Cornerstone Financial Corp
Form 10-Q
May 14, 2010

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

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FORM 10-Q

[X] Quarterly report pursuant to section 13 or 15 (d) of the Securities Exchange Act of 1934
For the quarterly period ended March 31, 2010

-OR-

[ ] Transition report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from ___________ to _____________.

CORNERSTONE FINANCIAL CORPORATION
(Exact name of registrant, as specified in its charter)

| NEW JERSEY | 80-0282551 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

| 6000 Midlantic Drive, Suite 120 S, Mount Laurel, New Jersey | 08054 |
|---|---|
| (Address of principal executive offices) | Zip Code |

Registrant's telephone number, including area code: (856) 439-0300

Securities registered pursuant to Section 12(b) of the Act:

None
(Title of Class)

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, No Par Value
(Title of Class)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES X NO ___.

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation SD-T during the preceding 12 months (or for such shorter period that the registrant was required

to submit and post such files). YES X NO .

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

Large accelerated filer [ ]  Accelerated filer [ ]
Non-accelerated filer [ ]  Smaller reporting company [X]
(Do not check if a smaller reporting company)

Indicate by checkmark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.) YES NO X

As of May 12, 2010, there were 1,809,656 outstanding shares of the registrant's Common Stock.

CORNERSTONE FINANCIAL CORPORATION

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PART I. FINANCIAL INFORMATION

ITEM 1 - CONSOLIDATED FINANCIAL STATEMENTS

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

| (IN THOUSANDS, EXCEPT SHARE DATA) | MARCH 31, 2010 | DECEMBER 31, 2009 |
|---|---|---|
| ASSETS: | (unaudited) | |
| Cash and due from banks | $ 7,080 | $ 4,742 |
| Federal funds sold | 12,000 | - |
| Cash and cash equivalents | 19,080 | 4,742 |
| Investment securities: | | |
| Held to maturity (fair value 2010 - $51,667; 2009 - $47,294) | 51,858 | 48,059 |
| Loans receivable | 237,428 | 238,424 |
| Less allowance for loan losses | 3,541 | 3,432 |
| Loans receivable, net | 233,887 | 234,992 |
| Federal Home Loan Bank stock | 1,353 | 1,572 |
| Premises and equipment, net | 7,801 | 7,871 |
| Accrued interest receivable | 1,587 | 1,484 |
| Bank owned life insurance | 4,562 | 4,521 |
| Deferred taxes | 1,235 | 1,154 |
| Other assets | 1,650 | 1,749 |
| Total Assets | $ 323,013 | $ 306,144 |

LIABILITIES:

| | | |
|---|---|---|
| Non-interest bearing deposits | $ 32,946 | $ 37,500 |
| Interest bearing deposits | 114,768 | 99,132 |
| Certificates of deposit | 122,073 | 112,861 |
| Total deposits | 269,787 | 249,493 |
| Advances from the Federal Home Loan Bank | 25,000 | 29,883 |
| Line of Credit | 4,722 | 4,672 |
| Subordinated debt | 3,000 | 3,000 |
| Unsettled Securities payable | 1,000 | - |
| Other liabilities | 1,216 | 1,283 |
| Total Liabilities | 304,725 | 288,331 |
| Commitments and Contingencies (Note 3) | | |
| STOCKHOLDERS' EQUITY: | | |
| Preferred stock: $0 par value; $1,000 per share stated value, authorized 1,000,000 shares; issued and outstanding 1,900 at March 31, 2010 and December 31, 2009, respectively | 1,900 | 1,900 |
| Common stock: $0 par value: authorized 10,000,000 shares; issued and outstanding 1,809,656 at March 31, 2010 and December 31, 2009, respectively | - | - |
| Additional paid-in capital | 16,623 | 16,623 |
| Retained deficit | (235) | (710) |
| Total Shareholders' Equity | 18,288 | 17,813 |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | $ 323,013 | $ 306,144 |

See accompanying notes to consolidated financial statements



CORNERSTONE FINANCIAL CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS

| | THREE MONTHS ENDED | |
|---|---|---|
| (IN THOUSANDS, EXCEPT PER SHARE DATA) | MARCH 31, 2010 | MARCH 31, 2009 |
| INTEREST INCOME | (Unaudited) | (Unaudited) |
| Interest and fees on loans | $ 3,373 | $ 2,964 |
| Interest on investment securities | 547 | 384 |
| Interest on federal funds | 2 | 3 |
| TOTAL INTEREST INCOME | 3,922 | 3,351 |
| INTEREST EXPENSE | | |

| | | |
|---|---|---|
| Interest on deposits | 938 | 1,232 |
| Interest on borrowings | 184 | 295 |
| TOTAL INTEREST EXPENSE | 1,122 | 1,527 |
| Net interest income | 2,800 | 1,824 |
| Provision for loan losses | 109 | 341 |
| NET INTEREST INCOME AFTER LOAN LOSS PROVISION | 2,691 | 1,483 |
| NON-INTEREST INCOME | | |
| Service charges on deposit accounts | 49 | 27 |
| Origination fees on mortgage loans sold | - | 4 |
| Bank owned life insurance income | 41 | 43 |
| Gain on sale of Loan | 39 | - |
| Miscellaneous fee income | 25 | 19 |
| TOTAL NON-INTEREST INCOME | 154 | 93 |
| NON-INTEREST EXPENSE | | |
| Salaries and employee benefits | 1,200 | 1,064 |
| Net occupancy | 321 | 464 |
| Data processing and other service costs | 100 | 85 |
| Professional services | 138 | 83 |
| Advertising and promotion | 26 | 41 |
| Other real estate owned expense | 9 | 9 |
| FDIC expense | 109 | 54 |
| Other operating expenses | 167 | 123 |
| TOTAL NON-INTEREST EXPENSE | 2,070 | 1,923 |
| Income(loss) before income taxes | 775 | (347) |
| Income tax expense (benefit) | 300 | (149) |
| NET INCOME(LOSS) | 475 | $ (198) |
| Preferred stock dividends | 33 | - |
| Net income(loss) available to common shareholders | $ 442 | $ (198) |
| EARNINGS PER SHARE | | |
| Basic | $ 0.24 | $ (0.12) |
| Diluted | $ 0.24 | $ (0.12) |
| WEIGHTED AVERAGE SHARES OUTSTANDING | | |
| Basic | 1,810 | 1,656 |
| Diluted | 1,810 | 1,656 |

See accompanying notes to consolidated financial statements

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CORNERSTONE FINANCIAL CORPORATION
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(Unaudited)

| (DOLLARS IN THOUSANDS) | COMPREHENSIVE INCOME | PREFERRED STOCK | COMMON STOCK | ADDITIONAL PAID-IN CAPITAL | ACCUMULATED EARNINGS (DEFICIT) |
|---|---|---|---|---|---|
| Balance at December 31, 2009 Comprehensive income | | $ 1,900 | $ - | $ 16,623 | $ (710) |
| Net Income | $ 475 | - | - | - | 475 |
| Comprehensive income | $ 475 | | | | |
| Stock based compensation | | - | - | 33 | - |
| Preferred Stock Dividend ($17.50 per share) | | - | - | (33) | - |
| Balance at March 31, 2010 | | $ 1,900 | $ - | $ 16,623 | $ (235) |

See accompanying notes to consolidated financial statements.



