

# CORNERSTONE BANCSHARES INC

## FORM 10-Q (Quarterly Report)

Filed 5/17/1999 For Period Ending 3/31/1999

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

# U.S. Securities and Exchange Commission

Washington, D.C. 20549

## FORM 10-Q

(Mark One)

**QUARTERLY REPORT PURSUANT SECTION 13 OR 15(D) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended MARCH 31, 1999

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

For the transition period from to

*Commission file number 333-26699*

## CORNERSTONE BANCSHARES, INC.

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

TENNESSEE  
(State or other jurisdiction of  
incorporation or organization)

62-1173944  
(IRS Employer  
Identification No.)

**5319 HIGHWAY 153  
CHATTANOOGA, TENNESSEE 37343**  
(Address of principal executive offices)

(423) 877-8181  
(Issuer's telephone number)

Check whether the issuer (1) filed all reports required to be filed by  
Section 12, 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such  
reports), and  
(2) has been subject to such filing requirements for the past 90 days. Yes X No

### APPLICABLE ONLY TO CORPORATE ISSUERS

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 1,009,961 SHARES  
OF COMMON STOCK AS OF MARCH 31, 1999.

**PART I -- FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**CONSOLIDATED STATEMENTS OF CONDITION**

	Unaudited March 31,	December 31,	Unaudited March 31,
	-----	-----	-----
ASSETS	1999	1998	1998
	-----	-----	-----
Cash and due from banks	5,454,637	4,268,967	6,166,368
Federal funds sold	6,445,000	8,425,000	14,310,000
Investment securities available for sale	8,524,813	9,280,116	9,375,520
Investment securities held to maturity	8,024,303	9,077,465	1,687,672
Loans, less allowance for loan loss	67,174,147	72,492,549	63,759,536
Premises and equipment, net	1,940,085	1,967,329	1,955,463
Accrued interest receivable	570,966	638,441	676,599
Excess cost over fair value of assets acquired	2,806,331	2,834,124	2,838,954
Other assets	1,568,554	1,522,143	1,220,424
	-----	-----	-----
Total assets	102,508,835	110,506,134	108,990,536
	=====	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY			
Deposits			
Non interest bearing	10,396,679	14,151,526	10,975,143
NOW accounts	13,749,522	12,998,223	13,314,076
Savings deposits and money market accounts	9,315,445	10,283,103	10,764,728
Time deposits of \$100,000 or more	15,677,132	17,489,618	10,768,783
Time deposits of less than \$100,000	40,517,135	43,089,138	51,303,483
	-----	-----	-----
Total deposits	89,655,913	98,011,608	97,126,213
Accrued interest payable	210,626	270,634	342,958
Other liabilities	913,699	470,861	332,220
Note payable	1,250,000	1,250,000	856,000
	-----	-----	-----
Total liabilities	92,030,238	100,003,103	98,655,391
	-----	-----	-----
Redeemable common stock	237,504	478,744	478,744
	-----	-----	-----
Stockholders' equity			
Common stock	1,009,561	1,009,461	1,009,061
Additional paid-in capital	9,260,418	9,017,430	9,001,716
Undivided profits (deficit)	(44,978)	(41,695)	(202,101)
Net unrealized gain in securities available for sale	16,092	39,091	47,725
	-----	-----	-----
Total stockholders' equity	10,478,597	10,503,031	10,335,145
	-----	-----	-----
Total liabilities and stockholders equity	102,508,835	110,506,134	108,990,536
	=====	=====	=====

