

COMMUNITY BANCSHARES INC /DE/  
Form 10-Q  
November 12, 2004

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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 September 30, 2004

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> (State or Other Jurisdiction of Incorporation or Organization)	<b>63-0868361</b> (I.R.S. Employer Identification No.)
<b>68149 Main Street, Blountsville, Alabama</b> (Address of Principal Executive Offices)	<b>35031</b> (Zip Code)

**(205) 429-1000**

(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 October 31, 2004, there were 8,420,716 shares of the registrant's common stock, \$.10 par value per share, outstanding.**

### **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 may not be realized due to a variety of factors, including, without limitation:

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;

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

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. You should not place undue reliance on forward-looking statements, as they are inherently uncertain and speak only as of the date they were made. 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.

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

	(Unaudited) September 30, 2004	December 31, 2003
<i>Assets</i>		
Cash and due from banks	\$ 28,778,663	\$ 30,370,220
Interest-bearing deposits in banks and federal funds sold	6,485,673	14,550,000
Cash and cash equivalents	35,264,336	44,920,220
Securities available for sale	141,919,571	156,270,593
Loans held for sale		1,821,221
Loans, net of allowance for loan losses of \$10,052,575 and \$14,357,624	306,698,111	301,849,451
Capitalized lease receivable	2,887,993	2,959,818
Accrued interest receivable	2,993,075	3,260,957
Premises and equipment, net	21,309,182	22,796,143
Goodwill and other intangible assets, net	2,385,961	2,445,524
Foreclosed assets	4,801,232	6,945,494
Other assets	16,824,639	15,285,190
<b>Total assets</b>	<b>\$ 535,084,100</b>	<b>\$ 558,554,611</b>
<i>Liabilities and stockholders' equity</i>		
Deposits:		
Noninterest-bearing	\$ 58,512,605	\$ 56,255,701
Interest-bearing	372,517,170	397,689,888
Total deposits	431,029,775	453,945,589
Other short-term borrowings	342,042	600,000
FHLB long-term debt	38,000,000	38,000,000
Capitalized lease obligations	3,912,500	3,976,367
Other long-term debt		3,168,502
Trust preferred securities (Note 6)		10,000,000
Junior subordinated debt (Note 6)	10,310,000	
Accrued interest payable	1,262,266	4,248,861
Other liabilities	6,573,296	9,297,672
<b>Total liabilities</b>	<b>491,429,879</b>	<b>523,236,991</b>
Commitments and contingencies (Note 10)		
Stockholders' equity		
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; 8,631,162 and 6,978,671 shares issued as of September 30, 2004 and December 31, 2003, respectively; 2,191,897 shares of which are exchangeable for preferred stock)	863,116	697,868

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Additional paid-in-capital	<b>48,807,812</b>	40,996,918
Stock warrant outstanding	<b>242,524</b>	
Treasury common stock, at cost (99,869 and 86,888 shares, as of September 30, 2004 and December 31, 2003, respectively)	<b>(980,427)</b>	(894,029)
Retained earnings (deficit)	<b>(1,772,089)</b>	(2,075,986)
Unearned ESOP common stock (110,577 and 123,111 shares as of September 30, 2004 and December 31, 2003, respectively)	<b>(1,615,908)</b>	(1,741,248)
Accumulated other comprehensive loss	<b>(1,890,807)</b>	(1,665,903)
	<hr/>	<hr/>
Total stockholders' equity	<b>43,654,221</b>	35,317,620
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Total liabilities and stockholders' equity	<b>\$ 535,084,100</b>	\$ 558,554,611
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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	
	September 30,	
	2004	2003
Interest income:		
Loans, including fees	\$ 6,345,294	\$ 6,645,482
Interest on investment securities:		
Taxable securities	1,381,696	924,482
Tax-exempt securities	70,572	83,578
Federal funds sold	19,132	39,622
Other	58,990	131,366
Total interest income	7,875,684	7,824,530
Interest expense:		
Deposits	2,176,746	2,438,689
Short-term borrowings	906	814
FHLB long-term debt	575,868	575,870
Capitalized lease obligations	43,589	41,643
Junior subordinated debentures	325,038	306,522
Other long-term debt		61,710
Total interest expense	3,122,147	3,425,248
Net interest income	4,753,537	4,399,282
Provision for loan losses	344,770	1,864,539
Net interest income, after provision for loan losses	4,408,767	2,534,743
Noninterest income:		
Service charges on deposits	749,816	594,493
Insurance commissions	667,776	597,911
Bank club dues	86,515	101,031
Debt cancellation fees	(13,668)	25,764
Securities gains, net	(44,302)	374,371
Other	118,083	119,653
Total noninterest income	1,564,220	1,813,223
Noninterest expense:		
Salaries and employee benefits	3,143,251	3,444,171
Occupancy	636,941	564,741
Furniture and equipment	386,905	359,006
Insurance	311,296	349,345
Director and committee fees	80,478	118,350
Professional services	494,804	917,052
Foreclosed assets, net	55,644	447,054
Disposal or impairment of assets	87,586	58,553

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Litigation, fraud or burglary	2,072	(867)
Other	698,134	1,330,368
	<u>          </u>	<u>          </u>
Total noninterest expense	5,897,111	7,587,773
	<u>          </u>	<u>          </u>
Income (loss) before income taxes	75,876	(3,239,807)
Income taxes	(56,595)	1,876,026
	<u>          </u>	<u>          </u>
Net income (loss)	\$ 19,281	\$ (1,363,781)
	<u>          </u>	<u>          </u>
Earnings (loss) per share:		
Basic	\$	\$ (0.29)
Diluted	\$	\$ (0.29)

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



## Community Bancshares, Inc. and Subsidiaries

## Consolidated Statements of Income

(Unaudited)

	Nine months ended	
	September 30,	
	2004	2003
Interest income:		
Loans, including fees	\$ 18,893,936	\$ 21,025,694
Interest on investment securities:		
Taxable securities	4,207,205	3,540,965
Tax-exempt securities	214,448	258,833
Federal funds sold	79,262	196,904
Other	169,184	145,620
Total interest income	<u>23,564,035</u>	<u>25,168,016</u>
Interest expense:		
Deposits	6,521,101	7,985,237
Short-term borrowings	2,148	2,527
FHLB long-term debt	1,715,088	1,708,829
Capitalized lease obligations	122,535	126,804
Junior subordinated debentures	1,018,310	954,488
Other long-term debt	49,706	139,680
Total interest expense	<u>9,428,888</u>	<u>10,917,565</u>
Net interest income	14,135,147	14,250,451
Provision for loan losses	722,442	5,475,019
Net interest income, after provision for loan losses	<u>13,412,705</u>	<u>8,775,432</u>
Noninterest income:		
Service charges on deposits	2,151,951	1,915,315
Insurance commissions	1,948,704	1,734,497
Bank club dues	269,087	312,394
Debt cancellation fees	(45,168)	74,331
Securities gains, net	193,690	1,102,967
Other	371,307	651,133
Total noninterest income	<u>4,889,571</u>	<u>5,790,637</u>
Noninterest expense:		
Salaries and employee benefits	9,261,481	10,083,128
Occupancy	1,756,770	1,736,461
Furniture and equipment	1,114,296	1,114,004
Insurance	909,549	930,544
Director and committee fees	269,400	337,967
Professional services	1,247,986	3,185,481
Foreclosed assets, net	483,081	979,958
Disposal or impairment of assets	190,419	95,435

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Litigation, fraud or burglary	23,837	38,350
Other	2,643,839	3,337,765
	<u>                    </u>	<u>                    </u>
Total noninterest expense	17,900,658	21,839,093
	<u>                    </u>	<u>                    </u>
Income (loss) before income taxes	401,618	(7,273,024)
Income taxes	(97,721)	2,818,928
	<u>                    </u>	<u>                    </u>
Net income (loss)	\$ 303,897	\$ (4,454,096)
	<u>                    </u>	<u>                    </u>
Earnings (loss) per share:		
Basic	\$ 0.04	\$ (0.96)
Diluted	\$ 0.04	\$ (0.96)

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)

Nine months ended September 30, 2003 and 2004

	<i>Shares of</i>		<i>Additional Paid in Capital</i>	<i>Stock Warrant Outstanding</i>	<i>Treasury Common Stock</i>	<i>Retained Earnings</i>	<i>Unearned ESOP Common Stock</i>	<i>Accumulated Other Comprehensive Income (Loss)</i>	<i>Total</i>
	<i>Common</i>	<i>Common</i>							
	<i>Stock</i>	<i>Stock</i>							
	<i>Issued</i>	<i>Stock</i>							
Balance at December 31, 2002	4,810,089	\$ 481,009	\$ 30,806,862	\$	\$ (441,768)	\$ 11,023,961	\$ (1,999,858)	\$ 440,750	\$ 40,310,956
Comprehensive income:									
Net loss during period						(4,454,096)			(4,454,096)
Change in unrealized gain (loss) on securities available for sale net of reclassification adjustment and tax effect								(2,229,700)	(2,229,700)
Total comprehensive loss									(6,683,796)
Common stock issued in lieu of cash paid for directors' fees at \$7.00 per share	17,030	1,703	117,514						119,217
Release of ESOP common stock			(57,835)				192,780		134,945
Treasury common stock acquired					(452,261)				(452,261)
Balance at September 30, 2003	4,827,119	\$ 482,712	\$ 30,866,541	\$	\$ (894,029)	\$ 6,569,865	\$ (1,807,078)	\$ (1,788,950)	\$ 33,429,061
Balance at December 31, 2003	6,978,672	\$ 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						303,897			303,897
Change in unrealized gain (loss) on securities available for sale net of reclassification adjustments and tax effect								(224,904)	(224,904)

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<b>Total comprehensive income</b>									<b>78,993</b>
<b>Issuance of common stock at \$5.35 per share</b>	<b>1,586,771</b>	<b>158,676</b>	<b>8,330,549</b>						<b>8,489,225</b>
<b>Common stock issuance costs</b>			<b>(825,844)</b>	<b>242,524</b>					<b>(583,320)</b>
<b>Common stock issued in lieu of cash paid for directors fees at \$5.35 per share</b>	<b>20,719</b>	<b>2,072</b>	<b>108,478</b>						<b>110,550</b>
<b>Common stock issued for stock options exercised</b>	<b>45,000</b>	<b>4,500</b>	<b>236,250</b>						<b>240,750</b>
<b>Release of ESOP common stock</b>			<b>(38,539)</b>			<b>125,340</b>			<b>86,801</b>
<b>Treasury common stock acquired</b>					<b>(86,398)</b>				<b>(86,398)</b>
<b>Balance at September 30, 2004</b>	<b>8,631,162</b>	<b>\$ 863,116</b>	<b>\$ 48,807,812</b>	<b>\$ 242,524</b>	<b>\$ (980,427)</b>	<b>\$ (1,772,089)</b>	<b>\$ (1,615,908)</b>	<b>\$ (1,890,807)</b>	<b>\$ 43,654,221</b>

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

## Community Bancshares, Inc. and Subsidiaries

## Consolidated Statements of Cash Flows

(Unaudited)

	Nine months ended	
	September 30,	
	2004	2003
<b>Operating activities:</b>		
Net income (loss)	\$ 303,897	\$ (4,454,096)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Provision for loan losses	722,442	5,475,019
Depreciation and amortization	1,224,166	1,317,228
Net amortization of securities	727,414	828,729
Deferred tax expense	2,990,664	(929,822)
Realized investment security gains	(193,690)	(1,102,967)
(Gain) loss on sale or impairment of premises and equipment	(20,479)	20,409
Realized losses on foreclosed assets	483,296	979,958
Decrease in accrued interest receivable	267,882	962,449
Increase in accrued interest payable	(2,986,595)	293,490
Other	(6,593,554)	194,267
<b>Net cash (used) provided by operating activities</b>	<b>(3,074,557)</b>	<b>3,584,664</b>
<b>Investing activities:</b>		
Proceeds from sales, calls and pay downs of securities available for sale	64,418,271	107,845,745
Proceeds from maturity of securities available for sale		18,200,000
Purchase of securities available for sale	(50,975,811)	(139,680,392)
Loan originations and principal collections, net	(5,200,307)	33,765,837
Proceeds from sale of premises and equipment	914,969	94,885
Additions to premises and equipment	(572,132)	(569,575)
Net proceeds from sale of foreclosed assets	3,179,568	1,615,962
<b>Net cash provided by investing activities</b>	<b>11,764,558</b>	<b>21,272,462</b>
<b>Financing activities:</b>		
Net increase in demand deposits, NOW accounts, savings and time open deposit accounts	15,899,376	23,120,925
Net decrease in certificates of deposit	(38,815,190)	(42,638,846)
Net decrease in short-term borrowings	(257,958)	(1,230,584)
Decrease in capitalized lease obligations	(63,867)	(59,687)
Repayment of long-term debt	(3,168,502)	(304,350)
Issuance of common stock, net of transaction costs	8,146,655	
Purchase of common stock into treasury	(86,399)	
<b>Net cash used in financing activities</b>	<b>(18,345,885)</b>	<b>(21,112,542)</b>
<b>Net change in cash and cash equivalents</b>	<b>(9,655,884)</b>	<b>3,744,584</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>44,920,220</b>	<b>40,206,613</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 35,264,336</b>	<b>\$ 43,951,197</b>

