

# CORNERSTONE BANCSHARES INC

## FORM 10KSB40 (Annual and Transition Reports)

Filed 3/26/2001 For Period Ending 12/31/2000

Address	4154 RINGGOLD RD CHATTANOOGA, Tennessee 37412-416
Telephone	423-698-2454
CIK	0001038773
Fiscal Year	12/31

# Securities and Exchange Commission

Washington, D.C. 20549

## FORM 10-KSB

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2000

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

COMMISSION FILE NUMBER 000-30497

CORNERSTONE BANCSHARES, INC.  
(NAME OF SMALL BUSINESS ISSUER IN ITS CHARTER)

TENNESSEE

62-1173944

-----  
(STATE OF INCORPORATION)

(I.R.S. EMPLOYER  
IDENTIFICATION NO.)

**5319 HIGHWAY 153**  
**CHATTANOOGA, TENNESSEE 37343**  
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)(ZIP CODE)

(423) 385-3000  
(ISSUER'S TELEPHONE NUMBER)

Securities registered pursuant to Section 12(b) of  
the Act: None  
Securities registered pursuant to Section 12(g) of the Act:  
**Common Stock, Par Value \$1.00 Per Share**  
(TITLE OF CLASS)

Check whether the issuer (1) filed all reports required to be filed by  
Section 13 or 15(d) of the Exchange Act during the past 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 X No

Check if disclosure of delinquent filers in response to Item 405 of Regulation S-B is not contained in this form, and no disclosure will 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-KSB or any amendment to this Form 10-KSB. [X]

Revenues for the Registrant's fiscal year ended December 31, 2000, total \$10,086,776.

The aggregate market value of the Registrant's outstanding Common Stock held by nonaffiliates of the Registrant on January 31, 2001 was  
approximately \$15,166,177. There were 1,166,129 shares of Common Stock outstanding as of January 31, 2001.

Transitional Small Business Disclosure Format (check one): Yes No [X]

### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement of Cornerstone Bancshares, Inc. for the Annual Meeting of its Shareholders to be held April 19, 2001, to the  
extent stated herein, and are incorporated by reference.

**CORNERSTONE BANCSHARES, INC.  
ANNUAL REPORT ON FORM 10-KSB  
FOR THE FISCAL YEAR ENDED DECEMBER 31, 2000**

**TABLE OF CONTENTS**

ITEM NUMBER -----		PAGE NUMBER -----
	PART I	
1.	Description of Business.....	3
2.	Description of Property.....	9
3.	Legal Proceedings.....	9
4.	Submission of Matters to a Vote of Security Holders.....	9
	PART II	
5.	Market for Common Equity and Related Stockholder Matters.....	10
6.	Management's Discussion and Analysis or Plan of Operation.....	10
7.	Financial Statements.....	32
8.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.....	32
	PART III	
9.	Directors, Executive Officers, Promoters and Control Persons; Compliance with Section 16(a) of the Exchange Act.....	33
10.	Executive Compensation.....	33
11.	Security Ownership of Certain Beneficial Owners and Management.....	33
12.	Certain Relationships and Related Transactions.....	33
13.	Exhibits and Reports on Form 8-K.....	34
	Signatures.....	35
	Index of Exhibits .....	37

## **FORWARD-LOOKING STATEMENTS**

This form contains certain forward-looking statements including statements relating to present or future factors generally affecting the banking industry and specifically affecting Cornerstone Bancshares, Inc. (the "company") operations, markets, and products. Without limiting the foregoing, the words "believes," "anticipates," "intends," "expects" or similar expressions are intended to identify forward-looking statements that involve certain risks and uncertainties. Actual results could differ materially from those projected for many reasons including, without limitation, changing events and trends that have influenced Cornerstone's assumptions. These trends and events include (i) changes in the interest rate environment which may reduce margins, (ii) non-achievement of expected growth, (iii) less favorable than anticipated changes in national and local business environment and securities markets, (iv) adverse changes in the regulatory requirements affecting Cornerstone, (v) greater competitive pressures among financial institutions in Cornerstone's market, and (vi) greater than expected loan losses. Additional information and other factors that could affect future financial results are included in Cornerstone's filings with the Securities and Exchange Commission.

**PART I****ITEM 1. DESCRIPTION OF BUSINESS****OVERVIEW****THE COMPANY**

Cornerstone Bancshares, Inc. (the "Company" or "Cornerstone") was incorporated under the laws of the State of Tennessee and 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. Its wholly-owned subsidiary, Cornerstone Community Bank, a Tennessee banking corporation (the "Bank"), resulted from the merger of The Bank of East Ridge and Cornerstone Community Bank effective October 15, 1997.

The primary activity of the Company currently is, and is expected to remain for the foreseeable future, the ownership and operation of the Bank. As a bank holding company, the Company is intended 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.

While the Company 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, the Company currently has no plans, understandings or agreements concerning any other activities other than as described below. The results of operations and financial condition of the Company for the foreseeable future, therefore, will be determined primarily by the results of operations and financial condition of the Bank.

**THE BANK**

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. Funds not invested in the loan portfolio are invested by the Bank primarily in obligations of the U.S. Government, various states and their political subdivisions. In addition to deposits, sources of funds for the Bank's loans and other investments include amortization and prepayment of loans, sales of loans or participations in loans, and sales of its investment securities. 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.

**EMPLOYEES**

As of February 1, 2001, Cornerstone had 55 full-time equivalent employees of whom 53 are full-time, and 4 are part-time. The employees are not represented by a collective bargaining unit. Cornerstone believes its relationship with its employees to be good.

**CUSTOMERS**

It is the opinion of management that there is no single customer or affiliated group of customers whose deposits, if withdrawn, would have a material adverse effect on the business of Cornerstone.

## **COMPETITION**

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

Based on total assets of approximately \$116,673,000 at December 31, 2000, the Bank represents 2.12% of the deposit base in Chattanooga, Tennessee-Georgia Metropolitan Statistical Area ("Chattanooga MSA"). Three major regional banks represent approximately 66% of the deposits in the Chattanooga MSA. The larger financial institutions have greater resources and lending limits than the Bank, and each of the three institutions has over 20 branches in the county. There are several credit unions located in Hamilton County. Since credit unions are not subject to income taxes in the way commercial banks are taxed, credit unions have an advantage in offering 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 will focus 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**

### **GENERAL**

The Company 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 "Board"). The Company is required to file with the Board annual reports and such additional information as the Board may require pursuant to the Act. The Board may also make examinations of the Company and its subsidiaries. The Company 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 Bank Insurance Fund (the "BIF") of the Federal Deposit Insurance Corporation (the "FDIC") and is, therefore, 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 operation of the Company 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. The TDFI, FDIC and 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.

### **INSURANCE OF DEPOSIT ACCOUNTS**

Deposits of the Bank are insured by the FDIC to a maximum of \$100,000 for each insured depositor through the BIF, one of the two deposit insurance funds established by Federal Law. 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 requires an annual audit by independent accountants and also periodically makes its own examinations of insured institutions. The FDIC may revalue assets of an institution, based upon appraisals, and require establishment of 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. Depending upon a BIF member's risk classification and subgroup, applicable regulations provide that its deposit insurance premium may be as low as .04% of insured deposits or as high as .31% of insured deposits. Additionally, because the BIF has exceeded its designated reserve ratio, the FDIC has now reduced to zero the assessment rate that is applicable to the most highly rated BIF members. The Bank has been notified that, based on its risk classification and supervisory subgroup, its BIF assessment rate is 0.03% of insured deposits for the period from January 1, to June 30, 2001. This is the second most favorable assessment rate applicable to insured institutions. In addition, the Deposit Insurance Funds Act of 1998 (DIFA) requires that a Financing Corporation (FICO) assessment be paid by the Bank. The annual FICO assessment rate for banks is presently 0.0196% of deposits. The Bank paid \$24,243 in assessments, during the year ended December 31, 2000.

Subsequent to the enactment of 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 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. Banks receiving lower regulatory ratings are required to maintain Tier 1 capital in an amount that is at least 100 to 200 basis points higher than 3.0% of total assets.

At December 31, 2000, the Bank had Tier 1 capital of \$ 9.56 million or 8.40% of total average assets.

Certain provisions of the Federal Reserve Act, made applicable to the Bank by Section 18(j) of the Federal Deposit Insurance Act (12 U.S.C. Section 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 may revalue assets of an institution, based upon appraisals, and may require the establishment of specific reserves in amounts equal to the difference between such revaluation and the book value of the assets. The FDIC also is 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. The Bank does not know 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 Board regulations that require it to maintain reserves against its transaction accounts (primarily checking accounts). Because reserves generally must be maintained in cash or in non-interest bearing accounts, the effect of the reserve requirements is to increase the Bank's cost of funds. The 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.

### **TENNESSEE SUPERVISION AND REGULATION**

As a Tennessee-chartered commercial bank, the Bank is subject to various state laws and regulations which limit the amount that can be loaned to a single borrower, the types of permissible investments, and geographic and new product expansion, among other things. The Bank must submit an application 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 Federal Deposit Insurance Act (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 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 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**

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

The Bank and the Company are "affiliated" within the meaning of the Act. Certain provisions of the Act establish standards for the terms of, limits 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 and 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, the Company and any other subsidiary of the Company, and to related interests of such persons.

In addition to the banking regulations imposed on the Company, the securities of the Company are not exempt from the federal and state securities laws as are the securities of a bank. Accordingly, an offering of the Company's securities

must be registered under both the Securities Act of 1933 (the "Securities Act") and state securities laws or qualify for exemptions from registration.

Under Section 106(b) of 1970 Amendments to the Act (12 U.S.C. Section 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 the Company; the Bank (other than a loan, discount, deposit, or trust service) or any other subsidiary of the Company; (ii) refrain from obtaining any property, credit or service from any competitor of the Company; the Bank or any subsidiary of the Company; or (iii) provide any credit, property or service to the Company, the Bank (other than those related to and usually provided in connection with a loan, discount, deposit or trust service) or any subsidiary of the Company.

Most bank holding companies are required to give the 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 Board may disapprove such a purchase or redemption if it determines that the proposal constitutes an unsafe or unsound practice, would violate any law, regulation, Board order or directive or any condition imposed by, or written agreement with, the Board. The prior notice requirement does not apply to certain "well-capitalized" bank holding companies that meet specified criteria.

In November 1985, the Board adopted its Policy Statement on Cash Dividends Not Fully Covered by Earnings. The Policy Statement sets forth various guidelines that the Board believes that a bank holding company should follow in establishing its dividend policy. In general, the 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.

Cornerstone Community Bank is operating under a Memorandum of Understanding with the Tennessee Department of Financial Institutions and the Federal Deposit Insurance Corporation. Among other things, the Memorandum provides the following:

- The Board of Directors must develop a written management plan that addresses Cornerstone Community Bank's plans for size, structure, growth, earnings, services, information systems, personnel, accounting, financial reporting and operating matters;
- Cornerstone Community Bank must maintain a Tier I leverage capital ratio of equal to or greater than 8%;
- Cornerstone Community Bank may not pay dividends without the prior approval of the FDIC; and
- Cornerstone Community Bank must report its progress on the actions required by the Memorandum to the FDIC on specific dates.

At December 31, 2000, Cornerstone Community Bank reported to the FDIC that it was in compliance with all but three provisions of the Memorandum. The Bank feels it is substantially in compliance with the remaining three provisions. Because of the increased regulatory scrutiny required by the Memorandum, the activities of Cornerstone Community Bank and Cornerstone are more restricted, and these restrictions may affect the flexibility of Cornerstone in conducting its business operations.

## **LEGISLATION AFFECTING THE COMPANY AND THE BANK**

The following information describes statutory and regulatory provisions and is qualified in its entirety by reference to the particular statutory and regulatory provisions.

Far-reaching legislation, including the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("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 state banks and bank holding companies like the Bank and the Company, 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 the 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 new 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:

- (i) annual on-site examinations by regulators (except for smaller, well-capitalized banks with high management ratings, which must be examined every 18 months);
- (ii) 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;
- (iii) new uniform disclosure requirements for interest rates and terms of deposit accounts;
- (iv) a requirement that the FDIC establish a risk-based deposit insurance assessment system by 1994;
- (v) authorization for the FDIC to impose one or more special assessments on its insured banks to recapitalize the BIF;
- (vi) 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;
- (vii) 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;
- (viii) 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;
- (ix) 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;
- (x) 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);
- (xi) uniform regulations regarding real estate lending; and
- (xii) 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.

The activities permissible to the Company and the Bank were substantially expanded by the recently enacted Gramm-Leach-Bliley Act (the "Gramm Act") which President Clinton signed into law on November 12, 1999. 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 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 the Company, from disclosing nonpublic personal financial information to third parties unless customers have the opportunity to "opt out" of the disclosure.

Bills are regularly introduced in both the United States Congress and the Tennessee general Assembly that contain wide-ranging proposals for altering the structures, regulations and competitive relationships of the nation's financial institutions. It cannot be predicted whether or what form any proposed legislation will be adopted or the extent to which the business of the Company or the Bank may be affected thereby.

## **ITEM 2. DESCRIPTION OF PROPERTY**

As of December 31, 2000, the principal offices of the Company and the Bank were located at 5319 Highway 153, Chattanooga, Tennessee 37343. This property is owned by the Company.

The Bank and the Company operate four full-service branches in Hamilton County, Tennessee: 5319 Highway 153, Chattanooga, Tennessee 4154 Ringgold Road, East Ridge, Tennessee 610 Georgia Avenue, Chattanooga, Tennessee 2280 Gunbarrel Road, Chattanooga, Tennessee

During fiscal year 2000 the Bank purchased the 2280 Gunbarrel Road property from AmSouth Bank. The Bank closed two branches that were previously located at Albertson Food Stores on Highway 58 and Gunbarrel Road. The Bank closed the Albertson grocery store branch location on Highway 58 on August 1, 2000 and on Gunbarrel Road on November 15, 2000. The Bank opened the 2280 Gunbarrel Road location on November 16, 2000. The 2280 Gunbarrel Road property is a full service 3200 square foot branch.

The Georgia Avenue branch contains 1800 square feet and is leased pursuant to a lease agreement, which provides for an initial term of three years with two three-year renewal options. The Company owns the property located at 4154 Ringgold Road and 5319 Highway 153.

