

FORM 10-K

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

For the fiscal year ended December 31, 2014

OR

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

For transition period from _____ to _____

Commission file number 000-30497



(Exact Name of Registrant as Specified in its Charter)

Tennessee

(State of Incorporation)

62-1173944

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

835 Georgia Avenue,
Chattanooga, TN 37402

(Address of principal executive offices)(Zip Code)

(423) 385-3000

(Registrant's telephone number, including area code)

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

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

Indicate by check mark if Registrant is a well known seasoned issuer, as defined in Rule 405 of the of the Securities Act.

Yes No

Indicate by check mark if Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.

Yes No

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 and 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 whether the Registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files).

Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (229.405 of this chapter) is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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.

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

The aggregate market value of the common stock held by non-affiliates of the Registrant on June 30, 2014 was \$13 million. The market value calculation was determined using the closing sale price of the Registrant's common stock on June 30, 2014, as reported on the OTC Bulletin

Board. For purposes of this calculation, the term “affiliate” refers to all directors, executive officers and 10% shareholders of the Registrant. As of the close of business on December 31, 2014, there were 6,627,398 shares of the Registrant’s common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

None

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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 7), 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 this Annual Report on Form 10-K, as well as the following: (i) the possibility that our asset quality would decline or that we experience greater loan losses than anticipated, (ii) high levels of other real estate, primarily as a result of foreclosures, (iii) the impact of liquidity needs on our results of operations and financial condition, (iv) competition from financial institutions and other financial service providers, (v) economic conditions in the local markets where we operate, (vi) the impact of obtaining regulatory approval prior to the payment of dividends, (vii) the impact of our Series A Preferred Stock on net income available to holders of our Common Stock and earnings per common share, (viii) the impact of negative developments in the financial industry and U.S. and global capital and credit markets, (ix) the impact of recently enacted legislation on our business, (x) the relatively greater credit risk of residential construction and land development loans in our loan portfolio, (xi) adverse impact on operations and financial condition of changes in interest rates, (xii) our ability to obtain additional capital and, if obtained, the possible significant dilution to current shareholders, (xiii) the impact of federal and state regulations on our operations and financial performance, (xiv) whether a significant deferred tax asset we have can be fully realized, (xv) our ability to retain the services of key personnel, (xvi) the impact of Tennessee’s anti-takeover statutes and certain charter and bylaw provisions on potential acquisitions of the holding company, (xvii) our ability to adapt to technological changes, and (xviii) the impact of business combinations. 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.

PART I

ITEM 1. BUSINESS

OVERVIEW

Cornerstone was incorporated on September 19, 1983, under the laws of the State of Tennessee. Cornerstone is a bank holding company registered under the Bank Holding Company Act of 1956, as amended, and was formerly known as East Ridge Bancshares, Inc. It has one wholly-owned subsidiary: Cornerstone Community Bank, a Tennessee banking corporation (the “Bank”), which resulted from the merger of The Bank of East Ridge and Cornerstone Community Bank effective October 15, 1997. The Bank owned and operated a subsidiary, Eagle Financial, Inc. (“Eagle”), a finance and factoring company. On December 1, 2011, the Bank elected to transfer the operations, assets and liabilities of Eagle into the Bank. The transfer allowed the Bank to combine the operations of Eagle with the Bank’s asset based lending department. As a result, the Bank formed Eagle Financial, a division of Cornerstone Community Bank. The Bank maintains the existence of this subsidiary in an inactive status.

Cornerstone

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

On December 8, 2014, Cornerstone announced the signing of a definitive agreement to merge with SmartFinancial, Inc., which would create a combined company that will operate under the name SmartFinancial, Inc. Under the terms of the agreement, each outstanding share of common stock of SmartFinancial will be converted into 4.20 shares of Cornerstone common stock, subject to adjustment based on an anticipated reverse stock split of Cornerstone’s common stock, which is expected to adjust the ratio to 1.05 shares of Cornerstone common stock for each share of SmartFinancial common stock. Additionally, each outstanding share of SmartFinancial preferred stock will be converted into a share of Cornerstone preferred stock with similar rights and preferences. Current holders of Cornerstone’s preferred stock will be asked to vote on an amendment to Cornerstone’s charter to allow Cornerstone to redeem its outstanding preferred stock prior to the completion of the merger. Completion of the merger is subject to a number of conditions, including approval by bank regulatory authorities and both SmartFinancial’s and Cornerstone’s shareholders.

The Bank

The Bank is a Tennessee-chartered commercial bank established in 1985 which has its principal executive offices in Chattanooga, Tennessee. The principal business of the Bank consists of attracting deposits from the general public and investing those funds, together with funds generated from operations and from principal and interest payments on loans, primarily in commercial loans, commercial and residential real estate loans, consumer loans and residential and commercial construction loans. Funds not invested in the loan portfolio are invested by the Bank primarily in obligations of the U.S. Government, U.S. Government agencies, and various states and their political subdivisions. In addition to deposits, sources of funds for the Bank’s loans and other investments include amortization and prepayment of loans, sales of loans or participations in loans, sales of its investment securities and borrowings from other financial institutions. The principal sources of income for the Bank are interest and fees collected on loans, fees collected on deposit accounts and interest and dividends collected on other investments. The principal expenses of the Bank are interest paid on deposits, employee compensation and benefits, office expenses and other overhead expenses.

At December 31, 2014, the Bank had five full-service banking offices located in Hamilton County, Tennessee and one loan production office located in Dalton, Georgia.

Eagle Financial, a Division of Cornerstone Community Bank

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

Employees

As of December 31, 2014, Cornerstone had 104 full-time equivalent employees. The employees are not represented by a collective bargaining unit. Cornerstone believes that its relationship with its employees is good.

Competition

All phases of the Bank's banking activities are highly competitive. The Bank competes actively with over 20 commercial banks, as well as finance companies, credit unions, and other financial institutions located in its service area, which includes Hamilton County, Tennessee.

The Bank's deposits totaled approximately \$309 million as of December 31, 2014. The deposit base represents approximately 4% of the deposit base in the Chattanooga, Tennessee Metropolitan Statistical Area (MSA). Three major regional banks represent approximately 57% of the deposits in the Chattanooga, Tennessee MSA. These larger financial institutions have greater resources and higher lending limits than the Bank, and each of the three institutions has over 20 branches in the Chattanooga, Tennessee MSA. There are also several credit unions located in Hamilton County, Tennessee. Credit unions are not subject to the same income tax structure as commercial banks. This advantage enables credit unions to offer competitive rates to potential customers. The Bank also faces competition in certain areas of its business from mortgage banking companies, consumer finance companies, insurance companies, money market mutual funds and investment banking firms, some of which are not subject to the same degree of regulation as the Bank.

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

Supervision and Regulation

Cornerstone and the Bank are subject to state and federal banking laws and regulations that impose specific requirements and restrictions and provide for general regulatory oversight over virtually all aspects of our operations. These laws and regulations generally are intended to protect depositors, not shareholders. The following discussion is only a general summary of some of the more significant statutory and regulatory provisions. This summary is qualified by reference to the particular statutory and regulatory provisions. Any change in applicable laws or regulations may have a material effect on our business and prospects.

General

Cornerstone is a bank holding company within the meaning of the Bank Holding Company Act of 1956, as amended (the "Act"), and is registered with and regulated by the Board of Governors of the Federal Reserve System (the "Federal Reserve Board"). Cornerstone is required to file with the Federal Reserve Board annual reports and such additional information as the Federal Reserve Board may require pursuant to the Act. The Federal Reserve Board may also make examinations of Cornerstone and its subsidiary.

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

Federal and state banking laws and regulations govern all areas of the operations of Cornerstone and the Bank, including reserves, loans, mortgages, capital, issuance of securities, payment of dividends and establishment of branches. Federal and state banking agencies also have the general authority to limit the dividends paid by insured banks if such payments should be deemed to constitute an unsafe or unsound banking practice. In accordance with and as a result of the exercise of this general authority, the Bank is currently prohibited from paying dividends without prior regulatory approval. The TDFI, FDIC and Federal Reserve Board have the authority to impose penalties, initiate civil and administrative actions and take other steps intended to prevent banks from engaging in unsafe or unsound practices.

On April 2, 2010, the Bank entered into a Stipulation to the Issuance of a Consent Order (the “Stipulation”) with the FDIC. Pursuant to the Stipulation, the Bank consented, without admitting or denying any charges of unsafe or unsound banking practices or violations of law or regulations, to the issuance of a Consent Order (the “Order”) by the FDIC, also effective as of April 2, 2010. On April 8, 2010, the Bank also executed a written agreement (the “Agreement”) with the TDFI.

The Order and the Agreement (collectively, the “Action Plans”) contained substantially similar terms and were based on the findings of the FDIC and TDFI during their joint examination of the Bank commenced on October 8, 2009 (the “Examination”), as disclosed in the Joint Report of Examination (the “Report”). The Order and the Agreement represented agreements between the Bank, on the one hand, and the FDIC and the TDFI, respectively, on the other hand, as to areas of the Bank’s operations that warranted improvement and presented plans for making those improvements. The Action Plans imposed no fines or penalties on the Bank.

The Action Plans required the Bank to implement several governance, budgeting, credit management, risk management and reporting procedures. The Bank substantially complied with the terms of the Action Plans. As a result, on August 17, 2012, the FDIC and the TDFI issued written confirmation to the Bank’s Board of Directors that the Action Plans had been terminated. Some of the procedures established by the Action Plans, however, remain in place, including the requirement for approval by the Regional Director of the FDIC and the Commissioner of the TDFI of any dividends declared or paid by the Bank to Cornerstone.

Cornerstone received a letter dated March 30, 2010, from its primary banking regulator, the Federal Reserve Bank of Atlanta (the “FRBA”), directing Cornerstone to obtain the FRBA’s written approval before Cornerstone (i) incurs any indebtedness; (ii) declares or pays any dividends; (iii) redeems any corporate stock; or (iv) makes any other payment representing a reduction in its capital, except for the payment of normal and routine operating expenses. As required by the letter, Cornerstone continues to seek and receive the FRBA’s approval for payment of dividends on its preferred stock. To date, Cornerstone is in compliance with the requirements of the FRBA letter.

The most significant impact of the FRBA’s letter relates to the payment of dividends on Cornerstone’s preferred stock. However, Cornerstone has been able to consistently raise additional capital and the company generated positive earnings during 2013 and 2014. These two elements coupled with the Bank’s stabilization of asset quality have, in Cornerstone’s estimation, led to the approval of dividend payments on the preferred stock.

FDIC Insurance of Deposit Accounts

The FDIC insures the deposit accounts of the Bank up to the maximum amount provided by law. The general insurance limit is \$250,000. The FDIC assesses deposit insurance premiums on each insured institution quarterly based on annualized rates for one of four risk categories. Under the rules in effect through March 31, 2011, these rates were applied to the institution’s deposits. Each institution was assigned to one of four risk categories based on its capital, supervisory ratings and other factors. Well capitalized institutions that are financially sound with only a few minor weaknesses were assigned to Risk Category I. Risk Categories II, III and IV presented progressively greater risks to the DIF. A range of initial base assessment rates applied to each risk category, subject to adjustments based on an institution’s unsecured debt, secured liabilities and brokered deposits.

As required by the Dodd-Frank Act, the FDIC adopted rules effective April 1, 2011, under which insurance premium assessments are based on an institution’s total assets minus its tangible equity (defined as Tier 1 capital) instead of its deposits. Under these rules, an institution with total assets of less than \$10 billion is assigned to a risk category as described above, and a range of initial base assessment rates apply to each category, subject to adjustment downward based on unsecured debt issued by the institution and, except for an institution in Risk Category I, adjustment upward if the institution’s brokered deposits exceed 10% of its domestic deposits, to produce total base assessment rates. Total base assessment rates range from 2.5 to 9 basis points for Risk Category I, 9 to 24 basis points for Risk Category II, 18 to 33 basis points for Risk Category III, and 30 to 45 basis points for Risk Category IV, all subject to further adjustment upward if the institution holds more than a de minimis amount of unsecured debt issued by another FDIC-insured institution. The FDIC may increase or decrease its rates by 2 basis points without further rulemaking. In an emergency, the FDIC may also impose a special assessment.

Pursuant to the Dodd-Frank Act, the FDIC has established 2.0% as the designated reserve ratio (“DRR”), which is the ratio of the DIF to insured deposits. The FDIC has adopted a plan under which it will meet the statutory minimum DRR of 1.35% by September 30, 2020, the deadline imposed by the Dodd-Frank Act. The Dodd-Frank Act requires the FDIC to offset the effect of the increase in the statutory minimum DRR to 1.35% on institutions with assets of less than \$10 billion from the former statutory minimum of 1.15%.

The FDIC also collects a deposit-based assessment from insured financial institutions on behalf of the Financing Corporation (the “FICO”). The funds from these assessments are used to service debt issued by FICO in its capacity as a financial vehicle for the Federal Savings & Loan Insurance Corporation. The FICO assessment rate is set quarterly. In 2014, it was 0.62 cents per \$100 of assessable deposits. These assessments will continue until the debt matures in 2017 through 2019.

State of Tennessee Supervision and Regulation

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

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

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

Federal Supervision and Regulation

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

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

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

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

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

Specific Legislation Affecting Cornerstone and the Bank

The following information summarizes certain statutory and regulatory provisions affecting Cornerstone and the Bank and is qualified in its entirety by reference to such statutory and regulatory provisions.

FIRREA and FDICIA

Far-reaching legislation, including the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA") and the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") have for years impacted the business of banking. FIRREA primarily affected the regulation of savings institutions rather than the regulation of commercial banks and bank holding companies like the Bank and Cornerstone, but did include provisions affecting deposit insurance premiums, acquisitions of thrifts by banks and bank holding companies, liability of commonly controlled depository institutions, receivership and conservatorship rights and procedures and substantially increased penalties for violations of banking statutes, regulations and orders.

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

The additional supervisory powers and regulations mandated by FDICIA include a "prompt corrective action" program based upon five regulatory zones for banks, in which all banks are placed largely based on their capital positions. Regulators are permitted to take increasingly harsh action as a bank's financial condition declines. Regulators are also empowered to place in receivership or require the sale of a bank to another depository institution when a bank's ratio of tangible equity to total assets reaches two percent. Better capitalized institutions are generally subject to less onerous regulation and supervision than banks with lesser amounts of capital.

Various other sections of the FDICIA impose substantial audit and reporting requirements and increase the role of independent accountants and outside directors. Set forth below is a list containing certain other significant provisions of the FDICIA:

- annual on-site examinations by regulators (except for smaller, well-capitalized banks with high management ratings, which must be examined every 18 months);

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

Capital Regulations

The federal bank regulatory authorities have adopted risk-based capital guidelines for banks that are designed to make regulatory capital requirements more sensitive to differences in risk profiles among banks and account for off-balance sheet items. The guidelines are minimums, and the federal regulators have noted that banks contemplating significant expansion programs should not allow expansion to diminish their capital ratios and should maintain such ratios in excess of the minimums.

In December 2010, the Basel Committee on Banking Supervision (“BCBS”), an international forum for cooperation on banking supervisory matters, announced the “Basel III” capital standards, which substantially revised the existing capital requirements for banking organizations. On July 2, 2013, the Federal Reserve adopted a final rule for the Basel III capital framework and, on July 9, 2013, the OCC also adopted a final rule and the FDIC adopted the same provisions in the form of an “interim” final rule. The rule applies to all national and state banks and savings associations and most bank holding companies and savings and loan holding companies, which we collectively refer to herein as “covered” banking organizations. Bank holding companies with less than \$500 million in total consolidated assets are not subject to the final rule, nor are savings and loan holding companies substantially engaged in commercial activities or insurance underwriting. In certain respects, the rule imposes more stringent requirements on “advanced approaches” banking organizations, which are those organizations with \$250 billion or more in total consolidated assets, \$10 billion or more in total foreign exposures, or that have opted in to the Basel II capital regime. The requirements in the rule began to phase in on January 1, 2014, for advanced approaches banking organizations, and began to phase in on January 1, 2015 for other covered banking organizations. The requirements in the rule will be fully phased in by January 1, 2019.

The rule imposes higher risk-based capital and leverage requirements than those previously in place. Specifically, the rule imposes the following minimum capital requirements:

- a new common equity Tier 1 risk-based capital ratio of 4.5%;
- a Tier 1 risk-based capital ratio of 6% (increased from the current 4% requirement);
- a total risk-based capital ratio of 8% (unchanged from current requirements);
- a leverage ratio of 4%; and
- a new supplementary leverage ratio of 3% applicable to advanced approaches banking organizations, resulting in a leverage ratio requirement of 7% for such institutions.

Under the rule, Tier 1 capital is redefined to include two components: common equity Tier 1 capital and additional Tier 1 capital. The new and highest form of capital, common equity Tier 1 capital, consists solely of common stock (plus related surplus), retained earnings, accumulated other comprehensive income, and limited amounts of minority interests that are in the form of common stock. Additional Tier 1 capital includes other perpetual instruments historically included in Tier 1 capital, such as noncumulative perpetual preferred stock. The rule permits bank holding companies with less than \$15 billion in total consolidated assets to continue to include trust preferred securities and cumulative perpetual preferred stock issued before May 19, 2010 in Tier 1 capital, but not in common equity Tier 1 capital, subject to certain restrictions. Tier 2 capital consists of instruments that previously qualified as Tier 2 capital plus instruments that the rule has disqualified from Tier 1 capital treatment.

In addition, in order to avoid restrictions on capital distributions or discretionary bonus payments to executives, a covered banking organization must maintain a “capital conservation buffer” on top of its minimum risk-based capital requirements. This buffer must consist solely of Tier 1 common equity, but the buffer applies to all three measurements (common equity Tier 1, Tier 1 capital and total capital). The capital conservation buffer will be phased in incrementally over time, becoming fully effective on January 1, 2019, and will consist of an additional amount of common equity equal to 2.5% of risk-weighted assets.

The prior capital rules required certain deductions from or adjustments to capital. The final rule retains many of these deductions and adjustments and also provides for new ones. As a result, deductions from common equity Tier 1 capital will be required for goodwill (net of associated deferred tax liabilities), intangible assets such as non-mortgage servicing assets and purchased credit card relationships (net of associated deferred tax liabilities), deferred tax assets that arise from net operating loss and tax credit carryforwards (net of any related valuations allowances and net of deferred tax liabilities), any gain on sale in connection with a securitization exposure, any defined benefit pension fund net asset (net of any associated deferred tax liabilities) held by a bank holding company (this provision does not apply to a bank or savings association), the aggregate amount of outstanding equity investments (including retained earnings) in financial subsidiaries, and identified losses. Other deductions will be necessary from different levels of capital.

Additionally, the final rule provides for the deduction of three categories of assets: (i) deferred tax assets arising from temporary differences that cannot be realized through net operating loss carrybacks (net of related valuation allowances and of deferred tax liabilities), (ii) mortgage servicing assets (net of associated deferred tax liabilities) and (iii) investments in more than 10% of the issued and outstanding common stock of unconsolidated financial institutions (net of associated deferred tax liabilities). The amount in each category that exceeds 10% of common equity Tier 1 capital must be deducted from common equity Tier 1 capital. The remaining, nondeducted amounts are then aggregated, and the amount by which this total amount exceeds 15% of common equity Tier 1 capital must be deducted from common equity Tier 1 capital. Amounts of minority investments in consolidated subsidiaries that exceed certain limits and investments in unconsolidated financial institutions may also have to be deducted from the category of capital to which such instruments belong.

Accumulated other comprehensive income (AOCI) is presumptively included in common equity Tier 1 capital and often would operate to reduce this category of capital. The final rule provides a one-time opportunity at the end of the first quarter of 2015 for covered banking organizations to opt out of much of this treatment of AOCI. The final rule also has the effect of increasing capital requirements by increasing the risk weights on certain assets, including high volatility commercial real estate, mortgage servicing rights not includable in common equity Tier 1 capital, equity exposures, and claims on securities firms, that are used in the denominator of the three risk-based capital ratios.

Prompt Corrective Action

As an insured depository institution, the Bank is required to comply with the capital requirements promulgated under the Federal Deposit Insurance Act and the regulations under it, which set forth five capital categories, each with specific regulatory consequences. Beginning January 1, 2015, the minimum capital levels for each prompt corrective action category were enhanced pursuant to recently adopted new capital regulations, described above under “Capital Regulations”. The following is a list of the newly revised criteria (as currently in effect) for each prompt corrective action category:

- *Well Capitalized* - A well-capitalized institution:
 - has total risk-based capital ratio of 10% or greater;
 - has a Tier 1 risk-based capital ratio of 8% or greater;
 - has a common equity Tier 1 risk-based ratio of 6.5% or greater; and
 - has a Tier 1 leverage ratio of 5% or greater.
- *Adequately Capitalized* - An adequately capitalized institution:
 - has a total risk-based capital ratio of 8% or greater;
 - has a Tier 1 risk-based capital ratio of 6% or greater;
 - has a common equity Tier 1 risk-based capital ratio of 4.5% or greater;
 - has a Tier 1 leverage ratio of 4% or greater; and
 - does not meet the definition of a well capitalized bank.
- *Undercapitalized* – An undercapitalized institution:
 - has total risk-based capital ratio of less than 8%;
 - has a Tier 1 risk-based capital ratio of less than 6%;
 - has a common equity Tier 1 risk-based capital ratio of less than 4.5%; or
 - has a Tier 1 leverage ratio of less than 4%.
- *Significantly Undercapitalized* - A significantly undercapitalized institution:
 - has a total risk-based capital ratio of less than 6%;
 - has a Tier 1 risk-based capital ratio of less than 4%;
 - has a common equity Tier 1 risk-based capital ratio of less than 3%; or
 - has a Tier 1 leverage ratio of less than 3%.
- *Critically Undercapitalized* - A critically undercapitalized institution has a ratio of tangible equity to total assets that is equal to or less than 2%.

If the FDIC determines, after notice and an opportunity for hearing, that an institution is in an unsafe or unsound condition, the FDIC is authorized to reclassify the institution to the next lower capital category (other than critically undercapitalized) and require the submission of a plan to correct the unsafe or unsound condition.

If the institution is not well capitalized, it cannot accept brokered deposits without prior FDIC approval. Even if approved, rate restrictions will govern the rate the institution may pay on the brokered deposits. In addition, a bank that is undercapitalized cannot offer an effective yield in excess of 75 basis points over the “national rate” paid on deposits (including brokered deposits, if approval is granted for the bank to accept them) of comparable size and maturity. The “national rate” is defined as a simple average of rates paid by insured depository institutions and branches for which data are available and is published weekly by the FDIC. Institutions subject to the restrictions that believe they are operating in an area where the rates paid on deposits are higher than the “national rate” can use the local market to determine the prevailing rate if they seek and receive a determination from the FDIC that it is operating in a high-rate area. Regardless of the determination, institutions must use the national rate to determine conformance for all deposits outside their market areas.

If the institution becomes less than adequately capitalized, it must adopt a capital restoration plan acceptable to the FDIC. The institution also would become subject to increased regulatory oversight, and is increasingly restricted in the scope of its permissible activities. Each company having control over an undercapitalized institution also must provide a limited guarantee that the institution will comply with its capital restoration plan. Except under limited circumstances consistent with an accepted capital restoration plan, an undercapitalized institution may not grow. An undercapitalized institution may not acquire another institution, establish additional branch offices or engage in any new line of business unless it is determined by the appropriate federal banking agency to be consistent with an accepted capital restoration plan, or unless the FDIC determines that the proposed action will further the purpose of prompt corrective action. The appropriate federal banking agency may take any action authorized for a significantly undercapitalized institution if an undercapitalized institution fails to submit an acceptable capital restoration plan or fails in any material respect to implement a plan accepted by the agency. A critically undercapitalized institution is subject to having a receiver or conservator appointed to manage its affairs and the loss of its charter to conduct banking activities.

An insured depository institution may not pay a management fee to a bank holding company controlling that institution or any other person having control of the institution if, after making the payment, the institution would be undercapitalized. In addition, an institution cannot make a capital distribution, such as a dividend or other distribution that is in substance a distribution of capital, to the owners of the institution if following such a distribution the institution would be undercapitalized.

Gramm-Leach-Bliley Act

The activities permissible to Cornerstone and the Bank were substantially expanded by the Gramm-Leach-Bliley Act of 1999 (the “Gramm Act”). The Gramm Act repealed the anti-affiliation provisions of the Glass-Steagall Act to permit the common ownership of commercial banks, investment banks and insurance companies. The Gramm Act amended the Act to permit a financial holding company to engage in any activity and acquire and retain any company that the Federal Reserve Board determines to be (i) financial in nature or incidental to such financial activity, or (ii) complementary to a financial activity and that does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. The Gramm Act also modified existing law relating to financial privacy and community reinvestment. The new financial privacy provisions generally prohibit financial institutions, including the Bank and Cornerstone, from disclosing nonpublic personal financial information to third parties unless customers have the opportunity to “opt out” of the disclosure.

The Dodd-Frank Act

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”). The impact of the Dodd-Frank Act on the financial services industry will be broad, with enhanced regulatory oversight and compliance, including, among other things, (i) enhanced resolution authority of troubled and failing banks and their holding companies; (ii) increased capital and liquidity requirements; (iii) increased regulatory examination fees; (iv) changes to assessments to be paid to the FDIC for federal deposit insurance; and (v) numerous other provisions designed to improve supervision and oversight of, and strengthening safety and soundness for, the financial services sector. In addition, the Dodd-Frank Act established a new framework for systemic risk and oversight in the industry which has resulted and will continue to result in sweeping changes in the regulation of financial institutions aimed at strengthening safety and soundness for the financial services sector. A summary of certain provisions of the Dodd-Frank Act is set forth below:

- *Increased Capital Standards and Enhanced Supervision* . The federal banking agencies were required to establish minimum leverage and risk-based capital requirements for banks and bank holding companies (see “Capital Regulations” above). The Dodd-Frank Act also increases regulatory oversight, supervision and examination of banks, bank holding companies and their respective subsidiaries by the appropriate regulatory agency.

- *Federal Deposit Insurance* . The Dodd-Frank Act made permanent the \$250,000 deposit insurance limit for insured deposits. The Dodd-Frank Act also changed the assessment base for federal deposit insurance from the amount of insured deposits to consolidated assets less tangible equity, eliminated the ceiling on the size of the DIF and increased the floor of the size of the DIF.
- *The Consumer Financial Protection Bureau (“Bureau”)* . The Dodd-Frank Act centralized responsibility for consumer financial protection by creating a new agency, the Bureau, responsible for implementing, examining and, for large financial institutions (i.e., those with more than \$10 billion in assets), enforcing compliance with federal consumer financial laws. The Bureau has broad rulemaking, supervisory and enforcement authority over consumer financial products and services, including deposit products, residential mortgages, home-equity loans and credit cards. On July 21, 2011, the Dodd-Frank Act transferred the responsibility for implementation of a wide variety of existing consumer protection rules and regulations to the Bureau. In addition, the Dodd-Frank Act tasks the Bureau with implementation of many new consumer protection initiatives required by that law. While the exact impact of any future changes is unknown, the Bank expects that it will incur additional expense related to the implementation of those rules. Another provision of the Dodd-Frank Act, commonly known as the Durbin Amendment, became effective October 1, 2011. The Durbin Amendment limits interchange fees payable on debit card transactions for financial institutions with more than \$10 billion in assets. While the Durbin Amendment does not directly apply to the Bank, competitive market forces related to the reduction mandated by the Durbin Amendment may result in a decrease in revenue from interchange fees for smaller financial institutions.
- *Interest on Demand Deposit Accounts* . The Dodd-Frank Act repeals the prohibition on the payment of interest on demand deposit accounts effective one year after the date of enactment, thereby permitting depository institutions to pay interest on business checking and other accounts.
- *Mortgage Reform* . The Dodd-Frank Act provides for mortgage reform addressing a customer’s ability to repay, restricts variable-rate lending by requiring the ability to repay to be determined for variable rate loans by using the maximum rate that will apply during the first five years of a variable-rate loan term, and makes more loans subject to requirement for higher-cost loans, new disclosures and certain other restrictions.

We expect that many of the requirements called for in the Dodd-Frank Act will be implemented over time, and most will be subject to implementing regulations over the course of several years. Given the continued uncertainty associated with the manner in which many of the provisions of the Dodd-Frank Act will be implemented by the various regulatory agencies and through regulations, the full extent of the impact such requirements will have on financial institutions’ operations remains unclear. The changes resulting from the Dodd-Frank Act may impact the profitability of our business activities, require changes to certain of our business practices, impose upon us more stringent capital, liquidity and leverage ratio requirements or otherwise adversely affect our business. These changes may also require us to invest significant management attention and resources to evaluate and make necessary changes in order to comply with new statutory and regulatory requirements.

Future Legislation

Legislation is regularly introduced in both the United States Congress and the Tennessee General Assembly that contains wide-ranging proposals for altering the structures, regulations and competitive relationships of the nation’s financial institutions. Such legislation may change banking statutes and the operating environment of Cornerstone and/or the Bank in substantial and unpredictable ways and could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance, depending upon whether any of this potential legislation will be enacted and, if enacted, the effect that it or any implementing regulations would have on the financial condition or result of operations of Cornerstone and/or the Bank.

ITEM 1A. RISK FACTORS

Investing in our common stock involves various risks which are particular to Cornerstone, its industry and its market area. Several risk factors regarding investing in our securities are discussed below. This listing should not be considered as all-inclusive. If any of the following risks were to occur, we may not be able to conduct our business as currently planned and our financial condition or operating results could be negatively impacted. These matters could cause the trading price of our securities to decline in future periods.

If our asset quality were to decline or if we experienced greater loan losses than anticipated, our earnings and overall financial condition would be adversely affected.

Our assets are primarily comprised of loans. The risk of credit losses on loans varies with, among other things, general economic conditions, the type of loan being made, the creditworthiness of the borrower over the term of the loan and, in the case of a collateralized loan, the value and marketability of the collateral for the loan. While the risk of nonpayment of loans is inherent in banking, in recent years we have experienced higher nonpayment levels than anticipated, which has had a significant adverse effect on our earnings and overall financial condition. We have taken actions to prevent future problems, including the creation of a special asset committee to develop and review action plans for minimizing loan losses and the dedication of resources to assist in the collection and recovery process. The Bank has also established a loan review committee comprised of a majority of non-employee directors to periodically review the Bank's loan portfolio and identify and categorize problem credits. To minimize the likelihood of a substandard loan portfolio, we assess the credit worthiness of customers and perform collateral valuations. Management also maintains an allowance for loan losses based upon, among other things, historical experience and an evaluation of economic conditions and regular reviews of delinquencies and loan portfolio quality. Based upon such factors, management makes various assumptions and judgments about the ultimate collectability of the loan portfolio and provides an allowance for loan losses based upon a percentage of the outstanding balances and takes a charge against earnings with respect to specific loans when their ultimate collectability is considered questionable. If management's assumptions and judgments prove to be incorrect and the allowance for loan losses is inadequate to absorb losses, or if regulatory authorities require us to increase our allowance for loan losses as a part of their examination process, additional provision expense would be incurred and our earnings and capital could be significantly and adversely affected. Moreover, additions to the allowance may be necessary based on changes in economic and real estate market conditions, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of management's control. These additions may require increased provision expense which would negatively impact our results of operations.

We have high levels of foreclosed assets, primarily as a result of foreclosures.

We have continued to resolve non-performing real estate loans and as a result we continue to have high levels of foreclosed assets. Foreclosed real estate expense consists of three types of charges: maintenance costs, valuation adjustments due to new appraisal values and gains or losses on disposition. Although levels of foreclosed assets have decreased in 2014 compared to recent years and local real estate values have improved, these charges will likely continue to negatively affect our results of operations.

Liquidity needs could adversely affect our results of operations and financial condition.

We rely on dividends from the Bank as our primary source of funds. However, in November 2009, following the conclusion of a joint examination of the Bank by the FDIC and the TDFI, the FDIC placed restrictions on the Bank's ability to pay cash dividends, requiring that the Bank first obtain a non-objection from the FDIC. Furthermore, the majority of the Bank's funds are comprised of customer deposits and loan repayments. While scheduled loan repayments are a relatively stable source of funds, they are subject to the ability of borrowers to repay the loans. The repayment of loans can be adversely affected by a number of factors, including changes in economic conditions, adverse trends or events affecting business industry groups, reductions in real estate values or markets, business closings or lay-offs, inclement weather, natural disasters and international instability. Additionally, deposit levels may be affected by a number of factors, including rates paid by competitors, general interest rate levels, returns available to customers on alternative investments and general economic conditions. Accordingly, we currently are, and may from time to time in the future be, required to rely on secondary sources of liquidity to meet withdrawal demands or otherwise fund operations. Alternative sources include advances from the Federal Home Loan Bank and federal funds lines of credit from correspondent banks. These sources might not be sufficient to meet future liquidity demands. We may be required to slow or discontinue loan growth, capital expenditures or other investments or liquidate assets if these alternative sources are not adequate.

Competition from financial institutions and other financial service providers may adversely affect our profitability.

The banking business is highly competitive and we experience competition in each of our markets from many other financial institutions. We compete with other commercial banks, credit unions, savings and loan associations, mortgage banking firms, consumer finance companies, securities brokerage firms, insurance companies, money market funds, and other mutual funds, as well as other community banks and super-regional and national financial institutions that operate offices in our primary market areas and elsewhere.

Additionally, we face competition from de novo community banks, including those with senior management who were previously affiliated with other local or regional banks or those controlled by investor groups with strong local business and community ties. These de novo community banks may offer higher deposit rates or lower cost loans in an effort to attract our customers, and may attempt to hire our management and employees.

We compete with these other financial institutions both in attracting deposits and in making loans. In addition, we have to attract our customer base from other existing financial institutions and from new residents. We expect competition to increase in the future as a result of legislative, regulatory and technological changes and the continuing trend of consolidation in the financial services industry.

Our success depends significantly upon economic conditions in the local markets where we operate.

Substantially all of our loan and deposit customers live, work and bank in the Chattanooga, Tennessee MSA. As a result, our success depends upon a sound local economy to provide opportunities for new business ventures, increased loan demand and the need for deposit services. Our profitability is impacted by these local factors as well as general economic conditions and interest rates. For example, our earnings may be negatively impacted by increases in unemployment rates or reductions in population, income levels, deposits and housing starts and home prices. In recent years, adverse economic conditions have inhibited our growth and diminished the ability of some of our customers to service their loan obligations. If economic conditions in our local markets deteriorate again, we could experience any of the following consequences, each of which could further adversely affect our business:

- demand for our products and services could decline;
- loan delinquencies could increase; and
- nonperforming assets and foreclosures could increase.

A prolonged economic downturn could also negatively impact collateral values or cash flows of borrowing businesses, and as a result our primary source of repayment could be insufficient to service the debt. In addition, adverse consequences to us in the event of a prolonged economic downturn in our local markets could be compounded by the fact that many of our commercial and real estate loans are secured by real estate located in those market areas. Significant decline in real estate values in these market areas would mean that the collateral for many of our loans would provide less security. As a result, we would be more likely to suffer losses on defaulted loans because our ability to fully recover on defaulted loans by selling the real estate collateral would be diminished. Adverse economic conditions in our local markets, including sustained periods of increased payment delinquencies, foreclosures or losses in the State of Tennessee or the State of Georgia, could impair our ability to collect loans and could otherwise have a negative effect on our assets, revenues, results of operations and financial condition.

Cornerstone is required to obtain regulatory approval prior to the payment of dividends.

Cornerstone's Series A Convertible Preferred Stock requires annual dividend payments that equal ten percent of the original issue price of \$25.00 per share. The dividends are scheduled to be paid at the end of each quarter. However, prior to the payment of the quarterly dividend Cornerstone must first obtain approval from the Federal Reserve Bank ("FRB"). Cornerstone provides information to the FRB which includes an evaluation of asset quality, earnings quarter and year to date and liquidity. Prior approval would also be required before common stock dividends could be paid.

