

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

FORM 10-Q

(Mark One)

- QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2014
- TRANSITION REPORT PURSUANT SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from _____ to _____

Commission File Number: **000-30497**



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

<u>Tennessee</u> (State or other jurisdiction of incorporation or organization)	<u>62-1173944</u> (I.R.S. Employer Identification No.)
<u>835 Georgia Avenue Chattanooga, Tennessee</u> (Address of principal executive offices)	<u>37402</u> (Zip Code)
<u>423-385-3000</u> (Registrant's telephone number, including area code)	<u>Not Applicable</u> (Former name, former address and former fiscal year, if changes since last report)

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

Yes No

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

Yes No

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

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

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

Yes No

As of August 1, 2014 there were 6,627,398 shares of common stock, \$1.00 par value per share, issued and outstanding.

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FORWARD-LOOKING STATEMENTS

Cornerstone Bancshares, Inc. (“Cornerstone”) may from time to time make written or oral statements, including statements contained in this report (including, without limitation, certain statements in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in Part I, Item 2), that constitute forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 (the “Exchange Act”). The words “expect,” “anticipate,” “intend,” “consider,” “plan,” “believe,” “seek,” “should,” “estimate,” and similar expressions are intended to identify such forward-looking statements, but other statements may constitute forward-looking statements. These statements should be considered subject to various risks and uncertainties. Such forward-looking statements are made based upon management’s belief as well as assumptions made by, and information currently available to, management pursuant to “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995. Cornerstone’s actual results may differ materially from the results anticipated in forward-looking statements due to a variety of factors. Such factors include, without limitation, those specifically described in Item 1A of Part I of our Annual Report on Form 10-K for the fiscal year ended December 31, 2013, as well as the following: (i) the possibility that our asset quality would decline or that we experience greater loan losses than anticipated, (ii) increased levels of other real estate, primarily as a result of foreclosures, (iii) the impact of liquidity needs on our results of operations and financial condition, (iv) competition from financial institutions and other financial service providers, (v) economic conditions in the local markets where we operate, (vi) the impact of obtaining regulatory approval prior to the payment of dividends, (vii) the impact of our Series A Preferred Stock on net income available to holders of our Common Stock and earnings per common share, (viii) the impact of negative developments in the financial industry and U.S. and global capital and credit markets, (ix) the impact of recently enacted legislation on our business, (x) the relatively greater credit risk of residential construction and land development loans in our loan portfolio, (xi) adverse impact on operations and financial condition due to changes in interest rates, (xii) our ability to obtain additional capital and, if obtained, the possible significant dilution to current shareholders, (xiii) the impact of federal and state regulations on our operations and financial performance, (xiv) whether a significant deferred tax asset we have can be fully realized, (xv) our ability to retain the services of key personnel, (xvi) the impact of Tennessee’s anti-takeover statutes and certain charter provisions on potential acquisitions of the holding company, and (xvii) our ability to adapt to technological changes. Many of such factors are beyond Cornerstone’s ability to control or predict, and readers are cautioned not to put undue reliance on such forward-looking statements. Cornerstone does not intend to update or reissue any forward-looking statements contained in this report as a result of new information or other circumstances that may become known to Cornerstone.

Cornerstone Bancshares, Inc. and Subsidiary
Consolidated Balance Sheets

ASSETS	Unaudited June 30, 2014	December 31, 2013
Cash and due from banks	\$ 2,222,077	\$ 2,149,467
Interest-bearing deposits at other financial institutions	16,818,780	22,702,270
Total cash and cash equivalents	<u>19,040,857</u>	<u>24,851,737</u>
Securities available for sale	83,314,607	92,208,672
Securities held to maturity (fair value \$31,309 and \$35,027 at June 30, 2014 and December 31, 2013, respectively)	30,993	34,165
Federal Home Loan Bank stock, at cost	2,322,900	2,322,900
Loans, net of allowance for loan losses of \$3,329,789 and \$3,203,158 at June 30, 2014 and December 31, 2013, respectively	289,039,362	286,236,578
Bank premises and equipment, net	4,862,213	4,992,449
Accrued interest receivable	1,082,522	977,925
Foreclosed assets	12,996,286	12,925,748
Other assets	7,221,565	7,673,179
Total assets	<u>\$ 419,911,305</u>	<u>\$ 432,223,353</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing demand deposits	\$ 65,965,561	\$ 75,206,540
Interest-bearing demand deposits	26,241,666	24,563,987
Savings deposits and money market accounts	82,268,935	86,329,930
Time deposits	156,935,842	155,313,920
Total deposits	<u>331,412,004</u>	<u>341,414,377</u>
Accrued interest payable	80,077	82,320
Federal funds purchased and securities sold under agreements to repurchase	21,913,135	22,974,117
Federal Home Loan Bank advances and other borrowings	25,000,000	26,740,000
Other liabilities	1,137,134	878,811
Total liabilities	<u>379,542,350</u>	<u>392,089,625</u>
Stockholders' equity:		
Preferred stock - no par value; 2,000,000 shares authorized; 600,000 shares issued and outstanding in 2014 and 2013	14,928,618	14,892,927
Common stock - \$1.00 par value; 20,000,000 shares authorized; 6,709,199 shares issued in 2014 and 2013; 6,627,398 and 6,547,074 shares outstanding in 2014 and 2013, respectively	6,627,398	6,547,074
Additional paid-in capital	21,740,560	21,549,883
Accumulated deficit	(3,063,508)	(3,099,451)
Accumulated other comprehensive income	135,887	243,295
Total stockholders' equity	<u>40,368,955</u>	<u>40,133,728</u>
Total liabilities and stockholders' equity	<u>\$ 419,911,305</u>	<u>\$ 432,223,353</u>

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

Cornerstone Bancshares, Inc. and Subsidiary
Consolidated Statements of Income

	Unaudited Three Months Ended June 30,		Unaudited Six Months Ended June 30,	
	2014	2013	2014	2013
INTEREST INCOME				
Loans, including fees	\$ 4,225,125	\$ 4,079,369	\$ 8,320,593	\$ 8,221,105
Securities and interest-bearing deposits at other financial institutions	346,507	482,117	776,997	922,023
Federal funds sold	10,112	14,533	17,275	36,005
Total interest income	<u>4,581,744</u>	<u>4,576,019</u>	<u>9,114,865</u>	<u>9,179,133</u>
INTEREST EXPENSE				
Time deposits	365,537	455,340	741,027	920,596
Other deposits	75,965	131,534	143,039	269,464
Federal funds purchased and securities sold under agreements to repurchase	20,621	16,743	39,281	34,823
Federal Home Loan Bank advances and other borrowings	263,201	315,948	524,611	656,387
Total interest expense	<u>725,324</u>	<u>919,565</u>	<u>1,447,958</u>	<u>1,881,270</u>
Net interest income before provision for loan losses	3,856,420	3,656,454	7,666,907	7,297,863
Provision for loan losses	350,000	-	515,000	300,000
Net interest income after provision for loan losses	<u>3,506,420</u>	<u>3,656,454</u>	<u>7,151,907</u>	<u>6,997,863</u>
NONINTEREST INCOME				
Customer service fees	209,538	201,302	398,449	389,783
Net gains from sale of securities	300,201	424,971	402,473	424,971
Net gains from sale of loans and other assets	6,529	52,382	25,443	201,582
Other noninterest income	18,220	18,650	30,436	36,468
Total noninterest income	<u>534,488</u>	<u>697,305</u>	<u>856,801</u>	<u>1,052,804</u>
NONINTEREST EXPENSE				
Salaries and employee benefits	1,722,503	1,622,501	3,549,487	3,219,792
Net occupancy and equipment expense	324,086	339,606	632,918	677,485
Depository insurance	164,167	161,120	318,843	320,964
Foreclosed assets, net	363,122	798,456	712,492	927,148
Other operating expenses	801,047	780,045	1,462,234	1,532,219
Total noninterest expenses	<u>3,374,925</u>	<u>3,701,728</u>	<u>6,675,974</u>	<u>6,677,608</u>
Income before income tax expense	665,983	652,031	1,332,734	1,373,059
Income tax expense	<u>256,500</u>	<u>256,000</u>	<u>511,100</u>	<u>524,900</u>
Net income	409,483	396,031	821,634	848,159
Preferred stock dividend requirements	375,000	375,000	750,000	750,000
Accretion on preferred stock discount	<u>17,845</u>	<u>17,845</u>	<u>35,691</u>	<u>35,690</u>
Net income available to common shareholders	<u>\$ 16,638</u>	<u>\$ 3,186</u>	<u>\$ 35,943</u>	<u>\$ 62,469</u>
EARNINGS PER COMMON SHARE				
Basic	\$ -	\$ -	\$ 0.01	\$ 0.01
Diluted	\$ -	\$ -	\$ 0.01	\$ 0.01
DIVIDENDS DECLARED PER COMMON SHARE				
	\$ -	\$ -	\$ -	\$ -

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

Cornerstone Bancshares, Inc. and Subsidiary
Consolidated Statements of Comprehensive Income

	Unaudited Three Months Ended June 30	
	2014	2013
Net income	\$ 409,483	\$ 396,031
Other comprehensive income, net of tax:		
Unrealized holding losses arising during the period, net of tax benefit of \$131,726 and \$290,725 in 2014 and 2013, respectively	(214,920)	(474,341)
Reclassification adjustment for gains included in net income, net of tax expense of \$114,076 and \$161,489 in 2014 and 2013, respectively	(186,125)	(263,482)
Total other comprehensive loss	(401,045)	(737,823)
Comprehensive income (loss)	\$ 8,438	\$ (341,792)

