

COMMUNITY BANCSHARES INC /DE/  
Form 10-Q  
November 14, 2005

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

Washington, D.C. 20549

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**FORM 10-Q**

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(Mark One)

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

For the quarterly period ended September 30, 2005

OR

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

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

Commission file number 000-16461

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**COMMUNITY BANCSHARES, INC.**

(Exact Name of Registrant as Specified in Its Charter)

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<b>Delaware</b> (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 by check mark whether the registrant is a shell company (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 19, 2005, there were 8,680,415 shares of the registrant's common stock, \$.10 par value per share, outstanding.**

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Additional paid-in-capital	<b>50,067,003</b>	49,162,306
Stock warrants outstanding	<b>242,524</b>	242,524
Treasury common stock, at cost (104,955 and 99,869 shares as of September 30, 2005 and December 31, 2004, respectively)	<b>(1,021,238)</b>	(980,428)
Retained earnings (deficit)	<b>(1,281,222)</b>	(1,899,382)
Unearned ESOP common stock (93,180 and 106,092 shares as of September 30, 2005 and December 31, 2004, respectively)	<b>(1,441,938)</b>	(1,571,058)
Accumulated other comprehensive loss	<b>(3,604,975)</b>	(2,947,314)
	<hr/>	<hr/>
Total stockholders' equity	<b>43,847,009</b>	42,876,764
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Total liabilities and stockholders' equity	<b>\$ 569,929,832</b>	\$ 553,423,778
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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	
	2005	2004
Interest income:		
Loans, including fees	\$ 7,260,284	\$ 6,345,294
Interest on investment securities:		
Taxable securities	1,196,947	1,381,696
Tax-exempt securities	13,495	70,572
Federal funds sold	77,571	19,132
Other	125,426	58,990
Total interest income	<u>8,673,723</u>	<u>7,875,684</u>
Interest expense:		
Deposits	2,634,220	2,176,746
Short-term borrowings	2,898	906
FHLB long-term debt	524,258	575,868
Capitalized lease obligations	65,139	43,589
Junior subordinated debentures	271,875	325,038
Other long-term debt	825	
Total interest expense	<u>3,499,215</u>	<u>3,122,147</u>
Net interest income	5,174,508	4,753,537
Provision for loan losses	317,889	344,770
Net interest income, after provision for loan losses	<u>4,856,619</u>	<u>4,408,767</u>
Noninterest income:		
Service charges on deposits	776,034	749,816
Insurance commissions	468,124	667,776
Bank club dues	68,077	86,515
Debt cancellation fees	(5,048)	(13,668)
Securities losses, net		(44,302)
Other	175,596	118,083
Total noninterest income	<u>1,482,783</u>	<u>1,564,220</u>
Noninterest expense:		
Salaries and employee benefits	3,026,370	3,143,251
Occupancy	600,905	636,941
Furniture and equipment	455,042	386,905
Insurance	132,372	311,296
Director and committee fees	94,450	80,478
Professional services	386,924	494,804
Foreclosed assets, net	293,500	55,644
Disposal or impairment of assets	36,480	87,586
Litigation, fraud or burglary	8,743	2,072
Other	1,089,932	698,134

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Total noninterest expense	<b>6,124,718</b>	5,897,111
Income before income taxes	<b>214,684</b>	75,876
Income taxes	<b>(48,248)</b>	(56,595)
Net income	<b>\$ 166,436</b>	\$ 19,281
Earnings per share:		
Basic	<b>\$ 0.02</b>	\$
Diluted	<b>\$ 0.02</b>	\$

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,	
	2005	2004
Interest income:		
Loans, including fees	\$ 20,303,282	\$ 18,893,936
Interest on investment securities:		
Taxable securities	3,978,218	4,207,205
Tax-exempt securities	56,636	214,448
Federal funds sold	202,645	79,262
Other	282,979	169,184
<b>Total interest income</b>	<b>24,823,760</b>	<b>23,564,035</b>
Interest expense:		
Deposits	7,500,714	6,521,101
Short-term borrowings	6,500	2,148
FHLB long-term debt	1,663,477	1,715,088
Capitalized lease obligations	174,115	122,535
Junior subordinated debentures	812,604	1,018,310
Other long-term debt	825	49,706
<b>Total interest expense</b>	<b>10,158,235</b>	<b>9,428,888</b>
Net interest income	14,665,525	14,135,147
Provision for loan losses	662,935	722,442
Net interest income, after provision for loan losses	14,002,590	13,412,705
Noninterest income:		
Service charges on deposits	2,223,490	2,151,951
Insurance commissions	1,704,197	1,948,704
Bank club dues	219,176	269,087
Debt cancellation fees	(17,449)	(45,168)
Securities gains (losses), net	(38,823)	193,690
Other	1,037,373	371,307
<b>Total noninterest income</b>	<b>5,127,964</b>	<b>4,889,571</b>
Noninterest expense:		
Salaries and employee benefits	9,192,422	9,261,481
Occupancy	1,733,855	1,756,770
Furniture and equipment	1,241,446	1,114,296
Insurance	772,115	909,549
Director and committee fees	287,800	269,400
Professional services	1,184,477	1,247,986
Foreclosed assets, net	365,632	483,081
Disposal or impairment of assets	77,102	190,419
Litigation, fraud or burglary	250,009	23,837
Other	3,092,635	2,643,839

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Total noninterest expense	<b>18,197,493</b>	17,900,658
Income before income taxes	<b>933,061</b>	401,618
Income taxes	<b>(314,901)</b>	(97,721)
Net income	<b>\$ 618,160</b>	\$ 303,897
Earnings per share:		
Basic	<b>\$ 0.07</b>	\$ 0.04
Diluted	<b>\$ 0.07</b>	\$ 0.04

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, 2004 and 2005

	<i>Shares of Common Stock Issued</i>	<i>Common Stock</i>	<i>Additional Paid in Capital</i>	<i>Stock Warrants Outstanding</i>	<i>Treasury Common Stock</i>	<i>Retained Earnings</i>	<i>Unearned ESOP Common Stock</i>	<i>Accumulated Other Comprehensive Loss</i>	<i>Total</i>
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 adjustment and tax effect								(224,904)	(224,904)
<b>Total comprehensive income</b>									<b>78,933</b>
Issuance of common stock at \$5.35 per share	1,586,771	158,676	8,330,549						8,489,225
Common stock issuance costs			(825,844)	242,524					(583,320)
Common stock issued for stock options exercised	45,000	4,500	236,250						240,750
Common stock issued in lieu of cash paid for directors fees at \$5.35 per share	20,720	2,072	108,478						110,550
Release of ESOP common stock			(38,539)				125,340		86,801
Treasury common stock acquired					(86,398)				(86,398)
Balance at September 30, 2004	8,631,163	\$ 863,116	\$ 48,807,812	\$ 242,524	\$ (980,427)	\$ (1,772,089)	\$ (1,615,908)	\$ (1,890,807)	\$ 43,654,221
<b>Balance at December 31, 2004</b>	<b>8,701,162</b>	<b>\$ 870,116</b>	<b>\$ 49,162,306</b>	<b>\$ 242,524</b>	<b>\$ (980,428)</b>	<b>\$ (1,899,382)</b>	<b>\$ (1,571,058)</b>	<b>\$ (2,947,314)</b>	<b>\$ 42,876,764</b>
Comprehensive losses:									
Net income during period						618,160			618,160
Change in unrealized gain (loss) on securities available for sale net of reclassification adjustments and tax effect								(657,661)	(657,661)
<b>Total comprehensive loss</b>									<b>(39,501)</b>
Common stock issued for stock options exercised	153,000	15,300	836,129						851,429
Common stock issued in lieu of cash paid for directors fees at \$5.35 per	14,388	1,439	96,544						97,983

share									
Release of ESOP common stock			(27,976)			129,120			101,144
Treasury common stock acquired				(40,810)					(40,810)
<b>Balance at September 30, 2005</b>	<b>8,868,550</b>	<b>\$ 886,855</b>	<b>\$ 50,067,003</b>	<b>\$ 242,524</b>	<b>\$ (1,021,238)</b>	<b>\$ (1,281,222)</b>	<b>\$ (1,441,938)</b>	<b>\$ (3,604,975)</b>	<b>\$ 43,847,009</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,	
	2005	2004
<b>Operating activities:</b>		
Net income	\$ 618,160	\$ 303,897
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Provision for loan losses	662,935	722,442
Depreciation and amortization	1,287,885	1,224,166
Net amortization of securities	706,458	727,414
Deferred tax expense	160,173	2,990,664
Realized investment security losses (gains)	38,823	(193,690)
Gain on sale or impairment of premises and equipment	(38,509)	(20,479)
Realized losses on foreclosed assets	365,632	483,296
(Increase) decrease in accrued interest receivable	(484,200)	267,882
Decrease in accrued interest payable	(175)	(2,986,595)
Other	(703,426)	(6,593,554)
<b>Net cash provided (used) by operating activities</b>	<b>2,613,756</b>	<b>(3,074,557)</b>
<b>Investing activities:</b>		
Proceeds from sales, calls and pay downs of securities available for sale	46,580,951	64,418,271
Proceeds from maturity of securities available for sale	5,000,000	
Purchase of securities available for sale	(47,880,447)	(50,975,811)
Loan originations and principal collections, net	(34,125,913)	(5,200,307)
Proceeds from sale of premises and equipment	116,600	914,969
Additions to premises and equipment	(4,118,496)	(572,132)
Net proceeds from sale of foreclosed assets	586,763	3,179,568
Asset acquisition	(704,306)	
<b>Net cash (used) provided by investing activities</b>	<b>(34,544,848)</b>	<b>11,764,558</b>
<b>Financing activities:</b>		
Net (decrease) increase in demand deposits, NOW accounts, savings and time open deposit accounts	(21,918,132)	15,899,376
Net increase (decrease) in certificates of deposit	10,651,405	(38,815,190)
Net decrease in short-term borrowings	(20,640)	(257,958)
Decrease in capitalized lease obligations	(36,262)	(63,867)
Increase in (repayment of) long-term debt	29,200,000	(3,168,502)
Issuance of common stock, net of transaction costs	851,429	8,146,655
Purchase of common stock into treasury		(86,399)
<b>Net cash provided (used) by financing activities</b>	<b>18,727,800</b>	<b>(18,345,885)</b>
<b>Net change in cash and cash equivalents</b>	<b>(13,203,292)</b>	<b>(9,655,884)</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>52,512,452</b>	<b>44,920,220</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 39,309,160</b>	<b>\$ 35,264,336</b>

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Supplemental cash flow disclosures:		
Interest paid on deposits and borrowed funds	<b>\$ 10,158,410</b>	\$ 12,415,482
Schedule of non-cash investing and financing activities:		
Foreclosure of other real estate owned	<b>171,843</b>	1,813,068
Loan charge-offs, net of recoveries	<b>481,966</b>	5,027,491
Treasury Stock acquired through debts previously contracted	<b>9,720</b>	86,399
Deconsolidation of special purpose trust (Note 6):		
Recognition of the equity investments in the special purpose trust		310,000
Removal of the special purpose trust preferred securities		10,000,000
Recognition of the junior subordinated debt in the special purpose trust		10,310,000

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

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**Community Bancshares, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

**Note 1 General**

The accompanying unaudited consolidated financial statements include the accounts of Community Bancshares, Inc. ( Community Bancshares ) and its wholly-owned subsidiaries, which, together with Community Bancshares, are hereinafter referred to collectively as the Company. The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to the Securities and Exchange Commission's (the Commission or the SEC ) Quarterly Report on Form 10-Q and Article 10 of the Commission's Regulation S-X. Accordingly, the financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine month period ended September 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005 or for any other future periods. For further information, please refer to the audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2004 (the Form 10-K ).