Our Series A Convertible Preferred Stock will reduce net income available to holders of our Common Stock and earnings per common share.

The cash dividends paid or accumulated on our Series A Convertible Preferred Stock, and any future capital stock we may issue which is senior to our Common Stock, will reduce any net income available to holders of Common Stock and our earnings per common share. The preferred stock will also receive preferential treatment in the event of liquidation, dissolution or winding up of our Company. To date, we have received regulatory approval first and have made seventeen dividend payments on the Series A Convertible Preferred Stock. However, because of the need for regulatory approval to pay future dividends on the Series A Convertible Preferred Stock, dividends could accumulate and become quite substantial. The higher these accumulated dividends, the higher the preference payable in the event of liquidation, dissolution or winding up of our Company and the less likely the holders of our Common Stock will be able to realize any proceeds in such event.

Negative developments in the financial services industry and U.S. and global capital and credit markets may lead to additional regulation and further deterioration of our results of operations and financial condition.

Negative developments in the capital and credit markets in recent years have resulted in uncertainty in the financial markets. Financial institutions across the United States, including the Bank, have experienced deteriorating asset quality. Loan portfolios include impaired loans to businesses struggling to stay in operation or achieve adequate cash flow. Further, a decline in collateral values supporting these loans has also impacted the ability of a business or consumer to obtain loans or increased financial institutions losses in the event of foreclosure and liquidation. At the same time, financial institutions have become concerned about liquidity. This concern has increased the competition for deposits in our local market as well as wholesale funding options. These events have impacted our stock price, as well as the stock price of other bank holding companies. The potential impact of these events may be an expansion of existing or creation of new federal or state laws and regulations regarding lending and funding practices, liquidity standards and compliance issues. Continued negative developments below, as well as our ability to respond to these new operating and regulatory requirements, could further negatively impact our results of operations. The negative consequences could limit our ability to originate new loans or obtain adequate funding or increase costs associated with regulatory compliance. Ultimately, these changes could result in modifications to our existing or future strategic plans, capital requirements, compensation, financial performance and stock performance.

Recently enacted legislation might not stabilize the U.S. financial system.

The U.S. Congress enacted the Emergency Economic Stabilization Act of 2008 (“EESA”) in response to the impact of the volatility and disruption in the capital and credit markets on the financial sector. The Treasury and the federal banking regulators implemented a number of programs under this legislation to address these conditions and the asset quality, capital and liquidity issues they have caused for certain financial institutions and to improve the general availability of credit for consumers and businesses. In addition, the U.S. Congress enacted the American Recovery and Reinvestment Act of 2009 (“ARRA”) in an effort to save and create jobs, stimulate the U.S. economy and promote long-term growth and stability. The EESA and ARRA have been followed by numerous actions by the Federal Reserve, the U.S. Congress, the U.S. Treasury, the FDIC, the Commission and others to address the liquidity and credit crisis that followed the sub-prime meltdown. These measures include homeowner relief that encourages loan restructuring and modification; the establishment of significant liquidity and credit facilities for financial institutions and investment banks; the lowering of the federal funds rate; emergency action against short selling practices; a temporary guaranty program for money market funds; the establishment of a commercial paper funding facility to provide back-stop liquidity to commercial paper issuers; and coordinated international efforts to address illiquidity and other weaknesses in the banking sector. The purpose of these legislative and regulatory actions is to stabilize the U.S. financial system. The Temporary Liquidity Guarantee Program (“TLGP”), the EESA, the ARRA and the other regulatory initiatives described above may not have their desired effects. If the volatility in the markets continues and economic conditions fail to improve or worsen, our business, financial condition, results of operations and/or access to credit, as well as the trading price of our common stock, could be materially and adversely affected.

Our loan portfolio includes residential construction and land development loans, which have a greater credit risk than residential mortgage loans.

We engage in residential construction and land development loans to developers. This type of lending is generally considered to have more complex credit risks than traditional single-family residential lending because the principal is concentrated in a limited number of loans with repayment dependent on the successful operation of the related real estate project. Consequently, these loans are more sensitive to the current adverse conditions in the real estate market and the general economy. These loans are generally less predictable and more difficult to evaluate and monitor and collateral may be difficult to dispose of in a market decline. Furthermore, during adverse general economic conditions, which were experienced in residential real estate construction nationwide, borrowers involved in the residential real estate construction and development business suffer above normal financial strain. As the residential real estate development and construction market in our markets previously deteriorated, our borrowers in this segment experienced difficulty repaying their obligations to us. If additional charge-offs or foreclosures relating to these loans are necessary in the future, our results of operations would be negatively impacted. Additionally, to the extent repayment is dependent upon the sale of newly constructed homes or lots, such sales are likely to be at lower prices or at a slower rate than was expected when the loan was made, which may result in such loans being placed on non-accrual status and subject to higher loss estimates even if the borrower keeps interest payments current. These adverse economic and real estate market conditions may lead to further increases in non-performing loans and other real estate owned, increased charge-offs from the disposition of non-performing assets, and increases in provision for loan losses, all of which would negatively impact our financial condition and results of operations.

Changes in interest rates could adversely affect our results of operations and financial condition.

Changes in interest rates may affect our level of interest income, the primary component of our gross revenue, as well as the level of our interest expense. Interest rates are highly sensitive to many factors that are beyond our control, including general economic conditions and the policies of various governmental and regulatory authorities. Accordingly, changes in interest rates could decrease our net interest income. Changes in the level of interest rates also may negatively affect our ability to originate real estate loans, the value of our assets and the ability to realize gains from the sale of our assets, all of which ultimately affects earnings. Economic events prompted the Federal Reserve, beginning in September 2007, to reduce its federal funds rate. Due to the rapid decline in interest rates, we were unable to recalibrate our liabilities at the same rate at which loan rates declined. As a result, the net interest margin was impacted negatively during 2009. If the Federal Reserve's federal funds rate remains at extremely low levels or does not increase above our interest rate floors, our funding costs may increase which will negatively impact the net interest margin and our financial performance.

We may require additional capital which may not be able to be obtained or, if obtained, may cause significant dilution to current shareholders.

We may require capital from sources other than earnings generation. Such other sources may include an offering of equity-based securities, which could significantly dilute your investment in the event of conversion. We may need to pursue additional sources of capital, which may include additional equity investments, additional offerings of equity-based securities, borrowed funds or any combination of these sources. Our ability to access these alternative capital sources may be limited to the condition of the capital markets. Therefore, we may have difficulty rebuilding the Bank's capital reserves and we may provide new investors in the future certain rights, preferences and privileges senior to our current shareholders which may adversely impact our current shareholders.

Recently enacted legislation could have a negative impact on our business.

The impact of the Dodd-Frank Act on the financial services industry will be broad, with enhanced regulatory oversight and compliance, including, among other things, (i) enhanced resolution authority of troubled and failing banks and their holding companies; (ii) increased capital and liquidity requirements; (iii) increased regulatory examination fees; (iv) changes to assessments to be paid to the FDIC for federal deposit insurance; and (v) numerous other provisions designed to improve supervision and oversight of, and strengthening safety and soundness for, the financial services sector. In addition, the Dodd-Frank Act established a new framework for systemic risk and oversight in the industry which has resulted and will continue to result in sweeping changes in the regulation of financial institutions aimed at strengthening safety and soundness for the financial services sector.

We expect that many of the requirements called for in the Dodd-Frank Act will be implemented over time, and most will be subject to implementing regulations over the course of several years. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank Act will be implemented by the various regulatory agencies and through regulations, the full extent of the impact such requirements will have on financial institutions' operations is unclear. The changes resulting from the Dodd-Frank Act may impact the profitability of our business activities, require changes to certain of our business practices, impose upon us more stringent capital, liquidity and leverage ratio requirements or otherwise adversely affect our business. These changes may also require us to invest significant management attention and resources to evaluate and make necessary changes in order to comply with new statutory and regulatory requirements.

We are subject to federal and state regulations that may negatively impact our operations and financial performance.

We operate in a highly regulated industry and are subject to examination, supervision and comprehensive regulation by various federal and state agencies, including the Federal Reserve, the FDIC and the TDFI. Many of the banking regulations we are governed by are intended to protect depositors, the public or the insurance funds maintained by the FDIC, not shareholders. Compliance with the numerous banking regulations is costly and requires investment in human and information technology resources. Certain of our activities, such as the payment of dividends, mergers and acquisitions, investments, loans and interest rates charged, interest rates paid on deposits and locations of offices, are impacted by these regulations. We are also subject to capitalization guidelines established by banking authorities, which require us to maintain adequate capital to support our growth. To be categorized as “well capitalized,” an institution must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios.

The laws and regulations applicable to the banking industry are subject to change at any time. We cannot predict the events that will result in regulatory changes nor their impact on the banking industry in general and us in particular. Because government regulation greatly affects the business and financial results of all commercial banks and bank holding companies, the cost of compliance could adversely affect our ability to operate profitably.

The Sarbanes-Oxley Act of 2002 and the related rules and regulations promulgated by the Commission have increased the scope, complexity and cost of corporate governance, reporting and disclosure practices. These regulations are applicable to us. We have experienced, and may continue to experience, increasing compliance costs as a result of the Sarbanes-Oxley Act. These necessary costs are proportionately higher for a company of our size and will affect our profitability more than that of some of our larger competitors.

U.S. Banking agencies have finalized revisions to their risk-based and leverage capital requirements consistent with agreements reached by the Basel Committee on Banking Supervision (Basel III). The final rules establish tougher capital standards through more restrictive capital definitions, higher risk-weighted assets, additional capital buffers, and higher requirements for minimum capital ratios. These reforms could have a material negative impact on the profitability and returns on equity of U.S. banks, including the Bank.

We have a significant deferred tax asset that might not be fully realized.

We have net deferred tax assets of \$1.8 million as of December 31, 2014. We did not establish a valuation allowance against our net deferred tax assets as of December 31, 2013 or December 31, 2014 because we believe that it is more likely than not that all of these assets will be realized. In evaluating the need for a valuation allowance, we estimated future taxable income based on management prepared forecasts. This process required significant judgment by management about matters that are by nature uncertain. If future events differ significantly from our current forecasts, we may need to establish a valuation allowance, which could have a material adverse effect on our results of operations and financial condition.

We rely heavily on the services of key personnel and the unexpected loss of any of those personnel could adversely affect our operations.

We are dependent on certain key officers who have important customer relationships or are instrumental to our lending, depository and bank operations. We believe that our future results will also depend upon our ability to attract and retain highly skilled and qualified personnel.

We are subject to Tennessee's anti-takeover statutes and certain charter provisions that could decrease our chances of being acquired even if the acquisition is in the best interest of our shareholders.

As a Tennessee corporation, we are subject to various legislative acts that impose restrictions on and require compliance with procedures designed to protect shareholders against unfair or coercive mergers and acquisitions. These statutes may delay or prevent offers to acquire us and increase the difficulty of consummating any such offers, even if the acquisition would be in our shareholders' best interests. Our charter also contains provisions which may make it difficult for another entity to acquire us without the approval of a majority of the disinterested directors on our board of directors. Secondly, the amount of common stock owned by, and other compensation arrangements with, certain of our officers and directors may make it more difficult to obtain shareholder approval of potential takeovers that they oppose. Agreements with our senior management also provide for significant payments under certain circumstances following a change in control. These compensation arrangements, together with the common stock and option ownership of our board of directors and management, could make it difficult or expensive to obtain majority support for shareholder proposals or potential acquisition proposals that the board of directors and officers oppose.

The success and growth of our operations will depend on our ability to adapt to technological changes.

The banking industry and the ability to deliver financial services is becoming more dependent on technological advancement, such as the ability to process loan applications over the Internet, accept electronic signatures, provide process status updates instantly, reliable on-line banking capabilities and other customer expected conveniences that are cost efficient to our business processes. As these technologies are improved in the future, we may, in order to remain competitive, be required to make significant capital expenditures.

If we engage in business combination transactions, we may face risks associated with integration of operations or undiscovered losses or other problems.

Such negotiated acquisitions will be accompanied by the risks commonly encountered in acquisitions, including, among other things:

- credit risk associated with the other bank's loans and leases and investments;
- difficulty of integrating operations and personnel;
- potential disruption of the our ongoing business; and
- potential loss of key employees, customers and deposits of the other bank.

A failure in or breach of our operational or security systems or infrastructure, or those of our third party vendors and other service providers or other third parties, including as a result of cyber attacks, could disrupt our business, result in the disclosure or misuse of confidential or proprietary information, damage our reputation, increase our costs, and cause losses.

We rely heavily on communications and information systems to conduct our business. Information security risks for financial institutions have generally increased in recent years. Our operating systems and infrastructure must continue to be protected. Our operating systems and facilities may stop operating properly or become disabled or damaged as a result of a number of factors, including electrical or telecommunication outages; natural disasters such as earthquakes, tornadoes, and floods; disease pandemics; events arising from local or larger scale political or social matters, including terrorist acts; and cyber attacks.

Our technologies, systems and networks, those of third parties with whom we do business, and our customers' devices may become the target of cyber attacks or information security breaches that could result in the unauthorized release, gathering, monitoring, misuse, loss, or destruction of confidential information. As threats of cyber attacks continue to evolve, we may be required to expend additional resources to continue to modify or enhance our protective measures or to investigate and remediate information security vulnerabilities.

Any of these events could result in client attrition, regulatory fines, penalties or intervention, reputation damage, reimbursement or other compensation costs, and/or additional compliance costs, any of which could have a material effect on our results of operations or financial condition.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None

ITEM 2. PROPERTIES

As of December 31, 2014, the principal offices of Cornerstone are located at 835 Georgia Avenue, Chattanooga, Tennessee 37402. In addition, the Bank operates five full-service branches and one loan production office that are located at:

| | |
|------------------------|--|
| Banking Branches | 4154 Ringgold Road, East Ridge, Tennessee (owned by the Bank) 5319 Highway 153, Hixson, Tennessee (owned by the Bank) 2280 Gunbarrel Road, Chattanooga, Tennessee (owned by the Bank) 8966 Old Lee Highway, Ooltewah, Tennessee (owned by the Bank) 835 Georgia Avenue, Chattanooga, Tennessee (leased by the Bank as of December 31, 2014; owned by the Bank as of February 24, 2015) |
| Loan Production Office | 202 West Crawford Street, Dalton, Georgia (leased by the Bank) |

The Georgia Avenue facility located in downtown Chattanooga, Tennessee serves as a branch location for the Bank's customers as well as Cornerstone's executive offices. This property was leased by the Bank as of December 31, 2014 but was purchased subsequent to year end. Additional information regarding this purchase is disclosed under Item 13 Related Party Transactions. The transaction closed on February 24, 2015. Cornerstone leases and operates a service center located at 6401 Lee Highway, Suite 119, Chattanooga, Tennessee to facilitate all of its noncustomer contact functions.

ITEM 3. LEGAL PROCEEDINGS

As of the end of 2014, neither Cornerstone nor the Bank was involved in any material litigation. The Bank is periodically involved as a plaintiff or defendant in various legal actions in the ordinary course of its business. Management believes that any claims pending against Cornerstone or its subsidiaries are without merit or that the ultimate liability, if any, resulting from them will not materially affect the Bank's financial condition or Cornerstone's consolidated financial position.

ITEM 4. MINE SAFETY DICLOSURES

Not applicable.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

On January 5, 2015, Cornerstone had 6,627,398 shares of common stock outstanding. Cornerstone's common stock is quoted on the OTC Bulletin Board under the symbol "CSBQ" but is not listed on a national securities exchange. There are ten market makers who provide a market for Cornerstone's common stock.

There were approximately 550 holders of record of the common stock as of December 31, 2014. This number does not include shareholders with shares in nominee name held by the Depository Trust Company (DTC). As of the end of 2014, there were approximately 3,871,000 shares held in nominee name by DTC.

Cornerstone paid no cash dividends on common stock in 2013 or 2014. Cornerstone must obtain the approval of the FRBA prior to declaring or paying a dividend on its common or preferred stock. Cornerstone's board of directors will continue to evaluate the amount of future dividends, if any, after capital needs required for expected growth of assets are reviewed. Subject to regulatory approval, the payment of dividends is within the discretion of the board of directors, considering Cornerstone's expenses, the maintenance of reasonable capital and risk reserves, and appropriate capitalization requirements for state banks. Currently, the Bank is under a restriction from the FDIC that no dividend can be paid from the Bank to the holding company without prior approval.

Table 1 presents the high and low closing prices of Cornerstone's common stock for the periods indicated, as reported by published sources, and cash dividends declared on its common stock for the last two fiscal years. The prices reflect inter-dealer prices, without retail mark-up, mark-down or commission, and may not represent actual transactions.

TABLE 1

| High and Low Common Stock Price for Cornerstone | | | Cash Dividends |
|--|------------|-------------|-----------------------|
| 2015 Fiscal Year | Low | High | Paid Per Share |
| First Quarter (through February 2, 2015) | \$ 3.20 | \$ 3.50 | - |
| 2014 Fiscal Year | | | |
| First Quarter | \$ 2.30 | \$ 2.50 | - |
| Second Quarter | \$ 2.35 | \$ 2.62 | - |
| Third Quarter | \$ 2.46 | \$ 3.05 | - |
| Fourth Quarter | \$ 2.90 | \$ 3.70 | - |
| 2013 Fiscal Year | | | |
| First Quarter | \$ 1.73 | \$ 2.89 | - |
| Second Quarter | \$ 1.75 | \$ 2.28 | - |
| Third Quarter | \$ 2.01 | \$ 2.69 | - |
| Fourth Quarter | \$ 2.20 | \$ 2.60 | - |

For information relating to compensation plans under which our equity securities are authorized for issuance, see Item 12.

There were 600,000 shares of our Series A Convertible Preferred Stock outstanding as of December 31, 2014. Table 2 presents information relating to dividends paid on the Series A Convertible Preferred Stock.

TABLE 2

| Series A Convertible Preferred Stock Dividend Payments | | | Amount |
|---|--------------------|---------------------|------------------|
| Year | Record Date | Date Payable | Per Share |
| 2014 | March 31, 2014 | August 26, 2014 | \$ 0.625 |
| | June 30, 2014 | November 25, 2014 | \$ 0.625 |
| | September 30, 2014 | February 25, 2015 | \$ 0.625 |
| 2013 | March 31, 2013 | August 22, 2013 | \$ 0.625 |
| | June 30, 2013 | November 7, 2013 | \$ 0.625 |
| | September 30, 2013 | February 20, 2014 | \$ 0.625 |
| | December 31, 2013 | May 15, 2014 | \$ 0.625 |

ITEM 6. SELECTED FINANCIAL DATA

Table 3 presents selected financial data for the periods indicated (amounts in thousands, except per share data).

TABLE 3

| | 2014 | 2013 | 2012 | 2011 | 2010 |
|---|-------------|-------------|-------------|-------------|-------------|
| Total interest income | \$ 18,137 | \$ 18,453 | \$ 19,353 | \$ 20,494 | \$ 25,211 |
| Total interest expense | 2,789 | 3,523 | 4,785 | 6,362 | 9,202 |
| Net interest income | 15,348 | 14,930 | 14,568 | 14,132 | 16,009 |
| Provision for loan losses | 515 | 300 | 430 | 445 | 7,291 |
| Net interest income after provision for loan losses | 14,833 | 14,630 | 14,138 | 13,687 | 8,718 |
| Noninterest income | 1,819 | 1,940 | 1,019 | 1,183 | 3,081 |
| Noninterest expense | 14,000 | 13,846 | 13,178 | 13,652 | 18,042 |
| Income before income taxes | 2,652 | 2,724 | 1,979 | 1,218 | (6,243) |
| Income tax expense / (benefit) | 1,014 | 1,043 | 577 | 188 | (1,535) |
| Net income (loss) | \$ 1,638 | \$ 1,681 | \$ 1,402 | \$ 1,030 | \$ (4,708) |
| Per Common Share Data: | | | | | |
| Net income / (loss), basic | \$ 0.01 | \$ 0.02 | \$ 0.02 | \$ 0.05 | \$ (0.73) |
| Net income / (loss), assuming dilution | 0.01 | 0.02 | 0.02 | 0.05 | (0.73) |
| Cash dividends paid | - | - | - | - | - |
| Book value | 3.88 | 3.86 | 4.01 | 3.89 | 3.55 |
| Tangible book value(1) | 3.88 | 3.85 | 4.01 | 3.89 | 3.55 |
| Financial Condition Data: | | | | | |
| Assets | \$ 415,740 | \$ 432,223 | \$ 443,446 | \$ 422,655 | \$ 441,499 |
| Loans, net of unearned interest and allowance | 291,869 | 286,237 | 270,850 | 260,365 | 276,115 |
| Cash and investments | 105,069 | 119,417 | 137,860 | 127,332 | 133,651 |
| Federal funds sold | - | - | - | - | - |
| Deposits | 308,654 | 341,414 | 344,881 | 314,042 | 355,447 |
| FHLB advances and other borrowings | 36,000 | 26,740 | 37,175 | 43,045 | 54,715 |
| Federal funds purchased and repurchase agreements | 29,410 | 22,974 | 19,587 | 29,391 | 24,325 |
| Shareholders' equity | 40,662 | 40,134 | 40,889 | 35,208 | 25,819 |
| Tangible shareholders' equity(1) | 40,662 | 40,131 | 40,878 | 35,186 | 25,782 |
| Selected Ratios: | | | | | |
| Interest rate spread | 3.73% | 3.64% | 3.67% | 3.36% | 3.24% |
| Net interest margin(2) | 3.90% | 3.80% | 3.85% | 3.55% | 3.43% |
| Return on average assets | 0.39% | 0.39% | 0.34% | 0.24% | (0.94)% |
| Return on average equity | 4.04% | 4.12% | 3.78% | 3.46% | (15.79)% |
| Return on average tangible equity(1) | 4.04% | 4.12% | 3.78% | 3.47% | (15.81)% |
| Average equity to average assets | 9.65% | 9.51% | 8.94% | 6.91% | 5.95% |
| Common stock dividend payout ratio | N/A | N/A | N/A | N/A | N/A |
| Ratio of nonperforming assets to total assets | 2.61% | 3.82% | 5.94% | 6.26% | 5.99% |
| Ratio of allowance for loan losses to nonperforming loans | 121.99% | 89.83% | 102.26% | 93.90% | 66.98% |
| Ratio of allowance for loan losses to total average loans, net of unearned income | 1.19% | 1.15% | 2.28% | 2.71% | 2.93% |

(1) Tangible shareholders' equity is shareholders' equity less goodwill and intangible assets.

(2) Net interest margin is the net yield on interest-earning assets and is the difference between the interest yield earned on interest-earning assets less the interest rate paid on interest-bearing liabilities.

GAAP Reconciliation and Management Explanation of Non-GAAP Financial Measures

Certain financial information included in Cornerstone’s summary of consolidated financial data is determined by methods other than in accordance with U.S. generally accepted accounting principles (“GAAP”). These non-GAAP financial measures are “tangible book value per common share,” “tangible shareholders’ equity,” and “return on average tangible equity.” Management uses these non-GAAP measures in its analysis of Cornerstone’s financial performance.

- “Tangible book value per common share” is defined as total equity reduced by recorded preferred stock, goodwill and other intangible assets divided by total common shares outstanding. This measure is important to investors interested in changes from period-to-period in book value per common share exclusive of changes in intangible assets. Goodwill, an intangible asset that is recorded in a purchase business combination, has the effect of increasing total book value while not increasing the tangible assets of a company. For companies, such as Cornerstone, that have engaged in business combinations, purchase accounting can result in the recording of significant amounts of goodwill related to such transactions.
- “Tangible shareholders’ equity” is shareholders’ equity less goodwill and other intangible assets.
- “Return on average tangible equity” is defined as earnings for the period divided by average equity reduced by average goodwill and other intangible assets.

These disclosures should not be viewed as a substitute for results determined in accordance with GAAP, and are not necessarily comparable to non-GAAP performance measures which may be presented by other companies. Table 4 presents a reconciliation to provide a more detailed analysis of these non-GAAP performance measures:

TABLE 4

| | At and for the Fiscal Years Ended December 31, | | | | |
|---|---|----------------|----------------|----------------|-----------------|
| | 2014 | 2013 | 2012 | 2011 | 2010 |
| Number of common shares outstanding | 6,627,398 | 6,547,074 | 6,500,396 | 6,500,396 | 6,500,396 |
| Total stockholders’ equity | \$40,662,105 | \$40,133,728 | \$40,886,836 | \$35,208,305 | \$25,819,153 |
| Less: preferred stock | 14,964,309 | 14,892,927 | 14,821,546 | 9,899,544 | 2,727,424 |
| Book value | \$25,697,796 | \$25,240,801 | \$26,065,290 | \$25,308,761 | \$23,091,729 |
| Book value per common share | \$ 3.88 | \$ 3.86 | \$ 4.01 | \$ 3.89 | \$ 3.55 |
| Book value | \$25,697,796 | \$25,240,801 | \$26,065,290 | \$25,308,761 | \$23,091,729 |
| Less: goodwill and other intangible assets | - | 2,427 | 10,530 | 22,487 | 37,317 |
| Tangible book value | \$25,697,796 | \$25,238,374 | \$26,054,760 | \$25,286,274 | \$23,054,412 |
| Effect of intangible assets per common share | \$ - | \$.01 | \$ - | \$ - | \$ - |
| Tangible book value per common share | \$ 3.88 | \$ 3.85 | \$ 4.01 | \$ 3.89 | \$ 3.55 |
| Net income / (loss) | \$ 1,638,282 | \$ 1,680,809 | \$ 1,402,063 | \$ 1,030,052 | \$ (4,707,521) |
| Average equity | 40,567,000 | 40,764,000 | 37,115,000 | 29,740,000 | 29,820,000 |
| Return on average equity | 4.04% | 4.12% | 3.78% | 3.46% | (15.79)% |
| Average equity | \$40,567,000 | \$40,764,000 | \$37,115,000 | \$29,740,000 | \$29,820,000 |
| Less: goodwill and other intangible assets | - | 2,427 | 10,530 | 22,487 | 37,317 |
| Average tangible equity | \$40,567,000 | \$40,761,573 | \$37,104,470 | \$29,717,513 | \$29,782,683 |
| Effect of intangible assets | 0.00% | 0.00% | 0.00% | (0.01)% | (0.02)% |
| Return on average tangible equity | 4.04% | 4.12% | 3.78% | 3.47% | (15.81)% |

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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” (MD&A) in Item 7), 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 this Annual Report on Form 10-K, as well as the following: (i) the possibility that our asset quality would decline or that we experience greater loan losses than anticipated, (ii) high levels of other real estate, primarily as a result of foreclosures, (iii) the impact of liquidity needs on our results of operations and financial condition, (iv) competition from financial institutions and other financial service providers, (v) economic conditions in the local markets where we operate, (vi) the impact of obtaining regulatory approval prior to the payment of dividends, (vii) the impact of our Series A Preferred Stock on net income available to holders of our Common Stock and earnings per common share, (viii) the impact of negative developments in the financial industry and U.S. and global capital and credit markets, (ix) the impact of recently enacted legislation on our business, (x) the relatively greater credit risk of residential construction and land development loans in our loan portfolio, (xi) adverse impact on operations and financial condition due to changes in interest rates, (xii) our ability to obtain additional capital and, if obtained, the possible significant dilution to current shareholders, (xiii) the impact of federal and state regulations on our operations and financial performance, (xiv) whether a significant deferred tax asset we have can be fully realized, (xv) our ability to retain the services of key personnel, (xvi) the impact of Tennessee’s anti-takeover statutes and certain charter provisions on potential acquisitions of the holding company, (xvii) our ability to adapt to technological changes, and (xviii) the impact of business combinations. 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.

Introduction and Recent Developments

On December 8, 2014, Cornerstone announced the signing of a definitive agreement to merge with SmartFinancial, Inc., which would create a combined company that will operate under the name SmartFinancial, Inc. Under the terms of the agreement, each outstanding share of common stock of SmartFinancial will be converted into 4.20 shares of Cornerstone common stock, subject to adjustment based on an anticipated reverse stock split of Cornerstone’s common stock, which is expected to adjust the ratio to 1.05 shares of Cornerstone common stock for each share of SmartFinancial common stock. Additionally, each outstanding share of SmartFinancial preferred stock will be converted into a share of Cornerstone preferred stock with similar rights and preferences. Current holders of Cornerstone’s preferred stock will be asked to vote on an amendment to Cornerstone’s charter to allow Cornerstone to redeem its outstanding preferred stock prior to the completion of the merger. Completion of the merger is subject to a number of conditions, including approval by bank regulatory authorities and both SmartFinancial’s and Cornerstone’s shareholders.

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 December 31, 2014 and December 31, 2013, and Cornerstone's results of operations for each of the three-years ended December 31, 2014, 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.

Review of Financial Performance

As of December 31, 2014, Cornerstone had total consolidated assets of approximately \$416 million, total loans of approximately \$295 million, total deposits of approximately \$309 million and stockholders' equity of approximately \$41 million. Cornerstone earned net income of approximately \$1.6 million for 2014 compared to net income of approximately \$1.7 million for 2013 and approximately \$1.4 million for 2012.

Results of Operations

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 Cornerstone's earnings. For the year ended December 31, 2014, Cornerstone recorded net interest income of approximately \$15,348,000, which resulted in a net interest margin of 3.90% . For the year ended December 31, 2013, Cornerstone recorded net interest income of approximately \$14,930,000, which resulted in a net interest margin of 3.80%. For the year ended December 31, 2012, Cornerstone recorded net interest income of approximately \$14,568,000, which resulted in a net interest margin of 3.85%.

Table 5 presents information with respect to interest income from average interest-earning assets, expressed both in dollars and yields, and interest expense on average interest-bearing liabilities, expressed both in dollars and rates, for the periods indicated. The table includes loan yields, which reflect the amortization of deferred loan origination and commitment fees. Interest income from investment securities includes the accretion of discounts and amortization of premiums.

TABLE 5

Yields Earned on Average Earning Assets and
Rates Paid on Average Interest-Bearing Liabilities
Years Ended December 31,

| (In thousands) | 2014 | | | 2013 | | | 2012 | | |
|--|-------------------|----------------------------|--------------|-------------------|----------------------------|--------------|-------------------|----------------------------|--------------|
| | Average Balance | Interest Income/Expense(1) | Yield/Rate | Average Balance | Interest Income/Expense(1) | Yield/Rate | Average Balance | Interest Income/Expense(1) | Yield/Rate |
| ASSETS | | | | | | | | | |
| Interest-earning assets: | | | | | | | | | |
| Loans(1)(2) | \$ 293,708 | \$ 16,690 | 5.68% | \$ 278,975 | \$ 16,705 | 5.99% | \$ 268,828 | \$ 17,289 | 6.43% |
| Investment securities(3) | 89,114 | 1,416 | 1.72% | 98,108 | 1,694 | 1.94% | 89,587 | 2,004 | 2.53% |
| Other earning assets | 13,615 | 31 | 0.23% | 20,749 | 54 | 0.26% | 27,010 | 60 | 0.22% |
| Total interest-earning assets | 396,437 | 18,137 | 4.60% | 397,832 | 18,453 | 4.69% | 385,425 | 19,353 | 5.09% |
| Allowance for loan losses | (3,284) | | | (4,547) | | | (6,140) | | |
| Cash and other assets | 27,350 | | | 35,409 | | | 35,756 | | |
| Total assets | <u>\$ 420,503</u> | | | <u>\$ 428,694</u> | | | <u>\$ 415,041</u> | | |
| TOTAL LIABILITIES AND EQUITY | | | | | | | | | |
| Interest-bearing liabilities: | | | | | | | | | |
| Deposits: | | | | | | | | | |
| NOW accounts | \$ 26,921 | \$ 40 | 0.15% | \$ 26,196 | \$ 55 | 0.21% | \$ 26,483 | \$ 87 | 0.33% |
| Money market / savings | 82,903 | 273 | 0.33% | 88,912 | 419 | 0.47% | 62,958 | 460 | 0.73% |
| Time deposits | 157,112 | 1,428 | 0.91% | 165,748 | 1,766 | 1.07% | 187,733 | 2,471 | 1.32% |
| Total interest-bearing deposits | 266,936 | 1,741 | 0.65% | 280,856 | 2,240 | 0.80% | 277,174 | 3,018 | 1.09% |
| Securities sold under agreement to repurchase | 22,026 | 85 | 0.39% | 22,041 | 74 | 0.34% | 21,312 | 94 | 0.44% |
| Other borrowings | 30,845 | 964 | 3.13% | 31,634 | 1,209 | 3.82% | 39,282 | 1,673 | 4.26% |
| Total interest-bearing liabilities | 319,807 | 2,790 | 0.87% | 334,531 | 3,523 | 1.05% | 337,768 | 4,785 | 1.42% |
| Net interest spread | | | <u>3.73%</u> | | | <u>3.64%</u> | | | <u>3.67%</u> |
| Other liabilities: | | | | | | | | | |
| Demand deposits | 59,219 | | | 51,614 | | | 39,936 | | |
| Accrued interest payable and other liabilities | 910 | | | 1,785 | | | 222 | | |
| Stockholders' equity | 40,567 | | | 40,764 | | | 37,115 | | |
| Total liabilities and stockholders' equity | <u>\$ 420,503</u> | | | <u>\$ 428,694</u> | | | <u>\$ 415,041</u> | | |
| Net interest margin | | <u>\$ 15,347</u> | <u>3.90%</u> | | <u>\$ 14,930</u> | <u>3.80%</u> | | <u>\$ 14,568</u> | <u>3.85%</u> |

(1) Interest income on loans includes amortization of deferred loan fees and other discounts of \$85 thousand, \$176 thousand, and \$168 thousand for the fiscal years ended December 31, 2014, 2013, and 2012, respectively.

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

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

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

☐ The net interest margin increased 10 basis points from 3.80% as of December 31, 2013 to 3.90% as of December 31, 2014. The improvement in the net interest margin was primarily derived from the decrease in total interest-bearing liability expense. Over the last two years, Cornerstone has been able to reduce its expense in local deposits as well as the expense incurred from Federal Home Loan Bank (FHLB) advances and other borrowings. The Bank will have an opportunity to further decrease interest costs in FHLB advances during 2015, as \$10 million of long-term advances mature. Management anticipates a reduction in interest cost of approximately 300 basis points or \$300 thousand annually. The new advances will be short-term in nature, 12 months or less, but will allow the Bank to improve its net interest margin and will still allow management to position the balance sheet for interest rate risk if interest rates rise in the near future.

☐ As of December 31, 2014, the Bank's loan portfolio yield decreased from 5.99% as of December 31, 2013 to 5.68% as of December 31, 2014. The decline in loan portfolio yield is primarily attributable to the competition in Cornerstone's lending market. Despite the decline in loan yield, the Bank was able to generate approximately the same in interest income as in 2013. In 2013, the Bank earned approximately \$16,705,000 in interest income and in 2014 the Bank earned approximately \$16,690,000 in interest income. Management anticipates that 2015 could be very similar. Management believes the loan portfolio will continue to increase in 2015. However, a lower loan yield could result as well.

☐ As of December 31, 2014, the Bank's investment portfolio resulted in a yield of 1.72% compared to 1.94% as of December 31, 2013 and 2.53% as of December 31, 2012. The decline in investment yield is primarily attributable to the reduction in the Bank's municipal securities. During this three-year period, the Bank elected to realize a significant portion of its unrealized gain in the municipal portfolio. The total gain realized during the three-year period is approximately \$1.4 million. The additional revenue from these transactions was used, primarily, to address elevated foreclosed asset expenses. Management believes the size of the investment portfolio is appropriate given the Bank's anticipated increase in loans during 2015. However, management does not see significant opportunities to improve the investment portfolio yield until interest rates increase. At that point, approximately 74% of the investment portfolio, which is comprised of floating rate mortgage backed securities, will increase in yield. Finally, the Bank will continue to use the investment portfolio for liquidity and pledging purposes with the State of Tennessee Collateral Pool, correspondent bank lines and to secure repurchase agreements. As of December 31, 2014, the Bank's securities portfolio was invested 89.22% in United States Government agency or sponsored agency securities, 8.19% in municipal general obligation securities and the remaining 2.59% in FHLB stock.

