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COMMUNITY BANCSHARES INC /DE/

Form 10-Q

May 15, 2002

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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 March 31, 2002  
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 63-0868361  
(State or other jurisdiction of (I.R.S. Employer Identification No.)  
incorporation or organization)

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

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY  
PROCEEDINGS DURING THE PRECEDING 5 YEARS:

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.  yes  no

APPLICABLE ONLY TO CORPORATE ISSUERS:

As of May 8, 2002, there were 4,637,855 shares of the registrant's common stock, \$.10 par value shares, outstanding.

Form 10-Q

COMMUNITY BANCSHARES, INC.

March 31, 2002

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PART 1

Item 1 - Financial Statements

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

March 31, 2002

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Assets	
Cash .....	\$ 6,619,405
Due from banks .....	11,098,037
Interest-bearing deposits with banks. ....	200,000
Federal funds sold .....	45,395,000
Securities available for sale .....	111,383,948
Loans .....	465,532,536
Less: Unearned income. ....	57,627
Allowance for loan losses .....	7,201,046
-----	
Net Loans .....	458,273,863
Premises and equipment, net .....	37,192,064
Accrued interest. ....	5,730,234
Intangibles, net. ....	2,608,855
Other real estate .....	4,446,638
Other assets .....	7,653,850
-----	
Total Assets.....	\$ 690,601,894
=====	
Liabilities and Shareholders' Equity	
Deposits:	
Noninterest-bearing.....	\$ 68,880,565
Interest-bearing.....	508,756,203
-----	
Total Deposits .....	577,636,768
Other short-term borrowings .....	4,835,216
Accrued interest. ....	4,471,008
FHLB borrowing .....	38,000,000
Capitalized lease obligations .....	5,735,087
Long-term debt .....	4,396,052
Guaranteed preferred beneficial interest in the Company's junior subordinated deferrable interest debentures .....	10,000,000
Other liabilities .....	3,759,551
-----	
Total Liabilities .....	648,833,682
Shareholders' Equity	
Preferred stock, par value \$.01 per share, 200,000 shares authorized, no shares issued .....	-
Common stock, par value \$.10 per share, 20,000,000 shares authorized, 4,826,601 and 4,808,331 shares issued, as of March 31, 2002 and December 31 2001, respectively.....	482,660
Capital surplus .....	30,933,881
Retained earnings .....	13,622,813
Treasury Stock, 20,803 shares .....	(396,768)
Unearned ESOP shares - 167,943 and 174,267 shares as of March 31, 2002 and December 31, 2001, respectively.....	(2,254,662)
Accumulated other comprehensive loss.....	(619,712)
-----	
Total Shareholders' Equity .....	41,768,212
-----	
Total Liabilities and Shareholders' Equity.....	\$ 690,601,894
=====	

See notes to consolidated financial statements

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

	For the Three Months 2002
	-----
Interest Income	
Interest and fees on loans.....	\$ 11,014,615
Interest on investment securities:	
Taxable securities.....	1,550,545
Securities exempt from federal income taxes .....	145,088
Interest on federal funds sold .....	143,083
Interest on deposits in other banks .....	6,994
	-----
Total Interest Income .....	12,860,325
	-----
Interest Expense	
Interest on deposits .....	4,899,885
Interest on other short-term borrowings .....	18,897
Interest on capitalized lease obligations.....	68,698
FHLB borrowings .....	563,350
Interest on long-term debt. ....	53,898
Interest on guaranteed preferred beneficial interest in the Company's junior subordinated deferrable interest debentures.....	280,303
	-----
Total Interest Expense. ....	5,885,031
	-----
Net Interest Income.....	6,975,294
Provision for loan losses .....	1,040,419
	-----
Net Interest Income After Provision For Loan Losses.....	5,934,875
Noninterest Income	
Service charges on deposits .....	985,081
Insurance commissions.....	535,128
Bank club dues .....	156,396
Debt cancellation fees .....	72,955
Gain on sale of branches.....	1,551,443
Other operating income .....	217,060
Investment securities gains .....	16,646
	-----
Total Noninterest Income.....	3,534,709
	-----
Noninterest Expenses	
Salaries and employee benefits .....	3,978,539
Occupancy expense .....	755,347
Furniture and equipment expense. ....	464,014
Director and committee fees .....	107,600
Loss on disposal of premises and equipment.....	395,575
Other operating expenses .....	1,921,876

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Total Noninterest Expenses .....	7,622,951
Income before income taxes .....	1,846,633
Income tax expense.....	614,120
Net Income.....	\$ 1,232,513
Earnings per common share - basic.....	\$ 0.27
Earnings per common share - diluted.....	\$ 0.27
Dividends per share.....	\$ --

