

CORNERSTONE BANCSHARES INC

FORM 10KSB

(Annual Report (Small Business Issuers))

Filed 3/27/2006 For Period Ending 12/31/2005

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FORM 10-KSB

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

For the fiscal year ended December 31, 2005

Commission file number 000-30497



(Name of Small Business Issuer in Its Charter)

Tennessee

(State of Incorporation)

62-1173944

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

5319 Highway 153

Hixson, Tennessee 37343

(Address of principal executive offices)(Zip Code)

(423) 385-3000

(Issuer's telephone number)

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

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

Check whether the issuer is required to file reports pursuant to Section 13 or Section 15(d) of the Securities Exchange Act of 1944.

Yes No

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

Yes No

Check if disclosure of delinquent filers in response to Item 405 of Regulation S-B is not contained in this form, and no disclosure will be contained to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

Check whether the issuer is a shell company (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). Yes No

Revenues for the Registrant's fiscal year ended December 31, 2005, total \$22,576,802.

The aggregate market value of the Registrant's outstanding Common Stock held by nonaffiliates of the Registrant on February 15, 2006 was approximately \$67,607,878. There were 3,208,284 shares of Common Stock outstanding as of February 15, 2006.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrants definitive 2006 Proxy Statement are incorporated by reference in Part III of this Form 10-KSB.

CORNERSTONE BANCSHARES, INC.
Annual Report on Form 10-KSB
For the Fiscal Year Ended December 31, 2005

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Forward-Looking Statements

In addition to the historical information contained herein, this report contains certain forward-looking statements including statements relating to present or future factors generally affecting the banking industry and specifically affecting the operations, markets, and products of Cornerstone Bancshares, Inc. (the “Company”), Cornerstone Community Bank (the “Bank”) and Eagle Financial, Inc. (“Eagle”). Forward-looking statements are based upon estimates and assumptions that are subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond the Company’s control, and many of which, with respect to future business decisions, are subject to change. Without limiting the foregoing, the words “believes,” “anticipates,” “intends,” “expects,” “are of the opinion that” or similar expressions are intended to identify forward-looking statements that involve certain risks and uncertainties. You should not place undue reliance on these forward-looking statements.

Actual results could differ materially from those projected for many reasons including, without limitation, changing events and trends that have influenced the Company’s and the Bank’s assumptions. These trends and events include (i) changes in the interest rate environment which may reduce margins, (ii) non-achievement of expected growth, (iii) less favorable than anticipated changes in national and local business environment and securities markets, (iv) adverse changes in the regulatory requirements affecting the Company and the Bank, (v) greater competitive pressures among financial institutions in the Company’s and the Bank’s markets, and (vi) greater than expected loan losses. Additional information and other factors that could affect future financial results are included in the Company’s filings with the Securities and Exchange Commission. We assume no obligation to update any forward-looking statements as a result of new information, future events or developments, except as required by applicable securities laws.

PART I

ITEM 1. DESCRIPTION OF BUSINESS

Business Development

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

Business of the Company

The Company

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

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

The Bank

The Bank's business consists primarily of attracting deposits from the general public and, with these and other funds, originating real estate loans, consumer loans, business loans, and residential and commercial construction loans. Funds not invested in the loan portfolio are invested by the Bank primarily in obligations of the U.S. Government, U.S. Government agencies, various states and their political subdivisions. In addition to deposits, sources of funds for the Bank loans and other investments include amortization and prepayment of loans, sales of loans or participations in loans, sales of its investment securities and borrowings from other financial institutions. The principal sources of income for the Bank are interest and fees collected on loans, fees collected on deposit accounts and interest and dividends collected on other investments. The principal expenses of the Bank are interest paid on deposits, employee compensation and benefits, office expenses and other overhead expenses.

Eagle

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

Employees

As of February 15, 2006, the Company and the Bank collectively had 87 full-time equivalent employees of whom 81 are full-time, and 12 are part-time. The employees are not represented by a collective bargaining unit. The Company and the Bank believe that their relationships with their employees are good.

Customers

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

Competition

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

Based on total deposits of approximately \$252,436,000 at December 31, 2005, the Bank represents 3.52% of the deposit base in the Chattanooga, Tennessee-Georgia Metropolitan Statistical Area ("Chattanooga MSA"). Three major regional banks represent approximately 60% of the deposits in the Chattanooga MSA. These larger financial institutions have greater resources and higher lending limits than the Bank, and each of the three institutions has over 20 branches in Hamilton County. There are several credit unions located in Hamilton County. Since credit unions are not subject to income taxes in the way commercial banks are, credit unions have an advantage in offering competitive rates to potential customers. The Bank also faces competition in certain areas of its business from mortgage banking companies, consumer finance companies, insurance companies, money market mutual funds and investment banking firms, some of which are not subject to the same degree of regulation as the Bank.

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

Supervision and Regulation

General

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

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

Federal and state banking laws and regulations govern all areas of the operation of the Company and the Bank, including reserves, loans, mortgages, capital, issuance of securities, payment of dividends and establishment of branches. Federal and state banking agencies also have the general authority to limit the dividends paid by insured banks if such payments should be deemed to constitute an unsafe or unsound banking practice. The TDFI, FDIC and Board have the authority to impose penalties, initiate civil and administrative actions and take other steps intended to prevent banks from engaging in unsafe or unsound practices.

Insurance of Deposit Accounts

Deposits of the Bank are insured by the FDIC to a maximum of \$100,000 for each insured depositor through the BIF, one of the two deposit insurance funds established by federal law. As an insurer, the FDIC issues regulations, conducts examinations and generally supervises the operations of its insured institutions (institutions insured by the FDIC hereinafter are referred to as "insured institutions"). Any insured institution which does not operate in accordance with or conform to FDIC regulations, policies and directives, may be sanctioned for non-compliance. For example, proceedings may be instituted against an insured institution if the institution or any director, officer or employee thereof engages in unsafe and unsound practices, is operating in an unsafe or unsound condition, or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC. If insurance of accounts is terminated by the FDIC, the deposits in the institution will continue to be insured by the FDIC for a period of two years following the date of termination. The FDIC recommends an annual audit by independent accountants and also periodically makes its own examinations of the Bank. The FDIC may revalue assets of an institution, based upon appraisals, and require establishment of specific reserves in amounts equal to the difference between such reevaluation and the book value of the assets.

On September 15, 1992, the FDIC approved final regulations adopting a risk-related deposit insurance system. The risk-related regulations, which became effective January 1, 1993, resulted in a significant spread between the highest and lowest deposit insurance premiums. Under the risk-related insurance regulations, each insured depository institution is assigned to one of three risk classifications: "well capitalized," "adequately capitalized," or "under capitalized." Within each risk classification, there are three subgroups. Each insured depository institution is assigned to one of these subgroups within its risk classification based upon supervisory evaluations submitted to the FDIC by the institution's primary federal regulator. Depending upon a BIF member's risk classification and subgroup, applicable regulations provide that its deposit insurance premium may be as low as 0.004% of insured deposits or as high as .31% of insured deposits. Additionally, because the BIF has exceeded its designated reserve ratio, the FDIC has now reduced to zero the assessment rate that is applicable to the most highly rated BIF members. The Bank has been notified that, based on its risk classification and supervisory subgroup, its BIF assessment rate is 0.004% of insured deposits for the period from January 1, to December 31, 2005. This is the most favorable assessment rate applicable to insured institutions. In addition, the Deposit Insurance Funds Act of 1998 (DIFA) requires that a Financing Corporation ("FICO") assessment be paid by the Bank. The annual FICO assessment rate for banks is presently 0.0154% of deposits. The Bank paid \$27,579 in assessments during the year ended December 31, 2005.

Subsequent to the enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), the FDIC issued risk-based bank capital guidelines which went into effect in stages through 1992. In accordance with the FDIC's risk-based standards, an institution's assets and off-balance sheet activities are categorized into one of four risk categories, with either a 0%, 20%, 50%, or 100% amount of capital to be held against these assets. In addition, the guidelines divide capital instruments into Tier 1 (core) capital and Tier 2 (supplementary) capital. The risk-based capital adequacy guidelines require that (i) Tier 1 capital equal or exceed 4% of risk-weighted assets; (ii) Tier 2 capital may not exceed 100% of Tier 1 capital, although certain Tier 2 capital elements are subject to additional limitations; (iii) assets and off-balance sheet items must be weighted according to risk; and (iv) the total capital to risk-weighted assets ratio must be at least 8.0%. The FDIC's current leverage capital requirement requires banks receiving the highest regulatory rating based upon the FDIC's routine examination process, to maintain Tier 1 capital equal to 3.0% of the bank's total assets. Banks receiving lower regulatory ratings are required to maintain Tier 1 capital in an amount that is at least 100 to 200 basis points higher than 3.0% of total assets.

At December 31, 2005, the Bank had Tier 1 capital of \$26.0 million or 9.20% of total year to date average assets.

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

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

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

Tennessee Supervision and Regulation

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

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

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

Federal Supervision and Regulation

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

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

In addition to the banking regulations imposed on the Company, the securities of the Company are not exempt from the federal and state securities laws as are the securities of the Bank. Accordingly, an offering of the Company’s securities must be registered under both the Securities Act of 1933 (the “Securities Act”) and state securities laws or qualify for exemptions from registration.

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

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

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

Legislation Affecting the Company and the Bank

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

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

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

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

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

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

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

ITEM 2. DESCRIPTION OF PROPERTY

As of December 31, 2005, the principal offices of the Company and the Bank are located at 5319 Highway 153, Hixson, Tennessee 37343. This property is owned by the Company. In addition, the Bank operates four full-service branches in Hamilton County, Tennessee that are located at:

4154 Ringgold Road, East Ridge, Tennessee
610 Georgia Avenue, Chattanooga, Tennessee
2280 Gunbarrel Road, Chattanooga, Tennessee
8966 Old Lee Highway, Ooltewah, Tennessee

The Georgia Avenue branch contains 1800 square feet and is leased pursuant to a lease agreement which provides an initial term of three years with two three-year renewal options. Rent is currently \$ 29,482 per annum. The Bank owns the properties located at 2280 Gunbarrel Road, 4154 Ringgold Road, 5319 Highway 153 and 8966 Old Lee Highway.

The Company completed the construction and remodeling of the branch on Ringgold Road, East Ridge, Tennessee. The branch was updated to make more efficient use of the branch’s square footage and to open two additional customer drive-thru lanes. The Bank razed a branch operations building located in the back of the branch property in the process.

The Company operates a service center to house all its non-customer contact functions located at 6401 Lee Corners, Suite B, Chattanooga, Tennessee. The facility has 15,600 square feet and is leased pursuant to a lease agreement which provides for an initial term of five years with one five-year renewal option . Rent is currently \$ 86,000 per annum.

ITEM 3. LEGAL PROCEEDINGS

As of the end of 2005, neither the Company, the Bank nor Eagle was involved in any material litigation. The Bank is periodically involved as a plaintiff or defendant in various legal actions in the ordinary course of its business. Management believes that those claims are without merit or that the ultimate liability, if any, resulting from them will not materially affect the Bank’s financial condition or the Company’s consolidated financial position.

PART II

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

The Company's common stock is quoted on the OTC Bulletin Board but is not listed on a national securities exchange. Morgan Keegan, a subsidiary of Regions Bank, is the principal market maker for Cornerstone stock. There are nine other market makers who assist in providing a market.

Table 1 below sets forth the high and low closing prices of the Company's common stock for the periods indicated, as reported by published sources and as adjusted to reflect a 100% stock dividend paid on September 16, 2004. The prices reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions.

There were approximately 610 holders of record of the common stock as of December 31, 2005. This number does not include shareholders with shares in nominee name held by DTC. As of the end of 2005, there were 1,557,885 shares held in nominee name by DTC.

Cornerstone paid two cash dividends in 2005. The first dividend was paid on January 18, 2005 in the amount of \$0.10 per share and the second dividend was paid on July 11, 2005 in the amount of \$0.08 per share. The Company announced quarterly dividends of \$0.06 each quarter, the first of which was paid January 9, 2006. The Company's board of directors will decide the amount of the next year's dividends, if any, after the capital needs required for expected growth of assets are reviewed. The payment of dividends is solely within the discretion of the Board of Directors, considering Cornerstone's expenses, the maintenance of reasonable capital and risk reserves, and appropriate capitalization requirements for state banks.

TABLE 1

High and Low Common Stock Share Price for the Company

2006 Fiscal Year	Low	High
First Quarter (through Feb. 2006)	\$23.25	\$27.25
2005 Fiscal Year		
First Quarter	\$15.74	\$18.50
Second Quarter	\$16.75	\$18.50
Third Quarter	\$17.60	\$20.50
Fourth Quarter	\$19.50	\$24.99
2004 Fiscal Year		
First Quarter	\$10.00	\$12.50
Second Quarter	\$11.50	\$13.90
Third Quarter	\$11.90	\$15.00
Fourth Quarter	\$14.00	\$17.00
2003 Fiscal Year		
First Quarter	\$6.25	\$7.25
Second Quarter	\$6.05	\$8.75
Third Quarter	\$8.25	\$9.50
Fourth Quarter	\$8.95	\$11.65

On October 12, 2004, Cornerstone filed a Form SB-2 with the Securities and Exchange Commission to register the issuance of up to 500,000 shares of common stock. On November 4, 2004, the Securities and Exchange Commission declared the registration statement effective and the offering was fully subscribed by the end of 2004. Due to administrative issues associated with IRA accounts not all of the funds were collected until January of 2005. This created a subscription receivable in the capital section on the Company's balance sheet since the funds were not collected prior to year end. As of February 5, 2005 all funds from the subscription were collected and available for use by the Company.



Table 2 sets forth the number of shares and average share price for the Company's Equity Compensation Plans.

TABLE 2

Equity Compensation Plan Year Ended December 31, 2005			
Plan category	Number of securities to be issued upon exercise of outstanding options	Weighted average exercise price of outstanding options	Number of securities remaining available for future issuance
Equity compensation plans approved by security holders:	361,250	\$ 9.08	414,350
Equity compensation plans not approved by security holders:	0	\$ 0.00	0
Total	<u>361,250</u>	<u>\$ 9.08</u>	<u>414,350</u>

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

Forward-Looking Statements

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

Management's Discussion And Analysis Or Plan Of Operation

General

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

Summary

Net income for 2005 was \$4,324,519 which represents a 68.2% increase from the Company's net income of \$2,571,083 in 2004. Net income per common share of \$1.42 for 2005 was 37.9% higher than 2004 net income per common share of \$1.03. Pretax income of \$6,881,135 for 2005 increased \$2,717,552 from 2004 pretax income of \$4,163,583.

The increase in net income per common share from 2004 to 2005 comes directly from the dramatic growth of the Company's earning assets, especially average loans, which grew 30.3%. This growth coupled with repetitive loan and security repricing as the Federal Reserve increased the target Federal Funds rate throughout 2005 helped the Company realize a 39.2% increase in net interest income to \$14,594,290. Also contributing to improved net income was a 35.5% increase in non-interest income. Most of the increase was due to operating lease income, a new product line the Bank introduced in 2004, and the sale of commercial loans to conduit lenders. Asset quality remained at its better than industry standard level during 2005. Dramatic loan growth required the Bank to increase the loan loss provision to \$1,401,600 during 2005. Non-interest expense increased 19.3% in 2005 due mostly to an increase in salaries and benefits of 15.4% and the addition of depreciation expense associated with leased assets.