During 2014, the Bank was able to reduce its total deposit cost from 0.80% as of December 31, 2013 to 0.65% as of December 31, 2014. This decrease was in part due the Bank consistently monitoring local market conditions and adjusting interest rates on deposits when appropriate. The Bank did experience a decline in average total interest-bearing deposits to approximately \$267 million as of December 31, 2014 from approximately \$281 million as of December 31, 2013. The most significant decline occurred in the Bank's time deposit accounts. Average time deposits decreased by approximately \$9 million from the December 31, 2013 total of approximately \$166 million to approximately \$157 million as of December 31, 2014. Management is currently reviewing liquidity and deposit gathering opportunities to not only address the need to increase total deposits but also provide the best solutions to address future interest rate risk.

Tables 6 and 7 present the changes in interest income and interest expense that are attributable to three factors:

- (i) A change in volume or amount of an asset or liability.
- (ii) A change in interest rates.
- (iii) A change caused by the combination of changes in asset or deposit mix.

The tables describe the extent to which changes in interest rates and changes in volume of interest-earning assets and interest-bearing liabilities have affected Cornerstone's interest income and expense during the periods indicated. For each category of interest-earning assets and interest-bearing liabilities, information is provided as to changes attributable to change in volume (change in volume multiplied by current rate) and change in rates (change in rate multiplied by current volume). The remaining difference has been allocated to mix.

TABLE 6

INTEREST INCOME AND EXPENSE ANALYSIS

| (In Thousands) | Year Ended December 31, 2014 Compared to 2013 | | | |
|--|--|----------------|-------------|---------------|
| | Volume | Rate | Mix | Net Change |
| Interest income: | | | | |
| Loans (1)(2) | \$ 837 | \$ (911) | \$ 59 | \$ (15) |
| Investment securities | (155) | (196) | 73 | (278) |
| Other earning assets | (16) | (4) | (3) | (23) |
| Total interest income | 666 | (1,111) | 129 | (316) |
| Interest expense: | | | | |
| NOW accounts | 1 | (16) | - | (15) |
| Money market and savings accounts | (20) | (116) | (10) | (146) |
| Time deposits | (79) | (251) | (8) | (338) |
| Other borrowings | (25) | (213) | (7) | (245) |
| Securities sold under agreement to repurchase | - | 11 | - | 11 |
| Total interest expense | (123) | (585) | (25) | (733) |
| Change in net interest income (expense) | | | | \$ 417 |

(1) Loan amounts include interest income recognized on a cash basis on nonaccrual loans.

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

TABLE 7

INTEREST INCOME AND EXPENSE ANALYSIS

| (In Thousands) | Year Ended December 31, 2013 Compared to 2012 | | | |
|--|--|----------------|-------------|----------------|
| | Volume | Rate | Mix | Net Change |
| Interest income: | | | | |
| Loans (1)(2) | \$ 608 | \$ (1,227) | \$ 35 | \$ (584) |
| Investment securities | 165 | (579) | 104 | (310) |
| Other earning assets | (16) | 8 | 2 | (6) |
| Total interest income | 757 | (1,798) | 141 | (900) |
| Interest expense: | | | | |
| NOW accounts | (1) | (31) | - | (32) |
| Money market and savings accounts | 122 | (231) | 68 | (41) |
| Time deposits | (235) | (414) | (56) | (705) |
| Other borrowings | (292) | (139) | (33) | (464) |
| Securities sold under agreement to repurchase | 2 | (22) | - | (20) |
| Total interest expense | (404) | (837) | (21) | (1,262) |
| Change in net interest income (expense) | | | | \$ 362 |

(1) Loan amounts include interest income recognized on a cash basis on nonaccrual loans.

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

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. The provision for loan losses amounted to \$515 thousand for the year ended December 31, 2014 compared to \$300 thousand for the year ended December 31, 2013. Cornerstone maintains policies and procedures used to estimate the allowance for loan losses which are periodically reviewed by regulators. Refer to additional documentation on the allowance for loan losses immediately prior to Table 17. There are factors beyond Cornerstone's control, such as conditions in the local and national economy, which may negatively impact Cornerstone's asset quality. The measurements are approximations which may require additional provisions to loan losses based upon changing circumstances or when additional information becomes available or known. Other matters relating to the changes in provision for loan losses are presented below:

☐ In 2014, Cornerstone increased its allowance for loan losses account to provide an adequate allowance for the increase in outstanding loans. First, Cornerstone recognized \$515 thousand of provision expense. Second, for the twelve months ended December 31, 2014, Cornerstone received approximately \$1.4 million in recoveries of loans previously charged off. The provision expense and recoveries were offset with existing loan charge offs totaling approximately \$1.6 million. Cornerstone's net charge-offs were approximately \$200 thousand. This relatively low net charge-off amount allowed Cornerstone to increase its allowance for loan losses with only \$515 thousand in provision expense. Management believes that its allowance methodology and the inputs used in the estimation process are appropriate and consistent with generally accepted accounting principles and interagency policy statements published by the Bank's regulatory agencies.

☐ To address the problem credits in the Bank's loan portfolio, a Special Asset Committee was created in 2008. The Committee continues to meet at least monthly to review problem loans. The Committee coordinates various activities across multiple departments in the Bank, such as reviewing loan grades assigned by the Bank's loan review department and overseeing the development and review of action plans that identify possible strategies to minimize the Bank's losses. The early detection and proactive resolution process serves to assist customers in the current economic environment while potentially minimizing the Bank's losses.

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

Table 8 presents the components of noninterest income for the years ended December 31, 2014, 2013 and 2012 (in thousands).

TABLE 8

| | 2014 | 2013 | 2012 |
|--|-----------------|-----------------|-----------------|
| Customer service fees | \$ 850 | \$ 821 | \$ 803 |
| Other noninterest income | 57 | 63 | 64 |
| Net gain from sale of securities | 700 | 652 | - |
| Net gain from sale of loans & other assets | 212 | 404 | 152 |
| Total noninterest income | <u>\$ 1,819</u> | <u>\$ 1,940</u> | <u>\$ 1,019</u> |

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

- ☐ The Bank was able to slightly increase its customer service fees during 2014. Management performed research during 2014 to ensure its service charges were appropriate when compared to other financial institutions in our market. Management anticipates a slight increase in customer service fees in 2015, when compared to 2014, as the new fee schedule is in effect for the entire year.
- ☐ In 2014 and 2013, the Bank elected to liquidate a portion of its municipal securities portfolio to take advantage of market conditions and offset losses associated with the disposal of foreclosed assets. These realized gains have assisted the Bank in reducing its foreclosed assets from approximately \$20 million as of December 31, 2012 to approximately \$8 million as of December 31, 2014.
- ☐ The Bank actively seeks opportunities to lend through the Small Business Administration (SBA) lending programs. As a result of this effort the Bank is able to generate fees and improve its noninterest income. In 2013, the Bank was able to close several SBA loans and generate approximately \$404 thousand in fees. In 2014, the Bank did not have as many loan opportunities. Therefore, the amount of fees generated were closer to historic levels as seen in 2012. The Bank continues to look for these opportunities to increase its noninterest income and provide lending to customers and our community.

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 expenses.

Table 9 presents the components of noninterest expense for the years ended December 31, 2014, 2013 and 2012 (in thousands).

TABLE 9

| | 2014 | 2013 | 2012 |
|-------------------------------------|------------------|------------------|------------------|
| Salaries and employee benefits | \$ 7,054 | \$ 6,555 | \$ 6,327 |
| Net occupancy and equipment expense | 1,231 | 1,335 | 1,447 |
| Depository insurance | 640 | 645 | 804 |
| Foreclosed assets, net | 1,842 | 2,002 | 1,101 |
| Other operating expenses | 3,233 | 3,309 | 3,499 |
| Total noninterest expense | <u>\$ 14,000</u> | <u>\$ 13,846</u> | <u>\$ 13,178</u> |

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

- ☐ Salaries and employee benefits have increased since 2012 as the Bank continues to address employee cost of living adjustments. Prior to 2013, the Bank had not increased salary expense for cost of living adjustments for three years. Furthermore, Cornerstone elected not to contribute to the 401(k) plan. Cornerstone hopes to address this issue in the near future.

Management continues to evaluate occupancy and equipment expense components to determine if cost savings can be realized. The Bank has been able to reduce this cost by approximately \$216 thousand when comparing 2014 to 2012. Management believes the 2014 amounts will remain constant or slightly decrease as the Bank purchases its Miller Plaza branch facilities and experiences lower operating expense as compared to rent expense amounts.

The Bank's depository insurance has decreased from approximately \$804 thousand in 2012 to approximately \$640 thousand in 2014. Cornerstone has been able to reduce this expense as improvements have been made in the Bank's asset quality and regulatory performance ratings. Management anticipates that the 2015 depository insurance amount will be similar to the amount recorded in 2014. The Bank anticipates a reduction in this expense as asset quality and ratings continue to improve.

In 2014, as with prior years, the Bank experienced elevated amounts of foreclosed asset expense. Management sees this expense item as its greatest opportunity to improve earnings in the near future. The Bank has been able to reduce its foreclosed assets from approximately \$20 million as of December 31, 2012 to approximately \$8 million as of December 31, 2014. Management anticipates that the Bank's foreclosed asset expense will remain elevated during 2015 as management attempts to reduce this balance further.

Income Tax Expense

The difference between Cornerstone's expected income tax expense, computed by multiplying income before income taxes by statutory income tax rates, and actual income tax expense is primarily attributable to new market tax credits for federal and state purposes, tax exempt loans and tax exempt securities.

Financial Condition

Overview -Cornerstone's consolidated balance sheet reflects significant changes over the last two years. During 2014, total assets decreased approximately \$16 million or 3.81% from approximately \$432 million as of December 31, 2013 to approximately \$416 million as of December 31, 2014. The decrease was derived primarily from a decrease in cash and cash equivalents from approximately \$24.9 million as of December 31, 2013 to approximately \$15.5 million as of December 31, 2014 and a decrease in foreclosed assets from approximately \$12.9 million as of December 31, 2013 to approximately \$8.0 million as of December 31, 2014. The total decrease in cash and cash equivalents is primarily related to a decrease in deposits that is described in detail in Tables 23 and 24. Foreclosed assets decreased due to a strategic initiative to move non-earning assets off the balance sheet. Total loans increased approximately \$6 million or 2.05% from approximately \$289 million as of December 31, 2013 to approximately \$295 million as of December 31, 2014. Finally, stockholders' equity increased approximately \$1 million or 1.32% from approximately \$40 million as of December 31, 2013 to approximately \$41 million as of December 31, 2014.

Investments -The Bank's investment portfolio totaled approximately \$90 million or 21.54% of total assets as of December 31, 2014, compared to a total of approximately \$95 million or 21.88% of total assets as of December 31, 2013. The reduction in the investment portfolio resulted from the Bank liquidating a portion of its municipal inventory to offset foreclosed asset expense.

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

Table 10 presents the carrying value of the Bank's investments at the dates indicated. Available for sale securities are carried at fair market value and securities held to maturity are held at their book value (amounts in thousands).

TABLE 10

| Investment Portfolio Years Ended December 31, | | | |
|--|------------------|------------------|------------------|
| | 2014 | 2013 | 2012 |
| Securities available for sale: | | | |
| U.S. Government agency obligations | \$ 563 | \$ 3,481 | \$ 4,018 |
| Mortgage-backed securities | 79,299 | 73,479 | 48,445 |
| State and political subdivisions | 7,331 | 15,249 | 23,634 |
| Totals | <u>87,193</u> | <u>92,209</u> | <u>76,097</u> |
| Securities held to maturity: | | | |
| Mortgage-backed securities | 25 | 34 | 45 |
| Totals | <u>25</u> | <u>34</u> | <u>45</u> |
| Federal Home Loan Bank stock, at cost | <u>2,323</u> | <u>2,323</u> | <u>2,323</u> |
| Total Investments | <u>\$ 89,541</u> | <u>\$ 94,566</u> | <u>\$ 78,465</u> |

Management anticipates the Bank's investment portfolio to remain at year end 2014 levels to provide an appropriate investment to total asset percentage.

A second objective of the security portfolio is to provide adequate collateral to satisfy pledging requirements with the State of Tennessee collateral pool, the Federal Home Loan Bank, repurchase agreements and correspondent banks. As of December, 31, 2014, the Bank had pledged securities with a market value of approximately \$69 million and unpledged securities with a market value of approximately \$18 million.

For December 31, 2014, tables 11 and 12 present the book value of the Bank's investments, the weighted average yields on the Bank's investments and the periods to maturity of the Bank's investments for the "Securities Available for Sale" and the "Securities Held to Maturity," respectively. Tables 13 and 14 present this information for December 31, 2013.

TABLE 11 (amounts in thousands)

| Weighted Average Yields on the Available For Sale Investments Periods of Maturity from December 31, 2014 | | | | | | | | |
|---|------------------|-------------------------|---------------|-------------------------|-----------------|-------------------------|------------------|-------------------------|
| | Less than 1 year | | 1 to 5 years | | 5 to 10 years | | Over 10 years | |
| | Amount | Weighted Avg. Yield (1) | Amount | Weighted Avg. Yield (1) | Amount | Weighted Avg. Yield (1) | Amount | Weighted Avg. Yield (1) |
| Securities available for sale: | | | | | | | | |
| U.S. Government agencies | \$ - | - | \$ - | - | \$ 560 | 1.18% | \$ - | - |
| Mortgage-backed securities (2) | - | - | 7 | 5.20% | 5,022 | 1.84% | 74,103 | 1.27% |
| Tax-exempt municipal bonds | - | - | 899 | 6.21% | 2,271 | 5.03% | 3,858 | 4.37% |
| Totals | <u>\$ -</u> | <u>-</u> | <u>\$ 906</u> | <u>6.20%</u> | <u>\$ 7,853</u> | <u>2.72%</u> | <u>\$ 77,961</u> | <u>1.42%</u> |
| Total Securities Available for Sale | <u>\$ 86,720</u> | <u>1.58%</u> | | | | | | |

- (1) The weighted average yields on tax-exempt securities have been computed on a tax-equivalent basis.
- (2) Mortgages are allocated by maturity and not amortized.

TABLE 12 (amounts in thousands)

| Weighted Average Yields on the Held to Maturity Investments | | | | | | | | |
|---|------------------|------------------------|--------------|-------------------------|---------------|-------------------------|---------------|-------------------------|
| Periods of Maturity from December 31, 2014 | | | | | | | | |
| | Less than 1 year | | 1 to 5 years | | 5 to 10 years | | Over 10 years | |
| | Amount | Weighted Avg. Yield(1) | Amount | Weighted Avg. Yield (1) | Amount | Weighted Avg. Yield (1) | Amount | Weighted Avg. Yield (1) |
| Securities held to maturity | | | | | | | | |
| Mortgage-backed securities (2) | \$ - | - | \$ 6 | 2.09% | \$ 14 | 1.53% | \$ 5 | 2.88% |
| Totals | \$ - | - | \$ 6 | 2.09% | \$ 14 | 1.53% | \$ 5 | 2.88% |
| Total Securities Held to Maturity | \$ 25 | 1.92% | | | | | | |
| Federal Home Loan Bank stock, at cost | \$ 2,323 | 4.98% | | | | | | |
| Total Investments | \$ 89,068 | 1.67% | | | | | | |

- (1) The weighted average yields on tax-exempt securities have been computed on a tax-equivalent basis.
(2) Mortgages are allocated by maturity and not amortized.

TABLE 13 (amounts in thousands)

| Weighted Average Yields on the Available For Sale Investments | | | | | | | | |
|---|------------------|-------------------------|--------------|-------------------------|---------------|-------------------------|---------------|-------------------------|
| Periods of Maturity from December 31, 2013 | | | | | | | | |
| | Less than 1 year | | 1 to 5 years | | 5 to 10 years | | Over 10 years | |
| | Amount | Weighted Avg. Yield (1) | Amount | Weighted Avg. Yield (1) | Amount | Weighted Avg. Yield (1) | Amount | Weighted Avg. Yield (1) |
| Securities available for sale: | | | | | | | | |
| U.S. Government agencies | \$ - | - | \$ - | - | \$ - | - | \$ 3,433 | 1.02% |
| Mortgage-backed securities (2) | - | - | - | - | 13 | 5.47% | 73,443 | 1.16% |
| Tax-exempt municipal bonds | - | - | 1,266 | 6.09% | 4,237 | 4.46% | 9,406 | 5.21% |
| Totals | \$ - | - | \$ 1,266 | 6.09% | \$ 4,250 | 4.46% | \$ 86,282 | 1.60% |
| Total Securities Available for Sale | \$ 91,798 | 1.79% | | | | | | |

- (1) The weighted average yields on tax-exempt securities have been computed on a tax-equivalent basis.
(2) Mortgages are allocated by maturity and not amortized.

TABLE 14 (amounts in thousands)

| Weighted Average Yields on the Held to Maturity Investments | | | | | | | | |
|---|------------------|------------------------|--------------|-------------------------|---------------|-------------------------|---------------|-------------------------|
| Periods of Maturity from December 31, 2013 | | | | | | | | |
| | Less than 1 year | | 1 to 5 years | | 5 to 10 years | | Over 10 years | |
| | Amount | Weighted Avg. Yield(1) | Amount | Weighted Avg. Yield (1) | Amount | Weighted Avg. Yield (1) | Amount | Weighted Avg. Yield (1) |
| Securities held to maturity | | | | | | | | |
| Mortgage-backed securities (2) | \$ - | - | \$ 7 | 1.92% | \$ 16 | 1.80% | \$ 11 | 1.54% |
| Totals | \$ - | - | \$ 7 | 1.92% | \$ 16 | 1.80% | \$ 11 | 1.54% |
| Total Securities Held to Maturity | \$ 34 | 1.74% | | | | | | |
| Federal Home Loan Bank stock, at cost | \$ 2,323 | 4.18% | | | | | | |
| Total Investments | \$ 94,155 | 1.85% | | | | | | |

- (1) The weighted average yields on tax-exempt securities have been computed on a tax-equivalent basis.
(2) Mortgages are allocated by maturity and not amortized.

Lending -All lending activities of the Bank are under the direct supervision and control of the Directors Loan Committee (DLC). The DLC is comprised of three members of management and five independent directors that serve only in a director capacity and are not employees of the Bank. Also present at meetings of the committee are the loan review officer and other lending officers, as required. This oversight committee enforces loan authorizations for each officer, makes lending decisions on loans exceeding such limits, reviews and oversees problem credits, and determines the allocation of funds for each lending category.

At December 31, 2014 and 2013, Cornerstone's net loan portfolio constituted approximately 70.2% and 66.2% of Cornerstone's total assets, respectively.

Table 15 presents the composition of Cornerstone's loan portfolio at the indicated dates.

TABLE 15

| (In thousands) | Loan Portfolio Composition | | | | | | | | | |
|--|----------------------------|---------|------------|---------|------------|---------|------------|---------|------------|---------|
| | Years Ended December 31, | | | | | | | | | |
| | 2014 | | 2013 | | 2012 | | 2011 | | 2010 | |
| | Amount | Percent | Amount | Percent | Amount | Percent | Amount | Percent | Amount | Percent |
| Commercial, financial and agricultural | \$ 37,863 | 12.82% | \$ 38,999 | 13.47% | \$ 40,140 | 14.49% | \$ 37,458 | 13.99% | \$ 51,160 | 17.94% |
| Real estate – construction | 34,449 | 11.66% | 41,597 | 14.37% | 38,557 | 13.92% | 31,031 | 11.59% | 29,848 | 10.46% |
| Real estate – mortgage | 76,907 | 26.04% | 76,315 | 26.37% | 71,195 | 25.70% | 70,543 | 26.34% | 71,878 | 25.20% |
| Real estate – commercial | 143,168 | 48.47% | 129,799 | 44.84% | 125,172 | 45.19% | 126,057 | 47.08% | 129,031 | 45.23% |
| Consumer loans | 2,977 | 1.01% | 2,730 | 0.95% | 1,927 | 0.70% | 2,676 | 1.00% | 3,330 | 1.17% |
| Total Loans | \$ 295,364 | 100.00% | \$ 289,440 | 100.00% | \$ 276,991 | 100.00% | \$ 267,765 | 100.00% | \$ 285,247 | 100.00% |

Significant matters relating to the changes in the loan portfolio composition are presented below:


 During 2014, the Bank experienced a decrease in real estate construction loans and an increase in real estate commercial loans as the loans were converted from construction to permanent financing. Management anticipates that this trend will continue into 2015 as the Chattanooga, TN market continues to remodel existing properties or build new projects. These types of projects allow the Bank to assist in building the community and creates an opportunity for a long term relationship.

Table 16 presents the scheduled maturities of the loans in Cornerstone's loan portfolio as of December 31, 2014 based on their contractual terms to maturity. Overdrafts are reported as due in less than one year. Loans unpaid at maturity are renegotiated based on current market rates and terms.

TABLE 16

Loans Maturing
Year-end Balance as of December 31, 2014

| (In thousands) | Less than One Year | 1 to 5 Years | Over 5 Years | Total |
|--|-----------------------|-------------------|------------------|-------------------|
| Commercial, financial and agricultural | \$ 24,559 | \$ 11,439 | \$ 1,865 | \$ 37,863 |
| Real estate – construction | 23,151 | 11,038 | 260 | 34,449 |
| Real estate – mortgage | 9,052 | 40,500 | 27,355 | 76,907 |
| Real estate – commercial | 19,889 | 91,594 | 31,685 | 143,168 |
| Consumer | 1,389 | 1,588 | - | 2,977 |
| Total Loans | <u>\$ 78,040</u> | <u>\$ 156,159</u> | <u>\$ 61,165</u> | <u>\$ 295,364</u> |

Types of Loans

Commercial, Financial and Agricultural Loans- The Bank's commercial loan portfolio is comprised of commercial, industrial, and non-farm non-residential loans, hereinafter referred to as commercial loans (excluding commercial construction loans). These installment loans and lines of credit are extended to individuals, partnerships and corporations for a variety of business purposes, such as accounts receivable and inventory financing, equipment financing, business expansion and working capital. The following is a list of terms imbedded in the Bank's commercial loan portfolio:

- The terms of the Bank's commercial loans generally range from ninety days to a fifteen year amortization with a five year balloon.
- Commercial loans are generally tied to the prime index and adjust with changes in the prime rate. The Bank also extends fixed interest rate loans when appropriate to match the borrower's needs.
- Loans secured by marketable equipment are required to be amortized over a period not to exceed 60 months.
- Generally, loans secured by current assets such as inventory or accounts receivable are structured as revolving lines of credit with annual maturities.
- Loans secured by chattel, mortgages and accounts receivable may not exceed 85% of their market value.
- Loans secured by listed stocks, municipal bonds and mutual funds may not exceed 70% of their market value.
- Unsecured short-term loans and lines of credit must meet criteria set by the Bank's Loan Committee. Current financial statements support all commercial loans, and such financial statements are updated annually.
- Substantially all of the Bank's commercial loans are secured and are guaranteed by the principals of the borrower.

Real Estate: Construction Loans- The Bank makes residential construction loans to owner-occupants and to persons building residential properties for resale. The Bank has two main areas of construction loans: one is to residential real estate developers for speculative or custom single-family residential properties, and the other is to custom commercial construction projects with guaranteed takeout provisions. Construction loans are usually variable rate loans made for terms of one year or less, but extensions are permitted if construction has continued satisfactorily, the loan is current and other circumstances warrant the extension. Construction loans are limited to 80% of the appraised value of the lot and the completed value of the proposed structure.

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

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

Real Estate: Mortgage Loans- Real estate mortgage loans include all one to four family residential loans secured by real estate for purposes other than construction or acquisition and development. All real estate loans are held in the Bank's loan portfolio except for loans that are designated as loans held for sale. The loans held for sale are qualified by the Federal National Mortgage Association and have been pre-approved by an underwriting specialist prior to closing. The remainder of the Bank's mortgage loans are home equity loans and are made at fixed interest rates for terms of one to three years with balloon payment provisions and amortized over a 10 to 15 year period. The Bank's experience indicates that real estate loans normally remain outstanding for much shorter periods than their stated maturity because the borrowers repay the loans in full either upon the sale of the secured property or upon the refinancing of the original loan.

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

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

Real Estate: Commercial Loans- Commercial real estate mortgage loans include commercial loans secured by real estate for purposes other than construction or acquisition and development. All real estate loans are held in the Bank's loan portfolio except for loans that have been participated to correspondent banks. The Bank will sell these participations if a loan exceeds the Bank's legal lending limit or as is deemed appropriate by the Director's Loan Committee. Commercial real estate mortgage loans are a combination of properties that are leased out or used for a primary place of a business the Bank has a relationship with. Most of the commercial real estate loans have fixed interest rates for terms of one to three years with balloon payment provisions and are amortized over a 10 to 15 year period, but whenever possible the Bank will seek a variable rate loan which would be tied to the New York prime rate and adjusted monthly. The Bank's experience indicates that real estate loans normally remain outstanding for much shorter periods than their stated maturity because the borrowers repay the loans in full either upon the sale of the secured property or upon the refinancing of the original loan. Commercial real estate loans are made for up to 85% of the value of the property securing the loan, based upon an appraisal if the loan amount is over \$100,000. The Bank also requires title insurance to insure the priority of the property lien on its real estate loans over \$50,000 and requires fire and casualty insurance on all of its loans.

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

Lending Commitments- Commitments under standby letters of credit and undisbursed loan commitments totaled approximately \$47 million as of December 31, 2014 compared to approximately \$34 million as of December 31, 2013. This number includes all lines of credit that have not been fully drawn and loan commitments in the same status.

Origination, Purchase and Sale of Loans

The Bank originates the majority of its loans in Hamilton County, Tennessee. However, the Bank also originates loans in Marion, Sequatchie and Bradley Counties in Tennessee, and Dade, Walker, Whitfield and Catoosa Counties in Georgia, each of which is within 150 miles of Chattanooga, Tennessee. Loans are originated by 13 relationship managers who operate from the Bank's offices in Chattanooga, Tennessee and from the loan production office in Dalton, Georgia. These relationship managers actively solicit loan applications from existing customers, local manufacturers and retailers, builders, real estate developers, real estate agents and others. The Bank also receives numerous loan applications as a result of customer referrals and walk-ins to its offices.

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

The Bank's loan approval process is intended to be conservative but also responsive to customer needs. Loans are approved in accordance with the Bank's written loan policy, which provides for several tiers of approval authority, based on a borrower's aggregate debt with the Bank. The Bank's legal lending limit is 25% of the Bank's qualifying equity for secured loans and 15% for unsecured loans.

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

Loan Fee Income

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

Commitment fees are charged by the Bank to the borrower for certain loans and are calculated as a percentage of the principal amount of the loan. These fees normally are deducted from the proceeds of the loan and generally range from 0.5% to 2.0% of the principal amount, depending on the type and volume of loans made and market conditions such as the demand for loans, the availability of money and general economic conditions. The Bank complies with Accounting Standard Codification Topic 310, "Receivables," and amortizes all significant loan fees over the life of the loan. The Bank also receives miscellaneous fee income from late payment charges, overdraft fees, property inspection fees, and miscellaneous services related to its existing loans.

Problem Loans and Allowance for Loan Losses

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

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

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

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

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

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

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. A loan or portion thereof is charged-off against the allowance when management has determined that losses on such loans are probable. Recoveries on any loans charged-off in prior fiscal periods are credited to the allowance. It is the opinion of the Bank's management that the balance in the allowance for loan losses as of December 31, 2014 is adequate to absorb possible losses from loans currently in the portfolio.

Table 17 presents the Bank's internal watchlist for loans classified as doubtful as of December 31, 2014 and 2013. Table 18 presents the Bank's internal watchlist for loans classified as substandard as of December 31, 2014 and 2013.

TABLE 17

| (In thousands) | Internal Watchlist Composition-Doubtful | | | |
|---|---|-------------|-------------------|-------------|
| | December 31, 2014 | | December 31, 2013 | |
| | Amount | Impairment | Amount | Impairment |
| Commercial and industrial | \$ - | \$ - | \$ - | \$ - |
| Construction and development | - | - | - | - |
| Single family real estate | - | - | - | - |
| Multi-family real estate | - | - | - | - |
| Owner occupied commercial real estate | - | - | - | - |
| Non-owner occupied commercial real estate | - | - | - | - |
| Consumer | - | - | - | - |
| Totals | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> |

TABLE 18

| (In thousands) | Internal Watchlist Composition-Substandard | | | |
|---|--|---------------|-------------------|---------------|
| | December 31, 2014 | | December 31, 2013 | |
| | Amount | Impairment | Amount | Impairment |
| Commercial and industrial | \$ 1,992 | \$ 273 | \$ 2,137 | \$ 55 |
| Construction and development | 1,231 | - | 674 | - |
| Single family real estate | 2,702 | 15 | 5,210 | 11 |
| Multi-family real estate | - | - | 125 | - |
| Owner occupied commercial real estate | 1,334 | 228 | 4,646 | 86 |
| Non-owner occupied commercial real estate | 3,152 | 150 | 2,217 | 412 |
| Consumer | - | - | - | - |
| Totals | <u>\$ 10,411</u> | <u>\$ 666</u> | <u>\$ 15,009</u> | <u>\$ 564</u> |

☐ The information listed in tables 17 and 18 reflect the amount of the Bank's loans net of any partial charge-off amount that has been previously recorded.

☐ During 2014, the Bank saw a decrease in the number and dollar volume of substandard loans. The Bank has been able to convert substandard loans to foreclosed assets or upgrade to performing loans. At December 31, 2014, management had determined that approximately \$666 thousand was needed in specific loan impairment for substandard loans and \$30 thousand for non-substandard loans. The majority of this amount, approximately \$651 thousand, was concentrated in three loans. Management believes two of these loans, which have been assigned an impairment amount of \$423 thousand, could be refinanced or the underlying businesses sold in 2015. In either instance, the Bank is anticipating that it will be able to collect the full amount of its outstanding book balance. The remaining, with an assigned impairment amount of approximately \$228 thousand, will most likely continue to have an impairment during 2015 and could take additional time for management to work with the borrower.

Table 19 presents Cornerstone's allocation of the allowance for loan losses as of December 31, 2014, 2013, 2012, 2011, and 2010.

TABLE 19

| (In thousands) | Allowance for Loan Losses Years Ended December 31, | | | | | |
|--|---|---|-----------------|---|-----------------|---|
| | 2014 | | 2013 | | 2012 | |
| | Amount | Percent of loans by category to total loans | Amount | Percent of loans by category to total loans | Amount | Percent of loans by category to total loans |
| Balance at end of period applicable to | | | | | | |
| Commercial, financial and agricultural | \$ 638 | 12.82% | \$ 352 | 13.47% | \$ 809 | 14.49% |
| Real estate – construction | 130 | 11.66% | 319 | 14.37% | 1,241 | 13.92% |
| Real estate – mortgage | 1,097 | 26.04% | 938 | 26.37% | 1,528 | 25.70% |
| Real estate – commercial | 1,595 | 48.47% | 1,549 | 44.84% | 2,549 | 45.19% |
| Consumer | 35 | 1.01% | 45 | .95% | 14 | 0.70% |
| Totals | <u>\$ 3,495</u> | <u>100.00%</u> | <u>\$ 3,203</u> | <u>100.00%</u> | <u>\$ 6,141</u> | <u>100.00%</u> |

| (In thousands) | 2011 | | 2010 | |
|--|-----------------|---|-----------------|---|
| | Amount | Percent of loans by category to total loans | Amount | Percent of loans by category to total loans |
| Balance at end of period applicable to | | | | |
| Commercial, financial and agricultural | \$ 482 | 13.99% | \$ 925 | 17.94% |
| Real estate – construction | 827 | 11.59% | 3,238 | 10.46% |
| Real estate – mortgage | 2,518 | 26.34% | 3,111 | 25.20% |
| Real estate – commercial | 3,557 | 47.08% | 1,793 | 45.23% |
| Consumer | 16 | 1.00% | 65 | 1.17% |
| Totals | <u>\$ 7,400</u> | <u>100.00%</u> | <u>\$ 9,132</u> | <u>100.00%</u> |


 In 2014, Cornerstone calculated its allowance for loan and leases losses (“ALLL”) by including measurements such as environmental factors for growth, environmental factors for real estate values, historical metrics and specific loan products with increased levels of risk, such as asset based lending. Further, Cornerstone calculated its ALLL using a ten-quarter look-back time frame. Management believes its allowance methodology is consistent with generally accepted accounting principles and interagency policy statements published by the Bank’s regulatory agencies.

Table 20 represents the scheduled maturities of floating and fixed interest rate loans in Cornerstone’s loan portfolio as of December 31, 2014, based on their contractual terms to maturity. Overdrafts are reported as loans due in less than one year.

TABLE 20

| | Less than 1 Year | 1 to 5 Years | Over 5 Years | Total |
|--|------------------|-------------------|------------------|-------------------|
| Floating Interest Rate Loans: | | | | |
| Commercial, financial and agricultural | \$ 14,822 | \$ 1,725 | \$ 1,627 | \$ 18,174 |
| Real estate-construction | 13,553 | 3,518 | 240 | 17,311 |
| Real estate-commercial | 1,869 | 17,425 | 20,189 | 39,483 |
| Real estate-mortgage | 2,905 | 3,308 | 18,570 | 24,783 |
| Consumer | 323 | 166 | - | 489 |
| Total floating interest rate loans | <u>\$ 33,472</u> | <u>\$ 26,142</u> | <u>\$ 40,626</u> | <u>\$ 100,240</u> |
| Fixed Interest Rate Loans: | | | | |
| Commercial, financial and agricultural | \$ 9,737 | \$ 9,714 | \$ 238 | \$ 19,689 |
| Real estate-construction | 9,598 | 7,520 | 20 | 17,138 |
| Real estate-commercial | 18,020 | 74,169 | 11,496 | 103,685 |
| Real estate-mortgage | 6,147 | 37,192 | 8,785 | 52,124 |
| Consumer | 1,066 | 1,422 | - | 2,488 |
| Total fixed interest rate loans | <u>44,568</u> | <u>130,017</u> | <u>20,539</u> | <u>195,124</u> |
| Total loans | <u>\$ 78,040</u> | <u>\$ 156,159</u> | <u>\$ 61,165</u> | <u>\$ 295,364</u> |

Table 21 presents Cornerstone's delinquent, nonaccrual and troubled debt restructuring loans as of December 31 for the five years indicated.

