

CORNERSTONE BANCSHARES INC

FORM 10QSB (Quarterly Report of Financial Condition)

Filed 8/14/2001 For Period Ending 6/30/2001

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U.S. Securities and Exchange Commission

Washington, D.C. 20549

FORM 10-QSB

(Mark One)

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

For the quarterly period ended JUNE 30, 2001

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

For the transition period from to

Commission file number 000-30497

CORNERSTONE BANCSHARES, INC.

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

TENNESSEE
(State of other jurisdiction of
incorporation or organization)

62-1175427
(IRS Employer
Identification No.)

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

(423) 385-3000
(Issuer's telephone number)

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

APPLICABLE ONLY TO CORPORATE ISSUERS

The aggregate market value of the Registrant's outstanding Common Stock held by nonaffiliates of the Registrant on June 30, 2001 was
approximately \$15,972,671. There were 1,228,667 shares of Common Stock outstanding as of June 30, 2001.

Transitional Small Business Disclosure Format (check one) :

Yes No

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
CORNERSTONE BANCSHARES**

PRESENTATION OF FINANCIAL INFORMATION

The 2001 financial information in this report has not been audited. The information included herein should be read in conjunction with the notes to consolidated financial statements included in the 2000 Annual Report to Shareholders which was furnished to each shareholder of the Company in March 2001. The consolidated financial statements presented herein conform to generally accepted accounting principles and to general industry practices.

CONSOLIDATION

The accompanying consolidated financial statements include the accounts of Cornerstone Bancshares Inc. and its sole subsidiary Cornerstone Community Bank.

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

ACCOUNTING POLICIES

During interim periods, Cornerstone Bancshares follows the accounting policies set forth in its 10-KSB for the year ended December 31, 2000, as filed with the Securities and Exchange Commission. Since December 31, 2000, there have been no changes in any accounting principles or practices, or in the method of applying any such principles or practices.

INTERIM FINANCIAL DATA (UNAUDITED)

In the opinion of Cornerstone management, the accompanying interim financial statements contain all material adjustments, consisting only of normal recurring adjustments necessary to present fairly the financial condition, the results of operations, and cash flows for the interim period. Results for interim periods are not necessarily indicative of the results to be expected for a full year.

EARNINGS PER COMMON SHARE

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

FORWARD-LOOKING STATEMENTS

Certain written and oral statements made by or with the approval of an authorized executive officer of the Company may constitute "forward-looking statements" as defined under the Private Securities Litigation Reform Act of 1995. Words or phrases such as "should result, are expected to, we anticipate, we estimate, we project" or similar expressions are intended to identify forward-looking statements. These statements are subject to certain risks and uncertainties that could cause actual results to differ materially from Cornerstone's historical experience and its present expectations or projections. These risks and uncertainties include, but are not limited to, unanticipated economic changes, interest rate movements and the impact of competition. Caution should be taken not to place undue reliance on any such forward-looking statements since such statements speak only as of the date of making such statements.

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

CONSOLIDATED BALANCE SHEETS

	Unaudited June 30,	December 31,	Unaudited June 30,
ASSETS	2001	2000	2000
Cash and due from banks	\$ 4,722,868	4,633,514	\$ 9,857,546
Due from banks time deposits	1,842,687	-	-
Federal funds sold	6,900,000	2,400,000	-
Investment securities available for sale	13,921,207	16,047,715	17,008,300
Investment securities held to maturity	2,964,373	4,012,414	4,938,914
Loans, less allowance for loan loss	85,878,378	83,431,776	81,247,022
Premises and equipment, net	3,836,972	3,391,138	2,247,022
Accrued interest receivable	696,888	849,142	717,828
Excess cost over fair value of assets acquired	2,601,988	2,662,499	2,665,275
Other assets	2,005,909	1,950,557	2,040,660
Total assets	\$ 125,371,271	119,378,755	\$ 120,722,567
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LIABILITIES AND STOCKHOLDERS' EQUITY			
Deposits			
Noninterest-bearing	\$ 13,317,226	11,924,140	\$ 13,593,950
NOW accounts	16,656,522	13,687,959	21,932,543
Savings deposits and money market accounts	12,829,439	10,459,568	11,132,449
Time deposits of \$100,000 or more	18,468,971	16,911,729	16,973,270
Time deposits of less than \$100,000	46,847,566	48,266,503	42,241,131
Total deposits	108,119,723	101,249,899	105,873,344
Federal funds purchased and securities sold under agreement to repurchase	1,111,974	3,144,291	2,506,094
Federal Home Loan Bank Advance	2,000,000	2,000,000	-
Accrued interest payable	168,169	183,834	190,035
Other liabilities	434,824	282,570	211,509
Total Liabilities	111,834,690	106,860,594	108,780,982
Redeemable common stock	-	-	-
Stockholders' Equity			
Common stock	1,228,667	1,166,129	1,166,129
Additional paid-in capital	12,039,867	11,322,276	11,322,276
Retained Earnings (deficit)	25,561	(92,694)	(357,700)
Accumulated other comprehensive income	242,485	122,450	(189,120)
Total Stockholders' Equity	13,536,580	12,518,161	11,941,585
Total liabilities and stockholders equity	\$ 125,371,271	119,378,755	\$ 120,722,567
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CONSOLIDATED STATEMENTS OF INCOME

