, management considers, among other factors, the length of time and extent to which the fair value has been less than cost, the financial condition and near term prospects of the issuer, and the intent and ability of the Bank to retain its investment for a period of time sufficient to allow for any anticipated recovery. The term "other-than-temporary" is not intended to indicate that the decline is permanent, but indicates that the prospects for a near-term recovery of value is not necessarily favorable, or that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. Once a decline in value for a debt security is determined to be other-than-temporary, the other-than-temporary impairment is separated into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income.

Federal Home Loan Bank stock:

Cornerstone, as a member of the Federal Home Loan Bank (FHLB) system, is required to maintain an investment in capital stock of the FHLB. Based on redemption provisions of the FHLB, the stock has no quoted market value and is carried at cost. At its discretion, the FHLB may declare dividends on the stock. Management reviews for impairment based on the ultimate recoverability of the cost basis in the FHLB stock.

Loans:

Cornerstone grants mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio is represented by real estate loans secured by properties located in Chattanooga, Tennessee and surrounding areas. The ability of Cornerstone's debtors to honor their contracts is somewhat dependent on the real estate and economic conditions in these areas.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity are stated at unpaid principal balances, less the allowance for loan losses and net deferred loan fees and costs. Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated market value in the aggregate.

Interest income is accrued based on the unpaid principal balance. Loan origination and commitment fees, as well as certain direct origination costs, are deferred and amortized as a yield adjustment over the lives of the related loans using the interest method. Amortization of deferred loan fees is discontinued when a loan is placed on nonaccrual status.

The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days past due unless the credit is well-secured and in process of collection. Credit card loans and other consumer loans are typically charged off no later than 120 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2010, 2009 and 2008

Note 1. Summary of Significant Accounting Policies (continued)

Loans: (continued)

All interest accrued but not collected for loans that are charged off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

A troubled-debt restructuring (TDR) is a loan that the Bank has granted a concession to the borrower, which would not otherwise be considered due to the borrower experiencing financial difficulty. If a loan is in nonaccrual status before it is determined to be a TDR, then the loan remains in nonaccrual status. TDR loans in nonaccrual status may be returned to accrual status if there has been at least a six month sustained period of repayment performance by the borrower. When the Bank modifies the terms of an existing loan that is not considered a TDR, the Bank accounts for the loan modification as a new loan if the terms of the new loan resulting from the refinancing or restructuring are at least as favorable to the Bank as the terms for comparable loans to other customers with similar risk characteristics who are not undergoing a refinancing or restructuring and the modifications are more than minor.

Allowance for loan losses:

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's quarterly review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of allocated and general components. The allocated component relates to loans that are classified as impaired. For those loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical charge-off experience and expected loss given default derived from the Bank's internal risk rating process. Other adjustments may be made to the allowance for pools of loans after an assessment of internal or external influences on credit quality that are not fully reflected on the historical loss or risk rating data.

A loan is considered impaired when, based on current information and events, it is probable that Cornerstone will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, Cornerstone does not separately identify individual consumer loans for impairment disclosures, unless such loans are the subject of a restructuring agreement due to financial difficulties of the borrower.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 1. Summary of Significant Accounting Policies (continued)

Derivative loan commitments:

Mortgage loan commitments are referred to as derivative loan commitments if the loan that will result from exercise of the commitment will be held for sale upon funding. Loan commitments that are derivatives are recognized at fair value on the consolidated balance sheet in derivative assets or derivative liabilities with changes in their fair values recorded in net gains on sales of loans.

Cornerstone records a zero value for the loan commitment at inception, when the commitment is issued to a borrower. Subsequent to inception, changes in the fair value of the loan commitment are recognized based on changes in the fair value of the underlying mortgage loan due to interest rate changes, changes in the probability the derivative loan commitment will be exercised, and the passage of time. In estimating fair value, Cornerstone assigns a probability to a loan commitment based on an expectation that it will be exercised and the loan will be funded.

Premises and equipment:

Land is carried at cost. Buildings and equipment are carried at cost, less accumulated depreciation and amortization computed on the straight-line and declining balance methods over the estimated useful lives of the assets. Maintenance and repairs are expensed as incurred while major additions and improvements are capitalized. Gains and losses on dispositions are included in current operations.

Investment in partnership:

Cornerstone's investment in a partnership consists of an equity interest in a lending partnership for the purposes of investing in the New Market Tax Credit Program. This program permits taxpayers to claim a credit against federal income taxes for Qualified Equity Investments made to acquire stock or a capital interest in designated Community Development Entities (CDEs). These designated CDEs must use substantially all (defined as 85 percent) of these proceeds to make qualified low-income community investments.

Cornerstone uses the equity method when it owns an interest in a partnership and can exert significant influence over the partnership's operations but cannot control the partnership's operations. Under the equity method, Cornerstone's ownership interest in the partnership's capital is reported as an investment on its consolidated balance sheets and Cornerstone's allocable share of the income or loss from the partnership is reported in noninterest income or expense in the consolidated statements of income. Cornerstone ceases recording losses on an investment in partnership when the cumulative losses and distributions from the partnership exceed the carrying amount of the investment and any advances made by Cornerstone. After Cornerstone's investment in such partnership reaches zero, cash distributions received from these investments are recorded as income.

Foreclosed assets:

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less cost to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenues and expenses from operations and changes in the valuation allowance are included in net expenses from foreclosed assets.

Securities sold under agreements to repurchase:

Cornerstone enters into sales of securities under agreements to repurchase identical securities the next day. Securities sold under agreements to repurchase amounted to \$24,325,372 at December 31, 2010, mature on a daily basis and are secured by securities available for sale with a fair value of approximately \$28,067,000.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 1. Summary of Significant Accounting Policies (continued)

Income taxes:

Cornerstone accounts for income taxes in accordance with income tax accounting guidance in ASC Topic 740. The income tax accounting guidance results in two components of income tax expense – current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to taxable income or loss. Cornerstone determines deferred income taxes using the liability method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities. Cornerstone's deferred taxes relate primarily to differences between the basis of the allowance for loan losses and accumulated depreciation. Deferred tax assets and liabilities are reflected at income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. Cornerstone files consolidated income tax returns with its subsidiary. With few exceptions, Cornerstone is no longer subject to tax examinations by tax authorities for years before 2007.

Cornerstone recognizes deferred tax assets if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. Cornerstone follows the statutory requirements for its income tax accounting and generally avoids risks associated with potentially problematic tax positions that may be challenged upon examination. Cornerstone recognizes interest and penalties on income taxes as a component of income tax expense.

Transfers of financial assets:

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over assets is deemed to be surrendered when (1) the assets have been isolated from Cornerstone, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) Cornerstone does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity, or the ability to unilaterally cause the holder to return specific assets.

Advertising costs:

Cornerstone expenses all advertising costs as incurred. Advertising expense was \$79,790, \$97,734, and \$92,252, for the years ended December 31, 2010, 2009 and 2008, respectively.

Statements of cash flows:

Cornerstone considers all cash and amounts due from depository institutions, interest-bearing deposits at other financial institutions, and federal funds sold to be cash equivalents for purposes of the statements of cash flows.

Stock option plan:

Cornerstone recognizes compensation cost relating to share-based payment transactions in accordance with ASC Topic 718. Compensation cost has been measured based on the grant date fair value of the equity or liability instruments issued. Compensation cost is calculated and recognized over the employee service period, generally defined as the vesting period. Cornerstone uses a stock option pricing model to determine the fair value of the award on the grant date.

Segment reporting:

ASC Topic 280, "Segment Reporting," provides for the identification of reportable segments on the basis of distinct business units and their financial information to the extent such units are reviewed by an entity's chief decision maker (which can be an individual or group of management persons). ASC Topic 280 permits aggregation or combination of segments that have similar characteristics. In Cornerstone's operations, each bank branch is viewed by management as being a separately identifiable business or segment from the perspective of monitoring performance and allocation of financial resources. Although the branches operate

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
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December 31, 2010, 2009 and 2008

Note 1. Summary of Significant Accounting Policies (continued)

Segment reporting: (continued)

independently and are managed and monitored separately, each is substantially similar in terms of business focus, type of customers, products and services. Further, the results of Eagle for 2010, 2009 and 2008 were not significant for separate disclosure. Accordingly, Cornerstone's consolidated financial statements reflect the presentation of segment information on an aggregated basis in one reportable segment.

Earnings per common share:

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

Variable interest entities:

An entity is referred to as a variable interest entity (VIE) if it meets the criteria outlined in ASC Topic 810, which are: (1) the entity has equity that is insufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, or (2) the entity has equity investors that cannot make significant decisions about the entity's operations or that do not absorb the expected losses or receive the expected returns of the entity. A VIE must be consolidated by Cornerstone if it is deemed to be the primary beneficiary of the VIE, which is the party involved with the VIE that has a majority of the expected losses, expected residual returns, or both. At December 31, 2010, Cornerstone has an investment in Appalachian Fund for Growth II Partnership that qualifies as an unconsolidated VIE.

Comprehensive income:

Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains on securities available for sale, and unrealized losses related to factors other than credit losses on debt securities.

Reclassification:

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

Off-balance sheet credit related financial instruments:

In the ordinary course of business, Cornerstone has entered into commitments to extend credit, including commitments under credit card arrangements, commercial letters of credit, and standby letters of credit. Such financial instruments are recorded when they are funded.

Subsequent events:

Cornerstone has evaluated subsequent events for potential recognition and/or disclosures in the consolidated financial statements and accompanying notes included in this Annual Report on Form 10-K.