TABLE 21

| Delinquent, Nonaccrual and Troubled Debt Restructured Loans | | | | | |
|---|-------------------|-------------------|-------------------|-------------------|-------------------|
| | 2014 | 2013 | 2012 | 2011 | 2010 |
| Ratio of non-performing assets to total loans | 3.68% | 5.70% | 9.51% | 9.86% | 9.27% |
| Ratio of delinquent (30-days or more) but accruing loans to: | | | | | |
| Total loans | 0.56% | 0.78% | 2.38% | 3.05% | 0.81% |
| Total assets | 0.40% | 0.52% | 1.49% | 1.93% | 0.52% |
| Actual for Years Ended December 31, | | | | | |
| (In thousands) | 2014 | 2013 | 2012 | 2011 | 2010 |
| Accruing loans that are contractually past due 90-days or more: | | | | | |
| Commercial, financial and agricultural | \$ - | \$ - | \$ - | \$ - | \$ - |
| Real estate-construction | - | - | - | - | - |
| Real estate-commercial | - | - | - | - | - |
| Real estate-mortgage | - | - | - | - | - |
| Consumer | - | - | - | - | - |
| Total loans | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> |
| Nonaccruing loans 90-days or more: | | | | | |
| Commercial, financial and agricultural | \$ 1,195 | \$ 1,631 | \$ 2,467 | \$ 42 | \$ 75 |
| Real estate-construction | 40 | 47 | 53 | 1,622 | - |
| Real estate-commercial | 496 | 882 | 2,869 | 2,563 | 8,426 |
| Real estate-mortgage | 1,134 | 1,006 | 616 | 3,641 | 5,114 |
| Consumer | - | - | - | 14 | 18 |
| Total loans | <u>\$ 2,865</u> | <u>\$ 3,566</u> | <u>\$ 6,005</u> | <u>\$ 7,882</u> | <u>\$ 13,633</u> |
| Troubled debt restructurings not included above | <u>3,767</u> | <u>3,328</u> | <u>5,316</u> | <u>2,671</u> | <u>948</u> |
| Total loans | <u>\$ 295,364</u> | <u>\$ 289,440</u> | <u>\$ 276,991</u> | <u>\$ 267,765</u> | <u>\$ 285,247</u> |

☐ The Bank has seen an improvement in recent years in its ratio of non-performing assets to total loans. This trend has been the result of the Bank working with existing customers to restructure problem loans and the reduction of other real estate owned in the event a workout solution could not be found and the Bank had to foreclose on the property. To facilitate the disposal of other real estate the Bank elected to realize investment portfolio gains. This additional revenue allowed management to be more aggressive in the disposal of other real estate during this period. To provide further emphasis on this point, the Bank had approximately \$20.3 million in foreclosed assets as recent as December 31, 2012. As of December 31, 2014, the amount of foreclosed assets had been reduced to approximately \$8.0 million. While the December 31, 2014 amount in foreclosed assets remains at elevated levels compared to amounts pre-2008, management has seen a significant improvement in the Bank's non-performing asset ratios and anticipates reductions in other real estate operating expense in future years.

☐ The Bank has also seen an improvement in its loans that are past due 30 days or more. Management believes this ratio is an important indicator for possible future problems in its loan portfolio. The level of past due loans 30 days or more of 0.56% as of December 31, 2014 and the decline in the Bank's nonaccrual loans to approximately \$2.9 million for the same time period are both positive indicators regarding the trend in the Bank's asset quality. Management believes the Bank's nonaccrual loan total will decrease during 2015 if further improvements occur in several large loans as expected.

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

☐ The Bank has developed an internal loan watchlist that identifies classified loans and assists management in monitoring their potential risk to Bank earnings. The Bank also had loans graded substandard of approximately \$10.4 million as of December 31, 2014 compared to approximately \$15.0 million as of December 31, 2013. The Bank also had loans graded special mention of approximately \$7.8 million as of December 31, 2014 compared to approximately \$10.6 million as of December 31, 2013. Management continues to see positive results in the majority of metrics used to measure loan quality. During 2015, management expects the amount of substandard loans to decrease. Increases in special mention, especially, early in the year could occur as loans are upgraded from substandard to special mention for a period of evaluation before loans are ultimately assigned a pass grade.

Table 22 presents Cornerstone's loan loss experience for the periods indicated.

TABLE 22

| Loan Loss Reserve Analysis Years Ending December 31, | | | | | |
|---|------------|------------|------------|------------|------------|
| (in thousands) | 2014 | 2013 | 2012 | 2011 | 2010 |
| Average loans | \$ 293,708 | \$ 278,925 | \$ 268,828 | \$ 273,523 | \$ 311,407 |
| Allowance for possible loan losses, beginning of the period | \$ 3,203 | \$ 6,141 | \$ 7,400 | \$ 9,132 | \$ 5,905 |
| Charge-offs for the period: | | | | | |
| Commercial, financial and agricultural | 108 | 699 | 74 | 36 | 433 |
| Real estate – construction | 58 | 1,193 | 782 | 232 | 1,260 |
| Real estate – mortgage | 896 | 842 | 1,022 | 1,613 | 562 |
| Real estate – commercial | 470 | 1,879 | 958 | 1,238 | 2,309 |
| Consumer | 50 | 96 | 33 | 29 | 114 |
| Total charge-offs | 1,582 | 4,709 | 2,869 | 3,148 | 4,688 |
| Recoveries for the period: | | | | | |
| Commercial, financial and agricultural | 58 | 99 | 144 | 94 | 282 |
| Real estate – construction | 771 | 1,058 | 145 | 532 | 19 |
| Real estate – mortgage | 324 | 241 | 36 | 65 | 54 |
| Real estate – commercial | 156 | 68 | 838 | 259 | 213 |
| Consumer | 50 | 5 | 17 | 21 | 56 |
| Total recoveries | 1,359 | 1,471 | 1,180 | 971 | 624 |
| Net charge-offs for the period | 223 | 3,238 | 1,689 | 2,177 | 4,064 |
| Provision for loan losses | 515 | 300 | 430 | 445 | 7,291 |
| Allowance for possible loan losses, end of period | \$ 3,495 | \$ 3,203 | \$ 6,141 | \$ 7,400 | \$ 9,132 |
| Ratio of allowance for loan losses to total average loans outstanding | 1.19% | 1.15% | 2.28% | 2.71% | 2.93% |
| Ratio of net charge-offs during the period to average loans outstanding during the period | 0.08% | 1.16% | 0.63% | 0.80% | 1.31% |

Sources of Funds

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

Table 23 presents the Bank's core vs. non-core funding as of December 31, 2014 and 2013.

TABLE 23**Core and Non-Core Funding**

(In thousands)

| | December 31, 2014 | | December 31, 2013 | |
|--|-------------------|---------------|-------------------|---------------|
| | Amount | Percent | Amount | Percent |
| Core funding: | | | | |
| Noninterest-bearing demand deposits | \$ 57,035 | 15.2% | \$ 75,206 | 19.3% |
| Interest-bearing demand deposits | 26,464 | 7.1% | 24,564 | 6.3% |
| Savings and money market accounts | 80,861 | 21.6% | 86,330 | 22.2% |
| Time deposits under \$100,000 | 57,128 | 15.3% | 74,080 | 19.0% |
| Total core funding | <u>221,488</u> | <u>59.2%</u> | <u>260,180</u> | <u>66.8%</u> |
| Non-core funding: | | | | |
| Time deposits greater than \$100,000 | 87,166 | 23.3% | 81,234 | 20.9% |
| Federal funds purchased | 10,000 | 2.7% | - | -% |
| Securities sold under agreements to repurchase | 19,410 | 5.2% | 22,974 | 5.9% |
| Federal Home Loan Bank advances | 36,000 | 9.6% | 25,000 | 6.4% |
| Total non-core funding | <u>152,576</u> | <u>40.8%</u> | <u>129,208</u> | <u>33.2%</u> |
| Total | <u>\$ 374,064</u> | <u>100.0%</u> | <u>\$ 389,388</u> | <u>100.0%</u> |

☐ The Bank's noninterest-bearing demand deposits decreased from approximately \$75 million as of December 31, 2013 to approximately \$57 million as of December 31, 2014. Decreases were also seen in the Bank's under \$100,000 time deposit accounts. The Bank has been able to improve its net interest margin by repricing the maturing time deposits during this time. However, the loss of noninterest-bearing demand deposits negatively impacted the Bank. Management is in the process of evaluating liquidity plans that not only improve the company's core funding percentages but also address interest rate risk. The improvement of the Bank's core funding position will be a high priority for management during 2015.

☐ During 2014, the Bank has attempted to remain interest rate competitive on interest-bearing demand deposits, savings and money market relationships. The majority of the Bank's depository base is seeking these types of products as opposed to time deposits. Customers have consistently kept their deposits in non-maturity based products in anticipation of interest rate increases in the market.

☐ To offset the decrease in core funding, the Bank elected to increase its borrowings from the Federal Home Loan Bank (FHLB). Recent borrowings from FHLB have been short-term and have, therefore, enabled the Bank to reduce its cost of funds. Approximately \$10 million of long-term advances will mature in 2015 and management anticipates the new advances to be short-term in nature to allow the Bank to improve its net interest margin and allow management to position the balance sheet for interest rate risk if interest rates rise in the near future.

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

Table 24 presents the composition of deposits for the Bank, excluding accrued interest payable, by type for the years ended December 31, 2014, 2013 and 2012 (in thousands).

TABLE 24

Deposit Composition
Years Ended December 31,

| (In thousands) | 2014 | 2013 | 2012 |
|-----------------------------------|-------------------|-------------------|-------------------|
| Demand deposits | \$ 57,035 | \$ 75,206 | \$ 60,054 |
| NOW deposits | 26,464 | 24,564 | 30,179 |
| Savings and money market deposits | 80,861 | 86,330 | 80,994 |
| Time deposits \$100,000 and over | 87,166 | 81,234 | 87,737 |
| Time deposits under \$100,000 | 57,128 | 74,080 | 85,917 |
| Total Deposits | <u>\$ 308,654</u> | <u>\$ 341,415</u> | <u>\$ 344,881</u> |

Table 25 presents a breakdown by category of the average amount of deposits and the average rate paid on deposits for the periods indicated:

TABLE 25

Average Amount and Average Rate Paid on Deposits
Years Ending December 31,

| (In thousands) | 2014 | | 2013 | | 2012 | |
|-----------------------------------|-------------------|--------------|-------------------|--------------|-------------------|--------------|
| | Amount | Rate | Amount | Rate | Amount | Rate |
| Demand deposits | \$ 59,219 | | \$ 51,614 | | \$ 39,936 | |
| NOW deposits | 26,921 | 0.15% | 26,196 | 0.21% | 26,483 | 0.33% |
| Savings and money market deposits | 82,903 | 0.33% | 88,912 | 0.47% | 62,958 | 0.73% |
| Time deposits | 157,112 | 0.91% | 165,748 | 1.07% | 187,733 | 1.32% |
| Total Deposits | <u>\$ 326,155</u> | <u>0.53%</u> | <u>\$ 332,470</u> | <u>0.68%</u> | <u>\$ 317,110</u> | <u>0.95%</u> |

Table 26 presents a breakdown as of December 31, 2014, of the Bank's scheduled maturity of time deposits (in thousands):

TABLE 26

| | Balances |
|--|-------------------|
| <u>Denominations less than \$100,000</u> | |
| Three months or less | \$ 9,519 |
| Over three but less than six months | 10,196 |
| Over six but less than twelve months | 16,795 |
| Over twelve months | 20,618 |
| | <u>\$ 57,128</u> |
| <u>Denomination greater than \$100,000</u> | |
| Three months or less | \$ 20,506 |
| Over three but less than six months | 5,241 |
| Over six but less than twelve months | 32,850 |
| Over twelve months | 28,569 |
| | <u>\$ 87,166</u> |
| Totals | <u>\$ 144,294</u> |

Borrowings- The Bank joined the Federal Home Loan Bank of Cincinnati in October 2000. The Federal Home Loan Bank (FHLB) allows the Bank to borrow funds on a contractual basis many times at rates lower than the costs of local certificates of deposit. In addition, the FHLB has the ability to provide structured advances that best reduce or leverage the interest rate risk of the Bank. During 2014, the Bank increased its FHLB borrowings by \$11 million. The increase allowed the Bank to obtain short-term funding at favorable interest rates. As of December 31, 2014, the interest rates on these loans ranged from 0.23% to 4.25%. The weighted average interest rate for all FHLB advances equals 2.32%. This is an area of opportunity for the Bank during 2015 as an additional \$10 million in FHLB advances will mature. This will allow the Bank to significantly reduce its interest cost by renewing the \$10 million in advances at shorter terms and lower interest rates. As of December 31, 2014, the Bank had approximately \$13.4 million in additional availability with the FHLB.

The Bank has five Federal Funds lines of credit available with correspondent banks with a total availability of \$30 million as of December 31, 2014. This is an improvement over the availability as of December 31, 2013. At that time the Bank had three Federal Funds lines of credit totaling \$15 million.

Cornerstone's short-term borrowings (borrowings which mature within the next fiscal year) consist primarily of federal funds purchased and securities sold under agreements to repurchase, Federal Home Loan Bank (FHLB) advances, and other borrowings. Information concerning these short-term borrowings as of and for each of the years in the three-year period ended December 31, 2014, is as follows (dollars in thousands):

TABLE 27

| | At December 31, | | |
|--|-----------------|-----------|-----------|
| | 2014 | 2013 | 2012 |
| Amounts outstanding at year-end: | | | |
| Federal funds purchased and securities sold under agreements to repurchase | \$ 29,410 | \$ 22,974 | \$ 19,587 |
| FHLB advances | 26,000 | 5,000 | 10,000 |
| Other borrowings | - | 1,740 | 870 |
| Weighted average interest rates at year-end: | | | |
| Federal funds purchased and securities sold under agreements to repurchase | 0.33% | 0.33% | 0.37% |
| FHLB advances | 1.60% | 4.43% | 4.05% |
| Other borrowings | -% | 2.00% | 6.50% |
| Maximum amount of borrowings at any month-end: | | | |
| Federal funds purchased and securities sold under agreements to repurchase | \$ 47,143 | \$ 32,974 | \$ 28,399 |
| FHLB advances | 26,000 | 5,000 | 10,000 |
| Other borrowings | 1,740 | 1,740 | 870 |
| Average balances for the year: | | | |
| Federal funds purchased and securities sold under agreements to repurchase | \$ 22,319 | \$ 22,041 | \$ 21,312 |
| FHLB advances | 18,000 | 5,000 | 8,462 |
| Other borrowings | 858 | 1,595 | 870 |
| Weighted average interest rates for the year: | | | |
| Federal funds purchased and securities sold under agreements to repurchase | 0.32% | 0.34% | 0.44% |
| FHLB advances | 3.00% | 4.47% | 4.08% |
| Other borrowings | 1.00% | 2.41% | 6.50% |

Capital

Capital Resources- Stockholder's average equity for 2014 and 2013 totaled \$40.6 and \$40.8 million, respectively. As of December 31, 2014, Cornerstone's actual stockholder equity totaled \$40.7 million compared to \$40.1 million as of December 31, 2013. As of December 31, 2014 and 2013, the number of shares of Series A Preferred Stock outstanding was 600,000. The number of common shares outstanding were 6,627,398 and 6,547,074 as of December 31, 2014 and December 31, 2013, respectively.

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

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

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) established five capital categories for banks. Under the regulation defining these five capital categories, each bank is classified into one of the five categories based on its level of risk-based capital as measured by Tier I capital, total risk-based capital, and Tier I leverage ratios and its supervisory ratings. Table 28 lists the five categories of capital and each of the minimum requirements for the three risk-based ratios.

TABLE 28

Minimum Requirements for Risk-Based Capital Ratios

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

The Bank was considered well capitalized as of December 31, 2014 and its capital ratios were as follows:

| | |
|---------------------------------|--------|
| Tier 1 leverage ratio | 9.38% |
| Tier 1 risk-based capital ratio | 12.32% |
| Total risk-based capital ratio | 13.45% |

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

The Bank's liquidity target is measured by adding net cash, short-term and marketable securities not pledged and dividing this number by total deposits and short-term liabilities not secured by assets pledged. The Bank's liquidity ratio at December 31, 2014 was 19.8% The Bank is not subject to any specific liquidity requirements imposed by regulatory orders. The Bank is subject, however, to general FDIC guidelines which are concerned with funding sources and dependence on noncore deposits and does not require a specific minimum level of liquidity. Management believes its liquidity ratios and funding sources meet or exceed these guidelines.

Cornerstone's liquidity is dependent on dividends from its subsidiary. Currently, the holding company's expenses are tied to shareholder and related Securities and Exchange Commission required filings expense. The Bank is presently restricted from passing up any dividends to the holding company unless the Bank receives prior approval from the FDIC who reviews the Bank's profitability and overall safety and soundness before allowing dividends to be paid.

Management does not know of any other trends, demands, commitments, events or uncertainties that will result in or are reasonably likely to result in liquidity increasing or decreasing in any material manner.

Table 29 presents the average loan to deposit ratios, a liquidity measure, for periods indicated:

TABLE 29

| | <u>December 31, 2014</u> | <u>December 31, 2013</u> |
|-----------------------------------|--------------------------|--------------------------|
| Average loans to average deposits | 90.05% | 83.91% |

Off-Balance Sheet Arrangements

Cornerstone does not have any off-balance sheet arrangements.

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, "Summary of Significant Accounting Policies," 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 and lease losses and reduced through loan and lease 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 the "Problem Loans and Allowance for Loan Losses" section within the MD&A for a discussion of Cornerstone's methodology of establishing the allowance as well as Note 1 in the notes to Cornerstone's consolidated financial statements.

Estimates of Fair Value

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

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

Changes in fair value could materially impact our financial results. Refer to Note 12, "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 8, "Income Taxes," in the notes to Cornerstone's consolidated financial statements for more information. As of December 31, 2014, Cornerstone had a net deferred tax asset of \$1.8 million and did not establish a valuation allowance against its net deferred tax assets as of December 31, 2013 or December 31, 2014 because it is more likely than not that all of these assets will be realized. In evaluating the need for a valuation allowance, we estimated future taxable income based on management prepared forecasts. This process required significant judgment by management about matters that are by nature uncertain. If future events differ significantly from our current forecasts, we may need to establish a valuation allowance, which could have a material adverse effect on our results of operations and financial condition.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Sensitivity

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

Earnings at Risk Model

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

At December 31, 2014, the Bank's earnings at risk model demonstrated that the Bank was within its policy limits for a 200, 300 and 400 basis point change in interest rates. The policy limits have been established by the Directors ALCO committee and are calculated and reported quarterly.

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.

As of December 31, 2014, the Bank's economic value of equity model demonstrated that the Bank was within its policy limits for a 200, 300 and 400 basis point change in interest rates. The policy limits have been established by the Directors ALCO committee and are calculated and reported quarterly.

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.

As of December 31, 2014, the Bank's regular liquidity measurements indicated that the liquidity position was within policy limits. The policy limits have been established by the Directors ALCO committee and are calculated and reported quarterly.

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.

As of December 31, 2014, the Bank's basic surplus measurement indicated that the Bank was within policy limits. The policy limits have been established by the Directors ALCO committee and are calculated and reported quarterly.

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

As of December 31, 2014, the Bank's dependency ratio measurement indicated that the current position was within policy limits. The policy limits have been established by the Directors ALCO committee and are calculated and reported quarterly.


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.

BalanceSheet 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.

Like any forecasting technique, interest rate simulation modeling is based on a large number of assumptions. In this case, the assumptions relate primarily to loan and deposit growth, asset and liability prepayments, interest rates and balance sheet management strategies. Management believes that both individually and in the aggregate the assumptions are reasonable. Nevertheless, the simulation modeling process produces only a sophisticated estimate, not a precise calculation of exposure.

 The majority of the Bank's variable loans are indexed to the Prime Rate as published in *The Wall Street Journal*. These variable rate loans contain a provision stating that an interest rate floor ranging from 4.0% to 7.5% exists. Almost all of the Bank's variable rate loans have repriced to the interest rate floors. The Bank's interest rate model estimates the most likely rate adjustment scenario.

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

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

Consolidated Financial Statements and Footnotes

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MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of Cornerstone is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) or 15d-15(f) promulgated under the Exchange Act as a process designed by, or under the supervision of, Cornerstone's principal executive and principal financial officers and effected by Cornerstone's board of directors, management and other personnel, 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 and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of Cornerstone's assets;
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that Cornerstone's receipts and expenditures are being made only in accordance with authorizations of Cornerstone's management and directors; and
- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of Cornerstone's assets that could have a material effect on the financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Cornerstone's management has assessed the effectiveness of internal controls over financial reporting as of December 31, 2014. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in "Internal Control-Integrated Framework."

Based on this assessment management believes that, as of December 31, 2014, Cornerstone's internal control over financial reporting was effective based on those criteria.

This annual report does not include an attestation report of Cornerstone's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by Cornerstone's registered public accounting firm pursuant to transitional rules of the Securities and Exchange Commission that permit Cornerstone to provide only management's report in this annual report.

Report of Independent Registered Public Accounting Firm

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

We have audited the accompanying consolidated balance sheets of Cornerstone Bancshares, Inc. and Subsidiary (the "Company") as of December 31, 2014 and 2013, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. The financial statements of Cornerstone Bancshares, Inc. and Subsidiary for the year ended December 31, 2012, was audited by other auditors who have ceased operations and whose report dated March 28, 2013, expressed an unqualified opinion on those statements.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Cornerstone Bancshares, Inc. and Subsidiary as of December 31, 2014 and 2013, and the results of their operations and their cash flows for the years then ended in conformity with United States generally accepted accounting principles.

/s/ MAULDIN & JENKINS, LLC

Chattanooga, Tennessee
March 30, 2015

The report below is a copy of the report issued by the Company's previous independent auditors, Hazlett, Lewis & Bieter, PLLC.

Report of Independent Registered Public Accounting Firm

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

We have audited the accompanying consolidated balance sheets of Cornerstone Bancshares, Inc. and subsidiary (Company) as of December 31, 2012 and 2011, and the related consolidated statements of operations, comprehensive income, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2012. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Cornerstone Bancshares, Inc. and subsidiary as of December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2012, in conformity with United States generally accepted accounting principles.

/s/ Hazlett, Lewis & Bieter, PLLC

Chattanooga, Tennessee
March 28, 2013

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

December 31, 2014 and 2013

| | 2014 | 2013 |
|---|-----------------------|-----------------------|
| ASSETS | | |
| Cash and due from banks | \$ 1,930,751 | \$ 2,149,467 |
| Interest-bearing deposits at other financial institutions | 13,596,970 | 22,702,270 |
| Total cash and cash equivalents | 15,527,721 | 24,851,737 |
| Securities available for sale | 87,192,909 | 92,208,672 |
| Securities held to maturity (fair value of \$25,702 in 2014 and \$35,027 in 2013) | 25,428 | 34,165 |
| Federal Home Loan Bank stock, at cost | 2,322,900 | 2,322,900 |
| Loans, net of allowance for loan losses of \$3,495,129 in 2014 and \$3,203,158 in 2013 | 291,869,338 | 286,236,578 |
| Bank premises and equipment, net | 4,828,123 | 4,992,449 |
| Accrued interest receivable | 1,142,899 | 977,925 |
| Foreclosed assets | 8,000,365 | 12,925,748 |
| Other assets | 4,830,113 | 7,673,179 |
| Total assets | \$ 415,739,796 | \$ 432,223,353 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Deposits: | | |
| Noninterest-bearing demand deposits | \$ 57,034,792 | \$ 75,206,540 |
| Interest-bearing demand deposits | 26,464,173 | 24,563,987 |
| Savings deposits and money market accounts | 80,861,110 | 86,329,930 |
| Time deposits | 144,294,390 | 155,313,920 |
| Total deposits | 308,654,465 | 341,414,377 |
| Accrued interest payable | 71,925 | 82,320 |
| Federal funds purchased and securities sold under agreements to repurchase | 29,409,505 | 22,974,117 |
| Federal Home Loan Bank advances and other borrowings | 36,000,000 | 26,740,000 |
| Other liabilities | 941,796 | 878,811 |
| Total liabilities | 375,077,691 | 392,089,625 |
| Stockholders' equity: | | |
| Preferred stock - no par value; 2,000,000 shares authorized; 600,000 shares issued and outstanding in 2014 and 2013 | 14,964,309 | 14,892,927 |
| Common stock - \$1.00 par value; 20,000,000 shares authorized in 2014 and 2013; 6,709,199 shares issued in 2014 and 2013; 6,627,398 and 6,547,074 shares outstanding in 2014 and 2013 | 6,627,398 | 6,547,074 |
| Additional paid-in capital | 21,821,060 | 21,549,883 |
| Accumulated deficit | (3,032,551) | (3,099,451) |
| Accumulated other comprehensive income | 281,889 | 243,295 |
| Total stockholders' equity | 40,662,105 | 40,133,728 |
| Total liabilities and stockholders' equity | \$ 415,739,796 | \$ 432,223,353 |

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME
Years Ended December 31, 2014, 2013, and 2012

| | 2014 | 2013 | 2012 |
|--|-------------------|-------------------|-------------------|
| INTEREST INCOME | | | |
| Loans, including fees | \$ 16,690,496 | \$ 16,705,237 | \$ 17,288,855 |
| Securities and interest-bearing deposits at other financial institutions | 1,416,190 | 1,694,292 | 2,003,620 |
| Federal funds sold | 30,678 | 53,502 | 60,404 |
| Total interest income | <u>18,137,364</u> | <u>18,453,031</u> | <u>19,352,879</u> |
| INTEREST EXPENSE | | | |
| Time deposits | 1,427,758 | 1,766,237 | 2,471,135 |
| Other deposits | 313,105 | 473,921 | 546,812 |
| Federal funds purchased and securities sold under agreements to repurchase | 84,641 | 73,903 | 94,402 |
| Federal Home Loan Bank advances and other borrowings | 964,351 | 1,208,490 | 1,672,478 |
| Total interest expense | <u>2,789,855</u> | <u>3,522,551</u> | <u>4,784,827</u> |
| Net interest income before provision for loan losses | 15,347,509 | 14,930,480 | 14,568,052 |
| Provision for loan losses | <u>515,000</u> | <u>300,000</u> | <u>430,000</u> |
| Net interest income after provision for loan losses | <u>14,832,509</u> | <u>14,630,480</u> | <u>14,138,052</u> |
| NONINTEREST INCOME | | | |
| Customer service fees | 849,984 | 821,072 | 803,251 |
| Other noninterest income | 57,148 | 62,457 | 64,519 |
| Net gains from sale of securities | 700,390 | 652,421 | - |
| Net gains from sale of loans and other assets | 211,819 | 403,569 | 151,710 |
| Total noninterest income | <u>1,819,341</u> | <u>1,939,519</u> | <u>1,019,480</u> |
| NONINTEREST EXPENSES | | | |
| Salaries and employee benefits | 7,054,474 | 6,555,059 | 6,327,226 |
| Net occupancy and equipment expense | 1,230,099 | 1,335,126 | 1,447,204 |
| Depository insurance | 640,097 | 644,918 | 803,902 |
| Foreclosed assets, net | 1,841,575 | 2,001,755 | 1,100,670 |
| Other operating expenses | 3,233,318 | 3,309,532 | 3,498,867 |
| Total noninterest expenses | <u>13,999,563</u> | <u>13,846,390</u> | <u>13,177,869</u> |
| Income before income tax expense | 2,652,287 | 2,723,609 | 1,979,663 |
| Income tax expense | <u>1,014,005</u> | <u>1,042,800</u> | <u>577,600</u> |
| Net income | 1,638,282 | 1,680,809 | 1,402,063 |
| Preferred stock dividend requirements | 1,500,000 | 1,500,000 | 1,229,780 |
| Accretion of preferred stock discount | <u>71,382</u> | <u>71,381</u> | <u>63,924</u> |
| Net income available to common stockholders | <u>\$ 66,900</u> | <u>\$ 109,428</u> | <u>\$ 108,359</u> |
| EARNINGS PER COMMON SHARE | | | |
| Basic | \$ 0.01 | \$ 0.02 | \$ 0.02 |
| Diluted | <u>0.01</u> | <u>0.02</u> | <u>0.02</u> |

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
Years Ended December 31, 2014, 2013, and 2012

| | <u>2014</u> | <u>2013</u> | <u>2012</u> |
|--|---------------------|--------------------|---------------------|
| Net income | \$ 1,638,282 | \$ 1,680,809 | \$ 1,402,063 |
| Other comprehensive income, net of tax: | | | |
| Unrealized holding gains (losses) arising during the year, net of tax (expense) benefit of \$(289,804), \$492,528 and \$(203,643) in 2014, 2013 and 2012, respectively | 472,836 | (803,598) | 332,259 |
| Reclassification adjustment for gains included in net income, net of tax expense of \$266,148 and \$247,920 in 2014 and 2013, respectively | <u>(434,242)</u> | <u>(404,501)</u> | <u>-</u> |
| Total other comprehensive income (loss) | <u>38,594</u> | <u>(1,208,099)</u> | <u>332,259</u> |
| Comprehensive income | <u>\$ 1,676,876</u> | <u>\$ 472,710</u> | <u>\$ 1,734,322</u> |

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Years Ended December 31, 2014, 2013, and 2012

| | Preferred Stock | Common Stock | Additional Paid-in Capital | Accumulated Deficit | Accumulated Other Comprehensive Income | Total Stockholders' Equity |
|---|----------------------|---------------------|----------------------------------|------------------------|---|----------------------------------|
| BALANCE, December 31, 2011 | \$ 9,899,544 | \$ 6,500,396 | \$ 21,316,438 | \$ (3,627,208) | \$ 1,119,135 | \$ 35,208,305 |
| Stock compensation expense | - | - | 74,048 | - | - | 74,048 |
| Issuance of Series A Convertible Preferred Stock | 4,858,078 | - | - | - | - | 4,858,078 |
| Preferred stock dividends paid | - | - | - | (985,917) | - | (985,917) |
| Accretion on preferred stock | 63,924 | - | - | (63,924) | - | - |
| Net income | - | - | - | 1,402,063 | - | 1,402,063 |
| Unrealized holding gains on securities available for sale, net of reclassification adjustment and taxes | - | - | - | - | 332,259 | 332,259 |
| BALANCE, December 31, 2012 | 14,821,546 | 6,500,396 | 21,390,486 | (3,274,986) | 1,451,394 | 40,888,836 |
| Stock compensation expense | - | - | 129,056 | - | - | 129,056 |
| Issuance of common stock, 46,678 shares | - | 46,678 | 30,341 | - | - | 77,019 |
| Preferred stock dividends paid | - | - | - | (1,433,893) | - | (1,433,893) |
| Accretion on preferred stock | 71,381 | - | - | (71,381) | - | - |
| Net income | - | - | - | 1,680,809 | - | 1,680,809 |
| Unrealized holding gains (losses) on securities available for sale, net of reclassification adjustment | - | - | - | - | (1,208,099) | (1,208,099) |
| BALANCE, December 31, 2013 | 14,892,927 | 6,547,074 | 21,549,883 | (3,099,451) | 243,295 | 40,133,728 |
| Stock compensation expense | - | - | 160,500 | - | - | 160,500 |
| Issuance of common stock, 80,324 shares | - | 80,324 | 110,677 | - | - | 191,001 |
| Preferred stock dividends paid | - | - | - | (1,500,000) | - | (1,500,000) |
| Accretion on preferred stock | 71,382 | - | - | (71,382) | - | - |
| Net income | - | - | - | 1,638,282 | - | 1,638,282 |
| Unrealized holding gains on securities available for sale, net of reclassification adjustment | - | - | - | - | 38,594 | 38,594 |
| BALANCE, December 31, 2014 | <u>\$ 14,964,309</u> | <u>\$ 6,627,398</u> | <u>\$ 21,821,060</u> | <u>\$ (3,032,551)</u> | <u>\$ 281,889</u> | <u>\$ 40,662,105</u> |

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years Ended December 31, 2014, 2013, and 2012

| | 2014 | 2013 | 2012 |
|---|----------------------|----------------------|----------------------|
| CASH FLOWS FROM OPERATING ACTIVITIES | | | |
| Net income | \$ 1,638,282 | \$ 1,680,809 | \$ 1,402,063 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 413,496 | 506,902 | 529,001 |
| Provision for loan losses | 515,000 | 300,000 | 430,000 |
| Stock compensation expense | 160,500 | 129,056 | 74,048 |
| Gains from sale of securities | (700,390) | (652,421) | - |
| Net gains from sale of loans and other assets | (211,819) | (403,569) | (151,710) |
| Loss from sale and write-downs of foreclosed assets | 1,412,960 | 1,687,965 | 899,534 |
| Deferred income taxes | 540,748 | 105,340 | (383,150) |
| Changes in other operating assets and liabilities: | | | |
| Accrued interest receivable | (164,974) | 235,853 | 113,680 |
| Accrued interest payable | (10,395) | (38,238) | 9,855 |
| Other assets and liabilities | (51,955) | 869,860 | 1,720,001 |
| Net cash provided by operating activities | <u>3,541,453</u> | <u>4,421,557</u> | <u>4,643,322</u> |
| CASH FLOWS FROM INVESTING ACTIVITIES | | | |
| Proceeds from security sales, maturities, and paydowns: | | | |
| Securities available for sale | 21,406,610 | 34,902,675 | 43,951,252 |
| Securities held to maturity | 8,715 | 10,892 | 24,032 |
| Purchase of securities available for sale | (15,676,305) | (52,397,426) | (33,522,131) |
| Distribution from equity investment | 2,393,603 | - | - |
| Loan originations and principal collections, net | (6,054,571) | (13,018,303) | (15,789,776) |
| Purchase of bank premises and equipment | (228,252) | (14,253) | (160,164) |
| Proceeds from sale of bank premises and equipment and foreclosed assets | <u>3,658,254</u> | <u>3,422,717</u> | <u>2,328,625</u> |
| Net cash provided by (used in) investing activities | <u>5,508,054</u> | <u>(27,093,698)</u> | <u>(3,168,162)</u> |
| CASH FLOWS FROM FINANCING ACTIVITIES | | | |
| Net (decrease) increase in deposits | (32,759,912) | (3,466,216) | 30,838,649 |
| Increase (decrease) in federal funds purchased and securities sold under agreements to repurchase | 6,435,388 | 3,386,730 | (9,803,423) |
| Proceeds from Federal Home Loan Bank advances | 16,000,000 | - | - |
| Repayment of Federal Home Loan Bank advances | (5,000,000) | (10,000,000) | (5,000,000) |
| Repayment of other borrowings | (1,740,000) | (435,000) | (870,000) |
| Payment of dividends | (1,500,000) | (1,433,893) | (985,917) |
| Issuance of common stock | 191,001 | 77,019 | - |
| Issuance of preferred stock | - | - | 4,858,078 |
| Net cash (used in) provided by financing activities | <u>(18,373,523)</u> | <u>(11,871,360)</u> | <u>19,037,387</u> |
| NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS | <u>(9,324,016)</u> | <u>(34,543,501)</u> | <u>20,512,547</u> |
| CASH AND CASH EQUIVALENTS, beginning of year | <u>24,851,737</u> | <u>59,395,238</u> | <u>38,882,691</u> |
| CASH AND CASH EQUIVALENTS, end of year | <u>\$ 15,527,721</u> | <u>\$ 24,851,737</u> | <u>\$ 59,395,238</u> |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION | | | |
| Cash paid during the period for interest | \$ 2,800,250 | \$ 3,560,789 | \$ 4,774,972 |
| Cash paid during the period for taxes | <u>767,687</u> | <u>1,107,997</u> | <u>965,888</u> |
| NONCASH INVESTING AND FINANCING ACTIVITIES | | | |
| Acquisition of real estate through foreclosure | \$ 1,681,157 | \$ 1,672,659 | \$ 8,530,357 |
| Financed sales of foreclosed assets | <u>1,538,976</u> | <u>\$ 3,939,495</u> | <u>\$ 3,484,160</u> |

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014, 2013, and 2012

Note 1. Summary of Significant Accounting Policies

The accounting and reporting policies of Cornerstone Bancshares, Inc. and subsidiary (Cornerstone) conform with United States generally accepted accounting principles (U.S. GAAP) and practices within the banking industry. The Financial Accounting Standards Board (FASB) has adopted the FASB Accounting Standards Codification (ASC) as the single source of authoritative nongovernmental U.S. GAAP. Rules and interpretive releases of the Securities and Exchange Commission (SEC) are also sources of authoritative U.S. GAAP for SEC registrants. The policies that materially affect financial position and results of operations are summarized as follows:

Nature of operations:

Cornerstone is a bank-holding company which owns all of the outstanding common stock of Cornerstone Community Bank (the Bank). The Bank provides a variety of financial services through five full service branch locations in Chattanooga, Tennessee and a loan production office in Dalton, Georgia. The Bank's primary deposit products are demand deposits, savings accounts, and certificates of deposit. Its primary lending products are commercial loans, real estate loans, and installment loans.