	Unaudited Three months ended June 30,		Unaudited Six months ended June 30,	
	2001	2000	2001	2000
INTEREST INCOME				
Interest and fees on loans	\$ 2,003,190	\$ 1,978,042	\$ 4,020,657	\$ 3,822,591
Interest on investment securities	267,847	359,024	565,728	688,169
Interest on federal funds sold	44,989	17,364	100,161	19,882
Interest on due from banks time deposits	29,700		57,498	-
Interest on other earning aseets	6,732	10	13,171	263
Total interest income	2,352,459	2,354,441	4,757,216	4,530,905
INTEREST EXPENSE				
Interest bearing demand accounts	69,812	75,010	130,254	137,597
Money market accounts	57,412	68,693	122,365	128,791
Savings accounts	28,266	28,981	57,658	58,930
Time deposits of less than \$100,000	698,488	595,892	1,440,657	1,144,747
Time deposits of \$100,000 or more	288,135	235,379	591,249	440,681
Federal funds purchased	82	7,673	82	29,259
Securities sold under agreements to repurchase	13,350	36,557	40,896	57,648
Other borrowings	24,932	-	49,589	-
Total interest expense	1,180,476	1,048,185	2,432,750	1,997,653
Net interest income	1,171,983	1,306,255	2,324,465	2,533,253
Provision for loan losses	104,500	256,000	270,000	414,500
Net interest income after the provision for loan losses	1,067,483	1,050,255	2,054,465	2,118,752
NONINTEREST INCOME				
Service charges on deposit accounts	116,399	94,087	222,797	187,104
Net securities gains (losses)	-	-	83,705	-
Other income	104,808	43,600	180,040	110,174
Total noninterest income	221,206	137,687	486,542	297,278
NONINTEREST EXPENSE				
Salaries and employee benefits	555,128	570,077	1,108,646	1,129,714
Occupancy and equipment expense	150,576	138,768	282,813	264,237
Other operating expense	486,067	464,799	980,997	882,584
Total noninterest expense	1,191,771	1,173,644	2,372,456	2,276,535
Income before provision for income taxes	96,918	14,298	168,551	139,496
Provision for income taxes	12,046	18,154	50,296	42,378
NET INCOME	\$ 84,872	\$ (3,856)	\$ 118,255	\$ 97,118
Basic net income per common share	0.07	(0.00)	0.10	0.08
Diluted net income per common share	0.07	(0.00)	0.09	0.08
Dividends declared per common share	-	-	-	-

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Six Months Ended June 30

	Unaudited 2001	Unaudited 2000
Cash flows from operating activities:		
Net income	118,255	97,118
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Provision for possible loan losses	270,000	414,500
Net Charge-offs	(226,624)	(330,255)
Provision for depreciation and amortization	209,067	174,097
Accrued interest receivable	152,254	(61,669)
Accrued interest payable	(15,665)	165
Changes in other assets and liabilities:	96,902	61,774
Net cash provided by (used in) operating activities	604,189	355,729
Cash flows from investing activities:		
Purchase of investment securities: AFS	(3,645,237)	(4,053,044)
Purchase of investment securities: HTM	-	-
Purchase of Bank due from time	(1,842,687)	-
Proceeds from security transactions: AFS	5,770,419	368,362
Proceeds from security transactions: HTM	1,100,996	793,762
Net increase in loans	(2,472,169)	(10,007,388)
Purchase of bank premises and equipment	(543,792)	(132,563)
Net cash provided by (used in) investing activities	(1,632,471)	(13,030,871)
Cash flows from financing activities:		
Net increase in deposits	6,869,824	14,527,717
Net increase in repurchase agreements	(2,032,317)	326,731
Net increase of other borrowings	-	-
Issuance of common stock	780,129	(43,462)
Net cash provided by (used in) financing activities	5,617,636	14,810,986
Net increase (decrease) in cash and cash equivalents	4,589,354	2,135,844
Cash and cash equivalents beginning of period	7,033,514	7,721,701
Cash and cash equivalents end of period	\$ 11,622,868	\$ 9,857,546