See notes to consolidated financial statements

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

	For the Three Months 2002
Net Income.....	\$ 1,232,513
Components of other comprehensive income:	
Unrealized holding gains (losses) arising during the period before income tax and reclassification adjustments .....	(609,370)
Reclassification adjustments for net gains (losses) included in net income.....	(16,646)
Other comprehensive gains (losses), before income taxes .....	(626,016)
Income tax expense (benefit) related to other comprehensive income.....	(250,406)
Total other comprehensive income (loss), net of income tax.....	(375,610)
Comprehensive income.....	\$ 856,903

See notes to consolidated financial statements

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

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	For the Three Months 2002
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Operating Activities:	
Net income.....	\$ 1,232,513
Adjustments to reconcile net income to net cash provided by operating activities:	
Provision for loan losses .....	1,040,419
Provision for depreciation and amortization .....	566,866
Amortization of investment security premiums and accretion of discounts.....	73,075
Deferred tax expense (benefit) .....	164,908
Realized investment security gains. ....	(16,646)
Gain on sale of branches.....	(1,551,443)
Loss on sale of premises and equipment .....	395,575
Decrease in accrued interest receivable. ....	1,133,827
Increase in accrued interest payable .....	244,834
Other .....	(844,973)
	-----
Net cash provided by operating activities .....	2,438,955
	-----
Investing Activities:	
Proceeds from sales of securities available for sale .....	11,597,387
Proceeds from maturity of securities available for sale .....	2,000,000
Purchase of securities available for sale .....	(3,984,476)
Net decrease in loans to customers .....	10,719,993
Proceeds from sale of premises and equipment. ....	60,350
Capital expenditures .....	(136,100)
Net proceeds from sale of other real estate .....	177,903
Cash paid in branch sale.....	(8,294,497)
	-----
Net cash provided by (used) in investing activities .....	12,140,560
	-----
Financing Activities:	
Net increase (decrease) in demand deposits, NOW accounts, savings and time open deposit accounts.....	6,614,878
Net (decrease) increase in certificates of deposit .....	(11,355,951)
Net increase (decrease) in short-term borrowings .....	475,289
Net decrease in capitalized lease obligations .....	(30,989)
Repayment of long-term debt .....	(207,308)
Issuance of common stock. ....	--
	-----
Net cash (used) provided by financing activities .....	(4,504,081)
	-----
Net increase in cash and cash equivalents .....	10,075,434
Cash and cash equivalents at beginning of year .....	53,037,008
	-----
Cash and cash equivalents at end of period.....	\$ 63,112,442
	=====

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(UNAUDITED)

For the Three Months  
2002  
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Supplemental disclosures of cash flow information:

Cash paid during the period for:

Interest.....	\$	5,814,023
Income taxes.....		947

Supplemental schedule of non-cash investing and financing activities:

Real estate acquired through foreclosure.....	\$	1,246,862
Assets (except cash) disposed of in branch sale.....		25,660,924
Deposit liabilities including accrued interest released in branch sale.....		35,502,014

See notes to consolidated financial statements

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES  
(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 month period ending March 31, 2002 are not necessarily indicative of the results that may be expected for the year ending December 31, 2002. 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, 2001.

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.

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### NOTE 2 - BUSINESS COMBINATIONS

Community Bank closed on the sale of loans, deposits and property of its two bank offices located in Pulaski, Tennessee on March 31, 2002. The Company paid cash of \$8,294,497 (includes vault cash and cash items) in settlement of the sale and recognized a gain on the sale of \$1,551,443 representing the premium received on deposits less the discount given on loans and fixed assets. Total assets sold in the transaction approximated \$25,925,000 of which loans (including accrued interest) and fixed assets were sold totaling \$23,965,982 and \$1,568,940, respectively, while deposit liabilities (including accrued interest) of \$35,502,014 were sold.

### NOTE 3 - CAPITAL SECURITIES

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 elected to defer its March 2002 interest payment 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 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 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.

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### NOTE 3 - CAPITAL SECURITIES - Continued

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.



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### NOTE 4 - SEGMENT REPORTING

All of the Company's offices offer similar products and services, are located in the same geographic region and serve the same customer segments of the market. As a result, management considers all units as one operating segment and therefore feels that the basic financial statements and related footnotes provide sufficient detail related to segment reporting.

### NOTE 5 - 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 new Community Bank office. Management of the Company commenced an investigation of the 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 made a presentation alleging that Community Bank had been overcharged by subcontractors on that construction project and another ongoing 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. Upon completion of its investigation, the joint committee is to inform the Boards of Directors of the Company and Community Bank of its findings and recommendations. The joint committee retained legal counsel and an independent accounting firm to assist the committee in its investigation. Management has also been informed that the directors of Community Bank who alleged the construction overcharges have contacted bank regulatory agencies and law enforcement authorities. Management believes that these agencies and authorities either have conducted or are currently conducting investigations regarding this matter.

