

COMMUNITY BANCSHARES INC /DE/  
Form 10-Q  
August 14, 2003

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SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF  
THE SECURITIES EXCHANGE ACT OF 1934  
FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2003  
OR

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

COMMISSION FILE NO. 000-16461

COMMUNITY BANCSHARES, INC.  
(Exact name of registrant as specified in its charter)

DELAWARE  
(State or other jurisdiction of  
incorporation or organization)

63-0868361  
(I.R.S. Employer Identification No.)

68149 MAIN STREET  
BLOUNTSVILLE, ALABAMA 35031  
(Address of principal executive offices)

(205) 429-1000  
(Registrant's telephone number)

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 EXCHANGE ACT RULE 12B-2):

YES  NO

AS OF JULY 31, 2003, THERE WERE 4,667,196 SHARES OF THE REGISTRANT'S  
COMMON STOCK, \$.10 PAR VALUE, OUTSTANDING.

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FORM 10-Q  
COMMUNITY BANCSHARES, INC.

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JUNE 30, 2003

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PART 1  
ITEM 1 - FINANCIAL STATEMENTS

COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CONDITION  
(UNAUDITED)

JUNE 30, 2003  
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ASSETS

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|   |                |
|---|----------------|
| Cash and due from banks .....   | \$ 34,592,699  |
| Interest-bearing deposits in banks and federal funds sold .....   | 25,475,000     |
| Securities available for sale .....   | 123,755,469    |
| Loans (net of unearned income) .....  | 326,405,014    |
| Allowance for possible loan losses .....  | (11,232,217)   |
| Net loans .....   | 315,172,797    |
| Capitalized lease receivable .....  | 3,006,969      |
| Premises and equipment, net .....   | 24,642,901     |
| Accrued interest receivable .....   | 3,347,539      |
| Goodwill and other intangible assets, net .....   | 2,673,681      |
| Other real estate owned .....   | 11,803,355     |
| Other assets .....  | 9,398,199      |
| TOTAL ASSETS .....  | \$ 553,868,609 |
| =====   |                |
| LIABILITIES AND SHAREHOLDERS' EQUITY  |                |
| Deposits:   |                |
| Noninterest-bearing .....   | \$ 59,343,955  |
| Interest-bearing .....  | 392,583,264    |
| Total deposits .....  | 451,927,219    |
| Other short-term borrowings .....   | --             |
| Accrued interest payable .....  | 3,898,351      |
| FHLB long-term debt .....   | 38,000,000     |
| Capitalized lease obligations .....   | 4,017,864      |
| Other long-term debt .....  | 3,376,528      |
| Trust preferred securities .....  | 10,000,000     |
| Other liabilities .....   | 5,778,265      |
| Total liabilities .....   | 516,998,227    |
| Shareholders' equity  |                |
| Preferred stock (par value \$.01 per share, 200,000 shares<br>authorized, no shares issued) .....   | --             |
| Common stock (par value \$.10 per share, 20,000,000<br>shares authorized, 4,827,119 and 4,810,089 shares issued as of<br>June 30, 2003 and December 31, 2002, respectively) ..... | 482,712        |
| Additional paid in capital .....  | 30,885,819     |
| Retained earnings .....   | 7,933,646      |
| Treasury stock (23,803 shares as of June 30, 2003 and<br>December 31, 2002) .....   | (441,768)      |
| Unearned ESOP shares (136,120 and 148,972 shares as of<br>June 30, 2003 and December 31, 2002, respectively) .....  | (1,871,338)    |
| Accumulated other comprehensive income (loss), net of taxes .....   | (118,689)      |
| Total shareholders' equity .....  | 36,870,382     |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY .....  | \$ 553,868,609 |
| =====   |                |

See accompanying notes to consolidated financial statements

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|   | FOR THE THREE MONTHS ENDED |    |
|---|----------------------------|----|
|   | 2003                       |    |
|   | -----                      |    |
| INTEREST INCOME   |                            |    |
| Interest and fees on loans .....                          | \$ 7,019,307               | \$ |
| Interest on investment securities:                        |                            |    |
| Taxable securities .....                                  | 1,241,836                  |    |
| Non taxable securities .....                              | 85,930                     |    |
| Interest on federal funds sold .....                      | 75,024                     |    |
| Other interest .....                                      | 7,144                      |    |
|   | -----                      |    |
| Total interest income .....                               | 8,429,241                  |    |
|   | -----                      |    |
| INTEREST EXPENSE  |                            |    |
| Interest on deposits .....                                | 2,661,340                  |    |
| Interest on short-term borrowings .....                   | 563                        |    |
| FHLB long-term debt .....                                 | 569,609                    |    |
| Interest on capitalized lease obligations .....           | 42,709                     |    |
| Interest on trust preferred securities .....              | 333,802                    |    |
| Interest on other long-term debt .....                    | 47,499                     |    |
|   | -----                      |    |
| Total interest expense .....                              | 3,655,522                  |    |
|   | -----                      |    |
| Net interest income .....                                 | 4,773,719                  |    |
| Provision for loan losses .....                           | 2,321,041                  |    |
|   | -----                      |    |
| Net interest income after provision for loan losses ..... | 2,452,678                  |    |
| NONINTEREST INCOME  |                            |    |
| Service charges on deposits .....                         | 710,264                    |    |
| Insurance commissions .....                               | 572,793                    |    |
| Bank club dues .....                                      | 104,804                    |    |
| Debt cancellation fees .....                              | 18,452                     |    |
| Other operating income .....                              | 305,943                    |    |
| Securities gains, net .....                               | 80,955                     |    |
|   | -----                      |    |
| Total noninterest income .....                            | 1,793,211                  |    |
|   | -----                      |    |
| NONINTEREST EXPENSE                                       |                            |    |
| Salaries and employee benefits .....                      | 3,310,160                  |    |
| Occupancy expense .....                                   | 582,715                    |    |
| Furniture and equipment expense .....                     | 387,607                    |    |
| Insurance expense .....                                   | 287,808                    |    |
| Director and committee fees .....                         | 97,417                     |    |
| Professional services .....                               | 1,233,278                  |    |
| Net loss on sale or write-down of other                   |                            |    |
| real estate owned .....                                   | 280,176                    |    |
| Net loss on disposal or write-down of assets .....        | 36,882                     |    |
| Other operating expenses .....                            | 1,026,474                  |    |
|   | -----                      |    |
| Total noninterest expense .....                           | 7,242,517                  |    |
|   | -----                      |    |
| INCOME (LOSS) FROM CONTINUING OPERATIONS                  |                            |    |
| BEFORE INCOME TAXES .....                                 | (2,996,628)                |    |
| Applicable income taxes .....                             | 455,422                    |    |
|   | -----                      |    |
| INCOME (LOSS) FROM CONTINUING OPERATIONS .....            | (2,541,206)                |    |
|   | -----                      |    |

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See accompanying notes to consolidated financial statements

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COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME - CONTINUED  
(UNAUDITED)

|  | FOR THE      |
|--|--------------|
|  | PERIOD ENDED |
|  | 2009         |
|  | 2008         |
| DISCONTINUED OPERATIONS:   |              |
| Income from operations of divested branches<br>(includes gain on disposal of \$6,520,542) .....                                | 17           |
| Applicable income taxes .....  | (4)          |
| NET INCOME (LOSS) .....  | \$ (2,54)    |
| OTHER COMPREHENSIVE INCOME:  |              |
| Unrealized holding gains (losses) arising during period,<br>net of income taxes of \$116,016 and \$940,453, respectively ..... | \$ 17        |
| Reclassification adjustment related to net realized gains, net of<br>income taxes of \$32,382 and \$42,918, respectively ..... | (4)          |
| OTHER COMPREHENSIVE INCOME .....   | 12           |
| COMPREHENSIVE INCOME (LOSS) .....  | \$ (2,41)    |
| Earnings (loss) per common share - income (loss) from continuing operations:   |              |
| Basic .....  | \$           |
| Diluted .....  | \$           |
| Earnings (loss) per common share - net income (loss):  |              |
| Basic .....  | \$           |
| Diluted .....  | \$           |
| Weighted average number of shares outstanding:   |              |
| Basic .....  | 4,65         |
| Diluted .....  | 4,65         |
| Dividends per share .....  | \$           |

