

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

FORM 10-K

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

For the fiscal year ended December 31, 2008

OR

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

For transition period from _____ to _____

Commission file number 000-30497



(Exact Name of Registrant as Specified in its Charter)

Tennessee
(State of Incorporation)

62-1173944

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

**835 Georgia Avenue,
Chattanooga, TN 37402**

(Address of principal executive offices)(Zip Code)

(423) 385-3000

(Registrant's telephone number, including area code)

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

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

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

Yes No

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

Yes No

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

Yes No

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

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

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

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

Yes No

The aggregate market value of the common stock held by non-affiliates of the Registrant on June 30, 2008 was \$38 million. The market value calculation was determined using the closing sale price of the Registrant's common stock on June 30, 2008, as reported on the Over the Counter ("OTC") Bulletin Board. For purposes of this calculation, the term "affiliate" refers to all directors, executive officers and 10% shareholders of the Registrant. As of the close of business on December 31, 2008 there were 6,319,718 shares of the Registrant's common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Proxy Statement for the 2009 Annual Meeting of Shareholders (the "2009 Proxy Statement") are incorporated by reference into Part III of this Annual Report on Form 10-K to the extent described herein.

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FORWARD-LOOKING STATEMENTS

Cornerstone Bancshares, Inc. (“Cornerstone”) may from time to time make written or oral statements, including statements contained in this report which may constitute forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 (the “Exchange Act”). The words “expect,” “anticipate,” “intend,” “consider,” “plan,” “believe,” “seek,” “should,” “estimate,” and similar expressions are intended to identify such forward-looking statements, but other statements may constitute forward-looking statements. These statements should be considered subject to various risks and uncertainties. Such forward-looking statements are made based upon management’s belief as well as assumptions made by, and information currently available to, management pursuant to “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995. Cornerstone’s actual results may differ materially from the results anticipated in forward-looking statements due to a variety of factors. Such factors include, without limitation, those specifically described in Item 1A of Part I of this Annual Report on Form 10-K, as well as the following: (i) unanticipated deterioration in the financial condition of borrowers resulting in significant increases in loan losses and provisions for those losses, (ii) increased competition with other financial institutions, (iii) lack of sustained growth in the economy in the Chattanooga, Tennessee area, (iv) rapid fluctuations or unanticipated changes in interest rates, (v) the inability of our bank subsidiary, Cornerstone Community Bank, to satisfy regulatory requirements for its expansion plans, (vi) the inability of Cornerstone to achieve its targeted expansion goals in the Knoxville, Tennessee and Dalton, Georgia markets, (vii) the inability of Cornerstone to grow its loan portfolio at historic or planned rates and (viii) changes in the legislative and regulatory environment, including compliance with the various provisions of the Sarbanes-Oxley Act of 2002. Many of such factors are beyond Cornerstone’s ability to control or predict, and readers are cautioned not to put undue reliance on such forward-looking statements. Cornerstone does not intend to update or reissue any forward-looking statements contained in this report as a result of new information or other circumstances that may become known to Cornerstone.

PART I

ITEM 1. BUSINESS

OVERVIEW

Cornerstone was incorporated on September 19, 1983 under the laws of the State of Tennessee 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. It has two wholly-owned subsidiaries: 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, and Eagle Financial Inc., a Tennessee corporation ("Eagle"), created December 1, 2005 with the assets acquired from Eagle Financial, LLC, a Tennessee limited liability company, and Eagle Funding, LLC, a Nevada limited liability company.

Cornerstone

The primary activity of Cornerstone currently is, and is expected to remain for the foreseeable future, the ownership and operation of the Bank. As a bank holding company, Cornerstone intends to facilitate the Bank's ability to serve its customers' requirements for financial services. The holding company structure also provides flexibility for expansion through the possible acquisition of other financial institutions and the provision of additional banking-related services, as well as certain non-banking services, which a traditional commercial bank may not provide under present laws. The holding company structure also affords additional flexibility in terms of capital formation and financing opportunities.

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

The Bank

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

At December 31, 2008, the Bank had 5 full-service banking offices located in Hamilton County, Tennessee.

During 2007, the Bank established two loan production offices ("LPO"). The first LPO opened by the Bank is located in Dalton, Georgia. The LPO, which is located in Whitfield County, Georgia, expanded the Bank's presence in North Georgia. The second LPO is located in Knoxville, Tennessee. The Knoxville LPO offers a new market for the Bank to compete for loans.

Eagle

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

Employees

As of December 31, 2008, Cornerstone had 121 full-time equivalent employees. The employees are not represented by a collective bargaining unit. Cornerstone believes that its relationship with its employees is good.

Competition

All phases of the Bank's banking activities are highly competitive. The Bank competes actively with 24 commercial banks, as well as finance companies, credit unions, and other financial institutions located in its service area, which includes Hamilton County, Tennessee.

The Bank's deposits totaled approximately \$327 million as of December 31, 2008. The deposit base represents approximately 5.5% of the deposit base in the Hamilton County Tennessee Metropolitan Statistical Area. Three major regional banks represent approximately 74% of the deposits in the Hamilton County Tennessee MSA. These larger financial institutions have greater resources, higher lending limits than the Bank, and each of the three institutions has over 20 branches in the Hamilton County MSA. There are also several credit unions located in Hamilton County. Credit unions are not subject to the same income tax structure as commercial banks. This advantage enables credit unions to offer competitive rates to potential customers. The Bank also faces competition in certain areas of its business from mortgage banking companies, consumer finance companies, insurance companies, money market mutual funds and investment banking firms, some of which are not subject to the same degree of regulation as the Bank.

The Bank competes for deposits principally by offering depositors a variety of deposit programs with competitive interest rates, quality service and convenient locations and hours. The Bank 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

Cornerstone is a bank holding company within the meaning of the Bank Holding Company Act of 1956, as amended (the "Act") and is registered with and regulated by the Board of Governors of the Federal Reserve System (the "Board"). Cornerstone 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 Cornerstone and its subsidiaries. Cornerstone is also required to comply with the rules and regulations of the Securities and Exchange Commission (the "Commission") under federal securities laws.

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

Federal and state banking laws and regulations govern all areas of the operation of Cornerstone and the Bank, including reserves, loans, mortgages, capital, issuance of securities, payment of dividends and establishment of branches. Federal and state banking agencies also have the general authority to limit the dividends paid by insured banks if such payments should be deemed to constitute an unsafe or unsound banking practice. 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.

FDIC Insurance of Deposit Accounts

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

Subsequent to the enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), the FDIC issued risk-based bank capital guidelines which went into effect in stages through 1992. In accordance with the FDIC's risk-based standards, an institution's assets and off-balance sheet activities are categorized into one of four risk categories, with either a 0%, 20%, 50%, or 100% amount of capital to be held against these assets. In addition, the guidelines divide capital instruments into Tier 1 (core) capital and Tier 2 (supplementary) capital. The risk-based capital adequacy guidelines require that (i) Tier 1 capital equal or exceed 4% of risk-weighted assets; (ii) Tier 2 capital may not exceed 100% of Tier 1 capital, although certain Tier 2 capital elements are subject to additional limitations; (iii) assets and off-balance sheet items must be weighted according to risk; and (iv) the total capital to risk-weighted assets ratio must be at least 8.0%. The FDIC's current leverage capital requirement requires banks receiving the highest regulatory rating based upon the FDIC's routine examination process, to maintain Tier 1 capital equal to 3.0% of the bank's total assets. 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.

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

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

Although the Bank is not a member of the Federal Reserve System, it is subject to 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.

State of Tennessee Supervision and Regulation

As a State of 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 to, and receive the approval of, the TDFI before opening a new branch office or merging with another financial institution. The Commissioner of the TDFI has the authority to enforce state laws and regulations by ordering a director, officer or employee of the Bank to cease and desist from violating a law or regulation or from engaging in unsafe or unsound banking practices.

Tennessee law contains limitations on the interest rates that may be charged on various types of loans and restrictions on the nature and amount of loans that may be granted and on the type of investments which may be made. The operations of banks are also affected by various consumer laws and regulations, including those relating to equal credit opportunity and regulation of consumer lending practices. All Tennessee banks, including the Bank, must become and remain insured under the FDIA.

State banks are subject to regulation by the TDFI with regard to capital requirements and the payment of dividends. Tennessee has adopted the provisions of the 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

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

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

In addition to the banking regulations imposed on Cornerstone, the securities of Cornerstone are not exempt from the federal and state securities laws as are the securities of the Bank. Accordingly, an offering of Cornerstone'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 the 1970 Amendments to the Act (12 U.S.C. § 1972), the Bank is prohibited from extending credit, selling or leasing property or furnishing any service to any customer on the condition or requirement that the customer (i) obtain any additional property, service or credit from 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 Cornerstone, the Bank or any subsidiary of Cornerstone; or (iii) provide any credit, property or service to Cornerstone, the Bank (other than those related to and usually provided in connection with a loan, discount, deposit or trust service) or any subsidiary of Cornerstone.

Most bank holding companies are required to give the 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 that 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.

Legislation Affecting Cornerstone and the Bank

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

FIRREA and FDICIA

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

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

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

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

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

Gramm-Leach-Bliley Act

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

Temporary Liquidity Guarantee Program

On November 21, 2008, the Board of Directors of the FDIC adopted a final rule relating to the Temporary Liquidity Guarantee Program (“TLGP”). The TLGP was announced by the FDIC on October 14, 2008, preceded by the determination of systemic risk by the U.S. Treasury, as an initiative to counter the system-wide crisis in the nation’s financial sector. Under the TLGP, the FDIC will (i) guarantee, through the earlier of maturity or June 30, 2012, certain newly issued senior unsecured debt issued by participating institutions and (ii) provide unlimited FDIC deposit insurance coverage for noninterest bearing transaction deposit accounts, Negotiable Order of Withdrawal Accounts (commonly known as NOW accounts) paying less than 0.5% interest per annum and Interest on Lawyers Trust Accounts (commonly known as IOLTA) held at participating FDIC-insured institutions through December 31, 2009. Coverage under the TLG Program was available for the first 30 days without charge. The fee assessment for coverage of senior unsecured debt ranges from 50 basis points to 100 basis points per annum, depending on the initial maturity of the debt. The fee assessment for deposit insurance coverage is 10 basis points per quarter on amounts in covered accounts exceeding \$250,000. The Bank elected to participate in the unlimited deposit insurance coverage for noninterest bearing transaction deposit accounts, but declined to participate in the senior unsecured debt guarantee coverage.

Future Legislation

Legislation is 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. Such legislation may change banking statutes and the operating environment of Cornerstone and/or the Bank in substantial and unpredictable ways and could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance, depending upon whether any of this potential legislation will be enacted and, if enacted, the effect that it or any implementing regulations would have on the financial condition or results of operations of Cornerstone and/or the Bank. With the recent enactments of the EESA and the ARRA, the nature and extent of future legislative and regulatory changes affecting financial institutions is uncertain. It cannot be predicted whether or what form any proposed legislation will be adopted or the extent to which the business of Cornerstone and/or the Bank may be affected thereby.

ITEM 1A. RISK FACTORS

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

Cornerstone’s business strategy includes expansion into new markets and the development of new products.

Cornerstone intends to continue pursuing a growth strategy for its business through acquisitions and de novo branch openings. Cornerstone’s prospects must be considered in light of the risks, expenses and difficulties occasionally encountered by financial services companies in growth stages, which may include the following:

- maintaining loan quality;
- maintaining adequate management personnel and information systems to oversee such growth; and
- maintaining adequate internal control and compliance functions.

Cornerstone may face risks with respect to future expansion.

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

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

Cornerstone may incur substantial costs to expand. There can be no assurance that integration efforts for any future mergers or acquisitions will be successful. Also, Cornerstone may issue equity securities, including common stock and securities convertible into shares of Cornerstone's common stock in connection with future acquisitions, which could cause ownership and economic dilution to Cornerstone's shareholders. There is no assurance that, following any future mergers or acquisitions, Cornerstone's integration efforts will be successful or after giving effect to the acquisition, will achieve profits comparable to or better than its historical experience.

Cornerstone is subject to the success of the local economies where it operates.

With the exception of the Bank's loan production office in Knoxville, Tennessee substantially all of our loan and deposit customers live, work and bank in the Chattanooga, TN MSA. Cornerstone's success depends upon a sound local economy to provide opportunities for new business ventures, increased loan demand and the need for deposit services. Cornerstone's profit is impacted by these local factors as well as general economic conditions and interest rates. For example, Cornerstone's earnings could be impacted by changes in population, income levels, deposits and housing starts. Adverse economic conditions in specific market areas could reduce Cornerstone's growth rate and affect the ability of its customers to repay their loans. Secondly, adverse market conditions could affect the market value of the real estate or other collateral securing Cornerstone's loan portfolio. Sustained periods of increased payment delinquencies, foreclosures or losses in the State of Tennessee or the State of Georgia could adversely affect the value of the collateral and potentially affect Cornerstone's assets, revenues, results of operations and financial condition.

Impact of recent negative developments in the financial services industry and U.S. and global credit markets may adversely impact Cornerstone's operations and results.

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

There can be no assurance that recently enacted legislation will stabilize the U.S. financial system.

Under the Temporary Liquidity Guarantee Program (“TLGP”) the FDIC may offer a guarantee of certain financial institution indebtedness in exchange for an insurance premium to be paid to the FDIC by issuing financial institutions. Participation in the TLGP likely will require the payment of additional insurance premiums to the FDIC. We may be required to pay higher FDIC premiums than those published for 2009 because market developments have depleted the deposit insurance fund of the FDIC and reduced the ratio of reserves to insured deposits. The U.S. Congress enacted the Emergency Economic Stabilization Act of 2008 (“EESA”) in response to the impact of the volatility and disruption in the capital and credit markets on the financial sector. The U.S. Department of the Treasury (“U.S. Treasury”) and the federal banking regulators are implementing a number of programs under this legislation that are intended to address these conditions and the asset quality, capital and liquidity issues they have caused for certain financial institutions and to improve the general availability of credit for consumers and businesses. In addition, the U.S. Congress recently enacted the American Recovery and Reinvestment Act of 2009 (“ARRA”) in an effort to save and create jobs, stimulate the U.S. economy and promote long-term growth and stability. There can be no assurance as to the actual impact that the TLGP, the EESA, the ARRA and their implementing regulations, the FDIC programs, or any other governmental program will have on the financial markets. The failure of the TLGP, the EESA, the ARRA, the FDIC or the U.S. government to stabilize the financial markets and a continuation or worsening of current financial market conditions could materially and adversely affect Cornerstone’s business, financial condition, results of operations, access to credit and/or the trading price of Cornerstone’s common stock.

Cornerstone may require additional capital which may not be able to be obtained.

Cornerstone may require capital from sources other than earnings generation. These additional sources may include additional equity investments, trust preferred offerings, borrowed funds or any combination of these sources of funds. Cornerstone’s ability to access these alternative capital sources may be limited due to regulatory restrictions or the condition of the capital markets. Therefore, Cornerstone’s ability to enact a bank acquisition, increase its loan portfolio or expand its branch network may be impaired.

Cornerstone is subject to Federal and State regulations that impact its operations and financial performance.

Cornerstone is subject to examinations and supervision from both federal and state regulatory agencies. These agencies require compliance with numerous banking regulations. These regulations increase costs and require human and information technology resources to comply. Certain activities of Cornerstone such as the payment of dividends, investments, acquisitions, and branching are impacted by these regulations.

The laws and regulations applicable to the banking industry are subject to change at any time. Cornerstone cannot predict the events that will result in regulatory changes nor their impact on the banking industry and Cornerstone’s earnings.

Cornerstone operates in a highly regulated industry and is subject to examination, supervision, and comprehensive regulation by various federal and state agencies including the Board, the FDIC and the TDFI. Cornerstone’s regulatory compliance is costly and restricts and regulates certain of its activities, including payment of dividends, mergers and acquisitions, investments, loans and interest rates charged, interest rates paid on deposits and locations of offices. Cornerstone is also subject to capitalization guidelines established by its regulators, which require it to maintain adequate capital to support its growth.

The laws and regulations applicable to the banking industry could change at any time, and Cornerstone cannot predict the effects of these changes on its business and profitability. Because government regulation greatly affects the business and financial results of all commercial banks and bank holding companies, Cornerstone’s cost of compliance could adversely affect its ability to operate profitably.

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

Cornerstone could experience declines or losses in earnings if asset quality declines.

Cornerstone’s assets are primarily comprised of loans. If the Bank’s loan customers fail to repay their loans in accordance with the terms of the loan agreement, the Bank’s earnings would be negatively impacted. To minimize the likelihood of a substandard loan portfolio the Bank assesses the credit worthiness of a customer as well as performing collateral valuations. An allowance for loan losses is also maintained in an attempt to address the various risks involved with lending. In determining the amount of the allowance, Cornerstone relies on an analysis of the loan portfolio based on volume and types of loans, internal loan classifications, delinquency trends, local and economic conditions and other pertinent information. Negative changes in these valuation methods would result in a decline in asset quality. Any increase in Cornerstone’s allowance for loan losses would have a negative impact on earnings.

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

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

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

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

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

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

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

Changes in interest rates may affect Cornerstone's level of interest income, the primary component of its gross revenue, as well as the level of its interest expense. Interest rates are highly sensitive to many factors that are beyond Cornerstone's control, including general economic conditions and the policies of various governmental and regulatory authorities. Accordingly, changes in interest rates could decrease Cornerstone's net interest income. Changes in the level of interest rates also may negatively affect Cornerstone's ability to originate real estate loans, the value of its assets and the ability to realize gains from the sale of its assets, all of which ultimately affects earnings. Recent economic events have prompted the Federal Reserve to reduce its federal funds rate. Due to the rapid decline in interest rates, the Bank was unable to recalibrate its liabilities at the same rate at which loan rates declined. As a result, the net interest margin was impacted negatively during 2008 and will continue into 2009. If the Federal Reserve's federal funds rate remains at extremely low levels or does not increase above the Bank's interest rate floors, Cornerstone's funding costs may increase which will negatively impact the net interest margin and Cornerstone's financial performance.

Cornerstone relies heavily on the services of key personnel.

Cornerstone relies on the strategies and management services of Gregory B. Jones, its Chairman of the Board and Chief Executive Officer. Although Cornerstone has entered into an employment agreement with Mr. Jones, the loss of his services could have a material adverse effect on Cornerstone's business, results of operations and financial condition. Cornerstone is also dependent on certain other key officers who have important customer relationships or are instrumental to its lending and depository operations. Changes in key personnel and their responsibilities may be disruptive to operations and could have a material adverse effect on Cornerstone's financial condition and earnings. Cornerstone believes that its future results will also depend upon its ability to attract and retain highly skilled and qualified personnel, particularly in those areas where Cornerstone may open new branches.

Cornerstone's recent results may not be indicative of its future results.