	Unaudited Six Months Ended June 30	
	2014	2013
Net income	\$ 821,634	\$ 848,159
Other comprehensive income, net of tax:		
Unrealized holding gains (losses) arising during the period, net of tax (expense) (expense) benefit of \$(87,111) and \$427,124 in 2014 and 2013, respectively.	142,125	(696,892)
Reclassification adjustment for gains include in net income, net of tax expense of \$152,940 and \$161,489 in 2014 and 2013, respectively	(249,533)	(263,482)
Total other comprehensive loss	(107,408)	(960,374)
Comprehensive income (loss)	\$ 714,226	\$ (112,215)

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

Cornerstone Bancshares, Inc. and Subsidiary
Consolidated Statement of Changes in Stockholders' Equity - Unaudited
For the Six Months Ended June 30, 2014

	<u>Preferred Stock</u>	<u>Common Stock</u>	<u>Additional Paid-in Capital</u>	<u>Accumulated Deficit</u>	<u>Accumulated Other Comprehensive Income</u>	<u>Total Stockholders' Equity</u>
BALANCE, December 31, 2013	\$14,892,927	\$ 6,547,074	\$21,549,883	\$ (3,099,451)	\$ 243,295	\$ 40,133,728
Stock compensation expense	-	-	80,000	-	-	80,000
Issuance of common stock, 80,324 shares	-	80,324	110,677	-	-	191,001
Preferred stock dividends paid	-	-	-	(750,000)	-	(750,000)
Accretion on preferred stock	35,691	-	-	(35,691)	-	-
Net income	-	-	-	821,634	-	821,634
Unrealized holding losses on securities available for sale, net of reclassification adjustment	-	-	-	-	(107,408)	(107,408)
BALANCE, June 30, 2014	<u>\$14,928,618</u>	<u>\$ 6,627,398</u>	<u>\$21,740,560</u>	<u>\$ (3,063,508)</u>	<u>\$ 135,887</u>	<u>\$ 40,368,955</u>

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

Cornerstone Bancshares, Inc. and Subsidiary
Consolidated Statements of Cash Flows

	Unaudited	
	Six Months Ended June 30,	
	2014	2013
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 821,634	\$ 848,159
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	246,093	217,661
Provision for loan losses	515,000	300,000
Stock compensation expense	80,000	64,528
Gain on sale of securities	(402,473)	(424,971)
Net gains on sales of loans and other assets	(25,443)	(201,582)
Changes in other operating assets and liabilities:		
Accrued interest receivable	(104,597)	60,851
Accrued interest payable	(2,243)	(27,094)
Other assets and liabilities	1,240,336	1,096,992
Net cash provided by operating activities	<u>2,368,307</u>	<u>1,934,544</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from security sales, maturities, and paydowns:		
Securities available for sale	12,673,540	21,494,189
Securities held to maturity	3,182	5,012
Purchase of securities available for sale	(3,603,228)	(46,297,289)
Loan originations and principal collections, net	(4,152,593)	(1,822,518)
Purchase of bank premises and equipment	(62,878)	(3,254)
Proceeds from the sale of bank premises and equipment and foreclosed assets	325,144	2,398,465
Net cash provided by (used in) investing activities	<u>5,183,167</u>	<u>(24,225,395)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Net decrease in deposits	(10,002,373)	(5,681,328)
Net (decrease) increase in federal funds purchased and securities sold under agreements to repurchase	(1,060,982)	3,319,677
Net payments on Federal Home Loan Bank advances and other borrowings	(1,740,000)	(5,435,000)
Payment of dividends on preferred stock	(750,000)	(683,893)
Issuance of common stock	191,001	77,019
Net cash used in financing activities	<u>(13,362,354)</u>	<u>(8,403,525)</u>
NET DECREASE IN CASH AND CASH EQUIVALENTS	(5,810,880)	(30,694,376)
CASH AND CASH EQUIVALENTS, beginning of period	<u>24,851,737</u>	<u>59,395,238</u>
CASH AND CASH EQUIVALENTS, end of period	<u>\$ 19,040,857</u>	<u>\$ 28,700,862</u>
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash paid during the period for interest	\$ 1,450,201	\$ 1,908,364
Cash paid during the period for taxes	80,010	-
NONCASH INVESTING AND FINANCING ACTIVITIES		
Acquisition of real estate through foreclosure	\$ 1,316,064	\$ 1,604,806
Financed sales of foreclosed assets	<u>433,750</u>	<u>1,329,400</u>

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

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

Note 1. Presentation of Financial Information

Nature of Business -Cornerstone is a bank holding company whose primary business is performed by its wholly-owned subsidiary, Cornerstone Community Bank (the "Bank"). The Bank provides a full range of banking services to the Chattanooga, Tennessee market. The Bank has also established a loan production office in Dalton, Georgia to further enhance the Bank's lending markets.

Interim Financial Information (Unaudited)- The financial information in this report for June 30, 2014 and June 30, 2013 has not been audited. The information included herein should be read in conjunction with the annual consolidated financial statements and footnotes thereto included in the 2013 Annual Report to Shareholders which was furnished to each shareholder of Cornerstone in April of 2014. The consolidated financial statements presented herein conform to U.S. generally accepted accounting principles and to general industry practices. In the opinion of Cornerstone's management, the accompanying interim financial statements contain all material adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial condition, the results of operations, and cash flows for the interim period. Results for interim periods are not necessarily indicative of the results to be expected for a full year.

Use of Estimates -The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities as of the balance sheet date and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term include the determination of the allowance for loan losses, foreclosed assets and deferred tax assets.

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

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

Accounting Policies -During interim periods, Cornerstone follows the accounting policies set forth in its Annual Report on Form 10-K for the year ended December 31, 2013 as filed with the Securities and Exchange Commission. Since December 31, 2013, there have been no significant changes in any accounting principles or practices, or in the method of applying any such principles or practices.

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

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

The following is a summary of the basic and diluted earnings per share for the three and six month periods ended June 30, 2014 and June 30, 2013.

	Three Months Ended June 30,	
	2014	2013
Net income available to common shareholders	\$ 16,638	\$ 3,186
Weighted average common shares outstanding	6,627,398	6,547,074
Effect of dilutive stock options	179,888	112,416
Diluted shares	6,807,286	6,659,490
Basic earnings per common share	<u>\$ 0.00</u>	<u>\$ 0.00</u>
Diluted earnings per common share	<u>\$ 0.00</u>	<u>\$ 0.00</u>

	Six Months Ended June 30,	
	2014	2013
Net income available to common shareholders	\$ 35,943	\$ 62,469
Weighted average common shares outstanding	6,601,070	6,547,074
Effect of dilutive stock options	160,068	117,454
Diluted shares	6,761,138	6,664,528
Basic earnings per common share	<u>\$ 0.01</u>	<u>\$ 0.01</u>
Diluted earnings per common share	<u>\$ 0.01</u>	<u>\$ 0.01</u>

For the three and six months ended June 30, 2014, the effects of outstanding antidilutive stock options are excluded from the computation of diluted earnings per common share because the exercise price of such options are higher than the market price. There are 222,435 and 545,075 antidilutive stock options as of June 30, 2014 and 2013, respectively.

Note 2. Stock Based Compensation

Accounting Policies- Cornerstone, as required by FASB, applies the fair value recognition provisions of ASC 718, "Compensation –Stock Compensation." For the six month period ended June 30, 2014, \$80,000 in compensation cost was charged to earnings related to the vested incentive stock options.

*Officer and Employee Plans -*Cornerstone has two stock option plans under which officers and employees can be granted incentive stock options or non-qualified stock options to purchase a total of up to 1,420,000 shares of Cornerstone's common stock. The exercise price for incentive stock options must be not less than 100 percent of the fair market value of the common stock on the date of the grant. The exercise price of the non-qualified stock options may be equal to or more or less than the fair market value of the common stock on the date of the grant. The incentive stock options vest 30 percent on the second anniversary of the grant date, 60 percent on the third anniversary of the grant date and 100 percent on the fourth anniversary of the grant date, and the non-qualified stock options vest 50 percent on the first anniversary of the grant date and 100 percent on the second anniversary of the grant date. The options expire ten years from the grant date. At June 30, 2014, the total remaining compensation cost to be recognized on non-vested options is approximately \$710,000.