See accompanying notes to consolidated financial statements

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COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES

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CONSOLIDATED STATEMENTS OF INCOME  
(UNAUDITED)

|  | FOR THE SIX MONTHS ENDED |    |
|--|--------------------------|----|
|  | 2003                     |    |
|  | -----                    |    |
| INTEREST INCOME  |                          |    |
| Interest and fees on loans .....                                   | \$ 14,380,212            | \$ |
| Interest on investment securities:                                 |                          |    |
| Taxable securities .....   | 2,616,483                |    |
| Non taxable securities .....                                       | 175,255                  |    |
| Interest on federal funds sold .....                               | 157,282                  |    |
| Other interest .....   | 14,254                   |    |
|  | -----                    |    |
| Total interest income .....  | 17,343,486               |    |
|  | -----                    |    |
| INTEREST EXPENSE   |                          |    |
| Interest on deposits .....   | 5,546,548                |    |
| Interest on short-term borrowings .....                            | 1,713                    |    |
| FHLB long-term debt .....  | 1,132,959                |    |
| Interest on capitalized lease obligations .....                    | 85,161                   |    |
| Interest on trust preferred securities .....                       | 647,966                  |    |
| Interest on other long-term debt .....                             | 77,970                   |    |
|  | -----                    |    |
| Total interest expense .....                                       | 7,492,317                |    |
|  | -----                    |    |
| Net interest income .....  | 9,851,169                |    |
| Provision for loan losses .....                                    | 3,610,480                |    |
|  | -----                    |    |
| Net interest income after provision for loan losses .....          | 6,240,689                |    |
| NONINTEREST INCOME   |                          |    |
| Service charges on deposits .....                                  | 1,320,822                |    |
| Insurance commissions .....  | 1,136,586                |    |
| Bank club dues .....   | 211,363                  |    |
| Debt cancellation fees .....                                       | 48,567                   |    |
| Other operating income .....                                       | 531,480                  |    |
| Securities gains, net .....  | 728,596                  |    |
|  | -----                    |    |
| Total noninterest income .....                                     | 3,977,414                |    |
|  | -----                    |    |
| NONINTEREST EXPENSE  |                          |    |
| Salaries and employee benefits .....                               | 6,638,957                |    |
| Occupancy expense .....  | 1,171,720                |    |
| Furniture and equipment expense .....                              | 754,998                  |    |
| Insurance expense .....  | 581,199                  |    |
| Director and committee fees .....                                  | 219,617                  |    |
| Professional services .....  | 2,268,429                |    |
| Net loss on sale or write-down of other<br>real estate owned ..... | 532,904                  |    |
| Net loss on disposal of assets .....                               | 36,882                   |    |
| Other operating expenses .....                                     | 2,046,614                |    |
|  | -----                    |    |
| Total noninterest expense .....                                    | 14,251,320               |    |
|  | -----                    |    |
| LOSS FROM CONTINUING OPERATIONS                                    |                          |    |
| BEFORE INCOME TAXES .....  | (4,033,217)              |    |

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|                                       |             |
|---------------------------------------|-------------|
| Applicable income taxes .....         | 942,902     |
|                                       | -----       |
| LOSS FROM CONTINUING OPERATIONS ..... | (3,090,315) |
|                                       | -----       |

See accompanying notes to consolidated financial statements

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COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME - CONTINUED  
(UNAUDITED)

|  |                |
|--|----------------|
|  | FOR THE        |
|  | -----          |
|  | 200            |
|  | -----          |
| DISCONTINUED OPERATIONS:   |                |
| Income from operations of divested branches<br>(includes gain on disposal of \$8,071,985) .....                                  |                |
| Applicable income taxes .....  |                |
| NET INCOME (LOSS) .....  | \$ (3,090,315) |
|  | =====          |
| OTHER COMPREHENSIVE INCOME:  |                |
| Unrealized holding gains (losses) arising during period,<br>net of income taxes of \$81,521 and \$696,705, respectively .....    | \$ (12,000)    |
| Reclassification adjustment related to net realized gains, net of<br>income taxes of \$ 291,438 and \$49,576, respectively ..... | (43,000)       |
| OTHER COMPREHENSIVE INCOME (LOSS) .....  | (55,000)       |
| COMPREHENSIVE INCOME (LOSS) .....  | \$ (3,640,000) |
|  | =====          |
| Earnings (loss) per common share - income (loss) from continuing operations:   |                |
| Basic .....  | \$             |
| Diluted .....  | \$             |
| Earnings (loss) per common share - net income (loss):  |                |
| Basic .....  | \$             |
| Diluted .....  | \$             |
| Weighted average number of shares outstanding:   |                |
| Basic .....  | 4,640,000      |
| Diluted .....  | 4,640,000      |
| Dividends per share .....  | \$             |

See accompanying notes to consolidated financial statements

COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

|   | FOR THE SIX    |
|---|----------------|
|   | -----          |
|   | 2003           |
|   | -----          |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>   |                |
| Net income (loss) .....   | \$ (3,090,315) |
| Adjustments to reconcile net income (loss) to net cash<br>provided by operating activities: |                |
| Provision for loan losses .....   | 3,610,480      |
| Provision for depreciation and amortization .....   | 874,550        |
| Amortization of investment security premiums<br>and accretion of discounts .....            | 388,111        |
| Deferred tax expense .....  | 71,455         |
| Realized investment security gains .....  | (728,596)      |
| Gain on sale of branches .....  | --             |
| Loss on sale of premises and equipment .....  | 10,240         |
| Net loss or write-down on other real estate owned .....                                     | 532,904        |
| Decrease in accrued interest receivable .....   | 1,022,209      |
| Increase (decrease) in accrued interest payable .....                                       | 275,586        |
| Other .....   | 916,016        |
|   | -----          |
| Net cash provided by operating activities .....   | 3,882,640      |
|   | -----          |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>   |                |
| Proceeds from sales, calls and pay downs of securities<br>available for sale .....          | 74,912,228     |
| Proceeds from maturity of securities<br>available for sale .....                            | 18,200,000     |
| Purchase of securities available for sale .....   | (93,558,140)   |
| Cash disbursed in settlement of branch divestitures .....                                   | --             |
| Net decrease in loans to customers .....  | 25,136,450     |
| Proceeds from sale of premises and equipment .....  | 19,035         |
| Capital expenditures .....  | (211,528)      |
| Net proceeds from sale of other real estate .....   | 983,583        |
|   | -----          |
| Net cash provided by (used in) investing activities .....                                   | 25,481,628     |
|   | -----          |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>   |                |
| Net increase in demand deposits,<br>NOW accounts and savings accounts .....                 | 14,417,713     |
| Net decrease in certificates of deposit and other time deposits .....                       | (21,954,298)   |
| Net decrease increase in short-term borrowings .....  | (1,725,133)    |
| Net decrease in capitalized lease obligations .....   | (40,305)       |
| Repayment of long-term debt .....   | (201,159)      |
|   | -----          |
| Net cash provided by (used in) financing activities .....                                   | (9,503,182)    |
|   | -----          |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS .....                                  | 19,861,086     |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD .....  | 40,206,613     |
|   | -----          |



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CASH AND CASH EQUIVALENTS, END OF PERIOD ..... \$ 60,067,699  
 =====

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COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES  
 CONSOLIDATED STATEMENTS OF CASH FLOWS - CONTINUED  
 (UNAUDITED)

|   | FOR THE SIX MONTHS ENDED JUNE 30, |                        |
|---|-----------------------------------|------------------------|
|   | -----<br>2003<br>-----            | -----<br>2002<br>----- |
| SUPPLEMENTAL CASH FLOW DISCLOSURES:                         |                                   |                        |
| Cash paid for:  |                                   |                        |
| Interest .....  | \$ 7,216,731                      | \$12,012,698           |
| Income taxes .....  | --                                | 1,611,346              |
| SCHEDULE OF NON-CASH INVESTING AND<br>FINANCING ACTIVITIES: |                                   |                        |
| Foreclosure of other real estate owned .....                | 5,826,391                         | 2,148,108              |
| Loan charge-offs, net of recoveries .....                   | 2,162,533                         | 2,429,477              |

See accompanying notes to consolidated financial statements

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COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

NOTE 1 - GENERAL

The consolidated financial statements include the accounts of Community Bancshares, Inc. and its wholly-owned subsidiaries, collectively, hereinafter referred to as the "Company". The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three or six month periods ended June 30, 2003 are not necessarily indicative of the results that may be expected for the year ending December 31, 2003. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2002.