Cornerstone may not be able to sustain its historical rate of growth or could experience very limited or no increase in assets at all. Various factors, such as the general economic environment, interest rates, regulatory and legislative considerations and competition, may also impede or prohibit Cornerstone's ability to expand its market presence.

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

As a Tennessee corporation, Cornerstone is subject to various legislative acts which impose restrictions on and require compliance with procedures designed to protect shareholders against unfair or coercive mergers and acquisitions. These statutes may delay or prevent offers to acquire Cornerstone and increase the difficulty of consummating any such offers, even if the acquisition would be in its shareholders' best interests. Cornerstone's amended and restated charter also contains provisions which may make it difficult for another entity to acquire it without the approval of a majority of the disinterested directors on its board of directors. Secondly, the amount of common stock owned by, and other compensation arrangements with, Cornerstone's officers and directors may make it more difficult to obtain shareholder approval of potential takeovers that they oppose. As of March 2, 2009, directors and executive officers beneficially owned approximately 16.8% of Cornerstone's common stock. Agreements with Cornerstone's senior management also provide for significant payments under certain circumstances following a change in control. These compensation arrangements, together with the common stock and option ownership of Cornerstone's board of directors and management, could make it difficult or expensive to obtain majority support for shareholder proposals or potential acquisition proposals that the board of directors and officers oppose.

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

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

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

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

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

In order to maintain capital at desired or required regulatory levels, Cornerstone's board of directors may decide from time to time to issue additional shares of common stock, or securities convertible into, exchangeable for or representing rights to acquire shares of its common stock. The sale of these shares may significantly dilute the book value per share of its common stock. New investors in the future may also have rights, preferences and privileges senior to its current shareholders which may adversely impact its current shareholders.

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

Cornerstone derives the majority of its income from dividends on the shares of common stock of the Bank and Eagle. The ability of the Bank and Eagle to declare and pay dividends is limited by its obligations to maintain sufficient capital and by other general restrictions on its dividends that are applicable to banks that are regulated by the FDIC and the Department of Financial Institutions. In addition, the Board may impose restrictions on Cornerstone's ability to pay dividends on its common stock. As a result, Cornerstone cannot assure its shareholders that it will declare or pay dividends on shares of its common stock in the future.

ITEM 1B. UNRESOLVED STAFF COMMENTS

There are no written comments from the Commission staff regarding our periodic or current reports under the Exchange Act which remain unresolved.

ITEM 2. PROPERTIES

As of December 31, 2008, the principal offices of Cornerstone are located at 835 Georgia Avenue, Chattanooga, Tennessee 37402. In addition, the Bank operates five full-service branches and two loan production offices that are located at:

Branches	4154 Ringgold Road, East Ridge, Tennessee 5319 Highway 153, Hixson, Tennessee 2280 Gunbarrel Road, Chattanooga, Tennessee 8966 Old Lee Highway, Ooltewah, Tennessee 835 Georgia Avenue, Chattanooga, Tennessee
Loan Production Offices	202 West Crawford Street, Dalton, Georgia 9724 Kingston Pike Suite 305B Knoxville, Tennessee

The Georgia Avenue facility located in downtown Chattanooga, Tennessee serves as a branch location for the Bank's customers as well as Cornerstone's Executive offices. The Bank owns the properties located at 2280 Gunbarrel Road, 4154 Ringgold Road, 5319 Highway 153 and 8966 Old Lee Highway. The Bank also owns a vacant building and lot at 103 S. Campbell Station Road Knoxville, TN. The Bank intends to renovate the structure into a full service branch opening in 2010. Cornerstone operates a service center to facilitate all of its non-customer contact functions located at 6401 Lee Corners, Suite 119, Chattanooga, Tennessee.

ITEM 3. LEGAL PROCEEDINGS

As of the end of 2008, neither Cornerstone, the Bank nor Eagle was involved in any material litigation. The Bank is periodically involved as a plaintiff or defendant in various legal actions in the ordinary course of its business. Management believes that any claims pending against Cornerstone or its subsidiaries are without merit or that the ultimate liability, if any, resulting from them will not materially affect the Bank's or Eagle's financial condition or Cornerstone's consolidated financial position.

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

No matters were submitted during the fourth quarter of 2008 to a vote of security holders of Cornerstone through a solicitation of proxies or otherwise.

PART II

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

On February 20, 2009, Cornerstone had 6,319,718 shares of common stock outstanding. Cornerstone's common stock is quoted on the OTC Bulletin Board but is not listed on a national securities exchange. There are ten market makers who provide a market for Cornerstone's common stock.

There were approximately 549 holders of record of the common stock as of December 31, 2008. This number does not include shareholders with shares in nominee name held by DTC. As of the end of 2008, there were 3,728,120 shares held in nominee name by DTC. Cornerstone paid quarterly cash dividends in 2008 in the amount of \$0.07 per share. Cornerstone announced, in November 2008, a first quarter 2009 dividend of \$0.07, which was paid on January 5, 2009. Cornerstone's board of directors will continue to evaluate the amount of future dividends, if any, after capital needs required for expected growth of assets are reviewed. The payment of dividends is solely within the discretion of the board of directors, considering Cornerstone's expenses, the maintenance of reasonable capital and risk reserves, and appropriate capitalization requirements for state banks.

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

TABLE 1

High and Low Common Stock Share Price for the Company			Dividends paid
2009 Fiscal Year	Low	High	Per Share
First Quarter (through Feb. 24, 2009)	\$ 3.76	\$ 6.00	\$.07
2008 Fiscal Year			
First Quarter	\$ 7.99	\$ 10.90	\$ 0.07
Second Quarter	\$ 5.85	\$ 8.95	\$ 0.07
Third Quarter	\$ 5.25	\$ 7.25	\$ 0.07
Fourth Quarter	\$ 4.75	\$ 6.00	\$ 0.07
2007 Fiscal Year			
First Quarter	\$ 14.25	\$ 16.50	\$ 0.05
Second Quarter	\$ 14.30	\$ 15.30	\$ 0.05
Third Quarter	\$ 10.95	\$ 14.50	\$ 0.05
Fourth Quarter	\$ 10.05	\$ 12.40	\$ 0.05

Table 2 presents information regarding the equity compensation plans under which equity securities of Cornerstone are authorized for issuance. For further information relating to Cornerstone's equity compensation plans, see Item 12 of this report.

TABLE 2

Equity Compensation Plan Year Ended December 31, 2008			
Plan category	Number of securities to be issued upon exercise of outstanding options	Weighted average exercise price of outstanding options	Number of securities remaining available for future issuance
Equity compensation plans approved by security holders:	837,225	\$ 7.03	567,525
Equity compensation plans not approved by security holders:	-	-	80,000
Total	837,225	\$ 7.03	647,525

ITEM 6. SELECTED FINANCIAL DATA

Table 3 presents selected financial data for the periods indicated (amounts in thousands).

TABLE 3

	At and for the Fiscal Years Ended December 31,				
	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Total interest income	\$ 30,680	\$ 34,784	\$ 29,158	\$ 20,672	\$ 14,058
Total interest expense	12,698	14,414	10,306	6,077	3,575
Net interest income	17,982	20,370	18,852	14,594	10,483
Provision for loan losses	3,498	10,409	1,106	1,401	840
Net interest income after provision for loan losses	14,484	9,961	17,746	13,193	9,643
Noninterest income:					
Investment securities gains	—	—	—	—	—
Other income	1,892	1,695	2,111	1,904	1,405
Noninterest expense	12,568	10,926	10,718	8,216	6,885
Income before income taxes	3,808	730	9,139	6,881	4,163
Income tax expense / (benefit)	\$ 1,296	\$ (141)	\$ 3,328	\$ 2,556	\$ 1,592
Net income	\$ 2,512	\$ 871	\$ 5,811	\$ 4,325	\$ 2,571
Per Share Data:					
Net income, basic	\$ 0.40	\$ 0.13	\$ 0.90	\$ 0.71	\$ 0.52
Net income, assuming dilution	\$ 0.39	\$ 0.13	\$ 0.85	\$ 0.66	\$ 0.46
Dividends paid	\$ 0.28	\$ 0.20	\$ 0.12	\$ 0.09	\$ 0.03
Book value	\$ 5.78	\$ 5.70	\$ 5.86	\$ 5.07	\$ 4.32
Tangible book value(1)	\$ 5.33	\$ 5.24	\$ 5.40	\$ 4.54	\$ 3.88
Financial Condition Data:					
Assets	\$ 471,803	\$ 444,421	\$ 374,942	\$ 323,611	\$ 248,614
Loans, net of unearned interest	\$ 378,472	\$ 369,883	\$ 305,879	\$ 262,008	\$ 202,555
Cash and investments	\$ 57,286	\$ 51,798	\$ 51,557	\$ 46,074	\$ 34,614
Federal funds sold	\$ 11,025	\$ —	\$ —	\$ —	\$ —
Deposits	\$ 326,583	\$ 313,250	\$ 275,816	\$ 252,435	\$ 187,832
FHLB advances and line of credit	\$ 71,250	\$ 47,100	\$ 39,500	\$ 30,000	\$ 27,000
Subordinated debentures	\$ —	\$ —	\$ —	\$ —	\$ —
Federal funds purchased and repurchase agreements	\$ 35,790	\$ 41,560	\$ 19,249	\$ 4,790	\$ 7,409
Shareholders' equity	\$ 36,502	\$ 36,327	\$ 38,183	\$ 32,466	\$ 24,807
Tangible shareholders' equity(1)	\$ 33,661	\$ 33,386	\$ 35,137	\$ 29,089	\$ 22,266
Selected Ratios:					
Interest rate spread	3.67%	4.51%	5.16%	4.93%	4.70%
Net interest margin(2)	4.16%	5.22%	5.80%	5.43%	5.02%
Return on average assets	0.55%	0.21%	1.69%	1.51%	1.15%
Return on average equity	6.71%	2.14%	16.27%	14.98%	13.83%
Return on average tangible equity(1)	7.26%	2.31%	17.78%	16.96%	16.02%
Average equity to average assets	8.27%	9.86%	10.36%	10.09%	8.30%
Dividend payout ratio	70.59%	149.71%	13.33%	12.17%	4.84%
Ratio of nonperforming assets to total assets	1.48%	0.40%	0.40%	0.47%	0.08%
Ratio of allowance for loan losses to nonperforming loans	226.23%	791.16%	25.90%	20.70%	5.33%
Ratio of allowance for loan losses to total average loans, net of unearned income	2.49%	3.88%	1.50%	1.50%	1.47%

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

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

GAAP Reconciliation and Management Explanation of Non-GAAP Financial Measures

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

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

These disclosures should not be viewed as a substitute for results determined in accordance with GAAP, and are not necessarily comparable to non-GAAP performance measures which may be presented by other companies. Table 4 presents a reconciliation to provide a more detailed analysis of these non-GAAP performance measures:

TABLE 4

	At and for the Fiscal Years Ended December 31,				
	2008	2007	2006	2005	2004
Book value per share	\$ 5.78	\$ 5.70	\$ 5.86	\$ 5.07	\$ 4.32
Effect of intangible assets per share	\$ 0.45	\$ 0.46	\$ 0.47	\$ 0.53	\$ 0.44
Tangible book value per share	\$ 5.33	\$ 5.24	\$ 5.40	\$ 4.54	\$ 3.88
Return on average equity	6.71%	2.14%	16.27%	14.98%	13.83%
Effect of intangible assets	0.55%	0.17%	1.51%	1.98%	2.19%
Return on average tangible equity	7.26%	2.31%	17.78%	16.96%	16.02%

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

Forward-Looking Statements

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

Management's Discussion And Analysis of Financial Condition and Results of Operations

Cornerstone Bancshares, Inc. (“Cornerstone”) is a bank holding company and the parent of Cornerstone Community Bank, (the “Bank”) a Tennessee banking corporation, and Eagle Financial, Inc., (“Eagle”), an accounts receivable financing company that operate primarily in and around Hamilton County, Tennessee. The Bank has also established loan production offices in Knoxville, Tennessee and Dalton, Georgia. The Bank’s business consists primarily of attracting deposits from the general public and, with these and other funds, originating real estate loans, consumer loans, business loans, and residential and commercial construction loans. The principal sources of income for the Bank are interest and fees collected on loans, fees collected on deposit accounts, and interest and dividends collected on other investments. The principal expenses of the Bank are interest paid on deposits, employee compensation and benefits, office expenses, and other overhead expenses. Eagle’s principal source of income is revenue received from the purchase of receivables. Expenses are related to employee compensation and benefits, office and overhead expenses.

The following is a discussion of our financial condition at December 31, 2008 and December 31, 2007 and our results of operations for each of the three-years ended December 31, 2008, 2007 and 2006. The purpose of this discussion is to focus on information about our financial condition and results of operations which is not otherwise apparent from the consolidated financial statements. The following discussion and analysis should be read along with our consolidated financial statements and the related notes included elsewhere herein.

Review of Financial Performance

As of December 31, 2008, Cornerstone had total consolidated assets of approximately \$472 million, total loans of approximately \$388 million, total deposits of approximately \$327 million and stockholders’ equity of approximately \$37 million. Cornerstone’s net income increased to \$2.5 million for 2008 compared to \$871 thousand for 2007 and \$5.8 million for 2006.

Results of Operations

Net Interest Income -Net interest income represents the amount by which interest earned on various earning assets exceeds interest paid on deposits and other interest bearing liabilities. Net interest income is also the most significant component of our earnings. For the year ended December 31, 2008, Cornerstone recorded net interest income of approximately \$17,982,000, which resulted in a net interest margin of 4.16%. For the year ended December 31, 2007, Cornerstone recorded net interest income of approximately \$20,370,000, which resulted in a net interest margin of 5.22%. For the year ended December 31, 2006, Cornerstone recorded net interest income of approximately \$18,853,000, which resulted in a net interest margin of 5.80%.

Table 5 presents information with respect to interest income from average interest-earning assets, expressed both in dollars and yields, and interest expense on average interest-bearing liabilities, expressed both in dollars and rates, for the periods indicated. The table includes loan yields, which reflect the amortization of deferred loan origination and commitment fees. Interest income from investment securities includes the accretion of discounts and amortization of premiums.

TABLE 5

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


(In thousands)	2008			2007			2006		
	Average Balance	Interest Income/Expense(1)	Yield/Rate	Average Balance	Interest Income/Expense(1)	Yield/Rate	Average Balance	Interest Income/Expense(1)	Yield/Rate
ASSETS									
Interest-earning assets:									
Loans(1)(2)	\$ 385,957	\$ 28,661	7.43%	\$ 353,278	\$ 32,981	9.34%	\$ 284,105	\$ 27,317	9.61%
Investment securities(3)	47,096	1,996	4.36%	37,673	1,750	4.80%	36,218	1,584	4.48%
Federal funds sold	869	23	2.70%	760	52	6.86%	4,686	258	5.51%
Total interest-earning assets	433,922	30,680	7.08%	391,711	34,783	8.89%	325,009	29,159	8.98%
Allowance for loan losses	(8,496)			(5,009)			(4,104)		
Cash and other assets	27,179			26,341			23,836		
Total assets	<u>\$ 452,605</u>			<u>\$ 413,043</u>			<u>\$ 344,741</u>		
TOTAL LIABILITIES AND EQUITY									
Interest-bearing liabilities:									
Deposits:									
NOW accounts	\$ 30,106	\$ 211	0.70%	\$ 36,327	\$ 802	2.21%	\$ 34,701	\$ 427	1.23%
Money market / Savings	51,600	826	1.60%	55,808	2,018	3.61%	58,477	2,225	3.80%
Time deposits, \$100m and over	59,083	2,371	4.01%	61,172	3,134	5.12%	43,692	1,993	4.56%
Time deposits, under \$100m	131,138	5,891	4.49%	107,498	5,387	5.01%	88,773	3,899	4.39%
Total interest-bearing deposits	271,927	9,299	3.42%	260,805	11,341	4.35%	225,643	8,544	3.78%
Federal funds purchased	12,952	339	2.62%	11,374	613	5.39%	4,570	232	5.07%
Securities sold under agreement to repurchase	18,580	261	1.41%	8,103	244	3.01%	4,020	116	2.88%
Other borrowings	68,578	2,799	4.08%	48,282	2,216	4.59%	35,429	1,414	3.98%
Total interest-bearing Liabilities	372,037	12,698	3.41%	328,564	14,414	4.39%	269,662	10,306	3.82%
Net interest spread			<u>3.67%</u>			<u>4.51%</u>			<u>5.16%</u>
Other liabilities:									
Demand deposits	42,915			41,503			37,056		
Accrued interest payable and other liabilities	218			2,240			2,295		
Stockholders' equity	37,435			40,737			35,728		
Total liabilities And stockholders' equity	<u>\$ 452,605</u>			<u>\$ 413,043</u>			<u>\$ 344,741</u>		
Net interest margin		<u>\$ 17,982</u>	<u>4.16%</u>		<u>\$ 20,369</u>	<u>5.22%</u>		<u>\$ 18,853</u>	<u>5.80%</u>

(1) Interest income on loans includes amortization of deferred loan fees and other discounts of \$227 thousand, \$302 thousand, and \$288 thousand for the fiscal years ended December 31, 2008, 2007, and 2006, respectively.

(2) Nonperforming loans are included in the computation of average loan balances, and interest income on such loans is recognized on a cash basis.

(3) Yields on securities are calculated on a fully tax equivalent basis.

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

 Starting in September 2007, the Federal Reserve Bank initiated a series of interest rate reductions, that as of January 30, 2009, resulted in a Federal Funds Target rate of 0.25%. This 500 basis point reduction has placed downward pressure on the banking industry's net interest margins. Cornerstone was also impacted by this reduction which lowered its net interest margin to 4.16% for the year-end 2008 compared to 5.22% for the year-end 2007. Currently, the variable portion of the Bank's loan portfolio, indexed to the prime interest rate, has reached interest rate floors ranging from 5.00% to 7.00%. To compensate for the reduction in loan yields the Bank lowered its interest bearing liabilities from 4.39% in 2007 to 3.41% for 2008. However, uncertainty of liquidity in the national market resulted in certificate of deposit rates to remain abnormally elevated throughout 2008. This resulted in a disintermediation within the Bank's deposit base as balances migrated from transactional accounts to certificate of deposit accounts. Finally, the Bank expects rate pressure on its interest rate loan floors throughout 2009. However, the Bank anticipates a return to more traditional certificate of deposit interest rates in early 2009. The Bank anticipates that its net interest margin will remain in the low 4.00% range throughout 2009.

As of December 31, 2008, the Bank's investment portfolio resulted in a yield of 4.36% compared to 4.80% for the same time period in 2007. The Bank's investment portfolio is used primarily for pledging purposes with the State of Tennessee Collateral Pool, Federal Reserve Bank discount window and to secure repurchase agreements. As of December 31, 2008, approximately 50% of the security portfolio was invested in Agency LIBOR floaters to protect the Bank from rapid increases in interest rates. In the future, the Bank intends to purchase longer term securities with artificially high spreads in relation to the U.S. Treasury yields to balance the security portfolio's current yield and protect against potential rapid increases in interest rates or if inflation concerns materialize. These artificially high spreads to the U.S. Treasuries are a result of perceived principal risk to the underlying credit. However, once the economy starts to improve these spreads should reduce to more historic yield levels.