CORNERSTONE FINANCIAL CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

| (IN THOUSANDS) | THREE MONTHS ENDED MARCH 31, 2010 (Unaudited) | MARCH (Unau |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net Income(loss) | $ 475 | $ |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Provision for loan losses | 109 | |
| Depreciation | 94 | |
| Amortization of premiums and discounts, net | 25 | |
| Stock Option expense | 33 | |
| Deferred tax (benefit) | (81) | |
| Decrease in other real estate owned | - | |
| Loans originated for sale | - | (1 |
| Proceeds from sales of loans held for sale | - | 1 |
| Income on Bank Owned Life Insurance | (41) | |
| Increase (decrease) in accrued interest receivable and other assets | (4) | |

| | | |
|---|---|---|
| Increase (decrease) in other liabilities | (67) | |
| Net cash provided by operating activities | 543 | |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of investments held to maturity | (5,652) | (17 |
| Maturity and calls of investments held to maturity | 2,828 | 8 |
| Redemption of FHLB Stock | 219 | |
| Net decrease (increase) in loans | 996 | (19 |
| Purchases of premises and equipment | (24) | |
| Net cash used in investing activities | (1,633) | (28 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net increase in deposits | 20,294 | 26 |
| Proceeds from borrowings | 242,650 | 23 |
| Principal payments on borrowings | (247,483) | (19 |
| Cash dividend paid for preferred stock | (33) | |
| Net cash provided by financing activities | 15,428 | 31 |
| Net increase in cash and cash equivalents | 14,338 | 2 |
| Cash and cash equivalents at the beginning of the period | 4,742 | 9 |
| Cash and cash equivalents at the end of the period | $ 19,080 | $ 12 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | | |
| Cash paid during the period for interest | $ 1,137 | $ 1 |
| Cash paid during the period for income taxes | 126 | |
| SUPPLEMENTAL NON-CASH INVESTING AND FINANCING ACTIVITIES: | | |
| Unsettled HTM investment security | $ 1,000 | $ |

See accompanying notes to consolidated financial statements.



CORNERSTONE FINANCIAL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 1 - BASIS OF PRESENTATION

The consolidated financial statements include the accounts of Cornerstone Financial Corporation and its wholly owned subsidiary, Cornerstone Bank (together, the "Company"). These interim statements, which are unaudited, were prepared in accordance with instructions for Form 10-Q. In the opinion of management, all adjustments, consisting of normal recurring accruals, necessary for fair presentation of the interim financial statements have been included.

Cornerstone Financial Corporation was formed in 2008 at the direction of the Board of Directors of Cornerstone Bank to serve as a holding company for the Bank. The holding company reorganization was completed in January 2009. The statement of financial condition as of December 31, 2009 has been derived from audited financial statements. For further information, refer to the consolidated financial statements and footnotes thereto included in Cornerstone Financial Corporation's Annual Report on Form 10-K for the year ended December 31, 2009 as filed with the United States Securities and Exchange Commission.

NOTE 2 - USE OF ESTIMATES

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of income 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 allowance for loan losses and the evaluation of deferred taxes.

NOTE 3 - CONTINGENCIES

The Company, from time to time, is a party to routine litigation that arises in the normal course of business. Management does not believe the resolution of this litigation would have a material adverse effect on the Company's financial condition or results of operations. However, the ultimate outcome of any such matter, as with litigation generally, is inherently uncertain and it is possible that some of these matters may be resolved materially adverse to the Company.

NOTE 4 - EARNINGS PER SHARE

Basic earnings per share is calculated on the basis of net income divided by the weighted average number of shares outstanding. Diluted earnings per share includes dilutive potential common shares as computed under the treasury stock method using average common stock prices.

NOTE 5 - STOCK OPTIONS

The Company accounts for stock options in accordance with FASB Accounting Standards Codification (ASC) Topic 718 "Stock Compensation." The Company recognizes the grant-date fair-value of stock options and other equity-based compensation issued to employees in the statement of operations. The Company had $369 thousand in unrecognized compensation costs relating to non-vested stock based compensation awards at March 31, 2010.



On March 1, 2008, options to purchase a total of 1,750 shares of common stock were granted with an exercise price of $7.49 per share. These options will expire ten years from the date of the grant and vest on a one-third per year basis, with one-third being immediately vested. The exercise price of each option equals the market price of the common stock on the date of the grant.

On July 16, 2009, options to purchase a total of 45,000 shares of common stock were granted with an exercise price of $5.00 per share. These options will expire ten years from the date of the grant and vest on a one-third per year basis beginning on July 16, 2010, with vesting accelerating in certain circumstances such as change in control of the Company. The exercise price of each option equals the market price of the common stock on the date of the grant.

On January 16, 2010, options to purchase a total of 111,000 shares of common stock were granted with an exercise price of $4.50 per share. These options will expire ten years from the date of the grant and vest on a one-third per year basis beginning on January 21, 2011, with vesting accelerating in certain circumstances such as change in control of the Company. The exercise price of each option equals the market price of the common stock on the date of the grant.

NOTE 6 - INVESTMENT SECURITIES

A comparison of amortized cost and approximate fair value of investment securities held to maturity at March 31, 2009 and December 31, 2009 is as follows (in thousands):

| MARCH 31, 2010 | COST | GROSS UNREALIZED GAINS | GROSS UNREALIZED LOSSES | FAIR VALUE |
|---|---|---|---|---|
| INVESTMENTS HELD TO MATURITY: | | | | |
| Government agency obligations | $ 43,376 | $ 102 | $ (289) | $ 43,18 |
| Mortgage backed securities | 8,482 | 83 | (87) | 8,47 |
| Total | $ 51,858 | $ 185 | $ (376) | $ 51,66 |

| DECEMBER 31, 2009 | COST | GROSS UNREALIZED GAINS | GROSS UNREALIZED LOSSES | FAIR VALUE |
|---|---|---|---|---|
| INVESTMENTS HELD TO MATURITY: | | | | |
| Government agency obligations | $ 39,019 | $ 42 | $ (721) | $ 38,34 |
| Mortgage backed securities | 9,040 | 46 | (132) | 8,95 |
| Total | $ 48,059 | $ 88 | $ (853) | $ 47,29 |

The following table sets forth information regarding the fair value and unrealized losses on the Company's temporarily impaired investment securities at March 31, 2010 and December 31, 2009 for the time periods shown (in thousands):

| MARCH 31, 2010 | LESS THAN 12 MONTHS | | 12 MONTHS OR LONGER | | |
|---|---|---|---|---|---|
| | FAIR VALUE | UNREALIZED LOSSES | FAIR VALUE | UNREALIZED LOSSES | FAI |
| INVESTMENTS HELD TO MATURITY: | | | | | |
| Government Agency Obligations | $ 2 ,864 | $ 41 | $ 17,714 | $ 248 | $ |
| Mortgage Backed Securities | 4,740 | 87 | - | - | |
| Total temporarily impaired investment securities | $ 7,604 | $ 128 | $ 17,714 | $ 248 | $ |

| | DECEMBER 31, 2009 | | | | |
|---|---|---|---|---|---|
| | LESS THAN 12 MONTHS | | 12 MONTHS OR LONGER | | |
| | FAIR VALUE | UNREALIZED LOSSES | FAIR VALUE | UNREALIZED LOSSES | FAI |
| INVESTMENTS HELD TO MATURITY: | | | | | |
| Government Agency Obligations | $ 33,940 | $ 721 | - | - | $ |
| Mortgage Backed Securities | 4,715 | 132 | - | - | |
| Total temporarily impaired investment securities | $ 38,655 | $ 853 | $ - | $ - | $ |

Management has taken into consideration the following information in reaching the conclusion that the impairment of the securities listed in the table above are not other than temporary. The unrealized losses disclosed above are the result of fluctuations in market interest rates currently offered on like securities and do not reflect a deterioration or downgrade of the investment issuer's credit-worthiness or ability to meet its cash flow requirements. The Company believes that it is probable that it will receive all future contractual cash flows and does not intend to sell and will not be required to sell these investment securities until recovery or maturity. The U.S. Government agency sponsored securities which are listed have call provisions priced at par if called prior to their respective maturity dates.