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

**Note 2 Recent Accounting Pronouncements**

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment (SFAS 123R), which is a revision of SFAS 123 and supersedes Accounting Principles Board (APB) Opinion 25. On April 14, 2005, the Securities and Exchange Commission announced the adoption of a new rule that amended the compliance dates for SFAS No. 123R. Under SFAS 123R, registrants would have been required to implement the standard as of the beginning of the first interim or annual period that begins after June 15, 2005. The Commission's new rule allows issuers to implement SFAS 123R at the beginning of their next fiscal year, instead of the next reporting period, that begins after June 15, 2005. The Commission's new rule does not change the accounting required by SFAS 123R; it changes only the dates for compliance with the standard. The new standard requires companies to recognize an expense in the statement of operations for the grant-date fair value of stock options and other equity-based compensation issued to employees, but expresses no preference for a type of valuation method. This expense will be recognized over the period during which an employee is required to provide service in exchange for the award. SFAS 123R carries forward prior guidance on accounting for awards to non-employees. If an equity award is modified after the grant date, incremental compensation cost will be recognized in an amount equal to the excess of the fair value of the modified award over the fair value of the original award immediately prior to the modification. The Corporation is evaluating the impact on its results of operations from adopting SFAS 123R, but expects it to be comparable to the pro forma effects of applying the original SFAS 123 on any future stock options granted (see Note 4).

In December 2004, The FASB issued Statement on Accounting Standards (SFAS) No. 153 *Exchanges of Nonmonetary Assets* to amend APB Opinion No. 29. The guidance in APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The guidance in that Opinion, however, included certain exceptions to that principle. This Statement amends Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The

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provisions of this Statement shall be effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. Earlier application is permitted for nonmonetary asset exchanges occurring in fiscal periods beginning after the date this Statement is issued. The provisions of this Statement shall be applied prospectively. The Company does not believe this Statement will have a material impact on the financial statements.

**Community Bancshares, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

In May 2005, the FASB issued SFAS No. 154 *Accounting Changes and Error Corrections*. This Statement replaces APB Opinion No. 20, *Accounting Changes*, and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*, and changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed.

Opinion 20 previously required that most voluntary changes in accounting principle be recognized by including in net income in the period of the change, the cumulative effect of changing to the new accounting principle. This new Statement requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. When it is impracticable to determine the period-specific effects of an accounting change on one or more individual prior periods presented, this Statement requires that the new accounting principle be applied to the balances of assets and liabilities as of the beginning of the earliest period for which retrospective application is practicable and that a corresponding adjustment be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period rather than being reported in an income statement. When it is impracticable to determine the cumulative effect of applying a change in accounting principle to all prior periods, this Statement requires that the new accounting principle be applied as if it were adopted prospectively from the earliest date practicable.

This Statement carries forward, without change, the guidance contained in Opinion 20 for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. This Statement also carries forward the guidance in Opinion 20 requiring justification of a change in accounting principle on the basis of preferability. This Statement is effective for fiscal years beginning after December 15, 2005. Early adoption is permitted in certain circumstances. The Company does not believe this Statement will have material effect on its financial position or results of operations.

**Note 3 Earnings per Common Share**

Basic earnings per share represents income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if potentially dilutive common shares had all been issued, as well as any adjustment to income that would result from this assumed issuance. Potential common shares that may be issued by the Company relate solely to outstanding stock options and warrants, and are determined using the treasury stock method. For the nine month period ended September 30, 2005, 103,000 outstanding stock options were excluded from this calculation because they were considered antidilutive. For the three month period ended September 30, 2005, 88,000 outstanding stock options were excluded from this calculation because they were considered antidilutive.

## Community Bancshares, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements

(Unaudited)

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

	Three months ended		Nine months ended	
	September 30,		September 30,	
(Dollars in thousands)				
	2005	2004	2005	2004
Net income	\$ 166,436	\$ 19,281	\$ 618,160	\$ 303,897
Less: preferred stock dividends				
Net income applicable to common stock	\$ 166,436	\$ 19,281	\$ 618,160	\$ 303,897
Weighted average number of common shares outstanding	8,625,954	8,415,375	8,556,284	8,215,216
Effect of dilutive options and warrants	227,056	97,065	178,203	99,334
Weighted average number of common shares outstanding used to calculate diluted earnings per common share	8,853,010	8,512,440	8,734,487	8,314,550

No dividends on our common stock were declared during the three or nine month periods ended September 30, 2005 or 2004.

**Note 4 Stock Based Compensation**

The Company occasionally grants stock options to purchase the Company's common stock to officers and directors. These options have been granted at a strike price equivalent to the current fair value of the Company's common stock on the grant date and have a maximum term of five years. With the exception of 88,000 options granted in 2005 at a strike price of \$6.81 that remain outstanding, all options fully vested at the time of grant of those options. Of the 88,000 options that did not vest immediately, 44,000 vest on January 12, 2006 and 44,000 vest on January 12, 2007. Most of the options with a per share exercise price at or above \$7.00 do not expire following an officer or director's termination. Options with a per share exercise price below \$7.00 terminate at various times ranging from 60 days to one year following an officer or director's termination. As of September 30, 2005, the Company had outstanding options held by officers and directors to purchase an aggregate of 1,802,000 shares of the Company's common stock.

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





## Community Bancshares, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements

(Unaudited)

The following sets forth certain information regarding the outstanding stock options, including the warrant, for the nine months ended September 30, 2004 and 2005:

	<u>Number of shares</u>	<u>Weighted Average Exercise Price</u>
Balance, December 31, 2003	932,500	8.12
Granted, nine months ended September 30, 2004	877,687	5.47
Expired or cancelled, nine months ended September 30, 2004	(193,000)	9.93
	<u>1,617,187</u>	6.47
<b>Balance, December 31, 2004</b>	<b>1,577,187</b>	<b>6.52</b>
<b>Granted, nine months ended September 30, 2005</b>	<b>615,000</b>	<b>6.91</b>
<b>Exercised, nine months ended September 30, 2005</b>	<b>(153,000)</b>	<b>5.56</b>
<b>Expired, nine months ended September 30, 2005</b>	<b>(101,000)</b>	<b>7.10</b>
	<u>1,938,187</u>	<u>6.69</u>

The following sets forth stock options and common stock warrants outstanding as of September 30, 2005:

<u>Exercise Prices</u>	<u>Number</u>	<u>Expiration Date</u>	<u>Options/Warrants Exercisable</u>
Options with exercise price of \$7.00	537,000	2008	537,000
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 \$5.35	377,500	2009	377,500
Options with exercise price of \$5.50	25,000	2009	25,000
Warrants with exercise price of \$5.89	140,187	2008	140,187
Options with exercise price of \$7.00	30,000	2009	30,000
Options with exercise price of \$7.05	5,000	2009	5,000
Options with exercise price of \$6.81	528,000	2010	528,000
Options with exercise price of \$7.88	15,000	2010	15,000
Options with exercise price of \$7.68	50,000	2010	50,000
	<u>1,938,187</u>		<u>1,938,187</u>
Total options and warrants outstanding, September 30, 2005	1,938,187		1,938,187

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The Company permits option and warrant 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, but provides little or no increase in capital account balances. No option holders tendered previously owned shares during the nine months ended September 30, 2005 or 2004.

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

## Community Bancshares, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements

(Unaudited)

Of the Company's options granted during the nine months ended September 30, 2005 and 2004, 511,000 of options granted in 2005 and all options granted in 2004 vest immediately, so, for purposes of pro forma disclosure, the compensation expense related to these options has been recognized on the grant date. The Company's pro forma information, after giving effect to the deduction for stock-based employee compensation expenses determined under fair value based method for all awards, net of tax, is as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Net income:				
As reported	\$ 166,436	\$ 19,281	\$ 618,160	\$ 303,897
Deducts:				
Total stock-based employee compensation expense determined under fair value based method for all awards, net of tax		(9,438)	(801,338)	(974,308)
Pro forma net income (loss)	\$ 166,436	\$ 9,843	\$ (183,178)	\$ (670,411)
Basic earnings (loss) per share:				
As reported	\$ 0.02	\$	\$ 0.07	\$ 0.04
Pro forma	0.02		(0.02)	(0.08)
Diluted earnings (loss) per share				
As reported	0.02		0.07	0.04
Pro forma	0.02		(0.02)	(0.08)

The weighted average per share fair values of options granted to employees during the nine months ended September 30, 2005 and 2004 were \$2.45 and \$2.15, 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:

	2005	2004
Dividend yield	0%	0%
Expected volatility	.468	.403
Risk free interest rate	2.87%	3.17%
Expected life (in years)	3.2	5

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

## Accounting for Derivative Instruments and Hedging Activities

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The following table presents the notional and carrying values of the Company's derivative position held for hedging purposes at both September 30, 2005 and December 31, 2004. This derivative position was executed in the over-the-counter market.

	September 30, 2005		December 31, 2004	
	Notional Value	Carrying Value	Notional Value	Carrying Value
<b>Fair Value Hedges:</b>				
Interest rate swap agreement	\$ 20,000,000	(510,000)	\$ 20,000,000	\$ (288,000)

*Interest-Rate Risk*

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

## Community Bancshares, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements

(Unaudited)

*Fair Value Hedges*

The Company entered into an interest rate swap with a notional principal amount of \$20,000,000 in December 2003 to convert fixed-rate long-term time deposits to a floating rate. The critical terms of the interest rate swap matches the terms of the corresponding time deposits. All components of the derivative instrument's gain or loss are considered in the assessment of hedge effectiveness. There were no fair-value hedging gains or losses as a result of hedge ineffectiveness recognized during the nine months ended September 30, 2005 and 2004. The Company recognized a decrease in interest expense of \$238,250 for the nine months ended September 30, 2004 and an increase of \$10,823 for the nine months ended September 30, 2005 related to its interest rate swap accounted for as a fair value hedge. At September 30, 2005, the interest rate swap had a remaining term of 1.6 years. Fluctuations in the fair value of derivatives contracts are typically attributable to market risk and market interest rates, and such values may be volatile. The Company believes that credit risk is relatively low because the Company transacts only with counterparties that it believes are high quality credits.

