

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 March 31, 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	62-1173944
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
835 Georgia Avenue Chattanooga, Tennessee	37402
(Address of principal executive offices)	(Zip Code)
423-385-3000	Not Applicable
(Registrant's telephone number, including area code)	(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 May 1, 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) there can be no assurance 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

	Unaudited March 31, 2013	December 31, 2012
ASSETS		
Cash and due from banks	\$ 5,074,926	\$ 3,222,139
Interest-bearing deposits at other financial institutions	30,826,261	56,173,099
Total cash and cash equivalents	35,901,187	59,395,238
Securities available for sale	91,125,829	76,096,646
Securities held to maturity (fair value approximates \$43,630 and \$46,212 at March 31, 2013 and December 31, 2012, respectively)	42,579	45,086
Federal Home Loan Bank stock, at cost	2,322,900	2,322,900
Loans, net of allowance for loan losses of \$5,669,215 and \$6,141,281 at March 31, 2013 and December 31, 2012, respectively	266,880,672	270,850,465
Bank premises and equipment, net	5,289,384	5,399,340
Accrued interest receivable	1,323,499	1,213,778
Foreclosed assets	21,159,242	20,332,313
Other assets	7,664,340	7,790,634
Total assets	<u>\$ 431,709,632</u>	<u>\$ 443,446,400</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing demand deposits	\$ 55,400,253	\$ 60,053,838
Interest-bearing demand deposits	26,547,365	30,178,624
Savings deposits and money market accounts	89,564,444	80,994,239
Time deposits	165,391,211	173,653,892
Total deposits	336,903,273	344,880,593
Accrued interest payable	91,268	120,558
Federal funds purchased and securities sold under agreements to repurchase	21,150,464	19,587,387
Federal Home Loan Bank advances and other borrowings	31,740,000	37,175,000
Other liabilities	938,088	794,026
Total liabilities	390,823,093	402,557,564
Stockholders' equity:		
Preferred stock - no par value; 2,000,000 shares authorized; 600,000 shares issued and outstanding in 2013 and 2012, respectively	14,839,391	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	21,420,827	21,390,486
Retained deficit	(3,149,596)	(3,274,986)
Accumulated other comprehensive income	1,228,843	1,451,394
Total stockholders' equity	40,886,539	40,888,836
Total liabilities and stockholders' equity	<u>\$ 431,709,632</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 March 31,	
	2013	2012
INTEREST INCOME		
Loans, including fees	\$ 4,141,736	\$ 4,143,944
Securities and interest-bearing deposits at other financial institutions	439,906	467,006
Federal funds sold	21,472	15,087
Total interest income	4,603,114	4,626,037
INTEREST EXPENSE		
Time deposits	465,256	699,094
Other deposits	137,930	121,243
Federal funds purchased and securities sold under agreements to repurchase	18,080	32,230
Federal Home Loan Bank advances and other borrowings	340,439	461,207
Total interest expense	961,705	1,313,774
Net interest income before provision for loan losses	3,641,409	3,312,263
Provision for loan losses	300,000	-
Net interest income after provision for loan losses	3,341,409	3,312,263
NONINTEREST INCOME		
Customer service fees	188,481	197,434
Other noninterest income	17,818	20,288
Net gains from sale of loans and other assets	149,200	49,664
Total noninterest income	355,499	267,386
NONINTEREST EXPENSES		
Salaries and employee benefits	1,597,291	1,591,135
Net occupancy and equipment expense	337,879	335,813
Depository insurance	159,844	202,783
Foreclosed assets, net	128,692	150,320
Other operating expenses	752,174	794,081
Total noninterest expenses	2,975,880	3,074,132
Income before income tax expense	721,028	505,517
Income tax expense	268,900	149,000
Net income	452,128	356,517
Preferred stock dividend requirements	375,000	265,856
Accretion on preferred stock discount	17,845	14,468
Net income available to common stockholders	\$ 59,283	\$ 76,193
EARNINGS PER COMMON SHARE		
Basic	\$ 0.01	\$ 0.01
Diluted	0.01	0.01
DIVIDENDS DECLARED PER COMMON SHARE		
	\$ -	\$ -

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

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

	Unaudited Three Months Ended March 31,	
	2013	2012
Net income	\$ 452,128	\$ 356,517
Other comprehensive income, before tax:		
Unrealized holding losses arising during the period	(358,953)	(61,258)
Reclassification adjustment for gains include in net income	-	-
Other comprehensive income, before tax	(358,953)	(61,258)
Income tax benefit related to other comprehensive income taxes	136,402	23,278
Other comprehensive income, net of tax	(222,551)	(37,980)
Comprehensive income	<u>\$ 229,577</u>	<u>\$ 318,537</u>

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 three months ended March 31, 2013