Cornerstone Bancshares, Inc and Subsidiary Changes in Stockholders' Equity
June 30, 2001

	Comprehensive Income	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income	Total Stockholders' Equity
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BALANCE, December 31, 2000		\$ 1,166,129	\$11,322,276	\$ (92,694)	\$ 122,450	\$ 12,518,161
Issuance of Common Stock		62,538	717,591			780,129
Comprehensive Income: Net Income	\$ 118,255			118,255		118,255
Other comprehensive income, net of tax: Unrealized holding gains (losses) on securities available for sale, net of reclassification adjustment	120,036				120,036	120,036
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Total comprehensive income	\$ 238,291					

BALANCE, June 30, 2000 (Unaudited)		\$ 1,228,667	\$12,039,867	\$ 25,561	\$ 242,485	\$ 13,536,580
		=====	=====	=====	=====	=====

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

OVERVIEW

Cornerstone Bancshares, Inc. ("Cornerstone") ended the first six months of 2001 with total assets of \$125 million, a 5.0% increase from December 31, 2000, and a 3.9% increase from June 30, 2000. Cornerstone reported net income for the first six months ending June 30, 2001 of \$118,255, or \$0.10 basic earnings per share, compared to \$97,118 or \$0.08 basic earnings per share, for the same period in 2000. The increase in earnings represents a 21.8% increase from the first six months of 2000 compared to the first six months of 2001.

The increase in net income from the first half 2000 to the first half 2001 is due to several factors. The Bank's non-interest income not including securities gains increased \$106 thousand or 35.5% over the same period in 2000 and had a security gain of \$84 thousand. The increase in non-interest income can mostly be attributed to an increase in secondary mortgage sales. The loan loss provision decreased \$145 thousand, which is an expense reduction of 35% over the same period in 2000. The Bank experienced a decrease in the Bank's net interest income, of \$209 thousand or 8.2%, when compared to the same period in 2000. This decrease was due to the dramatic 275 basis point decrease in interest rates implemented by the Federal Reserve during the first half of 2001. Cornerstone was and still is positioned to reprice assets quicker than liabilities during the three months following an interest rate move. Therefore, which the Bank's deposits will reprice faster than its loans and securities and the net interest income will return to a targeted level of 4.75%. The net result was a 21.8% increase in net income and the expectation that the Bank's future earnings during the remaining six months of 2001 will meet management's expectations unless the economy falls into a recession and the Federal Reserve continues to cut interest rates. The management of the Bank believes strongly that, at the end of 2001, it will have the amount of its substandard loans returned to, or below, peer bank standards and as a result, expects a lower provision to the loan loss allowance. Core customer relationships, which bring low cost deposits and quality loans to the balance sheet, remain a top priority for the Bank. Cornerstone also plans to continue to focus its efforts on small business relationships in the future.

The Strategic plan of Cornerstone entails providing a competitive footprint (convenient branches) to the Chattanooga Metropolitan Statistical Area allowing Cornerstone to compete with the three major regional banks located in the area. Cornerstone will focus its efforts in the suburb branch network and not on a central Hub Bank located in downtown Chattanooga. The customer base will consist of small businesses and individual consumers.

Cornerstone Community Bank is operating under a Memorandum of Understanding with the Tennessee Department of Financial Institutions and the Federal Deposit Insurance Corporation. Among other things, the Memorandum provides the following:

- The Board of Directors must develop a written management plan that addresses Cornerstone Community Bank's plans for size, structure, growth, earnings, services, information systems, personnel, accounting, financial reporting and operating matters;

- Cornerstone Community Bank must maintain a Tier I leverage capital ratio of equal to or greater than eight percent (8%);
- Cornerstone Community Bank may not pay dividends without the prior approval of the FDIC; and
- Cornerstone Community Bank must report its progress on the actions required by the Memorandum to the FDIC on specific dates.

As of June 30, 2001, the FDIC Field Examination Team reported that Cornerstone Community Bank was in compliance with all provisions of the Memorandum and recommended the Memorandum be terminated to the Regional Director of the FDIC.

FINANCIAL CONDITION

EARNING ASSETS. Average earning assets for the six months ending June 30, 2001, increased \$11.2 million, or 11.2%, above the six months ending June 30, 2000, while actual earning assets increased \$8.4 million or 8.1% during the same time period. The average balance increase was due to strong loan demand in the second half of 2000 and a steady growth in core deposits during the current reporting period. Management expects average earning assets to steadily increase during the rest of 2001 and anticipates similar growth in 2002.