#### 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

### NOTE 5 - CONTINGENCIES - Continued

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,

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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 August 2000. The amended complaint also alleges that the defendants breached their fiduciary duties and were guilty of gross financial mismanagement, including allegations concerning the making or approval of certain loans and taking allegedly improper actions to conceal 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, nonderivative 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.

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. On February 25, 2002, the Company and Community Bank filed a motion for limited discovery relating to its motion to disqualify the plaintiffs' law firm. As a result of the inherent

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## NOTE 5 - CONTINGENCIES - Continued

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. Regardless of the outcome, however, this lawsuit could be costly, time-consuming and a diversion of management's attention.

## Towns Derivative Litigation

On November 19, 1998, Mr. William Towns, a shareholder of the Company, filed a shareholder derivative action against the directors of the Company in the state Circuit Court of Blount County, Alabama. Mr. Towns amended his complaint on January 14, 1999 to add the Company and Community Bank as defendants in the action. On February 11, 1999, the complaint was again amended to add Mr. Pat Bellew and Mrs. Mary Bellew, who are also shareholders of the Company, as additional plaintiffs. The complaint alleged that the directors of the Company breached their fiduciary duty to the Company and its shareholders, engaged in fraud, fraudulent concealment, suppression of material fact and suppression of the plaintiff shareholders, failed to supervise management, and conspired to conceal wrongful acts from the Company's shareholders and paid themselves excessive director fees. The complaint also alleged that the Board of Directors acquiesced in mismanagement and misconduct by Kennon R. Patterson, Sr., the Chairman of the Board, Chief Executive Officer and President of the Company, including alleged self dealing, payment of excessive compensation, misappropriation of corporate opportunities and misappropriation of funds. The complaint sought an unspecified amount of compensatory and punitive damages, removal of the current directors, appointment of a new Board of Directors, and attorneys fees and cost.

On December 21, 1998, the Company and its directors filed a motion with the court seeking to have the complaint dismissed. On March 1, 1999, the Company's Board of Directors appointed a special Board committee comprised of non-employee directors of the Company, to review the plaintiffs' allegations in accordance with Delaware law. On April 6, 1999, each of the parties to the action requested that the court stay the litigation and related discovery, motions and hearings, pending completion of the special committee's review. On April 30, 1999, the court entered an order staying the litigation and related discovery, motions and hearing in accordance with the parties' request. On October 15, 1999, the special committee filed its final report with the court. On October 21, 1999, the parties forwarded to the court an agreed-upon order governing the confidentiality of the special committee's report, which the court entered on January 2, 2000. On August 3, 2000, the Company, Community Bank and the Company's directors filed a motion to stay the proceedings until the Company's and Community Bank's joint investigative committee had completed its investigation of the alleged construction overcharges discussed above. At the request of the Company and the other defendants in the action, the court continued a hearing on the motion to dismiss. On February 23, 2001, the court indicated that there was no reason to continue the stay of this action. The parties are awaiting a hearing on the defendants' motion to dismiss the case. Management of the Company believes that the plaintiffs' allegations are false and that the action lacks merit. The Company and its directors intend to defend the action vigorously, and management of the Company believes that the action will not have a material adverse effect on the Company's financial condition or results of operations. Regardless of the outcome, however, this lawsuit could be costly, time consuming and a diversion of management's attention.

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### Corr Family Litigation

On September 14, 2000, another action was filed in the state Circuit Court of Blount County, Alabama, against the Company, Community Bank and certain directors and officers of the Company and Community Bank by Bryan A. Corr and six other related shareholders of the Company alleging that the directors actively participated in or ratified the misappropriation of corporate income. The action was not styled as a shareholder derivative action. On

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### NOTE 5 - CONTINGENCIES - Continued

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. The Company and its directors believe that this lawsuit is without merit and intend to defend the action vigorously. 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.

### Auto Loan Litigation

On June 28, 2000, Community Bank filed an action in the United States District Court for the Northern District of Alabama against Carl Gregory Ford L-M, Inc., an automobile dealership located in Ft. Payne, Alabama, Carl Gregory and Doug Broaddus, the owners of the dealership, several employees and former employees of the dealership and Gerald Scot Parrish, a former employee of Community Bank, with respect to certain loans originated during 1998 in Community Bank's Wal-Mart office in Ft. Payne, Alabama. In the complaint Community Bank alleged that the defendants willingly and knowingly conducted, participated in, were employed by or associated with, or aided and abetted an enterprise within the meaning of the Racketeer Influenced and Corrupt Organizations Act (RICO) for the purpose of defrauding Community Bank. The complaint also asserted that the defendants committed fraud, misrepresentation and deceit by submitting to Community Bank and/or approving applications for automobile loans which contained false and/or fraudulent information for the purpose of deceiving, influencing and persuading Community Bank to provide loans to customers of the automobile dealership who were otherwise not qualified to receive such loans, and suppressed material facts regarding the veracity of information contained in loan applications and the ability of persons seeking the loans to repay them. Community Bank also alleged in the complaint that the automobile dealership is responsible for the acts of its officers, agents and employees, and that the dealership and its management failed to adequately train and/or supervise its employees. The complaint stated that the defendants participated in a conspiracy to violate RICO and Alabama statutes dealing with fraud, misrepresentation and suppression of material facts, and asserted civil liability under Alabama law for violation of federal statutes dealing with financial institution fraud, mail and wire fraud and making false statements for the purpose of influencing the actions of a financial institution upon an application or loan.