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income	Total Stockholders' Equity
BALANCE, December 31, 2012	\$ 14,821,546	\$ 6,500,396	\$ 21,390,486	\$ (3,274,986)	\$ 1,451,394	\$ 40,888,836
Issuance of common stock	-	46,678	30,341	-	-	77,019
Preferred stock dividends	-	-	-	(308,893)	-	(308,893)
Accretion on preferred stock	17,845	-	-	(17,845)	-	-
Net income	-	-	-	452,128	-	452,128
Unrealized holding gains (losses) on securities available for sale, net of reclassification adjustment and taxes	-	-	-	-	(222,551)	(222,551)
BALANCE, March 31, 2013	<u>\$ 14,839,391</u>	<u>\$ 6,547,074</u>	<u>\$ 21,420,827</u>	<u>\$ (3,149,596)</u>	<u>\$ 1,228,843</u>	<u>\$ 40,886,539</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	
	Three months ended March 31,	
	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 452,128	\$ 356,517
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	92,933	111,418
Provision for loan losses	300,000	-
Stock compensation expense	-	18,512
Net (gains) losses on sales of loans and other assets	(80,357)	28,473
Changes in other operating assets and liabilities:		
Net change in loans held for sale	(262,750)	37,175
Accrued interest receivable	(109,721)	(6,545)
Accrued interest payable	(29,290)	(305)
Other assets and liabilities	406,758	852,928
Net cash provided by operating activities	<u>769,701</u>	<u>1,398,173</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from security transactions:		
Securities available for sale	8,287,586	8,331,149
Securities held to maturity	2,477	5,131
Purchase of securities available for sale	(23,654,937)	(10,523,308)
Loan originations and principal collections, net	2,933,738	1,643,836
Purchase of bank premises and equipment	(3,732)	(49,077)
Proceeds from sale of other real estate and other assets	252,233	1,458,489
Net cash (used in) provided by investing activities	<u>(12,182,635)</u>	<u>866,220</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Net (decrease) increase in deposits	(7,977,320)	1,773,714
Net increase (decrease) in federal funds purchased and securities sold under agreements to repurchase	1,563,077	(7,945,510)
Net payments on Federal Home Loan Bank advances and other borrowings	(5,435,000)	(435,000)
Payment of dividends on preferred stock	(308,893)	(187,538)
Issuance of preferred stock	-	532,127
Issuance of common stock	77,019	-
Net cash used in financing activities	<u>(12,081,117)</u>	<u>(6,262,207)</u>
NET DECREASE IN CASH AND CASH EQUIVALENTS	(23,494,051)	(3,997,814)
CASH AND CASH EQUIVALENTS, beginning of period	59,395,238	38,882,691
CASH AND CASH EQUIVALENTS, end of period	\$ 35,901,187	\$ 34,884,877
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash paid during the period for interest	\$ 990,995	\$ 1,314,079
Cash paid during the period for taxes	<u>-</u>	<u>913,327</u>
NONCASH INVESTING AND FINANCING ACTIVITIES		
Acquisition of real estate through foreclosure	<u>\$ 1,154,400</u>	<u>\$ 1,969,300</u>

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

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

Note 1. Presentation of Financial Information

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

Interim Financial Information (Unaudited)- The financial information in this report for March 31, 2013 and March 31, 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.

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 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 increases 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 month periods ended March 31, 2013 and March 31, 2012.

Basic earnings per common share calculation:	Three Months Ended March 31,	
	2013	2012
Numerator: Net income available to common shareholders	\$ 59,283	\$ 76,193
Denominator: Weighted avg. common shares outstanding	6,547,074	6,500,396
Effect of dilutive stock options	123,499	85,425
Diluted shares	6,670,573	6,585,821
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>

Note 2. Stock Based Compensation

Accounting Policies- Cornerstone, as required by FASB, applies the fair value recognition provisions of ASC 718, Compensation –Stock Compensation. For the three month period ended March 31, 2013, no compensation cost was charged to earnings related to the vested incentive stock options.

Officer and Employee Plans -Cornerstone has two stock option plans under which officers and employees can be granted incentive stock options or non-qualified stock options to purchase a total of up to 1,420,000 shares of Cornerstone’s common stock. The exercise price for incentive stock options must be not less than 100 percent of the fair market value of the common stock on the date of the grant. The exercise price of the non-qualified stock options may be equal to or more or less than the fair market value of the common stock on the date of the grant. The incentive stock options vest 30 percent on the second anniversary of the grant date, 60 percent on the third anniversary of the grant date and 100 percent on the fourth anniversary of the grant date, and the non-qualified stock options vest 50 percent on the first anniversary of the grant date and 100 percent on the second anniversary of the grant date. The options expire ten years from the grant date. At March 31, 2013, the total remaining compensation cost to be recognized on non-vested options is approximately \$596,000. A summary of the status of these stock option plans is presented in the following table:

	Number	Weighted Average Exercisable Price	Weighted- Average Contractual Remaining Term (in years)	Aggregate Intrinsic Value
Outstanding at December 31, 2012	670,300	\$ 3.86	6.2 Years	\$ 232,900
Granted	193,000	2.37	9.9 Years	
Exercised	-	-		
Forfeited	(57,475)	(3.51)		
Outstanding at March 31, 2013	<u>805,825</u>	<u>\$ 3.52</u>	7.2 Years	\$ 233,437
Options exercisable at March 31, 2013	<u>303,125</u>	<u>\$ 6.17</u>		

