UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2005

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from ______ to ______

Commission file number 000-16461

Community Bancshares, Inc.

(Exact Name of Registrant as Specified in Its Charter)

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

Registrant s telephone number, including area code (205) 429-1000

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
None	None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, $.10 Par Value Per Share

(Title of Class)

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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 x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of in the Exchange Act.

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ¨ No x

The aggregate market value of Community Bancshares, Inc. s common stock, par value $.10 per share, held by non-affiliates on June 30, 2005 was $66.1 million.

As of March 30, 2006, there were 8,792,641 shares of the common stock, par value $.10 per share, of Community Bancshares, Inc., issued and outstanding.

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IMPORTANT INFORMATION ABOUT THIS REPORT

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

The words Community Bancshares, Community Bank, Community Credit, Community Insurance, Southern Select, Community Appraisals Community Funding refer, respectively, to each of the above entities in their individual capacities.

SPECIAL CAUTIONARY NOTICE REGARDING FORWARD-LOOKING STATEMENTS

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

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

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

- our business strategy;
- future performance, developments, transactions or market forecasts;
- projected benefits to us as a result of any changes in our regulatory restrictions; and
- projected investments and dispositions of assets.

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

- future economic or business conditions;
- governmental monetary and fiscal policies, as well as legislative and regulatory changes, including changes in tax laws and regulations;
- the risks of changes in interest rates on the levels, composition and costs of deposits, loan demand, and the values of loan collateral, securities, and interest sensitive assets and liabilities;
- interest rate risks and credit risks of borrowers;

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

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

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

changes in accounting policies, rules and practices;

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

the outcome of our proxy contest with one of our stockholders, including as the result of the actions that may be taken by the alternative slate of directors nominated by that stockholder, if such directors are elected;

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

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

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

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PART I

ITEM 1. BUSINESS.

General

Our company is made up of the following entities:

- Community Bancshares, Inc., a Delaware bank holding company that owns 100% of Community Funding, Community Bank and indirectly, Community Bank s subsidiaries;
- Community Bank, a community-focused Alabama commercial bank;
- 1st Community Credit Corporation, a finance company subsidiary of Community Bank;
- Community Insurance Corp., a subsidiary of Community Bank that is as an insurance agency for the sale of title, property, casualty and life insurance to individuals and businesses;
- Southern Select Insurance, Inc., a subsidiary of Community Insurance that brokers agricultural, commercial and personal insurance products;
- Community Appraisals, Inc., a subsidiary of Community Bank that provided appraisal services in connection with the lending activities of Community Bank and its subsidiaries, but ceased operations in late 2003; and
- Community Funding Corporation, a subsidiary of Community Bancshares, Inc. formed on December 30, 2003 to purchase and maintain certain nonperforming assets of Community Bank.

As of December 31, 2005, we had total consolidated assets of $572.5 million, total deposits of $438.9 million, total consolidated liabilities, including deposits, of $528.1 million, and consolidated stockholders equity of $44.3 million.

Our principal executive offices, which also serve as the principal executive offices of Community Bank, Community Appraisals and Community Funding, are located at 68149 Main Street, Blountsville, Alabama 35031, and our telephone number at that address is (205) 429-1000. The principal executive offices of Community Credit are located at 587 Highway 31 N.W., Suite A, Hartselle, Alabama 35640, and the telephone number at that address is (256) 751-2031. The principal executive offices of Community Insurance and Southern Select are located at 401 Holmes Avenue, Huntsville, Alabama 35801, and the telephone number at that address is (256) 533-5600.

Community Bancshares

Community Bancshares is a Delaware corporation that is registered as a bank holding company with the Board of Governors of the Federal Reserve System, or the Federal Reserve, under the Bank Holding Company Act of 1956, as amended, or the BHC Act. Community Bancshares was organized in 1983 and commenced business in 1985.

Our Commercial Banking Business

We conduct our commercial banking operations through Community Bank. Community Bank is an Alabama banking corporation founded in 1923. Community Bank is a member of the FDIC and its deposits are insured by the FDIC.