During 2008 the Bank contracted with Promontory Interfinancial Network, LLC to offer the Certificate of Deposit Account Registry Service ("CDARS") to the Bank's existing depository base as well as potential new deposit customers in the Chattanooga, TN MSA that had been previously unavailable. The CDARS program allows the Bank to provide FDIC insurance coverage for certificates of deposit accounts in excess of \$100,000. Effectively, the CDARS program allows the Bank to obtain certificate of deposit accounts greater than \$100,000 and break the large deposit into smaller amounts which are placed with other banks that are part of the CDARS network. This program enables the customer to interact with one bank and still receive the same FDIC insurance coverage of multiple banking institutions. The CDARS network also gives the Bank further access to brokered deposits, at a competitive interest rate, as an additional source of wholesale funding.

Tables 6 and 7 present the changes in interest income and interest expense that are attributable to three factors:

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

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

TABLE 6

INTEREST INCOME AND EXPENSE ANALYSIS

(In Thousands)	Year Ended December 31, 2008 Compared to 2007			
	Volume	Rate	Mix	Net Change
Interest income:				
Loans (1)(2)	\$ 2,428	\$ (7,372)	\$ 622	\$ (4,320)
Investment securities	411	(188)	23	246
Federal funds sold	3	(22)	(10)	(29)
Total interest income				(4,103)
Interest expense:				
NOW accounts	(44)	(455)	(92)	(591)
Money market and savings accounts	(67)	(1,040)	(85)	(1,192)
Time deposits, \$100,000 and over	(93)	(402)	(268)	(763)
Time deposits, less than \$100,000	1,017	(931)	418	504
Other borrowings	828	(349)	104	583
Federal funds purchased	41	(359)	44	(274)
Securities sold under agreement to repurchase	148	(297)	166	17
Total interest expense				(1,716)
Change in net interest income (expense)				\$ (2,387)

TABLE 7

INTEREST INCOME AND EXPENSE ANALYSIS

(In Thousands)	Year Ended December 31, 2007 Compared to 2006			
	Volume	Rate	Mix	Net Change
Interest income:				
Loans (1)(2)	\$ 6,461	\$ (954)	\$ 157	\$ 5,664
Investment securities	69	105	(8)	166
Federal funds sold	(204)	(8)	6	(206)
Total interest income				5,624
Interest expense:				
NOW accounts	36	356	(16)	376
Money market and savings accounts	(96)	(103)	(8)	(207)
Time deposits, \$100,000 and over	895	343	(98)	1,140
Time deposits, less than \$100,000	938	666	(116)	1,488
Other borrowings	590	294	(82)	802
Federal funds purchased	367	36	(22)	381
Securities sold under agreement to repurchase	123	11	(7)	127
Total interest expense				4,107
Change in net interest income (expense)				\$ 1,517

(1) Loan amounts include non-accruing loans.

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

Provision for Loan Losses -The provision for loan losses represents a charge to earnings necessary to establish an allowance for loan losses that, in management's evaluation, should be adequate to provide coverage for the inherent losses on outstanding loans. The provision for loan losses amounted to \$3.5 million for the year ended December 31, 2008 compared to \$10.4 million for the year ended December 31, 2007. Cornerstone's policies and procedures used to estimate the allowance for loan losses, as well as the resultant provision for loan losses, are considered adequate by management and are periodically reviewed by regulators. However, there are factors beyond Cornerstone's control, such as conditions in the local and national economy which may negatively impact Cornerstone's asset quality. The measurements are approximations which may require additional provisions to loan losses based upon changing circumstances or when additional information becomes available or known. Other matters relating to the changes in provision for loan losses are presented below:

Cornerstone's provision for loan losses during 2008 was needed to address multiple credits that were not able to maintain operations or cash flow due in large part to the economic downturn. The provision allocation differs from the amount charged to earnings in 2007 which was concentrated in two large credits. These large credits contained alleged fraud perpetrated by the customer against the Bank. The Bank expects further economic deterioration during 2009. Therefore, the Bank anticipates that the 2009 provision will be equal to or slightly larger than the charge to earnings for provision in 2008.

To address the problem credits within the Bank's loan portfolio a Special Asset Committee was created. This committee has instructed the Bank's loan review department to identify potential problem loans as quickly as possible. This early detection will allow the Bank to assist customers with this severe economic environment and potentially minimize losses. Secondly, during 2008 the Bank hired a special asset consultant to assist in the disposal of problem assets in an optimal manner.

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

Table 8 presents the components of non interest income for the years ended December 31, 2008, 2007 and 2006 (in thousands).

TABLE 8

	2008	2007	2006
Customer service fees	\$ 1,727	\$ 1,426	\$ 1,298
Other noninterest income	108	165	91
Operating lease income	-	-	301
Net gain from sale of loans & other assets	57	104	421
Total noninterest income	\$ 1,892	\$ 1,695	\$ 2,111

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

☐ The Bank continues to see moderate increases in its customer service fees. While traditional account service fees are included in the \$1.7 million generated during 2008 the amount also includes fees associated with the Bank's payroll processing services. Fiscal year 2008 marked the first full year the Bank provided processing services to payroll processors located across the United States. The payroll processors generate thousands of payroll transactions each week while depositing relatively large amounts on a short term basis. These ACH transactions are then forwarded through the Federal Reserve Bank to the recipient's checking accounts.

☐ One of the major components in other fee income in prior years was the Bank's operating lease income. The Bank had entered into an operating lease agreement with one of its customers that resulted in monthly lease income to the Bank. The lease has been terminated with the customer, who subsequently purchased the assets. Currently, the Bank has no income from operating lease agreements.

☐ Included in the net gain from sale of loans and other assets is the Bank's loss of \$141 thousand on the sale of assets. This loss was incurred on multiple pieces of other real estate and foreclosed assets. Without these losses, the Bank's non-interest income increased 15.2% over 2007 and should continue to increase during 2009.

Non Interest Expense -Items reported as non interest expense include salaries and employee benefits, occupancy and equipment expense and other operating expense.

Table 9 presents the components of non interest expense for the years ended December 31, 2008, 2007 and 2006 (in thousands).

TABLE 9

	2008	2007	2006
Salaries and employee benefits	\$ 7,140	\$ 6,609	\$ 6,018
Net occupancy and equipment expense	1,520	1,355	1,075
Depreciation on leased assets	-	-	245
Other operating expenses	3,908	2,962	3,380
Total noninterest expense	\$ 12,568	\$ 10,926	\$ 10,718

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

☐ Salary expense increased 8.0% over 2007 due primarily to an increase in risk management personnel. Additional employees included in the risk management department included one employee added to the compliance department, two added to the internal audit department and one consultant contracted to assist in Information Technology security. This along with cost of living adjustments represented the majority of the Cornerstone's increase.

☐ Occupancy and equipment expense has increased from prior periods in part due to the relocation of the Bank's downtown branch and Cornerstone's corporate headquarters. While the relocation has increased expenses, the Bank's presence in downtown Chattanooga, Tennessee, provides existing Bank customers with greater access to the Bank's services as well as attracting potential new customers. The Bank also opened two loan production offices during 2007; one in Knoxville, Tennessee, and one in Dalton, Georgia.

Significant increases in non interest expense were in the other operating expense category which increased 31.9% over 2007. The majority of the increases can be segmented into three areas. First, the FDIC assessment increased \$220 thousand; second, other real estate expense increased \$167 thousand; and third, legal expense increased \$160 thousand. All three categories are related to the deterioration of asset quality and the expense required to properly obtain and ultimately dispose of collateral securing problem loans.

Income Tax Expense

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

Financial Condition

Overview -Cornerstone's consolidated balance sheet reflects significant growth since December 31, 2007. Total assets increased approximately \$28 million or 6.3% from \$444 million as of December 31, 2007 to \$472 million as of December 31, 2008. During 2008 total loans increased \$4 million or 1.2% from approximately \$384 million as of December 31, 2007 to approximately \$388 million as of December 31, 2008. Finally, stockholders' equity remained relatively unchanged during 2008 at approximately \$36 million as of December 31, 2008 and December 31, 2007.

Investments -The Bank's investment portfolio totaled \$46.4 million or 9.8% of total assets as of the year end 2008 compared to a total of \$36.9 million or 8.3% of total assets as of year end 2007. The portfolio is accounted for in two classifications: "Held to Maturity" and "Available for Sale". The Bank also has an investment in Federal Home Loan Bank Stock. The objective of the Bank's investment policy is to invest funds not otherwise needed to meet the loan demand of the Bank's market area and to meet the following five objectives: Gap Management, Liquidity, Pledging, Return, and Local Community Support. In doing so, the Bank uses the portfolio to provide structure and liquidity that the loan portfolio cannot. The management investment committee balances the market and credit risks against the potential investment return, ensures investments are compatible with the pledge requirements of the Bank's deposit of public funds, maintains compliance with regulatory investment requirements, and assists various public entities with their financing needs. The management investment committee is authorized to execute security transactions for the investment portfolio based on the decisions of the Board of Directors 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 the Bank's needed liquidity and longer-term securities purchased to generate stable income for the Bank during periods of interest rate fluctuations.

Table 10 presents the carrying value of the Bank's investments at the dates indicated. Available for sale securities are carried at fair market value and securities held to maturity are held at their book value (amounts in thousands).

TABLE 10

Investment Portfolio Years Ending December 31,

	2008	2007	2006
Securities available for sale:			
U.S. Government and agency obligations	\$ 8,252	\$ 27,414	\$ 26,470
Mortgage-backed and other securities	31,182	3,836	2,634
State & political subdivisions tax-exempt	4,623	3,503	3,249
Totals	\$ 44,057	\$ 34,753	\$ 32,353
Securities held to maturity:			
Mortgage-backed and other securities	\$ 169	\$ 200	\$ 236
Totals	\$ 169	\$ 200	\$ 236
Federal Home Loan Bank stock, at cost	2,188	1,912	1,332
Total Investments	\$ 46,414	\$ 36,865	\$ 33,921

During 2008 the Bank elected to increase the amount of mortgage backed and municipal securities. The mortgage backed securities were obtained instead of U.S. Government and agency obligations, as traditionally acquired, to provide increased yield while maintaining a 20% risk weight classification for capital requirements. During the 4th quarter of 2008 and continuing into 2009, the Bank has purchased mortgage backed securities guaranteed by Government National Mortgage Association or "Ginnie Mae." These securities qualify for 0% risk weight allocation thereby improving the Bank's overall risk weighted capital position. The increase in municipal securities has been obtained due to higher yields when compared to alternative investments and to provide collateral at the Federal Reserve discount window.



A second objective of the security portfolio is to provide adequate collateral to satisfy pledging requirements with the State of Tennessee collateral pool, repurchase agreements and the Federal Reserve discount window. During 2008 the Bank increased its Federal Reserve discount window borrowing to approximately \$4 million by year-end. This increase allowed the Bank to obtain additional funding, if needed, in the event the Bank's daily fed fund lines were negatively impacted.

For December 31, 2008 tables 11 and 12 present the book value of the Bank's investments, the weighted average yields on the Bank's investments and the periods to maturity of the Bank's investments for the "Securities Available for Sale" and the "Securities Held to Maturity," respectively. Available for Sale and Held to Maturity information relating to December 31, 2007 is presented in tables 13 and 14.

TABLE 11

Weighted Average Yields on the Available For Sale Investments
Periods of Maturity from December 31, 2008

	Less than 1 year		1 to 5 years		5 to 10 years		Over 10 years	
	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)
Securities available for sale:								
U.S. Government agencies	\$ 6,127	4.15%	\$ 0	0.00%	\$ 0	0.00%	\$ 2,125	6.12%
Mortgage-backed securities (2)	0	0.00%	0	0.00%	11	6.99%	31,171	2.99%
Tax-exempt municipal bonds	127	5.02%	925	6.38%	1,793	6.06%	1,778	6.26%
Totals	\$ 6,254	4.16%	\$ 925	6.38%	\$ 1,804	6.07%	\$ 35,074	3.34%
Total Securities Available for Sale	\$ 44,057	3.62%						

TABLE 12

Weighted Average Yields on the Held to Maturity Investments
Periods of Maturity from December 31, 2008

	Less than 1 year		1 to 5 years		5 to 10 years		Over 10 years	
	Amount	Weighted Avg. Yield(1)	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)
Securities held to maturity:								
Mortgage-backed securities (2)	\$ 0	0.00%	\$ 6	6.70%	\$ 17	3.74%	\$ 146	5.54%
Totals	\$ 0	0.00%	\$ 6	6.70%	\$ 17	3.74%	\$ 146	5.54%
Total Securities held to maturity	\$ 169	5.40%						
Federal Home Loan Bank stock, at cost	\$ 2,188	5.33%						
Total Investments	\$ 46,414	3.73%						

TABLE 13

Weighted Average Yields on the Available For Sale Investments
Periods of Maturity from December 31, 2007

	Less than 1 year		1 to 5 years		5 to 10 years		Over 10 years	
	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)
Securities available for sale:								
U.S. Government agencies	\$ 8,491	4.43%	\$ 16,848	4.57%	\$ 0	0.00%	\$ 2,075	6.12%
Mortgage-backed securities (2)	0	0.00%	2	6.30%	13	7.01%	3,821	5.17%
Tax-exempt municipal bonds	126	5.14%	739	4.29%	1,233	4.28%	1,405	4.09%
Totals	\$ 8,617	4.44%	\$ 17,589	4.56%	\$ 1,246	4.31%	\$ 7,301	5.32%
Total Securities Available for Sale	\$ 34,753	4.76%						

TABLE 14

Weighted Average Yields on the Held to Maturity Investments
Periods of Maturity from December 31, 2007

	Less than 1 year		1 to 5 years		5 to 10 years		Over 10 years	
	Amount	Weighted Avg. Yield(1)	Amount	Weighted Avg. Yield(1)	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield(1)
Securities held to maturity:								
Mortgage-backed securities (2)	\$ 0	0.00%	\$ 13	6.72%	\$ 13	5.20%	\$ 174	6.36%
Totals	\$ 0	0.00%	\$ 13	6.72%	\$ 13	5.20%	\$ 174	6.36%
Total Securities held to maturity	\$ 200	6.31%						
Federal Home Loan Bank stock, at cost	\$ 1,912	5.52%						
Total Investments	\$ 36,865	4.80%						

(1)The weighted average yields on tax-exempt securities have been computed on a tax-equivalent basis.

(2) Mortgages are allocated by maturity and not amortized

Lending -All lending activities of the Bank are under the direct supervision and control of the Directors Loan Committee, which consists of the Chief Executive Officer, President, Senior Loan Administrator, and five outside directors. Also present at meetings of the committee are the loan review officer and other lending officers as required. All lending activities of Eagle are under the direct supervision and control of its Board of Directors which consist of the Chief Executive Officer, President, Treasurer, Secretary, Bank's Senior Loan Administrator and three outside directors. These loan committees enforce loan authorizations for each officer, make lending decisions on loans exceeding such limits, review and oversee problem credits, and determine the allocation of funds for each lending category.

At December 31, 2008 and 2007, Cornerstone's loan portfolio constituted approximately 80.2% and 83.2% of Cornerstone's total assets, respectively.

Table 15 presents the composition of the Cornerstone's loan portfolio at the indicated dates.

TABLE 15

Loan Portfolio Composition
Years Ending December 31,

(In thousands)	2008		2007		2006		2005		2004	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Commercial, financial and agricultural	\$ 83,140	21.42%	\$ 98,065	25.57%	\$ 98,542	31.77%	\$ 86,039	32.40%	\$ 61,742	30.09%
Real estate – construction	70,456	18.15%	76,832	20.03%	57,606	18.57%	47,071	17.72%	36,824	17.94%
Real estate – mortgage	72,737	18.74%	64,585	16.84%	48,700	15.70%	48,645	17.19%	38,193	18.61%
Real estate – commercial	155,728	40.13%	138,074	35.99%	99,197	31.98%	79,608	29.98%	61,860	30.14%
Consumer loans	6,029	1.56%	6,037	1.57%	6,092	1.98%	7,191	2.71%	6,602	3.22%
Total loans	\$ 388,090	100.00%	\$ 383,593	100.00%	\$ 310,137	100.00%	\$ 265,554	100.00%	\$ 205,221	100.00%

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


 Overall the Bank's loan portfolio increased 1.2% during 2008 when compared to 2007 year-end total. The Bank continued to place an emphasis on loan quality by continuing its credit underwriting process and collateral inspection procedures.

Table 16 presents the scheduled maturities of the loans in Cornerstone's loan portfolio as of December 31, 2008 based on their contractual terms to maturity. Overdrafts are reported as due in less than one year. Loans unpaid at maturity are renegotiated based on current market rates and terms.

TABLE 16

Loans Maturing
Year-end balance as of December 31, 2008

(In thousands)	Less than One Year	1 to 5 Years	Over 5 Years	Total
Commercial, financial and agricultural	\$ 64,548	\$ 14,254	\$ 4,338	\$ 83,140
Real estate – construction	52,718	16,805	933	70,456
Real estate – mortgage	22,932	41,546	8,259	72,737
Real estate – commercial	34,947	106,824	13,957	155,728
Consumer	2,248	3,716	65	6,029
Total Loans	<u>\$ 177,393</u>	<u>\$ 183,145</u>	<u>\$ 27,552</u>	<u>\$ 388,090</u>

Types of Loans

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

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

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

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

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

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

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

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

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

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

Lending Commitments- Commitments under standby letters of credit and undisbursed loan commitments totaled approximately \$67 million as of December 31, 2008 compared to approximately \$77 million as of December 31, 2007. This number includes all lines of credit that have not been fully drawn and loan commitments in the same status.

Origination, Purchase and Sale of Loans

The Bank originates the majority of its loans in Hamilton County, Tennessee. However, the Bank also originates loans in Marion, Sequatchie, Knox and Bradley Counties in Tennessee, and Dade, Walker, Whitfield and Catoosa Counties in Georgia, each of which is within 150 miles of Chattanooga, Tennessee. Loans are originated by 18 relationship managers who operate from the Bank's offices in Chattanooga, Tennessee and from the loan production offices in Dalton, Georgia and Knoxville, Tennessee. These relationship managers actively solicit loan applications from existing customers, local manufacturers and retailers, builders, real estate developers, real estate agents and others. The Bank also receives numerous loan applications as a result of customer referrals and walk-ins to its offices.

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

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

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

Loan Fee Income

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

Commitment fees are charged by the Bank to the borrower for certain loans and are calculated as a percentage of the principal amount of the loan. These fees normally are deducted from the proceeds of the loan and generally range from 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 significant loan fees over the life of the loan. The Bank also receives miscellaneous fee income from late payment charges, overdraft fees, property inspection fees, and miscellaneous services related to its existing loans.

