

COMMUNITY BANCSHARES INC /DE/  
Form 10-Q  
May 09, 2005

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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(Mark One)

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

For the quarterly period ended March 31, 2005

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 000-16461

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**COMMUNITY BANCSHARES, INC.**

(Exact Name of Registrant as Specified in Its Charter)

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|   |  |
|---|--|
| <b>Delaware</b><br>(State or Other Jurisdiction of<br>Incorporation or Organization)        | <b>63-0868361</b><br>(I.R.S. Employer<br>Identification No.) |
| <b>68149 Main Street, Blountsville, Alabama</b><br>(Address of Principal Executive Offices) | <b>35031</b><br>(Zip Code)                                   |
| <b>(205) 429-1000</b><br>(Registrant's Telephone Number, Including Area Code)               |  |

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act):  Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

**As of April 25, 2005, there were 8,524,505 shares of the registrant's common stock, \$.10 par value per share, outstanding.**

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**PART 1****Item 1. Financial Statements.****Community Bancshares, Inc. and Subsidiaries****Consolidated Balance Sheets**

|  | (Unaudited)<br>March 31,<br>2005 | December 31, 2004     |
|--|----------------------------------|-----------------------|
| <i>Assets</i>  |                                  |                       |
| Cash and due from banks  | \$ 19,010,468                    | \$ 33,669,110         |
| Interest-bearing deposits in banks   | 3,657,390                        | 5,368,342             |
| Federal funds sold   | 17,635,000                       | 13,475,000            |
| Cash and cash equivalents  | 40,302,858                       | 52,512,452            |
| Securities available for sale  | 148,990,958                      | 147,167,933           |
| Loans, net of allowance for loan losses of \$4,589,321 and \$4,624,584   | 300,212,718                      | 295,754,943           |
| Capitalized lease receivable   | 2,831,204                        | 2,863,755             |
| Accrued interest receivable  | 3,174,277                        | 2,766,104             |
| Premises and equipment, net  | 21,187,453                       | 21,177,897            |
| Goodwill and other intangible assets, net  | 2,346,253                        | 2,366,107             |
| Foreclosed assets  | 10,260,956                       | 11,126,227            |
| Other assets   | 18,051,540                       | 17,688,360            |
| <b>Total assets</b>  | <b>\$ 547,358,217</b>            | <b>\$ 553,423,778</b> |
| <i>Liabilities and stockholders' equity</i>  |                                  |                       |
| Deposits:  |                                  |                       |
| Noninterest-bearing  | \$ 64,085,400                    | \$ 70,279,948         |
| Interest-bearing   | 378,569,455                      | 378,346,834           |
| Total deposits   | 442,654,855                      | 448,626,782           |
| Other short-term borrowings  | 551,461                          | 621,490               |
| FHLB long-term debt  | 38,000,000                       | 38,000,000            |
| Capitalized lease obligations  | 3,880,256                        | 3,893,234             |
| Junior subordinated debt (Note 6)  | 10,310,000                       | 10,310,000            |
| Accrued interest payable   | 1,451,414                        | 1,729,478             |
| Other liabilities  | 8,469,402                        | 7,366,030             |
| <b>Total liabilities</b>   | <b>505,317,388</b>               | <b>510,547,014</b>    |
| Commitments and contingencies (Note 9)   |                                  |                       |
| <i>Stockholders' equity</i>  |                                  |                       |
| Preferred stock (par value \$.10 per share; 200,000 shares authorized; no shares issued or outstanding)  |                                  |                       |
| Common stock (par value \$.10 per share; 20,000,000 shares authorized; 8,726,162 and 8,701,162 shares issued as of March 31, 2005 and December 31, 2004, respectively; 2,191,897 shares of which are exchangeable for preferred stock) | 872,616                          | 870,116               |
| Additional paid-in-capital   | 49,282,796                       | 49,162,306            |
| Stock warrant outstanding  | 242,524                          | 242,524               |

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|  |                       |                |
|--|-----------------------|----------------|
| Treasury common stock, at cost (99,869 shares, as of both March 31, 2005 and December 31, 2004)                  | <b>(980,428)</b>      | (980,428)      |
| Retained earnings (deficit)  | <b>(1,548,687)</b>    | (1,899,382)    |
| Unearned ESOP common stock (101,788 and 106,092 shares as of March 31, 2005 and December 31, 2004, respectively) | <b>(1,528,018)</b>    | (1,571,058)    |
| Accumulated other comprehensive loss   | <b>(4,299,974)</b>    | (2,947,314)    |
|  | <hr/>                 | <hr/>          |
| Total stockholders' equity   | <b>42,040,829</b>     | 42,876,764     |
|  | <hr/>                 | <hr/>          |
| Total liabilities and stockholders' equity   | <b>\$ 547,358,217</b> | \$ 553,423,778 |
|  | <hr/>                 | <hr/>          |

The accompanying notes are an integral part of these consolidated financial statements

## Community Bancshares, Inc. and Subsidiaries

## Consolidated Statements of Income

(Unaudited)

|  | Three months ended March 31, |                  |
|--|------------------------------|------------------|
|  | 2005                         | 2004             |
| Interest income:                                     |                              |                  |
| Loans, including fees                                | \$ 6,198,754                 | \$ 6,345,206     |
| Interest on investment securities:                   |                              |                  |
| Taxable securities                                   | 1,428,705                    | 1,414,476        |
| Tax-exempt securities                                | 29,477                       | 73,149           |
| Federal funds sold                                   | 60,098                       | 39,272           |
| Other  | 85,893                       | 49,933           |
| Total interest income                                | <u>7,802,927</u>             | <u>7,922,036</u> |
| Interest expense:                                    |                              |                  |
| Deposits   | 2,381,163                    | 2,216,389        |
| Short-term borrowings                                | 1,514                        | 644              |
| FHLB long-term debt                                  | 569,609                      | 569,610          |
| Capitalized lease obligations                        | 53,054                       | 39,579           |
| Junior subordinated debentures                       | 271,875                      | 334,935          |
| Other long-term debt                                 | 32,787                       | 32,787           |
| Total interest expense                               | <u>3,277,215</u>             | <u>3,193,944</u> |
| Net interest income                                  | 4,525,712                    | 4,728,092        |
| Provision for loan losses                            | 259,085                      | 299,385          |
| Net interest income, after provision for loan losses | <u>4,266,627</u>             | <u>4,428,707</u> |
| Noninterest income:                                  |                              |                  |
| Service charges on deposits                          | 662,379                      | 663,426          |
| Insurance commissions                                | 639,918                      | 674,322          |
| Bank club dues                                       | 77,410                       | 92,601           |
| Debt cancellation fees                               | (5,283)                      | (15,217)         |
| Securities gains (losses), net                       | (2,484)                      | 237,992          |
| Foreclosed assets, net                               |                              | 2,605            |
| Other  | 743,927                      | 144,983          |
| Total noninterest income                             | <u>2,115,867</u>             | <u>1,800,712</u> |
| Noninterest expense:                                 |                              |                  |
| Salaries and employee benefits                       | 3,002,931                    | 3,072,187        |
| Occupancy  | 541,456                      | 600,521          |
| Furniture and equipment                              | 379,804                      | 364,748          |
| Insurance  | 321,730                      | 292,027          |
| Director and committee fees                          | 103,250                      | 117,650          |
| Professional services                                | 396,247                      | 658,119          |
| Foreclosed assets, net                               | 40,910                       |                  |
| Disposal or impairment of assets                     | 23,537                       | 23,367           |
| Litigation, fraud or burglary                        |                              | 18,076           |

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|                            |                   |           |
|----------------------------|-------------------|-----------|
| Other                      | <b>1,026,080</b>  | 1,025,394 |
|                            | <hr/>             | <hr/>     |
| Total noninterest expense  | <b>5,835,945</b>  | 6,172,089 |
|                            | <hr/>             | <hr/>     |
| Income before income taxes | <b>546,549</b>    | 57,330    |
| Income taxes               | <b>(195,854)</b>  | (2,287)   |
|                            | <hr/>             | <hr/>     |
| Net income                 | <b>\$ 350,695</b> | \$ 55,043 |
|                            | <hr/>             | <hr/>     |
| Earnings per share:        |                   |           |
| Basic                      | <b>\$ 0.04</b>    | \$ 0.01   |
| Diluted                    | <b>\$ 0.04</b>    | \$ 0.01   |

The accompanying notes are an integral part of these consolidated financial statements

## Community Bancshares, Inc. and Subsidiaries

## Consolidated Statements of Changes in Stockholders Equity (Unaudited)

Three months ended March 31, 2004 and 2005

|   | <i>Shares of<br/>Common<br/>Stock<br/>Issued</i> | <i>Common<br/>Stock</i> | <i>Additional<br/>Paid in Capital</i> | <i>Stock<br/>Warrant<br/>Outstanding</i> | <i>Treasury<br/>Common<br/>Stock</i> | <i>Retained<br/>Earnings</i> | <i>Unearned<br/>ESOP<br/>Common<br/>Stock</i> | <i>Accumulated<br/>Other<br/>Comprehensive<br/>Income (Loss)</i> | <i>Total</i>  |
|---|--|-------------------------|---------------------------------------|--|--------------------------------------|------------------------------|---|--|---------------|
| Balance at December 31, 2003  | 6,978,671  | \$ 697,868              | \$ 40,996,918                         | \$                                       | \$ (894,029)                         | \$ (2,075,986)               | \$ (1,741,248)                                | \$ (1,665,903)   | \$ 35,317,620 |
| Comprehensive income:   |  |                         |                                       |  |                                      |                              |   |  |               |
| Net income during period  |  |                         |                                       |  |                                      | 55,043                       |   |  | 55,043        |
| Change in unrealized gain (loss) on securities available for sale net of reclassification adjustment and tax effect |  |                         |                                       |  |                                      |                              |   | 635,645  | 635,645       |
| Total comprehensive income  |  |                         |                                       |  |                                      |                              |   |  | 690,688       |
| Issuance of common stock at \$5.35 per share  | 1,586,771  | 158,676                 | 8,330,549                             |  |                                      |                              |   |  | 8,489,225     |
| Common stock issuance costs   |  |                         | (815,047)                             | 242,524                                  |                                      |                              |   |  | (572,523)     |
| Common stock issued in lieu of cash paid for directors fees at \$5.35 per share                                     | 20,720   | 2,072                   | 108,478                               |  |                                      |                              |   |  | 110,550       |
| Release of ESOP common stock  |  |                         | (11,398)                              |  |                                      |                              | 35,620  |  | 24,222        |
| Treasury common stock acquired  |  |                         |                                       |  | (16,384)                             |                              |   |  | (16,384)      |
| Balance at March 31, 2004   | 8,586,162  | \$ 858,616              | \$ 48,609,500                         | \$ 242,524                               | \$ (910,413)                         | \$ (2,020,943)               | \$ (1,705,628)                                | \$ (1,030,258)   | \$ 44,043,398 |
| Balance at December 31, 2004  | 8,701,162  | \$870,116               | \$49,162,306                          | \$242,524                                | \$ (980,428)                         | \$ (1,899,382)               | \$ (1,571,058)                                | \$ (2,947,314)   | \$42,876,764  |

|   |           |           |              |           |             |               |               |               |  |             |             |         |  |  |  |  |  |  |          |        |              |
|---|-----------|-----------|--------------|-----------|-------------|---------------|---------------|---------------|--|-------------|-------------|---------|--|--|--|--|--|--|----------|--------|--------------|
| <b>Comprehensive losses:</b>  |           |           |              |           |             |               |               |               |  |             |             |         |  |  |  |  |  |  |          |        |              |
| <b>Net income during period</b>   |           |           |              |           |             |               |               |               |  | 350,695     | 350,695     |         |  |  |  |  |  |  |          |        |              |
| <b>Change in unrealized gain (loss) on securities available for sale net of reclassification adjustments and tax effect</b> |           |           |              |           |             |               |               |               |  | (1,352,660) | (1,352,660) |         |  |  |  |  |  |  |          |        |              |
| <b>Total comprehensive loss</b>   |           |           |              |           |             |               |               |               |  |             | (1,001,965) |         |  |  |  |  |  |  |          |        |              |
| <b>Common stock issued for stock options exercised</b>  |           |           |              |           |             |               |               |               |  | 25,000      | 2,500       | 131,250 |  |  |  |  |  |  | 133,750  |        |              |
| <b>Release of ESOP common stock</b>   |           |           |              |           |             |               |               |               |  |             |             |         |  |  |  |  |  |  | (10,760) | 43,040 | 32,280       |
| <b>Balance at March 31, 2005</b>  | 8,726,162 | \$872,616 | \$49,282,796 | \$242,524 | \$(980,428) | \$(1,548,687) | \$(1,528,018) | \$(4,299,974) |  |             |             |         |  |  |  |  |  |  |          |        | \$42,040,829 |

The accompanying notes are an integral part of these consolidated financial statements



## Community Bancshares, Inc. and Subsidiaries

## Consolidated Statements of Cash Flows

(Unaudited)

|  | Three months ended March 31, |                      |
|--|------------------------------|----------------------|
|  | 2005                         | 2004                 |
| <b>Operating activities:</b>   |                              |                      |
| Net income   | \$ 350,695                   | \$ 55,043            |
| Adjustments to reconcile net income to net cash provided (used) by operating activities:         |                              |                      |
| Provision for loan losses  | 259,085                      | 299,385              |
| Depreciation and amortization  | 421,346                      | 406,568              |
| Net amortization of securities   | 226,138                      | 176,145              |
| Deferred tax expense   | 147,229                      | 1,229,146            |
| Realized investment security losses (gains)  | 2,484                        | (237,992)            |
| Gain on sale or impairment of premises and equipment   | (2,715)                      | (44,271)             |
| Realized losses (gains) on foreclosed assets   | 40,910                       | (2,605)              |
| Increase in accrued interest receivable  | (408,173)                    | (29,627)             |
| (Decrease) increase in accrued interest payable  | (278,064)                    | 215,013              |
| Other  | 1,763,799                    | (3,055,216)          |
| <b>Net cash provided (used) by operating activities</b>  | <b>2,522,734</b>             | <b>(988,411)</b>     |
| <b>Investing activities:</b>   |                              |                      |
| Proceeds from sales, calls and pay downs of securities available for sale                        | 13,170,221                   | 21,268,450           |
| Proceeds from maturity of securities available for sale  | 5,000,000                    |                      |
| Purchase of securities available for sale  | (22,476,301)                 | (25,224,408)         |
| Loan originations and principal collections, net   | (4,413,918)                  | 1,574,137            |
| Proceeds from sale of premises and equipment   | 73,600                       | 911,970              |
| Additions to premises and equipment  | (481,483)                    | (112,033)            |
| Net proceeds from sale of foreclosed assets  | 316,737                      | 562,591              |
| <b>Net cash used by investing activities</b>   | <b>(8,811,144)</b>           | <b>(1,019,293)</b>   |
| <b>Financing activities:</b>   |                              |                      |
| Net (decrease) increase in demand deposits, NOW accounts, savings and time open deposit accounts | (6,408,784)                  | 2,379,479            |
| Net increase (decrease) in certificates of deposit   | 436,857                      | (6,415,027)          |
| Net decrease in short-term borrowings  | (70,029)                     | (30,000)             |
| Decrease in capitalized lease obligations  | (12,978)                     | (21,446)             |
| Repayment of long-term debt  |                              | (1,470,258)          |
| Issuance of common stock, net of transaction costs   | 133,750                      | 7,916,702            |
| Purchase of common stock into treasury   |                              | (16,384)             |
| <b>Net cash provided (used) by financing activities</b>  | <b>(5,921,184)</b>           | <b>2,343,066</b>     |
| <b>Net change in cash and cash equivalents</b>   | <b>(12,209,594)</b>          | <b>335,362</b>       |
| <b>Cash and cash equivalents, beginning of period</b>  | <b>52,512,452</b>            | <b>44,920,220</b>    |
| <b>Cash and cash equivalents, end of period</b>  | <b>\$ 40,302,858</b>         | <b>\$ 45,255,582</b> |

Supplemental cash flow disclosures:

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|  |                |              |
|--|----------------|--------------|
| Interest paid on deposits and borrowed funds                             | \$ 3,555,279   | \$ 2,978,931 |
| Schedule of non-cash investing and financing activities:                 |                |              |
| Foreclosure of other real estate owned                                   | <b>190,633</b> | 1,237,524    |
| Loan charge-offs, net of recoveries                                      | <b>294,349</b> | 3,423,568    |
| Deconsolidation of special purpose trust (Note 6):                       |                |              |
| Recognition of the equity investments in the special purpose trust       |                | 310,000      |
| Removal of the special purpose trust preferred securities                |                | 10,000,000   |
| Recognition of the junior subordinated debt in the special purpose trust |                | 10,310,000   |

The accompanying notes are an integral part of these consolidated financial statements

**Community Bancshares, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

**Note 1 General**

The accompanying unaudited consolidated financial statements include the accounts of Community Bancshares, Inc. ( Community Bancshares ) and its wholly-owned subsidiaries, which, together with Community Bancshares, are hereinafter referred to collectively as the Company. The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to the Securities and Exchange Commission's (the Commission or the SEC ) Quarterly Report on Form 10-Q and Article 10 of the Commission's Regulation S-X. Accordingly, the financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three month period ended March 31, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005 or for any other future periods. For further information, please refer to the audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2004 (the Form 10-K ).

Certain reclassifications of prior years' amounts have been made to conform to current year presentation. These reclassifications had no effect on net income, total assets, total liabilities, or stockholders' equity.