Community Bank operates through 18 locations in nine counties in Alabama. Community Bank offers a wide range of commercial and retail banking services, which principally include checking transaction accounts and personal and commercial loans to customers in our target market area. Community Bank seeks to provide its customers with outstanding service and to become a vital component of each of the communities that it serves. We believe that the retail nature of Community Bank s commercial banking operations allows for diversification of customers and that our loans to businesses are not concentrated in any one industry.

Community Bank s lending activities include commercial, real estate and consumer loans. The majority of Community Bank s loans are to individuals and small to mid-sized businesses in Alabama. Its commercial loan services include term loans, lines of credit and agricultural loans. It provides a broad range of short to medium-term commercial loans, both secured and unsecured, to various local businesses for working capital, business expansion and the purchase of equipment and machinery. Its real estate lending activities include fixed and adjustable rate residential mortgage loans, construction loans, second mortgages, home improvement loans and home equity lines of credit. Its consumer lending services include loans for automobiles, recreational vehicles and boats, as well as unsecured personal loans and loans secured by deposit accounts.

Community Bank operates primarily in small non-urban communities. As of December 31, 2005, Community Bank operated 17 full service offices and one paying and receiving office located in a Wal-Mart® store, which primarily opens deposit accounts, cashes checks and receives deposits and loan payments.

For the year ended December 31, 2005, Community Bank had pretax income of $3.6 million. During the fiscal years 2004 and 2003, Community Bank had pretax income of $1.5 million and a pretax loss of $(19.6) million, respectively. Its loan portfolio, which made up 58.8% of our assets at December 31, 2005, 54.3% at December 31, 2004 and 56.6% at December 31, 2003, continues to represent our largest earning asset. As of December 31, 2005, Community Bank had total commercial banking loans of $336.4 million.

Our Other Operations

Consumer Finance Operations

1st Community Credit Corporation operates 15 finance company offices in Limestone, Madison, Morgan, Blount, Cullman, Marshall, Etowah, DeKalb, Walker, Talladega and St. Clair Counties, Alabama, primarily in local communities where Community Bank does not operate. Community Credit provides smaller loans to a market segment traditionally not pursued by Community Bank. These loans typically involve greater risk and generate higher yields than standard commercial bank loans. We believe that, by conducting this business, we reach a customer base not served by our banking operations. For the year ended December 31, 2005, Community Credit had a pretax income of $0.7 million. For the years ended December 31, 2004 and December 31, 2003, we had $1.4 million and $0.9 million, respectively, in pretax income from the operations of Community Credit. At December 31, 2005, the loan portfolio at Community Credit was $37.2 million, representing 6.5% of our total consolidated assets. At December 31, 2004 and 2003, the loan portfolio at Community Credit was $35.2 million and $31.2 million, representing 6.4% and 5.6% of our total assets, respectively.

Insurance Agency Operations

Community Insurance Corp. serves as an agency in the sale of title, property, casualty and life insurance products to individuals and businesses in the Huntsville metropolitan area. Community Insurance owns 100% of Southern Select Insurance, Inc., a managing general agency in Huntsville that brokers agricultural, commercial and personal insurance products. For the years ended December 31, 2005, 2004 and 2003, we had $73,000, $81,000 and $(486,000), respectively, in pretax income (losses) from our insurance agency.

Appraisal Operations

Community Appraisals, Inc. previously provided appraisal services in connection with the lending activities of Community Bank and Community Credit. For the years ended December 31, 2004 and 2003, our appraisal business generated $1,000 and $6,000, respectively, in pretax losses. At this time and during all of 2005, Community Appraisals was inactive and therefore generated no income. Community Bank outsources its appraisal needs to qualified third parties.