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Supplemental cash flow disclosures:		
Interest paid on deposits and borrowed funds	<b>\$ 12,415,482</b>	\$ 10,624,075
Schedule of non-cash investing and financing activities:		
Foreclosure of other real estate owned	<b>1,813,068</b>	6,426,542
Loan charge-offs, net of recoveries	<b>5,027,491</b>	3,199,753
Treasury stock acquired through debts previously contracted	<b>86,399</b>	452,261
Deconsolidation of special purpose trust (Note 6):		
Recognition of the equity investments in the special purpose trust	<b>310,000</b>	
Removal of the special purpose trust preferred securities	<b>10,000,000</b>	
Recognition of the junior subordinated debt in the special purpose trust	<b>10,310,000</b>	

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

**Note 1 General**

The 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, they 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 and nine month periods ended September 30, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004 or for any other interim periods. For further information, refer to the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2003 (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**

In January 2003, the Financial Accounting Standards Board ( FASB ) issued FIN 46, Consolidation of Variable Interest Entities. FIN 46 defines a variable interest entity ( VIE ) as a corporation, partnership, trust, or any other legal structure used for business purposes that has: (a) an insufficient amount of equity to permit the entity to finance its activities without additional subordinated financial support from other parties; or (b) a group of equity holders that lack the direct or indirect ability to make decisions about an entity's activities through voting rights or similar rights; or (c) a group of equity holders who are not obligated to absorb the expected losses of the entity or the right to receive the expected residual returns of the entity. FIN 46 requires a VIE to be consolidated by an investor company if the investor company, regardless of voting interests, is subject to a majority (greater than 50%) of the risk of the expected losses from the VIE's activities or is entitled to receive a majority (greater than 50%) of the VIE's expected residual returns or both. Prior to FIN 46, a partially-owned entity was only consolidated into the investor company's consolidated financial statements if it was controlled by the investor company through voting interests.

In December 2003, the FASB issued a revision of FIN 46. The Revised Interpretation codifies both the proposed modifications and other decisions previously issued through certain FASB Staff Positions ( FSP ) and supersedes the original Interpretation to include: (1) deferring the effective date of the Interpretation's provisions for certain variable interests; (2) providing additional core exceptions for certain other variable interests; (3) clarifying the impact of troubled debt restructurings on the requirement to reconsider (a) whether an entity is a VIE or (b) which party is the primary beneficiary of a VIE; and (4) revising Appendix B of the Interpretation to provide additional guidance on what constitutes a variable interest. The Revised Interpretation is effective for financial statements of periods ending after December 15, 2003. Entities which previously adopted the provisions of the original Interpretation had the option of continuing to apply those provisions until the effective date of the Revised Interpretation or applying the provisions of the Revised Interpretation at an earlier date. As discussed in Note 6, Variable Interest Entities, the Company adopted FIN 46 on March 31, 2004.

In March 2004, the SEC issued Staff Accounting Bulletin ( SAB ) 105, Application of Accounting Principles to Loan Commitments, which addresses certain issues regarding the accounting for and disclosure of loan commitments relating to the origination of mortgage loans that will be held for resale. Such commitments are considered derivatives under the provisions of SFAS No. 133, as amended by SFAS No. 149, and are therefore required to be recorded at fair value. SAB 105 stipulates that, in recording those commitments, no consideration should be given to any expected future cash flows related to the associated servicing of the future loan. SAB 105 further stipulates that no other internally-developed intangible assets, such as customer relationship intangibles, should be recorded as part of the loan commitment derivative. SAB 105 requires disclosure of accounting policies for loan commitment derivatives, including methods and assumptions used to estimate fair value and any associated economic hedging strategies. The provisions of SAB 105 are effective for loan commitment derivatives that are entered into after March 31, 2004 and have not had a material impact on the Company's financial statements.

In March 2004, the Emerging Issues Task Force ( EITF ) reached a final consensus on Issue No. 03-1, *The Meaning of Other-Than-Temporary and Its Application to Certain Investments*. The Issue applies to debt and equity securities within the scope of SFAS No. 115, certain debt and equity securities within the scope of SFAS No. 124, and equity securities that are not subject to the scope of SFAS No. 115 and not accounted for under the equity method of accounting (i.e., cost method investments). Issue 03-1 outlines a three-step model for assessing other-than-temporary impairment. The model involves first determining whether an investment is impaired, then evaluating whether the impairment is other-than-temporary, and if it is, recognizing an impairment loss equal to the difference between the investment's cost and its fair value. The model was to be applied prospectively to all current and future investments in interim or annual reporting periods beginning after June 15, 2004. However, in September 2004 the FASB staff issued



FASB Staff Position ( FSP ) EITF Issue 03-1-1 which delayed the effective date for the measurement and recognition guidance contained in Issue 03-1. The guidance for analyzing securities for impairment will be effective with the final issuance of FSP EITF Issue 03-1-a. The disclosure guidance of Issue 03-1 remains effective and requires quantitative and qualitative disclosures for investments accounted for under SFAS No. 115 and SFAS No. 124 for the first annual reporting period ending after December 15, 2003. In addition, disclosures related to cost method investments are effective for annual reporting periods ending after June 15, 2004. Comparative information for the periods prior to the period of initial application is not required.

### 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 been issued, as well as any adjustment to income that would result from 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.

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

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2004	2003	2004	2003
Net income (loss)	\$ 19,281	\$ (1,363,781)	\$ 303,897	\$ (4,454,096)
Less: preferred stock dividends				
Net income (loss) applicable to common stock	\$ 19,281	\$ (1,363,781)	\$ 303,897	\$ (4,454,096)
Weighted average number of common shares outstanding	8,415,375	4,669,789	8,215,216	4,652,012
Effect of dilutive options	97,065		99,334	
Weighted average number of common shares outstanding used to calculate diluted earnings per common share	8,512,440	4,669,789	8,314,550	4,652,012

No dividends were declared during the nine month periods ended September 30, 2004 or 2003.

### Note 4 Stock Based Compensation

The Company occasionally grants stock options to purchase the Company's common stock to officers and directors. The 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. Vesting traditionally has been immediate. As of September 30, 2004, the Company had outstanding options held by its officers and directors to purchase an aggregate of 1,477,000 shares of the Company's common stock. On February 20, 2004, upon the closing of its private

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placement of common stock, the Company became obligated to issue to the placement agent in that offering a warrant (the Warrant ) to purchase 140,187 shares of the Company s common stock at an 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 cashless exercise.

The following tables set forth certain information regarding stock options as well as the warrant discussed above for the nine months ended September 30, 2004:

	Number of Shares	Weighted Average Exercise Price
Balance, December 31, 2003	932,500	\$ 8.12
Granted, nine months ended September 30, 2004.	877,687	5.47
Exercised, expired or cancelled, nine months ended September 30, 2004.	(193,000)	9.93
<b>Balance, September 30, 2004</b>	<b>1,617,187</b>	<b>6.47</b>

<u>Exercise Prices</u>	Options Issued	Expiration Date	Options Exercisable
Options with exercise price of \$5.35	577,500	2009	577,500
Options with exercise price of \$5.50	50,000	2009	50,000
Options with exercise price of \$7.00	10,000	2009	10,000
Options with exercise price of \$7.05	5,000	2009	5,000
Warrant with exercise price of \$5.89	140,187	2008	140,187
Options with exercise price of \$7.00	599,000	2008	599,000
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
<b>Total outstanding, September 30, 2004</b>	<b>1,617,187</b>		<b>1,617,187</b>

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 nine month period ended September 30, 2004 under this scenario.

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 charge for the options resulted in a decrease to additional paid in capital of \$242,524.

Since the Company's options granted in 2004 and 2003 vest immediately, for purposes of pro forma disclosure, the compensation expense related to these options has been recognized in the year granted. 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:

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2004	2003	2004	2003
Net income (loss):				
As reported	\$ 19,281	\$ (1,363,781)	\$ 303,897	\$ (4,454,096)
Deducts:				
Total stock-based employee compensation expense determined under fair value based method for all awards, net of tax	(9,438)	(717,466)	(974,308)	(887,795)
Pro forma net loss	\$ 9,843	\$ (2,081,247)	\$ (670,411)	\$ (5,341,891)
Basic earnings (loss) per share:				
As reported	\$	\$ (0.29)	\$ 0.04	\$ (0.96)
Pro forma		(0.45)	(0.08)	(1.15)
Diluted earnings (loss) per share				
As reported		(0.29)	0.04	(0.96)
Pro forma		(0.45)	(0.08)	(1.15)

The weighted average fair values of options granted to officers and directors during the first nine months of 2004 and 2003 and used above for pro forma disclosures were \$2.15 and \$2.11 per share, 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:

	2004	2003
Dividend yield	0%	0%
Expected volatility	.403	.283
Risk free interest rate	3.17%	3.26%
Expected life (in years)	5	5

**Note 5 On Balance Sheet Derivatives Instruments and Hedging Activities**

*Accounting for Derivative Instruments and Hedging Activities*

The following table presents the notional value and carrying value amounts of the Company's derivative positions held for hedging purposes at both September 30, 2004 and December 31, 2003. This derivative position was executed in the over-the-counter market.

	September 30, 2004		December 31, 2003	
	Notional	Carrying	Notional	Carrying
	Value	Value	Value	Value
<b>Fair Value Hedges:</b>				
Interest rate swap agreement	\$ 20,000,000	\$ (102,000)	\$ 20,000,000	\$

*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 has entered into an interest rate swap to convert fixed rate long-term debt to floating rate debt. The critical terms of the interest rate swap matches the terms of the corresponding fixed rate long-term debt. All components of each derivative instrument's gain or loss are included in the assessment of hedge effectiveness, unless otherwise noted. There were no fair-value hedging gains or losses as a result of hedge ineffectiveness, recognized for the nine month period ended September 30, 2004 and 2003. The Company recognized a decrease to interest expense of \$238,250 for the nine months ended September 30, 2004 related to its interest rate swap accounted for as a fair value hedge. At September 30, 2004, the interest rate swap had a negative carrying value of \$102,000 and a remaining term of 2.6 years. Fluctuations in the fair value of derivatives contracts are typically attributable to market risk, since credit risk is minimal because the Company deals only with high-quality counterparties. The Company was not a party to any interest rate swaps during the first nine months of 2003.

**Note 6 Variable Interest Entities**

The Company adopted FIN 46 as of March 31, 2004. As a result, the Company deconsolidated its special purpose trust which was formed for the issuance of trust preferred securities to outside investors, 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 table below, 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 special purpose trust; and 3) to recognize the Company's equity investment in the common stock of the special purpose 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 special purpose 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 September 30, 2004 consolidated balance sheet:

	<b>Balance</b>		
	<b>Prior to</b>	<b>Adjustments</b>	<b>Adjusted</b>
	<b>Adjustment</b>	<b>for FIN 46</b>	<b>Balance</b>
	<u>          </u>	<u>          </u>	<u>          </u>
Other assets	\$ 16,514,639	\$ 310,000	\$ 16,824,639
Trust preferred securities	10,000,000	(10,000,000)	
Junior subordinated debentures		10,310,000	10,310,000

**Note 7 Issuance of Common Stock**

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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 3,738,324 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 2,191,898 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;

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.