Principles of consolidation:

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

Use of estimates:

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the valuation of deferred tax assets, other-than-temporary impairments of securities, valuation of foreclosed assets, and the fair value of financial instruments.

Significant group concentrations of credit risk:

Most of Cornerstone's activities are with customers located in middle and eastern Tennessee. The types of securities that Cornerstone invests in are included in Note 4. The types of lending Cornerstone engages in are included in Note 5. Cornerstone does not have any significant concentrations to any one industry or customer.

Commercial real estate, including commercial construction loans, represented 55 percent and 54 percent of the loan portfolio at December 31, 2014 and 2013, respectively.

At December 31, 2014, there were no concentrations of deposits. At December 31, 2013, Cornerstone had a concentration in deposits of one customer totaling approximately \$20,204,000. This balance accounted for approximately 6 percent of total deposits at December 31, 2013.

Securities:

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014, 2013, and 2012

Note 1. Summary of Significant Accounting Policies (continued)

Securities: (continued)

Debt securities not classified as held to maturity are classified as available for sale. Securities available for sale are carried at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Realized gains and losses on securities available for sale are included in other income and, when applicable, are reported as a reclassification adjustment, net of tax, in other comprehensive income. Gains and losses on sales of securities are determined using the specific-identification method. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities.

The Bank conducts a regular assessment of its securities portfolio to determine whether any are other-than-temporarily impaired. In estimating other-than-temporary impairment losses, management considers, among other factors, the length of time and extent to which the fair value has been less than cost, the financial condition and near term prospects of the issuer, and the intent and ability of the Bank to retain its investment for a period of time sufficient to allow for any anticipated recovery. The term "other-than-temporary" is not intended to indicate that the decline is permanent, but indicates that the prospects for a near-term recovery of value is not necessarily favorable, or that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. Once a decline in value for a debt security is determined to be other-than-temporary, the other-than-temporary impairment is separated into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income.

Federal Home Loan Bank stock:

Cornerstone, as a member of the Federal Home Loan Bank (FHLB) system, is required to maintain an investment in capital stock of the FHLB. Based on redemption provisions of the FHLB, the stock has no quoted market value and is carried at cost. At its discretion, the FHLB may declare dividends on the stock. Management reviews for impairment based on the ultimate recoverability of the cost basis in the FHLB stock.

Loans:

Cornerstone grants mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio is represented by real estate loans secured by properties located in Chattanooga, Tennessee and surrounding areas. The ability of Cornerstone's debtors to honor their contracts is dependent on the real estate and economic conditions in these areas.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity are stated at unpaid principal balances, less the allowance for loan losses and net deferred loan fees and costs. When applicable, mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated market value in the aggregate.

Interest income is accrued based on the unpaid principal balance. Loan origination and commitment fees, as well as certain direct origination costs, are deferred and amortized as a yield adjustment over the lives of the related loans using the interest method. Amortization of deferred loan fees is discontinued when a loan is placed on nonaccrual status.

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014, 2013, and 2012

Note 1. Summary of Significant Accounting Policies (continued)

Loans: (continued)

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

A troubled-debt restructuring (TDR) is a loan that the Bank has granted a concession to the borrower, which would not otherwise be considered due to the borrower experiencing financial difficulty. If a loan is in nonaccrual status before it is determined to be a TDR, then the loan remains in nonaccrual status. TDR loans in nonaccrual status may be returned to accrual status if there has been at least a six month sustained period of repayment performance by the borrower. When the Bank modifies the terms of an existing loan that is not considered a TDR, the Bank accounts for the loan modification as a new loan if the terms of the new loan resulting from the refinancing or restructuring are at least as favorable to the Bank as the terms for comparable loans to other customers with similar risk characteristics who are not undergoing a refinancing or restructuring and the modifications are more than minor.

Allowance for loan losses:

The allowance for loan losses is maintained at a level that management believes to be adequate to absorb probable losses in the loan portfolio. Loan losses are charged against the allowance when management believes that the full collectability of the loan is unlikely. As such, a loan may be partially charged-off after a "confirming event" has occurred, which serves to validate that full repayment pursuant to the terms of the loan is unlikely. Subsequent recoveries are credited to the allowance.

Management's determination of the adequacy of the allowance is based on an evaluation of the portfolio, current economic conditions, volume, growth, composition of the loan portfolio, homogeneous pools of loans, risk ratings of specific loans, historical loan loss factors, loss experience of various loan segments, identified impaired loans, and other factors related to the portfolio. This evaluation is performed at least quarterly and is inherently subjective, as it requires material estimates that are susceptible to significant change including the amounts and timing of future cash flows expected to be received on any impaired loans.

As part of management's quarterly assessment of the allowance, management divides the loan portfolio into five segments: commercial real estate-mortgage (includes owner-occupied and all other), consumer real estate-mortgage, construction and land development, commercial and industrial, and consumer and other. Each segment is then analyzed such that a specific and general allocation of the allowance is estimated for each loan segment.

The general component involves the use of a historic loss model to estimate losses inherent in the loan portfolio. The model includes each of the five loan portfolio segments and utilizes the incurred losses over the last ten quarters to estimate inherent losses. The historic loss percentages derived from this model are then applied to the outstanding non-impaired loan balance for each loan category. The amounts for each loan category are then summed to determine the amount of loan loss allowance required.

The estimated general loan loss allocation for all five loan portfolio segments is then adjusted for management's estimate of probable losses for several environmental factors. The allocation for environmental factors is particularly subjective. This amount represents estimated probable inherent credit losses which exist, but have not yet been identified, as of the balance sheet date, and is based upon quarterly trend assessments in delinquent and nonaccrual loans, unanticipated charge-offs, credit concentration changes, prevailing economic conditions, changes in lending personnel experience, changes in lending policies or procedures, and other influencing factors. These environmental factors are considered for each of the loan segments and the general allowance allocation, as determined by the processes noted above for each component, is increased or decreased based on the incremental assessment of these various environmental factors.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014, 2013, and 2012

Note 1. Summary of Significant Accounting Policies (continued)

Allowance for loan losses: (continued)

The Bank's allowance for loan losses includes a specific allocation for loans classified as impaired. In assessing the adequacy of the allowance, Cornerstone considers the results of our ongoing independent loan review process. Cornerstone undertakes this process both to ascertain whether there are loans in the portfolio whose credit quality has weakened over time and to assist in the overall evaluation of the risk characteristics of the entire loan portfolio. Cornerstone's loan review process includes the judgment of management, independent loan reviewers, and reviews that may have been conducted by third-party reviewers. Cornerstone incorporates relevant loan review results in the loan impairment determination. For each impaired loan, management determines the impaired amount and assigns a specific reserve. In addition, regulatory agencies, as an integral part of their examination process, will periodically review Cornerstone's allowance for loan losses and may require the company to record adjustments to the allowance based on their judgment about information available to them at the time of their examinations.

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

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, Cornerstone does not separately identify individual consumer loans for impairment disclosures, unless such loans are the subject of a restructuring agreement due to financial difficulties of the borrower.

Derivative loan commitments:

Mortgage loan commitments are referred to as derivative loan commitments if the loan that will result from exercise of the commitment will be held for sale upon funding. Loan commitments that are derivatives are recognized at fair value on the consolidated balance sheet in derivative assets or derivative liabilities with changes in their fair values recorded in net gains on sales of loans.

Cornerstone records a zero value for the loan commitment at inception, when the commitment is issued to a borrower. Subsequent to inception, changes in the fair value of the loan commitment are recognized based on changes in the fair value of the underlying mortgage loan due to interest rate changes, changes in the probability the derivative loan commitment will be exercised, and the passage of time. In estimating fair value, Cornerstone assigns a probability to a loan commitment based on an expectation that it will be exercised and the loan will be funded.

Premises and equipment:

Land is carried at cost. Premises and equipment are carried at cost less accumulated depreciation computed on the straight-line and declining balance methods over the estimated useful lives of the assets or the expected terms of the leases, if shorter. Expected terms include lease option periods to the extent that the exercise of such options is reasonably assured. Maintenance and repairs are expensed as incurred while major additions and improvements are capitalized. Gains and losses on dispositions are included in noninterest income.

| | Years |
|------------------------------------|-------|
| Buildings and improvements | 10-40 |
| Furniture, fixtures, and equipment | 3-10 |

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014, 2013, and 2012

Note 1. Summary of Significant Accounting Policies (continued)

Investment in partnership:

Cornerstone's investment in a partnership consists of an equity interest in a lending partnership for the purposes of investing in the New Market Tax Credit Program. This program permits taxpayers to claim a credit against federal income taxes for Qualified Equity Investments made to acquire stock or a capital interest in designated Community Development Entities (CDEs). These designated CDEs must use substantially all (defined as 85 percent) of these proceeds to make qualified low-income community investments.

Cornerstone uses the equity method when it owns an interest in a partnership and can exert significant influence over the partnership's operations but cannot control the partnership's operations. Under the equity method, Cornerstone's ownership interest in the partnership's capital is reported as an investment on its consolidated balance sheets and Cornerstone's allocable share of the income or loss from the partnership is reported in noninterest income or expense in the consolidated statements of income. Cornerstone ceases recording losses on an investment in partnership when the cumulative losses and distributions from the partnership exceed the carrying amount of the investment and any advances made by Cornerstone. After Cornerstone's investment in such partnership reaches zero, cash distributions received from these investments are recorded as income.

Foreclosed assets:

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less cost to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenues and expenses from operations and changes in the valuation allowance are included in net expenses from foreclosed assets.

Securities sold under agreements to repurchase:

Cornerstone enters into sales of securities under agreements to repurchase identical securities the next day. Securities sold under agreements to repurchase amounted to \$19,409,506 at December 31, 2014, mature on a daily basis, and are secured by securities available for sale with a fair value of approximately \$24,207,000.

Income taxes:

Cornerstone accounts for income taxes in accordance with income tax accounting guidance in ASC Topic 740. The income tax accounting guidance results in two components of income tax expense – current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to taxable income or loss. Cornerstone determines deferred income taxes using the liability method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities. Cornerstone's deferred taxes relate primarily to differences between the basis of the allowance for loan losses, foreclosed assets, and accumulated depreciation. Deferred tax assets and liabilities are reflected at income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. Cornerstone files consolidated income tax returns with its subsidiary. With few exceptions, Cornerstone is no longer subject to tax examinations by tax authorities for years before 2011.

Cornerstone recognizes deferred tax assets if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. Cornerstone follows the statutory requirements for its income tax accounting and generally avoids risks associated with potentially problematic tax positions that may be challenged upon examination. Cornerstone recognizes interest and penalties on income taxes as a component of income tax expense.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014, 2013, and 2012

Note 1. Summary of Significant Accounting Policies (continued)

Transfers of financial assets:

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over assets is deemed to be surrendered when (1) the assets have been isolated from Cornerstone, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) Cornerstone does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity, or the ability to unilaterally cause the holder to return specific assets.

Advertising costs:

Cornerstone expenses all advertising costs as incurred. Advertising expense was \$112,864, \$89,859 and \$89,068 for the years ended December 31, 2014, 2013 and 2012, respectively.

Statements of cash flows:

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

Stock option plan:

Cornerstone recognizes compensation cost relating to share-based payment transactions in accordance with ASC Topic 718. Compensation cost has been measured based on the grant date fair value of the equity or liability instruments issued. Compensation cost is calculated and recognized over the employee service period, generally defined as the vesting period. Cornerstone uses a stock option pricing model to determine the fair value of the award on the grant date.

Segment reporting:

ASC Topic 280, "Segment Reporting," provides for the identification of reportable segments on the basis of distinct business units and their financial information to the extent such units are reviewed by an entity's chief decision maker (which can be an individual or group of management persons). ASC Topic 280 permits aggregation or combination of segments that have similar characteristics. In Cornerstone's operations, each bank branch is viewed by management as being a separately identifiable business or segment from the perspective of monitoring performance and allocation of financial resources. Although the branches operate independently and are managed and monitored separately, each is substantially similar in terms of business focus, type of customers, products, and services. Accordingly, Cornerstone's consolidated financial statements reflect the presentation of segment information on an aggregated basis in one reportable segment.

Earnings per common share:

Basic earnings per common share represents income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by Cornerstone relate solely to outstanding stock options and are determined using the treasury stock method.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014, 2013, and 2012

Note 1. Summary of Significant Accounting Policies (continued)

Variable interest entities:

An entity is referred to as a variable interest entity (VIE) if it meets the criteria outlined in ASC Topic 810, which are: (1) the entity has equity that is insufficient to permit the entity to finance its activities without additional subordinated financial support from other parties or (2) the entity has equity investors that cannot make significant decisions about the entity's operations or that do not absorb the expected losses or receive the expected returns of the entity. A VIE must be consolidated by Cornerstone if it is deemed to be the primary beneficiary of the VIE, which is the party involved with the VIE that has a majority of the expected losses, expected residual returns, or both. At December 31, 2013, Cornerstone had an investment in Appalachian Fund for Growth II Partnership that qualified as an unconsolidated VIE. This equity investment was distributed to the owners in 2014.

Comprehensive income:

Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains on securities available for sale and unrealized losses related to factors other than credit losses on debt securities.

Off-balance sheet credit related financial instruments:

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

Subsequent events:

Cornerstone has evaluated subsequent events for potential recognition and/or disclosures in the consolidated financial statements and accompanying notes included in this Annual Report on Form 10-K.

Note 2. Preferred Stock

During 2010, Cornerstone initiated a preferred stock offering, which ended on December 31, 2012. Specifics of the preferred stock offering were as follows:

- Issuance of 600,000 shares of Series A Convertible Preferred Stock at a price of \$25.00 per share.
- The annual cash dividend on each share of Series A Preferred Stock is \$2.50, which is equal to 10% of the original issue price of \$25.00 per share, and is payable quarterly in arrears, if, as, and when declared on the 15th day of February, May, August, and November that immediately follows the end of the dividend period to which such dividends relate. Any dividend payable on shares of Series A Preferred Stock that is not declared by our board of directors or paid will accumulate.
- Each share of Series A Preferred Stock will be convertible at the shareholder's option at any time into five (5) shares of our common stock reflecting an initial conversion price of \$5.00 per share of common stock. The shares of Series A Preferred Stock are also convertible at Cornerstone's option, in whole or in part, into shares of Cornerstone's common stock at the conversion rate, at any time on or after July 31, 2015, if the closing price of Cornerstone's common stock equals or exceeds 150% of the conversion price on each of the thirty (30) consecutive trading days immediately preceding the date Cornerstone gives notice of its election to so convert.
- Subject to prior regulatory approval, each share of Series A Preferred Stock is redeemable by Cornerstone, in whole or in part, at any time after July 31, 2015, for a redemption price of \$25.00 per share plus any accumulated and unpaid dividends.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014, 2013, and 2012

Note 2. Preferred Stock (continued)

At December 31, 2014 and 2013, the preferred stock dividends accumulated for each period, which were not declared, totaled \$750,000 for each year.

Note 3. Restrictions on Cash and Due From Banks

The Bank is required to maintain balances on hand or with the Federal Reserve Bank based on a percentage of deposits. At December 31, 2014 and 2013, these reserve balances were approximately \$672,000 and \$724,000, respectively.

Note 4. Securities

Securities have been classified in the balance sheet according to management's intent as either securities held to maturity or securities available for sale. The amortized cost and approximate fair value of securities at December 31, 2014 and 2013, are as follows:

| | December 31, 2014 | | | |
|--|----------------------|------------------------------|-------------------------------|----------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| Debt securities available for sale: | | | | |
| U.S. Government agencies | \$ 560,183 | \$ 2,840 | \$ - | \$ 563,023 |
| State and municipal securities | 7,028,388 | 302,697 | - | 7,331,085 |
| Mortgage-backed securities: | | | | |
| Residential mortgage guaranteed by GNMA or FNMA | 16,852,496 | 44,954 | (9,179) | 16,888,271 |
| Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies | 62,278,948 | 273,571 | (141,989) | 62,410,530 |
| | <u>\$ 86,720,015</u> | <u>\$ 624,062</u> | <u>\$ (151,168)</u> | <u>\$ 87,192,909</u> |
| Debt securities held to maturity: | | | | |
| Mortgage-backed securities: | | | | |
| Residential mortgage guaranteed by GNMA or FNMA | <u>\$ 25,428</u> | <u>\$ 274</u> | <u>\$ -</u> | <u>\$ 25,702</u> |

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2014, 2013, and 2012

Note 4. Securities (continued)

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

U.S. Government sponsored agencies include entities such as Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Government National Mortgage Association.

At December 31, 2014 and 2013, securities with a carrying value of approximately \$12,612,000 and \$14,385,000, respectively, were pledged to secure public deposits and for other purposes required or permitted by law.

At December 31, 2014 and 2013, the carrying amount of securities pledged to secure repurchase agreements was approximately \$24,207,000 and \$25,521,000, respectively.

At December 31, 2014 and 2013, securities with a carrying value of approximately \$18,705,000 and \$20,140,000, respectively, were pledged to the Federal Home Loan Bank as collateral for the Bank's borrowings.

At December 31, 2014 and 2013, the Bank had pledged securities with a carrying amount of approximately \$13,037,000 and \$11,978,000, respectively, to other financial institutions as collateral for federal funds purchased.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014, 2013, and 2012

Note 4. Securities (continued)

The amortized cost and fair value of securities at December 31, 2014, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | Securities Available for Sale | | Securities Held to Maturity | |
|----------------------------------|-------------------------------|----------------------|-----------------------------|------------------|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Due in one year or less | \$ - | \$ - | \$ - | \$ - |
| Due from one year to five years | 898,930 | 934,341 | - | - |
| Due from five years to ten years | 2,831,489 | 2,931,593 | - | - |
| Due after ten years | 3,858,152 | 4,028,174 | - | - |
| | 7,588,571 | 7,894,108 | - | - |
| Mortgage-backed securities | 79,131,444 | 79,298,801 | 25,428 | 25,702 |
| | <u>\$ 86,720,015</u> | <u>\$ 87,192,909</u> | <u>\$ 25,428</u> | <u>\$ 25,702</u> |

For the year ended December 31, 2014, there were available for sale securities sold with proceeds totaling \$12,240,478 which resulted in gross gains realized of \$700,390. For the year ended December 31, 2013, there were available for sale securities sold with proceeds totaling \$8,171,961 which resulted in gross gains realized of \$652,421. For the year ended December 31, 2012, there were no securities sold.

The following tables present 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, at December 31, 2014 and 2013:

| | As of December 31, 2014 | | | | | |
|--|-------------------------|-------------------------|----------------------|-------------------------|---------------------|-------------------------|
| | Less than 12 Months | | 12 Months or Greater | | Total | |
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| Mortgage-backed securities: | | | | | | |
| Residential mortgage guaranteed by GNMA or FNMA | \$ 7,018,137 | \$ (9,179) | \$ - | \$ - | \$ 7,018,137 | \$ (9,179) |
| Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies | 9,504,525 | (52,831) | 17,546,169 | (89,158) | 27,050,694 | (141,989) |
| | <u>\$16,522,662</u> | <u>\$ (62,010)</u> | <u>\$17,546,169</u> | <u>\$ (89,158)</u> | <u>\$34,068,831</u> | <u>\$ (151,168)</u> |

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014, 2013, and 2012

Note 4. Securities (continued)

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

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

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

Mortgage-backed securities: At December 31, 2014, twelve 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 Cornerstone does not intend to sell the investments and it is not more likely than not that Cornerstone will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, Cornerstone does not deem those investments to be other-than-temporarily impaired at December 31, 2014.

Note 5. Loans and Allowance for Loan Losses

At December 31, 2014 and 2013, the Bank's loans consist of the following (in thousands):

| | 2014 | 2013 |
|---|-------------------|-------------------|
| Commercial real estate-mortgage: | | |
| Owner-occupied | \$ 68,581 | \$ 65,747 |
| All other | 74,587 | 64,052 |
| Consumer real estate-mortgage | 76,907 | 76,315 |
| Construction and land development | 34,449 | 41,597 |
| Commercial and industrial | 37,863 | 38,999 |
| Consumer and other | 2,977 | 2,730 |
| Total loans | 295,364 | 289,440 |
| Less: Allowance for loan losses | (3,495) | (3,203) |
| Loans, net | \$ 291,869 | \$ 286,237 |

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2014, 2013, and 2012

Note 5. Loans and Allowance for Loan Losses (continued)

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

Real estate:

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

- Commercial real estate-mortgage loans include owner-occupied commercial real estate loans and other commercial real estate loans. Owner-occupied commercial real estate loans to operating businesses are long-term financing of land and buildings. Other commercial real estate loans are generally secured by income producing properties.
- Consumer real estate-mortgage loans include loans secured by 1-4 family and multifamily residential properties. These loans are repaid by various means such as a borrower's income, sale of the property, or rental income derived from the property.
- Construction and land development loans include extensions of credit to real estate developers or investors where repayment is dependent on the sale of the real estate or income generated from the real estate collateral. These loans are repaid through cash flow related to the operations, sale, or refinance of the underlying property. This portfolio segment also includes owner-occupied construction loans for commercial businesses for the development of land or construction of a building. These loans are repaid by cash flow generated from the business operation. Real estate loans for income-producing properties such as apartment buildings, office and industrial buildings, and retail shopping centers are repaid from rent income derived from the properties.

Commercial and industrial:

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

Consumer and other:

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

| | 2014 | 2013 | 2012 |
|--|--------------|--------------|--------------|
| An analysis of the allowance for loan losses follows: | | | |
| Balance, beginning of year | \$ 3,203,158 | \$ 6,141,281 | \$ 7,400,049 |
| Provision for loan losses | 515,000 | 300,000 | 430,000 |
| Charge-offs | (1,581,992) | (4,708,605) | (2,868,576) |
| Recoveries | 1,358,963 | 1,470,482 | 1,179,808 |
| Balance, end of year | \$ 3,495,129 | \$ 3,203,158 | \$ 6,141,281 |

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014, 2013, and 2012

Note 5. Loans and Allowance for Loan Losses (continued)

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 loans at December 31, 2014 and 2013, is summarized in the tables below (in thousands):

As of December 31, 2014:

| | Commercial Real Estate- Mortgage | Consumer Real Estate- Mortgage | Construction and Land Development | Commercial and Industrial | Consumer and Other | Total |
|------------------|--|--------------------------------------|---|---------------------------------|-----------------------|-------------------|
| Performing loans | \$ 138,711 | \$ 74,828 | \$ 33,696 | \$ 36,314 | \$ 2,977 | \$ 286,526 |
| Impaired loans | 4,457 | 2,079 | 753 | 1,549 | - | 8,838 |
| Total | <u>\$ 143,168</u> | <u>\$ 76,907</u> | <u>\$ 34,449</u> | <u>\$ 37,863</u> | <u>\$ 2,977</u> | <u>\$ 295,364</u> |

As of December 31, 2013:

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

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

As of December 31, 2014:

| | Commercial Real Estate- Mortgage | Consumer Real Estate- Mortgage | Construction and Land Development | Commercial and Industrial | Consumer and Other | Total |
|-----------------------|--|--------------------------------------|---|---------------------------------|-----------------------|-----------------|
| Allowance related to: | | | | | | |
| Performing loans | \$ 1,191 | \$ 1,082 | \$ 130 | \$ 361 | \$ 35 | \$ 2,799 |
| Impaired loans | 404 | 15 | - | 277 | - | 696 |
| Total | <u>\$ 1,595</u> | <u>\$ 1,097</u> | <u>\$ 130</u> | <u>\$ 638</u> | <u>\$ 35</u> | <u>\$ 3,495</u> |

As of December 31, 2013:

| | Commercial Real Estate- Mortgage | Consumer Real Estate- Mortgage | Construction and Land Development | Commercial and Industrial | Consumer and Other | Total |
|-----------------------|--|--------------------------------------|---|---------------------------------|-----------------------|----------|
| Allowance related to: | | | | | | |
| Performing loans | \$ 1,051 | \$ 927 | \$ 319 | \$ 297 | \$ 45 | \$ 2,639 |
| Impaired loans | 498 | 11 | - | 55 | - | 564 |

| | | | | | | | | | | | | |
|-------|----|--------------|----|------------|----|------------|----|------------|----|-----------|----|--------------|
| Total | \$ | <u>1,549</u> | \$ | <u>938</u> | \$ | <u>319</u> | \$ | <u>352</u> | \$ | <u>45</u> | \$ | <u>3,203</u> |
|-------|----|--------------|----|------------|----|------------|----|------------|----|-----------|----|--------------|

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014, 2013, and 2012

Note 5. Loans and Allowance for Loan Losses (continued)

The following tables detail the changes in the allowance for loan losses during December 31, 2014 and 2013, by loan classification (in thousands):

As of December 31, 2014:

| | <u>Commercial Real Estate- Mortgage</u> | <u>Consumer Real Estate- Mortgage</u> | <u>Construction and Land Development</u> | <u>Commercial and Industrial</u> | <u>Consumer and Other</u> | <u>Total</u> |
|----------------------------|---|---|--|--|-------------------------------|-----------------|
| Balance, beginning of year | \$ 1,549 | \$ 938 | \$ 319 | \$ 352 | \$ 45 | \$ 3,203 |
| Provision for loan losses | 360 | 731 | (902) | 336 | (10) | 515 |
| Charge-offs | (470) | (896) | (58) | (108) | (50) | (1,582) |
| Recoveries | 156 | 324 | 771 | 58 | 50 | 1,359 |
| Balance, end of year | <u>\$ 1,595</u> | <u>\$ 1,097</u> | <u>\$ 130</u> | <u>\$ 638</u> | <u>\$ 35</u> | <u>\$ 3,495</u> |

As of December 31, 2013:

| | <u>Commercial Real Estate- Mortgage</u> | <u>Consumer Real Estate- Mortgage</u> | <u>Construction and Land Development</u> | <u>Commercial and Industrial</u> | <u>Consumer and Other</u> | <u>Total</u> |
|----------------------------|---|---|--|--|-------------------------------|-----------------|
| Balance, beginning of year | \$ 2,549 | \$ 1,528 | \$ 1,241 | \$ 809 | \$ 14 | \$ 6,141 |
| Provision for loan losses | 811 | 11 | (787) | 143 | 122 | 300 |
| Charge-offs | (1,879) | (842) | (1,193) | (699) | (96) | (4,709) |
| Recoveries | 68 | 241 | 1,058 | 99 | 5 | 1,471 |
| Balance, end of year | <u>\$ 1,549</u> | <u>\$ 938</u> | <u>\$ 319</u> | <u>\$ 352</u> | <u>\$ 45</u> | <u>\$ 3,203</u> |

Credit quality indicators:

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

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.
- Loans 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 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.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014, 2013, and 2012

Note 5. Loans and Allowance for Loan Losses (continued)

Credit quality indicators: (continued)

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

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

As of December 31, 2014:

| | <u>Commercial Real Estate- Mortgage</u> | <u>Consumer Real Estate- Mortgage</u> | <u>Construction and Land Development</u> | <u>Commercial and Industrial</u> | <u>Consumer and Other</u> | <u>Total</u> |
|-----------------|---|---|--|--|-------------------------------|-------------------|
| Pass | \$ 135,586 | \$ 72,753 | \$ 33,201 | \$ 32,684 | \$ 2,977 | \$ 277,201 |
| Special mention | 3,096 | 1,452 | 17 | 3,187 | - | 7,752 |
| Substandard | 4,486 | 2,702 | 1,231 | 1,992 | - | 10,411 |
| | <u>\$ 143,168</u> | <u>\$ 76,907</u> | <u>\$ 34,449</u> | <u>\$ 37,863</u> | <u>\$ 2,977</u> | <u>\$ 295,364</u> |

As of December 31, 2013:

| | <u>Commercial Real Estate- Mortgage</u> | <u>Consumer Real Estate- Mortgage</u> | <u>Construction and Land Development</u> | <u>Commercial and Industrial</u> | <u>Consumer and Other</u> | <u>Total</u> |
|-----------------|---|---|--|--|-------------------------------|-------------------|
| Pass | \$ 119,398 | \$ 67,444 | \$ 40,850 | \$ 33,394 | \$ 2,730 | \$ 263,816 |
| Special mention | 3,538 | 3,536 | 73 | 3,468 | - | 10,615 |
| Substandard | 6,863 | 5,335 | 674 | 2,137 | - | 15,009 |
| | <u>\$ 129,799</u> | <u>\$ 76,315</u> | <u>\$ 41,597</u> | <u>\$ 38,999</u> | <u>\$ 2,730</u> | <u>\$ 289,440</u> |

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014, 2013, and 2012

Note 5. Loans and Allowance for Loan Losses (continued)

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 December 31, 2014, 2013, and 2012 (in thousands):

| | At December 31, 2014 | | | For the Year Ended December 31, 2014 | |
|---|------------------------|--------------------------------|----------------------|---|----------------------------------|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
| Impaired loans without a valuation allowance: | | | | | |
| Commercial real estate – mortgage | \$ 2,428 | \$ 2,480 | \$ - | \$ 4,386 | \$ 127 |
| Consumer real estate – mortgage | 1,738 | 1,742 | - | 1,880 | 114 |
| Construction and land development | 753 | 766 | - | 462 | 44 |
| Commercial and industrial | 1,033 | 1,085 | - | 1,186 | 41 |
| Consumer and other | - | - | - | - | - |
| Total | 5,952 | 6,073 | - | 7,914 | 326 |
| Impaired loans with a valuation allowance: | | | | | |
| Commercial real estate – mortgage | 2,029 | 2,029 | 404 | 683 | 98 |
| Consumer real estate – mortgage | 341 | 476 | 15 | 676 | 24 |
| Construction and land development | - | - | - | - | - |
| Commercial and industrial | 516 | 516 | 277 | 401 | 52 |
| Consumer and other | - | - | - | - | - |
| Total | 2,886 | 3,021 | 696 | 1,760 | 174 |
| Total impaired loans | \$ 8,838 | \$ 9,094 | \$ 696 | \$ 9,674 | \$ 500 |

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

| | | | | | |
|----------------------|------------------|------------------|---------------|------------------|---------------|
| Total impaired loans | <u>\$ 13,790</u> | <u>\$ 14,056</u> | <u>\$ 564</u> | <u>\$ 16,537</u> | <u>\$ 780</u> |
|----------------------|------------------|------------------|---------------|------------------|---------------|

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014, 2013, and 2012

Note 5. Loans and Allowance for Loan Losses (continued)

| | 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 December 31, 2014 and 2013 (in thousands):

As of December 31, 2014:

| | 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 | \$ 664 | \$ - | \$ 496 | \$ 1,160 | \$ 67,421 | \$ 68,581 |
| All other | - | - | - | - | 74,587 | 74,587 |
| Consumer real estate-mortgage | 419 | - | 1,134 | 1,553 | 75,354 | 76,907 |
| Construction and land development | 521 | - | 40 | 561 | 33,888 | 34,449 |
| Commercial and industrial | 54 | - | 1,195 | 1,249 | 36,614 | 37,863 |
| Consumer and other | 8 | - | - | 8 | 2,969 | 2,977 |
| Total | \$ 1,666 | \$ - | \$ 2,865 | \$ 4,531 | \$ 290,833 | \$ 295,364 |

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014, 2013, and 2012

Note 5. Loans and Allowance for Loan Losses (continued)

As of December 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 | \$ 678 | \$ - | \$ 838 | \$ 1,516 | \$ 64,231 | \$ 65,747 |
| All other | 867 | - | 44 | 911 | 63,141 | 64,052 |
| Consumer real estate-mortgage | 419 | - | 1,006 | 1,425 | 74,890 | 76,315 |
| Construction and land development | 50 | - | 47 | 97 | 41,500 | 41,597 |
| Commercial and industrial | 201 | - | 1,631 | 1,832 | 37,167 | 38,999 |
| Consumer and other | 35 | - | - | 35 | 2,695 | 2,730 |
| Total | \$ 2,250 | \$ - | \$ 3,566 | \$ 5,816 | \$283,624 | \$289,440 |

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 December 31, 2014 and 2013, the Bank has loans of approximately \$4,956,000 and \$5,753,000, respectively, that were modified in troubled debt restructurings. Troubled commercial loans are restructured by specialists within our Special Asset department and all restructurings are approved by committees and credit officers separate and apart from the normal loan approval process. These specialists are trained to reduce the Bank's overall risk and exposure to loss in the event of a restructuring through obtaining either or all of the following: improved documentation, additional guaranties, increase in curtailments, reduction in collateral terms, additional collateral, or other similar strategies.

The following tables present a summary of loans that were modified as troubled debt restructurings during the years ended December 31, 2014, 2013, and 2012 (amounts in thousands):

During the year ended December 31, 2014:

| | Pre-Modification Number of Contracts | Post-Modification Outstanding Recorded Investment | Outstanding Recorded Investment |
|---------------------------------|--|---|------------------------------------|
| Commercial real estate-mortgage | 3 | \$ 902 | \$ 902 |
| Consumer real estate-mortgage | 1 | 65 | 65 |

During the year ended December 31, 2013:

| | Pre-Modification Number of Contracts | Post-Modification Outstanding Recorded Investment | Outstanding Recorded Investment |
|-----------------------------------|--|---|------------------------------------|
| Commercial real estate-mortgage | 2 | \$ 2,073 | \$ 2,073 |
| Consumer real estate-mortgage | 2 | 239 | 239 |
| Construction and land development | 3 | 728 | 728 |
| Commercial and industrial | 3 | 2,389 | 2,389 |

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

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Note 5. Loans and Allowance for Loan Losses (continued)

During the year ended December 31, 2012:

| | Pre-Modification Number of Contracts | Post-Modification Outstanding Recorded Investment | Outstanding Recorded Investment |
|-----------------------------------|--|---|------------------------------------|
| Commercial real estate-mortgage | 5 | \$ 5,971 | \$ 5,971 |
| Consumer real estate-mortgage | 1 | 65 | 65 |
| Construction and land development | 3 | 1,178 | 1,178 |
| Commercial and industrial | 5 | 2,432 | 2,432 |

The Bank did not have any loans modified as troubled debt restructurings over the last twelve months that subsequently defaulted during the years ended December 31, 2014, 2013 and 2012.

In the ordinary course of business, the Bank has granted loans to principal officers and directors and their affiliates. Annual activity of these related party loans were as follows:

| | 2014 | 2013 |
|-------------------|---------------------|---------------------|
| Beginning balance | \$ 1,380,170 | \$ 1,833,982 |
| New loans | 3,780,391 | 50,384 |
| Repayments | (1,653,406) | (504,196) |
| Ending balance | <u>\$ 3,507,155</u> | <u>\$ 1,380,170</u> |

Note 6. Bank Premises and Equipment

A summary of bank premises and equipment at December 31, 2014 and 2013, is as follows:

| | 2014 | 2013 |
|-----------------------------------|---------------------|---------------------|
| Land | \$ 2,145,003 | \$ 2,145,003 |
| Buildings and improvements | 4,343,643 | 4,297,565 |
| Furniture, fixtures and equipment | <u>3,315,766</u> | <u>3,313,948</u> |
| | 9,804,412 | 9,756,516 |
| Accumulated depreciation | <u>(4,976,289)</u> | <u>(4,764,067)</u> |
| | <u>\$ 4,828,123</u> | <u>\$ 4,992,449</u> |

Depreciation expense for the years ended December 31, 2014, 2013 and 2012, amounted to \$365,377, \$420,287, and \$461,905, respectively.

Certain bank facilities and equipment are leased under various operating leases. Total rent expense on these leases for the years ended December 31, 2014, 2013 and 2012, was \$382,719, \$390,464, and \$390,571, respectively.