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

A summary of the status of these stock option plans is presented in the following table:

	Number	Weighted Average Exercisable Price	Weighted- Average Contractual Remaining Term (in years)	Aggregate Intrinsic Value
Outstanding at December 31, 2013	810,825	\$ 3.51	6.5 Years	\$ 257,570
Granted	207,000	2.40	9.9 Years	
Exercised	-	-		
Forfeited	(73,640)	5.05		
Outstanding at June 30, 2014	<u>944,185</u>	<u>\$ 3.15</u>	7.2 Years	\$ 382,980
Options exercisable at June 30, 2014	<u>343,085</u>	<u>\$ 4.92</u>		

Board of Directors Plan - Cornerstone has a stock option plan under which members of the Board of Directors, at the formation of the Bank, were granted options to purchase a total of up to 600,000 shares of 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 are 50% on each of the first and second anniversary of the grant date with full vesting occurring at the second anniversary date. At June 30, 2014, the total remaining compensation cost to be recognized on non-vested options is approximately \$160,000. A summary of the status of this stock option plan is presented in the following table:

	Number	Weighted Average Exercisable Price	Weighted- Average Contractual Remaining Term (in years)	Aggregate Intrinsic Value
Outstanding at December 31, 2013	190,250	\$ 3.07	6.9 Years	\$ 64,800
Granted	80,000	2.40	9.9 Years	
Exercised	-	-		
Forfeited	(16,000)	5.44		
Outstanding at June 30, 2014	<u>254,250</u>	<u>\$ 2.71</u>	7.8 Years	\$ 101,100
Options exercisable at June 30, 2014	<u>151,750</u>	<u>\$ 2.93</u>		

The weighted average grant date fair value of all stock options granted during the six months ended June 30, 2014 was \$1.30. This was determined using the Black-Scholes option-pricing model with the following weighted-average assumptions:

Dividend yield	0.0%
Expected life	8.5 Years
Expected volatility	45.73%
Risk-free interest rate	2.32%

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

Note 3. Securities

The amortized cost and fair value of securities available-for-sale and held to maturity at June 30, 2014 and December 31, 2013 are summarized as follows:

	June 30, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Debt securities available-for-sale:				
U.S. Government agencies	\$ 690,436	\$ 1,202	\$ -	\$ 691,638
State and municipal securities	10,446,393	460,705	(7144)	10,899,954
Mortgage-backed securities:				
Residential mortgage guaranteed by GNMA or FNMA	5,148,549	32,338	(1,002)	5,179,885
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	66,791,823	216,798	(465,491)	66,543,130
	<u>\$ 83,077,201</u>	<u>\$ 711,043</u>	<u>\$ (473,637)</u>	<u>\$ 83,314,607</u>
Debt securities held to maturity:				
Mortgage-backed securities:				
Residential mortgage guaranteed by GNMA or FNMA	\$ 30,993	\$ 318	\$ (1)	\$ 31,309

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

	December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Debt securities available-for-sale:				
U.S. Government agencies	\$ 3,433,216	\$ 48,119	\$ -	\$ 3,481,335
State and municipal securities	14,908,761	425,021	(84,544)	15,249,238
Mortgage-backed securities:				
Residential mortgage guaranteed by GNMA or FNMA	7,047,076	85,203	-	7,132,279
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	66,408,975	205,025	(268,180)	66,345,820
	<u>\$ 91,798,028</u>	<u>\$ 763,368</u>	<u>\$ (352,724)</u>	<u>\$ 92,208,672</u>
Debt securities held to maturity:				
Mortgage-backed securities:				
Residential mortgage guaranteed by GNMA or FNMA	\$ 34,165	\$ 862	\$ -	\$ 35,027

At June 30, 2014, securities with a fair value totaling approximately \$ 75 million were pledged to secure public funds, securities sold under agreements to repurchase, as collateral for federal funds purchased from other financial institutions and serve as collateral for borrowings at the Federal Reserve Discount Window and Federal Home Loan Bank.

For the six months ended June 30, 2014 and 2013, there were available-for-sale securities sold with proceeds totaling \$9,229,167 and \$5,328,170, respectively, which resulted in gross gains realized of \$402,473 and \$424,971, respectively.

The amortized cost and estimated market value of securities at June 30, 2014, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Securities Available-for-Sale		Securities Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ -	\$ -	\$ -	\$ -
Due from one year to five years	900,216	948,320	-	-
Due from five years to ten years	3,077,554	3,244,206	-	-
Due after ten years	7,159,059	7,399,066	-	-
	<u>11,136,829</u>	<u>11,591,592</u>	<u>-</u>	<u>-</u>
Mortgage-backed securities	71,940,372	71,723,015	30,993	31,309
	<u>\$ 83,077,201</u>	<u>\$ 83,314,607</u>	<u>\$ 30,993</u>	<u>\$ 31,309</u>

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The following tables present the gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities available-for-sale have been in a continuous unrealized loss position, as of June 30, 2014 and as of December 31, 2013:

	As of June 30, 2014					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
State and municipal securities	\$ 358,700	\$ (318)	\$ 555,000	\$ (6,826)	\$ 913,700	\$ (7,144)
Residential mortgage guaranteed by GNMA or FNMA	1,409,761	(1,002)	-	-	1,409,761	(1,002)
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies sponsored agencies	17,254,013	(106,428)	22,935,622	(359,063)	40,189,635	(465,491)
	<u>\$ 19,022,474</u>	<u>\$ (107,748)</u>	<u>\$ 23,490,622</u>	<u>\$ (365,889)</u>	<u>\$ 42,513,096</u>	<u>\$ (473,637)</u>

	As of December 31, 2013					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
State and municipal securities	\$ 3,025,250	\$ (84,544)	-	-	\$ 3,025,250	\$ (84,544)
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies sponsored agencies	27,782,942	(221,827)	8,761,049	(46,353)	36,543,991	(268,180)
	<u>\$ 30,808,192</u>	<u>\$ (306,371)</u>	<u>\$ 8,761,049</u>	<u>\$ (46,353)</u>	<u>\$ 39,569,241</u>	<u>\$ (352,724)</u>

Upon acquisition of a security, the Bank determines the appropriate impairment model that is applicable. If the security is a beneficial interest in securitized financial assets, the Bank uses the beneficial interests in securitized financial assets impairment model. If the security is not a beneficial interest in securitized financial assets, the Bank uses the debt and equity securities impairment model. The Bank conducts periodic reviews to evaluate each security to determine whether an other-than-temporary impairment has occurred. The Bank does not have any securities that have been classified as other-than-temporarily-impaired at June 30, 2014 or December 31, 2013.

At June 30, 2014 and December 31, 2013, the categories of temporarily impaired securities, and management's evaluation of those securities, are as follows:

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State and municipal securities: At June 30, 2014, two investments in obligations of state and municipal securities had unrealized losses. The Bank believes the unrealized losses on those investments were caused by the interest rate environment and do not relate to the underlying credit quality of the issuers. Because the Bank has the intent and ability to hold those investments for a time necessary to recover their amortized cost bases, which may be until maturity, the Bank does not consider those investments to be other-than-temporarily impaired at June 30, 2014.

Mortgage-backed securities: At June 30, 2014, fifteen investments in residential mortgage-backed securities had unrealized losses. This impairment is believed to be caused by the current interest rate environment. The contractual cash flows of those investments are guaranteed or issued by an agency of the U.S. Government. Because the decline in market value is attributable to the current interest rate environment and not credit quality, and because the Bank does not intend to sell the investments and it is not more likely than not that the Bank will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Bank does not deem those investments to be other-than-temporarily impaired at June 30, 2014.

Note 4. Loans and Allowance for Loan Losses

At June 30, 2014 and December 31, 2013, loans are summarized as follows (in thousands):

	June 30, 2014	December 31, 2013
Commercial real estate-mortgage:		
Owner-occupied	\$ 70,808	\$ 65,747
All other	71,407	64,052
Consumer real estate-mortgage	75,603	76,315
Construction and land development	32,734	41,597
Commercial and industrial	38,973	38,999
Consumer and other	2,844	2,730
Total loans	<u>292,369</u>	<u>289,440</u>
Less: Allowance for loan losses	<u>(3,330)</u>	<u>(3,203)</u>
Loans, net	<u>\$ 289,039</u>	<u>\$ 286,237</u>

The following describe risk characteristics relevant to each of the portfolio segments:

Real estate:

As discussed below, Cornerstone offers various types of real estate loan products. All loans within this portfolio segment are particularly sensitive to the valuation of real estate:

- Commercial real estate-mortgage loans include owner-occupied commercial real estate loans and other commercial real estate loans. Owner-occupied commercial real estate loans to operating businesses are long-term financing of land and buildings. Other commercial real estate loans are generally secured by income producing properties.
- Consumer real estate-mortgage loans include loans secured by 1-4 family and multifamily residential properties. These loans are repaid by various means such as a borrower's income, sale of the property, or rental income derived from the property.

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- Construction and land development loans include extensions of credit to real estate developers or investors where repayment is dependent on the sale of the real estate or income generated from the real estate collateral. These loans are repaid through cash flow related to the operations, sale or refinance of the underlying property. This portfolio segment also includes owner-occupied construction loans for commercial businesses for the development of land or construction of a building. These loans are repaid by cash flow generated from the business operation. Real estate loans for income-producing properties such as apartment buildings, office and industrial buildings, and retail shopping centers are repaid from rent income derived from the properties.

Commercial and industrial:

The commercial and industrial loans include those loans to commercial customers for use in normal business operations to finance working capital needs, equipment purchases, or expansion projects. Loans are repaid by business cash flows. Collection risk in this portfolio is driven by the creditworthiness of the underlying borrower, particularly cash flows from the customers' business operations.

Consumer and other:

The consumer loan portfolio segment includes direct consumer installment loans, overdrafts and other revolving credit loans, and educational loans. Loans in this portfolio are sensitive to unemployment and other key consumer economic measures.