Asset Quality Improvement

Community Funding Corporation was formed in December 2003 for the purpose of purchasing and maintaining certain of Community Bank s nonperforming assets in order to improve Community Bank s asset quality. Community Funding conducted no business in 2003. Since its formation, Community Bancshares has capitalized Community Funding with $4.0 million. Community Funding has used the cash to purchase nonperforming assets from Community Bank. The pretax loss for Community Funding for the year ended December 31, 2004 was $2,300. At December 31, 2005, Community Funding owned $4.0 million in assets and had a pretax loss of $15,000.

Our Market Area

Community Bank currently has 18 branches in nine counties, most of which are situated in northern Alabama. We serve customers in five counties in north Alabama Blount, Lauderdale, Limestone, Madison and Morgan Counties; two counties in northwest Alabama Marion and Winston Counties; and two counties in southwest Alabama Marengo and Perry Counties. We have focused on those market areas between the Birmingham and Huntsville metropolitan areas, where significant growth and economic change have transpired over the last decade.

Community Bank s primary market area is Blount County, which was added to the Birmingham metropolitan area in 1983. The Birmingham Metropolitan Statistical Area, or MSA, consists of seven counties and is home to approximately 1.1 million people, representing the most populous MSA in the State of Alabama. Once known as the South s largest manufacturing center, Birmingham previously relied heavily on both the steel and manufacturing industries. Manufacturing remains an important part of Birmingham s economy but the economy has become more

diverse in its industries, and, according to the Birmingham Regional Chamber of Commerce, the healthcare, banking and professional services industries are its leading economic sectors and largest employers.

Community Bank also has customers in four counties Lauderdale, Limestone, Madison and Morgan Counties which are proximate to or within the Huntsville MSA, currently one of Alabama s fastest growing metropolitan areas. According to the Huntsville Chamber of Commerce, Huntsville s achievements include outstanding job growth in primary business sectors and confirmation of over 4,700 direct jobs slated to come to Redstone Arsenal between now and 2011 as a result of the U.S Department of Defense Base Realignment and Closure Process.

Huntsville possesses a diverse economic base and is home to numerous industries, including technology, space and defense, manufacturing, and retail and service. Huntsville is home to numerous centers of global excellence, including the Cummings Research Park (over 22,000 employees and more than 220 companies, according to the Huntsville Chamber of Commerce), the NASA Marshall Space Flight Center, and the US Army Redstone Arsenal.

Community Bank has branches in Marion, Lauderdale and Winston Counties, located in northwest Alabama, near the Mississippi border. These counties are economically driven by manufacturing and furniture production. Community Bank also operates in Marengo and Perry Counties, located in southwest Alabama, where manufacturing, catfish farming, livestock and the timber industry are important components of the local economy. These are relatively low growth areas, with income levels that are below Alabama averages.

Community Bank Foundation

In early 2004, the Board of Directors of Community Bank authorized the establishment of the Community Bank Foundation (the Foundation). The Foundation is a private non-profit organization established as a vehicle for making a positive contribution to the communities in which Community Bank and its subsidiaries do business. The Foundation has been notified by the Internal Revenue Service of its approval as a tax exempt organization. It is anticipated that the Foundation will award college scholarships to deserving high school seniors, make contributions to schools, hospitals, senior citizen centers, centers for abused children or spouses, children s camps and other worthy organizations whose purpose is to make our communities better places to live and work.

Competition

The banking business in Alabama is highly competitive with respect to loans, deposits and other financial services and is dominated by a number of major banks and bank holding companies that have offices and affiliates operating over wide geographic areas, and that have greater resources at their disposal than we do. We compete for deposits, loans and other business with these institutions as well as with other types of financial services entities, including savings and loan associations, credit unions, securities and mutual fund firms, mortgage companies, and insurance companies. Many of the major commercial banks operating in or around Community Bank s service areas offer services such as investment and trust services, which we do not currently offer. As a community bank, we compete through our community identity, customer loyalty and customer service tailored to the needs of our local residents.

