

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2013

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

For the transition period from _____ to _____.

Commission File Number: **000-30497**



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

Tennessee

(State or other jurisdiction of incorporation or organization)

62-1173944

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

835 Georgia Avenue Chattanooga, Tennessee

(Address of principal executive offices)

37402

(Zip Code)

423-385-3000

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changes since last report)

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

Yes No

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

Yes No

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

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

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

Yes No

As of November 7, 2013 there were 6,547,074 shares of common stock, \$1.00 par value per share, issued and outstanding.

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FORWARD-LOOKING STATEMENTS

Cornerstone Bancshares, Inc. (“Cornerstone”) may from time to time make written or oral statements, including statements contained in this report (including, without limitation, certain statements in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in Item 2), that constitute forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 (the “Exchange Act”). The words “expect,” “anticipate,” “intend,” “consider,” “plan,” “believe,” “seek,” “should,” “estimate,” and similar expressions are intended to identify such forward-looking statements, but other statements may constitute forward-looking statements. These statements should be considered subject to various risks and uncertainties. Such forward-looking statements are made based upon management’s belief as well as assumptions made by, and information currently available to, management pursuant to “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995. Cornerstone’s actual results may differ materially from the results anticipated in forward-looking statements due to a variety of factors. Such factors include, without limitation, those specifically described in Item 1A of Part I of our Annual Report on Form 10-K for the fiscal year ended December 31, 2012, as well as the following: (i) the possibility that our asset quality would decline or if we experience greater loan losses than anticipated, (ii) increased levels of other real estate, primarily as a result of foreclosures, (iii) the impact of liquidity needs on our results of operations and financial condition, (iv) competition from financial institutions and other financial service providers, (v) economic conditions in the local markets where we operate, (vi) the impact of obtaining regulatory approval prior to the payment of dividends, (vii) the impact of our Series A Preferred Stock on net income available to holders of our Common Stock and earnings per common share, (viii) the impact of negative developments in the financial industry and U.S. and global capital and credit markets, (ix) the possibility that recently enacted legislation will continue to stabilize the U.S. financial system, (x) the relatively greater credit risk of residential construction and land development loans in our loan portfolio, (xi) adverse impact on operations and financial condition due to changes in interest rates, (xii) our ability to obtain additional capital and, if obtained, the possible significant dilution to current shareholders, (xiii) the impact of recently enacted legislation on our business, (xiv) the impact of federal and state regulations on our operations and financial performance, (xv) whether a significant deferred tax asset we have can be fully realized, (xvi) our ability to retain the services of key personnel, (xvii) the impact of Tennessee’s anti-takeover statutes and certain charter provisions on potential acquisitions of the holding company, and (xviii) our ability to adapt to technological changes. Many of such factors are beyond Cornerstone’s ability to control or predict, and readers are cautioned not to put undue reliance on such forward-looking statements. Cornerstone does not intend to update or reissue any forward-looking statements contained in this report as a result of new information or other circumstances that may become known to Cornerstone.

Cornerstone Bancshares, Inc. and Subsidiary
Consolidated Balance Sheets

ASSETS	Unaudited September 30, 2013	December 31, 2012
Cash and due from banks	\$ 2,148,352	\$ 3,222,139
Interest-bearing deposits at other financial institutions	19,106,638	56,173,099
Total cash and cash equivalents	<u>21,254,990</u>	<u>59,395,238</u>
Securities available for sale	95,282,416	76,096,646
Securities held to maturity (fair value \$37,589 and \$46,212 at September 30, 2013 and December 31, 2012, respectively)	36,620	45,086
Federal Home Loan Bank stock, at cost	2,322,900	2,322,900
Loans, net of allowance for loan losses of \$3,158,766 and \$6,141,281 at September 30, 2013 and December 31, 2012, respectively	281,021,767	270,850,465
Bank premises and equipment, net	5,094,668	5,399,340
Accrued interest receivable	1,221,841	1,213,778
Foreclosed assets	14,923,933	20,332,313
Other assets	8,522,148	7,790,634
Total assets	<u>\$ 429,681,283</u>	<u>\$ 443,446,400</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing demand deposits	\$ 54,452,293	\$ 60,053,838
Interest-bearing demand deposits	25,463,874	30,178,624
Savings deposits and money market accounts	90,665,979	80,994,239
Time deposits	170,174,142	173,653,892
Total deposits	<u>340,756,288</u>	<u>344,880,593</u>
Accrued interest payable	100,129	120,558
Federal funds purchased and securities sold under agreements to repurchase	20,508,655	19,587,387
Federal Home Loan Bank advances and other borrowings	26,740,000	37,175,000
Other liabilities	1,426,357	794,026
Total liabilities	<u>389,531,429</u>	<u>402,557,564</u>
Stockholders' equity:		
Preferred stock - no par value; 2,000,000 shares authorized; 600,000 shares issued and outstanding in 2013 and 2012	14,875,081	14,821,546
Common stock - \$1.00 par value; 20,000,000 shares authorized; 6,709,199 shares issued in 2013 and 2012; 6,547,074 and 6,500,396 shares outstanding in 2013 and 2012, respectively	6,547,074	6,500,396
Additional paid-in capital	21,517,620	21,390,486
Accumulated deficit	(3,110,707)	(3,274,986)
Accumulated other comprehensive income	320,786	1,451,394
Total stockholders' equity	<u>40,149,854</u>	<u>40,888,836</u>
Total liabilities and stockholders' equity	<u>\$ 429,681,283</u>	<u>\$ 443,446,400</u>

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

Cornerstone Bancshares, Inc. and Subsidiary
Consolidated Statements of Income

	Unaudited Three months ended September 30,		Unaudited Nine months ended September 30,	
	2013	2012	2013	2012
INTEREST INCOME				
Loans, including fees	\$ 4,293,583	\$ 4,241,492	\$ 12,514,688	\$ 12,571,193
Investment securities	457,299	478,172	1,379,322	1,563,433
Federal funds sold & other earning assets	9,510	15,647	45,515	44,075
Total interest income	<u>4,760,392</u>	<u>4,735,311</u>	<u>13,939,525</u>	<u>14,178,701</u>
INTEREST EXPENSE				
Time deposits	445,397	612,286	1,365,993	1,946,341
Other deposits	117,327	144,157	386,791	398,859
Federal funds purchased and securities sold under agreements to repurchase	21,435	21,889	56,258	77,193
Federal Home Loan Bank advances and other borrowings	284,882	394,066	941,269	1,281,010
Total interest expense	<u>869,041</u>	<u>1,172,398</u>	<u>2,750,311</u>	<u>3,703,403</u>
Net interest income before provision for loan losses	3,891,351	3,562,913	11,189,214	10,475,298
Provision for loan losses	-	100,000	300,000	100,000
Net interest income after provision for loan losses	<u>3,891,351</u>	<u>3,462,913</u>	<u>10,889,214</u>	<u>10,375,298</u>
NONINTEREST INCOME				
Customer service fees	218,304	197,509	608,087	602,107
Net gains from sale of securities	-	-	424,971	-
Net gains from sale of loans and other assets	39,164	48,199	240,746	124,109
Other noninterest income	12,500	12,944	48,968	51,844
Total noninterest income	<u>269,968</u>	<u>258,652</u>	<u>1,322,772</u>	<u>778,060</u>
NONINTEREST EXPENSE				
Salaries and employee benefits	1,619,030	1,566,359	4,838,822	4,727,049
Net occupancy and equipment expense	333,850	354,555	1,011,335	1,038,296
Depository insurance	161,956	236,927	482,920	682,830
Foreclosed assets, net	381,847	314,088	1,308,995	945,163
Other operating expenses	967,888	731,090	2,500,107	2,307,172
Total noninterest expenses	<u>3,464,571</u>	<u>3,203,019</u>	<u>10,142,179</u>	<u>9,700,510</u>
Income before provision for income taxes	696,748	518,546	2,069,807	1,452,848
Provision for income taxes	<u>268,200</u>	<u>154,300</u>	<u>793,100</u>	<u>421,500</u>
Net income	428,548	364,246	1,276,707	1,031,348
Preferred stock dividend requirements	375,000	308,893	1,125,000	854,780
Accretion on preferred stock discount	<u>17,845</u>	<u>16,370</u>	<u>53,535</u>	<u>46,079</u>
Net income available to common shareholders	<u>\$ 35,703</u>	<u>\$ 38,983</u>	<u>\$ 98,172</u>	<u>\$ 130,489</u>
EARNINGS PER COMMON SHARE				
Basic	\$ 0.01	\$ 0.01	\$ 0.01	\$ 0.02
Diluted	\$ 0.01	\$ 0.01	\$ 0.01	\$ 0.02
DIVIDENDS DECLARED PER COMMON SHARE				
	\$ -	\$ -	\$ -	\$ -