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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 shareholders' equity.

The Company has not changed its accounting and reporting policies from those stated in the annual report on Form 10-K for the year ended December 31, 2002. The unaudited interim financial statements included in this report should be read in conjunction with the audited financial statements and footnotes included in such annual report on Form 10-K. These policies, along with the disclosures presented in the other footnotes, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Those accounting policies involving significant estimates and assumptions by management, which have, or could have, a material impact on the carrying value of certain assets and impact comprehensive income, are considered critical accounting policies. The Company recognizes the following as critical accounting policies: Accounting for Allowance for Loan Losses and Accounting for Income Taxes.

Accounting for Allowance for Loan Losses. Management's ongoing evaluation of the adequacy and allocation of the allowance considers both impaired and unimpaired loans and takes into consideration the Company's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrowers' ability to repay, estimated value of any underlying collateral, the reviews of regulators, and an analysis of current economic conditions. While management believes that it has exercised prudent judgment and applied reasonable assumptions which have resulted in an allowance presented in accordance with generally accepted accounting principles, there can be no assurance that in the future, adverse economic conditions, increased nonperforming loans, regulatory concerns, or other factors will not require further increases in, or reallocation of the allowance.

Accounting for Income Taxes. The Company uses the asset and liability method of accounting for income taxes. Determination of the deferred and current provision requires analysis by management of certain transactions and the related tax laws and regulations. Management exercises significant judgment in evaluating the amount and timing of recognition of the resulting tax liabilities and assets. Those judgments and estimates are re-evaluated on a continual basis as regulatory and business factors change.

### NOTE 2 - STOCK BASED COMPENSATION

SFAS No. 123, "Accounting for Stock-Based Compensation," defines a fair value based method of accounting for an employee stock option or similar equity instrument. However, SFAS No. 123 allows an entity to continue to measure compensation costs for those plans using the intrinsic value based method of accounting prescribed by APB Opinion No. 25, Accounting for Stock issued to Employees. Entities electing to remain with the accounting in Opinion No. 25 must make pro forma disclosures of net income and earnings per share as if the fair value based method of accounting defined in SFAS No. 123 had been applied. Under the fair value based method, compensation cost is measured at the grant

date based on the value of the award and is recognized over the service period, which is usually the vesting period. Under the intrinsic value based method, compensation cost is the excess, if any, of the quoted market price of the stock at the grant date or other measurement date over the amount an employee must pay to acquire the stock. The Company has elected to continue to measure compensation cost for its stock option plans under the provisions in APB Opinion 25 and has calculated the fair value of outstanding options for

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purposes of pro forma disclosure utilizing the Black-Scholes method.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

The Company's options granted during the first six months of 2003 vest immediately; therefore, for purposes of pro forma disclosure, the compensation expense related to these options was recognized when granted. No options were granted during the first six months of 2002.

The Company's pro forma information follows:

|   | FOR THE THREE<br>MONTHS ENDED JUNE 30, |              |
|---|--|--------------|
|   | 2003                                   | 2002         |
| Net income (loss):  |  |              |
| As reported .....   | \$ (2,541,206)                         | \$ 2,827,022 |
| Deducts:  |  |              |
| Total stock-based employee compensation expense<br>determined under fair value based method for all<br>awards, net of tax ..... | (30,739)                               | --           |
| Pro forma net income (loss) .....   | \$ (2,571,945)                         | \$ 2,827,022 |
| Basic earnings (loss) per share:  |  |              |
| As reported .....   | \$ (0.55)                              | \$ 0.61      |
| Pro forma .....   | \$ (0.55)                              | \$ 0.61      |
| Diluted earnings (loss) per share:  |  |              |
| As reported .....   | \$ (0.55)                              | \$ 0.61      |
| Pro forma .....   | \$ (0.55)                              | \$ 0.61      |

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 for the options granted in 2003: dividend yield 0%; expected volatility of .283; risk-free interest rates of 3.10% for options issued in the first quarter of 2003 and 2.50% for options issued in the second quarter of 2003; and expected lives of 5 years.

### NOTE 3 - CONTINGENCIES

#### BACKGROUND

At a meeting of Community Bank's Board of Directors on June 20, 2000, a director brought to the attention of the Board the total amount of money Community Bank had paid subcontractors in connection with the construction of a

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new Community Bank office in Guntersville, Alabama. Management of the Company commenced an investigation of the

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expenditures. At the request of management, the architects and subcontractors involved in the construction project made presentations to the Boards of Directors of the Company and Community Bank on July 15 and July 18, 2000, respectively. At the July 18, 2000 meeting of the Board of Directors of Community Bank, another director alleged that Community Bank had been overcharged by subcontractors on that construction project and another current construction project. On July 18, 2000, the Boards of Directors of the Company and Community Bank appointed a joint committee comprised of independent directors of the Company and of Community Bank to investigate the alleged overcharges. The joint committee retained independent legal counsel and an independent accounting firm to assist the committee in its investigation and has made its report to the Boards of Directors. The directors of Community Bank who alleged the construction overcharges have made similar charges to bank regulatory agencies and law enforcement authorities. These agencies and authorities are currently conducting investigations regarding this matter. As indicated in Footnote 22 in the Annual Report on Form 10-K, the Company recognized an aggregate asset impairment of \$1,972,000.

### BENSON LITIGATION

On July 21, 2000, three shareholders of the Company, M. Lewis Benson, Doris E. Benson and John M. Packard, Jr., filed a lawsuit in the state Circuit Court of Marshall County, Alabama against the Company, Community Bank, certain directors and officers of the Company and Community Bank, an employee of Community Bank and two construction subcontractors. The plaintiffs purported to file the lawsuit as a shareholder derivative action, which relates to the alleged construction overcharges being investigated by the joint committee of the Boards of Directors of the Company and Community Bank. The complaint alleges that the directors, officers and employee named as defendants in the complaint breached their fiduciary duties, failed to properly supervise officers and agents of the Company and Community Bank, and permitted waste of corporate assets by allegedly permitting the subcontractor defendants to overcharge Community Bank in connection with the construction of two new Community Bank offices, and to perform the construction work without written contracts, budgets, performance guarantees and assurances of indemnification. In addition, the complaint alleges that Kennon R. Patterson, Sr., the Chairman, President and Chief Executive Officer of the Company, breached his fiduciary duties by allegedly permitting the two named subcontractors to overcharge for work performed on the two construction projects in exchange for allegedly discounted charges for work these subcontractors performed in connection with the construction of Mr. Patterson's residence. The complaint further alleges that the director defendants knew or should have known of this alleged arrangement between Mr. Patterson and the subcontractors. The complaint also alleges that Mr. Patterson, the Community Bank employee and the two subcontractor defendants made false representations and suppressed information about the alleged overcharges and arrangement between Mr. Patterson and the subcontractors.

On August 15, 2000, the plaintiffs filed an amended complaint adding Andy C. Mann, a shareholder of the Company, as a plaintiff and adding a former director of the Company and Community Bank as a defendant. The amended complaint generally reiterates the allegations of the original complaint. In addition, the amended complaint alleges that Community Bank was overcharged on all construction projects from January 1997 to the present. The amended complaint also alleges that the defendants breached their fiduciary duties and are guilty of gross financial mismanagement, including allegations concerning the making or approval of certain loans and taking allegedly improper actions to conceal

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the fact that certain loans were uncollectible. On September 18, 2000 the plaintiffs filed a second amended complaint. The second amended complaint generally reiterates the allegations of the original and first amended complaints. In addition, the second amended complaint alleges that the plaintiffs were improperly denied their rights to inspect and copy certain records of the Company and Community Bank. The second amended complaint also alleges that the directors of the Company abdicated their roles as directors either by express agreement or as a result of wantonness and gross negligence. The second amended complaint asserts that the counts involving inspection of corporate records and director abdication are individual, non-derivative claims. The second amended complaint seeks, on behalf of the Company, an unspecified amount of compensatory damages in excess of \$1 million, punitive damages, disgorgement of allegedly improperly paid profits and appropriate equitable relief. Upon motion of the defendants, the case was transferred to the state Circuit Court in Blount County, Alabama by order dated September 21, 2000, as amended on October 12, 2000.