Problem Loans and Allowance for Loan Losses

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

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

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

Assets classified as substandard or doubtful require the Bank to establish general allowances for loan losses. If an asset or portion thereof is classified as loss, the Bank must either establish specific allowances for loan losses in the amount of 100% of the portion of the asset classified as loss or charge off such amount. General loss allowances established to cover possible losses related to assets classified as substandard or doubtful may be included, up to certain limits, in determining the Bank's regulatory capital, while specific valuation allowances for loan losses do not qualify as regulatory capital.

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

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

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. A loan or portion thereof is charged off against the 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, 2008 is adequate to absorb possible losses from loans currently in the portfolio.

Table 17 presents Cornerstone's allocation of the allowance for loan losses as of December 31, 2008, 2007, 2006, 2005 and 2004.

TABLE 17

Allowance for Loan Losses Years Ending December 31,						
2008			2007		2006	
	Amount	Percent of loans by category to total loans	Amount	Percent of loans by category to total loans	Amount	Percent of loans by category to total loans
(In thousands)						
Balance at end of period applicable to						
Commercial, financial and agricultural	\$ 4,955	21.42%	\$ 9,482	25.57%	\$ 1,686	31.77%
Real estate – construction	1,433	18.15%	2,447	20.03%	1,581	18.57%
Real estate – mortgage	1,532	18.74%	101	16.84%	77	15.70%
Real estate – commercial	1,376	40.13%	1,434	35.99%	703	31.98%
Consumer	322	1.56%	246	1.57%	211	1.98%
Totals	<u>\$ 9,618</u>	<u>100.00%</u>	<u>\$ 13,710</u>	<u>100.00%</u>	<u>\$ 4,258</u>	<u>100.00%</u>
2005			2004			
	Amount	Percent of loans by category to total loans	Amount	Percent of loans by category to total loans		
(In thousands)						
Balance at end of period applicable to						
Commercial, financial and agricultural	\$ 1,438	32.40%	\$ 1,002	30.09%		
Real estate – construction	1,253	17.72%	962	17.94%		
Real estate – mortgage	79	17.19%	122	18.61%		
Real estate – commercial	535	29.98%	361	30.14%		
Consumer	240	2.71%	211	3.22%		
Totals	<u>\$ 3,545</u>	<u>100.00%</u>	<u>\$ 2,658</u>	<u>100.00%</u>		


In recent years Cornerstone has refined its loan loss allowance to include measurements such as environmental factors for growth, environmental factors for real estate values, historical metrics and specific loan products with increased levels of risk, such as asset based lending. This process enables Cornerstone to support and estimate the necessary allowance needed to protect Cornerstone against possible losses. The allowance as of December 31, 2008 totaled \$9.6 million compared to \$13.7 million as of December 31, 2007. The most significant events occurring in the loan loss allowance during 2008 were provisions totaling \$3.5 million and a charge-off \$6 million in the 1st quarter of 2008.

Table 18 presents Cornerstone's delinquent and non-performing assets as of December 31, 2008 and 2007.

TABLE 18

Delinquent and Non-performing Assets
Actual for Years Ending December 31,

(In thousands)	2008	2007
Accruing loans that are contractually past due 90-days or more:		
Commercial, financial and agricultural	\$ 0	\$ 0
Real estate – construction	0	0
Real estate – mortgage	0	0
Real estate- commercial	0	0
Consumer	0	0
Total Loans	<u>\$ 0</u>	<u>\$ 0</u>
Non-accruing loans 90-days or more:		
Commercial, financial and agricultural	\$ 0	\$ 124
Real estate – construction	1,180	341
Real estate – mortgage	720	28
Real estate – commercial	2,352	192
Consumer	0	0
Total Loans	<u>\$ 4,252</u>	<u>\$ 685</u>
Real estate acquired through foreclosure	\$ 2,459	\$ 1,038
Property acquired through repossession	257	0
Total acquired	<u>\$ 2,716</u>	<u>\$ 1,038</u>
Total Loans	<u>\$ 388,090</u>	<u>\$ 383,593</u>
Ratio of non-performing assets to total loans	1.80%	0.45%
Ratio of delinquent (30-days or more) but accruing loans to:		
Total loans	2.08%	1.12%
Total assets	1.71%	0.97%

 Recent economic developments have negatively impacted the Bank's loan portfolio. Real estate loans in all three classifications were negatively impacted during 2008. The Bank continues to monitor its real estate loan portfolio closely in an attempt to identify potential problem loans as soon as possible. However, as of year end 2008 the Bank had foreclosed on ten residential properties, six vacant real estate lots and two commercial properties.

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

Table 19 presents Cornerstone's loan loss experience for the periods indicated.

TABLE 19

		Loan Loss Reserve Analysis Years Ending December 31,				
(in thousands)		2008	2007	2006	2005	2004
Average loans		\$ 385,957	\$ 353,278	\$ 284,105	\$ 236,265	\$ 181,335
Allowance for possible loan losses, Beginning of the period		\$ 13,710	\$ 4,258	\$ 3,545	\$ 2,658	\$ 2,011
Charge-offs for the period:						
Commercial, financial and agricultural		6,991	737	307	275	165
Real estate – construction		434	84	0	48	0
Real estate – mortgage		193	0	104	50	138
Real estate - commercial		210	180	0	78	0
Consumer		151	74	70	111	69
Total charge-offs		7,979	1,075	481	562	372
Recoveries for the period:						
Commercial, financial and agricultural		362	114	66	12	149
Real estate – construction		14	0	0	1	0
Real estate – mortgage		1	4	7	6	7
Real estate – commercial		0	0	0	0	0
Consumer		12	0	15	28	23
Total recoveries		389	118	88	47	179
Net charge-offs for the period		7,590	957	393	515	193
Provision for loan losses		3,498	10,409	1,106	1,402	840
Adjustments		0	0	0	0	0
Allowance for possible loan losses, end of period		\$ 9,618	\$ 13,710	\$ 4,258	\$ 3,545	\$ 2,658
Ratio of allowance for loan losses to total average loans outstanding		2.49%	3.88%	1.50%	1.50%	1.47%
Ratio of net charge-offs during the period to average loans outstanding during the period		1.97%	0.27%	0.14%	0.22%	0.10%

Intangibles- During 2002, Cornerstone adopted the provisions of Statement of Financial Statement No. 142 Goodwill and other Intangible Assets concerning the \$2,541,476 goodwill created by the merger with the Bank of East Ridge. Goodwill is tested annually for impairment. If the carrying value of goodwill exceeds the fair value, a write-down is recorded. No impairment loss was recognized during 2008, 2007 or 2006. Also, in December, 2005, Cornerstone completed the purchase of Eagle Financial, Inc. and recorded an intangible asset of \$848,916. Amortization expense relating to this intangible for 2008, 2007 and 2006 was \$108,000, \$108,000 and \$345,388, respectively.

Sources of Funds

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

Part of the banking industries lexicon is core and non-core funding. Core funding includes all deposits except time deposits issued in denominations of \$100,000 or greater. All other funding is classified as non-core funding. The Bank attempts to minimize its reliance on non-core funding by attracting local deposit accounts. However, local market competition or advantageous interest rate positions can influence the Bank to select non-core funding.

Table 20 presents the Bank's, core vs. non-core funding as of December 31, 2008 and 2007 (in thousands).

TABLE 20

Core vs. Non-Core Funding

	December 31, 2008		December 31, 2007	
	Amount	Percent	Amount	Percent
Core funding:				
Noninterest bearing demand deposits	\$ 40,078	9.3%	\$ 45,285	11.3%
Interest-bearing demand deposits	26,909	6.3%	31,985	8.0%
Savings & money market accounts	35,848	8.3%	49,970	12.4%
Time deposits under \$100,000	147,928	34.5%	114,505	28.5%
Total core funding	<u>250,763</u>	<u>58.4%</u>	<u>241,745</u>	<u>60.2%</u>
Non-core funding:				
Brokered deposits	16,763	3.9%	13,255	3.3%
Time deposits greater than \$100,000	59,057	13.8%	58,250	14.5%
Federal funds purchased	0	0.0%	28,450	7.1%
Securities sold under agreements to repurchase	35,790	8.3%	13,110	3.3%
Federal Home Loan Bank advances	67,000	15.6%	47,000	11.6%
Total non-core funding	<u>178,610</u>	<u>41.6%</u>	<u>160,065</u>	<u>39.8%</u>
Total	<u>\$ 429,373</u>	<u>100.0%</u>	<u>\$ 401,810</u>	<u>100.0%</u>

During 2008 Cornerstone continued to see an erosion of its non-interest bearing demand deposits, interest bearing demand deposits, savings and money market accounts. The primary reason for the decline in deposit balances can be attributed to increased competition and Cornerstone's attempt to reprice interest sensitive deposits to compensate for the decline in the Bank's loan yields. To compensate for the decline in these accounts Cornerstone offered local market certificate of deposit specials and obtained additional Federal Home Loan Bank advances.

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 advertise for deposits outside of this area and has had moderate success attracting deposits from credit unions around the United States. The Bank does not rely upon any single person or group of related persons for a material portion of its deposits. However, the Bank has a large depositor related to its ACH business line that leaves a large amount of money for the Bank to use as it passes through the Bank to its final destination. A principal source of deposits for the Bank consists of short-term money market and other accounts, which are highly responsive to changes in market interest rates. Accordingly, the Bank, like all financial institutions, is subject to short-term fluctuations in deposits in response to customer actions due to changing short-term market interest rates. The ability of the Bank to attract and maintain deposits and the Bank's cost of funds has been and will continue to be significantly affected by money market conditions.

Table 21 presents the composition of deposits for the Bank, excluding accrued interest payable, by type for the years ended December 31, 2008, 2007 and 2006 (in thousands).

TABLE 21

Deposit Composition
Years Ending December 31,

(In thousands)	2008	2007	2006
Demand deposits	\$ 40,078	\$ 45,285	\$ 41,723
NOW deposits	26,909	31,985	38,160
Savings & money market deposits	35,848	49,970	56,913
Time deposits \$100,000 and over	59,057	58,250	44,544
Time deposits under \$100,000	164,692	127,760	94,476
Total Deposits	<u>\$ 326,584</u>	<u>\$ 313,250</u>	<u>\$ 275,816</u>

On October 3, 2008, the Emergency Economic Stabilization Act of 2008 (“EESA”) became law. The EESA enabled the FDIC to temporarily increase the amount of FDIC deposit insurance coverage from \$100,000 to \$250,000 per qualified depositor through December 31, 2009. Also during the fourth quarter of 2008, the FDIC’s Temporary Liquidity Guarantee Program extended unlimited deposit insurance coverage for non-interest bearing transaction accounts at participating FDIC insured banks. Finally, the FDIC offered coverage regarding debt obligation coverage. These services were offered by the FDIC with a fee structure for each product. The Bank chose to accept the unlimited transaction account coverage but refused the debt obligation coverage.

The Bank’s deposit liabilities were impacted due to uncertainty of liquidity in the national markets causing certificate of deposit rates to stay unnaturally high throughout 2008. This resulted in a disintermediation within the Bank’s deposit base as balances migrated from transactional accounts to certificate of deposit accounts. Accounts contained within the classification of “Time deposits under \$100,000” increased due to local market certificate of deposit specials and additional funds obtained from the traditional brokered certificate of deposit market and additional funds obtained through the CDARS program.

Table 22 presents a breakdown by category of the average amount of deposits and the average rate paid on deposits for the periods indicated:

TABLE 22

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

(In thousands)	2008		2007		2006	
	Amount	Rate	Amount	Rate	Amount	Rate
Demand deposits	\$ 42,915		\$ 41,503		\$ 37,056	
NOW deposits	30,106	0.70%	36,327	2.21%	34,701	1.23%
Savings & money market deposits	51,600	1.60%	55,808	3.61%	58,477	3.80%
Time deposits \$100,000 and over	59,083	4.01%	61,172	5.12%	43,692	4.56%
Time deposits under \$100,000	131,138	4.49%	107,498	5.01%	88,773	4.39%
Total Deposits	<u>\$ 314,842</u>	<u>3.42%</u>	<u>\$ 302,308</u>	<u>4.35%</u>	<u>\$ 262,699</u>	<u>3.78%</u>

Borrowings- The Bank joined the Federal Home Loan Bank of Cincinnati in October of 2000. The Federal Home Loan Bank (the “FHLB”) allows the Bank to borrow funds on a contractual basis many times at rates lower than the costs of local certificates of deposit. In addition, the FHLB has the ability to provide structured advances that best reduce or leverage the interest rate risk of the Bank. The Bank as of the end of the year had \$67 million outstanding with the FHLB. The FHLB offers multiple products to assist banks in their funding needs. The advances from the FHLB as of December 31, 2008 are structured as an obligation with a fixed rate with the majority of loans incorporating an optional conversion to a floating rate after a stated period of time. The loans have maturities ranging from May 2010 to January 2017. As of December 31, 2008, the interest rates on these loans ranged from 3.52% to 5.00%. The Bank has several Federal Funds lines of credit available with correspondent banks with a total availability of \$40 million as of the end of 2008. In addition, the Bank has the right to borrow from the Federal Reserve Bank if necessary to supplement its supply of funds available for lending and to meet deposit withdrawal requirements. As of December 31, 2008, Cornerstone had established a line of credit of \$8.5 million priced at New York Prime Rate minus 150 basis points. The loan was established to insert capital infusions to the Bank to fund growth or retire treasury stock, if any, as needed. This line allows Cornerstone to act as a source of strength for the Bank without the expense or dilution of additional common stock. As of December 31, 2008, there was \$4.3 million borrowed on the line of credit and Cornerstone has the remaining balance available to inject capital into the Bank or fund other investments.

Capital

Capital Resources- Stockholder's average equity for 2008 and 2007 totaled \$37.4 million and \$40.7 million, respectively. As of December 31, 2008, Cornerstone's actual stockholder equity totaled \$36.5 million compared to \$36.3 million as of December 31, 2007. The number of common shares outstanding decreased to 6,319,718 as of year end 2008 from 6,369,718 as of year end 2007. Changes in the number of common shares outstanding resulted from Cornerstone repurchasing 72,000 shares of treasury stock during 2008 and subsequently issuing 22,000 shares prior to the 2008 year-end.

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


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

The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") established five capital categories for banks. Under the regulation defining these five capital categories, each bank is classified into one of the five categories based on its level of risk-based capital as measured by Tier I capital, total risk-based capital, and Tier I leverage ratios and its supervisory ratings. Table 23 lists the five categories of capital and each of the minimum requirements for the three risk-based ratios.

TABLE 23

Minimum Requirements for Risk-Based Capital Ratios

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

 As of December 31, 2008, the Bank exceeded the regulatory minimums and qualified as a well-capitalized institution under the regulations. The Bank had Tier I capital of \$36.3 or 7.9% of average assets as of December 31, 2008 compared to Tier I capital of \$31.6 or 7.4% of average assets as of December 31, 2007. The Bank had total capital of \$41.4 or 10.3% of risk weighted assets as of December 31, 2008 compared to total capital of \$36.6 or 9.3% of risk weighted assets as of December 31, 2007.

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 ensure funds are available at all times, Cornerstone devotes resources to projecting on a monthly basis the amount of funds accessible. Liquidity requirements can also be met through short-term borrowing or the disposition of short-term assets, which are generally matched to correspond to the maturity of liabilities.

Cornerstone's liquidity target is measured by adding the Bank's net cash, short term and marketable securities not pledged and dividing this number by total deposits and short-term liabilities not secured by assets pledged. The Bank's liquidity ratio at year end 2008 was 10.4% compared to 4.8% at year end 2007. Cornerstone is not subject to any specific liquidity requirements imposed by regulatory orders. Cornerstone is subject however, to general FDIC guidelines, which do not require a minimum level of liquidity. Management believes its liquidity ratios meet or exceed these guidelines.

In December 2008, Cornerstone applied for \$12 million under the U.S. Treasury’s Capital Purchase Program, instituted as part of the Troubled Asset Relief Program established under the EESA. At present, this application has not been approved, and Cornerstone has not received any assurances that it will be approved. Management does not know of any other trends, demands, commitments, events or uncertainties that will result in or are reasonably likely to result in liquidity increasing or decreasing in any material manner.

Table 24 presents the average loan to deposit ratios, a liquidity measure, for periods indicated:

TABLE 24

	<u>December 31, 2008</u>	<u>December 31, 2007</u>
Average loans to average deposits	122.59%	116.86%

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Cornerstone’s Asset/Liability Committee (“ALCO”) actively measures and manages interest rate risk using a process developed by the Bank. The ALCO is also responsible for approving Cornerstone’s asset/liability management policies, overseeing the formulation and implementation of strategies to improve balance sheet positioning and earnings, and reviewing Cornerstone’s interest rate sensitivity position.

The primary tool that management uses to measure short-term interest rate risk is a net interest income simulation model prepared by an independent national consulting firm and reviewed by another separate and independent national consulting firm. These simulations estimate the impact that various changes in the overall level of interest rates over one- and two-year time horizons would have on net interest income. The results help Cornerstone develop strategies for managing exposure to interest rate risk.

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

Table 25 presents the re-pricing of the Bank’s interest earning assets and interest-bearing liabilities as of December 31, 2008. This interest sensitivity gap table is designed to monitor the Bank’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 Bank’s interest rate management policy is to attempt to maintain a relatively stable net interest margin in periods of interest rate fluctuations. The Bank’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. The information set forth below is based on the following assumptions of management: (i) savings 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) securities other than mortgage-backed securities have been scheduled by maturity date while mortgages have been amortized over the life of the mortgage. Table 25 excludes the interest sensitive assets and liabilities of Eagle and the Bank’s holding company, Cornerstone Bancshares, Inc. The exclusion for Eagle is an interest sensitive asset, consisting of accounts receivable, totaling \$1.2 million. The exclusion for the holding company is an interest sensitive liability, which is a line of credit with \$4.3 million outstanding. Both the interest sensitive asset of Eagle and the interest sensitive liability of the holding company would be accounted for in the less than one year analysis.