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

The weighted average grant date fair value of stock options granted during the three months ended March 31, 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%

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 March 31, 2013, the total remaining compensation cost to be recognized on non-vested options is approximately \$123,000. 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		
Exercised	-	-		
Forfeited	-	-		
Outstanding at March 31, 2013	<u>190,250</u>	<u>\$ 3.08</u>	7.6 Years	\$ 58,193
Options exercisable at March 31, 2013	<u>100,250</u>	<u>\$ 4.04</u>		

The weighted average grant date fair value of stock options granted during the three months ended March 31, 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 March 31, 2013 and December 31, 2012 are summarized as follows:

	March 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Debt securities available-for-sale:				
U.S. Government agencies	\$ 3,912,202	\$ 54,799	\$ -	\$ 3,967,001
State and municipal securities	21,512,100	1,850,863	-	23,362,963
Mortgage-backed securities:				
Residential mortgage loans guaranteed by GNMA or FNMA	8,532,585	168,643	-	8,701,228
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	55,168,704	66,220	(140,287)	55,094,637
	<u>\$ 89,125,591</u>	<u>\$ 2,140,525</u>	<u>\$ (140,287)</u>	<u>\$ 91,125,829</u>
Debt securities held to maturity:				
Mortgage-backed securities:				
Residential mortgage loans guaranteed by GNMA or FNMA	\$ 42,579	\$ 1,051	\$ -	\$ 43,630

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	\$ 45,086	\$ 1,341	\$ (8)	\$ 46,212

At March 31, 2013, securities with a fair value totaling approximately \$ 53 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.

The amortized cost and estimated market value of securities at March 31, 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	1,091,942	1,166,169	-	-
Due from five years to ten years	5,499,656	6,056,232	-	-
Due after ten years	18,832,704	20,107,563	-	-
	<u>\$ 25,424,302</u>	<u>\$ 27,329,964</u>	-	-
Mortgage-backed securities	63,701,289	63,795,865	42,579	43,630
	<u>\$ 89,125,591</u>	<u>\$ 91,125,829</u>	<u>\$ 42,579</u>	<u>\$ 43,630</u>

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

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 March 31, 2013 and as of December 31, 2012:

	As of March 31, 2013					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Mortgage-backed Securities:						
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	\$33,814,587	\$ (140,287)	\$ -	\$ -	\$33,814,587	\$ (140,287)
	<u>\$33,814,587</u>	<u>\$ (140,287)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$33,814,587</u>	<u>\$ (140,287)</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>

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 March 31, 2013 or December 31, 2012.

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

Mortgage-backed securities: At March 31, 2013, seven 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 March 31, 2013.

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Note 4. Loans and Allowance for Loan Losses

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

	March 31, 2013	December 31, 2012
Commercial real estate-mortgage:		
Owner-occupied	\$ 62,460	\$ 58,425
All other	64,483	66,747
Consumer real estate-mortgage	70,260	71,195
Construction and land development	33,220	38,557
Commercial and industrial	40,302	40,140
Consumer and other	1,825	1,927
Total loans	272,550	276,991
Less: Allowance for loan losses	(5,669)	(6,141)
Loans, net	<u>\$ 266,881</u>	<u>\$ 270,850</u>

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

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

March 31, 2013	Commercial Real Estate- Mortgage	Consumer Real Estate- Mortgage	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Performing loans	\$ 116,417	\$ 66,790	\$ 32,271	\$ 37,513	\$ 1,825	\$ 254,816
Impaired loans	10,526	3,470	949	2,789	-	17,734
Total	<u>\$ 126,943</u>	<u>\$ 70,260</u>	<u>\$ 33,220</u>	<u>\$ 40,302</u>	<u>\$ 1,825</u>	<u>\$ 272,550</u>

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	<u>\$ 125,172</u>	<u>\$ 71,195</u>	<u>\$ 38,557</u>	<u>\$ 40,140</u>	<u>\$ 1,927</u>	<u>\$ 276,991</u>

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

March 31, 2013	Commercial Real Estate- Mortgage	Consumer Real Estate- Mortgage	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Allowance related to:						
Performing loans	\$ 872	\$ 912	\$ 222	\$ 75	\$ 10	\$ 2,091
Impaired loans	2,072	570	460	476	-	3,578
Total	<u>\$ 2,944</u>	<u>\$ 1,482</u>	<u>\$ 682</u>	<u>\$ 551</u>	<u>\$ 10</u>	<u>\$ 5,669</u>

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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
Allowance related to:						
Performing loans	\$ 319	\$ 952	\$ 781	\$ 29	\$ 14	\$ 2,095
Impaired loans	2,230	576	460	780	-	4,046
Total	<u>\$ 2,549</u>	<u>\$ 1,528</u>	<u>\$ 1,241</u>	<u>\$ 809</u>	<u>\$ 14</u>	<u>\$ 6,141</u>