**Note 6 Long-term Debt***FHLB long-term debt:*

Community Bancshares' wholly owned principal operating subsidiary, Community Bank, is a member of the Federal Home Loan Bank of Atlanta, or the FHLBA, and is approved to borrow up to \$79.6 million under the FHLBA's Convertible Advance Program. As of September 30, 2005, Community Bank had borrowed \$67.2 million. These borrowings are secured under a blanket lien agreement on qualifying mortgage instruments in Community Bank's loan portfolio. Under this security agreement, upon 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 borrowings from the FHLBA as of September 30, 2005 are as follows:

Principal	Rate	Maturity	Options
\$ 38,000,000	3-month LIBOR	August 10, 2015	Convertible by the FHLBA on August 10, 2007. If not converted, rate changes to 5.75% and will be fixed until maturity.
\$ 9,200,000	4.02%	August 23, 2010	Convertible by the FHLBA on August 23, 2007.
\$ 20,000,000	3.91%	September 16, 2015	Convertible by the FHLBA on September 16, 2015.

At June 30, 2005, Community Bank had borrowed from the FHLBA \$38.0 million at a fixed rate of 5.93% per annum with a final maturity of March 1, 2010. The borrowing was callable by the FHLBA on every quarterly payment date during the life of the obligation. On August 8, 2005,

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the Bank restructured this borrowing into the \$38.0 million listed in the table above. This restructure was considered to be a modification of debt; therefore, no gain or loss was recognized.

### *Junior subordinated debt:*

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

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

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

**Community Bancshares, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

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

Both the debentures and the trust preferred securities accrue and pay interest semiannually at a rate of 10.875% per annum. The junior subordinated debentures have a maturity date of March 8, 2030, at which time the principal amount of the debentures becomes payable together with any accrued but unpaid interest 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 and the Company, as the holder of the trust preferred and trust common securities. The debentures represent the sole asset of the Trust.

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

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

	<b>Balance Prior To Adjustment</b>	<b>Adjustments for FIN 46</b>	<b>Adjusted Balance</b>
Other assets	\$ 17,378,360	\$ 310,000	\$ 17,688,360
Trust preferred securities	10,000,000	(10,000,000)	
Junior subordinated debt		10,310,000	10,310,000

Under the terms of the indenture governing the debentures, the Company may elect to defer payments of interest due on the debentures for up to ten consecutive semiannual payment periods. The Company elected to defer the March 2002, September 2002, March 2003, September 2003 and March 2004 interest payments, but on September 8, 2004, the Company paid all deferred interest plus the accrued interest thereon totaling \$3,739,490 and has since paid interest on the debentures when due. The accrued interest payable balance on September 30, 2005 was \$66,458.

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:



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

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

As specified in the indenture, if the debentures are redeemed prior to maturity, then the redemption price will be a percentage of the principal amount, ranging from 105.438% during the 12 months following March 8, 2010 to 100.00% following March 8, 2020, plus any accrued but unpaid interest due on the debentures at the time of

**Community Bancshares, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

redemption. If the debentures are redeemed prior to March 8, 2010 following a tax event, capital treatment event or investment company event, the redemption price will be the greater of (i) 100% of the principal amount of debentures redeemed, and (ii) the present value of the remaining principal and interest payments between the redemption date and March 8, 2010, plus, in either case, any accrued but unpaid interest due on the debentures at the time of redemption.

**Note 7 Issuance of Common Stock**

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

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

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

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

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

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.

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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 nine months ended September 30, 2005 and 2004 was 14,388 shares at a fair market value of \$97,983 on the issue date and 20,720 shares at a fair market value of \$110,550 on the issue date, respectively. Directors' fees are accrued when incurred and the aggregate fair market value of the shares issued is charged to accrued directors' fees once issued.

During the nine months ended September 30, 2005, 110,000 stock options were exercised at a price of \$5.35 per share, 3,000 stock options were exercised at a price of \$6.81, 25,000 stock options were exercised at a price of \$5.50 and 15,000 stock options were exercised at a price of \$7.00 resulting in an increase to total stockholders' equity of \$851,429. During the nine months ended September 30, 2004, 45,000 stock options were exercised resulting in an increase to total stockholders' equity of \$240,750.

## Community Bancshares, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements

(Unaudited)

## Note 8 Pension Plan

Components of the net periodic benefit cost of the Company's pension plan and benefit restoration plan for the nine months ended September 30, 2005 and 2004 are as follows:

	September 30, 2005		September 30, 2004	
	Pension Plan	Benefit Restoration Plan	Pension Plan	Benefit Restoration Plan
Interest cost on earned benefit obligation	\$ 406,641	\$ 110,046	\$ 396,768	\$ 102,079
Estimated return on plan assets	(474,054)		(412,311)	
Amortization of net experience loss	93,390	3,684	17,766	
Net periodic benefit cost	\$ 25,977	\$ 113,730	\$ 2,223	\$ 102,079

The Company contributed \$783,061 to the pension plan during the first nine months of 2004 and contributed \$2,007,850 during the first nine months of 2005.

## Note 9 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. Questions were subsequently raised about a number of Community Bank construction projects. A joint committee of the boards of directors of Community Bancshares and Community Bank conducted an investigation as did law enforcement and bank regulatory authorities. Following these investigations, the boards of directors terminated the employment of Kennon R. Patterson, Sr., former Chairman, President and Chief Executive Officer of Community Bancshares and Chairman and Chief Executive Officer of Community Bank, and Larry Bishop, former Vice President of Community Bank and the FDIC commenced administrative proceedings against Mr. Patterson and Mr. Bishop, which are still pending. On March 10, 2005, Mr. Patterson and Mr. Bishop were convicted in the United States District Court for the Northern District of Alabama of conspiracy, bank fraud and causing false entries to be made in bank records. Mr. Patterson was also convicted of filing false income tax returns. Sentencing of these individuals has been rescheduled by the court to November 30, 2005.

**Patterson Employment Litigation**

Plaintiffs: Community Bancshares, Inc. and Community Bank

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

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

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

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

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

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

**Community Bancshares, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

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

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

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

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

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

On January 25, 2005, Mr. Patterson filed a third-party complaint in this lawsuit against R.B. Jackson, Jimmie Trotter, Glynn Debter, John J. Lewis, Jr., Patrick M. Frawley and Powell Goldstein, LLP. The third-party complaint alleges that Messrs. Jackson, Trotter, Debter and Lewis, as members of Community Bank's Audit Committee, Powell Goldstein, LLP, as the independent counsel for Community Bank's Audit Committee, and Mr. Frawley, acting individually and in concert with one another, interfered with Mr. Patterson's employment agreement with Community Bancshares. On April 19, 2005, Powell Goldstein, LLP was dismissed from the lawsuit.

**Patterson ESOP Litigation**

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

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

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

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

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

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

**Community Bancshares, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

**Patterson Benefit Restoration Plan Litigation**

Plaintiff: Kennon R. Patterson, Sr.

Defendant: Community Bancshares, Inc. Benefit Restoration Plan

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

**Employee Litigation**

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

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

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

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

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

**Other Litigation**



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

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

**Community Bancshares, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

**Contingency Losses**

In all claims against the Company, management has assessed where losses are both probable and can be reasonably estimated. As of September 30, 2005, management believes there are no losses where losses are both probable and can be reasonably estimated; therefore, there are no accruals for contingent liabilities.

**Note 11 Acquisition of Assets**

On April 29, 2005, Community Bank purchased certain mortgage assets from American Family Mortgage, LLC. Under the terms of the transaction, Community Bank acquired mortgage assets including, without limitation, all of American Family Mortgage's mortgage loans, pipeline mortgage loans and fixed assets as well as ownership of the American Family Mortgage name. As consideration in the transaction, Community Bank paid an aggregate purchase price of approximately \$971,966, consisting of \$721,966 in cash, and an additional \$250,000 to be paid over three years subject to certain performance criteria.

As a result of the asset purchase, the Company recorded \$17,660 in premises and equipment and \$704,306 of goodwill. Since goodwill has an indefinite life, this asset will not be amortized, but will be tested for impairment at least annually unless events occur that require earlier testing.

**Note 12 Material Contracts**

On October 12, 2005, Community Bank and Community Funding Corporation entered into a Real Property Sales Contract with Salvatore Cangiano (the purchaser), pursuant to which the Purchaser will purchase from the Company Heritage Valley Ranch, approximately 900 acres of property near Blountsville, AL, acquired by the Company in connection with mortgage foreclosures in December 2004. However, on November 9, 2005, the Company received notice from Mr. Cangiano that he did not wish to move forward with the transaction and under the terms of the contract he has the right to do so without penalty. His notice was accepted by the Company on November 10, 2005.

On November 10, 2005, Community Bank and Community Funding entered into a Real Property Sales Contract with William Carrington and Anne Davenport - Carrington (the purchaser), pursuant to which the Purchaser will purchase from the Company Heritage Valley Ranch, approximately 900 acres of property near Blountsville, AL, acquired by the Company in connection with mortgage foreclosures in December 2004. The sales price is \$9,750,000 and the sale is contingent upon the Purchaser being able to obtain financing. Subject to its normal credit underwriting standards and procedures, including without limitation approval of its Board of Directors, Community Bank will lend the Purchaser \$9,262,500 and Purchaser will contribute \$487,500. Neither the Company, nor the Companies Officers, Directors, or other affiliates, nor those persons respective affiliates had any prior material relationship with the Purchaser.

**Note 13 Subsequent Events**

On November 9, 2005, Community Bank closed on the sale of its branch located in Double Springs, Alabama. The following outlines the total assets sold and total liabilities released in the transaction:

Loans	\$ 1,677,528
Premises and equipment, net	939,150
Accrued interest receivable	9,912
Cash and cash items	170,741
	<hr/>
Total assets	\$ 2,797,331
	<hr/>
Deposits	\$ 7,852,849
Accrued interest payable	28,772
Other liabilities	2,535
	<hr/>
Total liabilities	\$ 7,884,156
	<hr/>

The Company paid \$4,660,153 in cash on the transaction and recognized a total gain of \$426,672 representing the premium received on deposits and loans.

### **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, anticipated events, assumptions, estimates, intentions, and future performance, and involve known and unknown risks, uncertainties and other factors, many of which are 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, project, continue, plan, point to, could, intend, seek, target, and other similar words and expressions. Such forward looking statements include, without limitation, statements regarding:

our business strategy, including our entry into new markets and the exit from certain existing markets;

future performance, developments, transactions or market forecasts;

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

projected investments in and dispositions of assets.