On June 29, 2000 and August 31, 2000, the court granted Community Bank's motions to dismiss without prejudice two of the employees of the automobile dealership as defendants in the action. On September 13, 2000, the court granted Mr. Parrish's action to dismiss the complaint, but granted Community Bank 15 days to amend the complaint. On September 27, 2000, Community Bank filed an amended complaint which generally reiterated the allegations of

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the original complaint and added specific information concerning the allegedly fraudulent activity and the use of the United States mail, telephone and other wire transmissions in the conduct of such activity. On December 1, 2000, the court dismissed Community Bank's claims based upon mail and wire fraud in the amended complaint but otherwise denied Mr. Parrish's motion to dismiss the complaint. On October 10, 2001, the court granted a joint motion to bifurcate the trial into separate stages of liability and damages. On October 23 and November 19, 2001, the court granted Community Bank's motion to dismiss without prejudice three of the employees of the automobile dealership as defendants in the action.

The defendants have filed answers to the amended complaint which generally deny the material allegations in the complaint and allege that any injury suffered by Community Bank was the result of the contributory negligence of Community Bank, its officers, employees and agents. In the lawsuit, Community Bank seeks damages of an unspecified amount to recover losses incurred in connection with the loans made at Community Bank's Wal-Mart office in Ft. Payne, Alabama, along with all costs associated with the lawsuit. Any amounts received by Community Bank as a result of this litigation will be treated as a recovery on loan losses.

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NOTE 5 - CONTINGENCIES - Continued

### Employee Litigation

On November 15, 2000, Michael W. Alred and Michael A. Bean, two former directors and executive officers of Community Bank, filed suit against Community Bank in the United States District Court for the Northern District of Alabama alleging that their employment was wrongfully terminated for allegedly providing information to bank regulatory and law enforcement authorities concerning possible violations of laws and regulations, gross mismanagement, gross waste of funds and abuse of authority by Community Bank, its directors, officers and employees. According to the complaint, the information which these two individuals provided to authorities concerned certain bank construction projects, specific loans, charge-offs, expenses and past due accounts. The complaint seeks reinstatement of the plaintiffs to their former positions as officers and directors of Community Bank as well as compensatory and punitive damages. Community Bank and its directors believe this lawsuit is without merit and intend to defend the action vigorously. Management of the Company 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 litigation 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

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of Community Bank.

### NOTE 6 - SUBSEQUENT EVENTS

On May 03, 2002, Community Bank consummated the sale of its Rainsville and Ft. Payne bank offices and recorded a gain of approximately \$1,588,000, representing an 8% premium on the 30-day average of core deposits equaling approximately \$1,645,000 less a discount on loans of approximately \$57,000.

The sale of the Bank's Marshall County offices is expected to occur on May 31, 2002, assuming satisfaction of customary conditions prior to closing. This transaction is expected to result in a gain representing an 8% premium on the 30 day average of core deposits less the agreed upon discount on loans.

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### NOTE 7 - RECENTLY ISSUED ACCOUNTING STANDARDS

In June 1998, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 133, Accounting for Derivative Instruments and Hedging Activities. This statement establishes accounting and reporting standards for derivative instruments and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial condition and measure those instruments at fair value. The accounting for changes in the fair value of a derivative is to be determined based upon the intended use of the derivative. For certain hedge designations (cash flow and foreign currency exposure) the derivative's gain or loss is reported as a component of other comprehensive income. Other designations require the gain or loss to be recognized in earnings in the period of change. This statement, amended as to effective date by SFAS No. 137, is effective for financial statements for periods beginning after June 15, 2000. In June 2000, the Financial Accounting Standards Board also issued SFAS No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities - an Amendment of SFAS No. 133. The adoption of SFAS No. 133, as amended by SFAS No. 138 did not have a material impact on the Company's consolidated financial statements.

In September 2000, the FASB issued SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities - a replacement of FASB Statement No. 125. While SFAS No. 140 carries over most of the provisions of SFAS No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, it provides new standards for reporting financial assets transferred as collateral and new standards for the derecognition of financial assets, in particular transactions involving the use of special purpose entities. SFAS No. 140 also prescribes additional disclosures for collateral transactions and for securitization transactions accounted for as sales. The new collateral standards and disclosure requirements are effective for fiscal years ending after December 15, 2000, while the new standards for the derecognition of financial assets are effective for transfers made after March 31, 2001. The adoption of this statement did not have a material effect on the Company's consolidated financial statements.