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

March 31, 2013	Commercial Real Estate- Mortgage	Consumer Real Estate- Mortgage	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Beginning balance	\$ 2,549	\$ 1,528	\$ 1,241	\$ 809	\$ 14	\$ 6,141
Charged-off loans	(227)	(299)	(155)	(310)	(13)	(1,004)
Recovery of charge-offs	51	157	9	14	1	232
Provision for loan losses	571	96	(413)	38	8	300
Ending balance	<u>\$ 2,994</u>	<u>\$ 1,482</u>	<u>\$ 682</u>	<u>\$ 551</u>	<u>\$ 10</u>	<u>\$ 5,669</u>

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 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, remain properly underwritten and are 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.
- Additionally, the Bank's external loan review provider samples other loan relationships between \$100 thousand and \$500 thousand with an emphasis on commercial and commercial real estate loans and insider loans.
- The Bank's internal loan review department samples approximately 33 percent of all other loan relationships less than \$500 thousand on an annual basis for review.
- If a loan is delinquent 60 days or more or a pattern of delinquency exists, the loan will be selected for review.
- Generally, all loans on the Bank's internal watchlist are reviewed annually by internal loan review or external loan review providers.

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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.

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

March 31, 2013	Commercial Real Estate- Mortgage	Consumer Real Estate- Mortgage	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Pass	\$ 113,593	\$ 56,720	\$ 31,700	\$ 33,067	\$ 1,825	\$ 236,905
Special mention	2,352	6,888	99	4,256	-	13,595
Substandard	472	3,182	472	190	-	4,316
Substandard-impaired	9,159	3,121	489	2,789	-	15,558
Doubtful	1,367	349	460	-	-	2,176
	<u>\$ 126,943</u>	<u>\$ 70,260</u>	<u>\$ 33,220</u>	<u>\$ 40,302</u>	<u>\$ 1,825</u>	<u>\$ 272,550</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>

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

	At March 31, 2013			For the quarter ended March 31, 2013	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans without a valuation allowance:					
Commercial real estate – mortgage	\$ 5,427	\$ 5,690	\$ -	\$ 4,416	\$ 64
Consumer real estate – mortgage	2,524	2,524	-	1,518	32
Construction and land development	471	498	-	357	4
Commercial and industrial	2,045	2,102	-	2,078	9
Consumer and other	-	-	-	-	-
Total	\$ 10,467	\$ 10,814	\$ -	\$ 8,369	\$ 109
Impaired loans with a valuation allowance:					
Commercial real estate – mortgage	\$ 5,099	\$ 5,764	\$ 2,072	\$ 5,453	\$ 69
Consumer real estate – mortgage	946	946	570	1,149	12
Construction and land development	478	478	460	592	4
Commercial and industrial	744	744	476	896	20
Consumer and other	-	-	-	-	-
Total	\$ 7,267	\$ 7,932	\$ 3,578	\$ 8,090	\$ 105
Total impaired loans	\$ 17,734	\$ 18,746	\$ 3,578	\$ 16,459	\$ 214

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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
Consumer and other	-	-	-	-	-
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
Consumer and other	-	-	-	-	-
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 March 31, 2013 and December 31, 2012 (in thousands):

March 31, 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	\$ 1,371	\$ -	\$ 360	\$ 1,731	\$ 60,729	\$ 62,460
All other	498	-	2,393	2,891	61,592	64,483
Consumer real estate-mortgage	1,250	-	1,014	2,264	67,996	70,260
Construction and land development	365	-	531	896	32,324	33,220
Commercial and industrial	537	-	2,066	2,603	37,699	40,302
Consumer and other	2	-	-	2	1,823	1,825
Total	\$ 4,023	\$ -	\$ 6,364	\$ 10,387	\$ 262,163	\$ 272,550
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 March 31, 2013 and December 31, 2012, the bank has loans of approximately \$8,695,000 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 table presents a summary of loans that were modified as troubled debt restructurings during the three month period ending March 31, 2013 and 2012. (amounts in thousands):

March 31, 2013	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial real estate-mortgage	6	\$ 8,354	\$ 8,354
Consumer real estate-mortgage	3	270	270
Construction and land development	1	459	459
Commercial and industrial	5	2,432	2,432

March 31, 2012	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Consumer real estate-mortgage	3	\$ 2,893	\$ 2,331
Construction and land development	1	591	456
Commercial and industrial	1	20	20

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 the maximum exposure to credit loss, without consideration of collateral, is represented by the contractual amount of those instruments.

A summary of the Bank's total contractual amount for all off-balance sheet commitments at March 31, 2013 is as follows:

Commitments to extend credit	\$	33.4 million
Standby letters of credit	\$	3.3 million

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 March 31, 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 Disclosures" ASC Topic 820, the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

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

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

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

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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 March 31, 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.