Our competitive environment has been and will continue to be materially affected by the enactment by Congress of the Gramm-Leach-Bliley Financial Services Modernization Act of 1999, or the GLB Act. This law authorized a bank holding company that possesses a prescribed amount of capital and meets other criteria to become a financial holding company, which enables it to then engage in investment banking, insurance underwriting and the sale of insurance, as well as any other activity that federal regulators view as financial in nature. We may face greater competition as more financial holding companies enter our market area and offer a more diverse line of financial products and consolidated financial services than we may offer.

Seasonality

Our management believes that our business, including our subsidiaries businesses, is not seasonal in nature.

Customer Concentration

For each of the years ended December 31, 2005, 2004 and 2003, we did not, and we presently expect for the year ended December 31, 2006, that we will not derive more than 10% of our revenues, on a consolidated basis, from any one customer.

Employees

At December 31, 2005, the Company had 277 full-time equivalent employees.

Supervision and Regulation

The banking and financial services industry is extensively regulated under both federal and state law. The following discussion summarizes certain statutes, rules and regulations affecting our business and operations. This summary is qualified in its entirety by reference to the statutory and regulatory provisions referred to below and elsewhere and is not intended to be an exhaustive description of the statutes or regulations applicable to us. Changes in the laws and regulations that apply to us can affect our operations in substantial and unpredictable ways. We cannot

accurately predict whether legislation will be enacted, and, if enacted, the ultimate effect that it or any implementing regulations will have on our business, financial condition or results of operations.

The following summary describes our regulatory environment in the absence of any restrictive memoranda, orders or agreements with our regulators and therefore is further subject to, and does not address, the regulatory restrictions to which we have been subject. You

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should refer to and carefully review these restrictions, which are described below in this report. To the extent that the limitations imposed by those regulatory restrictions on our business activities are different than as described in this summary, then the regulatory restrictions govern.

Supervision, regulation, and examination of holding companies and banks by bank regulatory agencies are intended primarily for the protection of depositors rather than holders of our securities, including our preferred stock and common stock.

Holding Company Regulation

General

Community Bancshares is a bank holding company within the meaning of the BHC Act, and is subject to supervision, examination, and reporting by the Federal Reserve. The State of Alabama does not currently regulate bank holding companies. Community Bancshares is required to file with the Federal Reserve periodic reports and any additional information as the Federal Reserve may require. The Federal Reserve regularly examines Community Bancshares and may examine its subsidiaries.

Investment Activities

The BHC Act requires prior Federal Reserve approval for, among other things:

- the acquisition by a bank holding company of direct or indirect ownership or control of more than 5% of the voting shares or substantially all of the assets of any bank; and

- a merger or consolidation of a bank holding company with another bank holding company.

The Change in Bank Control Act and Federal Reserve regulations also generally require a notice and prior action thereon if anyone not subject to the BHC Act application acquires 10% or more of a bank s or its parent holding company s securities where the bank or holding company has a class of securities registered under the Exchange Act.

A bank holding company may acquire direct or indirect ownership or control of voting shares of any company that is engaged directly or indirectly in banking, managing or controlling banks, or performing services for its authorized subsidiaries. A bank holding company may also engage in or acquire an interest in a company that engages in activities that the Federal Reserve has determined by regulation or order to be so closely related to banking as to be a proper incident to those activities.

The GLB Act made substantial revisions to the statutory restrictions separating banking activities from certain other financial activities. Under the GLB Act, bank holding companies that are well-capitalized and well-managed and meet other conditions can elect to become financial holding companies. Financial holding companies and their subsidiaries are permitted to acquire or engage in previously impermissible activities such as insurance underwriting, securities underwriting and distribution, travel agency activities, board insurance agency activities, merchant banking, and other activities that the Federal Reserve determines to be financial in nature or complementary to those activities. In addition, under the merchant banking authority added by the GLB Act and Federal Reserve regulations, financial holding companies are authorized to invest in companies that engage in activities that are not financial in nature, as long as the financial holding company makes its investment with the intention of limiting the investment in duration, does not manage the company on a day-to-day basis, and the investee company does not cross-market with any of the financial holding company s controlled depository institutions. Financial holding companies continue to be subject to the overall oversight and supervision of the Federal Reserve, but the GLB Act applies the concept of functional regulation to the activities conducted by subsidiaries. For example, insurance activities would be subject to supervision and regulation by state insurance authorities. Community Bancshares has not sought approval to become a financial holding company and presently has no intention of doing so.