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 first nine months of 2004 was 20,720 shares at a fair market value of \$110,550 on the issue date. 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 September 30, 2004, 45,000 stock options were exercised at a grant price of \$5.35 per share, resulting in an increase to total stockholders' equity of \$240,750.

#### Note 8 Pension Plan

Components of the Company's pension plan and benefit restoration plan net periodic benefit cost as of September 30, 2004 are as follows:

	<b>Pension</b>	<b>Benefit</b>
	<b>Plan</b>	<b>Restoration</b>
	<b>Plan</b>	<b>Plan</b>
Interest cost on earned benefit obligations	\$ 265,253	\$ 102,079
Estimated return on plan assets	(274,874)	
Amortization of net experience loss	11,844	
<b>Net periodic benefit cost</b>	<b>\$ 2,223</b>	<b>\$ 102,079</b>

The Company was required to contribute, and has contributed, \$783,061 and \$829,866 to the pension plan during 2004 and 2003, respectively.

#### Note 9 Long-term Debt

On November 3, 1993, the Company's Employee Stock Ownership Plan, the ESOP, borrowed \$1.2 million from Colonial Bank to purchase shares of the Company's common stock, and the Company guaranteed all obligations of the ESOP under this ESOP loan. The ESOP loan was amended from time to time, including additional borrowings, but was paid off during the first quarter of 2004 with direct financing from the Company in the form of a note from the ESOP. As the ESOP note is paid off, the Company releases shares from the pledge, and these shares are

allocated to ESOP participants annually.

The Company's loan to the ESOP bears interest at a floating rate at the prime rate of interest. As of September 30, 2004, the interest rate on the ESOP note was 4.75%. Principal and interest payments on the ESOP note are due monthly through November 16, 2010, with the remaining principal and interest, if any, due upon that date. The ESOP note may be prepaid in whole or in part without penalty under the note agreement. The Company makes contributions to the ESOP that enables the ESOP to make payments due under the ESOP note 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 and 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 September 30, 2004, was \$1,603,175.

During the second quarter of 2004, the Company paid off in full a 20 year, subordinated installment capital note due to Mr. Jeffrey K. Cornelius on October 1, 2004 that was bearing interest at the fixed annual rate of 7.0%. The balance of this note at December 31, 2003 was \$1,410,211.

#### **Note 10 Contingencies**

##### **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. Based upon the size of this amount, management commenced an investigation into these expenditures.



At the request of management, the architects and subcontractors involved in the construction project made presentations to the boards of directors of the Community Bancshares and Community Bank on July 15 and July 18, 2000, respectively. At the July 18, 2000 meeting of the board of directors of Community Bank, another director alleged that Community Bank had been overcharged by subcontractors on that construction project, as well as on another construction project that remained uncompleted at that time.

On July 18, 2000, the boards of directors of Community Bancshares and Community Bank appointed a joint committee comprised of independent directors to investigate these alleged overcharges. The joint committee retained independent legal counsel and an independent accounting firm to assist its investigation and has since made its report to the boards of directors.

Community Bank's directors who alleged the construction overcharges also informed bank regulatory agencies and law enforcement authorities of their concerns. These agencies and authorities conducted their own investigations into this matter. Based on its findings, the FDIC issued restitution and/or removal orders against Kennon R. Patterson, Sr., former Chairman and Chief Executive Officer of the Company and Community Bank, and Larry Bishop, former Vice President of Community Bank. These regulatory actions are still pending at this time. The board of directors of Community Bancshares and the board of directors of Community Bank terminated Kennon R. Patterson, Sr. on January 27, 2003, and the board of directors of Community Bank terminated Larry Bishop on February 6, 2003. On October 29, 2003, the United States Department of Justice announced the filing of a 25-count indictment against Messrs. Patterson and Bishop, and a construction contractor, in connection with a scheme to divest Community Bank's funds for Mr. Patterson's personal benefit. On November 14, 2003, Mr. Patterson informed Community Bancshares that he was taking a leave of absence from Community Bancshares' board of directors pending a resolution of the criminal charges against him. Mr. Patterson stated that he would not seek re-election to Community Bancshares' board of directors if the criminal charges were not resolved prior to the expiration of his current term in 2005. On June 24, 2004, at the Company's 2004 annual meeting of stockholders, Mr. Patterson was removed as a director of the Company. Community Bancshares and Community Bank continue to seek recovery of all amounts owed by Mr. Patterson to Community Bank.

#### **Patterson Litigation I**

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

Defendants: Community Bancshares, Community Bank, five of the directors of Community Bancshares and Community Bank, and Powell, Goldstein, Frazer and Murphy, LLP, as counsel to Community Bank's Audit Committee

On April 9, 2003, Mr. Patterson filed an adversary proceeding against the defendants in the United States Bankruptcy Court for the Northern District of Alabama in connection with his petition for protection under Chapter 11 of the United States Bankruptcy Code. Mr. Patterson's complaint:

alleges that Community Bancshares breached its employment agreement with Mr. Patterson by terminating his employment on January 27, 2003 and failing to pay him for compensation and benefits that had accrued prior to his termination; and

alleges that Community Bank, members of Community Bank's Audit Committee, the Audit Committee's independent counsel and Community Bancshares' current Chairman, President and Chief Executive Officer conspired to interfere with Mr. Patterson's contract and business relationship with Community Bancshares.

The suit seeks damages in excess of \$150.0 million for, among other things, lost compensation and benefits, mental anguish, and damage to Mr. Patterson's reputation.

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On May 9, 2003 the defendants filed a motion to dismiss the suit, and, on June 17, 2003, the court denied the motion to dismiss the suit as to Community Bancshares, Community Bank and the named directors. On July 7, 2003, those defendants filed a counterclaim against Mr. Patterson asserting that Mr. Patterson breached his employment agreement with Community Bancshares, engaged in fraudulent conduct, and converted property belonging to Community Bank to his personal use.

On January 12, 2004, the bankruptcy proceeding filed by Mr. Patterson was dismissed without prejudice. Community Bancshares, Community Bank and the individual defendants moved to dismiss the adversary proceeding in bankruptcy filed against them by Mr. Patterson. That motion was granted on July 26, 2004, and the adversary proceeding was dismissed.

## **Patterson Litigation II**

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 in order to pursue those claims which had been asserted against him as counterclaims in the adversary proceeding in bankruptcy. 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.

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.

## **Patterson Litigation III**

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

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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.

### **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 July 21, 2000, the plaintiffs filed a lawsuit, styled as a stockholder derivative suit, in the state Circuit Court of Marshall County, Alabama against the defendants, relating to alleged overcharges in construction costs. At the time, these charges were being investigated by a joint committee of the boards of directors of Community Bancshares and Community Bank.

The complaint:

alleges that the directors, officers and employee named as defendants (i) breached their fiduciary duties, (ii) failed to properly supervise officers and agents of Community Bancshares and Community Bank, and (iii) permitted waste of corporate assets by permitting the subcontractor defendants to overcharge Community Bank in connection with the construction of two new Community Bank branch offices, and to perform the construction work without written contracts, budgets, performance guarantees and assurances of indemnification;

alleges that Kennon R. Patterson, Sr., the Company's former Chairman, President and Chief Executive Officer, breached his fiduciary duties by permitting the two named subcontractors to overcharge for work performed on the two construction projects in exchange for discounted charges for work these subcontractors performed in connection with the construction of Mr. Patterson's residence;

alleges that the director defendants knew or should have known of this alleged arrangement between Mr. Patterson and the subcontractors; and

alleges that Mr. Patterson, the Community Bank employee and the two subcontractor defendants made false representations and suppressed information about the overcharges and arrangement between Mr. Patterson and the subcontractors.

On August 15, 2000, the plaintiffs filed an amended complaint that generally reiterates the allegations of the original complaint, and further:

alleges that the Bank was overcharged on all construction projects from January 1997 to the present; and

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alleges that the defendants breached their fiduciary duties and are guilty of gross financial mismanagement, including making or approving loans and taking improper actions to conceal the fact that the loans were uncollectible.

On September 18, 2000, the plaintiffs filed a second amended complaint generally reiterating the allegations of the original and first amended complaints, and further:

alleging that the plaintiffs were improperly denied their rights to inspect and copy certain records of Community Bancshares and Community Bank; and

alleging that the directors of Community Bancshares abdicated their roles as directors either by express agreement or as a result of wantonness and gross negligence.

The second amended complaint further asserts that the counts involving inspection of corporate records and director abdication are individual, non-derivative claims. The second amended complaint seeks, on behalf of Community Bancshares, an unspecified amount of compensatory damages in excess of \$1.0 million, punitive damages, disgorgement of improperly paid profits and appropriate equitable relief. Upon a motion of the defendants, the case was transferred to the state Circuit Court in Blount County, Alabama by order dated September 21, 2000, as amended on October 12, 2000.

Tentative settlements of the lawsuit were announced in November 2002, August 2003 and November 2003 but were not finalized.

On January 6, 2004, the Circuit Court of Blount County, Alabama disapproved a proposed settlement of the Benson and Packard derivative lawsuits. Subsequently, another settlement proposal was made by the individual defendants, other than Kennon R. Patterson, Sr., directly to Community Bancshares and Community Bank. Pursuant to this new settlement, Community Bank would receive \$1.655 million, less any fees awarded by the Court to the plaintiffs' attorneys. A special committee of the Boards of Directors of the two companies, consisting of the members who are not defendants in the cases, accepted the offer which was then filed with the Court on February 19, 2004. All proceedings in these cases were then stayed pending a decision from the Supreme Court of Alabama as to whether the cases could proceed as to Mr. Patterson and Larry Bishop prior to their trial on criminal charges. On October 25, 2004 the Supreme Court of Alabama lifted the stay for the limited purpose of allowing the Circuit Court of Blount County to consider a settlement. No hearing has been scheduled.

On or about April 5, 2004, Travelers Casualty and Surety Company of America filed a motion for permission to intervene in the Benson litigation asserting that, to the extent that it is required to reimburse Community Bancshares and Community Bank for losses pursuant to the Company's fidelity bond, it will be subrogated to the derivative claims made on behalf of Community Bancshares and Community Bank in the Benson litigation.

#### **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 April 4, 2003, the plaintiffs, which are the same as in the Benson case described above, filed a derivative action against the defendants. This action, while stemming from the same facts alleged in the Benson Litigation, is based not upon what the director-defendants did (and did not do) before learning of the over billing [sic.] allegations against [Mr.] Patterson in July 2000 but, instead, is based upon what they have done (and failed to do) after the filing of the Benson lawsuit that is, after they learned of the allegations against [Mr.] Patterson in July 2000.

On June 18, 2003, the Circuit Court of Jefferson County, Alabama granted the motion filed by Community Bancshares, Community Bank and most of the individual defendants to transfer the suit to the Circuit Court of Blount County, Alabama.

On or about October 1, 2003, one of the defendants, Dudley, Hopton-Jones, Sims & Freeman, PLLP, formerly the certified public accountants and outside auditors for Community Bancshares and Community Bank, filed a cross-claim against Community Bank, Community Bancshares, 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, all of whom are directors or former directors of

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Community Bancshares and/or Community Bank. The cross-claim demands compensatory damages, interest, and costs, including the amount of any adverse judgment entered in this cause against Dudley, Hopton-Jones. Punitive damages are also demanded in some counts. The basis for the claims is common law indemnity, contractual indemnity, negligence, misrepresentation, suppression, and concealment of material facts, and, civil conspiracy.

On November 11, 2003 Community Bancshares, Community Bank, and certain individual defendants entered into an agreement to settle this case, which was not finalized.

On January 6, 2004, the Circuit Court of Blount County, Alabama disapproved a proposed settlement of the Benson and Packard derivative lawsuits. Subsequently, another settlement proposal was made by the individual defendants, other than Kennon R. Patterson, Sr., directly to Community Bancshares and Community Bank. Pursuant to this new settlement, Community Bank would receive \$1.655 million, less any fees awarded by the Court to the plaintiffs attorneys. A special committee of the Boards of Directors of the two companies, consisting of the members who are not defendants in the cases, accepted the offer which was then was filed



with the Court on February 19, 2004. All proceedings in these cases were then stayed pending a decision from the Supreme Court of Alabama as to whether the cases could proceed as to Mr. Patterson and Larry Bishop prior to their trial on criminal charges. On October 25, 2004 the Supreme Court of Alabama lifted the stay for the limited purpose of allowing the Circuit Court of Blount County to consider a settlement. No hearing has been scheduled.