# CONSOLIDATED STATEMENTS OF INCOME

	Unaudited March 31,	Unaudited March 31,
	----- 1999 -----	----- 1998 -----
INTEREST INCOME		
Interest and fees on loans	1,577,138	1,561,652
Interest on investment securities	275,936	277,784
Interest on federal funds sold	38,533	85,643
Interest on other earning assets	--	--
	-----	-----
Total interest income	1,891,607	1,925,079
	-----	-----
INTEREST EXPENSE		
Interest bearing demand accounts	60,781	63,323
Money market accounts	52,070	57,493
Savings accounts	26,629	26,402
Time deposits of less than \$100,000	555,771	651,315
Time deposits of \$100,000 or more	238,067	167,569
Federal funds purchased	732	570
Securities sold under agreements to repurchase	1,678	--
Other borrowings	24,219	18,169
	-----	-----
Total interest expense	959,947	984,842
	-----	-----
Net interest income	931,660	940,237
Provision for loan losses	50,000	47,018
Net interest income after the provision for loan losses	881,660	893,219
	-----	-----
NONINTEREST INCOME		
Service charges on deposit accounts	91,178	97,757
Net securities gains (losses)	--	--
Other income	37,031	54,988
	-----	-----
Total noninterest income	128,209	152,745
	-----	-----
NONINTEREST EXPENSE		
Salaries and employee benefits	480,345	412,701
Occupancy and equipment expense	128,183	108,388
Other operating expense	382,756	308,859
	-----	-----
Total noninterest expense	991,284	829,949
	-----	-----
Income before provision for income taxes	18,586	216,016
Provision for income taxes	21,868	128,096
	-----	-----
NET INCOME	(3,283)	87,919
	=====	=====
Basic net income per common share	(0.00)	0.09
Diluted net income per common share	(0.00)	0.08
Dividends declared per common share	--	--

# CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Three Months Ended March 31

	1999	1998
	-----	-----
Cash flows from operating activities:		
Net income	(3,283)	87,919
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Provision for possible loan losses	50,000	47,018
Provision for depreciation and amortization	--	--
Accrued interest receivable	67,475	(44,114)
Accrued interest payable	(60,008)	17,407
Changes in other assets and liabilities:	(225,449)	(634,872)
	-----	-----
Net cash used in operating activities	(171,264)	(526,642)
	-----	-----
Cash flows from investing activities:		
Purchase of investment securities available for sale	(2,316,702)	(1,822,040)
Proceeds from security transactions	4,086,499	2,051,829
Net increase in loans	5,318,402	(3,333,193)
Purchase of bank premises and equipment	(32,312)	(144,215)
Net cash used in investing activities	7,055,887	(3,247,619)
	-----	-----
Cash flows from financing activities:		
Net increase in deposits	(8,343,937)	15,276,408
Net increase in repurchase agreements	663,135	--
Net increase of notes payable	--	--
Issuance of common stock	1,848	1,670,329
	-----	-----
Net cash provided by financing activities	(7,678,954)	16,946,737
	-----	-----
Net increase in cash and cash equivalents	(794,330)	13,172,476
	-----	-----
Cash and cash equivalents beginning of period	12,693,967	7,303,892
	-----	-----
Cash and cash equivalents end of period	11,899,637	20,476,368
	=====	=====
	(794,330)	13,172,476

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
CORNERSTONE BANCSHARES, INC.**

**PRESENTATION OF FINANCIAL INFORMATION**

The 1999 financial information in this report has not been audited. The information included herein should be read in conjunction with the notes to consolidated financial statements included in the 1998 Annual Report to Shareholders which was furnished to each shareholder of Cornerstone Bancshares, Inc. (the "Company" or "Cornerstone") in March 1999. The consolidated financial statements presented herein conform to generally accepted accounting principles and to general industry practices.

**Consolidation**

The accompanying consolidated financial statements include the accounts of the Company and its sole subsidiary Cornerstone Community Bank (the "Bank").

Substantially all intercompany transactions, profits and balances have been eliminated.

**Accounting Policies**

During interim periods, the company follows the accounting policies set forth in its Annual Report on Form 10-K for the year ended December 31, 1998, as filed with the Securities and Exchange Commission. Since December 1998, there have been no changes in any accounting principles or practices, or in the method of applying any such principles or practices.

**Interim Financial Data (Unaudited)**

In the opinion of the Company 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, cash flows for the interim period. Results for interim periods are not necessarily indicative of the results to be expected for a full year.

**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 (denominator). Diluted EPS is computed by dividing income available to common shareholders (numerator) by 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.

**Forward-Looking Statements**

Certain written and oral statements made by or with the approval of an authorized executive officer of the Company may constitute "forward-looking statements" as defined under the Private Securities Litigation Reform Act of 1995. Words or phrases such as "should result", "are expected

to," "we anticipate," "we estimate," "we project" or similar expressions are intended to identify forward-looking statements. These statements are subject to certain risks and uncertainties that could cause actual results to differ materially from the Company's historical experience and its present expectations or projections. These risks and uncertainties include, but are not limited to, unanticipated economic changes, interest rate movements and the impact of competition. Caution should be taken not to place undue reliance on any such forward-looking statements since such statements speak only as of the date of making such statements.