NOTE 7 - LOANS RECEIVABLE

Loans receivable consist of the following (in thousands):

| | MARCH 31, 2010 | DECEMBER 31, 2009 |
|---|---|---|
| Commercial | $ 92,023 | $ 91,717 |
| Real estate - commercial | 106,420 | 105,702 |
| Real estate - residential | 17,204 | 19,137 |
| Construction | 12,298 | 12,104 |
| Consumer loans | 9,604 | 9,875 |
| Net deferred loan fees | (121) | (111) |
| | 237,428 | 238,424 |
| Allowance for loan losses | (3,541) | (3,432) |
| Loans receivable, net | $ 233,887 | $ 234,992 |

Under New Jersey banking laws, the Bank is subject to a loans-to-one-borrower limitation of 15% of capital funds. At March 31, 2010, the loans-to-one-borrower limitation was approximately $4.3 million; this excludes an additional 10% of capital funds, or approximately $2.9 million which may be loaned if collateralized by readily marketable securities. At March 31, 2010, there were no loans outstanding or committed to any one borrower which individually or in the aggregate exceeded the Bank's loans-to-one-borrower limitation of 15% of

capital funds.

Non-performing assets include non-accrual loans, which are loans on which the accrual of interest has ceased, and impaired loans. Loans are generally placed on non-accrual status if, in the opinion of management, collection is doubtful, or when principal or interest is past due 90 days or more unless the collateral is considered sufficient to cover principal and interest and the loan is in the process of collection. The Company recognized $17 thousand in interest income on non-accrual loans during the three month period ended March 31, 2010 and $32 thousand for the three month period ended March 31, 2009.

Impaired loans are measured based on the present value of expected future discounted cash flows, the fair value of the loan or the fair value of the underlying collateral if the loan is collateral dependent. The recognition of interest income on impaired loans is the same as for non-accrual loans discussed above. At March 31, 2010 the Company had $6.7 million in non-accrual loans compared to $8.1 million in non-accrual loans at December 31, 2009. At March 31,



2010, the Company had eight impaired loan relationships totaling $7.5 million (included within the non-accrual loans discussed above) in which $6.0 million was sufficiently collateralized and a specific reserve of $1.5 million has been recorded for the remaining balance. The average balance of impaired loans totaled $8.4 million as of March 31, 2010, and interest income recorded on impaired loans during the three months ended March 31, 2010 totaled $30 thousand, as compared to $32 thousand for the three months ended March 31, 2009.

Included in the balance of the loans past due 90 days or more is a principal balance of $634 thousand dollars representing the Bank's participation interest in two loans originated by another New Jersey based institution. Although the borrowers have ceased making payments on these loans, we have received a legal opinion from our legal counsel that the Bank has valid claims against the lead/originating bank for violations of the participation agreements, and we have filed suit asserting these claims. In the event the lead bank is unable to collect from the borrowers, we believe, based on said legal opinion that our ability to collect on these loans will depend upon the outcome of our legal action against the lead/originating bank.

The following table provides information regarding risk elements in the loan portfolio as of March 31, 2010 and December 31, 2009

| (DOLLARS IN THOUSANDS) | MARCH 31, 2010 | DECEMBER |
|---|---|---|
| Loans past due 90 days or more and accruing | | |
| Commercial | $ 634 | $ |
| Commercial real estate | 165 | |
| Total loans past due 90 days or more and accruing | 799 | |

| (DOLLARS IN THOUSANDS) | MARCH 31, 2010 | DECEMBE |
|---|---|---|

| | |
|---|---|
| Non-performing assets: | |
| Non-accrual loans: | |
| Commercial | $ 1,398 |
| Commercial real estate | 5,315 |
| Residential real estate | - |
| Total | 6,713 |
| Restructured loans | - |
| Total non-performing loans | 6,713 |
| Real estate owned | - |
| Total non-performing assets | $ 6,713 |
| Non-performing loans as a percentage of loans | 2.83% |
| Non-performing assets as a percentage of loans and real estate owned | 2.83% |
| Non-performing assets as a percentage of total assets | 2.08% |

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The following table sets forth with respect to the Bank's allowance for losses on loans

| (dollars in thousands) | MARCH 31, 2010 | MARCH |
|---|---|---|
| Balance at beginning of year | $ 3,432 | $ |
| Provision: | | |
| Commercial | 109 | |
| Total Provision | 3,541 | |
| Charge-offs (net of recoveries) | - | |
| Consumer | - | |
| Total Charge-offs | - | |
| Net charge-offs | - | |
| Balance at end of period | $ 3,541 | $ |
| Period-end loans outstanding | $237,428 | $21 |
| Average loans outstanding | $235,172 | $20 |
| Allowance as a percentage of period-end loans | 1.51% | |
| Net charge-offs as a percentage of average loans | 0.00% | |

NOTE 8 - BANK OWNED LIFE INSURANCE

Bank Owned Life Insurance ("BOLI") is carried at its aggregate cash surrender value less surrender charges and totaled $4.6 million at March 31, 2010. Income of $41 thousand was recognized on the BOLI during the three month period ended March 31, 2010 as compared to $43 thousand for the three month period ended March 31, 2009. The Bank is the sole owner and beneficiary of the BOLI.

NOTE 9 - DEFERRED COMPENSATION PLANS

Effective January 1, 2006, the Bank adopted a Nonqualified Deferred Compensation Plan (The "Executive Plan") and the Directors' Fee Deferral and Death Benefit Plan (the "Directors' Plan"). Both plans provide for payments of deferred compensation to participants. The Company recorded $ 43 thousand in deferred compensation expense during the three month period ended March 31, 2010 as compared to $35 thousand for the three month period ended March 31, 2009.

NOTE 10 - INCOME TAXES

The Company accounts for uncertainties in income taxes in accordance with Financial ASC Topic 740 "Accounting for Uncertainty in Income Taxes." ASC Topic 740 prescribes a threshold and measurement process for recognizing in the financial statements a tax position taken or expected to be taken in a tax return. ASC Topic 740 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company has determined that there are no significant uncertain tax positions requiring recognition in its financial statements.

Federal tax years 2006 through 2009 remain subject to examination as of March 31, 2010, while tax years 2005 through 2009 remain subject to examination by state taxing jurisdictions. In the event the Company is assessed for interest and/or penalties by taxing authorities, such assessed amounts will be classified in the financial statements as income tax expense.

The ability to realize deferred tax assets is dependent upon a variety of factors, including the generation of future taxable income, the existence of taxes paid and recoverable, the reversal of deferred tax liabilities, and tax planning strategies. Based upon these and other factors, the Company determined that it is more likely then not that its deferred tax asset will be realized. As such, no valuation allowance was established for the deferred tax asset as of March 31, 2010 or December 31, 2009. The Company will continue to reassess the realizability of the deferred tax asset in future periods. If, in the future, it is determined that the Company's deferred tax asset is not realizable, a valuation allowance may be established against the deferred tax asset, which may have a material impact on the Company's net income in the period in which it is recorded.

NOTE 11 - FAIR VALUE OF FINANCIAL INSTRUMENTS

ASC Topic 820 "Fair Value Measurements and Disclosures" establishes a framework for measuring fair value in U.S. generally accepted accounting principles, and expands disclosure requirements for fair value measurements. ASC Topic 820 does not require any new fair value measurements. The adoption of ASC Topic 820 did not have a material impact on the Company's consolidated financial statements.



ASC Topic 820 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels, as described below:

- Level 1. Level 1 inputs are unadjusted quoted prices in active markets for identical assets or liabilities.