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

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

	Unaudited Three Months Ended	
	September 30	
	2013	2012
Net income	\$ 428,548	\$ 364,246
Other comprehensive income, net of tax:		
Unrealized holding (losses) gains arising during the period, net of tax benefit (expense) of \$104,336 and (\$67,898) in 2013 and 2012, respectively	(170,234)	110,781
Total other comprehensive (loss) income	(170,234)	110,781
Comprehensive income	\$ 258,314	\$ 475,027

	Unaudited Nine Months Ended	
	September 30	
	2013	2012
Net income	\$ 1,276,707	\$ 1,031,348
Other comprehensive income, net of tax:		
Unrealized holding (losses) gains arising during the period, net of tax benefit (expense) of \$531,464 and (\$189,051) in 2013 and 2012, respectively	(867,126)	308,452
Reclassification adjustment for gains included in net income, net of tax expense of \$161,489 in 2013	(263,482)	-
Total other comprehensive (loss) income	(1,130,608)	308,452
Comprehensive income	\$ 146,099	\$ 1,339,800

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

Cornerstone Bancshares, Inc. and Subsidiary
Consolidated Statement of Changes in Stockholders' Equity - Unaudited
For the nine months ended September 30, 2013

	<u>Preferred Stock</u>	<u>Common Stock</u>	<u>Additional Paid-in Capital</u>	<u>Accumulated Deficit</u>	<u>Accumulated Other Comprehensive Income</u>	<u>Total Stockholders' Equity</u>
BALANCE, December 31, 2012	\$ 14,821,546	\$ 6,500,396	\$ 21,390,486	\$ (3,274,986)	\$ 1,451,394	\$ 40,888,836
Stock compensation expense	-	-	96,793	-	-	96,793
Issuance of common stock, 46,678 shares	-	46,678	30,341	-	-	77,019
Preferred stock dividends	-	-	-	(1,058,893)	-	(1,058,893)
Accretion on preferred stock	53,535	-	-	(53,535)	-	-
Net income	-	-	-	1,276,707	-	1,276,707
Unrealized holding gains (losses) on securities available for sale, net of reclassification adjustment and taxes	-	-	-	-	(1,130,608)	(1,130,608)
BALANCE, September 30, 2013	<u>\$ 14,875,081</u>	<u>\$ 6,547,074</u>	<u>\$ 21,517,620</u>	<u>\$ (3,110,707)</u>	<u>\$ 320,786</u>	<u>\$ 40,149,854</u>

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

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

	Unaudited	
	Nine months ended September 30,	
	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 1,276,707	\$ 1,031,348
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	295,836	418,721
Provision for loan losses	300,000	100,000
Stock compensation expense	96,793	55,536
Gains on sale of securities	(424,971)	-
Net (gains) losses on sales of loans and other assets	(240,746)	(124,109)
Changes in other operating assets and liabilities:		
Accrued interest receivable	(8,063)	(24,021)
Accrued interest payable	(20,429)	25,378
Other assets and liabilities	1,509,377	2,469,965
Net cash provided by operating activities	<u>2,784,504</u>	<u>3,952,818</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from security transactions:		
Securities available for sale	29,187,978	30,392,105
Securities held to maturity	8,354	16,904
Purchase of securities available for sale	(49,745,656)	(26,098,797)
Loan originations and principal collections, net	(11,836,658)	(15,547,286)
Purchase of bank premises and equipment	(17,734)	(101,036)
Proceeds from sale of other real estate and other assets	6,098,875	2,769,712
Net cash used in investing activities	<u>(26,304,841)</u>	<u>(8,568,398)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Net (decrease) / increase in deposits	(4,124,305)	14,921,054
Net increase / (decrease) in federal funds purchased and securities sold under agreements to repurchase	921,268	(10,010,775)
Net payments on Federal Home Loan Bank advances and other borrowings	(10,435,000)	(5,870,000)
Payment of dividends on preferred stock	(1,058,893)	(705,886)
Issuance of common stock	77,019	-
Issuance of preferred stock	-	2,230,029
Net cash (used in) provided by financing activities	<u>(14,619,911)</u>	<u>564,422</u>
NET (DECREASE) IN CASH AND CASH EQUIVALENTS	(38,140,248)	(4,051,158)
CASH AND CASH EQUIVALENTS, beginning of period	59,395,238	38,882,691
CASH AND CASH EQUIVALENTS, end of period	<u>\$ 21,254,990</u>	<u>\$ 34,831,533</u>
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash paid during the period for interest	\$ 2,770,740	\$ 3,678,025
Cash paid during the period for taxes	755,820	943,327
NONCASH INVESTING AND FINANCING ACTIVITIES		
Acquisition of real estate through foreclosure	\$ 1,604,806	\$ 7,399,290

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

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

Note 1. Presentation of Financial Information

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

Interim Financial Information (Unaudited)- The financial information in this report for September 30, 2013 and September 30, 2012 has not been audited. The information included herein should be read in conjunction with the annual consolidated financial statements and footnotes thereto included in the 2012 Annual Report to Shareholders which was furnished to each shareholder of Cornerstone in April of 2013. The consolidated financial statements presented herein conform to U.S. generally accepted accounting principles and to general industry practices. In the opinion of Cornerstone's management, the accompanying interim financial statements contain all material adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial condition, the results of operations, and cash flows for the interim period. Results for interim periods are not necessarily indicative of the results to be expected for a full year.

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

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

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

Accounting Policies -During interim periods, Cornerstone follows the accounting policies set forth in its Annual Report on Form 10-K for the year ended December 31, 2012 as filed with the Securities and Exchange Commission. Since December 31, 2012, there have been no significant changes in any accounting principles or practices, or in the method of applying any such principles or practices, except for the following:

In February 2013, the Financial Accounting Standards Board (FASB) issued updated guidance related to disclosure of reclassification amounts out of other comprehensive income. The standard requires that companies present either in a single note or parenthetically on the face of the financial statements, the effect of significant amounts reclassified from each component of accumulated other comprehensive income based on its source and the income statement line items affected by the reclassification. The new requirements took effect for public companies in fiscal years, and interim periods within those years, beginning after December 15, 2012. The Company adopted this standard on January 1, 2013. The effect of adopting this standard increased our disclosure requirements surrounding reclassification items out of accumulated other comprehensive income.

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

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

The following is a summary of the basic and diluted earnings per share for the three and nine month periods ended September 30, 2013 and September 30, 2012.

	<u>Three Months Ended September 30,</u>	
	2013	2012
Basic earnings per common share calculation:		
Numerator: Net income available to common shareholders	\$ 35,703	\$ 38,983
Denominator: Weighted avg. common shares outstanding	6,547,074	6,500,396
Effect of dilutive stock options	145,508	3,758
Diluted shares	6,692,582	6,504,154
Basic earnings per common share	<u>\$ 0.01</u>	<u>\$ 0.01</u>
Diluted earnings per common share	<u>\$ 0.01</u>	<u>\$ 0.01</u>

	<u>Nine Months Ended September 30,</u>	
	2013	2012
Basic earnings per common share calculation:		
Numerator: Net income available to common shareholders	\$ 98,172	\$ 130,489
Denominator: Weighted avg. common shares outstanding	6,547,074	6,500,396
Effect of dilutive stock options	127,453	59,090
Diluted shares	6,674,527	6,559,486
Basic earnings per common share	<u>\$ 0.01</u>	<u>\$ 0.02</u>
Diluted earnings per common share	<u>\$ 0.01</u>	<u>\$ 0.02</u>

For the three and nine months ended September 30, 2013, potential common shares of 503,075 were not included in the calculation of diluted earnings per share because the assumed exercise of such shares would be anti-dilutive.

Note 2. Stock Based Compensation

Accounting Policies- Cornerstone, as required by FASB, applies the fair value recognition provisions of ASC 718, *Compensation –Stock Compensation* . As a result, for the nine month period ended September 30, 2013, the compensation cost charged to earnings related to the vested incentive stock options was approximately \$97,000, which had no material impact on earnings per share.