LOAN PORTFOLIO. Cornerstone's average loans for the first six months of 2001 were \$86.3 million, an increase of \$8.5 million or 10.9% from the first half of 2000, while actual balances increased to \$87.0 million, an increase of 5.7% above \$82.3 million in loans in the first half of 2000. Management is anticipating increased loan growth for the remainder of the year in both average and actual balances.

INVESTMENT PORTFOLIO. Cornerstone's average investment securities portfolio and Federal Funds sold increased by 10.8% or \$2.3 million for the six months ending June 30, 2000 compared to the six months ending June 30, 2001, while actual balances increased \$3.7 million, an increase of 16.8%. The growth is the direct result of deposit growth. The majority of the proceeds from this deposit growth were placed in Federal Funds (\$6.9 million) as management allowed expensive deposits to terminate while waiting for loan growth to revive and an appropriate investment environment to grow the investment portfolio. Cornerstone maintains an investment strategy of making prudent investment decisions with active management of the portfolio to optimize, within the constraints of established policies, an adequate return and value. Investment objectives include, in order of priority, Gap Management, Liquidity, Pledging, Return, and Local Community Support. Cornerstone maintains two classifications of investment securities: "Held to Maturity" (HTM) and "Available for Sale" (AFS). The "Available for Sale" securities are carried at fair market value, whereas "Held to Maturity" securities are carried at book value. As of June 30, 2001, net unrealized gains in the "Available for Sale" portfolio amounted to \$367,402, a 2.72% increase in value.

DEPOSITS. Cornerstone's average deposits increased \$9.1 million or 9.5% for the six month period ending June 30, 2000 compared to the same period ending June 30, 2001, while actual deposit balances increased \$2.2 million or 2.1%. The actual deposit growth was concentrated in certificates of deposit, which increased 17.4% during the same time period. Management will

continue to focus its efforts on attracting core deposits and expects certificates of deposit to decrease over the remainder of 2001 while deposits in general increase in the 10% level for the next several quarters. Transaction accounts will be continuously solicited from new customers and existing customers, and represent one of Cornerstone's highest priorities and should provide Cornerstone with an increased net interest margin.

OTHER LIABILITIES. During the last quarter of 2000, Cornerstone acquired an advance from the Federal Home Loan Bank of Cincinnati (FHLB). The advance was in the amount of \$2,000,000 and had a maturity of 10 years with call and put options after two years. Management of the Cornerstone believes the FHLB provides an inexpensive method to reduce interest rate risk by obtaining longer term liabilities to match the typically longer termed assets the Bank has on its Balance sheet and usually below the cost of certificates of deposit.

CAPITAL RESOURCES. Stockholders' average equity increased \$1.3 million or 10.7% to \$13.2 million for the six months ending June 30, 2001, compared with \$11.9 million during the same six months ending June 30, 2000. Actual equity increased \$1.6 million or 13.4% from June 30, 2000 to June 30, 2001. This increase was primarily due to a registered stock offering with net proceeds of approximately \$.8 million. The balance represents current year earnings from operations and net unrealized gains in available for sale investment securities.

**CONSOLIDATED AVERAGE BALANCE SHEET
INTEREST INCOME / EXPENSE AND YIELD / RATES**

Taxable equivalent basis
(in thousands)

Assets	Six months ended June 30,					
	2001			2000		
	Average Balance	Income / Expense	Yield/ Rate	Average Balance	Income / Expense	Yield / Rate
Earning Assets:						
Loans, net of unearned income	86,331	4,021	9.39%	77,838	3,823	9.88%
Due from banks time deposits	1,780	57	6.51%	-	-	0.00%
Federal Funds Sold	4,132	100	4.89%	673	20	5.94%
Investment securities	17,967	566	6.35%	20,878	688	6.63%
Other earning assets	357	13	7.45%	-	-	0.00%
Total earning assets	110,567	4,757	8.68%	99,389	4,531	9.17%
Allowance for loan losses	(1,160)			(1,003)		
Cash and other assets	13,237			12,857		
TOTAL ASSETS	122,643			111,243		
Liabilities and Stockholders' Equity						
Interest bearing liabilities:						
Interest bearing demand deposits	15,214	130	1.73%	16,169	138	1.71%
Savings deposits	10,483	180	3.46%	11,073	188	3.41%
Time deposits	47,472	1,441	6.12%	41,337	1,145	5.57%
Time deposits of \$100,000 or more	19,270	591	6.19%	15,486	441	5.72%
Federal funds and securities sold under Agreement to repurchase	2,122	41	3.89%	3,294	87	5.31%
Other borrowings	2,000	50	5.00%	-	-	0.00%
Total interest bearing liabilities	96,561	2,433	5.08%	87,359	1,998	4.60%
Net interest spread		2,324			2,533	
Noninterest bearing demand deposits	12,038			11,358		
Accrued expenses and other liabilities	853			610		
Stockholders' equity	13,191			11,916		
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	122,643			111,243		
Net interest margin on earning assets			4.24%			5.14%
Net interest spread on earning assets			3.60%			4.57%
Taxable equivalent adjustment:						
Loans		-			-	
Investment Securities		2			0	
Total adjustment		2			0	