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

| | | |
|-------|-----------|----------------|
| 2015 | \$ | 348,455 |
| 2016 | | 284,152 |
| 2017 | | 83,570 |
| 2018 | | 7,452 |
| 2019 | | 6,831 |
| Total | <u>\$</u> | <u>730,460</u> |

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Note 7. Time and Related-Party Deposits

At December 31, 2014, the scheduled maturities of time deposits are as follows (in thousands):

| | | |
|--------------|-----------|----------------|
| 2015 | \$ | 95,107 |
| 2016 | | 23,981 |
| 2017 | | 13,399 |
| 2018 | | 7,833 |
| 2019 | | 3,974 |
| Total | \$ | 144,294 |

Deposits from related parties held by the Bank at December 31, 2014 and 2013, amounted to approximately \$1,191,000 and \$779,000, respectively.

As of December 31, 2014 and 2013, certificates of deposit equal to or greater than \$100,000 amounted to approximately \$87,166,000 and \$81,234,000, respectively.

Note 8. Income Taxes

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

Income tax expense in the consolidated statements of income for the years ended December 31, 2014, 2013 and 2012, consists of the following:

| | 2014 | 2013 | 2012 |
|--|---------------------|---------------------|-------------------|
| Current tax expense | \$ 473,257 | \$ 937,460 | \$ 960,750 |
| Deferred tax (benefit) expense related to: | | | |
| Allowance for loan losses | (110,983) | 244,565 | (255,287) |
| Foreclosed assets | 669,694 | (219,483) | (58,692) |
| Other | (17,963) | 80,258 | (69,171) |
| Income tax expense | \$ 1,014,005 | \$ 1,042,800 | \$ 577,600 |

Income tax expense is different from expected tax expense computed by multiplying income before income tax expense by the statutory federal income tax rates. These differences are reconciled as follows:

| | 2014 | 2013 | 2012 |
|---|---------------------|---------------------|-------------------|
| Expected tax at statutory rates | \$ 901,778 | \$ 926,027 | \$ 673,085 |
| Increase (decrease) resulting from tax effect of: | | | |
| State income taxes, net of federal tax benefit | 113,783 | 116,843 | 84,928 |
| New market tax credits | - | - | (180,000) |
| Other | (1,556) | (70) | (413) |
| Income tax expense | \$ 1,014,005 | \$ 1,042,800 | \$ 577,600 |

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 8. Income Taxes (continued)

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

| | <u>2014</u> | <u>2013</u> |
|--|---------------------|---------------------|
| Deferred tax assets: | | |
| Deferred compensation | \$ 71,791 | \$ 87,383 |
| Deferred loan fees | 41,861 | 43,838 |
| Allowance for loan losses | 1,337,472 | 1,226,489 |
| Foreclosed assets | 776,278 | 1,445,972 |
| Other | 40,890 | - |
| | <u>2,268,292</u> | <u>2,803,682</u> |
| Deferred tax liabilities: | | |
| Depreciation | 74,353 | 76,884 |
| Life insurance | 201,503 | 205,443 |
| Net unrealized gain on securities available for sale | 191,004 | 167,349 |
| Other | - | 11,826 |
| | <u>466,860</u> | <u>461,502</u> |
| Net deferred tax asset | <u>\$ 1,801,432</u> | <u>\$ 2,342,180</u> |

ASC Topic 740, "Income Taxes," clarifies the accounting for uncertainty in tax positions. ASC Topic 740 requires that Cornerstone recognize in its financial statements, the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. Cornerstone recognized no interest and penalties assessed by taxing authorities on any underpayment of income tax for 2014, 2013, or 2012.

Note 9. Federal Home Loan Bank Advances and Other Borrowings

The Bank has agreements with the Federal Home Loan Bank of Cincinnati (FHLB) that can provide advances to the Bank in an amount up to \$49,387,988. All of the Bank's loans secured by first mortgages on 1-4 family residential, multi-family properties and commercial properties are pledged as collateral for these advances. Additionally, the Bank had pledged securities with a carrying amount of approximately \$18,705,000 as of December 31, 2014 and \$20,140,000 as of December 31, 2013.

At December 31, 2014 and 2013, FHLB advances consist of the following:

| | <u>2014</u> | <u>2013</u> |
|--|-------------|--------------|
| Long-term advance dated August 13, 2007, requiring monthly interest payments, fixed at 4.43%, with a put option exercisable in February 2009 and then quarterly thereafter, principal due in August 2014 | \$ - | \$ 5,000,000 |
| Long-term advance dated January 7, 2008, requiring monthly interest payments, fixed at 3.52%, with a put option exercisable in January 2011 and then quarterly thereafter, principal due in January 2015 | 5,000,000 | 5,000,000 |
| Short-term advance dated July 30, 2014, requiring monthly interest payments, fixed at 0.23%, principal due in January 2015 | 8,000,000 | - |
| Long-term advance dated February 9, 2005, requiring monthly interest payments, fixed at 3.86%, convertible on February 2010, principal due in February 2015 | 5,000,000 | 5,000,000 |

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
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Note 9. Federal Home Loan Bank Advances and Other Borrowings (continued)

| | <u>2014</u> | <u>2013</u> |
|---|----------------------|----------------------|
| Short-term advance dated November 20, 2014, requiring monthly interest payments, fixed at 0.36%, principal due in November 2015 | 8,000,000 | - |
| Long-term advance dated January 20, 2006, requiring monthly interest payments, fixed at 4.18%, with a put option exercisable in January 2009 and then quarterly thereafter, principal due in January 2016 | 5,000,000 | 5,000,000 |
| Long-term advance dated January 10, 2007, requiring monthly interest payments, fixed at 4.25%, with a put option exercisable in January 2008 and then quarterly thereafter, principal due in January 2017 | 5,000,000 | 5,000,000 |
| | <u>\$ 36,000,000</u> | <u>\$ 25,000,000</u> |

During the fixed rate term, the advances may be prepaid subject to a prepayment penalty as defined in the agreements. On convertible agreements, the FHLB has the right to convert the fixed rate on the above advances at the end of the initial fixed rate period and on a quarterly basis thereafter. If the conversion option is exercised, the advances will bear interest at the three-month London Interbank Offered Rate (LIBOR) adjusted quarterly at a spread of zero basis points to the LIBOR index. Subsequent to any conversion, the Bank has the option to prepay the advances, in full or in part, without penalty on the conversion date or any subsequent quarterly repricing date. On agreements with put options, the FHLB has the right, at its discretion, to terminate only the entire advance prior to the stated maturity date. The termination option may only be exercised on the expiration date of the predetermined lockout period and on a quarterly basis thereafter.

As of December 31, 2013, Cornerstone had a borrowing outstanding of \$1,740,000 with a correspondent financial institution. The loan was fully secured with cash collateral and required quarterly interest payments at an annual rate of two percent. Principal and all accrued interest not yet paid was due upon maturity in March 2014. At maturity, Cornerstone elected to renew the existing debt with the correspondent financial institution with the same terms and a new maturity date of March 2015. On June 30, 2014, Cornerstone elected to repay the loan plus accrued interest in full. As of December 31, 2014, there were no amounts outstanding under this borrowing.

The primary source of liquidity for Cornerstone is the payment of dividends from the Bank. As of December 31, 2014, the Bank was under a dividend restriction that requires regulatory approval prior to the payment of a dividend from the Bank to Cornerstone.

At December 31, 2014, scheduled maturities of the Federal Home Loan Bank advances and other borrowings are as follows:

| | | |
|-------|----|------------|
| 2015 | \$ | 26,000,000 |
| 2016 | | 5,000,000 |
| 2017 | | 5,000,000 |
| Total | \$ | 36,000,000 |

Note 10. Employee Benefit Plans

401(k) plan:

Cornerstone has a 401(k) employee benefit plan covering substantially all employees that have completed at least 30 days of service and met minimum age requirements. Cornerstone's contribution to the plan is discretionary. Cornerstone elected not to make a contribution to the plan for 2014, 2013 and 2012.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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Note 10. Employee Benefit Plans (continued)

Employee Stock Ownership Plan:

Cornerstone has a non-leveraged employee stock ownership plan (ESOP) to which Cornerstone makes 100% of the contributions for purchasing Cornerstone's common stock and allocates the contributions among the participants based on regulatory guidelines. Cornerstone's contribution is discretionary, as determined by the Compensation Committee. Employer contributions are available to all employees after 1,000 hours of service. There are certain age and years-of-service requirements before contributions can be made for the benefit of the employee. The ESOP plan also provides for a three year 100% vesting requirement; therefore, employees terminating employment before their third anniversary date will forfeit their accrued benefit under the ESOP. The forfeiture is re-allocated among the remaining ESOP participants. Contributions were made to the ESOP of \$10,000 in 2014 and \$3,500 in 2012. No contributions were made in 2013.

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

In the normal course of business, the Bank has outstanding commitments and contingent liabilities, such as commitments to extend credit and standby letters of credit, which are not included in the accompanying financial statements. The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual or notional amount of those instruments. The Bank uses the same credit policies in making such commitments as it does for instruments that are included in the balance sheet. At December 31, 2014 and 2013, undisbursed loan commitments aggregated approximately \$46,478,000 and \$33,664,000, respectively. In addition, there were outstanding standby letters of credit totaling approximately \$330,000 and \$396,000, respectively.

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

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

The Bank incurred insignificant losses on its commitments during 2014, 2013, and 2012.

Note 12. Fair Value Disclosures

Cornerstone uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with ASC Topic 820, "Fair Value Measurements and Disclosures," 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.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014, 2013, and 2012

Note 12. Fair Value Disclosures (continued)

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.

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. There have been no changes in the methodologies used at December 31, 2014 and 2013.

The following methods and assumptions were used by Cornerstone in estimating fair value disclosures for financial instruments:

Cash and cash equivalents:

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

Securities:

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

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

Loans:

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

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014, 2013, and 2012

Note 12. Fair Value Disclosures (continued)

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.

Federal funds purchased and securities sold under agreements to repurchase:

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

Federal Home Loan Bank advances and other borrowings:

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

Accrued interest:

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

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

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

The tables below present the recorded amount of assets and liabilities measured at fair value on a recurring basis.

| | Balance as of December 31, 2014 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Other Unobservable Inputs (Level 3) |
|--|---------------------------------------|--|---|---|
| Debt securities available for sale: | | | | |
| U.S. Government agencies | \$ 563,023 | \$ - | \$ 563,023 | \$ - |
| State and municipal securities | 7,331,085 | - | 7,331,085 | - |
| Mortgage-backed securities: | | | | |
| Residential mortgage guaranteed by GNMA or FNMA | 16,888,271 | - | 16,888,271 | - |
| Collateralized mortgage obligations issued or guaranteed by U.S. Government agencies or sponsored agencies | 62,410,530 | - | 62,410,530 | - |
| Total securities available for sale | \$ 87,192,909 | \$ - | \$ 87,192,909 | \$ - |

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December 31, 2014, 2013, and 2012

Note 12. Fair Value Disclosures (continued)

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

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

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

| | Balance as of December 31, 2014 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Other Unobservable Inputs (Level 3) |
|-------------------|---------------------------------------|--|---|---|
| Impaired loans | \$ 2,190,522 | \$ - | \$ - | \$ 2,190,522 |
| Foreclosed assets | 8,000,365 | - | - | 8,000,365 |

| | Balance as of December 31, 2013 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Other Unobservable Inputs (Level 3) |
|-------------------|---------------------------------------|--|---|---|
| Impaired loans | \$ 3,331,680 | \$ - | \$ - | \$ 3,331,680 |
| Foreclosed assets | 12,925,748 | - | - | 12,925,748 |

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December 31, 2014, 2013, and 2012

Note 12. Fair Value Disclosures (continued)

Loans considered impaired under ASC 310-10-35, "Receivables", are loans for which, based on current information and events, it is probable that Cornerstone will be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreement. Impaired loans can be measured based on the present value of expected payments using the loan's original effective rate as the discount rate, the loan's observable market price, or the fair value of the collateral less selling costs if the loan is collateral dependent.

The fair value of impaired loans were primarily measured based on the value of the collateral securing these loans. Impaired loans are classified within Level 3 of the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory, and/or accounts receivable. Cornerstone determines the value of the collateral based on independent appraisals performed by qualified licensed appraisers. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Appraised values are discounted for costs to sell and may be discounted further based on management's historical knowledge, changes in market conditions from the date of the most recent appraisal, and/or management's expertise and knowledge of the customer and the customer's business. Such discounts by management are subjective and are typically significant unobservable inputs for determining fair value. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors discussed above.

Foreclosed assets, consisting of properties obtained through foreclosure or in satisfaction of loans, are initially recorded at the lower of the loan's carrying amount or the fair value less estimated costs to sell upon transfer of the loans to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value or fair value less costs to sell. Fair values are generally based on third party appraisals of the property and are classified within Level 3 of the fair value hierarchy. The appraisals are sometimes further discounted based on management's historical knowledge, and/or changes in market conditions from the date of the most recent appraisal, and/or management's expertise and knowledge of the customer and the customer's business. Such discounts are typically significant unobservable inputs for determining fair value. In cases where the carrying amount exceeds the fair value, less estimated costs to sell, a loss is recognized in noninterest expense.

For Level 3 assets measured at fair value on a nonrecurring basis as of December 31, 2014, the significant unobservable inputs used in the fair value measurements are presented below.

| | Balance as of December 31, 2014 | Valuation Technique | Significant Other Unobservable Input | Weighted Average of Input |
|-------------------|------------------------------------|------------------------|--|---------------------------------|
| Impaired loans | \$ 2,190,522 | Appraisal | Appraisal discounts (%) | 28.9% |
| Foreclosed assets | 8,000,365 | Appraisal | Appraisal discounts (%) | 14.5% |

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

| | 2014 | | 2013 | |
|------------------------------|--------------------|-------------------------|--------------------|-------------------------|
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| Assets: | | | | |
| Cash and cash equivalents | \$ 15,528 | \$ 15,528 | \$ 24,852 | \$ 24,852 |
| Securities | 87,218 | 87,219 | 92,243 | 92,244 |
| Federal Home Loan Bank stock | 2,323 | 2,323 | 2,323 | 2,323 |
| Loans, net | 291,869 | 292,490 | 286,237 | 287,411 |
| Accrued interest receivable | 1,143 | 1,143 | 978 | 978 |

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December 31, 2014, 2013, and 2012

Note 12. Fair Value Disclosures (continued)

| | 2014 | | 2013 | |
|--|-----------------|----------------------|-----------------|----------------------|
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| Liabilities: | | | | |
| Noninterest-bearing demand deposits | \$ 57,035 | \$ 57,035 | \$ 75,207 | \$ 75,207 |
| Interest-bearing demand deposits | 26,464 | 26,464 | 24,564 | 24,564 |
| Savings deposits and money market accounts | 80,861 | 80,861 | 86,330 | 86,330 |
| Time deposits | 144,294 | 145,907 | 155,314 | 156,698 |
| Federal funds purchased and securities sold under agreements to repurchase | 29,410 | 29,410 | 22,974 | 22,974 |
| Federal Home Loan Bank advances and other borrowings | 36,000 | 36,321 | 26,740 | 27,449 |
| Accrued interest payable | 72 | 72 | 82 | 82 |
| Unrecognized financial instruments (net of contract amount): | | | | |
| Commitments to extend credit | - | - | - | - |
| Letters of credit | - | - | - | - |
| Lines of credit | - | - | - | - |

Note 13. Contingencies

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

Note 14. Stock Option Plans

Cornerstone has stock option plans which are more fully described below. For the years ended December 31, 2014, 2013 and 2012, Cornerstone recognized \$160,500, \$129,056 and \$74,048, respectively, in compensation expense for all stock options.

For the years ended December 31, 2014, 2013, and 2012, the fair value of each option granted is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

| | Years Ended December 31, | | |
|-------------------------|--------------------------|-----------|-----------|
| | 2014 | 2013 | 2012 |
| Dividend yield | 0.0% | 0.0% | 0.0% |
| Expected life | 8.5 years | 7.0 years | 7.0 years |
| Expected volatility | 45.73% | 47.60% | 44.62% |
| Risk-free interest rate | 2.32% | 1.23% | 1.44% |

The expected volatility is based upon historical volatility. The risk-free interest rates for periods within the contractual life of the awards are based on the U.S. Treasury yield curve in effect at the time of the grant. The expected life is based on historical exercise experience. The dividend yield assumption is based on Cornerstone's history and expectation of dividend payouts.

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December 31, 2014, 2013, and 2012

Note 14. Stock Option Plans (continued)

Board of Directors Plan:

Cornerstone has a stock option plan under which members of the Board of Directors, at the formation of the Bank, were granted options to purchase a total of up to 600,000 shares of common stock. Only non-qualified stock options could be granted under the Plan. In addition, members of the Board of Directors could be issued options under the Cornerstone 2002 Long-Term Incentive Plan to purchase up to 1,200,000 shares of Cornerstone stock. The options available for issuance to Board members under the 2002 Long-Term Incentive Plan are shared with officers and employees of Cornerstone. The exercise price of each option equals the market price of Cornerstone's stock on the date of grant and the option's maximum term is ten years, at which point they expire. Vesting for options granted during 2014, 2013, and 2012 are 50% on each of the first and second anniversary of the grant date with full vesting occurring at the second anniversary date. At December 31, 2014, the total remaining compensation cost to be recognized on non-vested options is approximately \$130,000. An analysis of this stock option plan is presented in the following table:

| | Years Ended December 31, | | | | | | |
|--|------------------------------|------------------------------------|------------------------------|------------------------------|------------------------------|---------|---------|
| | 2014 | | 2013 | | 2012 | | |
| | Average Exercise Price | Aggregate Intrinsic Value(1) | Average Exercise Price | Average Exercise Price | Average Exercise Price | | |
| Shares | Price | Value(1) | Shares | Price | Shares | Price | |
| Outstanding at beginning of year | 190,250 | \$ 3.07 | 145,250 | \$ 3.30 | 55,250 | \$ 5.98 | |
| Granted | 80,000 | 2.40 | 45,000 | \$ 2.37 | 90,000 | \$ 1.65 | |
| Exercised | - | - | - | - | - | - | |
| Forfeited | 16,000 | 5.44 | - | - | - | - | |
| Outstanding at end of year | 254,250 | \$ 2.71 | \$ 264,500 | 190,250 | \$ 3.07 | 145,250 | \$ 3.30 |
| Options exercisable at year-end | 151,750 | \$ 2.93 | \$ 170,550 | 100,250 | \$ 4.03 | 55,250 | \$ 5.98 |
| Weighted-average fair value of options granted during the year | \$ 1.30 | | | \$ 1.17 | | \$ 0.78 | |

- (1) The aggregate intrinsic value of a stock option in the table above represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on December 31, 2014. This amount changes based on changes in the market value of Cornerstone's stock.

Information pertaining to options outstanding at December 31, 2014, is as follows:

| Exercise Prices | Number Outstanding | Options Outstanding | | Options Exercisable | |
|-----------------|--------------------|---------------------------------|---------------------------------|---------------------|---------------------------------|
| | | Weighted Average Remaining Life | Weighted Average Exercise Price | Number Exercisable | Weighted Average Exercise Price |
| \$ 9.23 | 8,000 | 0.2 Years | \$ 9.23 | 8,000 | \$ 9.23 |
| 7.99 | 12,800 | 3.2 Years | 7.99 | 12,800 | 7.99 |
| 3.60 | 18,450 | 4.2 Years | 3.60 | 18,450 | 3.60 |
| 2.40 | 80,000 | 9.2 Years | 2.40 | - | 2.40 |
| 2.37 | 45,000 | 8.2 Years | 2.37 | 22,500 | 2.37 |
| 1.65 | 90,000 | 7.2 Years | 1.65 | 90,000 | 1.65 |

Outstanding at end

of year

254,250

7.4 Years \$

2.71

151,750 \$

2.93

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

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Note 14. Stock Option Plans (continued)

Board of Directors Plan: (continued)

Information pertaining to non-vested options for the year ended December 31, 2014, is as follows:

| | Number of Shares | Weighted Average Grant Date Fair Value |
|---------------------------------------|---------------------|--|
| Non-vested options, December 31, 2013 | 90,000 | \$ 0.98 |
| Granted | 80,000 | 1.30 |
| Vested | (67,500) | 0.91 |
| Forfeited | - | - |
| Non-vested options, December 31, 2014 | <u>102,500</u> | \$ 1.27 |

The total fair value of shares that vested during 2014 and 2013 was approximately \$179,000 and \$102,600, respectively.

Officer and Employee Plans:

Cornerstone has two stock option plans, the 1996 Cornerstone Statutory and Non-statutory Option Plan and the Cornerstone 2002 Long-Term Incentive Plan, under which officers and employees could be granted incentive stock options or non-qualified stock options to purchase a total of up to 220,000 and 1,200,000 shares, respectively, of Cornerstone's common stock. The option price for incentive stock options shall be not less than 100 percent of the fair market value of the common stock on the date of the grant. The non-qualified stock options may be equal to or more or less than the fair market value of the common stock on the date of the grant. The stock options vest at 30 percent on the second and third anniversaries of the grant date and 40 percent on the fourth anniversary of the grant date. These options expire ten years from the grant date. At December 31, 2014, the total remaining compensation cost to be recognized on non-vested options is approximately \$658,000. An analysis of the activity for each of the years ended December 31, 2014, 2013 and 2012, for this stock option plan follows:

| | Years Ended December 31, | | | | | | |
|---|--------------------------|------------------------------|------------------------------------|----------------|------------------------------|----------------|------------------------------|
| | 2014 | | 2013 | | 2012 | | |
| | Shares | Average Exercise Price | Aggregate Intrinsic Value(1) | Shares | Average Exercise Price | Shares | Average Exercise Price |
| Outstanding at beginning of year | 810,825 | \$ 3.51 | 670,300 | \$ 3.86 | 572,600 | \$ 4.63 | |
| Granted | 207,000 | \$ 2.40 | 203,000 | \$ 2.37 | 202,000 | \$ 1.65 | |
| Exercised | - | - | - | - | - | - | |
| Forfeited | <u>(77,990)</u> | \$ 4.89 | <u>(62,475)</u> | \$ 3.40 | <u>(104,300)</u> | \$ 3.89 | |
| Outstanding at end of year | <u>939,835</u> | \$ 3.15 | \$ 953,940 | <u>810,825</u> | \$ 3.51 | <u>670,300</u> | \$ 3.86 |
| Options exercisable at year- end | <u>345,735</u> | \$ 4.88 | \$ 264,144 | <u>307,025</u> | \$ 6.10 | <u>274,680</u> | \$ 6.82 |
| Weighted- | | | | | | | |

| | | | |
|---|---------|---------|---------|
| average fair value of options granted during the year | \$ 1.30 | \$ 1.17 | \$ 0.78 |
|---|---------|---------|---------|

- (1) The aggregate intrinsic value of a stock option in the table above represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on December 31, 2014. This amount changes based on changes in the market value of Cornerstone's stock.

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December 31, 2014, 2013, and 2012

Note 14. Stock Option Plans (continued)

Officer and Employee Plans: (continued)

Information pertaining to options outstanding at December 31, 2014, is as follows:

| Exercise Prices | Options Outstanding | | | Options Exercisable | | |
|----------------------------|---------------------|---------------------------------|---------------------------------|---------------------|---------------------------------|--|
| | Number Outstanding | Weighted Average Remaining Life | Weighted Average Exercise Price | Number Exercisable | Weighted Average Exercise Price | |
| \$ 9.23 | 39,910 | 0.2 Years | \$ 9.23 | 39,910 | \$ 9.23 | |
| 13.25 | 16,800 | 1.2 Years | 13.25 | 16,800 | 13.25 | |
| 15.25 | 11,825 | 2.2 Years | 15.25 | 11,825 | 15.25 | |
| 15.20 | 2,750 | 2.3 Years | 15.20 | 2,750 | 15.20 | |
| 7.99 | 45,000 | 3.2 Years | 7.99 | 45,000 | 7.99 | |
| 3.60 | 69,550 | 4.2 Years | 3.60 | 69,550 | 3.60 | |
| 1.70 | 167,000 | 6.2 Years | 1.70 | 100,200 | 1.70 | |
| 1.55 | 3,000 | 6.3 Years | 1.55 | 1,800 | 1.55 | |
| 1.10 | 5,000 | 6.6 Years | 1.10 | 3,000 | 1.10 | |
| 1.02 | 5,000 | 6.8 Years | 1.02 | 3,000 | 1.02 | |
| 1.65 | 173,000 | 7.2 Years | 1.65 | 51,900 | 1.65 | |
| 2.37 | 190,000 | 8.2 Years | 2.37 | - | - | |
| 2.40 | 206,000 | 9.2 Years | 2.40 | - | - | |
| 2.50 | 5,000 | 8.6 Years | 2.50 | - | - | |
| Outstanding at end of year | <u>939,835</u> | 6.8 Years | \$ 3.15 | <u>345,735</u> | \$ 4.88 | |

Information pertaining to non-vested options for the year ended December 31, 2014, is as follows:

| | Number of Shares | Weighted Average Grant Date Fair Value |
|---------------------------------------|------------------|--|
| Non-vested options, December 31, 2013 | 503,800 | \$ 0.98 |
| Granted | 207,000 | 1.30 |
| Vested | (107,400) | 0.87 |
| Forfeited | <u>(9,300)</u> | 1.01 |
| Non-vested options, December 31, 2014 | <u>594,100</u> | \$ 1.11 |

The total fair value of shares that vested during 2014, 2013 and 2012, was approximately \$281,000, \$190,000, and \$73,000, respectively.

Note 15. Liquidity and Capital Resources

Cornerstone's primary source of funds with which to pay its future obligations is the receipt of dividends from its subsidiary Bank. Banking regulations provide that the Bank must maintain capital sufficient to enable it to operate as a viable institution and, as a result, has limited the amount of dividends the Bank may pay without prior approval.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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Note 16. Minimum Regulatory Capital Requirements

Cornerstone (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the Tennessee Department of Financial Institutions and the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on Cornerstone's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, Cornerstone and the Bank must meet specific capital guidelines that involve quantitative measures of Cornerstone's and the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. Cornerstone's and the Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require Cornerstone and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2014 and 2013, that Cornerstone and the Bank meet all capital adequacy requirements to which they are subject.

During 2013, the Federal Reserve released final United States Basel III regulatory capital rules implementing the global regulatory capital reforms of Basel III and certain changes required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The FDIC and OCC also approved the final rule during 2013. The rule applies to all banking organizations that are currently subject to regulatory capital requirements, as well as certain savings and loan holding companies. The rule strengthens the definition of regulatory capital, increases risk-based capital requirements, and makes selected changes to the calculation of risk-weighted assets. The rule becomes effective January 1, 2015, for Cornerstone and most banking organizations subject to a transition period for several aspects of the rule including the new minimum capital ratio requirements, the capital conservation buffer, and the regulatory capital adjustments and deductions.

As of December 31, 2014, the most recent notification from the Federal Deposit Insurance Corporation (FDIC) categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total-risk based, Tier I risk-based, and Tier I leverage ratios as set forth in the following tables. There are no conditions or events since that notification that management believes have changed the Bank's prompt corrective action category. Cornerstone's and the Bank's capital amounts and ratios are also presented in the table. Dollar amounts are presented in thousands.

| | Actual | | For Capital Adequacy Purposes | | To be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|-----------|-------|-------------------------------|-------|--|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| As of December 31, 2014: | | | | | | |
| Total capital to risk-weighted assets: | | | | | | |
| Consolidated | \$ 36,107 | 11.6% | \$ 24,817 | 8.0% | N/A | N/A |
| Cornerstone | | | | | | |
| Community Bank | 41,670 | 13.5% | 24,784 | 8.0% | \$ 30,981 | 10.0% |
| Tier I capital to risk-weighted assets: | | | | | | |
| Consolidated | 32,612 | 10.5% | 12,408 | 4.0% | N/A | N/A |
| Cornerstone | | | | | | |
| Community Bank | 38,175 | 12.3% | 12,392 | 4.0% | 18,588 | 6.0% |
| Tier I capital to average assets: | | | | | | |
| Consolidated | 32,612 | 8.0% | 16,304 | 4.0% | N/A | N/A |
| Cornerstone | | | | | | |
| Community Bank | 38,175 | 9.4% | 16,287 | 4.0% | 20,359 | 5.0% |

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2014, 2013, and 2012

Note 16. Minimum Regulatory Capital Requirements (continued)

| | Actual | | For Capital Adequacy Purposes | | To be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|-----------|-------|-------------------------------|-------|--|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| As of December 31, 2013: | | | | | | |
| Total capital to risk-weighted assets: | | | | | | |
| Consolidated | \$ 34,820 | 11.3% | \$ 24,634 | 8.0% | N/A | N/A |
| Cornerstone Community Bank | 39,342 | 12.8% | 24,552 | 8.0% | \$ 30,691 | 10.0% |
| Tier I capital to risk-weighted assets: | | | | | | |
| Consolidated | 31,617 | 10.3% | 12,317 | 4.0% | N/A | N/A |
| Cornerstone Community Bank | 36,139 | 11.8% | 12,276 | 4.0% | 18,414 | 6.0% |
| Tier I capital to average assets: | | | | | | |
| Consolidated | 31,617 | 7.5% | 16,885 | 4.0% | N/A | N/A |
| Cornerstone Community Bank | 36,139 | 8.6% | 16,870 | 4.0% | 21,087 | 5.0% |

Note 17. Earnings per Common Share

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

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

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

| | 2014 | 2013 | 2012 |
|---|--------------|--------------|--------------|
| Net income | \$ 1,638,282 | \$ 1,680,809 | \$ 1,402,063 |
| Less: Preferred stock dividend requirements | 1,500,000 | 1,500,000 | 1,229,780 |
| Less: Preferred stock accretion | 71,382 | 71,381 | 63,924 |
| Net income applicable to common stock | \$ 66,900 | \$ 109,428 | \$ 108,359 |
| Average number of common shares outstanding | 6,614,414 | 6,547,074 | 6,500,396 |
| Effect of dilutive stock options | 222,373 | 115,213 | 50,136 |
| Average number of common shares outstanding used to calculate diluted earnings per common share | 6,836,787 | 6,662,287 | 6,550,532 |

The effects of outstanding antidilutive stock options are excluded from the computation of diluted earnings per common share. There were 217,435, 358,550, and 358,550, antidilutive stock options for 2014, 2013 and 2012, respectively.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

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Note 18. Recent Accounting Pronouncements

In January 2014, the FASB issued Accounting Standards Update (ASU) 2014-04, "Receivables-Troubled Debt Restructurings by Creditors: Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure." The amendments in this ASU reduce diversity in practice by clarifying when an in substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The amendments in this ASU clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. An entity can elect to adopt the amendments in this ASU using either a modified retrospective transition method or a prospective transition method. Cornerstone does not believe the adoption of this ASU will have a significant impact on the consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers." This update is a joint project with the International Accounting Standards Board initiated to clarify the principles for recognizing revenue and to develop a common revenue standard that is meant to remove inconsistencies and weaknesses in revenue requirements, provide a more robust framework for addressing revenue issues, improve comparability of revenue recognition practices, provide more useful information to users of financial statements and simplify the preparation of financial statements. The guidance in this update supersedes the revenue recognition requirements in ASC Topic 605, "Revenue Recognition" and most industry-specific guidance throughout the Industry Topics of Codification. This update is effective for annual and interim periods beginning after December 15, 2016. Cornerstone does not believe this update will have a significant impact on the consolidated financial statements.

In June 2014, the FASB issued ASU 2014-11, "Transfers and Servicing: Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures." The amendments in this ASU require two accounting changes. First, the amendments in this ASU change the accounting for repurchase-to-maturity transactions to secured borrowing accounting. Second, for repurchase financing arrangements, the amendments require separate accounting for a transfer of a financial asset executed contemporaneously with a repurchase agreement with the same counterparty, which will result in secured borrowing accounting for the repurchase agreement. This ASU also includes new disclosure requirements. The accounting changes in this ASU are effective for public business entities for the first interim or annual period beginning after December 15, 2014. An entity is required to present changes in accounting for transactions outstanding on the effective date as a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption. Earlier application for a public business entity is prohibited. Cornerstone is currently reviewing this ASU to determine if it will have an impact on the consolidated financial statements.

In August 2014, the FASB issued ASU 2014-14, "Receivables—Troubled Debt Restructurings by Creditors: Classification of Certain Government—Guaranteed Mortgage Loans upon Foreclosure." The amendments in this ASU require that a mortgage loan be derecognized and that a separate other receivable be recognized upon foreclosure if (1) the loan has a government guarantee that is not separable from the loan before foreclosure; (2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim; and (3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. The amendments in this ASU are effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The adoption of this guidance is not expected to have a significant impact on the Cornerstone's consolidated financial statements.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

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Note 19. Equity Investment

During 2006, Cornerstone invested \$3,000,000 for a 25% share of the Appalachian Fund for Growth II Partnership (AFG), which was managed by the Southeast Local Development Corporation (General Partner). AFG was targeting high job creation and retention businesses and businesses providing important community services. The funds were deployed to help: 1) attract new businesses to under-served service areas by offering creative financing; 2) supply creative financing for businesses to rehabilitate existing distressed properties to facilitate community development; and 3) leverage other private investment into its targeted communities. In return for its investment in AFG, Cornerstone and other investors received new market tax credits of approximately \$180,000 during 2012. No new market tax credit was received in 2013 or 2014. During 2014, Cornerstone received approximately \$2,393,600 in equity distributions to facilitate the winding down of the fund. AFG was dissolved during 2014.

AFG met the criteria of a VIE outlined in ASC Topic 810, "Consolidation". AFG was not consolidated by Cornerstone, as Cornerstone was not the primary beneficiary.

Note 20. Agreement and Plan of Merger

On December 5, 2014, Cornerstone, the Bank, SmartFinancial, Inc. (SmartFinancial), and SmartFinancial's wholly owned subsidiary, SmartBank, entered into an Agreement and Plan of Merger (the Merger Agreement), pursuant to which SmartFinancial will be merged with and into Cornerstone (the Merger), and the entity surviving the Merger (the Surviving Company) will be renamed SmartFinancial, Inc. The banks will initially remain separate and operate under their respective names in their respective markets.

Under the terms of the Merger Agreement, each outstanding share of SmartFinancial common stock will be converted into 4.20 shares of Cornerstone common stock, subject to adjustment based on an anticipated reverse stock split of Cornerstone's common stock. Additionally, each outstanding share of SmartFinancial preferred stock will be converted into a share of Cornerstone preferred stock with similar rights and preferences. Current holders of Cornerstone's preferred stock will be asked to vote on an amendment to Cornerstone's charter to allow Cornerstone to redeem its outstanding preferred stock prior to the completion of the Merger.

Based on consideration of all the relevant facts and circumstances of the Merger, for accounting purposes, SmartFinancial will be considered to have acquired Cornerstone. As a result, following the completion of the Merger, the historical financial statements of the Surviving Company will be the historical financial statements of SmartFinancial. The Merger will be effected by the issuance of shares of Cornerstone stock to SmartFinancial shareholders. The assets and liabilities of Cornerstone as of the effective date of the Merger will be recorded at their estimated fair values and added to those of SmartFinancial. Any excess of purchase price over the net estimated fair values of the acquired assets and liabilities of Cornerstone will be allocated to all identifiable intangible assets. Any remaining excess will then be allocated to goodwill. The goodwill resulting from the Merger will not be amortized to expense, but instead will be reviewed for impairment at least annually. To the extent goodwill were impaired, its carrying value would be written down to its implied fair value and a charge would be made to earnings. Intangibles with definite useful lives will be amortized to expense over their estimated useful lives.