Officer and Employee Plans -Cornerstone has two stock option plans under which officers and employees can be granted incentive stock options or non-qualified stock options to purchase a total of up to 1,420,000 shares of Cornerstone’s common stock. The exercise price for incentive stock options must be not less than 100 percent of the fair market value of the common stock on the date of the grant. The exercise price of the non-qualified stock options may be equal to or more or less than the fair market value of the common stock on the date of the grant. The incentive stock options vest 30 percent on the second anniversary of the grant date, 60 percent on the third anniversary of the grant date and 100 percent on the fourth anniversary of the grant date, and the non-qualified stock options vest 50 percent on the first anniversary of the grant date and 100 percent on the second anniversary of the grant date. The options expire ten years from the grant date. At September 30, 2013, the total remaining compensation cost to be recognized on non-vested options is approximately \$519,000. A summary of the status of these stock option plans is presented in the following table:

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

	Number	Weighted Average Exercisable Price	Weighted- Average Contractual Remaining Term (in years)	Aggregate Intrinsic Value
Outstanding at December 31, 2012	670,300	\$ 3.86	6.2 Years	\$ 232,900
Granted	203,000	2.37	9.4 Years	
Exercised	-	-		
Forfeited	(57,475)	(3.51)		
Outstanding at September 30, 2013	<u>815,825</u>	<u>\$ 3.51</u>	6.8 Years	\$ 207,030
Options exercisable at September 30, 2013	<u>305,525</u>	<u>\$ 6.13</u>		

Board of Directors Plan -Cornerstone has a stock option plan under which members of the Board of Directors, at the formation of the Bank, were granted options to purchase a total of up to 600,000 shares of the Bank's common stock. On October 15, 1997, the Bank stock options were converted to Cornerstone stock options. Only non-qualified stock options may be granted under the plan. The exercise price of each option equals the market price of Cornerstone's stock on the date of grant and the maximum term is ten years. Vesting is 50 percent on the first anniversary of the grant date and 100 percent on the second anniversary of the grant date. At September 30, 2013, the total remaining compensation cost to be recognized on non-vested options is approximately \$97,000. A summary of the status of this stock option plan is presented in the following table:

	Number	Weighted Average Exercisable Price	Weighted- Average Contractual Remaining Term (in years)	Aggregate Intrinsic Value
Outstanding at December 31, 2012	145,250	\$ 3.30	7.2 Years	\$ 57,600
Granted	45,000	2.37	9.4 Years	
Exercised	-	-		
Forfeited	-	-		
Outstanding at September 30, 2013	<u>190,250</u>	<u>\$ 3.08</u>	7.1 Years	\$ 52,200
Options exercisable at September 30, 2013	<u>100,250</u>	<u>\$ 4.04</u>		

The weighted average grant date fair value of all stock options granted during the nine months ended September 30, 2013 was \$1.17. This was determined using the Black-Scholes option-pricing model with the following weighted-average assumptions:

Dividend yield	0.0%
Expected life	7.0 Years
Expected volatility	47.60%
Risk-free interest rate	1.23%

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

Note 3. Securities

The amortized cost and fair value of securities available-for-sale and held-to-maturity at September 30, 2013 and December 31, 2012 are summarized as follows:

	September 30, 2013			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
Debt securities available for sale:				
U.S. Government agencies	\$ 3,479,680	\$ 48,665	\$ -	\$ 3,528,345
State and municipal securities	17,065,923	683,599	(55,166)	17,694,356
Mortgage-backed securities:				
Residential mortgage loans guaranteed by GNMA or FNMA	7,797,244	106,280	-	7,903,524
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	66,403,939	53,727	(301,475)	66,156,191
	<u>\$ 94,746,786</u>	<u>\$ 892,271</u>	<u>\$ (356,641)</u>	<u>\$ 95,282,416</u>
Debt securities held to maturity:				
Mortgage-backed securities:				
Residential mortgage loans guaranteed by GNMA or FNMA	\$ 36,620	\$ 969	\$ -	\$ 37,589

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

	December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Debt securities available for sale:				
U.S. Government agencies	\$ 3,961,956	\$ 56,195	\$ -	\$ 4,018,151
State and municipal securities	21,531,727	2,101,590	-	23,633,317
Mortgage-backed securities:				
Residential mortgage loans guaranteed by GNMA or FNMA	9,092,205	132,038	(1,824)	9,222,419
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	39,151,568	86,099	(14,908)	39,222,759
	<u>\$ 73,737,456</u>	<u>\$ 2,375,922</u>	<u>\$ (16,732)</u>	<u>\$ 76,096,646</u>
Debt securities held to maturity:				
Mortgage-backed securities:				
Residential mortgage loans guaranteed by GNMA or FNMA	<u>\$ 45,086</u>	<u>\$ 1,341</u>	<u>\$ (8)</u>	<u>\$ 46,212</u>

At September 30, 2013, securities with a fair value totaling approximately \$73 million were pledged to secure public funds, securities sold under agreements to repurchase, as collateral for federal funds purchased from other financial institutions and serve as collateral for borrowings at the Federal Reserve Discount Window.

For the three months ended September 30, 2013, there were no available for sale securities sold. For the nine months ended September 30, 2013, there were available for sale securities sold with proceeds totaling \$5,328,170 which resulted in gross gains realized of \$424,971. There were no securities sales during 2012.

The amortized cost and estimated market value of securities at September 30, 2013, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Securities Available for Sale		Securities Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ -	\$ -	\$ -	\$ -
Due from one year to five years	1,267,124	1,338,576	-	-
Due from five years to ten years	6,310,901	6,648,634	-	-
Due after ten years	12,967,578	13,235,491	-	-
	<u>\$ 20,545,603</u>	<u>\$ 21,222,701</u>	<u>\$ -</u>	<u>\$ -</u>
Mortgage-backed securities	74,201,183	74,059,715	36,620	37,589
	<u>\$ 94,746,786</u>	<u>\$ 95,282,416</u>	<u>\$ 36,620</u>	<u>\$ 37,589</u>

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The following tables present the gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities available for sale have been in a continuous unrealized loss position, as of September 30, 2013 and as of December 31, 2012:

	As of September 30, 2013					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
State and municipal securities	\$ 1,138,535	\$ (40,736)	\$ 554,465	\$ (14,430)	\$ 1,693,000	\$ (55,166)

Mortgage-backed securities						
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	48,435,866	(278,248)	9,042,662	(23,227)	57,478,528	(301,475)
	<u>\$ 49,574,401</u>	<u>\$ (318,984)</u>	<u>\$ 9,597,127</u>	<u>\$ (37,657)</u>	<u>\$ 59,171,528</u>	<u>\$ (356,641)</u>

	As of December 31, 2012					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Mortgage-backed securities:						
Residential mortgage loans guaranteed by GNMA or FNMA	\$ 667,325	\$ (1,824)	\$ -	\$ -	\$ 667,325	\$ (1,824)
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	22,514,641	(14,908)	-	-	22,514,641	(14,908)
	<u>\$ 23,181,966</u>	<u>\$ (16,732)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 23,181,966</u>	<u>\$ (16,732)</u>

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Upon acquisition of a security, the Bank determines the appropriate impairment model that is applicable. If the security is a beneficial interest in securitized financial assets, the Bank uses the beneficial interests in securitized financial assets impairment model. If the security is not a beneficial interest in securitized financial assets, the Bank uses the debt and equity securities impairment model. The Bank conducts periodic reviews to evaluate each security to determine whether an other-than-temporary impairment has occurred. The Bank does not have any securities that have been classified as other-than-temporarily-impaired at September 30, 2013 or December 31, 2012.

At September 30, 2013 and December 31, 2012, the significant categories of temporarily impaired securities and management's evaluation of those securities are as follows:

State and municipal securities: At September 30, 2013, three investments in obligations of state and municipal securities had unrealized losses. The Bank believes the unrealized losses on those investments were caused by the interest rate environment and does not relate to the underlying credit quality of the issuers. Because the Bank has the intent and ability to hold those investments for a time necessary to recover their amortized cost bases, which may be until maturity, the Bank does not consider those investments to be other-than-temporarily impaired at September 30, 2013.

Mortgage-backed securities: At September 30, 2013, eighteen investments in residential mortgage-backed securities had unrealized losses. This impairment is believed to be caused by the current interest rate environment. The contractual cash flows of those investments are guaranteed or issued by an agency of the U.S. Government. Because the decline in market value is attributable to the current interest rate environment and not credit quality, and because the Bank does not intend to sell the investments and it is not more likely than not that the Bank will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Bank does not deem those investments to be other-than-temporarily impaired at September 30, 2013.