Source of Financial Strength

Federal Reserve policy requires a bank holding company to act as a source of financial and managerial strength to its subsidiary banks. This means that a bank holding company must be prepared to use available resources to provide adequate capital funds to its bank subsidiaries during periods of financial stress and must have sufficient financial flexibility and capital-raising capacity to provide ongoing support to the banks. In addition, under the Financial Institutions Reform, Recovery and Enforcement Act of 1989, or FIRREA, if a bank holding company has more than one bank or thrift subsidiary, each of the bank holding company s subsidiary depository institutions are responsible for any losses to the

FDIC as a result of an affiliated depository institution s failure. As a result, a bank holding company may be required to loan money to its subsidiaries in the form of capital notes or other instruments which qualify as capital under regulatory rules. Any loans from a bank holding company to its subsidiary banks likely will be unsecured and subordinated to the bank s depositors and perhaps to other creditors of that bank.

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Transactions With Affiliates

Community Bancshares is a legal entity separate and distinct from Community Bank. Various legal limitations restrict Community Bank from lending or otherwise supplying funds to Community Bancshares or its other affiliates. Section 23A of the Federal Reserve Act limits a bank s covered transactions, which include extensions of credit with any affiliate, to 10% of the bank s capital and surplus. All covered and exempt transactions between a bank and its affiliates must be on terms and conditions consistent with safe and sound banking practices, and banks and their subsidiaries are prohibited from purchasing low-quality assets from the bank s affiliates. Finally, all of a bank s extensions of credit to an affiliate must be appropriately secured by acceptable collateral, generally United States government or agency securities.

Section 23B of the Federal Reserve Act requires that covered and exempt transactions among affiliates be on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the bank or its subsidiary, as those prevailing at the time for transactions with unaffiliated companies.

Bank Regulation

General

Community Bank is an Alabama bank whose deposits are insured by the FDIC. Community Bank is subject to regulation and examination by the Alabama Superintendent of Banks and by the FDIC. The Alabama Superintendent of Banks and the FDIC regulate and examine all of Community Bank s operations, including its overall financial condition and resources, loan loss reserves, the quality of its loan portfolio, mortgages, payments of dividends, interest rates charged, the establishment of branches, the actions of its directors and management, the investment of its funds, and compliance with its charter and the law.

The powers of Alabama-chartered banks include provisions designed to provide these banks with competitive equality to the powers of national banks. In addition, the GLB Act permits banks to engage in financial activities through subsidiaries in a manner similar to financial holding companies.

Dividends

Dividends from Community Bank historically have been Community Bancshares primary source of funds for servicing debt and paying cash dividends to our stockholders.

Under Alabama law, a bank may not pay a dividend in excess of 90% of its net earnings until its surplus is equal to at least 20% of its capital. The prior approval of the FDIC and/or the Alabama Superintendent is required if the total of all dividends declared by a bank in any calendar year will exceed the sum of that bank s net earnings for the year and its retained net earnings for the preceding two calendar years, less any required transfers to surplus. In addition, a bank may not pay dividends from its surplus without the prior approval of the Superintendent. During 2004 and 2005, Community Bank paid no cash dividends to Community Bancshares.

In addition, Community Bancshares and Community Bank are subject to various regulatory policies and requirements that affect the payment of dividends, including requirements to maintain adequate capital. The appropriate federal and state regulatory authorities are authorized to determine, based on the financial condition of a bank or bank holding company, that the payment of dividends would be an unsafe or unsound practice and to prohibit payment of those dividends. The FDIC and the Alabama Superintendent have indicated that paying dividends that deplete a bank s capital base to an inadequate level would be an unsound and unsafe banking practice.