Note 2. Preferred Stock

During 2010, Cornerstone initiated a preferred stock offering. The offering period is scheduled to end on June 30, 2011. Specifics of the preferred stock offering are as follows:

- Issuance of up to 600,000 shares of Series A Convertible Preferred Stock at a price of \$25.00 per share.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2010, 2009 and 2008

Note 2. Preferred Stock (continued)

- The annual cash dividend on each share of Series A Preferred Stock is \$2.50, which is equal to 10% of the original issue price of \$25.00 per share, and is payable quarterly in arrears, if, as and when declared on the 15th day of February, May, August and November that immediately follows the end of the dividend period to which such dividends relate. Any dividend payable on shares of Series A Preferred Stock that is not declared by our board of directors or paid will accumulate.
- Each share of Series A Preferred Stock will be convertible at the shareholder's option at any time into five (5) shares of our common stock reflecting an initial conversion price of \$5.00 per share of common stock. The shares of Series A Preferred Stock are also convertible at Cornerstone's option, in whole or in part, into shares of Cornerstone's common stock at the conversion rate, at any time on or after July 31, 2015 if the closing price of Cornerstone's common stock equals or exceeds 150% of the conversion price on each of the thirty (30) consecutive trading days immediately preceding the date Cornerstone gives notice of its election to so convert.

On October 28, 2010, Cornerstone announced a preferred stock dividend of \$0.625 per share payable to preferred shareholders on record as of October 15, 2010 with a payment date of November 15, 2010. The amount of the dividend totaled \$34,463.

Note 3. Restrictions on Cash and Due From Banks

The Bank is required to maintain balances on hand or with the Federal Reserve Bank based on a percentage of deposits. At December 31, 2010 and 2009, these reserve balances were approximately \$632,000 and \$1,011,000, respectively.

Note 4. Securities

Securities have been classified in the balance sheet according to management's intent as either securities held to maturity or securities available for sale. The amortized cost and approximate fair value of securities at December 31, 2010 and 2009, are as follows:

	December 31, 2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Loss	Fair Value
Debt securities available for sale:				
U.S. Government agencies	\$ 4,571,444	\$ 15,635	\$ -	\$ 4,587,079
State and municipal securities	20,868,771	191,429	(323,988)	20,736,212
Mortgage-backed securities:				
Residential mortgage guaranteed by GNMA	18,747,272	130,609	(24,856)	18,853,025
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	<u>64,575,092</u>	<u>135,479</u>	<u>(636,453)</u>	<u>64,074,118</u>
	<u>\$108,762,579</u>	<u>\$473,152</u>	<u>\$(985,297)</u>	<u>\$108,250,434</u>
Debt securities held to maturity:				
Mortgage-backed securities:				
Residential mortgage guaranteed by GNMA	<u>\$ 95,702</u>	<u>\$ 2,686</u>	<u>\$ -</u>	<u>\$ 98,388</u>

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2010, 2009 and 2008

Note 4. Securities (continued)

	December 31, 2009			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Loss	
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>

U.S. Government sponsored agencies include entities such as Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Federal Home Loan Banks.

At December 31, 2010 and 2009, securities with a carrying value of approximately \$17,262,000 and \$22,835,000, respectively, were pledged to secure public deposits and for other purposes required or permitted by law.

At December 31, 2010 and 2009, the carrying amount of securities pledged to secure repurchase agreements was approximately \$28,067,000 and \$47,002,000, respectively.

At December 31, 2010 and 2009, securities with a carrying value of approximately \$50,317,000 and \$54,380,000, respectively, were pledged to the Federal Home Loan Bank as collateral for the Bank's borrowings.

At December 31, 2010, the Bank had pledged securities with a carrying amount of approximately \$4,191,000 to other financial institutions as collateral for federal funds purchased. At December 31, 2009, the Bank had no securities pledged to other financial institutions as collateral for federal funds purchased.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2010, 2009 and 2008

Note 4. Securities (continued)

The amortized cost and fair value of securities at December 31, 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.

	<u>Securities Available for Sale</u>		<u>Securities Held to Maturity</u>	
	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Amortized Cost</u>	<u>Fair Value</u>
Due in one year or less	\$ -	\$ -	\$ -	\$ -
Due from one year to five years	599,399	609,291	-	-
Due from five years to ten years	4,455,540	4,569,681	-	-
Due after ten years	<u>20,385,276</u>	<u>20,144,319</u>	<u>-</u>	<u>-</u>
	25,440,215	25,323,291	-	-
Mortgage-backed securities	<u>83,322,364</u>	<u>82,927,143</u>	<u>95,702</u>	<u>98,388</u>
	<u>\$108,762,579</u>	<u>\$108,250,434</u>	<u>\$95,702</u>	<u>\$98,388</u>

For the year ended December 31, 2010, there were available for sale securities sold with proceeds totaling \$85,186,273 which resulted in gross gains and losses realized of \$1,699,276 and \$1,140, respectively. For the year ended December 31, 2009, there were available for sale securities sold with proceeds totaling \$18,951,608 which resulted in gross gains and losses realized of \$414,193 and \$14,439, respectively. There were no sales of securities available for sale for the year ended December 31, 2008.

The following tables present 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, at December 31, 2010 and 2009:

	<u>As of December 31, 2010</u>					
	<u>Less than 12 Months</u>		<u>12 Months or Greater</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>
Debt securities available for sale:						
State and municipal securities	\$ 6,110,458	\$(154,802)	\$6,440,892	\$(169,186)	\$12,551,350	\$(323,988)
Mortgage-backed securities:						
Residential mortgage guaranteed by GNMA	5,647,347	(24,856)	-	-	5,647,347	(24,856)
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	<u>34,694,782</u>	<u>(636,453)</u>	<u>-</u>	<u>-</u>	<u>34,694,782</u>	<u>(636,453)</u>
	<u>\$46,452,587</u>	<u>\$(816,111)</u>	<u>\$6,440,892</u>	<u>\$(169,186)</u>	<u>\$52,893,479</u>	<u>\$(985,297)</u>

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2010, 2009 and 2008

Note 4. Securities (continued)

	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	-	-	<u>198,443</u>	<u>(5,518)</u>	<u>198,443</u>	<u>(5,518)</u>
	<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	<u>\$ 48,767</u>	<u>\$ (70)</u>	<u>\$ 25,594</u>	<u>\$ (307)</u>	<u>\$ 74,361</u>	<u>\$ (377)</u>

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

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

State and municipal securities: At December 31, 2010, 29 investments in obligations of state and municipal securities had unrealized losses. Cornerstone 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 Company has the intent and ability to hold those investments for a time necessary to recover their amortized cost bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at December 31, 2010.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 4. Securities (continued)

Mortgage-backed securities: At December 31, 2010, 12 investments in residential mortgage-backed securities 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 Cornerstone does not intend to sell the investments and it is not more likely than not that Cornerstone will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, Cornerstone does not deem those investments to be other-than-temporarily impaired at December 31, 2010.

Note 5. Loans and Allowance for Loan Losses

At December 31, 2010 and 2009, the Bank's loans consist of the following (in thousands):

	2010	2009
Commercial real estate-mortgage:		
Owner-occupied	\$ 64,971	\$ 77,350
All other	64,060	75,960
Consumer real estate-mortgage	71,878	70,976
Construction and land development	29,848	47,651
Commercial and industrial	51,160	60,560
Consumer and other	3,330	4,195
Total loans	285,247	336,692
Less: Allowance for loan losses	(9,132)	(5,905)
Loans, net	<u>\$276,115</u>	<u>\$330,787</u>

	2010	2009	2008
An analysis of the allowance for loan losses follows:			
Balance, beginning of year	\$ 5,905,054	\$ 9,618,265	\$13,710,109
Provision charged to operations	7,291,000	14,898,898	3,498,000
Charge-offs	(4,688,054)	(19,095,793)	(7,978,767)
Recoveries	624,171	483,684	388,923
Balance, end of year	<u>\$ 9,132,171</u>	<u>\$ 5,905,054</u>	<u>\$ 9,618,265</u>

Cornerstone follows the loan impairment accounting guidance in ASC Topic 310. A loan is considered impaired when, based on current information and events, it is probable that Cornerstone will be unable to collect all amounts due from the borrower in accordance with the contractual terms of the loan. Impaired loans include nonperforming loans and loans modified in troubled debt restructurings where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a reduction in interest rates, payment extensions, forgiveness of principal, forbearance or other actions intended to maximize collections.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
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Note 5. Loans and Allowance for Loan Losses (continued)

The composition of loans by loan classification for impaired and performing loans at December 31, 2010 is summarized in the table below (in thousands):

	<u>Commercial Real Estate- Mortgage</u>	<u>Consumer Real Estate- Mortgage</u>	<u>Construction and Land Development</u>	<u>Commercial and Industrial</u>	<u>Consumer and Other</u>	<u>Total</u>
Performing loans	\$119,084	\$61,455	\$27,774	\$50,492	\$3,279	\$262,084
Impaired loans	9,947	10,423	2,074	668	51	23,163
Total	<u>\$129,031</u>	<u>\$71,878</u>	<u>\$29,848</u>	<u>\$51,160</u>	<u>\$3,330</u>	<u>\$285,247</u>

The following table shows the allowance for loan losses allocation by loan classification for impaired and performing loans as of December 31, 2010 (in thousands):

	<u>Commercial Real Estate- Mortgage</u>	<u>Consumer Real Estate- Mortgage</u>	<u>Construction and Land Development</u>	<u>Commercial and Industrial</u>	<u>Consumer and Other</u>	<u>Total</u>
Allowance related to:						
Performing loans	\$ 887	\$ 691	\$3,178	\$588	\$48	\$5,392
Impaired loans	906	2,420	60	337	17	3,740
Total	<u>\$1,793</u>	<u>\$3,111</u>	<u>\$3,238</u>	<u>\$925</u>	<u>\$65</u>	<u>\$9,132</u>

The following table details the changes in the allowance for loan losses during December 31, 2010 by loan classification (in thousands):