The Company operates a service center to house all its non-customer contact functions located at 6401 Lee Corners, Suite B, Chattanooga, Tennessee. The facility has 7800 square feet and is leased pursuant to a lease agreement, which provides for an initial term of 5 years with one five-year renewal option.

## **ITEM 3. LEGAL PROCEEDINGS**

As of the end of 2000, the Bank was a party in three separate but related lawsuits stemming from its relationship with Island Cove Marina (see financial report note 11 for further comment). Management believes that the complaints are without merit and that any loss to the Bank would not have a material effect on the financial condition of the Bank.

The Bank is periodically involved as a plaintiff or defendant in various legal actions in the ordinary course of its business. Management believes that those claims are without merit or that the ultimate liability, if any, resulting from them will not materially affect the Bank's financial condition.

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

No matters were submitted to a vote of shareholders of the Company during the fourth quarter of the Company's fiscal year ended December 31, 2000.

## PART II

### ITEM 5. MARKET FOR THE COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The Company Common Stock is not listed, traded or quoted on any securities exchange or in the over-the-counter market, and no dealer makes a market in the Common Stock. To Cornerstone management's knowledge, the most recent transaction with respect to Cornerstone Common Stock was \$13.00 per share. On February 4, 2000 the Company filed a registration statement on Form S-1 (SEC File Number 333-96185) to issue 150,000 shares of common stock at \$13.00 a share. The Company terminated the offering on December 31, 2000 and has received commitments for approximately 70,000 shares. The Company is in the process of collecting the proceeds and will ultimately contribute capital to the Bank with the majority of the funds. The Company will retain the balance for working capital.

There were approximately 596 holders of record of the common stock as of December 31, 2000.

Cornerstone currently intends to retain its earnings, if any, for use in the business and does not anticipate paying any cash dividends in the foreseeable future. The Board of Directors cannot predict when such dividends, if any will ever be made. The payment of dividends, if any, shall at all times be subject to the payment of Cornerstone's expenses, the maintenance of reasonable working capital and risk reserves, and minimum capitalization requirements for state banks. As a condition of its approval to complete the Bank merger with Bank of East Ridge, the Company is currently restricted by the Federal Reserve Bank from paying dividends without its prior approval.

### ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

#### FORWARD-LOOKING STATEMENTS

Management's discussion of the Company and management's analysis of the Company's operations and 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 federal and state securities laws. Although the Bank 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 the Company's customers, and other risks that cannot be accurately quantified or completely identified. Many factors affecting the Company'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. Because these factors are unpredictable and beyond the Company'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 the Company, and not to predict the future or to guarantee results. The Company is unable to predict the types of circumstances, conditions and factors that can cause anticipated results to change. The Company undertakes no obligation to publish revised forward-looking statements to reflect the occurrence of changes or unanticipated events, circumstances, or results.

#### GENERAL

The following should be read in conjunction with the information and tables, which follow. For a discussion of liquidity and the impact of inflation, see "Capital Resources/Liquidity" below.

#### SUMMARY

Net income for 2000 was \$362,124 a 188% increase from Cornerstone's net income of (\$413,123) in 1999. Net income per common share of \$0.31 for 2000 was 179% higher than 1999 net income per share of (\$0.39). Pretax income of \$684,681 for 2000 increased \$1,358,083 from 1999 pretax loss of (\$673,402).

The increase in net income per share from 1999 to 2000 represents a general strengthening of the Bank's balance sheet while maintaining strict expense control. Assisting in the recovery was the Bank's ability to increase its net interest margin while growing the balance sheet \$14 million. Still persisting is a higher than peer bank substandard loan portfolio which continues

to restrict the Bank's ability to rapidly increase earnings to a peer bank level. In 2000, the Bank's net loan charge-off was \$419,640 down from \$1,253,191 in 1999.

## BUSINESS OF THE COMPANY

The Company's earnings depend primarily on the Bank's "net interest income," which is the difference between the interest income it receives from its assets (primarily its loans and other investments) and the interest expense (or "cost of funds") which it pays on its liabilities (primarily its deposits). Net interest income is a function of (i) the difference between rates of interest earned on interest-earning assets and rates of interest paid on interest-bearing liabilities (the "interest rate spread" or "net interest spread") and (ii) the relative amounts of its interest-earning assets and interest-bearing liabilities. When interest-earning assets approximate or exceed interest-bearing liabilities, any positive interest rate spread will generate net interest income. The Bank adheres to an asset and liability management strategy which is intended to control the impact of interest rate fluctuations upon the Company's earnings and to make the yields on the Bank's loan portfolio and other investments more responsive to its cost of funds, in part by more closely matching the maturities of its interest-earning assets and its interest-bearing liabilities, while still maximizing net interest income. Nevertheless, the Bank is and will continue to be affected by changes in the levels of interest rates and other factors beyond its control.

Unless specifically noted below, the following information is presented on a consolidated basis reflecting the Company's performance as a whole. The Company's results of operations are dependent primarily upon the results of operations of the Bank

For the fiscal years ended December 31, 2000 and 1999, the Company's weighted average rate earned on all interest-earning assets was 9.20% and 8.37%, respectively, and the Company's weighted average rate paid on all interest-bearing liabilities for the same years was 4.88% and 4.54%, respectively. The Company's interest rate spread for the years ended December 31, 2000 and 1999 therefore was 4.32% and 3.83%, respectively, and its net interest income for such years was \$5,039,255 and \$4,043,984, respectively. For fiscal 2000, the Company recorded a net income of \$362,124 or \$0.31 basic earnings per share as compared with net income of (\$413,123) or (\$0.39) basic earnings per share for fiscal 1999. The increase in net income was due to growth in earning assets coupled with an increase in the Bank's net interest margin.

The table below sets forth certain additional measures of the Company's performance for the periods indicated. Average balances in the table, as well as all average balances presented elsewhere in this report, were derived based on daily balances whenever possible. However, some average balances, which require data from the Company, as opposed to the Bank, were derived based on month-end balances since the data processing systems for those entities do not provide daily average balance information. The use of month-end averages does not materially alter any information given, and all averages are still representative of the operations of the Company.

	YEARS ENDED DECEMBER 31,		
	2000	1999	1998
	----	----	----
Net Interest Margin (Net interest income divided by average interest-earning assets) .....	4.92%	4.40%	4.28%
Return on Average Assets (Net income divided by average total assets) .....	0.318%	(0.402)%	0.235%
Return on Average Equity (Net income divided by average equity) .....	3.103%	(3.79)%	2.42%
Equity-to-Assets (Average equity divided by average total assets) .....	10.23%	10.60%	9.72%
Loans to Deposits (Average loans divided by average daily deposits) ....	82.13%	77.39%	74.41%
Dividend Payout Ratio			
(Dividends declared by the Company divided by net income) .....	0.00%	0.00%	0.00%

**NET INTEREST INCOME**

The following table sets forth 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.

YEARS ENDED DECEMBER 31,

(In thousands)	2000			1999			1998		
	AVERAGE BALANCE	INTEREST INCOME/ EXPENSE (1)	AVERAGE YIELD/ RATE	AVERAGE BALANCE	INTEREST INCOME/ EXPENSE (1)	AVERAGE YIELD/ RATE	AVERAGE BALANCE	INTEREST INCOME/ EXPENSE (1)	AVERAGE YIELD/ RATE
<b>ASSETS</b>									
Interest-earning assets:									
Loans(1)(2) .....	80,526	7,979	9.91%	69,643	6,361	9.13%	69,356	6,738	9.72%
Investment securities .....	20,907	1,382	6.58%	18,613	1,147	6.16%	20,269	1,297	6.40%
Federal funds sold .....	995	61	6.23%	3,580	179	5.01%	3,289	176	5.35%
Other earning assets.....	--		0.00%	--		0.00%	16	1	6.25%
Total interest-earning assets .....	102,428	9,422	9.20%	91,836	7,687	8.37%	92,930	8,212	8.84%
Allowance for loan losses .....	(1,069)			(1,059)			(900)		
Cash and other assets .....	12,682			12,113			13,733		
<b>Total assets .....</b>	<b>114,041</b>			<b>102,890</b>			<b>105,763</b>		
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>									
Interest-bearing liabilities:									
Deposits									
NOW accounts .....	15,463	270	1.75%	13,604	231	1.70%	12,287	260	2.12%
Money market / Savings accts .....	11,084	393	3.55%	9,890	324	3.28%	10,195	374	3.67%
Time deposits, \$100m and over .....	16,147	956	5.94%	15,897	884	5.56%			
Time deposits, other .....	43,499	2,558	5.89%	39,554	2,107	5.33%	60,234	3,507	5.82%
Total interest-bearing deposits .....	86,193	4,183	4.85%	78,945	3,546	4.49%	82,716	4,141	5.01%
Federal Funds Purchased .....	675	44	6.52%	29	2	5.17%	175	8	4.86%
Securities sold under agreement to repurchase .....	2,938	154	5.24%	519	30	5.68%			
Long-term debt .....	22	1	4.55%	732	65	8.88%	1,025	82	7.97%
Total interest-bearing liabilities .....	89,828	4,382	4.88%	80,225	3,643	4.54%	83,916	4,231	5.04%
Other liabilities:									
Demand deposits .....	11,850			11,042			10,490		
Accrued interest payable and other liabilities .....	693			718			1,079		
Total other liabilities .....	12,543			11,760			11,569		
Total liabilities .....	102,371			91,985			95,485		
Redeemable Stock .....	59			239			479		
Stockholders' equity .....	11,611			10,666			9,799		
Total liabilities and stockholders' equity .....	114,041			102,890			105,763		

YEARS ENDED DECEMBER 31,

	2000	1999	1998
FINANCIAL RATIOS			
Excess of interest-earning assets over interest-bearing liabilities .....	12,600	11,611	9,014
Ratio of interest-earning assets to interest-bearing liabilities .....	114.03%	114.47%	110.74%
Net interest income .....	5,039	4,044	3,981
Interest rate spread (difference between rate earned on interest-earning assets and rate paid on interest-bearing liabilities).....	4.32%	3.83%	3.79%
Net interest margin (net interest income divided by average interest-earning assets) .....	4.92%	4.40%	4.28%

(1) Interest income on loans includes amortization of deferred loan fees and other discounts of \$ 13m, \$ 0, and \$ 0, for the fiscal years ended December 31, 2000, 1999, and 1998, 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.

The following table sets forth information regarding the weighted average contractual yields earned on the Company's interest-earning assets and the weighted average interest rates paid on the Company's interest-bearing liabilities outstanding at December 31, 2000. Investment securities are shown at the Book value, as securities are held available for sale and held to maturity.

(In thousands)	Amount	Average Yield/Rate
	-----	-----
Interest-earning assets:		
Loans .....	80,526	9.91%
Investment securities		
Taxable securities .....	20,907	6.58%
Tax-exempt securities		
Federal funds sold .....	995	6.23%
Total interest-earning assets .....	102,428	9.20%
Interest-bearing liabilities:		
NOW Accounts .....	15,463	1.75%
Money market and savings accounts .....	11,084	3.55%
Time Deposits of \$100,000 or more .....	16,147	5.94%
Time deposits .....	43,499	5.89%
Total deposits .....	86,193	4.85%
Federal Funds Purchased .....	675	6.52%
Securities Sold under agreement to repurchase	2,938	5.24%
Long term debt .....	22	4.55%
Total interest-bearing liabilities .....	89,828	4.88%

Changes in interest income and interest expense are attributable to three factors: (i) a change in volume or amount of an asset or liability; (ii) a change in interest rates; or (iii) a change caused by the combination of changes in asset or deposit mix. The following table describes the extent to which changes in interest rates and changes in volume of interest-earning assets and interest-bearing liabilities have affected the Company'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.

Year Ended December 31,  
2000 Compared to 1999

(In thousands)	Volume	Rate	Mix	Net Change
<hr/>				
Interest income:				
Loans (1)(2).....	1,079	629	-85	1,623
Investment securities .....	151	86	-9	228
Federal funds sold.....	-160	12	31	-118
Other earning assets.....	0	0	0	0
<hr/>				
Total interest income.....				1,733
Interest expense:				
NOW accounts.....	32	7	-1	38
Money market and saving accounts.....	42	30	-3	69
Time deposits, \$100,000 and over.....	15	61	-1	75
Time deposits, less than \$100,000.....	232	242	-22	453
<hr/>				
Total deposits.....				635
Other borrowings.....	-35	-1	-28	-64
Fed Funds Purchased.....	43	9	-9	43
Securities sold under agreement to repurchase.	127	-13	11	124
<hr/>				
Total other interest-bearing liabilities....				103
Total interest expense.....				738
Change in net interest income (expense).....				995
<hr/>				

Year Ended December 31,  
1999 Compared to 1998

	Volume	Rate	Mix	Net Change
<b>Interest income:</b>				
Loans (1)(2).....	26	-405	2	-377
Investment securities .....	-102	-44	-4	-150
Federal funds sold.....	15	-12	1	3
Other earning assets.....	0	0	-1	-1
<b>Total interest income.....</b>				<b>-524</b>
<b>Interest expense:</b>				
NOW accounts.....	22	-57	6	-29
Money market and saving accounts.....	-10	-38	-1	-50
Time deposits, \$100,000 and over.....	-1,102	-195	-102	-1,399
Time deposits, less than \$100,000.....	884	0	0	884
<b>Total deposits.....</b>				<b>-594</b>
Other borrowings.....	-26	7	3	-17
Fed Funds Purchased.....	-8	0	0	-8
Securities sold under agreement to repurchase.....	30	0	0	30
<b>Total other interest-bearing liabilities....</b>				<b>6</b>
<b>Total interest expense.....</b>				<b>-588</b>
<b>Change in net interest income (expense)</b>				<b>64</b>

(1) Loan amounts include non-accruing loans.