Note 4. Loans and Allowance for Loan Losses

At September 30, 2013 and December 31, 2012, loans are summarized as follows (in thousands):

	September 30, 2013	Percent	December 31, 2012	Percent
Commercial real estate-mortgage:				
Owner-occupied	\$ 66,143	23.28%	\$ 58,425	21.09%
All other	66,721	23.48%	66,747	24.10%
Consumer real estate-mortgage	69,911	24.60%	71,195	25.70%
Construction and land development	38,970	13.71%	38,557	13.92%
Commercial and industrial	39,782	14.00%	40,140	14.49%
Consumer and other	2,654	0.93%	1,927	0.70%
Total loans	284,181	100.00%	276,991	100.00%
Less: Allowance for loan losses	(3,159)		(6,141)	
Loans, net	\$ 281,022		\$ 270,850	

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

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The composition of loans by loan classification for impaired and performing loan status at September 30, 2013 and December 31, 2012, is summarized in the tables below (amounts in thousands):

September 30, 2013	Commercial Real Estate- Mortgage	Consumer Real Estate- Mortgage	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Performing loans	\$ 125,418	\$ 66,950	\$ 38,712	\$ 38,027	\$ 2,654	\$ 271,761
Impaired loans	7,446	2,961	258	1,755	-	12,420
Total	\$ 132,864	\$ 69,911	\$ 38,970	\$ 39,782	\$ 2,654	\$ 284,181

December 31, 2012	Commercial Real Estate- Mortgage	Consumer Real Estate- Mortgage	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Performing loans	\$ 115,959	\$ 69,329	\$ 37,607	\$ 36,980	\$ 1,927	\$ 261,802
Impaired loans	9,213	1,866	950	3,160	-	15,189
Total	\$ 125,172	\$ 71,195	\$ 38,557	\$ 40,140	\$ 1,927	\$ 276,991

The following tables show the allowance for loan losses allocation by loan classification for impaired and performing loans as of September 30, 2013 and December 31, 2012 (amounts in thousands):

September 30, 2013	Commercial Real Estate- Mortgage	Consumer Real Estate- Mortgage	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Allowance related to:						
Performing loans	\$ 784	\$ 922	\$ 339	\$ 196	\$ 20	\$ 2,261
Impaired loans	682	134	-	82	-	898
Total	\$ 1,466	\$ 1,056	\$ 339	\$ 278	\$ 20	\$ 3,159

December 31, 2012	Commercial Real Estate- Mortgage	Consumer Real Estate- Mortgage	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Allowance related to:						
Performing loans	\$ 319	\$ 952	\$ 781	\$ 29	\$ 14	\$ 2,095
Impaired loans	2,230	576	460	780	-	4,046
Total	\$ 2,549	\$ 1,528	\$ 1,241	\$ 809	\$ 14	\$ 6,141

The following tables detail the changes in the allowance for loan losses for the nine month period ending September 30, 2013 and year ending December 31, 2012, by loan classification (amounts in thousands):

September 30, 2013	Commercial Real Estate- Mortgage	Consumer Real Estate- Mortgage	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Beginning balance	\$ 2,549	\$ 1,528	\$ 1,241	\$ 809	\$ 14	\$ 6,141
Charged-off loans	(1,874)	(688)	(1,185)	(694)	(19)	(4,460)
Recovery of charge-offs	61	224	810	80	3	1,178
Provision for (reallocation of) loan losses	730	(8)	(527)	83	22	300
Ending balance	\$ 1,466	\$ 1,056	\$ 339	\$ 278	\$ 20	\$ 3,159

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December 31, 2012	Commercial Real Estate- Mortgage	Consumer Real Estate- Mortgage	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Beginning balance	\$ 3,557	\$ 2,518	\$ 827	\$ 482	\$ 16	\$ 7,400
Charged-off loans	(958)	(1,022)	(782)	(74)	(33)	(2,869)
Recovery of charge-offs	838	36	145	144	17	1,180
Provision for (reallocation of) loan losses	(888)	(4)	1,051	257	14	430
Ending balance	<u>\$ 2,549</u>	<u>\$ 1,528</u>	<u>\$ 1,241</u>	<u>\$ 809</u>	<u>\$ 14</u>	<u>\$ 6,141</u>

Credit quality indicators:

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

The Bank's loan grading process is as follows:

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

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

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The following tables outline the amount of each loan classification and the amount categorized into each risk rating as of September 30, 2013 and December 31, 2012 (amounts in thousands):

September 30, 2013	Commercial Real Estate-Mortgage	Consumer Real Estate-Mortgage	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Pass	\$ 120,812	\$ 58,536	\$ 38,027	\$ 33,456	\$ 2,654	\$ 253,485
Special mention	4,209	5,377	95	4,105	-	13,786
Substandard	397	3,037	590	466	-	4,490
Substandard-impaired	7,164	2,961	258	1,755	-	12,138
Doubtful-impaired	282	-	-	-	-	282
	<u>\$ 132,864</u>	<u>\$ 69,911</u>	<u>\$ 38,970</u>	<u>\$ 39,782</u>	<u>\$ 2,654</u>	<u>\$ 284,181</u>

December 31, 2012	Commercial Real Estate-Mortgage	Consumer Real Estate-Mortgage	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Pass	\$ 111,313	\$ 57,959	\$ 36,802	\$ 36,482	\$ 1,904	\$ 244,460
Special mention	4,145	8,401	198	330	18	13,092
Substandard	501	2,969	607	168	5	4,250
Substandard-impaired	9,213	1,866	950	3,160	-	15,189
	<u>\$ 125,172</u>	<u>\$ 71,195</u>	<u>\$ 38,557</u>	<u>\$ 40,140</u>	<u>\$ 1,927</u>	<u>\$ 276,991</u>

After the Bank's independent loan review department completes the loan grade assignment, a loan impairment analysis is performed on loans graded substandard or worse. The following tables present summary information pertaining to impaired loans by loan classification as of September 30, 2013 and December 31, 2012 (in thousands):

	At September 30, 2013			For the quarter ended September 30, 2013	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans without a valuation allowance:					
Commercial real estate – mortgage	\$ 4,578	\$ 4,797	\$ -	\$ 4,683	\$ 183
Consumer real estate – mortgage	2,066	2,066	-	1,854	73
Construction and land development	258	271	-	349	11
Commercial and industrial	1,353	1,396	-	1,875	31
Total	<u>\$ 8,255</u>	<u>\$ 8,530</u>	<u>\$ -</u>	<u>\$ 8,761</u>	<u>\$ 298</u>
Impaired loans with a valuation allowance:					
Commercial real estate – mortgage	\$ 2,868	\$ 2,943	\$ 682	\$ 4,670	\$ 126
Consumer real estate – mortgage	895	895	134	1,110	49
Construction and land development	-	-	-	296	-
Commercial and industrial	402	402	82	740	38
Total	<u>\$ 4,165</u>	<u>\$ 4,240</u>	<u>\$ 898</u>	<u>\$ 6,816</u>	<u>\$ 213</u>
Total impaired loans	<u>\$ 12,420</u>	<u>\$ 12,770</u>	<u>\$ 898</u>	<u>\$ 15,577</u>	<u>\$ 511</u>

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	At December 31, 2012			For the year ended December 31, 2012	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans without a valuation allowance:					
Commercial real estate – mortgage	\$ 3,406	\$ 3,453	\$ -	\$ 4,389	\$ 180
Consumer real estate – mortgage	513	540	-	1,538	52
Construction and land development	244	251	-	358	19
Commercial and industrial	2,111	2,155	-	2,277	55
Total	\$ 6,274	\$ 6,399	\$ -	\$ 8,562	\$ 306
Impaired loans with a valuation allowance:					
Commercial real estate – mortgage	\$ 5,807	\$ 5,848	\$ 2,230	\$ 6,616	\$ 215
Consumer real estate – mortgage	1,353	1,353	576	2,606	61
Construction and land development	706	706	460	642	49
Commercial and industrial	1,049	1,049	780	700	132
Total	\$ 8,915	\$ 8,956	\$ 4,046	\$ 10,564	\$ 457
Total impaired loans	\$ 15,189	\$ 15,355	\$ 4,046	\$ 19,126	\$ 763

The following tables present an aged analysis of past due loans as of September 30, 2013 and December 31, 2012 (in thousands):