As to Community Bancshares, the Federal Reserve may prohibit the payment of dividends to our stockholders if it determines that the payment would constitute an unsafe or unsound practice. The Federal Reserve s position is that a bank holding company should not pay dividends if it is experiencing earnings weaknesses or other financial pressures and should not pay dividends that exceed its net income, that are inconsistent with its capital position or that could only be funded in ways that weaken its financial health, such as by borrowing or selling its assets. In addition, a bank holding company must not pay dividends if such payment would affect its ability to provide adequate financial support for its subsidiary banks. As of December 31, 2004, under a Memorandum of Understanding (MOU) between Community Bancshares and the Federal Reserve Bank of Atlanta, the Federal Reserve restricted Community Bancshares from declaring or paying any dividends, including the payments on our trust preferred securities, or repurchasing our capital stock without prior Federal Reserve approval. However, because of the improved financial condition of our organization, combined with our compliance with the MOU, the MOU between Community Bancshares and the Federal Reserve was terminated on March 17, 2005.

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Safety and Soundness

The FDIC has adopted the Federal Financial Institutions Examination Council s, or the FFIEC, internal rating system for assessing the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special supervisory attention. Each financial institution is assigned a confidential composite CAMELS rating based on an evaluation and rating of the following six components of an institution s financial condition and operations:

Capital adequacy;
Asset quality;

Management;

Earnings;

Liquidity; and

Sensitivity to market risk.

For most institutions, the FFIEC has indicated that market risk primarily reflects exposures to changes in interest rates. When regulators evaluate this component, consideration is expected to be given to the sensitivity of the financial institution s earnings or the economic value of its capital to adverse changes in interest rates, foreign exchange rates, commodity prices, or equity prices; management s ability to identify, measure, monitor and control exposure to market risk; the nature and complexity of interest rate risk exposure arising from non-trading positions; and the adequacy of its capital and earnings in relation to its level of exposure.

Capital Regulations

The federal bank regulatory agencies have adopted risk-based capital guidelines for bank holding companies and banks. The guideline for a minimum ratio of capital to risk-weighted assets, including certain off-balance-sheet activities, such as standby letters of credit, is 8.0%. At least half of the total capital must consist of Tier 1 Capital, which includes common equity, retained earnings and a limited amount of qualifying preferred stock, less goodwill. The remainder may consist of Tier 2 Capital, which includes non-qualifying preferred stock, qualifying subordinated, perpetual, and/or mandatory convertible debt, term subordinated debt, intermediate term preferred stock and up to 45.0% of the pretax unrealized holding gains on available-for-sale equity securities with readily determinable market values that are prudently valued, and a limited amount of any loan loss allowance.

All bank holding companies and banks are expected to hold capital commensurate with the level and nature of their risks, including the volume and severity of their problem loans. The federal agencies have established minimum leverage ratio guidelines for bank holding companies, national banks, and state banks, which provide for a minimum leverage ratio of Tier 1 Capital to adjusted average quarterly assets equal to 3.0%, plus an additional cushion of 1.0% to 2.0% if the institution has less than the highest regulatory rating. The guidelines also provide that institutions experiencing internal growth or making acquisitions will be expected to maintain capital positions substantially above the minimum supervisory levels. Higher capital may be required in individual cases, depending upon a bank holding company s risk profile. Lastly, the Federal Reserve s guidelines indicate that the Federal Reserve will continue to consider a Tangible Tier 1 Leverage Ratio, calculated by deducting all intangibles, in evaluating proposals for expansion or new activity.

FDICIA requires the federal banking agencies to take prompt corrective action in respect of depository institutions that do not meet minimum capital requirements. FDICIA established five capital tiers:

well capitalized;

- adequately capitalized;
- undercapitalized;
- significantly undercapitalized; and
- critically undercapitalized.

A depository institution s capital tier will depend upon how its capital levels compare to various measures and certain other factors, as established by regulation. The capital measures used by the federal banking regulators are:

- the Total Capital ratio, which is the ratio of the total of Tier 1 Capital and Tier 2 Capital to total risk-weighted assets;
- the Tier 1 Capital ratio; and
- the Leverage Ratio.