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

The composition of loans by loan classification for impaired and performing loan status at June 30, 2014 and December 31, 2013, is summarized in the tables below (amounts in thousands):

June 30, 2014	Commercial Real Estate- Mortgage	Consumer Real Estate- Mortgage	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Performing loans	\$ 136,940	\$ 72,969	\$ 32,369	\$ 37,365	\$ 2,844	\$ 282,487
Impaired loans	5,275	2,634	365	1,608	-	9,822
Total	\$ 142,215	\$ 75,603	\$ 32,734	\$ 38,973	\$ 2,844	\$ 292,369

December 31, 2013	Commercial Real Estate- Mortgage	Consumer Real Estate- Mortgage	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Performing loans	\$ 121,817	\$ 72,868	\$ 41,228	\$ 37,007	\$ 2,730	\$ 275,650
Impaired loans	7,982	3,447	369	1,992	-	13,790
Total	\$ 129,799	\$ 76,315	\$ 41,597	\$ 38,999	\$ 2,730	\$ 289,440

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The following tables show the allowance for loan losses allocation by loan classification for impaired and performing loans as of June 30, 2014 and December 31, 2013 (amounts in thousands):

June 30, 2014	Commercial Real Estate- Mortgage	Consumer Real Estate- Mortgage	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Allowance related to:						
Performing loans	\$ 1,341	\$ 1,069	\$ 262	\$ 301	\$ 77	\$ 3,050
Impaired loans	31	140	-	109	-	280
Total	<u>\$ 1,372</u>	<u>\$ 1,209</u>	<u>\$ 262</u>	<u>\$ 410</u>	<u>\$ 77</u>	<u>\$ 3,330</u>

December 31, 2013	Commercial Real Estate- Mortgage	Consumer Real Estate- Mortgage	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Allowance related to:						
Performing loans	\$ 1,051	\$ 927	\$ 319	\$ 297	\$ 45	\$ 2,639
Impaired loans	498	11	-	55	-	564
Total	<u>\$ 1,549</u>	<u>\$ 938</u>	<u>\$ 319</u>	<u>\$ 352</u>	<u>\$ 45</u>	<u>\$ 3,203</u>

The following tables detail the changes in the allowance for loan losses for the six month period ending June 30, 2014 and year ending December 31, 2013, by loan classification (amounts in thousands):

June 30, 2014	Commercial Real Estate- Mortgage	Consumer Real Estate- Mortgage	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Beginning balance	\$ 1,549	\$ 938	\$ 319	\$ 352	\$ 45	\$ 3,203
Charged-off loans	(427)	(350)	(13)	(53)	(37)	(880)
Recovery of charge-offs	56	42	337	29	28	492
Provision for (reallocation of) loan losses	194	579	(381)	82	41	515
Ending balance	<u>\$ 1,372</u>	<u>\$ 1,209</u>	<u>\$ 262</u>	<u>\$ 410</u>	<u>\$ 77</u>	<u>\$ 3,330</u>

December 31, 2013	Commercial Real Estate- Mortgage	Consumer Real Estate- Mortgage	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Beginning balance	\$ 2,549	\$ 1,528	\$ 1,241	\$ 809	\$ 14	\$ 6,141
Charged-off loans	(1,879)	(842)	(1,193)	(699)	(96)	(4,709)
Recovery of charge-offs	68	241	1,058	99	5	1,471
Provision for (reallocation of) loan losses	811	11	(787)	143	122	300
Ending balance	<u>\$ 1,549</u>	<u>\$ 938</u>	<u>\$ 319</u>	<u>\$ 352</u>	<u>\$ 45</u>	<u>\$ 3,203</u>

Credit quality indicators:

Federal regulations require the Bank to review and classify its assets on a regular basis. To fulfill this requirement, the Bank systematically reviews its loan portfolio to ensure the Bank's large loan relationships are being maintained within its loan policy guidelines, remain properly underwritten and are properly classified by loan grade. This review process is performed by the Bank's management, internal and external loan review, internal auditors, and state and federal regulators.

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The Bank's loan grading process is as follows:

- All loans are assigned a loan grade at the time of origination by the relationship manager. Typically, a loan is assigned a loan grade of "pass" at origination.
- Loan relationships greater than or equal to \$500 thousand are reviewed by the Bank's external loan review provider on an annual basis.
- Additionally, the Bank's external loan review provider samples other loan relationships between \$100 thousand and \$500 thousand with an emphasis on commercial and commercial real estate loans and insider loans.
- The Bank's internal loan review department samples approximately 33 percent of all other loan relationships less than \$500 thousand on an annual basis for review.
- If a loan is delinquent 60 days or more or a pattern of delinquency exists, the loan will be selected for review.
- Generally, all loans on the Bank's internal watchlist are reviewed annually by internal loan review or external loan review providers.

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

The following tables outline the amount of each loan classification and the amount categorized into each risk rating as of June 30, 2014 and December 31, 2013 (amounts in thousands):

June 30, 2014	Commercial Real Estate- Mortgage	Consumer Real Estate- Mortgage	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Pass	\$ 133,731	\$ 70,474	\$ 32,024	\$ 34,419	\$ 2,844	\$ 273,492
Special mention	4,391	1,553	267	2,745	-	8,956
Substandard	4,093	3,576	443	1,809	-	9,921
	<u>\$ 142,215</u>	<u>\$ 75,603</u>	<u>\$ 32,734</u>	<u>\$ 38,973</u>	<u>\$ 2,844</u>	<u>\$ 292,369</u>
December 31, 2013	Commercial Real Estate- Mortgage	Consumer Real Estate- Mortgage	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Pass	\$ 119,398	\$ 67,444	\$ 40,850	\$ 33,394	\$ 2,730	\$ 263,816
Special mention	3,538	3,536	73	3,468	-	10,615
Substandard	6,863	5,335	674	2,137	-	15,009
	<u>\$ 129,799</u>	<u>\$ 76,315</u>	<u>\$ 41,597</u>	<u>\$ 38,999</u>	<u>\$ 2,730</u>	<u>\$ 289,440</u>

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After the Bank's independent loan review department completes the loan grade assignment, a loan impairment analysis is performed on loans graded substandard or worse. The following tables present summary information pertaining to impaired loans by loan classification as of June 30, 2014 and December 31, 2013 (in thousands):

	At June 30, 2014			For the quarter ended June 30, 2014	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans without a valuation allowance:					
Commercial real estate – mortgage	\$ 5,139	\$ 5,180	\$ -	\$ 5,368	\$ 126
Consumer real estate – mortgage	1,957	1,972	-	2,052	62
Construction and land development	365	378	-	367	12
Commercial and industrial	1,249	1,292	-	1,390	23
Total	\$ 8,710	\$ 8,822	\$ -	\$ 9,177	\$ 223
Impaired loans with a valuation allowance:					
Commercial real estate – mortgage	\$ 136	\$ 145	\$ 31	\$ 823	\$ 3
Consumer real estate – mortgage	677	688	140	994	19
Construction and land development	-	-	-	-	-
Commercial and industrial	359	359	109	390	22
Total	\$ 1,172	\$ 1,192	\$ 280	\$ 2,207	\$ 44
Total impaired loans	\$ 9,882	\$ 10,014	\$ 280	\$ 11,384	\$ 267

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	At December 31, 2013			For the year ended December 31, 2013	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans without a valuation allowance:					
Commercial real estate – mortgage	\$ 5,786	\$ 5,854	\$ -	\$ 4,657	\$ 340
Consumer real estate – mortgage	2,177	2,202	-	2,669	96
Construction and land development	369	383	-	358	23
Commercial and industrial	1,563	1,621	-	1,857	60
Total	\$ 9,895	\$ 10,060	\$ -	\$ 9,541	\$ 519
Impaired loans with a valuation allowance:					
Commercial real estate – mortgage	\$ 2,196	\$ 2,285	\$ 498	\$ 4,869	\$ 118
Consumer real estate – mortgage	1,270	1,281	11	1,353	90
Construction and land development	-	-	-	177	-
Commercial and industrial	429	430	55	597	53
Total	\$ 3,895	\$ 3,996	\$ 564	\$ 6,996	\$ 261
Total impaired loans	\$ 13,790	\$ 14,056	\$ 564	\$ 16,537	\$ 780

The following tables present an aged analysis of past due loans as of June 30, 2014 and December 31, 2013 (amounts in thousands):

June 30, 2014	30-89 Days Past Due and		Past Due 90 Days or More and		Total Past Due	Current Loans	Total Loans
	Accruing		Accruing				
Commercial real estate-mortgage:							
Owner-occupied	\$ 342	\$ -	\$ 319	\$ 661	\$ 70,147	\$ 70,808	
All other	-	-	179	179	71,228	71,407	
Consumer real estate-mortgage	954	-	926	1,880	73,723	75,603	
Construction and land development	-	-	44	44	32,690	32,734	
Commercial and industrial	337	-	1,384	1,721	37,252	38,973	
Consumer and other	8	-	-	8	2,836	2,844	
Total	\$ 1,641	\$ -	\$ 2,852	\$ 4,493	\$ 287,876	\$ 292,369	

December 31, 2013	30-89 Days Past Due and		Past Due 90 Days or More and		Total Past Due	Current Loans	Total Loans
	Accruing		Accruing				
Commercial real estate-mortgage:							
Owner-occupied	\$ 678	\$ -	\$ 838	\$ 1,516	\$ 64,231	\$ 65,747	
All other	867	-	44	911	63,141	64,052	
Consumer real estate-mortgage	419	-	1,006	1,425	74,890	76,315	
Construction and land development	50	-	47	97	41,500	41,597	
Commercial and industrial	201	-	1,631	1,832	37,167	38,999	
Consumer and other	35	-	-	35	2,695	2,730	
Total	\$ 2,250	\$ -	\$ 3,566	\$ 5,816	\$ 283,624	\$ 289,440	

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Impaired loans also include loans that the Bank has elected to formally restructure when, due to the weakening credit status of a borrower, the restructuring may facilitate a repayment plan that seeks to minimize the potential losses that the Bank may have to otherwise incur. At June 30, 2014 and December 31, 2013, the Bank has loans of approximately \$5,006,000 and \$5,753,000, respectively, that were modified in troubled debt restructurings. Troubled commercial loans are restructured by specialists within our Special Asset department and all restructurings are approved by committees and credit officers separate and apart from the normal loan approval process. These specialists are trained to reduce the Bank's overall risk and exposure to loss in the event of a restructuring through obtaining either or all of the following: improved documentation, additional guaranties, increase in curtailments, reduction in collateral terms, additional collateral or other similar strategies.

There was one commercial real estate-mortgage loan with a pre-modification and post-modification outstanding recorded investment of \$480,000 that was modified as a troubled debt restructuring during the six month period ending June 30, 2014.