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

The following table sets forth the re-pricing of the Company's interest earning assets and interest-bearing liabilities as of December 31, 2000. The time periods in the table represent the period, following December 31, 2000, during which an asset or liability matures or can be repriced. This interest sensitivity gap table is designed to monitor the Company's interest rate risk exposure within the designated time period. In order to control interest rate risk, management regularly monitors the volume of interest sensitive assets relative to interest sensitive liabilities over specific time intervals. The Company's interest rate management policy is to attempt to maintain a relatively stable net interest margin in periods of interest rate fluctuations. The Company's policy is to attempt to maintain a ratio of cumulative gap to total interest sensitive assets of negative 15.00% to positive 15.00% in the time period of one year or less. Presently the Bank is in a negative one-year cumulative GAP position of (24.63%) and is actively seeking adjustable rate loans and longer-term liabilities to reduce the Bank's sensitivity. The Bank to date has not participated in any derivative products to address this issue and does not foresee the need to do so in the immediate future. Below is a table, which reflects the Company's interest-earning assets and interest-bearing liabilities. The information set forth below is based on the following assumptions - by Management. (i) saving and money market and NOW accounts will be less interest rate sensitive and the re-pricing on these accounts will be spread out over a five-year period; and (ii) the non-mortgage securities have been scheduled by maturity date while mortgages have been amortized over the life of the mortgage.

(In thousands)	Less than One Year -----	1 to 5 Years -----	Over 5 Years -----	Total -----
<b>INTEREST SENSITIVE ASSETS</b>				
Fed Funds Sold.....	2,400	0	0	2,400
Investment Securities				
Taxable (1).....	4,155	13,831	2,291	20,314
Tax-exempt (1).....	0	0	132	132
Loans (2)				
Fixed rate & Adjustable rate 1-4 mort....	6,876	14,392	2,822	24,091
Scheduled payments.....	29,240	30,454	789	60,483
<b>Total Interest-Sensitive Assets.....</b>	<b>42,672</b>	<b>58,678</b>	<b>6,035</b>	<b>107,384</b>
<b>INTEREST SENSITIVE LIABILITIES</b>				
NOW.....	7,264	10,895	0	18,159
Money Market.....	4,494	1,498	0	5,992
Time Deposits.....	56,606	10,899	12	65,179
Other interest-bearing liabilities.....	3,144	2,000	0	5,144
Long-term debt.....	0	0	0	0
<b>Total Interest Sensitive Liabilities.....</b>	<b>69,170</b>	<b>25,292</b>	<b>12</b>	<b>94,474</b>
Interest Sensitivity Gap.....	(26,461)	33,386	6,023	12,947
Cumulative Gap.....	(26,498)	6,888	12,947	
Ratio of cumulative gap to total				
Interest sensitive assets.....	(24.63%)	6.45%	12.05%	

(1) All AFS securities are shown at the market value and HTM are shown at book value.

(2) Non-performing loans are included as interest-earning assets.

## LENDING ACTIVITIES

### LOAN POLICY

All lending activities of Cornerstone are under the direct supervision and control of the Directors Loan Committee, which consists of the chief executive officer, the executive vice president of lending and four outside directors. The loan committee enforces loan authorizations for each officer, makes lending decisions on loans exceeding such limits, services all requests for office credits to extent allowable under current laws and regulations, administers all problem credits, and determines the allocation of funds for each lending division. Cornerstone's established maximum loan volume to assets is 80%. The loan portfolio consists primarily of real estate, commercial and installment loans.

**GENERAL**

At December 31, 2000, the Company's loan portfolio constituted approximately 68.36% of the Company's total assets. The following table sets forth the composition of the Company's loan portfolio at the indicated dates.

(In thousands)	At December 31,			
	2000		1999	
	Amount	Percent	Amount	Percent
Commercial, financial, and agricultural.....	16,209	19.17%	13,661	18.89%
Real estate - construction.....	9,976	11.80%	5,560	7.69%
Real estate - mortgage.....	52,720	62.34%	46,760	64.65%
Consumer loans.....	5,669	6.70%	6,345	8.77%
Total loans.....	84,574	100.00%	72,326	100.00%

The following table sets forth the scheduled maturities of the loans in the Company's loan portfolio as of December 31, 2000 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.

	Loans Maturing			
	Less than One Year	One to Five Years	More than Five Years	Total
Commercial, financial and agricultural.....	11,569	4,639	0	16,209
Real estate - construction.....	8,054	1,922	0	9,976
Real estate - mortgage.....	15,061	34,313	3,346	52,720
Consumer loans.....	1,785	3,618	265	5,669
Total Loans.....	36,470	44,492	3,611	84,574

## **TYPES OF LOANS**

### **COMMERCIAL LOANS**

Commercial, industrial, and non-farm non-residential loans, hereinafter referred to as commercial loans (excluding commercial construction loans) totaled \$ 16.2 million or 19.2% of the Company's loan portfolio at December 31, 2000. Commercial loans consist of loans and lines of credit 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 terms of the Bank's commercial loans generally range from 90 days to 5 year balloon and a 15 year amortization, and the loans generally carry interest rates which adjust in accordance with changes in the prime rate, but when appropriate will be fixed to match the borrower's needs. Substantially all of the Bank's commercial loans are secured and guaranteed by the principals of the borrower.

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 revolving lines of credit with annual maturities. Loans secured by chattel mortgages and accounts receivable may not exceed 80% 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. Commercial loans, which are considered small business loans, are the core business of Cornerstone. Most loans are made with a long-term relationship intended and Cornerstone also seeks to obtain the borrower's business and personal depository accounts.

### **REAL ESTATE - CONSTRUCTION LOANS**

As of December 31, 2000, Cornerstone had \$10.0 million in construction and development loans outstanding, which represented 11.8% of the loan portfolio. All construction and development loans are held in the Bank's loan portfolio. The Bank makes residential construction loans to owner-occupants and to persons building residential properties for resale. The majority of the Bank's construction loans are made to residential real estate developers for speculative single-family residential properties. Construction loans are usually variable rate loans made for terms of one year or less, but extensions are permitted if construction has continued satisfactorily and if 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 salability 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, which 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**

At December 31, 2000, real estate mortgage loans totaled \$ 52.7 million or 62.3% of the Company's loan portfolio. Real estate mortgage loans include all loans secured by real estate for purposes other than construction or acquisition and development and are hereinafter referred to as real estate loans. All real estate loans are held in the Bank's loan portfolio. Of this amount, \$ 24.1 million or 28.5% of the Company's loan portfolio was comprised of loans secured by one to four family residential properties, including home equity loans (loans secured by the equity in the borrower's residence but not necessarily for the purpose of home improvement). Most of these home equity loans are made at fixed interest rates for terms of one to three years with balloon payment provisions and amortized over a 10-15 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.

At December 31, 2000, the remainder of the Company's real estate loans totaled \$ 28.6 million or 33.8% of the Company's loan portfolio. These loans were comprised of multifamily residential and commercial properties.

## **CONSUMER LOANS**

At December 31, 2000, consumer loans totaled \$ 5.7 million or 6.7% of the Company's loan portfolio. These loans consist of consumer installment loans and consumer credit card balances. As of December 31, 2000, the Bank had \$ .3 million credit card balances outstanding.

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.

## **ORIGINATION, PURCHASE AND SALE OF LOANS**

The Bank originates loans primarily in Hamilton County, Tennessee. The Bank also originates loans in Marion, Sequatchie, and Bradley Counties in Tennessee, and Dade, Walker and Catoosa Counties in Georgia each of, which is contiguous to Hamilton County. Loans are originated by eight loan officers who operate from the Bank's offices in Chattanooga. These loan officers 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 loan officers 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. Certain loan officers have the authority to approve loans of up to \$ 100,000. All other loan officers have the authority to approve secured loans of up to at least \$ 10,000. There is an Officers Loan Committee comprised of the senior officers of the Bank which must approve any loan that increases the borrower's aggregate indebtedness above an individual officer's limit, but that is not more than \$ 250,000. The Directors Loan Committee mentioned above must approve all loans over \$ 250,000 but that is not more than \$ 1,000,000. All loans above \$1,000,000 up to the Bank's legal lending limit must be approved by the Board of Directors of 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 stockholders. 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 which it otherwise would be unable to make due to capital or other funding considerations. As of the end December 31, 2000, the Bank had a purchased participation balance of \$540 thousand and had sold participation balance of \$4.1 million.

## **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 1/2% to 2% 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 FASB 91 and amortizes all loan fees in excess of \$5,000 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. For the year ended December 31, 2000, the Bank recognized origination, commitment and other loan fees totaling \$ 405,877, which equaled 4.31% of the Company's total interest income for the year.

## **PROBLEM LOANS AND ALLOWANCE FOR LOAN LOSSES**

### **PROBLEM LOANS**

In originating loans, the Company 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 guaranty of the security for the loan. The Company has instituted measures at the Bank which are designed to reduce the risk of, and monitor exposure to, credit losses.

The Bank's loan portfolio is systematically (all loans over \$100,000 secured and \$50,000 unsecured will be reviewed and graded annually) reviewed by the Bank's management and periodically by third party loan review consultants, external auditors, and State and Federal regulators to identify deficiencies. Input from all the above parties 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 monthly by the Loan Committee of the Board of Directors, and 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 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 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 (unless the obligation is both well secured and in the process of collection) 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 "real estate owned" until it is sold and is carried at the lower of cost (defined as fair value at foreclosure) 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.

The Bank attempts to sell real estate owned promptly after foreclosure, and it sold \$833,995 of its real estate owned due to loan foreclosures during the year ended December 31, 2000. The book value of real estate owned that was sold by the Bank during the year ended December 31, 2000 totaled \$865,578. As of December 31, 2000, there was \$542,000 in value of real estate owned as a result of foreclosure.

The following table sets forth information regarding the Company's delinquent and non-performing assets as of the dates indicated.

(In thousands)	At December 31,	
	2000	1999
	----	----
Accruing loans which are contractually past due 90 days or more:		
Commercial, financial, and agricultural.....	0	3
Real estate - construction.....	0	0
Real estate - mortgage.....	0	0
Consumer.....	1	3
Total .....	1	6
Ratio of delinquent (30 days or more) but accruing loans to:		
Total loans.....	1.19%	1.20%
Total assets.....	0.85%	0.82%
Non-accruing loans:		
Commercial, financial, and agricultural.....	243	532
Real estate - construction.....	0	0
Real estate - mortgage.....	0	318
Consumer loans.....	9	10
Total .....	252	860
Real estate acquired through foreclosure.....	542	393
Property acquired through repossession.....	6	31
Total loans and real estate acquired through foreclosure and repossessions.....	548	424
Total loans.....	84,574	72,325
Ratio of non-performing assets to total loans:.....	0.95%	1.78%

**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 monthly by charges to income in response to changes to outstanding loan balances.

The Bank maintains a general allowance equal to approximately 1.35% of the total principal amount of loans outstanding and management adjusts the general allowance monthly by charges or credits to income in response to changes in the outstanding loan balance. Management also may establish specific loan loss allowances for specific loans after considering such factors as past delinquencies on the loan, the value of the underlying collateral and the size of the loan. A loan or portion thereof is charged off against the general 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 general allowance for loan losses as of December 31, 2000 is adequate to absorb possible losses from loans currently in the portfolio.

The following table summarizes the Company's loan loss experience for the periods indicated.

(In thousands)	Years Ended December 31,	
	2000	1999
Average loans.....	80,526	69,643
Allowance for possible loan losses, beginning of the period.....	1,002	1,400
Charge-offs for the period:		
Commercial, financial, and agricultural.....	267	1,014
Real estate - construction.....	0	0
Real estate - mortgage.....	209	111
Consumer.....	186	387
Total charge-offs.....	662	1,512
Recoveries for the period:		
Commercial, financial, and agricultural.....	93	131
Real estate - construction.....	0	0
Real estate - mortgage.....	54	13
Consumer.....	95	115
Total recoveries.....	242	259
Net charge-offs for the period.....	420	1,253
Provision for loan losses.....	560	855
Allowance for possible loan losses, end of the period.....	1,142	1,002
Ratio of allowance for loan losses to total average loans outstanding.....	1.42%	1.44%
Ratio of net charge-offs during the period to average loans outstanding during the period.....	0.52%	1.80%

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 moderate. The total amount of loans in each of these loan rating categories is weighted by a factor that management believes reasonably reflects losses that can be anticipated with respect to loans in each of these categories. Based on these weightings, the Bank's management establishes an allowance for loan losses that is reviewed by its Board of Directors each month.

The following table sets forth the Company's allocation of the allowance for loan losses as of December 31, 2000, and 1999.

(In thousands)	At December 31, 2000		At December 31, 1999	
	Amount	Percent of loans In each category To total loans	Amount	Percent of loans In each category To total loans
Commercial, financial, and agricultural.....	219	19.17%	189	18.89%
Real estate - construction.....	135	11.80%	77	7.69%
Real estate - mortgage.....	712	62.33%	648	64.65%
Consumer .....	76	6.70%	88	8.77%
<b>Total .....</b>	<b>1,142</b>	<b>100.00%</b>	<b>1,002</b>	<b>100.00%</b>

## INVESTMENT ACTIVITIES

### INVESTMENT POLICY

The objective of Cornerstone's investment policy is to invest funds not otherwise needed to meet the loan demand of Cornerstone's market area and to meet the five following objectives: Gap Management, Liquidity, Pledging, Return, and Local Community Support. In doing so, Cornerstone will use the portfolio to provide structure and liquidity that the loan portfolio cannot. The management investment committee will balance the market risk and credit risks against the potential investment return, make investments compatible with the pledge requirements of Cornerstone's deposit of public funds, maintain compliance with regulatory investment requirements, and assists the 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 Board Asset Liability Committee (ALCO). All the investment transactions occurring since the previous ALCO meeting are reviewed by the ALCO at its next monthly meeting, in addition to the entire portfolio. The investment policy allows portfolio holdings to include short-term securities purchased to provide Cornerstone's needed liquidity and longer-term securities purchased to generate stable income for Cornerstone during periods of interest rate fluctuations.

The Company's investment portfolio totaled \$ 21 million or 17.4% of total assets at December 31, 2000.

The following table sets forth the carrying value of the Bank's investments at the dates indicated. Securities held in both available for sale and held to maturity status. Securities available for sale are carried at fair market value and securities held to maturity are held at their book value.

(In thousands)	At December 31,	
	2000	1999
Securities available for sale:		
U.S. Government and agency obligations.....	12,284	8,935
Mortgage-backed and other securities.....	3,632	4,404
States & political subdivisions tax-exempt.....	132	0
Stock.....	350	0
Total.....	16,398	13,339
Securities held to maturity:		
U.S. Government and agency obligations.....	200	198
Mortgage-backed and other securities.....	3,812	5,525
States & political subdivisions tax-exempt.....	0	0
Total.....	4,012	5,723
Total Securities.....	20,410	19,062

The following table sets forth the book value of the Bank's investments at December 31, 2000, the weighted average yields on the Bank's investments at December 31, 2000 and the periods to maturity of the Bank's investments from December 31, 2000.