Business of the Company

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

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

For the fiscal years ended December 31, 2005 and 2004, the Company's weighted average rate earned on all interest-earning assets was 7.68% and 6.73%, respectively, and the Company's weighted average rate paid on all interest-bearing liabilities for the same years was 2.75% and 2.03%, respectively. The Company's interest rate spread for the years ended December 31, 2005 and 2004 therefore was 4.93% and 4.70%, respectively, and its net interest income for such years was \$14,594,290 and \$10,483,424 respectively. For fiscal 2005, the Company recorded net income of \$4,324,519 or \$1.42 basic earnings per common share as compared with net income of \$2,571,083 or \$1.03 basic earnings per common share for fiscal 2004. The increase in net income was due to a 39.2% increase in the Bank's net interest income and a 35.5% increase in non-interest income, while non-interest expense increased only 19.3%.

Table 3 below sets forth certain additional measures of the Company's performance for the periods indicated. Average balances in the table, as well as all average balances presented elsewhere in this report, were derived based on daily balances whenever possible. However, some average balances, which require data from the Company, as opposed to the Bank, were derived based on month-end balances since the data processing systems for those entities do not provide daily average balance information. The use of month-end averages does not materially alter any information given, and all averages are still representative of the operations of the Company.

TABLE 3

Performance Measures
Years Ended December 31,

	2005	2004	2003
Net Interest Margin			
(Net interest income divided by average interest-earning assets)	5.43%	5.02%	4.87%
Return on Average Assets			
(Net income divided by average total assets)	1.51%	1.15%	1.06%
Return on Average Equity			
(Net income divided by average equity)	14.98%	13.83%	11.68%
Equity to Assets			
(Average equity divided by average total assets)	10.09%	8.30%	9.04%
Loans to Deposits			
(Average loans divided by average deposits)	109.04%	104.73%	101.21%
Dividend Payout Ratio			
(Dividends paid by the Company divided by net income)	12.17%	4.84%	0.00%

Results of Operations

Year ended December 31, 2005 compared to year ended December 31, 2004:

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

Net interest income before loan loss provision for 2005 increased by \$4,110,866 or 39.2% over 2004. The increase in net interest income from 2004 to 2005 is due to material growth of the balance sheet and interest rate sensitivity of the Bank's assets compared to its liabilities. Interest income grew 47.0% as the Federal Reserve increased the target Federal Funds rate 200 basis points during 2005. The Bank was in a favorable position to take advantage of the rapid and predictable increases due to its loan and security portfolios being mostly variable rate instruments. Loan origination fees remained strong as the Bank became more proficient at Small Business Administration (SBA) lending and asset based lending. The Bank anticipates loan growth to continue along with loan origination fees. Interest expense increased 70.0% in 2005. Cornerstone funded the rapid asset growth primarily with certificates of deposit and money market deposits which are typically more expensive for new deposits while retaining existing deposits. This allowed the cost of the funds to only go up 72 basis points while the raw cost of the funds increased 70%.

Interest income increased \$6,613,367 or 47.0% in 2005 from 2004. Interest income produced by the loan portfolio increased \$6,323,768 or 48.5% from 2004 to 2005. Interest income on investment securities and Federal Funds sold increased slightly at \$289,599 or 28.2% from 2004 to 2005. The increase in loan interest income was due to a large increase in the volume and rate of loans as the portfolio grew, and was increased further by loan origination fees and servicing fees generated by the origination of SBA loans. The Bank attributes the strong loan growth to an increase in the number of relationship managers and their level of expertise. The small securities income increase was due to the generally higher interest rate environment, which presented few opportunities to invest without material interest rate risk exposure. Total interest expense increased \$2,502,501 or 70.0% in 2005 from 2004.

One of the most useful tools for measuring the ability of a community bank to make money is its ability to maximize its net interest margin and its interest rate spread. The net interest margin, or the net yield on earning assets, is computed by dividing fully taxable equivalent net interest income by average-earning assets. This ratio represents the difference between the average yield on average-earning assets and the average rate paid for all funds used to support those earning assets. The Companies ended 2005 with a net interest margin of 5.43%. The net interest spread, defined as the rate of interest income minus the rate of interest expense, increased 23 basis points from 4.70% in 2004 to 4.93%

in 2005. The yield on earning assets increased 95 basis points to 7.68% in 2005 from 6.73% in 2004.

Allowance for Loan Loss. The allowance for possible loan loss represents management's assessment of the risks associated with extending credit and its evaluation of the quality of the loan portfolio. Management analyzes the loan portfolio to determine the adequacy of the allowance for possible loan losses and the appropriate provisions required to maintain a level considered adequate to absorb anticipated loan losses. Management believes that the allowance for possible loan losses balance of \$3,545,042 as of December 31, 2005, is sufficient to absorb known credit risks in the portfolio. No assurance can be given, however, that adverse economic circumstances will not result in increased losses in the loan portfolio and require greater provisions for possible loan losses in the future.

Non-performing Assets. Non-performing assets include non-performing loans and foreclosed real estate held for sale. Non-performing loans include loans classified as non-accrual or renegotiated. Cornerstone's policy is to place a loan on non-accrual status when it is contractually past due 90 days or more as to payment of principal or interest. At the time a loan is placed on non-accrual status, interest previously accrued but not collected may be reversed and charged against current earnings. Recognition of any interest after a loan has been placed on non-accrual status is accounted for on a cash basis. As of December 31, 2005, the Company had \$1,731,383 of non-performing assets.

Non-interest Income. Non-interest income consists of revenues generated from a broad range of financial services and activities including fee-based services and profits and commissions earned through credit life insurance sales and other activities. In addition, gains or losses realized from the sale of investment securities are included in non-interest income. Total non-interest income increased by \$498,844 or 35.5% from 2004 to 2005. Fee income from service charges on deposit accounts increased \$84,872 or 9.4% in 2005. The Bank had no security gain in 2005. Fees generated from the sale of loans sold to the secondary market increased \$116,581 in 2005 due to an increase in SBA loan origination. Operating lease income increased \$292,505 or 118.3% during 2005. This service is offered on a very selective basis and the Bank does not expect to see significant growth in this area in 2006.

Non-interest Expense. Non-interest expense for 2005 increased by \$1,330,558 or 19.3% from 2004. Salaries and employee benefits increased by \$602,405 or 15.4% from \$3,900,505 in 2004 to \$4,502,910 in 2005. Hiring of additional personnel to cover the growth of the Bank, accounted for the majority of the increase for 2005. Occupancy expense increased 12.0% as the Bank continued to operate five full service branches and update equipment. Other non-interest expense increased \$443,055 or 21.8% in 2005. This increase was related to data processing and other expenses incurred due to the Bank's growth. Lastly depreciation expense associated with the Bank's operating leases increased \$193,246 or 104.0% due to increased number of leases outstanding.

Financial Condition

Earning Assets. Average earning assets in 2005 increased \$62,408 million or 27.89% over 2004 due to material loan growth in 2005. This loan growth led the expansion of the balance sheet and the Bank funded the loan growth with a combination of FHLB borrowings, money market deposits and certificates of deposit. The average security portfolio grew \$2.6 million or 9.6% to maintain an appropriate amount of securities for pledging purposes and liquidity.

Loan Portfolio. The Bank's average loans for 2005 were \$236.3 million, an increase of 30.3% over \$181.3 million in average loans for 2004. The actual balance, before the loan loss allowance, at the end of 2005 was \$265.6 million, representing an increase of \$60.3 million from 2004. Loan growth for 2005, was evenly weighted throughout the year with several large, high quality loans greatly increasing the Bank's outstanding balances. The growth was concentrated in commercial and commercial real estate. The Bank hired additional relationship managers during 2005 in an effort to continue the Bank's growth. The Bank feels strongly that the key to success in lending, as well as for the Bank as a whole, is to hire talented employees to provide outstanding customer service in a safe and sound manner.

Investment Securities . Cornerstone's average investment securities portfolio increased \$2.6 million from 2004 to 2005, while Federal Funds increased \$1.8 million during the same period. The average investment portfolio and average federal funds sold for 2005 was \$32.7 million. Cornerstone maintains an investment strategy of seeking portfolio yields within acceptable risk levels as well as providing liquidity, pledging requirements and GAP management. To accomplish these strategies, the Bank positioned the Investment Portfolio on the assumption that there was a higher probability of rates continuing to rise, and as a result took a cautious interest rate stance and invested appropriately. The majority of the purchases during 2005 were in US Agency callable notes structured with an interest rate cushion to protect the Bank if interest rates continue to rise. The Bank allowed its US Agency LIBOR floaters to be called as rates increased during 2005 without replacing them, as the agency U.S. Agency callable securities represented a better value due to the compressed spreads on the LIBOR floaters and scarcity of the security. Cornerstone maintains two classifications of investment securities: "Held to Maturity" and "Available for Sale." The "Available for Sale" securities are carried at fair market value, whereas "Held to Maturity" securities are carried at book value. At year-end 2005, unrealized losses in the "Available for Sale" portfolio amounted to \$341,466.

Intangibles. During 2002, the Company adopted the provisions of Statement of Financial Statement No. 142 Goodwill and other Intangible Assets concerning the \$2,541,476 goodwill created by the merger with the Bank of East Ridge. Goodwill and is tested annually for impairment. If the carrying value of goodwill exceeds the fair value, a write-down is recorded. No impairment loss was recognized during 2005, 2004 or 2003. Also, in December, 2005, the Company completed the purchase of Eagle Financial, Inc. and recorded an intangible asset of 848,916. Amortization expense of \$13,500 was recognized on this amortizable intangible.

Deposits. Cornerstone's average deposits increased \$43.5 million or 25.2% from 2004 to 2005. From year-end 2004 to year-end 2005, total actual deposits increased \$64.6 million or 34.4%. The Bank's deposit strategy continues to be focused on attracting transaction deposits from business customers while filling funding gaps with certificate of deposit specials to attract incremental funds while not driving up the cost of certificates already on the books. The Bank saw extraordinary success during 2005 in attracting business and public deposits to the Bank. Average interest bearing transaction accounts increased 25.3% while average demand deposits increased 24.4%. This success partially funded the Bank's loan growth and allowed the Bank to maintain its net interest margin at an above peer bank level. The Bank expects to continue its focus on attracting deposits from businesses, especially transaction accounts, which are less expensive and tie the customer base closely to the Bank.

Capital Resources. Stockholders average equity increased \$10.3 million or 55.4%. The Company had net income of \$4,324,519 in 2005, and the value of the investment security portfolio's unrealized gains or losses, net of tax, decreased from a gain of \$116.0 thousand to a loss of \$165.9 thousand. The actual balance of stockholder's equity increased \$7.7 million or 30.9% from \$24.8 million as of the end of 2004 to \$32.5 million. During 2005, the Company completed the 500,000 shares initial offering that begun at the end of 2004 represented approximately \$7 million in additional capital. Also during 2005, several directors exercised non-qualified options adding an additional \$2.2 million to the Company's capital.

Net Interest Income

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

TABLE 4

Yields Earned on Average Earning Assets and
Rates Paid on Average Interest Bearing Liabilities

	Years Ended December 31,								
	2005			2004			2003		
(In thousands)	Average	Interest	Yield/	Average	Interest	Yield/	Average	Interest	Yield/
	Balance	Income/ Expense (1)	Rate	Balance	Income/ Expense (1)	Rate	Balance	Expense (1)	Rate
ASSETS									
Interest-earning assets:									
Loans(1)(2)	\$ 236,265	\$ 19,354	8.19%	\$ 181,335	\$ 13,030	7.19%	\$ 141,586	\$ 10,326	7.29%
Investment securities(3)	29,705	1,217	4.24%	27,115	1,006	3.87%	24,118	980	4.16%
Federal funds sold	2,976	101	3.39%	1,218	23	1.89%	1,550	20	1.29%
Other earning assets	0	0	0.00%	0	0	0.00%	0	0	0.00%
Total interest-earning assets	268,946	20,672	7.68%	209,668	14,059	6.73%	167,254	11,326	6.79%
Allowance for loan losses	(3,025)			(2,293)			(1,843)		
Cash and other assets	20,288			16,426			12,791		
Total assets	<u>\$ 286,209</u>			<u>\$ 223,801</u>			<u>\$ 178,202</u>		
TOTAL LIABILITIES AND EQUITY									
Interest-bearing liabilities:									
Deposits:									
NOW accounts	\$ 33,943	329	0.97%	\$ 28,843	138	0.48%	\$ 22,299	66	0.30%
Money market / Savings	45,232	1,107	2.45%	32,282	429	1.33%	25,467	339	1.33%
Time deposits, \$100m and									
Over	32,611	1,145	3.51%	25,734	649	2.52%	19,430	606	3.12%
Time deposits, under \$100 m	70,167	2,240	3.19%	58,367	1,457	2.50%	54,679	1,577	2.88%
Total interest-bearing deposits	181,953	4,821	2.65%	145,226	2,673	1.84%	121,872	2,588	2.12%
Federal funds purchased	4,269	143	3.35%	2,140	33	1.54%	2,248	33	1.47%
Securities sold under									
agreement to repurchase	3,501	60	1.71%	2,575	23	0.89%	2,602	22	0.85%
Other borrowings	30,973	1,054	3.40%	25,942	846	3.26%	16,123	568	3.52%
Total interest-bearing									
Liabilities	220,696	6,078	2.75%	175,889	3,575	2.03%	142,848	3,211	2.25%
Net interest spread			4.93%			4.70%			4.54%
Other liabilities:									
Demand deposits	34,730			27,918			18,017		
Accrued interest payable and									
other liabilities	1,909			1,408			1,224		
Stockholders' equity	28,874			18,586			16,113		
Total liabilities									
And stockholders' equity	<u>\$ 286,209</u>			<u>\$ 223,801</u>			<u>\$ 178,202</u>		
Net interest margin		<u>\$ 14,594</u>	<u>5.43%</u>		<u>\$ 10,484</u>	<u>5.02%</u>		<u>\$ 8,116</u>	<u>4.87%</u>

(1) Interest income on loans includes amortization of deferred loan fees and other discounts of \$262 million, \$229 million, and \$115 million for the fiscal years ended December 31, 2005, 2004, and 2003, respectively.

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

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

Table 5 below sets forth information regarding the weighted average contractual yields earned on the Company's interest-earning assets and the weighted average interest rates paid on the Company's interest-bearing liabilities outstanding at December 31, 2005. Investment

securities available for sale (“AFS”) are held at market value and held to maturity (“HTM”) are shown at amortized costs.