September 30, 2013	30-89 Days Past Due and Accruing	Past Due 90 Days or More and Accruing	Nonaccrual	Total Past Due	Current Loans	Total Loans
Commercial real estate-mortgage:						
Owner-occupied	\$ 431	\$ -	\$ 494	\$ 925	\$ 65,218	\$ 66,143
All other	-	-	924	924	65,797	66,721
Consumer real estate-mortgage	712	-	964	1,676	68,235	69,911
Construction and land development	48	-	22	70	38,900	38,970
Commercial and industrial	552	-	1,692	2,244	37,538	39,782
Consumer and other	2	-	-	2	2,652	2,654
Total	\$ 1,745	\$ -	\$ 4,096	\$ 5,841	\$ 278,340	\$ 284,181

December 31, 2012	30-89 Days Past Due and Accruing	Past Due 90 Days or More and Accruing	Nonaccrual	Total Past Due	Current Loans	Total Loans
Commercial real estate-mortgage:						
Owner-occupied	\$ 2,738	\$ -	\$ 956	\$ 3,694	\$ 54,731	\$ 58,425
All other	636	-	1,913	2,549	64,198	66,747
Consumer real estate-mortgage	1,858	-	616	2,474	68,721	71,195
Construction and land development	100	-	53	153	38,404	38,557
Commercial and industrial	1,227	-	2,467	3,694	36,446	40,140
Consumer and other	35	-	-	35	1,892	1,927
Total	\$ 6,594	\$ -	\$ 6,005	\$ 12,599	\$ 264,392	\$ 276,991

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Impaired loans also include loans that the Bank has elected to formally restructure when, due to the weakening credit status of a borrower, the restructuring may facilitate a repayment plan that seeks to minimize the potential losses that the Bank may have to otherwise incur. At September 30, 2013 and December 31, 2012, the Bank has loans of approximately \$6,119,000 and \$9,403,000, respectively, that were modified for troubled debt restructuring. Troubled commercial loans are restructured by specialists within our Special Asset department and all restructurings are approved by committees and credit officers separate and apart from the normal loan approval process. These specialists are trained to reduce the Bank's overall risk and exposure to loss in the event of a restructuring through obtaining either or all of the following: improved documentation, additional guaranties, increase in curtailments, reduction in collateral terms, additional collateral or other similar strategies.

The following tables present a summary of loans that were modified as troubled debt restructurings during the nine month periods ending September 30, 2013 and 2012 (amounts in thousands):

September 30, 2013	<u>Number of Contracts</u>	<u>Pre-Modification Outstanding Recorded Investment</u>	<u>Post-Modification Outstanding Recorded Investment</u>
Commercial real estate-mortgage	2	\$ 2,073	\$ 2,073
Consumer real estate-mortgage	1	66	66
Construction and land development	3	898	898
Commercial and industrial	3	2,389	2,389

September 30, 2012	<u>Number of Contracts</u>	<u>Pre-Modification Outstanding Recorded Investment</u>	<u>Post-Modification Outstanding Recorded Investment</u>
Commercial real estate-mortgage	2	\$ 4,233	\$ 4,233
Consumer real estate-mortgage	1	65	65
Construction and land development	3	1,178	1,178
Commercial and industrial	4	2,408	2,408

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

Note 5. Commitments and Contingent Liabilities

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

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Standby letters of credit are generally issued on behalf of an applicant (our customer) to a specifically named beneficiary and are the result of a particular business arrangement that exists between the applicant and the beneficiary. Standby letters of credit have fixed expiration dates and are usually for terms of two years or less unless terminated beforehand due to criteria specified in the standby letter of credit. A typical arrangement involves the applicant routinely being indebted to the beneficiary for such items as inventory purchases, insurance, utilities, lease guarantees or other third party

commercial transactions. The standby letter of credit would permit the beneficiary to obtain payment from the Bank under certain prescribed circumstances. Subsequently, the Bank would seek reimbursement from the applicant pursuant to the terms of the standby letter of credit.

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

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

A summary of the Bank's total contractual amount for all off-balance sheet commitments at September 30, 2013 is as follows:

Commitments to extend credit	\$34.1 million
Standby letters of credit	\$392.2 thousand

Various legal claims also arise from time to time in the normal course of business. In the opinion of management, the resolution of claims outstanding at September 30, 2013 will not have a material effect on Cornerstone's consolidated financial statements.

Note 6. Fair Value Disclosures

Fair Value Measurements:

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

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

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

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

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

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

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

The following methods and assumptions were used by Cornerstone in estimating fair value disclosures for financial instruments. There have been no changes in the methodologies used at September 30, 2013 and December 31, 2012.

Cash and cash equivalents:

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

Securities:

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

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

Loans:

For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for fixed-rate loans are estimated using discounted cash flow analysis, using market interest rates for comparable loans. Generally, Level 3 inputs are utilized for this estimate. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with ASC Topic 310, *Accounting by Creditors for Impairment of a Loan*. The fair value of impaired loans is estimated using several methods including collateral value, liquidation value and discounted cash flows.

Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At September 30, 2013 and December 31, 2012, substantially all of the total impaired loans were evaluated based on the fair value of collateral. In accordance with ASC Topic 820, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, Cornerstone records the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, Cornerstone records the impaired loan as nonrecurring Level 3.

Cash surrender value of life insurance:

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

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Foreclosed assets:

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

Deposits:

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

Fed funds purchased and securities sold under agreements to repurchase:

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

Federal Home Loan Bank advances and other borrowings:

The carrying amounts of FHLB advances and other borrowings approximate their fair value. These liabilities are included in Level 3 of the fair value hierarchy.

Accrued interest:

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

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

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

	Balance as of September 30, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Debt securities available for sale:				
U.S. Government agencies	\$ 3,528,345	\$ -	\$ 3,528,345	\$ -
State and municipal securities	17,694,356	-	17,694,356	-
Mortgage-backed securities:				
Residential mortgage loans guaranteed by GNMA or FNMA	7,903,524	-	7,903,524	-
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	<u>66,156,191</u>	<u>-</u>	<u>66,156,191</u>	<u>-</u>
Total securities available for sale	<u>\$ 95,282,416</u>	<u>\$ -</u>	<u>\$ 95,282,416</u>	<u>\$ -</u>
Cash surrender value of life insurance	<u>\$ 1,224,437</u>	<u>\$ -</u>	<u>\$ 1,224,437</u>	<u>\$ -</u>

	Balance as of December 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Debt securities available for sale:				
U.S. Government agencies	\$ 4,018,151	\$ -	\$ 4,018,151	\$ -
State and municipal securities	23,633,317	-	23,633,317	-
Mortgage-backed securities:				
Residential mortgage loans guaranteed by GNMA or FNMA	9,222,419	-	9,222,419	-
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	<u>39,222,759</u>	<u>-</u>	<u>39,222,759</u>	<u>-</u>
Total securities available for sale	<u>\$ 76,096,646</u>	<u>\$ -</u>	<u>\$ 76,096,646</u>	<u>\$ -</u>
Cash surrender value of life insurance	<u>\$ 1,199,725</u>	<u>\$ -</u>	<u>\$ 1,199,725</u>	<u>\$ -</u>

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

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

Certain assets and liabilities are measured at fair value on a nonrecurring basis, which means the assets and liabilities are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The tables below present information about assets and liabilities on the balance sheet at September 30, 2013 and December 31, 2012 for which a nonrecurring change in fair value was recorded (amounts in thousands).

	Balance as of September 30, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Impaired loans	\$ 3,267	\$ -	\$ 3,267	\$ -
Foreclosed assets (<i>OREO & Repossessions</i>)	14,924	-	14,924	-

	Balance as of December 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Impaired loans	\$ 4,869	\$ -	\$ 4,869	\$ -
Foreclosed assets (<i>OREO & Repossessions</i>)	20,332	-	20,332	-

Loans include impaired loans held for investment for which an allowance for loan losses has been calculated based upon the fair value of the loans at September 30, 2013 and December 31, 2012.