- Level 2. Level 2 inputs are inputs other than quoted prices included in Level 1 that are observable, either directly or indirectly. Level 2 inputs include quoted prices for similar assets, quoted prices in markets that are not considered to be active, and observable inputs other than quoted prices such as interest rates.

- Level 3. Level 3 inputs are unobservable inputs.

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

As of March 31, 2010 and December 31, 2009, the Company did not have any assets or liabilities measured at fair value on a recurring or nonrecurring basis.

As required by ASC topic 825-10-65, the estimated fair value of financial instruments at March 31, 2010 and December 31, 2009 was as follows:

| | MARCH 31, 2010 | | DECEMBER 31, |
|---|---|---|---|
| (IN THOUSANDS) | CARRYING AMOUNT | ESTIMATED FAIR VALUE | CARRYING AMOUNT |
| Financial assets: | | | |
| Cash and cash equivalents | $ 19,080 | $ 19,080 | $ 4,742 |
| Investments held to maturity | | | |
| Federal Agency Securities | 43,376 | 43,189 | 39,019 |
| Mortgage-backed Securities | 8,482 | 8,478 | 9,040 |
| Loans receivable | 237,428 | 264,616 | 238,424 |
| FHLB stock | 1,353 | 1,353 | 1,572 |
| Bank Owned Life Insurance | 4,562 | 4,562 | 4,521 |
| Accrued interest receivable | 1,587 | 1,587 | 1,484 |
| Total financial assets | $ 315,868 | $ 342,865 | $ 298,802 |
| Financial Liabilities: | | | |
| Checking Accounts | $ 52,388 | $ 52,388 | $ 56,783 |
| Statement savings accounts | 3,255 | 3,255 | 3,430 |
| Money market accounts | 27,115 | 27,115 | 19,658 |
| Index Accounts | 64,956 | 64,956 | 56,761 |
| Certificates of deposit | 122,073 | 121,083 | 112,861 |
| FHLB advances | 25,000 | 25,000 | 29,883 |
| Line of Credit | 4,722 | 4,722 | 4,672 |
| Subordinated Debt | 3,000 | 3,000 | 3,000 |
| Accrued interest payable | 207 | 207 | 222 |
| Total financial liabilities | $ 302,716 | $ 301,726 | $ 287,270 |

| | CONTRACT VALUE | ESTIMATED FAIR VALUE | CONTRACT VALUE |
|---|---|---|---|

| | | | |
|---|---|---|---|
| Off-balance sheet instruments: | | | |
| Commitments to extend credit | $ 49,176 | $ - | $ 45,684 |
| | ========= | ========= | ========= |

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NOTE 12 - RECENT ACCOUNTING PRONOUNCEMENTS

Below is a discussion of recent accounting pronouncements. Recent pronouncements not discussed below were deemed to not be applicable to the Company.

ASC TOPIC 820-10-65, DETERMINING FAIR VALUE WHEN THE VOLUME AND LEVEL OF ACTIVITY FOR THE ASSET OR LIABILITY HAVE SIGNIFICANTLY DECREASED AND IDENTIFYING TRANSACTIONS THAT ARE NOT ORDERLY

In April 2009, the FASB issued guidance regarding identifying circumstances that indicate a transaction is not orderly and guidance on estimating fair value when the volume and level of activity for the asset or liability have significantly decreased. The guidance emphasizes that fair value 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 under current market conditions. This guidance was adopted by the Company for the interim period beginning April 1, 2009 and did not have a material effect on the Company's financial position or results of operations.

ASC TOPIC 320-10-65, RECOGNITION AND PRESENTATION OF OTHER-THAN-TEMPORARY IMPAIRMENTS

In April 2009, the FASB issued guidance regarding the recognition and presentation of other-than-temporary impairments on debt and equity securities in the financial statements. This guidance modified the presentation of OTTI losses and expands existing disclosure requirements about OTTI. The guidance was adopted by the Company for the interim period beginning April 1, 2009, and did not have a material effect on the Company's financial position or results of operations.

ASC TOPIC 825-10-50, INTERIM DISCLOSURES ABOUT FAIR VALUE OF INSTRUMENTS

In April 2009, the FASB issued guidance which requires publicly traded companies to disclose the fair value of financial instruments in interim financial statements. This guidance was adopted by the Company for the interim period beginning April 1, 2009 and the required disclosures are included in Footnote 11.

FASB STATEMENT NO. 168, THE FASB ACCOUNTING STANDARDS CODIFICATION AND THE HIERARCHY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

In June 2009, the FASB issued FASB Statement No. 168 "The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles - a replacement of FASB Statement No. 162" (SFAS No. 168). SFAS No. 168 established the FASB Accounting Standards Codification. The Codification will become the exclusive authoritative reference for nongovernmental U.S. GAAP for use in financial statements issued for interim and annual periods ending after September 15, 2009, except for SEC rules and interpretive releases, which are also authoritative GAAP for SEC registrants. The contents of the Codification will carry the same level of authority, eliminating the four-level GAAP hierarchy previously set forth in Statement 162, which has been superseded by Statement 168. All authoritative GAAP issued by the FASB after this Statement

will be referred to as Accounting Standards Updates. Accounting Standards Updates will not be considered authoritative in their own right, rather they will only serve to update the Codification, provide background information about the guidance, and provide basis for conclusions on changes in the Codification. The Codification retains existing GAAP without changing it except in one instance related to software revenue recognition, which does not impact the Company. SFAS No. 168 is effective for the Company for the interim period ending September 30, 2009 and effective for this Form 10-Q. All references to authoritative literature are required to cite the Codification as opposed to legacy accounting pronouncements.



NOTE 13 - PRIVATE PLACEMENT COMMON STOCK OFFERING AND PREFERRED STOCK ISSUANCE

In June 2009, the Board of Directors of the Company approved a private placement common stock offering to accredited investors. In connection with this offering, the Board of Directors approved the issuance of common stock purchase warrants. As part of the offering, one warrant was issued for each share of Company common stock, no par, sold in the stock offering. Each warrant issued under the offering will allow the holder of the warrant to purchase one share of Company common stock, $0 par, for a price of $9.00 per share through June 26, 2013. For the year ended December 31, 2009, the Company sold 153,889 shares under this offering and issued 153,889 common stock warrants. The $1.1 million proceeds received from the common stock offering were recorded as additional paid in capital.

In December 2009, the Company authorized the establishment of 2,000 shares of $0 par, $1,000 stated value, Perpetual Non-Cumulative Convertible Preferred Stock. The preferred stock is entitled to receive, as and when declared by the Company's Board of Directors, non-cumulative cash dividends at the annual rate equal to 7% of the stated value. In December 2009, the Company sold 1,900 preferred shares. The preferred stock is redeemable at the Company's option at any time after six months from the issue date at the stated value plus any dividends declared but unpaid. The preferred shares have priority of dividends such that, no dividends or distributions shall be declared or paid to common shareholders unless full dividends on all outstanding preferred shares have been declared and paid for the most recently completed calendar quarter.

NOTE 14 - SUBSEQUENT EVENTS

The Company has evaluated subsequent events through the filing date of this report, and determined that there were no recognized or nonrecognized subsequent events to report.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS

FORWARD-LOOKING STATEMENTS

Cornerstone Financial Corporation (the "Company") may from time to time make written or oral "forward-looking statements," including statements contained in the Company's filings with the Securities and Exchange Commission (including this Quarterly Report on Form 10-Q and the exhibits hereto), in its reports to shareholders and in other communications by the Company, which are made in good faith by the Company pursuant to the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995.