(In thousands)	Periods to Maturity from December 31, 2000							
	1 Year or less		1 - 5 Years		5 - 10 Years		Over 10 Years	
	Amount	Weighted Average Yield (1)	Amount	Weighted Average Yield (1)	Amount	Weighted Average Yield (1)	Amount	Weighted Average Yield (1)
AVAILABLE FOR SALE:								
U. S. Treasuries .....	0	0.00%	0	0.00%	0	0.00%	0	0.00%
U. S. Government agencies .....	999	6.72%	11,110	6.46%	0	0.00%	0	0.00%
Mortgage backed Securities (2) ...	68	6.15%	87	6.98%	390	6.95%	3,084	7.19%
Tax-exempt municipal bonds .....	0	0.00%	0	0.00%	125	7.44%	0	0.00%
Other bonds, notes, de- bentures, and securities .....	350	0.00%	0	0.00%	0	0.00%	0	0.00%
Total .....	1,417	6.69%	11,197	6.46%	515	7.07%	3,084	7.19%
Total Available for Sale: .....	16,212	6.64%						

(In thousands)	Periods to Maturity from December 31, 2000							
	1 Year or less		1 - 5 Years		5 - 10 Years		Over 10 Years	
	Amount	Weighted Average Yield (1)	Amount	Weighted Average Yield (1)	Amount	Weighted Average Yield (1)	Amount	Weighted Average Yield (1)
HELD TO MATURITY:								
U. S. Treasuries .....	0	0.00%	0	0.00%	0	0.00%	0	0.00%
U. S. Government agencies .....	200	6.29%	0	0.00%	0	0.00%	0	0.00%
Mortgage backed Securities (2) ...	0	0.00%	818	6.45%	791	6.84%	2,204	6.78%
Tax-exempt municipal bonds .....	0	0.00%	0	0.00%	0	0.00%	0	0.00%
Other bonds, notes, de- bentures, and securities .....	0	0.00%	0	0.00%	0	0.00%	0	0.00%
Total .....	200	6.29%	818	6.45%	791	6.84%	2,204	6.78%
Total Held to Maturity.....	4,013	6.70%						
Total Securities .....	20,226	6.65%						

(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

## SOURCES OF FUNDS

### GENERAL

Time, money market, savings and demand deposits are the major source of the Company's funds for lending and other investment purposes. All deposits are held by the Bank. In addition, the Company 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 Company'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.

### 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 Metropolitan Statistical Area (MSA). The Bank does not advertise for deposits outside of this area. The Bank does not solicit funds from brokers, nor does it 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 have been and will continue to be significantly affected by money market conditions.

The following tables set forth the composition of deposits for the Company, excluding accrued interest payable, by type for the years ended December 31, 2000 and December 31, 1999.

(In thousands)	2000	1999
Demand Deposits .....	11,924	12,412
NOW accounts .....	13,688	12,626
Savings & Money market deposits .....	10,460	10,255
Time deposits less than \$100,000 .....	48,266	39,923
Time deposits \$100,000 or more .....	16,912	16,130
<b>Total deposits. ....</b>	<b>101,250</b>	<b>91,346</b>

The following table presents a breakdown by category of the average amount of deposits and the average rate paid on deposits for the periods indicated:

(In thousands)	2000		1999	
Demand Deposits .....	11,850		11,042	
NOW accounts .....	15,463	1.75%	13,604	1.70%
Savings & Money market deposits .....	11,084	3.55%	9,890	3.28%
Time deposits less than \$100,000 .....	43,499	5.89%	39,554	5.33%
Time deposits \$100,000 or more .....	16,147	5.94%	15,897	5.56%
<b>Total deposits.....</b>	<b>98,043</b>	<b>4.47%</b>	<b>89,987</b>	<b>4.05%</b>

## **BORROWINGS**

The Bank joined the Federal Home Loan Bank of Cincinnati in October of 2000. The Federal Home Loan Bank (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. The Bank as of the end of the year had \$2 million outstanding with the FHLB. The advance was a 10-year advance at 5.0% with a two year one time only call/put option. The Bank has available several Federal Funds lines of credit available with correspondent banks with a total availability of \$11 million as of the end of 2000. As of December 31, 2000, the Bank had no outstanding balances. 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.

## **FINANCIAL CONDITION**

**EARNING ASSETS.** Average earning assets in 2000 increased \$10.6 million or 11.5% over 1999 due to loan and security growth. This was as a result of an across the board increase in deposits, which will be discussed below.

**LOAN PORTFOLIO.** Cornerstone's average loans for 2000 were \$80.5 million, an increase of 15.6% over \$69.6 million in average loans for 1999. Loan growth for 2000 was funded through deposit growth and growth of commercial repurchase agreements. The actual balance for the end of 2000, was \$84.6 million an increase of \$12.2 million from 1999. During 2000, the portfolio grew dramatically as the Bank hired key personnel from some other local banks in the area. The loan growth was concentrated in commercial development and commercial real estate.

**INVESTMENT PORTFOLIO.** Cornerstone's average investment securities portfolio increased 12.3% or \$2.3 million from 1999 to 2000. When the balance of the portfolio and fed funds sold are combined the growth is nonexistent. The average investment portfolio and average federal funds sold for 2000 was \$21.9 million a decrease of 1.3% from 1999. Cornerstone maintains an investment strategy of seeking portfolio yields within acceptable risk levels as well as providing liquidity, pledging requirements, and GAP management. To assist in the accomplishment of these missions the Bank materially reduced its mortgage backed security exposure during 2000. The Bank ended the year with less than 37% of the portfolio in mortgage backed securities. The Bank replaced these securities with non-callable bullet and one time only callable U.S. Agency securities that have a much lower interest rate risk. Cornerstone maintains two classifications of investment securities. "Held to Maturity" and "Available for Sale." The "Available for Sale" securities are carried at fair market value, where as "Held to Maturity" securities are carried at book value. At year end 2000, unrealized gains in the "Available for Sale" portfolio amounted to \$185,629.

**DEPOSITS.** Cornerstone's average deposits increased \$8.1 million or 9.0% from 1999 to 2000. From year end 1999 to year end 2000, total deposits increased \$9.9 million or 10.8%. The Bank's strategy shifted in 2000 to allow the growth of certificates of deposits, as well as, attracting transaction deposits from small businesses. This strategy funded the Bank's loan growth and allowed the Bank to increase its net interest margin to an above peer bank level. The bank expects to continue attracting deposits from small businesses, but will focus its efforts on transaction accounts, which are less expensive and tie our customer base closely to the Bank.

**CAPITAL RESOURCES.** Stockholders average equity increased \$0.9 million or 8.9%. The Bank had net income of \$362,124 in 2000, and the value of the security portfolio increased from a \$183 thousand loss to a \$122 thousand gain. The actual balance increased \$0.9 million or 7.43% from \$11.6 million as of the end of 1999 to \$12.5 million. The Bank completed a registered offering of 150,000 shares of Company common stock of which approximately 70,000 were sold at \$13 per share.

## **BALANCE SHEET MANAGEMENT**

**LIQUIDITY MANAGEMENT.** Liquidity is the ability of a company to convert assets into cash without significant loss and to raise funds by increasing liabilities. Liquidity management involves having the ability to meet day-to-day cash flow requirements of its customers, whether they are depositors wishing to withdraw funds or borrowers requiring funds to meet their credit needs.

The primary function of asset / liability management is not only to assure adequate liquidity in order for Cornerstone to meet the needs of its customer base, but to maintain an appropriate balance between interest-sensitive assets and interest-sensitive liabilities so that Cornerstone can profitably deploy its assets and therefore optimize earning. Both assets and liabilities are considered sources of liquidity funding and both are, therefore, monitored on a daily basis.

The asset portion of the balance sheet provides liquidity primarily through loan repayment and maturity of investment securities. Additional sources of liquidity are the investment in Federal Funds sold and prepayments from the mortgage backed securities from the investment portfolio.

The liability portion of the balance sheet provides liquidity through various interest bearing and non-interest bearing deposit accounts. Other short-term liabilities, which do not qualify as a deposit, are Federal Funds purchased and securities under agreement to repurchase (REPO's). Both are temporary solutions for liquidity as Fed Funds must be paid off at least once every 30 days and REPO's must be collateralized by investment securities. At year-end December 31, 1999, Cornerstone had \$1 million in Federal Funds purchased and \$1.2 million in REPO's. Longer-term liabilities are limited to FHLB advances, which would be used to reduce interest rate risk and Holding Company loans used to repurchase common stock or finance any acquisition in the future.

## **RESULTS OF OPERATIONS**

Year ended December 31, 2000 compared to year ended December 31, 1999

**NET INTEREST INCOME.** Net interest income is the principal component of a financial institution's income stream and represents the spread between interest and fee income generated from earning assets and the interest expense paid on liabilities. The following discussion is on a fully taxable equivalent basis.

Net interest income before the loan loss provision for 2000 increased \$995,271 or 24.7% over 1999. The increase in net interest income from 1999 to 2000 is due to growth in loans and deposits to fund the growth. The Bank also benefited from its prime rate loans, which increased as the Federal Reserve raised interest rates. This was anticipated in 2000 and is anticipated to reverse in 2001; the Bank will focus efforts to re-price its liabilities as quickly as assets in 2001 through the solicitation of transaction accounts with lower interest cost

Interest income increased \$1,734,124 or 22.6% in 2000 from 1999. Interest income produced by the loan portfolio increased \$1,616,309 or 25.4% from 1999 to 2000. Interest income on investment securities and Federal Funds sold increased \$117,815 or 8.9% from 1999 to 2000. The increase in loan interest income was due to the Banks hiring of key loan personnel who managed to get their customers to migrate to Cornerstone from their original institution. The securities portfolio increase was due to the commitment of the bank to invest in low interest rate risk securities and the construction of a maturity ladder that can be shortened or stretched as interest rates dictate.

Total interest expense increased \$738,853 or 20.3% in 2000 from 1999. The interest expense increase from 1999 to 2000, was a result of interest rates increasing as the Federal Reserve increased rates in 2000 and the Bank's percentage increase of certificates of deposits in the deposit mix.

One of the most useful tools for measuring the ability of a small community bank to make money is its ability to make money to maximize net interest margin and the interest rate spread. The net interest margin, or the net yield on earning assets, is computed by dividing fully taxable equivalent net interest income by average-earning assets. This ratio represents the difference between the average yield on average-earning assets and the average rate paid for all funds used to support those earning assets. The net interest margin increased 52 basis points in 2000 to 4.92%. The net cost of funds, defined as interest expense divided by average-earning assets, increased 58 basis points from 3.97% in 1999 to 4.28% in 2000. The yield on earning assets increased 83 basis points to 9.20% in 2000 from 8.37% in 1999.

**ALLOWANCE FOR LOAN LOSS.** The allowance for possible loan loss represents management's assessment of the risks associated with extending credit and its evaluation of the quality of the loan portfolio. Management analyzes the loan portfolio to determine the adequacy of the allowance for possible loan losses and the appropriate provisions required to maintain a level considered adequate to absorb anticipated loan losses. Management believes that the \$1,141,869 as of

December 31, 2000, in the allowance for possible loan loss account is sufficient to absorb known credit risks in the portfolio. No assurance can be given, however, that adverse economic circumstances will not result in increased losses in the loan portfolio and require greater provisions for possible loan losses in the future.

**NON-PERFORMING ASSETS.** Non-performing assets include non-performing loans and foreclosed real estate held for sale. Non-performing loans include loans classified as non-accrual or renegotiated. Cornerstone's policy is to place a loan on non-accrual status when it is contractually past due 90 days or more as to payment of principal or interest. At the time a loan is placed on non-accrual status, interest previously accrued but not collected may be reversed and charged against current earnings. Recognition of any interest after a loan has been placed on non-accrual is accounted for on a cash basis. As of December 31, 2000, Cornerstone had \$799,581 of non-performing assets.

**NON-INTEREST INCOME.** Non-interest income consists of revenues generated from a broad range of financial services and activities including fee-based services and profits and commissions earned through credit life insurance sales and other activities. In addition, gains or losses realized from the sale of investment portfolio securities are included in non-interest income. Total non-interest income increased by \$80,341 or 13.7% from 1999 to 2000. Fee income from service charges on deposit accounts increased \$15,606 or 3.20% in 2000.

**NON-INTEREST EXPENSE.** Non-interest expense for 2000 decreased by \$12,839 or 0.3% from 1999. Salaries and employee benefits increased by \$58,248 or 2.8% from 1999 for \$2,173,199. This relatively small increase was due to management's ability to reduce overtime and maintain headcount to a number under sixty full-time equivalents throughout 2000. Occupancy expense increased 30.4% as the Bank opened another full service branch on Gunbarrel Road and closed two grocery store branches as Albertson withdrew from the market. All other non-interest expense decreased \$113,955 or 5.4% in 2000, primarily due to reduced charge-offs.

### Capital Resources / Liquidity

**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 from banks, is a result of its operating, investing and financing activities. In order to insure 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.

Cornerstone's liquidity target is measured by adding all the Bank's net cash, short term and marketable securities and dividing this number by total deposits and short term liabilities not secured by assets pledged. The approved liquidity policy is targeted at 15% and currently the Bank's liquidity ratio is 11.4%. Cornerstone is not subject to any specific regulatory liquidity requirements imposed by regulatory orders. Cornerstone is subject to general FDIC guidelines, which do not require a minimum level of liquidity. Management believes its liquidity ratios meet or exceed these guidelines. Management does not know of any trends or demands, which are reasonably likely to result in liquidity increasing or decreasing in any material manner.

The following table sets forth liquidity ratios for periods indicated:

	December 31, 2000	December 31, 1999
Average loans to average deposits.....	82.1%	77.4%

**IMPACT OF INFLATION AND CHANGING PRICES.** The financial statements and related financial data presented herein have been prepared in accordance with 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 concerned with two inflationary factors; the first and the most common is the general impact of inflation on operations of Cornerstone and is reflected in increased operating costs. The other and most dangerous to the Bank's profitability 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 the Company 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 rates 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.