#### **Fidelity Bond Litigation**

<u>Plaintiffs:</u>	Community Bancshares and Community Bank
<u>Defendant:</u>	Travelers Casualty & Surety Company of America
<u>Third-Party Defendants:</u>	Certain present and former directors of Community Bancshares and Community Bank, a former officer of Community Bank, and two accounting firms formerly engaged by Community Bancshares

On August 20, 2004, Community Bancshares and Community Bank filed suit in the Circuit Court of Blount County, Alabama against Travelers Casualty & Surety Company of America, issuer of a financial institution fidelity bond purchased by Community Bancshares and Community Bank. The complaint:

alleges that Travelers breached its contract with Community Bancshares and Community Bank by failing to pay a claim related to employee dishonesty in connection with the construction of Mr. Patterson's house; and

seeks a declaratory judgment to the effect that Community Bancshares and Community Bank are entitled to the full amount of the claim, and that Travelers is not entitled to subrogation of the claims of Community Bancshares and Community Bank against certain individual defendants in the Benson derivative litigation.

On October 19, 2004, Travelers filed a third-party complaint against certain present and former directors of Community Bancshares and Community Bank, a former officer of Community Bank, and two accounting firms which were formerly engaged by Community Bancshares. The third-party complaint:

alleges that the individual defendants breached a duty of loyalty, duty of care, duty of fair dealing and other duties to Community Bancshares and Community Bank in connection with their actions and/or their failure to act with respect to the construction overcharges and other related matters;

alleges that the individual defendants wasted assets of Community Bank by agreeing to excessive construction payments and making certain other expenditures;

alleges that the director defendants permitted certain insiders of Community Bank to receive loans from Community Bank which involved more than the normal risk of repayment or presented other unfavorable features in violation of Alabama banking law;

alleges that the director defendants abdicated their role as board members by not supervising the actions of Mr. Patterson;

alleges that Mr. Patterson and Larry Bishop made false representations and/or suppressed material information concerning construction projects and certain Community Bank loans;

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alleges that the director defendants, Mr. Patterson and Mr. Bishop all conspired to commit the alleged wrongs stated above;

alleges that the accounting firms breached a duty of care and committed malpractice in negligently auditing Community Bancshares and Community Bank during the time when the construction overcharges and other alleged improprieties occurred; and

seeks damages from the third-party defendants equal to the amount of Community Bancshares and Community Bank's claim against Travelers under the financial institution fidelity bond.

On October 1, 2004, Travelers filed a notice that the case was being removed from the Circuit Court of Blount County, Alabama to the United States District Court for the Northern District of Alabama. On October 28, 2004, Community Bancshares and Community Bank filed a motion to remand the case to the Circuit Court of Blount County.

### **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.

### **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.

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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. Community Bancshares presently believes that, other than the litigation discussed above, there is no other litigation to which Community Bancshares or its affiliates presently are subject 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 Community Bancshares' financial condition or results of operations.

Community Bancshares' Certificate of Incorporation and Bylaws provide that, in certain circumstances, Community Bancshares will indemnify its directors and officers, and, provided such persons acted in accordance with the standards set forth in the Delaware General Corporation Law and Community Bancshares' organizational documents, advance expenses to its directors and officers in connection with investigations and proceedings in connection with their service as officers and directors of Community Bancshares.

### **Contingency Losses**

In all claims against the Company, management has assessed where losses are both probable and can be reasonably estimated. As a result of this assessment, the Company accrued \$2,500,000 for gross possible losses during 2003. As of September 30, 2004, \$309,896 of this reserve remained and is reported in other liabilities on the Company's balance sheet. Management believes this reserve is warranted based on the status of pending settlements. The difference of \$2,190,014 was the result of settlement agreements reached during the first nine months of 2004.

## 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, 2003.

### Overview

We conduct our operations, which consist primarily of traditional commercial banking operations, through Community Bank and its subsidiaries. We provide a full range of financial services to individual and corporate customers in eleven counties in north Alabama—Blount, Cullman, DeKalb, Etowah, Lauderdale, Limestone, Madison, Marshall, Morgan, St. Clair and Talladega Counties; three counties in northwest Alabama—Marion, Walker 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.

For the year ended December 31, 2003, the Company had a loss of approximately \$13.1 million. In comparison, the Company reported net income of approximately \$904,000 for the year ended December 31, 2002. This change of approximately \$14.0 million is attributable to a variety of factors, including, among other things:

income of approximately \$8.5 million from discontinued operations which was recorded in the Company's 2002 net income, and no similar income realized in 2003;

an increase of approximately \$7.1 million in noninterest expenses due to: (i) increased professional fees associated with continued litigation and regulatory issues the Company has been confronting; (ii) increased foreclosed assets and related costs, as the Company has identified and addressed problems in its loan portfolio and the resulting increase in foreclosed assets, (iii) impairments on fixed assets as part of the Company's branch rationalization decisions, and (iv) losses that were realized on certain pending litigation matters;

a decline of approximately \$4.6 million in net interest income occurred in 2003, primarily due to: (i) lower levels of earning assets, resulting from the Company's decreased new loan growth and an increase in contractual and early payments, as well as charge-offs and foreclosures, and (ii) lower yields on earning assets due to: (x) an overall lower interest rate environment, (y) increased nonaccrual loans, and (z) increased levels of investment securities, which typically have lower yields than loans; and

an increase of approximately \$1.4 million in the provision for loan losses, reflecting the Company's continuing efforts to timely identify and resolve problem loans.

These factors were partially offset by a related tax benefit during 2003 of approximately \$8.1 million.

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For the first nine months of 2004, the Company had net income of \$304,000, which represented an increase of \$4.8 million from the Company's net loss of \$4.5 million for the first nine months of 2003. For the three months ended September 30, 2004, the Company had net income of \$19,000, which represented an increase of \$1.4 million from the Company's net loss of \$1.4 million for the corresponding period in 2003. For both periods, increases in net income were mostly attributable to the decrease in the provision for loan losses and noninterest expenses, partially offset by decreases in noninterest income. Net interest income increased for the three months ended September 30, 2004, as compared to the same period in 2003, but decreased slightly on a year to date comparison.

During the fourth quarter of 2003, the Company commenced a private placement of its common stock, and, as of December 31, 2003, the Company had sold 2,151,553 shares of its common stock at a price of \$5.35 per share, resulting in net proceeds of approximately \$10.4 million. 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 2,191,898 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 Company completed this offering on February 20, 2004, selling an additional 1,586,771 shares of its common stock for \$7.9 million of additional net proceeds, resulting in the sale of a total of 3,738,324 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. In connection with the closing of the offering on February 20, 2004, the Company became obligated to issue to 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.

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

litigation losses.

## Critical Accounting Policies

The Company's accounting policies are established in accordance with accounting principles generally accepted in the United States and general practices within the Company's 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 the Company has at the time. 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 the Company's estimates and judgments, then the Company's financial condition and results of operations may prove to be materially different from the presentation herein.

The Company recognizes the following as critical accounting policies:

*Accounting for Allowance for Loan Losses.* Management analyzes the loan portfolio to determine the adequacy of the allowance for loan losses and the appropriate provision required to maintain a level that management considers to be adequate to absorb anticipated loan losses. When management believes 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. Management's evaluation of the adequacy of the allowance for loan losses is based on a formal analysis which assesses the risks within the loan portfolio. Among other factors that management considers are the following:

the Company's 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;

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. Management believes that the allowance for loan losses was adequate at September 30, 2004. While management uses 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 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.

*Accounting for Income Taxes.* The Company uses the asset and liability method of accounting for income taxes. The Company's determination of the deferred and current provision for income taxes requires analysis by the Company's management of certain transactions and the related tax laws and regulations applicable to those transactions. Management exercises significant judgment in

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evaluating the amount and timing of the recognition of the resulting tax liabilities and assets. Those judgments and estimates are re-evaluated on a continual basis as regulatory and business factors change. However, because management's judgments and estimates are inherently subjective and subject to change, there can be no assurance that the Company's 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, management acquires 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 10 to the Company's consolidated financial statements, legal proceedings are pending or threatened against the Company, its subsidiaries as well as their respective indemnities. Except as discussed in Note 10:

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

management is 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, management has not provided any amounts in the consolidated financial statements for unfavorable outcome, if any.

As discussed in Note 10, as of December 31, 2003, the Company had accrued \$2.5 million for potential settlements on pending litigation, where in management's best judgment, these settlements were both probable and reasonably estimated. These estimates were based on current circumstances of pending matters, and, although management believes the loss recognized was appropriate, circumstances could change resulting in a different amount of loss. As of September 30, 2004, the balance accrued for potential losses was \$310,000. The decrease in the reserve was the result of settlement agreements reached, substantially all of which was the Corr Family litigation. Management believes the amount accrued is warranted based on the status of pending settlements.

The present litigation environment is substantially uncertain, and it is possible that the Company's 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, the Company and its subsidiaries may enter into discussions in an attempt to settle particular cases if it is in the best interests of the Company's stockholders to do so.

*Accounting for Impaired Assets.* Statement of Financial Accounting Standard No. 144 ( SFAS 144 ), Accounting for the Impairment or Disposal of Long-Lived Assets, requires long-lived assets to be sold to 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. As of December 31, 2003, the Company has classified three properties as held for sale. Consequently, the Company incurred a loss of \$928,397 on these assets in transferring them to held for sale. The Company used estimates in determining the fair values of these assets and, although the Company believes the fair values established are reasonable, it is possible that the Company's results of operations, cash flows or financial position could be materially affected by the eventual sale of the assets. During the quarter ended March 31, 2004, one of these properties was sold and the Company recognized a \$50,000 gain in the sale. As of September 30, 2004, two properties remained classified as held for sale.

## FINANCIAL CONDITION

*As of September 30, 2004 compared to December 31, 2003*

**General**

The Company's total assets at September 30, 2004 were \$535.1 million, a decrease of \$23.5 million, or 4.2%, from \$558.6 million at December 31, 2003. The Company experienced an increase in loans, net of allowance for loan losses, of \$4.8 million during the first nine months of 2004. The Company experienced a decline in deposits during the first nine months of 2004 of \$22.9 million, or 5.0%, primarily as the result of management's decision not to rebid on higher priced certificates of deposits, since minimal loan growth has

reduced our funding needs and we have sought to focus on building profitable relationships. Noninterest-bearing deposits increased \$2.2 million, or 3.9%, from December 31, 2003 to September 30, 2004, and interest-bearing deposits have decreased by \$25.2 million, or 6.3%.

### **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 government deposits. The Company's investment securities decreased \$14.4 million to \$141.9 million at September 30, 2004, from \$156.3 million at December 31, 2003. This 9.2% decrease in investment securities occurred as the Company implemented strategies to reduce investment securities to make funds available for lending activities. 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 \$326,000 at September 30, 2004, compared to \$260,000 at December 31, 2003. At September 30, 2004, the Company had \$6.2 million in federal funds sold, compared to \$14.3 million at December 31, 2003, representing a decrease of \$8.1 million, or 56.6%. This significant decline in the Company's federal funds sold is due to the Company's focus on increasing higher yielding investment securities and loans by shifting funds away from federal funds as well as the overall decrease in deposits.

Cash due from banks decreased \$1.6 million during the first nine months of 2004, from \$30.4 million at December 31, 2003 to \$28.8 million at September 30, 2004.

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 \$316.8 million at September 30, 2004, which represented an increase of approximately \$600,000, or 0.2%, from \$316.2 million at December 31, 2003. This increase was primarily the result of efforts focused on quality loan growth during 2004. Loans held for sale decreased to zero as all these loans were sold during the second quarter of 2004.