These forward-looking statements involve risks and uncertainties, such as statements of the Company's plans, objectives, expectations, estimates and

intentions that are subject to change based on various important factors (many of which are beyond the Company's control). Forward-looking statements may be identified by the use of words such as "expects," "subject," "believe," "will," "intends," "will be," or "would." The factors which could cause the Company's financial performance to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements include those items listed under "Item 1A-Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2009 and the following factors, among others: the strength of the United States economy in general and the strength of the local economies in which the Company conducts operations; the effects of, and changes in, trade, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System ("Federal Reserve"); inflation; interest rates; market and monetary fluctuations; the timely development of new products and services by the Company and the perceived overall value of these products and services by users, including the features, pricing and quality compared to competitors' products and services; the success of the Company in gaining regulatory approval of its products, services, dividends and of new branches, when required; the impact of changes in financial services laws and regulations (including laws concerning taxes, banking, securities and insurance); technological changes; acquisitions; the ability to continue to effectively manage costs, including the costs incurred in connection with the opening of new branches; changes in consumer spending and saving habits; and the success of the Company at managing the risks resulting from these factors.



The Company cautions that the above listed factors are not exclusive. The Company does not undertake to update any forward-looking statement, whether written or oral, that may be made from time to time by or on behalf of the Company.

## OVERVIEW

### CORNERSTONE FINANCIAL CORPORATION

The Company was formed in 2008 at the direction of the Board of Directors of Cornerstone Bank (the "Bank") to serve as a holding company for the Bank. The Board believed that establishing a holding company would provide greater flexibility in raising capital and conducting the Bank's business. The holding company reorganization was completed in January 2009.

We have adopted a strategy of continued growth. At March 31, 2010, we had total assets of $323.0 million, total deposits of $269.8 million and total loans, net of $233.9 million compared to total assets of $306.1 million, total deposits of $249.5 million and total loans, net of $235.0 million at December 31, 2009. Our growth in assets and deposits reflects our commitment to provide outstanding customer service and a broad array of banking products driven by our customers needs. We believe our strategy provides us with a competitive advantage over other financial institutions by developing lasting customer relationships that will enable us to continue to attract core deposits and loans within our market area.

### INTEREST RATE RISK

Our primary objective in managing interest rate risk is to minimize the adverse impact of changes in interest rates on our net interest income while creating an asset/liability structure that maximizes earnings. Our Asset Liability Management Committee actively monitors and manages our interest rate exposure

using gap analysis and interest rate simulation models.

Gap analysis measures the difference between volumes of rate-sensitive assets and liabilities and quantifies these repricing differences for various time intervals. Static gap analysis describes interest rate sensitivity at a point in time. However, gap analysis alone does not accurately measure the potential magnitude of changes in net interest income since changes in interest rates do not affect assets and liabilities at the same rate, to the same extent, or on the same basis. Furthermore, static gap analysis does not consider future growth or changes in the asset mix.

A positive gap (asset sensitive) indicates that more assets reprice during a given period compared to liabilities, while a negative gap (liability sensitive) indicates that more liabilities reprice during a given period compared to assets.

Generally, during a period of falling interest rates, a positive gap would tend to adversely affect net interest income, while a negative gap would tend to result in an increase in net interest income. During a period of rising interest rates, in general, a positive gap would tend to result in an increase in net interest income while a negative gap would tend to affect net interest income adversely. However, certain assets and liabilities may react differently to changes in interest rates even though they reprice or mature in the same or similar time periods. The interest rates on certain assets and liabilities may change at different times than changes in market interest rates, with some changing in advance of changes in market rates and some lagging behind changes in market rates. Also, certain assets (e.g., adjustable rate mortgages) often have provisions that may limit changes both each time the interest rate changes and on a cumulative basis over the life of the loan. Additionally, the actual prepayments and withdrawals in the event of a change in interest rates may differ significantly from those assumed in the calculations shown in the table below. Finally, the ability of borrowers to service their debt may decrease in the event of an interest rate increase. Consequently, any model used to analyze interest rate sensitivity will be vulnerable to the assumptions made with respect to the foregoing factors.



We use a computer-based simulation model to assess the impact of changes in interest rates on net interest income. The model incorporates management's business plan assumptions and related asset and liability yields/costs, deposit sensitivity and the size, composition and maturity or repricing characteristics of our assets and liabilities. The assumptions are based on what management believes at that time to be the most likely interest rate environment. Actual results may differ from simulated results due to the various factors discussed above.

The following table sets forth the amount of our interest-earning assets and interest-bearing liabilities at March 31, 2010, which are expected to mature or reprice in each of the time periods shown:

| (DOLLARS IN THOUSANDS) | ONE YEAR OR LESS | ONE-FIVE YEARS | OVER FIVE YEARS | NON-RATE SENSITIVE ASSETS/ LIABILITI |
|---|---|---|---|---|

| | | | | |
|---|---|---|---|---|
| INTEREST-EARNING ASSETS: | | | | |
| Short term investments | $ 12,000 | $ - | $ - | $ - |
| Investment securities held to maturity | - | - | 51,858 | - |
| Loans receivable | 110,331 | 75,234 | 51,863 | - |
| Total interest-earning assets | 122,331 | 75,234 | 103,721 | - |
| NON-RATE SENSITIVE ASSETS: | | | | |
| Other assets | - | - | - | 21,727 |
| Total assets | $ 122,331 | $ 75,234 | $103,721 | $ 21,727 |
| INTEREST-BEARING LIABILITIES: | | | | |
| Interest-bearing demand | $ 19,442 | $ - | $ - | $ - |
| Statement savings | 3,255 | - | - | - |
| Money market | 92,071 | - | - | - |
| Certificates of deposit | 82,794 | 39,279 | - | - |
| Subordinated debt | 3,000 | - | - | - |
| Borrowings | - | 29,722 | - | - |
| Total interest-bearing liabilities | 200,562 | 69,001 | - | - |
| NON-RATE SENSITIVE LIABILITIES: | | | | |
| Non-interest bearing deposits | - | - | - | 32,946 |
| Other liabilities | - | - | - | 2,216 |
| Capital | - | - | - | 18,288 |
| Total liabilities and capital | $ 200,562 | $ 69,001 | $ - | $ 53,510 |
| Period GAP | $ (78,231) | $ 6,233 | $103,721 | $(31,723 |
| Cumulative interest-earning assets | $ 122,331 | $197,565 | $301,286 | |
| Cumulative interest-bearing liabilities | $ 200,562 | $269,563 | $269,563 | |
| Cumulative GAP | $ (78,231) | $(71,998) | $ 31,723 | |
| Cumulative RSA/RSL (1) | 60.99% | 73.29% | 111.77% | |

(1) Cumulative rate sensitive (interest-earning) assets divided by cumulative rate sensitive (interest-bearing) liabilities.

At March 31, 2010, our interest rate sensitivity gap was within Board approved guidelines.



Gap analysis and interest rate simulation models require assumptions about certain categories of assets and deposits. For purposes of these analyses, assets and liabilities are stated at their contractual maturity, estimated likely call date, or earliest repricing opportunity. Interest-bearing demand deposits, statement savings and money market accounts do not have a stated maturity or repricing term and can be withdrawn or repriced at any time. This may impact our net interest income if more expensive alternative sources of deposits are required to fund loan growth or deposit runoff. Management projects the repricing characteristics of these accounts based on historical performance and assumptions that it believes reflect their rate sensitivity.

The following discussion focuses on the major components of our operations and presents an overview of the significant changes in our financial condition at

March 31, 2010 as compared to December 31, 2009 and our results of operations for the three month periods ended March 31, 2010 as compared to the same period in 2009.