	<u>Commercial Real Estate- Mortgage</u>	<u>Consumer Real Estate- Mortgage</u>	<u>Construction and Land Development</u>	<u>Commercial and Industrial</u>	<u>Consumer and Other</u>	<u>Total</u>
Balance, beginning of year	\$1,189	\$ 719	\$3,179	\$786	\$ 32	\$5,905
Charge-offs	(2,309)	(562)	(1,260)	(443)	(114)	(4,688)
Recoveries	213	54	19	282	56	624
Provision charged to operations	<u>2,700</u>	<u>2,900</u>	<u>1,300</u>	<u>300</u>	<u>91</u>	<u>7,291</u>
Balance, end of year	<u>\$1,793</u>	<u>\$3,111</u>	<u>\$3,238</u>	<u>\$925</u>	<u>\$ 65</u>	<u>\$9,132</u>

Credit quality indicators:

Federal regulations require us to review and classify our assets on a regular basis. There are three classifications for problem assets: substandard, doubtful, and loss. "Substandard assets" must have one or more defined weaknesses and are characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected. "Doubtful assets" have the weaknesses of substandard assets with the additional characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss. An asset classified "loss" is considered uncollectible and of such little value that continuance as an asset of the institution is not warranted. The regulations also provide for a "special mention" category, described as assets which do not currently expose an institution to a sufficient degree of risk to warrant classification but do possess credit deficiencies or potential weaknesses deserving close attention. When we classify an asset as substandard or doubtful, we may establish a specific allowance for loan losses.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 5. Loans and Allowance for Loan Losses (continued)

The following table outlines the amount of each loan classification and the amount categorized into each risk rating as of December 31, 2010 (in thousands):

	Commercial Real Estate- Mortgage	Consumer Real Estate- Mortgage	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Pass	\$ 97,692	\$49,974	\$24,401	\$41,963	\$3,215	\$217,245
Special mention	19,289	3,786	2,121	7,405	54	32,655
Substandard	2,103	7,695	1,252	1,124	10	12,184
Substandard-impaired	9,947	10,423	2,074	668	51	23,163
	<u>\$129,031</u>	<u>\$71,878</u>	<u>\$29,848</u>	<u>\$51,160</u>	<u>\$3,330</u>	<u>\$285,247</u>

After the Bank's independent loan review department completes the loan grade assignment, a loan impairment analysis is performed on loans graded substandard or worse. The following table presents summary information pertaining to impaired loans by loan classification as of December 31, 2010 (in thousands):

	Unpaid Principal Balance	Related Allowance	Average Investment
Impaired loans without a valuation allowance:			
Commercial real estate – mortgage	\$ 1,663	\$ -	\$ 2,747
Consumer real estate – mortgage	998	-	776
Construction and land development	1,793	-	1,526
Commercial and industrial	70	-	782
Consumer and other	2	-	1
Total	<u>\$ 4,526</u>	<u>\$ -</u>	<u>\$ 5,832</u>
Impaired loans with a valuation allowance:			
Commercial real estate – mortgage	\$ 8,284	\$ 906	\$ 8,494
Consumer real estate – mortgage	9,425	2,420	8,968
Construction and land development	281	60	2,674
Commercial and industrial	598	337	1,060
Consumer and other	49	17	178
Total	<u>\$18,637</u>	<u>\$3,740</u>	<u>\$21,374</u>
Total impaired loans	<u>\$23,163</u>	<u>\$3,740</u>	<u>\$27,206</u>

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 5. Loans and Allowance for Loan Losses (continued)

At December 31, 2010 and 2009, information pertaining to impaired loans is as follows (in thousands):

	December 31,	
	2010	2009
Impaired loans without a valuation allowance	\$ 4,526	\$ 7,138
Impaired loans with a valuation allowance	<u>18,637</u>	<u>23,957</u>
Total impaired loans	<u>\$23,163</u>	<u>\$31,095</u>
Valuation allowance related to impaired loans	<u>\$ 3,740</u>	<u>\$ 2,145</u>

	Years Ended December 31,		
	2010	2009	2008
Average investment in impaired loans	<u>\$27,206</u>	<u>\$28,555</u>	<u>\$10,891</u>
Interest income recognized on impaired loans	<u>\$ 943</u>	<u>\$ 1,601</u>	<u>\$ 966</u>
Interest income recognized on a cash basis on impaired loans	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

Included in impaired loans are troubled debt restructurings that are classified as impaired. At December 31, 2010 and 2009, the Bank has loans of approximately \$7,006,000 and \$2,312,000, respectively, that were modified in troubled debt restructurings and impaired. At December 31, 2010, there were \$948 thousand of accruing restructured loans that remain in a performing status.

The following table presents an aged analysis of past due loans as of December 31, 2010 (in thousands):

	30-89 Days Past Due and Accruing	Past Due 90 Days or More and Accruing	Nonaccrual	Total Past Due	Current Loans	Total Loans
Commercial real estate-mortgage:						
Owner-occupied	\$ 985	\$ -	\$ 618	\$ 1,603	\$ 63,368	\$ 64,971
All other	203	-	7,808	8,011	56,049	64,060
Consumer real estate-mortgage	631	-	5,114	5,745	66,133	71,878
Construction and land development	317	-	-	317	29,531	29,848
Commercial and industrial	116	-	75	191	50,969	51,160
Consumer and other	<u>54</u>	<u>-</u>	<u>18</u>	<u>72</u>	<u>3,258</u>	<u>3,330</u>
Total	<u>\$2,306</u>	<u>\$ -</u>	<u>\$13,633</u>	<u>\$15,939</u>	<u>\$269,308</u>	<u>\$285,247</u>

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2010, 2009 and 2008

Note 5. Loans and Allowance for Loan Losses (continued)

At December 31, 2009, information pertaining to past due and nonaccrual loans is as follows (in thousands):

Loans past due over 90 days still on accrual	\$ -
Loans on nonaccrual	<u>7,360</u>
Total past due loans	<u>\$ 7,360</u>

In the ordinary course of business, the Bank has granted loans to principal officers and directors and their affiliates. Annual activity of these related party loans were as follows:

	<u>2010</u>	<u>2009</u>
Beginning balance	\$190,041	\$189,673
New loans	540,444	65,196
Repayments	<u>(64,149)</u>	<u>(64,828)</u>
Ending balance	<u>\$666,336</u>	<u>\$190,041</u>

Note 6. Bank Premises and Equipment

A summary of bank premises and equipment at December 31, 2010 and 2009, is as follows:

	<u>2010</u>	<u>2009</u>
Land	\$ 3,711,003	\$3,315,050
Buildings and improvements	4,806,209	4,578,792
Furniture, fixtures and equipment	<u>3,653,710</u>	<u>4,414,075</u>
	12,170,922	12,307,917
Accumulated depreciation	<u>(4,123,552)</u>	<u>(4,209,858)</u>
	<u>\$ 8,047,370</u>	<u>\$ 8,098,059</u>

Depreciation expense for the years ended December 31, 2010, 2009 and 2008, amounted to \$513,468, \$670,054, and \$588,490, respectively.

Certain bank facilities and equipment are leased under various operating leases. Total rent expense on these leases for the years ended December 31, 2010, 2009 and 2008, was \$423,580, \$426,861, and \$386,714, respectively.

Future minimum rental commitments under non-cancelable leases are as follows:

2011	\$ 367,176
2012	345,317
2013	342,083
2014	342,083
2015	230,202
Thereafter	<u>128,605</u>
Total	<u>\$1,755,466</u>

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
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Note 7. Goodwill

The changes in the carrying amounts of goodwill are as follows:

	2010	2009
Balance, beginning of year	\$2,541,476	\$2,541,476
Goodwill acquired	-	-
Goodwill impairment	2,541,476	-
Balance, end of year	\$ -	\$2,541,476

Cornerstone's policy is to assess goodwill for impairment on an annual basis or between annual assessments if an event occurs or circumstances change that would more likely than not reduce the fair value of goodwill below its carrying amount as required by authoritative accounting guidance. Impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value. The impairment testing is a two-step process. Step one compares the fair value of the reporting unit to the carrying value. If the fair value is below the carrying value, step two is performed. Step two involves a process similar to business combination accounting in which fair value is assigned to all assets, liabilities and other (non-goodwill) intangibles. The result of step two is the implied fair value of goodwill. If the implied fair value of goodwill is below the recorded goodwill amount, an impairment charge is recorded for the difference.

Cornerstone performed its annual impairment analysis in December 2010. ASC Topic 350, "Intangibles-Goodwill and Other," states that the fair value of a reporting unit refers to the price that would be received to sell the unit as a whole in an orderly transaction between market participants at the measurement date. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. Cornerstone obtained published information on the market price to book value and market price to tangible book value for other financial institutions located in Tennessee and Georgia, financial institutions in the southeastern region of the United States, and recently completed merger and acquisition transactions. This information was compared to Cornerstone's market price to book value and market price to tangible book value. Based on this testing, step two analysis was required.

The results from the impairment analysis led management and the board of directors to conclude that Cornerstone's goodwill was fully impaired as of December 31, 2010. The impairment amount of \$2,541,476 was recorded in noninterest expenses in the Consolidated Statements of Operations. The impairment was primarily a result of the continuing economic downturn and its implications on entity valuations. Finally, Cornerstone's goodwill was originally recorded as a non-taxable stock purchase. Therefore, the \$2,541,476 goodwill impairment is not deductible for taxes and thus no tax benefit was recognized.

Note 8. Time and Related-Party Deposits

At December 31, 2010, the scheduled maturities of time deposits are as follows (in thousands):

2011	\$143,613
2012	85,965
2013	9,379
2014	2,897
2015	5,286
Thereafter	451
Total	\$247,591

Deposits from related parties held by the Bank at December 31, 2010 and 2009, amounted to approximately \$792,000 and \$564,000, respectively.