The following table presents a summary of loans that were modified as troubled debt restructurings during the six month period ending June 30, 2013 (amounts in thousands):

June 30, 2013	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial real estate-mortgage	2	\$ 555	\$ 555
Consumer real estate-mortgage	1	66	66
Construction and land development	3	898	898
Commercial and industrial	3	2,389	2389

There were no loans that were modified as troubled debt restructurings during the past twelve months and for which there was a subsequent payment default.

Note 5. Commitments and Contingent Liabilities

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

Standby letters of credit are generally issued on behalf of an applicant (our customer) to a specifically named beneficiary and are the result of a particular business arrangement that exists between the applicant and the beneficiary. Standby letters of credit have fixed expiration dates and are usually for terms of two years or less unless terminated beforehand due to criteria specified in the standby letter of credit. A typical arrangement involves the applicant routinely being

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indebted to the beneficiary for such items as inventory purchases, insurance, utilities, lease guarantees or other third party commercial transactions. The standby letter of credit would permit the beneficiary to obtain payment from the Bank under certain prescribed circumstances. Subsequently, the Bank would seek reimbursement from the applicant pursuant to the terms of the standby letter of credit.

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

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

A summary of the Bank's total contractual amount for all off-balance sheet commitments at June 30, 2014 is as follows:

Commitments to extend credit	\$ 45.9 million
Standby letters of credit	\$ 452 thousand

Various legal claims also arise from time to time in the normal course of business. In the opinion of management, the resolution of claims outstanding at June 30, 2014 will not have a material effect on Cornerstone's consolidated financial statements.

Note 6. Fair Value Disclosures

Fair Value Measurements:

Cornerstone uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the "Fair Value Measurements and Disclosures" ASC Topic 820, the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

ASC Topic 820 provides a consistent definition of fair value, which focuses on exit price in an orderly transaction between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

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

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

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

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

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

The following methods and assumptions were used by Cornerstone in estimating fair value disclosures for financial instruments. There have been no changes in the methodologies used at June 30, 2014 and December 31, 2013.

Cash and cash equivalents:

The carrying amounts of cash and cash equivalents approximate fair values based on the short-term nature of the assets. Cash and cash equivalents are classified as Level 1 of the fair value hierarchy.

Securities:

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

The carrying value of Federal Home Loan Bank stock approximates fair value based on the redemption provisions of the Federal Home Loan Bank. Federal Home Loan Bank stock is classified as Level 3 of the fair value hierarchy.

Loans:

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

Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At June 30, 2014, substantially all of the total impaired loans were evaluated based on the fair value of collateral. The remaining impaired loans were evaluated based on a discounted cash flow methodology. In accordance with ASC Topic 820, these impaired loans with a valuation allowance require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, Cornerstone records the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value or is based on a discounted cash flow methodology and there is no observable market price, Cornerstone records the impaired loan as nonrecurring Level 3. At December 31, 2013, impaired loans were evaluated based on the fair value of collateral and on the discounted cash flow methodology.

Cash surrender value of life insurance:

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

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Foreclosed assets:

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

Deposits:

The fair value of deposits with no stated maturity, such as noninterest-bearing and interest-bearing demand deposits, savings deposits, and money market accounts, is equal to the amount payable on demand at the reporting date. The carrying amounts of variable-rate, fixed-term certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies market interest rates on comparable instruments to a schedule of aggregated expected monthly maturities on time deposits. Generally, Level 3 inputs are utilized in this estimate.

Securities sold under agreements to repurchase:

The carrying amount of these liabilities approximates their estimated fair value. These liabilities are included in Level 3 of the fair value hierarchy.

Federal Home Loan Bank advances and other borrowings:

The fair value of these fixed rate advances is estimated based on discounted contractual cash flows using current incremental borrowing rates for similar type borrowing arrangements. These liabilities are included in Level 3 of the fair value hierarchy.

Accrued interest:

The carrying amounts of accrued interest approximate fair value. Accrued interest is included in Level 3 of the fair value hierarchy.

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

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

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

	Balance as of June 30, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Debt securities available-for-sale:				
U.S. Government agencies	\$ 691,638	\$ -	\$ 691,638	\$ -
State and municipal securities	10,899,954	-	10,899,954	-
Mortgage-backed securities:				
Residential mortgage guaranteed by GNMA or FNMA	5,179,885	-	5,179,885	-
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	66,543,130	-	66,543,130	-
Total securities available-for-sale	\$ 83,314,607	\$ -	\$ 83,314,607	\$ -

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

	Balance as of December 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Debt securities available-for-sale:				
U.S. Government agencies	\$ 3,481,335	\$ -	\$ 3,481,335	\$ -
State and municipal securities	15,249,238	-	15,249,238	-
Mortgage-backed securities:				
Residential mortgage guaranteed by GNMA or FNMA	7,132,279	-	7,132,279	-
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	<u>66,345,820</u>	<u>-</u>	<u>66,345,820</u>	<u>-</u>
Total securities available-for-sale	<u>\$ 92,208,672</u>	<u>\$ -</u>	<u>\$ 92,208,672</u>	<u>\$ -</u>

Cornerstone has no assets or liabilities whose fair values are measured on a recurring basis using Level 3 inputs. Additionally, there were no transfers between Level 1 and Level 2 in the fair value hierarchy.

Certain assets and liabilities are measured at fair value on a nonrecurring basis, which means the assets and liabilities are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The tables below present information about assets and liabilities on the balance sheet at June 30, 2014 and December 31, 2013 for which a nonrecurring change in fair value was recorded (amounts in thousands).

	Balance as of June 30, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Impaired loans	\$ 892	\$ -	\$ 878	\$ 14
Foreclosed assets	12,996	-	12,996	-

	Balance as of December 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Impaired loans	\$ 3,331	\$ -	\$ 891	\$ 2,440
Foreclosed assets	12,926	-	12,926	-

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

Loans include impaired loans held for investment for which an allowance for loan losses has been calculated based upon the fair value of the loans at June 30, 2014 and December 31, 2013.

The carrying amount and estimated fair value of Cornerstone's financial instruments at June 30, 2014 and December 31, 2013 are as follows (in thousands):

	June 30, 2014		December 31, 2013	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Assets:				
Cash and cash equivalents	\$ 19,041	\$ 19,041	\$ 24,852	\$ 24,852
Securities	83,346	83,346	92,243	92,244
Federal Home Loan Bank stock	2,323	2,323	2,323	2,323
Loans, net	289,039	289,587	286,237	287,411
Cash surrender value of life insurance	1,243	1,243	1,233	1,233
Accrued interest receivable	1,083	1,083	978	978
Liabilities:				
Noninterest-bearing demand deposits	65,966	65,966	75,207	75,207
Interest-bearing demand deposits	26,242	26,242	24,564	24,564
Savings deposits and money market accounts	82,269	82,269	86,330	86,330
Time deposits	156,936	158,216	155,314	156,698
Federal funds purchased and securities sold under agreements to repurchase	21,913	21,913	22,974	22,974
Federal Home Loan Bank advances and other borrowings	25,000	25,497	26,740	27,449
Accrued interest payable	80	80	82	82
Unrecognized financial instruments (net of contract amount):				
Commitments to extend credit	-	-	-	-
Letters of credit	-	-	-	-
Lines of credit	-	-	-	-

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

Three months ended
June 30

(Amounts in thousands)

Assets	2014			2013		
	Average Balance	Income/Expense	Yield/Rate	Average Balance	Income/Expense	Yield/Rate
Earning assets:						
Loans, net of unearned income	\$ 292,039	\$ 4,225	5.80%	\$ 272,718	\$ 4,079	6.00%
Investment securities	93,074	347	1.64%	102,164	482	2.13%
Other earning assets	15,647	10	0.26%	20,635	15	0.28%
Total earning assets	<u>400,760</u>	<u>\$ 4,582</u>	4.62%	<u>395,517</u>	<u>\$ 4,576</u>	4.70%
Allowance for loan losses	(3,112)			(5,315)		
Cash and other assets	29,303			39,994		
TOTAL ASSETS	<u>\$ 426,951</u>			<u>\$ 430,196</u>		
Liabilities and Shareholders' Equity						
Interest-bearing liabilities:						
Interest-bearing demand deposits	\$ 28,462	\$ 11	0.16%	\$ 25,640	\$ 16	0.24%
Savings deposits	15,054	4	0.11%	12,214	8	0.25%
MMDA's	65,740	61	0.37%	77,206	108	0.56%
Time deposits	160,174	366	0.92%	167,078	455	1.09%
Federal funds purchased and securities sold under agreements to repurchase	22,580	21	0.37%	20,752	17	0.32%
Federal Home Loan Bank and other borrowings	27,776	263	3.80%	31,740	316	3.99%
Total interest-bearing liabilities	<u>319,786</u>	<u>726</u>	0.91%	<u>334,630</u>	<u>920</u>	1.10%
Net interest spread		<u>\$ 3,856</u>	<u>3.71%</u>		<u>\$ 3,657</u>	3.60%
Noninterest-bearing demand deposits	65,528			52,401		
Accrued expenses and other liabilities	927			2,100		
Shareholders' equity	40,710			41,065		
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	<u>\$ 426,951</u>			<u>\$ 430,196</u>		
Net yield on earning assets			<u>3.89%</u>			<u>3.77%</u>
Taxable equivalent adjustment:						
Loans		0			0	
Investment securities		33			60	
Total adjustment		<u>33</u>			<u>60</u>	

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

Six months ended
June 30

(Amounts in thousands)