TABLE 25

Re-pricing of Interest Sensitive Assets and Liabilities
Year-end balance as of December 31, 2008

(In thousands)	Less than One Year	1 to 5 Years (3)	Over 5 Years (3)	Total
Interest Sensitive Assets:				
Federal funds sold	\$ 11,025	\$ 0	\$ 0	\$ 11,025
Investment securities				
Taxable (1)	34,945	32	7,512	42,489
Tax-exempt (1)	125	900	2,899	3,924
Loans (2)				
Fixed rate and adjustable rate 1-4 family mortgage	18,294	32,010	7,686	57,990
Scheduled payments	172,602	146,947	9,395	328,944
Other	3,078	0	0	3,078
Total Interest Sensitive Assets	\$ 240,069	\$ 179,889	\$ 27,492	\$ 447,450
Interest Sensitive Liabilities:				
NOW accounts	\$ 10,766	\$ 16,143	\$ 0	\$ 26,909
Money market and savings accounts	17,122	18,726	0	35,848
Time deposits	192,694	31,055	0	223,749
Other interest bearing liabilities	72,790	30,000	0	102,790
Total Interest Sensitive Liabilities	\$ 293,372	\$ 95,924	\$ 0	\$ 389,296
Interest Sensitive Gap	(53,303)	83,965	27,492	58,154
Cumulative Interest Sensitive Gap	(53,303)	30,662	58,154	
Ratio of cumulative gap to total Interest Sensitive Assets	(11.91)%	6.85%	13.00%	

(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.

(3) All assets and liabilities in these categories are fixed rates.

Impact of Inflation and Changing Price- The financial statements and related financial data presented herein have been prepared in accordance with U.S. generally accepted accounting principles, which require the measurement of the financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time and due to inflation. Management is primarily concerned with two inflationary factors; The first and the most common is the general impact of inflation on operations of Cornerstone and is reflected in increased operating costs. The other and more material to the Bank's profitability are interest rate adjustments by the Federal Reserve and the general fixed income market in reaction to inflation. In other words, interest rate risk, unlike most industrial companies, substantially impacts Cornerstone because virtually all of the assets and liabilities of Cornerstone are monetary in nature. As a result, interest rates may have a more significant impact on Cornerstone's performance than the effects of general levels of inflation. Interest 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.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

Consolidated Financial Statements and Footnotes

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MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of Cornerstone is responsible for establishing and maintaining adequate internal control over financial reporting. Cornerstone's internal control system was designed to provide reasonable assurance to Cornerstone's management and board of directors regarding the preparation and fair presentation of published financial statements. All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Cornerstone's management has assessed the effectiveness of internal controls over financial reporting as of December 31, 2008. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework.

Based on our assessment we believe that, as of December 31, 2008, Cornerstone's internal control over financial reporting is effective based on those criteria.

Report of Independent Registered Public Accounting Firm

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

We have audited the accompanying consolidated balance sheets of Cornerstone Bancshares, Inc. and subsidiaries (Company) as of December 31, 2008 and 2007, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2008. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. 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 subsidiaries as of December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008, in conformity with U.S. generally accepted accounting principles.

We were not engaged to examine management's assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2008, included in *Management's Report on Internal Control Over Financial Reporting* found in Item 9A(T) of Form 10-K for the year ended December 31, 2008, and, accordingly, we do not express an opinion thereon.

/s/ HAZLETT, LEWIS & BIETER, PLLC

Chattanooga, Tennessee
March 18, 2009

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
December 31, 2008 and 2007

	<u>2008</u>	<u>2007</u>
ASSETS		
Cash and due from banks	\$ 10,872,390	\$ 14,933,349
Federal funds sold	11,025,000	-
Cash and cash equivalents	21,897,390	14,933,349
Securities available for sale	44,056,559	34,751,985
Securities held to maturity (fair value approximates \$169,759 at 2008 and \$199,678 at 2007)	169,284	200,037
Federal Home Loan Bank stock, at cost	2,187,500	1,911,600
Loans, net of allowance for loan losses of \$9,618,265 in 2008 and \$13,710,109 in 2007	378,471,619	369,883,009
Bank premises and equipment, net	8,471,955	6,470,893
Accrued interest receivable	1,771,091	2,407,977
Goodwill and amortizable intangibles	2,840,773	2,941,798
Other assets	11,937,004	10,920,605
Total assets	<u>\$ 471,803,175</u>	<u>\$ 444,421,253</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing demand deposits	\$ 40,077,977	\$ 45,284,518
Interest-bearing demand deposits	26,908,572	31,984,590
Savings deposits and money market accounts	35,847,667	49,970,489
Time deposits of \$100,000 or more	59,056,590	58,250,272
Time deposits under \$100,000	164,692,417	127,759,856
Total deposits	326,583,223	313,249,725
Accrued interest payable	469,586	216,086
Federal funds purchased and securities sold under agreements to repurchase	35,790,246	41,560,355
Federal Home Loan Bank advances and line of credit	71,250,000	47,100,000
Other liabilities	1,208,611	5,967,737
Total liabilities	<u>435,301,666</u>	<u>408,093,903</u>
Stockholders' equity:		
Preferred stock - no par value; 2,000,000 shares authorized; no shares issued	-	-
Common stock - \$1.00 par value; 10,000,000 shares authorized; 6,522,718 shares issued in 2008 and 2007; 6,319,718 and 6,369,718 outstanding in 2008 and 2007	6,319,718	6,369,718
Additional paid-in capital	20,311,638	20,532,787
Retained earnings	10,056,680	9,317,878
Accumulated other comprehensive income	(186,527)	106,967
Total stockholders' equity	<u>36,501,509</u>	<u>36,327,350</u>
Total liabilities and stockholders' equity	<u>\$ 471,803,175</u>	<u>\$ 444,421,253</u>

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME
Years Ended December 31, 2008, 2007 and 2006

	2008	2007	2006
INTEREST INCOME			
Loans, including fees	\$ 28,660,491	\$ 32,981,334	\$ 27,317,002
Securities and interest-bearing deposits in other banks	1,996,228	1,750,023	1,583,984
Federal funds sold	23,455	52,161	257,820
Total interest income	30,680,174	34,783,518	29,158,806
INTEREST EXPENSE			
Time deposits of \$100,000 or more	2,370,873	3,134,084	1,993,796
Other deposits	6,928,475	8,206,843	6,550,906
Federal funds purchased and securities sold under agreements to repurchase	600,163	857,161	347,861
Federal Home Loan Bank advances and line of credit	2,798,563	2,215,517	1,413,546
Total interest expense	12,698,074	14,413,605	10,306,109
Net interest income before provision for loan losses	17,982,100	20,369,913	18,852,697
Provision for loan losses	3,498,000	10,409,365	1,106,600
Net interest income after provision for loan losses	14,484,100	9,960,548	17,746,097
NONINTEREST INCOME			
Customer service fees	1,726,681	1,425,822	1,298,041
Other noninterest income	107,522	165,495	91,047
Operating lease income	-	-	300,932
Net gains from sale of loans and other assets	57,828	103,773	421,236
Total noninterest income	1,892,031	1,695,090	2,111,256
NONINTEREST EXPENSES			
Salaries and employee benefits	7,139,594	6,608,808	6,018,619
Net occupancy and equipment expense	1,520,378	1,354,642	1,075,081
Depreciation on leased assets	-	-	244,580
Other operating expenses	3,907,793	2,962,151	3,379,950
Total noninterest expenses	12,567,765	10,925,601	10,718,230
Income before income tax expense	3,808,366	730,037	9,139,123
Income tax expense (benefit)	1,296,542	(141,115)	3,327,523
Net income	\$ 2,511,824	\$ 871,152	\$ 5,811,600
EARNINGS PER COMMON SHARE			
Basic	\$.40	\$.13	\$.90
Diluted	.39	.13	.85

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Years Ended December 31, 2008, 2007 and 2006

	<u>Comprehensive Income</u>	<u>Common Stock</u>	<u>Additional Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income</u>	<u>Total Stockholders' Equity</u>
BALANCE, December 31, 2005		\$ 3,200,863	\$ 21,201,903	\$ 8,229,552	\$ (165,955)	\$ 32,466,363
Issuance of common stock		15,526	246,333	-	-	261,859
Issuance of common stock under Director's stock option plan		51,500	249,940	-	-	301,440
Tax benefit received from Director's stock option exercise		-	202,012	-	-	202,012
Stock compensation expense		-	147,925	-	-	147,925
Dividends - \$.14 per share		-	-	(908,464)	-	(908,464)
Split-up effected in the form of a dividend		3,251,659	-	(3,251,659)	-	-
Repurchase of common stock		(7,700)	(199,107)	-	-	(206,807)
Comprehensive income:						
Net income	\$ 5,811,600	-	-	5,811,600	-	5,811,600
Other comprehensive income, net of tax:						
Unrealized holding gains (losses) on securities available for sale, net of reclassification adjustment	107,337	-	-	-	107,337	107,337
Total comprehensive income	<u>\$ 5,918,937</u>					
BALANCE, December 31, 2006		6,511,848	21,849,006	9,881,029	(58,618)	38,183,265
Issuance of common stock		5,870	20,446	-	-	26,316
Issuance of common stock under Director's stock option plan		5,000	41,610	-	-	46,610
Stock compensation expense		-	220,016	-	-	220,016
Dividends - \$.22 per share		-	-	(1,434,303)	-	(1,434,303)
Repurchase of common stock		(153,000)	(1,598,291)	-	-	(1,751,291)
Comprehensive income:						
Net income	\$ 871,152	-	-	871,152	-	871,152
Other comprehensive income, net of tax:						
Unrealized holding gains (losses) on securities available for sale, net of reclassification adjustment	165,585	-	-	-	165,585	165,585
Total comprehensive income	<u>\$ 1,036,737</u>					
BALANCE, December 31, 2007		<u>\$ 6,369,718</u>	<u>\$ 20,532,787</u>	<u>\$ 9,317,878</u>	<u>\$ 106,967</u>	<u>\$ 36,327,350</u>

(continued on next page)

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Years Ended December 31, 2008, 2007 and 2006

(continued from previous page)

	<u>Comprehensive Income</u>	<u>Common Stock</u>	<u>Additional Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income</u>	<u>Total Stockholders' Equity</u>
BALANCE, December 31, 2007		\$ 6,369,718	\$ 20,532,787	\$ 9,317,878	\$ 106,967	\$ 36,327,350
Issuance of common stock		22,000	60,500	-	-	82,500
Stock compensation expense		-	279,400	-	-	279,400
Dividends - \$.28 per share		-	-	(1,773,022)	-	(1,773,022)
Repurchase of common stock		(72,000)	(561,049)	-	-	(633,049)
Comprehensive income:						
Net income	\$ 2,511,824	-	-	2,511,824	-	2,511,824
Other comprehensive income, net of tax:						
Unrealized holding gains (losses) on securities available for sale, net of reclassification adjustment	(293,494)	-	-	-	(293,494)	(293,494)
Total comprehensive income	<u>\$ 2,218,330</u>					
BALANCE, December 31, 2008		<u>\$ 6,319,718</u>	<u>\$ 20,311,638</u>	<u>\$ 10,056,680</u>	<u>\$ (186,527)</u>	<u>\$ 36,501,509</u>

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years Ended December 31, 2008, 2007 and 2006

	2008	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	\$ 2,511,824	\$ 871,152	\$ 5,811,600
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	694,499	605,062	990,052
Provision for loan losses	3,498,000	10,409,365	1,106,600
Stock compensation expense	279,400	220,016	147,925
Gain on sales of loans and other assets	(57,828)	(103,773)	(421,236)
Deferred income taxes	3,302,186	(3,478,707)	(481,466)
Changes in other operating assets and liabilities:			
Net change in loans held for sale	(112,000)	484,900	(97,752)
Accrued interest receivable	636,886	(287,199)	(381,318)
Accrued interest payable	253,500	(92,306)	65,528
Other assets and liabilities	(7,509,166)	3,154,062	(1,438,845)
Net cash provided by operating activities	<u>3,497,301</u>	<u>11,782,572</u>	<u>5,301,088</u>
CASH FLOWS FROM INVESTING ACTIVITIES			
Proceeds from security transactions:			
Securities available for sale	23,596,577	13,008,453	1,865,807
Securities held to maturity	30,594	36,467	85,400
Purchase of securities available for sale	(33,350,455)	(15,037,296)	(3,975,324)
Purchase of Federal Home Loan Bank stock	(275,900)	(559,400)	(247,700)
Loan originations and principal collections, net	(14,691,368)	(76,239,255)	(43,432,372)
Purchase of bank premises and equipment	(2,589,553)	(840,644)	(1,278,809)
Purchase of equity investment	-	-	(3,000,000)
Proceeds from sale of other real estate and other assets	1,357,027	784,592	806,406
Net cash used in investing activities	<u>(25,923,078)</u>	<u>(78,847,083)</u>	<u>(49,176,592)</u>
CASH FLOWS FROM FINANCING ACTIVITIES			
Net increase in deposits	13,333,498	37,433,192	23,380,643
(Decrease) increase in federal funds purchased and securities sold under agreements to repurchase	(5,770,109)	22,310,654	14,458,964
Proceeds from Federal Home Loan Bank advances	20,000,000	35,000,000	20,000,000
Repayment of Federal Home Loan Bank advances	-	(27,000,000)	(11,000,000)
Net borrowings (repayments) under line of credit	4,150,000	(400,000)	500,000
Purchase of common stock	(633,049)	(1,751,291)	(206,807)
Payment of dividends	(1,773,022)	(1,303,577)	(775,138)
Issuance of common stock	82,500	72,926	563,299
Net cash provided by financing activities	<u>29,389,818</u>	<u>64,361,904</u>	<u>46,920,961</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	6,964,041	(2,702,607)	3,045,457
CASH AND CASH EQUIVALENTS, beginning of year	<u>14,933,349</u>	<u>17,635,956</u>	<u>14,590,499</u>
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 21,897,390</u>	<u>\$ 14,933,349</u>	<u>\$ 17,635,956</u>
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION			
Cash paid during the period for interest	\$ 12,444,574	\$ 14,505,911	\$ 10,240,581
Cash paid during the period for taxes	<u>738,886</u>	<u>4,092,910</u>	<u>3,259,073</u>
NONCASH INVESTING AND FINANCING ACTIVITIES			
Acquisition of real estate through foreclosure	\$ 2,915,414	\$ 1,518,329	\$ 493,588
Loan extended in lieu of cash for sale of leased assets	<u>-</u>	<u>-</u>	<u>1,950,435</u>

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008, 2007 and 2006

Note 1. Summary of Significant Accounting Policies

The accounting and reporting policies of Cornerstone Bancshares, Inc. and subsidiaries (Cornerstone) conform with accounting principles generally accepted in the United States of America and accepted accounting and reporting practices within the banking industry. The significant accounting policies are summarized as follows:

Nature of operations and geographic concentration:

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

Principles of consolidation:

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

Goodwill:

Goodwill represents the excess of the cost of Cornerstone's 1997 purchase of the net assets of the Bank of East Ridge over the underlying fair value of such net assets at the date of acquisition. Cornerstone applies the provisions of Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets," which requires that goodwill and other intangible assets deemed to have an indefinite life not be amortized. Goodwill is tested annually for impairment. If the carrying value of goodwill exceeds the fair value, a write-down is recorded. There was no impairment in any of the years ending December 31, 2008, 2007 or 2006.

Use of estimates:

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

Securities:

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

Debt securities not classified as held to maturity are classified as available for sale. Securities available for sale are carried at market value with unrealized gains and losses reported in other comprehensive income. Realized gains and losses on securities available for sale are included in other income and, when applicable, are reported as a reclassification adjustment, net of tax, in other comprehensive income.

Declines in the market value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other than temporary impairment losses, management considers (1) the length of time and the extent to which the market value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of Cornerstone to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008, 2007 and 2006

Note 1. Summary of Significant Accounting Policies (continued)

Loans:

Cornerstone grants mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio is represented by mortgage loans throughout Chattanooga, Tennessee and surrounding areas. The ability of Cornerstone's customers to pay their loans is dependent upon both real estate and general economic conditions in this concentrated area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for the allowance for loan losses, if any, and any deferred fees or costs on originated loans. Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated market value in the aggregate. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment to the related loan yield using the interest method.

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

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

Allowance for loan losses:

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

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

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as either doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008, 2007 and 2006

Note 1. Summary of Significant Accounting Policies (continued)

Allowance for loan losses: (continued)

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

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

Premises and equipment:

Land is carried at cost. Other premises and equipment are carried at cost net of accumulated depreciation. Depreciation is computed using the straight-line method based on the estimated useful lives of the assets. Maintenance and repairs are expensed as incurred while major additions and improvements are capitalized. Gains and losses on dispositions, if any, are reported in current operations.

Investment in partnership:

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

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

Other real estate owned:

Real estate properties acquired through or in lieu of loan foreclosure are initially recorded at the lower of Cornerstone's carrying amount or fair value less estimated selling cost at the date of foreclosure. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. After foreclosure, these assets are carried at the lower of their new cost basis or fair value less cost to sell. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. The portion of interest costs relating to development of real estate is capitalized. Valuations are periodically performed by management, and any subsequent write-downs are recorded as a charge to operations, if necessary, to reduce the carrying value of a property to the lower of its cost or fair value less cost to sell.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008, 2007 and 2006

Note 1. Summary of Significant Accounting Policies (continued)

Income taxes:

Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which the temporary differences are expected to be recovered or settled.

Transfers of financial assets:

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

Advertising costs:

Cornerstone expenses all advertising costs as incurred. Advertising expense was \$92,252, \$83,632, and \$84,233, for the years ended December 31, 2008, 2007 and 2006, respectively.

Cash and cash equivalents:

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

Stock-based compensation:

At December 31, 2008, Cornerstone had two stock-based compensation plans. Effective January 1, 2006, Cornerstone adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" (SFAS 123R), which was issued by the FASB in December 2004. SFAS 123R revises SFAS 123 "Accounting for Stock Based Compensation", and supersedes APB 25, "Accounting for Stock Issued to Employees" (APB 25) and its related interpretations. SFAS 123R requires recognition of the cost of employee services received in exchange for an award of equity instruments in the financial statements over the period the employee is required to perform the services in exchange for the award (presumptively the vesting period). SFAS 123R also requires measurement of the cost of employee services received in exchange for an award based on the grant date fair value of the award. SFAS 123R also amends SFAS 95 "Statement of Cash Flows", to require that excess tax benefits be reported as financing cash inflows, rather than as a reduction of taxes paid, which is included within operating cash flows.

Cornerstone adopted SFAS 123R using the modified prospective application as permitted under SFAS 123R. Accordingly, prior period amounts have not been restated. Under this application, Cornerstone is required to record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding at the date of adoption. Prior to the adoption of SFAS 123R, Cornerstone used the intrinsic value method as prescribed by APB 25 and thus recognized no compensation expense for options granted with exercise prices equal to the fair market value of Cornerstone's common stock on the date of grant.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008, 2007 and 2006

Note 1. Summary of Significant Accounting Policies (continued)

Segment reporting:

Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information" (SFAS 131) provides for the identification of reportable segments on the basis of distinct business units and their financial information to the extent such units are reviewed by an entity's chief decision maker (which can be an individual or group of management persons). SFAS 131 permits aggregation or combination of segments that have similar characteristics. In Cornerstone's operations, each bank branch is viewed by management as being a separately identifiable business or segment from the perspective of monitoring performance and allocation of financial resources. Although the branches operate independently and are managed and monitored separately, each is substantially similar in terms of business focus, type of customers, products and services. Further, the results of Eagle for 2008, 2007 and 2006 were not significant for separate disclosure. Accordingly, Cornerstone's consolidated financial statements reflect the presentation of segment information on an aggregated basis in one reportable segment.