**Note 2 Recent Accounting Pronouncements**

On April 14, 2005, the SEC announced the adoption of a new rule (Staff Accounting Bulletin 107) that amended the compliance dates for SFAS No. 123R. Under SFAS No. 123R, registrants would have been required to implement the new standard as of the beginning of the first interim or annual period that begins after June 15, 2005. The Commission's new rule allows companies to implement Statement No. 123R at the beginning of their next fiscal year, instead of the next reporting period, that begins after June 15, 2005. The Commission's new rule does not change the accounting required by SFAS No. 123R; it changes only the dates for compliance with the standard.

**Note 3 Earnings per Common Share**

Basic earnings per share represents income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if potentially dilutive common shares had all been issued, as well as any adjustment to income that would result from this assumed issuance. Potential common shares that may be issued by the Company relate solely to outstanding stock options and warrants, and are determined using the treasury stock method. As of March 31, 2005, 93,000 outstanding stock options were excluded from this calculation because they are considered antidilutive.

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

|  | Three months ended March 31, |           |
|--|------------------------------|-----------|
|  | 2005                         | 2004      |
|  | (Dollars in 000 s)           |           |
| Net income   | \$ 350,695                   | \$ 55,043 |
| Less: preferred stock dividends  |                              |           |
| Net income applicable to common stock  | \$ 350,695                   | \$ 55,043 |
| Weighted average number of common shares outstanding   | 8,509,841                    | 7,849,078 |
| Effect of dilutive options and warrants  | 139,771                      | 32,224    |
| Weighted average number of common shares outstanding used to calculate diluted earnings per common share | 8,649,612                    | 7,881,302 |

No dividends were declared during the three month periods ended March 31, 2005 or 2004.

## Community Bancshares, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements

(Unaudited)

**Note 4 Stock Based Compensation**

The Company occasionally grants stock options to purchase the Company's common stock to officers and directors. These options have been granted at a strike price equivalent to the deemed current fair value of the Company's common stock on the grant date and have a maximum term of five years. The vesting periods vary among option agreements, but the majority of the options are fully vested at the time of grant. Most of the options with a per share exercise price at or above \$7.00 do not expire following an officer or director's termination. Options with a per share exercise price below \$7.00 terminate at various times ranging from 60 days to one year following an officer or director's termination. As of March 31, 2005, the Company had outstanding options held by officers and directors to purchase an aggregate of 1,935,000 shares of the Company's common stock.

On February 20, 2004, upon the closing of its private placement of common stock, the Company granted to the placement agent in that offering a warrant (the warrant) to purchase 140,187 shares of the Company's common stock at a per share exercise price of \$5.89. The warrant expires on February 20, 2008, and until that date, may be exercised either in cash or pursuant to a cashless exercise.

The following sets forth certain information regarding the outstanding stock options, including the warrant, for the three months ended March 31, 2004 and 2005:

|   | Number of<br>Shares | Weighted Average<br>Exercise Price |
|---|---------------------|------------------------------------|
|   | <u>          </u>   | <u>          </u>                  |
| Balance, December 31, 2003                              | 932,500             | 8.12                               |
| Granted, three months ended March 31, 2004              | 862,687             | 5.45                               |
| Expired or cancelled, three months ended March 31, 2004 | (105,500)           | 13.06                              |
|   | <u>          </u>   |                                    |
| Balance March 31, 2004                                  | (1,689,687)         | 6.44                               |
|   | <u>          </u>   |                                    |
| <b>Balance, December 31, 2004</b>                       | <b>1,577,187</b>    | <b>6.52</b>                        |
| Granted, three months ended March 31, 2005              | 550,000             | 6.81                               |
| Exercised, three months ended March 31, 2005            | (25,000)            | 5.35                               |
| Expired, three months ended March 31, 2005              | (27,000)            | 6.37                               |
|   | <u>          </u>   |                                    |
| <b>Balance, March 31, 2005</b>                          | <b>2,075,187</b>    | <b>6.61</b>                        |
|   | <u>          </u>   |                                    |

The following sets forth stock options outstanding as of March 31, 2005:

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| <u>Exercise Prices</u>                           | <u>Number</u>    | <u>Expiration<br/>Date</u> | <u>Options<br/>Exercisable</u> |
|--|------------------|----------------------------|--------------------------------|
| Options with exercise price of \$7.00            | 590,000          | 2008                       | 590,000                        |
| Options with exercise price of \$7.00            | 142,500          | 2007                       | 142,500                        |
| Options with exercise price of \$10.00           | 88,000           | 2006                       | 88,000                         |
| Options with exercise price of \$18.00           | 5,000            | 2005                       | 5,000                          |
| Options with exercise price of \$5.35            | 477,500          | 2009                       | 477,500                        |
| Options with exercise price of \$5.50            | 50,000           | 2009                       | 50,000                         |
| Options with exercise price of \$5.89 (warrant)  | 140,187          | 2008                       | 140,187                        |
| Options with exercise price of \$7.00            | 30,000           | 2009                       | 30,000                         |
| Options with exercise price of \$7.05            | 5,000            | 2009                       | 5,000                          |
| Options with exercise price of \$6.81            | 547,000          | 2010                       | 547,000                        |
| <b>Total options outstanding, March 31, 2005</b> | <b>2,075,187</b> |                            | <b>2,075,187</b>               |

## Community Bancshares, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements

(Unaudited)

The Company permits option holders to tender previously owned shares in lieu of cash to pay the exercise price for shares acquired through option exercise. This technique results in an increase in the number of shares outstanding with little or no increase in capital account balances. No option holders tendered shares during the three months ended March 31, 2005 or 2004.

The Company accounts for its stock based compensation in accordance with Accounting Principles Board Opinion No. 25 ( APB 25 ), Accounting for Stock Issued to Employees and related interpretations. Generally, stock based compensation expense is not reflected in net income as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. In accordance with Statement of Financial Accounting Standard No. 123 ( SFAS 123 ), Accounting for Stock-Based Compensation, the Company has recorded the warrant to purchase 140,187 shares of the Company's common stock, which was issued at the fair value of the Company's common stock, using the Black-Scholes model to determine a fair value of \$1.73 per share. Since the warrants were issued as compensation for services rendered for the common stock issuance, the related charge resulted in a decrease to additional paid in capital of \$242,524.

Since the majority of the Company's options granted in the three months ended March 31, 2005 and 2004 vest immediately, for purposes of pro forma disclosure, the compensation expense related to these options has been recognized on the grant date. The Company's pro forma information, after giving effect to the deduction for stock-based employee compensation expenses determined under fair value based method for all awards, net of tax, is as follows:

|  | <u>Three months ended March 31,</u> |                     |
|--|-------------------------------------|---------------------|
|  | <u>2005</u>                         | <u>2004</u>         |
| Net income:  |                                     |                     |
| As reported  | \$ 350,695                          | \$ 55,043           |
| Deducts:   |                                     |                     |
| Total stock-based employee compensation expense determined under fair value based method for all awards,<br>net of tax | <u>(1,048,428)</u>                  | <u>(945,400)</u>    |
| Pro forma net income (loss)  | <u>(697,733)</u>                    | <u>\$ (890,357)</u> |
| Basic earnings (loss) per share:   |                                     |                     |
| As reported  | \$ 0.04                             | \$ 0.01             |
| Pro forma  | <u>(0.08)</u>                       | <u>(0.11)</u>       |
| Diluted earnings (loss) per share:   |                                     |                     |
| As reported  | \$ 0.04                             | \$ 0.01             |
| Pro forma  | <u>(0.08)</u>                       | <u>(0.11)</u>       |

The weighted average per share fair values of options granted to employees during the three months ended March 31, 2005 and 2004 were \$3.01 and \$2.13, respectively. The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used:

|                          | <u>2005</u>  | <u>2004</u> |
|--------------------------|--------------|-------------|
| Dividend yield           | <b>0%</b>    | 0%          |
| Expected volatility      | <b>.468</b>  | .403        |
| Risk free interest rate  | <b>2.87%</b> | 3.15%       |
| Expected life (in years) | <b>5</b>     | 5           |



## Community Bancshares, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements

(Unaudited)

**Note 5 On Balance Sheet Derivatives Instruments and Hedging Activities***Accounting for Derivative Instruments and Hedging Activities*

The following table presents the notional and carrying values of the Company's derivative position held for hedging purposes at both March 31, 2005 and December 31, 2004. This derivative position was executed in the over-the-counter market.

|                              | March 31, 2005 |                | December 31, 2004 |                |
|------------------------------|----------------|----------------|-------------------|----------------|
|                              | Notional Value | Carrying Value | Notional Value    | Carrying Value |
| <b>Fair Value Hedges:</b>    |                |                |                   |                |
| Interest rate swap agreement | \$ 20,000,000  | (530,000)      | \$ 20,000,000     | \$ (288,000)   |

*Interest-Rate Risk*

The Company uses derivative instruments to manage the risk of earnings fluctuations caused by interest rate volatility. The effect of interest rate movements on hedged assets or liabilities will generally be offset by the derivative instrument.

*Fair Value Hedges*

The Company entered into an interest rate swap in December 2003 to convert fixed-rate long-term time deposits to a floating rate. The critical terms of the interest rate swap matches the terms of the corresponding time deposits. All components of the derivative instrument's gain or loss are considered in the assessment of hedge effectiveness. There were no fair-value hedging gains or losses as a result of hedge ineffectiveness, recognized during the three months ended March 31, 2005 and 2004. The Company recognized a decrease to interest expense of \$18,621 and \$89,784 for the three months ended March 31, 2005 and 2004, respectively, related to its interest rate swap accounted for as a fair value hedge. At March 31, 2005, the interest rate swap had a remaining term of 2.2 years. Fluctuations in the fair value of derivatives contracts are typically attributable to market risk, and the Company believes that credit risk is relatively low because the Company transacts only with high credit quality counterparties.

**Note 6 Long-term Debt**

*FHLB long-term debt:*

Community Bancshares' wholly owned principal operating subsidiary, Community Bank, is a member of the Federal Home Loan Bank of Atlanta, or the FHLBA, and, since 1999, has been approved to borrow up to \$38.0 million under the FHLBA's Convertible Advance Program. As of March 31, 2005, Community Bank had borrowed the entire \$38.0 million available under this program. These borrowings accrue interest at a fixed rate of 5.93% per annum and have a final maturity of March 1, 2010. These borrowings are subject to a call feature upon every quarterly payment date during the life of the obligation. The first call date for this advance was March 1, 2001, and the advance has not been called to date. These borrowings are secured under a specific lien agreement on both qualifying mortgage instruments in Community Bank's loan portfolio and qualifying securities in the Bank's investment portfolio. Under this lien agreement, in an event of default, the FHLBA may declare all or any part of the indebtedness and accrued interest, including any prepayment fees, to be immediately due and payable. Included in the list of events of default is the situation where the FHLBA reasonably and in good faith determines that a material adverse change has occurred in the financial condition of Community Bank from that disclosed at the time of the making of any advance or from the condition of Community Bank as most recently disclosed to the FHLBA.

**Community Bancshares, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

*Junior subordinated debt:*

The Company currently has one subsidiary business trust, Community (AL) Capital Trust I (the Trust), which has issued:

\$10,000,000 of preferred capital securities, or trust preferred securities, representing undivided beneficial interests in the assets of the Trust, to a third party special purpose company, which in turn pooled the trust preferred securities together with similar securities of other issuers and sold certificates representing interests in that closed-end, unmanaged pool to investors; and the Trust used the proceeds from the sale of the trust preferred securities to the pool to purchase the debentures from the Company; and

\$310,000 of its common securities to the Company, which represent all of the Trust's outstanding common securities.

As guarantor, the Company unconditionally guarantees the payments of all amounts due on the trust preferred securities, which guarantee is limited to the extent the Trust has funds available for payment of distributions. The Company issued and sold to the Trust approximately \$10,310,000 in aggregate principal amount of unsecured junior subordinated debentures, which were issued under an indenture, and which represent the sole assets of the Trust.

Both the debentures and the trust preferred securities accrue and pay interest semiannually at a rate of 10.875% per annum and have a maturity date of March 8, 2030, at which time the principal amount of the debentures becomes due and the trust preferred securities become mandatorily redeemable by the Company. When the Company makes payments to the Trust, as the holder of the debentures, the Trust, in turn, makes payments to the pool, as the holder of the trust preferred securities. The debentures represent the sole asset of the Trust.

The Company adopted FIN 46 as of March 31, 2004. As a result, the Company deconsolidated the Trust because the Company does not absorb a majority of the expected losses or residual returns of the trusts. The Trust was previously consolidated because it is controlled by the Company through a majority voting interest. The effect of such deconsolidation, as portrayed in the following table, was (1) to remove the trust preferred securities from the consolidated balance sheet; (2) to recognize the Company's junior subordinated debt obligation to the Trust; and (3) to recognize the Company's equity investment in the common stock of the Trust. The junior subordinated debt obligation and equity investment was previously eliminated in consolidation. The equity investment, totaling \$310,000, represents the Company's maximum exposure to loss as a result of its involvement with the Trust. The adoption of FIN 46 had no impact on the Company's net income or earnings per share.

The following is a summary of the impact of the adoption of FIN 46 as it related to the Company's December 31, 2004 consolidated balance sheet:

| <b>Balance Prior<br/>To Adjustment</b> | <b>Adjustments<br/>for FIN 46</b> | <b>Adjusted<br/>Balance</b> |
|--|-----------------------------------|-----------------------------|
|--|-----------------------------------|-----------------------------|

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|                            |               |              |               |
|----------------------------|---------------|--------------|---------------|
| Other assets               | \$ 17,378,360 | \$ 310,000   | \$ 17,688,360 |
| Trust preferred securities | 10,000,000    | (10,000,000) |               |
| Junior subordinated debt   |               | 10,310,000   | 10,310,000    |

Under the terms of the indenture governing the debentures, the Company may elect to defer payments of interest due on the debentures for up to ten consecutive semiannual payment periods. The Company elected to defer the March 2002, September 2002, March 2003, September 2003 and March 2004 interest payments, but on September 8, 2004, the Company paid all deferred interest plus the accrued interest thereon totaling \$3,739,490. The accrued interest payable balance on March 31, 2005 was \$69,479.

**Community Bancshares, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

The trust preferred securities are mandatorily redeemable upon their maturity, or upon their earlier redemption as provided in the indenture. Additionally, the Company has the right to redeem the debentures purchased by the Trust:

in whole or in part, on or after, but not at any time before, March 8, 2010; and

in whole, but not in part, at any time within 90 days following the occurrence and during the continuation of a tax-event, capital treatment event or investment company event, as those terms are defined in the indenture.

As specified in the indenture, if the debentures are redeemed prior to maturity, then the redemption price will be a percentage of the principal amount, ranging from 105.438% during the 12 months following March 8, 2010 to 100.00% following March 8, 2010, plus any accrued but unpaid interest due on the debentures at the time of redemption. If the debentures are redeemed prior to March 8, 2010 following a tax event, capital treatment event or investment company event, the redemption price will be the greater of (i) 100% of the principal amount of debentures redeemed, and (ii) the present value of the remaining principal and interest payments between the redemption date and March 8, 2010, plus, in either case, any accrued but unpaid interest due on the debentures at the time of redemption.

**Note 7 Issuance of Common Stock**

During the first quarter of 2004, the Company completed a private placement of its common stock, and upon its completion, the Company had sold a total of 3,738,323 shares of its common stock at a price of \$5.35 per share, resulting in total net proceeds of approximately \$18.3 million, of which 1,586,771 shares for net proceeds of \$7.9 million were sold during the first quarter of 2004. In addition, the Company granted to those investors who initially purchased shares in the offering prior to December 31, 2003, an option to exchange, by December 31, 2008, in whole but not in part, the shares of the Company's common stock purchased in the offering for shares of the Company's newly designated Series 2003 noncumulative preferred stock.

The Series 2003 noncumulative preferred stock has a liquidation preference equal to the aggregate purchase price of the 2,191,897 shares of common stock initially purchased in the offering, and each whole share of the Series 2003 noncumulative preferred stock will have a liquidation preference of \$500,000. The Series 2003 noncumulative preferred stock has, among other things, the following designations:

has terms consistent with the Company's Tier 1 capital treatment for regulatory purposes;

is noncumulative and is not entitled to the payment of, or otherwise accrue, any dividends;

is not entitled to the benefit of any sinking fund or similar arrangement;

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has no preemptive, preferential or other right to purchase, subscribe for or convert into any other of the Company's securities;

is not required to be purchased at any time by the Company;

does not provide registration rights requiring the Company to register the shares of the Series 2003 noncumulative preferred stock;  
and

has no voting power with respect to any Company matters, except in the case of a merger or a significant acquisition or sales transaction, in which case, the Series 2003 noncumulative preferred stock will be entitled to one vote per whole share, and will vote together, as one class, with the holders of our common stock.

The complete terms of the Series 2003 noncumulative preferred stock are set forth in the Certificate of Designation of the Series 2003 Noncumulative Preferred Stock of Community Bancshares, Inc., which the Company has filed with the Secretary of State of the State of Delaware as part of its Certificate of Incorporation, as well as with the SEC in its periodic reports.

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**Community Bancshares, Inc. and Subsidiaries**
**Notes to Consolidated Financial Statements****(Unaudited)**

Community Bank has advisory director boards established in the various markets it serves. These advisory directors are given the option to receive their fees in cash or stock. Common stock issued in lieu of cash for advisory directors' fees during the three months ended March 31, 2004 was 20,720 shares at a fair market value of \$110,550 on the issue date. No common stock was issued for directors' fees during the three month period ended March 31, 2005. Directors' fees are accrued when incurred and the aggregate fair market value of the shares issued is charged to accrued Directors' fees when issued.