Assets	2014			2013		
	Average Balance	Income/Expense	Yield/Rate	Average Balance	Income/Expense	Yield/Rate
Earning assets:						
Loans, net of unearned income	\$ 291,935	\$ 8,321	5.75%	\$ 274,199	\$ 8,221	6.05%
Investment securities	94,513	777	1.81%	94,495	922	2.27%
Other earning assets	13,760	17	0.25%	26,668	36	0.27%
Total earning assets	<u>400,208</u>	<u>\$ 9,115</u>	<u>4.63%</u>	<u>395,362</u>	<u>\$ 9,179</u>	<u>4.75%</u>
Allowance for loan losses	(3,109)			(5,622)		
Cash and other assets	29,519			38,781		
TOTAL ASSETS	<u>\$ 426,618</u>			<u>\$ 428,521</u>		
Liabilities and Shareholders' Equity						
Interest-bearing liabilities:						
Interest-bearing demand deposits	\$ 28,218	\$ 20	0.14%	\$ 27,031	\$ 35	0.26%
Savings deposits	15,216	7	0.09%	11,919	15	0.25%
MMDA's	65,521	116	0.36%	75,719	219	0.58%
Time deposits	160,278	741	0.93%	167,919	921	1.11%
Federal funds purchased and securities sold under agreements to repurchase	22,074	39	0.36%	20,920	35	0.34%
Federal Home Loan Bank and other borrowings	29,708	525	3.56%	32,224	656	4.11%
Total interest-bearing liabilities	<u>321,015</u>	<u>1,448</u>	<u>0.91%</u>	<u>335,732</u>	<u>1,881</u>	<u>1.13%</u>
Net interest spread		<u>\$ 7,667</u>	<u>3.72%</u>		<u>\$ 7,298</u>	<u>3.62%</u>
Noninterest-bearing demand deposits	64,310			49,632		
Accrued expenses and other liabilities	714			2,058		
Shareholders' equity	40,579			41,099		
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	<u>\$ 426,618</u>			<u>\$ 428,521</u>		
Net yield on earning assets			<u>3.90%</u>			<u>3.79%</u>
Taxable equivalent adjustment:						
Loans		0			0	
Investment securities		72			142	
Total adjustment		<u>72</u>			<u>142</u>	

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A) OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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

The following is a discussion of Cornerstone's financial condition at June 30, 2014 and December 31, 2013 and our results of operations for the three months and six months ended June 30, 2014 and 2013. The purpose of this discussion is to focus on information about Cornerstone's financial condition and results of operations which is not otherwise apparent from the consolidated financial statements. The following discussion and analysis should be read along with Cornerstone's consolidated financial statements and the related notes included elsewhere herein.

Critical Accounting Policies

Cornerstone's accounting and reporting policies are in accordance with accounting principles generally accepted in the United States of America and conform to general practices within the banking industry. Our significant accounting policies are described in Note 1, "Presentation of Financial Information," to the consolidated financial statements and are integral to understanding the MD&A. Critical accounting policies include the initial adoption of an accounting policy that has a material impact on our financial presentation as well as accounting estimates reflected in our financial statements that require us to make estimates and assumptions about matters that were highly uncertain at the time. Disclosure about critical estimates is required if different estimates that Cornerstone reasonably could have used in the current period would have a material impact on the presentation of our financial condition, changes in financial condition or results of operations. The following is a description of our critical accounting policies.

Allowance for Loan Losses

The allowance for loan losses is established and maintained at levels management deems adequate to absorb credit losses inherent in the portfolio as of the balance sheet date. The allowance is increased through the provision for loan losses and reduced through loan charge-offs, net of recoveries. The level of the allowance is based on known and inherent risks in the portfolio, past loan loss experience, underlying estimated values of collateral securing loans, current economic conditions and other factors as well as the level of specific impairments associated with impaired loans. This process involves our analysis of complex internal and external variables and it requires that management exercise judgment to estimate an appropriate allowance.

Changes in the financial condition of individual borrowers, economic conditions or changes to our estimated risks could require us to significantly decrease or increase the level of the allowance. Such a change could materially impact Cornerstone's net income as a result of the change in the provision for loan losses. Refer to Note 1 and 4 in the notes to Cornerstone's consolidated financial statements for a discussion of Cornerstone's methodology of establishing the allowance.

Estimates of Fair Value

Fair value is used on a recurring basis for certain assets and liabilities in which fair value is the primary basis of accounting. Cornerstone's available-for-sale securities are measured at fair value on a recurring basis. Additionally, fair value is used to measure certain assets and liabilities on a nonrecurring basis. Cornerstone uses fair value on a nonrecurring basis for foreclosed assets and collateral associated with impaired collateral-dependent loans. Fair value is also used in certain impairment valuations, including assessments of goodwill, other intangible assets and long-lived assets.

Fair value is the price that could be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. Estimating fair value in accordance with applicable accounting guidance requires that Cornerstone make a number of significant judgments. Accounting guidance provides three levels of fair value. Level 1 fair value refers to observable market prices for identical assets or liabilities. Level 2 fair value refers to similar assets or liabilities with observable market data. Level 3 fair value refers to assets and liabilities where market prices are unavailable or impracticable to obtain for similar assets or liabilities. Level 3 valuations require modeling techniques, such as discounted cash flow analyses. These modeling techniques incorporate Cornerstone's assessments regarding assumptions that market participants would use in pricing the asset or the liability.

Changes in fair value could materially impact our financial results. Refer to Note 6, "Fair Value Disclosures," in the notes to Cornerstone's consolidated financial statements for a discussion of the methodology in calculating fair value.

Income Taxes

Cornerstone is subject to various taxing jurisdictions where Cornerstone conducts business. Cornerstone estimates income tax expense based on amounts expected to be owed to these jurisdictions. Cornerstone evaluates the reasonableness of our effective tax rate based on a current estimate of annual net income, tax credits, non-taxable income, non-deductible expenses and the applicable statutory tax rates. The estimated income tax expense or benefit is reported in the consolidated statements of income.

The accrued tax liability or receivable represents the net estimated amount due or to be received from tax jurisdictions either currently or in the future and is reported in other liabilities or other assets, respectively, in Cornerstone's consolidated balance sheets. Cornerstone assesses the appropriate tax treatment of transactions and filing positions after considering statutes, regulations, judicial precedent and other pertinent information and maintains tax accruals consistent with management's evaluation. Changes in the estimate of accrued taxes occur periodically due to changes in tax rates, interpretations of tax laws, the status of examinations by tax authorities and newly enacted statutory, judicial and regulatory guidance that could impact the relative merits of tax positions. These changes, if or when they occur, could impact accrued taxes and future tax expense and could materially affect our financial results.

Cornerstone periodically evaluates uncertain tax positions and estimates the appropriate level of tax reserves related to each of these positions. Additionally, Cornerstone evaluates its deferred tax assets for possible valuation allowances based on the amounts expected to be realized. The evaluation of uncertain tax positions and deferred tax assets involves a high degree of judgment and subjectivity. Changes in the results of these evaluations could have a material impact on our financial results. Refer to Note 8, "Income Taxes," to Cornerstone's consolidated financial statements set forth in its Annual Report on Form 10-K for the year ended December 31, 2013 for more information.

Review of Financial Performance

As of June 30, 2014, Cornerstone had total consolidated assets of approximately \$420 million, total loans of approximately \$292 million, total securities of approximately \$83 million, total deposits of approximately \$ 331 million and stockholders' equity of approximately \$40 million. Net income for the three and six month period ended June 30, 2014 totaled \$409,483 and \$821,634, respectively.

Results of Operations

Net income for the three months ended June 30, 2014 was \$409,483 or \$0.00 basic earnings per common share, compared to a net income of \$396,031 or \$0.00 basic earnings per common share, for the same period in 2013. Net income for the six months ended June 30, 2014 was \$821,634 or \$0.01 basic earnings per common share, compared to a net income of \$848,159 or \$0.01 basic earnings per common share, for the same period in 2013.

The following table presents our results for the three and six months ended June 30, 2014 compared to the three and six months ended June 30, 2013 (amounts in thousands).





	Three months ended June 30,		2014-2013	Dollar Amount Change	Six months ended June 30,		2014-2013	Dollar Amount Change
	2014	2013	Percent Increase (Decrease)		2014	2013	Percent Increase (Decrease)	
Interest income	\$ 4,582	\$ 4,576	0.13%	\$ 6	\$ 9,115	\$ 9,179	(0.70)%	\$ (64)
Interest expense	725	919	(21.11)%	(194)	1,448	1,881	(23.02)%	(433)
Net interest income before provision for loan loss	3,857	3,657	5.47%	200	7,667	7,298	5.06%	369
Provision for loan loss	350	-	-	350	515	300	71.67%	215
Net interest income after provision for loan loss	3,507	3,657	(4.10)%	(150)	7,152	6,998	2.20%	154
Total noninterest income	534	697	(23.39)%	(163)	857	1,053	(18.61)%	(196)
Total noninterest expense	3,375	3,702	(8.83)%	(327)	6,676	6,678	(0.03)%	(2)
Income before income taxes	666	652	2.15%	14	1,333	1,373	(2.91)%	(40)
Provision for income taxes	257	256	0.39%	1	511	525	(2.67)%	(14)
Net income	\$ 409	\$ 396	3.28%	\$ 13	\$ 822	\$ 848	(3.07)%	\$ (26)

Net Interest Income -Net interest income represents the amount by which interest earned on various earning assets exceeds interest paid on deposits and other interest-bearing liabilities. Net interest income is also the most significant component of our earnings. For the three months ended June 30, 2014, net interest income before provision for loan loss, increased approximately \$200 thousand or 5.47 percent over the same period of 2013. For the six months ended June 30, 2014, net interest income before provision for loan loss increased \$369 thousand or 5.06 percent.