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.

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 March 31, 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.

Foreclosed assets:

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

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Deposits:

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

Securities sold under agreements to repurchase:

The carrying amount of these liabilities approximates their estimated fair value.

Federal Home Loan Bank advances and other borrowings:

The carrying amounts of FHLB advances and other borrowings approximate their fair value.

Accrued interest:

The carrying amounts of accrued interest approximate fair value.

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

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

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

	Balance as of March 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Debt securities available for sale:				
U.S. Government agencies	\$ 3,967,001	\$ -	\$ 3,967,001	\$ -
State and municipal securities	23,362,963	-	23,362,963	-
Mortgage-backed securities:				
Residential mortgage loans guaranteed by GNMA or FNMA	8,701,228	-	8,701,228	-
Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies	55,094,637	-	55,094,637	-
Total securities available for sale	<u>\$ 91,125,829</u>	<u>\$ -</u>	<u>\$ 91,125,829</u>	<u>\$ -</u>
Cash surrender value of life insurance	<u>\$ 1,207,962</u>	<u>\$ -</u>	<u>\$ 1,207,962</u>	<u>\$ -</u>

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	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 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	39,222,759	-	39,222,759	-
Total securities available for sale	\$ 76,096,646	\$ -	\$ 76,096,646	\$ -
Cash surrender value of life insurance	\$ 1,199,725	\$ -	\$ 1,199,725	\$ -

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

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 March 31, 2013 and December 31, 2012 for which a nonrecurring change in fair value was recorded (amounts in thousands).

	Balance as of March 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Impaired loans	\$ 3,689	\$ -	\$ 3,689	\$ -
Foreclosed assets (<i>OREO & Repossessions</i>)	21,159	-	21,159	-

	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 March 31, 2013 and December 31, 2012. Losses derived from Level 2 inputs were calculated by models incorporating significant observable market data.

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

	March 31, 2013		December 31, 2012	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Assets:				
Cash and cash equivalents	\$ 35,901	\$ 35,901	\$ 59,395	\$ 59,395
Securities	91,168	91,170	76,142	76,143
Federal Home Loan Bank stock	2,323	2,323	2,323	2,323
Loans, net	266,881	267,312	270,850	271,128
Cash surrender value of life insurance	1,208	1,208	1,200	1,200
Accrued interest receivable	1,323	1,323	1,214	1,214
Liabilities:				
Noninterest-bearing demand deposits	55,400	55,400	60,054	60,054
Interest-bearing demand deposits	26,547	26,547	30,179	30,179
Savings deposits and money market accounts	89,564	89,564	80,994	80,994
Time deposits	165,391	165,641	173,654	175,177
Federal funds purchased and securities sold under agreements to repurchase	21,150	21,150	19,587	19,587
Federal Home Loan Bank advances and other borrowings	31,740	31,740	37,175	37,175
Accrued interest payable	91	91	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

(Amounts in thousands)

	Three months ended					
	March 31					
	2013			2012		
	Average Balance	Income/ Expense	Yield/ Rate	Average Balance	Income/ Expense	Yield/ Rate
Assets						
Earning assets:						
Loans, net of unearned income	\$ 275,696	\$ 4,142	6.09%	\$ 265,814	\$ 4,144	6.27%
Investment securities	86,741	440	2.35%	88,641	467	2.43%
Other earning assets	<u>33,484</u>	<u>21</u>	0.26%	<u>23,880</u>	<u>15</u>	0.25%
Total earning assets	395,921	<u>\$ 4,603</u>	4.78%	378,335	<u>\$ 4,626</u>	4.99%
Allowance for loan losses	(5,933)			(7,121)		
Cash and other assets	<u>36,838</u>			<u>37,497</u>		
TOTAL ASSETS	<u>\$ 426,827</u>			<u>\$ 408,711</u>		
Liabilities and Shareholders' Equity						
Interest-bearing liabilities:						
Interest-bearing demand deposits	\$ 28,438	\$ 20	0.29%	\$ 24,891	\$ 21	0.34%
Savings deposits	11,620	7	0.26%	9,859	10	0.40%
MMDA's	74,215	110	0.60%	39,373	90	0.92%
Time deposits	168,789	465	1.12%	195,111	699	1.44%
Federal funds purchased and securities sold under agreements to repurchase	21,090	18	0.35%	26,291	32	0.49%
Federal Home Loan Bank and other borrowings	<u>32,713</u>	<u>340</u>	4.22%	<u>42,634</u>	<u>461</u>	4.35%
Total interest-bearing liabilities	336,865	<u>962</u>	1.16%	338,159	<u>1,314</u>	1.56%
Net interest spread		<u>\$ 3,641</u>	3.62%		<u>\$ 3,312</u>	3.43%
Noninterest-bearing demand deposits	46,812			34,479		
Accrued expenses and other liabilities	2,016			486		
Shareholders' equity	<u>41,135</u>			<u>35,587</u>		
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	<u>\$ 426,827</u>			<u>\$ 408,711</u>		
Net yield on earning assets			<u>3.79%</u>			<u>3.59%</u>
Taxable equivalent adjustment:						
Loans		0			0	
Investment securities		<u>62</u>			<u>68</u>	
Total adjustment		<u>62</u>			<u>68</u>	

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS 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 March 31, 2013 and December 31, 2012 and our results of operations for the three months ended March 31, 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 Note 1 and 4 in the notes to Cornerstone's consolidated financial statements for a discussion of Cornerstone's methodology of establishing the allowance.