RESULTS OF OPERATIONS - SIX MONTHS ENDED JUNE 30, 2001 COMPARED TO SIX MONTHS ENDED JUNE 30, 2000

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

Net interest income before loan loss provision for the first six months of 2001 decreased \$208,788 or 8.24% below net interest income before loan loss provision as of first six months of 2000. The decrease in net interest income as of June 30, 2001 is primarily due to a sharp change in policy of the Federal Reserve who decreased the Fed Discount rate 275 basis points during the first six months of 2001. Compounding the compression of the net interest margin was the shift in liability mix to a larger concentration of certificates of deposit. One hundred percent (100%) of the net growth in average liabilities came from certificates of deposit which are the most expensive deposits of the Bank. The decrease in net interest margin was above Cornerstone's management's expectation and management anticipates the possibility of further cuts by the Federal Reserve if the economy slips into a recession. Management foresees the margin returning to the budgeted 4.75% by the end of the fourth quarter. Three factors contribute to this net interest margin forecast: First, Cornerstone anticipates that certificates of deposit will reprice rapidly during the second and third quarter from an average 6.50% to average 4.75%; Second, Cornerstone will continue to solicit transaction accounts from small businesses and reduce Cornerstone's percentage of certificates of deposit to total deposits; and Third, Cornerstone plans to continue to grow Cornerstone's earning assets as a percentage of total assets.

Interest income increased \$226,311 or 5.0% for the period ended June 30, 2001 compared the same period ended June 30, 2000. Interest income produced by the loan portfolio increased \$198,066 or 5.2% for the six month period ended June 30, 2000 compared to six month period ended June 30, 2001 due to the increase in average loans outstanding and origination fees associated with loan growth for the period. The increase of loan interest income was partially offset by the sharp decrease in interest rates on the Bank's variable rate loans. Management estimates the average balances will continue to increase but will restrain origination of these loans to insure quality standards and documentation are maintained. Interest income on investment securities, federal funds and other investments increased \$28,244 or 4.0% for the six month period ending June 30, 2000 compared to the six month period ended June 30, 2001, due primarily to an increase in the average balance of Federal Funds sold raised to fund loan growth for the third and fourth quarter of 2001.

Total interest expense increased \$435,097 or 21.8% from June 30, 2000 to June 30, 2001. The interest expense increase from the first six months of 2000 to the first six months of 2001 is primarily due to an increase in the rates for certificates of deposit during the fourth quarter of 2000 and the first quarter of 2001. In addition the Bank grew the average balance of deposits 9.9% during the first half of 2001 compared with the first half of 2000.

The trend in net interest income is commonly evaluated in terms of average rates using the net interest margin and the interest rate spread. The net interest margin, or the net yield on earning assets, is computed by dividing fully taxable equivalent net interest income by average earning assets. This ratio represents the difference between the average yield on average earning

assets and the average rate paid for all funds used to support those earning assets. The net interest margin for the first six months of 2001 was 4.24%. The yield on earning assets decreased 49 basis points to 8.68% for the period ended June 30, 2001 compared to 9.17% for the period ended June 30, 2000.

The interest rate spread measures the difference between the average yield on earning assets and the average rate paid on interest bearing sources of funds. The interest rate spread eliminates the impact of non-interest bearing funds and gives a direct perspective on the effect of market interest rate movements. As a result of fluctuations of interest rates during the early part of 2001 and an asset sensitivity during the first six months of an interest rate movement, the interest rate spread was 3.60% for the six month period ending June 30, compared to 4.57% for the same period ending June 30, 2000, a decrease of 97 basis points.