COMPARISON OF FINANCIAL CONDITION AT MARCH 31, 2010 AND DECEMBER 31, 2009

Total assets at March 31, 2010 were $323.0 million, an increase of $16.9 million or 5.5% over December 31, 2009. This change was primarily due to increases in cash and cash equivalents of $14.3 million, accrued interest receivable of $103 thousand, deferred taxes of $81 thousand, investments held to maturity of $3.8 million, bank owned life insurance of $41 thousand, partially offset by decreases in loans receivable, net, of $1.1 million, Federal Home Loan Bank ("FHLB") stock of $219 thousand, other assets of $99 thousand and premise and equipment of $70 thousand.

Gross loans receivable at March 31, 2010, totaled $237.4 million, a decrease of $996 thousand or 0.4% from December 31, 2009. This decrease was attributable to decreases in real estate loans secured by residential properties of $1.9 million and consumer loans of $ 271 thousand partially offset by increases in commercial loans of $307 thousand, commercial real estate loans of $718 thousand and construction loans of $194 thousand. The reduction in residential real estate loans reflects the payoff of a non-accrual loan relationship totaling $1.8 million. See Footnote 7 to our Consolidated Financial Statements for a breakdown of the components of our loan portfolio.

Non-performing assets include non-accrual loans, which are loans on which the accrual of interest has ceased, impaired loans, restructured loans and real estate owned. Loans are generally placed on non-accrual status if, in the opinion of management, collection is doubtful, or when principal or interest is past due 90 days or more unless the collateral is considered sufficient to cover principal and interest and the loan is in the process of collection. Impaired loans are measured based on the present value of expected future discounted cash flows, the market price of the loan or the fair value of the underlying collateral if the loan is collateral dependent. At March 31, 2010, we had a total of $6.7 million in non accrual loans as compared to $8.1 million in non-accrual loans at December 31, 2009. At March 31, 2010, we had eight impaired loan relationships totaling $7.5 million (included in the non-accrual loans set forth above) as compared to ten loan relationships at December 31, 2009 totaling $10.5 million. At March 31, 2010 a specific reserve of $1.5 million has been recorded against these loans. The average balance of impaired loans totaled $8.4 million for the three months ended March 31, 2010 as compared to $1.8 million at March 31, 2009, and interest income recorded on impaired loans during the three months ended March 31, 2010, totaled $30 thousand as compared to $32 thousand for the three month period ended March 31, 2009.

Included in the balance of the loans past due 90 days or more is a principal balance of $634 thousand dollars representing the Bank's participation interest in two loans originated by another New Jersey based institution. Although the borrowers have ceased making payments on these loans, we have received a legal opinion from our legal counsel that the Bank has valid claims against the lead/originating bank for violations of the participation agreements, and we have filed suit asserting these claims. In the event the lead bank is unable to collect from the borrowers, we believe, based on said legal opinion that our ability to collect on these loans will depend upon the outcome of our legal action against the lead/originating bank.

Real estate acquired by foreclosure or by deed in lieu of foreclosure is classified as real estate owned until it is sold. At March 31, 2010 and December 31, 2009 we had no real estate owned.

All of our investment securities are classified as held to maturity. Our investment securities portfolio increased by $3.8 million or 7.9% to $51.8 million at March 31, 2010, from $48.1 million at December 31, 2009. The held to maturity investment purchases were concentrated in United State Government agency securities. See Footnote 6 to our Consolidated Financial statements for more information regarding our investment securities portfolio. The increase in investment securities reflects management's efforts to further diversify its growing balance sheet and to more prudently manage its capital base by investing in lower risk weighted assets.

Total liabilities at March 31, 2010 amounted to $304.7 million, an increase of $16.4 million or 5.7% from December 31, 2009. This change was primarily due to increases in total deposits of $20.3 million, line of credit borrowings from Atlantic Central Bankers Bank (ACBB) of $50 thousand and other liabilities of $933 thousand, offset by a decrease of $4.9 million in advances from Federal Home Loan Bank.

Total deposits at March 31, 2010 were $269.8 million, an increase of $20.3 million or 8.1% from December 31, 2009. The change in total deposits was related to a significant increase in interest bearing core deposits (i.e. all interest bearing deposit accounts other then certificate of deposit accounts) of $15.6 million, coupled with an increase of $9.2 million in certificates of deposit, partially offset by a decrease in non-interest bearing accounts of $4.5 million. The change in deposits was primarily related to the competitive pricing of our deposit products coupled with the continued development of relationships with local small businesses and the high level of individualized service provided by our team of retail branch managers. Consumer and commercial deposits are attracted principally from within our primary market area. We do not obtain funds through brokers, nor do we solicit funds outside the State of New Jersey, although we do accept deposits from residents of other states.

At March 31, 2010, we had advances from the FHLB in the amount of $25.0 million, a decrease of $4.9 million or 16.3 % from December 31, 2009. The weighted average interest rate on these borrowings from the FHLB was 1.49% at March 30, 2010 as compared to 2.03% at December 31, 2009.

On October 31, 2008, the Bank issued a hybrid capital instrument in the aggregate amount of $3.0 million in the form of subordinated debt. A portion of this instrument qualifies as Tier II capital. The term of the debt is for a six year period with a maturity date of November 1, 2014. The initial interest rate was 5.00% fixed for the first year then adjusted to a variable rate equal to prime rate for the remaining five years. The debt security is redeemable, at the Bank's option, at par on any April 30th or October 31st through the maturity date.

On February 17, 2009, the Company entered into a non-revolving line of credit loan agreement with ACBB in an amount up to $5.0 million. The term of the debt is for a three year period with a maturity date of February 17, 2012. The interest rate adjusts at a variable rate equal to prime rate plus 25 basis points with a floor of 4.25%. The Company has an outstanding balance on the line of credit of $4.7 million and has contributed $4.4 million as additional capital to the Bank.

Stockholders' equity at March 31, 2010 amounted to $18.3 million, an increase of $475 thousand or 2.7% over December 31, 2009. This increase reflects net income of $475 thousand, stock based compensation expense of $33 thousand and $33 thousand in cash paid for the declaration of dividends on preferred stock for the three month period ended March 31, 2010.

RESULTS OF OPERATIONS

NET INCOME. We recorded net income for the three month period ended March 31, 2010 of $475 thousand or $0.24 per common share (after preferred stock dividend) as compared to a net loss of $198 thousand or $0.12 per share for the same period in 2009. The change in net income for the three-month period compared to the prior period was attributable to increases of $976 thousand in net interest income, $61 thousand in non-interest income, a decrease of $232 thousand in provision for loan losses and $140 thousand in net occupancy cost, offset by increases of $55 thousand in FDIC insurance premium expense, $136 thousand in increased employee salaries and benefits expense and an increase of $99 thousand in other non interest expenses. The decrease in net occupancy costs was the result of costs associated with the closing of the Moorestown Route 38 Branch during the first quarter of 2009. The net interest margin for the three-month period ended March 31, 2010 increased by 83 basis points to 3.93% as compared to 3.10% for the same period in 2009.



INTEREST INCOME. Total interest income amounted to $3.9 million for the three-month period ended March 31, 2010, an increase of $571 thousand or 17.0% when compared to the same period in 2009. The increase in interest income was related to increases of $32.1 million in average loans and $16.7 million in average investment securities, partially offset by a reduction in the average yield. The average yield on our interest-earning assets was 5.45% for the three month period ended March 31, 2010 compared to 5.62% during the same period in 2009. The reduction in yield in the quarterly period reflects generally reduced market rates of interest, as the Federal Reserve has maintained a low interest rate policy to help stimulate the U.S. economy.

INTEREST EXPENSE. Total interest expense amounted to $1.1 million for the three-month period ended March 31, 2010, a decrease of $405 thousand or 26.5 % when compared to the same period in 2009. The decrease in interest expense resulted from a decrease of $2.5 million in average borrowed funds and lower rates paid on deposit and borrowing products when compared to the same period in 2009, offsetting the growth in average interest bearing deposits of $35.4 million. The average cost of interest-bearing liabilities was 1.70% for the three-month period ended March 31, 2010 compared to 2.80% during the same period in 2009.