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Under these regulations, a bank will be:

well capitalized if it has a Total Capital ratio of 10.0% or greater, a Tier 1 Capital ratio of 6.0% or greater, and is not subject to any written agreement, order, capital directive, or prompt corrective action directive by a federal bank regulatory agency to meet and maintain a specific capital level for any capital measure;

adequately capitalized if it has a Total Capital ratio of 8.0% or greater, a Tier 1 Capital ratio of 4.0% or greater, and a leverage ratio of 4.0% or greater or 3.0% in some circumstances and is not well capitalized;

undercapitalized if it has a Total Capital ratio of less than 8.0% or a Tier 1 capital ratio of less than 4.0%, or 3.0% in some circumstances;

significantly undercapitalized if it has a Total Capital ratio of less than 6.0%, a Tier 1 Capital ratio of less than 3.0%, or a leverage ratio of less than 3.0%; or

critically undercapitalized if its tangible equity is equal to or less than 2.0% of average quarterly tangible assets.

The following table sets forth the capital information of Community Bancshares and Community Bank as of December 31, 2005:

CAPITAL ADEQUACY RATIOS

	Actual		Minimum Capital Requirement		Minimum to be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(dollars in thousands)					
Total risk based capital to risk weighted assets:						
Consolidated	$ 58,511	15.77%	$ 29,691	8.00%	$ 37,114	10.00%
Community Bank	51,245	14.06	29,154	8.00	36,442	10.00
Tier 1 capital to risk weighted assets:						
Consolidated	53,871	14.52	14,846	4.00	22,268	6.00
Community Bank	46,689	12.81	14,577	4.00	21,865	6.00
Tier 1 capital to average assets (leverage ratio):						
Consolidated	53,871	9.58	22,504	4.00	28,130	5.00
Community Bank	46,689	8.37	22,308	4.00	27,886	5.00

Community Reinvestment Act

Community Bancshares and Community Bank are subject to the Community Reinvestment Act, or the CRA, and the federal banking agencies related regulations. Under the CRA, all banks and thrifts have a continuing and affirmative obligation, consistent with their safe and sound operation, to help meet the credit needs for their entire communities, including low and moderate-income neighborhoods. The CRA does not establish specific lending requirements or programs for financial institutions, nor does it limit an institution s discretion to develop the types of products and services that it believes are best suited to its particular community, consistent with the CRA. The CRA requires a depository institution s primary federal regulator, in connection with its examination of the institution, to assess the institution s record of assessing and meeting the credit needs of the community served by that institution, including low and moderate-income neighborhoods. The regulatory agency s assessment of the institution s record is made available to the public. Further, such assessment is required of any institution that has applied to:

- charter a bank;
- obtain deposit insurance coverage for a newly-chartered institution;
- establish a new branch office that accepts deposits;
- relocate an office; or
- merge or consolidate with, or acquire the assets or assume the liabilities of, a federally regulated financial institution.

A less than satisfactory CRA rating will slow, if not preclude, expansion of banking activities.

Current CRA regulations rate institutions based on their actual performance in meeting community credit needs. CRA performance is evaluated by the FDIC, Community Bank s primary federal regulator using a lending test, an investment test, and a service test. The FDIC also will consider:

- demographic data about the community;

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- the institution s capacity and constraints;
- the institution s product offerings and business strategy; and
- data on the prior performance of the institution and similarly situated lenders.

The Federal bank regulators recently proposed changes to their CRA regulations. Financial holding company subsidiaries must receive satisfactory or better CRA ratings to engage in financial holding company or subsidiary activities permitted by the GLB Act. Community Bank received a satisfactory CRA rating on its most recent examination.