ALLOWANCE FOR LOAN LOSSES. The allowance for possible loan losses represents management's assessment of the risks associated with extending credit and its evaluation of the quality of the loan portfolio. Management analyzes the loan portfolio to determine the adequacy of the allowance for possible loan losses and the appropriate provisions required to maintain a level considered adequate to absorb anticipated loan losses. Management believes that the \$1.2 million in the allowance for loan loss account at June 30, 2001 reflects the full known extent of credit exposure. Cornerstone made a \$270,000 provision during the second half of 2001 and anticipates similar provisions in the future as the loan portfolio grows and unanticipated loan losses occur. No assurances can be given, however, that adverse economic circumstances will not result in increased losses in the loan portfolio, and require greater provisions for possible loan losses in the future.

NON-PERFORMING ASSETS. Non-performing assets include non-performing loans and foreclosed real estate held for sale. Non-performing loans include loans classified as non-accrual or renegotiated. Cornerstone's policy is to place a loan on non-accrual status when payment of principal or interest is contractually 90 or more days past due. At the time a loan is placed on non-accrual status, interest previously accrued but not collected may be reversed and charged against current earnings. As of June 30, 2001 Cornerstone had \$66,235 in non-accrual loans and \$553,254 in non-performing assets.

NON-INTEREST INCOME. Non-interest income consists of revenues generated from a broad range of financial services and activities, including fee-based services and profits, commissions earned through credit life insurance sales and other activities. In addition, gains or losses realized from the sale of loans are included in non-interest income. Total non-interest income increased by \$189,264 or 63.7% from the first half of 2000 compared with the first half of 2001. The gain in non-interest income was broad based in almost every category, but was especially strong in secondary market mortgage lending, which was benefited by a low interest rate environment and strong consumer confidence. Included in this increase was a security gain taken in January of 2001 in the amount of \$83,705.

NON-INTEREST EXPENSE. Non-interest expense for the first six months of 2001 increased by \$95,921 or 4.2% as compared to the first six months in 2000. Salaries and employee benefits decreased by \$21,068 or 1.9% for the six months ending June 30, 2001 over the same period ending June 30, 2000. Occupancy expense as of June 30, 2001 increased by \$18,576 or 7.0% over the same period in 2000. All other non-interest expenses for the six month period ended June 30, 2001 increased \$98,413 or 11.2% over the non-interest expenses for the same period ended June 30, 2000.

**CONSOLIDATED AVERAGE BALANCE SHEET
INTEREST INCOME / EXPENSE AND YIELD / RATES**

Taxable equivalent basis
(in thousands)

	Three months ended June 30,					
	2001			2000		
Assets	Average Balance	Income / Expense	Yield/ Rate	Average Balance	Income / Expense	Yield / Rate
Earning Assets:						
Loans, net of unearned income	87,180	2,003	9.24%	79,974	1,978	9.92%
Due from banks time deposits	1,833	30	6.52%	-	-	0.00%
Investment securities	21,771	314	5.80%	22,699	377	6.66%
Other earning assets	360	7	7.52%	-	-	0.00%
Total earning assets	111,144	2,354	8.52%	102,673	2,355	9.20%
Allowance for loan losses	(1,162)			(1,021)		
Cash and other assets	13,436			12,761		
TOTAL ASSETS	123,418			114,413		
Liabilities and Stockholders' Equity						
Interest bearing liabilities:						
Interest bearing demand deposits	16,234	70	1.73%	17,272	75	1.74%
Savings deposits	10,544	86	3.27%	11,453	98	3.42%
Time deposits	46,930	698	5.99%	42,827	596	5.58%
Time deposits of \$100,000 or more	19,062	288	6.08%	15,731	235	6.00%
Federal funds and securities sold under Agreement to repurchase	1,744	13	3.10%	3,353	44	5.29%
Other borrowings	2,000	25	5.01%	-	-	0.00%
Total interest bearing liabilities	96,513	1,180	4.92%	90,635	1,048	4.64%
Net interest spread		1,173			1,307	
Noninterest bearing demand deposits	12,549			11,191		
Accrued expenses and other liabilities	889			688		
Stockholders' equity	13,466			11,919		
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	123,418			114,413		
Net interest margin on earning assets			4.24%			5.10%
Net interest spread on earning assets			3.60%			4.56%
Taxable equivalent adjustment:						
Loans		-			-	
Investment Securities		1			0	
Total adjustment		1			0	