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On August 24, 2000, the Board of Directors of the Company designated the directors of the Company who serve on the joint investigative committee as a special litigation committee to investigate and evaluate the allegations and issues raised in this lawsuit and to arrive at such decisions and take such action as the special litigation committee deems appropriate. On June 8, 2001, the special litigation committee filed its report under seal with the court. On June 18, 2001, the court entered an order affirming the confidentiality of the special committee's report. On June 28, 2001, the Company, Community Bank and various other defendants filed a motion with the court to adopt the report of the special committee, for partial summary judgment and to realign the Company and Community Bank as plaintiffs in the lawsuit.

Following a hearing on August 29, 2001, the court denied these motions on November 8, 2001. The court also ruled that the plaintiffs were entitled to conduct discovery except as it related to one of the subcontractor defendants and granted the plaintiffs' motion to unseal the report of the special litigation committee. On November 14, 2001, the directors of the Company filed a motion for the court to alter, amend, or vacate its November 8, 2001 rulings. On February 7, 2002, the Company and Community Bank filed a motion to disqualify Maynard, Cooper & Gale, P.C., the law firm representing the plaintiffs, due to conflicts of interest. The court held a hearing on these motions on February 22, 2002 and the parties are awaiting a ruling. A tentative settlement of the lawsuit was announced in November, 2002, but was not finalized. On or about April 21, 2003 the plaintiffs filed a motion to enforce the tentative settlement. The court scheduled a hearing on September 5, 2003 to consider the fairness of this tentative settlement. On or about July 25, 2003 the Alabama Banking Department filed a motion to intervene in the case for the purpose of opposing this settlement.

On July 30, 2003 the Company, Community Bank and certain individual defendants agreed to a new settlement of this case and the Packard case (see "Packard Derivative Litigation" below) which supersedes the settlement announced in November, 2002. On August 11, 2003 the court entered an order substituting this new settlement for the prior one for purposes of the fairness hearing on September 5, 2003. The terms of the new settlement are set forth in Exhibit 99(c) to a Form 8-K filed by the Company with the Securities and Exchange Commission on August 12, 2003. Shareholders of the Company may file objections to the new settlement with the Clerk of the Circuit Court of Blount County, Alabama, no later than three business days prior to the fairness hearing. The new settlement is subject to the approval of the Alabama Superintendent of Banks and the court.

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Because of the inherent uncertainties of the litigation process, the Company is unable at this time to predict the outcome of this lawsuit and its effect on the Company's financial condition and results of operations.

### PACKARD DERIVATIVE LITIGATION

On April 4, 2003, a group composed of the same plaintiffs as in the Benson case filed another derivative action against Sheffield Electrical Contractors, Inc., Steve Sheffield, Jay Bolden, Dudley, Hopton-Jones, Sims & Freeman, PLLP, Glynn Debter, Kennon R. Patterson, Jr., Robert O. Summerford, Jimmie Trotter, John Lewis, Jr., Merritt Robbins, Stacy Mann, B. K. Walker, Jr., Denny Kelly, Roy B. Jackson, Loy McGruder, and Hodge Patterson. The complaint in this new derivative lawsuit, besides adding defendants known during but not named in the Benson lawsuit, is based upon the same allegations as in the Benson case but bases its claims against the director-defendants not "for what they did (and did not do) before learning of the over billing [sic.] allegations against Patterson [Kennon R. Patterson, Sr., the Company's former Chairman and CEO] in July 2000" but, instead "only for what they have done (and failed to do) after the filing of the Benson lawsuit -- that is, after they learned of the allegations against Patterson in July 2000." [Emphasis in the original.] On June 18, 2003 the court granted the motion filed by the Company, Community Bank and most of the individual defendants to transfer the suit to the Circuit Court of Blount County, Alabama. On July 30, 2003 the Company, Community Bank and certain individual defendants agreed to a tentative settlement of this case as part of

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the settlement of the Benson case (see "Benson Litigation" above). Because of the inherent uncertainties of the litigation process, the Company is unable at this time to predict the outcome of this lawsuit and its effect on the Company's financial condition and results of operations.

### CORR FAMILY LITIGATION

On September 14, 2000, Bryan A. Corr and six other shareholders of the Company related to Mr. Corr filed an action in the Circuit Court of Blount County, Alabama, against the Company, Community Bank, and certain directors and officers of the Company and Community Bank. The plaintiffs have alleged that the directors of the Company actively participated in or ratified the misappropriation of corporate income. The action was not styled as a shareholder derivative action. On January 3, 2001, the defendants filed a motion for summary judgment on the basis that these claims are derivative in nature and cannot be brought on behalf of individual shareholders. The court has not ruled on the motion. On May 15, 2003, the court granted the defendants' motion for summary judgment. The plaintiffs have appealed the court's ruling. Although management currently believes that this action will not have a material adverse effect on the Company's financial condition or results of operations, regardless of the outcome, the action could be costly, time consuming, and a diversion of management's attention.

### LENDING ACTS LITIGATION

On October 11, 2002, William Alston, Murphy Howard, and Jason Tittle filed an action against Community Bank, Community Bancshares, Inc., Holsombeck Motors, Inc., Lee Brown d/b/a Alabama Bond & Investigation a/k/a ABI Recovery, Chris Holmes d/b/a Alabama Bond & Investigation a/k/a ABI Recovery, Regina Holsombeck, Kennon "Ken" Patterson, Sr., Hodge Patterson, James Timothy "Tim" Hodge, Ernie Stephens, and the State of Alabama Department of Revenue. The plaintiffs in this class action allege that Community Bank and others conspired or used extortionate methods to effect a lending scheme of "churning phantom

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loans", and that profits from the scheme were used to secure an interest in and/or to invest in an enterprise that affects interstate commerce. The allegations state that Community Bank used various methods to get uneducated customers with fair to poor credit to sign numerous "phantom loans" when the customers only intended to sign for one loan. Claims include racketeering activity within the meaning of the Racketeer Influenced and Corrupt Organizations Act of 1970, conspiracy, spoliation, conversion, negligence, wantonness, outrage, and civil conspiracy.

The Company and Community Bank intend to defend the action vigorously and currently are conducting discovery to ascertain what substance, if any, there is to the claims. Although management currently believes that this action will not have a material adverse effect on the Company's financial condition or results of operations, regardless of the outcome, the action could be costly, time consuming, and a diversion of management's attention.

### PATTERSON LITIGATION

On April 9, 2003 Kennon R. Patterson, Sr., former Chairman, President and Chief Executive Officer of the Company, filed an adversary proceeding in the United States Bankruptcy Court for the Northern District of Alabama in connection with his petition for protection under Chapter 11 of the United States Bankruptcy Code. Defendants of the adversary proceeding are the Company, Community Bank, five directors of the Company and Community Bank and the law firm of Powell, Goldstein, Frazer and Murphy, LLP which represents Community Bank's Audit Committee. The complaint alleges that the Company breached its employment agreement with Mr. Patterson by terminating his employment on January 27, 2003 and failed to pay him for compensation and benefits which had allegedly accrued prior to his termination. The complaint also alleges that Community Bank, members of Community Bank's Audit Committee, the Audit Committee's independent counsel and the Company's current Chairman, President and Chief Executive Officer conspired to interfere with Mr. Patterson's contract and business relationship with the Company. The suit seeks damages in excess of \$150 million for, among other things, lost

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compensation and benefits, mental anguish, and damage to Mr. Patterson's reputation. The Company believes that this lawsuit is without merit and intends to defend the action vigorously. On May 9, 2003 the defendants filed a motion to dismiss the suit. On June 17, 2003 the court denied the motion to dismiss the suit as to the Company, Community Bank and the individual defendants. On July 7, 2003, those defendants filed a counterclaim against Mr. Patterson asserting that Mr. Patterson breached his employment agreement with the Company, engaged in fraudulent conduct, and converted property belong to Community Bank to his own use. Although management currently believes that this action will not have a material adverse effect on the Company's financial condition or results of operations, regardless of the outcome, the action could be costly, time consuming and a diversion of management's attention.