## 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 through 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 average equity to average assets, average tangible assets, and average equity to net loans.

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 potential 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 the 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.

(In thousands)	December 31, 2000	December 31, 1999
	----- Amount	----- Amount
CAPITAL:		
Tier I Capital:		
Stockholders' equity .....	9,556	8,480
Plus loss of AFS Securities .....	-	183
Less disallowed intangibles .....	-	-
	-----	-----
Total Tier I capital .....	9,556	8,663
Tier II capital:		
Qualifying debt .....	-	-
Qualifying allowance for loan losses .....	1,119	941
	-----	-----
Total Tier II capital .....	10,674	9,604
Total capital .....	10,674	9,604
Risk-adjusted assets .....	89,533	75,192
Average assets .....	114,041	102,890
RATIOS:		
Tier I capital to risk-adjusted assets .....	10.67%	11.52%
Tier II capital to risk-adjusted assets .....	11.92%	12.77%
Leverage - Tier I capital to average assets		
Less disallowed intangibles .....	8.38%	8.42%

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. The following table lists the five categories of capital and each of the minimum requirements for the three risk-based 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

On December 31, 2000, Cornerstone exceeded the regulatory minimums and qualified as a well-capitalized institution under the regulations.

## ITEM 7. FINANCIAL STATEMENTS

The following consolidated financial statements of the Company and its subsidiary, together with the Report of Independent Certified Public Accountants thereon, are included on page F-1 through F-30 of this Annual Report on Form 10-KSB:

Report of Independent Certified Public Accountants on the Financial Statements

### **Consolidated Balance Sheets as of December 31, 2000 and 1999**

Consolidated Statements of Operations for the years ended December 31, 2000, 1999 and 1998

Consolidated Statements of Changes in Stockholders' Equity for the years ended December 31, 2000, 1999 and 1998

Consolidated Statements of Cash Flows for the years ended December 31, 2000, 1999 and 1998

### **Notes to Consolidated Financial Statements**

Report of Independent Certified Public Accountants on Accompanying Information

### **Consolidating Balance Sheet**

### **Consolidating Statement of Operation**

## ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Neither the Company nor the Bank had any change in accountants or disagreements with accountants on accounting and financial disclosure during the two most recent fiscal years or subsequently.

**PART III****ITEM 9. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT**

Information relating to the directors and executive officers of the Company is set forth under the caption "Proposal I: Election of Directors - Information About Nominees" on pages 4 through 5 of the Company's 2001 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 Securities Exchange Act of 1934, as amended, by the Company's executive officers and directors, persons who own more than ten percent of the Company's common stock and their affiliates who are required to comply with such reporting requirements is set forth in "Introduction - Section 16 (a) Beneficial Ownership Reporting Compliance" on page 3 of the Company's 2001 Proxy Statement. Such information is incorporated into this report by reference.

**ITEM 10. EXECUTIVE COMPENSATION**

Information relating to Director compensation is set forth under the caption "Executive Compensation and Other Information" on page 10 of the Company's 2001 Proxy Statement, and information relating to executive compensation is set forth under the caption "Executive Compensation and Other Information" on pages 6 through 12 of the Company's 2001 Proxy Statement. Such information is incorporated into this report by reference.

**ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT**

Information relating to ownership of the Company's common stock by certain persons is set forth under the caption "Introduction - Voting Securities and Principal Holders Thereof" on pages 1 through 3 of the Company's 2001 Proxy Statement. Such information is incorporated into this report by reference.

**ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

Information relating to certain transactions between the Company, and its affiliates and certain other persons is set forth under the caption "Certain Relationships and Related Transactions" on page 12 of the 2001 Proxy Statement. Such information is incorporated into this report by reference.

**ITEM 13. EXHIBITS AND REPORTS ON FORM 8-K**

## (a) Exhibits

The following exhibits are filed as a part of or incorporated by reference in this report:

Exhibit No. -----	Description -----
3.1*	Articles of Incorporation of the Company
3.2*	Bylaws of the Company, as amended (see attached amendment)
4.	The right of securities holders are defined in the Articles of Incorporation and Bylaws provided in exhibits 3.1 and 3.2 respectively.
10.1**	Cornerstone Statutory-Nonstatutory Stock Option Plan
10.2**	Employment Agreement between Cornerstone Bancshares, Inc. and Gregory B. Jones, dated March 1, 1999.
10.3**	Employment Agreement between Cornerstone Bancshares, Inc. and Nathaniel F. Hughes, dated March 1, 1999.
10.4**	Employment Agreement between Cornerstone Bancshares, Inc. and Jerry D. Lee, dated May 1, 1999.
21.+	The sole subsidiary of Cornerstone Bancshares, Inc. is Cornerstone Community Bank, Chattanooga, Tennessee.

---

\*Incorporated herein by reference to the exhibit of the same number in the Company's Registration Statement on Form S-4, as amended (No. 333-26699).

\*\*Incorporated herein by reference to the exhibit of the same number in the Company's Registration Statement on Form S-1, as amended (No. 333-96185).

+ Filed herewith.

**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.**  
(Registrant)

Date: March 26, 2001

By: /s/ GREGORY B. JONES

-----  
Gregory B. Jones  
President and Chief  
Executive Officer

By: /s/ NATHANIEL F. HUGHES

-----  
Nathaniel F. Hughes  
EVP & Chief Financial 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 26, 2001.

<i>Signature</i> -----	<i>Title</i> -----
/s/ EARL A. MARLER, JR. ----- Earl A. Marler, Jr.	Chairman of the Board
/s/ GREGORY B. JONES ----- Gregory B. Jones	President, Chief Executive Officer and Director (principal executive officer and principal financial officer)
/s/ RAMESH V. AMIN ----- Ramesh V. Amin	Director

/s/ B. KENNETH DRIVER Director

-----  
B. Kenneth Driver

/s/ KARL FILLAUER Director

-----  
Karl Fillauer

/s/ JAMES H. LARGE Director

-----  
James H. Large

/s/ LAWRENCE D. LEVINE Director

-----  
Lawrence D. Levine

/s/ RUSSELL W. LLOYD Director

-----  
Russell W. Lloyd

/s/ DOYCE G. PAYNE Director

-----  
Doyce G. Payne

/s/ TURNER SMITH Director

-----  
Turner Smith

/s/ BILLY O. WIGGINS Director

-----  
Billy O. Wiggins

/s/ MARSHA YESSICK Director

-----  
Marsha Yessick

## INDEX OF EXHIBITS

Exhibit No. -----	Description -----
3.1*	Articles of Incorporation of the Company
3.2*	Bylaws of the Company, as amended (see attached amendment)
4.	The right of securities holders are defined in the Articles of Incorporation and Bylaws provided in exhibits 3.1 and 3.2 respectively.
10.1**	Cornerstone Statutory-Nonstatutory Stock Option Plan
10.2**	Employment Agreement between Cornerstone Bancshares, Inc. and Gregory B. Jones, dated March 1, 1999.
10.3**	Employment Agreement between Cornerstone Bancshares, Inc. and Nathaniel F. Hughes, dated March 1, 1999.
10.4**	Employment Agreement between Cornerstone Bancshares, Inc. and Jerry D. Lee, dated May 1, 1999.
21.+	The sole subsidiary of Cornerstone Bancshares, Inc. is Cornerstone Community Bank, Chattanooga, Tennessee.

---

\*Incorporated herein by reference to the exhibit of the same number in the Company's Registration Statement on Form S-4, as amended (No. 333-26699).

\*\*Incorporated herein by reference to the exhibit of the same number in the Company's Registration Statement on Form S-1, as amended (No. 333-96185).

+ Filed herewith.

**REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS**

**ON THE FINANCIAL STATEMENTS**

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 as of December 31, 2000 and 1999, 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, 2000. 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 generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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, 2000 and 1999, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2000, in conformity with generally accepted accounting principles.

Chattanooga, Tennessee  
January 12, 2001

**CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY**

**CONSOLIDATED BALANCE SHEETS**  
**December 31, 2000 and 1999**

	2000	1999
	-----	-----
<b>ASSETS</b>		
Cash and due from banks	\$ 4,633,514	\$ 7,721,701
Federal funds sold	2,400,000	-
Securities available for sale	16,397,715	13,339,306
Securities held to maturity (fair value approximates \$4,009,990 at December 31, 2000)	4,012,414	5,723,320
Loans, net of allowance for loan losses of \$1,141,869 in 2000 and \$1,001,809 in 1999	83,431,776	71,323,878
Bank premises and equipment, net	3,391,138	2,231,179
Accrued interest receivable	849,142	656,159
Excess cost over fair value of net assets acquired	2,662,499	2,722,651
Other assets	1,600,557	2,084,033
	-----	-----
Total assets	\$119,378,755	\$105,802,227
	=====	=====
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Deposits:		
Noninterest-bearing demand deposits	\$ 11,924,140	\$ 12,411,939
Interest-bearing demand deposits	13,687,959	12,626,200
Savings deposits and money market accounts	10,459,568	10,254,825
Time deposits of \$100,000 or more	16,911,729	16,129,350
Time deposits under \$100,000	48,266,503	39,923,313
	-----	-----
Total deposits	101,249,899	91,345,627
Accrued interest payable	183,834	189,870
Federal funds purchased and securities sold under agreements to repurchase	3,144,291	2,179,363
Federal Home Loan Bank advance	2,000,000	-
Other liabilities	282,570	193,108
	-----	-----
Total liabilities	106,860,594	93,907,968
	-----	-----
Commitments and contingencies		
Redeemable common stock	-	237,504
	-----	-----
Stockholders' equity:		
Preferred stock - no par value; 2,000,000 shares authorized; no shares issued	-	-
Common stock - \$1.00 par value; 2,000,000 shares authorized; 1,166,129 shares issued and outstanding in 2000 and 1999	1,166,129	1,166,129
Additional paid-in capital	11,322,276	11,128,734
Retained earnings (deficit)	(92,694)	(454,818)
Accumulated other comprehensive income	122,450	(183,290)
	-----	-----
Total stockholders' equity	12,518,161	11,656,755
	-----	-----
Total liabilities and stockholders' equity	\$119,378,755	\$105,802,227
	=====	=====

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, 2000, 1999 and 1998**

	2000	1999	1998
<b>INTEREST INCOME</b>			
Loans	\$ 7,977,863	\$ 6,361,554	\$ 6,739,054
Securities	1,382,448	1,146,591	1,296,613
Federal funds sold	61,282	179,324	176,299
<b>Total interest income</b>	<b>9,421,593</b>	<b>7,687,469</b>	<b>8,211,966</b>
<b>INTEREST EXPENSE</b>			
Time deposits of \$100,000 or more	955,612	884,435	988,663
Other deposits	3,226,911	2,662,507	3,152,473
Federal funds purchased and securities sold under agreements to repurchase	198,722	22,500	8,518
Federal Home Loan Bank advance	1,093	-	-
Other	-	74,043	81,736
<b>Total interest expense</b>	<b>4,382,338</b>	<b>3,643,485</b>	<b>4,231,390</b>
<b>Net interest income before provision for loan losses</b>	<b>5,039,255</b>	<b>4,043,984</b>	<b>3,980,576</b>
<b>Provision for loan losses</b>	<b>559,700</b>	<b>855,000</b>	<b>715,343</b>
<b>Net interest income after provision for loan losses</b>	<b>4,479,555</b>	<b>3,188,984</b>	<b>3,265,233</b>
<b>NONINTEREST INCOME</b>			
Service charges	502,504	486,898	467,718
Other noninterest income	54,774	47,324	108,304
Net gains from sale of loans and securities	107,905	50,620	110,218
<b>Total noninterest income</b>	<b>665,183</b>	<b>584,842</b>	<b>686,240</b>
<b>NONINTEREST EXPENSES</b>			
Salaries and employee benefits	2,173,199	2,114,951	1,669,883
Net occupancy and equipment expense	293,971	225,435	224,717
Other operating expenses	1,992,887	2,106,842	1,656,585
<b>Total noninterest expenses</b>	<b>4,460,057</b>	<b>4,447,228</b>	<b>3,551,185</b>
<b>Income (loss) before income tax expense (benefit)</b>	<b>684,681</b>	<b>(673,402)</b>	<b>400,288</b>
<b>Income tax expense (benefit)</b>	<b>322,557</b>	<b>(260,279)</b>	<b>151,956</b>
<b>Net income (loss)</b>	<b>\$ 362,124</b>	<b>\$ (413,123)</b>	<b>\$ 248,332</b>
<b>EARNINGS (LOSS) PER SHARE</b>			
Basic	\$ .31	\$ (0.39)	\$ .25
Diluted	.30	(0.39)	.24

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, 2000, 1999 and 1998**

	Comprehensive Income	Total Stockholders' Equity	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income
BALANCE, December 31, 1997		\$ 8,215,085	\$ 874,954	\$ 7,587,441	\$(290,027)	\$ 42,717
Redemption of common stock		(350,107)	(27,897)	(322,210)	-	-
Issuance of common stock		1,964,187	162,404	1,801,783	-	-
Increase in redeemable common stock		(49,584)	-	(49,584)	-	-
Comprehensive income:						
Net income	\$ 248,332	248,332	-	-	248,332	-
Other comprehensive income, net of tax:						
Unrealized holding gains (losses) on securities available for sale, net of reclassification adjustment	(3,626)	(3,626)	-	-	-	(3,626)
Total comprehensive income	\$ 244,706					
BALANCE, December 31, 1998		10,024,287	1,009,461	9,017,430	(41,695)	39,091
Redemption of common stock		(270,928)	(19,352)	(251,576)	-	-
Issuance of common stock		2,568,588	176,020	2,392,568	-	-
Increase in redeemable common stock		(29,688)	-	(29,688)	-	-
Comprehensive income:						
Net loss	\$(413,123)	(413,123)	-	-	(413,123)	-
Other comprehensive income, net of tax:						
Unrealized holding gains (losses) on securities available for sale, net of reclassification adjustment	(222,381)	(222,381)	-	-	-	(222,381)
Total comprehensive income (loss)	(635,504)					
BALANCE, December 31, 1999		11,656,755	1,166,129	11,128,734	(454,818)	(183,290)

(continued on page 5)

**CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY**

**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**  
**Years Ended December 31, 2000, 1999 and 1998**

(continued from page 4)