Earnings per 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 Cornerstone relate solely to outstanding stock options, and are determined using the treasury stock method.

Variable interest entities:

An entity is referred to as a variable interest entity (VIE) if it meets the criteria outlined in FASB Interpretation No. 46-R, "Consolidation of Variable Interest Entities (revised December 2003)" (FIN 46-R), which are: (1) the entity has equity that is insufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, or (2) the entity has equity investors that cannot make significant decisions about the entity's operations or that do not absorb the expected losses or receive the expected returns of the entity.

In addition, as specified in FIN 46-R, a VIE must be consolidated by Cornerstone if it is deemed to be the primary beneficiary of the VIE, which is the party involved with the VIE that has a majority of the expected losses, expected residual returns, or both. Cornerstone has an investment in Appalachian Fund for Growth II Partnership that qualifies as an unconsolidated VIE.

Reclassification:

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

Off-balance sheet credit related financial instruments:

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008, 2007 and 2006

Note 2. Restrictions on Cash and Due From Banks

The Bank is required to maintain balances on hand or with the Federal Reserve Bank based on a percentage of deposits. At December 31, 2008 and 2007, these reserve balances were approximately \$2,321,000 and \$2,826,000, respectively.

Note 3. Securities

Securities have been classified on 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, 2008 and 2007, is as follows:

	December 31, 2008			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
Securities available for sale:				
U.S. Government securities	\$ 7,976,040	\$ 275,731	\$ -	\$ 8,251,771
State and municipal securities	4,609,632	82,013	(68,830)	4,622,815
Mortgage-backed securities	31,753,504	160,387	(731,918)	31,181,973
	<u>\$ 44,339,176</u>	<u>\$ 518,131</u>	<u>\$ (800,748)</u>	<u>\$ 44,056,559</u>
Securities held to maturity:				
Mortgage-backed securities	<u>\$ 169,284</u>	<u>\$ 1,158</u>	<u>\$ (683)</u>	<u>\$ 169,759</u>
	December 31, 2007			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
Securities available for sale:				
U.S. Government securities	\$ 27,335,992	\$ 116,624	\$ (38,942)	\$ 27,413,674
State and municipal securities	3,436,399	66,369	(3)	3,502,765
Mortgage-backed securities	3,817,522	20,427	(2,403)	3,835,546
	<u>\$ 34,589,913</u>	<u>\$ 203,420</u>	<u>\$ (41,348)</u>	<u>\$ 34,751,985</u>
Securities held to maturity:				
Mortgage-backed securities	<u>\$ 200,037</u>	<u>\$ 424</u>	<u>\$ (783)</u>	<u>\$ 199,678</u>

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008, 2007 and 2006

Note 3. Securities (continued)

At December 31, 2008 and 2007, securities with a carrying value of approximately \$11,262,000 and \$11,255,000, respectively, were pledged to secure public deposits and for other purposes required or permitted by law.

At December 31, 2008 and 2007, the carrying amount of securities pledged to secure repurchase agreements was approximately \$32,516,000 and \$18,270,000, respectively.

The amortized cost and estimated market value of securities at December 31, 2008, 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	Market Value	Amortized Cost	Market Value
Due in one year or less	\$ 6,121,575	\$ 6,253,467	\$ -	\$ -
Due from one year to five years	900,112	925,194	-	-
Due from five years to ten years	1,752,383	1,792,728	-	-
Due after ten years	3,811,602	3,903,197	-	-
	12,585,672	12,874,586	-	-
Mortgage-backed securities	31,753,504	31,181,973	169,284	169,759
	<u>\$ 44,339,176</u>	<u>\$ 44,056,559</u>	<u>\$ 169,284</u>	<u>\$ 169,759</u>

For the years ended December 31, 2008, 2007 and 2006, there were no sales of securities available for sale.

The following tables present gross unrealized losses and market value, aggregated by investment category and length of time that individual securities available for sale have been in a continuous unrealized loss position, at December 31, 2008 and 2007:

	As of December 31, 2008					
	Less than 12 Months		12 Months or Greater		Total	
	Market Value	Gross Unrealized Losses	Market Value	Gross Unrealized Losses	Market Value	Gross Unrealized Losses
Securities available for sale:						
State and municipal securities	\$ 1,125,144	\$ (48,772)	\$ 206,650	\$ (20,058)	\$ 1,331,794	\$ (68,830)
Mortgage-backed securities	19,234,621	(719,051)	642,457	(12,867)	19,877,078	(731,918)
	<u>\$ 20,359,765</u>	<u>\$ (767,823)</u>	<u>\$ 849,107</u>	<u>\$ (32,925)</u>	<u>\$ 21,208,872</u>	<u>\$ (800,748)</u>
Securities held to maturity:						
Mortgage-backed securities	<u>\$ 26,405</u>	<u>\$ (289)</u>	<u>\$ 30,897</u>	<u>\$ (394)</u>	<u>\$ 57,302</u>	<u>\$ (683)</u>

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008, 2007 and 2006

Note 3. Securities (continued)

	As of December 31, 2007					
	Less than 12 Months		12 Months or Greater		Total	
	Market Value	Gross Unrealized Losses	Market Value	Gross Unrealized Losses	Market Value	Gross Unrealized Losses
Securities available for sale:						
U.S. Government securities	\$ 873,281	\$ (29)	\$ 12,951,003	\$ (38,913)	\$ 13,824,284	\$ (38,942)
State and municipal securities	-	-	229,139	(3)	229,139	(3)
Mortgage-backed securities	851,190	(2,403)	-	-	851,190	(2,403)
	<u>\$ 1,724,471</u>	<u>\$ (2,432)</u>	<u>\$ 13,180,142</u>	<u>\$ (38,916)</u>	<u>\$ 14,904,613</u>	<u>\$ (41,348)</u>
Securities held to maturity:						
Mortgage-backed securities	<u>\$ 31,603</u>	<u>\$ (34)</u>	<u>\$ 111,525</u>	<u>\$ (749)</u>	<u>\$ 143,128</u>	<u>\$ (783)</u>

Although there have been declines in the market value and credit quality of some of Cornerstone's investment securities during 2008, management believes it is probable that Cornerstone will be able to collect all amounts due according to the contractual terms of securities considered to be impaired at year end. Management believes the impairment relates primarily to the current interest rate environment and an overall temporary decline in values in the financial markets. Since management has the ability to hold its debt securities until maturity, or for the foreseeable future for its securities available for sale, no declines in fair value are deemed to be other than temporary in nature.

Note 4. Loans and Allowance for Loan Losses

At December 31, 2008 and 2007, the Bank's loans consist of the following (in thousands):

	2008	2007
Mortgage loans on real estate:		
Residential 1-4 family	\$ 42,136	\$ 35,309
Residential multifamily (5 or more)	14,747	16,573
Held for sale	104	216
Commercial	155,728	138,074
Construction	70,456	76,832
Second mortgages	3,030	2,270
Equity lines of credit	12,720	10,214
	<u>298,921</u>	<u>279,488</u>
Commercial loans	83,140	97,896
Consumer installment loans:		
Personal	5,486	5,652
Credit cards	543	557
	<u>6,029</u>	<u>6,209</u>
Total loans	388,090	383,593
Less: Allowance for loan losses	(9,618)	(13,710)
Loans, net	\$ 378,472	\$ 369,883

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008, 2007 and 2006

Note 4. Loans and Allowance for Loan Losses (continued)

	<u>2008</u>	<u>2007</u>	<u>2006</u>
An analysis of the allowance for loan losses follows:			
Balance, beginning of year	\$ 13,710,109	\$ 4,258,352	\$ 3,545,042
Provision charged to operations	3,498,000	10,409,365	1,106,600
Charge-offs	(7,978,767)	(1,075,670)	(470,367)
Recoveries	388,923	118,062	77,077
Balance, end of year	<u>\$ 9,618,265</u>	<u>\$ 13,710,109</u>	<u>\$ 4,258,352</u>

The Bank's only significant concentration of credit at December 31, 2008, occurred in real estate loans which totaled approximately \$299 million. While real estate loans accounted for 77 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.

The following is a summary of information pertaining to impaired and non-accrual loans:

	December 31,	
	<u>2008</u>	<u>2007</u>
Impaired loans without a valuation allowance	\$ 2,543,320	\$ 17,075
Impaired loans with a valuation allowance	17,375,043	13,176,547
Total impaired loans	<u>\$ 19,918,363</u>	<u>\$ 13,193,622</u>
Valuation allowance related to impaired loans	<u>\$ 5,872,373</u>	<u>\$ 9,789,748</u>
Total non-accrual loans	<u>\$ 4,252,791</u>	<u>\$ 684,903</u>
Total loans past-due ninety days or more and still accruing	<u>\$ -</u>	<u>\$ -</u>

	Years Ended December 31,		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
Average investment in impaired loans	<u>\$ 10,891,357</u>	<u>\$ 3,348,873</u>	<u>\$ 1,754,906</u>
Interest income recognized on impaired loans	<u>\$ 966,011</u>	<u>\$ 1,182,407</u>	<u>\$ 121,987</u>
Interest income recognized on a cash basis on impaired loans	<u>\$ -</u>	<u>\$ 28,900</u>	<u>\$ 78,391</u>

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

	<u>2008</u>	<u>2007</u>
Beginning balance	\$ 772,942	\$ 751,496
New loans	65,177	521,678
Repayments	(648,446)	(500,232)
Ending balance	<u>\$ 189,673</u>	<u>\$ 772,942</u>

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008, 2007 and 2006

Note 5. Bank Premises and Equipment

A summary of bank premises and equipment at December 31, 2008 and 2007, is as follows:

	<u>2008</u>	<u>2007</u>
Land	\$ 3,338,413	\$ 1,658,625
Buildings and improvements	4,537,349	4,131,932
Furniture, fixtures and equipment	<u>4,255,237</u>	<u>3,849,462</u>
	12,130,999	9,640,019
Accumulated depreciation	<u>(3,659,044)</u>	<u>(3,169,126)</u>
	<u>\$ 8,471,955</u>	<u>\$ 6,470,893</u>

Depreciation expense for the years ended December 31, 2008, 2007 and 2006, amounted to \$588,490, \$500,573, and \$644,664, respectively.

Certain bank facilities and equipment are leased under various operating leases. Total rent expense on these leases for the years ended December 31, 2008, 2007 and 2006, was \$386,714, \$384,004, and \$235,455, respectively.

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

2009	\$ 362,507
2010	344,662
2011	343,212
2012	341,003
2013	341,003
Thereafter	<u>699,540</u>
Total	<u>\$ 2,431,927</u>

Note 6. Time and Related-Party Deposits

At December 31, 2008, the scheduled maturities of time deposits are as follows:

2009	\$ 192,693
2010	27,416
2011	2,662
2012	50
2013	<u>928</u>
Total	<u>\$ 223,749</u>

Deposits from related parties held by the Bank at December 31, 2008 and 2007, amounted to approximately and \$1,007,000 and \$692,000, respectively.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008, 2007 and 2006

Note 7. Income Taxes

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

Income tax expense in the statements of income for the years ended December 31, 2008, 2007 and 2006, consists of the following:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Current tax expense	\$ (2,005,644)	\$ 3,337,592	\$ 3,808,989
Deferred tax expense (benefit) related to:			
Allowance for loan losses	3,158,858	(3,623,934)	(356,910)
Other	<u>143,328</u>	<u>145,227</u>	<u>(124,556)</u>
Income tax expense (benefit)	<u>\$ 1,296,542</u>	<u>\$ (141,115)</u>	<u>\$ 3,327,523</u>

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

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Expected tax at statutory rates	\$ 1,294,844	\$ 248,213	\$ 3,107,302
Increase (decrease) resulting from tax effect of:			
State income taxes, net of federal tax benefit	163,379	31,318	392,068
New market tax credits	(150,000)	(300,000)	(150,000)
Other	<u>(11,681)</u>	<u>(120,646)</u>	<u>(21,847)</u>
Income tax expense (benefit)	<u>\$ 1,296,542</u>	<u>\$ (141,115)</u>	<u>\$ 3,327,523</u>

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

	<u>2008</u>	<u>2007</u>
Deferred tax assets:		
Deferred compensation	\$ 124,583	\$ 133,011
Deferred loan fees	52,150	103,112
Allowance for loan losses	1,935,933	5,094,791
Net unrealized loss on securities available for sale	151,194	-
Other	<u>28,334</u>	<u>68,351</u>
	<u>2,292,194</u>	<u>5,399,265</u>
Deferred tax liabilities:		
Depreciation	126,979	96,972
Life insurance	186,721	173,427
Net unrealized gain in securities available for sale	-	85,303
Other	<u>14,165</u>	<u>13,545</u>
	<u>327,865</u>	<u>369,247</u>
Net deferred tax asset	<u>\$ 1,964,329</u>	<u>\$ 5,030,018</u>

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008, 2007 and 2006

Note 7. Income Taxes (continued)

In July 2006, FASB issued Financial Interpretation No. 48, "Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109" (FIN 48), which clarifies the accounting for uncertainty in tax positions. This Interpretation requires that Cornerstone recognize in its financial statements, the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 were effective as of the beginning of Cornerstone's 2007 fiscal year. The adoption of this interpretation did not have a material impact on Cornerstone's consolidated financial statements. Further, Cornerstone recognized no interest and penalties assessed by taxing authorities on any underpayment of income tax for 2008, 2007 or 2006.

Note 8. Federal Funds Purchased and Securities Sold Under Agreements to Repurchase

Federal funds purchased and securities sold under agreements to repurchase amounted to \$35,790,246 and \$41,560,355 at December 31, 2008 and 2007, respectively. These agreements generally mature within one to four days from the transaction date.

Note 9. Federal Home Loan Bank Advances and Line of Credit

The Bank has agreements with the Federal Home Loan Bank of Cincinnati (FHLB) that can provide advances to the Bank in an amount up to approximately \$76,000,000. All of the Bank's loans secured by first mortgages on 1-4 family residential, multi-family properties, and commercial properties are pledged as collateral for these advances.

At December 31, 2008 and 2007, FHLB advances consist of the following:

	<u>2008</u>	<u>2007</u>
Long-term advance dated December 27, 2000, requiring monthly interest payments, fixed at 5.00% until conversion option is exercised, principal due in December 2010	\$ 2,000,000	\$ 2,000,000
Long-term advance dated February 9, 2005, requiring monthly interest payments, fixed at 3.86%, convertible on February 2010, principal due in February 2015	5,000,000	5,000,000
Long-term advance dated May 14, 2007, requiring monthly interest payments, fixed at 4.78%, with a put option exercisable in November 2007 and then quarterly thereafter, principal due in May 2010	5,000,000	5,000,000
Long-term advance dated December 6, 2007, requiring monthly interest payments, fixed at 3.87%, until maturity, principal due in December 2010	5,000,000	5,000,000
Long-term advance dated June 26, 2008, requiring monthly interest payments, fixed at 3.64%, until maturity, principal due in July 2010	5,000,000	-
Long-term advance dated July 2, 2008, requiring monthly interest payments, fixed at 3.85%, until maturity, principal due in July 2011	5,000,000	-
Long-term advance dated January 18, 2008, requiring monthly interest payments, fixed at 3.59%, until maturity, principal due in January 2013	5,000,000	-

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008, 2007 and 2006

Note 9. Federal Home Loan Bank Advances and Line of Credit (continued)

	<u>2008</u>	<u>2007</u>
Long-term advance dated May 11, 2007, requiring monthly interest payments, fixed at 4.66%, with a put option exercisable in February 2008 and then quarterly thereafter, principal due in May 2011	\$ 5,000,000	\$ 5,000,000
Long-term advance dated May 15, 2007, requiring monthly interest payments, fixed at 4.58%, with a put option exercisable in May 2008 and then quarterly thereafter, principal due in May 2012	5,000,000	5,000,000
Long-term advance dated July 31, 2007, requiring monthly interest payments, fixed at 4.50%, with a put option exercisable in July 2008 and then quarterly thereafter, principal due in July 2013	5,000,000	5,000,000
Long-term advance dated August 7, 2007, requiring monthly interest payments, fixed at 4.43%, with a put option exercisable in February 2009 and then quarterly thereafter, principal due in August 2014	5,000,000	5,000,000
Long-term advance dated January 2, 2008, requiring monthly interest payments, fixed at 3.52% with a put option exercisable in January 2011 and the quarterly thereafter, principal due in January 2015	5,000,000	-
Long-term advance dated January 20, 2006, requiring monthly interest payments, fixed at 4.18%, with a put option exercisable in January 2009 and then quarterly thereafter, principal due in January 2016	5,000,000	5,000,000
Long-term advance dated January 10, 2007, requiring monthly interest payments, fixed at 4.25%, with a put option exercisable in January 2008 and then quarterly thereafter, principal due in January 2017	5,000,000	5,000,000
	<u>\$ 67,000,000</u>	<u>\$ 47,000,000</u>

Scheduled maturities of the Federal Home Loan Bank advances are as follows:

2009	\$ -
2010	17,000,000
2011	10,000,000
2012	5,000,000
2013	10,000,000
Thereafter	<u>25,000,000</u>
Total	<u>\$ 67,000,000</u>

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008, 2007 and 2006

Note 9. Federal Home Loan Bank Advances and Line of Credit (continued)

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

Cornerstone has an \$8,500,000 line of credit with another bank that is secured by 100% of the Bank's common stock and bears interest at Prime minus 1.50%, due quarterly. Outstanding principal and accrued interest are due in March 2009. Borrowings outstanding under the agreements were \$4,250,000 and \$100,000 at December 31, 2008 and 2007, respectively.

Note 10. Employee Benefit Plans

401(k) plan:

Cornerstone has a 401(k) employee benefit plan covering substantially all employees that have completed at least 30 days of service and met minimum age requirements. Cornerstone's contribution to the plan is discretionary and was \$87,408 for 2008, \$230,732 for 2007 and \$195,445 for 2006.

Employee Stock Ownership Plan:

Cornerstone has a non-leveraged employee stock ownership plan (ESOP) to which Cornerstone makes 100% of the contributions for purchasing Cornerstone's common stock, and allocates the contributions among the participants based on regulatory guidelines. Cornerstone's contribution is discretionary, as determined by the Compensation Committee. Employer contributions are available to all employees after 1,000 hours of service. There are certain age and years-of-service requirements before contributions can be made for the benefit of the employee. The ESOP plan also provides for a three year 100% vesting requirement; therefore, employees terminating employment before their third anniversary date will forfeit their accrued benefit under the ESOP. The forfeiture will be re-allocated among the remaining ESOP participants. Cornerstone made a contribution of \$166,347 in 2008, no contribution to the ESOP in 2007 and a contribution of \$248,261 in 2006.