The 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 our deposits, loan demand, and the values of loan collateral, securities, and interest sensitive assets and liabilities;

interest rate risks and credit risks of our borrowers;

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

our potential inability to successfully enter into new markets or to realize the expected benefits of entering into those new markets, or to recognize anticipated sales proceeds and savings from exiting certain existing markets;

our potential inability to successfully implement our strategic plan;

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

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

the risks of mergers, acquisitions and divestitures, 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;

our expected use of borrowed funds;

risks that the sales of other real estate owned will not close on the terms agreed, including without limitation time and price;

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

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

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

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

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

### Overview

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

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

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

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

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

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

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

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

improved regulatory relations and results.

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

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

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

During March 2005, the FDIC, the Federal Reserve Bank of Atlanta, and the Alabama State Banking Department terminated all regulatory enforcement agreements, memoranda, plans and/or orders governing our operations. We believe these actions will:

substantially reduce our costs associated with complying with these regulatory restrictions;

substantially reduce our FDIC insurance expense (up to an estimated \$750,000 per year);

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

ease collateral requirements on FHLBA borrowings;



increased borrowing capacity at the FHLBA;

enable us to expand more freely into higher growth markets;

allow us to expand correspondent and vendor relationships; and

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

settlement of the lending acts litigation which has been costly for the Company;

recovery of \$333,000 from a previously charged-off loan;

continued improvement in asset quality resulting from more management time that can be spent on managing credit risk; and

on September 20, 2005, we listed our stock for trading on the NASDAQ Capital Market.

We believe the combined effect of these developments helps position the Company to better focus on customer attraction and retention, improved marketing of competitive products and services, expansion into higher growth markets, management of an improved balance sheet, and future profitability.

### **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 to small and medium-sized businesses 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 loans and investment securities; and

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

The level of net interest income is determined primarily by the average balances, or volume, of interest-earning assets and the various spreads between the rates we earn on our interest-earning assets and the rates we pay on our interest-bearing liabilities. 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 with a positive spread over our interest costs and with reasonable relations between the maturities or repricing dates of these assets and liabilities.

*Net Noninterest Income*

Our net noninterest revenues consist primarily of:

service charges on customer deposit accounts;

insurance commissions;

securities gains or losses; and

other service fees charged to customers.

Our net noninterest expenses consist primarily of:

salaries and employee benefits;

costs to hold and maintain premises and equipment;

insurance;

director and committee fees;

professional service fees, especially legal and accounting; and

cost of foreclosed assets.

### **Critical Accounting Policies**

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

We recognize the following as our critical accounting policies:

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

our past loan loss experience;

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

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

the estimated value of any underlying collateral;

our internal loan reviews;

the reviews of regulators and their comparisons to similar institutions; and

analyses of current economic conditions.

The consideration and application of many of these factors involve assumptions, estimates and judgments that are inherently uncertain and are subject to change. We believe that our allowance for loan losses was adequate at September 30, 2005, based upon the information that was available to us at that time. While we use available information to recognize losses on loans, future additions to the allowance for loan losses may be necessary based on economic changes and changes to various borrowers. Certain economic and interest rate changes could materially affect the allowance for loan losses. Our allowance for loan losses is also subject to regulatory examinations and determinations as to adequacy, which may take into account such factors as the methodology used to calculate the allowance for loan losses and the size of the allowance for loan losses in comparison to a group of peer banks identified by our regulators. During their routine examinations of banks, the Federal Deposit Insurance Corporation and the Alabama State Banking Department may require us to make additional provisions to our allowance for loan losses as a result of the regulator's judgment differing from our credit evaluations and allowance for loan loss methodology.

*Accounting for Income Taxes.* We use the asset and liability method of accounting for income taxes. Our determination of the deferred and current provision for income taxes requires analysis of certain transactions and the related tax laws and regulations applicable to those transactions. We exercise significant judgment in evaluating the amount and timing of the recognition of the resulting tax liabilities and assets. Our judgments and estimates are re-evaluated on a continual basis as

regulatory and business factors change. However, because our judgments and estimates are inherently subjective and subject to change, there can be no assurance that our determination of the provision for income taxes will not be changed, upward or downward, in future periods.

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

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

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

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

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

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

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

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

accordingly, we have not provided any reserves for losses in the consolidated financial statements for an unfavorable outcome, if any, with respect to such proceedings.

As of December 31, 2004, we had accrued \$309,896 for potential losses on pending litigation, where in our best judgment, losses were both probable and reasonably estimated. The estimates were based on current circumstances of pending matters. As of September 30, 2005, we believe no reserve is warranted since there are no contingency losses that we believe to be both probable and reasonably estimable and therefore, no amounts have been accrued.

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

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

### FINANCIAL CONDITION

#### As of September 30, 2005 compared to December 31, 2004

##### General

The Company's total assets at September 30, 2005 were \$569.9 million, an increase of \$16.5 million, or 3.0%, from \$553.4 million at December 31, 2004. The Company experienced an increase in loans, net of allowance for loan losses, of \$33.5 million, or 11.3%, during the first nine months of 2005. The Company experienced a decline in deposits during the first nine months of 2005 of \$11.2 million, or 2.5%. Noninterest-bearing deposits increased \$2.6 million, or 3.7%, from December 31, 2004 to September 30, 2005, while interest-bearing deposits have decreased by \$13.8 million, or 3.7%.

### **Earning Assets**

The earning assets of the Company principally are comprised of:

loans;

investment securities;

interest-bearing balances in other banks; and

federal funds sold.

The Company's investment securities portfolio is used by the Company to make various term investments, to provide a source of liquidity for the Company and to serve as collateral to secure certain deposits. The fair value of the Company's investment securities decreased \$5.6 million, or 3.8%, to \$141.6 million at September 30, 2005, from \$147.2 million at December 31, 2004. The Company also maintains short-term investments in the form of interest-bearing deposits with other banks. These interest-bearing deposits with other banks amounted to \$2.1 million at September 30, 2005, compared to \$5.4 million at December 31, 2004, representing a decrease of \$3.3 million, or 60.0%. At September 30, 2005, the Company had \$17.2 million in federal funds sold, compared to \$13.5 million at December 31, 2004, representing an increase of \$3.7 million, or 27.8%.

Total cash due from banks decreased \$13.2 million, or 25.1%, during the first nine months of 2005, from \$52.5 million at December 31, 2004 to \$39.3 million at September 30, 2005 as cash received in December 2004 from the sale of poor quality loans was reinvested into higher quality loans and investment securities in early 2005. Excess cash and cash equivalents along with securities available for sale have also been the funding source for loan growth and have offset, in part, deposit declines.

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 \$334.1 million at September 30, 2005, which represented an increase of approximately \$33.7 million, or 11.2%, from \$300.4 million at December 31, 2004. We believe that balance sheet growth, achieved through the growth of total loans, is integral to the Company's profitability. In order to achieve this growth, we presently expect to continue our expansion into new demographically attractive markets such as the new branch located in Huntsville, Alabama that opened in August 2005.

### **Nonperforming Assets and Past Due Loans**

The Company's nonperforming assets primarily are comprised of:

nonaccruing loans;

loans 90 days past due or greater;

restructured loans;

nonaccruing securities; and

other real estate owned.

Between December 31, 2004 and September 30, 2005, the Company's ratio of the allowance for loan losses to total nonperforming assets increased slightly from 36.22% to 38.47%, but has decreased significantly from 63.61% at September 30, 2004. The decrease from September 30, 2004 occurred as poor quality loans which carried higher allowances were sold in the fourth quarter of 2004 coupled with the increase in other real estate owned which generally carry no allowance since they are marked to estimated fair value when acquired. The ratio of total nonperforming assets to total assets decreased to 2.19% at September 30, 2005, from 2.31% at year-end 2004, while the ratio of nonperforming loans to total loans, net of unearned income, increased to 0.67% at September 30, 2005 from 0.55% at December 31, 2004. Total nonperforming assets decreased \$0.3 million, or 2.2%, to \$12.5 million at September 30, 2005, from total nonperforming assets of \$12.8 million at December 31, 2004.



The following table summarizes the Company's nonperforming assets at September 30, 2005 and 2004, as well as December 31, 2004.

### NONPERFORMING ASSETS

(Dollars in thousands)

	September 30,		December 31, 2004
	2005	2004	
Nonaccruing loans	\$ 1,792	\$ 8,464	\$ 1,115
Loans past due 90 days or more	205	271	290
Restructured loans	236	2,267	238
<b>Total nonperforming loans</b>	<b>2,233</b>	<b>11,002</b>	<b>1,643</b>
Other real estate owned	10,259	4,801	11,126
<b>Total nonperforming assets</b>	<b>\$ 12,492</b>	<b>\$ 15,803</b>	<b>\$ 12,769</b>
<b>Ratios:</b>			
Allowance for loan losses to loans, net of unearned income	1.44%	3.17%	1.54%
Allowance for loan losses to total nonperforming assets	38.47	63.61	36.22
Total nonperforming loans to total loans (net of unearned income)	0.67	3.47	0.55
Total nonperforming assets to total assets	2.19	2.95	2.31

### Funding and Other Debt Obligations

The Company's primary sources of funding are from the deposits of customers of Community Bank and from the Company's short-term and long-term borrowings. Total deposits of \$437.4 million at September 30, 2005 reflected a decrease of \$11.2 million, or 2.5%, from total deposits of \$448.6 million at year-end 2004 due to a decrease in interest-bearing deposits. Noninterest-bearing deposits increased \$2.6 million, or 3.7%, to \$72.9 million at September 30, 2005, from \$70.3 million at December 31, 2004, while interest-bearing deposits decreased \$13.8 million, or 3.7%, to \$364.5 million at September 30, 2005, from \$378.3 million at December 31, 2004. Total short-term borrowings remained level and were \$601,000 at September 30, 2005 and \$621,000 at December 31, 2004.

On May 6, 2004, Community Bancshares, Inc. established a line of credit with First Commercial Bank in the amount of \$3,000,000. The rate on any used portion of the line of credit is the prime rate plus 50 basis points. The line of credit will mature on May 1, 2009, and only interest is due on outstanding amounts for two years, with principal payments to begin thereafter. At September 30, 2005, there was no balance outstanding on this line of credit.

Community Bank is a member of the Federal Home Loan Bank of Atlanta, or the FHLBA, and is approved to borrow up to \$79.6 million under the FHLBA's Convertible Advance Program. As of September 30, 2005, Community Bank had borrowed \$67.2 million. 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.

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The Company's borrowings from the FHLBA as of September 30, 2005 are as follows:

<u>Principal</u>	<u>Rate</u>	<u>Maturity</u>	<u>Options</u>
\$ 38,000,000	3-month LIBOR	August 10, 2015	Convertible by the FHLBA on August 10, 2007. If not converted, rate flips to 5.75% and will be fixed until maturity.
\$ 9,200,000	4.02%	August 23, 2010	Convertible by the FHLBA on August 23, 2007.
\$ 20,000,000	3.91%	September 16, 2015	Convertible by the FHLBA on September 16, 2015.