TABLE 5

Weighted Average of Interest Earning Assets and Interest Bearing Liabilities
Actual Year End Balance for December 31, 2005

(In thousands)	Amount	Average Yield/Rate
Interest-earning assets:		
Loans	\$ 236,265	8.19%
Investment securities	29,705	4.10%
Federal funds sold	2,976	3.39%
Total interest-earning assets	\$ 268,946	7.68%
Interest bearing liabilities:		
NOW account deposits	\$ 33,943	0.97%
Savings and money market deposits	45,232	2.45%
Time deposits under \$100,000	70,167	3.19%
Time deposits of \$100,000 or more	32,611	3.51%
Federal funds purchased	4,269	3.35%
Securities sold under agreements to repurchase	3,501	1.71%
Long-term debt	30,973	3.40%
Total interest bearing liabilities	\$ 220,696	2.75%

Table 6 sets forth the changes in interest income and interest expense that are attributable to three factors: (i) a change in volume or amount of an asset or liability; (ii) a change in interest rates; or (iii) a change caused by the combination of changes in asset or deposit mix. The following table describes the extent to which changes in interest rates and changes in volume of interest-earning assets and interest-bearing liabilities have affected the Company's interest income and expense during the periods indicated. For each category of interest-earning assets and interest-bearing liabilities, information is provided as to changes attributable to change in volume (change in volume multiplied by current rate) and change in rates (change in rate multiplied by current volume). The remaining difference has been allocated to mix.

Table 7 sets forth the re-pricing of the Company's interest earning assets and interest-bearing liabilities as of December 31, 2005. This interest sensitivity gap table is designed to monitor the Company's interest rate risk exposure within the designated time period. In order to control interest rate risk, management regularly monitors the volume of interest sensitive assets relative to interest sensitive liabilities over specific time intervals. The Company's interest rate management policy is to attempt to maintain a relatively stable net interest margin in periods of interest rate fluctuations. The Company's policy is to attempt to maintain a ratio of cumulative gap to total interest sensitive assets of negative 15.00% to positive 15.00% in the time period of one year or less. Presently, the Bank is in a positive one-year cumulative GAP position of 22.3% and is confident that it is positioned properly for the Federal Reserve's FOMC anticipated actions during 2006. Due to the Federal Reserve's announcement that the Federal Funds rates are approaching a neutral position, the Bank has begun the process of moving the Bank's interest sensitivity to a more neutral position. This will be accomplished by purchasing longer term securities with call protection and increasing the number of fixed rate loans. The Bank to date has not participated in any derivative products to address this issue and does not foresee the need to do so in the immediate future. Below is a table, which reflects the Company's interest-earning assets and interest-bearing liabilities. The information set forth below is based on the following assumptions of management: (i) savings and money market and NOW accounts will be less interest rate sensitive and the re-pricing on these accounts will be spread out over a five-year period; and (ii) securities other than mortgage-backed securities have been scheduled by maturity date while mortgages have been amortized over the life of the mortgage.

TABLE 6**INTEREST INCOME AND EXPENSE ANALYSIS**

(In Thousands)	Year Ended December 31, 2005 Compared to 2004			
	Volume	Rate	Mix	Net Change
Interest income:				
Loans (1)(2)	\$ 4,499	\$ 2,363	(\$541)	\$ 6,321
Investment securities	110	110	(9)	211
Federal funds sold	54	36	(12)	78
Other earning assets	0	0	0	0
Total interest income				6,610
Interest expense:				
NOW accounts	49	166	(25)	190
Money market and savings accounts	317	507	(146)	678
Time deposits, \$100,000 and over	171	303	22	496
Time deposits, less than \$100,000	376	484	(78)	782
Other borrowings	171	40	(9)	202
Federal funds purchased	73	82	(41)	114
Securities sold under agreement to repurchase	15	24	(2)	37
Total interest expense				2,499
Change in net interest income (expense)				\$ 4,111

INTEREST INCOME AND EXPENSE ANALYSIS

(In Thousands)	Year Ended December 31, 2004 Compared to 2003			
	Volume	Rate	Mix	Net Change
Interest income:				
Loans (1)(2)	\$ 2,858	\$ (181)	\$ 27	\$ 2,704
Investment securities	116	(52)	(38)	26
Federal funds sold	(6)	7	2	3
Other earning assets	0	0	0	0
Total interest income				2,733
Interest expense:				
NOW accounts	31	345	(304)	72
Money market and savings accounts	91	0	(1)	90
Time deposits, \$100,000 and over	159	0	(116)	43
Time deposits, less than \$100,000	92	(5)	(207)	(120)
Other borrowings	320	0	(42)	278
Federal funds purchased	(2)	0	1	(1)
Securities sold under agreement to repurchase	0	149	(147)	2
Total interest expense				364
Change in net interest income (expense)				\$ 2,369

(1) Loan amounts include non-accruing loans.

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

TABLE 7

Re-pricing of Interest Sensitive Assets and Liabilities
Year-end balance as of December 31, 2005

(In thousands)	Less than One			Total
Interest Sensitive Assets:	Year	1 to 5 Years (3)	Over 5 Years (3)	
Federal funds sold	\$ 0	\$ 0	\$ 0	\$ 0
Investment securities				
Taxable (1)	5,581	22,427	187	28,195
Tax-exempt (1)	0	565	2,724	3,289
Loans (2)				
Fixed rate and adjustable rate 1-4 family mortgage	27,265	8,378	631	36,274
Scheduled payments	192,219	36,142	919	229,280
Total Interest Sensitive Assets	\$ 225,065	\$ 67,512	\$ 4,461	\$ 297,038
Interest Sensitive Liabilities:				
NOW accounts	\$ 17,401	\$ 26,100	\$ 0	\$ 43,501
Money market and savings accounts	35,533	11,844	0	47,377
Time deposits	92,401	29,425	0	121,826
Other interest bearing liabilities	13,430	17,000	2,000	32,430
Total Interest Sensitive Liabilities	\$ 158,765	\$ 84,369	\$ 2,000	\$ 245,134
Interest Sensitive Gap	\$ 66,300	(\$16,857)	\$ 2,461	\$ 51,904
Cumulative Interest Sensitive Gap	\$ 66,300	\$ 49,443	\$ 51,904	
Ratio of cumulative gap to total Interest Sensitive Assets	<u>22.32%</u>	<u>16.65%</u>	<u>17.47%</u>	

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

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

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

Lending Activities

Loan Policy

All lending activities of the Bank are under the direct supervision and control of the Directors Loan Committee, which consists of the Chief Executive Officer, President, Senior Loan Administrator, and five outside directors. Also present at meetings of the committee are the loan review officer and other lending officers as required. All lending activities of Eagle are under the direct supervision and control of its Board of Directors which consist of the Chief Executive Officer, President, Treasurer, Secretary, Bank's Senior Loan Administrator and four outside directors. These loan committees enforce loan authorizations for each officer, makes lending decisions on loans exceeding such limits, services all requests for officer credits to the extent allowable under current laws and regulations, administers all problem credits, and determines the allocation of funds for each lending category. The Bank's established maximum loan volume to assets is 85%. The loan portfolio consists primarily of real estate, commercial and installment loans.

General

At December 31, 2005, the Company's loan portfolio constituted approximately 81.0% of the Company's total assets, approximately 82.9% for the Bank, and 76.7% for Eagle. Table 8 sets forth the composition of the Company's loan portfolio at the indicated dates.

TABLE 8

Loan Portfolio Composition
Years Ending December 31,

	2005		2004		2003		2002		2001	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Commercial, financial and agricultural	\$ 86,039	32.40%	\$ 61,742	30.09%	\$ 42,420	26.97%	\$ 28,034	22.48%	\$ 20,424	19.42%
Real estate - construction	47,071	17.72%	36,824	17.94%	24,081	15.31%	20,517	16.46%	13,190	12.54%
Real estate - mortgage	45,645	17.19%	38,193	18.61%	28,185	17.92%	28,331	22.72%	30,828	29.32%
Real estate - commercial	79,608	29.98%	61,860	30.14%	56,527	35.94%	41,926	33.62%	34,541	32.85%
Consumer loans	7,191	2.71%	6,602	3.22%	6,077	3.86%	5,880	4.72%	6,170	5.87%
Total loans	<u>\$265,554</u>	100.00%	<u>\$205,221</u>	100.00%	<u>\$157,290</u>	100.00%	<u>\$124,688</u>	100.00%	<u>\$105,154</u>	100.00%

Table 9 sets forth the scheduled maturities of the loans in the Company's loan portfolio as of December 31, 2005 based on their contractual terms to maturity. Overdrafts are reported as due in less than one year. Loans unpaid at maturity are renegotiated based on current market rates and terms.

TABLE 9

Loans Maturing
Year-end balance as of December 31, 2005

(In thousands)	Less than One			Total
	Year	1 to 5 Years	Over 5 Years	
Commercial, financial and agricultural	\$ 77,239	\$ 8,795	\$ 5	\$ 86,039
Real estate - construction	46,229	842	0	47,071
Real estate - mortgage	36,636	8,378	631	45,645
Real estate - commercial	55,815	22,991	802	79,608
Consumer	3,565	3,514	112	7,191
Total Loans	<u>\$ 219,484</u>	<u>\$ 44,520</u>	<u>\$ 1,550</u>	<u>\$ 265,554</u>

Types of Loans*Commercial Loans*

Commercial, industrial, and non-farm non-residential loans, hereinafter referred to as commercial loans (excluding commercial construction loans) totaled \$86.0 million or 32.4% of the Company's loan portfolio at December 31, 2005. Commercial loans consist of loans and lines of credit to individuals, partnerships and corporations for a variety of business purposes, such as accounts receivable and inventory financing, equipment financing, business expansion and working capital. The terms of the Bank's commercial loans generally range from 90 days to a 15 year amortization with a five year balloon. The loans generally carry interest rates, which adjust in accordance with changes in the prime rate, but when appropriate will be fixed to match the borrower's needs. Substantially all of the Bank's commercial loans are secured and are guaranteed by the principals of the borrower. This is the fastest growing area of the loan portfolio and is being staffed to continue this trend. The Bank believes this area has the best potential for future growth and has the highest barriers of entry to our competitors.

Loans secured by marketable equipment are required to be amortized over a period not to exceed 60 months. Generally, loans secured by current assets such as inventory or accounts receivable are structured as revolving lines of credit with annual maturities. Loans secured by chattel mortgages and accounts receivable may not exceed 85% of their market value. Loans secured by listed stocks, municipal bonds and mutual funds may not exceed 70% of their market value. Unsecured short-term loans and lines of credit must meet criteria set by the Bank's Loan Committee. Current financial statements support all commercial loans, and such financial statements are updated annually. Commercial loans, which are considered small business loans, are the core business of the Bank. Most loans are made with a long-term relationship intended and the Bank also seeks to obtain the borrower's business and personal depository accounts.

Real Estate - Construction Loans

As of December 31, 2005, Cornerstone had \$47.1 million in construction and development loans outstanding, which represented 17.7% of the loan portfolio. All construction and development loans are held in the Bank's loan portfolio. The Bank makes residential construction loans to owner-occupants and to persons building residential properties for resale. The Bank has two main areas of construction loans: one is to residential real estate developers for speculative or custom single-family residential properties, and the other is to custom commercial construction projects with guaranteed takeout provisions. Construction loans are usually variable rate loans made for terms of one year or less, but extensions are permitted if construction has continued satisfactorily and if the loan is current and other circumstances warrant the extension. Construction loans are limited to 80% of the appraised value of the lot and the completed value of the proposed structure.

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

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

Real Estate - Mortgage Loans

At December 31, 2005, real estate mortgage loans totaled \$45.6 million or 17.2% of the Company's loan portfolio. Real estate mortgage loans include all one to four family residential loans secured by real estate for purposes other than construction or acquisition and development. All real estate loans are held in the Bank's loan portfolio except for loans that are designated as loans held for sale. The loans held for sale are FHLB or FNMA qualified and have been pre-approved by an underwriting specialist prior to closing. As of December 31, 2005, the Bank held \$603 thousand of these secondary market mortgages. The remainder of the Bank's mortgage loans are home equity loans and are made at fixed interest rates for terms of one to three years with balloon payment provisions and amortized over a 10 to 15 year period. The Bank's experience indicates that real estate loans normally remain outstanding for much shorter periods (seven years on average) than their stated maturity because the borrowers repay the loans in full either upon the sale of the secured property or upon the refinancing of the original loan.

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

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

Real Estate -Commercial

At December 31, 2005, commercial real estate mortgage loans totaled \$ 79.6 million or 30.0% of the Company's loan portfolio. Commercial real estate mortgage loans include all one to four family residential loans secured by real estate for purposes other than construction or acquisition and development. All real estate loans are held in the Bank's loan portfolio except for loans that have been participated to correspondent banks. The Bank will sell these participations once a loan exceeds the Bank's legal lending limit or is deemed appropriate by the Director's Loan Committee. Commercial real estate mortgage loans are a combination of properties that are leased out or used for a primary place of a business the Bank has a relationship with. Most of the commercial real estate loans have fixed interest rates for terms of one to three years with balloon payment provisions and are amortized over a 10-15 year period, but whenever possible the Bank will seek a variable rate loan which would be tied to the New York prime rate and adjusted monthly. The Bank's experience indicates that real estate loans normally remain outstanding for much shorter periods (seven years on average) than their stated maturity because the borrowers repay the loans in full either upon the sale of the secured property or upon the refinancing of the original loan.

Commercial real estate loans are made for up to 85% of the value of the property securing the loan, based upon an appraisal if the loan amount is over \$100,000. The Bank also requires title insurance to insure the priority of the property lien on its real estate loans over \$50,000 and requires fire and casualty insurance on all of its loans.

Consumer Loans

At December 31, 2005, consumer loans totaled \$7.2 million or 2.7% of the Company's loan portfolio. These loans consist of consumer installment loans and consumer credit card balances. As of December 31, 2005, the Bank had \$951 thousand credit card balances outstanding

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

Lending Commitments

As of December 31, 2005, commitments under standby letters of credit and undisbursed loan commitments aggregated approximately \$63,972,000. This number includes all lines that have not been fully drawn and loan commitments in the same status.

Origination, Purchase and Sale of Loans

The Bank originates loans primarily in Hamilton County, Tennessee. The Bank also originates loans in Marion, Sequatchie, and Bradley Counties in Tennessee, and Dade, Walker and Catoosa Counties in Georgia, each of which is contiguous to Hamilton County. Loans are originated by thirteen loan officers who operate from the Bank's offices in Chattanooga. These loan officers actively solicit loan applications from existing customers, local manufacturers and retailers, builders, real estate developers, real estate agents and others. The Bank also receives numerous loan applications as a result of customer referrals and walk-ins to its offices.

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

The Bank's loan approval process is intended to be conservative but also responsive to customer needs. Loans are approved in accordance with the Bank's written loan policy, which provides for several tiers of approval authority, based on a borrower's aggregate debt with the Bank. Certain loan officers have the authority to approve loans of up to \$ 500,000. All other loan officers have the authority to approve secured loans of up to at least \$ 25,000. There is an Officers Loan Committee comprised of the senior officers of the Bank which must approve any loan that increases the borrower's aggregate indebtedness above an individual officer's limit, but that is not more than \$ 2,000,000. The Directors Loan Committee must approve all loans over \$ 2,000,000 up to \$ 4,500,000. All loans above \$4,500,000 up to the Bank's legal lending limit must be approved by the Board of Directors of the Bank. The Bank's legal lending limit is 25% of the Bank's qualifying equity for secured loans and 15% for unsecured loans.