## **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION.**

### **OVERVIEW**

The Company ended the first three months of 1999 with total assets of \$102 million, a 7.3% decrease from December 31, 1998, and a 6.0% decrease from March 31, 1998. The Company reported net income for the three months ending March 31, 1999 of \$(3,283), or \$0.0 basic earnings per share, compared to \$87,919, or \$0.09 basic earnings per share, for the same period in 1998. The decline in earnings represents a 103.7% decrease from the first quarter 1998 compared to the first quarter of 1999.

The decrease in net income from March 1998 to March 1999 is primarily due a reorganization of the executive staff and an extensive review of lending and accounting procedures. The result created higher salaries as the Bank hired expertise needed to remain competitive and in compliance with all Federal laws. In addition, the Bank incurred higher than normal professional and legal expenses as management reviewed the loan portfolio and brought the loan quality back to an acceptable quality level.

### **FINANCIAL CONDITION**

**Earning Assets.** Average earning assets for March 31, 1999 increased \$12.2 million or 15% above March 1998, while actual earning assets decreased \$5.6 million or 5.8% during the same time period. The average balance increase was primarily due to an expected increase in loans outstanding. The actual balance decrease was due to a late increase during the quarter in federal funds in 1998 and a late quarter decrease in loans in 1999.

**Loan Portfolio.** Cornerstone's average loans for the first three months of 1999 were \$72.2 million, an increase of 16.6%, while actual balances increased to \$68.4 million, an increase of 5.9% over \$64.6 million in loans for the first three months of 1998. Loan growth for 1999 has been primarily funded through federal funds and reduced investments.

Management is anticipating increased loan growth (more than 10%) for the remainder of the year in actual balances, with only a relatively small increase in average balances. However, the amount of such growth, if any, will depend upon general economic conditions.

**Investment Portfolio.** Cornerstone's investment securities portfolio decreased by 9.9% or \$1.8 million from March 1998 to March 1999. Cornerstone maintains an investment strategy of making prudent investment decisions with active management of the portfolio to optimize, within the constraints of established policies, an adequate return and value. Investment objectives include Gap Management, Liquidity, Pledging, Return, and Local Community Support in that order of priority. Cornerstone maintains two classifications of investment securities: "Held to Maturity" and "Available for Sale." The "Available for Sale" securities are carried at fair market value, whereas the "Held to Maturity" securities are carried at book value. As of March 31, 1999, unrealized gains in the "Available for Sale" portfolio amounted to \$24,381.

**Deposits.** Cornerstone's average deposits increased \$5.8 million or 7.7% from March 1998 to March 1999, while actual deposit balances decreased \$7.5 million or 7.7%. The largest

portion of decrease was a \$5.9 million, or 9.5% decrease in time deposits. This is due to Cornerstone's strategy to only pay premium rates for certificates of deposit when loan growth dictates additional funding. Transaction accounts are continuously solicited from new customers and existing customers. Transaction accounts are the Bank's highest priority and will provide the Bank with an increased net interest margin.

Capital Resources. Stockholders' equity increased \$0.2 million or 2.0% to \$10.5 million as of March 31, 1999, compared with \$10.3 at March 31, 1998. This increase was primarily due to earnings being retained.

## **RESULTS OF OPERATIONS - QUARTER ENDED MARCH 31, 1999 COMPARED TO QUARTER ENDED MARCH 31, 1998**

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

Net interest income for the first three months of 1999 decreased \$8,574 or 1% below net interest income earned as of March 1998. The decrease in net interest income as of March 31, 1999 is primarily due to a decrease in the Bank's net interest spread on earning assets, which dropped from 4.11% to 3.48% in 1999. Reduced loan yields contributed the majority of the net interest spread reduction.

Interest income decreased \$33,472 or 1.7% as of March 1999 compared to March 1998. Interest income produced by the loan portfolio increased \$15,486 or 1% from March 1998 to March 1999 due to the decrease in average yields for the period. Two factors contributed to the reduction of loan yields, first, a general decrease in interest rates and second, increased competition for existing and new customer loan balances. Interest income on investment securities and federal funds decreased \$48,958 or 13.5% from March 1998 to March 1999, due primarily to reduced balances.