**RESULTS OF OPERATIONS - QUARTER ENDED JUNE 30, 2001 COMPARED TO QUARTER ENDED
JUNE 30, 2000**

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

Net interest income before provision for loan loss for the second three months of 2001 decreased \$134,272 or 10.3% below net interest income before provision for loan loss for second three months of 2000. The decrease in net interest income for the second quarter of 2001 is primarily due to a continued sharp decrease of the target Federal Funds rate of 275 basis points during 2001. This fact coupled with certificates of deposit retaining the large percentage of total average deposits, allowed cost of funds to drop only to 4.92% from 5.26% during the first quarter of 2001. While yield on earning assets decreased sharply from 9.20% to 8.52% over the same time period. These two facts contributed to a sharp decrease in Cornerstone's net interest margin from 5.10% to 4.24% in the second three months of 2000 as compared to the second three months of 2001, while decreasing one base point from the first quarter of 2001. The decrease was above Cornerstone management's expectation and management anticipates the possibility of further cuts by the Federal Reserve if the US economy slips into a recession. Management foresees the margin returning to budgeted 4.75% by the end of the fourth quarter.

Interest income decreased \$1,982 or 0.1% for the second quarter of 2001 compared to the second quarter of 2000. Interest income produced by the loan portfolio increased \$25,148 or 1.3% from the second quarter 2000 to the second quarter 2001, due to the increase in average loans, outstanding for the period and loan fees for loan origination. Management estimates the average balances will increase, but will closely monitor origination of these loans to insure quality standards and documentation are maintained. Interest income on investment securities and Federal Funds Sold decreased \$27,000 or 7.2% from second quarter 2000 to second quarter 2001, due to increase in the amount of average Federal Funds Sold and a rapid decrease in the interest paid for these balances.

Total interest expense increased \$132,291 or 12.6% from the second quarter of 2000 to the second quarter of 2001. From the second quarter of 2000 to the second quarter of 2001, the interest expense increase is primarily due to growth of average deposits, which were mostly concentrated in certificates of deposit. Management is actively pursuing customer relationships with small business and municipalities to obtain lower cost deposits and reduce Cornerstone's exposure to certificates of deposit. Management anticipates total interest expense to drop during the third and fourth quarter of 2001.

The trend in net interest income is commonly evaluated in terms of average rates, using the net interest margin and the interest rate spread. The net interest margin, or the net yield on earning assets, is computed by dividing the fully taxable equivalent net interest income by the average earning assets. This ratio represents the difference between the average yield on average earning assets and the average rate paid for all funds used to support those earning assets. The net interest margin for the second quarter of 2001 was 4.24%. The yield on earning assets decreased 49 basis points to 8.52% for the three month period ended June 30, 2001 from 9.20% for the same period ended June 30, 2000.

The interest rate spread measures the difference between the average yield on earning assets and the average rate paid on interest bearing sources of funds. The interest rate spread eliminates the impact of noninterest bearing funds and gives a direct perspective on the effect of market interest rate movements. As a result of changes in the asset and liability mix during late 2000 and reduced loan rates during the current period, the interest rate spread was 3.60%, a decrease of 97 basis points for the three month period ending June 30, 2000 compared to the same period ending June 30, 2001.

ALLOWANCE FOR LOAN LOSSES. The allowance for possible loan losses represents management's assessment of the risks associated with extending credit and its evaluation of the quality of the loan portfolio. Management analyzes the loan portfolio to determine the adequacy of the allowance for possible loan losses and the appropriate provisions required to maintain a level considered adequate to absorb anticipated loan losses. Management believes that the \$1.2 million for the second quarter ended June 30, 2001 in the allowance for loan loss account reflects the full known extent of credit exposure. Cornerstone made a \$104,500 provision during the second quarter of 2001 and anticipates similar provisions in the future as the loan portfolio grows and unanticipated loan losses occur. No assurances can be given, however, that adverse economic circumstances will not result in increased losses in the loan portfolio, and require greater provisions for possible loan losses in the future.

NON-PERFORMING ASSETS. Non-performing assets include non-performing loans and foreclosed real estate held for sale. Non-performing loans include loans classified as non-accrual or renegotiated. Cornerstone's policy is to place a loan on non-accrual status when payment of principal or interest is contractually 90 or more days past due. At the time a loan is placed on non-accrual status, interest previously accrued but not collected may be reversed and charged against current earnings. As of June 30, 2001 Cornerstone had \$66,235 in non-accrual loans and \$553,254 in non-performing assets.

NON-INTEREST INCOME. Non-interest income consists of revenues generated from a broad range of financial services and activities, including fee-based services and profits, commissions earned through credit life insurance sales and other activities. In addition, gains or losses realized from the sale of loans are included in non-interest income. Total non-interest income increased by \$83,519 or 60.7% from the second quarter of 2000 compared with the second quarter 2001. The gain in non-interest income was broad based in almost every category, but was especially strong in secondary market mortgage lending, which was benefited by a low interest rate environment and strong consumer confidence.