During the quarter ended March 31, 2005, 25,000 stock options were exercised at a grant price of \$5.35 per share, resulting in an increase to total stockholders' equity of \$133,750. No stock options were exercised during the quarter ended March 31, 2004.

**Note 8 Pension Plan**

Components of the net periodic benefit cost of the Company's pension plan and benefit restoration plan for the three months ended March 31, 2005 and 2004 are as follows:

|  | March 31, 2005  |                                | March 31, 2004  |                                |
|--|-----------------|--------------------------------|-----------------|--------------------------------|
|  | Pension<br>Plan | Benefit<br>Restoration<br>Plan | Pension<br>Plan | Benefit<br>Restoration<br>Plan |
| Interest cost on earned benefit obligation | \$ 135,547      | \$ 36,682                      | \$ 132,256      | \$ 34,079                      |
| Estimated return on plan assets            | (158,018)       |                                | (137,437)       |                                |
| Amortization of net experience loss        | 31,130          | 1,228                          | 5,922           |                                |
| Net periodic benefit cost                  | <u>\$ 8,659</u> | <u>\$ 37,910</u>               | <u>\$ 741</u>   | <u>\$ 34,079</u>               |

The Company contributed \$783,061 to the pension plan during the first quarter of 2005 and expects to contribute an additional \$1,900,347 during the second quarter in 2005.

**Note 9 Contingencies****Background**

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At a June 20, 2000 meeting of the board of directors of Community Bank, one of Community Bank's directors brought to the attention of the board of directors the total amount of money that Community Bank had paid to subcontractors in connection with the construction of a new Community Bank branch office in Guntersville, Alabama. Questions were subsequently raised about a number of Community Bank construction projects. A joint committee of the boards of directors of Community Bancshares and Community Bank conducted an investigation as did law enforcement and bank regulatory authorities. Following these investigations, the boards of directors terminated the employment of Kennon R. Patterson, Sr., former Chairman, President and Chief Executive Officer of Community Bancshares and Chairman and Chief Executive Officer of Community Bank, and Larry Bishop, former Vice President of Community Bank and the FDIC commenced administrative proceedings against Mr. Patterson and Mr. Bishop, which are still pending. On March 10, 2005, Mr. Patterson and Mr. Bishop were convicted in the United States District Court for the Northern District of Alabama of conspiracy, bank fraud and causing false entries to be made in bank records. Mr. Patterson was also convicted of filing false income tax returns. Sentencing of these individuals has not yet been set.

### **Patterson Employment Litigation**

Plaintiffs: Community Bancshares, Inc. and Community Bank

Defendants: Kennon R. Patterson, Sr., Community Bancshares former Chairman, President and Chief Executive Officer

On September 14, 2004, Community Bancshares and Community Bank filed suit against Mr. Patterson in the Circuit Court of Blount County, Alabama. Community Bancshares and Community Bank's complaint:

alleges that Mr. Patterson breached his employment agreement with Community Bancshares by failing to faithfully perform the duties assigned to him;



**Community Bancshares, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

alleges that Mr. Patterson made fraudulent misrepresentations to, or suppressed material information from, Community Bancshares and Community Bank and/or their officers, directors and agents concerning his bankruptcy, the release of mortgages which Community Bank held on his house, and payments made by Community Bancshares and Community Bank to companies owned by Mr. Patterson and members of his family;

alleges that Mr. Patterson removed property belonging to Community Bancshares and Community Bank following the termination of his employment; and

alleges that Mr. Patterson breached a duty of loyalty and other fiduciary duties owed to Community Bancshares and Community Bank.

On October 18, 2004, Mr. Patterson filed an answer and counterclaim against Community Bancshares and Community Bank. Mr. Patterson's counterclaim:

alleges that Community Bancshares breached its employment agreement with Mr. Patterson by terminating his employment;

alleges that Community Bancshares failed to pay to Mr. Patterson compensation and benefits of \$2.4 million which had allegedly accrued prior to the termination of his employment;

alleges that Community Bank intentionally interfered with the employment contract between Mr. Patterson and Community Bancshares by instigating, promoting, assisting in and participating in the termination of Mr. Patterson's employment agreement; and

alleges that Community Bancshares falsely represented to Mr. Patterson that his employment would not be terminated until March 31, 2008.

On January 25, 2005, Mr. Patterson filed a third-party complaint in this lawsuit against R.B. Jackson, Jimmie Trotter, Glynn Debter, John J. Lewis, Jr., Patrick M. Frawley and Powell, Goldstein, Frazer & Murphy, LLP. The third-party complaint alleges that Messrs. Jackson, Trotter, Debter and Lewis, as members of Community Bank's Audit Committee, Powell, Goldstein, Frazier & Murphy, LLP, as the independent counsel for Community Bank's Audit Committee, and Mr. Frawley, acting individually and in concert with one another, interfered with Mr. Patterson's employment agreement with Community Bancshares.

**Patterson ESOP Litigation**

Plaintiffs: Community Bancshares, Inc. Employee Stock Ownership Plan (the "ESOP") and North Star Trust Company, as Trustee of the ESOP

Defendants: Kennon R. Patterson, Sr., Community Bancshares' former Chairman, President and Chief Executive Officer

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On March 15, 2004, the Employee Stock Ownership Plan, or ESOP, of Community Bancshares, together with the ESOP trustee, North Star Trust Company, filed suit against Mr. Patterson in the United States District Court for the Northern District of Alabama. The ESOP's complaint:

alleges that Mr. Patterson breached his fiduciary duty to the ESOP by engaging in activities which adversely affected the value of the Community Bancshares stock held by the ESOP and concealing information with respect to those activities from other ESOP fiduciaries; and

**Community Bancshares, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

seeks a declaratory judgment that Mr. Patterson is not entitled to a distribution of his accrued benefits in the ESOP and that such benefits may be held and used to offset the damages which the ESOP suffered as a result of Mr. Patterson's alleged breach of fiduciary duty.

On July 7, 2004, the Court denied Mr. Patterson's motion to dismiss the case. On or about July 23, 2004, Mr. Patterson filed a counterclaim seeking a judgment that he is entitled to benefits from the ESOP and declaratory and injunctive relief compelling the payment of such benefits. On July 26, 2004 the Court, at Mr. Patterson's request, stayed discovery in the case pending Mr. Patterson's trial on criminal charges.

**Patterson Benefit Restoration Plan Litigation**

Plaintiff: Kennon R. Patterson, Sr.

Defendant: Community Bancshares, Inc. Benefit Restoration Plan

On February 17, 2005, Mr. Patterson filed suit in the United States District Court for the Northern District of Alabama to compel payment of his accrued benefits under the Community Bancshares, Inc. Benefit Restoration Plan, a nonqualified supplemental retirement plan. The complaint seeks a judgment against the plan and an order compelling the payment of benefits.

**Benson Litigation**

Plaintiffs: M. Lewis Benson, Doris E. Benson, John M. Packard, Jr. and Andy C. Mann, four of Community Bancshares' stockholders

Defendants: Community Bancshares, Community Bank, certain of the present and former directors of Community Bancshares and Community Bank, an employee of Community Bank and two construction subcontractors previously hired by the Company

On January 31, 2005, the Circuit Court of Blount County, Alabama approved a pro tanto settlement of the Benson and Packard shareholder derivative lawsuits. These lawsuits alleged, among other things, that the members of the Boards of Directors of Community Bancshares and Community Bank breached their fiduciary duties with respect to supervision of construction projects and the investigation of allegations of impropriety with respect to such projects. Pursuant to the pro tanto settlement, Community Bancshares and Community Bank received a total of \$625,000, and the defendants who were current or former directors or officers of Community Bancshares or Community Bank, except for Kennon R. Patterson, Sr., were dismissed from the lawsuits. Community Bancshares and Community Bank have been realigned as plaintiffs in the lawsuits against the remaining defendants.

**Packard Derivative Litigation**

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Plaintiffs: M. Lewis Benson, Doris E. Benson, John M. Packard, Jr. and Andy C. Mann, four of Community Bancshares stockholders

Defendants: Sheffield Electrical Contractors, Inc., Steve Sheffield, Jay Bolden, Dudley, Hopton-Jones, Sims & Freeman, PLLP, Glynn C. Debter, Kennon R. Patterson, Jr., Robert O. Summerford, Jimmie A. Trotter, John L. Lewis, Jr., Merritt M. Robbins, Stacey W. Mann, B. K. Walker, Jr., Denny Kelly, Roy B. Jackson, Loy D. McGruder, and Hodge Patterson

On January 31, 2005, the Circuit Court of Blount County, Alabama approved a pro tanto settlement of the Benson and Packard shareholder derivative lawsuits. These lawsuits alleged, among other things, that the members of the Boards of Directors of Community Bancshares and Community Bank breached their fiduciary duties with respect to supervision of construction projects and the investigation of allegations of impropriety with respect to such projects. Pursuant to the pro tanto settlement, Community Bancshares and Community Bank received a total of \$625,000, and the defendants who were current or former directors or officers of Community Bancshares or Community Bank, except for Kennon R. Patterson, Sr., were dismissed from the lawsuits. Community Bancshares and Community Bank have been realigned as plaintiffs in the lawsuits against the remaining defendants.

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**Community Bancshares, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

**Lending Acts Litigation**

**Plaintiffs:** William Alston, Murphy Howard, and Jason Tittle

**Defendants:** Community Bancshares, Community Bank, Holsombeck Motors, Inc., Lee Brown d/b/a Alabama Bond & Investigation a/k/a ABI Recovery, Chris Holmes d/b/a Alabama Bond & Investigation a/k/a ABI Recovery, Regina Holsombeck, Kennon Ken Patterson, Sr., Hodge Patterson, James Timothy Tim Hodge, Ernie Stephens, and the State of Alabama Department of Revenue

On October 11, 2002, the plaintiffs filed a class action against the defendants alleging that Community Bank and others conspired or used extortionate methods to effect a lending scheme of churning phantom loans, and that profits from the scheme were used to secure an interest in and/or to invest in an enterprise that affects interstate commerce. The plaintiffs specifically allege that Community Bank used various methods to get uneducated customers with fair to poor credit to sign numerous phantom loans when the customers only intended to sign for one loan. Claims include racketeering activity within the meaning of the Racketeer Influenced and Corrupt Organizations Act of 1970, conspiracy, spoliation, conversion, negligence, wantonness, outrage, and civil conspiracy.

On or about February 17, 2004, an amended complaint was filed in this lending acts litigation. The amended complaint, which completely replaces the original complaint, omits class action and racketeering claims and alleges violations of the Truth in Lending Act and Regulation Z of the Federal Reserve Board in addition to conversion, negligence, outrage, suppression, fraud and misrepresentation, trespass, conspiracy and failure to provide notice before disposition of collateral for loans. On April 2, 2004, eighty-one individuals, most of whom were formerly members of the purported class in the lending acts litigation filed by William Alston, filed suit against Community Bancshares, Community Bank and a former Community Bank employee in the Circuit Court of Jefferson County, Alabama. This suit claims that the defendants injured the plaintiffs, primarily in connection with lending at Community Bank's office in Double Springs, Alabama, by wrongfully taking property, committing fraud, furnishing inaccurate information to credit reporting agencies, negligently hiring, training and supervising employees, negligently handling customer accounts, altering loan documents and failing to honor oral and written contracts with the plaintiffs.

On February 2, 2005, Community Bancshares and Community Bank settled the claims of Mr. Alston and Mr. Howard for amounts which are not material to the financial statements of Community Bancshares. On March 29, 2005, Community Bancshares and Community Bank settled the claims of Mr. Tittle for an amount which is not material to the financial statements of Community Bancshares. Claims of the other plaintiffs are still pending.

**Employee Litigation**

**Plaintiffs:** Bishop K. Walker, Jr., former Senior Executive Vice President and General Counsel of Community Bancshares, and his wife, Wanda Walker, and Denny G. Kelly, former President of Community Bank, and his wife, Arlene Kelly

**Defendants:** Community Bancshares, Community Bank, Kennon R. Patterson, Sr., and a number of unidentified defendants

On May 5, 2003, the plaintiffs filed separate suits in the Circuit Court of Blount County, Alabama, against the defendants alleging that they were induced to retire based upon misrepresentations made by Kennon R. Patterson, Sr., who at the time was Community Bancshares' Chairman,

President and Chief Executive Officer. The plaintiffs claim that Mr. Patterson's actions constituted fraud, promissory fraud, fraudulent suppression, fraud in the inducement, deceit, fraudulent deceit, negligence, recklessness, wantonness and breach of contract. The complaints seek an unspecified amount of compensatory and punitive damages.

**Community Bancshares, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

On October 23, 2003, Community Bancshares and Community Bank filed counterclaims against Mr. Walker and Mr. Kelly seeking repayment of amounts paid to them as part of a severance arrangement and, in the case of Mr. Kelly, amounts owed to Community Bank in connection with the two loans from Community Bank to Mr. Kelly.

Mr. Kelly and Mr. Walker each filed an amended complaint on or about April 20, 2004. The amended complaints add Mrs. Kelly and Mrs. Walker as parties plaintiff and allege that representations were made by the defendants to Mrs. Kelly and Mrs. Walker that the defendants would purchase their personal and jointly owned stock of the Company. The complaints assert that the defendants' failure to purchase such stock constitutes promissory fraud, fraudulent misrepresentation, fraudulent suppression, negligence and/or wantonness. Mr. Walker's amended complaint also seeks damages based on Community Bank's refusal to accept a deed in lieu of foreclosure on Mr. Walker's home. On June 15, 2004, Community Bank amended its counterclaim against Mr. Walker to recover a loan deficiency balance following Community Bank's foreclosure on Mr. Walker's home.

**Other Litigation**

In addition to the foregoing, Community Bancshares and its affiliates also are from time to time parties to other legal proceedings arising in the ordinary course of Community Bancshares' business. We presently believe that, other than the litigation discussed above, there is no other litigation to which Community Bancshares or its affiliates presently are party that, if such litigation were to result in an outcome unfavorable to Community Bancshares, would, individually or in the aggregate, have a material adverse effect on our financial condition or results of operations.

Our certificate of incorporation and bylaws provide that, in certain circumstances, we will indemnify our directors and officers, and, provided such persons acted in accordance with the standards set forth in the Delaware General Corporation Law and our organizational documents, advance expenses to our directors and officers in connection with investigations and proceedings in connection with their service as officers and directors.

**Contingency Losses**

In all claims against the Company, management has assessed where losses are both probable and can be reasonably estimated. As of March 31, 2005, \$302,021 was accrued for contingency losses and is reported in other liabilities on the Company's balance sheet. Management believes this reserve is warranted based on the status of pending litigation and settlements.

**Note 10 Subsequent Events**

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On April 29, 2005, Community Bank purchased certain mortgage assets from American Family Mortgage, LLC. Under the terms of the transaction, Community Bank acquired mortgage assets including, without limitation, all of American Family Mortgage's mortgage loans, pipeline mortgage loans and fixed assets as well as ownership of the American Family Mortgage name. As consideration in the transaction, Community Bank paid an aggregate purchase price of approximately \$1,000,000, consisting of \$750,000 in cash, subject to certain escrow provisions and contingencies, and an additional \$250,000 to be paid over three years subject to certain performance criteria.

During April 2005, Community Bank entered into two contracts to purchase real estate in Huntsville, Alabama. The first is an agreement for Community Bank to purchase a bank building located at 312 Clinton Avenue for a total purchase price of \$2,000,500. Earnest money of \$100,000 was delivered to the escrow agent upon signing the agreement. The second is an agreement to purchase one acre of land located in the commercial development Paramount East on Highway 72 West for a total purchase price \$653,627. Earnest money of \$10,000 was delivered to the escrow agent upon signing the agreement.



**IMPORTANT INFORMATION ABOUT THIS REPORT**

In this Quarterly Report on Form 10-Q, which we refer to as this Report, the words Company, we, us and our refer to the combined entities of Community Bancshares, Inc., Community Bank, 1<sup>st</sup> Community Credit Corporation, Community Insurance Corp., Southern Select Insurance, Inc., Community Appraisals, Inc., and Community Funding Corporation.

The words Community Bancshares, Community Bank, Community Credit, Community Insurance, Southern Select, Community Appraisals, and Community Funding refer to each of those entities individually.

**SPECIAL CAUTIONARY NOTICE**

**REGARDING FORWARD-LOOKING STATEMENTS**

Certain statements made or incorporated by reference in this Report are forward-looking statements within the meaning of, and subject to the protections of, Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, or the Exchange Act.

Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, anticipations, assumptions, estimates, intentions, and future performance, and involve known and unknown risks, uncertainties and other factors, many of which may be beyond our control, and which may cause our actual results, performance or achievements to be materially different from future results, performance or achievements expressed or implied by the forward-looking statements.

All statements other than statements of historical fact are statements that could be forward-looking statements. You can identify these forward-looking statements through our use of words such as may, will, anticipate, hope, project, assume, should, indicate, would, contemplate, expect, estimate, continue, plan, point to, could, intend, seek, target, and other similar words and expressions of forward looking statements include, without limitation, statements regarding:

our business strategy, including our entry into new markets;

future performance, developments, transactions or market forecasts;

projected benefits to us as a result of any changes in our regulatory restrictions; and

projected investments and disposition of assets.