### EMPLOYEE LITIGATION

On May 5, 2003 two former executive officers of the Company and Community Bank filed separate suits in the Circuit Court of Blount County, Alabama, against the Company, Community Bank, Kennon R. Patterson, Sr., former Chairman and Chief Executive Officer of the Company and Community Bank, and a number of fictitious defendants. Bishop K. Walker, Jr., former Senior Executive Vice President and General Counsel of the Company, and Denny G. Kelly, former President of Community Bank, allege that they were induced to retire based on misrepresentations made by Kennon R. Patterson, Sr. who was allegedly acting within the scope of his duties as an agent of the Company and Community Bank.

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Plaintiffs claim that these actions constituted fraud, promissory fraud, fraudulent suppression, fraud in the inducement, deceit, fraudulent deceit, negligence, recklessness, wantonness and breach of contract. The complaints ask for an unspecified amount of compensatory and punitive damages. Although management currently believes that this action will not have a material adverse effect on the Company's financial condition or results of operations, regardless of the outcome, the action could be costly, time consuming and a diversion of management's attention.

### GENERAL

The Company and its subsidiaries are from time to time also parties to other legal proceedings arising in the ordinary course of business. Management believes, after consultation with legal counsel, that no such proceedings, if resulting in an outcome unfavorable to the Company, will, individually or in the aggregate, have a material adverse effect on the Company's financial condition or results of operations.

The Company's Certificate of Incorporation provides that, in certain circumstances, the Company will indemnify and advance expenses to its directors and officers for judgments, settlements and legal expenses incurred as a result of their service as officers and directors of the Company. Community Bank's Bylaws contain a similar provision for indemnification of directors and officers of Community Bank.

### NOTE 4 - DISCONTINUED OPERATIONS

During 2002, Community Bank consummated the sale of the following branches: two Pulaski, Tennessee locations on March 31, 2002, two DeKalb County, Alabama locations on May 3, 2002, and six Marshall County, Alabama locations on May 31, 2002. Income and expenses related to these locations are included in discontinued operations for the three and six months ended June 30, 2002 for comparative purposes.

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### NOTE 5 - RECENTLY ISSUED ACCOUNTING STANDARDS

In January 2003, the FASB issued FIN 46, which clarifies the application of Accounting Research Bulletin ("ARB") 51, Consolidated Financial Statements, to certain entities (called variable interest entities) in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. The disclosure requirements of this Interpretation are effective for all financial statements issued after January 31, 2003. The consolidation requirements apply to all variable interest entities created after January 31, 2003. In addition, public companies must apply the consolidation requirements to variable interest entities that existed prior to February 1, 2003 and remain in existence as of the beginning of annual or interim periods beginning after June 15, 2003. Management is currently assessing the impact of FIN 46, and does not expect this Interpretation to have a material impact to the Consolidated Financial Statements.

On April 30, 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. The provisions of SFAS No. 149 are effective for fiscal quarters beginning after June 15, 2003. Management does not believe the



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provisions of this standard will have a material impact on results of future operations.

In May 2003, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity", and is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The changes in this Statement require that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. In particular, the changes in this Statement (1) is expected to result in a more complete depiction of an entity's liabilities and equity and should, thereby, assist investors and creditors in assessing the amount, timing, and likelihood of potential future cash outflows and equity share issuances, (2) is expected to enhance the relevance of accounting information by providing more information about an entity's obligations to transfer assets or issue shares, thus, improving its predictive value to users. Reliability of accounting information should be improved by providing a portrayal of an entity's capital structure that is unbiased, verifiable, and more representationally faithful than information reported prior to issuance of this Statement. Those changes may result in more consistent reporting of these financial instruments. Management does not believe the provisions of this standard will have a material impact on the Company.

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### 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. (the "Company") and its subsidiaries. Unless the context otherwise indicates, the Company shall include the Company and its subsidiaries. This analysis should be read in conjunction with the financial statements and related notes appearing in Item 1 of this Report and Management's Discussion and Analysis of Financial Condition and Results of Operations appearing in the Company's Annual Report on Form 10-K for the year ended December 31, 2002.

#### FORWARD LOOKING INFORMATION

Certain statements in this Report are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements are not based on historical facts and may be identified by their reference to a future period or by the use of forward-looking terminology, such as "anticipate," "estimate," "expect," "may" and "should." These forward-looking statements include, without limitation, those relating to the Company's future growth and profitability, economic prospects of market areas, dividends, pending litigation, branch office divestitures, non-compliant or impaired loans, capital requirements, operating strategy, deposits, consumer base, allowance for loan losses, non-performing assets, interest rate sensitivity, market risk and impact of inflation. We caution you not to place undue reliance on these forward-looking statements. Actual results could differ materially from those indicated in such forward-looking statements due to a variety of factors. These factors include, but are not limited to, changes in economic conditions and government fiscal and monetary policies, changes in prevailing interest rates and effectiveness of the Company's interest rate strategies, laws, regulations and regulatory authorities affecting financial institutions, changes in and effectiveness of the Company's operating or expansion strategies, geographic concentration of the Company's assets and

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operations, competition from other financial services companies, unexpected financial results or outcomes of legal proceedings, and other risks detailed from time to time in the Company's press releases and filings with the Securities and Exchange Commission. We undertake no obligation to update these forward-looking statements to reflect events or circumstances occurring after the date of this Report.

### FINANCIAL CONDITION

JUNE 30, 2003 COMPARED TO DECEMBER 31, 2002

#### SUMMARY

Total assets at June 30, 2003 were \$553,869,000, down from \$567,596,000 at December 31, 2002. The Company continued to experience declines in loans. The Company also experienced a decline in deposits during the quarter due mostly to management's decision not to rebid on higher priced out of state funds, since funding is not currently needed for liquidity at the Company's subsidiary, Community Bank.

#### EARNING ASSETS

The earning assets of the Company are mainly composed of investment securities, federal funds sold and loans. Investment securities decreased \$146,000 at June 30, 2003 from \$123,901,000 at December 31, 2002. The investment securities portfolio is used to make various term investments, to provide a source of liquidity and to serve as collateral to secure certain government deposits. Short-term investments in the form of interest-bearing deposits with banks were \$260,000 at June 30, 2003 compared to \$200,000 at December 31, 2002. The Company had \$25,215,000 in federal funds sold at June 30, 2003, compared to \$24,030,000 at December 31, 2002, representing an increase of \$1,185,000, or 4.9%.

Cash and due from banks increased \$18,616,000 during the first six months of 2003. Earnings credit rates are applied to balances held in the Company's correspondent bank accounts held with other banks. The Company is given a credit based on its balance and the credit is used to offset service charges to the Company. These earnings

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credit rates are currently higher than the federal funds sold rates. The Company increased its balances in its main correspondent account during 2003 to take advantage of the better rate; therefore, earning a larger credit against service charges it would have paid than the interest income it otherwise would have received had the funds been in federal funds sold.

Loans comprise the largest single category of the Company's earning assets. Loans, net of unearned income, were \$326,405,000 at June 30, 2003 down \$32,779,000, or 9.1%, from \$359,184,000 at December 31, 2002. The Company continues to experience a decline in total loans because of economic downturns, the tightening of the Company's credit standards, increased charge-offs of loans made in previous years, and lack of loan demand in the markets it currently serves.

#### NONPERFORMING ASSETS AND PAST DUE LOANS

Between December 31, 2002 and June 30, 2003, the ratio of the allowance for loan losses to total nonperforming assets (defined as nonaccruing loans, loans past due 90 days or greater, restructured loans, nonaccruing securities, and other real estate) declined from 43.95% at year-end 2002 to 37.46% at June 30,

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2003. The ratio of total nonperforming assets to total assets increased to 5.41% at June 30, 2003 from 3.92% at year-end 2002, while the ratio of nonperforming loans to total loans, net of unearned income, increased to 5.57% at June 30, 2003 from 4.06% at December 31, 2002. These changes were primarily due to an increase in nonaccruing loans of \$4,235,000 or 41.9%, to \$14,334,000 at June 30, 2003 from \$10,099,000 at December 31, 2002 and an increase in other real estate of \$4,127,000, or 53.8%, to \$11,803,000 at June 30, 2003 from \$7,676,000 at December 31, 2002. In addition, loans past due 90 days or more increased \$197,000, or 15.9%, to \$1,438,000 at June 30, 2003 from \$1,241,000 at December 31, 2002. Total nonperforming assets increased \$7,722,000, or 34.7%, to \$29,982,000 at June 30, 2003 from \$22,260,000 at December 31, 2002. The significant increase in nonaccrual loans was mostly due to a \$5,150,000 real estate loan to the Company's former Chairman and Chief Executive Officer who filed bankruptcy in January, 2003. It is the Company's policy to place loans on nonaccrual status when a borrower files bankruptcy.