In June 2001, the FASB issued SFAS No. 141, Business Combinations. This statement addresses financial accounting and reporting for business combinations and supersedes ABP Opinion No. 16, Business Combinations, and SFAS No. 38, Accounting for Preacquisition Contingencies of Purchased Enterprises. All business combinations in the scope of SFAS No. 141 are to be accounted for using

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one method, the purchase method. Prior to the issuance of this statement, subject to certain criteria, business combinations were accounted for using one of two methods, the pooling-of-interests method or the purchase method. The two methods produce different financial statement results. The single-method approach used in SFAS No. 141 reflects the conclusion that virtually all business combinations are acquisitions and therefore should be accounted for in the same manner as other asset acquisitions based on the values exchanged. This statement provides expanded and revised guidance related to the allocation of the purchase price to goodwill and other intangibles arising from the business combination. The provisions of SFAS No. 141 apply to all business combinations initiated after June 30, 2001. The adoption of SFAS No. 141 has not had a material effect on the Company's consolidated financial statements.

In June 2001, the FASB issued SFAS No. 142, Goodwill and Other Intangible Assets, which addresses financial accounting and reporting for acquired goodwill and other intangible assets and supersedes APB Opinion No. 17, Intangible Assets. SFAS No. 142 provides new standards for accounting relating to intangible assets after initial recognition in the financial statements. This statement proscribes the accounting practice of amortizing or expensing intangibles ratably over a prescribed period of time and imposes new guidance requiring that goodwill and certain other intangibles be tested for impairment at least annually by comparing fair values of those assets with their recorded amounts. Additional disclosure requirements also are provided. The provisions of SFAS No. 142 are required to be applied in fiscal years beginning after December 15, 2001. The adoption of this statement is not expected to have a material effect on the Company's consolidated financial statements.

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### NOTE 7 - RECENTLY ISSUED ACCOUNTING STANDARDS - Continued

In June 2001, the FASB issued SFAS No. 143, Accounting for Asset Retirement Obligations. This statement requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. This statement is effective for financial statements issued for fiscal years beginning after June 15, 2002. The adoption of this statement is not expected to have a material effect on the Company's consolidated financial statements.

In August 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-lived Assets. This statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets. This statement supersedes FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of, and the accounting and reporting provisions of APB Opinion No. 30, Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions, for the disposal of a segment of a business (as previously defined in that opinion). This statement also amends Accounting Research Bulletin No. 51, Consolidated Financial Statements, to eliminate the exception to consolidation for a subsidiary for which control is likely to be temporary. The major changes resulting from this statement relate to the establishment of a single method for the recognition of impairment losses on long-lived assets to be held and used whether from discontinuance of a business segment or otherwise. This statement is effective for financial statements issued for fiscal years beginning after December 15, 2001. The adoption of this statement has not had a material effect on the Company's consolidated financial statements.

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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, 2001.

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 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

March 31, 2002 compared to December 31, 2001

Summary

Total assets at March 31, 2002 were approximately \$690,602,000, down from approximately \$729,482,000 at December 31, 2001. The decrease in total assets was mainly attributable to both the sale of Community Bank's Pulaski, Tennessee branches as well as an overall decrease in loan volume. Refer to



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"Notes to Consolidated Financial Statements, Note 2-Business Combinations" throughout the discussion of financial condition.

### Earning Assets

The earning assets of the Company are mainly composed of investment securities, federal funds sold and loans. Investment securities decreased \$10,295,000, or 8.5%, to approximately \$111,384,000 at March 31, 2002 from approximately \$121,679,000 at December 31, 2001. 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 \$200,000 at both March 31, 2002 and December 31, 2001. The Company had \$45,395,000 in federal funds sold at March 31, 2002, compared to \$30,000,000 at December 31, 2001, representing an increase of \$15,395,000, or 51.3%. The increase in federal funds sold was primarily due to the decline in outstanding loans during the first quarter of 2002. Management has also kept federal funds sold balances at high levels in anticipation of funding necessary to consummate the sale of its branch offices.

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Loans comprise the largest single category of the Company's earning assets. Loans, net of unearned income, were approximately \$465,475,000 at March 31, 2002 down \$36,045,000, or 7.2%, from \$501,520,000 at December 31, 2001. This decrease is partly attributable to the sale of the loan portfolio in the Pulaski, Tennessee branches sale, but the Company continues to experience a decline in total loans because of economic downturns, the tightening of the Company's credit standards, and increased charge-offs of loans made in previous years.