Estimates of Fair Value

Fair value is used on a recurring basis for certain assets and liabilities in which fair value is the primary basis of accounting. Cornerstone's available for sale securities 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 the applicable statutory tax rates. The estimated income tax expense or benefit is reported in the consolidated statements of income.

The accrued tax liability or receivable represents the net estimated amount due or to be received from tax jurisdictions either currently or in the future and 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 March 31, 2013, Cornerstone had total consolidated assets of approximately \$432 million, total loans of approximately \$273 million, total securities of approximately \$91 million, total deposits of approximately \$ 337 million and stockholders’ equity of approximately \$41 million. Net income for the three month period ended March 31, 2013 totaled \$452,128.





Results of Operations

Net income for the three months ended March 31, 2013 was \$452,128 or \$0.01 basic earnings per common share, compared to a net income of \$356,517 or \$0.01 basic earnings per common share, for the same period in 2012.

The following table presents our results for the three months ended March 31, 2013 compared to the three months ended March 31, 2012 (amounts in thousands).

	Three months ended March 31,		2013-2012	Dollar
	2013	2012	Percent Increase (Decrease)	Amount Change
Interest income	\$ 4,603	\$ 4,626	(0.50)%	\$ (23)
Interest expense	962	1,314	(26.79)%	(352)
Net interest income before provision for loan loss	3,641	3,312	9.93%	329
Provision for loan loss	300	-	100%	300
Net interest income after provision for loan loss	3,341	3,312	0.88%	29
Total noninterest income	355	267	32.96%	88
Total noninterest expense	2,976	3,074	(3.19)%	(98)
Income before income taxes	721	505	(42.77)%	216
Provision for income taxes	269	149	(80.54)%	120
Net income	\$ 452	\$ 356	(26.97)%	\$ 96

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 March 31, 2013, net interest income before the provision for loan losses, increased approximately \$329 thousand or 9.93 percent over the same period of 2012. 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 3.62 percent compared to 3.43 percent for the three month periods ended March 31, 2013 and 2012, respectively. The net interest margin on a tax equivalent basis was 3.79 percent and 3.59 percent for the three month periods ended March 31, 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 as of March 31, 2013 has been positively impacted by a reduction in interest expense of the funding of the Bank. The primary savings have been a reduction in the Federal Home Loan Bank balances and a migration of funding from certificates of deposit into transactional accounts. First quarter 2013 interest income remains stable when compared to the first quarter of 2012. While yield on earning assets decreased 0.21 percent the Bank compensated by increasing the balance of average earning assets by approximately \$17 million.
-  The Bank's loan portfolio yield decreased to 6.09 percent for the three months ended March 31, 2013 compared to 6.27 percent for the three months ended March 31, 2012. Management anticipates interest rates to continue to decrease in the loan portfolio but anticipates consistent revenue by increasing the amount of the loan portfolio.
-  For the three month period ended March 31, 2013, the Bank was successful in maintaining an investment portfolio yield of 2.35 percent compared to 2.43 percent for the same time period in 2012. This was accomplished primarily by the Bank's stable municipal bond portfolio and floating rate instruments that are at the floor of their interest rate structure. The Bank decreased the amount of its investment portfolio to an average balance of approximately \$87 million as of March 31, 2013 from approximately \$89 million as of March 31, 2012. Management believes the present level of investment securities is sufficient to provide for all pledging needs and represents an appropriate amount of the balance sheet to provide liquidity and interest rate protection.
-  The Bank's net interest margin increased from March 31, 2012 to March 31, 2013 by 20 basis points. The majority of the increase is due to reduced interest expense relating to fewer FHLB borrowings and a migration from certificates of deposit to transactional accounts. Management believes that the balance sheet will remain at the present level or increase slightly and expects to see a conversion of cash into loans which should increase the Bank's net interest margin.


Provision for Loan Losses -The provision for loan losses represents a charge to earnings necessary to establish an allowance for loan losses that, in management's evaluation, should be adequate to provide coverage for the inherent losses on outstanding loans. Cornerstone recorded \$300 thousand in provision for loan losses for the three months ended March 31, 2013. Cornerstone did not record provision for loan losses for the three months ended March 31, 2012.