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

The carrying amount and estimated fair value of Cornerstone's financial instruments at September 30, 2013 and December 31, 2012 are as follows (in thousands):

	September 30, 2013		December 31, 2012	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Assets:				
Cash and cash equivalents	\$ 21,255	\$ 21,255	\$ 59,395	\$ 59,395
Securities	95,319	95,320	76,142	76,143
Federal Home Loan Bank stock	2,323	2,323	2,323	2,323
Loans, net	281,022	281,403	270,850	271,128
Cash surrender value of life insurance	1,224	1,224	1,200	1,200
Accrued interest receivable	1,222	1,222	1,214	1,214
Liabilities:				
Noninterest-bearing demand deposits	54,452	54,452	60,054	60,054
Interest-bearing demand deposits	25,464	25,464	30,179	30,179
Savings deposits and money market accounts	90,666	90,666	80,994	80,994
Time deposits	170,174	171,541	173,654	175,177
Federal funds purchased and securities sold under agreements to repurchase	20,509	20,509	19,587	19,587
Federal Home Loan Bank advances and other borrowings	26,740	26,740	37,175	37,175
Accrued interest payable	100	100	121	121
Unrecognized financial instruments (net of contract amount):				
Commitments to extend credit	-	-	-	-
Letters of credit	-	-	-	-
Lines of credit	-	-	-	-

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

Three months ended
September 30

(Amounts in thousands)

Assets	2013			2012		
	Average Balance	Income/Expense	Yield/Rate	Average Balance	Income/Expense	Yield/Rate
Earning assets:						
Loans*	\$ 281,341	\$ 4,294	6.05%	\$ 270,109	\$ 4,241	6.23%
Investment securities	104,261	457	1.89%	91,889	478	2.36%
Other earning assets	14,937	9	0.24%	27,460	16	0.23%
Total earning assets	400,539	\$ 4,760	4.75%	389,458	\$ 4,735	4.89%
Allowance for loan losses	(3,933)			(5,892)		
Cash and other assets	34,462			34,878		
TOTAL ASSETS	\$ 431,068			\$ 418,443		
Liabilities and Shareholders' Equity						
Interest-bearing liabilities:						
Interest-bearing demand deposits	\$ 25,388	\$ 10	0.16%	\$ 26,357	\$ 21	0.32%
Savings deposits	12,858	7	0.22%	10,702	10	0.36%
MMDA's	78,715	100	0.50%	56,761	114	0.79%
Time deposits	166,401	445	1.06%	189,882	612	1.28%
Federal funds purchased and securities sold under agreements to repurchase	25,102	22	0.34%	19,471	22	0.45%
Federal Home Loan Bank and other borrowings	29,012	285	3.90%	37,336	394	4.19%
Total interest-bearing liabilities	337,476	869	1.02%	340,509	1,173	1.37%
Net interest spread		\$ 3,891	3.73%		\$ 3,562	3.53%
Noninterest-bearing demand deposits	51,727			40,722		
Accrued expenses and other liabilities	1,483			(288)		
Shareholders' equity	40,382			37,501		
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 431,068			\$ 418,443		
Net yield on earning assets			<u>3.89%</u>			<u>3.70%</u>
Taxable equivalent adjustment:						
Loans		0			0	
Investment securities		39			69	
Total adjustment		<u>39</u>			<u>69</u>	

* Loans includes non-accrual loans which yield zero percent.

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

Nine months ended
September 30

(Amounts in thousands)

Assets	2013			2012		
	Average Balance	Income/Expense	Yield/Rate	Average Balance	Income/Expense	Yield/Rate
Earning assets:						
Loans*	\$ 276,606	\$ 12,515	6.05%	\$ 266,187	\$ 12,571	6.31%
Investment securities	97,786	1,379	2.10%	91,827	1,563	2.58%
Other earning assets	23,232	45	0.26%	25,535	44	0.23%
Total earning assets	397,624	\$ 13,939	4.74%	383,549	\$ 14,179	5.02%
Allowance for loan losses	(5,053)			(6,345)		
Cash and other assets	36,808			35,968		
TOTAL ASSETS	\$ 429,379			\$ 413,172		
Liabilities and Shareholders' Equity						
Interest-bearing liabilities:						
Interest-bearing demand deposits	\$ 26,477	\$ 46	0.23%	\$ 26,526	\$ 65	0.33%
Savings deposits	12,235	22	0.24%	10,317	29	0.37%
MMDA's	76,729	319	0.56%	47,625	305	0.86%
Time deposits	167,406	1,366	1.09%	191,378	1,946	1.36%
Federal funds purchased and securities sold under agreements to repurchase	22,330	56	0.34%	22,309	77	0.46%
Federal Home Loan Bank and other borrowings	31,142	941	4.04%	39,990	1,281	4.28%
Total interest-bearing liabilities	336,319	2,750	1.09%	338,145	3,703	1.46%
Net interest spread		\$ 11,189	3.65%		\$ 10,475	3.55%
Noninterest-bearing demand deposits	50,338			38,684		
Accrued expenses and other liabilities	1,865			(163)		
Shareholders' equity	40,857			36,507		
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 429,379			\$ 413,172		
Net yield on earning assets			3.81%			3.73%
Taxable equivalent adjustment:						
Loans		0			0	
Investment securities		156			212	
Total adjustment		156			212	

* Loans includes non-accrual loans which yield zero percent.

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

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

The following is a discussion of Cornerstone's financial condition at September 30, 2013 and December 31, 2012 and our results of operations for the three and nine months ended September 30, 2013 and 2012. The purpose of this discussion is to focus on information about Cornerstone's financial condition and results of operations which is not otherwise apparent from the consolidated financial statements. The following discussion and analysis should be read along with Cornerstone's consolidated financial statements and the related notes included elsewhere herein.

Critical Accounting Policies

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

Allowance for Loan Losses

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

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

Estimates of Fair Value

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

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

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

Income Taxes

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

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

Cornerstone periodically evaluates uncertain tax positions and estimates the appropriate level of tax reserves related to each of these positions. Additionally, Cornerstone evaluates its deferred tax assets for possible valuation allowances based on the amounts expected to be realized. The evaluation of uncertain tax positions and deferred tax assets involves a high degree of judgment and subjectivity. Changes in the results of these evaluations could have a material impact on our financial results. Refer to Note 9, "Income Taxes," in the notes to Cornerstone's consolidated financial statements set forth in its Annual Report on Form 10-K for the year ended December 31, 2012 for more information.

Review of Financial Performance

As of September 30, 2013, Cornerstone had total consolidated assets of approximately \$430 million, total loans of approximately \$284 million, total securities of approximately \$95 million, total deposits of approximately \$341 million and stockholders' equity of approximately \$40 million. Net income for the three and nine month periods ended September 30, 2013 totaled \$428,548 and \$1,276,707, respectively.

Results of Operations

Net income for the three months ended September 30, 2013 was \$428,548 compared to a net income of \$364,246 for the same period in 2012. Net income for the nine months ended September 30, 2013 was \$1,276,707 compared to a net income of \$1,031,348 for the same period in 2012.

The following table presents our results for the three and nine months ended September 30, 2013 compared to the three and nine months ended September 30, 2012 (amounts in thousands).


	Three months ended September 30,		2013-2012	Dollar Amount Change	Nine months ended September 30,		2013-2012	Dollar Amount Change
	2013	2012	Percent Increase (Decrease)		2013	2012	Percent Increase (Decrease)	
Interest income	\$ 4,760	\$ 4,735	0.53%	\$ 25	\$ 13,939	\$ 14,178	(1.69)%	\$ (239)
Interest expense	869	1,172	(25.85)%	(303)	2,750	3,703	(25.74)%	(953)
Net interest income								
before provision for loan loss	3,891	3,563	9.21%	328	11,189	10,475	6.82%	714
Provision for loan loss	-	100	(100.00)%	(100)	300	100	200.00%	200
Net interest income after provision for loan loss	3,891	3,463	12.36%	428	10,889	10,375	4.95%	514
Total noninterest income	270	258	4.65%	12	1,323	778	70.05%	545
Total noninterest expense	3,464	3,203	8.15%	261	10,142	9,700	4.56%	442
Income before income taxes	697	518	34.56%	178	2,070	1,453	42.46%	617
Provision for income taxes	268	154	74.03%	114	793	422	87.91%	371
Net income	\$ 429	\$ 364	17.86%	65	\$ 1,277	\$ 1,031	23.86%	246


Net Interest Income -Net interest income represents the amount by which interest earned on various earning assets exceeds interest paid on deposits and other interest-bearing liabilities. Net interest income is also the most significant component of our earnings. For the three months ended September 30, 2013, net interest income before the provision for loan loss increased approximately \$328 thousand or 9.21 percent over the same period of 2012. For the nine months ended September 30, 2013, net interest income before the provision for loan loss increased \$714 thousand or 6.82 percent.