### **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, 2003 and September 30, 2004, the Company's ratio of the allowance for loan losses to these total nonperforming assets increased from 59.62% at year-end 2003 to 63.61% at September 30, 2004, and has increased significantly from 42.34% at September 30, 2003. The ratio of total nonperforming assets to total assets decreased to 2.95% at September 30, 2004, from 4.31% at year-end 2003, while the ratio of nonperforming loans to total loans, net of unearned income, decreased to 3.47% at September 30, 2004 from 5.42% at December 31, 2003. These changes were primarily due to a decrease in nonaccruing loans of \$5.6 million, or 39.7%, to \$8.5 million at September 30, 2004, from nonaccruing loans of \$14.1 million at December 31, 2003, due to ongoing efforts to improve credit quality, as well as sales of nonperforming loans to third parties. Loans 90 days or more past due decreased to \$0.3 million at September 30, 2004, from \$0.6 million at December 31, 2003. Total nonperforming assets decreased \$8.3 million, or 34.4%, to \$15.8 million at September 30, 2004, from total nonperforming assets of \$24.1 million at December 31, 2003. The Company continues to recognize problem assets that have resulted from the credit standards applied by, and other actions of, prior management. This recognition, together with the improvement in the Company's credit standards has resulted in significantly higher than normal nonperforming assets.

The following table summarizes the Company's nonperforming assets at September 30, 2004 and 2003, as well as December 31, 2003.

### NONPERFORMING ASSETS

(Dollars in 000 s)

	September 30,		December 31, 2003
	2004	2003	
Nonaccruing loans	\$ 8,464	\$ 14,248	\$ 14,138
Loans past due 90 days or more	271	1,404	611
Restructured loans	2,267	2,076	2,390
<b>Total nonperforming loans</b>	<b>11,002</b>	<b>17,728</b>	<b>17,139</b>
Other real estate owned	4,801	10,759	6,945
<b>Total nonperforming assets</b>	<b>\$ 15,803</b>	<b>\$ 28,487</b>	<b>\$ 24,084</b>
<b>Ratios:</b>			
Allowance for loan losses to loans, net of unearned income	3.17%	3.81%	4.51%
Allowance for loan losses to total nonperforming assets	63.61	42.34	59.62
Total nonperforming loans to total loans (net of unearned income)	3.47	5.60	5.42
Total nonperforming assets to total assets	2.95	5.28	4.31

On November 9, 2004, the United States District Court for the Northern District of Alabama vacated a restraining order against the real estate held as collateral on the loan to Kennon R. Patterson. The principal balance of the loan is \$5,150,000 and is included in nonaccrual loans. Management believes adequate reserves have been established for credit risk inherent in this loan. We will continue to monitor all relevant factors and make all warranted adjustments based on changing circumstances. Although the Company expects to pursue foreclosure and forfeiture proceedings, there is no assurance that the Company will be able to successfully foreclose or that it will be able to do so on favorable terms.

### 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 and long-term borrowings. Total deposits of \$431.0 million at September 30, 2004 reflected a decrease of \$22.9 million, or 5.0%, from total deposits of \$453.9 million at year-end 2003 due to decreases in interest-bearing deposits. Deposits are Community Bank's primary source of funds. Noninterest-bearing deposits increased \$2.2 million, or 3.9%, to \$58.5 million at September 30, 2004, from \$56.3 million at December 31, 2003, while interest-bearing deposits decreased \$25.2 million, or 6.3%, to \$372.5 million at September 30, 2004, from \$397.7 million at December 31, 2003. Certificates of deposit and other time deposits of \$100,000 or more decreased \$5.9 million, or 8.5%, to \$63.4 million at September 30, 2004, from \$69.3 million at December 31, 2003. The Company has experienced declines in interest-bearing deposits as a result of decreases in certificates of deposit as the Company has sought to lower its cost of funds and therefore, reduced rates paid on, and to attract, these accounts. Total short-term borrowings decreased \$258,000 to \$342,000 at September 30, 2004 from \$600,000 at December 31, 2003.

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 will be the prime rate plus 50 basis points. It will mature on May 1, 2009, and only interest is due for two



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years with principal payments to begin thereafter. At September 30, 2004, 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 September 30, 2004, 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 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 September 30, 2004 and December 31, 2003, while other long-term debt decreased \$3.2 million, or 100.0%, to a zero balance at September 30, 2004,

from \$3.2 million at December 31, 2003. This decrease resulted from the pay-off of the loan to the Company's ESOP on February 11, 2004, which was guaranteed by the Company and thus recorded as debt on the Company's balance sheet, and the pay-off of a subordinated promissory note on June 8, 2004 in the total aggregate amount of \$1.4 million to Mr. Jeffrey K. Cornelius.

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

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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 its special purpose trust which was formed for the issuance of trust preferred securities to outside investors, because it 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, was:

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

to recognize the Company's junior subordinated debt obligation to the special purpose trust; and

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

On November 3, 1993, the ESOP borrowed \$1.2 million from Colonial Bank to purchase shares of the Company's common stock, and the Company guaranteed all obligations of the ESOP under this ESOP loan. The ESOP loan has been amended from time to time, including additional borrowings but was paid off in full during the first quarter of 2004 and was replaced with direct financing from the Company in the same amount that previously was outstanding under the ESOP note. As the ESOP note is paid off, the Company releases shares from the pledge, and these shares are allocated to ESOP participants annually.

The Company's loan to the ESOP bears interest at a floating rate at the prime rate of interest. As of September 30, 2004, the interest rate on the note was 4.75%. 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 September 30, 2004, was \$1.6 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 has 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.

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The Company has 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 the Company is not obligated for this payment, 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, there will be no effect on net income, but cash out flows will increase as the liability will be reduced each month as benefit payments are made. We do not expect to have a determination on this matter until at least 2005. Please also see Note 10 in the unaudited notes to consolidated financial statements included in this report.

On June 24, 2004, at the annual meeting of stockholders, Mr. Patterson was removed as a director of the Company.

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## Liquidity

The following is a discussion of cash flows and sources of liquidity. The Company experienced an approximate \$9.7 million decrease in cash and cash equivalents during the first nine months of 2004, due primarily to cash flows used by financing activities as the Company experienced reductions in certificates of deposit and paid off certain long-term debt. Cash used by operating activities was \$3.1 million, compared to cash provided by operating activities of \$3.6 million for the nine month period ended September 30, 2003. Investing activities provided cash of \$11.8 million, resulting mostly from proceeds of sales, calls, and paydowns of securities net of purchases of securities and loan originations net of collections. The Company used \$18.3 million of cash and cash equivalents in financing activities during the first nine months of 2004, compared to \$21.1 million for financing activities during the first nine months of 2003. Certificates of deposits decreased \$38.8 million during the first nine months of 2004, which was slightly offset by increases in cash from the growth of demand deposits, NOW deposits, and other savings deposits totaling \$15.9 million, and further offset by a cash increase of \$8.1 million as a result of the issuance of common stock. The Company also used \$3.2 million to pay off certain long-term debt.

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. As described below under Regulatory Restrictions, the Bank currently cannot pay dividends to the Company without the prior approval of the regulatory authorities.

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 above in Note 10 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, or as it resolves its non-performing assets.

## Capital Resources

The Company's total stockholders' equity at September 30, 2004 was 8.16% of total assets, as compared to 6.32% at December 31, 2003. This increase is primarily the result of the Company's recent completion in the first quarter of 2004 of a private placement of its common stock. See Note 7 to the Company's unaudited consolidated financial statements included in this Report.

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

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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;

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



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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 \$52.1 million at September 30, 2004, compared to \$44.1 million at December 31, 2003. Tier 1 Capital plus Tier 2 Capital components are referred to as Total Risk-Based Capital, which was equal to \$56.3 million at September 30, 2004, as compared to \$48.4 million at year-end 2003.

The Company's Tier 1 and Total Risk-Based Capital ratios were 15.79% and 17.07%, respectively, at September 30, 2004, compared to 13.23% and 14.52%, respectively, at year-end 2003. At September 30, 2004, 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 9.62% and 7.96% at September 30, 2004 and December 31, 2003, respectively. As described below under Regulatory Restrictions, the Company is currently required by its regulators to maintain a minimum Tier 1 leverage ratio of 6.50%. The Company was in compliance with that requirement at September 30, 2004.

The Bank is required to maintain a Tier 1 capital ratio of at least 7.0% pursuant to a Safety and Soundness Compliance Plan issued by the FDIC and the Alabama State Banking Department, as further described below under Regulatory Restrictions.

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 September 30, 2004 and December 31, 2003:

	September 30,		December 31,	
	2004		2003	
	Amount	Ratio	Amount	Ratio
(Dollars in thousands)				
<b>Total risk based capital</b>				
<b>(to risk weighted assets):</b>				
<b>Consolidated</b>	\$ 56,291	17.07%	\$ 48,423	14.52%
<b>Community Bank</b>	49,983	15.30	46,919	14.10
<b>Tier 1 capital</b>				
<b>(to risk weighted assets):</b>				
<b>Consolidated</b>	52,095	15.79	44,127	13.23
<b>Community Bank</b>	45,827	14.03	42,633	12.81
<b>Tier 1 capital</b>				
<b>(to quarterly average assets):</b>				
<b>Consolidated</b>	52,095	9.62	44,127	7.96
<b>Community Bank</b>	45,827	8.51	42,633	7.72

#### 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.

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The FDIC's deposit insurance 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 1.52 to 1.68 basis points in 2003, and was 1.54 basis points during the first and second quarters of 2004 and 1.48 during the third quarter of 2004.

During the nine months ended September 30, 2003, the Bank expensed approximately \$643,000 in total deposit premiums and expensed approximately \$625,000 of total deposit insurance premiums through September 30, 2004.

### **Regulatory Restrictions**

The Company and the Bank presently are subject to a number of restrictions that have been imposed by their regulators under four separate orders summarized as follows.

#### *Memorandum of Understanding between Community Bancshares and the Federal Reserve Bank of Atlanta*

On April 9, 2001, the Company's board of directors entered into a Memorandum of Understanding, or MOU, with the Federal Reserve Bank of Atlanta, or the FRB, after the FRB rated the Company's condition as less than satisfactory. Under the terms of the MOU:

Community Bancshares is prohibited from conducting the following activities without the FRB's prior written approval:

declaring or paying any dividends or any other capital distributions on its capital stock, including repurchasing of corporate stock;

incurring additional indebtedness or altering the terms of existing indebtedness; or

increasing the annual management fees charged by Community Bancshares to Community Bank;

Community Bancshares must maintain a Tier 1 leverage ratio of at least 6.5% as of the end of every fiscal quarter, and must notify the FRB in the event that the ratio is anticipated to fall below that level at the end of any calendar quarter;

Community Bancshares must review at least quarterly and update and provide to the FRB its Capital and Income Plan, detailing the capital positions and earnings performance of Community Bank and describe how those positions and performance would be maintained at adequate levels;

Within 60 days of the date of the MOU, Community Bancshares was required, among other things, to:

establish a capital and dividend policy, including minimum target levels of capital and establishing appropriate guidelines for dividends; and

provide the FRB with a plan to strengthen its overall internal audit program;

Within 30 days of the date of the MOU, Community Bancshares was required to provide the FRB with a contingency plan for conserving or raising cash, as well as a listing of loans or other credit extended by Community Bank to facilitate the purchase of Community Bancshares common stock;

For any loans determined not to be in compliance with Section 23A of the Federal Reserve Act, Community Bancshares agreed to provide a plan detailing how the violation(s) would be corrected;

Community Bancshares agreed to provide the FRB, within 30 days of the end of each quarter, a written report detailing the action taken to ensure compliance with the MOU, which must include:

updated cash flow statements showing the projected sources and uses of funds for a 3-year period, consisting of the current year and the next two years;

parent-only balance sheets, income statements and statement of changes in stockholders equity for the period ending that quarter;

a litigation update concerning suits involving current or former stockholders; and

copies of any Community Bank correspondence with the Alabama Banking Department, which, together with the Alabama Superintendent of Banks, is referred to as the Department, and the FDIC regarding compliance with their supervisory actions.

In addition, on March 8, 2002, the FRB requested, and Community Bancshares agreed, to an amendment to the MOU, which prohibits Community Bancshares from making any distributions of interest, principal or other sums on junior subordinated debentures or trust preferred securities without the FRB's prior written approval. A second amendment was agreed to on November 27, 2002, which prohibits Community Bancshares, including any of its non-bank subsidiaries and the Employee Stock Ownership Plan, from amending any existing compensation arrangements or initiating any new compensation, indemnification or other payment arrangements with or on behalf of any employee, officer or director of Community Bancshares without the FRB's prior approval.