The Bank has in the past purchased and sold commercial loan participations with correspondent banks and will continue the practice when management feels the action would be in the best interest of shareholders. The purchase of loan participations allows the Bank to expand its loan portfolio and increase profitability while still maintaining the high credit standards, which are applied to all extensions of credit made by the Bank. The sale of loan participations allows the Bank to make larger loans and retain a servicing fee for its labor, which it otherwise would be unable to make due to capital or other funding considerations. As of the end December 31, 2005, the Bank had participations purchased totaling \$4.5 million and participations sold of \$20.8 million.

Loan Fee Income

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

Commitment fees are charged by the Bank to the borrower for certain loans and are calculated as a percentage of the principal amount of the loan. These fees normally are deducted from the proceeds of the loan and generally range from 1/2% to 2% of the principal amount, depending on the type and volume of loans made and market conditions such as the demand for loans, the availability of money and general economic conditions. The Bank complies with FASB 91 and amortizes all significant loan fees over the life of the loan.

The Bank also receives miscellaneous fee income from late payment charges, overdraft fees, property inspection fees, and miscellaneous services related to its existing loans. For the year ended December 31, 2005, the Bank recognized origination, commitment and other loan fees totaling \$1,631,844, which equaled 8.4% of the Company's total loan interest income for the year.

Problem Loans and Allowance for Loan Losses

Problem Loans

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

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



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

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

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

The Bank attempts to sell real estate owned promptly after foreclosure, and sold \$224,696 of its real estate owned due to loan foreclosures during the year ended December 31, 2005. The book value of real estate owned that was sold by the Bank during the year ended December 31, 2005 totaled \$244,916. As of December 31, 2005, the Bank had \$776,136 in value of real estate owned as a result of foreclosure.

Table 10 sets forth information regarding the Company's delinquent and non-performing assets as of the dates indicated.

Allowance for Loan Losses

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

The Bank maintains a general allowance equal to approximately 1.30% of the total principal amount of loans outstanding and management adjusts the general allowance monthly by charges or credits to income in response to changes in the outstanding loan balance. Management also may establish specific loan loss allowances for specific loans after considering such factors as past delinquencies on the loan, the value of the underlying collateral and the size of the loan. A loan or portion thereof is charged off against the general allowance when management has determined that losses on such loans are probable. Recoveries on any loans charged-off in prior fiscal periods are credited to the allowance. It is the opinion of the Bank's management that the balance in the general allowance for loan losses as of December 31, 2005 is adequate to absorb possible losses from loans currently in the portfolio.

TABLE 10

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

(In thousands)	2005	2004
Accruing loans that are contractually past due 90-days or more:		
Commercial, financial and agricultural	\$ 216	\$ 0
Real estate - construction	0	0
Real estate - mortgage	0	0
Consumer	0	0
Total Loans	\$ 216	\$ 0
Non-accruing loans 90-days or more:		
Commercial, financial and agricultural	\$ 0	\$ 0
Real estate - construction	52	102
Real estate - mortgage	670	39
Consumer	12	1
Total Loans	\$ 734	\$ 142
Real estate acquired through foreclosure	\$ 776	\$ 98
Property acquired through repossession	5	20
Total acquired	\$ 781	\$ 118
Total Loans	\$ 265,554	\$ 205,221
Ratio of non-performing assets to total loans	0.66%	0.10%
Ratio of delinquent (30-days or more) but accruing loans to:		
Total loans	0.82%	0.34%
Total assets	0.67%	0.28%

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

on these weightings, the Bank's management establishes an allowance for loan losses that is reviewed by its Board of Directors each month.

Table 11 summarizes the Company's loan loss experience for the periods indicated.

TABLE 11

		Loan Loss Reserve Analysis Years Ending December 31,				
(in thousands)		2005	2004	2003	2002	2001
Average loans		\$ 236,265	\$ 181,335	\$ 141,586	\$ 107,676	\$ 90,860
Allowance for possible loan losses,						
Beginning of the period		\$ 2,658	\$ 2,011	\$ 1,591	\$ 1,322	\$ 1,142
Charge-offs for the period:						
Commercial, financial and agricultural		275	165	223	423	129
Real estate - construction		48	0	0	0	0
Real estate - mortgage		128	138	6	12	69
Consumer		111	69	106	2	60
Total charge-offs		562	372	335	497	403
Recoveries for the period:						
Commercial, financial and agricultural		12	149	183	75	108
Real estate - construction		1	0	3	0	1
Real estate - mortgage		6	7	0	7	3
Consumer		28	23	24	27	36
Total recoveries		47	179	210	109	148
Net charge-offs for the period		515	186	125	388	255
Provision for loan losses		1402	840	545	683	435
Adjustments		0	0	0	(26)	0
Allowance for possible loan losses, end of period		\$ 3,545	\$ 2,658	\$ 2,011	\$ 1,591	\$ 1,322
Ratio of allowance for loan losses to total average loans outstanding		1.50%	1.47%	1.42%	1.48%	1.46%
Ratio of net charge-offs during the period to average loans outstanding during the period		0.22%	0.10%	0.09%	0.36%	0.28%

Table 12 below sets forth the Company's allocation of the allowance for loan losses as of December 31, 2005, 2004 and 2003.

TABLE 12

Allowance for Loan Losses Years Ending December 31,						
(In thousands) Balance at end of period applicable to	2005		2004		2003	
	Amount	Percent of loans by category to total loans	Amount	Percent of loans by category to total loans	Amount	Percent of loans by category to total loans
Commercial, financial and agricultural	\$ 1,438	32.40%	\$ 1,002	30.09%	\$ 840	26.97%
Real estate - construction	1,253	17.72%	962	17.94%	539	15.31%
Real estate - commercial	535	29.98%	361	30.14%	352	35.94%
Real estate - mortgage	79	17.19%	122	18.61%	139	17.92%
Consumer	240	2.71%	211	3.22%	141	3.86%
Totals	<u>\$ 3,545</u>	<u>100.00%</u>	<u>\$ 2,658</u>	<u>100.00%</u>	<u>\$ 2,011</u>	<u>100.00%</u>

(In thousands) Balance at end of period applicable to	2002		2001	
	Amount	Percent of loans by category to total loans	Amount	Percent of loans by category to total loans
Commercial, financial and agricultural	\$ 537	22.48%	\$ 388	19.42%
Real estate - construction	524	16.46%	332	12.54%
Real estate - commercial	245	22.71%	251	32.85%
Real estate - mortgage	138	33.62%	200	29.32%
Consumer	147	4.72%	151	5.87%
Totals	<u>\$ 1,591</u>	<u>100.00%</u>	<u>\$ 1,322</u>	<u>100.00%</u>

Investment Activities

Investment Policy

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

The Bank's investment portfolio totaled \$ 31.5 million or 9.7% of total assets at December 31, 2005.

Table 13 sets forth the carrying value of the Bank's investments at the dates indicated. Securities are held in both available for sale and held to maturity categories. Securities available for sale are carried at fair market value and securities held to maturity are held at their book value.

TABLE 13

Securities Portfolio			
Years Ending December 31,			
Securities available for sale:	2005	2004	2003
U.S. Government and agency obligations	\$ 22,349	\$ 10,977	\$ 11,088
Mortgage-backed and other securities	4,000	11,326	11,208
State & political subdivisions tax-exempt	3,285	3,140	1,453
Corporate debt	494	1,027	1,659
Totals	\$ 30,128	\$ 26,470	\$ 24,408
Securities held to maturity:			
U.S. Government and agency obligations	\$ 0	\$ 0	\$ 0
Mortgage-backed and other securities	322	391	641
State & political subdivisions tax-exempt	0	0	0
Corporate debt	0	0	0
Totals	\$ 322	\$ 391	\$ 641
Federal Home Loan Bank stock, at cost	1,034	854	582
Total Securities	\$ 31,484	\$ 27,715	\$ 26,049

For December 31, 2005 tables 14 and 15 set forth the book value of the Bank's investments, the weighted average yields on the Bank's investments and the periods to maturity of the Bank's investments for the "Securities Available for Sale" and the "Securities Held to Maturity," respectively.

TABLE 14

Weighted Average Yields on the Available For Sale Investments								
Periods of Maturity from December 31, 2005								
Securities available for sale:	Less than 1 year		1 to 5 years		5 to 10 years		Over 10 years	
	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)
U.S. Treasuries	\$ 0	0.00%	\$ 0	0.00%	\$ 0	0.00%	\$ 0	0.00%
U.S. Government agencies	0	0.00%	22,350	4.36%	0	0.00%	739	5.71%
Mortgage-backed securities (2)	0	0.00%	10	6.67%	20	6.68%	3,230	4.42%
Tax-exempt municipal bonds	0	0.00%	565	4.71%	619	4.16%	2,101	5.22%
Other bonds, notes, debentures and securities	494	7.02%	0	0.00%	0	0.00%	0	0.00%
Totals	\$ 494	7.02%	\$ 22,925	4.37%	\$ 639	4.24%	\$ 6,070	4.86%

Total Securities

Available for Sale

\$ 30,128

4.51%

TABLE 15

Weighted Average Yields on the Held To Maturity Investments
Periods of Maturity from December 31, 2005

Securities held to maturity:	Less than 1 year		1 to 5 years		5 to 10 years		Over 10 years	
	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)	Amount	Weighted Avg. Yield (1)
U.S. Treasuries	\$ 0	0.00%	\$ 0	0.00%	\$ 0	0.00%	\$ 0	0.00%
U.S. Government agencies	0	0.00%	0	0.00%	0	0.00%	0	0.00%
Mortgage-backed securities (2)	0	0.00%	29	7.50%	37	6.68%	256	5.87%
Tax-exempt municipal bonds	0	0.00%	0	0.00%	0	0.00%	0	0.00%
Other bonds, notes, debentures and securities	0	0.00%	0	0.00%	0	0.00%	0	0.00%
Totals	\$ 0	0.00%	\$ 29	7.50%	\$ 37	6.68%	\$ 256	5.87%
Total Securities held to maturity	\$ 322	6.02%						
Federal Home Loan Bank stock, at cost	\$ 1,034	4.87%						
Total Securities	\$ 31,484	4.54%						

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

(2) Mortgages are allocated by maturity and not amortized

Sources of Funds

General

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

Deposits

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

Table 16 sets forth the composition of deposits for the Company, excluding accrued interest payable, by type for the years ended December 31, 2005, December 31, 2004 and December 31, 2003.

TABLE 16

Deposit Composition Years Ending December 31,			
(In thousands)	2005	2004	2003
Demand deposits	\$ 42,118	\$ 34,024	\$ 22,327
NOW deposits	33,080	32,855	28,514
Savings & money market deposits	55,411	31,211	27,712
Time deposits under \$100,000	83,119	59,653	58,535
Time deposits \$100,000 and over	38,707	30,089	22,264
Total Deposits	<u>\$ 252,435</u>	<u>\$ 187,832</u>	<u>\$ 159,352</u>

Table 17 presents a breakdown by category of the average amount of deposits and the average rate paid on deposits for the periods indicated:

TABLE 17

Average Amount and Average Rate Paid on Deposits Years Ending December 31,						
(In thousands)	2005		2004		2003	
	Amount	Rate	Amount	Rate	Amount	Rate
Demand deposits	\$ 34,730		\$ 27,918		\$ 18,017	
NOW deposits	33,943	0.97%	28,843	0.48%	22,299	0.30%
Savings & money market deposits	45,232	2.45%	32,282	1.33%	25,467	1.33%
Time deposits under \$100,000	70,167	3.19%	58,367	2.50%	54,679	2.88%
Time deposits \$100,000 and over	32,611	3.51%	25,734	2.52%	19,430	3.12%
Total Deposits	<u>\$ 216,683</u>	<u>2.65%</u>	<u>\$ 173,144</u>	<u>1.55%</u>	<u>\$ 139,892</u>	<u>1.85%</u>

Borrowings

The Bank joined the Federal Home Loan Bank of Cincinnati in October of 2000. The Federal Home Loan Bank (the "FHLB") allows the Bank to borrow funds on a contractual basis many times at rates lower than the costs of local certificates of deposit. In addition, the FHLB has the ability to provide structured advances that best reduce or leverage the interest rate risk of the Bank. The Bank as of the end of the year had \$30 million outstanding with the FHLB. All the loans are from \$2 to \$5 million in size and are structured as ten year obligations with an optional conversion to a floating rate after a stated period of time. The loans have maturities ranging from December 2010 to February 2015 and have conversion dates ranging from immediate to February 2010. Interest rates range from 2.4% to 5.0%. The Bank has several Federal Funds lines of credit available with correspondent banks with a total availability of \$33 million as of the end of 2005. In addition, the Bank has the right to borrow from the Federal Reserve Bank if necessary to supplement its supply of funds available for lending and to meet deposit withdrawal requirements. As of December 31, 2005, the Company had established a line of credit of \$5.0 million priced at 1 month LIBOR plus 150 basis points. The loan was established to insert capital infusions to the Bank to fund growth or retire treasury stock, if any, as needed. This line allows the Company to act as a source of strength for the Bank without the expense or dilution of additional common stock. As of December 31, 2005, there were no borrowings on the line of credit and the Company has the entire amount available to inject capital into the Bank or fund other investments.

Balance Sheet Management

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



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

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

The liability portion of the balance sheet provides liquidity through various interest bearing and non-interest bearing deposit accounts. Other short-term liabilities, which do not qualify as a deposit, are Federal Funds purchased and securities under agreement to repurchase (REPO's). Both are temporary solutions for liquidity as Federal Funds must be paid off at least once every 30 days and REPO's must be collateralized by investment securities. At year-end December 31, 2005, the Company had \$2.4 million Federal Funds purchased and \$2.4 million in REPO's. Longer-term liabilities are limited to FHLB advances, which would be used to reduce interest rate risk, and Company loans used to repurchase common stock or finance any acquisition in the future.

Capital Resources / Liquidity

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

The Company's liquidity target is measured by adding the Bank's net cash, short term and marketable securities not pledged and dividing this number by total deposits and short-term liabilities not secured by assets pledged. The approved liquidity policy is targeted at 10% and currently the Bank's liquidity ratio is 7.9%. The Company is not subject to any specific liquidity requirements imposed by regulatory orders. The Company is subject to general FDIC guidelines, which do not require a minimum level of liquidity. Management believes its liquidity ratios meet or exceed these guidelines. Management does not know of any trends or demands, which are reasonably likely to result in liquidity increasing or decreasing in any material manner.

Table 18 sets forth the average loan to deposit ratios, a liquidity measure, for periods indicated:

TABLE 18

	December 31, 2005	December 31, 2004
Average loans to average deposits	109.04%	104.73%

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

Capital Adequacy

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

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

Table 19 sets forth the composition of the Bank's capital at December 31, 2005 and 2004.