Cornerstone's interest rate spread on a tax equivalent basis (which is the difference between the average yield on earning assets and the average rate paid on interest-bearing liabilities) was 3.73 percent compared to 3.53 percent for the three month periods ended September 30, 2013 and 2012, respectively. The interest rate spread on a tax equivalent basis was 3.65 percent compared to 3.55 percent for the nine month periods ended September 30, 2013 and 2012, respectively.

The net interest margin on a tax equivalent basis was 3.89 percent and 3.70 percent for the three months ending September 30, 2013 and 2012, respectively. The net interest margin on a tax equivalent basis was 3.81 percent and 3.73 percent for the nine months ending September 30, 2013 and 2012, respectively.

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

 The Bank's net interest income before provision for loan loss as of September 30, 2013 has been positively impacted by a reduction in cost of funds. The cost of funds reduction was the result of a decrease in interest rates paid by the Bank and a change in the deposit mix with customers choosing to place deposits in transactional accounts rather than certificates of deposit. The Bank's cost of funds was approximately \$869 thousand for the three months ended September 30, 2013 compared to \$1.2 million during the same time period in 2012.

 The Bank's loan portfolio yield decreased to 6.05 percent for the three months ended September 30, 2013 compared to 6.23 percent for the three months ended September 30, 2012. Management believes the interest rates on loans will continue to decrease as the Bank attempts to increase its outstanding loan balances in a very competitive market. If management is successful in increasing the amount of outstanding loans, the resulting change in asset mix would increase the Bank's total interest income.

For the three month period ended September 30, 2013, the Bank’s investment portfolio yielded 1.89 percent compared to 2.36 percent for the same time period in 2012. The decrease in the investment portfolio yield was due to the liquidation of approximately \$5 million in municipal securities during the second quarter of 2013 combined with an increase in variable interest rate mortgage-backed securities.

The Bank’s net interest margin for the three month period ending September 30, 2013 compared to September 30, 2012 increased by 19 basis points. The Bank was able to achieve this increase primarily due to the decreases in the total interest-bearing liabilities. Specifically, Cornerstone was able to reduce its Federal Home Loan Bank and borrowings cost from 4.19 percent for the three months ended September 30, 2012 to 3.90 percent for the three months ended September 30, 2013.

Provision for Loan Losses -The provision for loan losses represents a charge to earnings necessary to establish an allowance for loan losses that, in management’s evaluation, should be adequate to provide coverage for the inherent losses on outstanding loans. Based upon management’s evaluation, Cornerstone determined that its allowance for loan losses was adequate and therefore, did not record additional loan loss expense during the third quarter of 2013. For the year, Cornerstone has recorded \$300,000 on provision for loan losses.

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

The following table presents the components of noninterest income for the three and nine months ended September 30, 2013 and 2012 (dollars in thousands):

	Three months ended		2013-2012 Percent Increase (Decrease)	Nine months ended		2013-2012 Percent Increase (Decrease)
	September 30,			September 30,		
	2013	2012		2013	2012	
Service charges on deposit accounts	\$ 218	\$ 197	10.66%	\$ 608	\$ 602	1.00%
Net gains on sale of securities	-	-	-	425	-	N/A
Net gains on sale of loans and other assets	39	48	(18.75)%	241	124	94.35%
Other noninterest income	13	13	0.00%	49	52	(5.77)%
Total noninterest income	\$ 270	\$ 258	4.25%	\$ 1,323	\$ 778	70.05%

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

The Bank has maintained a consistent amount of noninterest income for the three months ended September 30, 2013 and September 30, 2012. The Bank has been able to increase its deposit account balances since September 30, 2012. The Bank has only experienced a slight increase in service charges during this time due to a significant reduction in overdraft fees.

The Bank realized a \$425 thousand security gain on the liquidation of approximately \$5 million in municipal bond securities during the second quarter of 2013. The security gain is the primary increase in noninterest income for the nine months ended September 30, 2013 compared to the nine months ended September 30, 2012.

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

The following table presents the components of noninterest expense for the three and nine months ended September 30, 2013 and 2012 (dollars in thousands).

	Three months ended		2013-2012	Nine months ended		2013-2012
	September 30,		Percent	September 30,		Percent
	2013	2012	Increase (Decrease)	2013	2012	Increase (Decrease)
Salaries and employee benefits	\$ 1,619	\$ 1,566	3.38%	\$ 4,839	\$ 4,727	2.37%
Occupancy and equipment expense	334	355	(5.92)%	1,011	1,038	(2.60)%
Foreclosed asset expense, net	382	314	21.66%	1,309	945	38.52%
FDIC depository insurance	162	237	(31.65)%	483	683	(29.28)%
Other operating expense	967	731	32.42%	2,500	2,307	8.37%
Total noninterest expense	\$ 3,464	\$ 3,203	8.18%	\$ 10,142	\$ 9,700	4.56%

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

- ☐ Cornerstone's employee expense increased slightly when comparing both the three and nine months ended September 30, 2013 to September 30, 2012. The increase is primarily attributable to an increase in the Bank's employee performance incentive compensation accrual. Management has elected to maintain consistent salary levels as the Bank continues to improve its earnings. The incentive compensation is distributed to employees during the fourth quarter of each year if the Bank achieves certain annual performance goals.
- ☐ As of September 30, 2013, the Bank had incurred approximately \$1.3 million in foreclosed assets expense. The expense consists of asset write-downs based upon current appraisals, carrying cost and losses on the sale of foreclosed assets. Management, in its financial reporting, nets the foreclosed assets expense and write-downs against the revenue generated from income producing real estate. As of September 30, 2012, the Bank had incurred \$945 thousand in foreclosed asset expense. The increase in expense when comparing September 30, 2013 to September 30, 2012 can be attributed, in part, to the liquidation of foreclosed assets during the third quarter of 2013. During this time period the Bank was able to reduce its foreclosed asset balance by approximately \$3.9 million.
- ☐ Depository insurance during the third quarter decreased from approximately \$237 thousand as of September 30, 2012 to approximately \$162 thousand as of September 30, 2013. Management anticipates the FDIC expense to reduce further as the Bank's regulatory status improves.
- ☐ The Bank has experienced only slight increases its other operating cost when comparing the three and nine months ended September 30, 2013 to September 30, 2012. The ability to maintain these costs at consistent levels can be attributed to the Bank's employees as cost saving measures have been evaluated and implemented over the last three years.

Financial Condition

Overview- Cornerstone's consolidated assets totaled approximately \$443 million as of December 31, 2012. As of September 30, 2013, total consolidated assets had decreased approximately \$13.8 million or 3.1 percent to approximately \$430 million.

Liabilities as of September 30, 2013 and December 31, 2012 totaled approximately \$390 million and \$403 million, respectively.


Stockholders' equity as of September 30, 2013 and December 31, 2012 totaled approximately \$40 million and \$41 million, respectively.

Securities- The Bank's investment portfolio, primarily consisting of Ginnie Mae agency, mortgage-backed securities and municipal securities, amounted to approximately \$95 million as of September 30, 2013 compared to approximately \$76 million as of December 31, 2012. The primary purposes of the Bank's investment portfolio are to provide liquidity, satisfy pledging requirements and collateralize the Bank's repurchase accounts.

Loans -The composition of loans at September 30, 2013 and at December 31, 2012 of each classification are summarized in the following table (dollars in thousands):

	September 30, 2013	December 31, 2012
Commercial real estate-mortgage:		
Owner-occupied	\$ 66,143	\$ 58,425
All other	66,721	66,747
Consumer real estate-mortgage	69,911	71,195
Construction and land development	38,970	38,557
Commercial and industrial	39,782	40,140
Consumer and other	2,654	1,927
Total loans	284,181	276,991
Less: Allowance for loan losses	(3,159)	(6,141)
Loans, net	\$ 281,022	\$ 270,850

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

 During the third quarter of 2013, the Bank did not record a provision expense to the loan loss allowance. Management believes that it has established an allowance for loan losses that adequately accounts for the Bank's identified loan impairment. However, additional provision to the loan loss allowance may be needed in future quarters as the Bank works its problem assets through the collection cycle.