The Merger Agreement contains customary representations, warranties and covenants by all parties. Conditions to each party's obligation to consummate the Merger include the following, as well as other customary conditions: (1) approval of the Merger Agreement by shareholders of Cornerstone and SmartFinancial, (2) approval of the Merger by regulatory authorities, (3) action by no more than 7% of the outstanding shares of SmartFinancial common stock and Cornerstone common stock taken together that would establish the right to dissent from the Merger under Tennessee law, (4) redemption of outstanding shares of Cornerstone's preferred stock and (5) the completion by Cornerstone of financing transactions that may be necessary to obtain regulatory approval of the Merger. Conditions to SmartFinancial's obligation to consummate the Merger include the following: (1) evidence that Cornerstone has amended its charter to allow the redemption of its outstanding preferred stock, the conversion of SmartFinancial's outstanding preferred stock and the reverse stock split, (2) approval by Cornerstone shareholders of an amended and restated charter, (3) approval by Cornerstone shareholders of amended and restated bylaws and (4) adoption by Cornerstone board of directors and approval by Cornerstone shareholders of an incentive compensation plan.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

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Note 20. Agreement and Plan of Merger (continued)

The Merger Agreement provides certain termination rights for both Cornerstone and SmartFinancial and further provides that, upon termination of the Merger Agreement under certain circumstances, Cornerstone or SmartFinancial, as applicable, will be obligated to pay the other party a termination fee of \$1,200,000 plus expenses.

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY
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Note 21. Condensed Parent Information

| BALANCE SHEETS | | | |
|--|--------------------------|----------------------|-------------------|
| | December 31, 2014 | December 31, 2013 | |
| ASSETS | | | |
| Cash | \$ 637,635 | \$ 3,376,410 | |
| Investment in subsidiary | 39,733,504 | 38,096,440 | |
| Other assets | <u>334,115</u> | <u>435,972</u> | |
| Total assets | <u>\$ 40,705,254</u> | <u>\$ 41,908,822</u> | |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | | |
| Other liabilities | \$ 43,149 | \$ 35,094 | |
| Other borrowings | <u>-</u> | <u>1,740,000</u> | |
| Total liabilities | 43,149 | 1,775,094 | |
| Stockholders' equity | <u>40,662,105</u> | <u>40,133,728</u> | |
| Total liabilities and stockholders' equity | <u>\$ 40,705,254</u> | <u>\$ 41,908,822</u> | |
| STATEMENTS OF INCOME | | | |
| | Years Ended December 31, | | |
| | 2014 | 2013 | 2012 |
| INCOME | | | |
| Dividends | \$ - | \$ - | \$ - |
| Interest income | <u>665</u> | <u>956</u> | <u>-</u> |
| | 665 | 956 | - |
| EXPENSES | | | |
| Interest expense | 19,802 | 49,836 | 170,872 |
| Other operating expenses | <u>476,894</u> | <u>286,105</u> | <u>436,283</u> |
| Loss before equity in undistributed earnings | (496,031) | (334,985) | (607,155) |
| Equity in undistributed earnings of subsidiary | 1,942,913 | 1,887,294 | 1,775,918 |
| Income tax benefit | <u>191,400</u> | <u>128,500</u> | <u>233,300</u> |
| Net income | 1,638,282 | 1,680,809 | 1,402,063 |
| Preferred stock dividend requirements | <u>1,500,000</u> | <u>1,500,000</u> | <u>1,229,780</u> |
| Accretion on preferred stock discount | <u>71,382</u> | <u>71,381</u> | <u>63,924</u> |
| Net income available to common shareholders | <u>\$ 66,900</u> | <u>\$ 109,428</u> | <u>\$ 108,359</u> |

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Note 21. Condensed Parent Information (continued)

| | <u>2014</u> | <u>2013</u> | <u>2012</u> |
|---|--------------------------|----------------------------|----------------------------|
| STATEMENTS OF CASH FLOWS | | | |
| CASH FLOWS FROM OPERATING ACTIVITIES | | | |
| Net income | \$ 1,638,282 | \$ 1,680,809 | \$ 1,402,063 |
| Adjustments to reconcile net income to net cash used in operating activities: | | | |
| Stock compensation expense | - | - | 74,048 |
| Equity in undistributed income of subsidiary | (1,152,913) | (1,887,294) | (1,775,918) |
| Other | 15,856 | 110,651 | 1,719,222 |
| Net cash used in operating activities | <u>501,225</u> | <u>(95,834)</u> | <u>1,419,415</u> |
| CASH FLOWS FROM FINANCING ACTIVITIES | | | |
| Net repayments under other borrowings | (1,740,000) | (435,000) | (870,000) |
| Issuance of preferred stock | - | - | 4,858,078 |
| Payment of preferred dividends | <u>(1,500,000)</u> | <u>(1,433,893)</u> | <u>(985,917)</u> |
| Net cash (used in) provided by financing activities | <u>(3,240,000)</u> | <u>(1,868,893)</u> | <u>3,002,161</u> |
| NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS | (2,738,775) | (1,964,727) | 4,421,576 |
| CASH AND CASH EQUIVALENTS, beginning of year | <u>3,376,410</u> | <u>5,341,137</u> | <u>919,561</u> |
| CASH AND CASH EQUIVALENTS, end of year | <u>\$ 637,635</u> | <u>\$ 3,376,410</u> | <u>\$ 5,341,137</u> |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION | | | |
| Cash paid during the year for: | | | |
| Interest | \$ 19,802 | \$ 85,236 | \$ 174,473 |
| Income taxes | <u>-</u> | <u>-</u> | <u>-</u> |

CORNERSTONE BANCSHARES, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014, 2013, and 2012

Note 22. Quarterly Data (unaudited)

| | Years Ended December 31, | | | | | | | |
|---|--------------------------|------------------|-------------------|------------------|-------------------|------------------|-------------------|------------------|
| | 2014 | | | | 2013 | | | |
| | Fourth Quarter | Third Quarter | Second Quarter | First Quarter | Fourth Quarter | Third Quarter | Second Quarter | First Quarter |
| Interest income | \$4,520,241 | \$4,502,258 | \$4,581,744 | \$4,533,121 | \$4,513,506 | \$4,760,392 | \$4,576,019 | \$4,603,114 |
| Interest expense | 650,170 | 691,727 | 725,324 | 722,634 | 772,240 | 869,041 | 919,565 | 961,705 |
| Net interest income, before provision for loan losses | 3,870,071 | 3,810,531 | 3,856,420 | 3,810,487 | 3,741,266 | 3,891,351 | 3,656,454 | 3,641,409 |
| Provision for loan losses | - | - | 350,000 | 165,000 | - | - | - | 300,000 |
| Net interest income, after provision for loan losses | 3,870,071 | 3,810,531 | 3,506,420 | 3,645,487 | 3,741,266 | 3,891,351 | 3,656,454 | 3,341,409 |
| Noninterest income | 458,774 | 503,766 | 534,488 | 322,313 | 616,747 | 269,968 | 697,305 | 355,499 |
| Noninterest expenses | 3,664,483 | 3,659,106 | 3,374,925 | 3,301,049 | 3,704,211 | 3,464,571 | 3,701,728 | 2,975,880 |
| Income before income taxes | 664,362 | 655,191 | 665,983 | 666,751 | 653,802 | 696,748 | 652,031 | 721,028 |
| Income tax expense | 253,405 | 249,500 | 256,500 | 254,600 | 249,700 | 268,200 | 256,000 | 268,900 |
| Net income | 410,957 | 405,691 | 409,483 | 412,151 | 404,102 | 428,548 | 396,031 | 452,128 |
| Preferred stock dividend requirement | 375,000 | 375,000 | 375,000 | 375,000 | 375,000 | 375,000 | 375,000 | 375,000 |
| Accretion on preferred stock dividends | 17,845 | 17,846 | 17,845 | 17,846 | 17,846 | 17,845 | 17,845 | 17,845 |
| Net income available to common shareholders | \$ 18,112 | \$ 12,845 | \$ 16,638 | \$ 19,305 | \$ 11,256 | \$ 35,703 | \$ 3,186 | \$ 59,283 |
| Earnings per common share: | | | | | | | | |
| Basic | \$ 0.01 | \$ - | \$ - | \$ - | \$ - | \$ 0.01 | \$ - | \$ 0.01 |
| Diluted | \$ 0.01 | \$ - | \$ - | \$ - | \$ - | \$ 0.01 | \$ - | \$ 0.01 |

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None

ITEM 9A. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

Cornerstone maintains disclosure controls and procedures, as defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934 (the “Exchange Act”), that are designed to ensure that information required to be disclosed by it in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Commission’s rules and forms and that such information is accumulated and communicated to Cornerstone’s management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Cornerstone carried out an evaluation, under the supervision and with the participation of its management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures as of the end of December 31, 2014. Based on the evaluation of these disclosure controls and procedures, the Chief Executive Officer and Chief Financial Officer have concluded that as of December 31, 2014, Cornerstone’s disclosure controls and procedures were effective.

Management’s Report on Internal Control over Financial Reporting

The report of Cornerstone’s management on internal control over financial reporting is set forth in Item 8 of this Annual Report on Form 10-K and incorporated herein by reference.

Changes in Internal Controls

There were no changes in Cornerstone's internal control over financial reporting during Cornerstone's fiscal quarter ended December 31, 2014 that have materially affected, or are reasonably likely to materially affect, Cornerstone's internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Information about Director Nominees

Set forth below with respect to the nominees for director of the Company is information regarding their business experience during the past five years and other information. In addition, the individual experiences, qualifications, attributes and/or skills of each nominee for director that led to his or her nomination and contribute to the Board's effectiveness as a whole are discussed below.

| <u>Name</u> | <u>Age</u> | <u>Principal Occupation and Qualifications</u> |
|---------------------|------------|--|
| Monique P. Berke | 48 | Vice President, Investment Operations of Unum Group, a global provider of financial protection benefits. She previously served as Vice President, Human Resources, Global Services for Unum. Prior to 2009, she owned and operated Berke Coaching & Consulting, providing consulting services to Fortune 500 companies. Ms. Berke has extensive experience in the financial services industry with specializations in human resources and operational effectiveness. Her corporate and consulting backgrounds add extensive experience to the Board in matters concerning human resources, process and change management and strategic planning. She has served on several community non-profit boards and committees and is the recipient of many professional awards. |
| B. Kenneth Driver | 79 | Vice Chairman and Co-CEO of Fillauer Companies, Inc., a Chattanooga based prosthetic manufacturer since 1914. He previously served as President and Chief Operations Officer of Fillauer Companies, Inc. from 1994 to 2007. Since 2007 he has served as the Vice Chairman and Vice CEO of the Fillauer Companies. He has been a director of the Company since 1997. Mr. Driver has extensive experience in matters involved in running a large public company, has served in several capacities from CFO to President and has expertise in finance and accounting, corporate governance, employee matters, and mergers and acquisitions. |
| Karl Fillauer | 67 | Chairman and Co-CEO of Fillauer Companies, Inc., a Chattanooga based prosthetic manufacturer since 1914. He has been a director of the Company since 1997. Mr. Fillauer brings significant executive management experience and insight to the Board and is proficient in matters relating to finance and accounting, corporate governance, employee matters, and mergers and acquisitions. |
| Nathaniel F. Hughes | 56 | President and Chief Executive Officer of the Company since November 2009. He previously served as President and CEO of the Company's sole banking subsidiary, Cornerstone Community Bank (the "Bank"), from March 2012 to February 2015. Prior to that Mr. Hughes served as President and Interim Chief Executive Officer of the Bank from November 2009 to March 2012. Prior to that time Mr. Hughes served as President and Chief Financial Officer of the Company and President and Chief Operating Officer of the Bank from June 2004 to November 2009; President and Chief Financial Officer of the Company and the Bank from April 2003 to June 2004; and Executive Vice President and Chief Financial Officer of the Company and the Bank from February 1999 to April 2003. Mr. Hughes has been a director of the Company since April 2003. He has over 30 years experience in the banking and financial services industry, including expertise in finance and accounting. Mr. Hughes possesses extensive knowledge of the Company's business and regulatory environment, including matters affecting public companies. As chief executive, he is intimately involved in the Company's strategic vision and direction and interacts with key executives and constituents within and outside the organization. He also serves on the boards of several non-profit organizations. |

| <u>Name</u> | <u>Age</u> | <u>Principal Occupation and Qualifications</u> |
|----------------------|------------|--|
| Frank S. McDonald | 63 | President of FMA Architects, PLLC, a Chattanooga based architectural firm, for more than twenty-five years. He has been a director of the Company since September 2005. Mr. McDonald's extensive experience in the development and real estate industry assists the Bank's loan origination process and credit risk management. In addition, he has vast experience in board governance and has served as Chairman of several non-profit organizations. |
| Doyce G. Payne, M.D. | 64 | Dr. Payne practiced obstetrics and gynecology in the Chattanooga area for more than twenty years prior to his redirecting his practice to International Medical Missions in 2003. He has been a director of the Company since 1997. As a resident of Chattanooga, his knowledge of the Chattanooga market fits well with the Company's strategy of focusing on its core banking franchise in Hamilton County. He also serves on the boards of several non-profit organizations. |
| Wesley M. Welborn | 56 | Chairman of the Board of Directors of the Company and the Bank since November 2009. Mr. Welborn is a Partner with the Lamp Post Group, a Chattanooga based small business incubator. Mr. Welborn also has served as President of Welborn & Associates, Inc., a Chattanooga based consulting firm specializing in transportation logistics, for more than ten years. He has been a director of the Company since September 2005. Mr. Welborn has served on the boards of numerous trucking companies and associations. In addition, he served on the board of a publicly traded bank for many years and for two terms as a director of the Federal Reserve Bank of Atlanta's Birmingham Branch. He also serves on the boards of several non-profit organizations. |
| Billy O. Wiggins | 72 | President of Checks, Inc., a Chattanooga based specialty check printing company, for more than twenty years. He has been a director of the Company since 1997. Mr. Wiggins has expertise in retailing and wholesaling and extensive experience in the matters involved in running a large company, including finance and accounting, corporate governance, employee matters, and mergers and acquisitions. |
| Marsha Yessick | 67 | Owner of Yessick's Design Center, a Chattanooga based interior design company, for more than thirty years and a current member of the American Society of Interior Designers. She has been a director of the Company since 1997. As the founder and operator of several businesses, Ms. Yessick has developed significant experience in managing and operating businesses of varying sizes. In addition, her background assists the Company in human resources management. |

Executive Officers

The following sets forth the names and certain information with respect to Cornerstone's executive officers (except for Mr. Nathaniel F. Hughes whose information is included above):

| <u>Name</u> | <u>Age</u> | <u>Principal Occupation and Qualifications</u> |
|-----------------|------------|--|
| John H. Coxwell | 64 | Senior Executive Vice President of Cornerstone Community Bank since 2012. Prior to joining Cornerstone, Mr. Coxwell had a thirty-plus year career as a Certified Public Accountant (CPA) and financial institution specialist. His CPA experience includes managerial positions with Deloitte & Touche and, most recently, thirteen years as Managing Partner of Hazlett, Lewis & Bieter, PLLC. Originally from Waynesboro, MS, he is a graduate of Auburn University. His civic involvement includes board positions with the Chattanooga Symphony & Opera and READ Chattanooga (now Re:Start – the Center for Adult Education) where he also served as Board President. He is a former member of the Kiwanis Club of Chattanooga and the Chattanooga Downtown Rotary Club. |

| <u>Name</u> | <u>Age</u> | <u>Principal Occupation and Qualifications</u> |
|----------------------|------------|---|
| Robert B. Watson | 58 | President of Cornerstone Community Bank since February 2015. Mr. Watson brings 35 years' experience in the banking industry to his position as President of Cornerstone Community Bank, where he served as Executive Vice President and Senior Loan Administrator from March 2011. Prior to joining Cornerstone in June of 2002, he worked in executive capacities with several regional and community banks, most recently as President and Chief Operating Officer of First Volunteer Bank of Tennessee. A native of Chattanooga, he holds a bachelor's degree in Accounting and Finance from the University of Tennessee at Chattanooga (UTC). He is a graduate of the LSU School of Banking. His past civic involvement includes board positions with Chattanooga Christian School, Shepherds Arms Rescue Mission and the UTC Finance Advisory Board. |
| James R. Vercoe, Jr. | 62 | Executive Vice President and Chief Credit Officer of Cornerstone Community Bank since December 2013. Prior to that, he served as Senior Vice President and Chief Credit Officer since 2010. Bob Vercoe joined Cornerstone in November of 2010 as a 30-year veteran of the banking industry, having served in executive positions with banks in Charlotte, NC; Nashville, TN; and Chattanooga, TN. Originally from Raleigh, NC, he holds a bachelor's degree in U.S. History and an MBA in finance from the University of North Carolina at Chapel Hill. |
| Gary W. Petty, Jr. | 40 | Chief Financial Officer of the Company since 2009 and Executive Vice President and Chief Operations Officer of Cornerstone Community Bank since January 2014. Prior to that, Mr. Petty served as Chief Financial Officer and Senior Vice President of the Bank from January 2007 to December 2013. He also served as interim Chief Operations Officer from February 2012 to December 2013. Prior to 2007, Mr. Petty served as Vice President/Internal Auditor since 2004. Gary Petty started with Cornerstone in January of 2000 as a credit analyst and has nearly twenty years' experience in the banking industry. He received his undergraduate degree in Economics from the University of Georgia and a Master of Accountancy degree from the University of Tennessee at Chattanooga . |

CORPORATE GOVERNANCE AND THE BOARD OF DIRECTORS

The Company's business is managed by its employees under the direction and oversight of the Board of Directors. Board members are kept informed of the Company's business through discussions with management, materials provided to them by management and their participation in Board and Board Committee meetings.

Board Leadership Structure

The offices of Chairman of the Board and Chief Executive Officer ("CEO") are separated, with Nathaniel F. Hughes holding the position of President and CEO and Wesley M. Welborn being Chairman of the Board. The Company does not have a formal policy with respect to the separation or combination of the offices of Chairman of the Board and CEO. Rather, the Board has the discretion to combine or separate these roles as it deems appropriate from time to time, which provides the Board with necessary flexibility to adjust to changed circumstances. In light of the transition in management in 2009 and the many challenges arising from the difficult economic and regulatory environment, the Board determined that separating the roles of Chairman and CEO would allow the CEO to devote the requisite significant time and focus on managing our business and restoring financial strength. However, under other circumstances, the Board may determine that combining these roles would better serve the Company by enabling one individual to act as a bridge between management and the Board. Historically, the Company has not designated a separate lead independent director at times when the offices of Chairman and CEO were combined.

Risk Oversight

Oversight of risk management is a central focus of the Board and its committees. The full Board regularly receives reports both from Board committees and from management with respect to the various risks facing the Company, including the Bank, and oversees planning and responding to them as appropriate. The Audit Committee currently has primary responsibility for oversight of financial risk and for oversight of the Company's risk management processes, including those relating to litigation and regulatory compliance. Under its charter, the Audit Committee is required to discuss the Company's risk assessment and risk management policies and to inquire about any significant risks and exposures and the steps taken to monitor and minimize such risks. The Asset/Liability Management and Strategic Planning Committee actively measures and manages interest rate risk and is responsible for approving the Company's asset/liability management policies and for overseeing the formulation and implementation of strategies to improve balance sheet positioning and earnings. The Human Resource/Compensation Committee is chiefly responsible for compensation-related risks. Under its charter, the Human Resource/Compensation Committee must discuss and review the key business and other risks the Company faces and the relationship of those risks to certain compensation arrangements. The Bank's Loan Committee has primary responsibility for credit risk and the committee's duties include oversight of the Bank's credit risk department. Each of these committees receives regular reports from management concerning areas of risk for which the committee has oversight responsibility. The Bank is in the process of developing an Enterprise Risk approach to managing the Company's risk. The objective is to consolidate and simplify the Company's major risk components and report them to the Board in a manageable format.

Code of Conduct

The Company has adopted a Code of Conduct, which contains provisions consistent with the SEC's description of a code of ethics, which applies to its directors, officers and employees, including its principal executive officers, principal financial officer, principal accounting officer, controller and persons performing similar functions. The purpose of the Code of Conduct is, among other things, to provide written standards that are reasonably designed to deter wrongdoing and to: (1) promote honest and ethical conduct; (2) provide full, fair, accurate, timely and understandable disclosure in reports and documents that the Company files with the SEC and other public communications by the Company; (3) assure compliance with applicable governmental laws, rules and regulations; (4) require prompt reporting of any violations of the Code of Conduct; and (5) establish accountability for adherence to the Code of Conduct. Each director is required to read and certify annually that he or she has read, understands and will comply with the Code of Conduct. The Company's Code of Conduct is available on the Company's website at www.cscbank.com in the Investor Relations area.

Audit Committee

The Audit Committee selects and engages the Company's independent registered public accounting firm each year. In accordance with its charter, the Audit Committee, among other things, reviews the Company's financial statements, the results of internal auditing, financial reporting procedures, reports of regulatory authorities, compliance with internal controls required by the Federal Deposit Insurance Corporation Improvement Act and regularly reports to the Board with respect to all significant matters presented at meetings of the Audit Committee. The charter of the Audit Committee is available on the Company's website at www.cscbank.com in the Investor Relations area. The Audit Committee is currently comprised of three non-employee directors, Messrs. Payne, Fillauer and McDonald, each of whom is "independent" as defined by the Nasdaq listing standards and the rules and regulations of the SEC. The Audit Committee does not have an "audit committee financial expert," as defined in applicable SEC rules, because no director on the Board satisfies the criteria of an audit committee financial expert and the Company has not been able to find a suitable board member who is such an expert. The Audit Committee held four meetings for the Company during 2014, each of which was held concurrently with the Bank's Audit Committee. Prior to the release of quarterly reports in 2014, the Audit Committee or a member of the Audit Committee also reviewed and discussed the interim financial information contained therein with the Company's independent registered public accounting firm during fiscal 2014.

Audit Committee Report

Committee Charter

The Audit Committee and the Board have approved and adopted a charter for the Audit Committee, a copy of which is available on the Company's website at www.cscbank.com in the Investor Relations area. In accordance with the charter, the Audit Committee assists the Board in fulfilling its responsibility for overseeing the accounting, auditing and financial reporting processes of the Company. The responsibilities of the Audit Committee are described in greater detail in its charter.

Auditor Independence

The Audit Committee received from Mauldin & Jenkins, LLC (M&J) written disclosures and a letter regarding its independence as required by Public Company Accounting Oversight Board Rule 3526, “Communication with Audit Committees Concerning Independence,” describing all relationships between the independent registered public accounting firm and the Company that might bear on the registered public accounting firm’s independence, and discussed this information with M&J. The Audit Committee also reviewed and discussed with management and with M&J the quality and adequacy of the Company’s internal controls. The Audit Committee also reviewed with M&J and financial management of the Company the audit plans, audit scope and audit procedures. The discussions with M&J also included the matters required by the Public Accounting Oversight Board Auditing Standard No. 16. The Audit Committee has also considered, and concluded, that the provision of services by M&J described under the caption “Audit and Non-Audit Fees” are compatible with maintaining the independence of M&J.

Review of Audited Financial Statements

The Audit Committee has reviewed the audited financial statements of the Company as of and for the fiscal year ended December 31, 2014 and has discussed the audited financial statements with management and with M&J. Based on all of the foregoing reviews and discussions with management and M&J, the Audit Committee recommended to the Board of Directors that the audited financial statements be included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2014, to be filed with the SEC.

The foregoing report is submitted by the following members of the Audit Committee:

Doyce G. Payne, M.D., Chairman
Karl Fillauer
Frank S. McDonald

Section 16(a) Beneficial Ownership Reporting Compliance

Under 16(a) of the Exchange Act, directors and executive officers of the Company and persons who own 10% or more of the Company’s Common Stock are required to report to the Securities and Exchange Commission (the “SEC”), within specified due dates, their initial beneficial ownership of the Company’s Common Stock and all subsequent changes to their beneficial ownership. Officers, directors and greater than 10% shareholders are required by SEC regulations to furnish the Company with copies of all forms they file in accordance with Section 16(a). Based solely on the Company’s review of these reports or on representations or information provided to the Company by the persons required to make such filings, the Company believes that all Section 16(a) filing requirements were complied with during the last fiscal year with the exception of the following filings: (1) John H. Coxwell filed one late report on Form 4 on March 16, 2015, reporting one transaction related to the issuance on April 1, 2014 of 15,384 shares of the Company’s Common Stock.

ITEM 11. EXECUTIVE COMPENSATION

Introduction

The Human Resources / Compensation Committee (the “Committee”) carries out the Board’s overall responsibilities with respect to executive compensation, director compensation and reviews the performance of the Company’s principal executive officer (the “PEO”). The Committee also oversees administration of the Company’s employee benefit plans, including the Company’s 401(k) plan and ESOP. The Committee operates under a written charter (see www.cscbank.com) that is approved annually by the Board. The Committee Chairperson sets the agenda and calendar for the Committee. The Committee has the authority to hire independent consultants to advise the Committee on compensation matters. For fiscal 2014, the Committee did not hire an independent consultant to advise the Committee on compensation matters. The PEO reviews the performance of the other named executive officers and recommends to the Committee compensation packages for each of them.

Total compensation of the Company’s named executive officers is determined primarily by the Company’s size in earning assets, the Company’s financial performance and the individual executive’s performance. In determining what types and levels of total compensation to offer the named executive officers, the Committee follows its written Executive Compensation Policy, including guidelines, using predetermined Company financial parameters for the distribution of the particular components of total compensation to the named executive officers.

Compensation Philosophy

The Company's overall executive compensation philosophy is to align its compensation program with optimizing shareholder value. To that end, the program is designed to recognize superior operating performance and to attract, retain and motivate the executive talent essential to the Company's financial success. Consistent with this philosophy, the Committee is guided by the following objectives when administering the Company's overall compensation program:

- Attract and retain highly qualified executives who reflect the Company's culture and values;
- Motivate executives to provide excellent leadership and achieve the Company's goals;
- Provide substantial performance-related incentive compensation that is aligned with the Company's strategies and directly tied to meeting specific Company objectives;
- Strongly link the interests of the executives to the value derived by the Company's shareholders from owning the Company's Common Stock; and
- Be fair, ethical, transparent and accountable in setting and disclosing executive compensation.

In furtherance of these objectives, the following considerations underlie the Committee's determination with respect to the following principal elements of compensation for the named executive officers:

Base Salary – Individual salary determinations should be based upon the officer's qualifications, behaviors, cultural adherence and performance.

Annual Cash Incentives – Executives should have a portion of their total cash compensation at risk, contingent upon meeting Company objectives.

Long-Term Equity-Based Awards – Executives who are critical to the Company's long-term success should participate in long-term incentive opportunities that link a portion of their total compensation to increasing shareholder value.

Retirement Plans and Other Benefits – Executives should participate in the Company's benefit programs, such as health insurance, 401(k) plan, ESOP, vacation and life insurance, at a level consistent with policy, prevailing law and current regulation.

Total compensation is intended to correlate to the Company's ability to grow earning assets, which in turn enhances the Company's growth in shareholder value. The Committee did not use competitive salary surveys to determine or measure the total compensation of the named executive officers. A portion of each named executive officer's total compensation consists of cash payments, including base salary and/or annual cash incentive awards. In addition, a portion of each named executive officer's total compensation consists of equity awards designed to align the interests of the named executive officers with the interests of the Company's stakeholders, who include shareholders, employees, directors and community interests.

Fiscal 2014 Summary Compensation Table and Narrative

Under rules established by the SEC, the Company is required to provide certain data and information regarding the compensation and benefits awarded to, earned by or paid to all persons who served as principal executive officer of the Company during 2014 and certain other executive officers, including the three other most highly compensated executive officers whose total compensation exceeded \$100,000 (the "named executive officers"). The disclosure requirements include the use of tables and narrative discussion of any material factors necessary to an understanding of the information disclosed in the tables. The summary compensation table below sets forth certain elements of compensation for the named executive officers of the Company and the Bank for the periods indicated.

FISCAL 2014 SUMMARY COMPENSATION TABLE

| Name and Principal Position | Year | Salary (\$) | Bonus \$(1) | Stock Awards (\$) | Option Awards \$(2) | Non- equity Incentive Plan Compensation (\$) | Director | All Other Compens- ation \$(4) | Total (\$) |
|--|------|----------------|----------------|-------------------------|---------------------------|---|--|---|---------------|
| | | | | | | | Fees Earned or Paid in Cash \$(3) | | |
| (a) | (b) | (c) | (d) | (e) | (f) | (g) | (h) | (i) | (j) |
| Nathaniel F. Hughes President & CEO Company & Bank | 2014 | 169,200 | 6,000 | 0 | 32,500 | 0 | 8,064 | 0 | 215,764 |
| | 2013 | 169,200 | 203 | 0 | 29,250 | 0 | 8,064 | 0 | 206,717 |
| | 2012 | 169,200 | 1,000 | 0 | 19,500 | 0 | 8,064 | 0 | 197,764 |
| John H. Coxwell Senior Ex. Vice President Bank (5) | 2014 | 128,799 | 6,000 | 26,250 | 32,500 | 0 | 0 | 0 | 193,549 |
| | 2013 | 60,000 | 203 | 35,000 | 17,550 | 0 | 0 | 0 | 112,753 |
| | 2012 | 35,000 | 500 | 19,269 | 0 | 0 | 0 | 0 | 54,769 |

Robert B. Watson

| | | | | | | | | | |
|----------------------------|------|---------|--------|---|--------|---|---|---|---------|
| Ex. Vice President | 2014 | 154,269 | 12,500 | 0 | 19,500 | 0 | 0 | 0 | 186,269 |
| Sr. Loan Officer | 2013 | 140,000 | 203 | 0 | 17,550 | 0 | 0 | 0 | 157,753 |
| Bank | 2012 | 140,000 | 1,000 | 0 | 11,700 | 0 | 0 | 0 | 152,700 |
| James R. Vercoe Jr. | | | | | | | | | |
| Ex. Vice President | 2014 | 135,000 | 11,000 | 0 | 19,500 | 0 | 0 | 0 | 165,500 |
| Chief Credit Officer | 2013 | 125,000 | 217 | 0 | 17,550 | 0 | 0 | 0 | 142,767 |
| Bank | 2012 | 125,500 | 1,000 | 0 | 11,700 | 0 | 0 | 0 | 137,700 |
| Gary W. Petty Jr. | | | | | | | | | |
| Ex. Vice President | 2014 | 132,500 | 8,000 | 0 | 19,500 | 0 | 0 | 0 | 160,000 |
| COO Bank; | 2013 | 125,000 | 203 | 0 | 17,550 | 0 | 0 | 0 | 142,753 |
| CFO Company | 2012 | 125,000 | 1,000 | 0 | 11,700 | 0 | 0 | 0 | 137,700 |

- (1) Represents cash bonuses paid to the entire workforce in connection with the Christmas holiday season.
- (2) The amounts in this column reflect the aggregate grant date fair value of option awards computed in accordance with FASB ASC Topic 718. The fair value of each option award is estimated on the date of grant using the Black-Scholes option-pricing model. Fiscal 2012 option awards were made on March 1, 2012 with a Black-Scholes value of \$0.78 per share. Fiscal 2013 option awards were made on March 1, 2013 with a Black-Scholes value of \$1.17 per share. Fiscal 2014 option awards were made on March 1, 2014 with a Black-Scholes value of \$1.30 per share. A more detailed discussion of the assumptions used in the valuation of option awards made in fiscal 2012, 2013 and 2014 based on performance during 2011, 2012 and 2013 may be found in Note 14 of the Notes to the Financial Statements in this report. Options acquired pursuant to option grants must generally be held at least two years before partial vesting is possible.
- (3) The amounts in this column reflect the aggregate amount of cash fees earned or paid to employee directors for attending meetings of the Board and the Bank, as described in greater detail under the section entitled "Director Compensation" below.
- (4) No contributions were made for fiscal 2012, 2013 and 2014 to the Company's 401(k) or ESOP plans. The Bank paid \$10,000 in 2014 to give the ESOP plan liquidity for individuals that had less than 1,000 shares that requested to liquidate their shares as per the plan and administrative fees. The Bank paid \$4,757 in 2014 to the 401(k) plan for administrative fees.
- (5) John Coxwell was hired by the Bank June 1, 2012.

Outstanding Equity Awards at 2014 Fiscal Year-End Table and Narrative

The following table sets forth information concerning outstanding equity based awards for each of the named executive officers as of December 31, 2014. Because the Company has never issued stock appreciation rights, restricted stock awards or other stock awards, the table excludes all columns relating to such awards.

OUTSTANDING EQUITY AWARDS AT 2014 FISCAL YEAR-END

| Name | Grant Date | Option Awards (1) | | Option Exercise Price (\$) | Option Expiration Date |
|---------------------------|------------|---|-------------------|----------------------------|------------------------|
| | | Number of Securities Underlying Unexercised Options (2) | | | |
| | | Exercisable (#) | Unexercisable (#) | | |
| Nathaniel F. Hughes(3)(4) | 3/01/2005 | 18,000 | | 9.225 | 3/01/2015 |
| | 3/01/2008 | 8,500 | | 7.990 | 3/01/2018 |
| | 3/01/2009 | 10,000 | | 3.600 | 3/01/2019 |
| | 3/01/2011 | 15,000 | 10,000 | 1.700 | 3/01/2021 |
| | 3/01/2012 | 7,500 | 17,500 | 1.650 | 3/01/2022 |
| | 3/01/2013 | 0 | 25,000 | 2.370 | 3/01/2023 |
| | 3/01/2014 | 0 | 25,000 | 2.400 | 3/01/2024 |
| John H. Coxwell (4) | 3/01/2013 | 0 | 15,000 | 2.370 | 3/01/2023 |
| | 3/01/2014 | 0 | 25,000 | 2.400 | 3/01/2024 |

| Name | Option Awards (1) | | | | |
|--------------------------|-------------------|---|-------------------|----------------------------|------------------------|
| | Grant Date | Number of Securities Underlying Unexercised Options (2) | | Option Exercise Price (\$) | Option Expiration Date |
| | | Exercisable (#) | Unexercisable (#) | | |
| Robert B. Watson(3)(4) | 3/01/2005 | 6,000 | | 9.225 | 3/01/2015 |
| | 3/01/2008 | 7,000 | | 7.990 | 3/01/2018 |
| | 3/01/2009 | 10,000 | | 3.600 | 3/01/2019 |
| | 3/01/2011 | 9,000 | 6,000 | 1.700 | 3/01/2021 |
| | 3/01/2012 | 4,500 | 10,500 | 1.650 | 3/01/2022 |
| | 3/01/2013 | 0 | 15,000 | 2.370 | 3/01/2023 |
| | 3/01/2014 | 0 | 15,000 | 2.400 | 3/01/2024 |
| James R. Vercoe, Jr. (4) | 3/01/2011 | 9,000 | 6,000 | 1.700 | 3/01/2021 |
| | 3/01/2012 | 4,500 | 10,000 | 1.650 | 3/01/2022 |
| | 3/01/2013 | 0 | 15,000 | 2.370 | 3/01/2023 |
| | 3/01/2014 | 0 | 15,000 | 2.400 | 3/01/2024 |
| Gary W. Petty, Jr.(3)(4) | 3/01/2005 | 1,500 | | 9.225 | 3/01/2015 |
| | 3/01/2008 | 3,000 | | 7.990 | 3/01/2018 |
| | 3/01/2009 | 5,000 | | 3.600 | 3/01/2019 |
| | 3/01/2011 | 9,000 | 6,000 | 1.700 | 3/01/2021 |
| | 3/01/2012 | 4,500 | 10,500 | 1.650 | 3/01/2022 |
| | 3/01/2013 | 0 | 15,000 | 2.370 | 3/01/2023 |
| | 3/01/2014 | 0 | 15,000 | 2.400 | 3/01/2024 |

- (1) All employee stock options awarded before 2013 were awarded under the Company's Statutory-Nonstatutory Stock Option Plan, which was approved by the shareholders in 1996, and the Company's 2002 Long Term Incentive Plan, which was approved by the shareholders in 2002. All unexercised stock options have been adjusted for the 2-for-1 stock splits of September 2004 and December 2006. During 2012, the Company's 2002 Long Term Incentive Plan expired.
- (2) All employee stock options vest 30% on the second anniversary of the grant date, 60% on the third anniversary of the grant date and 100% on the fourth anniversary of the grant date.
- (3) On February 26, 2010, all named executive officers voluntarily forfeited their options for the award years 2006 and 2007, and the shares underlying these options became available for distribution in connection with future awards under the plan.
- (4) The shares underlying options that were issued in 2013 and 2014 were issued without a qualified plan and, therefore, these options are considered non-qualified.