Note 11. Financial Instruments With Off-Balance-Sheet Risk

In the normal course of business, the Bank has outstanding commitments and contingent liabilities, such as commitments to extend credit and standby letters of credit, which are not included in the accompanying financial statements. The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual or notional amount of those instruments. The Bank uses the same credit policies in making such commitments as it does for instruments that are included in the balance sheet. At December 31, 2008 and 2007, undisbursed loan commitments aggregated \$63,426,000 and \$71,690,000, respectively. In addition, there were outstanding standby letters of credit totaling \$3,983,000 and \$4,996,000, respectively.

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008, 2007 and 2006

Note 11. Financial Instruments With Off-Balance-Sheet Risk (continued)

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

The Bank incurred insignificant losses on its commitments during 2008, 2007 and 2006.

Note 12. Fair Value Disclosures

Fair value measurements:

On January 1, 2008, Cornerstone adopted Statement of Financial Accounting Standards No. 157, "Fair Value Measurements," (SFAS 157), which defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS 157 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value.

Level 1: Quoted prices (unadjusted) or identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

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

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

Cornerstone utilizes fair value measurements to record fair value adjustments to certain assets and determine fair value disclosures. Accordingly, securities available for sale are recorded at fair value on a recurring basis. Additionally, from time to time, Cornerstone may be required to record other assets at fair value on a nonrecurring basis, such as loans held for sale, and impaired loans. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

Following is a description of valuation methodologies used for assets and liabilities recorded at fair value.

Securities available for sale-Investment securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities, U.S. Government securities and municipal bonds.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008, 2007 and 2006

Note 12. Fair Value Disclosures (continued)

Fair value measurements (continued):

Impaired loans-Cornerstone does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with SFAS 114, "Accounting by Creditors for Impairment of a Loan," (SFAS 114). The fair value of impaired loans is estimated using one of several methods, including collateral value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. In accordance with SFAS 157, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, we record the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, we record the impaired loan as nonrecurring Level 3.

Assets and liabilities recorded at fair value on a recurring basis are as follows (amounts in thousands).

	Balance as of December 31, 2008	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Securities available for sale	\$ 44,057	\$ -	\$ 44,057	\$ -

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

Assets measured at fair value on a nonrecurring basis are included in the table below (amounts in thousands).

	Balance as of December 31, 2008	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans	\$ 11,503	\$ -	\$ -	\$ 11,503

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral-dependent loans, had a carrying amount of approximately \$17,375,000, with a valuation allowance of approximately \$5,872,000 at December 31, 2008. Losses derived from Level 3 inputs were calculated primarily by models utilizing estimated collateral value or the discounted present value of expected cash flows.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 12. Fair Value Disclosures (continued)

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 Cornerstone's entire holdings of a particular financial instrument. Because no market exists for a significant portion of Cornerstone'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 is estimated based on bid prices published in financial newspapers or bid quotations received from securities dealers.

Federal Home Loan Bank stock:

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

Loans, net:

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 deposits, 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 and line of credit:

The carrying amounts of the FHLB advances and the line of credit approximate their fair value.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008, 2007 and 2006

Note 12. Fair Value Disclosures (continued)

Fair value of financial instruments (continued)

Commitments to extend credit:

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

The carrying amount and estimated fair value of Cornerstone's financial instruments at December 31, 2008 and 2007, are as follows (in thousands):

	2008		2007	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Assets:				
Cash and cash equivalents	\$ 21,897	\$ 21,897	\$ 14,933	\$ 14,933
Securities	44,226	44,226	34,952	34,952
Federal Home Loan Bank stock	2,188	2,188	1,912	1,912
Loans, net	378,472	380,394	369,883	373,116
Liabilities:				
Noninterest-bearing demand deposits	40,078	40,078	45,285	45,285
Interest-bearing demand deposits	26,909	26,909	31,985	31,985
Savings deposits and money market accounts	35,848	35,848	49,970	49,970
Time deposits	223,749	225,882	186,010	189,106
Federal funds purchased and securities sold under agreements to repurchase	35,790	35,790	41,560	41,560
Federal Home Loan Bank advances and line of credit	71,250	71,250	47,100	47,100
Unrecognized financial instruments (net of contract amount):				
Commitments to extend credit	-	-	-	-

Note 13. Contingencies

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008, 2007 and 2006

Note 14. Stock Option Plans

Cornerstone has stock option plans which are more fully described below. For the years ended December 31, 2008, 2007 and 2006 Cornerstone recognized \$279,400, \$220,016 and \$147,925 respectively, in compensation expense for all stock options.

The fair value of each option granted is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	Years Ended December 31,		
	2008	2007	2006
Dividend yield	1.47%	1.33%	0.98%
Expected life	8.0 years	7.0 years	6.6 years
Expected volatility	20.27%	12.22%	11.80%
Risk-free interest rate	4.22%	4.51%	5.11%

The expected volatility is based upon historical volatility. The risk-free interest rates for periods within the contractual life of the awards are based on the U.S. Treasury yield curve in effect at the time of the grant. The expected life is based on historical exercise experience. The dividend yield assumption is based on Cornerstone's history and expectation of dividend payouts. During 2006 Cornerstone's stock options were subject to a 2-for-1 stock dividend. The impact of the dividend was to double the total number of options available under each of the stock option plans and reduce the existing option price in half. The information shown below retroactively reflects the impact of this dividend. Below is a more detailed description of the stock option plans.

Board of Directors plan:

Cornerstone has a stock option plan under which members of the Board of Directors, at the formation of the Bank, were granted options to purchase a total of up to 600,000 shares of common stock. Only non-qualified stock options may be granted under the Plan. In addition, members of the Board of Directors can be issued options under the Cornerstone 2002 Long-Term Incentive Plan to purchase up to 1,200,000 shares of Cornerstone stock. The options available for issuance to Board members under the 2002 Long-Term Incentive Plan are shared with officers and employees of Cornerstone. The exercise price of each option equals the market price of Cornerstone's stock on the date of grant and the option's maximum term is ten years, at which point they expire. Vesting for options granted during 2006, 2007 and 2008, are 50% on each of the first and second anniversary of the grant date with full vesting occurring at the second anniversary date. At December 31, 2008, the total remaining compensation cost to be recognized on non-vested options is approximately \$44,000. An analysis of this stock option plan is presented in the following table:

	Years Ended December 31,					
	2008		2007		2006	
	Shares	Average Exercise Price	Shares	Average Exercise Price	Share	Average Exercise Price
Outstanding at beginning of year	69,000	\$ 11.23	67,000	\$ 10.61	90,000	\$ 3.80
Granted	12,800	7.99	9,000	15.25	40,000	13.25
Exercised	-	-	(5,000)	9.32	(63,000)	2.55
Forfeited	-	-	(2,000)	13.25	-	-
Outstanding at end of year	<u>81,800</u>	\$ 10.73	<u>69,000</u>	\$ 11.23	<u>67,000</u>	\$ 10.61
Options exercisable at year-end	<u>64,500</u>	\$ 10.95	<u>42,000</u>	\$ 9.51	<u>22,500</u>	\$ 6.20
Weighted-average fair value of options granted during the year	\$ 2.23		\$ 3.33		\$ 3.24	



CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008, 2007 and 2006

Note 14. Stock Option Plans (continued)

- (1) The aggregate intrinsic value of a stock option in the table above represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on December 31, 2008. This amount changes based on changes in the market value of the Cornerstone's stock. The fair value (present value of the estimated future benefit to the option holder) of each option grant is estimated on the date of grant using the Black-Scholes option pricing model.

Information pertaining to options outstanding at December 31, 2008, is as follows:

Exercise Prices	Options Outstanding			Options Exercisable		
	Number Outstanding	Weighted Average Remaining Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price	
\$ 5.44	16,000	5.2 Years	\$ 5.44	16,000	\$ 5.44	
9.23	8,000	6.2 Years	9.23	8,000	9.23	
13.25	36,000	7.2 Years	13.25	36,000	13.25	
15.25	9,000	8.2 Years	15.25	4,500	15.25	
7.99	12,800	9.2 Years	7.99	-	-	
Outstanding at end of year	<u>81,800</u>	7.9 Years	10.73	<u>64,500</u>	10.95	

Information pertaining to non-vested options for the year ended December 31, 2008, is as follows:

	Number of Shares	Weighted Average Grant Date Fair Value
Non-vested options, December 31, 2007	27,000	\$ 13.93
Granted	12,800	7.99
Vested	(22,500)	13.65
Forfeited/expired	-	-
Non-vested options, December 31, 2008	<u>17,300</u>	9.88

The total fair value of shares vested during 2008 was approximately \$ 171,000.

Officer and Employee Plans:

Cornerstone has two stock option plans, the 1996 Cornerstone Statutory and Non-statutory Option Plan and the Cornerstone 2002 Long-Term Incentive Plan, under which officers and employees can be granted incentive stock options or non-qualified stock options to purchase a total of up to 220,000 and 1,200,000 shares, respectively, of Cornerstone's common stock. The option price for incentive stock options shall be not less than 100 percent of the fair market value of the common stock on the date of the grant. The non-qualified stock options may be equal to or more or less than the fair market value of the common stock on the date of the grant. The stock options vest at 30 percent on the second and third anniversaries of the grant date and 40 percent on the fourth anniversary of the grant date. These options expire ten years from the grant date. At December 31, 2008, the total remaining compensation cost to be recognized on non-vested options is approximately \$573,000. An analysis of the activity for each of the years ending December 31, 2008, 2007 and 2006, for this stock option plan follows:

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008, 2007 and 2006

Note 14. Stock Option Plans (continued)

	Years Ended December 31,						
	2008		2007		2006		
	Shares	Average Exercise Price	Aggregate Intrinsic Value(1)	Shares	Average Exercise Price	Shares	Average Exercise Price
Outstanding at beginning of year	715,075	\$ 6.52		669,120	\$ 5.79	632,500	\$ 4.64
Granted	71,500	7.99		53,800	15.25	82,800	13.25
Exercised	(22,000)	3.75		(5,870)	4.48	(46,180)	3.54
Forfeited	(9,150)	13.34		(1,975)	14.03	-	-
Outstanding at end of year	<u>755,425</u>	\$ 6.63	\$ 1,634,022	<u>715,075</u>	\$ 6.52	<u>669,120</u>	\$ 5.79
Options exercisable at year-end	<u>549,516</u>	\$ 4.87	\$ 1,634,022	<u>470,990</u>	\$ 4.06	<u>367,120</u>	\$ 3.71
Weighted-average fair value of options granted during the year	\$ 2.23			\$ 3.33		\$ 3.24	

- (1) The aggregate intrinsic value of a stock option in the table above represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on December 31, 2008. This amount changes based on changes in the market value of the Cornerstone's stock. The total intrinsic value of options exercised during 2008 was approximately \$78,000. The fair value (present value of the estimated future benefit to the option holder) of each option grant is estimated on the date of grant using the Black-Scholes option pricing model.

Information pertaining to options outstanding at December 31, 2008, is as follows:

Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$3.25 - \$3.75	346,600	2.8 Years	\$ 3.50	346,600	\$ 3.50
5.44	132,440	5.2 Years	5.44	132,440	5.44
9.23	78,910	6.2 Years	9.23	47,346	9.23
13.25	77,100	7.2 Years	13.25	23,130	13.25
15.25	46,875	8.2 Years	15.25	-	-
15.20	2,750	8.3 Years	15.20	-	-
7.99	<u>70,750</u>	9.2 Years	7.99	-	-
Outstanding at end of year	<u>755,425</u>	5.0 Years	6.63	<u>549,516</u>	4.87

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 14. Stock Option Plans (continued)

Information pertaining to non-vested options for the year ended December 31, 2008, is as follows:

	Number of Shares	Weighted Average Grant Date Fair Value
Non-vested options, December 31, 2007	244,085	\$ 11.08
Granted	71,500	7.99
Vested	(100,526)	8.15
Forfeited/expired	(9,150)	13.34
Non-vested options, December 31, 2008	<u>205,909</u>	11.31

The total fair value of shares vested during 2008 was approximately \$693,000.

Note 15. Liquidity and Capital Resources

Cornerstone's primary source of funds with which to pay its future obligations is the receipt of dividends from its subsidiary bank. Banking regulations provide that the Bank must maintain capital sufficient to enable it to operate as a viable institution and, as a result, may limit the amount of dividends the Bank may pay without prior approval. It is management's intention to limit the amount of dividends paid in order to maintain compliance with capital guidelines and to maintain an appropriate capital position in the Bank.

Note 16. Regulatory Matters

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

Quantitative measures established by regulation to ensure capital adequacy require Cornerstone and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2008 and 2007, that Cornerstone and the Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2008, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following tables. There are no conditions or events since that notification that management believes have changed the Bank's prompt corrective action category for bank capital.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008, 2007 and 2006

Note 16. Regulatory Matters (continued)

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

	Actual		Minimum Capital Requirements		Minimum To Be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2008:						
Total capital to risk-weighted assets:						
Consolidated	\$ 38,974	9.7%	\$ 32,282	8.0%	N/A	N/A
Cornerstone Community Bank	41,410	10.3%	32,130	8.0%	\$ 40,163	10.0%
Tier 1 capital to risk-weighted assets:						
Consolidated	33,873	8.4%	16,141	4.0%	N/A	N/A
Cornerstone Community Bank	36,336	9.1%	16,065	4.0%	24,098	6.0%
Tier 1 capital to average assets:						
Consolidated	33,873	7.4%	18,390	4.0%	N/A	N/A
Cornerstone Community Bank	36,336	7.9%	18,339	4.0%	22,924	5.0%
As of December 31, 2007:						
Total capital to risk-weighted assets:						
Consolidated	\$ 38,353	9.7%	\$ 31,660	8.0%	N/A	N/A
Cornerstone Community Bank	36,651	9.3%	31,409	8.0%	\$ 39,261	10.0%
Tier 1 capital to risk-weighted assets:						
Consolidated	33,297	8.4%	15,830	4.0%	N/A	N/A
Cornerstone Community Bank	31,635	8.1%	15,704	4.0%	23,556	6.0%
Tier 1 capital to average assets:						
Consolidated	33,297	7.7%	17,282	4.0%	N/A	N/A
Cornerstone Community Bank	31,635	7.4%	17,187	4.0%	21,484	5.0%

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 17. 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, 2008, 2007 and 2006, is as follows:

	<u>Before-Tax Amount</u>	<u>Tax (Expense) Benefit</u>	<u>Net-of-Tax Amount</u>
Year ended December 31, 2008:			
Unrealized holding gains and losses arising during the period	\$ (444,690)	\$ 151,196	\$ (293,494)
Less reclassification adjustment for gains realized in net income	<u>-</u>	<u>-</u>	<u>-</u>
	<u>\$ (444,690)</u>	<u>\$ 151,196</u>	<u>\$ (293,494)</u>
Year ended December 31, 2007:			
Unrealized holding gains and losses arising during the period	\$ 250,886	\$ (85,301)	\$ 165,585
Less reclassification adjustment for gains realized in net income	<u>-</u>	<u>-</u>	<u>-</u>
	<u>\$ 250,886</u>	<u>\$ (85,301)</u>	<u>\$ 165,585</u>
Year ended December 31, 2006:			
Unrealized holding gains and losses arising during the period	\$ 162,632	\$ (55,295)	\$ 107,337
Less reclassification adjustment for gains realized in net income	<u>-</u>	<u>-</u>	<u>-</u>
	<u>\$ 162,632</u>	<u>\$ (55,295)</u>	<u>\$ 107,337</u>

Note 18. 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 Cornerstone relate to outstanding stock options, determined using the treasury stock method.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008, 2007 and 2006

Note 18. Earnings Per Common Share (continued)

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

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Net income	\$ 2,511,824	\$ 871,152	\$ 5,811,600
Less: Preferred stock dividends	-	-	-
Net income applicable to common stock	<u>\$ 2,511,824</u>	<u>\$ 871,152</u>	<u>\$ 5,811,600</u>
Average number of common shares outstanding	6,322,150	6,498,794	6,481,568
Effect of dilutive stock options	<u>136,826</u>	<u>339,346</u>	<u>352,630</u>
Average number of common shares outstanding used to calculate diluted earnings per common share	<u><u>6,458,976</u></u>	<u><u>6,838,140</u></u>	<u><u>6,834,198</u></u>

The effects of outstanding antidilutive stock options are excluded from the computation of diluted earnings per share. There were 329,526 and 62,150 antidilutive stock options for 2008 and 2007, respectively. There were no antidilutive stock options during 2006. During 2006, Cornerstone enacted a 2-for-1 split in the form of stock dividend.

Note 19. Recent Accounting Pronouncements

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" (SFAS 157). This standard defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 applies only to fair-value measurements that are already required or permitted by other accounting standards and is expected to increase the consistency of those measurements. The definition of fair value focuses on the exit price, i.e., the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, not the entry price, i.e., the price that would be paid to acquire the asset or received to assume the liability at the measurement date. The statement emphasizes that fair value is a market-based measurement; not an entity-specific measurement. Therefore, the fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. The effective date for SFAS 157 is for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Cornerstone adopted the guidance of SFAS 157 beginning January 1, 2008, and the adoption did not have a material impact on Cornerstone's consolidated financial statements.

On October 10, 2008, the FASB issued FSP FAS 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active" (FSP FAS 157-3). FSP FAS 157-3 clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP FAS 157-3 is effective upon issuance, including prior periods for when financial statements have not been issued. Cornerstone adopted FSP FAS 157-3 for the period ended December 31, 2008, and the adoption did not have any significant impact on Cornerstone's consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities — Including an Amendment of FASB Statement No. 115" (SFAS 159). This standard permits an entity to choose to measure many financial instruments and certain other items at fair value. This option is available to all entities. Most of the provisions in SFAS 159 are elective; however, the amendment to SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities", applies to all entities with available-for-sale and trading securities. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Cornerstone did not elect the fair value option as of January 1, 2008, for any of its financial assets or financial liabilities and, accordingly, the adoption of the statement did not have a material impact on Cornerstone's consolidated financial statements.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008, 2007 and 2006

Note 19. Recent Accounting Pronouncements (continued)

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, "Non-controlling Interests in Consolidated Financial Statements — An Amendment of ARB No. 51" (SFAS 160), which, among other things, provides guidance and establishes amended accounting and reporting standards for a parent company's non-controlling interest in a subsidiary. Cornerstone is currently evaluating the impact of adopting SFAS 160, which is effective for fiscal years beginning on or after December 15, 2008.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141(R), "Business Combinations" (SFAS 141R), which replaces SFAS No. 141, "Business Combinations". SFAS 141(R), among other things, establishes principles and requirements for how an acquirer entity recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed (including intangibles) and any non-controlling interests in the acquired entity. Cornerstone is currently evaluating the impact of adopting the statement, which is effective for fiscal years beginning on or after December 15, 2008.