	Comprehensive Income	Total Stockholders' Equity	Common Stock
	-----	-----	-----
BALANCE, December 31, 1999		\$11,656,755	\$1,166,129
Issuance of common stock		193,542	-
Comprehensive income:			
Net income	\$ 362,124	362,124	-
Other comprehensive income, net of tax:			
Unrealized holding gains on securities available for sale, net of reclassification adjustment	305,740	305,740	-
	-----	-----	-----
Total comprehensive income	\$ 667,864		
	=====		

BALANCE, December 31, 2000		\$12,518,161	1,166,129
		=====	=====

	Additional Paid-in Capital	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income
	-----	-----	-----
BALANCE, December 31, 1999	\$ 11,128,734	\$ (454,818)	\$ (183,290)
Issuance of common stock	193,542	-	-
Comprehensive income:			
Net income	-	362,124	-
Other comprehensive income, net of tax:			
Unrealized holding gains on securities available for sale, net of reclassification adjustment	-	-	305,740
	-----	-----	-----
Total comprehensive income			
BALANCE, December 31, 2000	\$ 11,322,276	\$ (92,694)	\$ 122,450
	=====	=====	=====

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, 2000, 1999 and 1998**

	2000	1999	1998
	-----	-----	-----
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net income (loss)	\$ 362,124	\$ (413,123)	\$ 248,332
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	347,566	309,842	421,406
Provision for loan losses	559,700	855,000	715,343
Gains on sales of loans	(82,407)	(50,620)	(110,218)
Gains on sales of securities	(25,498)	-	-
Deferred income taxes	76,090	119,294	(248,610)
Proceeds from sales of loans held for sale	5,645,356	4,267,333	6,969,087
Originations of loans held for sale	(5,562,949)	(4,216,713)	(6,858,869)
Changes in other operating assets and liabilities:			
Accrued interest receivable	(192,983)	(17,718)	(53,995)
Accrued interest payable	(6,036)	(80,764)	(54,917)
Other assets and liabilities	603,756	(298,644)	(144,068)
	-----	-----	-----
Net cash provided by operating activities	1,724,719	473,887	883,491
	-----	-----	-----
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Proceeds from security transactions:			
Securities available for sale	1,791,570	4,904,263	6,318,245
Securities held to maturity	1,687,329	3,323,155	8,736,045
Purchase of securities available for sale	(4,403,171)	(9,246,955)	(8,139,733)
Purchase of securities held to maturity	-	-	(7,101,585)
Net increase in loans	(13,621,136)	(771,662)	(12,796,580)
Purchase of bank premises and equipment	(1,496,731)	(369,322)	(223,054)
Proceeds from sale of other real estate	803,995	153,326	-
Payments related to bank combination	-	-	(457,637)
	-----	-----	-----
Net cash used in investing activities	(15,238,144)	(2,007,195)	(13,664,299)
	-----	-----	-----
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Net (decrease) increase in deposits	9,904,272	(6,665,981)	16,161,803
Increase in federal funds purchased and securities sold under repurchase agreements	964,928	2,179,363	-
Proceeds from borrowings on debt	2,000,000	-	395,000
Principal paid on notes payable	-	(1,250,000)	-
Redemption of common stock	(237,504)	(270,928)	(350,107)
Issuance of redeemed common stock	193,542	2,568,588	1,964,187
	-----	-----	-----
Net cash provided by (used in) financing activities	12,825,238	(3,438,958)	18,170,883
	-----	-----	-----
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	(688,187)	(4,972,266)	5,390,075
<b>CASH AND CASH EQUIVALENTS, beginning of year</b>	7,721,701	12,693,967	7,303,892
	-----	-----	-----
<b>CASH AND CASH EQUIVALENTS, end of year</b>	\$ 7,033,514	\$ 7,721,701	\$ 12,693,967
	=====	=====	=====
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION</b>			
Cash paid during the period for interest	\$ 4,388,107	\$ 3,724,249	\$ 4,215,080
Cash paid during the period for taxes	210,000	44,403	425,171
	=====	=====	=====
<b>NONCASH INVESTING AND FINANCING ACTIVITIES</b>			
Acquisition of real estate through foreclosure	\$ 1,015,151	\$ 545,929	\$ -
Increase in redeemable common stock	-	29,688	49,584
	=====	=====	=====

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, 2000, 1999 AND 1998**

**Note 1. Summary of Significant Accounting Policies**

The accounting and reporting policies of Cornerstone Bancshares, Inc. and subsidiary (Company) conform with generally accepted accounting principles and practices within the banking industry. The policies that materially affect financial position and results of operations are summarized as follows:

**Nature of operations:**

The Company 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 four locations in Chattanooga, Tennessee. 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.

**Principles of consolidation:**

The consolidated financial statements include the accounts of the Company and its subsidiary. All material intercompany accounts and transactions have been eliminated in consolidation.

**Excess cost over fair value of net assets acquired:**

The excess cost over fair value of net assets acquired represents the excess of the cost of the investment over the underlying net assets of the subsidiary bank at the date of acquisition. Certain amounts have been allocated to specific tangible assets in the accompanying financial statements. The excess cost over fair value of net assets acquired is being amortized over 25 years using the straight-line method. Amortization expense for the years ended December 31, 2000, 1999 and 1998, amounted to \$114,753, \$111,473 and \$111,170, respectively.

**Use of estimates:**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for losses on loans, the allowance for losses on foreclosed assets, and deferred income taxes. In connection with the determination of the allowances for losses on loans and foreclosed assets, management obtains independent appraisals for significant properties and other assets.

**Note 1. Summary of Significant Accounting Policies (continued)**

Use of estimates: (continued)

While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowances for losses on loans and foreclosed assets. Such agencies may require the Bank to recognize additions to the allowances based on their judgments about information available to them at the time of their examination. Because of these factors, it is reasonably possible that the allowances for losses on loans and foreclosed assets may change materially in the near term.

Cash and cash equivalents:

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, and federal funds sold.

Securities held to maturity:

Bonds, notes, and debentures for which the Bank has the positive intent and ability to hold to maturity are reported at cost, adjusted for premiums and discounts that are recognized in interest income using the interest method over the period to maturity.

Securities available for sale:

Securities available for sale consist of bonds, notes, debentures and certain equity securities not classified as securities held to maturity. Unrealized holding gains and losses, net of tax, on securities available for sale are reported as a net amount in a separate component of stockholders' equity until realized. Gains and losses on the sale of securities available for sale are determined using the specific-identification method. Premiums and discounts are recognized in interest income over the period to maturity.

Securities sold under agreements to repurchase:

Securities sold under agreements to repurchase, which are classified as secured borrowings, generally are repurchased within one to four days from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction. The Company may be required to provide additional collateral based on the fair value of the underlying securities.

**Note 1. Summary of Significant Accounting Policies (continued)****Loans:**

Loans are stated at unpaid principal balances less the allowance for loan losses.

Loans are placed on nonaccrual when a loan is specifically determined to be impaired or when, in the opinion of management, there is an indication that the borrower may be unable to meet payments as they become due. Any unpaid interest previously accrued on those loans is reversed from income. Interest income generally is not recognized on specific impaired loans unless the likelihood of further loss is remote. Interest payments received on such loans are applied as a reduction of the loan principal balance. Interest income on other nonaccrual loans is recognized only to the extent of interest payments received.

The allowance for loan losses is maintained at a level which, in management's judgment, is adequate to absorb credit losses inherent in the loan portfolio. The amount of the allowance is based on management's evaluation of the collectibility of the loan portfolio, including the nature of the portfolio, credit concentrations, trends in historical loss experience, specific impaired loans, and economic conditions. Allowances for impaired loans are generally determined based on collateral values or the present value of estimated cash flows. The allowance is increased by a provision for loan losses, which is charged to expense, and reduced by charge-offs, net of recoveries.

**Foreclosed assets:**

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value 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. Revenue and expenses from operations and changes in the valuation allowance are included in net expenses on foreclosed assets.

**Bank premises and equipment:**

Bank premises and equipment are stated at cost, less accumulated depreciation. Depreciation is computed using the straight-line depreciation method and accelerated depreciation methods for both financial statement purposes and income tax purposes. Bank premises are depreciated over 30 years, and furniture, fixtures and equipment are depreciated over 5 to 12 years.

Additions and major renewals and betterments are capitalized and depreciated over their estimated useful lives. Repairs, maintenance, and minor renewals are charged to operating expense as incurred. When property is replaced or otherwise disposed of, the cost of such assets and the related accumulated depreciation are removed from the accounts. The gain or loss, if any, is recorded in the statement of income.

**Note 1. Summary of Significant Accounting Policies (continued)**

Deferred income taxes:

Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

**Reclassifications:**

Certain amounts in the 1999 and 1998 financial statements have been reclassified to conform with the 2000 presentation.

**Note 2. 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 market value of securities at December 31, 2000 and 1999, is as follows:

	2000			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
Securities available for sale:				
Securities of U.S. Government agencies and corporations	\$ 12,108,747	\$ 181,060	\$ (5,495)	\$ 12,284,312
State and municipal securities	125,000	6,724	--	131,724
Mortgage-backed and other securities	3,978,439	21,380	(18,140)	3,981,679
	----- \$ 16,212,186 =====	----- \$ 209,164 =====	----- \$ (23,635) =====	----- \$ 16,397,715 =====
Securities held to maturity:				
Securities of U.S. Government agencies and corporations	\$ 199,760	\$ --	\$ (57)	\$ 199,703
Mortgage-backed and other securities	3,812,654	8,836	(11,203)	3,810,287
	----- \$ 4,012,414 =====	----- \$ 8,836 =====	----- \$ (11,260) =====	----- \$ 4,009,990 =====

**Note 2. Securities (continued)**

	1999			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
Securities available for sale:				
Securities of U.S. Government agencies and corporations.....	\$ 9,141,183	\$ --	\$ (206,480)	\$ 8,934,703
Mortgage-backed and other securities.....	4,475,836	6,757	(77,990)	4,404,603
	\$ 13,617,019	\$ 6,757	\$ (284,470)	\$ 13,339,306
Securities held to maturity:				
Securities of U.S. Government agencies and corporations.....	\$ 198,436	\$ --	\$ (401)	\$ 198,035
Mortgage-backed and other securities.....	5,524,884	5,559	(57,759)	5,472,684
	\$ 5,723,320	\$ 5,559	\$ (58,160)	\$ 5,670,719

At December 31, 2000 and 1999, securities with a carrying value of approximately \$12,816,000 and \$8,745,000, respectively, were pledged to secure public deposits and for other purposes required or permitted by law. At December 31, 2000 and 1999, the carrying amount of securities pledged to secure repurchase agreements was approximately \$6,226,000 and \$3,628,000, respectively.

The amortized cost and estimated market value of securities at December 31, 2000, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Securities Available For Sale		Securities Held To Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less.....	\$ 1,066,914	\$ 1,067,634	\$ 199,760	\$ 199,703
Due from one year to five years.....	11,196,499	11,371,881	817,792	817,844
Due from five years to ten years....	514,795	521,160	791,136	791,205
Due after ten years.....	3,083,978	3,087,040	2,203,726	2,201,238
	15,862,186	16,047,715	4,012,414	4,009,990
Other securities with no stated maturity.....	350,000	350,000	-	-
	\$16,212,186	\$16,397,715	\$4,012,414	\$4,009,990

**Note 2. Securities (continued)**

There were no sales of securities available for sale in 1999 and 1998. For the year ended December 31, 2000, proceeds from sales of securities available for sale amounted to \$1,020,625. The Bank had gross realized gains of \$25,498 in 2000. There were no gross realized losses in 2000. The tax provision applicable to these net realized gains amounted to \$9,700 in 2000.

**Note 3. Loans and Allowance for Loan Losses**

At December 31, 2000 and 1999, the Bank's loans consist of the following (in thousands):

	2000	1999
	-----	-----
Mortgage loans on real estate:		
Residential 1-4 family.....	\$ 18,666	\$ 17,063
Residential multifamily (5 or more).....	3,133	1,475
Commercial.....	25,496	21,843
Construction.....	9,976	5,560
Second mortgages.....	3,295	4,090
Equity lines of credit.....	2,130	2,289
	-----	-----
	62,696	52,320
	-----	-----
Commercial loans.....	16,209	13,661
	-----	-----
Consumer installment loans:		
Personal.....	5,354	5,427
Credit cards.....	315	918
	-----	-----
	5,669	6,345
	-----	-----
Less: Allowance for loan losses.....	84,574	72,326
	(1,142)	(1,002)
	-----	-----
Loans, net.....	\$ 83,432	\$ 71,324
	=====	=====

**Note 3. Loans and Allowance for Loan Losses (continued)**

A summary of transactions in the allowance for loan losses for the years ended December 31, 2000, 1999 and 1998, is as follows:

	2000 -----	1999 -----	1998 -----
Balance, beginning of year.....	\$1,001,809	\$1,400,000	\$ 915,005
Provision for loan losses.....	559,700	855,000	715,343
Loans charged-off.....	(661,930)	(1,512,047)	(318,041)
Recoveries of loans previously charged-off.....	242,290	258,856	87,693
	-----	-----	-----
Balance, end of year.....	\$1,141,869 =====	\$1,001,809 =====	\$1,400,000 =====

The Bank's only significant concentration of credit at December 31, 2000, occurred in real estate loans which totaled approximately \$62,696,000. While real estate loans accounted for 74 percent of total loans, these loans were primarily residential development and construction loans, residential mortgage loans, and commercial loans secured by commercial properties. Substantially all real estate loans are secured by properties located in Tennessee.

In the normal course of business, the Bank makes loans to executive officers and directors and their affiliates of the Bank on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other borrowers. Loans to executive officers, principal shareholders, and directors and their affiliates were approximately \$1,470,000 and \$1,711,000 at December 31, 2000 and 1999, respectively.

The following is a summary of information pertaining to impaired loans at December 31, 2000 and 1999 (in thousands):

	DECEMBER 31, -----	
	2000 ----	1999 ----
Total impaired loans.....	\$252 ====	\$860 ====
Valuation allowance related to impaired loans..	\$ 25 ----	\$169 ----
	Years Ended December 31, -----	
	2000 ----	1999 ----
Average investment in impaired loans.....	\$377 ====	\$904 ====

**Note 3. Loans and Allowance for Loan Losses (continued)**

Impaired loans without a valuation allowance were insignificant in relation to the Bank's loan portfolio at December 31, 2000 and 1999.