The forward-looking statements may not be realized due to a variety of factors, including, without limitation:

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future economic or business conditions;

governmental monetary and fiscal policies, as well as legislative and regulatory changes, including changes in tax laws and regulations;

the risks of changes in interest rates on the levels, composition and costs of deposits, loan demand, and the values of loan collateral, securities, and interest sensitive assets and liabilities;

interest rate risks and credit risks of borrowers;

the effects of competition from a wide variety of local, regional, national and other providers of financial, investment and insurance services;

our potential inability to successfully enter into new markets or to realize the expected benefits of entering into those new markets;

our potential inability to successfully implement our strategic plan;

the failure of assumptions underlying the establishment of the allowance for loan losses and other estimates, and the uncertainty and costs of litigation;

our potential inability to realize the expected operational and financial benefits resulting from our improved regulatory standing and the elimination of some of the litigation in which we have been involved;

the risks of mergers, acquisitions and divestures, including, without limitation, the related time and costs of implementing such transactions, and the possible failure to achieve expected gains, revenue growth and/or expense savings expected from such transactions;

changes in accounting policies, rules and practices;

difficulties with, or changes in the cost or effectiveness of, technology and/or products;

the effects of war or other conflict, acts of terrorism or other catastrophic events that affect general economic conditions; and

other factors and other information discussed in this Report, as well as other factors and risks described in any of our other reports that we make with the SEC under the Exchange Act.

All written or oral statements that are made by or are attributable to us are expressly qualified in their entirety by this cautionary notice. We have no obligation and do not undertake to update, revise or correct any of the forward-looking statements after the date of this Report, or after the respective dates on which such statements otherwise are made.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

This discussion is intended to assist in an understanding of the financial condition and results of operations of Community Bancshares, Inc. and its subsidiaries. Unless the context otherwise clearly indicates, the term "Company" includes Community Bancshares, Inc. and its subsidiaries, and the terms "Bank" and "Community Bank" refer to Community Bank, the Company's wholly-owned commercial banking subsidiary. This analysis should be read in conjunction with the unaudited financial statements and related notes appearing in Item 1 of this Report and the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations," and the notes to consolidated financial statements, appearing in the Company's Annual Report on Form 10-K for the year ended December 31, 2004.

**Overview**

We conduct our operations, which consist primarily of traditional commercial banking operations, through Community Bank and its subsidiaries. Through Community Bank, we provide a full range of banking services to individual and corporate customers in five counties in north Alabama—Blount, Lauderdale, Limestone, Madison and Morgan Counties; two counties in northwest Alabama—Marion and Winston Counties; and two counties in southwest Alabama—Marengo and Perry Counties. The retail nature of Community Bank's commercial banking operations allows for diversification of depositors and borrowers, and Community Bank's management believes it is not dependent upon a single or a few customers. Community Bank does not have a significant portion of commercial banking loans concentrated within a single industry or group of related industries. Also, we do not consider our commercial banking operations to be seasonal in nature.

During 2004, many positive developments occurred at our Company. A summary of several key 2004 developments include:

following our December 2003 private placement of \$10.4 million of our common stock, we sold an additional \$7.9 million of our common stock in an extension of that private placement during February 2004, which capital infusions provided the resources necessary to continue execution of the Bank's recovery, rehabilitation, and growth strategies;

a \$13.3 million improvement in net income, primarily as a result of improved non-interest expenses as well as reductions in the loan loss provision;

significant improvement in asset quality, driven by improved credit risk management and the sale of \$18.0 million in poor quality loans;

after the elimination of various legal entanglements, the foreclosure on our largest single loan (\$5.2 million) providing us the ability to market and liquidate the collateral securing this problem asset;

the resolution of certain shareholder related litigation for which we have incurred significant legal fees over the past several years;

the settlement of a fidelity bond claim/litigation resulting in a \$450,000 payment to the Company; and

improved regulatory relations and results.

During the first quarter of 2005, additional positive developments for the Company occurred. These include:

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Approval of the settlement of the Benson and Packard derivative lawsuits on January 31, 2005, resulting in a \$625,000 payment to the Company;

The conviction of our former Chairman, Kennon R. Patterson, Sr. on March 11, 2005, on 15 counts of conspiracy to commit fraud, bank fraud, false entries in bank records and filing false income tax returns, among others, which we view as another positive development for the Company's image and future prospects; and

Notice during March, 2005 from the FDIC, the Federal Reserve Bank of Atlanta, and the Alabama State Banking Department that all regulatory agreements, memoranda, plans and/or orders have been terminated, which actions we expect to:

substantially reduce costs associated with complying with these regulatory restrictions;

substantially reduce our FDIC insurance expense (by an estimated \$400,000 per year);

improve liquidity as a result of lower pledging requirements on public funds;

ease collateral requirements on FHLB borrowings;

enable us to expand more freely into growth markets;

allow us to expand correspondent and vendor relationships; and

enable us to continue to attract qualified, experienced management and board members.

Management believes the combined effect of these developments helps position the Company to better strive towards a renewed focus on customer attraction and retention, improved marketing of competitive products and services, expansion into higher growth markets, and management of an improved balance sheet.

As mentioned previously, we completed a private placement of our common stock in early 2004. During the fourth quarter of 2003, we commenced a private placement of our common stock, and, as of December 31, 2003, we had sold 2,151,552 shares of our common stock at a price of \$5.35 per share, resulting in net proceeds of approximately \$10.4 million. In addition, we granted to those investors who purchased shares in the offering prior to December 31, 2003, as well as to one investor who purchased an additional 40,345 shares after December 31, 2003, an option to exchange by December 31, 2008, in whole but not in part, the shares of our common stock purchased in the offering for shares of our designated Series 2003 noncumulative preferred stock. The Series 2003 noncumulative preferred stock has a liquidation preference equal to the aggregate purchase price of the 2,191,897 shares of common stock initially purchased in the offering, and each whole share of the Series 2003 noncumulative preferred stock will have a liquidation preference of \$500,000. We completed the private placement on February 20, 2004, selling an additional 1,586,771 shares of our common stock at a price of \$5.35 per share after December 31, 2003, for \$7.9 million of additional net proceeds, resulting in the sale of a total of 3,738,323 shares for total net proceeds from the offering of \$18.3 million.

In connection with the offering, the Company entered into an engagement letter with FIG Partners, L.L.C., an affiliate of Burke Capital Group, L.L.C., pursuant to which FIG Partners agreed to serve as placement agent for the offering, and the Company agreed to grant to FIG Partners, upon the closing of the offering, a warrant to purchase shares of the Company's common stock. Upon the closing of the offering on February 20, 2004, the Company granted FIG Partners a warrant to purchase up to 140,187 shares of the Company's common stock at an exercise price of \$5.89 per share. The warrant expires on February 20, 2008, and, until that date, may be exercised either in cash or pursuant to a cashless exercise.

### **Primary Sources of Revenues and Expenses**

#### *Net Interest Income*

While Community Bank provides most traditional banking services, its principal activities as a community bank are the taking of demand and time deposits and the making of secured and unsecured consumer loans and commercial loans in its markets. As a result, our principal source of revenue is net interest income at Community Bank. Net interest income is the difference between:

income we receive on our interest-earning assets, such as investment securities and loans; and

payments we make on our interest-bearing sources of funds, such as deposits and borrowings.

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The level of net interest income is determined primarily by the average balances, or volume, of interest-earning assets and the various rate spreads between the interest-earning assets and our funding sources. Changes in our net interest income from period to period result from, among other things:

increases or decreases in the volumes of interest-earning assets and interest-bearing liabilities;

increases or decreases in the average rates earned and paid on those assets and liabilities;

our ability to manage the interest-earning asset portfolio, which includes loans;

the availability and costs of particular sources of funds, such as non-interest bearing deposits; and

our ability to match our liabilities to fund our assets.

### *Net Noninterest Income*

Our net noninterest revenues consist primarily of:

service charges on customer deposit accounts;

insurance commissions;

securities gains or losses; and

other service fees charged to customers.

Our net noninterest expenses consist primarily of:

salaries and employee benefits;

costs to hold and maintain premises and equipment;

insurance;

director and committee fees;

professional service fees, especially legal and accounting; and

cost of foreclosed assets.

### **Critical Accounting Policies**

Our accounting policies are established in accordance with accounting principles generally accepted in the United States, or "GAAP", and general practices within our industry. The application of certain of these accounting policies involves a significant amount of judgment as well as the use of estimates and assumptions based upon information that we have at the time of these judgments. These estimates and judgments involve significant uncertainties, and are susceptible to change. If different assumptions or conditions were to prevail, depending upon the magnitude of any discrepancies from our estimates and judgments, then our financial condition and results of operations may prove to be materially different from the presentation herein.

We recognize the following as our critical accounting policies:

*Accounting for Allowance for Loan Losses.* We analyze our loan portfolio to determine the adequacy of allowance for loan losses and the appropriate provision required to maintain a level that we consider to be adequate to absorb anticipated loan losses. When we believe that the collection of the principal of a loan is unlikely, that loan is charged off against the allowance for loan losses. Subsequent recoveries of principal on that loan are added back to the allowance for loan losses. Our evaluation of the adequacy of the allowance for loan losses is based on a formal analysis that assesses the risks within the loan portfolio. Among other factors that we consider are the following:

our past loan loss experience;

known and inherent risks in the loan portfolio, including past due and nonperforming loans;

adverse situations that may affect the borrowers' ability to repay those loans;

the estimated value of any underlying collateral;

our internal loan reviews;

the reviews of regulators; and

an analysis of current economic conditions.

The consideration and application of many of these factors involve assumptions, estimates and judgments that are inherently uncertain and are subject to change. We believe that the allowance for loan losses was adequate at March 31, 2005, based upon the information that was available to us at that time. While we use available information to recognize losses on loans, future additions to the allowance for loan losses may be necessary based on economic changes and changes to various borrowers. Certain economic and interest rate factors could have a material effect on the determination of the allowance for loan losses. Our allowance for loan losses is also subject to regulatory examinations and determinations as to adequacy, which may take into account such factors as the methodology used to calculate the allowance for loan losses and the size of the allowance for loan losses in comparison to a group of peer banks identified by our regulators. During their routine examinations of banks, the Federal Deposit Insurance Corporation and the Alabama State Banking Department may require us to make additional provisions to our allowance for loan losses where, in the opinion of the regulators, credit evaluations and allowance for loan loss methodology differ materially from ours.



*Accounting for Income Taxes.* We use the asset and liability method of accounting for income taxes. Our determination of the deferred and current provision for income taxes requires analysis of certain transactions and the related tax laws and regulations applicable to those transactions. We exercise significant judgment in evaluating the amount and timing of the recognition of the resulting tax liabilities and assets. Our judgments and estimates are re-evaluated on a continual basis as regulatory and business factors change. However, because our judgments and estimates are inherently subjective and subject to change, there can be no assurance that our determination of the provision for income taxes will not be changed, upward or downward, in future periods.

*Accounting for Contingencies.* Statement of Financial Accounting Standard No. 5 ( SFAS 5 ), Accounting for Contingencies, defines a contingency as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss. It will ultimately be resolved when one or more future events occur or fail to occur. SFAS 5 defines the different levels of probability as to whether or not future events will confirm the existence of a loss as follows:

probable meaning that the future event or events are likely to occur;

reasonably possible meaning that the chance of the future event or events occurring is more than remote but less than likely; or

remote meaning that the chance of the future event or events is slight.

Professional judgment is required to classify the likelihood of the future events occurring. In assessing these levels of probability, we acquire all relevant information concerning the uncertain set of circumstances. An accrual of a loss occurs when it is both probable that an asset has been impaired or a liability has been incurred and when the amount of loss can be reasonably estimated.

As discussed in Note 9 to our consolidated financial statements, legal proceedings are pending or threatened against us, our subsidiaries as well as their respective indemnities. Except as discussed in Note 9:

we have not concluded that it is probable that a loss has been incurred in any pending litigation;

we are unable to make a meaningful estimate of the amount or range of loss that could result from an unfavorable outcome of pending litigation; and

accordingly, we have not provided any amounts in the consolidated financial statements for unfavorable outcome, if any.

As discussed in Note 9, as of December 31, 2003, we had accrued \$2.5 million for potential losses on pending litigation, where in our best judgment, losses were both probable and reasonably estimated. The estimates were based on current circumstances of pending matters. As of March 31, 2005, \$302,021 of this reserve remained and is reported in other liabilities on our balance sheet. We believe this reserve is warranted and adequate based on the status of pending settlements as of March 31, 2005.

The present litigation environment, though improved, is substantially uncertain, and it is possible that our consolidated results of operations, cash flows or financial position could be materially affected by unfavorable outcomes or settlements of certain pending litigation. All such cases are, and will continue to be, vigorously defended. However, we and our subsidiaries may enter into discussions in an attempt to settle particular cases if it is in the best interests of our stockholders to do so.

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*Accounting for Impaired Assets.* Statement of Financial Accounting Standard No. 144 ( SFAS 144 ), Accounting for the Impairment or Disposal of Long-Lived Assets, requires that long-lived assets which are to be sold be classified as held for sale when certain criteria are met. A long-lived asset classified as held for sale is measured at the lower of its carrying amount or fair value less cost to sell and no longer depreciated while it is classified as held for sale. We used estimates in determining the fair values of assets classified as held for sale and, although we believe the fair values established are reasonable, it is possible that our results of operations, cash flows or financial position could be materially affected by the eventual sale of the assets.

## FINANCIAL CONDITION

### As of March 31, 2005 compared to December 31, 2004

#### General

The Company's total assets at March 31, 2005 were \$547.4 million, a decrease of \$6.0 million, or 1.1%, from \$553.4 million at December 31, 2004. The Company experienced an increase in loans, net of allowance for loan losses, of \$4.4 million, or 1.5%, during the first three months of 2005. The Company experienced a decline in deposits during the first three months of 2005 of \$5.9 million, or 1.3%. Noninterest-bearing deposits decreased \$6.2 million, or 8.8%, from December 31, 2004 to March 31, 2005, and interest-bearing deposits have increased by \$0.3 million, or .08%.

#### Earning Assets

The earning assets of the Company principally are comprised of:

loans;

investment securities;

interest-bearing balances in other banks; and

federal funds sold.

The Company's investment securities portfolio is used by the Company to make various term investments, to provide a source of liquidity for the Company and to serve as collateral to secure certain deposits. The fair value of the Company's investment securities increased \$1.8 million, or 1.2%, to \$149.0 million at March 31, 2005, from \$147.2 million at December 31, 2004. The Company also maintains short-term investments in the form of interest-bearing deposits with other banks. These interest-bearing deposits with other banks amounted to \$3.7 million at March 31, 2005, compared to \$5.4 million at December 31, 2004 representing a decrease of \$1.7 million, or 3.1%. At March 31, 2005, the Company had \$17.6 million in federal funds sold, compared to \$13.5 million at December 31, 2004, representing an increase of \$4.1 million, or 30.4%.

Total cash due from banks decreased \$12.2 million, or 23.2%, during the first three months of 2005, from \$52.5 million at December 31, 2004 to \$40.3 million at March 31, 2005, as cash received in December 2004 from the sale of poor quality loans was reinvested into higher quality loans and investment securities in early 2005.

Loans comprise the largest single category of the Company's earning assets. Loans, net of unearned income, but before the allowance for loan losses, were \$304.8 million at March 31, 2005, which represented an increase of approximately \$4.4 million, or 1.5%, from \$300.4 million at

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December 31, 2004. We believe that balance sheet growth, achieved through the growth of total loans, is integral to the Company's profitability. In order to achieve this growth, we presently expect to expand our business into demographically attractive markets that we currently do not serve.

### Nonperforming Assets and Past Due Loans

The Company's nonperforming assets primarily are comprised of:

nonaccruing loans;

loans 90 days past due or greater;

restructured loans;

nonaccruing securities; and

other real estate owned.

Between December 31, 2004 and March 31, 2005, the Company's ratio of the allowance for loan losses to these total nonperforming assets increased from 36.22% to 36.44%, and has decreased significantly from 52.61% at March 31, 2004. The decrease from March 31, 2004 occurred as poor quality loans which carried higher allowances were sold in the fourth quarter of 2004 coupled with the increase in other real estate owned which generally carry no allowance. The ratio of total nonperforming assets to total assets decreased to 2.30% at March 31, 2005, from 2.31% at year-end 2004, while the ratio of nonperforming loans to total loans, net of unearned income, increased to 0.77% at March 31, 2005 from 0.55% at December 31, 2004. Total nonperforming assets decreased \$0.2 million, or 1.6%, to \$12.6 million at March 31, 2005, from total nonperforming assets of \$12.8 million at December 31, 2004.

The following table summarizes the Company's nonperforming assets at March 31, 2005 and 2004, as well as December 31, 2004.