At June 30, 2005, Community Bank had borrowed from the FHLBA \$38.0 million at a fixed rate of 5.93% per annum with a final maturity of March 1, 2010. The borrowing was callable by the FHLBA on every quarterly payment date during the life of the obligation. On August 8, 2005, the Bank restructured this borrowing into the \$38.0 million listed in the table above. This restructure was considered to be a modification of debt; therefore, no gain or loss was recognized.

Of the new debt totaling \$29.2 million, \$19.2 million was used to fund securities purchases in a leverage transaction and we expect to use the remaining \$10.0 million for expected future loan funding.

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<sup>7</sup>/<sub>8</sub>% 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, and since then, has timely made all payments of interest due. The Company could elect to defer amounts due in the future.

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

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

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

As specified in the indenture, if the debentures are redeemed prior to maturity, then the redemption price will be a percentage of the principal amount, ranging from 105.438% in 2010 to 100.00% in and after 2020, plus any accrued but unpaid interest due on the debentures at the time of

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redemption. If the debentures are redeemed prior to March 8, 2010 following a tax event, capital treatment event or investment company event, the redemption price will be the greater of 100% of the debentures redeemed or the present value of the remaining principal and interest payments between the redemption date and March 8, 2010, plus, in either case, any accrued but unpaid interest due on the debentures at the time of redemption.

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

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

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

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

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

The Company sponsors an Employee Stock Ownership Plan, or ESOP, to provide the Company's employees with a means of owning its common stock. An employee becomes an eligible participant in the ESOP on June 30 or December 31 of any given year after completing 12 months of employment during which the employee is credited with 1,000 or more hours of service. Contributions by the Company to the ESOP are made at the discretion of the Company's board of directors, but may not be less than the amount required to cover any debt service due on the ESOP's loan, which is described below.

The Company has a loan to the ESOP that bears interest at a floating rate equal to the prime rate of interest. As of September 30, 2005, the interest rate on the note was 6.75%. 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, subject to applicable ERISA and tax restrictions. 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, 2005 was \$1.4 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 credited 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. The Company evaluated its obligations to Mr. Patterson in light of Mr. Patterson's indictment and subsequent conviction of certain crimes involving the Company, as well as other requirements of law applicable to ESOPs, and, as a result, on March 15, 2004, the ESOP and the ESOP trustee, North Star Trust Company, filed suit in the United States District Court for the Northern District of Alabama against Kennon R. Patterson, Sr. In the lawsuit, the ESOP seeks damages for alleged breaches of fiduciary duty by Mr. Patterson, and both the ESOP and the trustee seek a declaratory judgment that the ESOP has a right of set-off against Mr. Patterson's account in the ESOP, and the ESOP is not required to make a distribution of funds to Mr. Patterson. Mr. Patterson has since been convicted on various counts including bank fraud. Prior to September 20, 2005, the Company could have been required to contribute cash to the ESOP in order to enable the ESOP to make this lump sum cash payment. However, on September 20, 2005, the Company's stock was approved for trading on NASDAQ Capital Market, and as a result, the Company has amended its ESOP to no longer require cash distributions, but rather permit stock to be distributed. The Company now believes that should the ESOP be required to distribute the \$298,000 to Mr. Patterson, it can do so in stock thus eliminating the potential need for a cash contribution from the Company.

The Company also evaluated its obligations to Mr. Patterson under a supplemental nonqualified retirement plan and as a result has denied his request for payment of benefits under the plan. Our denial has been challenged by Mr. Patterson in pending litigation and therefore we have not removed the accrued liability for the benefit from the Company's consolidated balance sheet. The portion of the liability attributable to Mr. Patterson is approximately \$1.9 million and is included in other liabilities on the Company's consolidated balance sheet.

## Liquidity

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The following is a discussion of cash flows and sources of liquidity. The Company experienced an approximately \$13.2 million decrease in cash and cash equivalents during the first nine months of 2005, due primarily to cash used by investing activities as the Company experienced increases in loan demand. Cash provided by operating activities was \$2.6 million, compared to cash used by operating activities of \$3.1 million for the nine month period ended September 30, 2004. Investing activities used cash of \$34.5 million during the first nine months of 2005, resulting mostly from securities purchases and loan originations net of collections offset by proceeds of maturities, sales, calls, and paydowns of securities. The Company also used \$4.1 million of cash to invest in premises and equipment. Of the total used to invest in premises and equipment, approximately \$2.6 million was related to expansion into the Huntsville, Alabama market. Most of the remaining \$1.5 million was used for technological improvements throughout the Company including but not limited to new online banking software, a new voice over internet telephone system, ATM upgrades and new imaging hardware and software. Cash provided by financing activities was \$18.7 million during the first nine months of 2005, compared to \$18.3 million used by financing activities during the first nine months of 2004. Demand deposits, NOW and savings accounts decreased \$21.9 million during the first nine months of 2005, which was partially offset by increases in cash from the growth of certificates of deposit totaling \$10.7 million and also offset by the increase in long-term debt of \$29.2 million.

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

In addition to debt service, as described above, the Company also will expend capital to settle, resolve and pay legal and other professionals to assist it in defending against the litigation to which it presently is subject as described in Note 9 to the Company's unaudited consolidated financial statements included in this Report. The Company also may apply cash to maintain and improve capital levels at the parent company and at each subsidiary, as described below under Capital Resources. The Company also may use cash if it determines to review and possibly sell any of its branches that do not contribute to the Company's improved operations.

### Capital Resources

The Company's total stockholders' equity at September 30, 2005 was 7.69% of total assets, as compared to 7.75% at December 31, 2004.

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

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

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

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

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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.

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 of trust preferred securities issued to purchase the Company's junior subordinated deferrable interest debentures, totaled \$52.9 million at September 30, 2005, as compared to \$51.9 million at December 31, 2004. Tier 1 Capital plus Tier 2 Capital components are referred to as Total Risk-Based Capital, which was equal to \$57.4 million at September 30, 2005, as compared to \$56.0 million at year-end 2004.

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The Company's Tier 1 and Total Risk-Based Capital ratios were 14.52% and 15.77%, respectively, at September 30, 2005, compared to 15.81% and 17.06%, respectively, at year-end 2004. At September 30, 2005, both Tier 1 and Total Risk-Based Capital of the Company exceeded the regulatory minimum ratios of 4.0% and 8.0%, respectively. The Company's Tier 1 leverage ratio was 9.77% and 9.58% at September 30, 2005 and December 31, 2004, respectively.

The following table shows both the Company's and the Bank's regulatory total risk based capital and Tier 1 capital amounts and ratios as of September 30, 2005 and December 31, 2004:

	September 30, 2005		December 31, 2004	
	Amount	Ratio	Amount	Ratio
(Dollars in thousands)				
<b>Total risk based capital</b>				
<b>(to risk weighted assets):</b>				
<b>Consolidated</b>	\$ 57,448	15.77%	\$ 56,019	17.06%
<b>Community Bank</b>	50,707	14.12	49,573	15.42
<b>Tier 1 capital</b>				
<b>(to risk weighted assets):</b>				
<b>Consolidated</b>	52,891	14.52	51,909	15.81
<b>Community Bank</b>	46,215	12.87	45,548	14.17
<b>Tier 1 capital</b>				
<b>(to quarterly average assets):</b>				
<b>Consolidated</b>	52,891	9.77	51,909	9.58
<b>Community Bank</b>	46,215	8.62	45,548	8.47

#### FDIC Insurance Assessments

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

The FDIC's BIF assessment schedule continues to range from zero to 27 basis points per annum, and has remained unchanged since 2001. The FDIC also collects Financing Corporation ( FICO ) deposit assessments. The FICO assessments are set quarterly and ranged from 1.46 to 1.54 basis points in 2004, and was 1.44, 1.42 and 1.34 basis points for the first, second and third quarters of 2005, respectively.

During the nine months ended September 30, 2005 and 2004, the Bank expensed approximately \$415,927 and \$625,000, respectively, in total deposit insurance premiums. These premiums declined starting July 1, 2005 as a result of our improved regulatory status. Our FDIC BIF assessment rate for the third quarter was zero and our FICO rate was 1.34 basis points, resulting in significant savings for our Company.

#### Regulatory Restrictions

#### *Special and Important Update*

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

### **FDICIA**

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

FDICIA also contains a variety of other provisions that may affect the operations of the Company and the Bank, including new reporting requirements, regulatory standards for real estate lending, truth in savings provisions, the requirement that a depository institution give 90 days prior notice to customers and regulatory authorities before closing any branch, and a prohibition on the acceptance or renewal of brokered deposits by depository institutions that are not well capitalized or are adequately capitalized and have not received a waiver from the FDIC. The Bank had no brokered deposits as of September 30, 2005.

#### **Enforcement Policies and Actions**

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

#### **Off Balance Sheet Arrangements**

As of September 30, 2005, we had no material unconditional purchase obligations that were not recorded on the balance sheet.

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

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

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require the payment of a fee. The commitments for equity lines of credit may expire without being drawn upon. Therefore, the total commitments amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Company, is based on management's credit evaluation of the customer. At December 31, 2004, the outstanding commitments to grant loans represented a credit risk of \$24.0 million. At September 30, 2005, the outstanding commitments to grant loans represented a credit risk of \$27.2 million.

Standby letters-of-credit are conditional lending commitments issued by the Company to guarantee the performance of a customer to a third party. These letters-of-credit are primarily issued to support public and private borrowing arrangements. Essentially all letters-of-credit issued by the Company have expiration dates within one year, but the majority are automatically renewable for the beneficiary. The credit risk involved in issuing letters-of-credit is essentially the same as that involved in extending loan facilities to customers. At December 31, 2004, the Company has standby letters-of-credit outstanding of \$465,000. At September 30, 2005, the Company has standby letters-of-credit of \$650,000.

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The Company has also entered into interest rate swaps and may enter into more in the future as a means of hedging its assets or liabilities and to manage the risk of earnings fluctuations caused by interest rate volatility.

On December 8, 2003, the Company entered into an interest rate swap with a notional amount of \$20.0 million to convert fixed-rate long-term time deposits to a floating rate. The Company receives a fixed annual rate of 5.43% and pays a floating rate equal to the 3-month LIBOR plus 2.425%. This interest rate swap matures on June 8, 2006.

In August 2005, after restructuring its \$38.0 million FHLBA borrowing, the Company entered into a second interest rate swap with a notional amount of \$38.0 million that will begin on November 10, 2005. The Company entered this swap, which matures on August 10, 2007, to convert the floating rate portion of the borrowing to a fixed rate. Beginning November 10, 2005, the Company will receive a floating rate at 3-month LIBOR and pay an annual fixed rate of 4.22%.