Cornerstone's interest rate spread on a tax equivalent basis (which is the difference between the average yield on earning assets and the average rate paid on interest-bearing liabilities) was 3.71 percent compared to 3.60 percent for the three month periods ended June 30, 2014 and 2013, respectively. The interest rate spread on a tax equivalent basis was 3.72 percent compared to 3.62 percent for the six months periods ended June 30, 2014 and 2013, respectively.

The net interest margin on a tax equivalent basis was 3.89 percent and 3.77 percent for the three month periods ended June 30, 2014 and 2013, respectively. The net interest margin on a tax equivalent basis was 3.90 percent and 3.79 percent for the six month periods ended June 30, 2014 and 2013, respectively.

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

-  For the six months period ended June 30, 2014, the Bank's net interest income has been positively impacted by a reduction in interest expense of the funding of the Bank. The primary savings have been a reduction in the Federal Home Loan Bank balances and a decrease in interest rates on deposit accounts.
-  The Bank's loan portfolio yield decreased to 5.80 percent for the three months ended June 30, 2014 compared to 6.00 percent for the three months ended June 30, 2013. Management believes loan yields will continue to see downward pressure during 2014 as customers continue to refinance existing loans and general market conditions. Cornerstone will attempt to increase its outstanding loan balances during 2014 to offset the possible yield reduction.
-  For the three month period ended June 30, 2014, the Bank's investment portfolio yield decreased to 1.64 percent compared to 2.13 percent for the same time period in 2013. The decrease in the investment portfolio yield was due to the liquidation of approximately \$6.8 million in securities during the second quarter of 2014.
-  The Bank's net interest margin increased 11 basis points for the six month period ended June 30, 2014 compared to the six month period ended June 30, 2013. The majority of the increase is due to reduced interest expense relating to decreases in deposit rates and a reduction in FHLB borrowing expense. Management continues to try and adjust the Bank's balance sheet composition by reducing foreclosed assets and increasing the Bank's loan balances. Management anticipates continued improvement in the Bank's net interest margin with the increase in loans and reduction of FHLB advance rates, as they mature, in the next 9 months.



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. Cornerstone recorded \$350 thousand for the three months ended June 30, 2014. There was no provision for loan losses recorded in the three months ended June 30, 2013 due to the amount of loan loss recoveries that were recorded from previous loans that were charged off. For the six months period ended June 30, 2014, the Bank recorded \$515 thousand compared to \$300 thousand for the same period in 2013.

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

The following table presents the components of noninterest income for the three and six months ended June 30, 2014 and 2013 (dollars in thousands):

	Three months ended		2014-2013 Percent Increase (Decrease)	Six months ended		2014-2013 Percent Increase (Decrease)
	June 30,			June 30,		
	2014	2013		2014	2013	
Service charges on deposit accounts	\$ 210	\$ 201	4.48%	\$ 399	\$ 390	2.31%
Net gains on sale of securities	300	425	(29.41)%	403	425	(5.18)%
Net gains on sale of loans and other assets	6	52	(88.46)%	25	202	(87.62)%
Other noninterest income	18	19	(5.26)%	30	36	(16.67)%
Total noninterest income	\$ 534	\$ 697	(23.39)%	\$ 857	\$ 1,053	(18.61)%

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


-  The Bank sold approximately \$6.8 million of securities and recorded a gain of approximately \$300 thousand during the second quarter of 2014. For the six months ended June 30, 2014, approximately \$9.2 million of securities were sold with a recorded gain of approximately \$402 thousand. The Bank chose to liquidate the securities to offset foreclosed asset expense.
-  During the first six months of 2013, the Bank recorded approximately a \$100 thousand fee from the sale of a Small Business Administration ("SBA") 7A loan and approximately \$88 thousand in gains from the sale of mortgage loans while during the first six months of 2014, the Bank did not sell any SBA loans and the gains from the sale of mortgage loans were approximately \$48 thousand.


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

The following table presents the components of noninterest expense for the three and six months ended June 30, 2014 and 2013 (dollars in thousands).

	Three months ended June 30,		2014-2013 Percent Increase	Six months ended June 30,		2014-2013 Percent Increase
	2014	2013	(Decrease)	2014	2013	(Decrease)
Salaries and employee benefits	\$ 1,723	\$ 1,623	6.16%	\$ 3,549	\$ 3,220	10.22%
Occupancy and equipment expense	324	340	(4.71)%	633	678	(6.64)%
Foreclosed assets expense, net	363	798	(54.51)%	713	927	(23.09)%
FDIC depository insurance	164	161	1.86%	319	321	(0.62)%
Other operating expense	801	780	2.69%	1,462	1,532	(4.57)%
Total noninterest expense	\$ 3,375	\$ 3,702	(8.83)%	\$ 6,676	\$ 6,678	(0.03)%

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

 Cornerstone's employee expense increased when comparing both the three and six months ended June 30, 2014 and June 30, 2013. The increase is primarily attributable to the Bank addressing employee wage increases that were not provided for in the past three years. In addition, during the six months ended June 30, 2014, the Bank recorded compensation expense in the amount of \$196 thousand for stock grants issued to the Board of Directors and stock options issued to the employees versus none in the first six months of June 2013. Management does not anticipate additional stock grants or stock options to be issued in 2014.

 For the six month period ended June 30, 2014, the Bank recorded approximately \$713 thousand in foreclosed assets expense compared to approximately \$927 thousand during the six months ended June 30, 2013. The decrease in foreclosed asset expense can be attributed to a reduction of approximately \$5.9 million in foreclosed assets from June 30, 2013 through June 30, 2014. For the six month period ended June 30, 2014, the majority of the \$713 thousand in foreclosed assets expense was comprised of approximately \$535 thousand in appraisal write downs and losses incurred on the disposal of foreclosed assets. The Bank incurred approximately \$178 thousand in net carrying cost for its foreclosed assets during the six months ended June 30, 2014. A majority of the incremental expense was due to maintenance and repairs of the existing properties. Management anticipates approximately \$1.2 million of expense and write-downs on its foreclosed assets during 2014. Management nets the expense and write-downs of other real estate owned against the income generated from income producing real estate to calculate net foreclosed assets expense.

Financial Condition

Overview- Cornerstone's consolidated assets totaled approximately \$432 million as of December 31, 2013. As of June 30, 2014, total consolidated assets had decreased approximately \$12 million or 2.85 percent to approximately \$420 million.


Liabilities as of June 30, 2014 and December 31, 2013 totaled approximately \$380 million and \$392 million, respectively.

Stockholders' equity as of June 30, 2014 and December 31, 2013 totaled approximately \$40 million.


Securities- The Bank's investment portfolio, primarily consisting of collateralized mortgage obligations, mortgage backed securities and municipal securities, amounted to approximately \$83 million as of June 30, 2014 compared to approximately \$92 million as of December 31, 2013. The primary purposes of the Bank's investment portfolio is to provide liquidity, satisfy pledging requirements, collateralize the Bank's repurchase accounts and secure the Bank's FHLB borrowings.

Loans -The composition of loans at June 30, 2014 and at December 31, 2013 and the percentage of each classification to total loans are summarized in the following table (dollars in thousands):

	June 30, 2014		December 31, 2013	
	Amount	Percent	Amount	Percent
Commercial real estate-mortgage				
Owner-occupied	\$ 70,808	24.22%	\$ 65,747	22.72%
All other	71,407	24.42%	64,052	22.13%
Consumer real estate-mortgage	75,603	25.86%	76,315	26.37%
Construction and land development	32,734	11.20%	41,597	14.37%
Commercial and industrial	38,973	13.33%	38,999	13.47%
Consumer and other	2,844	0.97%	2,730	0.94%
Total loans	292,369	100.00%	289,440	100.00%
Less: Allowance for loan losses	(3,330)		(3,203)	
Loans, net	<u>\$ 289,039</u>		<u>\$ 286,237</u>	

 The Bank's gross loans increased from approximately \$276 million as of June 30, 2013 to approximately \$292 million as of June 30, 2014 or 5.9 percent. The primary increase was in commercial real estate loans as the Bank's relationship managers are marketing business loan products to business owners and the demand for business property continues to increase in the Chattanooga market. Management anticipates continued loan growth for the remainder of 2014.

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


 During the second quarter of 2014, the Bank recorded \$350 thousand in provision expense to the loan loss allowance. The Bank's net loan charge offs decreased from approximately \$1.3 million for the six month period ended June 30, 2013 to approximately \$388 thousand for the six month period ended June 30, 2014 or approximately 71 percent. The decrease in net loan charge offs is attributed to the decrease in problem loans. Cornerstone utilizes a ten quarter look-back time frame for its historic loan loss analysis for loan charge-offs and recoveries. Management believes its allowance methodology is consistent with generally accepted accounting principles and interagency policy statements published by the Bank's regulatory agencies. However, additional provision to the loan loss allowance may be needed in future quarters as the Bank works its problem assets through the collection cycle and as the loan portfolio continues to grow.

The following is a summary of changes in the allowance for loan losses for the six months ended June 30, 2014 and for the year ended December 31, 2013 and the ratio of the allowance for loan losses to total loans as of the end of each period (dollars in thousands):

	June 30, 2014	December 31, 2013
Balance, beginning of period	\$ 3,203	\$ 6,141
Loans charged-off	(880)	(4,709)
Recoveries of loans previously charged-off	492	1,471
Provision for loan losses	515	300
Balance, end of period	<u>\$ 3,330</u>	<u>\$ 3,203</u>
Total loans	\$ 292,369	\$ 289,440
Ratio of allowance for loan losses to loans outstanding at the end of the period	1.14%	1.11%
Ratio of net charge-offs to total loans outstanding for the period	0.13%	1.12%


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


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

 The Bank has been able to reduce its non-performing assets over the last twelve months. As of June 30, 2014, the Bank had approximately \$15.9 million in non-performing assets. The majority of this amount is comprised of foreclosed assets. The Bank has attempted to be proactive in its approach of minimizing the time a loan is recorded in nonaccrual status. Management has been able to transition loans from nonaccrual into foreclosed assets or, in some limited instances, upgrade the loan to a performing status. Management anticipates additional loans could transition into foreclosed assets in the future. However, management anticipates the balance of foreclosed and non-performing assets overall will continue to reduce as the Bank continues to allocate both financial and human resources towards this objective.