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 months ended March 31, 2013 and 2012 (dollars in thousands):

	Three months ended		2013-2012
	March 31, 2013	March 31, 2012	Percent Increase (Decrease)
Service charges on deposit accounts	\$ 188	\$ 197	(4.57)%
Net gains on sale of loans and other assets	149	50	198.%
Other noninterest income	18	20	(10.00)%
Total noninterest income	<u>\$ 355</u>	<u>\$ 267</u>	<u>32.96%</u>

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

 The Bank continues to experience a slight decrease in its service charges on deposit accounts during 2013 due to a continued reduction in customer overdraft charges.


 During the first quarter of 2013, the Bank recorded a \$100 thousand fee from the sale of a Small Business Administration (“SBA”) 7A loan. The Bank expects to continue originating SBA 7A loans and estimates loan fees from the sale of future loans during 2013 to be approximately \$250 thousand.


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 months ended March 31, 2013 and 2012 (dollars in thousands).

	Three months ended		2013-2012
	March 31, 2013	March 31, 2012	Percent Increase (Decrease)
Salaries and employee benefits	\$ 1,597	\$ 1,591	0.38%
Occupancy and equipment expense	338	336	0.60%
Foreclosed assets expense, net	129	150	(14.00)%
FDIC depository insurance	160	203	(21.18)%
Other operating expense	752	794	(5.29)%
Total noninterest expense	<u>\$ 2,976</u>	<u>\$ 3,074</u>	<u>(3.19)%</u>

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

 Cornerstone employee expense remained stable during the first quarter of 2013. The Bank does intend to hire additional sales staff but does not expect a material increase in salaries and benefits during 2013.

 As of March 31, 2013, the Bank had incurred \$7 thousand in write-down of other real estate and repossessed assets. The Bank incurred approximately \$122 thousand in net carrying cost for its foreclosed assets during the first quarter of 2013. A majority of the incremental expense was due to maintenance and repairs of the existing properties. Management anticipates a total of \$1.2 million of expense and write-downs on its foreclosed assets during 2013. Management nets the expense and write-downs of other real estate owned against the income generated from income producing real estate to calculate net foreclosed asset expense.

 Depository insurance decreased from approximately \$203 thousand as of March 31, 2012 to approximately \$160 thousand as of March 31, 2013. Management anticipates the FDIC expense to reduce further as the Bank’s regulatory status improves.

Financial Condition

Overview- Cornerstone's consolidated assets totaled approximately \$443 million as of December 31, 2012. As of March 31, 2013, total consolidated assets had decreased approximately \$11 million or 2.48 percent to approximately \$432 million.

Liabilities as of March 31, 2013 and December 31, 2012 totaled approximately \$391 million and \$403 million, respectively.


Stockholders' equity as of March 31, 2013 and December 31, 2012 totaled approximately \$41 million.

Securities- The Bank's investment portfolio, primarily consisting of Ginnie Mae Agency, mortgage-backed securities and municipal securities, amounted to approximately \$91 million as of March 31, 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, collateralize the Bank's repurchase accounts and secure the Bank's FHLB borrowings.

*Loans -*The composition of loans at March 31, 2013 and at December 31, 2012 and the percentage (%) of each classification to total loans are summarized in the following table (dollars in thousands):

	March 31, 2013		December 31, 2012	
	Amount	Percent	Amount	Percent
Commercial real estate-mortgage				
Owner-occupied	\$ 62,460	22.91%	\$ 58,425	21.09%
All other	64,483	23.66%	66,747	24.10%
Consumer real estate-mortgage	70,260	25.78%	71,195	25.70%
Construction and land development	33,220	12.19%	38,557	13.92%
Commercial and industrial	40,302	14.79%	40,140	14.49%
Consumer and other	1,825	0.67%	1,927	0.70%
Total loans	272,550	100.00%	276,991	100.00%
Less: Allowance for loan losses	(5,669)		(6,141)	
Loans, net	<u>\$ 266,881</u>		<u>\$ 270,850</u>	

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 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 first quarter of 2013, the Bank recorded \$300 thousand in provision expense to the loan loss allowance. Management also elected to change its historic loan loss analysis to incorporate a two and half year look-back period for loan charge-offs and recoveries. Previously, the Bank had used a one year look-back period in its loan loss allowance. The change was made to more accurately compare the Bank's history of loan losses and recoveries to the possible future loan losses and recoveries. 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 three months ended March 31, 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 (dollars in thousands):

	March 31, 2013	December 31, 2012
Balance, beginning of period	\$ 6,141	\$ 7,400
Loans charged-off	(1,004)	(2,869)
Recoveries of loans previously charged-off	232	1,180
Provision for loan losses	300	430
Balance, end of period	<u>\$ 5,669</u>	<u>\$ 6,141</u>
Total loans	\$ 272,550	\$ 276,991
Ratio of allowance for loan losses to loans outstanding at the end of the period	2.08%	2.22%
Ratio of net charge-offs to total loans outstanding for the period	0.28%	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 Bank has experienced a stabilization in its loan quality as the Chattanooga, Tennessee Metropolitan Statistical Area begins to recover from a long economic downturn. The number and dollar amount of impaired loans remained consistent during the first quarter of 2013. Management anticipates that its loan asset quality will improve as the economy recovers from the current economic recession.