### Nonperforming Assets and Past Due Loans

Between December 31, 2001 and March 31, 2002, 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 58.37% at year-end 2001 to 55.19% at March 31, 2002. The ratio of total nonperforming assets to total assets increased to 1.89% at March 31, 2002 from 1.71% at year-end 2001, while the ratio of nonperforming loans to total loans, net of unearned income, increased to 1.85% at March 31, 2002 from 1.64% at December 31, 2001. These changes were primarily due to an increase in nonaccruing loans of \$764,000, or 13.0%, to approximately \$6,623,000 at March 31, 2002 from \$5,859,000 at December 31, 2001 and an increase in other real estate of \$160,000, or 3.7%, to approximately \$4,447,000 at March 31, 2002 from approximately \$4,287,000 at December 31, 2001. These increases were partially offset by a decline in loans past due 90 days or more of \$368,000, or 15.7%, to approximately \$1,978,000 at March 31, 2002 from approximately \$2,346,000 at December 31, 2001. Total nonperforming assets increased \$556,000, or 4.5%, to approximately \$13,048,000 at March 31, 2002 from approximately \$12,492,000 at December 31, 2001. In their efforts to improve the asset quality and credit standards of the Company, management continues to recognize problem credits in a more timely manner through the loan review process implemented in 2001.

### 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 approximately \$577,637,000 at March 31, 2002 reflected a decrease of \$40,069,000, or 6.5%, from approximately \$617,706,000 at year-end

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2001. Deposits are Community Bank's primary source of funds. Noninterest-bearing deposits increased \$1,185,000, or 1.8%, to approximately \$68,881,000 at March 31, 2002 from approximately \$67,696,000 at December 31, 2001, while interest-bearing deposits decreased \$41,254,000, or 7.5%, to approximately \$508,756,000 at March 31, 2002 from approximately \$550,010,000 at December 31, 2001. Certificates of deposit of \$100,000 or more decreased \$12,299,000, or 10.3%, to approximately \$107,237,000 at March 31, 2002 from, approximately \$119,536,000 at December 31, 2001. The sale of the Pulaski, Tennessee branches attributed to approximately \$35,328,000 of the decrease in total deposits.

Total short-term liabilities increased approximately \$475,000, or 10.9%, to approximately \$4,835,000 at March 31, 2002 from approximately \$4,360,000 at December 31, 2001. FHLB borrowings remained constant at \$38,000,000 for both March 31, 2002 and December 31, 2001 while long-term debt decreased \$271,000, or 5.8%, to approximately \$4,396,000 at March 31, 2002 from approximately \$4,667,000 at December 31, 2001.

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 elected to defer its March 2002 interest payment 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 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.

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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 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.

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### Liquidity

The following is a discussion of cash flows. The Company experienced an approximate \$10,075,000 increase in cash and cash equivalents during the first three months of 2002. Cash provided by operating activities was approximately \$2,439,000. Investing activities provided an increase of approximately \$12,141,000 despite a cash payment of approximately \$8,294,000 in the sale of Community Bank's Pulaski, Tennessee branches. This payment was offset by increases in cash from other investing activities such as proceeds from the sale or calls of securities and decreases in loans to customers. Financing activities used approximately \$4,504,000 of cash and cash equivalents for the first quarter of 2002. Certificates of deposits decreased approximately \$11,356,000 excluding any decreases for the Pulaski, Tennessee branches, but was partially offset by increases in cash from the growth of demand deposits, NOW deposits, and other savings deposits totaling approximately \$6,615,000 also excluding any decreases due to the sale of the Pulaski, Tennessee branches.

In addition to the sale of the Pulaski, Tennessee branches, Community Bank has entered into agreements to sell eight more of its banking offices in the second quarter of 2002. Under each agreement the purchaser will receive the assets of each banking office mostly consisting of loans and fixed assets and will assume the liabilities, most of which are deposits. The cash transaction will be based upon the assets, liabilities and premium due to Community Bank at the time of each closing. Since the remaining offices, as a whole, carry more deposits than loans and other assets, Community Bank will disburse funds as a result of the transactions. The DeKalb County sale closed on May 3, 2002. After all settlements are finalized, the cash paid out in the sale will be approximately \$9.0 million. The Marshall County sale is expected to close on May 31, 2002 and although settlement amounts can not be determined until closing, management expects to pay as much as \$12 to \$13 million cash at settlement. Management expects the federal funds sold balance to remain at levels high enough to provide the funding of any cash disbursements upon the closing of these branch sales; however, these transactions will decrease the availability of liquid funds.

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 Community Bank in the form of management fee income and generally retains cash for its portion of tax benefit on intercompany income tax settlements. Without dividends or management fee income from Community Bank, the Company would not be able to pay expenses or service debt. Management fees for the first quarter of 2002 were \$75,000. Community Bank is unable to pay a dividend to the Company without prior approval of the regulatory authorities nor is the Company able to increase the management fee charged to Community Bank without the prior written approval of the Federal Reserve.