The reduction in rates paid on deposit liabilities and borrowings reflects the same factors, discussed above, affecting the yield on our earning assets.

ALLOWANCE FOR LOAN LOSSES. During the first quarter of 2010, we recorded a provision for loan losses of $109 thousand compared to a provision of $341 thousand for the same period in 2009. A provision for loan losses is charged to operations based on management's evaluation of the estimated and inherent losses in our loan portfolio. While management has increased its allowance for loan loss for the three-month period ended March 31, 2010, management believes the credit quality of our loan portfolio has stabilized. On a linked quarterly basis, our non-performing assets were stable from December 31, 2009, to March 31, 2010. We have not engaged in any sub prime lending activities that have plagued the banking industry. At March 31, 2010, our allowance for loan losses represented 1.49% of total loans outstanding and 56.3% of non-performing loans.

NON-INTEREST INCOME. For the three-months ended March 31, 2010, non-interest income, which is comprised principally of service charges on deposit accounts, origination fees on residential mortgage loans sold, loan syndication fees, bank owned life insurance income, ATM fees and other miscellaneous fee income totaled

$154 thousand, an increase of $61 thousand or 65.6% when compared to the same period in 2009. This increase is the result of a $22 thousand increase on service charges on deposit accounts and a $39 thousand dollar gain from the sale of a loan.

NON-INTEREST EXPENSE. Non-interest expense, which is comprised principally of salaries and employee benefits, net occupancy costs, FDIC insurance premium expense, advertising costs, data processing costs and professional services and other operating costs, totaled $2.1 million for the three months ended March 31, 2010, an increase of $147 thousand or 7.6% when compared to the same period in 2009. The increase in non-interest expense was primarily the result of increased salary and benefit costs of $136 thousand, data processing costs of $15 thousand, professional services of $55 thousand, FDIC expense of $55 thousand, and other operating expenses of $44, partially offset by decreases in net occupancy costs of $143 thousand and advertising and promotion of $15 thousand.

INCOME TAXES. We recorded a federal and state income tax expense of $300 thousand during the three month period ended March 31, 2010 compared to an income tax benefit of $149 thousand for the same period in 2009. The change in income tax expense reflects the changes in the Company's results of operations and its recognition of income for the three month period ended March 31, 2010. The effective tax rate for the three month period ended March 31, 2010 was 38.7% compared to 42.9% for the three month period ended March 31, 2009.



LIQUIDITY AND CAPITAL RESOURCES

LIQUIDITY. Liquidity represents our ability to meet our normal cash flow requirements for the funding of loans, repayment of deposits and payment of operating costs. Our primary sources of liquidity include growth in deposits, amortization and prepayment of loans, maturities of investment securities, and our borrowing capability. Management monitors liquidity daily, and on a monthly basis incorporates liquidity analysis into its asset/liability management program.

In addition to using growth in deposits, loan repayments and the investment portfolio as a source of liquidity, we also have access to unsecured, overnight lines of credit aggregating $58.7 million, consisting of $3.0 million, on an uncommitted basis, through ACBB and $55.7 million through the FHLB of New York. The arrangements with ACBB are for the sale of federal funds to the Bank, subject to the availability of such funds. Pursuant to a collateral agreement with the FHLB, advances under this line of credit are secured by a blanket lien on our residential mortgage loan portfolio. At March 31, 2010, we had no outstanding balance against the overnight line of credit at ACBB. In addition, the Company has a non revolving line of credit with ACBB for up to $5.0 million and as of March 31, 2010 there is an outstanding balance of $4.7 million. In addition, the Bank's membership in the FHLB provides the Bank with additional secured borrowing capacity of up to a maximum of 25% of the Bank's total assets, subject to certain conditions.

We had cash and cash equivalents of $19.1 million at March 31, 2010 in the form of cash and due from banks. At March 31, 2010, unused lines of credit available to our customers, committed undisbursed loan proceeds and standby letters of credit totaled $49.2 million. Certificates of deposit scheduled to mature in one year or less totaled $82.7 million at March 31, 2010. We anticipate that we will continue to have sufficient funds available to meet the needs of our customers for deposit repayments and loan fundings.

Our ability to generate deposits depends on the success of our branches. Our success is dependent on a number of factors, including our ability to establish branches in favorable locations, our ability to meet the needs of our customers through personalized services and a broad array of financial products, and the general economic conditions of the market area in which they are located. Unexpected changes in the national and local economy may also adversely affect our ability to attract or retain deposits and foster new loan relationships.

CAPITAL RESOURCES. Capital adequacy is the ability to support growth while protecting the interests of depositors and the deposit insurance fund. Bank regulatory agencies have developed certain capital ratio requirements, which are used to assist them in monitoring the safety and soundness of financial institutions. Management continually monitors these capital requirements.

The Bank is subject to risk-based capital guidelines promulgated by the FDIC that are designed to make regulatory capital requirements more sensitive to differences in risk profile among banks, to account for off-balance sheet exposure, and to minimize disincentives for holding liquid assets. Under the guidelines, assets and off-balance sheet items are assigned to broad risk categories, each with appropriate weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and off-balance sheet items. The minimum ratio of total capital to risk-weighted assets (including certain off-balance sheet activities, such as standby letters of credit) is 8%. At least 4% of total risk-weighted assets is required to be "Tier I Capital," consisting of common stockholders' equity and qualifying hybrid instruments, less certain goodwill items and other intangible assets. The remainder ("Tier II Capital") may consist of (a) the allowance for loan losses of up to 1.25% of risk-weighted assets, (b) excess of qualifying hybrid instruments, (c) perpetual debt (d) mandatory convertible securities, and (e) qualifying subordinated debt and intermediate-term preferred stock up to 50% of Tier I capital. Total capital is the sum of Tier I and Tier II capital less reciprocal holdings of other banking organizations, capital instruments, investments in unconsolidated subsidiaries and any other deductions as determined by the FDIC (determined on a case-by-case basis or as a matter of policy after formal rule-making).



In addition to the risk-based capital guidelines, the FDIC has adopted a minimum Tier I capital (leverage) ratio, under which banks must maintain a minimum level of Tier I capital to average total consolidated assets of at least 3% in the case of a bank that has the highest regulatory examination rating and is not contemplating significant growth or expansion. All other banks are expected to maintain a leverage ratio of at least 1% to 2% above the stated minimum.
The Bank was in compliance with all applicable minimum capital requirements for all periods presented. At March 31, 2010 the Bank maintained a Tier I leverage ratio of 7.39%, a Tier I risk-based capital ratio of 8.64% and a total risk-based capital ratio of 10.80%. The Bank's management believes that the Bank would be categorized as well capitalized under applicable FDIC capital adequacy regulations.

The Board of Governors of the Federal Reserve System has established similar capital requirements for bank holding companies, on a consolidated basis. However, these requirements only apply to bank holding companies with assets of $500 million or more. As such, the Company is not subject to these requirements.

On October 31, 2008, the Bank issued a hybrid capital instrument in the aggregate amount of $3.0 million in the form of subordinated debt. A portion of this instrument qualifies as Tier II capital. The term of the debt is for a six

year period with a maturity date of November 1, 2014. The initial interest rate was 5.00% fixed for the first year then adjusted to a variable rate equal to prime rate for the remaining five years. The debt security is redeemable, at the Bank's option, at par on any April 30th or October 31st through the maturity date.