TABLE 19

Bank Capital		
Years Ending December 31,		
(In thousands)	December 31, 2005	December 31, 2004
Capital:		
Tier I Capital:		
Stockholders' equity	\$ 25,816	\$ 19,989
Less gain on AFS securities	0	(116)
Plus loss on AFS securities	166	0
Less disallowed intangibles	(1)	0
Total Tier I Capital	<u>25,981</u>	<u>19,873</u>
Tier II Capital:		
Qualifying debt	0	0
Reserve for non-core Bank activities	310	263
Qualifying allowance for loan losses	3,422	2,665
Less disallowed intangibles	(224)	(289)
Total Tier II Capital	<u>3,508</u>	<u>2,639</u>
Total Capital	<u>\$ 29,489</u>	<u>\$ 22,512</u>
Risk-adjusted Assets	<u>\$ 280,439</u>	<u>\$ 218,199</u>
Average Assets	<u>\$ 283,394</u>	<u>\$ 221,073</u>
Ratios:		
Tier I capital to risk-adjusted assets	9.26%	9.11%
Tier II capital to risk-adjusted assets	10.52%	10.32%
Leverage ratio (Tier I capital to average assets Less disallowed intangibles)	9.17%	8.99%

The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") established five capital categories for banks. Under the regulation defining these five capital categories, each bank is classified into one of the five categories based on its level of risk-based capital as measured by Tier I capital, total risk-based capital, and Tier I leverage ratios and its supervisory ratings. Table 20 lists the five categories of

capital and each of the minimum requirements for the three risk-based ratios.

TABLE 20

Minimum Requirements for Risk-Based Capital Ratios

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

On December 31, 2005, the Company exceeded the regulatory minimums and qualified as a well-capitalized institution under the regulations. The Bank will adopt Statement of Financial Accounting Standard number 123R in 2006. There are no critical accounting policies applied that have alternative applications which would likely change the results of operations in a material amount. Management of the Bank believes it has made the proper judgements about its selection of accounting policies.

ITEM 7. FINANCIAL STATEMENTS

The consolidated financial statements of the Company and its subsidiary, together with the Report of Independent Certified Public Accountants thereon, are included on pages F-1 through F-28 of this Annual Report on Form 10-KSB.

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

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

ITEM 8A. CONTROLS AND PROCEDURES

Our principal executive officer and principal financial officer have evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13(a)-15(e) and 15(d)-15(e)) under the Securities Exchange Act of 1934, as amended (the "Exchange Act") as of December 31, 2005 (the "Evaluation Date"). Based upon such evaluation, such officers have concluded that, as of the Evaluation Date, our disclosure controls and procedures are effective in alerting them on a timely basis to material information relating to us (including our consolidated subsidiaries) required to be included in our periodic filings under the Exchange Act.

Since the Evaluation Date, there have not been any significant changes in our disclosure controls and procedures or in other factors that could significantly affect such controls. There were no significant deficiencies or material weaknesses, and therefore there were no corrective actions taken.

It should be noted that any system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events. Because of these and other inherent limitations of control systems, there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

PART III

ITEM 9. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Information relating to the directors and executive officers of the Company is set forth under the caption "Proposals - Election of Directors" in the Company's 2006 Proxy Statement. Such information is incorporated into this report by reference. Information relating to audit committee financial experts is set forth under the caption "Audit Committee Report - Identification of Members and Functions of Committee" in the Company's 2006 Proxy Statement. Such information is incorporated into this report by reference.

Section 16(a) Beneficial Ownership Reporting Compliance

Under Section 16(a) of the Securities Exchange Act of 1934, as amended, the directors and officers of the Company and any person who owns 10% or more of the Company's Common Stock are required to report to the Securities and Exchange Commission (the "SEC"), within specified due dates, their initial beneficial ownership of the Company's Common Stock and all subsequent changes to their beneficial ownership. Officers, directors, and greater than 10% shareholders are required by SEC regulations to furnish the Company with copies of all forms they file in accordance with Section 16(a). Based solely on the Company's review of these reports or on representations or information provided to the Company by the persons required to make such filings, the Company believes that all Section 16(a) filing requirements were complied with during the last fiscal year, with the exception of the following late filings: (a) each of Kenneth B. Driver, Karl Fillauer, James H. Large, Russell W. Lloyd, Doyce G. Payne M.D., Turner Smith, Billy O. Wiggins and Marsha Yessick filed one late report on a Form 4 on May 4, 2005 (with the exception of Mr. Driver, who filed such report on May 3, 2005), in which each reported one late transaction related to the grant on March 1, 2005 of stock options to acquire 500 shares of the Company's Common Stock; (b) Lawrence D. Levine filed four late reports on Form 4s, which were filed (i) on May 4, 2005, reporting one late transaction related to the grant on March 1, 2005 of stock options to acquire 500 shares of the Company's Common Stock, (ii) on August 10, 2005, reporting one late transaction related to the disposition on August 5, 2005 of 230 shares of the Company's Common Stock, (iii) on October 12, 2005, reporting one late transaction related to the exercise on October 5, 2005 of stock options to acquire 20,000 shares of the Company's Common Stock and (iv) on November 10, 2005, reporting one late transaction related to the disposition on November 2, 2005 of 5,500 shares of the Company's Common Stock; and (c) Earl A. Marler, Jr. filed three late reports on Form 4s, which were filed (i) on May 4, 2005, reporting one late transaction related to the grant on March 1, 2005 of stock options to acquire 500 shares of the Company's Common Stock, (ii) on June 13, 2005, reporting one late transaction related to the exercise on June 2, 2005 of stock options to acquire 10,000 shares of the Company's Common Stock and (iii) on December 14, 2005, reporting one late transaction related to the disposition on November 2, 2005 of 10,000 shares of the Company's Common Stock.

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

ITEM 10. EXECUTIVE COMPENSATION

Information relating to director compensation is set forth under the caption "Information About the Board of Directors and its Committees - Compensation of Directors" in the Company's 2006 Proxy Statement, and information relating to executive compensation is set forth under the caption "Executive Compensation" in the Company's 2006 Proxy Statement. Such information is incorporated into this report by reference.

ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

Information relating to ownership of the Company's common stock by certain persons is set forth under the caption "Security Ownership of Certain Beneficial Owners and Management" in the Company's 2006 Proxy Statement. Such information is incorporated into this report by reference. Information relating to equity compensation plans is set forth under the caption "Executive Compensation - Equity Compensation Plan Information as of December 31, 2005 in the Company's 2006 Proxy Statement. Such information is incorporated into this report by reference.

ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Information relating to certain transactions between the Company, and its affiliates and certain other persons is set forth under the caption "Certain Relationships and Related Transactions" in the Company's 2006 Proxy Statement. Such information is incorporated into this report by reference.

ITEM 13. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

(1) The following consolidated financial statements of the Company and its subsidiary, together with the Report of Independent Certified Public Accountants thereon, are included on pages F-1 through F-28 of this Annual Report on Form 10-KSB:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of December 31, 2005 and 2004

Consolidated Statements of Income for the years ended
December 31, 2005, 2004 and 2003

Consolidated Statements of Changes in Stockholders' Equity
for the years ended December 31, 2005, 2004 and 2003

Consolidated Statements of Cash Flows for the years ended
December 31, 2005, 2004 and 2003

Notes to Consolidated Financial Statements

All other financial statement schedules not listed are omitted because either they are not applicable, not required or the required information is included in the consolidated financial statements or the notes thereto.

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

<u>Exhibit No.</u>	<u>Description</u>
3.1	Amended and Restated Charters of Cornerstone Bancshares, Inc. (1)
3.2	First Amendment to Amended and Restated Charter of Cornerstone Bancshares, Inc. (2)
3.3	Amended and Restated Bylaws of Cornerstone Bancshares, Inc. (3)
4	The right of securities holders are defined in the Charter and Bylaws provided in exhibits 3.1, 3.2 and 3.3 respectively.

10.1	Cornerstone Community Bank Employee Stock Ownership Plan
14	Code of Ethics. (5)
21	Subsidiaries of the registrant.
31	Certifications of chief executive officer and chief financial officer
32	Section 906 certifications of chief executive officer and chief financial officer.

-
- (1) Incorporated by reference from Exhibit 3.1 of the registrant's Form 10-KSB filed on March 21, 2005 (File No. 000-30497).
 - (2) Incorporated by reference from Exhibit 3 of the registrant's Form 10-QSB filed on May 16, 2005 (File No. 000-30497).
 - (3) Incorporated by reference from Exhibit 3 of the registrant's Form 10-QSB filed on August 15, 2005 (File No. 000-30497).
 - (4) Incorporated by reference from Exhibit 3 of the registrant's Form 10-QSB filed on November 10, 2005 (File No. 000-30497)
 - (5) Incorporated by reference from Exhibit 10.1 of the registrant's Form 8-K filed on August 18, 2005, as amended (File No. 333).
 - (6) Incorporated by reference from Exhibit 14 of the registrant's Form 10-KSB on March 24, 2004 (File No. 000-30497)

(b) The following reports on Form 8-K were filed with the Securities and Exchange Commission during 2005:

- (1) Form 8-K filed on January 18, 2005 reporting earnings results for the fiscal quarter ended December 31, 2005.
- (2) Form 8-K filed on April 18, 2005 reporting earnings results for the fiscal quarter ended March 31, 2005.
- (3) Form 8-K filed on May 20, 2005 reporting the declaration of a cash dividend.
- (4) Form 8-K filed on June 3, 2005 reporting the resignation of Russell Lloyd as director.
- (5) Form 8-K filed on July 19, 2005 reporting earnings results for the fiscal quarter ended June 30, 2005.
- (6) Form 8-K filed on September 26, 2005 reporting the appointment of Miller Welborn and Frank McDonald as directors and a new earnings guidance.
- (7) Form 8-K filed on October 17, 2005 reporting earnings results for the fiscal quarter ended September 30, 2005.
- (8) Form 8-K filed on November 28, 2005 reporting the declaration of a cash dividend.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Information relating to principal accountant fees and services is set forth under the caption "Audit Committee Report - Audit Fees" in the Company's 2006 Proxy Statement. Such information is incorporated into this report by reference.

Report of Independent Registered Public Accounting Firm

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

We have audited the accompanying consolidated balance sheets of Cornerstone Bancshares, Inc. and subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the Standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Cornerstone Bancshares, Inc. and subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

/S/ HAZLETT, LEWIS & BIETER, PLLC

Chattanooga, Tennessee
February 17, 2006

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

December 31, 2005 and 2004

	2005	2004
ASSETS		
Cash and due from banks	\$ 14,590,499	\$ 6,900,054
Securities available for sale	30,127,486	26,470,691
Securities held to maturity (fair value of \$321,408 in 2005 and \$393,097 in 2004)	322,180	390,599
Federal Home Loan Bank stock, at cost	1,033,900	854,200
Loans, net of allowance for loan losses of \$3,545,042 in 2005 and \$2,665,464 in 2004	262,008,632	202,555,862
Bank premises and equipment, net	7,207,146	5,967,735
Accrued interest receivable	1,739,460	1,184,478
Goodwill and amortizable intangibles	3,376,892	2,541,476
Other assets	3,205,706	1,749,539
Total assets	\$ 323,611,901	\$ 248,614,634
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing demand deposits	\$ 42,118,351	\$ 34,024,241
Interest-bearing demand deposits	33,080,446	32,855,396
Savings deposits and money market accounts	55,410,928	31,211,457
Time deposits of \$100,000 or more	38,707,366	30,089,057
Time deposits under \$100,000	83,118,799	59,652,751
Total deposits	252,435,890	187,832,902
Accrued interest payable	242,864	91,595
Federal funds purchased and securities sold under agreements to repurchase	4,790,737	7,409,162
Federal Home Loan Bank advances	30,000,000	27,000,000
Other liabilities	3,676,047	1,473,655
Total liabilities	291,145,538	223,807,314
Stockholders' equity:		
Preferred stock - no par value; 2,000,000 shares authorized; no shares issued	—	—
Common stock - \$1.00 par value; 10,000,000 shares authorized in 2005 and 2004; shares issued and outstanding - 3,201,334 in 2005 and 2,868,823 in 2004	3,201,334	2,868,823
Common stock subscribed; 119,961 shares in 2004	—	119,961
Additional paid-in capital	21,211,135	19,160,936
Retained earnings	8,229,552	4,340,981
Accumulated other comprehensive income	(165,955)	116,034
	32,476,066	26,606,735

Treasury stock, 471 shares in 2005, at cost	(9,703)	—
Stock subscriptions receivable	—	(1,799,415)
Total stockholders' equity	<u>32,466,363</u>	<u>24,807,320</u>
Total liabilities and stockholders' equity	<u>\$ 323,611,901</u>	<u>\$ 248,614,634</u>

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

Years Ended December 31, 2005, 2004 and 2003

	2005	2004	2003
INTEREST INCOME			
Loans, including fees	\$ 19,353,740	\$ 13,029,972	\$ 10,326,391
Securities and interest-bearing deposits in other banks	1,217,405	1,006,068	980,062
Federal funds sold	100,937	22,675	19,965
Total interest income	20,672,082	14,058,715	11,326,418
INTEREST EXPENSE			
Time deposits of \$100,000 or more	1,144,939	648,651	606,162
Other deposits	3,675,702	2,024,596	1,981,634
Federal funds purchased and securities sold under agreements to repurchase	203,476	56,269	54,947
Federal Home Loan Bank advances and note payable	1,053,675	845,775	568,056
Total interest expense	6,077,792	3,575,291	3,210,799
Net interest income before provision for loan losses	14,594,290	10,483,424	8,115,619
Provision for loan losses	1,401,600	840,000	545,000
Net interest income after provision for loan losses	13,192,690	9,643,424	7,570,619
NONINTEREST INCOME			
Service charges	984,085	899,213	888,805
Other noninterest income	67,956	63,070	59,615
Operating lease income	539,756	247,251	—
Net gains from sale of loans and other assets	312,923	196,342	293,453
Total noninterest income	1,904,720	1,405,876	1,241,873
NONINTEREST EXPENSES			
Salaries and employee benefits	4,502,910	3,900,505	3,325,470
Net occupancy and equipment expense	859,313	767,461	683,811
Depreciation on leased assets	379,053	185,807	—
Other operating expenses	2,474,999	2,031,944	1,731,552
Total noninterest expenses	8,216,275	6,885,717	5,740,833
Income before income tax expense	6,881,135	4,163,583	3,071,659
Income tax expense	2,556,616	1,592,500	1,189,800

Net income	\$	<u>4,324,519</u>	\$	<u>2,571,083</u>	\$	<u>1,881,859</u>
EARNINGS PER COMMON SHARE						
Basic	\$	1.42	\$	1.03	\$.76
Diluted		<u>1.32</u>		<u>.92</u>		<u>.71</u>