During March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, "Disclosures about Derivative Instruments and Hedging Activities — An Amendment of FASB Statement No. 133" (SFAS 161). SFAS 161 amends and expands the disclosure requirements of SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133) with the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments; (b) how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations; and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. To meet those objectives, SFAS 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The adoption is not expected to have a material effect on the consolidated financial statements.

During May 2008, the FASB issued Statement of Financial Accounting Standards No. 162, "The Hierarchy of Generally Accepted Accounting Principles" (SFAS 162). This Statement identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States. This Statement is effective 60 days following the SEC approval of the Public Company Accounting Oversight Board amendments to AU Section 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles." Adoption of SFAS 162 will not be a change in Cornerstone's current accounting practices; therefore, it will not have a material impact on Cornerstone's consolidated financial condition or results of operations.

In September 2006, the FASB ratified the consensus reached by the Emerging Issues Task Force (EITF) on Issue No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split Dollar Life Insurance Arrangements" (EITF 06-4). EITF 06-4 requires the recognition of a liability and related compensation expense for endorsement split-dollar life insurance policies that provide a benefit to an employee that extends to post-retirement periods. Under EITF 06-4, life insurance policies purchased for the purpose of providing such benefits do not effectively settle an entity's obligation to the employee. Accordingly, the entity must recognize a liability and related compensation expense during the employee's active service period based on the future cost of insurance to be incurred during the employee's retirement. If the entity has agreed to provide the employee with a death benefit, then the liability for the future death benefit should be recognized by following the guidance in SFAS No. 106, "Employer's Accounting for Postretirement Benefits Other Than Pensions". Cornerstone adopted EITF 06-4 effective as of January 1, 2008, and the adoption did not have a material impact on Cornerstone's consolidated financial statements.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008, 2007 and 2006

Note 19. Recent Accounting Pronouncements (continued)

During June 2008, the FASB issued FASB Staff Position EITF 03-6-1, "Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities" (EITF 03-6-1). EITF 03-6-1 clarifies whether instruments, such as restricted stock, granted in share-based payments are participating securities prior to vesting. Such participating securities must be included in the computation of earnings per share under the two-class method as described in SFAS No. 128, "Earnings per Share." EITF 03-6-1 requires companies to treat unvested share-based payment awards that have non-forfeitable rights to dividend or dividend equivalents as a separate class of securities in calculating earnings per share. EITF 03-6-1 is effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2008, and requires a company to retrospectively adjust its earnings per share data. Early adoption is not permitted. It is not expected that the adoption of EITF 03-6-1 will have a material effect on consolidated results of operations or earnings per share.

In December 2008, the FASB issued FASB Staff Position No. FAS 140-4 and FIN 46(R)-8, "Disclosures about Transfers of Financial Assets and Interests in Variable Interest Entities" (FSP 140-4 and 46(R)-8). This FSP requires additional disclosures by public entities with continuing involvement in transfers of financial assets to special purpose entities and with variable interests in VIEs, including sponsors that have a variable interest in a VIE. Additionally, this FSP requires certain disclosures to be provided by a public entity that is (1) a sponsor of a qualifying special-purpose entity (SPE) that holds a variable interest in the qualifying SPE but was not the transferor (nontransferor) of financial assets to the qualifying SPE, and (2) a servicer of a qualifying SPE that holds a significant variable interest in the qualifying SPE but was not the transferor (nontransferor) of financial assets to the qualifying SPE. This FSP is effective for the first reporting period (interim or annual) that ends after December 15, 2008. Cornerstone adopted FSP 140-4 and 46(R)-8 as of December 31, 2008, and its adoption did not have a significant impact on the consolidated financial statements.

Cornerstone has determined that all other recently issued accounting pronouncements will not have a material impact on its consolidated financial statements or do not apply to its operations.

Note 20. Equity Investment

During 2006, Cornerstone invested \$3,000,000 for a 25% share of the Appalachian Fund for Growth II Partnership (AFG), which is managed by the Southeast Local Development Corporation (General Partner). AFG is targeting high job creation and retention businesses and businesses providing important community services. The funds are being deployed to help: 1) attract new businesses to under-served service areas by offering creative financing; 2) supply creative financing for businesses to rehabilitate existing distressed properties to facilitate community development; and 3) leverage other private investment into its targeted communities. In return for its investment in AFG, Cornerstone and other investors will receive new market tax credits. For 2008, 2007 and 2006 Cornerstone received approximately \$150,000, \$300,000 and \$150,000, respectively, in new market tax credits.

AFG meets the criteria of a VIE outlined in FIN 46-R. AFG has not been consolidated by Cornerstone as Cornerstone is not the primary beneficiary.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008, 2007 and 2006

Note 21. Condensed Parent Information

<u>BALANCE SHEETS</u>			
	December 31,	December 31,	
	2008	2007	2006
ASSETS			
Cash	\$ 439,440	\$ 387,064	
Investment in subsidiaries	37,295,042	33,257,674	
Loan to subsidiary	450,000	750,000	
Goodwill	2,541,476	2,541,476	
Other assets	513,738	201,448	
Total assets	<u>\$ 41,239,696</u>	<u>\$ 37,137,662</u>	
LIABILITIES AND STOCKHOLDERS' EQUITY			
Other liabilities	\$ 488,187	\$ 710,312	
Line of credit	4,250,000	100,000	
Total liabilities	4,738,187	810,312	
Stockholders' equity	<u>36,501,509</u>	<u>36,327,350</u>	
Total liabilities and stockholders' equity	<u>\$ 41,239,696</u>	<u>\$ 37,137,662</u>	
STATEMENTS OF INCOME			
	Years Ended December 31,		
	2008	2007	2006
INCOME			
Dividends	\$ 1,475,325	\$ 1,280,260	\$ 590,130
Interest income	33,336	158,039	139,935
	1,508,661	1,438,299	730,065
EXPENSES			
Interest expense	137,421	24,882	1,632
Other operating expenses	1,225,402	623,405	914,786
Income (loss) before equity in undistributed earnings	145,838	790,012	(186,353)
Equity in undistributed earnings (loss) of subsidiary	1,830,862	(228,170)	5,700,951
Income tax benefit	535,124	309,310	297,002
Net income	<u>\$ 2,511,824</u>	<u>\$ 871,152</u>	<u>\$ 5,811,600</u>

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008, 2007 and 2006

Note 21. Condensed Parent Information (continued)

	2008	2007	2006
STATEMENTS OF CASH FLOWS			
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	\$ 2,511,824	\$ 871,152	\$ 5,811,600
Adjustments to reconcile net income to net cash provided by operating activities:			
Stock compensation expense	279,400	220,016	147,925
Equity in undistributed income of subsidiary	(1,830,862)	228,170	(5,700,951)
Other	(534,415)	19,095	895,292
Net cash provided by operating activities	<u>425,947</u>	<u>1,338,433</u>	<u>1,153,866</u>
CASH FLOWS FROM INVESTING ACTIVITIES			
Repayment from (loan to) subsidiary	300,000	2,119,500	(1,440,706)
Capital contribution to subsidiary	(2,500,000)	-	-
Net cash (used in) provided by investing activities	<u>(2,200,000)</u>	<u>2,119,500</u>	<u>(1,440,706)</u>
CASH FLOWS FROM FINANCING ACTIVITIES			
Net borrowings (repayments) under line of credit	4,150,000	(400,000)	500,000
Purchase of common stock	(633,049)	(1,751,291)	(206,807)
Payment of dividends	(1,773,022)	(1,303,577)	(775,138)
Issuance of common stock	82,500	72,926	563,299
Net cash provided by (used in) financing activities	<u>1,826,429</u>	<u>(3,381,942)</u>	<u>81,354</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	52,376	75,991	(205,486)
CASH AND CASH EQUIVALENTS, beginning of year	<u>387,064</u>	<u>311,073</u>	<u>516,559</u>
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 439,440</u>	<u>\$ 387,064</u>	<u>\$ 311,073</u>
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION			
Cash paid during the year for:			
Interest	\$ 137,421	\$ 24,882	\$ 1,632
Income taxes	<u>-</u>	<u>3,592,300</u>	<u>2,944,000</u>

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008, 2007 and 2006

Note 22. Quarterly Data (unaudited)

	Years Ended December 31,							
	2008				2007			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest income	\$ 7,400,732	\$ 7,462,473	\$ 7,756,905	\$ 8,060,064	\$ 8,857,394	\$ 9,109,824	\$ 8,743,087	\$ 8,073,213
Interest expense	2,977,990	3,026,759	3,223,449	3,469,876	3,970,038	3,785,203	3,469,307	3,189,057
Net interest income, before provision for loan losses	4,422,742	4,435,714	4,533,456	4,590,188	4,887,356	5,324,621	5,273,780	4,884,156
Provision for loan losses	2,571,000	440,000	170,000	317,000	7,208,865	2,963,500	235,000	2,000
Net interest (loss) income, after provision for loan losses	1,851,742	3,995,714	4,363,456	4,273,188	(2,321,509)	2,361,121	5,038,780	4,882,156
Noninterest income	496,420	476,733	524,572	394,306	471,459	380,233	439,404	403,994
Noninterest expenses	3,104,109	3,151,037	3,215,991	3,096,628	2,856,953	2,370,989	3,011,708	2,685,951
(Loss) income before income taxes	(755,947)	1,321,410	1,672,037	1,570,866	(4,707,003)	370,365	2,466,476	2,600,199
Income tax (benefit) expense	(319,640)	461,194	598,981	556,007	(1,802,855)	(188,971)	902,289	948,422
Net (loss) income	\$ (436,307)	\$ 860,216	\$ 1,073,056	\$ 1,014,859	\$ (2,904,148)	\$ 559,336	\$ 1,564,187	\$ 1,651,777
Earnings (loss) per common share:								
Basic	\$ (0.07)	\$ 0.14	\$ 0.17	\$ 0.16	\$ (0.45)	\$ 0.09	\$ 0.24	\$ 0.25
Diluted	\$ (0.06)	\$ 0.13	\$ 0.17	\$ 0.15	\$ (0.42)	\$ 0.08	\$ 0.23	\$ 0.24

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

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

ITEM 9A(T). CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

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

Management's Report on Internal Control over Financial Reporting

The report of Cornerstone's management on internal control over financial reporting is set forth in Item 8 of this Annual Report on Form 10-K.

Changes in Internal Controls

There were no changes in Cornerstone's internal control over financial reporting during Cornerstone's fiscal quarter ended December 31, 2008 that have materially affected, or are reasonably likely to materially affect, Cornerstone's internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

There is no other information that should be disclosed or included in this Item 9B.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Information relating to the directors and executive officers of Cornerstone is set forth under the caption "Proposals - Election of Directors" in Cornerstone's 2009 Proxy Statement. Such information is incorporated into this report by reference. Such information is incorporated into this report by reference.

Information relating to Cornerstone's audit committee and audit committee financial experts is set forth under the caption "Corporate Governance and the Board of Directors—Audit Committee" in Cornerstone's 2009 Proxy Statement. Such information is incorporated into this report by reference.

Information relating to compliance with the reporting requirements of Section 16(a) of the Exchange Act by Cornerstone's executive officers and directors, persons who beneficially own more than ten percent of Cornerstone's common stock and their affiliates who are required to comply with such reporting requirements is set forth under the caption "Other Matters—Section 16(a) Beneficial Ownership Reporting Compliance" in Cornerstone's 2009 Proxy Statement. Such information is incorporated into this report by reference.

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

ITEM 11. EXECUTIVE COMPENSATION

Information relating to executive compensation and the compensation committee report is set forth under the captions “Compensation Discussion and Analysis” and “Executive Compensation” in Cornerstone’s 2009 Proxy Statement. Such information is incorporated into this report by reference.

Information relating to compensation committee interlocks and insider participation is set forth under the caption “Human Resource/Compensation Committee—Compensation Committee Interlocks and Insider Participation” in Cornerstone’s 2009 Proxy Statement. Such information is incorporated into this report by reference.

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

Information relating to beneficial ownership of Cornerstone’s common stock by certain persons is set forth under the caption “Security Ownership of Certain Beneficial Owners and Management” in Cornerstone’s 2009 Proxy Statement. Such information is incorporated into this report by reference.

Information relating to Cornerstone’s equity compensation plans is set forth under the caption “The Company’s Long-Term Equity and Qualified Retirements Plans” in Cornerstone’s 2009 Proxy Statement. Such information is incorporated into this report by reference.

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

Information relating to certain transactions between Cornerstone and its affiliates and certain other persons and to Cornerstone’s policies and procedures for approval of such transactions is set forth under the captions “Certain Relationships and Related Transactions” and “Corporate Governance and the Board of Directors—Policies and Procedures for Approval of Related Person Transactions” in Cornerstone’s 2009 Proxy Statement. Such information is incorporated into this report by reference.

Information relating to director independence is set forth under the caption “Corporate Governance and the Board of Directors—Board Composition and Director Independence” in Cornerstone’s 2009 Proxy Statement. Such information is incorporated into this report by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Information relating to principal accountant fees and services is set forth under the caption “Audit Committee Report – Audit Fees” in Cornerstone’s 2009 Proxy Statement. Such information is incorporated into this report by reference.

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

- (a) The following documents are filed as part of this report:
 - (1) Financial Statements

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

Report of Independent Registered Public Accounting Firm
Consolidated Balance Sheets as of December 31, 2008 and 2007
Consolidated Statements of Income for the years ended December 31, 2008, 2007 and 2006
Consolidated Statement of Changes in Stockholders’ Equity for the years ended December 31, 2008, 2007 and 2006
Consolidated Statements of Cash Flows for the years ended December 31, 2008, 2007 and 2006
Notes to Consolidated Financial Statements

- (2) Financial Statement Schedules:

Schedule II: Valuation and Qualifying Accounts

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

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

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

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

- (1) Incorporated by reference to Exhibit 3.1 of the registrant's Form 10-KSB filed on March 24, 2004 (File No. 000-30497).
- (2) Incorporated by reference to Exhibit 3 of the registrant's Form 10-Q filed on May 14, 2004 (File No. 000-30497).
- (3) Incorporated by reference to Exhibit 3.2 of the registrant's Form 10-KSB filed on March 24, 2004 (File No. 000-30497).
- (4) Incorporated by reference to Exhibit 10.1 of the registrant's Form 8-K filed on July 19, 2005 (File No. 000-30497).
- (5) Incorporated by reference to Exhibit 14 of the registrant's Form 10-KSB filed on March 24, 2004 (File No. 000-30497).

SIGNATURES

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

CORNERSTONE BANCSHARES, INC.

Date: March 19, 2009

By: /s/ Gregory B. Jones
Gregory B. Jones
Chairman and Chief Executive Officer
(principal executive officer)

By: /s/ Nathaniel F. Hughes
Nathaniel F. Hughes
President and Treasurer
(principal financial officer and accounting officer)

In accordance with the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities indicated on March 19, 2009.

<u>Signature</u>	<u>Title</u>
<u>/s/ Gregory B. Jones</u> Gregory B. Jones	Chairman of the Board and Chief Executive Officer and Director (principal executive officer)
<u>/s/ B. Kenneth Driver</u> B. Kenneth Driver	Director
<u>/s/ Karl Fillauer</u> Karl Fillauer	Director
<u>/s/ Nathaniel F. Hughes</u> Nathaniel F. Hughes	President and Treasurer (principal financial officer and accounting officer) and Director
<u>/s/ Jerry D. Lee</u> Jerry D. Lee	Executive Vice President and Senior Lender and Director
<u>/s/ Lawrence D. Levine</u> Lawrence D. Levine	Director
<u>/s/ Frank S. McDonald</u> Frank S. McDonald	Director
<u>/s/ Doyce G. Payne</u> Doyce G. Payne	Director
<u>/s/ W. Miller Welborn</u> W. Miller Welborn	Director
<u>/s/ Billy O. Wiggins</u> Billy O. Wiggins	Director
<u>/s/ Marsha Yessick</u> Marsha Yessick	Director

INDEX OF EXHIBITS

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10.1*	Cornerstone Community Bank Employee Stock Ownership Plan (4)
14	Code of Ethics. (5)
21	Subsidiaries of the registrant.
31.1	Certification of principal executive officer.
31.2	Certification of principal financial officer.
32	Section 906 certifications of chief executive officer and chief financial officer.

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

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CORNERSTONE BANCSHARES, INC.

LIST OF SUBSIDIARIES

Name of Subsidiary	State of Incorporation
Cornerstone Community Bank	Tennessee
Eagle Financial, Inc.	Tennessee

CERTIFICATIONS

I, Gregory B. Jones, certify that:

1. I have reviewed this report on Form 10-K of Cornerstone Bancshares, Inc. (the "Issuer") for the fiscal year ended December 31, 2008.
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Issuer as of, and for, the periods presented in this period report;
4. The Issuer's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the Issuer and have:
 - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Issuer, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) designed such internal controls over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) evaluated the effectiveness of the Issuer's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) disclosed in this report any change in the Issuer's internal control over financial reporting that occurred during the Issuer's fourth fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Issuer's internal control over financial reporting.
5. The Issuer's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting to the Issuer's auditors and the audit committee of Issuer's board of directors:
 - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Issuer's ability to record, process, summarize and report financial information; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Issuer's internal control over financial reporting.

Date: March 19, 2009

/s/ Gregory B. Jones

Gregory B. Jones, Chairman and
Chief Executive Officer
(principal executive officer)

CERTIFICATIONS

I, Nathaniel F. Hughes, certify that:

1. I have reviewed this report on Form 10-K of Cornerstone Bancshares, Inc. (the "Issuer") for the fiscal year ended December 31, 2008.
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Issuer as of, and for, the periods presented in this period report;
4. The Issuer's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the Issuer and have:
 - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Issuer, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) designed such internal controls over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) evaluated the effectiveness of the Issuer's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) disclosed in this report any change in the Issuer's internal control over financial reporting that occurred during the Issuer's fourth fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Issuer's internal control over financial reporting.
5. The Issuer's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting to the Issuer's auditors and the audit committee of Issuer's board of directors:
 - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Issuer's ability to record, process, summarize and report financial information; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Issuer's internal control over financial reporting.

Date: March 19, 2009

/s/ Nathaniel F. Hughes
Nathaniel F. Hughes, President and
Treasurer
(principal financial officer)

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

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

In connection with the Annual Report of Cornerstone Bancshares, Inc., a Tennessee corporation (the "Company"), on Form 10-K for the fiscal year ended December 31, 2008, as filed with the Securities and Exchange Commission (the "Report"), each of Gregory B. Jones, Chairman and Chief Executive Officer of the Company, and Nathaniel F. Hughes, President and Treasurer of the Company, do hereby certify, pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350), that to his knowledge:

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

/s/ Gregory B. Jones

Gregory B. Jones
Chairman and Chief Executive Officer
(principal executive officer)

/s/ Nathaniel F. Hughes

Nathaniel F. Hughes
President and Treasurer
(principal financial officer)

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