On February 17, 2009, the Company entered into a non-revolving line of credit loan agreement with ACBB in an amount up to $5.0 million. The term of the debt is for a three year period with a maturity date of February 17, 2012. The interest rate adjusts at a variable rate equal to prime rate plus 25 basis points with a floor of 4.25%. The Company has an outstanding balance on the line of credit of $4.7 million and has contributed $4.4 million as additional capital to the Bank.

In June 2009, the Board of Directors of the Company approved a private placement common stock offering to accredited investors. In connection with this offering, the Board of Directors approved the issuance of common stock purchase warrants. As part of the offering, one warrant was issued for each share of common stock, no par, sold in the stock offering. Each warrant issued under the offering will allow the holder of the warrant to purchase one share of common stock, $0 par, for a price of $9.00 per share through June 26, 2013. For the year ended December 31, 2009, the Company sold 153,889 shares under this offering and issued 153,889 common stock warrants. The $1.1 million proceeds received from the common stock offering were recorded as additional paid in capital.

In December 2009, the Company authorized the establishment of 2,000 shares of $0 par, $1,000 stated value, Perpetual Non-Cumulative Convertible Preferred Stock. The preferred stock is entitled to receive, as and when declared by the Company's Board of Directors, non-cumulative cash dividends at the annual rate equal to 7% of the stated value. In December 2009, the Company sold 1,900 preferred shares. The preferred stock is redeemable at the Company's option at any time after six months from the issue date at the state value plus any dividends declared but unpaid. The preferred shares have priority of dividends such that, no dividends or distributions shall be declared or paid to common shareholders unless full dividends on all outstanding preferred shares have been declared and paid for the most recently completed calendar quarter.

The Bank's capital ratio's at March 31, 2010 and December 31, 2009 are presented in the following table

| | MARCH 2010 | DECEMBER 2009 |
|---|---|---|
| Shareholders' equity to total assets | 5.7% | 5.8% |
| Leverage ratio | 7.4% | 7.3% |
| Risk-based capital ratios: | | |
| Tier 1 | 8.6% | 8.5% |
| Total Capital | 10.8% | 10.7% |



OFF-BALANCE SHEET ARRANGEMENTS. We are party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of our customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the statements of financial condition.

Commitments to extend credit are agreements to lend to a customer as long as

there is no violation of any condition established in the agreement. Commitments generally have fixed dates or other termination clauses and may require the payment of a fee. Some of the commitments are expected to expire without being drawn upon, and the total commitments do not necessarily represent future cash requirements. Total commitments to extend credit at March 31, 2010 were $49.2 million. We evaluate each customer's creditworthiness on a case by case basis. Collateral obtained, if deemed necessary, is based on management's credit evaluation of the customer. Collateral varies but may include accounts receivable, marketable securities, inventory, property, plant and equipment, residential and commercial real estate.

Standby letters of credit are conditional commitments issued to a third party for a customer. The credit risk involved in issuing standby letters of credit is similar to that involved in extending credit to customers. We evaluate each customer's creditworthiness on a case by case basis. Collateral obtained, if deemed necessary, is based on management's credit evaluation of the customer. Collateral varies, but may include accounts receivable, marketable securities, inventory, property, plant and equipment, and residential and commercial real estate. At March 31, 2010, our obligations under standby letters of credit totaled $1.3 million.

## CRITICAL ACCOUNTING POLICIES

### ALLOWANCE FOR LOSSES ON LOANS

The allowance for losses on loans is based on management's ongoing evaluation of the loan portfolio and reflects an amount considered by management to be its best estimate of known and inherent losses in the loan portfolio. Management considers a variety of factors when establishing the allowance, such as the impact of current economic conditions, diversification of the loan portfolio, delinquency statistics, results of independent loan review and related classifications. Our historic loss rates and the loss rates of peer financial institutions are also considered. In addition, certain individual loans which management has identified as problematic are specifically provided for, based upon an evaluation of the borrower's perceived ability to pay, the estimated adequacy of the underlying collateral and other relevant factors. Consideration is also given to examinations performed by regulatory agencies. Although provisions have been established and segmented by type of loan, based upon management's assessment of their differing inherent loss characteristics, the entire allowance for losses on loans is available to absorb loan losses in any category.

Management uses significant estimates to determine the allowance for loan losses. Since the allowance for loan losses is dependent, to a great extent, on conditions that may be beyond our control, it is possible that management's estimate of the allowance for loan losses and actual results could differ materially in the near term.

In addition, regulatory authorities, as an integral part of their examinations, periodically review the allowance for loan losses. They may require additions to the allowance based upon their judgments about information available to them at the time of examination.

### INCOME TAXES

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, as well as operating loss carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is established against deferred tax assets when, in the judgment of management, it is more likely than not that such deferred tax assets will not become available. Because the judgment about the level of future taxable income is dependent to a great extent on matters that may, at least in part, be beyond the our control, it is at least reasonably possible that management's judgment about the need for a valuation allowance for deferred taxes could change in the near term.

RECENT ACCOUNTING PRONOUNCEMENTS

See Footnote 13 to our Consolidated Financial Statements for discussion on Recent Accounting Pronouncements.

IMPACT OF INFLATION AND CHANGING PRICES

The consolidated financial statements of the Company and the footnotes thereto, presented elsewhere herein, have been prepared in accordance with the standards of the Public Company Accounting Oversight Board (United States), which require the measurement of financial position and operating results in terms of historical dollars without considering the change in the relative purchasing power of money over time due to inflation.

The impact of inflation is reflected in the increased cost of our operations. Unlike most industrial companies, nearly all of our assets and liabilities are monetary. As a result, interest rates have a greater impact on our performance than do the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the price of goods and services.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable to smaller reporting companies.

ITEM 4. CONTROLS AND PROCEDURES

The Registrant's chief executive officer and chief financial officer, after evaluating the effectiveness of the Registrant's "disclosure controls and procedures" (as defined in the Securities Exchange Act of 1934 Rules13a-15(e) and 15d-15(e)) as of the end of the period covered by this quarterly report, have concluded that as of such date, the Registrant's disclosure controls and procedures were effective to ensure at a reasonable assurance level that material information relating to the Registrant is recorded, processed, summarized and reported in a timely manner. There were no changes in the Registrant's internal control over financial reporting that occurred during the Registrant's first fiscal quarter of 2010 that have materially affected, or are reasonably likely to materially affect, the Registrant's internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The Company, from time to time, is a party to routine litigation that arises in the normal course of business. Management does not believe the resolution of

this litigation, if any, would have a material adverse effect on the Company's financial condition or results of operations. However, the ultimate outcome of any such matter, as with litigation generally, is inherently uncertain and it is possible that some of these matters may be resolved adversely to the Company.



ITEM 1A. RISK FACTORS

Not applicable.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Not applicable.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4. Removed and Reserved

ITEM 5. OTHER INFORMATION

Not applicable.

ITEM 6. EXHIBITS

(a) The following are filed as exhibits to this report:

31.1 Certification of Chief Executive Officer required under Section 302 of the Sarbanes - Oxley Act of 2002

31.2 Certification of Chief Financial Officer required under Section 302 of the Sarbanes - Oxley Act of 2002

32.1 Certification of Chief Executive Officer required under Section 906 of the Sarbanes - Oxley Act of 2002

32.2 Certification of Chief Financial Officer required under Section 906 of the Sarbanes - Oxley Act of 2002

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.

CORNERSTONE FINANCIAL CORPORATION

Date: May 12, 2010

By: /S/ GEORGE W. MATTEO, JR.

George W. Matteo, Jr.
President and Chief Executive Officer
(Principal Executive Officer)

Date: May 12, 2010

By: /S/ KEITH WINCHESTER

Keith Winchester
Executive Vice President and
Chief Financial Officer
(Principal Financial and Accounting Of