DIRECTOR COMPENSATION

Fees for Board Service

The Company's directors do not receive fees for attendance at meetings of the Board or committees of the Board of the Company. Rather, because these meetings are held concurrently with the meetings of the Board and equivalent committees of the Board of the Bank, meeting fees are paid by the Bank solely with respect to attendance at meetings of the Board and committees of the Board of the Bank. Although employee directors are entitled to receive cash fees for attendance at Board meetings, they are not eligible for Board committee attendance fees or to participate in the Company's annual cash incentive or long-term incentive award programs. In fiscal 2014, each director received \$672 for attendance at each concurrent Board meeting (two paid absences per calendar year are allowed). Each non-employee director (also referred to herein as an "independent director") also received \$204 for attendance at each concurrent Audit Committee meeting and \$179 for attendance at each other Board committee meeting (including concurrent meetings of equivalent Board and Bank committees and meetings of the Bank's Loan Committee), except that the Chairperson of the Audit Committee and of each other Board committee of the Bank received \$247 and \$204, respectively, for attendance at such meetings. The Chairman of the Board also receives cash chairmanship fees (currently, \$93,064 on an annualized basis) for such service of which \$72,876 was allocated to the Bank. Total director fees paid by the Company for services rendered on behalf of the Company in 2014 were \$199,496.

Director Annual Cash Incentive Awards

The independent directors of the Company are eligible to receive an annual cash incentive award if the Company meets certain financial performance goals set forth in its profit plan, as from time to time amended. These payments may be paid in cash or, at the election of each independent director under the 2004 Non-Employee Director Compensation Plan, in shares of Common Stock. Performance targets are established at the beginning of the fiscal year through the financial budgeting process. Therefore, the independent directors' annual cash incentive awards are determined based on the Company's overall financial performance. The opportunity to earn a cash incentive award payment ranges from 0% to 100% of the average independent directors' compensation received in Board, subsidiary Board and committee fees. The independent directors' cash incentive award pool is further limited to not be greater than the executive officers' cash incentive award pool. Because the Company did not provide any funds for the executive officers' cash incentive award pool in fiscal 2014, the independent directors did not receive any cash incentive awards for fiscal 2014.

Director Long-Term Equity Based Awards

The Company's independent directors are also eligible to participate in the Company's Statutory-Nonstatutory Stock Option Plan and the 2002 Long Term Incentive Plan, each of which was previously approved by the Board and its shareholders. The Compensation Committee establishes, in February of each fiscal year, assuming the achievement of certain financial targets for such fiscal year, the value of the Company's incentive stock options that will be issued the following calendar year. Based on the market value of the incentive stock options issued to all Company employees, the independent directors as a group set a participate guideline at a level of 20% of the total market value of all stock options granted to both employees and independent directors. The 2014 employee grant represents 72% of the total Company grant, while the independent director grant, as a group, represents 28% of the total Company grant. The independent directors were granted 10,000 non-qualified stock options per director to reward the Directors. The Board anticipates decreasing the issuance level in 2015. The non-qualified stock options issued to independent directors for 2014 vest 50% on the first anniversary of the grant date and 100% on the second anniversary of the grant date. The Company will recognize compensation expense related to the shares subject to these awards as the shares vest.

In 2012, the Company's independent directors chose to reinstate the reduction in director fees in previous years due to the Bank's financial difficulty. The increase in fees was decided to be in the form of stock grants. During 2012, the independent directors were issued 2,500 shares each with the exception of Miller Welborn who was granted 15,000 shares. During 2013 there no grants issued. During 2014, the independent directors were issued 5,000 shares each with the exception of Miller Welborn who was granted 30,000 shares.

Director Compensation Table

The following table sets forth the compensation earned by the Company's independent directors for services rendered during the fiscal year ended December 31, 2014:

DIRECTOR COMPENSATION FOR FISCAL 2014 *

| Name | Fees Earned or Paid in Cash (\$) | Stock Awards \$(1) | Option Awards \$(2) | Non-Equity Incentive Plan Compensation (\$) | All Other Compensation (\$) | Total (\$) |
|----------------------|---|--------------------------|---------------------------|--|-----------------------------------|---------------|
| Monique P. Berke | 8,644 | 0 | 0 | 0 | 0 | 8,644 |
| B. Kenneth Driver | 13,917 | 12,000 | 13,000 | 0 | 0 | 38,917 |
| Karl Fillauer | 10,212 | 12,000 | 13,000 | 0 | 0 | 35,212 |
| David G. Fussell | 9,455 | 12,000 | 13,000 | 0 | 0 | 34,455 |
| Frank S. McDonald | 15,395 | 12,000 | 13,000 | 0 | 0 | 40,395 |
| Doyce G. Payne, M.D. | 14,780 | 12,000 | 13,000 | 0 | 0 | 39,780 |
| Wesley M. Welborn | 93,064 | 72,000 | 13,000 | 0 | 0 | 178,064 |
| Billy O. Wiggins | 15,753 | 12,000 | 13,000 | 0 | 0 | 40,753 |
| Marsha Yessick | 10,212 | 12,000 | 13,000 | 0 | 0 | 35,212 |

- * Nathaniel F. Hughes is a named executive officer and Mr. Hughes was a member of the Board of Directors of the Company during all of fiscal 2014. His director compensation is set forth under “Column (h)” of the “Fiscal 2014 Summary Compensation Table” above and, as a result, has been omitted from this table.
- (1) Each non-employee director received 5,000 grant shares, 2,500 for 2013 and 2,500 for 2014. The shares were issued at \$2.40 per share in March 2014.
- (2) For each non-employee director, the aggregate number of shares of Common Stock underlying option awards outstanding (whether or not exercisable) at December 31, 2014, after giving effect to the 2-for-1 stock splits in September 2004 and December 2006, was as follows: Mrs. Berke – 0 shares; Mr. Driver—29,650 shares; Mr. Fillauer—29,650 shares; Mr. McDonald—28,650 shares; Dr. Payne—29,650 shares; Mr. Welborn—28,650 shares; Mr. Wiggins—29,650 shares; and Ms. Yessick—29,650 shares. Non-qualified stock options are granted to independent directors with an exercise price equal to the market price on the grant date, and vest 50% on the first anniversary of the grant date and 100% on the second anniversary of the grant date.

RETIREMENT AND CHANGE-IN-CONTROL BENEFITS

Stock Option Ownership; Vesting of Awards . As of December 31, 2014, Cornerstone’s named executive officers beneficially owned, in the aggregate, [389,000] stock options issued pursuant to Cornerstone’s 2002 Long Term Incentive Plan.

Under the terms of the Company’s 2002 Long Term Incentive Plan, the vesting of any outstanding stock options and other awards under the plan will be accelerated upon the occurrence of a change of control so that all awards not previously exercisable and vested are fully exercisable and vested. For purposes of this plan, a “change of control” means the happening of any of the following:

- When any “person” (as such term is used in Section 13(d) and 14(d) of the Securities Exchange Act of 1934 (the “Exchange Act”), other than Cornerstone or a subsidiary or any Cornerstone employee benefit plan (including its trustee)) is or becomes the “beneficial owner” (as defined in Rule 13d-3 under the Exchange Act) directly or indirectly of securities of Cornerstone representing 51% or more of the combined voting power of Cornerstone’s then outstanding securities;
- The occurrence of a transaction requiring shareholder approval for the acquisition of Cornerstone by an entity other than Cornerstone or a subsidiary through purchase of assets, by merger or otherwise; or
- The filing of an application with any regulatory authority having jurisdiction over the ownership of Cornerstone by any “person” (as defined above) to acquire 51% or more of the combined voting power of Cornerstone’s then outstanding securities.

Also under the terms of the plan, if the employment of a participant in the plan is terminated for any reason following a change of control, any outstanding stock options or other awards under the plan granted to the participant that are not fully exercisable and vested will become fully exercisable and vested as of the date of such termination and any obligations to pay amounts to Cornerstone or any subsidiary in connection with an award will be terminated as of the date when such termination occurs.

New Employment Agreements . On December 5, 2014 Cornerstone and Cornerstone Community Bank terminated their previous change of control and severance agreements with the named executive officers, as well as certain other officers of Cornerstone and Cornerstone Community Bank, and entered into new employment agreements. Each of the new employment agreements contains the following provisions, among others:

- *Severance on Cornerstone Termination without Cause* . For termination of each named executive officer by Cornerstone without cause, Cornerstone and/or Cornerstone Community Bank, as applicable, shall be required to pay a severance benefit equal to one times each such named executive officer’s annual base salary, payable over twelve months, and reimburse such named executive officer for the reasonable cost of premium payments paid by such named executive officer to continue then-existing health insurance coverage for the lesser of (A) twelve months or (B) such time as such named executive officer obtains other employment.
- *Severance on Named Executive Officer Termination with Cause* . For termination for cause by a such named executive officer resulting from a (A) material reduction in duties or responsibilities, (B) a material reduction in such named executive officer’s salary, or (C) a change in the location of employment outside of a 75 mile radius from such named executive officer primary office, Cornerstone and/or Cornerstone Community Bank, as applicable, shall be required to pay a severance benefit equal to one times such named executive officer’s annual base salary, payable over twelve months, and reimburse such named executive officer for the reasonable cost of premium payments paid by such named executive officer to continue then-existing health insurance coverage for the lesser of (Y) twelve months or (Z) such time as such named executive officer obtains other employment.

- *Severance on Change of Control* . If within twelve months following any change of control such named executive officer is terminated by Cornerstone and /or Cornerstone Community Bank (or their successor(s)), as applicable, without cause or such named executive officer terminates for cause resulting from a (A) material reduction in duties or responsibilities, (B) a material reduction in such named executive officer's salary, or (C) a change in the location of employment outside of a 75 mile radius from such named executive officer's primary office, such named executive officer shall receive as liquidated damages a severance payment equal to two times such named executive officer's annual base salary in one lump sum payment. Additionally, Cornerstone shall reimburse such named executive officer for the reasonable cost of premium payments paid by such named executive officer to continue then-existing health insurance coverage for the lesser of (Y) twelve months or (Z) such time as such named executive officer obtains other employment. The definition of change of control, however, expressly excludes the transactions contemplated by the Merger Agreement.
- *Severance on Non-Renewal* . Solely with respect to the proposed employment agreement with Nathaniel F. Hughes, which employment agreement has an initial term of one year with renewal for successive one year terms upon the mutual agreement of the parties, in the event that Cornerstone elects not to renew the employment agreement with Nathaniel F. Hughes for an additional one year term, then Cornerstone shall be required to pay a severance benefit equal to one times Mr. Hughes' annual base salary payable over twelve months and reimburse Mr. Hughes for the reasonable cost of premium payments paid by Mr. Hughes to continue then-existing health insurance coverage for the lesser of (A) twelve months or (B) such time as Mr. Hughes obtains other employment.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Set forth below is information, as of March 1, 2015, with respect to beneficial ownership by (i) each person who is known to the Company to be the beneficial owner of 5% or more of the outstanding shares of Common Stock, (ii) each director and nominee for director of the Company, (iii) each named executive officer (as such term is defined under Item 402(m)(2) of Regulation S-K, referred to herein collectively as the “named executive officers”) for the fiscal year ended December 31, 2014 (referred to herein as “fiscal 2014”), and (iv) all directors and executive officers of the Company as a group. Unless otherwise indicated below, to the Company’s knowledge, all persons listed below have the sole voting and investment power with respect to their shares of Common Stock (except to the extent that authority is shared by spouses under applicable law).

| Name and Address of Beneficial Owner | Description | Amount and Nature of Beneficial Ownership of Common Stock | Percent of Outstanding Common Stock (1) | Amount and Nature of Beneficial Ownership of Series A Convertible Preferred Stock | Percent of Outstanding Series A Convertible Preferred Stock |
|---|---|---|---|---|---|
| 5% or More Beneficial Owners: | | | | | |
| The Banc Funds Company, LLC 20 North Wacker Drive, Suite 3300 Chicago, IL 60606 | | 389,406(2) | 5.88% | | |
| Directors and Named Executive Officers: | | | | | |
| Monique P. Berke | Director | - | - | - | - |
| John H. Coxwell | Senior Executive Officer | 31,859(5)(6) | * | 71 | * |
| B. Kenneth Driver | Director | 160,494(3)(4)(5)(6) | 2.26% | 4,400(4) | * |
| Karl Fillauer | Director | 260,278(3)(4)(5)(6) | 3.66% | 4,000 | * |
| Nathaniel F. Hughes | President and Chief Executive Officer and Director | 254,013(3)(4)(5)(6) | 3.57% | 10,000 | 1.67% |
| Frank S. McDonald | Director | 41,859(3)(5)(6) | * | 1,000 | * |
| Doyce G. Payne, M.D. | Director | 188,293(3)(4)(5)(6) | 2.65% | 1,200 | * |
| Gary W. Petty, Jr. | Executive Vice President and Chief Financial Officer | 37,117(3)(6) | * | - | - |
| James R. Vercoe, Jr. | Executive Vice President and Chief Credit Officer, Bank | 31,500(3)(5)(6) | * | 600 | * |
| Robert B. Watson | President and Senior Loan Officer, Bank | 55,811(3)(4)(5)(6) | * | 1,980 | * |
| Wesley M. Welborn | Chairman and Director | 160,073(3)(4)(5)(6) | 2.25% | 4,000 | * |
| Billy O. Wiggins | Director | 191,062(3)(4)(5)(6) | 2.69% | 200 | * |
| Marsha Yessick | Director | 141,078(3)(4)(5) | 1.98% | 468 | * |
| All directors and executive officers as a group (13 persons) | | <u>1,553,437</u> | <u>22.27%</u> | <u>27,919</u> | <u>4.65%</u> |

* Signifies less than one percent.

(1) Unless otherwise indicated, beneficial ownership consists of sole voting and investing power based on 6,627,398 shares issued and outstanding on March 1, 2015.

(2) Based on a Schedule 13G/A filed jointly by Banc Fund VI L.P. (“BF VI”), an Illinois limited partnership, Banc Fund VII L.P. (“BF VII”), an Illinois Limited Partnership, and Banc Fund VIII L.P. (“BF VIII”), an Illinois limited Partnership, (collectively, the “Reporting Persons”). The general partner of BF VI is MidBanc VI L.P. (“MidBanc VI”), whose principal business is to be a general partner of BF VI. The general partner of BF VII is MidBanc VII L.P. (“MidBanc VII”), whose principal business is to be a general partner of BF VII. The general partner of BF VIII is MidBanc VIII L.P. (“MidBanc VIII”), whose principal business is to be a general partner of BF VIII. MidBanc VI, MidBanc VII, and MidBanc VIII are Illinois limited partnerships. The general partner of MidBanc VI, MidBanc VII, and MidBanc VIII is The Banc Funds Company, L.L.C., (“TBFC”), whose principal business is to be a general partner of MidBanc VI, MidBanc VII, and MidBanc VIII. TBFC is an Illinois limited liability company whose principal shareholder is Charles J. Moore. Mr. Moore has been the manager of BF VI, BF VII, and BF VIII, since their respective inceptions. As manager, Mr. Moore has voting and dispositive power over the securities of the issuer held by each of those entities. As the controlling member of TBFC, Mr. Moore will control TBFC, and therefore each of the Partnership entities directly and indirectly controlled by TBFC.

- (3) Includes the following numbers of shares subject to purchase pursuant to options that are exercisable or will become exercisable within 60 days of March 1, 2015: Mr. Coxwell—4,500 shares; Mr. Driver—23,650 shares; Mr. Fillauer—23,650 shares; Mr. Hughes—66,000 shares; Mr. McDonald—23,650 shares; Dr. Payne—23,650 shares; Mr. Petty—36,500 shares; Mr. Vercoe—28,500 shares; Mr. Watson—45,500 shares; Mr. Welborn—23,650 shares; Mr. Wiggins—23,650 shares; Ms. Yessick—23,650 shares; and all directors and officers as a group—304,600 shares. Such shares are deemed to be outstanding for the purposes of computing the percentage ownership of the individual holding such shares, but are not deemed outstanding for purposes of computing the percentage of any other person listed above as a beneficial owner.
- (4) Includes shares held by affiliated entities, shares held by spouses, children or other close relatives, and shares held jointly with spouses or as custodians or trustees, as follows: Mr. Driver—400 preferred shares; Mr. Fillauer—146,841 common shares and 2,000 preferred shares; Mr. Hughes—2,056 common shares; Dr. Payne—67,228 common shares and 1,200 preferred shares; Mr. Watson—780 preferred shares; Mr. Welborn—18,900 common shares; Mr. Wiggins—800 common shares; and Ms. Yessick—51,429 common shares and 468 preferred shares.
- (5) Includes the following numbers of shares subject to the conversion of Series A Convertible Preferred Stock which can be converted to Cornerstone Bancshares common stock at any time at the discretion of the owner at a 5 shares of common to 1 share of preferred conversion: Mr. Coxwell 355; Mr. Driver 22,000; Mr. Fillauer 20,000; Mr. Hughes 50,000; Mr. McDonald 5,000; Dr. Payne 6,000; Mr. Vercoe 3,000; Mr. Watson 9,900; Mr. Welborn 20,000; Mr. Wiggins 1,000; and Ms. Yessick 2,340.
- (6) Shares in the table do not include beneficially owned common stock in which the vesting will be accelerated upon the filing of an application with the Federal Reserve Bank for the SmartFinancial, Inc. and Cornerstone Bancshares, Inc. merger. Information shown below includes the numbers of shares subject to purchase pursuant to options that are exercisable due to prior vesting and vesting due to the stock option plan's merger feature: Mr. Coxwell—67,359 shares; Mr. Driver—165,494 shares; Mr. Fillauer—265,278 shares; Mr. Hughes—306,513 shares; Mr. McDonald—46,859 shares; Dr. Payne—193,293 shares; Mr. Petty—68,617 shares; Mr. Vercoe—63,000 shares; Mr. Watson—87,311 shares; Mr. Welborn—165,073 shares; Mr. Wiggins—196,062 shares; Ms. Yessick—146,078 shares; and all directors and officers as a group—1,770,937 shares.

Cornerstone Bancshares, Inc. Non-Qualified Plan Options

During 2013 and 2014, the Company issued non-qualified options to employees and directors. The options were originally documented in 2013 as being issued out of the Cornerstone Bancshares, Inc. 2002 Long Term Incentive Plan but that plan expired in 2012 and thus no additional options can be issued from the plan. The non-qualified options are governed by the grant document issued to the holders.

The non-qualified stock options for employees were issued at the market value of the Common Stock on the grant date and vest 30% on the second anniversary of the grant date, 60% on the third anniversary of the grant date and 100% on the fourth anniversary of the grant date. The non-qualified stock options for directors are issued at the market value of the Common Stock on the grant date and vest 50% on the first anniversary of the grant date and 100% on the second anniversary of the grant date. The term of all grants are determined by the Compensation Committee, but may not exceed ten years. As of December 31, 2014, a total of 410,000 non-qualified stock options had been issued to Company employees, of which 410,000 remained outstanding, none had been exercised, none remained exercisable, 410,000 remained unvested and none had been forfeited. As of December 31, 2014, a total of 125,000 non-qualified stock options had been issued to Company directors, of which 125,000 remained outstanding. Of the non-qualified stock options that had been issued as of December 31, 2014, none had been exercised, 22,500 remained exercisable, 102,500 remained unvested and none had been forfeited.

Equity Compensation Plan Information as of December 31, 2014

| <u>Plan category</u> | <u>Number of securities to be issued upon exercise of outstanding options</u> | <u>Weighted average exercise price of outstanding options</u> | <u>Number of securities remaining available for future issuance</u> |
|---|---|---|---|
| Equity compensation plans approved by security holders: | 659,085 | \$ 3.59 | - |
| Equity compensation plans not approved by security holders: | 535,000 | \$ 2.39 | - |
| Total | <u>1,194,085</u> | <u>\$ 3.05</u> | <u>-</u> |

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

Board Composition and Director Independence

The Board is currently comprised of nine directors. The directors of the Company are also directors of the Bank. The current Board is comprised of one employee director, Nathaniel F. Hughes, and eight non-employee directors, Messrs. Driver, Fillauer, McDonald, Payne, Welborn and Wiggins and Ms. Yessick and Ms. Berke. Although the OTC Bulletin Board does not have rules regarding director independence, the Board in its business judgment has determined that each of the non-employee directors, with the exception of Mr. Welborn, the chairman of the Board, is an “independent director,” as defined by the listing standards of the Nasdaq Stock Market, Inc. (the “Nasdaq listing standards”). The Board has four standing committees: the Audit Committee, the Asset/Liability Management and Strategic Planning Committee, the Human Resource/Compensation Committee and the Nominating/Board Governance Committee. The Board limits membership on the Audit Committee, the Human Resource/Compensation Committee and the Nominating/Board Governance Committee to independent directors as defined by the Nasdaq listing standards and the rules and regulations of the Securities and Exchange Commission (“SEC”). The standing committees advise the Board on policy origination and plan administrative strategy and assure policy compliance through management reporting from areas under their supervision. Each of these four committees has an identical counterpart which serves the board of the Bank. In addition, the Bank has a Directors Loan Committee (the “Bank’s Loan Committee”).

Various Company directors, executive officers and their affiliates, including corporations and firms of which they are officers or in which they and/or their families have an ownership interest, are customers of the Company and its subsidiary. These persons, corporations and firms have had transactions in the ordinary course of business with the Company and its subsidiary, including borrowings, all of which, in the opinion of management, were on substantially the same terms including interest rates and collateral as those prevailing at the time for comparable transactions with unaffiliated persons and did not involve more than the normal risk of collectability or present other unfavorable features. The Company and its subsidiary expect to have such transactions on similar terms with directors, executive officers and their affiliates in the future. The aggregate amount of loans outstanding by the Bank to directors, executive officers and related parties as of December 31, 2014 was \$3,507,155 which represented 8.6% of the Company’s consolidated shareholders’ equity on that date.

Policies and Procedures for the Approval of Related Person Transactions

The charter of the Audit Committee provides that it must approve all transactions between the Company and related parties, as defined in applicable SEC rules and regulations. In accordance with this responsibility, the Audit Committee on a timely basis reviews and, if appropriate, approves all related party transactions. At any time in which an executive officer, director or nominee for director becomes aware of any contemplated or existing transaction that, in that person’s judgment may be a related party transaction, such person is expected to notify the Chairperson of the Audit Committee of the transaction. Generally, the Chairperson of the Audit Committee reviews any reported transaction and may consult with outside legal counsel regarding whether the transaction is, in fact, a related party transaction requiring approval by the Audit Committee. If the transaction is considered to be a related party transaction, then the Audit Committee will review the transaction and, in deciding whether to approve the transaction, will consider the factors it deems appropriate under the circumstances, including, but not limited to, the following:

- The approximate dollar amount involved in the transaction, including the amount payable by or to the related person;
- The nature of the interest of the related person in the transaction;
- Whether the transaction may involve a conflict of interest;
- Whether the transaction involves the provision of goods or services to the Company that are available from unaffiliated third parties and, if so, whether the related party transaction is on terms no less favorable than terms generally available to an unaffiliated third party under the same or similar circumstances; and
- The purpose of the transaction and any potential benefits to the Company.

In addition to the Audit Committee’s written responsibility, as mandated by the Audit Committee’s charter, to approve related party transactions, the Company also has other written policies and procedures for approving and monitoring related third party transactions.

Related Party Transaction

On September 25, 2014, the full Board voted to approve the purchase of its Miller Plaza branch facility located at 835 Georgia Avenue, Chattanooga, TN in the form of a condominium from Lamp Post Properties. The Company’s Chairman of the Board, Wesley M. Welborn, owns 20 percent of Lamp Post Properties and, therefore, Mr. Welborn abstained from the September 25, 2014 vote. The purchase price of the building was \$1.4 million and includes floors 1 and 2 of the building along with 528.34 square footage of the basement, all naming rights and signage privileges for the building, and first right of refusal for 12 of the 19 parking spots assigned to Lamp Post Properties. The transaction closed on February 24, 2015.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Audit and Non-Audit Fees

The following table presents the aggregate fees billed to the Company for professional services rendered by Mauldin & Jenkins, LLC (M&J) for the fiscal years ended December 31, 2013 and December 31, 2014:

| Services | 2013* | 2014 |
|-------------------------|------------|------------|
| Audit Fees (1): | \$ 122,400 | \$ 137,783 |
| Audit Related Fees (2): | \$ 17,000 | \$ 0 |
| Tax Fees (3): | \$ 19,400 | \$ 19,800 |
| All Other Fees: | \$ 0 | \$ 0 |

- (1) Includes fees for the audit of the consolidated financial statements and review of the interim financial information contained in the quarterly reports on the form 10-Q and other regulatory reporting. In addition, this category includes fees for services rendered associated with the review of documents filed with the SEC.
- (2) Includes fees for attestation and related services traditionally performed by the auditor including attestation services not required by statute or regulation and consultation concerning financial accounting and reporting standards.
- (3) Includes fees for tax compliance services including preparation of original and amended federal and state income tax returns, preparation of personal property tax returns and tax payment and planning advice.

* A portion of 2013 fees were incurred through services provided by Hazlett, Lewis & Bieter, PLLC (HLB), whose partners joined Mauldin & Jenkins, LLC on June 1, 2013. Fees billed by HLB in relation to 2013 services related to Form 10-Q filings and review of estimated tax requirements totaled \$8,200 and \$600, respectively.

The charter of the Audit Committee provides that the duties and responsibilities of the Audit Committee include the pre-approval of all services that may be provided to the Company by the independent accountants whether or not related to the audit. In fiscal years 2013 and 2014, the Audit Fees, Audit Related Fees, Tax Fees and All Other Fees were pre-approved by the Audit Committee.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed as part of this report:

(1) Financial Statements

The following report and consolidated financial statements of Cornerstone and Subsidiary are included in Item 8:

Report of Independent Registered Public Accounting Firm
Consolidated Balance Sheets as of December 31, 2014 and 2013
Consolidated Statements of Income for the years ended December 31, 2014, 2013, and 2012
Consolidated Statements of Comprehensive Income for the years ended December 31, 2014, 2013, and 2012
Consolidated Statements of Changes in Stockholders' Equity for the years ended December 31, 2014, 2013, and 2012
Consolidated Statements of Cash Flows for the years ended December 31, 2014, 2013, and 2012
Notes to Consolidated Financial Statements

(2) Financial Statement Schedules:

Schedule II: Valuation and Qualifying Accounts

All other schedules for which provision is made in the applicable accounting regulation of the Securities and Exchange Commission are not required under the related instructions or are inapplicable and therefore have been omitted.

(3) The following documents are filed, furnished or incorporated by reference as exhibits to this report:

| <u>Exhibit No.</u> | <u>Description</u> |
|--------------------|--|
| 2.1* | Agreement and Plan of Merger dated as of December 5, 2014 by and among SmartFinancial, Inc., SmartBank, Cornerstone Bancshares, Inc. and Cornerstone Community Bank. |
| 3.1 | Amended and Restated Charter of Cornerstone Bancshares, Inc. as amended. |
| 3.2 | Amended and Restated Bylaws of Cornerstone Bancshares, Inc. (1) |
| 4 | The right of securities holders are defined in the Charter and Bylaws provided in exhibits 3.1 and 3.2. |
| 10.1* | Cornerstone Bancshares, Inc. Statutory - Nonstatutory Stock Option Plan. (2) |
| 10.2* | Cornerstone Bancshares, Inc. 2002 Long-Term Incentive Plan. (3) |
| 10.3* | Cornerstone Bancshares, Inc. 2004 Non-Employee Director Compensation Plan. (4) |
| 10.4* | Cornerstone Community Bank Employee Stock Ownership Plan. (5) |
| 10.5* | Form of Director Support Agreements by and among each current director of Smart Financial and Cornerstone and Cornerstone Community Bank. |
| 10.6* | Employment Agreement with Nathaniel F. Hughes. |
| 10.7* | Employment Agreement with Gary W. Petty, Jr. |
| 10.8* | Employment Agreement with Robert B. Watson. |
| 10.9* | Employment Agreement with James R. Vercoe, Jr. |
| 14 | Code of Ethics. (6) |
| 21 | Subsidiary of the registrant. |
| 23 | Consent of Mauldin and Jenkins, LLC. |
| 31.1 | Certification of principal executive officer. |
| 31.2 | Certification of principal financial officer. |
| 32 | Section 906 certifications of chief executive officer and chief financial officer. |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Calculation Linkbase Document |
| 101.DEF | XBRL Taxonomy Definition Linkbase Document |
| 101.LAB | XBRL Taxonomy Label Linkbase Document |
| 101.PRE | XBRL Taxonomy Presentation Linkbase Document |

* This item is a management contract or compensatory plan or arrangement required to be filed as an exhibit to this Form 10-K pursuant to Item 15(b) of this report.

(1) Incorporated by reference to Exhibit 3.2 of the registrant's Form 10-KSB filed on March 24, 2004.

(2) Incorporated by reference to Exhibit 10.1 of the registrant's Registration Statement on Form S-1 filed on February 4, 2000, as amended (File No. 333-96185).

(3) Incorporated by reference to Exhibit 99.1 of the registrant's Registration Statement on Form S-8 filed March 5, 2004 (File No. 333-113314).

(4) Incorporated by reference to Exhibit 99.3 of the registrant's Registration Statement on Form S-8 filed March 5, 2004 (File No. 333-113314).

- (5) Incorporated by reference to Exhibit 10.1 of the registrant's Form 8-K filed on July 19, 2005.
- (6) Incorporated by reference to Exhibit 14 of the registrant's Form 10-KSB filed on March 24, 2004.

SIGNATURES

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

CORNERSTONE BANCSHARES, INC.

Date: March 30, 2015

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

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

In accordance with the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities indicated on March 30, 2015.

| <u>Signature</u> | <u>Title</u> |
|---|--|
| <u>/s/ W. Miller Welborn</u> W. Miller Welborn | Chairman of the Board of Directors |
| <u>/s/ Nathaniel F. Hughes</u> Nathaniel F. Hughes | President (principal executive officer) and Director |
| <u>/s/ B. Kenneth Driver</u> B. Kenneth Driver | Director |
| <u>/s/ Karl Fillauer</u> Karl Fillauer | Director |
| <u>/s/ Frank S. McDonald</u> Frank S. McDonald | Director |
| <u>/s/ Doyce G. Payne</u> Doyce G. Payne | Director |
| <u>/s/ Billy O. Wiggins</u> Billy O. Wiggins | Director |
| <u>/s/ Marsha Yessick</u> Marsha Yessick | Director |
| <u>/s/ Monique Berke</u> Monique Berke | Director |
| <u>/s/ Gary W. Petty, Jr.</u> Gary W. Petty, Jr. | Executive Vice President and Chief Financial Officer (principal financial officer and accounting officer) |

INDEX OF EXHIBITS

| Exhibit No. | Description |
|-------------|--|
| 2.1* | Agreement and Plan of Merger dated as of December 5, 2014 by and among SmartFinancial, Inc., SmartBank, Cornerstone Bancshares, Inc. and Cornerstone Community Bank. |
| 3.1 | Amended and Restated Charter of Cornerstone Bancshares, Inc., as amended. |
| 3.2 | Amended and Restated Bylaws of Cornerstone Bancshares, Inc. (1) |
| 4 | The right of securities holders are defined in the Charter and Bylaws provided in exhibits 3.1 and 3.2. |
| 10.1* | Cornerstone Bancshares, Inc. Statutory - Nonstatutory Stock Option Plan. (2) |
| 10.2* | Cornerstone Bancshares, Inc. 2002 Long-Term Incentive Plan. (3) |
| 10.3* | Cornerstone Bancshares, Inc. 2004 Non-Employee Director Compensation Plan. (4) |
| 10.4* | Cornerstone Community Bank Employee Stock Ownership Plan. (5) |
| 10.5* | Form of Director Support Agreements by and among each current director of Smart Financial and Cornerstone and Cornerstone Community Bank. |
| 10.6* | Employment Agreement with Nathaniel F. Hughes. |
| 10.7* | Employment Agreement with Gary W. Petty, Jr. |
| 10.8* | Employment Agreement with Robert B. Watson. |
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(6) Incorporated by reference to Exhibit 14 of the registrant's Form 10-KSB filed on March 24, 2004.

CORNERSTONE BANCSHARES, INC.

LIST OF SUBSIDIARY

| <u>Name of Subsidiary</u> | <u>State of Incorporation</u> |
|----------------------------|-------------------------------|
| Cornerstone Community Bank | Tennessee |

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in the Registration Statements on Form S-8 (No. 333-113314 and No. 333-131006) of Cornerstone Bancshares, Inc. of our report dated March 30, 2015, relating to our audit of the consolidated financial statements, which appear in the Annual Report on Form 10-K of Cornerstone Bancshares, Inc. for the year ended December 31, 2014.

/s/ MAULDIN & JENKINS, LLC

Chattanooga, Tennessee
March 30, 2015

CERTIFICATIONS

I, Nathaniel F. Hughes, certify that:

1. I have reviewed this report on Form 10-K of Cornerstone Bancshares, Inc. (the "Issuer") for the fiscal year ended December 31, 2014.
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report.
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Issuer as of, and for, the periods presented in this period report.
4. The Issuer's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Issuer and have:
 - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Issuer, including its consolidated subsidiary, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) designed such internal controls over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) evaluated the effectiveness of the Issuer's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) disclosed in this report any change in the Issuer's internal control over financial reporting that occurred during the Issuer's fourth fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Issuer's internal control over financial reporting.
5. The Issuer's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Issuer's auditors and the audit committee of Issuer's board of directors:
 - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Issuer's ability to record, process, summarize and report financial information; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Issuer's internal control over financial reporting.

Date: March 30, 2015

/s/ Nathaniel F. Hughes

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

CERTIFICATIONS

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

1. I have reviewed this report on Form 10-K of Cornerstone Bancshares, Inc. (the "Issuer") for the fiscal year ended December 31, 2014.
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report.
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Issuer as of, and for, the periods presented in this period report.
4. The Issuer's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Issuer and have:
 - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Issuer, including its consolidated subsidiary, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) designed such internal controls over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) evaluated the effectiveness of the Issuer's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) disclosed in this report any change in the Issuer's internal control over financial reporting that occurred during the Issuer's fourth fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Issuer's internal control over financial reporting.
5. The Issuer's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Issuer's auditors and the audit committee of Issuer's board of directors:
 - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Issuer's ability to record, process, summarize and report financial information; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Issuer's internal control over financial reporting.

Date: March 30, 2015

/s/ Gary W. Petty, Jr.

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

CERTIFICATIONS OF CEO AND CFO PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT

CERTIFICATIONS PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

(18 U.S.C. SECTION 1350)

In connection with the Annual Report of Cornerstone Bancshares, Inc., a Tennessee corporation (the "Company"), on Form 10-K for the fiscal year ended December 31, 2014, as filed with the Securities and Exchange Commission (the "Report"), each of Nathaniel F. Hughes, President & Chief Executive Officer of the Company, and Gary W. Petty, Jr., Executive Vice President and Chief Financial Officer of the Company, do hereby certify, pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350), that to his knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ Nathaniel F. Hughes

Nathaniel F. Hughes
President & Chief Executive Officer
(principal executive officer)
Date: March 30, 2015

/s/ Gary W. Petty, Jr.

Gary W. Petty, Jr.
Executive Vice President and Chief Financial Officer
(principal financial officer and accounting officer)
Date: March 30, 2015

[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.]