As of December 31, 2010 and 2009, certificates of deposit equal to or greater than \$100,000 amounted to approximately \$113,965,000 and \$91,064,000, respectively.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2010, 2009 and 2008

Note 9. Income Taxes

Cornerstone files consolidated income tax returns with its subsidiary. Under the terms of a tax-sharing agreement, the subsidiary's allocated portion of the consolidated tax liability is computed as if they were reporting income and expenses to the Internal Revenue Service as a separate entity.

Income tax expense in the consolidated statements of income for the years ended December 31, 2010, 2009 and 2008, consists of the following:

	2010	2009	2008
Current tax expense (benefit)	\$ (522,382)	\$(6,637,188)	\$(2,005,644)
Deferred tax expense (benefit) related to:			
Allowance for loan losses	(1,030,423)	1,241,231	3,158,858
Other	17,508	59,917	143,328
Income tax expense (benefit)	<u>\$ (1,535,297)</u>	<u>\$ (5,336,040)</u>	<u>\$ 1,296,542</u>

The income tax expense is different from the expected tax expense computed by multiplying income before income tax expense by the statutory federal income tax rates. These differences are reconciled as follows:

	2010	2009	2008
Expected tax at statutory rates	\$(2,122,558)	\$(4,594,991)	\$1,294,844
(Decrease) increase resulting from tax effect of:			
State income taxes, net of federal tax benefit	(267,817)	(579,780)	163,379
New market tax credits	(112,500)	(150,000)	(150,000)
Impairment of goodwill	973,131	-	-
Other	(5,553)	(11,269)	(11,681)
Income tax expense (benefit)	<u>\$ (1,535,297)</u>	<u>\$ (5,336,040)</u>	<u>\$ 1,296,542</u>

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

	2010	2009
Deferred tax assets:		
Deferred compensation	\$ 115,296	\$118,724
Deferred loan fees	23,364	29,866
Allowance for loan losses	1,725,125	694,702
Net unrealized loss on securities available for sale	183,311	135,272
	<u>2,047,096</u>	<u>978,564</u>
Deferred tax liabilities:		
Depreciation	130,145	121,420
Life insurance	204,386	199,077
Other	4,352	10,808
	<u>338,883</u>	<u>331,305</u>
Net deferred tax asset	<u>\$1,708,213</u>	<u>\$647,259</u>

ASC Topic 740, "Income Taxes," clarifies the accounting for uncertainty in tax positions. ASC Topic 740 requires that Cornerstone recognize in its financial statements, the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. Cornerstone recognized no interest and penalties assessed by taxing authorities on any underpayment of income tax for 2010, 2009 or 2008.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
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Note 10. Federal Home Loan Bank Advances and Other Borrowings

The Bank has agreements with the Federal Home Loan Bank of Cincinnati (FHLB) that can provide advances to the Bank in an amount up to approximately \$60,000,000. All of the Bank's loans secured by first mortgages on 1-4 family residential, multi-family properties and commercial properties are pledged as collateral for these advances. Additionally, the Bank has pledged securities with a carrying amount of approximately \$50,317,000 as of December 31, 2010.

At December 31, 2010 and 2009, FHLB advances consist of the following:

	<u>2010</u>	<u>2009</u>
Long-term advance dated December 27, 2000, requiring monthly interest payments, fixed at 5.00% until conversion option is exercised, principal due in December 2010	\$ -	\$ 2,000,000
Long-term advance dated February 9, 2005, requiring monthly interest payments, fixed at 3.86%, convertible on February 2010, principal due in February 2015	5,000,000	5,000,000
Long-term advance dated May 14, 2007, requiring monthly interest payments, fixed at 4.78%, with a put option exercisable in November 2007 and then quarterly thereafter, principal due in May 2010	-	5,000,000
Long-term advance dated December 6, 2007, requiring monthly interest payments, fixed at 3.87%, until maturity, principal due in December 2010	-	5,000,000
Long-term advance dated June 26, 2008, requiring monthly interest payments, fixed at 3.64%, until maturity, principal due in July 2010	-	5,000,000
Long-term advance dated July 2, 2008, requiring monthly interest payments, fixed at 3.85%, until maturity, principal due in July 2011	5,000,000	5,000,000
Long-term advance dated January 22, 2008, requiring monthly interest payments, fixed at 3.59%, until maturity, principal due in January 2013	5,000,000	5,000,000
Long-term advance dated May 11, 2007, requiring monthly interest payments, fixed at 4.66%, with a put option exercisable in February 2008 and then quarterly thereafter, principal due in May 2011	5,000,000	5,000,000
Long-term advance dated May 15, 2007, requiring monthly interest payments, fixed at 4.58%, with a put option exercisable in May 2008 and then quarterly thereafter, principal due in May 2012	5,000,000	5,000,000
Long-term advance dated August 1, 2007, requiring monthly interest payments, fixed at 4.50%, with a put option exercisable in July 2008 and then quarterly thereafter, principal due in August 2013	5,000,000	5,000,000

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Note 10. Federal Home Loan Bank Advances and Other Borrowings (continued)

	<u>2010</u>	<u>2009</u>
Long-term advance dated August 13, 2007, requiring monthly interest payments, fixed at 4.43%, with a put option exercisable in February 2009 and then quarterly thereafter, principal due in August 2014	\$ 5,000,000	\$ 5,000,000
Long-term advance dated January 7, 2008, requiring monthly interest payments, fixed at 3.52% with a put option exercisable in January 2011 and then quarterly thereafter, principal due in January 2015	5,000,000	5,000,000
Long-term advance dated January 20, 2006, requiring monthly interest payments, fixed at 4.18%, with a put option exercisable in January 2009 and then quarterly thereafter, principal due in January 2016	5,000,000	5,000,000
Long-term advance dated January 10, 2007, requiring monthly interest payments, fixed at 4.25%, with a put option exercisable in January 2008 and then quarterly thereafter, principal due in January 2017	<u>5,000,000</u>	<u>5,000,000</u>
	<u>\$50,000,000</u>	<u>\$67,000,000</u>

During the fixed rate term, the advances may be prepaid subject to a prepayment penalty as defined in the agreements. On convertible agreements, the FHLB has the right to convert the fixed rate on the above advances at the end of the initial fixed rate period and on a quarterly basis thereafter. If the conversion option is exercised, the advances will bear interest at the three-month London Interbank Offered Rate (LIBOR) adjusted quarterly at a spread of zero basis points to the LIBOR index. Subsequent to any conversion, the Bank has the option to prepay the advances, in full or in part, without penalty on the conversion date or any subsequent quarterly repricing date. On agreements with put options, the FHLB has the right, at its discretion, to terminate only the entire advance prior to the stated maturity date. The termination option may only be exercised on the expiration date of the predetermined lockout period and on a quarterly basis thereafter.

Cornerstone had an \$8,500,000 line of credit with Silverton Bank (subsequently known as Silverton Bridge Bank, N.A.) that was secured by 100% of the Bank's common stock. During March 2009, the line of credit matured and was reworked into two loans, a \$4,350,000 amortizing term loan and a \$1,000,000 revolving line of credit. These loans continue to be secured by 100% of the Bank's common stock and bear interest at the greater of Prime plus 3% or 6.25%. The first loan requires semi-annual principal payments of \$435,000 beginning July 2010, quarterly interest payments beginning April 2010, and final payment of outstanding principal and accrued interest due July 2014. The second loan requires quarterly payment of principal of \$50,000 plus accrued interest beginning January 2010, and final payment of outstanding principal and accrued interest due April 1, 2011. Borrowings outstanding under these agreements were \$4,715,000 and \$5,350,000 at December 31, 2010 and 2009, respectively.

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Note 10. Federal Home Loan Bank Advances and Other Borrowings (continued)

During 2010, Midland Loan Services began servicing these two loans for the Federal Deposit Insurance Corporation (FDIC). Both of these loans contain certain compliance covenants which have been waived through December 31, 2010. Due to the increased nonperforming assets of the Bank and capital reductions due to net losses of both Cornerstone and the Bank, Cornerstone was not in compliance with several of the covenants on the loans at December 31, 2010. The covenants include stated minimum or maximum target amounts for Cornerstone's capital levels, the Bank's capital levels, nonperforming asset levels at the Bank and the ability of Cornerstone to meet the required annual debt service requirements, which are computed on a rolling quarter average. During March 2011, the FDIC waived the covenant compliance requirements for these loans through December 31, 2011, granted that all payments for both loans are made in accordance with the aforementioned repayment schedules.

The primary source of liquidity for Cornerstone is the payment of dividends from the Bank. As of December 31, 2010, the Bank was under a dividend restriction that requires regulatory approval prior to the payment of a dividend from the Bank to Cornerstone.

At December 31, 2010, scheduled maturities of the Federal Home Loan Bank advances and other borrowings are as follows:

2011	\$11,670,000
2012	5,870,000
2013	10,870,000
2014	6,305,000
2015	10,000,000
Thereafter	<u>10,000,000</u>
 Total	 <u>\$54,715,000</u>

Note 11. Employee Benefit Plans

401(k) plan:

Cornerstone has a 401(k) employee benefit plan covering substantially all employees that have completed at least 30 days of service and met minimum age requirements. Cornerstone's contribution to the plan is discretionary. Cornerstone elected not to make a contribution to the plan for 2010 and 2009. Cornerstone's contribution to the plan was \$87,408 for 2008.