The following is a summary of changes in the allowance for loan losses for the nine months ended September 30, 2013 and for the year ended December 31, 2012 and the ratio of the allowance for loan losses to total loans as of the end of each period (amounts in thousands):


	September 30, 2013	December 31, 2012
Balance, beginning of period	\$ 6,141	\$ 7,400
Loans charged-off	(4,460)	(2,869)
Recoveries of loans previously charged-off	1,178	1,180
Provision for loan losses	300	430
Balance, end of period	\$ 3,159	\$ 6,141
Total loans	\$ 284,181	\$ 276,991
Ratio of allowance for loan losses to loans outstanding at the end of the period	1.11%	2.22%
Ratio of net charge-offs to total loans outstanding for the period	1.15%	0.61%


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


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

The following table summarizes Cornerstone's non-performing assets at each quarter end from December 31, 2012 to September 30, 2013 (amounts in thousands):

	September 30, 2013	June 30, 2013	March 31, 2013	December 31, 2012
Non-accrual loans	\$ 4,096	\$ 6,883	\$ 6,364	\$ 6,005
Foreclosed assets	14,924	18,867	21,159	20,332
Total non-performing assets	\$ 19,020	\$ 25,750	\$ 27,523	\$ 26,337
30-89 days past due loans	\$ 1,659	\$ 5,111	\$ 4,023	\$ 6,594
Total loans outstanding	\$ 284,181	\$ 276,063	\$ 272,550	\$ 276,991
Allowance for loan losses	3,159	5,095	5,669	6,141
Ratio of non-performing loans to total loans outstanding at the end of the period	1.44%	2.49%	2.33%	2.17%
Ratio of non-performing assets to total allowance for loan losses at the end of the period	602.09%	505.40%	485.00%	428.87%

 The Bank's non-accrual loans have declined during the third quarter of 2013. Management has attempted to proactively resolve loans that have been classified as non-accrual, when possible, through aggressive collection efforts and the Bank's Special Assets department. Management anticipates that non-accrual balances will decline as the Bank continues to see a decline in the rate of loans being downgraded and management continues to proactively address these loans.


 The Bank's foreclosed assets have declined over the last three quarters. The Bank's Special Asset department has been successful in stabilizing, improving and marketing the foreclosed assets. As a result of these efforts, the Bank has seen a reduction in its foreclosed assets of approximately \$5.4 million since December 31, 2012. Currently, the Bank has approximately \$1.2 million under contract to sell. The disposition of nonperforming assets is one of the key factors to the Bank's success.


 As mentioned previously, the Bank has been able to reduce its non-accrual loans and foreclosed assets. The progress in these two areas demonstrates an improvement in the Bank's nonperforming assets. Since December 31, 2012, the Bank has been able to reduce its nonperforming assets from approximately \$26 million to approximately \$19 million as of September 30, 2013. This is a significant improvement in Bank's risk profile and expense amounts. Management also believes the positive trend in 30-89 past due loans demonstrates that the Bank's asset quality is improving.

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


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

	September 30, 2013		December 31, 2012	
	Amount	Percent	Amount	Percent
Core funding:				
Noninterest-bearing demand deposits	\$ 54,452	14.10%	\$ 60,054	15.0%
Interest-bearing demand deposits	25,464	6.59%	30,179	7.6%
Savings and money market accounts	90,666	23.47%	80,994	20.3%
Time deposits under \$100,000	81,064	20.99%	85,917	21.5%
Total core funding	251,646	65.15%	257,144	64.4%
Non-core funding:				
Time deposit of \$100,000 or more	\$ 89,110	23.07%	\$ 87,737	22.0%
Fed funds purchased and securities sold under agreements to repurchase	20,509	5.31%	19,587	4.9%
Federal Home Loan Bank advances	25,000	6.47%	35,000	8.7%
Total non-core funding	134,619	34.85%	142,324	35.6%
Total	\$ 386,265	100.00%	\$ 399,468	100.0%

 The Bank has seen a significant improvement in its liability structure by improving its core funding position and reducing its reliance on non-core funding sources. For example, the Bank has been able to reduce its FHLB borrowings to \$25 million as of September 30, 2013. Management is currently considering how best to fund future loan growth and maintain sufficient liquidity levels. Additional FHLB advances with defined maturity dates and fixed interest rates may allow the Bank to improve its net interest margin as well as assist in managing interest rate risk in the future.


 The Bank continues to offer competitive interest rates to attract and maintain its savings and money market accounts. Management anticipates that the local deposit market will continue to place funds in savings and money market accounts instead of time deposit accounts.


Capital Resources- At September 30, 2013 and December 31, 2012, Cornerstone's stockholders' equity amounted to approximately \$40.1 million and approximately \$40.9 million, respectively.

 Cornerstone's stockholders' equity decreased by approximately \$739 thousand during the first nine months of 2013. The primary reason for the decrease can be attributed to the decline in accumulated other comprehensive income which captures the Bank's decrease in its unrealized security gains. As of December 31, 2012, the Bank had approximately \$1.5 million in unrealized security gains. As of September 30, 2013, the amount of unrealized security gains had decreased to approximately \$321 thousand. One reason for the decrease can be attributed to the liquidation of approximately \$5 million of the Bank's security portfolio to realize an approximate gain of \$425 thousand. The second reason for the decline can be attributed to changes in the bond market. Stockholder's equity has also been decreased by the payment of dividends on its Series A convertible preferred stock. As of September 30, 2013, Cornerstone had paid approximately \$1.1 million in preferred stock dividends during 2013. The overall decrease in stockholders' equity has been offset by Cornerstone's year-to-date earnings of approximately \$1.3 million.

The following is a summary of the Bank's capital ratios as of September 30, 2013:

Tier 1 leverage ratio 8.45%
Tier 1 risk-based capital ratio 11.72%
Total risk-based capital ratio 12.75%

 Cornerstone had total outstanding borrowings of approximately \$1.7 million as of September 30, 2013 included in Federal Home Loan Bank and other borrowings.

 Cornerstone has requested permission from the Federal Reserve Bank of Atlanta (the "Federal Reserve") to pay its scheduled June 30, 2013 dividend on its Series A convertible preferred stock in the amount of \$0.625 per share. Cornerstone is waiting for a final decision from the Federal Reserve authorizing the payment of the dividend.

Market and Liquidity Risk Management

Interest Rate Sensitivity

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

Earnings at Risk Model

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

Economic Value of Equity

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

Liquidity Analysis

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

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

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

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

Leverage Analysis

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

Balance Sheet Analytics

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

Liquidity Risk Management

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

A comprehensive qualitative and quantitative analysis regarding market risk was disclosed in Cornerstone's Annual Report on Form 10-K for the year ended December 31, 2012. No material changes in the assumptions used in preparing, or results obtained from, the model have occurred since December 31, 2012.

Item 4. Controls and Procedures

Under the supervision and with the participation of management, including Cornerstone's Chief Executive Officer and Chief Financial Officer, Cornerstone has evaluated the effectiveness of its disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as of September 30, 2013 (the "Evaluation Date"). Based on such evaluation, such officers have concluded that, as of the Evaluation Date, Cornerstone's disclosure controls and procedures were effective in alerting them on a timely basis to material information relating to Cornerstone (including its consolidated subsidiary) required to be included in Cornerstone's periodic filings under the Exchange Act.

There were no changes in Cornerstone's internal control over financial reporting during Cornerstone's fiscal quarter ended September 30, 2013 that have materially affected, or are reasonably likely to materially affect, Cornerstone's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

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

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

None

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

Item 5. Other Information

None

Item 6. Exhibits

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

SIGNATURES

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

Cornerstone Bancshares, Inc.

Date: November 14, 2013

/s/ Nathaniel F. Hughes

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

Date: November 14, 2013

/s/ Gary W. Petty, Jr.

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

EXHIBIT INDEX

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

CERTIFICATION

I, Nathaniel F. Hughes, certify that:

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

Date: November 14, 2013

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

CERTIFICATION

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

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

Date: November 14, 2013

/s/ Gary W. Petty, Jr.

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

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

In connection with the Quarterly Report of Cornerstone Bancshares, Inc., a Tennessee corporation (“Cornerstone”), on Form 10-Q for the quarter ended September 30, 2013, as filed with the Securities and Exchange Commission (the “Report”), Nathaniel F. Hughes, President and Chief Executive Officer of Cornerstone, and Gary W. Petty, Jr., Executive Vice President and Chief Financial Officer of Cornerstone, respectively, do each hereby certify, pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350), that to his knowledge:

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

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

/s/ Nathaniel F. Hughes

Nathaniel F. Hughes
President and Chief Executive Officer
(principal executive officer)
November 14, 2013

/s/ Gary W. Petty, Jr.

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

November 14, 2013

[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.]