### FUNDING

The Company's primary sources of funding are from deposits from the customers of Community Bank and from other short-term and long-term borrowings. Total deposits of \$451,927,000 at June 30, 2003 reflected a decrease of \$7,537,000, or 1.6%, from \$459,464,000 at year-end 2002. Deposits are Community Bank's primary source of funds. Noninterest-bearing deposits increased \$6,423,000, or 12.1%, to \$59,344,000 at June 30, 2003 from \$52,921,000 at December 31, 2002, while interest-bearing deposits decreased \$13,960,000, or 3.4%, to \$392,583,000 at June 30, 2003 from \$406,543,000 at December 31, 2002. Certificates of deposit and other time deposits of \$100,000 or more decreased \$8,405,000, or 9.8%, to \$77,512,000 at June 30, 2003 from \$85,917,000 at December 31, 2002.

Total short-term borrowings decreased \$1,725,000, or 100%, to a zero balance at June 30, 2003 from \$1,725,000 at December 31, 2002. FHLB long-term debt remained constant at \$38,000,000 for both June 30, 2003 and December 31, 2002 while other long-term debt decreased \$201,000, or 5.6%, to \$3,377,000 at June 30, 2003 from \$3,578,000 at December 31, 2002.

In March 2000, the Company formed a wholly-owned Delaware statutory business trust, Community (AL) Capital Trust I (the "Trust"), which issued \$10,000,000 of guaranteed preferred securities representing undivided beneficial interests in the assets of the Trust ("Capital Securities"). All of the common securities of the Trust are owned by the Company. The proceeds from the issuance of the Capital Securities (\$10,000,000) and common securities (\$310,000) were used by the Trust to purchase \$10,310,000 of junior subordinated deferrable interest debentures of the Company which carry an annual interest rate of 10.875%. Under the terms of the indenture, the Company may elect to defer payments of interest for up to ten semiannual payment periods. The Company has elected to defer its March 2002, September 2002 and March 2003 interest payments and may elect to do so again based on the liquidity needs of the Company when future payments become due. For the duration of such deferral period, the Company is restricted from paying dividends to

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shareholders or paying debt that is junior to the debenture. The debentures represent the sole asset of the Trust. The debentures and related income statement effects are eliminated in the Company's consolidated financial statements. The Company is entitled to treat the aggregate liquidation amount of the debentures as Tier I capital under Federal Reserve guidelines.

The Capital Securities accrue and pay distributions semiannually at a rate of 10.875% per annum of the stated liquidation value of \$1,000 per capital security. The Company has entered into an agreement which fully and

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unconditionally guarantees payment of: (i) accrued and unpaid distributions required to be paid on the Capital Securities; (ii) the redemption price with respect to any Capital Securities called for redemption by the Trust; and (iii) payments due upon a voluntary or involuntary liquidation, winding up or termination of the Trust.

The Capital Securities are mandatorily redeemable upon the maturity of the debentures on March 8, 2030, or upon earlier redemption as provided in the indenture pursuant to which the debentures were issued. The Company has the right to redeem the debentures purchased by the Trust: (i) in whole or in part, on or after March 8, 2010; and (ii) 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 (each as defined in the indenture). As specified in the indenture, if the debentures are redeemed prior to maturity, 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 accrued but unpaid interest.

### LIQUIDITY

The Company experienced an approximate \$19,861,000 increase in cash and cash equivalents during the first six months of 2003. Cash provided by operating activities was \$3,883,000. Investing activities provided an increase of \$25,482,000, mostly from loan payments from customers. Financing activities used \$9,503,000 of cash and cash equivalents during the first six months of 2003. Certificates of deposits decreased \$21,954,000, but was partially offset by increases in cash from the growth of demand deposits, NOW deposits, and other savings deposits totaling \$14,418,000.

Dividends paid by Community Bank are the primary source of funds available to the Company. The Company relies on dividends from Community Bank in order to pay expenses, service debt and pay dividends to shareholders. Certain restrictions exist regarding the ability of Community Bank to transfer funds to the Company in the form of cash dividends, loans or advances. Although dividends from Community Bank are the primary source of funding, the Company also receives cash from its subsidiaries for its portion of tax benefit on intercompany income tax settlements. Community Bank discontinued paying the Company a management fee in 2003. The Company's primary cash outflow is now debt service. Community Bank is unable to pay a dividend to the Company without prior approval of the regulatory authorities.

### CAPITAL RESOURCES

Total shareholders' equity at June 30, 2003 was 6.7% of total assets as compared to 7.1% at December 31, 2002. The decrease experienced during the first six months of 2003 is primarily a result of net losses of \$3,090,000.

Bank regulatory authorities have issued risk-based capital guidelines that take into consideration risk factors associated with various categories of assets, both on and off the balance sheet. Under the guidelines, capital strength is measured in two tiers, which are used in conjunction with risk-adjusted assets to determine the risk-based capital ratios. The Company's Tier I capital, which includes common stock, retained earnings and guaranteed preferred beneficial interest in the Company's junior subordinate deferrable interest debentures, amounted to \$43,959,000 at June 30, 2003, compared to \$46,817,000 at December 31, 2002. Tier II capital components include supplemental capital components, such as qualifying allowance for loan losses and qualifying subordinated debt. Tier I capital plus the Tier II capital components are referred to as total risk-based capital, which was \$48,322,000 at June 30, 2003 as compared to \$52,897,000 at year-end 2002. The percentage ratios, as calculated under the guidelines, for tier I and total risk-based capital were 12.84% and 14.11%, respectively, at June 30, 2003, compared to 12.95% and 14.63%, respectively, at

year-end 2002. At June 30, 2003, both tier I and total risk-based capital of the Company exceeded the regulatory minimum ratios of 4% and 8%, respectively.

Another important indicator of capital adequacy in the banking industry is the leverage ratio. The tier I leverage ratio is defined as the ratio that the Company's tier I capital bears to total average assets minus goodwill. The Company's tier I leverage ratios were 7.85% and 8.20% at June 30, 2003 and December 31, 2002, respectively, exceeding the regulatory minimum requirement of 4%. The Company is currently under a special regulatory requirement of 6.50% for tier 1 leverage ratio. The Company's ratio currently exceeds that requirement.

#### RESULTS OF OPERATIONS

##### THREE AND SIX MONTHS ENDED JUNE 30, 2003 AND 2002

#### SUMMARY

The Company's net loss from continuing operations for the six months ended June 30, 2003 was \$3,090,000, a decrease of \$1,222,000 from a net loss from continuing operations of \$1,868,000 for the same period in 2002. Income from discontinued operations which includes the gain on disposal of \$5,927,000 during the first six months of 2002 brought net income to \$4,060,000. Both basic and diluted net loss per share was \$0.66 for the six months ended June 30, 2003, as compared to net income per share of \$0.88 for the same period in 2002.

The Company's net loss for the three month period ended June 30, 2003 was \$2,541,000 as compared to net income of \$2,827,000 for the same period of 2002; however, continuing operations during the three month period ended June 30, 2002 resulted in a net loss of \$1,882,000 in comparison to the \$2,541,000.

The following discussion is on results of operations from continuing operations of the Company. Refer to Note 6 of the Notes to Consolidated Financial Statements for a description of the presentation for discontinued operations.