Employee Stock Ownership Plan:

Cornerstone has a non-leveraged employee stock ownership plan (ESOP) to which Cornerstone makes 100% of the contributions for purchasing Cornerstone's common stock, and allocates the contributions among the participants based on regulatory guidelines. Cornerstone's contribution is discretionary, as determined by the Compensation Committee. Employer contributions are available to all employees after 1,000 hours of service. There are certain age and years-of-service requirements before contributions can be made for the benefit of the employee. The ESOP plan also provides for a three year 100% vesting requirement; therefore, employees terminating employment before their third anniversary date will forfeit their accrued benefit under the ESOP. The forfeiture will be re-allocated among the remaining ESOP participants. No contributions were made to the ESOP in 2010 or 2009. Cornerstone made a contribution of \$166,347 in 2008.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2010, 2009 and 2008

Note 12. Financial Instruments With Off-Balance-Sheet Risk

In the normal course of business, the Bank has outstanding commitments and contingent liabilities, such as commitments to extend credit and standby letters of credit, which are not included in the accompanying financial statements. The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual or notional amount of those instruments. The Bank uses the same credit policies in making such commitments as it does for instruments that are included in the balance sheet. At December 31, 2010 and 2009, undisbursed loan commitments aggregated approximately \$28,774,000 and \$42,287,000, respectively. In addition, there were outstanding standby letters of credit totaling approximately \$3,539,000 and \$3,708,000, respectively.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include accounts receivable, inventory, property and equipment, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Standby letters of credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank's policy for obtaining collateral, and the nature of such collateral, is essentially the same as that involved in making commitments to extend credit.

The Bank incurred insignificant losses on its commitments during 2010, 2009 and 2008.

Note 13. Fair Value Disclosures

Cornerstone uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with ASC Topic 820, "Fair Value Measurements and Disclosures," the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. 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.

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Note 13. Fair Value Disclosures (continued)

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. There have been no changes in the methodologies used at December 31, 2010 and 2009.

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.

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 December 31, 2010 and 2009, 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.

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Note 13. Fair Value Disclosures (continued)

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 assets, net 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.

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Note 13. Fair Value Disclosures (continued)

The tables below present the recorded amount of assets and liabilities measured at fair value on a recurring basis.

	Balance as of December 31, 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	\$ 4,587,079	\$ -	\$ 4,587,079	\$ -
State and municipal securities	20,736,212	-	20,736,212	-
Mortgage-backed securities:				
Residential mortgage guaranteed by GNMA	18,853,025	-	18,853,025	-
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	<u>64,074,118</u>	<u>-</u>	<u>64,074,118</u>	<u>-</u>
Total securities available for sale	<u>\$108,250,434</u>	<u>\$ -</u>	<u>\$108,250,434</u>	<u>\$ -</u>
Cash surrender value of life insurance	<u>\$ 1,113,824</u>	<u>\$ -</u>	<u>\$ 1,113,824</u>	<u>\$ -</u>
	Balance as of December 31, 2009	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	\$ 4,774,020	\$ -	\$ 4,774,020	\$ -
State and municipal securities	16,755,640	-	16,755,640	-
Mortgage-backed securities:				
Residential mortgage guaranteed by GNMA	52,726,767	-	52,726,767	-
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	49,960,448	-	49,960,448	-
Other	<u>198,443</u>	<u>-</u>	<u>198,443</u>	<u>-</u>
Total securities available for sale	<u>\$124,415,318</u>	<u>\$ -</u>	<u>\$124,415,318</u>	<u>\$ -</u>
Cash surrender value of life insurance	<u>\$ 1,100,874</u>	<u>\$ -</u>	<u>\$ 1,100,874</u>	<u>\$ -</u>

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2010, 2009 and 2008

Note 13. Fair Value Disclosures (continued)

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 December 31, 2010 and 2009, for which a nonrecurring change in fair value was recorded.

	Balance as of December 31, 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	\$14,897,633	\$ -	\$14,897,633	\$ -
Foreclosed assets	12,808,838	-	12,808,838	-
	Balance as of December 31, 2009	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Impaired loans	\$21,811,211	\$ -	\$21,811,211	\$ -
Foreclosed assets	10,327,297	-	10,327,297	-

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 December 31, 2010 and 2009. Losses derived from Level 2 inputs were calculated by models incorporating significant observable market data.

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

	2010		2009	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Assets:				
Cash and cash equivalents	\$ 22,982	\$ 22,982	\$ 38,202	\$ 38,202
Securities	108,346	108,349	124,551	124,551
Federal Home Loan Bank stock	2,323	2,323	2,229	2,229
Loans, net	276,115	277,796	330,787	331,456
Cash surrender value of life insurance	1,114	1,114	1,101	1,101
Accrued interest receivable	1,326	1,326	1,521	1,521
Liabilities:				
Noninterest-bearing demand deposits	28,980	28,980	41,972	41,972
Interest-bearing demand deposits	24,834	24,834	26,533	26,533
Savings deposits and money market accounts	34,042	34,042	31,030	31,030
Time deposits	247,591	249,990	305,207	307,596
Federal funds purchased and securities sold under agreements to repurchase	24,325	24,325	26,322	26,322
Federal Home Loan Bank advances and other borrowings	54,715	54,715	72,350	72,350
Accrued interest payable	177	177	351	351
Unrecognized financial instruments (net of contract amount):				
Commitments to extend credit	-	-	-	-
Letters of credit	-	-	-	-
Lines of credit	-	-	-	-

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2010, 2009 and 2008

Note 14. Contingencies

The Bank is involved in certain claims arising from normal business activities. Management believes that the impact of those claims are without merit and that the ultimate liability, if any, resulting from them will not materially affect the Bank's financial condition or Cornerstone's consolidated financial position, results of operations or cash flows.

Note 15. Stock Option Plans

Cornerstone has stock option plans which are more fully described below. For the years ended December 31, 2010, 2009 and 2008, Cornerstone recognized \$74,612, \$216,600 and \$279,400, respectively, in compensation expense for all stock options.

No options were awarded during 2010. For the years ended December 31, 2009 and 2008, the fair value of each option granted is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	Years Ended December 31,	
	2009	2008
Dividend yield	2.97%	1.47%
Expected life	7.0 years	8.0 years
Expected volatility	38.74%	20.27%
Risk-free interest rate	2.69%	4.22%

The expected volatility is based upon historical volatility. The risk-free interest rates for periods within the contractual life of the awards are based on the U.S. Treasury yield curve in effect at the time of the grant. The expected life is based on historical exercise experience. The dividend yield assumption is based on Cornerstone's history and expectation of dividend payouts.

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 common stock. Only non-qualified stock options may be granted under the Plan. In addition, members of the Board of Directors can be issued options under the Cornerstone 2002 Long-Term Incentive Plan to purchase up to 1,200,000 shares of Cornerstone stock. The options available for issuance to Board members under the 2002 Long-Term Incentive Plan are shared with officers and employees of Cornerstone. The exercise price of each option equals the market price of Cornerstone's stock on the date of grant and the option's maximum term is ten years, at which point they expire. Vesting for options granted during 2008 and 2009, are 50% on each of the first and second anniversary of the grant date with full vesting occurring at the second anniversary date. At December 31, 2010, the total remaining compensation cost to be recognized on non-vested options is approximately \$10,500. An analysis of this stock option plan is presented in the following table:

	Years Ended December 31,						
	2010			2009		2008	
	Shares	Average Exercise Price	Aggregate Intrinsic Value(1)	Shares	Average Exercise Price	Shares	Average Exercise Price
Outstanding at beginning of year	100,250	\$ 9.42		81,800	\$10.73	69,000	\$11.23
Granted	-	-		20,500	3.65	12,800	7.99
Exercised	-	-		-	-	-	-
Forfeited	-	-		(2,050)	3.65	-	-
Outstanding at end of year	<u>100,250</u>	\$ 9.42	\$ -	<u>100,250</u>	\$ 9.42	<u>81,800</u>	\$10.73
Options exercisable at year-end	<u>91,025</u>	\$10.01	\$ -	<u>75,400</u>	\$10.96	<u>64,500</u>	\$10.95
Weighted-average fair value of options granted during the year	\$ -				\$ 1.13		\$ 2.23

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Note 15. Stock Option Plans (continued)

- (1) The aggregate intrinsic value of a stock option in the table above represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on December 31, 2010. This amount changes based on changes in the market value of Cornerstone's stock. The fair value (present value of the estimated future benefit to the option holder) of each option grant is estimated on the date of grant using the Black-Scholes option pricing model.

Information pertaining to options outstanding at December 31, 2010, is as follows:

Exercise Prices	Number Outstanding	Options Outstanding		Options Exercisable	
		Weighted Average Remaining Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$ 5.44	16,000	3.2 Years	\$5.44	16,000	\$ 5.44
9.23	8,000	4.2 Years	9.23	8,000	9.23
13.25	36,000	5.2 Years	13.25	36,000	13.25
15.25	9,000	6.2 Years	15.25	9,000	15.25
7.99	12,800	7.2 Years	7.99	12,800	7.99
3.65	<u>18,450</u>	8.2 Years	3.65	<u>9,225</u>	3.65
Outstanding at end of year	<u>100,250</u>	5.7 Years	\$9.42	<u>91,025</u>	\$10.01

Information pertaining to non-vested options for the year ended December 31, 2010, is as follows:

	Number of Shares	Weighted Average Grant Date Fair Value
Non-vested options, December 31, 2009	24,850	\$ 4.77
Granted	-	-
Vested	(15,625)	5.09
Forfeited	<u>-</u>	-
Non-vested options, December 31, 2010	<u>9,225</u>	\$ 3.65

The total fair value of shares that vested during 2010 was approximately \$34,000.