Interest income recognized on impaired loans was insignificant to total interest income on loans for each of the years ending December 31, 2000, 1999 and 1998.

**Note 4. Bank Premises and Equipment**

A summary of bank premises and equipment at December 31, 2000 and 1999, is as follows:

	2000	1999
Land.....	\$1,183,278	\$ 463,278
Buildings and improvements.....	1,744,601	1,249,851
Furniture, fixtures and equipment.....	1,239,284	1,016,765
Work in progress.....	-	136,217
	-----	-----
	4,167,163	2,866,111
Accumulated depreciation.....	(776,025)	(634,932)
	-----	-----
	\$3,391,138	\$2,231,179
	=====	=====

Depreciation expense for the years ended December 31, 2000, 1999 and 1998, amounted to \$221,905, \$161,589 and \$199,944 respectively.

Certain bank facilities and equipment are leased under various operating leases. Total rent expense for the years ended December 31, 2000, 1999 and 1998, was \$144,080, \$108,863, and \$89,657, respectively.

Future minimum rental commitments under noncancelable leases are as follows:

2001.....	\$106,542
2002.....	89,628
2003.....	71,520
2004.....	55,904
2005.....	6,172
	-----
Total.....	\$329,766
	=====

## Note 5. Time Deposits

At December 31, 2000, the scheduled maturities of time deposits are as follows:

2001.....	\$53,952,360
2002.....	5,476,788
2003.....	4,062,294
2004.....	382,799
Thereafter.....	1,303,991
	-----
Total.....	\$65,178,232
	=====

## Note 6. Income Taxes

The Company files a consolidated federal income tax return 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 it was reporting income and expenses to the Internal Revenue Service as a separate entity.

Income tax expense (benefit) in the statement of operations for the years ended December 31, 2000, 1999 and 1998, consists of the following:

	2000	1999	1998
	-----	-----	-----
Current tax expense (benefit).....	\$246,467	\$(379,573)	\$400,566
Deferred tax expense (benefit) related to:			
Provision for loan losses.....	(24,513)	235,688	(199,449)
Net operating loss carryforward.....	58,981	(125,504)	(11,121)
Other.....	41,622	9,110	(38,040)
	-----	-----	-----
Income tax expense (benefit).....	\$322,557	\$(260,279)	\$151,956
	=====	=====	=====

The income tax provision (benefit) is different from the expected tax benefit computed by multiplying income before income tax benefit by the statutory federal income tax rates. The reasons for this difference are as follows:

	2000	1999	1998
	-----	-----	-----
Expected tax at statutory rates.....	\$232,792	\$(228,956)	\$136,097
Increase (decrease) resulting tax effect of:			
State income taxes, net of federal			
tax benefit.....	27,387	(26,667)	16,013
Nondeductible amortization.....	43,606	37,082	35,911
Other.....	18,772	(41,738)	(36,065)
	-----	-----	-----
Income tax expense (benefit).....	\$322,557	\$(260,279)	\$151,956
	=====	=====	=====

**Note 6. Income Taxes (continued)**

At December 31, 2000 and 1999, the Company had net operating loss carryforwards for state tax purposes of approximately \$445,000 and \$1,078,000, respectively. Such net operating loss carryforwards expire in 2014.

As of December 31, 2000, deferred tax assets recognized for deductible temporary differences totaled approximately \$1,270,000 and deferred tax liabilities for taxable temporary differences totaled approximately \$514,000.

**Note 7. Federal Home Loan Bank Advance**

The Company has borrowings under a \$2,000,000 convertible fixed rate advance from the Federal Home Loan Bank of Cincinnati dated December 27, 2000, maturing through 2010. The rate on the advance is 5% and is fixed for two years with the option for the Federal Home Loan Bank to convert the advance at the end of this period to a three-month London Interbank Offer Rate (LIBOR) at a spread of zero basis points to the LIBOR index. Borrowing is collateralized by certain securities of the Company. Interest is payable monthly. In the event that the Federal Home Loan Bank of Cincinnati converts the advance from the fixed rate to the LIBOR rate the Company may prepay the advance in full or part, without fee, on the effective conversion date or the quarterly repricing date.

**Note 8. Employee Benefit Plan**

The Bank has a 401(k) employee benefit plan covering substantially all employees who have completed at least one year of service and met minimum age requirements. The amount of employer contribution is computed annually under a defined formula based primarily on the employees' salaries. The maximum employer required contribution to the plan is 3 percent of the employees' annual salaries. Any additional contribution to the plan is determined at the discretion of the Board of Directors. For the years ended December 31, 2000, 1999 and 1998, total contributions to the plan were \$12,851, \$13,863, and \$10,850, respectively.

**Note 9. Financial Instruments With Off-Balance-Sheet Risk**

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include various commitments to extend credit and standby letters of credit. These instruments expose the Bank to varying degrees of credit and interest rate risk in excess of the amount recognized in the accompanying balance sheet. To manage this risk, the Bank uses the same management policies and procedures for financial instruments with off-balance-sheet risk as it does for financial instruments whose risk is reflected on the balance sheet.

**Note 9. Financial Instruments With Off-Balance-Sheet Risk (continued)**

The credit risk of all financial instruments varies based on many factors, including the value of collateral held and other security arrangements. To mitigate credit risk, the Bank generally determines the need for specific covenant, guarantee, and collateral requirements on a case-by-case basis, depending on the customer's creditworthiness. The amount and type of collateral held to reduce credit risk vary, but may include real estate, machinery, equipment, inventory, and accounts receivable as well as cash on deposit, stocks, bonds, and other marketable securities that are generally held in the Bank's possession. This collateral is valued and inspected to ensure both its existence and adequacy. The Bank requests additional collateral when appropriate.

At December 31, 2000, commitments under standby letters of credit and undisbursed loan commitments aggregated approximately \$15,151,000. The Bank's credit exposure for these financial instruments is represented by their contractual amounts. The Bank does not anticipate any material losses as a result of the commitments under standby letters of credit and undisbursed loan commitments.

**Note 10. Fair Value of Financial Instruments**

Fair value estimates are made at a specific point in time, based on relevant market information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature; involve uncertainties and matters of judgment; and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

Cash and cash equivalents:

For cash and cash equivalents, the carrying amount is a reasonable estimate of fair value.

**Securities:**

The fair value of securities, excluding Federal Home Loan Bank stock, is estimated based on bid prices published in financial newspapers or bid quotations received from securities dealers. The carrying amount of Federal Home Loan Bank stock approximates fair value based on the redemption provisions of the Federal Home Loan Bank.

**Note 10. Fair Value of Financial Instruments (continued)****Loans:**

The fair value of loans is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates, adjusted for credit risk and servicing costs. The estimate of maturity is based on historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of current economic and lending conditions.

**Deposits:**

The fair value of deposits with no stated maturity, such as demand deposits, money market accounts, and savings accounts, is equal to the amount payable on demand. The fair value of time deposits is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities.

Federal funds purchased and securities sold under agreements to repurchase:

The estimated value of these liabilities, which are extremely short term, approximates their carrying value.

Federal Home Loan Bank advances:

Rates currently available to the Bank for debt with similar terms and remaining maturities are used to estimate the fair value of existing debt.

The carrying amount and estimated fair value of the Company's financial instruments at December 31, 2000 and 1999, are as follows (in thousands):

	2000		1999	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<b>Assets:</b>				
Cash and due from banks	\$ 4,634	\$ 4,634	\$ 7,722	\$ 7,722
Federal funds sold	2,400	2,400	-	-
Securities	20,410	20,408	19,063	19,010
Net loans	83,432	83,979	71,324	71,600
<b>Liabilities:</b>				
Noninterest-bearing demand deposits	11,924	11,924	12,412	12,412
Interest-bearing demand deposits	13,688	13,687	12,626	12,626
Savings deposits and money market accounts	10,460	10,460	10,255	10,255
Time deposits	65,178	64,987	56,053	55,883
Federal funds purchased and securities sold under agreements to repurchase	3,144	3,144	2,179	2,179
Federal Home Loan Bank advances	2,000	2,000	-	-

## **Note 11. Contingencies**

During 1999, a third party complaint was filed against the Bank alleging that checks amounting to \$661,500 were deposited into accounts at the Bank under forged endorsements and the third party plaintiff seeks recovery of the funds. During 2000, another third party complaint was filed against the Bank also alleging that checks amounting to \$403,065 were deposited into accounts at the Bank under forged endorsements and the third party plaintiff seeks recovery of the funds. In both instances, the deposit accounts were owned by the same Bank customer. The Bank has filed claims under its forgery bond insurance policy and the insurance company is aggressively defending the Bank against the allegations. Subsequent to December 31, 2000, the Bank and insurance company settled these matters resulting in an insignificant loss to the Bank.

During 1999, the Bank was one of six defendants named in a lawsuit seeking \$3,000,000 in compensatory damages and \$5,000,000 in punitive damages. With respect to the Bank, the lawsuit alleges (1) that the Bank and a Bank employee violated banking obligations to the plaintiffs, who are partners in a limited partnership, by allowing the limited partnership to run large overdrafts in partial consideration for improper benefits given to the Bank employee by the manager of the limited partnership; (2) that the Bank employee influenced another bank to loan funds to the limited partnership at a time that the Bank employee knew of large overdrafts at the Bank; (3) that the Bank carried an overdraft with the limited partnership without notifying the plaintiffs; and (4) that the Bank breached duties owed to the plaintiffs under state common law and state and federal banking laws. The Bank has reviewed the matter with its general counsel and is vigorously defending the lawsuit. Although no assurance can be given with respect to the ultimate outcome of the lawsuit, management believes that the allegations against the Bank are without merit and should not have a material adverse effect on the consolidated financial condition of the Company or the financial condition of the Bank. Accordingly, no provision for this matter has been made in the Company's consolidated financial statements.

The Bank is involved in certain other claims arising from normal business activities. Management believes that those claims are without merit or that the ultimate liability, if any, resulting from them will not materially affect the Bank's financial condition or the Company's consolidated financial position.

## **Note 12. Liquidity and Capital Resources**

The Company's primary source of funds is the receipt of dividends from its subsidiary bank. Banking regulators limit the amount of dividends that the Bank may pay without prior approval of the Bank's regulatory agency. As discussed in Note 14, the Bank cannot pay dividends without specific regulatory approval.

### Note 13. Stock Options and Warrants

The Company 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 150,000 shares of the Bank's common stock. These options were granted for the specific purpose of raising capital. The option price was \$10.00 per share which was the estimated fair value of the stock at the June 30, 1996, grant date. The options expire ten years from the date of grant and were fully vested at the grant date. On October 15, 1997, the Bank stock options were converted to Company stock options. At December 31, 2000, the remaining contractual life of outstanding options was 5.5 years. A summary of the status of this plan is presented below:

	2000		1999		1998	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	140,000	\$10.00	150,000	\$10.00	150,000	\$10.00
Granted	-	-	-	-	-	-
Forfeited	(10,000)	10.00	(10,000)	10.00	-	-
Outstanding at end of year	130,000	\$10.00	140,000	\$10.00	150,000	\$10.00

The Company also has a stock option plan under which officers and employees can be granted up to 55,000 options to purchase shares of the Company's common stock. The options vest at 30 percent on the second and third anniversary of the grant date and 40 percent on the fourth anniversary. There were no shares allocated under this plan during 1998. A summary of the status of this plan is presented below:

	2000		1999	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	16,500	\$15.00	-	\$ -
Granted	19,200	13.00	21,500	15.00
Forfeited	-	-	(5,000)	15.00
Outstanding at end of year	35,700	\$13.92	16,500	\$15.00

**Note 13. Stock Options and Warrants (continued)**

The Company applies APB Opinion 25, ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES, and related Interpretations in accounting for its stock option plan for officers and employees. Accordingly, no compensation cost has been recognized for its fixed price stock option plan. Compensation costs for the Company's stock option plan for officers and employees were insignificant for the years ended December 31, 2000 and 1999.

A stock warrant was issued with each of the 590,130 original shares of the Company's common stock which entitles each stockholder to purchase an additional share of the Company's common stock at a specified price. At December 31, 2000 and 1999, warrants for the purchase of 166,767 shares were outstanding. The exercise price was \$12.00 per share until February 1999 and is \$15.00 per share thereafter. During a certain period of 1999, the Company offered warrants at \$13.00. If not exercised, such warrants will expire five years after issuance. No warrants were exercised in 2000, 157,168 warrants were exercised in 1999, and 134,507 warrants were exercised in 1998.

**Note 14. Regulatory Matters**

The Bank is 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 the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require 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). Management believes, as of December 31, 2000, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2000, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the institution's prompt corrective action category for bank capital.

**Note 14. Regulatory Matters (continued)**

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

	Actual		For Capital Adequacy Purposes	
	Amount	Ratio	Amount	Ratio
As of December 31, 2000:				
Total capital (to risk-weighted assets)	\$10,674	11.9%	\$7,154	8.0%
Tier I capital (to risk-weighted assets)	9,556	10.7%	3,577	4.0%
Tier I capital (to average assets)	9,556	8.4%	9,115	8.0%
As of December 31, 1999:				
Total capital (to risk-weighted assets)	\$ 9,604	12.8%	\$6,015	8.0%
Tier I capital (to risk-weighted assets)	8,663	11.5%	3,008	4.0%
Tier I capital (to average assets)	8,663	8.6%	8,105	8.0%

The Bank is operating under a Memorandum of Understanding (Memorandum) dated November 24, 1998, between the Board of Directors, the Tennessee Department of Financial Institutions, and the Federal Deposit Insurance Corporation. Among other things, the Memorandum provides the following:

- The Board of Directors was required to develop a written management plan that addresses the Bank's plans for size, structure, growth, earnings, services, information systems, personnel, accounting, financial reporting and operating matters.
- The Bank shall maintain a Tier I capital ratio of equal to or greater than 8%.
- The Bank shall not pay dividends without the prior approval of the FDIC.
- The Bank shall report its progress on the actions required by the Memorandum to the FDIC on specific dates.

At December 31, 2000, the Bank continues to operate under the Memorandum and management of the Bank believes that they are conforming to all provisions of the Memorandum.