### Capital Resources

Total shareholders' equity at March 31, 2002 was 6.05% of total assets as compared to 5.57% at December 31, 2001. The increase experienced during the first three months of 2002 is primarily a result of increased retained earnings from net income of approximately \$1,233,000 offset slightly by a decrease in accumulated other comprehensive income coupled with a decline in total assets attributable to the sale of the Pulaski, Tennessee branches.

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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 approximately \$49,355,000 at March 31, 2002, compared to approximately \$49,118,000 at December 31, 2001. 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 approximately \$56,654,000 at March 31, 2002 as compared to \$56,833,000 at year-end 2001. The percentage ratios, as calculated under the guidelines, for Tier I and Total Risk-based capital were 10.77% and 12.37%, respectively, at March 31, 2002, compared to 10.02% and 11.59%, respectively, at year-end 2001. At March 31, 2002, 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 6.83% and 6.70% at March 31, 2002 and December 31, 2001, respectively, exceeding the regulatory minimum requirement of 4%.

### RESULTS OF OPERATIONS

Three months ended March 31, 2002 and 2001

#### Summary

The Company's net income for the three months ended March 31, 2002 was approximately \$1,233,000, an increase of \$428,000, or 53.2%, from \$805,000 for the same period in 2001. Both basic and diluted net income per share was \$0.27 for the three months ended March 31, 2002, as compared to \$0.18 for the same period in 2001. This increase during the first quarter of 2002 compared to the same period of 2001 resulted from an increase of approximately \$684,000 or 10.9% in net interest income, before provision for loan losses, and an increase of \$860,000, or 32.1%, in noninterest income offsetting an increase of approximately \$745,000, or 10.8%, in noninterest expense during the first quarter of 2002 compared to the first quarter of 2001. The provision for loan losses increased \$89,000, or 9.4%, to approximately \$1,040,000 during the three months ended March 31, 2002, from approximately \$951,000 in the same period of 2001.

#### Net Interest Income

The following discussion is on a fully taxable equivalent basis. Net interest income, the difference between interest earned on assets and the cost of interest-bearing liabilities, was approximately \$7,092,000 for the three months ended March 31, 2002. Net interest income, before provision for loan losses, increased \$649,000, or 10.1%, from approximately \$6,443,000 for the same period of 2001. Revenues from interest earning assets of the Company decreased \$2,279,000, or 14.9%, to approximately \$12,978,000 for the three months ended March 31, 2002 from approximately \$15,257,000 for the same period in 2001. This decrease was due to lower yields on interest earning assets. Average earning assets outstanding during the first quarter of 2002 were approximately \$646,085,000, which represents an increase of approximately \$7,256,000, or 1.14%, from approximately \$638,829,000 for the first quarter of 2001. The

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Company's fully taxable equivalent yield on its average earning assets decreased 154 basis points to 8.15% for the first three months of 2002, compared to 9.69% for the same period of 2001. This decrease is reflective of the overall decrease in interest rates experienced during the year 2001. Interest expense for the three months ended March 31, 2002 decreased approximately \$2,928,000, or 33.2%, to \$5,886,000 from \$8,814,000 for the corresponding period of 2001. This decrease occurred due to a decline in rates paid on interest-bearing liabilities and more than offset the decline in income on interest-bearing assets. Average interest-bearing liabilities during the first quarter of 2002 were approximately \$605,001,000, which represents an increase of \$8,198,000, or 1.4%, from approximately \$596,803,000 for the same period of 2002. The rate paid on average interest-bearing liabilities decreased 204 basis points to 3.95% for the three month period ended March 31, 2002, compared to 5.99% for the first three months of 2001. This decrease is also attributable to the overall decline in interest rates during the year 2001.

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The Company's net interest margin, on a fully taxable equivalent basis, for the three months ended March 31, 2002 increased 36 basis points to 4.45%, from 4.09% for the three months ended March 31, 2001, due to the increase in net interest income, on a fully taxable equivalent basis. Net interest margin is computed by dividing net interest income, on a fully taxable equivalent basis, 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, on a fully taxable equivalent basis, for the three months ended March 31, 2002 increased 50 basis points to 4.20%, from 3.70% for the three months ended March 31, 2001, as the average cost of interest-bearing sources of funds decreased 204 basis points while the fully taxable equivalent average yield on interest earning assets decreased 154 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.