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

income:										
Net income	\$	2,571,083	—	—	—	2,571,083	—	—	—	2,571,083
Other comprehensive income, net of tax:										
Unrealized holding gains (losses) on securities available for sale, net of reclassification adjustment		(64,548)	—	—	—	—	(64,548)	—	—	(64,548)
Total comprehensive income	\$	<u>2,506,535</u>								
BALANCE,										
December 31, 2004		<u>\$2,868,823</u>	<u>\$ 119,961</u>	<u>\$19,160,936</u>	<u>\$ 4,340,981</u>	<u>\$ 116,034</u>	<u>\$ —</u>	<u>\$ (1,799,415)</u>	<u>\$ 24,807,320</u>	

(continued on page F-5)

reclassification adjustment	(281,989)	—	—	—	—	(281,989)	—	—	(281,989)
Total comprehensive income	<u>\$ 4,042,530</u>								
BALANCE, December 31, 2005	<u>\$3,201,334</u>	<u>\$ —</u>	<u>\$21,211,135</u>	<u>\$8,229,552</u>	<u>\$ (165,955)</u>	<u>\$ (9,703)</u>	<u>\$ —</u>	<u>\$ 32,466,363</u>	

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years Ended December 31, 2005, 2004 and 2003

	2005	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	\$ 4,324,519	\$ 2,571,083	\$ 1,881,859
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	764,127	710,686	390,383
Provision for loan losses	1,401,600	840,000	545,000
Gains on sales of loans and other assets	(312,923)	(196,342)	(293,453)
Deferred income taxes	(460,452)	(120,176)	(272,751)
Changes in other operating assets and liabilities:			
Net change in loans held for sale	(257,148)	808,978	2,486,457
Accrued interest receivable	(554,982)	(245,715)	(259,165)
Accrued interest payable	151,269	(10,568)	(19,107)
Other assets and liabilities	1,629,962	192,752	235,048
Net cash provided by operating activities	<u>6,685,972</u>	<u>4,550,698</u>	<u>4,694,271</u>
CASH FLOWS FROM INVESTING ACTIVITIES			
Proceeds from security transactions:			
Securities available for sale	11,818,836	20,441,782	20,475,056
Securities held to maturity	69,067	251,816	386,892
Purchase of securities available for sale	(16,037,889)	(22,564,473)	(24,394,458)
Loan originations and principal collections, net	(59,112,700)	(48,784,301)	(35,029,960)
Purchase of bank premises and equipment	(1,978,538)	(2,424,228)	(630,746)
Acquisition of business	(1,380,000)	—	—
Proceeds from sale of other real estate and other assets	300,464	336,637	255,050
Net cash used in investing activities	<u>(66,320,760)</u>	<u>(52,742,767)</u>	<u>(38,938,166)</u>
CASH FLOWS FROM FINANCING ACTIVITIES			
Net increase in deposits	64,602,988	28,480,627	28,905,951
Increase (decrease) in federal funds purchased and securities sold under agreements to repurchase	(2,618,425)	1,325,084	2,580,939
Proceeds from Federal Home Loan Bank advances	5,000,000	10,000,000	7,000,000
Proceeds from note payable	—	2,500,000	400,000
Repayment of Federal Home Loan Bank advances and note payable	(2,000,000)	(2,900,000)	—
Purchase of treasury stock	(82,506)	—	—
Proceeds from re—issuance of treasury stock	82,049	—	—
Payment of dividends	(526,476)	(124,316)	—
Issuance of common stock	2,867,603	5,679,653	100,000
Net cash provided by financing activities	<u>67,325,233</u>	<u>44,961,048</u>	<u>38,986,890</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS			
	7,690,445	(3,231,021)	4,742,995

CASH AND CASH EQUIVALENTS, beginning of year	<u>6,900,054</u>	<u>10,131,075</u>	<u>5,388,080</u>
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CASH AND CASH EQUIVALENTS, end of year	<u>\$ 14,590,499</u>	<u>\$ 6,900,054</u>	<u>\$ 10,131,075</u>
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SUPPLEMENTAL DISCLOSURES OF CASH

FLOW INFORMATION

Cash paid during the period for interest	\$ 5,926,523	\$ 3,585,859	\$ 3,229,906
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Cash paid during the period for taxes	<u>1,910,850</u>	<u>1,988,062</u>	<u>1,316,985</u>
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NONCASH INVESTING AND FINANCING ACTIVITIES

Acquisition of real estate through foreclosure	<u>\$ 1,010,555</u>	<u>\$ 53,111</u>	<u>\$ 104,261</u>
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The Notes to Consolidated Financial Statements are an integral part of these statements.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005, 2004 and 2003

Note 1. Summary of Significant Accounting Policies

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

Nature of operations and geographic concentration:

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

Principles of consolidation:

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

Goodwill:

Goodwill represents the excess of the cost of the Company's 1997 purchase of the net assets of the Bank of East Ridge over the underlying fair value of such net assets at the date of acquisition. The Company has adopted the provisions of Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets," which requires that goodwill and other intangible assets deemed to have an indefinite life not be amortized. Goodwill is tested annually for impairment. If the carrying value of goodwill exceeds the fair value, a write-down is recorded. No impairment loss was recognized during 2005, 2004 or 2003.

Use of estimates:

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

Securities:

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

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

Declines in the market value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other than temporary impairment losses, management considers (1) the length of time and the extent to which the market value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time

sufficient to allow for any anticipated recovery in market value. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Note 1. Summary of Significant Accounting Policies (continued)

Loans:

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

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

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

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

Allowance for loan losses:

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

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

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005, 2004 and 2003

Note 1. Summary of Significant Accounting Policies (continued)

Allowance for loan losses: (continued)

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

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

Premises and equipment:

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

Other real estate owned:

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

Income taxes:

Income taxes are provided for the tax effects of the transactions reported in the financial statements and consist of taxes currently due plus deferred income taxes related primarily to differences between the tax basis and the financial statement carrying amounts of the allowance for loan losses and accumulated depreciation. The deferred tax assets and liabilities represent the future tax return consequences of those differences, which will either be taxable or deductible when the assets and liabilities are recovered or settled. Deferred tax assets and liabilities are reflected at income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

Transfers of financial assets:

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company

does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005, 2004 and 2003

Note 1. Summary of Significant Accounting Policies (continued)

Advertising costs:

The Company expenses all advertising costs as incurred. Advertising expense was \$84,564, \$85,564, and \$33,146 for the years ended December 31, 2005, 2004 and 2003, respectively.

Cash and cash equivalents:

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

Stock-based compensation:

At December 31, 2005, the Company has two stock-based compensation plans, which are described fully in Note 13. The Company applies the recognition and measurement principles of APB Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations in accounting for those plans. No stock-based employee compensation is reflected in net income as all options granted under these plans had an exercise price equal to or above the market value of the underlying common stock on the date of the grant. The following table illustrates the effect on net income and earnings per share if the company had applied the fair value recognition provisions of FASB Statement No. 123, "Accounting for Stock-Based Compensation," to stock-based compensation.

Stock-based compensation:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Net income, as reported	\$ 4,324,519	\$ 2,571,083	\$ 1,881,859
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, net of the related tax effects	<u>(61,402)</u>	<u>(49,469)</u>	<u>(36,962)</u>
Pro forma net income	<u>\$ 4,263,117</u>	<u>\$ 2,521,614</u>	<u>\$ 1,844,897</u>
Earnings per share:			
Basic-as reported	\$ 1.42	\$ 1.03	\$ 0.76
Basic-pro forma	\$ 1.40	\$ 1.01	\$ 0.74
Diluted-as reported	\$ 1.32	\$ 0.92	\$ 0.71
Diluted-pro forma	\$ 0.90	\$ 0.69	\$ 1.30

Segment reporting:

Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information" provides for the identification of reportable segments on the basis of discreet business units and their financial information to the extent such units are reviewed by an entity's chief decision maker (which can be an individual or group of management persons). The Statement permits aggregation or combination of segments that have similar characteristics. In the Company's operations, each bank branch is viewed by management as being a separately identifiable business or segment from the perspective of monitoring performance and allocation of financial resources. Although the branches operate independently and are managed and monitored separately, each is substantially similar in terms of business focus, type of customers, products and services. Further, the results of

Eagle for 2005 were not significant for separate disclosure due to the proximity of the acquisition to December 31, 2005. Accordingly, the Company's consolidated financial statements reflect the presentation of segment information on an aggregated basis in one reportable segment.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005, 2004 and 2003

Note 1. Summary of Significant Accounting Policies (continued)

Off-balance sheet credit related financial instruments:

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

Note 2. Restrictions on Cash and Due From Banks

The Bank is required to maintain balances on hand or with the Federal Reserve Bank based on a percentage of deposits. At December 31, 2005 and 2004, these reserve balances were approximately \$2,635,000 and \$1,668,000, respectively.

Note 3. Securities

Securities have been classified in the balance sheet according to management's intent as either securities held to maturity or securities available for sale. The amortized cost and approximate market value of securities at December 31, 2005 and 2004, is as follows:

	2005			
	Gross Amortized Cost	Gross Unrealized Gains	Unrealized Losses	Market Value
Securities available for sale:				
U.S. Government agencies	\$ 22,652,365	\$ —	\$ (303,023)	\$ 22,349,342
State and municipal securities	3,261,104	54,620	(30,855)	3,284,869
Mortgage-backed securities	3,964,527	35,399	(401)	3,999,526
Corporate debt securities	500,937	—	(7,187)	493,750
	<u>\$ 30,378,933</u>	<u>\$ 90,019</u>	<u>\$ (341,466)</u>	<u>\$ 30,127,486</u>
Securities held to maturity:				
Mortgage-backed securities	\$ 322,180	\$ 985	\$ (1,757)	\$ 321,408
	2004			
	Gross Amortized Cost	Gross Unrealized Gains	Unrealized Losses	Market Value
Securities available for sale:				
U.S. Government agencies	\$ 10,980,741	\$ 14,936	\$ (18,565)	\$ 10,977,112
State and municipal securities	3,075,221	83,549	(18,484)	3,140,286

Mortgage-backed securities	11,224,993	102,076	(137)	11,326,932
Corporate debt securities	<u>1,013,926</u>	<u>12,435</u>	<u>—</u>	<u>1,026,361</u>
	<u>\$ 26,294,881</u>	<u>\$ 212,996</u>	<u>\$ (37,186)</u>	<u>\$ 26,470,691</u>
Securities held to maturity:				
Mortgage-backed securities	<u>\$ 390,599</u>	<u>\$ 3,578</u>	<u>\$ (1,080)</u>	<u>\$ 393,097</u>

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005, 2004 and 2003

Note 3. Securities (continued)

At December 31, 2005 and 2004, securities with a carrying value of approximately \$12,424,000 and \$8,628,000, respectively, were pledged to secure public deposits and for other purposes required or permitted by law.

At December 31, 2005 and 2004, the carrying amount of securities pledged to secure repurchase agreements was approximately \$6,936,000 and \$7,005,000, respectively.

The amortized cost and estimated market value of securities at December 31, 2005, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Securities Available for Sale		Securities Held to Maturity	
	Amortized Cost	Market Value	Amortized Cost	Market Value
Due in one year or less	\$ 500,937	\$ 493,750	\$ —	\$ —
Due from one year to five years	23,218,578	22,914,417	—	—
Due from five years to ten years	598,171	618,663	—	—
Due after ten years	2,096,720	2,101,130	—	—
	<u>26,414,406</u>	<u>26,127,960</u>	<u>—</u>	<u>—</u>
Mortgage-backed securities	<u>3,964,527</u>	<u>3,999,526</u>	<u>322,180</u>	<u>321,408</u>
	<u>\$ 30,378,933</u>	<u>\$ 30,127,486</u>	<u>\$ 322,180</u>	<u>\$ 321,408</u>

For the years ended December 31, 2005, 2004 and 2003, there were no sales of securities available for sale. At December 31, 2005, virtually all unrealized losses have arisen during the past twelve months.

Note 4. Loans and Allowance for Loan Losses

At December 31, 2005 and 2004, the Bank's loans consist of the following (in thousands):

	2005	2004
Mortgage loans on real estate:		
Residential 1-4 family	\$ 26,118	\$ 23,521
Residential multifamily (5 or more)	9,374	6,153
Held for sale	603	346
Commercial	79,608	61,860
Construction	47,071	36,824
Second mortgages	3,216	2,032
Equity lines of credit	6,334	6,141
	<u>172,324</u>	<u>136,877</u>
Commercial loans	<u>86,039</u>	<u>61,742</u>
Consumer installment loans:		
Personal	6,240	6,273

Credit cards	951	329
	<u>6,602</u>	<u>7,191</u>
Total loans	265,554	205,221
Less: Allowance for loan losses	(3,545)	(2,665)
Loans, net	<u>\$ 262,009</u>	<u>\$ 202,556</u>

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005, 2004 and 2003

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

A summary of transactions in the allowance for loan losses for the years ended December 31, 2005, 2004 and 2003, is as follows:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Balance, beginning of year	\$ 2,665,464	\$ 2,011,329	\$ 1,591,152
Provision for loan losses	1,401,600	840,000	545,000
Loans charged-off	(557,227)	(364,657)	(334,884)
Recoveries of loans previously charged-off	35,205	178,792	210,061
Balance, end of year	<u>\$ 3,545,042</u>	<u>\$ 2,665,464</u>	<u>\$ 2,011,329</u>

The Bank's only significant concentration of credit at December 31, 2005, occurred in real estate loans which totaled approximately \$172 million. While real estate loans accounted for 65 percent of total loans, these loans were primarily residential development and construction loans, residential mortgage loans, and commercial loans secured by commercial properties. Substantially all real estate loans are secured by properties located in Tennessee.

In the normal course of business, the Bank makes loans to executive officers, principal shareholders, and directors and their affiliates of the Bank on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other borrowers. Loans to executive officers, principal shareholders, and directors and their affiliates were approximately \$1,730,000 and \$1,189,000 at December 31, 2005 and 2004, respectively.

Loans classified as impaired were insignificant in relation to the Bank's loan portfolio at December 31, 2005 and 2004.

Interest income recognized on impaired loans was insignificant to total interest income on loans for each of the years ending December 31, 2005, 2004 and 2003.

Note 5. Bank Premises and Equipment

A summary of bank premises and equipment at December 31, 2005 and 2004, is as follows:

	<u>2005</u>	<u>2004</u>
Land	\$ 1,625,567	\$ 1,625,567
Buildings and improvements	3,388,834	3,076,321
Furniture, fixtures and equipment	5,113,021	3,248,714
	10,127,422	7,950,602
Accumulated depreciation	(2,920,276)	(1,982,867)
	<u>\$ 7,207,146</u>	<u>\$ 5,967,735</u>

Depreciation expense for the years ended December 31, 2005, 2004 and 2003, amounted to \$736,731, \$527,167, and \$288,637, respectively.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005, 2004 and 2003

Note 5. Bank Premises and Equipment (continued)

Certain bank facilities and equipment are leased under various operating leases. Total rent expense for the years ended December 31, 2005, 2004 and 2003, was \$160,626, \$147,451 and \$166,318, respectively.