The Company believes that it was in compliance in all material respects at September 30, 2004 with the MOU, as amended.

*Safety and Soundness Compliance Plan between Community Bank and the FDIC*

Based on an examination as of June 30, 2001, the FDIC and the Department requested Community Bank to develop and adopt a Safety and Soundness Compliance Plan. This Plan was adopted on March 5, 2002, and it replaced a similar document known as a Memorandum of Understanding that had been issued by the FDIC and the Department on April 18, 2001. Pursuant to the Plan:

the board of directors was required to review Community Bank's organizational structure and staffing requirements and then hire and train any additional personnel necessary to comply with the Plan;

the board of directors was required to review and revise Community Bank's loan policy and underwriting standards, loan collection plan, allowance for loan losses methodology, interest rate risk policy and asset liability management policy;

the board of directors had to adopt an internal audit program, an internal controls program, procedures for internal and external loan documentation review and a plan to reduce classified assets;

the Bank is restricted from extending credit to borrowers holding classified loans;

the board of directors committed to maintaining a Tier 1 capital ratio of at least 7.0% and to obtain regulatory approval prior to paying any dividends to Community Bancshares;

the board of directors is required to submit a budget and profit plan, and has to review the adequacy of loan loss allowances to assure an adequate balance prior to submitting Community Bank's Reports of Condition and Income;

Community Bank must engage an outside accounting firm to perform its internal audit function, and must form an administration department to strengthen its internal controls; and

management is required to make monthly progress reports to the board of directors regarding its success in meeting the Plan requirements and to submit quarterly progress reports to the regulators.

The Safety and Soundness Compliance Plan is still in effect, and detailed quarterly progress reports continue to be made to the Company's regulators. The Company believes it was in compliance at September 30, 2004 in all material respects with the Plan.

#### *Cease and Desist Order between Community Bank and the Alabama State Banking Department*

On December 10, 2002, the board of directors of Community Bank entered into an agreement with the Alabama State Banking Department. The agreement provided that the board of directors would take certain actions regarding:

an investigation into payments made in connection with several construction projects of Community Bank;

approval and management of payments and loans involving the Company's directors, officers and employees; and

expense controls and review of financial statements.

With respect to the investigation of construction payments, Community Bank's Audit Committee, with the assistance of independent accountants and counsel, was required to determine whether any directors, officers or employees improperly benefited from payments made by Community Bank for construction projects. If improper benefits were received, then the Audit Committee must determine the amount of such benefits, fix an appropriate rate of interest due to Community Bank on the principal amount of any benefit, require restitution of the amount of the benefit, plus accrued interest, and investigate any apparent negligence on the part of Community Bank employees with regard to improper payments. Community Bank has reported the Audit Committee's progress and findings to the Department for its review.

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The board of directors of Community Bank has agreed, among other things, to require board approval of all extensions of credit to insiders, as defined in the FRB's Regulation O. The board also has agreed to implement certain procedures for managing existing loans to insiders, including limitations on renewals, methods of collection of adversely classified loans to certain insiders, obtaining current appraisals on collateral, and securing adversely classified loans. In addition, the board has agreed to:

limit future extensions of credit and any payments other than ordinary compensation to any director, officers or employee who, after investigation, is deemed to owe restitution to Community Bank or whose loans have been adversely classified;

consult with the Department regarding settlement of certain litigation; and

obtain prior approval for sales or transfers of Community Bank's assets benefiting any director, officer or employee deemed to owe restitution.

In an effort to control Community Bank's expenses, the board has directed the Audit Committee to review for adequacy and appropriateness of bills paid by Community Bank for professional services from 1998 to the present, to recover fees improperly paid, if any, for the benefit of third parties and to establish additional internal controls for the payment of future bills.

On June 9, 2004, the Alabama State Banking Department issued a supplement to the cease and desist order which acknowledges that Community Bank's board of directors has completed its investigation into construction payments and has substantially completed its review of professional service bills. The supplement requires that Community Bank's board of directors maintain certain actions and procedures concerning loans to insiders and recovery of amounts due to the bank, which actions and procedures the board of directors has taken and implemented.

The Company believes that it was in compliance at September 30, 2004 in all material respects with this cease and desist order as revised by the supplement.

*Stipulation and Consent to the Issuance of an Order to Cease and Desist between Community Bank and the FDIC*

On March 4, 2003, the board of directors of Community Bank and the FDIC entered into a Stipulation and Consent to the Issuance of an Order to Cease and Desist. The Order was effective on March 22, 2003. The FDIC alleged in the Order to Cease and Desist deficiencies relating to the supervision of the board of directors over active management of Community Bank, supervision and control of lending to insiders and accurate maintenance of Community Bank's books and records. The FDIC characterized these deficiencies as unsafe and unsound banking practices. The board of directors consented to the Order without admitting or denying those allegations. Pursuant to the Order, the board of directors agreed to cease and desist from conduct giving rise to the noted deficiencies and to:

develop, within 30 days of the effective date of the Order, a written plan specifying the responsibilities and lines of authority for Community Bank's executive officers and outlining internal controls to ensure compliance with the plan; and

refrain from making, renewing or modifying any loans to current or former executive officers or directors without prior approval of the FDIC and the Department;

amend Community Bank's books and records to reflect the actual value of bank premises and fixed assets; and

supply a copy of the Order to Community Bancshares and provide Community Bancshares with a summary of the Order for inclusion in Community Bancshares' next stockholder communication.

The Company believes that it was in compliance at September 30, 2004 in all material respects with all provisions of the Order and the only on-going requirement relates to loans to former executive officers and directors.

**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 September 30, 2004.

#### **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 September 30, 2004, 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 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, 2003, the outstanding commitments to grant loans represented a credit risk of \$15.1 million. At September 30, 2004, the outstanding commitments to grant loans represented a credit risk of \$24.0 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. Almost all letters-of-credit issued by the Company have expiration dates within one year. 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, 2003, 194 standby letters-of-credit outstanding were \$194,000. At September 30, 2004, \$532,000 standby letters-of-credit were outstanding.

## RESULTS OF OPERATIONS

### For the three and nine month periods ended September 30, 2004 and 2003

#### General

Net income for the nine month period ended September 30, 2004 was \$300,000, representing basic earnings per share of \$0.04. Diluted earnings per share was also \$0.04 for the nine months ended September 30, 2004. As compared to the net loss of \$4.5 million, or a loss of \$0.96 per share on both basic and diluted basis, for the nine month period ended September 30, 2003, this is an increase in net income of \$4.8 million. These positive outcomes have resulted from, among other things, the improvement in our provision for loan losses and noninterest expenses, partially offset from declining net interest income and noninterest income.

The Company's net income for the three months ended September 30, 2004 was \$19,000, representing a \$1.4 million increase from net loss of \$1.4 million for the same period in 2003. Net income for the three months ended September 30, 2004 represented \$0.00 earnings per share on both a basic and diluted basis, compared to a \$0.29 loss per share during the three months ended September 30, 2003. The increase in earnings was due, among other factors, to decreases in provision for loan losses and noninterest expenses and an increase in net interest income, partially offset by decreases in noninterest income.

#### Net Interest Income

Net interest income represents the difference between the interest earned by the Company on its assets and the cost born by the Company on its interest-bearing liabilities. For the nine months ended September 30, 2004, the Company's net interest income before its provision for loan losses was \$14.1 million. Net interest income, before provision for loan losses, decreased approximately \$0.2 million, or 1.4%, from \$14.3 million for the same period of 2003. The decrease in net interest income was primarily due to the decrease in revenues related to interest-earning assets because of lower yields on, and smaller volumes of, interest-earning assets. Revenues from interest-earning assets of the Company decreased \$1.6 million, or 6.3%, to \$23.6 million for the nine months ended September 30, 2004 from \$25.2 million for the same period in 2003. Average earning assets outstanding during the first nine months of 2004 were \$484.4 million, which represents a decrease of \$5.7 million, or 1.2%, from \$490.1 million from the first nine months of 2003. The Company's volume of interest-earning assets decreased due to reductions in outstanding loans as well as the decline in funds available for investing, which, in turn, was partially due to the Company's reduction in higher priced deposits. In addition, and adding to the decrease in net interest income, the Company's yield on its average earning assets decreased 38 basis points to 6.49% for the first nine months of 2004, compared to 6.87% for the same period of 2003. The decrease in yield was related to the Company's decline in its loan volume, as loans generally earn higher yields than investment securities, and was also attributable to the Company's investment of excess funds in securities due to lack of loan volume.

Interest expense for the nine months ended September 30, 2004 was \$9.4 million, a decrease of \$1.5 million, or 13.8%, from its interest expense of \$10.9 million for the corresponding period of 2003. This decrease occurred due to a decline in rates paid on, and volume of, interest-bearing liabilities. Average interest-bearing liabilities during the first nine months of 2004 were \$442.5 million, which represents a decrease of \$10.9 million, or 2.4%, from \$453.4 million for the same period of 2003. 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 decreased 38 basis points to 2.84% for the nine month period ended September 30, 2004, compared to 3.22% for the first nine months of 2003.

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The Company's net interest margin for the nine months ended September 30, 2004, as well as the nine months ended September 30, 2003, was 3.89%. 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 nine months ended September 30, 2004 decreased one basis point to 3.64%, from 3.65% for the nine months ended September 30, 2003, as the decrease in the average cost of interest-bearing sources of funds almost equaled the decrease 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. The Company has also experienced declines in its net interest margin and net interest spread with the continued increase in nonearning assets as a result of higher nonaccrual loans and other real estate owned.

Net interest income before provision for loan losses for the three months ended September 30, 2004 was \$4.8 million as compared to \$4.4 million for the same period in 2003, representing a \$0.4 million increase. The annualized yield on average earning assets for the three month period ended September 30, 2004 was 6.61% while the rate paid on interest bearing liabilities was 2.93%, resulting in a net interest spread of 3.68%. The net interest margin for the three months ended September 30, 2004 was 3.99%.

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

At September 30, 2004, the Company had an allowance for loan losses of \$10.1 million, which represented a decrease of \$4.3 million, or 29.9%, from a December 31, 2003 allowance of \$14.4 million. The provision for loan losses was \$0.7 million and \$5.5 million for the nine months ended September 30, 2004 and 2003, respectively. 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 and to improve the overall credit quality of the Company. However, management has seen improvement in the quality of the Company's loan portfolio and has provided for a 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 3.17% at September 30, 2004, compared to 4.54% at December 31, 2003. Total loan charge-offs during the first nine months of 2004 amounted to \$6.1 million, \$1.0 million of which was the result of write-downs arising from transfers of loans to held for sale, all of which had been sold as of September 30, 2004. During the same period in 2003, total loan charge-offs were \$3.6 million and were primarily comprised of consumer loans. Loan charge-offs exceeded recoveries by \$5.0 million during the first nine months of 2004, which represented an additional change of \$1.8 million, from \$3.2 million net for the same period during 2003.

Although charged off loans were relatively high during the first nine months of 2004, the losses resulting from charged-off loans had been substantially reserved for by the end of 2003. As the losses were taken, resultant decreases occurred in the allowance for loan losses without additional negative impact on the provision for loan loss expense. Management believes that the Company's allowance for loan losses at September 30, 2004 is adequate; 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.

Provision for loan losses for the three months ended September 30, 2004, was \$0.3 million compared to \$1.9 million for the same period in 2003. Although net charge-offs of \$5.0 million were relatively high for the nine months ended September 30, 2004, most of the losses related to charge-offs during the first quarter of 2004, largely the result of the actions of prior management, and only \$0.7 million occurred during the three month period ended September 30, 2004. Quarterly net charge-offs annualized result in a ratio of net charge-offs to average loans, net of unearned income of 0.85%. Management is hopeful that future charge-off ratios will decline further below this level.

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 previously accrued but not collected is reversed and charged against current 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 Bank employed a qualified loan review specialist on April 12, 2004 who will be dedicated full-time to the loan review function, instead of engaging outside consultants for independent review of the loan portfolio which represented the Bank's initial strategy in early 2004.

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, management's judgment as to the adequacy of the allowance is necessarily approximate and imprecise.