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**RESULTS OF OPERATIONS****For the three and nine month periods ended September 30, 2005 and 2004****General**

The Company's net income for the nine month period ended September 30, 2005 was \$0.6 million, representing a \$0.3 million, or 103.3% increase from net income of \$0.3 million for the same period in 2004. Net income for the nine months ended September 30, 2005 represented \$0.07 earnings per share on both a basic and diluted basis, compared to basic and diluted earnings per share of \$0.04 during the nine month period ended September 30, 2004. This increase in earnings was due to marked improvements in net interest income, a decrease in provision for loan losses and improved noninterest income as a result of a settlement of litigation, all negligibly offset by an increase in noninterest expense.

The Company's net income for the three months ended September 30, 2005 was \$166,000 representing a \$147,000 increase from net income of \$19,000 for the same period in 2004. Net income for the three months ended September 30, 2005 represented \$0.02 earnings per share on both a basic and diluted basis compared to \$0.00 earnings per share during the three months ended September 30, 2004.

**Net Interest Income**

Net interest income represents the difference between the interest earned by the Company on its assets and the cost borne by the Company on its interest-bearing liabilities. For the nine months ended September 30, 2005, the Company's net interest income before its provision for loan losses was \$14.7 million. Net interest income, before provision for loan losses, increased approximately \$0.6 million, or 3.8%, from \$14.1 million for the same period of 2004. The increase in net interest income was due to the increase in revenues related to interest-earning assets because of higher yields earned on these assets as well as an improved balance sheet mix (more loans and less securities with loans earning higher yields) partially offset by an increase in interest expense due to higher rates paid on interest-bearing liabilities. Revenues from interest-earning assets of the Company increased \$1.2 million, or 5.3%, to \$24.8 million for the nine months ended September 30, 2005 from \$23.6 million for the same period in 2004. Average earning assets outstanding during the first nine months of 2005 were \$473.8 million, which represents a decrease of \$10.6 million, or 2.2%, from \$484.4 million from the first nine months of 2004. The Company's volume of interest-earning assets decreased due to reductions in securities, resulting from the reduction in the Company's level of deposits. Higher yields earned on interest-earning assets as well as an improved mix of securities and loans partially offset declines in interest income due to volume. The Company's yield on its average earning assets increased 50 basis points to 7.00% for the first nine months of 2005, compared to 6.50% for the same period of 2004. The increase in yield was attributable to the shift away from lower yielding securities into higher yielding loans as the Company has experienced initial success in its loan production efforts as well as higher overall interest rates.

Interest expense for the nine months ended September 30, 2005 was \$10.2 million, an increase of \$0.8 million, or 7.7%, from the Company's interest expense of \$9.4 million for the corresponding period of 2004. This increase occurred due to an increase in rates paid on, and despite a decrease in the volume of, deposits and other interest-bearing liabilities. Average deposits and other interest-bearing liabilities during the first nine months of 2005 were \$496.1 million, which represents a decrease of \$11.7 million, or 2.3%, from \$507.8 million for the same period of 2004. The volume of deposits and other interest-bearing liabilities decreased partially due to the Company's decision to not seek higher priced deposits as it tries to establish longer lasting relationships with its customers, based on customer service, rather than merely price. The rate paid by the Company on average deposits and other interest-bearing liabilities increased 26 basis points to 2.74% for the nine month period ended September 30, 2005, compared to 2.48% for the first nine months of 2004, as the Company raised rates on deposits in response to overall rate increases in the economy. Interest expense increases as a result of high rate environment were partially offset by the restructuring of the \$38.0 million FHLBA borrowing, reductions in volumes of higher cost deposits, increases in noninterest bearing deposits and the payoff in September 2004 of accrued interest on the Company's outstanding junior subordinated debt.

The Company's net interest margin for the nine months ended September 30, 2005 was 4.14% and was 3.90% for the same period in 2004. Net interest margin is computed by dividing net interest income by average interest-earning assets. This ratio represents the difference between the average yield returned on average interest-earning assets and the average rate paid on funds used to support those interest-earning assets, including both interest-bearing and noninterest-bearing sources.

The Company's net interest spread for the nine months ended September 30, 2005 increased 24 basis points to 4.26%, from 4.02% for the nine months ended September 30, 2004, as the increase in the average yield on interest-earning assets exceeded the increase in the average cost of interest-bearing sources of funds. 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.



Net interest income before provision for loan losses for the three months ended September 30, 2005 was \$5.2 million as compared to \$4.8 million for the same period in 2004, representing a \$0.4 million, or 8.9% increase. The annualized yield on average earning assets for the three month period ended September 30, 2005 was 7.23% while the rate paid on interest bearing liabilities was 2.81%, resulting in a net interest spread of 4.42%. The net interest spread for the three month period ended September 30, 2004, annualized, was 4.07%. The net interest margin for the three months ended September 30, 2005 was 4.32%, while the net interest margin for the same period in 2004 was 3.95%. The improved net interest spread and margin for the three months ended September 30, 2005 demonstrates continued improvement in this core income item.

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

The Company's allowance for loan losses at September 30, 2005 was \$4.8 million which represented an increase of \$0.2 million, or 3.9%, from a December 31, 2004 allowance of \$4.6 million. The provision for loan losses was \$0.7 million for both nine month periods ended September 30, 2005 and 2004. Management continues to make provisions for current losses in the Company's loan portfolio, as well as for any other deterioration identified, as it continues to evaluate the risks in its loan portfolio. The credit quality of the Company's loan portfolio has improved significantly; therefore, we have provided for a slight decrease in the allowance for loan losses as a percentage of total loans. As a percentage of total loans, net of unearned income, the allowance for loan losses was 1.44% at September 30, 2005, compared to 1.54% at December 31, 2004. Total loan charge-offs during the first nine months of 2005 amounted to \$1.3 million, a \$4.8 million decrease from \$6.1 million for the same period in 2004. Loan charge-offs exceeded recoveries by \$0.5 million during the first nine months of 2005, which represented a decrease of \$4.5 million, from \$5.0 million net for the same period during 2004. The Company sold a substantial amount of its poor quality loans in both March and December of 2004 which caused significantly higher charge-offs during those periods. Management believes that the Company's allowance for loan losses at September 30, 2005 was adequate based upon information available to management at that date; however, due to the inherent subjectivity and uncertainty of determining the appropriate allowance for loan losses, the Company can give no assurance that additional losses may not occur or that additional or unforeseen provisions to the allowance for loan losses will not be necessary.

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

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

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

The allowance for loan losses represents management's assessment of the risk associated with extending credit and its evaluation of the quality of the loan portfolio. Management analyzes the loan portfolio to determine the adequacy of the allowance for loan losses and the appropriate

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

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

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

The following table summarizes the levels of the allowance for loan losses as of September 30, 2005 and 2004, as well as December 31, 2004:

	September 30,		December 31, 2004
	2005	2004	
	(Dollars in thousands)		
Allowance for loan losses at beginning of period	\$ 4,625	\$ 14,358	\$ 14,358
Loans charged off:			
Commercial, financial and agricultural	39	2,362	3,888
Real estate - mortgage	282	2,180	6,046
Consumer	934	1,600	2,226
Total loans charged off	1,255	6,142	12,160
Recoveries on loans previously charged off:			
Commercial, financial and agricultural	20	457	517
Real estate - mortgage	542	72	272
Consumer	211	586	651
Total recoveries	773	1,115	1,440
Net loans charged off	482	5,027	10,720
Provision for loan losses	663	722	987
Allowance for loan losses at end of period	\$ 4,806	\$ 10,053	\$ 4,625
Loans, net of unearned income, at end of period	\$ 334,104	\$ 316,750	\$ 300,380
Average loans, net of unearned income, outstanding for the period	\$ 315,698	\$ 314,226	\$ 312,876
	September 30,		
	2005	2004	December 31, 2004
Ratios:			
Allowance for loan losses to loans, net of unearned income, at end of period	1.44%	3.17%	1.54%
Allowance for loan losses at end of period to average loans, net of unearned income	1.52	3.20	1.48
Net charge-offs (annualized) to average loans, net of unearned income	0.20	2.14	3.43
Net charge-offs (annualized) to allowance for loan losses, at end of period	13.38	66.67	231.78

**Noninterest Income**

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Noninterest income for the nine months ended September 30, 2005 and 2004 was \$5.1 million and \$4.9 million, respectively. For the nine month period ended September 30, 2005, service charges increased \$71,000, or 3.3%. At the end of the first quarter of 2005, the Company implemented strategies designed to increase noninterest income, but the strategies, thus far, have produced only modest results. Insurance commissions declined \$0.2 million, or 12.6% to \$1.7 million for the nine months ended September 30, 2005 from \$1.9 million during the same period last year. The Company recognized a \$39,000 net securities loss for the nine month period ended September 30, 2005, as compared to a \$194,000 net securities gain for the same period in 2004. Other operating income increased 179.8%, or \$0.7 million, due to a \$0.6 million positive litigation settlement the Company received during the first quarter of 2005.

Noninterest income was \$1.5 million and \$1.6 million for the three month periods ended September 30, 2005 and September 30, 2004, respectively. Service charges on deposit accounts for the three month period ended September 30, 2005 were \$776,000, an increase of \$26,000, or 3.5%, over the same period in 2004. Insurance commissions were also down \$0.2 million for the three month period ended September 30, 2005 from \$668,000 in 2004 to \$468,000 this year. Insurance commissions during both the three month and nine month periods in 2005 declined in most part as a result of a reclassification of amounts paid to outside producers from a noninterest expense to a contra item in insurance commissions income.

## NONINTEREST INCOME

(Dollars in thousands)

	Three months ended September 30,			Nine months ended September 30,		
	2005	2004	Percent Change	2005	2004	Percent Change
Service charges on deposits	\$ 776	\$ 750	3.5	\$ 2,223	2,152	3.3%
Insurance commissions	468	668	(29.9)	1,704	1,949	(12.6)
Bank club dues	68	86	(20.9)	219	269	(18.6)
Debt cancellation fees	(5)	(14)	64.3	(17)	(45)	62.2
Securities gains (losses), net		(44)	100.0	(39)	194	(120.0)
Other	176	118	49.2	1,038	371	179.8
<b>Total</b>	<b>\$ 1,483</b>	<b>\$ 1,564</b>		<b>\$ 5,128</b>	<b>\$ 4,890</b>	

## Noninterest Expenses

Noninterest expenses for the nine months ended September 30, 2005 were \$18.2 million, resulting in a \$0.3 million, or 1.7% increase from \$17.9 million for the same period in 2004. Salaries and employee benefits decreased \$0.1 million, or 0.7%, to \$9.2 million for the nine months ended September 30, 2005 from \$9.3 million for the same period last year. Although the Company has added employees due to its expansion activities, it has managed to offset the cost by reducing employees in other areas of the Company. Furniture and equipment expense increased \$127,000, or 11.4%, to \$1.2 million for the nine month period ended September 30, 2005 from \$1.1 million for the nine months ended September 30, 2004. This results from additional depreciation expense on the Company's investment in equipment which was purchased to improve and update its technology. The Company's expense on the disposal or impairment of assets decreased \$113,000, or 59.5% from the same period in 2004. Insurance expense decreased \$137,000, or 15.1%, to \$772,000 for the nine months ended September 30, 2005 from \$909,000 for the nine months ended September 30, 2004. The Company's insurance costs have declined as a result of improved regulatory status. Expense related to litigation, fraud or burglary increased \$226,000, or 941.7%, to \$250,000, from \$24,000 for the same period in 2004. This increase is due primarily to the settlement of certain litigation. The Company's legal expenses decreased \$199,000, or 24.8%, to \$602,000 during the nine month period ended September 30, 2005 compared to the same period in 2004. Other professional services expense increased \$134,000, or 29.9%, to \$582,000 for the nine month period ended September 30, 2005 from \$448,000 for the nine months ended September 30, 2004. During 2005, the Company outsourced its internal audit program which increased professional fees, but overall the Company saved through decreases in salaries and employee benefits. The Company also paid a consulting firm during 2005 to aide in its efforts to increase noninterest income. Other expense increased due to some expense recoveries that occurred in 2004 causing the 2004 expense to be lower than it otherwise would have been.