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

At March 31, 2002, the allowance for loan losses was \$7,201,000 which represented a decrease of \$91,000, or 1.2%, from the December 31, 2001 amount of \$7,292,000. This decrease includes a decrease of approximately \$278,000 as a result of the sale of the Pulaski, Tennessee branches. The provision for loan losses was \$1,040,000 and \$951,000 for the three months ended March 31, 2002 and 2001, respectively. This increase resulted from management's decision 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 1.54% at March 31, 2002, compared to 1.45% at December 31, 2001. Loan charge-offs exceeded recoveries by \$854,000 during the first three months of 2002, which represented an increase of \$289,000, or 51.2%, from \$565,000 for the same period during 2001. Management believes that the allowance for loan losses at March 31, 2002 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

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Noninterest income for the three months ended March 31, 2002 increased \$860,000, or 32.1%, to approximately \$3,535,000, from approximately \$2,675,000 for the same period of 2001, due to a gain recognized on the sale of Community Bank's Pulaski, Tennessee branches. Service charges on deposit accounts decreased \$41,000, or 4.0%, to approximately \$985,000 for the first quarter of 2002 from approximately \$1,026,000 in the first quarter of 2001. Debt cancellation fees decreased during the first quarter of 2002, as compared to the first quarter of 2001, approximately \$79,000, or 52.0%, due to decreased volume in debt cancellation coverage associated with the decline in the Company's loan portfolio. Other operating income decreased \$217,000, or 50.0%, to approximately \$217,000 for the first quarter of 2002 from approximately \$434,000 for the same period of 2001. The Company recorded net gains on the sale of investment securities of approximately \$17,000 during the three months ended March 31, 2002, compared to net gains on the sale of investment securities of approximately \$353,000 for the same period of 2001. The Company also recognized a gain on the sale of its Pulaski, Tennessee branches of approximately \$1,551,000 representing a 7% premium on the 30 day average of core deposits less an agreed upon discount on loans and fixed assets.

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### Noninterest Expenses

Noninterest expenses for the three months ended March 31, 2002 were approximately \$7,623,000, representing a \$745,000, or 10.8%, increase from \$6,878,000 for the same period of 2001. This increase is in most part due to a loss recognized on the disposal of one building located in Uniontown, Alabama and one building located in New Hope, Alabama. The primary components of noninterest expenses are salaries and employee benefits, which decreased \$102,000, or 2.5%, to approximately \$3,979,000 for the three months ended March 31, 2002 from approximately \$4,081,000 for the same period of 2001. The decrease in salaries and employee benefits is attributable to management's continued effort to lower staff costs by increasing efficiencies. Occupancy costs increased \$43,000, or 6.0%, to approximately \$755,000 for the first quarter of 2002 from approximately \$712,000 for the same period of 2001. Furniture and equipment expenses for the three month periods ended March 31, 2002 increased \$14,000, or 3.1%, to approximately \$464,000 from approximately \$450,000 for the same period of 2001. Director and committee fees decreased \$10,000, or 8.5%, to approximately \$108,000 for the first quarter of 2002 from approximately \$118,000 for the first quarter of 2001. Other operating expenses were approximately \$1,922,000 and \$1,504,000 for the three month periods ended March 31, 2002 and 2001, respectively. This increase of approximately \$418,000, or 27.8%, was primarily due to increased expenses, especially legal fees, related to the continued litigation against the Company.

### Income Taxes

The Company attempts to maximize its net income through active tax planning. The provision for income taxes increased \$282,000, or 84.9%, to approximately \$614,000 for the three months ended March 31, 2002 from approximately \$332,000 for the same period of 2001. The effective tax rate of approximately 33.3% for the first quarter of 2002 represents an increase from the effective tax rate of approximately 29.2% for the same period of 2001.

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

The estimated impact on Community Banks net interest income sensitivity over a one year time horizon at March 31, 2002 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 Basis Points	Level (Dollars in thou)
Prime Rate.....	3.75%	4.75%
Interest Income.....	\$ 44,345	\$ 46,711
Interest Expense.....	16,463	18,416
	-----	-----
Net Interest Income.....	\$ 27,882	\$ 28,295
	=====	=====
Dollar change from Level.....	\$ (413)	
Percentage change from Level.....	-1.46%	

As shown above, in a 100 basis point rising rate environment, the net interest margin should increase 1.26% and in a 100 basis point falling rate environment, the net interest margin should decrease 1.46%. These percent changes from a level rate scenario fall comfortably within Community Bank's ALCO policy limit of +/-7.00%.

PART II OTHER INFORMATION

Item 1 - Legal Proceedings

No reportable events or material developments have occurred since the filing of

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the Company's Annual Report on Form 10-K, for the year ended December 31, 2001, and filed on April 16, 2002.

Item 6 - Exhibits and Reports on Form 8-K

(a) Exhibits

11 Statement of computation of per share earnings

(b) Reports on Form 8-K

The Company did not file any reports on Form 8-K during the first quarter ended March 31, 2002.

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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 \_\_\_\_\_.

COMMUNITY BANCSHARES, INC.

By: /s/ KENNON R. PATTERSON, SR.

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Kennon R. Patterson, Sr.  
Chairman, Chief Executive Officer and President

By: /s/ KERRI C. NEWTON

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Kerri C. Newton  
Chief Financial Officer

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