The following table summarizes the levels of the allowance for loan losses as of September 30, 2004 and 2003, as well as December 31, 2003:

	September 30,		December 31,
	2004	2003	2003
Allowance for loan losses at beginning of period	\$ 14,358	\$ 9,784	\$ 9,784
Loans charged off:			
Commercial, financial and agricultural	2,362	566	1,203
Real Estate Mortgage	2,180	667	2,629
Consumer	1,600	2,336	3,439
<b>Total loans charged off</b>	<b>6,142</b>	<b>3,569</b>	<b>7,271</b>
Recoveries on loans previously charged off:			
Commercial, financial and agricultural	457	55	60
Real estate - mortgage	72	23	26
Consumer	586	292	378
<b>Total recoveries</b>	<b>1,115</b>	<b>370</b>	<b>464</b>
<b>Net loans charged off</b>	<b>5,027</b>	<b>3,199</b>	<b>6,807</b>
Provision for loan losses	722	5,475	11,381
<b>Allowance for loan losses at end of period</b>	<b>\$ 10,053</b>	<b>\$ 12,060</b>	<b>\$ 14,358</b>
<b>Loans, net of unearned income, at end of period</b>	<b>\$ 316,750</b>	<b>\$ 316,745</b>	<b>\$ 316,207</b>
<b>Average loans, net of unearned income, outstanding for the period</b>	<b>\$ 314,226</b>	<b>\$ 339,850</b>	<b>\$ 330,941</b>

	September 30,		December 31,
	2004	2003	2003
<b>Ratios:</b>			
Allowance for loan losses to loans, net of unearned income, at end of period	<b>3.17%</b>	3.81%	4.54%

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Allowance for loan losses at end of period to average loans, net of unearned income	<b>3.20</b>	3.55	4.34
Net charge-offs (annualized) to average loans, net of unearned income	<b>2.13</b>	1.26	2.06
Net charge-offs (annualized) to allowance for loan losses, at end of period	<b>66.67</b>	35.37	47.41

**Noninterest Income**

Noninterest income for the nine months ended September 30, 2004 and 2003 was \$4.9 million and \$5.8 million, respectively. The decrease of \$0.9 million, or 15.5%, was mostly due to a \$0.9 million decline in net securities gains. Service charges on deposits increased \$0.2 million, or 10.5%, to \$2.2 million for the nine months ended September 30, 2004. This increase is due to increased nonsufficient funds fees related to the Company's recognition of increased income from its courtesy overdraft program that was implemented in December 2003. Insurance commissions increased \$0.2 million to \$1.9 million for the nine months ended September 30, 2004, primarily as the result of increased sales of credit life insurance at Community Credit. The decrease in other noninterest income of \$0.3 million relates to a \$0.1 million decrease in appraisal fee income as the result of the closing of Community Appraisals as well as other small miscellaneous decreases which occurred during 2004.

Noninterest income for the three months ended September 30, 2004 decreased \$0.2 million, or 11.1%, to \$1.6 million, from \$1.8 million for the same period of 2003. Service charges on deposit accounts increased \$0.1 million, or 16.7%, to \$0.7 million for the three month period ended September 30, 2004, from \$0.6 million in the same period of 2003. This increase in service charges was the result of the Bank's new courtesy overdraft program implemented in late 2003. The Company's debt cancellation fees decreased \$39,000 during the three months ended September 30, 2004, as compared to the same period of 2003, due to the Bank's decision to no longer offer debt cancellation coverage to its customers. The Company experienced a negative side effect in the form of reduced debt cancellation fee income during 2004, due to rebates on early paid out loans that carried debt cancellation. Other operating income



remained relatively constant for the three month period ending September 30, 2004. The Company recorded a net loss of \$44,000 on the sale of investment securities during the three months ended September 30, 2004, compared to net gains on the sale of investment securities of \$374,000 for the same period of 2003. The Company also experienced a \$70,000, or 11.7%, increase in its insurance commissions, attributable to the increased revenues from Community Insurance, which helped to partially offset other decreases in noninterest income.

### **Noninterest Expenses**

Noninterest expenses for the nine month period ended September 30, 2004 were \$17.9 million, resulting in a \$3.9 million decline from \$21.8 million for the same period in 2003. One primary component of noninterest expenses is salaries and benefits. For the nine months ended September 30, 2004, salaries and benefits were down \$0.8 million, or 7.9%, to \$9.3 million, from \$10.1 million for the same period in 2003. Even with increases in health insurance costs, the Company has been able to reduce overall benefits costs by both freezing its defined benefit plan and implementing a 401(k) plan and recognizing reduced expenses in its ESOP plan. Occupancy expenses and furniture and equipment expenses remained stable at \$1.7 million and \$1.1 million, respectively, for the nine months ended September 30, 2004. Professional services expenses have declined \$2.0 million to \$1.2 million for the nine months ended September 30, 2004. For the comparable period in 2003, these fees were \$3.2 million, but during this period in 2003, the Company expensed in excess of \$1.0 million to comply with the Cease and Desist Order between Community Bank and the Alabama State Banking Department. Foreclosed asset costs are down \$0.5 million for the nine month period ended September 30, 2004 from the same period in 2003 as the Company's foreclosed asset balances have declined.

Noninterest expenses for the three months ended September 30, 2004 were \$5.9 million, representing a \$1.7 million, or 22.4%, decrease from noninterest expenses of \$7.6 million for the same period in 2003. Salaries and employee benefits decreased \$0.3 million, or 8.8%, to \$3.1 million for the three months ended September 30, 2004, from \$3.4 million for the same period of 2003. The Company continues to maintain staff levels as efficiently as possible. Occupancy costs increased by \$72,000 or 12.7%, during the three months ended September 30, 2004, compared to the three months ended September 30, 2003. Furniture and equipment expenses for the three month period ended September 30, 2004 increased \$28,000, or 7.8%, to \$387,000, from \$359,000 for the same period of 2003. The Company's insurance expense decreased \$38,000 to \$311,000 for the three months ended September 30, 2004, from \$349,000 for the same period in 2003. Director and committee fees decreased \$38,000, or 32.2%, to \$80,000 for the three months of 2004, from \$118,000 for the three months of 2003. This decrease is the result of fewer meetings of the Company's board of directors and committees, as the Company held a large number of meetings in 2003 to address ongoing litigation and various regulatory orders at the time. Other operating expenses decreased \$0.6 million, or 46.2%, to \$0.7 million for the three months of 2004, from \$1.3 million for the same period in 2003. The Company's professional services expense decreased \$0.4 million, or 44.4%, to \$0.5 million during the three months of 2004, compared to the three months of 2003. The reduction in professional services fees was the result of the Company being required to devote less attention and resources to ongoing litigation and regulatory matters. Although many of these matters are ongoing, they have been reduced in the aggregate, and the expenses associated with them have accordingly decreased. However, we do not expect professional service fees to remain as low as the three month period ended September 30, 2004 may indicate, as several pending matters may become more active and cause an increase in professional service fees.

### **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 manages 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 September 30, 2004 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. The prime rate shown is as of September 30, 2004.

**RATE SHOCK ANALYSIS**

	<b>-100</b>		<b>+100</b>
	<b>Basis</b>		<b>Basis</b>
	<b>Points</b>	<b>Level</b>	<b>Points</b>
	<u>          </u>	<u>          </u>	<u>          </u>
	<b>(Dollars in thousands)</b>		
Prime rate	3.75%	4.75%	5.75%
Interest income	\$ 24,776	\$ 26,295	\$ 27,636
Interest expense	11,879	12,941	14,025
	<u>          </u>	<u>          </u>	<u>          </u>
Net interest income	\$ 12,897	\$ 13,354	\$ 13,611
	<u>          </u>	<u>          </u>	<u>          </u>
Dollar change from level	\$ (429)		\$ (315)
Percentage change from level	-3.42%		-1.92%

As shown above, in a 100 basis point rising rate environment, the net interest margin is projected to increase 1.92% and in a 100 basis point falling rate environment, the net interest margin is projected to decrease 3.42%. These percent changes from a level rate scenario fall comfortably within the Company's ALCO policy limit of +/-7.00%.

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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 September 30, 2004, 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. Based upon the size of this amount, management commenced an investigation into these expenditures.

At the request of management, the architects and subcontractors involved in the construction project made presentations to the boards of directors of the Community Bancshares and Community Bank on July 15 and July 18, 2000, respectively. At the July 18, 2000 meeting of the board of directors of Community Bank, another director alleged that Community Bank had been overcharged by subcontractors on that construction project, as well as on another construction project that remained uncompleted at that time.

On July 18, 2000, the boards of directors of Community Bancshares and Community Bank appointed a joint committee comprised of independent directors to investigate these alleged overcharges. The joint committee retained independent legal counsel and an independent accounting firm to assist its investigation and has since made its report to the boards of directors.

Community Bank's directors who alleged the construction overcharges also informed bank regulatory agencies and law enforcement authorities of their concerns. These agencies and authorities conducted their own investigations into this matter. Based on its findings, the FDIC issued restitution and/or removal orders against Kennon R. Patterson, Sr., former Chairman and Chief Executive Officer of the Company and Community Bank, and Larry Bishop, former Vice President of Community Bank. These regulatory actions are still pending at this time. The board of directors of Community Bancshares and the board of directors of Community Bank terminated Kennon R. Patterson, Sr. on January 27, 2003, and the board of directors of Community Bank terminated Larry Bishop on February 6, 2003. On October 29, 2003, the United States Department of Justice announced the filing of a 25-count indictment against Messrs. Patterson and Bishop, and a construction contractor, in connection with a scheme to divest Community Bank's funds for Mr. Patterson's personal benefit. On November 14, 2003, Mr. Patterson informed Community Bancshares that he was taking a leave of absence from Community Bancshares' board of directors pending a resolution of the criminal charges against him. Mr. Patterson stated that he would not seek re-election to Community Bancshares' board of directors if the criminal charges were not resolved prior to the expiration of his current term in 2005. On June 24, 2004, at the annual meeting of stockholders, Mr. Patterson was removed as a director of the Company. Community Bancshares and Community Bank continue to seek recovery of all amounts owed by Mr. Patterson to Community Bank.

**Patterson Litigation I**

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

**Defendants:** Community Bancshares, Community Bank, five of the directors of Community Bancshares and Community Bank, and Powell, Goldstein, Frazer and Murphy, LLP, as counsel to Community Bank's Audit Committee

On April 9, 2003, Mr. Patterson filed an adversary proceeding against the defendants in the United States Bankruptcy Court for the Northern District of Alabama in connection with his petition for protection under Chapter 11 of the United States Bankruptcy Code. Mr. Patterson's

complaint:

alleges that Community Bancshares breached its employment agreement with Mr. Patterson by terminating his employment on January 27, 2003 and failing to pay him for compensation and benefits that had accrued prior to his termination; and

alleges that Community Bank, members of Community Bank's Audit Committee, the Audit Committee's independent counsel and Community Bancshares' current Chairman, President and Chief Executive Officer conspired to interfere with Mr. Patterson's contract and business relationship with Community Bancshares.

The suit seeks damages in excess of \$150.0 million for, among other things, lost compensation and benefits, mental anguish, and damage to Mr. Patterson's reputation.

On May 9, 2003 the defendants filed a motion to dismiss the suit, and, on June 17, 2003, the court denied the motion to dismiss the suit as to Community Bancshares, Community Bank and the named directors. On July 7, 2003, those defendants filed a counterclaim against Mr. Patterson asserting that Mr. Patterson breached his employment agreement with Community Bancshares, engaged in fraudulent conduct, and converted property belonging to Community Bank to his personal use.

On January 12, 2004, the bankruptcy proceeding filed by Mr. Patterson was dismissed without prejudice. Community Bancshares, Community Bank and the individual defendants moved to dismiss the adversary proceeding in bankruptcy filed against them by Mr. Patterson. That motion was granted on July 26, 2004, and the adversary proceeding was dismissed.

## **Patterson Litigation II**

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 in order to pursue those claims which had been asserted against him as counterclaims in the adversary proceeding in bankruptcy. 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.

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.

**Patterson Litigation III**

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.

#### **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 July 21, 2000, the plaintiffs filed a lawsuit, styled as a stockholder derivative suit, in the state Circuit Court of Marshall County, Alabama against the defendants, relating to alleged overcharges in construction costs. At the time, these charges were being investigated by a joint committee of the boards of directors of Community Bancshares and Community Bank.