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

2006	\$	152,000
2007		156,258
2008		130,518
2009		134,325
2010		137,700
Thereafter		<u>626,805</u>
Total	\$	<u><u>1,337,606</u></u>

Note 6. Time Deposits

At December 31, 2005, the scheduled maturities of time deposits are as follows:

2006	\$	92,418,648
2007		21,847,389
2008		4,359,272
2009		1,124,036
2010		2,074,786
Thereafter		<u>2,034</u>
Total	\$	<u><u>121,826,165</u></u>

Note 7. Concentrations in Deposits

At December 31, 2005, the Company had a concentration in the money market account of one customer totaling approximately \$20,500,000. This balance accounted for approximately 8 percent of total deposits. There were no concentrations at December 31, 2004.

Note 8. Income Taxes

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

Income tax expense in the statements of income for the years ended December 31, 2005, 2004 and 2003, consists of the following:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Current tax expense	\$ 3,017,068	\$ 1,712,676	\$ 1,462,551
Deferred tax expense (benefit) related to:			
Allowance for loan losses	(361,227)	(236,309)	(133,011)

Other	<u>(99,225)</u>	<u>116,133</u>	<u>(139,740)</u>
Income tax expense	<u>\$ 2,556,616</u>	<u>\$ 1,592,500</u>	<u>\$ 1,189,800</u>

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005, 2004 and 2003

Note 8. Income Taxes (continued)

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

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Expected tax at statutory rates	\$ 2,339,586	\$ 1,415,618	\$ 1,044,364
Increase (decrease) resulting from tax effect of:			
State income taxes, net of federal tax benefit	295,201	178,618	131,774
Other	(78,171)	(1,736)	13,662
Income tax expense	<u>\$ 2,556,616</u>	<u>\$ 1,592,500</u>	<u>\$ 1,189,800</u>

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

	<u>2005</u>	<u>2004</u>
Deferred tax assets:		
Deferred compensation	\$ 140,716	\$ 141,864
Deferred loan fees	213,710	236,316
Allowance for loan losses	1,113,947	752,720
Deferred gains	—	56,344
Net unrealized loss on securities available for sale	85,492	—
Other	108,612	24,432
	<u>1,662,477</u>	<u>1,211,676</u>
Deferred tax liabilities:		
Net unrealized gain on securities available for sale	—	59,775
Depreciation	260,174	364,975
Life insurance	156,443	148,632
Other	5,220	3,373
	<u>421,837</u>	<u>576,755</u>
Net deferred tax asset	<u>\$ 1,240,640</u>	<u>\$ 634,921</u>

Note 9. Federal Home Loan Bank Advances and Note Payable

The Bank has agreements with the Federal Home Loan Bank of Cincinnati (FHLB) that can provide convertible fixed rate advances to the Bank in an amount up to approximately \$42,300,000. All of the Bank's loans secured by first mortgages on 1-4 family residential, multi-family properties, and commercial properties are pledged as collateral for these advances.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005, 2004 and 2003

Note 9. Federal Home Loan Bank Advances and Note Payable (continued)

At December 31, 2005 and 2004, FHLB advances consist of the following:

	2005	2004
Long-term advance dated December 27, 2000, requiring monthly interest payments, fixed at 5.00% until conversion option is exercised, principal due in December 2010	\$ 2,000,000	\$ 2,000,000
Long-term advance dated November 1, 2001, requiring monthly interest payments, fixed at 3.94% until November 2006, principal due in November 2011	2,000,000	2,000,000
Long-term advance dated February 22, 2002, requiring monthly interest payments, fixed at 3.96% until February 2005, principal due in February 2012	—	2,000,000
Long-term advance dated April 26, 2002, requiring monthly interest payments, fixed at 4.11% until conversion option is exercised, principal due in April 2012	2,000,000	2,000,000
Long-term advance dated September 13, 2002, requiring monthly interest payments, fixed at 3.51% until September 2007, principal due in September 2012	2,000,000	2,000,000
Long-term advance dated January 17, 2003, requiring monthly interest payments, fixed at 2.61% until January 2006, principal due in January 2013	4,000,000	4,000,000
Long-term advance dated April 25, 2003, requiring monthly interest payments, fixed at 2.41% until April 2006, principal due in April 2013	3,000,000	3,000,000
Long-term advance dated January 23, 2004, requiring monthly interest payments, fixed at 2.50% until January 2007, principal due in January 2014	5,000,000	5,000,000
Long-term advance dated May 27, 2004, requiring monthly interest payments, fixed at 3.46% until May 2007, principal due		

in May 2014	5,000,000	5,000,000
Long-term advanced dated February 9, 2005, requiring monthly interest payments, fixed at 3.86% until February 2010, principal due in February 2015	5,000,000	—
	<u>\$ 30,000,000</u>	<u>\$ 27,000,000</u>

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005, 2004 and 2003

Note 9. Federal Home Loan Bank Advances and Note Payable (continued)

There are no scheduled maturities in 2006, 2007, 2008, or 2009. \$2,000,000 matures in 2010. The remaining \$28,000,000 matures thereafter.

During the fixed rate term of the above advances, the advances may be prepaid subject to a prepayment penalty as defined in the agreements. The FHLB has the right to convert the fixed rate on the above advances at the end of the initial fixed rate period and on a quarterly basis thereafter. If the conversion option is exercised, the advances will bear interest at the three-month London Interbank Offered Rate (LIBOR) adjusted quarterly at a spread of zero basis points to the LIBOR index. Subsequent to any conversion, the Bank has the option to prepay the advances, in full or in part, without penalty on the conversion date or any subsequent quarterly repricing date.

During 2002, the Company established a \$2,500,000 line of credit with a bank that is secured by a pledge of the Bank's common stock and bears interest at 1.50% above the one-month LIBOR, due in quarterly installments. During 2004, the Company renewed the line of credit, which matured on February 28, 2004, and increased the line to \$5,000,000. This line of credit continues to be secured by a pledge of the Bank's common stock and bears interest at 1.50% above the one-month LIBOR, due in quarterly installments. There were no borrowings outstanding under this line of credit at December 31, 2005 or 2004. The line of credit matures on February 28, 2006.

Note 10. Employee Benefit Plan

The Bank has a 401(k) employee benefit plan covering substantially all employees who have completed at least 30 days of service and met minimum age requirements. The Bank's contribution to the plan is discretionary and was \$142,719 for 2005, \$130,423 for 2004 and \$104,737 for 2003.

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

In the normal course of business, the Bank has outstanding commitments and contingent liabilities, such as commitments to extend credit and standby letters of credit, which are not included in the accompanying financial statements. The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual or notional amount of those instruments. The Bank uses the same credit policies in making such commitments as it does for instruments that are included in the balance sheet. At December 31, 2005 and 2004, undisbursed loan commitments aggregated \$57,935,000 and \$38,058,000, respectively. In addition, there were outstanding standby letters of credit totaling \$6,037,000 and \$4,752,000, respectively.

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

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

The Bank incurred an insignificant loss on its commitments during 2005, 2004 and 2003.

Note 12. Fair Value of Financial Instruments

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

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

Cash and cash equivalents:

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

Securities:

The fair value of securities is estimated based on bid prices published in financial newspapers or bid quotations received from securities dealers.

Federal Home Loan Bank stock:

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

Loans, net:

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

Deposits:

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

Federal funds purchased and securities sold under agreements to repurchase:

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

Federal Home Loan Bank advances and note payable:

The carrying amounts of the FHLB advances and the note payable approximate their fair value.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005, 2004 and 2003

Note 12. Fair Value of Financial Instruments (continued)

Commitments to extend credit:

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

The carrying amount and estimated fair value of the Company's financial instruments at December 31, 2005 and 2004, are as follows (in thousands):

	2005		2004	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Assets:				
Cash and due from banks	\$ 14,590	\$ 14,590	\$ 6,900	\$ 6,900
Securities	30,450	30,449	26,861	26,864
Federal Home Loan Bank stock	1,034	1,034	854	854
Loans, net	262,009	261,553	202,556	202,089
Liabilities:				
Noninterest-bearing demand deposits	\$ 42,118	\$ 42,118	\$ 34,024	\$ 34,024
Interest-bearing demand deposits	33,080	33,080	32,855	32,855
Savings deposits and money market accounts	55,411	55,411	31,212	31,212
Time deposits	121,826	120,828	89,742	89,548
Federal funds purchased and securities sold under agreements to repurchase	4,791	4,791	7,409	7,409
Federal Home Loan Bank advances	30,000	30,000	27,000	27,000
Unrecognized financial instruments (net of contract amount):				
Commitments to extend credit	—	—	—	—

Note 13. Contingencies

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

Note 14. Liquidity and Capital Resources

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



CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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Note 15. Stock Option Plans

The Company has a stock option plan under which members of the Board of Directors, at the formation of the Bank, were granted options to purchase a total of up to 150,000 shares of the Bank's common stock. The option price was \$10.00 per share which was the estimated fair value of the stock at the June 30, 1996, grant date. The options expire ten years from the date of grant and were fully vested at the grant date. On October 15, 1997, the Bank stock options were converted to Company stock options.

During 2004, the Company granted 5,000 options under this plan. These stock options vest at 50% on the first and second anniversary of the grant date. The option price was \$21.76 per share which was the estimated fair value of the stock at the grant date.

On September 16, 2004, the Company's stock options were subject to a 2-for-1 stock dividend doubling the total number of options available in the Director's stock option plan to 300,000 and reducing the existing option price in half. Amounts shown in the table below retroactively reflect this dividend.

During 2005, the Company granted 5,000 options under this plan. These stock options vest at 50% on the first and second anniversary of the grant date. The option price was \$18.45 per share which was the estimated fair value of the stock at the grant date. A summary of the status of this plan is presented in the following table.

	Outstanding Options		Exercisable Options	
	Number	Weighted Average Exercise Price	Number	Weighted Average Exercise Price
Outstanding, December 31, 2002	260,000	\$ 5.00	260,000	\$ 5.00
Options exercised	(20,000)	5.00	(20,000)	5.00
Outstanding, December 31, 2003	240,000	5.00	240,000	5.00
Options granted	10,000	10.88	—	—
Outstanding, December 31, 2004	250,000	5.24	240,000	5.00
Options granted	5,000	18.45	—	—
Options exercised	(209,000)	5.00	(209,000)	5.00
Options forfeited	(1,000)	14.67	—	—
Options which became exercisable	—	—	5,000	10.88
Outstanding, December 31, 2005	<u>45,000</u>	7.59	<u>36,000</u>	5.81

The weighted-average fair value per share of options granted during 2005 was \$4.10. At December 31, 2005, the range of exercise prices of outstanding options issued was \$5.00-\$18.45. The weighted-average remaining contractual life at December 31, 2005, was 2.9 years.

The Company has two stock option plans under which officers and employees can be granted incentive stock options or non-qualified stock options to purchase shares of the Company's common stock. The option price for incentive stock options shall be not less than 100 percent of the fair market value of the common stock on the date of the grant. The non-qualified stock options may be equal to or more or less than the fair market value of the common stock on the date of the grant. The stock options vest at 30 percent on the second and third anniversary of the grant date and 40 percent on the fourth anniversary. The options expire ten years from the grant date and the weighted-average remaining contractual life of outstanding stock options was 5.2 years at December 31, 2005.

On September 16, 2004, the Company's stock options were subject to a 2-for-1 stock dividend doubling the total number of options available under the officer and employee plans to 710,000 and reducing the existing option price in half. A summary of the status of these plans is presented in the following table. Amounts shown retroactively reflect this dividend:

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005, 2004 and 2003

Note 15. Stock Option Plans (continued)

	Outstanding Options		Exercisable Options	
	Number	Weighted Average Exercise Price	Number	Weighted Average Exercise Price
Outstanding, December 31, 2002	159,000	\$ 6.94	31,620	\$ 7.13
Options granted	58,500	7.25	—	—
Options which became exercisable	—	—	36,300	6.86
Outstanding, December 31, 2003	217,500	7.02	67,920	6.99
Options granted	68,500	10.88	—	—
Options forfeited	(2,250)	8.73	—	—
Options exercised	(1,550)	6.57	(1,550)	6.57
Options which became exercisable	—	—	41,740	6.76
Outstanding, December 31, 2004	282,200	7.95	108,110	6.91
Options granted	40,150	18.45	—	—
Options forfeited	(2,550)	8.94	—	—
Options exercised	(3,550)	6.53	(3,550)	6.53
Options which became exercisable	—	—	45,890	7.01
Outstanding, December 31, 2005	<u>316,250</u>	9.29	<u>150,450</u>	6.93

The weighted-average fair value per share of options granted was \$4.10, \$2.88, and \$1.75 for the years ended December 31, 2005, 2004 and 2003, respectively. At December 31, 2005, the range of exercise prices of outstanding options issued was \$6.50-\$18.45.

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

	Years Ended December 31,		
	2005	2004	2003
Dividend yield	0.98%	0.60%	0.00%
Expected life	6.9 years	6.9 years	6.9 years
Expected volatility	11.80%	10.00%	10.00%
Risk-free interest rate	4.19%	4.16%	3.62%

Note 16. Regulatory Matters

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the Tennessee Department of Financial Institutions and the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices.

The Company's and the Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005, 2004 and 2003

Note 16. Regulatory Matters (continued)

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2005 and 2004, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2005, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's prompt corrective action category for bank capital.

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

	Actual		For Capital Adequacy Purposes	
	Amount	Ratio	Amount	Ratio
As of December 31, 2005				
Total capital to risk-weighted assets:				
Consolidated	\$ 32,840	11.5%	\$ 22,943	8.0%
Cornerstone Community Bank	29,488	10.5%	22,435	8.0%
Tier I capital to risk-weighted assets:				
Consolidated	29,255	10.2%	11,471	4.0%
Cornerstone Community Bank	25,983	9.3%	11,218	4.0%
Tier I capital to average assets:				
Consolidated	29,255	10.3%	11,338	4.0%
Cornerstone Community Bank	25,983	9.2%	11,336	4.0%
As of December 31, 2004				
Total capital to risk-weighted assets:				
Consolidated	\$ 24,788	11.4%	\$ 17,456	8.0%
Cornerstone Community Bank	22,512	10.3%	17,456	8.0%
Tier I capital to risk-weighted assets:				
Consolidated	22,150	10.2%	8,728	4.0%
Cornerstone Community Bank	19,873	9.1%	8,728	4.0%
Tier I capital to average assets:				
Consolidated	22,150	10.0%	8,944	4.0%
Cornerstone Community Bank	19,873	9.0%	8,843	4.0%

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005, 2004 and 2003

Note 17. Other Comprehensive Income

Other comprehensive income consists of unrealized holding gains and losses on securities available for sale. A summary of other comprehensive income and the related tax effects for the years ended December 31, 2005, 2004 and 2003, is as follows:

	<u>Before-Tax Amount</u>	<u>Tax (Expense) Benefit</u>	<u>Net-of-Tax Amount</u>
Year ended December 31, 2005:			
Unrealized holding gains and losses arising during the period	\$ (427,257)	\$ 145,268	\$ (281,989)
Less reclassification adjustment for gains realized in net income	<u>—</u>	<u>—</u>	<u>—</u>
	<u>\$ (427,257)</u>	<u>\$ 145,268</u>	<u>\$ (281,989)</u>
Year ended December 31, 2004:			
Unrealized holding gains and losses arising during the period	\$ (97,800)	\$ 33,252	\$ (64,548)
Less reclassification adjustment for gains realized in net income	<u>—</u>	<u>—</u>	<u>—</u>
	<u>\$ (97,800)</u>	<u>\$ 33,252</u>	<u>\$ (64,548)</u>
Year ended December 31, 2003:			
Unrealized holding gains and losses arising during the period	\$ (152,714)	\$ 51,922	\$ (100,792)
Less reclassification adjustment for gains realized in net income	<u>—</u>	<u>—</u>	<u>—</u>
	<u>\$ (152,714)</u>	<u>\$ 51,922</u>	<u>\$ (100,792)</u>

Note 18. Earnings Per Common Share

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

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005, 2004 and 2003

Note 18. Earnings Per Common Share (continued)

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

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Net income	\$ 4,324,519	\$ 2,571,083	\$ 1,881,859
Less: Preferred stock dividends	<u>—</u>	<u>—</u>	<u>—</u>
Net income applicable to common stock	<u>\$ 4,324,519</u>	<u>\$ 2,571,083</u>	<u>\$ 1,881,859</u>
Average number of common shares outstanding	3,045,625	2,490,340	2,479,156
Effect of dilutive stock options	<u>220,235</u>	<u>308,873</u>	<u>184,762</u>
Average number of common shares outstanding used to calculate diluted earnings per common share	<u>3,265,860</u>	<u>2,799,213</u>	<u>2,663,918</u>

During 2004, the Company issued a 2-for-1 stock dividend. The average number of common shares outstanding and the effect of dilutive stock options for 2003 has have been retroactively adjusted to reflect this transaction.