### NONPERFORMING ASSETS

(Dollars in 000 s)

|   | March 31,        |                  | December 31,     |
|---|------------------|------------------|------------------|
|   | 2005             | 2004             | 2004             |
| (Dollars in thousands)  |                  |                  |                  |
| Nonaccruing loans   | \$ 1,799         | \$ 11,288        | \$ 1,115         |
| Loans past due 90 days or more                                    | 296              | 134              | 290              |
| Restructured loans  | 237              | 2,360            | 238              |
| <b>Total nonperforming loans</b>                                  | <b>2,332</b>     | <b>13,782</b>    | <b>1,643</b>     |
| Other real estate owned   | 10,261           | 7,571            | 11,126           |
| <b>Total nonperforming assets</b>                                 | <b>\$ 12,593</b> | <b>\$ 21,353</b> | <b>\$ 12,769</b> |
| <b>Ratios:</b>  |                  |                  |                  |
| Allowance for loan losses to loans, net of unearned income        | 1.51%            | 3.64%            | 1.54%            |
| Allowance for loan losses to total nonperforming assets           | 36.44            | 52.61            | 36.22            |
| Total nonperforming loans to total loans (net of unearned income) | 0.77             | 4.47             | 0.55             |
| Total nonperforming assets to total assets                        | 2.30             | 3.80             | 2.31             |

### Funding and Other Debt Obligations

The Company's primary sources of funding are from the deposits of customers of Community Bank and from the Company's short-term and long-term borrowings. Total deposits of \$442.7 million at March 31, 2005 reflected a decrease of \$5.9 million, or 1.3%, from total deposits of \$448.6 million at year-end 2004 due to decreases in noninterest-bearing deposits. Noninterest-bearing deposits decreased \$6.2 million, or 8.8%, to \$64.1 million at March 31, 2005, from \$70.3 million at December 31, 2004, while interest-bearing deposits increased \$0.3 million, or 0.1%, to \$378.6 million at March 31, 2005, from \$378.3 million at December 31, 2004. Total short-term borrowings decreased \$70,000, or 11.3%, to \$551,000 at March 31, 2005 from \$621,000 at December 31, 2004.

On May 6, 2004, Community Bancshares, Inc. established a line of credit with First Commercial Bank in the amount of \$3,000,000. The rate on any used portion of the line of credit is the prime rate plus 50 basis points. The line of credit will mature on May 1, 2009, and only interest is due on outstanding amounts for two years, with principal payments to begin thereafter. At March 31, 2005, there was no balance outstanding on this line of credit.

Community Bank is a member of the Federal Home Loan Bank of Atlanta, or the FHLBA, and, since 1999, has been approved to borrow up to \$38.0 million under the FHLBA's Convertible Advance Program. As of March 31, 2005, Community Bank had borrowed the entire \$38.0 million available under this program. These borrowings accrue interest at a fixed rate of 5.93% per annum and have a final maturity of March 1, 2010. These borrowings are subject to a call feature upon every quarterly payment date during the life of the obligation. The first call date for this advance was March 1, 2001, and the advance has not been called to date. These borrowings are secured under a blanket lien agreement on qualifying mortgage instruments in Community Bank's loan and investment portfolios. Under this lien agreement, in an event of default, the

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FHLBA may declare all or any part of the indebtedness and accrued interest, including any prepayment fees, to be immediately due and payable. Included in the list of events of default is the situation where the FHLBA reasonably and in good faith determines that a material adverse change has occurred in the financial condition of Community Bank from that disclosed at the time of the making of any advance or from the condition of Community Bank as most recently disclosed to the FHLBA. The Company's FHLBA long-term debt remained constant at \$38.0 million for both March 31, 2005 and December 31, 2004.

In March 2000, the Company completed an offering of \$10.0 million of trust preferred securities, pursuant to which:

the Company organized a Delaware statutory business trust called Community (AL) Capital Trust I, or the Trust, governed by an Amended and Restated Declaration of Trust;

the Company issued and sold to the Trust approximately \$10.3 million in aggregate principal amount of unsecured junior subordinated debentures, or debentures, which were issued under an Indenture, and which represent the sole assets of the Trust;

the Trust issued and sold:

\$10,000,000 of preferred capital securities, or trust preferred securities, representing undivided beneficial interests in the assets of the Trust, to a third party special purpose company, which in turn pooled the trust preferred securities together with similar securities of other issuers and sold certificates representing interests in that closed-end, unmanaged pool to investors; and the Trust used the proceeds from the sale of the trust preferred securities to the pool to purchase the debentures from the Company; and

\$310,000 of its common securities to the Company, which represent all of the Trust's outstanding common securities; and

pursuant to a Guarantee Agreement, the Company fully and unconditionally guaranteed the payments of all amounts due on the trust preferred securities, which guarantee is limited to the extent the Trust has funds available for payment of distributions.

Both the debentures and the trust preferred securities accrue and pay interest semiannually at a rate of 10-7/8% per annum and have a maturity date of March 8, 2030, at which time the principal amount of the debentures becomes due and the trust preferred securities become mandatorily redeemable by the Company. When the Company makes payments to the Trust, as the holder of the debentures, the Trust, in turn, makes payments to the pool, as the holder of the trust preferred securities. The debentures represent the sole asset of the Trust. The Company presently is entitled to treat the aggregate liquidation amount of the debentures as Tier 1 capital under Federal Reserve guidelines.

The Company may elect to defer payments of interest due on the debentures for up to ten semiannual payment periods. The Company elected to defer its March 2002, September 2002, March 2003, September 2003 and March 2004 interest payments, but on September 8, 2004 paid \$3.7 million, representing all deferred and current amounts then due. The Company could elect to defer amounts due in the future.

The trust preferred securities are mandatorily redeemable upon their maturity, or upon their earlier redemption as provided in the indenture. Additionally, the Company has the right to redeem the debentures purchased by the Trust:

in whole or in part, on or after, but not at any time before, March 8, 2010; and

in whole, but not in part, at any time within 90 days following the occurrence and during the continuation of a tax event, capital treatment event or investment company event, as those terms are defined in the indenture.

As specified in the indenture, if the debentures are redeemed prior to maturity, then the redemption price will be a percentage of the principal amount, ranging from 105.438% in 2010 to 100.00% in and after 2020, plus any accrued but unpaid interest due on the debentures at the time of redemption. If the debentures are redeemed prior to March 8, 2010 following a tax event, capital treatment event or investment company event, the redemption price will be the greater of 100% of the debentures redeemed or the present value of the remaining principal and interest payments between the redemption date and March 8, 2010, plus, in either case, any accrued but unpaid interest due on the debentures at the time of redemption.

The Company adopted FIN 46 as of March 31, 2004. As a result, the Company deconsolidated the Trust because the Company does not absorb a majority of the expected losses or residual returns of the Trust. The Trust was previously consolidated because it is controlled by the Company through a majority voting interest. The effect of such deconsolidation, was:

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to remove the trust preferred securities from the consolidated statement of condition;

to recognize the Company's junior subordinated debt obligation to the Trust; and

to recognize the Company's equity investment in the common stock of the Trust.

The junior subordinated debt obligation and equity investment was previously eliminated in consolidation. The equity investment, totaling \$310,000, represents the Company's maximum exposure to loss as a result of its involvement with the Trust. The adoption of FIN 46 had no impact on the Company's net income or earnings per share.

The Company sponsors an Employee Stock Ownership Plan, or ESOP, to provide the Company's employees with a means of owning its common stock. An employee becomes an eligible participant in the ESOP on June 30 or December 31 of any given year.



after completing 12 months of employment during which the employee is credited with 1,000 or more hours of service. Contributions by the Company to the ESOP are made at the discretion of the Company's board of directors, but may not be less than the amount required to cover any debt service due on the ESOP's loan, which is described below.

The Company has a loan to the ESOP that bears interest at a floating rate equal to the prime rate of interest. As of March 31, 2005, the interest rate on the note was 5.75%. Principal and interest payments on the ESOP loan are due monthly through November 16, 2010, with the remaining principal and interest, if any, due upon that date. The ESOP loan may be prepaid in whole or in part without penalty under the loan agreement. The Company makes contributions to the ESOP that enables the ESOP to make payments due under the ESOP loan and to make cash distributions to eligible participants. Under Statement of Position No. 93-6 (SOP 93-6), Employer's Accounting for Employee Stock Ownership Plans, employers that sponsor an ESOP with an employer loan should not report the ESOP's note payable or the employer's note receivable in the employer's balance sheet, nor should interest cost or interest income be recognized on the employer loan. The Company has followed SOP 93-6 accordingly. The principal balance of the Company's loan to the ESOP at March 31, 2005 was \$1.5 million.

Under the terms of the ESOP, after a person ceases to be an employee of Community Bancshares and/or its affiliates, that person is no longer eligible to participate in the ESOP. In that case, the person may demand to receive, as a lump sum payment, all amounts accrued to his benefit under the ESOP as of the end of the year immediately preceding that person's termination of employment with the Company.

Mr. Kennon R. Patterson, Sr., whose employment with the Company terminated in January 2003, has demanded to receive from the ESOP a total of approximately \$298,000, representing the total amount accrued by Mr. Patterson during his participation in the ESOP. To enable the ESOP to make these lump sum cash payments, the Company could be required to contribute cash to the ESOP in addition to its ongoing requirement to make contributions to service the ESOP debt. The Company evaluated its obligations to Mr. Patterson in light of Mr. Patterson's indictment and the requirements of law applicable to ESOPs, and, as a result, on March 15, 2004, the ESOP and the ESOP trustee, North Star Trust Company, filed suit in the United States District Court for the Northern District of Alabama against Kennon R. Patterson, Sr. In the lawsuit, the ESOP seeks damages for alleged breaches of fiduciary duty by Mr. Patterson, and both the ESOP and the trustee seek a declaratory judgment that the ESOP has a right of set-off against Mr. Patterson's account in the ESOP, and the ESOP is not required to make a distribution of funds to Mr. Patterson. Mr. Patterson has since been convicted on various counts including bank fraud.

The Company also evaluated its obligations to Mr. Patterson under a supplemental nonqualified retirement plan and as a result has denied his request for payment of benefits under the plan. Our denial has been challenged by Mr. Patterson in pending litigation and therefore we have not removed the accrued liability for the benefit from the Company's consolidated balance sheet. The portion of the liability attributable to Mr. Patterson is approximately \$1.7 million and is included in other liabilities on the Company's consolidated balance sheet. If it is determined that the Company is not obligated for this payment, then the liability will be reduced to zero and recorded as an increase to net income. If it is determined that the Company must pay the benefit, then there will be no effect on net income, but cash outflows will increase as the liability will be reduced each month as benefit payments are made.

## **Liquidity**

The following is a discussion of cash flows and sources of liquidity. The Company experienced an approximately \$12.2 million decrease in cash and cash equivalents during the first three months of 2005, due primarily to cash flows used by investing and financing activities as the Company experienced increases in loan demand and securities purchases, as well as reductions in demand deposits. Cash provided by operating activities was \$2.5 million, compared to cash used by operating activities of \$0.9 million for the three month period ended March 31, 2004. Investing activities used cash of \$8.8 million during the first three months of 2005, resulting mostly from purchases of securities and loan originations net of collections net of proceeds of maturities, sales, calls, and paydowns of securities. The Company used \$5.9 million of cash and cash equivalents in financing activities during the first three months of 2005, compared to \$2.3 million provided by financing activities during the first three months of 2004. Demand deposits, NOW and savings accounts decreased \$6.4 million during the first three months of 2005, which was minimally offset by increases in cash from the growth of certificates of deposit totaling \$0.4 million.

Community Bank represents the Company's principal operating subsidiary and source of earnings. Dividends paid by Community Bank historically have been the primary source of funds available to the Company, to pay expenses, service debt and pay dividends to stockholders. Generally, the Federal Reserve Act, Section 23A, limits loans and extensions of credit from banks to their affiliated holding companies. The Company also receives cash from its subsidiaries for its portion of tax benefit on intercompany income tax settlements. The intercompany tax settlements, however, are only possible if the subsidiaries generate taxable income sufficient to pay income taxes. Community Bank discontinued paying the Company a management fee in 2003.

In addition to debt service, as described above, the Company also will expend capital to settle, resolve and pay legal and other professionals to assist it in defending against the litigation to which it presently is subject as described in Note 9 to the Company's

unaudited consolidated financial statements included in this Report. The Company also may apply cash to maintain and improve capital levels at the parent company and at each subsidiary, as described below under Capital Resources. The Company also may use cash if it determines to review and possibly sell any of its branches that do not contribute to the Company's improved operations.

## Capital Resources

The Company's total stockholders' equity at March 31, 2005 was 7.68% of total assets, as compared to 7.75% at December 31, 2004. This 0.07% decrease is the result of the Company's decrease in total stockholders' equity, which in turn, resulted from increases in accumulated other comprehensive losses due to increased unrealized losses in the Company's securities portfolio.

The Federal Reserve and the FDIC have adopted risk-based capital guidelines for bank holding companies and state banks, respectively. The guideline for a minimum ratio of capital to risk-weighted assets (including certain off balance sheet activities, such as standby letters of credit) is 8%. At least half of the total capital must consist of Tier 1 Capital, which includes common equity, retained earnings and a limited amount of qualifying preferred stock, less goodwill. The remainder may consist of non-qualifying preferred stock, qualifying subordinated, perpetual, and/or mandatory convertible debt, term subordinated debt and intermediate term preferred stock and up to 45% of the pretax unrealized holding gains on available-for-sale equity securities with readily determinable market values that are prudently valued, and a limited amount of any loan loss allowance, which is referred to as Tier 2 Capital. Tier 1 Capital and Tier 2 Capital are together referred to as Total Capital.

In addition, the federal bank regulatory agencies have established minimum leverage ratio guidelines for bank holding companies, national banks, and state member banks, which provide for a minimum leverage ratio of Tier 1 Capital to adjusted average quarterly assets, or a leverage ratio, equal to 3%, plus an additional cushion of 1.0% to 2.0%, if the institution has less than the highest regulatory rating. The guidelines also provide that institutions experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels without significant reliance on intangible assets. Higher capital may be required in individual cases, depending upon a bank holding company's risk profile. All bank holding companies and banks are expected to hold capital commensurate with the level and nature of their risks, including the volume and severity of their problem loans. Lastly, the Federal Reserve's guidelines indicate that the Federal Reserve will continue to consider a Tangible Tier 1 Leverage Ratio (deducting all intangibles) in evaluating proposals for expansion or new activity.

The Federal Deposit Insurance Corporation Improvement Act of 1992, or FDICIA, requires the federal banking agencies to take prompt corrective action in respect of depository institutions that do not meet minimum capital requirements. FDICIA establishes five capital tiers: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized.

The capital measures used by the federal banking regulators are the Total Capital ratio, Tier 1 Capital ratio, and the leverage ratio. Under the regulations, a state bank will be:

well capitalized if it has a Total Capital ratio of 10% or greater, a Tier 1 Capital ratio of 6% or greater, and is not subject to any written agreement, order, capital directive, or prompt corrective action directive by a federal bank regulatory agency to meet and maintain a specific capital level for any capital measure;

adequately capitalized if it has a Total Capital ratio of 8% or greater, a Tier 1 Capital ratio of 4% or greater, and a leverage ratio of 4% or greater (3% in certain circumstances) and is not well capitalized;

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undercapitalized if it has a Total Capital ratio of less than 8%, a Tier 1 Capital ratio of less than 4% (3% in certain circumstances); or

critically undercapitalized if its tangible equity is equal to or less than 2% of average quarterly tangible assets.

FDICIA generally prohibits a depository institution from making any capital distribution (including payment of a dividend) or paying any management fee to its holding company if the depository institution would thereafter be undercapitalized. Undercapitalized depository institutions are subject to growth limitations and are required to submit a capital restoration plan for approval. An acceptable capital restoration plan requires the depository institution's parent holding company to guarantee that the institution comply with such capital restoration plan. The aggregate liability of the parent holding company is limited to the lesser of 5% of the depository institution's total assets at the time it became undercapitalized and the amount necessary to bring the institution into compliance with applicable capital standards. If a depository institution fails to submit an acceptable plan, it is treated as if it is significantly undercapitalized. If the controlling holding company fails to fulfill its obligations under FDICIA and files (or has filed against it) a petition under the federal Bankruptcy Code, the claim would be entitled to priority in such bankruptcy proceeding over third party creditors of the bank holding company.

The Federal Financial Institutions Examination Council's, or the FFIEC, internal rating system is used by the federal and state regulators for assessing the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special supervisory attention. Each financial institution is assigned a confidential composite rating based on an evaluation and rating of five essential components of an institution's financial condition and operations including:

Capital adequacy;

Asset quality;

Management;

Earnings;

Liquidity; and

Sensitivity to market risk.

Under this system, there is an emphasis on the quality of risk management practices. For most institutions, the FDIC has indicated that market risk primarily reflects exposures to changes in interest rates. When regulators evaluate this component, consideration is expected to be given to: management's ability to identify, measure, monitor and control market risk; the institution's size; the nature and complexity of its activities and its risk profile; and the adequacy of its capital and earnings in relation to its level of market risk exposure. Market risk is rated based upon, but not limited to: an assessment of the sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes in interest rates, foreign exchange rates, commodity prices, or equity prices; management's ability to identify, measure, and control exposure to market risk; and the nature and complexity of interest rate risk exposure arising from nontrading positions. Significantly undercapitalized depository institutions may be subject to a number of requirements and restrictions, including orders to sell sufficient voting stock to become adequately capitalized, requirements to reduce total assets, and cessation of receipt of deposits from correspondent banks. Critically undercapitalized institutions are subject to the appointment of a receiver or conservator.

The Company's Tier 1 Capital, including the \$10.0 million guaranteed preferred beneficial interest in the Company's junior subordinated deferrable interest debentures issued in connection with the Company's trust preferred securities offering, totaled \$52.4 million at March 31, 2005, as compared to \$51.9 million at December 31, 2004. Tier 1 Capital plus Tier 2 Capital components are referred to as Total Risk-Based Capital, which was equal to \$56.6 million at March 31, 2005, as compared to \$56.0 million at year-end 2004.

The Company's Tier 1 and Total Risk-Based Capital ratios were 15.62% and 16.87%, respectively, at March 31, 2005, compared to 15.81% and 17.06%, respectively, at year-end 2004. At March 31, 2005, both Tier 1 and Total Risk-Based Capital of the Company exceeded the regulatory minimum ratios of 4.0% and 8.0%, respectively. The Company's Tier 1 leverage ratio was 9.77% and 9.58% at March 31, 2005 and December 31, 2004, respectively.