Noninterest expenses for the three months ended September 30, 2005 were \$6.1 million, representing a \$0.2 million, or 3.9% increase from noninterest expenses of \$5.9 million for the same period in 2004. Occupancy costs decreased \$36,000, or 5.7%, during the three months ended September 30, 2005, compared to the three months ended September 30, 2004, while furniture and equipment expense increased \$68,000, or 17.6%, to \$455,000, from \$387,000. Director and committee fees increased \$14,000, or 17.5%, to \$94,000, for the three months ended September 30, 2005, from \$80,000 for the same period in 2004. Expense related to the disposal or impairment of assets decreased \$52,000, or 59.1%, to \$36,000 during the three month period ended September 30, 2005, compared to \$88,000 for the same period in 2004. Advertising expense increased \$13,000, or 40.6%, during the three month period ended September 30, 2005, from \$32,000 for the three month period ended September 30, 2004. Professional fees increased \$33,000, or 10.9%, from \$311,000 for the three month period ended September 30, 2004 to \$345,000 for the three month period ended September 30, 2005. Legal fees decreased \$143,000, or 77.7%, to \$41,000 for the three month period ended September 30, 2005 from \$184,000 for the same three month period ended September 30 in 2004, due to less litigation surrounding the Company.



## NONINTEREST EXPENSES

(Dollars in thousands)

	Three months ended September 30,			Nine months ended September 30,		
	2005	2004	Percent Change	2005	2004	Percent Change
Salaries and employee benefits	\$ 3,026	\$ 3,143	(3.7)%	\$ 9,192	\$ 9,261	(0.75)%
Occupancy	601	637	(5.7)	1,734	1,757	(1.3)
Furniture and equipment	455	387	17.6	1,241	1,114	11.4
Director and committee fees	94	80	17.5	288	269	7.1
Disposal or impairment of assets	36	88	(59.1)	77	190	(59.5)
Litigation, fraud, burglary	8	2	400.0	250	24	941.7
Amortization of intangibles-other	24	24		70	70	
Advertising	45	32	40.6	79	74	6.8
Insurance	132	311	(57.6)	772	909	(15.1)
Legal fees	41	184	(77.7)	602	801	(24.8)
Other professional services	345	311	10.9	582	448	29.9
Supplies	169	122	38.5	424	355	19.4
Postage	55	51	7.8	219	234	(6.4)
Telephone and data communications	225	241	(6.6)	650	675	(3.7)
Training and education	10	35	(71.4)	45	80	(43.8)
Foreclosed assets, net	294	56	425.0	366	483	(24.2)
Holding cost on foreclosed assets	60	37	62.2	228	240	(5.0)
Other	505	156	223.7	1,378	917	50.27
<b>Total</b>	<b>\$ 6,125</b>	<b>\$ 5,897</b>	<b>3.9</b>	<b>\$ 18,197</b>	<b>\$ 17,901</b>	<b>1.7</b>

## 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.

Inflation, particularly in energy costs has increased in recent months. The Federal Reserve has increased rates eleven times since July 2004 and is expected to continue to raise rates to curb inflation.





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

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

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

The estimated impact on the Company's net interest income sensitivity over a one year time horizon at September 30, 2005 is shown below. Such analysis assumes an immediate and nonparallel shift in interest rates and the Company's estimates of how interest-bearing transaction accounts will reprice. Although we believe the table is helpful, it is based on assumptions made that will not only be affected by interest rates, but also by the composition of our balance sheet, our balance sheet growth and many other factors that may or may not be beyond our control. The prime rate shown is as of September 30, 2005.

**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	5.75%	6.75%	7.75%
Interest income	\$ 36,711	\$ 35,335	\$ 33,789
Interest expense	<u>17,882</u>	<u>16,473</u>	<u>15,063</u>
Net interest income	<u>\$ 18,829</u>	<u>\$ 18,862</u>	<u>\$ 18,726</u>
Dollar change from level	\$ (33)		\$ (136)
Percentage change from level	(0.18)%		(0.72)%

As shown above, in a 100 basis point rising rate environment, the net interest margin is projected to decrease 0.72% and in a 100 basis point falling rate environment, the net interest margin is projected to decrease 0.18%. These percent changes from a level rate scenario fall comfortably within the Company's ALCO policy limit of +/-10.00%.

As a result of the Company's analysis of its interest rate sensitivity, particularly in a rising rate environment, during the restructuring of its \$38.0 million FHLBA borrowing to a 3-month LIBOR floating until August 10, 2007, the Company entered into an interest rate swap which will begin on November 10, 2007. The Company will pay a fixed rate of 4.22% and will receive 3-month LIBOR. The analysis above does not take the swap into effect. The swap is expected to cause the Company's change in net interest income to return to a positive position in a 100 basis point rise scenario.

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 nine months ended September 30, 2005, there has not been any change in the Company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II**

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

#### **Background**

At a June 20, 2000 meeting of the board of directors of Community Bank, one of Community Bank's directors brought to the attention of the board of directors the total amount of money that Community Bank had paid to subcontractors in connection with the construction of a new Community Bank branch office in Guntersville, Alabama. Questions were subsequently raised about a number of Community Bank construction projects. A joint committee of the boards of directors of Community Bancshares and Community Bank conducted an investigation as did law enforcement and bank regulatory authorities. Following these investigations, the boards of directors terminated the employment of Kennon R. Patterson, Sr., former Chairman, President and Chief Executive Officer of Community Bancshares and Chairman and Chief Executive Officer of Community Bank, and Larry Bishop, former Vice President of Community Bank and the FDIC commenced administrative proceedings against Mr. Patterson and Mr. Bishop, which are still pending. On March 10, 2005, Mr. Patterson and Mr. Bishop were convicted in the United States District Court for the Northern District of Alabama of conspiracy, bank fraud and causing false entries to be made in bank records. Mr. Patterson was also convicted of filing false income tax returns. Sentencing of these individuals has been scheduled for November 30, 2005.

#### **Patterson Employment Litigation**

Plaintiffs: Community Bancshares, Inc. and Community Bank

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

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

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

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

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

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

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

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

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

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

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

On January 25, 2005, Mr. Patterson filed a third-party complaint in this lawsuit against R.B. Jackson, Jimmie Trotter, Glynn Debter, John J. Lewis, Jr., Patrick M. Frawley and Powell, Goldstein, Frazer & Murphy, LLP. The third-party complaint alleges that Messrs. Jackson, Trotter, Debter and Lewis, as members of Community Bank's Audit Committee, Powell Goldstein, LLP, as the independent counsel for Community Bank's Audit Committee, and Mr. Frawley, acting individually and in concert with one another, interfered with Mr. Patterson's employment agreement with Community Bancshares. On April 19, 2005 Powell Goldstein, LLP was dismissed from the lawsuit.

### **Patterson ESOP Litigation**

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

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

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

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

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

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

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

Plaintiff: Kennon R. Patterson, Sr.

Defendant: Community Bancshares, Inc. Benefit Restoration Plan

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

### **Employee Litigation**

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

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

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

seek an unspecified amount of compensatory and punitive damages.

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

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

### **Other Litigation**

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

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

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

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

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

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

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

None.

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

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

### **Item 6. Exhibits**



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- 2.1 Purchase and Assumption Agreement by and between Community Bank, American Family Mortgage, LLC, and Ameridocs, LLC (1).
- 3.1 Certificate of Incorporation, as amended and restated May 2000 (2).
- 3.2 Bylaws, as amended and restated October 23, 2003 (3).
- 4.1 Indenture, dated March 23, 2000, by and between Community Bancshares, Inc. and The Bank of New York (4).
- 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 (5).
- 4.3 Warrant Agreement, dated February 20, 2004, by and between Community Bancshares, Inc. and FIG Partners, L.L.C. (6).
- 10.1 Plan document for the Community Bancshares, Inc. Benefit Restoration Plan adopted April 12, 1994, effective January 1, 1995 (7) (\*).
- 10.2 Subordinated Promissory Note, dated October 4, 1994, between Community Bancshares, Inc. as borrower and Jeffrey K. Cornelius as holder (8).
- 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 (9).
- 10.4 Guarantee Agreement, dated March 23, 2000, by and between Community Bancshares, Inc. and The Bank of New York (10).

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- 10.5 Lease Agreement, dated May 31, 2000, between REM, LLC, as lessor, and Community Bank, as lessee (11).
  - 10.6 Addendum to Lease Agreement and Loan Agreement, dated May 31, 2000, between REM, LLC and Community Bank (12).
  - 10.7 Form of Amendment to Nonqualified Stock Option Agreement, between Community Bancshares, Inc. and grantee, dated December 12, 2000 (13) (\*).
  - 10.8 Change in Control Agreement, dated September 18, 2001, between Community Bancshares, Inc. and Kerri C. Kinney (14) (\*).
  - 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 (15) (\*).
  - 10.10 Stock Purchase Agreement dated January, 2002 between Community Bancshares, Inc. and Denny G. Kelly and Arlene S. Kelly (16) (\*).
  - 10.11 Stock Purchase Agreement dated January, 2002 between Community Bancshares, Inc. and Bishop K. Walker and Wanda W. Walker (17) (\*).
  - 10.12 Severance Agreement dated the 9th day of January, 2002 by and between Denny G. Kelly and Community Bancshares, Inc. and Community Bank (18) (\*).
  - 10.13 Severance Agreement dated the 9th day of January, 2002 by and between Bishop K. Walker and Community Bancshares, Inc. and Community Bank (19) (\*).
  - 10.14 Amendment to Subordinated Promissory Note, dated March 26, 2002, between Community Bancshares, Inc. and Jeffrey K. Cornelius (20).
  - 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 (21) (\*).
  - 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 (22) (\*).
  - 10.17 Stock Option Agreement between Community Bancshares, Inc. and Patrick M. Frawley dated August 1, 2003 (23) (\*).
  - 10.18 Stock Option Agreement between Community Bancshares, Inc. and Stacey W. Mann dated August 1, 2003 (24) (\*).
  - 10.19 Stock Option Agreement between Community Bancshares, Inc. and Kerri C. Kinney dated August 1, 2003 (25) (\*).
  - 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 (26) (\*).
  - 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 (27) (\*).
  - 10.22 Employment Agreement, dated March 28, 1996 by and between Kennon R. Patterson, Sr. and Community Bancshares, Inc. (28) (\*).
  - 10.23 Amendment to Employment Agreement, dated October 14, 1999, by and between Kennon R. Patterson, Sr. and Community Bancshares, Inc. (29) (\*).
  - 10.24 Amendment Number 1 to the Community Bancshares, Inc. Benefit Restoration Plan (30) (\*).
  - 10.25 Amendment Number 2 to the Community Bancshares, Inc. Benefit Restoration Plan (31) (\*).
  - 10.26 Change in Control Agreement between Community Bancshares, Inc. and Stacey W. Mann (32) (\*).
  - 10.27 Change in Control Agreement between Community Bank and Patrick M. Frawley (33) (\*).
  - 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 (34) (\*).
  - 10.29 Stock Option Agreement between Community Bancshares, Inc. and Patrick M. Frawley dated January 27, 2004 (35) (\*).
  - 10.30 Stock Option Agreement between Community Bancshares, Inc. and Stacey W. Mann dated January 27, 2004 (36) (\*).