Note 19. Stock Subscriptions Receivable

Effective October 8, 2004, the Company filed an offering with the Securities and Exchange Commission to sell up to 500,000 shares of newly issued Company common stock. At December 31, 2004, the Company had sold the entire 500,000 shares for an issue price of \$15 per share. However, of this amount, there were 119,961 shares of common stock subscribed for which the Company had not yet received funds and issued common stock certificates. The Company recognized stock subscriptions receivable of \$1,799,415 as of December 31, 2004, related to this transaction. As of December 31, 2005, the stock subscriptions receivable has been fully settled and the related common stock certificates have been issued.

Note 20. Recent Accounting Pronouncements

In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." This Statement amends and clarifies financial accounting and reporting for derivative instruments, including certain embedded derivatives, and for hedging activities under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." This Statement amends SFAS No. 133 to reflect the decisions made as part of the Derivatives Implementation Group and in other FASB projects or deliberations. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. Adoption of this Standard had no material effect on the Company's consolidated financial statements.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity." This Statement establishes standards for how an entity classifies and measures certain financial instruments with characteristics of both liabilities and equity. This Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. Adoption of this Standard had no material effect on the Company's consolidated financial statements.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005, 2004 and 2003

Note 20. Recent Accounting Pronouncements (continued)

In December 2003, the FASB issued revised Interpretation No. 46 (FIN 46), "Consolidation of Variable Interest Entities." This Interpretation clarifies the application of ARB No. 51, "Consolidated Financial Statements," for certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated support from other parties. This Interpretation requires variable interest entities to be consolidated by the primary beneficiary which represents the enterprise that will absorb the majority of the variable interest entities' expected losses if they occur, receive a majority of the variable interest entities' residual returns if they occur, or both. This Interpretation was effective for variable interest entities created after January 31, 2003, and for variable interest entities in which an enterprise obtains an interest after that date. This Interpretation is effective in the first fiscal year or interim period beginning after December 15, 2004, for variable interest entities in which an enterprise holds a variable interest that was acquired before February 1, 2003, with earlier adoption permitted. Adoption of this Standard did not have a material effect on the Company's consolidated financial statements.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment," which is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS No. 123(R) supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and amends SFAS Statement No. 95, "Statement of Cash Flows." Generally, the approach to accounting for share-based payments in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values (i.e., pro forma disclosure is no longer an alternative to financial statement recognition). SFAS No. 123(R) is effective for the Company beginning January 1, 2006. The Company is currently evaluating the provisions of SFAS No. 123(R) to determine its impact on the Company's consolidated financial statements in future periods.

Note 21. Acquisition

On December 1, 2005, the Company acquired certain assets and assumed liabilities of Eagle for a purchase price of \$1,380,000 in cash plus assumption of approximately \$1,609,000 in liabilities. Assets acquired, primarily accounts receivable, amounted to approximately \$2,140,000. The excess of purchase price over the fair value of the assets acquired of \$848,916 was recorded as an intangible asset separable from goodwill, as it pertained to customer relationships, active customer contracts and brand recognition, and met the separability criteria of SFAS No. 141, "Business Combinations" (SFAS 141). The Company is amortizing the intangible assets over their benefit periods which range from 2 to 7 years. The Company recognized amortization expense of \$13,500 for the period ended December 31, 2005.

The acquisition was accounted for under the provisions of SFAS 141 and the results of operations have been included in the accompanying consolidated financial statements since its date of acquisition. Pro-forma disclosures of the acquisition have not been included, as the overall impact the acquisition was not material to the Company's operating results.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005, 2004 and 2003

Note 22. Quarterly Data (unaudited)

	Years Ended December 31,							
	2005				2004			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest income	\$ 6,067,709	\$ 5,437,881	\$ 4,843,999	\$ 4,322,493	\$ 3,871,916	\$ 3,704,596	\$ 3,404,307	\$ 3,077,896
Interest expense	1,873,554	1,641,591	1,427,333	1,135,314	1,003,096	946,760	817,978	807,457
Net interest income, before provision for loan losses	4,194,155	3,796,290	3,416,666	3,187,179	2,868,820	2,757,836	2,586,329	2,270,439
Provision for loan losses	502,000	349,600	340,000	210,000	255,000	175,000	250,000	160,000
Net interest income, after provision for loan losses	3,692,155	3,446,690	3,076,666	2,977,179	2,613,820	2,582,836	2,336,329	2,110,439
Noninterest income	840,877	491,748	270,378	301,717	415,308	314,439	328,514	347,615
Noninterest expenses	2,485,197	1,969,647	1,856,724	1,904,707	1,893,554	1,741,978	1,645,977	1,604,208
Income before income taxes	2,047,835	1,968,791	1,490,320	1,374,189	1,135,574	1,155,297	1,018,866	853,846
Income tax expense	706,116	738,000	578,500	534,000	418,000	447,700	396,300	330,500
Net income	<u>\$ 1,341,719</u>	<u>\$ 1,230,791</u>	<u>\$ 911,820</u>	<u>\$ 840,189</u>	<u>\$ 717,574</u>	<u>\$ 707,597</u>	<u>\$ 622,566</u>	<u>\$ 523,346</u>
Earnings per common share:								
Basic	\$ 0.43	\$ 0.40	\$ 0.30	\$ 0.29	\$ 0.29	\$ 0.28	\$ 0.25	\$ 0.21
Diluted	\$ 0.41	\$ 0.37	\$ 0.28	\$ 0.26	\$ 0.24	\$ 0.25	\$ 0.23	\$ 0.20

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005, 2004 and 2003

Note 23. Condensed Parent Information

BALANCE SHEETS

	2005	2004
ASSETS		
Cash	\$ 516,559	\$ 2,675,690
Investment in subsidiaries	27,511,971	19,989,410
Loan to subsidiary	1,428,794	—
Goodwill	2,541,476	2,541,476
Other assets	726,626	1,370
Total assets	\$ 32,725,426	\$ 25,207,946
LIABILITIES AND STOCKHOLDERS' EQUITY		
Other liabilities	\$ 259,063	\$ 400,626
Stockholders' equity	32,466,363	24,807,320
Total liabilities and stockholders' equity	\$ 32,725,426	\$ 25,207,946

STATEMENTS OF INCOME

	2005	2004	2003
INCOME			
Dividends	\$ 200,000	\$ 177,039	\$ —
Interest income	10,000	—	—
	210,000	177,039	—
EXPENSES			
Interest expense	—	38,485	5,540
Other operating expenses	263,824	203,881	133,317
Loss before equity in undistributed earnings of subsidiary	(53,824)	(65,327)	(138,857)
Equity in undistributed earnings of subsidiary	4,261,344	2,544,910	1,969,516
Income tax benefit	116,999	91,500	51,200
Net income	\$ 4,324,519	\$ 2,571,083	\$ 1,881,859

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005, 2004 and 2003

Note 23. Condensed Parent Information (continued)

	<u>2005</u>	<u>2004</u>	<u>2003</u>
STATEMENTS OF CASH FLOWS			
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	\$ 4,324,519	\$ 2,571,083	\$ 1,881,859
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Equity in undistributed income of subsidiary	(4,261,344)	(2,544,910)	(1,969,516)
Other	20,818	52,056	9,555
Net cash provided by (used in) operating activities	<u>83,993</u>	<u>78,229</u>	<u>(78,102)</u>
CASH FLOWS FROM INVESTING ACTIVITIES			
Acquisition of business	(1,380,000)	—	—
Loan to subsidiary	(1,428,794)	—	—
Capital contribution to subsidiary	(1,775,000)	(2,750,000)	(500,000)
Net cash used in investing activities	<u>(4,583,794)</u>	<u>(2,750,000)</u>	<u>(500,000)</u>
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from note payable	—	2,500,000	400,000
Repayment of note payable	—	(2,900,000)	—
Purchase of treasury stock	(82,506)	—	—
Proceeds from re-issuance of treasury stock	82,049	—	—
Payment of dividends	(526,476)	(124,316)	—
Issuance of common stock	2,867,603	5,679,653	100,000
Net cash provided by financing activities	<u>2,340,670</u>	<u>5,155,337</u>	<u>500,000</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(2,159,131)	2,483,566	(78,102)
CASH AND CASH EQUIVALENTS, beginning of year	<u>2,675,690</u>	<u>192,124</u>	<u>270,226</u>
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 516,559</u>	<u>\$ 2,675,690</u>	<u>\$ 192,124</u>
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION			
Cash paid during the year for:			
Interest	\$ —	\$ 40,503	\$ 3,522
Income taxes	<u>1,190,850</u>	<u>1,988,062</u>	<u>1,316,985</u>



SIGNATURES

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

CORNERSTONE BANCSHARES, INC.

Date: March 15, 2006

By: /s/ Gregory B. Jones

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

By /s/ Nathaniel F. Hughes

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

In accordance with the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities indicated on March 15, 2006.

<u>Signature</u>	<u>Title</u>
<u>/s/ Gregory B. Jones</u> Gregory B. Jones	Chairman of the Board and Chief Executive Officer and Director (principal executive officer)
<u>/s/ B. Kenneth Driver</u> B. Kenneth Driver	Director
<u>/s/ Karl Fillauer</u> Karl Fillauer	Director
<u>/s/ Nathaniel F. Hughes</u> Nathaniel F. Hughes	President and Treasurer (principal financial officer and accounting officer) and Director
<u>/s/ Jerry D. Lee</u> Jerry D. Lee	Executive Vice President and Senior Lender and Director
<u>/s/ James H. Large</u> James H. Large	Director
<u>/s/ Lawrence D. Levine</u> Lawrence D. Levine	Director
<u>/s/ Earl A. Marler, Jr.</u> Earl A. Marler, Jr.	Director
<u>/s/ Frank S. McDonald</u> Frank S. McDonald	Director
<u>/s/ Doyce G. Payne</u> Doyce G. Payne	Director

/s/ Turner Smith

Turner Smith

Director

/s/ W. Miller Welborn

Miller Welborn

Director

/s/ Billy O. Wiggins

Billy O. Wiggins

Director

/s/ Marsha Yessick

Marsha Yessick

Director

INDEX OF EXHIBITS

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

-
- (1) Incorporated by reference from Exhibit 3.1 of the registrant's Form 10-KSB filed on March 24, 2005 (File No. 000-30497).
- (2) Incorporated by reference from Exhibit 3 of the registrant's Form 10-QSB filed on May 14, 2005 (File No. 000-30497).
- (3) Incorporated by reference from Exhibit 3 of the registrant's Form 10-QSB filed on March 24, 2005 (File No. 000-30497)
- (4) Incorporated by reference from Exhibit 10.1 of the registrant's Form 8-K filed on August 18, 2005, as amended (File No. 333).
- (5) Incorporated by reference from Exhibit 14 of the registrant's Form 10-KSB on March 24, 2004 (File No. 000-30497)
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CORNERSTONE BANCSHARES, INC.

LIST OF SUBSIDIARIES

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

CERTIFICATIONS

I, Gregory B. Jones, certify that:

1. I have reviewed this report on Form 10-KSB of Cornerstone Bancshares, Inc. (the "Issuer") for the fiscal year ended December 31, 2005.
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Issuer as of, and for, the periods presented in this period report;
4. The Issuer's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the Issuer and have:
 - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Issuer, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) designed such internal controls over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) evaluated the effectiveness of the Issuer's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) disclosed in this report any change in the Issuer's internal control over financial reporting that occurred during the Issuer's fourth fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Issuer's internal control over financial reporting.
5. The Issuer's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting to the Issuer's auditors and the audit committee of Issuer's board of directors:
 - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Issuer's ability to record, process, summarize and report financial information; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Issuer's internal control over financial reporting.

Date: March 15, 2006

/s/ Gregory B. Jones

Gregory B. Jones, Chairman and
Chief Executive Officer

CERTIFICATIONS

I, Nathaniel F. Hughes certify that:

1. I have reviewed this report on Form 10-KSB of Cornerstone Bancshares, Inc. (the "Issuer") for the fiscal year ended December 31, 2005.
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Issuer as of, and for, the periods presented in this period report;
4. The Issuer's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the Issuer and have:
 - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Issuer, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) designed such internal controls over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) evaluated the effectiveness of the Issuer's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) disclosed in this report any change in the Issuer's internal control over financial reporting that occurred during the Issuer's fourth fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Issuer's internal control over financial reporting.
5. The Issuer's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting to the Issuer's auditors and the audit committee of Issuer's board of directors:
 - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Issuer's ability to record, process, summarize and report financial information; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Issuer's internal control over financial reporting.

Date: March 15, 2006

/s/ Nathaniel F. Hughes

Nathaniel F. Hughes, President and
Treasurer

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

In connection with the Annual Report of Cornerstone Bancshares, Inc., a Tennessee corporation (the "Company"), on Form 10-KSB for the fiscal year ended December 31, 2005, as filed with the Securities and Exchange Commission (the "Report"), each of Gregory B. Jones, Chairman and Chief Executive Officer of the Company, and Nathaniel F. Hughes, President and Treasurer of the Company, do hereby certify, pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350), that to his knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/ s/ Gregory B. Jones

Gregory B. Jones
Chairman and Chief Executive Officer

/s/ Nathaniel F. Hughes

Nathaniel F. Hughes
President and Treasurer

[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.]