Officer and Employee Plans:

Cornerstone has two stock option plans, the 1996 Cornerstone Statutory and Non-statutory Option Plan and the Cornerstone 2002 Long-Term Incentive Plan, under which officers and employees can be granted incentive stock options or non-qualified stock options to purchase a total of up to 220,000 and 1,200,000 shares, respectively, of Cornerstone's common stock. The option price for incentive stock options shall be not less than 100 percent of the fair market value of the common stock on the date of the grant. 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 stock options vest at 30 percent on the second and third anniversaries of the grant date and 40 percent on the fourth anniversary of the grant date. These options expire ten years from the grant date. At December 31, 2010, the total remaining compensation cost to be recognized on non-vested options is approximately \$200,000. An analysis of the activity for each of the years ending December 31, 2010, 2009 and 2008, for this stock option plan follows:

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Note 15. Stock Option Plans (continued)

Officer and Employee Plans: (continued)

	Years Ended December 31,						
	2010		Aggregate Intrinsic Value(1)	2009		2008	
	Average Exercise Shares	Price		Average Exercise Shares	Price	Average Exercise Shares	Price
Outstanding at beginning of year	799,675	\$6.18		755,425	\$ 6.63	715,075	\$6.52
Granted	-	-		115,850	3.65	71,500	7.99
Exercised	-	-		-	-	(22,000)	3.75
Forfeited	(278,775)	6.90		(71,600)	6.77	(9,150)	13.34
Outstanding at end of year	<u>520,900</u>	\$5.79	\$ -	<u>799,675</u>	\$6.18	<u>755,425</u>	\$6.63
Options exercisable at year-end	<u>385,270</u>	\$5.88	\$ -	<u>592,648</u>	\$5.69	<u>549,516</u>	\$4.87
Weighted-average fair value of options granted during the year	\$ -			\$1.13		\$2.23	

- (1) The aggregate intrinsic value of a stock option in the table above represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on December 31, 2010. This amount changes based on changes in the market value of Cornerstone's stock. The fair value (present value of the estimated future benefit to the option holder) of each option grant is estimated on the date of grant using the Black-Scholes option pricing model.

Information pertaining to options outstanding at December 31, 2010, is as follows:

Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$3.25 - \$3.63	182,600	0.8 Years	\$ 3.48	182,600	\$ 3.48
5.44	96,640	3.2 Years	5.44	96,640	5.44
9.23	57,910	4.2 Years	9.23	57,910	9.23
13.25	21,000	5.2 Years	13.25	21,000	13.25
15.25	14,450	6.2 Years	15.25	8,670	15.25
15.20	2,750	6.3 Years	15.20	1,650	15.20
7.99	56,000	7.2 Years	7.99	16,800	7.99
3.65	<u>89,550</u>	8.2 Years	3.65	-	-
Outstanding at end of year	<u>520,900</u>	4.0 Years	\$ 5.79	<u>385,270</u>	\$ 5.88

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Note 15. Stock Option Plans (continued)

Information pertaining to non-vested options for the year ended December 31, 2010, is as follows:

	<u>Number of Shares</u>	<u>Weighted Average Grant Date Fair Value</u>
Non-vested options, December 31, 2009	207,027	\$ 7.57
Granted	-	-
Vested	(58,203)	12.08
Forfeited	<u>(13,194)</u>	8.86
Non-vested options, December 31, 2010	<u>135,630</u>	\$ 5.49

The total fair value of shares that vested during 2010 was approximately \$125,000.

Note 16. Liquidity and Capital Resources

Cornerstone's primary source of funds with which to pay its future obligations is the receipt of dividends from its subsidiary Bank. Banking regulations provide that the Bank must maintain capital sufficient to enable it to operate as a viable institution and, as a result, has limited the amount of dividends the Bank may pay without prior approval.

Note 17. 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 into 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 consent order, 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. AND SUBSIDIARY
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Note 18. Minimum Regulatory Capital Requirements

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

Quantitative measures established by regulation to ensure capital adequacy require Cornerstone and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined).

As of December 31, 2010, the most recent notification from the Federal Deposit Insurance Corporation (FDIC) categorized the Bank as adequately capitalized under the regulatory framework for prompt corrective action.

Cornerstone's and the Bank's actual capital amounts and ratios are also presented in the table. Dollar amounts are presented in thousands.

	<u>Actual</u>		<u>Minimum Capital Requirements</u>		<u>Minimum Capital Requirements per the Action Plans</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
As of December 31, 2010:						
Total capital to risk-weighted assets:						
Consolidated	\$27,477	9.3%	\$23,572	8.0%	N/A	N/A
Cornerstone Community Bank	29,592	10.1%	23,534	8.0%	35,301	12.0%
Tier 1 capital to risk-weighted assets:						
Consolidated	23,727	8.1%	11,786	4.0%	N/A	N/A
Cornerstone Community Bank	25,882	8.8%	11,767	4.0%	29,418	10.0%
Tier 1 capital to average assets:						
Consolidated	23,727	5.2%	18,111	4.0%	N/A	N/A
Cornerstone Community Bank	25,882	5.8%	17,995	4.0%	35,990	8.0%
As of December 31, 2009:						
Total capital to risk-weighted assets:						
Consolidated	\$29,472	8.3%	\$28,556	8.0%	N/A	N/A
Cornerstone Community Bank	33,963	9.5%	28,532	8.0%	N/A	N/A
Tier 1 capital to risk-weighted assets:						
Consolidated	24,992	7.0%	14,278	4.0%	N/A	N/A
Cornerstone Community Bank	29,487	8.3%	14,266	4.0%	N/A	N/A
Tier 1 capital to average assets:						
Consolidated	24,992	5.2%	19,241	4.0%	N/A	N/A
Cornerstone Community Bank	29,487	6.1%	19,216	4.0%	N/A	N/A

Management of the Bank has determined it is not in compliance with the Action Plans, discussed in Note 17, for total and Tier 1 capital to risk-weighted assets and Tier 1 capital to average assets requirements at December 31, 2010. The Bank's board of directors must ensure that the Bank complies with the provisions of the Action Plans and that required quarterly written progress reports are furnished to the FDIC and TDFI.

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Note 19. Other Comprehensive Income

Other comprehensive income consists of unrealized holding gains and losses on securities available for sale. A summary of other comprehensive income and the related tax effects for the years ended December 31, 2010, 2009 and 2008, is as follows:

	<u>Before-Tax Amount</u>	<u>Tax (Expense) Benefit</u>	<u>Net-of-Tax Amount</u>
Year ended December 31, 2010:			
Unrealized holding gains and losses arising during the period	\$1,571,720	\$(597,254)	\$ 974,466
Less reclassification adjustment for gains realized in net income	<u>1,698,136</u>	<u>(645,292)</u>	<u>1,052,844</u>
	<u>\$(126,416)</u>	<u>\$ 48,038</u>	<u>\$ (78,378)</u>
Year ended December 31, 2009:			
Unrealized holding gains and losses arising during the period	\$ 296,642	\$(113,884)	\$ 182,758
Less reclassification adjustment for gains realized in net income	<u>399,754</u>	<u>(153,066)</u>	<u>246,688</u>
	<u>\$(103,112)</u>	<u>\$ 39,182</u>	<u>\$ (63,930)</u>
Year ended December 31, 2008:			
Unrealized holding gains and losses arising during the period	\$(444,690)	\$ 151,196	\$ (293,494)
Less reclassification adjustment for gains realized in net income	<u>-</u>	<u>-</u>	<u>-</u>
	<u>\$(444,690)</u>	<u>\$ 151,196</u>	<u>\$ (293,494)</u>

Note 20. Earnings (Loss) Per Common Share

Basic earnings (loss) per share represents income (loss) available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings (loss) per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance.

Potential common shares that may be issued by Cornerstone relate to outstanding stock options, determined using the treasury stock method.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2010, 2009 and 2008

Note 20. Earnings (Loss) Per Common Share (continued)

Earnings (loss) per common share have been computed based on the following:

	2010	2009	2008
Net (loss) income	\$(4,707,521)	\$(8,178,639)	\$2,511,824
Less: Preferred stock dividends	34,463	-	-
Net (loss) income applicable to common stock	<u>\$(4,741,984)</u>	<u>\$(8,178,639)</u>	<u>\$2,511,824</u>
Average number of common shares outstanding	6,500,396	6,500,396	6,508,631
Effect of dilutive stock options	-	-	<u>136.826</u>
Average number of common shares outstanding used to calculate diluted (loss) earnings per common share	<u>6,500,396</u>	<u>6,500,396</u>	<u>6,645,457</u>

The effects of outstanding antidilutive stock options are excluded from the computation of diluted earnings (loss) per share. There were 621,150, 899,925 and 329,526 antidilutive stock options for 2010, 2009 and 2008, respectively. The average number of common shares outstanding and the effect of dilutive stock options for 2008 have been retroactively adjusted to reflect two stock dividends that occurred during 2009.

Note 21. Recent Accounting Pronouncements

In July 2010, the FASB issued Accounting Standards Update (ASU) 2010-06, "Improving Disclosures about Fair Value Measurements". This update requires reporting entities to make new disclosures about recurring or nonrecurring fair value measurements including significant transfers into and out of Level 1 and Level 2 fair value measurements and information about purchases, sales, issuances, and settlements on a gross basis in the reconciliation of Level 3 fair value measurements. The ASU also clarified existing fair value measurement disclosure guidance relating to the level of disaggregation and inputs and valuation techniques used to measure fair value. This guidance related to transfers between Level 1 and Level 2 fair value measurements was effective for interim and annual reporting periods beginning after December 15, 2009. The guidance related to Level 3 fair value measurements is effective for periods beginning after December 15, 2010. The adoption of the new guidance did not significantly impact the financial statements.

In July 2010, the FASB issued ASU 2010-20, "Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses". ASU 2010-20 provides enhanced disclosures related to the credit quality of financing receivables and the allowance for credit losses and provides that new and existing disclosures should be disaggregated to provide greater information about the credit quality of financing receivables and allowance for credit losses. Under the provisions of ASU 2010-20, additional disclosures required for financing receivables include information regarding the aging of past due receivables, credit quality indicators, and modifications of financing receivables. The provisions of ASU 2010-20 are effective for public entities for periods ending after December 15, 2010, with the exception of disclosures about activity that occurs during a reporting period which are effective for periods beginning after December 15, 2010. Comparative disclosures are required only for periods ending subsequent to initial adoption. Cornerstone adopted the provisions of ASU 2010-20 and has provided the required disclosures in the consolidated financial statements provided herein. The disclosures relating to troubled debt restructurings have been deferred to align with the proposed ASU, "Receivables: Clarifications to Accounting for Troubled Debt Restructuring by Creditors," which has not yet been issued.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2010, 2009 and 2008

Note 21. Recent Accounting Pronouncements (continued)

In December 2010, the FASB issued ASU 2010-28, "When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts". This update modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that an impairment may exist. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2010.