- 10.31 Stock Option Agreement between Community Bancshares, Inc. and Kerri C. Kinney dated January 27, 2004 (37) (\*).
- 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 (38) (\*).
- 10.33 Form of Stock Option Agreement between Community Bancshares, Inc. and each of Merritt M. Robbins and Loy McGruder dated March 11, 2004 (39) (\*).
- 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. (40) (\*).
- 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 (41) (\*).
- 10.36 Promissory Note, Loan Agreement and Security Agreement by and between Community Bancshares, Inc. and First Commercial Bank dated May 6, 2004 (42).
- 10.37 Summary Description of Director Compensation (43) (\*).
- 10.38 Summary Description of Named Executive Officer Compensation (44) (\*).
- 10.39 Amendment Number 3 to the Community Bancshares, Inc. Benefit Restoration Plan (45) (\*).
- 10.40 Employment Agreement, dated March 29, 2005, between Community Bank and Patrick Frawley (46) (\*).
- 10.41 Form of Nonqualified Stock Option Agreement for Directors dated January 12, 2005 (47) (\*).
- 10.42 Form of Nonqualified Stock Option Agreement for Senior Officers dated January 12, 2005 (48) (\*).
- 10.43 Form of Nonqualified Stock Option Agreement for Officers dated January 12, 2005 (49) (\*).
- 10.44 Form of stock option agreement between Community Bancshares, Inc. and each of Glynn Debter, Roy B. Jackson, John J. Lewis, Jimmie Trotter, Kenneth K. Campbell, Terry G. Sanderson and Michael A. Tarpley (50) (\*).
- 10.45 Stock option agreement between Community Bancshares, Inc. and Patrick M. Frawley dated January 12, 2005 (51) (\*).
- 10.46 Stock option agreement between Community Bancshares, Inc. and Stacey W. Mann dated January 12, 2005 (52) (\*).
- 10.47 Stock option agreement between Community Bancshares, Inc. and Kerri C. Kinney dated January 12, 2005 (53) (\*).
- 10.48 Community Bancshares, Inc. 2005 Incentive Plan (54) (\*).
- 10.49 Form of Change in Control Agreement, dated November 10, 2005, between Community Bancshares, Inc. and John W. Brothers (\*).
- 10.50 Real Property Sales Contract, dated October 12, 2005, between Community Bancshares, Inc. and Salvatore Cangiano.
- 10.51 Real Property Sales Contract, dated November 10, 2005 between Community Bancshares, Inc. and William Carrington and Anne Davenport-Carrington.
- 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.

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

- (1) Filed as Exhibit 2.1 to Form 8-K on April 29, 2005, and incorporated herein by reference.
- (2) Filed as Exhibit 3.2 to Form 10-Q for the quarter ended June 30, 2000, and incorporated herein by reference.
- (3) Filed as Exhibit 3.1 to Form 10-Q for the quarter ended June 30, 2000, and incorporated herein by reference.
- (4) Filed as Exhibit 4.4 to Form 10-Q for the quarter ended March 31, 2000, and incorporated herein by reference.
- (5) Filed as Exhibit 4.2 to Form 10-Q for the quarter ended March 31, 2004, and incorporated herein by reference.
- (6) Filed as Exhibit 4.3 to Form 10-Q for the quarter ended March 31, 2004, and incorporated herein by reference.

- (7) Filed as Exhibit 10.13 to Form 10-K for the year ended December 31, 1995, and incorporated herein by reference.
- (8) Filed as Exhibit 10.15 to Form 10-K for the year ended December 31, 1995, and incorporated herein by reference.
- (9) Filed as Exhibit 10.1 to Form 10-Q for the quarter ended March 31, 2000, and incorporated herein by reference.
- (10) Filed as Exhibit 10.2 to Form 10-Q for the quarter ended March 31, 2000, and incorporated herein by reference.
- (11) Filed as Exhibit 10.1 to Form 10-Q for the quarter ended June 30, 2000, and incorporated herein by reference.
- (12) Filed as Exhibit 10.2 to Form 10-Q for the quarter ended June 30, 2000, and incorporated herein by reference.
- (13) Filed as Exhibit 10.45 to Form 10-K for the year ended December 31, 2000, and incorporated herein by reference.
- (14) Filed as Exhibit 10.1 to Form 10-Q for the quarter ended September 30, 2001, and incorporated herein by reference.
- (15) Filed as Exhibit 10.22 to Form 10-K for the year ended December 31, 2001, and incorporated herein by reference.
- (16) Filed as Exhibit 10.23 to Form 10-K for the year ended December 31, 2001, and incorporated herein by reference.
- (17) Filed as Exhibit 10.24 to Form 10-K for the year ended December 31, 2001, and incorporated herein by reference.
- (18) Filed as Exhibit 10.25 to Form 10-K for the year ended December 31, 2001, and incorporated herein by reference.
- (19) Filed as Exhibit 10.26 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, 2001, and incorporated herein by reference.
- (21) Filed as Exhibit 10.31 to Form 10-K for the year ended December 31, 2002, and incorporated herein by reference.
- (22) Filed as Exhibit 10.32 to Form 10-K for the year ended December 31, 2002, and incorporated herein by reference.
- (23) Filed as Exhibit 10.1 to Form 10-Q for the quarter ended September 30, 2003, and incorporated herein by reference.
- (24) Filed as Exhibit 10.2 to Form 10-Q for the quarter ended September 30, 2003, and incorporated herein by reference.
- (25) Filed as Exhibit 10.3 to Form 10-Q for the quarter ended September 30, 2003, and incorporated herein by reference.
- (26) Filed as Exhibit 10.4 to Form 10-Q for the quarter ended September 30, 2003, and incorporated herein by reference.
- (27) Filed as Exhibit 10.32 to Form 10-K for the year ended December 31, 1999, and incorporated herein by reference.
- (28) Filed as Exhibit 10.1 to Form 10-Q/A-2 for the quarter ended September 30, 1998, and incorporated herein by reference.
- (29) Filed as Exhibit 10.2 to Form 10-Q for the quarter ended September 30, 1999, and incorporated herein by reference.
- (30) Filed as Exhibit 10.26 to Form 10-K for the year ended December 31, 2003, and incorporated herein by reference.
- (31) Filed as Exhibit 10.27 to Form 10-K for the year ended December 31, 2003, and incorporated herein by reference.
- (32) Filed as Exhibit 10.28 to Form 10-K for the year ended December 31, 2003, and incorporated herein by reference.
- (33) Filed as Exhibit 10.29 to Form 10-K for the year ended December 31, 2003, and incorporated herein by reference.
- (34) Filed as Exhibit 10.30 to Form 10-Q for the quarter ended March 31, 2004, and incorporated herein by reference.
- (35) Filed as Exhibit 10.31 to Form 10-Q for the quarter ended March 31, 2004, and incorporated herein by reference.
- (36) Filed as Exhibit 10.32 to Form 10-Q for the quarter ended March 31, 2004, and incorporated herein by reference.
- (37) Filed as Exhibit 10.33 to Form 10-Q for the quarter ended March 31, 2004, and incorporated herein by reference.
- (38) Filed as Exhibit 10.34 to Form 10-Q for the quarter ended March 31, 2004, and incorporated herein by reference.
- (39) Filed as Exhibit 10.35 to Form 10-Q for the quarter ended March 31, 2004, and incorporated herein by reference.
- (40) Filed as Exhibit 10.36 to Form 10-Q for the quarter ended March 31, 2004, and incorporated herein by reference.

- (41) Filed as Exhibit 10.35 to Form 10-Q for the quarter ended June 30, 2004, and incorporated herein by reference.
- (42) Filed as Exhibit 10.36 to Form 10-Q for the quarter ended June 30, 2004, and incorporated herein by reference.
- (43) Filed as Exhibit 10.37 to Form 10-K for the year ended December 31, 2004, and incorporated herein by reference.
- (44) Filed as Exhibit 10.38 to Form 10-K for the year ended December 31, 2004, and incorporated herein by reference.
- (45) Filed as Exhibit 10.39 to Form 10-K for the year ended December 31, 2004, and incorporated herein by reference.
- (46) Filed as Exhibit 10.40 to Form 10-K for the year ended December 31, 2004, and incorporated herein by reference.
- (47) Filed as Exhibit 10.1 to Form 8-K on January 18, 2005, and incorporated herein by reference.
- (48) Filed as Exhibit 10.2 to Form 8-K on January 18, 2005, and incorporated herein by reference.
- (49) Filed as Exhibit 10.3 to Form 8-K on January 18, 2005, and incorporated herein by reference.
- (50) Filed as Exhibit 10.44 to Form 10-Q on May 9, 2005, and incorporated herein by reference.
- (51) Filed as Exhibit 10.45 to Form 10-Q on May 9, 2005, and incorporated herein by reference.
- (52) Filed as Exhibit 10.46 to Form 10-Q on May 9, 2005, and incorporated herein by reference.
- (53) Filed as Exhibit 10.47 to Form 10-Q on May 9, 2005, and incorporated herein by reference.
- (54) Filed as Exhibit A and included in Form DEF 14A on June 1, 2005, and incorporated herein by reference.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on November 10, 2005.

COMMUNITY BANCSHARES, INC.

November 10, 2005

By: /s/ PATRICK M. FRAWLEY

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Patrick M. Frawley  
*Chairman and Chief Executive Officer*

November 10, 2005

By: /s/ KERRI C. KINNEY

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Kerri C. Kinney  
*Chief Financial Officer*