The following table shows both the Company's and the Bank's regulatory total risk based capital and Tier 1 capital amounts and ratios as of March 31, 2005 and December 31, 2004:

|  | March 31, 2005   |               | December 31, 2004 |        |
|--|------------------|---------------|-------------------|--------|
|  | Amount           | Ratio         | Amount            | Ratio  |
| (Dollars in thousands)                                     |                  |               |                   |        |
| <b>Total risk based capital (to risk weighted assets):</b> |                  |               |                   |        |
| <b>Consolidated</b>  | <b>\$ 56,648</b> | <b>16.87%</b> | \$ 56,019         | 17.06% |
| <b>Community Bank</b>                                      | <b>50,297</b>    | <b>15.22</b>  | 49,573            | 15.42  |
| <b>Tier 1 capital (to risk weighted assets):</b>           |                  |               |                   |        |
| <b>Consolidated</b>  | <b>52,445</b>    | <b>15.62</b>  | 51,909            | 15.81  |
| <b>Community Bank</b>                                      | <b>46,161</b>    | <b>13.97</b>  | 45,548            | 14.17  |
| <b>Tier 1 capital (to quarterly average assets):</b>       |                  |               |                   |        |
| <b>Consolidated</b>  | <b>52,445</b>    | <b>9.77</b>   | 51,909            | 9.58   |
| <b>Community Bank</b>                                      | <b>46,161</b>    | <b>8.68</b>   | 45,548            | 8.47   |

#### FDIC Insurance Assessments

The Bank's deposits are insured by the FDIC's Bank Insurance Fund, or BIF, and the Bank is subject to FDIC Insurance Assessments. The FDIC utilizes a risk-based deposit insurance premium scheme to determine the assessment rates for BIF-insured depository institutions. Each financial institution is assigned to one of three capital groups - well capitalized, adequately capitalized or undercapitalized - and further assigned to one of three subgroups within a capital group, on the basis of supervisory evaluations by the institution's primary federal and, if applicable, state regulators and other information relevant to the institution's financial condition and the risk posed to the applicable insurance fund. The actual assessment rate applicable to a particular institution will, therefore, depend in part upon the risk assessment classification so assigned to the institution by the FDIC.

The FDIC's BIF assessment schedule continues to range from zero to 27 basis points per annum, and has remained unchanged since 2001. The FDIC also collects Financing Corporation ( FICO ) deposit assessments. The FICO assessments are set quarterly and ranged from 1.46 to 1.54 basis points in 2004, and was 1.44 basis points for the first quarter of 2005.

During the three months ended March 31, 2005 and 2004, the Bank expensed approximately \$199,000 and \$202,000, respectively in total deposit insurance premiums.

#### Regulatory Restrictions

*Special and Important Update*

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During the entire year of 2004, Community Bancshares and Community Bank were subject to four different regulatory agreements or orders. Since the issuance of these agreements and orders, the Company has materially complied with the requirements and expectations contained in the documents and cooperated fully with the regulatory authorities. Based on our compliance with, and performance under, those documents, as well as the result of our most recent examinations conducted by the FDIC, the Federal Reserve Bank of Atlanta and the Alabama State Banking Department, or the Department, all of these agreements and orders, the terms of which are described in our Annual Report on Form 10-K for the year ended December 31, 2003, were terminated during March 2005. Such restrictions were in place during all of 2004.

### **FDICIA**

FDICIA directs that each federal banking regulatory agency prescribe standards for depository institutions and depository institution holding companies relating to internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth composition, a maximum ratio of classified assets to capital, minimum earnings sufficient to absorb losses, a minimum ratio of market value to book value for publicly traded shares, and such other standards as the federal regulatory agencies deem appropriate.

FDICIA also contains a variety of other provisions that may affect the operations of the Company and the Bank, including new reporting requirements, regulatory standards for real estate lending, truth in savings provisions, the requirement that a depository institution give 90 days prior notice to customers and regulatory authorities before closing any branch, and a prohibition on the acceptance or renewal of brokered deposits by depository institutions that are not well capitalized or are adequately capitalized and have not received a waiver from the FDIC. The Bank had no brokered deposits as of March 31, 2005.

### **Enforcement Policies and Actions**

The Federal Reserve, the FDIC and the Department monitor compliance with laws and regulations. Violations of laws and regulations, or other unsafe and unsound practices, may result in these agencies imposing fines or penalties, cease and desist orders, or taking other enforcement actions. Under certain circumstances, these agencies may enforce these remedies directly against officers, directors, employees and others participating in the affairs of a bank or bank holding company. The regulatory agencies have extensive powers to enforce their agreements with banks and bank holding companies, including, among other actions, civil money penalties, and possible proceedings to terminate FDIC insurance.

### **Off Balance Sheet Arrangements**

As of March 31, 2005, we had no material unconditional purchase obligations that were not recorded on the balance sheet.

The Company in the normal course of business is party to credit related financial instruments with off balance sheet risk to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters-of-credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets.

The Company's exposure to credit loss is represented by the contractual amount of these commitments. The Company follows the same credit policies in making commitments as it does for on balance sheet instruments.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require the payment of a fee. The commitments for equity lines of credit may expire without being drawn upon. Therefore, the total commitments amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Company, is based on management's credit evaluation of the customer. At December 31, 2004, the outstanding commitments to grant loans represented a credit risk of \$24.0 million. At March 31, 2005, the outstanding commitments to grant loans represented a credit risk of \$25.7 million.

Standby letters-of-credit are conditional lending commitments issued by the Company to guarantee the performance of a customer to a third party. These letters-of-credit are primarily issued to support public and private borrowing arrangements. Essentially all letters-of-credit issued by the Company have expiration dates within one year, but the majority are automatically renewable for the beneficiary. The credit risk involved in issuing letters-of-credit is essentially the same as that involved in extending loan facilities to customers. At December 31, 2004, the Company has outstanding total standby letters-of-credit of \$465,000. At March 31, 2005, the Company has outstanding total standby letters-of-credit of \$287,000.



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**RESULTS OF OPERATIONS*****For the three month periods ended March 31, 2005 and 2004*****General**

The Company's net income for the three months ended March 31, 2005 was \$351,000, representing a \$296,000, or 538.2% increase from net income of \$55,000 for the same period in 2004. Net income for the three months ended March 31, 2005 represented \$0.04 earnings per share on both a basic and diluted basis, compared to a \$0.01 earnings per share during the three months ended March 31, 2004 on both a basic and diluted basis. This increase in earnings was due, among other factors, to increased noninterest income due to a favorable settlement in a litigation matter as well as decreased noninterest expenses, as further discussed below.

**Net Interest Income**

Net interest income represents the difference between the interest earned by the Company on its assets and the cost borne by the Company on its interest-bearing liabilities. For the three months ended March 31, 2005, the Company's net interest income before its provision for loan losses was \$4.5 million. Net interest income, before provision for loan losses, decreased approximately \$0.2 million, or 4.3%, from \$4.7 million for the same period of 2004. The decrease in net interest income was due to the decrease in revenues related to interest-earning assets because of smaller volumes of interest-earning assets as well as an increase in interest expense due to higher rates paid on interest-bearing liabilities. Revenues from interest-earning assets of the Company decreased \$0.1 million, or 1.3%, to \$7.8 million for the three months ended March 31, 2005 from \$7.9 million for the same period in 2004. Average earning assets outstanding during the first three months of 2005 were \$473.5 million, which represents a decrease of \$16.5 million, or 3.4%, from \$490.0 million from the first three months of 2004. The Company's volume of interest-earning assets decreased due to reductions in outstanding loans, resulting from the Company's sale of poor quality loans as well as the decline in funds available for investing, which, in turn, was partially due to the Company's decreased level of deposits. Higher yields earned on interest-earning assets partially offset declines in interest income due to volume. The Company's yield on its average earning assets increased 12 basis points to 6.59% for the first three months of 2005, compared to 6.47% for the same period of 2004. The increase in yield was attributable to rate increases over the past year.

Interest expense for the three months ended March 31, 2005 was \$3.3 million, an increase of \$0.1 million, or 3.1%, from the Company's interest expense of \$3.2 million for the corresponding period of 2004. This increase occurred due to an increase in rates paid on, and despite a decrease in the volume of, interest-bearing liabilities. Average interest-bearing liabilities during the first three months of 2005 were \$434.5 million, which represents a decrease of \$17.3 million, or 3.8%, from \$451.8 million for the same period of 2004. The volume of interest-bearing liabilities decreased partially due to the Company's decision to not seek higher priced deposits as it tries to establish long lasting relationships with its customers, based on customer service, rather than merely price. The rate paid by the Company on average interest-bearing liabilities increased 19 basis points to 3.02% for the three month period ended March 31, 2005, compared to 2.83% for the first three months of 2004, as the Company raised rates on deposits in response to overall rate increases in the economy.

The Company's net interest margin for the three months ended March 31, 2005 was 3.82% and was 3.86% for the same period in 2004. Net interest margin is computed by dividing net interest income by average interest-earning assets. This ratio represents the difference between the average yield returned on average interest-earning assets and the average rate paid on funds used to support those interest-earning assets, including both interest-bearing and noninterest-bearing sources.

The Company's net interest spread for the three months ended March 31, 2005 decreased 7 basis points to 3.57%, from 3.64% for the three months ended March 31, 2004, as the increase in the average cost of interest-bearing sources of funds slightly exceeded the increase in the average yield on interest-earning assets. Net interest spread measures the difference between the average yield on interest-earning assets and the average rate paid on interest-bearing sources of funds.

#### **Provision for Loan Losses and Allowance for Loan Losses**

The Company's allowance for loan losses at March 31, 2005, as well as at December 31, 2004, was \$4.6 million. The provision for loan losses was \$0.3 million for each of the three month periods ended March 31, 2005 and 2004. Management continues to make provisions for current losses in the Company's loan portfolio, as well as for any other deterioration identified, as it continues to evaluate the risks in its loan portfolio. The credit quality of the Company's loan portfolio has improved significantly; therefore, we have provided for a slight decrease in the allowance for loan losses. As a percentage of total loans, net of unearned income, the allowance for loan losses at the end of the period was 1.51% at March 31, 2005, compared to 1.54% at December 31, 2004. Total loan charge-offs during the first three months of 2005 amounted to \$0.4 million, a \$3.4 million decrease from \$3.8 million for the same period in 2004. Loan charge-offs exceeded recoveries by \$0.3 million during the first three months of 2005, which represented an increase of \$3.1 million, from \$3.4 million net for the same period during 2004. The Company sold a substantial amount of its poor quality loans in both March and December of 2004 which caused significantly higher charge-offs during those periods. Management believes that the Company's allowance for

loan losses at March 31, 2005 was adequate, based upon information available to management at that date; however, due to the inherent subjectivity and uncertainty of determining the appropriate allowance for loan losses, the Company can give no assurance that additional losses may not occur or that additional or unforeseen provisions to the allowance for loan losses will not be necessary.

The following discussion relates to the Company's policies as presently in effect. Interest on loans is accrued from the date an advance is made. The performance of loans is evaluated primarily on the basis of a review of each customer relationship over a period of time and the judgment of lending officers as to the ability of borrowers to meet the repayment terms of loans. If there is reasonable doubt as to the repayment of a loan in accordance with the agreed terms, then the loan may be placed on a nonaccrual basis pending the sale of any collateral or a determination as to whether sources of repayment exist. This action may be taken even though the financial condition of the borrower or the collateral may be sufficient ultimately to reduce or satisfy the obligation. Generally, when a loan is placed on a nonaccrual basis, all payments are applied to reduce principal to the extent necessary to eliminate doubt as to the repayment of the loan. Thereafter, any interest income on a nonaccrual loan is recognized only on a cash basis.

The Company's policy generally is to place a loan on nonaccrual status when it is contractually past due 90 days or more as to payment of principal or interest. A loan may be placed on nonaccrual status at an earlier date when concerns exist as to the ultimate collections of principal or interest. At the time a loan is placed on nonaccrual status, interest accrued in a prior year but not collected is charged against the allowance for loan losses and unpaid interest accrued in the current year is charged against earnings. Loans that are contractually past due 90 days or more, and which are well secured and in the process of collection generally are not placed on nonaccrual status.

Lending officers are responsible for the ongoing review and administration of loans assigned to them. As such, they make the initial identification of loans that present some difficulty in collection, or where circumstances indicate that the possibility of loss exists. The responsibilities of the lending officers include the collection effort on a delinquent loan. To strengthen internal controls in the collection of delinquencies, senior management and the Directors' Asset Quality Committee are informed of the status of delinquent and problem, or watch, loans on a monthly basis. Senior management reviews the allowance for loan losses and makes recommendations to the Board of Directors as to loan charge-offs on a monthly basis.

The allowance for loan losses represents management's assessment of the risk associated with extending credit and its evaluation of the quality of the loan portfolio. Management analyzes the loan portfolio to determine the adequacy of the allowance for loan losses and the appropriate provision required to maintain a level believed adequate to absorb anticipated loan losses. In assessing the adequacy of the allowance, management reviews the size, quality and risk of loans in the portfolio. Management also considers such factors as the Bank's loan loss experience, the amount of past due and nonperforming loans, specific known risks, the status and amount of nonperforming assets, underlying collateral values securing loans, current and anticipated economic conditions and other factors which affect the allowance for loan losses. An analysis of the credit quality of the loan portfolio and the adequacy of the allowance for loan losses is prepared by the Bank's Director of Risk Management and presented to the Board of Directors on a monthly basis. In addition, the qualified loan review specialist is dedicated full-time to the loan review function.

The Bank's allowance for loan losses is also subject to regulatory examinations and determinations as to adequacy, which may take into account such factors as the methodology used to calculate the allowance for loan losses and the size of the allowance for loan losses in comparison to a group of peer banks identified by the regulators. During their routine examinations of banks, the FDIC and the Department may require a bank to make additional provisions to its allowance for loan losses where, in the opinion of the regulators, credit evaluations and allowance for loan loss methodology differ materially from those of management.

While it is the Bank's policy to charge off in the current period loans for which a loss is considered probable, there are additional risks of future losses which cannot be quantified precisely or attributed to particular loans or classes of loans. Because these risks include the state of the economy and other external factors that are difficult to properly gauge and predict, management's judgment as to the adequacy of the allowance is necessarily approximate and imprecise.





**Noninterest Income**

Noninterest income for the three months ended March 31, 2005 increased \$0.3 million, or 17.5%, to \$2.1 million, from \$1.8 million for the same period of 2004 all as a result of income from the settlement of certain litigation in favor of the Company, net of other decreases in noninterest income categories.

**NONINTEREST INCOME**

|                                | March 31,          |                 | Percent<br>Change |
|--------------------------------|--------------------|-----------------|-------------------|
|                                | 2005               | 2004            |                   |
|                                | (Dollars in 000 s) |                 |                   |
| Service charges on deposits    | \$ 662             | \$ 663          | (0.2)%            |
| Insurance commissions          | 640                | 674             | (5.0)             |
| Securities gains (losses), net | (2)                | 238             | (100.8)           |
| Bank club dues                 | 77                 | 93              | (17.2)            |
| Debt cancellation fees         | (5)                | (15)            | 66.7              |
| Other operating income         | 744                | 148             | 402.7             |
|                                | <b>\$ 2,116</b>    | <b>\$ 1,801</b> | <b>17.5</b>       |

As mentioned above, the Company received \$625,000 resulting from the settlement of certain litigation. This income is included in other operating income and is the reason \$0.6 million of the increase during the first three months of 2005 as compared to the same period in 2004. Partially offsetting this increase is a \$240,000 decrease in net securities gains or losses from 2004 when the Company restructured its portfolio and was able to realize gains. Service charges on deposit accounts are down slightly; however, the Company presently expects to realize increases in service charges during the remainder of 2005 as strategies designed to increase this category of income are implemented. Insurance commissions are down 5.0% due to the timing of our income stream at our insurance agency subsidiary, but we believe this to be only temporary.

**Noninterest Expenses**

Noninterest expenses for the three months ended March 31, 2005 were \$5.8 million, representing a \$0.4 million, or 5.4%, decrease from noninterest expenses of \$6.2 million for the same period in 2004. Salaries and employee benefits decreased \$0.1 million, or 2.2%, to \$3.0 million for the three months ended March 31, 2005, from \$3.1 million for the same period of 2004. The Company continues to seek to maintain efficient staff. Occupancy costs decreased \$60,000, or 10.0%, during the three months ended March 31, 2005, compared to the same period in 2004, while furniture and equipment expenses increased \$15,000, or 4.1%, to \$380,000, from \$365,000. The Company's insurance expense increased \$30,000, or 10.3% to \$322,000 for the three months ended March 31, 2005, from \$292,000 for the same period in 2004. Director and committee fees decreased \$15,000, or 12.7%, to \$103,000 for the three months ended March 31, 2005, from \$118,000 for the three months ended March 31, 2004. This decrease is the result of the decline in the number of meetings as litigation against the Company has been reduced and all regulatory plans and orders have been terminated. The Company's legal expense decreased \$0.2 million, or 44.2%, to \$0.3 million during the three months ended March 31, 2005, compared to the same period in 2004, also a result of reduced litigation against the Company and the termination of all regulatory plans and orders.