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

	March 31, 2013	December 31, 2012	September 30, 2012	June 30, 2012
Non-accrual loans	\$ 6,364	\$ 6,005	\$ 7,971	\$ 7,124
Foreclosed assets	21,159	20,332	22,376	22,144
Total non-performing assets	<u>\$ 27,523</u>	<u>\$ 26,337</u>	<u>\$ 30,347</u>	<u>\$ 29,268</u>
30-89 days past due loans	\$ 4,023	\$ 6,594	\$ 3,819	\$ 2,495
Total loans outstanding	\$ 272,550	\$ 276,991	\$ 273,820	\$ 263,749
Allowance for loan losses	5,669	6,141	5,280	6,029
Ratio of non-performing loans to total loans outstanding at the end of the period	<u>2.33%</u>	<u>2.17%</u>	<u>2.91%</u>	<u>2.70%</u>
Ratio of non-performing assets to total allowance for loan losses at the end of the period	<u>485.50%</u>	<u>428.87%</u>	<u>574.75%</u>	<u>485.45%</u>

☐ The Bank's non-accrual balances decreased dramatically during the first quarter of 2013 compared to the first quarter of 2012. 30-89 days past due loans also declined in the first quarter of 2013 when compared to the first quarter of 2012.

☐ Management believes non-accrual loans will continue to decrease during the remainder of 2013 and expects to charge-off loans of \$2-3 million to reduce the outstanding balances on several large impaired loans that are fully provided for in the Bank's current allowance for loan losses. As a result, management does not anticipate a negative impact to the Bank's earnings.

☐ The Bank's foreclosed assets remained constant at approximately \$21 million as of March 31, 2013. The Bank has seen an improvement in the level of interest in its properties by potential buyers. Management is targeting a reduction in foreclosed asset levels by approximately \$6 million during the remainder of 2013.

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).

	March 31, 2013		December 31, 2012	
	Amount	Percent	Amount	Percent
Core funding:				
Noninterest-bearing demand deposits	\$ 55,400	14.3%	\$ 60,054	15.0%
Interest-bearing demand deposits	26,457	6.8%	30,179	7.6%
Savings & money market accounts	89,564	23.1%	80,994	20.3%
Time deposits under \$100,000	83,751	21.6%	85,917	21.5%
Total core funding	255,172	65.8%	257,144	64.4%
Non-core funding:				
Time deposit of \$100,000 or more	\$ 81,640	21.0%	\$ 87,737	22.0%
Fed funds purchased and securities sold under agreements to repurchase	21,150	5.5%	19,587	4.9%
Federal Home Loan Bank advances	30,000	7.7%	35,000	8.7%
Total non-core funding	132,790	34.2%	142,324	35.6%
Total	\$ 387,962	100.0%	\$ 399,468	100.0%

The Bank has seen a significant improvement in its liability structure since the beginning of 2011 as the percentage of core non-term deposits increased greatly year over year. The Bank will continue to see a reduction in its Federal Home Loan Bank advances during 2013.

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

The following is a summary of the Bank's capital ratios as of March 31, 2013:

Tier 1 leverage ratio	8.56%
Tier 1 risk-based capital ratio	12.07%
Total risk-based capital ratio	13.32%

Cornerstone has requested permission from the Federal Reserve Bank of Atlanta (the "Federal Reserve") to pay its scheduled December 31, 2012 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.

Cornerstone had other borrowings of approximately \$1.7 million as of March 31, 2013.

Market and Liquidity Risk Management

Interest Rate Sensitivity

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

Earnings at Risk Model

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

Economic Value of Equity

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

Liquidity Analysis

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

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

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

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

Leverage Analysis

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

Balance Sheet Analytics

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

Liquidity Risk Management

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

A comprehensive qualitative and quantitative analysis regarding market risk was disclosed in Cornerstone's Annual Report on Form 10-K for the year ended December 31, 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 March 31, 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 March 31, 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 6. Exhibits

<u>Exhibit Number</u>	<u>Description</u>
10.1	Loan agreement dated March 27, 2013 between Cornerstone and First Tennessee National Association.
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: May 15, 2013

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

Date: May 15, 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 supervision to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the Registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the Registrant’s internal control over financial reporting that occurred during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Registrant’s internal control over financial reporting; and
5. The Registrant’s other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant’s auditors and the audit committee of Registrant’s board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant’s ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant’s internal control over financial reporting.

Date: May 15, 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 supervision to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the Registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the Registrant’s internal control over financial reporting that occurred during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Registrant’s internal control over financial reporting; and
5. The Registrant’s other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant’s auditors and the audit committee of Registrant’s board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant’s ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant’s internal control over financial reporting.

Date: May 15, 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 March 31, 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)
May 15, 2013

/s/ Gary W. Petty, Jr.

Gary W. Petty, Jr.
Executive Vice President and Chief Financial Officer
(principal financial officer and accounting officer)
May 15, 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.]