Total interest expense decreased \$24,895 or 2.5% from March 31, 1998 to March 31, 1999. The interest expense decrease from the first quarter of 1998 to the first quarter of 1999 is primarily due to the general decrease in interest rates mentioned above.

The trend in net interest income is commonly evaluated in terms of average rates using the net interest margin and the interest rate spread. The net interest margin, or the net yield on earning assets, is computed by dividing fully taxable equivalent net interest income by average earning assets. This ratio represents the difference between the average yield on average earning assets and the average rate paid for all funds used to support those earning assets. The net interest margin at March 31, 1999 was 4.03%. The yield on earning assets decreased 115 basis points to 8.19% at March 31, 1999 from 9.34% at March 31, 1998.

The interest rate spread measures the difference between the average yield on earning assets and the average rate paid on interest bearing sources of funds. The interest rate spread eliminates the impact of noninterest bearing funds and gives a direct perspective on the effect of market interest rate movements. As a result of changes in the asset and liability mix during late 1998

and first quarter 1999, the interest rate spread was 3.48%, a decrease of 63 basis points from March 1998 to March 1999.

**Allowance for Loan Losses.** The allowance for possible loan losses represents management's assessment of the risks associated with extending credit and its evaluation of the quality of the loan portfolio. Management analyzes the loan portfolio to determine the adequacy of the allowance for possible loan losses and the appropriate provisions required to maintain a level considered adequate to absorb anticipated loan losses. Management believes that the \$1,208,310 for March 1999 in the allowance for loan loss account does not reflect the full known extent of credit exposure and anticipates adding \$500,000 to the allowance during 1999. No assurances can be given, however, that adverse economic circumstances will not result in increased losses in the loan portfolio, and require greater provisions for possible loan losses in the future.

**Non-performing Assets.** Non-performing assets include non-performing loans and foreclosed real estate held for sale. Non-performing loans include loans classified as non-accrual or renegotiated. Cornerstone's policy is to place a loan on non-accrual status when it is contractually past due 90 days or more as to payment of principal or interest. At the time a loan is placed on non-accrual status, interest previously accrued but not collected may be reversed and charged against current earnings. As of March 31, 1999 Cornerstone had \$1,019,256 in non-accrual loans and \$1,255,878 in non-performing loans.

**Non-interest Income.** Non-interest income consists of revenues generated from a broad range of financial services and activities including fee-based services and profits and commissions earned through credit life insurance sales and other activities. In addition, gains or losses realized from the sale of loans are included in non-interest income. Excluding gains from the sale of loans, total non-interest income decreased by \$24,536 or 16% from March 1998 to March 1999.

**Non-interest Expense.** Non-interest expense for the first three months of 1999 increased by \$161,335 or 19.4% as compared to the first three months in 1998. Salaries and employee benefits increased by \$67,644 or 16.4% in March 1999 over March 1998. Occupancy expense as of March 31, 1999 increased by \$19,795 or 18.3% over the same period in 1998. All other non-interest expenses at March 31, 1999 increased \$73,897 or 24% over the non-interest expenses as of March 31, 1998, primarily due to an increase in director fees, professional fees, and miscellaneous charge-offs.

## YEAR 2000 COMPLIANCE

The Year 2000 poses serious challenges to the banking industry. Many experts believe that even the most prepared organizations may encounter some implementation problems. The federal banking agencies are concerned that financial institutions avoid major disruptions to service and operations. All banks are required to have an action plan to address Year 2000 issues which must include an indication of management awareness of the problems and the commitment to solutions; identification of external risks; and operational issues that are relevant to a bank's Year 2000 planning.

The Federal Financial Institutions Examination Council ("FFIEC") has issued guidelines and target time frames to accomplish critical actions concerning Year 2000 compliance:

\* By September 30, 1997, all banks should have identified affected applications and databases. Mission critical applications should be identified and an action plan set for Year 2000 work.

\* By December 31, 1998, code enhancements and revisions, hardware upgrades, and other associated changes should have been largely completed by all banks. In addition, for mission critical applications, programming changes should have been largely completed and testing should be well underway.