#### NET INTEREST INCOME

Net interest income, the difference between interest earned on assets and the cost of interest-bearing liabilities, was \$9,851,000 for the six months ended June 30, 2003. Net interest income, before provision for loan losses, decreased \$2,194,000, or 18.2%, from \$12,045,000 for the same period of 2002. Revenues from interest earning assets of the Company decreased \$3,604,000, or 17.2%, to \$17,343,000 for the six months ended June 30, 2003 from \$20,947,000 for the same period in 2002. This decrease was due to lower yields on and volume of interest earning assets. Average earning assets outstanding during the first six months of 2003 were \$498,164,000, which represents a decrease of \$36,158,000, or 6.8%, from \$534,322,000 for the first six months of 2002. The Company's yield on its average earning assets decreased 89 basis points to 7.02% for the first six months of 2003, compared to 7.91% for the same period of 2002. This decrease is somewhat reflective of the overall decrease in interest rates experienced during the time frame. Interest expense for the six months ended June 30, 2003 decreased \$1,411,000, or 15.8%, to \$7,492,000 from \$8,903,000 for the corresponding period of 2002. This decrease occurred due to a decline in rates paid on and volume of interest-bearing liabilities. Average interest-bearing liabilities during the first six months of 2003 were \$457,379,000, which represents a decrease of \$14,666,000, or 3.1%, from \$472,045,000 for the same period of 2002. The rate paid on average

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interest-bearing liabilities decreased 50 basis points to 3.30% for the six month period ended June 30, 2003, compared to 3.80% for the first six months of 2002. This decrease is also attributable to the overall decline in interest rates during the year 2002.

The Company's net interest margin for the six months ended June 30, 2003 decreased 56 basis points to 3.99%, from 4.55% for the six months ended June 30, 2002, due to the decrease in net interest income. 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.

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The Company's net interest spread for the six months ended June 30, 2003 decreased 39 basis points to 3.72%, from 4.11% for the six months ended June 30, 2002, as the average cost of interest-bearing sources of funds decreased 50 basis points while the average yield on interest earning assets decreased 89 basis points. Net interest spread measures the difference between the average yield on interest earning assets and the average rate paid on interest-bearing sources of funds. The Company has also experienced declines in its net interest margin and net interest spread with the continued increase in nonearning assets as a result of higher nonaccrual loans and other real estate owned.

### PROVISION FOR LOAN LOSSES AND ALLOWANCE FOR LOAN LOSSES

At June 30, 2003, the allowance for loan losses was \$11,232,000 which represented an increase of \$1,448,000, or 14.8%, from the December 31, 2002 amount of \$9,784,000. The provision for loan losses was \$3,610,000 and \$4,054,000 for the six months ended June 30, 2003 and 2002, respectively. Management continues to make provisions for current losses in the loan portfolio as it continues its effort to improve the overall credit quality of the Company. In this effort, management has increased the allowance for loan losses account as a percent of loans to reserve for potential losses in the loan portfolio by recognizing additional provisions for loan loss expense. As a percentage of total loans, net of unearned income, the allowance for loan losses increased to 3.44% at June 30, 2003, compared to 2.72% at December 31, 2002. Loan charge-offs exceeded recoveries by \$2,163,000 during the first six months of 2003, which represented a decrease of \$266,000, or 11.0%, from \$2,429,000 for the same period during 2002. Management believes that the allowance for loan losses at June 30, 2003 is adequate; however, no assurance can be given that additional losses may not occur or that additional provisions to the allowance for loan losses will not be necessary.

### NONINTEREST INCOME

Noninterest income for the six months ended June 30, 2003 increased \$232,000, or 6.2%, to \$3,977,000, from \$3,745,000 for the same period of 2002. Service charges on deposit accounts decreased \$215,000, or 14.0%, to \$1,321,000 for the first six months of 2003 from \$1,536,000 in the first six months of 2002. Debt cancellation fees decreased during the first six months of 2003, as compared to the first six months of 2002, \$90,000, or 64.7%, due to decreased volume in debt cancellation coverage associated with the decline in the Company's loan portfolio. Other operating income decreased \$106,000 to \$531,000 for the first six months of 2003 from \$637,000 for the same period in 2002. The Company recorded net gains on the sale of investment securities of \$729,000 during the six months ended June 30, 2003, compared to net gains on the sale of investment securities of \$124,000 for the same period of 2002. The net securities gains were the primary reason for the increase in noninterest income, although the

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Company also experienced a 4.0%, or \$44,000, increase in insurance commissions attributable to increased revenues from the Company's subsidiary, Community Insurance Corp.

For the three months ended June 30, 2003, noninterest income was \$1,793,000, a decrease of \$242,000, or 11.9% from \$2,035,000 for the same period in 2002. For the three month period ended June 30, 2003 from the same period ended June 30, 2002, insurance commissions increased \$20,000, debt cancellation fees decreased \$61,000, other operating income decreased \$104,000 and net securities gains decreased \$26,000.

### NONINTEREST EXPENSES

Noninterest expenses for the six months ended June 30, 2003 were \$14,251,000, representing a \$439,000, or 3.2%, increase from \$13,812,000 for the same period of 2002. The primary components of noninterest expenses are salaries and employee benefits, which decreased \$571,000, or 7.9%, to \$6,639,000 for the six months ended June 30, 2003 from \$7,210,000 for the same period of 2002. Occupancy costs increased \$20,000, or 1.7%, to \$1,172,000 for the first six months of 2003 from \$1,152,000 for the same period of 2002. Furniture and equipment expenses for the six month period ended June 30, 2003 decreased \$71,000, or 8.6%, to \$755,000 from \$826,000 for the same period of 2002. Insurance expense increased \$398,000 to \$581,000 for the six months ended June 30, 2003 from \$183,000 for the same period in 2002. Director and committee fees increased \$18,000, or 8.9%, to \$220,000 for the first six months of 2003 from \$202,000 for the first six months of 2002. This increase is the result of increased Board

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meetings due to the many changes the Company has experienced during the first six months of 2003. Other operating expenses were \$2,047,000 and \$2,115,000 for the six month periods ended June 30, 2003 and 2002, respectively. Professional services expense increased \$662,000, or 41.2%, to \$2,268,000 due to professional services required to comply with the agreement with the Alabama State Banking Department and the investigation into payments made in connection with construction projects of the Bank.

For the three months ended June 30, 2003, noninterest expenses were \$7,243,000, an increase of \$163,000 over the same three month period in 2002 of \$7,080,000. The increase was due to increases in professional services and insurance expense of \$358,000 and \$197,000, respectively. This increase was partially offset by a \$427,000 decrease in salaries and employee benefits and a \$143,000 decrease in other operating expenses, but was further exacerbated by losses on other real estate and disposal of assets totaling \$317,000.

### INCOME TAXES

The Company attempts to maximize its net income through active tax planning. Tax benefits were \$943,000 for the six month period ended June 30, 2003 compared to tax expense of \$2,368,000 for the same period in 2002. The Company has experienced an effective tax rate of 23.4% thus far in 2003.

### RECENTLY ISSUED ACCOUNTING STANDARDS

In January 2003, the FASB issued FIN 46, which clarifies the application of Accounting Research Bulletin ("ARB") 51, Consolidated Financial Statements, to certain entities (called variable interest entities) in which equity investors do not have the characteristics of a controlling financial interest or do not

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have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. The disclosure requirements of this Interpretation are effective for all financial statements issued after January 31, 2003. The consolidation requirements apply to all variable interest entities created after January 31, 2003. In addition, public companies must apply the consolidation requirements to variable interest entities that existed prior to February 1, 2003 and remain in existence as of the beginning of annual or interim periods beginning after June 15, 2003. Management is currently assessing the impact of FIN 46, and does not expect this Interpretation to have a material impact to the Consolidated Financial Statements.

On April 30, 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. The provisions of SFAS No. 149 are effective for fiscal quarters beginning after June 15, 2003. Management does not believe the provisions of this standard will have a material impact on results of future operations.

In May 2003, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity", and is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The changes in this Statement require that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. In particular, the changes in this Statement (1) is expected to result in a more complete depiction of an entity's liabilities and equity and should, thereby, assist investors and creditors in assessing the amount, timing, and likelihood of potential future cash outflows and equity share issuances, (2) is expected to enhance the relevance of accounting information by providing more information about an entity's obligations to transfer assets or issue shares, thus, improving its predictive value to users. Reliability of accounting information should be improved by providing a portrayal of an entity's capital structure that is unbiased, verifiable, and more representationally faithful than information reported prior to issuance of this Statement. Those changes may result in more consistent reporting of these financial instruments. Management does not believe the provisions of this standard will have a material impact on the Company.

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### ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

#### INTEREST RATE SENSITIVITY

Community Bank's net interest income, and the fair value of its financial instruments, are influenced by changes in the level of interest rates. Community Bank manages its exposure to fluctuations in interest rates through policies established by its Asset/Liability Committee ("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 Bank's net interest income and net income to changes in interest rates. Such estimates are based upon a number of assumptions for each



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scenario, including balance sheet growth, deposit repricing characteristics and prepayment rates.