## NONINTEREST EXPENSES

|                                   | March 31,          |          | Percent   |
|-----------------------------------|--------------------|----------|-----------|
|                                   |                    |          | Change    |
|                                   | 2005               | 2004     | 2005/2004 |
|                                   | (Dollars in 000 s) |          |           |
| Salaries and employee benefits    | \$ 3,003           | \$ 3,072 | (2.2)%    |
| Occupancy                         | 541                | 601      | (10.0)    |
| Furniture and equipment           | 380                | 365      | 4.1       |
| Director and committee fees       | 103                | 118      | (12.7)    |
| Foreclosed assets, net            | 41                 |          |           |
| Disposal or impairment of assets  | 24                 | 23       | 4.3       |
| Litigation, fraud, burglary       |                    | 18       |           |
| Amortization of intangibles-other | 23                 | 23       |           |
| Advertising                       | 7                  | 27       | (74.1)    |
| Insurance                         | 322                | 292      | 10.3      |
| Legal fees                        | 298                | 534      | (44.2)    |
| Other professional services       | 98                 | 124      | (21.0)    |
| Supplies                          | 140                | 116      | 20.7      |
| Postage                           | 84                 | 89       | (5.6)     |
| Telephone and data communications | 216                | 216      |           |
| Training and education            | 21                 | 29       | (27.6)    |
| Holding cost on foreclosed assets | 88                 | 85       | 3.5       |
| Other                             | 447                | 440      | 1.6       |
| Total                             | \$ 5,836           | \$ 6,172 | 5.4       |

**Effects of Inflation**

Inflation generally increases the cost of funds and operating overhead, and, to the extent loans and other assets bear variable rates, the yields on such assets. Unlike most industrial companies, virtually all of the Company's assets and liabilities, as a financial institution, are monetary in nature. As a result, interest rates generally have a more significant impact on performance than the effects of general levels of inflation. Although interest rates do not necessarily move in the same direction, or to the same extent, as the prices of goods and services, low inflation or deflation generally has resulted in decreased interest rates.

In addition, inflation results in an increased cost of goods and services purchased, cost of salaries and benefits, occupancy expense and similar items. Inflation and related increases in interest rates generally decrease the market value of investments and loans held and may adversely affect the liquidity and earnings of our commercial banking and mortgage banking businesses, and our stockholders' equity. Mortgage originations and refinancings tend to slow as interest rates increase, and increased interest rates would likely reduce our earnings from such activities. Also, although earnings from the sale of residential mortgage loans in the secondary market have been insignificant to the Company's earnings over the past two years, the income from the sale of residential mortgage loans in the secondary market could be reduced by inflationary effects.



**Item 3. Quantitative and Qualitative Disclosures about Market Risk.****Interest Rate Sensitivity**

Interest rate risk is the risk to earnings or market value of equity from the potential movement in interest rates. The primary purpose of managing interest rate risk is to reduce interest rate volatility and achieve reasonable stability to earnings from changes in interest rates and preserve the value of the Company's equity. Changes in interest rates affect, among other things, the Company's net interest income, volume of loan production and the fair value of financial instruments, as well as of the Company's loan portfolio.

The Company seeks to manage its exposure to fluctuations in interest rates through policies established by its Asset/Liability Committee, which is referred to as ALCO. The ALCO meets periodically to monitor its interest rate risk exposure and implement strategies that might improve its balance sheet positioning and/or earnings. Management utilizes an Interest Rate Simulation model to estimate the sensitivity of the Company's net interest income and net income to changes in interest rates of given magnitudes. Such estimates are based upon a number of assumptions for each scenario, including balance sheet growth, deposit repricing characteristics and prepayment rates. Because this model involves a number of estimates and assumptions, which are inherently uncertain and subject to change, the Company makes no assurance that the model is accurate or reliable, or that the results are meaningful or reflective of any actual results.

The estimated impact on the Company's net interest income sensitivity over a one year time horizon at March 31, 2005 is shown below. Such analysis assumes an immediate and nonparallel shift in interest rates and the Company's estimates of how interest-bearing transaction accounts will reprice. Although we believe the table is helpful, it is based on assumptions made that will not only be affected by interest rates, but also the composition of our balance sheet, our balance sheet growth and many other factors that may or may not be beyond our control. The prime rate shown is as of March 31, 2005.

**RATE SHOCK ANALYSIS**

|                              | <b>-100<br/>Basis<br/>Points</b> | <b>Level</b>     | <b>+100<br/>Basis<br/>Points</b> |
|------------------------------|----------------------------------|------------------|----------------------------------|
|                              | (Dollars in 000 s)               |                  |                                  |
| Prime rate                   | 4.75%                            | 5.75%            | 6.75%                            |
| Interest income              | \$ 30,022                        | \$ 31,607        | \$ 33,044                        |
| Interest expense             | 13,970                           | 15,012           | 16,056                           |
| Net interest income          | <u>\$ 16,052</u>                 | <u>\$ 16,595</u> | <u>\$ 16,988</u>                 |
| Dollar change from level     | \$ (543)                         |                  | \$ 393                           |
| Percentage change from level | (3.27)%                          |                  | 2.37%                            |

As shown above, in a 100 basis point rising rate environment, the net interest margin is projected to increase 2.37% and in a 100 basis point falling rate environment, the net interest margin is projected to decrease 3.27%. These percent changes from a level rate scenario fall comfortably within the Company's ALCO policy limit of +/-10.00%.

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The Company uses additional tools to manage interest rate sensitivity, and continually tries to manage and monitor its interest rate sensitivity. Attempting to manage the Company's interest rate sensitivity is a constant challenge in a changing interest rate environment and one of the objectives of the Company's asset/liability management strategy. The Company manages its interest rate sensitivity with monitoring tools such as GAP analysis, interest rate simulation modeling and forecasting, using both interest rate shocks and likely rate scenarios and, finally, analysis of the Company's economic value of equity.

**Item 4. Controls and Procedures.**

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's reports and other information filed with the Securities and Exchange Commission, or the Commission, under the Securities Exchange Act of 1934, or the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms, and that such information is accumulated and communicated to the management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

The Company carried out an evaluation, under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon the foregoing, the Chief Executive Officer and the Chief Financial Officer concluded that, as of the end of the period covered by this Report, the Company's disclosure controls and procedures are effective, in all material respects, in the timely alerting of them to material information relating to the Company and its consolidated subsidiaries required to be included in the Company's Exchange Act reports.

During the three months ended March 31, 2005, there has not been any change in the Company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II**

### **Item 1. Legal Proceedings.**

#### **Background**

At a June 20, 2000 meeting of the board of directors of Community Bank, one of Community Bank's directors brought to the attention of the board of directors the total amount of money that Community Bank had paid to subcontractors in connection with the construction of a new Community Bank branch office in Guntersville, Alabama. Questions were subsequently raised about a number of Community Bank construction projects. A joint committee of the boards of directors of Community Bancshares and Community Bank conducted an investigation as did law enforcement and bank regulatory authorities. Following these investigations, the boards of directors terminated the employment of Kennon R. Patterson, Sr., former Chairman, President and Chief Executive Officer of Community Bancshares and Chairman and Chief Executive Officer of Community Bank, and Larry Bishop, former Vice President of Community Bank and the FDIC commenced administrative proceedings against Mr. Patterson and Mr. Bishop, which are still pending. On March 10, 2005, Mr. Patterson and Mr. Bishop were convicted in the United States District Court for the Northern District of Alabama of conspiracy, bank fraud and causing false entries to be made in bank records. Mr. Patterson was also convicted of filing false income tax returns. Sentencing of these individuals has not yet been set.

#### **Patterson Employment Litigation**

Plaintiffs: Community Bancshares, Inc. and Community Bank

Defendants: Kennon R. Patterson, Sr., Community Bancshares former Chairman, President and Chief Executive Officer

On September 14, 2004, Community Bancshares and Community Bank filed suit against Mr. Patterson in the Circuit Court of Blount County, Alabama. Community Bancshares and Community Bank's complaint:

alleges that Mr. Patterson breached his employment agreement with Community Bancshares by failing to faithfully perform the duties assigned to him;

alleges that Mr. Patterson made fraudulent misrepresentations to, or suppressed material information from, Community Bancshares and Community Bank and/or their officers, directors and agents concerning his bankruptcy, the release of mortgages which Community Bank held on his house, and payments made by Community Bancshares and Community Bank to companies owned by Mr. Patterson and members of his family;

alleges that Mr. Patterson removed property belonging to Community Bancshares and Community Bank following the termination of his employment; and

alleges that Mr. Patterson breached a duty of loyalty and other fiduciary duties owed to Community Bancshares and Community Bank.

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On October 18, 2004, Mr. Patterson filed an answer and counterclaim against Community Bancshares and Community Bank. Mr. Patterson's counterclaim:

alleges that Community Bancshares breached its employment agreement with Mr. Patterson by terminating his employment;

alleges that Community Bancshares failed to pay to Mr. Patterson compensation and benefits of \$2.4 million which had allegedly accrued prior to the termination of his employment;

alleges that Community Bank intentionally interfered with the employment contract between Mr. Patterson and Community Bancshares by instigating, promoting, assisting in and participating in the termination of Mr. Patterson's employment agreement; and

alleges that Community Bancshares falsely represented to Mr. Patterson that his employment would not be terminated until March 31, 2008.

On January 25, 2005, Mr. Patterson filed a third-party complaint in this lawsuit against R.B. Jackson, Jimmie Trotter, Glynn Debter, John J. Lewis, Jr., Patrick M. Frawley and Powell, Goldstein, Frazer & Murphy, LLP. The third-party complaint alleges that Messrs. Jackson, Trotter, Debter and Lewis, as members of Community Bank's Audit Committee, Powell, Goldstein, Frazier & Murphy, LLP, as the independent counsel for Community Bank's Audit Committee, and Mr. Frawley, acting individually and in concert with one another, interfered with Mr. Patterson's employment agreement with Community Bancshares.

### **Patterson ESOP Litigation**

Plaintiffs: Community Bancshares, Inc. Employee Stock Ownership Plan (the ESOP ) and North Star Trust Company, as Trustee of the ESOP

Defendants: Kennon R. Patterson, Sr., Community Bancshares former Chairman, President and Chief Executive Officer

On March 15, 2004, the Employee Stock Ownership Plan, or ESOP, of Community Bancshares, together with the ESOP trustee, North Star Trust Company, filed suit against Mr. Patterson in the United States District Court for the Northern District of Alabama. The ESOP's complaint:

alleges that Mr. Patterson breached his fiduciary duty to the ESOP by engaging in activities which adversely affected the value of the Community Bancshares stock held by the ESOP and concealing information with respect to those activities from other ESOP fiduciaries; and

seeks a declaratory judgment that Mr. Patterson is not entitled to a distribution of his accrued benefits in the ESOP and that such benefits may be held and used to offset the damages which the ESOP suffered as a result of Mr. Patterson's alleged breach of fiduciary duty.

On July 7, 2004, the Court denied Mr. Patterson's motion to dismiss the case. On or about July 23, 2004, Mr. Patterson filed a counterclaim seeking a judgment that he is entitled to benefits from the ESOP and declaratory and injunctive relief compelling the payment of such benefits. On July 26, 2004 the Court, at Mr. Patterson's request, stayed discovery in the case pending Mr. Patterson's trial on criminal charges.

### **Patterson Benefit Restoration Plan Litigation**

Plaintiff: Kennon R. Patterson, Sr.

Defendant: Community Bancshares, Inc. Benefit Restoration Plan

On February 17, 2005, Mr. Patterson filed suit in the United States District Court for the Northern District of Alabama to compel payment of his accrued benefits under the Community Bancshares, Inc. Benefit Restoration Plan, a nonqualified supplemental retirement plan. The complaint seeks a judgment against the plan and an order compelling the payment of benefits.

### **Benson Litigation**

Plaintiffs: M. Lewis Benson, Doris E. Benson, John M. Packard, Jr. and Andy C. Mann, four of Community Bancshares' stockholders

Defendants: Community Bancshares, Community Bank, certain of the present and former directors of Community Bancshares and Community Bank, an employee of Community Bank and two construction subcontractors previously hired by the Company

On January 31, 2005, the Circuit Court of Blount County, Alabama approved a pro tanto settlement of the Benson and Packard shareholder derivative lawsuits. These lawsuits alleged, among other things, that the members of the Boards of Directors of Community Bancshares and Community Bank breached their fiduciary duties with respect to supervision of construction projects and the investigation of allegations of impropriety with respect to such projects. Pursuant to the pro tanto settlement, Community Bancshares and Community Bank received a total of

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\$625,000, and the defendants who were current or former directors or officers of Community Bancshares or Community Bank, except for Kennon R. Patterson, Sr., were dismissed from the lawsuits. Community Bancshares and Community Bank have been realigned as plaintiffs in the lawsuits against the remaining defendants.

### **Packard Derivative Litigation**

Plaintiffs: M. Lewis Benson, Doris E. Benson, John M. Packard, Jr. and Andy C. Mann, four of Community Bancshares stockholders

Defendants: Sheffield Electrical Contractors, Inc., Steve Sheffield, Jay Bolden, Dudley, Hopton-Jones, Sims & Freeman, PLLP, Glynn C. Debter, Kennon R. Patterson, Jr., Robert O. Summerford, Jimmie A. Trotter, John L. Lewis, Jr., Merritt M. Robbins, Stacey W. Mann, B. K. Walker, Jr., Denny Kelly, Roy B. Jackson, Loy D. McGruder, and Hodge Patterson

On January 31, 2005, the Circuit Court of Blount County, Alabama approved a pro tanto settlement of the Benson and Packard shareholder derivative lawsuits. These lawsuits alleged, among other things, that the members of the Boards of Directors of Community Bancshares and Community Bank breached their fiduciary duties with respect to supervision of construction projects and the investigation of allegations of impropriety with respect to such projects. Pursuant to the pro tanto settlement, Community

Bancshares and Community Bank received a total of \$625,000, and the defendants who were current or former directors or officers of Community Bancshares or Community Bank, except for Kennon R. Patterson, Sr., were dismissed from the lawsuits. Community Bancshares and Community Bank have been realigned as plaintiffs in the lawsuits against the remaining defendants.

### **Lending Acts Litigation**

Plaintiffs: William Alston, Murphy Howard, and Jason Tittle

Defendants: Community Bancshares, Community Bank, Holsombeck Motors, Inc., Lee Brown d/b/a Alabama Bond & Investigation a/k/a ABI Recovery, Chris Holmes d/b/a Alabama Bond & Investigation a/k/a ABI Recovery, Regina Holsombeck, Kennon Ken Patterson, Sr., Hodge Patterson, James Timothy Tim Hodge, Ernie Stephens, and the State of Alabama Department of Revenue

On October 11, 2002, the plaintiffs filed a class action against the defendants alleging that Community Bank and others conspired or used extortionate methods to effect a lending scheme of churning phantom loans, and that profits from the scheme were used to secure an interest in and/or to invest in an enterprise that affects interstate commerce. The plaintiffs specifically allege that Community Bank used various methods to get uneducated customers with fair to poor credit to sign numerous phantom loans when the customers only intended to sign for one loan. Claims include racketeering activity within the meaning of the Racketeer Influenced and Corrupt Organizations Act of 1970, conspiracy, spoliation, conversion, negligence, wantonness, outrage, and civil conspiracy.

On or about February 17, 2004, an amended complaint was filed in this lending acts litigation. The amended complaint, which completely replaces the original complaint, omits class action and racketeering claims and alleges violations of the Truth in Lending Act and Regulation Z of the Federal Reserve Board in addition to conversion, negligence, outrage, suppression, fraud and misrepresentation, trespass, conspiracy and failure to provide notice before disposition of collateral for loans. On April 2, 2004, eighty-one individuals, most of whom were formerly members of the purported class in the lending acts litigation filed by William Alston, filed suit against Community Bancshares, Community Bank and a former Community Bank employee in the Circuit Court of Jefferson County, Alabama. This suit claims that the defendants injured the plaintiffs, primarily in connection with lending at Community Bank's office in Double Springs, Alabama, by wrongfully taking property, committing fraud, furnishing inaccurate information to credit reporting agencies, negligently hiring, training and supervising employees, negligently handling customer accounts, altering loan documents and failing to honor oral and written contracts with the plaintiffs.

On February 2, 2005, Community Bancshares and Community Bank settled the claims of Mr. Alston and Mr. Howard for amounts which are not material to the financial statements of Community Bancshares. On March 29, 2005, Community Bancshares and Community Bank settled the claims of Mr. Tittle for an amount which is not material to the financial statements of Community Bancshares. Claims of the other plaintiffs are still pending.

### **Employee Litigation**

Plaintiffs: Bishop K. Walker, Jr., former Senior Executive Vice President and General Counsel of Community Bancshares, and his wife, Wanda Walker, and Denny G. Kelly, former President of Community Bank, and his wife, Arlene Kelly

Defendants: Community Bancshares, Community Bank, Kennon R. Patterson, Sr., and a number of unidentified defendants

On May 5, 2003, the plaintiffs filed separate suits in the Circuit Court of Blount County, Alabama, against the defendants alleging that they were induced to retire based upon misrepresentations made by Kennon R. Patterson, Sr., who at the time was Community Bancshares' Chairman, President and Chief Executive Officer. The plaintiffs claim that Mr. Patterson's actions constituted fraud, promissory fraud, fraudulent suppression, fraud in the inducement, deceit, fraudulent deceit, negligence, recklessness, wantonness and breach of contract. The complaints



seek an unspecified amount of compensatory and punitive damages.

On October 23, 2003, Community Bancshares and Community Bank filed counterclaims against Mr. Walker and Mr. Kelly seeking repayment of amounts paid to them as part of a severance arrangement and, in the case of Mr. Kelly, amounts owed to Community Bank in connection with the two loans from Community Bank to Mr. Kelly.