\* Between January 1, 1999 and December 31, 1999, banks should be testing and implementing their Year 2000 conversion programs.

External factors which may adversely affect Cornerstone include reliance on vendors, such as third-party data processing services and software and hardware vendors; electronic data-sensitive exchange among other financial institutions which may not be Year 2000 compliant; corporate customers of Cornerstone and other debtors.

Cornerstone has been assessing its state of readiness by evaluating its information technology ("IT") and non-IT systems. IT systems commonly include data processing, accounting and telephone systems. With respect to its IT systems, Cornerstone estimates that its Year 2000 identification, assessment and remediation efforts are substantially complete. During 1999, further testing will be carried out in order to ensure that all systems are working properly. Cornerstone has assessed its Year 2000 status in regard to non-IT systems and has determined that no material risk exists.

Cornerstone has communicated with its significant vendors in order to determine the extent to which interfaces with such entities are vulnerable to Year 2000 issues and whether the products and services purchased from such entities are Year 2000 compliant. Cornerstone has received either verbal or written assurance from these vendors that they expect to address all their significant Year 2000 issues on a timely basis. With respect to significant borrowers and depositors, Cornerstone does not anticipate any material Year 2000 issues.

Cornerstone believes the cost of its Year 2000 identification, assessment, remediation and testing efforts will not exceed \$10,000.

## PART II - OTHER INFORMATION

### Item 1. Legal Proceedings

None

### Item 2. Changes in Securities

None

### Item 3. Defaults on Senior Securities

None

### Item 4. Submission of Matters to a Vote of Security Holders

None

### Item 5. Other Information

None

### Item 6. Exhibits and reports on Form 8-K

(a) Exhibits:

Financial Data Schedule (For SEC Use Only)

(b) There have been no Current Reports on Form 8-K during the quarter ended March 31, 1999.

## **SIGNATURES**

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

*Date: May 14, 1999*

*/s/Gregory B. Jones, President & CEO*

*Date: May 14, 1999*

*/s/Nathaniel F. Hughes, CFO*

**ARTICLE 9**

THIS SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM THE FINANCIAL STATEMENTS OF CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY FOR THE THREE MONTHS ENDED MARCH 31, 1999 AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.

PERIOD TYPE	3 MOS
FISCAL YEAR END	DEC 31 1999
PERIOD START	JAN 01 1999
PERIOD END	MAR 31 1999
CASH	5,454,637
INT BEARING DEPOSITS	0
FED FUNDS SOLD	6,445,000
TRADING ASSETS	0
INVESTMENTS HELD FOR SALE	0
INVESTMENTS CARRYING	8,024,303
INVESTMENTS MARKET	8,524,813
LOANS	68,382,457
ALLOWANCE	1,208,310
TOTAL ASSETS	102,508,835
DEPOSITS	89,655,913
SHORT TERM	1,250,000
LIABILITIES OTHER	1,124,315
LONG TERM	0
PREFERRED MANDATORY	0
PREFERRED	0
COMMON	1,009,461
OTHER SE	9,231,532
TOTAL LIABILITIES AND EQUITY	102,508,835
INTEREST LOAN	1,577,138
INTEREST INVEST	275,936
INTEREST OTHER	38,533
INTEREST TOTAL	1,891,607
INTEREST DEPOSIT	933,318
INTEREST EXPENSE	26,629
INTEREST INCOME NET	931,660
LOAN LOSSES	50,000
SECURITIES GAINS	0
EXPENSE OTHER	991,284
INCOME PRETAX	18,586
INCOME PRE EXTRAORDINARY	0
EXTRAORDINARY	0
CHANGES	0
NET INCOME	(3,283)
EPS PRIMARY	(0.00)
EPS DILUTED	(0.00)
YIELD ACTUAL	4.25
LOANS NON	1,019,256
LOANS PAST	67,661
LOANS TROUBLED	0
LOANS PROBLEM	0
ALLOWANCE OPEN	1,400,000
CHARGE OFFS	304,209
RECOVERIES	62,520
ALLOWANCE CLOSE	1,208,310
ALLOWANCE DOMESTIC	1,208,310
ALLOWANCE FOREIGN	0
ALLOWANCE UNALLOCATED	0

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