The estimated impact on Community Bank's net interest income sensitivity over a one year time horizon at June 30, 2003 is shown below. Such analysis assumes an immediate and nonparallel shift in interest rates and the Bank's estimates of how interest-bearing transaction accounts will reprice.

### RATE SHOCK ANALYSIS

|                                    | -100<br>BASIS<br>POINTS<br>----- | LEVEL<br>-----    | +100<br>BASIS<br>POINTS<br>----- |
|------------------------------------|----------------------------------|-------------------|----------------------------------|
| (DOLLARS IN THOUSANDS)             |                                  |                   |                                  |
| Prime Rate .....                   | 3.00%                            | 4.00%             | 5.00%                            |
| Interest Income .....              | \$30,879                         | \$32,272          | \$33,603                         |
| Interest Expense .....             | 10,791                           | 11,803            | 13,136                           |
| Net Interest Income .....          | \$20,088<br>=====                | \$20,469<br>===== | \$20,467<br>=====                |
| Dollar change from Level .....     | \$ -381                          |                   | \$ -2                            |
| Percentage change from Level ..... | -1.86%                           |                   | -0.00%                           |

As shown above, in a 100 basis point rising rate environment, the net interest margin is projected to remain unchanged and in a 100 basis point falling rate environment, the net interest margin is projected to decrease 1.86%. These percent changes from a level rate scenario fall comfortably within Community Bank's ALCO policy limit of +/-7.00%.

#### ITEM 4 - CONTROLS AND PROCEDURES

- (a) Disclosure Controls and Procedures. The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective.

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- (b) Management, in consultation with the Company's independent accountants, identified deficiencies related to the impairment of premises and the equipment and valuation of repossessions, which constitute "material weaknesses" under standards established by the American Institute of Certified

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Public Accountants. Management has established a plan to strengthen the procedures and controls surrounding these processes. Implementation has begun and completion of these plans is expected in the third quarter of 2003.

### PART II OTHER INFORMATION

#### ITEM 1 - LEGAL PROCEEDINGS

On or about April 21, 2003 the plaintiffs in the lawsuit styled Benson et al v. Community Bancshares, Inc. et al. filed a motion to enforce the tentative settlement announced in November, 2002. The court scheduled a hearing on September 5, 2003 to consider the fairness of this tentative settlement. On or about July 25, 2003 the Alabama Banking Department filed a motion to intervene in the case for the purpose of opposing this settlement. On July 30, 2003 the Company, Community Bank and certain individual defendants agreed to a new settlement of this case which supersedes the settlement announced in November, 2002. On August 11, 2003 the court entered an order substituting this new settlement for the prior one for purposes of the fairness hearing on September 5, 2003. The terms of the new settlement are set forth in Exhibit 99(c) to a Form 8-K filed by the Company with the Securities and Exchange Commission on August 12, 2003. Shareholders of the Company may file objections to the new settlement with the Clerk of the Circuit Court of Blount County, Alabama, no later than three business days prior to the fairness hearing. The new settlement is subject to the approval of the Alabama Superintendent of Banks and the court.

On May 15, 2003 the court granted the defendants' motion for summary judgment in the lawsuit styled Corr v. Patterson. The plaintiffs have appealed the court's ruling.

On May 5, 2003 two former executive officers of the Company and Community Bank filed separate suits in the Circuit Court of Blount County, Alabama, against the Company, Community Bank, Kennon R. Patterson, Sr., former Chairman and Chief Executive Officer of the Company and Community Bank, and a number of fictitious defendants. Bishop K. Walker, Jr., former Senior Executive Vice President and General Counsel of the Company, and Denny G. Kelly, former President of Community Bank, allege that they were induced to retire based on misrepresentations made by Kennon R. Patterson, Sr. who was allegedly acting within the scope of his duties as an agent of the Company and Community Bank. Plaintiffs claim that these actions constituted fraud, promissory fraud, fraudulent suppression, fraud in the inducement, deceit, fraudulent deceit, negligence, recklessness, wantonness and breach of contract. The complaints ask for an unspecified amount of compensatory and punitive damages. Although management currently believes that this action will not have a material adverse effect on the Company's financial condition or results of operations, regardless of the outcome, the action could be costly, time consuming and a diversion of management's attention.

On June 18, 2003, the court granted the motion filed by the Company, Community Bank and most of the individual defendants to transfer the lawsuit styled Packard et al. v. Sheffield Electrical Contractors, Inc. et al. from the Circuit Court of Jefferson County, Alabama, to the Circuit Court of Blount County, Alabama,. On July 30, 2003 the Company, Community Bank and certain individual defendants agreed to a tentative settlement of this case as part of the settlement of the Benson case.

On May 9, 2003 the defendants in the lawsuit styled Patterson v. Community Bancshares, Inc. et al. filed a motion to dismiss the suit. On June 17, 2003 the court denied the motion to dismiss the suit as to the Company, Community Bank and the individual defendants. On July 7, 2003, those defendants filed a counterclaim against Mr. Patterson asserting that Mr. Patterson breached his

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employment agreement with the Company, engaged in fraudulent conduct, and converted property belonging to Community Bank to his own use.

Except as noted above, no reportable events or material developments have occurred since the filing of the Company's Annual Report on Form 10-K (the "Form 10-K"), for the year ended December 31, 2002 and filed on April 15, 2003.

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### ITEM 4 - SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The annual meeting of stockholders of the Company was held on Thursday, July 24, 2003, at which the following matters were voted upon by the stockholders of the Company:

#### I. Election of Class I Directors

Roy B. Jackson, Stacey W. Mann and Jimmie Trotter were elected to serve as Class III directors of the Company until the annual meeting of stockholders in 2006 or until their successors are elected and qualified. The vote with respect to such election was as follows:

| Name           | Votes Cast<br>In Favor | Votes Cast<br>Against or<br>Withheld | Abstentions<br>or Broker<br>Non-Votes |
|----------------|------------------------|--------------------------------------|---------------------------------------|
| Roy B. Jackson | 3,261,646              | 840,988                              |                                       |
| Stacey W. Mann | 2,899,494              | 1,203,140                            |                                       |
| Jimmie Trotter | 3,269,091              | 833,543                              |                                       |

The following directors continued in office following the stockholders meeting:

| Name                     | Term Expires |
|--------------------------|--------------|
| Glynn Debter             | 2004         |
| John J. Lewis, Jr.       | 2004         |
| Loy McGruder             | 2004         |
| Kenneth K. Campbell      | 2005         |
| Patrick M. Frawley       | 2005         |
| Kennon R. Patterson, Sr. | 2005         |
| Merritt M. Robbins       | 2005         |

#### II. Removal of a Class III Director

The recommendation made by the Board of Directors that Kennon R. Patterson, Sr. be removed as a Class III director of the Company was not adopted. Pursuant to the Company's Certificate of Incorporation, the holders of at least 80% of the shares of Company common stock represented at the meeting, in person or by proxy, must affirmatively vote for removal in order for a director to be removed from office. With respect to removal of Mr. Patterson, the holders of 2,715,279 shares, or approximately 66.18 % of the shares represented at the

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meeting, voted in favor of removal, holders of 661,593 voted against removal, and holders of 725, 762 shares abstained.

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ITEM 6 - EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

- 11 Statement of computation of per share earnings
- 31.1 Rule 13a-14(a)/15d-14(a) Certifications of the Chief Executive Officer
- 31.2 Rule 13a-14(a)/15d-14(a) Certifications of the Chief Financial Officer
- 32.1 Rule 13a-14(b) Certifications of the Chief Executive Officer
- 32.2 Rule 13a-14(b) Certifications of the Chief Financial Officer

(b) Reports on Form 8-K

During the quarter ended June 30, 2003, no reports were filed on Form 8-K.

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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, hereunto duly authorized, in the city of Blountsville, State of Alabama, on August 14 , 2003.

COMMUNITY BANCSHARES, INC.

By:/s/ Patrick M. Frawley

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Patrick M. Frawley  
Chairman, Chief Executive Officer,  
and President

By:/s/ Kerri C. Kinney

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Kerri C. Kinney  
Chief Financial Officer

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