Mr. Kelly and Mr. Walker each filed an amended complaint on or about April 20, 2004. The amended complaints add Mrs. Kelly and Mrs. Walker as parties plaintiff and allege that representations were made by the defendants to Mrs. Kelly and Mrs. Walker that the defendants would purchase their personal and jointly owned stock of the Company. The complaints assert that the defendants' failure to purchase such stock constitutes promissory fraud, fraudulent misrepresentation, fraudulent suppression, negligence and/or wantonness. Mr. Walker's amended complaint also seeks damages based on Community Bank's refusal to accept a deed in lieu of foreclosure on Mr. Walker's home. On June 15, 2004, Community Bank amended its counterclaim against Mr. Walker to recover a loan deficiency balance following Community Bank's foreclosure on Mr. Walker's home.

### **Other Litigation**

In addition to the foregoing, Community Bancshares and its affiliates also are from time to time parties to other legal proceedings arising in the ordinary course of Community Bancshares' business. We presently believe that, other than the litigation discussed above, there is no other litigation to which Community Bancshares or its affiliates presently are party that, if such litigation were to result in an outcome unfavorable to Community Bancshares, would, individually or in the aggregate, have a material adverse effect on our financial condition or results of operations.

Our certificate of incorporation and bylaws provide that, in certain circumstances, we will indemnify our directors and officers, and, provided such persons acted in accordance with the standards set forth in the Delaware General Corporation Law and our organizational documents, advance expenses to our directors and officers in connection with investigations and proceedings in connection with their service as officers and directors.

### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

During the period covered by this Report, the Company did not sell any its equity securities that were not registered under the Securities Act of 1933, as amended.

### **Item 3. Defaults Upon Senior Securities.**

During the period covered by this Report, the Company did not default under the terms of any of its material indebtedness, nor has there been any material average of dividends or other material uncured delinquency with respect to any class of the Company's preferred stock.

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

During the period covered by this Report, the Company did not submit any matter to a vote of its stockholders, through the solicitation of proxies or otherwise.

### **Item 5. Other Information.**

During the period covered by this Report, there was no information required to be disclosed by the Company in a Current Report on Form 8-K that was not so reported, nor were there any material changes to the procedures by which the Company's security holders may recommend nominees to the Company's Board of Directors.

### **Item 6. Exhibits**

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- 3.1 Certificate of Incorporation, as amended and restated May 2000 (1).
- 3.2 Bylaws, as amended and restated October 23, 2003 (2).
- 4.1 Indenture, dated March 23, 2000, by and between Community Bancshares, Inc. and The Bank of New York (3).
- 4.2 Form of Option Agreement by and between Community Bancshares, Inc. and each of Acadia Fund I, L.P., Riggs Qualified Partners, Endurance Partners (Q.P.), L.P., Endurance Partners, L.P., Spence Limited, L.P., and John D. Norcross (4).
- 4.3 Warrant Agreement, dated February 20, 2004, by and between Community Bancshares, Inc. and FIG Partners, L.L.C. (5).
- 10.1 Plan document for the Community Bancshares, Inc. Benefit Restoration Plan adopted April 12, 1994, effective January 1, 1995 (6) (\*).
- 10.2 Subordinated Promissory Note, dated October 4, 1994, between Community Bancshares, Inc. as borrower and Jeffrey K. Cornelius as holder (7).
- 10.3 Amended and Restated Declaration of Trust, dated March 23, 2000, by and between The Bank of New York (Delaware), The Bank of New York, Community Bancshares, Inc. and Community (AL) Capital Trust I (8).
- 10.4 Guarantee Agreement, dated March 23, 2000, by and between Community Bancshares, Inc. and The Bank of New York (9).
- 10.5 Lease Agreement, dated May 31, 2000, between REM, LLC, as lessor, and Community Bank, as lessee (10).
- 10.6 Addendum to Lease Agreement and Loan Agreement, dated May 31, 2000, between REM, LLC and Community Bank (11).
- 10.7 Form of Amendment to Nonqualified Stock Option Agreement, between Community Bancshares, Inc. and grantee, dated December 12, 2000 (12) (\*).
- 10.8 Change in Control Agreement, dated September 18, 2001, between Community Bancshares, Inc. and Kerri C. Kinney (13) (\*).
- 10.9 Form of Stock Option Agreement between Community Bancshares, Inc. and each of Kennon R. Patterson, Sr., Glynn Debter, Roy B. Jackson, Denny Kelly, John J. Lewis, Jr., Loy McGruder, Kennon R. Patterson, Jr., Merritt Robbins, Robert O. Summerford, Jimmie Trotter and Kerri Newton dated December 18, 2001 (14) (\*).

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- 10.10 Stock Purchase Agreement dated January, 2002 between Community Bancshares, Inc. and Denny G. Kelly and Arlene S. Kelly (15) (\*).
  - 10.11 Stock Purchase Agreement dated January, 2002 between Community Bancshares, Inc. and Bishop K. Walker and Wanda W. Walker (16) (\*).
  - 10.12 Severance Agreement dated the 9th day of January, 2002 by and between Denny G. Kelly and Community Bancshares, Inc. and Community Bank (17) (\*).
  - 10.13 Severance Agreement dated the 9th day of January, 2002 by and between Bishop K. Walker and Community Bancshares, Inc. and Community Bank (18) (\*).
  - 10.14 Amendment to Subordinated Promissory Note, dated March 26, 2002, between Community Bancshares, Inc. and Jeffrey K. Cornelius (19).
  - 10.15 Form of Stock Option Agreement between Community Bancshares, Inc. and each of Kennon R. Patterson, Sr., Glynn Debter, Roy B. Jackson, Denny Kelly, John J. Lewis, Merritt Robbins, Robert O. Summerford and Jimmie Trotter dated July 19, 2002 (20) (\*).
  - 10.16 Form of Stock Option Agreement between Community Bancshares, Inc. and each of Patrick M. Frawley and Kerri C. Kinney dated February 6, 2003 (21) (\*).
  - 10.17 Stock Option Agreement between Community Bancshares, Inc. and Patrick M. Frawley dated August 1, 2003 (22) (\*).
  - 10.18 Stock Option Agreement between Community Bancshares, Inc. and Stacey W. Mann dated August 1, 2003 (23) (\*).
  - 10.19 Stock Option Agreement between Community Bancshares, Inc. and Kerri C. Kinney dated August 1, 2003 (24) (\*).
  - 10.20 Form of Stock Option Agreement between Community Bancshares, Inc. and each of Kenneth K. Campbell, Glynn Debter, Roy B. Jackson, John J. Lewis, Jr., Loy D. McGruder, Merritt M. Robbins and Jimmie Trotter dated August 1, 2003 (25) (\*).
  - 10.21 Form of Change in Control Agreement between Community Bancshares, Inc. and each of Kennon R. Patterson, Sr. and William H. Caughran, Jr. dated December 4, 1999 (26) (\*).
  - 10.22 Employment Agreement, dated March 28, 1996 by and between Kennon R. Patterson, Sr. and Community Bancshares, Inc. (27) (\*).
  - 10.23 Amendment to Employment Agreement, dated October 14, 1999, by and between Kennon R. Patterson, Sr. and Community Bancshares, Inc. (28) (\*).
  - 10.24 Amendment Number 1 to the Community Bancshares, Inc. Benefit Restoration Plan (29) (\*).
  - 10.25 Amendment Number 2 to the Community Bancshares, Inc. Benefit Restoration Plan (30) (\*).
  - 10.26 Change in Control Agreement between Community Bancshares, Inc. and Stacey W. Mann (31) (\*).
  - 10.27 Change in Control Agreement between Community Bank and Patrick M. Frawley (32) (\*).
  - 10.28 Form of Stock Option Agreement between Community Bancshares, Inc. and each of Kenneth K. Campbell, Glynn Debter, Roy B. Jackson, John J. Lewis, Jr., Loy McGruder, Merritt M. Robbins and Jimmie Trotter dated January 27, 2004 (33) (\*).
  - 10.29 Stock Option Agreement between Community Bancshares, Inc. and Patrick M. Frawley dated January 27, 2004 (34) (\*).
  - 10.30 Stock Option Agreement between Community Bancshares, Inc. and Stacey W. Mann dated January 27, 2004 (35) (\*).
  - 10.31 Stock Option Agreement between Community Bancshares, Inc. and Kerri C. Kinney dated January 27, 2004 (36) (\*).
  - 10.32 Form of Cancellation of Stock Option Agreement dated January 27, 2004 between Community Bancshares, Inc. and each of Merritt M. Robbins and Loy McGruder dated March 11, 2004 (37) (\*).
  - 10.33 Form of Stock Option Agreement between Community Bancshares, Inc. and each of Merritt M. Robbins and Loy McGruder dated March 11, 2004 (38) (\*).
  - 10.34 Promissory Note and Pledge Agreement, dated February 11, 2004, by and between the Community Bancshares, Inc. Employee Stock Ownership Plan and Community Bancshares, Inc. (39) (\*).

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- 10.35 Form of Amendment to Nonqualified Stock Option Agreements dated April 27, 2004 between Community Bancshares, Inc. and each of Patrick M. Frawley, Kenneth K. Campbell, Glynn Debter, Roy B. Jackson, Kerri C. Kinney, John J. Lewis, Jr., Loy D. McGruder, Stacey W. Mann, Merritt M. Robbins and Jimmie Trotter (40) (\*).
  - 10.36 Promissory Note, Loan Agreement and Security Agreement by and between Community Bancshares, Inc. and First Commercial Bank dated May 6, 2004 (41).
  - 10.37 Summary Description of Director Compensation (42) (\*).
  - 10.38 Summary Description of Named Executive Officer Compensation (43) (\*).
  - 10.39 Amendment Number 3 to the Community Bancshares, Inc. Benefit Restoration Plan (44) (\*).
  - 10.40 Employment Agreement, dated March 29, 2005, between Community Bank and Patrick Frawley(45) (\*).
  - 10.41 Form of Nonqualified Stock Option Agreement for Directors dated January 12, 2005 (46) (\*).
  - 10.42 Form of Nonqualified Stock Option Agreement for Senior Officers dated January 12, 2005 (47) (\*).
  - 10.43 Form of Nonqualified Stock Option Agreement for Officers dated January 12, 2005 (48) (\*).
  - 10.44 Form of stock option agreement between Community Bancshares, Inc. and each of Glynn Debtor, Roy B. Jackson, John L. Lewis, Jimmie Trotter, Kenneth K. Campbell, Terry G. Sanderson and Michael A. Tarpley (\*).
  - 10.45 Stock option agreement between Community Bancshares, Inc. and Patrick M. Frawley dated January 12, 2005 (\*).
  - 10.46 Stock option agreement between Community Bancshares, Inc. and Stacey W. Mann dated January 12, 2005 (\*).
  - 10.47 Stock option agreement between Community Bancshares, Inc. and Kerri C. Kinney dated January 12, 2005 (\*).
  - 31.1 Certifications of the Chief Executive Officer and the Chief Financial Officer pursuant to Exchange Act Rule 13a-14(a).
  - 32.1 Certifications of the Chief Executive Officer and the Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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(\* ) Management contract or compensation plan or arrangement.

- (1) Filed as Exhibit 3.2 to Form 10-Q for the quarter ended June 30, 2000, and incorporated herein by reference.
- (2) Filed as Exhibit 3.1 to Form 10-Q for the quarter ended June 30, 2000, and incorporated herein by reference.
- (3) Filed as Exhibit 4.4 to Form 10-Q for the quarter ended March 31, 2000, and incorporated herein by reference.
- (4) Filed as Exhibit 4.2 to Form 10-Q for the quarter ended March 31, 2004, and incorporated herein by reference.
- (5) Filed as Exhibit 4.3 to Form 10-Q for the quarter ended March 31, 2004, and incorporated herein by reference.
- (6) Filed as Exhibit 10.13 to Form 10-K for the year ended December 31, 1995, and incorporated herein by reference.
- (7) Filed as Exhibit 10.15 to Form 10-K for the year ended December 31, 1995, and incorporated herein by reference.
- (8) Filed as Exhibit 10.1 to Form 10-Q for the quarter ended March 31, 2000, and incorporated herein by reference.
- (9) Filed as Exhibit 10.2 to Form 10-Q for the quarter ended March 31, 2000, and incorporated herein by reference.
- (10) Filed as Exhibit 10.1 to Form 10-Q for the quarter ended June 30, 2000, and incorporated herein by reference.
- (11) Filed as Exhibit 10.2 to Form 10-Q for the quarter ended June 30, 2000, and incorporated herein by reference.
- (12) Filed as Exhibit 10.45 to Form 10-K for the year ended December 31, 2000, and incorporated herein by reference.
- (13) Filed as Exhibit 10.1 to Form 10-Q for the quarter ended September 30, 2001, and incorporated herein by reference.
- (14) Filed as Exhibit 10.22 to Form 10-K for the year ended December 31, 2001, and incorporated herein by reference.
- (15) Filed as Exhibit 10.23 to Form 10-K for the year ended December 31, 2001, and incorporated herein by reference.
- (16) Filed as Exhibit 10.24 to Form 10-K for the year ended December 31, 2001, and incorporated herein by reference.
- (17) Filed as Exhibit 10.25 to Form 10-K for the year ended December 31, 2001, and incorporated herein by reference.
- (18) Filed as Exhibit 10.26 to Form 10-K for the year ended December 31, 2001, and incorporated herein by reference.
- (19) Filed as Exhibit 10.31 to Form 10-K for the year ended December 31, 2001, and incorporated herein by reference.
- (20) Filed as Exhibit 10.31 to Form 10-K for the year ended December 31, 2002, and incorporated herein by reference.

- (21) Filed as Exhibit 10.32 to Form 10-K for the year ended December 31, 2002, and incorporated herein by reference.
- (22) Filed as Exhibit 10.1 to Form 10-Q for the quarter ended September 30, 2003, and incorporated herein by reference.
- (23) Filed as Exhibit 10.2 to Form 10-Q for the quarter ended September 30, 2003, and incorporated herein by reference.
- (24) Filed as Exhibit 10.3 to Form 10-Q for the quarter ended September 30, 2003, and incorporated herein by reference.
- (25) Filed as Exhibit 10.4 to Form 10-Q for the quarter ended September 30, 2003, and incorporated herein by reference.
- (26) Filed as Exhibit 10.32 to Form 10-K for the year ended December 31, 1999, and incorporated herein by reference.
- (27) Filed as Exhibit 10.1 to Form 10-Q/A-2 for the quarter ended September 30, 1998, and incorporated herein by reference.
- (28) Filed as Exhibit 10.2 to Form 10-Q for the quarter ended September 30, 1999, and incorporated herein by reference.
- (29) Filed as Exhibit 10.26 to Form 10-K for the year ended December 31, 2003, and incorporated herein by reference.
- (30) Filed as Exhibit 10.27 to Form 10-K for the year ended December 31, 2003, and incorporated herein by reference.
- (31) Filed as Exhibit 10.28 to Form 10-K for the year ended December 31, 2003, and incorporated herein by reference.
- (32) Filed as Exhibit 10.29 to Form 10-K for the year ended December 31, 2003, and incorporated herein by reference.
- (33) Filed as Exhibit 10.30 to Form 10-Q for the quarter ended March 31, 2004, and incorporated herein by reference.
- (34) Filed as Exhibit 10.31 to Form 10-Q for the quarter ended March 31, 2004, and incorporated herein by reference.
- (35) Filed as Exhibit 10.32 to Form 10-Q for the quarter ended March 31, 2004, and incorporated herein by reference.
- (36) Filed as Exhibit 10.33 to Form 10-Q for the quarter ended March 31, 2004, and incorporated herein by reference.
- (37) Filed as Exhibit 10.34 to Form 10-Q for the quarter ended March 31, 2004, and incorporated herein by reference.
- (38) Filed as Exhibit 10.35 to Form 10-Q for the quarter ended March 31, 2004, and incorporated herein by reference.
- (39) Filed as Exhibit 10.36 to Form 10-Q for the quarter ended March 31, 2004, and incorporated herein by reference.
- (40) Filed as Exhibit 10.35 to Form 10-Q for the quarter ended June 30, 2004, and incorporated herein by reference.
- (41) Filed as Exhibit 10.36 to Form 10-Q for the quarter ended June 30, 2004, and incorporated herein by reference.
- (42) Filed as Exhibit 10.37 to Form 10-K for the year ended December 31, 2004, and incorporated herein by reference.
- (43) Filed as Exhibit 10.38 to Form 10-K for the year ended December 31, 2004, and incorporated herein by reference.
- (44) Filed as Exhibit 10.39 to Form 10-K for the year ended December 31, 2004, and incorporated herein by reference.
- (45) Filed as Exhibit 10.40 to Form 10-K for the year ended December 31, 2004, and incorporated herein by reference.
- (46) Filed as Exhibit 10.1 to Form 8-K on January 18, 2005, and incorporated herein by reference.
- (47) Filed as Exhibit 10.2 to Form 8-K on January 18, 2005, and incorporated herein by reference.
- (48) Filed as Exhibit 10.3 to Form 8-K on January 18, 2005, and incorporated herein by reference.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on May 6, 2005.

COMMUNITY BANCSHARES, INC.

May 6, 2005

By: /s/ PATRICK M. FRAWLEY

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Patrick M. Frawley  
*Chairman and Chief Executive Officer*

May 6, 2005

By: /s/ KERRI C. KINNEY

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Kerri C. Kinney  
*Chief Financial Officer*