## Note 15. 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, 2000, 1999 and 1998, is as follows:

	Before-Tax Amount -----	Tax (Expense) Benefit -----	Net-of-Tax Amount -----
Year ended December 31, 2000:			
Unrealized holding gains and losses arising during the period	\$ 518,627	\$ (197,078)	\$ 321,549
Less reclassification adjustment for gains realized in net income	25,498 -----	(9,689) -----	15,809 -----
	\$ 493,129 =====	\$ (187,389) =====	\$ 305,740 =====
Year ended December 31, 1999:			
Unrealized holding gains and losses arising during the period	\$ (358,679)	\$ 136,298	\$ (222,381)
Less reclassification adjustment for gains realized in net income	-- -----	-- -----	-- -----
	(358,679) =====	\$ 136,298 =====	\$ (222,381) =====
Year ended December 31, 1998:			
Unrealized holding gains and losses arising during the period	\$ (5,848)	\$ 2,222	\$ (3,626)
Less reclassification adjustment for gains realized in net income	-- -----	-- -----	-- -----
	\$ (5,848) =====	\$ 2,222 =====	\$ (3,626) =====

## Note 16. Earnings Per Common Share

Basic earnings per share represents income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings 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 the Company relate to outstanding stock options and warrants, determined using the treasury stock method, and redeemable common stock, determined using the reverse treasury stock method.

**Note 16. Earnings Per Common Share (continued)**

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

	2000 ----	1999 ----	1998 ----
Net income (loss)	\$ 362,124	\$(413,123)	\$ 248,332
Less: Preferred stock dividends	-	-	-
	-----	-----	-----
Net income (loss) applicable to common stock	\$ 362,124	\$(413,123)	\$ 248,332
	=====	=====	=====
Average number of common shares outstanding	1,166,129	1,069,411	987,043
Effect of dilutive options	30,000	-	30,000
	-----	-----	-----
Average number of common shares outstanding used to calculate diluted earnings per common share	1,196,129	1,069,411	1,017,043
	=====	=====	=====

**Note 17. Redeemable Common Stock**

At December 31, 1999, the Company was obligated to redeem certain shares of common stock issued in connection with the combination of the Bank of East Ridge with Cornerstone Community Bank on October 15, 1997. Such obligation includes the right of a certain shareholder to sell certain shares of common stock to the Company over a three-year period at \$12.55, \$14.00, and \$16.00 per share in years 1998, 1999, and 2000, respectively. The Company has the option to redeem such shares during the same period at the same prices. During 2000, 1999, and 1998, the Company redeemed 14,844, 19,756, and 27,897 shares, respectively, under this obligation. As of December 31, 2000, all shares have been redeemed.

**Note 18. Condensed Parent Company Financial Statements**

Condensed financial statements of Cornerstone Bancshares, Inc. are summarized as follows:

**CONDENSED BALANCE SHEETS**

	2000 ----	1999 ----
ASSETS		
Cash	\$ 136,432	\$ 475,506
Excess cost over fair value of net assets acquired	2,662,499	2,722,651
Other assets	43,350	196,044
Investment in subsidiary	9,677,620	8,480,172
	-----	-----
Total assets	\$12,519,901	\$11,874,373
	=====	=====

**Note 18. Condensed Parent Company Financial Statements (continued)**

**CONDENSED BALANCE SHEETS (continued)**

	2000 ----	1999 ----
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Other liabilities	\$ 1,740	\$ (19,886)
Total liabilities	1,740	(19,886)
Redeemable common stock	--	237,504
Stockholders' equity:		
Preferred stock; no par value; 2,000,000 shares authorized; no shares issued	--	--
Common stock, \$1.00 par value; 2,000,000 shares authorized; 1,166,129 shares issued and outstanding in 2000 and 1999	1,166,129	1,166,129
Additional paid-in capital	11,322,276	11,128,734
Retained earnings (deficit)	(92,694)	(454,818)
Accumulated other comprehensive income	122,450	(183,290)
Total stockholders' equity	12,518,161	11,656,755
Total liabilities and stockholders' equity	\$ 12,519,901	\$ 11,874,373
	=====	=====

CONDENSED STATEMENTS OF OPERATIONS AND RETAINED EARNINGS

	2000 ----	1999 ----
INCOME		
Equity in subsidiary's earnings	\$ 591,708	\$ (141,071)
Interest income on securities	267	--
Total income	591,975	(141,071)
EXPENSES		
Interest expense	--	74,043
Other operating expenses	254,526	363,914
Total expenses	254,526	437,957
Income (loss) before income tax benefit	337,449	(579,028)
Income tax benefit	(24,675)	(165,905)
NET INCOME (LOSS)	362,124	(413,123)
RETAINED EARNINGS (DEFICIT), beginning of year	(454,818)	(41,695)
RETAINED EARNINGS (DEFICIT), end of year	\$ (92,694)	\$ (454,818)
	=====	=====

**Note 18. Condensed Parent Company Financial Statements (continued)**

**CONDENSED STATEMENTS OF CASH FLOWS**

	2000 ----	1999 ----
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	\$ 362,124	\$ (413,123)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Amortization	60,152	111,473
Equity in earnings of subsidiary	(591,708)	141,071
Changes in other operating assets and liabilities:		
Decrease in accrued interest payable	-	(19,027)
Decrease (increase) in other assets and liabilities	174,320	(395,482)
	-----	-----
Net cash provided by (used in) operating activities	4,888	(575,088)
	-----	-----
CASH FLOWS FROM INVESTING ACTIVITIES		
Additional capitalization of subsidiary	(300,000)	-
	-----	-----
CASH FLOWS FROM FINANCING ACTIVITIES		
Principal paid on notes payable	-	(1,250,000)
Redemption of common stock	(237,504)	(270,928)
Issuance of common stock	193,542	2,568,588
	-----	-----
Net cash provided by (used in) financing activities	(43,962)	1,047,660
	-----	-----
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(339,074)	472,572
CASH AND CASH EQUIVALENTS, beginning of year	475,506	2,934
	-----	-----
CASH AND CASH EQUIVALENTS, end of year	\$ 136,432	\$ 475,506
	=====	=====
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash paid during the period for interest	\$ -	\$ 93,070
	=====	=====

**CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2000 and 1999**

**Note 20. Quarterly Data (unaudited)**

	Years Ended December 31,			
	2000			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest income	\$ 2,438,482	\$ 2,452,205	\$ 2,354,441	\$ 2,176,465
Interest expense	1,228,295	1,156,391	1,048,185	949,467
Net interest income	1,210,187	1,295,814	1,306,256	1,226,998
Provision for loan losses	55,200	90,000	256,000	158,500
Net interest income, after provision for loan losses	1,154,987	1,205,814	1,050,256	1,068,498
Noninterest income	183,816	184,089	137,687	159,591
Noninterest expenses	1,063,230	1,120,293	1,173,644	1,102,890
Income (loss) before income taxes	275,573	269,610	14,299	125,199
Provision for income taxes	135,679	144,500	18,154	24,224
Net income (loss)	\$ 139,894	\$ 125,110	\$ (3,855)	\$ 100,975
Earnings per common share:				
Basic	\$ 0.12	\$ 0.11	\$ -	\$ 0.08
Diluted	\$ 0.12	\$ 0.10	\$ -	\$ 0.08

  

	Years Ended December 31,			
	1999			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest income	\$ 2,002,689	\$ 1,968,741	\$ 1,824,432	\$ 1,891,607
Interest expense	902,511	879,658	901,369	959,947
Net interest income	1,100,178	1,089,083	923,063	931,660
Provision for loan losses	95,000	105,000	605,000	50,000
Net interest income, after provision for loan losses	1,005,178	984,083	318,063	881,660
Noninterest income	146,486	151,581	158,566	128,209
Noninterest expenses	1,156,306	1,090,420	1,209,219	991,283
Income (loss) before income taxes	(4,642)	45,244	(732,590)	18,586
Provision for income taxes	(109,715)	(58,957)	(113,475)	21,868
Net income (loss)	\$ 105,073	\$ 104,201	\$ (619,115)	\$ (3,282)
Earnings per common share:				
Basic	\$ 0.09	\$ 0.09	\$ (0.56)	\$ (0.01)
Diluted	\$ 0.08	\$ 0.08	\$ (0.56)	\$ (0.01)

**REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS  
ON ACCOMPANYING INFORMATION**

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

Our report on our audits of the basic financial statements of Cornerstone Bancshares, Inc. and subsidiary for 2000, 1999 and 1998 appears on page 1. Those audits were made for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information shown on pages 29 and 30 is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and cash flows of the individual companies. The consolidating information has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

Chattanooga, Tennessee  
January 12, 2001

**CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY**

**CONSOLIDATING BALANCE SHEET**

December 31, 2000

	Cornerstone Community Bank -----	Cornerstone Bancshares, Inc. -----	Eliminations -----	Consolidated -----
<b>ASSETS</b>				
Cash and due from banks	\$ 4,633,514	\$ 136,432	\$ 136,432	\$ 4,633,514
Federal funds sold	2,400,000	-	-	2,400,000
Securities available for sale	16,397,715	-	-	16,397,715
Securities held to maturity	4,012,414	-	-	4,012,414
Loans, net of allowance for loan losses	83,431,776	-	-	83,431,776
Bank premises and equipment, net	3,391,138	-	-	3,391,138
Accrued interest receivable	849,142	-	-	849,142
Excess cost over fair value of net assets acquired	-	2,662,499	-	2,662,499
Other assets	1,557,207	43,350	-	1,600,557
Investment in subsidiary	-	9,677,620	9,677,620	-
	-----	-----	-----	-----
<b>Total assets</b>	<b>\$ 116,672,906</b>	<b>\$ 12,519,901</b>	<b>\$ 9,814,052</b>	<b>\$ 119,378,755</b>
	=====	=====	=====	=====
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>				
<b>Deposits:</b>				
Noninterest-bearing demand deposits	\$ 12,060,572	\$ -	\$ 136,432	\$ 11,924,140
Interest-bearing demand deposits	13,687,959	-	-	13,687,959
Savings deposits and money market accounts	10,459,568	-	-	10,459,568
Time deposits of \$100,000 or more	16,911,729	-	-	16,911,729
Time deposits under \$100,000	48,266,503	-	-	48,266,503
	-----	-----	-----	-----
<b>Total deposits</b>	<b>101,386,331</b>	<b>-</b>	<b>136,432</b>	<b>101,249,899</b>
	-----	-----	-----	-----
Accrued interest payable	183,834	-	-	183,834
Federal funds purchased and securities sold under agreements to repurchase	3,144,291	-	-	3,144,291
Federal Home Loan Bank advance	2,000,000	-	-	2,000,000
Other liabilities	280,830	1,740	-	282,570
	-----	-----	-----	-----
<b>Total liabilities</b>	<b>106,995,286</b>	<b>1,740</b>	<b>136,432</b>	<b>106,860,594</b>
	-----	-----	-----	-----
<b>Stockholders' equity:</b>				
Preferred stock	-	-	-	-
Common stock	590,130	1,166,129	590,130	1,166,129
Additional paid-in capital	-	11,322,276	-	11,322,276
Surplus	8,162,448	-	8,162,448	-
Retained earnings (deficit)	802,592	(92,694)	802,592	(92,694)
Accumulated other comprehensive income	122,450	122,450	122,450	122,450
	-----	-----	-----	-----
<b>Total stockholders' equity</b>	<b>9,677,620</b>	<b>12,518,161</b>	<b>9,677,620</b>	<b>12,518,161</b>
	-----	-----	-----	-----
<b>Total liabilities and stockholders' equity</b>	<b>\$ 116,672,906</b>	<b>\$ 12,519,901</b>	<b>\$ 9,814,052</b>	<b>\$ 119,378,755</b>
	=====	=====	=====	=====

**CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY**

**CONSOLIDATING STATEMENT OF OPERATIONS**  
**Year Ended December 31, 2000**

	Cornerstone Community Bank	Cornerstone Bancshares, Inc.	Eliminations	Consolidated
	-----	-----	-----	-----
<b>INTEREST INCOME</b>				
Loans	\$ 7,977,863	\$ -	\$ -	\$ 7,977,863
Securities	1,382,181	267	-	1,382,448
Federal funds sold	61,282	-	-	61,282
	-----	-----	-----	-----
Total interest income	9,421,326	267	-	9,421,593
	-----	-----	-----	-----
<b>INTEREST EXPENSE</b>				
Time deposits of \$100,000 or more	955,612	-	-	955,612
Other deposits	3,226,911	-	-	3,226,911
Federal funds purchased and securities sold under agreements to repurchase	198,722	-	-	198,722
Federal Home Loan Bank advance	1,093	-	-	1,093
	-----	-----	-----	-----
Total interest expense	4,382,338	-	-	4,382,338
	-----	-----	-----	-----
Net interest income before provision for loan losses	5,038,988	267	-	5,039,255
	-----	-----	-----	-----
Provision for loan losses	559,700	-	-	559,700
	-----	-----	-----	-----
Net interest income after provision for loan losses	4,479,288	267	-	4,479,555
	-----	-----	-----	-----
<b>NONINTEREST INCOME</b>				
Service charges	502,504	-	-	502,504
Other noninterest income	54,774	-	-	54,774
Net gains from sale of loans and securities	107,905	-	-	107,905
Equity in subsidiary's earnings	-	591,708	(591,708)	-
	-----	-----	-----	-----
Total noninterest income	665,183	591,708	(591,708)	665,183
	-----	-----	-----	-----
<b>NONINTEREST EXPENSES</b>				
Salaries and employee benefits	2,173,199	-	-	2,173,199
Net occupancy and equipment expense	293,971	-	-	293,971
Other operating expenses	1,738,361	254,526	-	1,992,887
	-----	-----	-----	-----
Total noninterest expenses	4,205,531	254,526	-	4,460,057
	-----	-----	-----	-----
Income (loss) before income tax expense (benefit)	938,940	337,449	(591,708)	684,681
	-----	-----	-----	-----
Income tax expense (benefit)	347,232	(24,675)	-	322,557
	-----	-----	-----	-----
Net income (loss)	\$ 591,708	\$ 362,124	\$ (591,708)	\$ 362,124
	=====	=====	=====	=====

F-30

**End of Filing**

Powered By **EDGAR**  
Online

© 2005 | EDGAR Online, Inc.