Other than disclosures contained within these statements, Cornerstone has determined that all other recently issued accounting pronouncements will not have a material impact on its consolidated financial statements or do not apply to its operations.

Note 22. Equity Investment

During 2006, Cornerstone invested \$3,000,000 for a 25% share of the Appalachian Fund for Growth II Partnership (AFG), which is managed by the Southeast Local Development Corporation (General Partner). AFG is targeting high job creation and retention businesses and businesses providing important community services. The funds are being deployed to help: 1) attract new businesses to under-served service areas by offering creative financing; 2) supply creative financing for businesses to rehabilitate existing distressed properties to facilitate community development; and 3) leverage other private investment into its targeted communities. In return for its investment in AFG, Cornerstone and other investors will receive new market tax credits. For 2010, 2009 and 2008 Cornerstone received approximately \$112,500, \$150,000 and \$150,000, respectively, in new market tax credits.

AFG meets the criteria of a VIE outlined in ASC Topic 810, "Consolidation". AFG has not been consolidated by Cornerstone, as Cornerstone is not the primary beneficiary.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2010, 2009 and 2008

Note 23. Condensed Parent Information

BALANCE SHEETS	December 31, 2010	December 31, 2009
ASSETS		
Cash	\$ 2,261,775	\$ 620,471
Investment in subsidiary	27,974,387	29,790,633
Goodwill	-	2,541,476
Other assets	<u>440,772</u>	<u>294,899</u>
Total assets	<u>\$30,676,934</u>	<u>\$33,247,479</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Other liabilities	\$ 142,781	\$ 60,000
Other borrowings	<u>4,715,000</u>	<u>5,350,000</u>
Total liabilities	4,857,781	5,410,000
Stockholders' equity	<u>25,819,153</u>	<u>27,837,479</u>
Total liabilities and stockholders' equity	<u>\$30,676,934</u>	<u>\$33,247,479</u>

STATEMENTS OF INCOME	Years Ended December 31,		
	2010	2009	2008
INCOME			
Dividends	\$ -	\$1,180,260	\$1,475,325
Interest income	<u>-</u>	<u>4,110</u>	<u>33,336</u>
	-	1,184,370	1,508,611
EXPENSES			
Interest expense	319,361	221,093	137,421
Goodwill impairment	2,541,476	-	-
Other operating expenses	<u>384,813</u>	<u>802,084</u>	<u>1,225,402</u>
(Loss) income before equity in undistributed (loss) earnings	(3,245,650)	161,193	145,838
Equity in undistributed (loss) earnings of subsidiary	(1,737,868)	(8,740,480)	1,830,862
Income tax benefit	<u>275,997</u>	<u>400,648</u>	<u>535,124</u>
Net (loss) income	(4,707,521)	(8,178,639)	2,511,824
Preferred stock dividends	<u>34,463</u>	<u>-</u>	<u>-</u>
Net (loss) income available to common shareholders	<u>\$(4,741,984)</u>	<u>\$(8,178,639)</u>	<u>\$2,511,824</u>

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2010, 2009 and 2008

Note 23. Condensed Parent Information (continued)

	<u>2010</u>	<u>2009</u>	<u>2008</u>
STATEMENTS OF CASH FLOWS			
CASH FLOWS FROM OPERATING ACTIVITIES			
Net (loss) income	\$(4,707,521)	\$(8,178,639)	\$ 2,511,824
Adjustments to reconcile net (loss) income to net cash provided by operating activities:			
Stock compensation expense	74,612	216,600	279,400
Equity in undistributed loss (income) of subsidiary	1,737,868	8,740,480	(1,830,862)
Goodwill impairment	2,541,476	-	-
Other	<u>(63,092)</u>	<u>247,241</u>	<u>(534,415)</u>
Net cash (used in) provided by operating activities	<u>(416,657)</u>	<u>1,025,682</u>	<u>425,947</u>
CASH FLOWS FROM INVESTING ACTIVITIES			
Repayment from subsidiary	-	450,000	300,000
Capital contribution to subsidiary	<u>-</u>	<u>(1,300,000)</u>	<u>(2,500,000)</u>
Net cash used in investing activities	<u>-</u>	<u>(850,000)</u>	<u>(2,200,000)</u>
CASH FLOWS FROM FINANCING ACTIVITIES			
Net (repayments) borrowings under other borrowings	(635,000)	1,100,000	4,150,000
Issuance of preferred stock	2,727,424	-	-
Payment of preferred dividends	(34,463)	-	-
Purchase of common stock	-	-	(633,049)
Payment of common stock dividends	-	(1,094,651)	(1,773,022)
Issuance of common stock	<u>-</u>	<u>-</u>	<u>82,500</u>
Net cash provided by financing activities	<u>2,057,961</u>	<u>5,349</u>	<u>1,826,429</u>
NET INCREASE IN CASH AND CASH EQUIVALENTS	1,641,304	181,031	52,376
CASH AND CASH EQUIVALENTS, beginning of year	<u>620,471</u>	<u>439,440</u>	<u>387,064</u>
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 2,261,775</u>	<u>\$ 620,471</u>	<u>\$ 439,440</u>
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION			
Cash paid during the year for:			
Interest	\$ 319,361	\$ 221,093	\$ 137,421
Income taxes	<u>-</u>	<u>-</u>	<u>-</u>

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2010, 2009 and 2008

Note 24. Quarterly Data (unaudited)

	Years Ended December 31,							
	2010				2009			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest income	\$ 5,445,229	\$ 5,933,035	\$ 6,731,978	\$ 7,101,186	\$ 6,609,921	\$ 6,406,525	\$ 6,427,866	\$ 6,864,115
Interest expense	1,918,673	2,175,985	2,510,794	2,596,362	2,761,685	2,765,954	2,791,068	2,870,676
Net interest income, before provision for loan losses	3,526,556	3,757,050	4,221,184	4,504,824	3,848,236	3,640,571	3,636,798	3,993,439
Provision for loan losses	4,130,000	681,000	1,465,000	1,015,000	4,150,000	3,390,000	1,633,898	5,725,000
Net interest (loss) income, after provision for loan losses	(603,444)	3,076,050	2,756,184	3,489,824	(301,764)	250,571	2,002,900	(1,731,561)
Noninterest income	170,041	1,416,005	1,091,221	403,662	1,149,425	184,232	730,291	263,114
Noninterest expenses	6,548,924	4,209,080	3,884,359	3,399,998	5,716,829	3,278,956	3,773,359	3,292,743
(Loss) income before income taxes	(6,982,327)	282,975	(36,954)	493,488	(4,869,168)	(2,844,153)	(1,040,168)	(4,761,190)
Income tax (benefit) expense	(1,699,200)	69,301	(55,099)	149,701	(1,904,367)	(1,144,617)	(437,369)	(1,849,687)
Net (loss) income	(5,283,127)	213,674	18,145	343,787	(2,964,801)	(1,699,536)	(602,799)	(2,911,503)
Preferred stock dividends	34,463	-	-	-	-	-	-	-
Net (loss) income available to common stockholders	\$ (5,317,590)	\$ 213,674	\$ 18,145	\$ 343,787	\$ (2,964,801)	\$ (1,699,536)	\$ (602,799)	\$ (2,911,503)
Earnings (loss) per common share:								
Basic	\$ (0.81)	\$ 0.03	\$ -	\$ 0.05	\$ (0.46)	\$ (0.26)	\$ (0.09)	\$ (0.45)
Diluted	\$ (0.81)	\$ 0.03	\$ -	\$ 0.05	\$ (0.46)	\$ (0.26)	\$ (0.09)	\$ (0.45)

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Cornerstone has not had any change in accountants or disagreements with accountants on accounting and financial disclosure during the two most recent fiscal years or subsequently.

ITEM 9A(T). CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

Cornerstone maintains disclosure controls and procedures, as defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934 (the “Exchange Act”), that are designed to ensure that information required to be disclosed by it in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Commission’s rules and forms and that such information is accumulated and communicated to Cornerstone’s management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Cornerstone carried out an evaluation, under the supervision and with the participation of its management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures as of the end of December 31, 2010. Based on the evaluation of these disclosure controls and procedures, the Chief Executive Officer and Chief Financial Officer have concluded that as of December 31, 2010, Cornerstone’s disclosure controls and procedures were effective.

Management’s Report on Internal Control over Financial Reporting

The report of Cornerstone’s management on internal control over financial reporting is set forth in Item 8 of this Annual Report on Form 10-K and incorporated herein by reference.

Changes in Internal Controls

There were no changes in Cornerstone’s internal control over financial reporting during Cornerstone’s fiscal quarter ended December 31, 2010 that have materially affected, or are reasonably likely to materially affect, Cornerstone’s internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Information relating to the directors and executive officers of Cornerstone is set forth under the caption “Proposals—Election of Directors” in Cornerstone’s 2011 Proxy Statement. Such information is incorporated into this report by reference.

Information relating to Cornerstone’s audit committee and audit committee financial experts is set forth under the caption “Corporate Governance and the Board of Directors—Audit Committee” in Cornerstone’s 2011 Proxy Statement. Such information is incorporated into this report by reference.

Information relating to compliance with the reporting requirements of Section 16(a) of the Exchange Act by Cornerstone’s executive officers and directors, persons who beneficially own more than ten percent of Cornerstone’s common stock and their affiliates who are required to comply with such reporting requirements is set forth under the caption “Other Matters—Section 16(a) Beneficial Ownership Reporting Compliance” in Cornerstone’s 2011 Proxy Statement. Such information is incorporated into this report by reference.