The following table summarizes Cornerstone's non-performing assets at each quarter end from September 30, 2013 to June 30, 2014 (amounts in thousands):

	June 30, 2014	March 31, 2014	December 31, 2013	September 30, 2013
Nonaccrual loans	\$ 2,852	\$ 4,779	\$ 3,566	\$ 4,096
Foreclosed assets	12,996	12,559	12,926	14,924
Total non-performing assets	<u>\$ 15,848</u>	<u>\$ 17,338</u>	<u>\$ 16,492</u>	<u>\$ 19,020</u>
30-89 days past due loans	\$ 1,641	\$ 2,193	\$ 5,816	\$ 1,659
Total loans outstanding	<u>\$ 292,369</u>	<u>\$ 292,952</u>	<u>\$ 289,440</u>	<u>\$ 284,181</u>
Allowance for loan losses	<u>\$ 3,330</u>	<u>\$ 3,011</u>	<u>\$ 3,203</u>	<u>\$ 3,159</u>
Ratio of non-performing loans to total loans outstanding at the end of the period	<u>0.98%</u>	<u>1.63%</u>	<u>1.23%</u>	<u>1.44%</u>
Ratio of total allowance for loan losses to nonaccrual loans at the end of the period	<u>116.76%</u>	<u>63.00%</u>	<u>89.82%</u>	<u>77.12%</u>


 The Bank's nonaccrual balances decreased during the second quarter of 2014 compared to the last three quarters. The nonaccrual loans have decreased from approximately \$7 million as of June 30, 2013 to approximately \$3 million to June 30, 2014 or approximately 58 percent. Management has attempted to proactively resolve loans that have been classified as nonaccrual when possible. Management anticipates that nonaccrual balances will start to decline even further as the Bank continues to see a decline in the rate of loans being downgraded and management continues to proactively address these loans.

 The Bank's foreclosed assets decreased from approximately \$19 million as of June 30, 2013 to approximately \$13 million as of June 30, 2014 or approximately 31 percent. The Bank has seen an improvement in the level of interest in its properties by potential buyers and has provided \$1.2 million for foreclosed asset expense again in the 2014 budget to decrease foreclosed assets. Management is targeting a net reduction in foreclosed asset levels by approximately \$3 million during the remainder of 2014.

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

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


	June 30, 2014		December 31, 2013	
	Amount	Percent	Amount	Percent
Core funding:				
Noninterest-bearing demand deposits	\$ 65,966	17.5%	\$ 75,206	19.3%
Interest-bearing demand deposits	26,242	6.9%	24,564	6.3%
Savings and money market accounts	82,269	21.7%	86,330	22.2%
Time deposits under \$100,000	66,858	17.7%	74,080	19.0%
Total core funding	241,335	63.8%	260,180	66.8%
Non-core funding:				
Time deposit of \$100,000 or more	\$ 90,078	23.8%	\$ 81,234	20.9%
Fed funds purchased and securities sold under agreements to repurchase	21,913	5.8%	22,974	5.9%
Federal Home Loan Bank advances	25,000	6.6%	25,000	6.4%
Total non-core funding	136,991	36.2%	129,208	33.2%
Total	\$ 378,326	100.0%	\$ 389,388	100.0%


 In 2011, the Bank began to address its reliance on non-core funding. Over the last several years, the Bank has been able to increase the amount of local core deposits. Management continues to evaluate different pricing, product and customer service options to further increase the core-funding position. The Bank has seen a decrease in funds as of June 30, 2014 when compared to December 31, 2013. However, the Bank historically, and in 2013 as well, experiences an increase in overall deposits during December of each year. Finally, the Bank, primarily through its Asset Liability Management Committee, will review the structure and nature of additional Federal Home Loan Bank advances as they mature. Over the next twelve months, the Bank will have \$15 million in advances mature. Management anticipates maintaining the level of borrowings from FHLB at approximately \$20-\$35 million over this time period. However, the Bank will be able to obtain additional advances or substitute the maturing advances with other forms of liability at a significantly lower interest cost than the current interest rates paid on the existing advances.

Capital Resources- At June 30, 2014 and December 31, 2013, Cornerstone's stockholders' equity amounted to approximately \$40.4 million and \$40.1 million, respectively.

The following is a summary of the Bank's capital ratios as of June 30, 2014:

Tier 1 leverage ratio	8.96%
Tier 1 risk-based capital ratio	12.19%
Total risk-based capital ratio	13.26%

 Cornerstone has received permission from the Federal Reserve Bank of Atlanta (the "Federal Reserve") to pay its scheduled March 31, 2014 dividend on its Series A convertible preferred stock in the amount of \$0.625 per share.

 Cornerstone paid off approximately \$1.7 million in other borrowings on June 30, 2014 to reduce interest expense. The repayment has no effect on liquidity since the borrowing was fully secured by cash.

Market and Liquidity Risk Management

Interest Rate Sensitivity

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

Earnings at Risk Model

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

Economic Value of Equity

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

Liquidity Analysis

The Bank uses a liquidity analysis model to examine the current liquidity position and analyze the potential sources of coverage in the event of a liquidity crisis.

The following is a brief description of the key measurements contained in the analysis:

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

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

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

Leverage Analysis

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

Balance Sheet Analytics

Balance sheet analytics involve an in depth examination of the balance sheet structure, including diversification of structure and most recent pricing practices. This review uses trend analysis to compare previous balance sheet positions. The analysis enables the ALCO to review significant changes in the Bank's loan and security portfolios as well as the Bank's deposit composition.

Liquidity Risk Management

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

A comprehensive qualitative and quantitative analysis regarding market risk was disclosed in Cornerstone's Annual Report on Form 10-K for the year ended December 31, 2013. No material changes in the assumptions used in preparing, or results obtained from, the model have occurred since December 31, 2013.

Item 4. Controls and Procedures

Under the supervision and with the participation of management, including Cornerstone's Chief Executive Officer and Chief Financial Officer, Cornerstone has evaluated the effectiveness of its disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as of March 31, 2014 (the "Evaluation Date".) Based on such evaluation, such officers have concluded that, as of the Evaluation Date, Cornerstone's disclosure controls and procedures were effective in alerting them on a timely basis to material information relating to Cornerstone (including its consolidated subsidiary) required to be included in Cornerstone's periodic filings under the Exchange Act.

There were no changes in Cornerstone's internal control over financial reporting during Cornerstone's fiscal quarter ended June 30, 2014 that have materially affected, or are reasonably likely to materially affect, Cornerstone's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

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

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

None

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

Item 5. Other Information

None

Item 6. Exhibits

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

SIGNATURES

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

Cornerstone Bancshares, Inc.

Date: August 14, 2014

/s/ Nathaniel F. Hughes

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

Date: August 14, 2014

/s/ Gary W. Petty, Jr.

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

EXHIBIT INDEX

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

CERTIFICATION

I, Nathaniel F. Hughes, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Cornerstone Bancshares, Inc (the “Registrant”);
2. Based on my knowledge, this quarterly 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 quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as, and for, the periods presented in this quarterly report;
4. The Registrant’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 Registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervisions, to ensure that material information relating to the Registrant, including its consolidated subsidiary, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - (b) Designed such internal control 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 Registrant’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 Registrant’s internal control over financial reporting that occurred during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Registrant’s internal control over financial reporting; and
5. The Registrant’s other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant’s auditors and the audit committee of Registrant’s board of directors (or persons performing the equivalent functions):
 - (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 Registrant’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 Registrant’s internal control over financial reporting.

Date: August 14, 2014

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

CERTIFICATION

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

1. I have reviewed this quarterly report on Form 10-Q of Cornerstone Bancshares, Inc (the "Registrant");
2. Based on my knowledge, this quarterly 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 quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as, and for, the periods presented in this quarterly report;
4. The Registrant'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 Registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervisions, to ensure that material information relating to the Registrant, including its consolidated subsidiary, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - (b) Designed such internal control 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 Registrant'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 Registrant's internal control over financial reporting that occurred during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of Registrant's board of directors (or persons performing the equivalent functions):
 - (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 Registrant'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 Registrant's internal control over financial reporting.

Date: August 14, 2014

/s/ Gary W. Petty, Jr.

Gary W. Petty, Jr.

Executive Vice President and Chief Financial Officer
(principal financial officer and accounting officer)

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

In connection with the Quarterly Report of Cornerstone Bancshares, Inc., a Tennessee corporation (“Cornerstone”), on Form 10-Q for the quarter ended June 30, 2014, as filed with the Securities and Exchange Commission (the “Report”), Nathaniel F. Hughes, President and Chief Executive Officer of Cornerstone, and Gary W. Petty, Jr., Executive Vice President and Chief Financial Officer of Cornerstone, respectively, do each 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 Cornerstone.

/s/ Nathaniel F. Hughes

Nathaniel F. Hughes
President and Chief Executive Officer
(principal executive officer)
August 14, 2014

/s/ Gary W. Petty, Jr.

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

August 14, 2014

[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.]