The complaint:

alleges that the directors, officers and employee named as defendants (i) breached their fiduciary duties, (ii) failed to properly supervise officers and agents of Community Bancshares and Community Bank, and (iii) permitted waste of corporate assets by permitting the subcontractor defendants to overcharge Community Bank in connection with the construction of two new Community Bank branch offices, and to perform the construction work without written contracts, budgets, performance guarantees and assurances of indemnification;

alleges that Kennon R. Patterson, Sr., the Company's former Chairman, President and Chief Executive Officer, breached his fiduciary duties by permitting the two named subcontractors to overcharge for work performed on the two construction projects in exchange for discounted charges for work these subcontractors performed in connection with the construction of Mr. Patterson's residence;

alleges that the director defendants knew or should have known of this alleged arrangement between Mr. Patterson and the subcontractors; and

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alleges that Mr. Patterson, the Community Bank employee and the two subcontractor defendants made false representations and suppressed information about the overcharges and arrangement between Mr. Patterson and the subcontractors.

On August 15, 2000, the plaintiffs filed an amended complaint that generally reiterates the allegations of the original complaint, and further:

alleges that the Bank was overcharged on all construction projects from January 1997 to the present; and

alleges that the defendants breached their fiduciary duties and are guilty of gross financial mismanagement, including making or approving loans and taking improper actions to conceal the fact that the loans were uncollectible.

On September 18, 2000, the plaintiffs filed a second amended complaint generally reiterating the allegations of the original and first amended complaints, and further:

alleging that the plaintiffs were improperly denied their rights to inspect and copy certain records of Community Bancshares and Community Bank; and

alleging that the directors of Community Bancshares abdicated their roles as directors either by express agreement or as a result of wantonness and gross negligence.

The second amended complaint further asserts that the counts involving inspection of corporate records and director abdication are individual, non-derivative claims. The second amended complaint seeks, on behalf of Community Bancshares, an unspecified amount of compensatory damages in excess of \$1.0 million, punitive damages, disgorgement of improperly paid profits and appropriate equitable relief. Upon a motion of the defendants, the case was transferred to the state Circuit Court in Blount County, Alabama by order dated September 21, 2000, as amended on October 12, 2000.

Tentative settlements of the lawsuit were announced in November 2002, August 2003 and November 2003 but were not finalized.

On January 6, 2004, the Circuit Court of Blount County, Alabama disapproved a proposed settlement of the Benson and Packard derivative lawsuits. Subsequently, another settlement proposal was made by the individual defendants, other than Kennon R. Patterson, Sr., directly to Community Bancshares and Community Bank. Pursuant to this new settlement, Community Bank would receive \$1.655 million, less any fees awarded by the Court to the plaintiffs' attorneys. A special committee of the Boards of Directors of the two companies, consisting of the members who are not defendants in the cases, accepted the offer which was then filed with the Court on February 19, 2004. All proceedings in these cases were then stayed pending a decision from the Supreme Court of Alabama as to whether the cases could proceed as to Mr. Patterson and Larry Bishop prior to their trial on criminal charges. On October 25, 2004 the Supreme Court of Alabama lifted the stay for the limited purpose of allowing the Circuit Court of Blount County to consider a settlement. No hearing has been scheduled.

On or about April 5, 2004, Travelers Casualty and Surety Company of America filed a motion for permission to intervene in the Benson litigation asserting that, to the extent that it is required to reimburse Community Bancshares and Community Bank for losses pursuant to the Company's fidelity bond, it will be subrogated to the derivative claims made on behalf of Community Bancshares and Community Bank in the Benson litigation.

#### **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 April 4, 2003, the plaintiffs, which are the same as in the Benson case described above, filed a derivative action against the defendants. This action, while stemming from the same facts alleged in the Benson Litigation, is based not upon what the director-defendants did (and did not do) before learning of the over billing [sic.] allegations against [Mr.] Patterson in July 2000 but, instead, is based upon what they have done (and

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failed to do) after the filing of the Benson lawsuit that is, after they learned of the allegations against [Mr.] Patterson in July 2000.

On June 18, 2003, the Circuit Court of Jefferson County, Alabama granted the motion filed by Community Bancshares, Community Bank and most of the individual defendants to transfer the suit to the Circuit Court of Blount County, Alabama.

On or about October 1, 2003, one of the defendants, Dudley, Hopton-Jones, Sims & Freeman, PLLP, formerly the certified public accountants and outside auditors for Community Bancshares and Community Bank, filed a cross-claim against Community Bank, Community Bancshares, 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, all of whom are directors or former directors of Community Bancshares and/or Community Bank. The cross-claim demands compensatory damages, interest, and costs, including the amount of any adverse judgment entered in this cause against Dudley, Hopton-Jones. Punitive damages are also demanded in some counts. The basis for the claims is common law indemnity, contractual indemnity, negligence, misrepresentation, suppression, and concealment of material facts, and, civil conspiracy.

On November 11, 2003 Community Bancshares, Community Bank, and certain individual defendants entered into an agreement to settle this case, which was not finalized.

On January 6, 2004, the Circuit Court of Blount County, Alabama disapproved a proposed settlement of the Benson and Packard derivative lawsuits. Subsequently, another settlement proposal was made by the individual defendants, other than Kennon R. Patterson, Sr., directly to Community Bancshares and Community Bank. Pursuant to this new settlement, Community Bank would receive \$1.655 million, less any fees awarded by the Court to the plaintiffs' attorneys. A special committee of the Boards of Directors of the two companies, consisting of the members who are not defendants in the cases, accepted the offer which was then filed with the Court on February 19, 2004. All proceedings in these cases were then stayed pending a decision from the Supreme Court of Alabama as to whether the cases could proceed as to Mr. Patterson and Larry Bishop prior to their trial on criminal charges. On October 25, 2004 the Supreme Court of Alabama lifted the stay for the limited purpose of allowing the Circuit Court of Blount County to consider a settlement. No hearing has been scheduled.

### **Fidelity Bond Litigation**

Plaintiffs: Community Bancshares and Community Bank  
Defendant: Travelers Casualty & Surety Company of America  
Third-Party Defendants: Certain present and former directors of Community Bancshares and Community Bank, a former officer of Community Bank, and two accounting firms formerly engaged by Community Bancshares

On August 20, 2004, Community Bancshares and Community Bank filed suit in the Circuit Court of Blount County, Alabama against Travelers Casualty & Surety Company of America, issuer of a financial institution fidelity bond purchased by Community Bancshares and Community Bank. The complaint:

alleges that Travelers breached its contract with Community Bancshares and Community Bank by failing to pay a claim related to employee dishonesty in connection with the construction of Mr. Patterson's house; and

seeks a declaratory judgment to the effect that Community Bancshares and Community Bank are entitled to the full amount of the claim, and that Travelers is not entitled to subrogation of the claims of Community Bancshares and Community Bank against certain individual defendants in the Benson derivative litigation.

On October 19, 2004, Travelers filed a third-party complaint against certain present and former directors of Community Bancshares and Community Bank, a former officer of Community Bank, and two accounting firms which were formerly engaged by Community Bancshares. The third-party complaint:

alleges that the individual defendants breached a duty of loyalty, duty of care, duty of fair dealing and other duties to Community Bancshares and Community Bank in connection with their actions and/or their failure to act with respect to the construction overcharges and other related matters;

alleges that the individual defendants wasted assets of Community Bank by agreeing to excessive construction payments and making certain other expenditures;

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alleges that the director defendants permitted certain insiders of Community Bank to receive loans from Community Bank which involved more than the normal risk of repayment or presented other unfavorable features in violation of Alabama banking law;

alleges that the director defendants abdicated their role as board members by not supervising the actions of Mr. Patterson;

alleges that Mr. Patterson and Larry Bishop made false representations and/or suppressed material information concerning construction projects and certain Community Bank loans;

alleges that the director defendants, Mr. Patterson and Mr. Bishop all conspired to commit the alleged wrongs stated above;

alleges that the accounting firms breached a duty of care and committed malpractice in negligently auditing Community Bancshares and Community Bank during the time when the construction overcharges and other alleged improprieties occurred; and

seeks damages from the third-party defendants equal to the amount of Community Bancshares and Community Bank's claim against Travelers under the financial institution fidelity bond.

On October 1, 2004, Travelers filed a notice that the case was being removed from the Circuit Court of Blount County, Alabama to the United States District Court for the Northern District of Alabama. On October 28, 2004, Community Bancshares and Community Bank filed a motion to remand the case to the Circuit Court of Blount County.

### **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.

### **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. Community Bancshares presently believes that, other than the litigation discussed above, there is no other litigation to which Community Bancshares or its affiliates presently are subject 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 Community Bancshares' financial condition or results of operations.

Community Bancshares' Certificate of Incorporation and Bylaws provide that, in certain circumstances, Community Bancshares will indemnify its directors and officers, and, provided such persons acted in accordance with the standards set forth in the Delaware General Corporation Law and Community Bancshares' organizational documents, advance expenses to its directors and officers in connection with investigations and proceedings in connection with their service as officers and directors of Community Bancshares.

### **Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities.**

During the fourth quarter of 2003, the Company commenced a private placement of its common stock, and, as of December 31, 2003, the Company had sold 2,151,553 shares of its common stock at a price of \$5.35 per share, resulting in net proceeds of approximately \$10.4 million. 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 Company completed this offering on February 20, 2004, selling an additional 1,586,771 shares of its common stock for \$7.9 million of additional net proceeds, resulting in the sale of a total of 3,738,324 shares for total net proceeds from the offering of \$18.3 million.

The Series 2003 noncumulative preferred stock has a liquidation preference to the Company's common stock equal to the aggregate purchase price of the 2,191,898 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:

The Series 2003 noncumulative preferred stock has terms consistent with the Company's Tier 1 capital treatment for regulatory purposes;

The Series 2003 noncumulative preferred stock is noncumulative and is not entitled to the payment of, or otherwise accrue, any dividends;

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The Series 2003 noncumulative preferred stock is not entitled to the benefit of any sinking fund or similar arrangement;

The Series 2003 noncumulative preferred stock has no preemptive, preferential or other right to purchase, subscribe for or convert into any other of the Company's securities;

The Company is not required to purchase the shares of Series 2003 noncumulative preferred stock;

Holders of the Series 2003 noncumulative preferred stock do not have registration rights requiring the Company to register the shares of the Series 2003 noncumulative preferred stock; and

The Series 2003 noncumulative preferred stock 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.

No underwriters were involved in this offering. FIG Partners, L.L.C., an affiliate of Burke Capital Group, L.L.C., served as the Company's sole placement agent in the offering. The investors in the offering were comprised entirely of accredited investors, as that term is defined in Rule 501 of Regulation D promulgated under the Securities Act of 1933. The common stock and options issued by the Company in the offering were not registered under the Securities Act of 1933, in reliance upon the exemption from registration under Section 4(2) and the safe harbor afforded by Rule 506 of Regulation D. The certificates evidencing the shares of common stock and the options sold in the offering bear restrictive legends permitting the transfer of the underlying securities only upon registration of the securities or an exemption under the Securities Act, together with an opinion of counsel.

In connection with the offering, the Company entered into an engagement letter with FIG Partners, 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. In connection with the closing of the offering on February 20, 2004, the Company became obligated to issue to 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.

During the first quarter of 2004, the Company reached a settlement in one of its pending litigation matters, as the result of which the Company repurchased 2,979 shares of the Company's common stock from the plaintiff at a price of \$5.50 per share.

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

Not applicable

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

None

**Item 5. Other Information.**

None

**Item 6. Exhibits and Reports on Form 8-K.**

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### (a) Exhibits

- 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) (\*).
- 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) (\*).

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- 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) (\*).
- 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).
- 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.

(b) Reports on Form 8-K

During the quarter ended September 30, 2004, no reports were filed on Form 8-K.



**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 November 12, 2004.

COMMUNITY BANCSHARES, INC.

November 12, 2004

By: /s/ PATRICK M. FRAWLEY

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Patrick M. Frawley  
*Chairman and Chief Executive Officer*

November 12, 2004

By: /s/ KERRI C. KINNEY

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Kerri C. Kinney  
*Chief Financial Officer*