Cornerstone has adopted a code of business conduct and ethics that applies to its directors, officers and employees, including its principal executive officers, principal financial officer, principal accounting officer, controller or persons performing similar functions.

ITEM 11. EXECUTIVE COMPENSATION

Information relating to executive compensation is set forth under the captions “Executive Compensation” and “Director Compensation” in Cornerstone’s 2011 Proxy Statement. Such information is incorporated into this report by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Information relating to beneficial ownership of Cornerstone’s common stock by certain persons is set forth under the caption “Security Ownership of Certain Beneficial Owners and Management” in Cornerstone’s 2011 Proxy Statement. Such information is incorporated into this report by reference.

Information relating to Cornerstone’s equity compensation plans is set forth under the caption “The Company’s Long-Term Equity and Qualified Retirements Plans—Equity Compensation Plan Information as of December 31, 2010” in Cornerstone’s 2011 Proxy Statement. Such information is incorporated into this report by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

Information relating to certain transactions between Cornerstone and its affiliates and certain other persons and to Cornerstone’s policies and procedures for approval of such transactions is set forth under the captions “Certain Relationships and Related Transactions” and “Corporate Governance and the Board of Directors—Policies and Procedures for Approval of Related Person Transactions” in Cornerstone’s 2011 Proxy Statement. Such information is incorporated into this report by reference.

Information relating to director independence is set forth under the caption “Corporate Governance and the Board of Directors—Board Composition and Director Independence” in Cornerstone’s 2011 Proxy Statement. Such information is incorporated into this report by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Information relating to principal accountant fees and services is set forth under the caption “Audit Committee—Audit and Non-Audit Fees” in Cornerstone’s 2011 Proxy Statement. Such information is incorporated into this report by reference.

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed as part of this report:

(1) Financial Statements

The following report and consolidated financial statements of Cornerstone and Subsidiaries are included in Item 8:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of December 31, 2010 and 2009

Consolidated Statements of Income for the years ended December 31, 2010, 2009 and 2008

Consolidated Statement of Changes in Stockholders' Equity for the years ended December 31, 2010, 2009 and 2008

Consolidated Statements of Cash Flows for the years ended December 31, 2010, 2009 and 2008

Notes to Consolidated Financial Statements

(2) Financial Statement Schedules:

Schedule II: Valuation and Qualifying Accounts

All other schedules for which provision is made in the applicable accounting regulation of the Securities and Exchange Commission are not required under the related instructions or are inapplicable and therefore have been omitted.

(3) The following documents are filed or incorporated by reference as exhibits to this report:

<u>Exhibit No.</u>	<u>Description</u>
3.1	Amended and Restated Charter of Cornerstone Bancshares, Inc. (1)
3.2	First Amendment to Amended and Restated Charter of Cornerstone Bancshares, Inc. (2)
3.3	Amended and Restated Bylaws of Cornerstone Bancshares, Inc. (3)
4	The right of securities holders are defined in the Charter and Bylaws provided in exhibits 3.1, 3.2 and 3.3 respectively.
10.1*	Cornerstone Bancshares, Inc. Statutory and Nonstatutory Stock Option Plan. (4)
10.2*	Cornerstone Bancshares, Inc. 2002 Long-Term Incentive Plan. (5)
10.3*	Cornerstone Bancshares, Inc. 2004 Non-Employee Director Plan. (6)
10.4*	Cornerstone Community Bank Employee Stock Ownership Plan. (7)
14	Code of Ethics. (8)
21	Subsidiaries of the registrant.
31.1	Certification of principal executive officer.
31.2	Certification of principal financial officer.
32	Section 906 certifications of chief executive officer and chief financial officer.

* This item is a management contract or compensatory plan or arrangement required to be filed as an exhibit to this Form 10-K pursuant to Item 15(b) of this report.

(1) Incorporated by reference to Exhibit 3.1 of the registrant's Form 10-Q/A filed on May 5, 2010.

(2) Incorporated by reference to Exhibit 3 of the registrant's Form 10-K filed on June 29, 2010.

(3) Incorporated by reference to Exhibit 3.2 of the registrant's Form 10-KSB filed on March 24, 2004.

(4) Incorporated by reference to Exhibit 10.1 of the registrant's Registration Statement on Form S-1 filed on February 4, 2000, as amended (File No. 333-96185).

(5) Incorporated by reference to Exhibit 99.1 of the registrant's Registration Statement on Form S-8 filed March 5, 2004 (File No. 333-113314).

(6) Incorporated by reference to Exhibit 99.3 of the registrant's Registration Statement on Form S-8 filed March 5, 2004 (File No. 333-113314).

(7) Incorporated by reference to Exhibit 10.1 of the registrant's Form 8-K filed on July 19, 2005.

(8) Incorporated by reference to Exhibit 14 of the registrant's Form 10-KSB filed on March 24, 2004.

SIGNATURES

In accordance with Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CORNERSTONE BANCSHARES, INC.

Date: March 30, 2011

By: /s/ Nathaniel F. Hughes
Nathaniel F. Hughes
President
(principal executive officer)

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

In accordance with the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities indicated on March 30, 2011.

<u>Signature</u>	<u>Title</u>
<u>/s/ W. Miller Welborn</u> W. Miller Welborn	Chairman of the Board of Directors
<u>/s/ Nathaniel F. Hughes</u> Nathaniel F. Hughes	President (principal executive officer) and Director
<u>/s/ B. Kenneth Driver</u> B. Kenneth Driver	Director
<u>/s/ Karl Fillauer</u> Karl Fillauer	Director
<u>/s/ David Fussell</u> David Fussell	Director
<u>/s/ Lawrence D. Levine</u> Lawrence D. Levine	Director
<u>/s/ Frank S. McDonald</u> Frank S. McDonald	Director
<u>/s/ Doyce G. Payne</u> Doyce G. Payne	Director
<u>/s/ Billy O. Wiggins</u> Billy O. Wiggins	Director
<u>/s/ Marsha Yessick</u> Marsha Yessick	Director
<u>/s/ Gary W. Petty, Jr.</u> Gary W. Petty, Jr.	Senior Vice President and Chief Financial Officer (principal financial officer and accounting officer)

INDEX OF EXHIBITS

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31.1	Certification of principal executive officer.
31.2	Certification of principal financial officer.
32	Section 906 certifications of chief executive officer and chief financial officer.

* This item is a management contract or compensatory plan or arrangement required to be filed as an exhibit to this Form 10-K pursuant to Item 15(b) of this report.

- (1) Incorporated by reference to Exhibit 3.1 of the registrant's Form 10-Q/A filed on May 5, 2010.
- (2) Incorporated by reference to Exhibit 3 of the registrant's Form 8-K filed on June 29, 2010.
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CORNERSTONE BANCSHARES, INC.

LIST OF SUBSIDIARY

<u>Name of Subsidiary</u>	<u>State of Incorporation</u>
Cornerstone Community Bank	Tennessee
Eagle Financial, Inc. (Subsidiary of Cornerstone Community Bank)	Tennessee

CERTIFICATIONS

I, Nathaniel F. Hughes, certify that:

1. I have reviewed this report on Form 10-K of Cornerstone Bancshares, Inc. (the "Issuer") for the fiscal year ended December 31, 2010.
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Issuer as of, and for, the periods presented in this period report;
4. The Issuer's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the Issuer and have:
 - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Issuer, including its consolidated subsidiary, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) designed such internal controls over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) evaluated the effectiveness of the Issuer's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) disclosed in this report any change in the Issuer's internal control over financial reporting that occurred during the Issuer's fourth fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Issuer's internal control over financial reporting.
5. The Issuer's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting to the Issuer's auditors and the audit committee of Issuer's board of directors:
 - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Issuer's ability to record, process, summarize and report financial information; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Issuer's internal control over financial reporting.

Date: March 30, 2011

/s/ Nathaniel F. Hughes
Nathaniel F. Hughes, President
(principal executive officer)

CERTIFICATIONS

I, Gary W. Petty, Jr., certify that:

1. I have reviewed this report on Form 10-K of Cornerstone Bancshares, Inc. (the "Issuer") for the fiscal year ended December 31, 2010.
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Issuer as of, and for, the periods presented in this period report;
4. The Issuer's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the Issuer and have:
 - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Issuer, including its consolidated subsidiary, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) designed such internal controls over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) evaluated the effectiveness of the Issuer's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) disclosed in this report any change in the Issuer's internal control over financial reporting that occurred during the Issuer's fourth fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Issuer's internal control over financial reporting.
5. The Issuer's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting to the Issuer's auditors and the audit committee of Issuer's board of directors:
 - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Issuer's ability to record, process, summarize and report financial information; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Issuer's internal control over financial reporting.

Date: March 30, 2011

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

CERTIFICATIONS OF CEO AND CFO PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT

**CERTIFICATIONS PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002
(18 U.S.C. SECTION 1350)**

In connection with the Annual Report of Cornerstone Bancshares, Inc., a Tennessee corporation (the "Company"), on Form 10-K for the fiscal year ended December 31, 2010, as filed with the Securities and Exchange Commission (the "Report"), each of Nathaniel F. Hughes, President of the Company, and Gary W. Petty, Jr., Senior Vice President and Chief Financial Officer of the Company, do hereby certify, pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350), that to his knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/ s/ Nathaniel F. Hughes

Nathaniel F. Hughes

President

(principal executive officer)

/ s/ Gary W. Petty, Jr.

Gary W. Petty, Jr.

Senior Vice President and Chief Financial Officer

(principal financial officer and accounting officer)

[A signed original of this written statement required by Section 906 has been provided to Cornerstone Bancshares, Inc. and will be retained by Cornerstone Bancshares, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.]