NON-INTEREST EXPENSE. Non-interest expense for the second three months of 2001 increased by \$17,228 or 1.6% as compared to the second three months in 2000. Salaries and employee benefits decreased by \$14,949 or 2.6% in second quarter of 2001 compared with the second quarter of 2000. Occupancy expense as of for the second quarter of 2001 increased by \$11,808 or 8.5% over the same period in 2000. All other non-interest expenses for the second quarter of 2001 increased \$21,268 or 4.6% over the non-interest expenses for the second quarter of 2000.

ALLOWANCE FOR LOAN LOSSES

Quarter Ending	2001		2000			
	June 30	March 31	December 31,	September 30	June 30	March 31
Balance at beginning of period	1,204,491	1,141,869	1,155,233	1,086,054	1,028,838	1,001,809
Loans charged-off	(184,858)	(115,132)	(159,494)	(72,003)	(259,543)	(170,891)
Loans recovered	43,303	12,254	90,929	51,183	60,758	39,420
Net charge-offs (recoveries)	(141,555)	(102,878)	(68,564)	(20,820)	(198,784)	(131,471)
Provision for loan losses charged to expense	104,500	165,500	55,200	90,000	256,000	158,500
Balance at end of period	1,167,436	1,204,491	1,141,869	1,155,233	1,086,054	1,028,838
Allowance for loan losses as a percentage of average loans outstanding for the period	1.339%	1.409%	1.360%	1.402%	1.358%	1.358%
Allowance for loan losses as a percentage of nonperforming assets and loans 90 days past due outstanding for the period	211.013%	100.959%	142.709%	164.388%	136.980%	83.251%
Annualized QTD net charge-offs as a percentage of average loans outstanding for the period	-0.649%	-0.481%	-0.327%	-0.101%	-0.994%	-0.694%
Annualized YTD net charge-offs as a percentage of average loans outstanding for the period	-0.566%	-0.481%	-0.521%	-0.590%	-0.849%	-0.694%
YTD Average Outstanding Loans	86,384,793	85,465,574	80,525,815	79,399,688	77,837,484	75,760,000
QTD Average Outstanding Loans	87,179,692	85,465,574	83,980,913	82,375,120	79,974,088	75,760,000
Nonperforming assets and loans 90 days past due	553,254	1,193,044	800,137	702,746	792,858	1,235,826

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 2. Changes in Securities

On February 4, 2000 the Company filed a registration statement on Form S-1 (SEC File Number 333-96185) to issue 150,000 shares of common stock at \$13.00 a share. The Company terminated the offering on December 31, 2000 and has received commitments for approximately 70,000 shares. The Company is in the process of collecting the proceeds and will ultimately purchase Bank stock with the majority of the funds. The Company will retain the balance for working capital.

Item 3. Defaults on Senior Securities

N/A

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

A. The annual meeting of shareholders was held on April 19, 2001.

B. The following directors were elected to the board of directors:

Ramesh V. Amin James H. Large Turner Smith Randy Brooks Lawrence D. Levine Bill O. Wiggins B. Kenneth Driver Russell W. Lloyd Marsha Yessick Karl Fillauer Earl A. Marler, Jr.

Gregory B. Jones
Doyce G. Payne, M.D.

C. The following matters were voted upon at the annual meeting:

	FOR	AGAINST	ABSTAIN	
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1.	To elect the following directors to serve for the ensuing year:			
	Ramesh V. Amin	96.0%	4.0%	0%
	James H. Large	99.0%	1.0%	0%
	Turner Smith	99.5%	0.5%	0%
	Randy Brooks	99.5%	0.5%	0%
	Lawrence D. Levine	99.0%	1.0%	0%
	Bill O. Wiggins	94.0%	6.0%	0%
	B. Kenneth Driver	96.5%	3.5%	0%
	Russell W. Lloyd	99.0%	1.0%	0%
	Marsha Yessick	98.5%	1.5%	0%
	Karl Fillauer	99.5%	0.5%	0%
	Earl A. Marler, Jr.	99.5%	0.5%	0%
	Gregory B. Jones	99.5%	0.5%	0%
	Doyce G. Payne, M.D.	99.0%	1.0%	0%
2	To ratify the appointment of Hazlett, Lewis & Bieter, PLL as independent auditors for the fiscal year ending December 31, 2001.	100%	0%	0%

Item 5. Other Information

None

Item 6. Exhibits and reports on Form 8-K

None

SIGNATURES

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

Date: August 13, 2001

Gregory B. Jones, President & CEO

Date: August 13, 2001

Nathaniel F. Hughes, EVP & CFO

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