Consumer Regulations

Interest and certain other charges collected or contracted for by Community Bank are subject to state usury laws and certain federal laws concerning interest rates. Community Bank s loan operations are also subject to certain federal laws applicable to credit transactions, such as:

- the federal Truth-In-Lending Act governing disclosures of credit terms to consumer borrowers;
- the Home Mortgage Disclosure Act of 1975 requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves;
- the Equal Credit Opportunity Act prohibiting discrimination on the basis of race, creed, or other prohibited factors in extending credit;
- the Fair Credit Reporting Act of 1978 governing the use and provision of information to credit reporting agencies;
- the Fair Debt Collection Act governing the manner in which consumer debts may be collected by collection agencies;
- The GLB Act, which requires banks and their affiliated companies to adopt and disclose privacy policies, including policies regarding the sharing of personal information they obtain from customers with third parties; and
- the rules and regulations of the various federal agencies charged with the responsibility of implementing such federal laws.

FDIC Insurance Assessments

Community Bank s deposits are primarily insured by the FDIC s Bank Insurance Fund, or BIF. The FDIC utilizes a risk-based deposit insurance premium schedule to determine the assessment rates for Bank Insurance Fund-insured depository institutions. Each financial institution is assigned to one of three capital groups:

- well capitalized;
- adequately capitalized; or

undercapitalized.

Each financial institution is further assigned to one of three subgroups within a capital group, on the basis of supervisory evaluations by the institution s primary federal and, if applicable, state regulators and other information relevant to the institution s financial condition and the risk posed to the applicable insurance fund. The actual assessment rate applicable to a particular institution will, therefore, depend in part upon the risk assessment classification so assigned to the institution by the FDIC.

The BIF assessment rates currently range from zero basis points on deposits for a financial institution in the highest category, to 27 basis points on deposits for an institution in the lowest category. In addition, the Deposit Insurance Funds Act of 1996 authorizes the FDIC to collect The Financing Corporation, or FICO, deposit assessments on Bank Insurance Fund and Savings Association Insurance Fund-assessable deposits at the same rate. FICO assessments are set quarterly, and in 2005 ranged from 1.34 to 1.44 cents per $100 of assessable deposits. For the first quarter of 2006, the FICO assessment rate for such deposits will be 1.32 cents per $100 of assessable deposits. Community Bank accrued insurance premiums in 2003, 2004 and 2005 of $777,000, $763,000 and $373,000, respectively, and paid FICO assessments of approximately $73,000, $68,000 and $61,000, in each of these years, respectively. The decline in our cost of FDIC insurance is directly attributable to our improved regulatory status and since the improved rates became effective on July 1, 2005, we anticipate additional savings to be recognized for the full year 2006.

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Congress passed the Federal Deposit Insurance Reform Act of 2005 and the Federal Deposit Insurance Reform Conforming Amendment Act of 2005, in each case at the beginning of February 2006. Among other things, this new law will merge BIF and SAIF during 2006. Deposits will remain insured up to a maximum of $100,000, but will be adjusted every five years based upon inflation. Retirement accounts will be insured for up to $250,000, and a bank that is less than adequately capitalized will not be able to accept employee benefit deposits. This law also changes the way FDIC insurance assessments and credits are calculated, and authorizes the FDIC to revise its risk-based deposit insurance assessment scheme.

Enforcement Policies and Actions

The Federal Reserve, the FDIC and the Alabama Superintendent monitor compliance with laws and regulations. Violations of laws and regulations, or other unsafe and unsound practices, may result in these agencies imposing fines or penalties, issuing cease and desist orders or memorandums of understanding, or taking other enforcement actions. Under certain circumstances, these agencies may enforce these remedies directly against officers, directors, employees and others participating in the affairs of a bank or bank holding company. The regulatory agencies have extensive powers to enforce their agreements with banks and bank holding companies, including, among other actions, civil money penalties, and possible proceedings to terminate FDIC insurance. We previously have been subject to a memorandum of understanding, a safety and soundness compliance plan and two cease and desist orders. However, we were notified in March 2005 that all regulatory memoranda, agreements, plans and orders to which we were subject had been terminated. See Our Current Regulatory Restrictions.

Fiscal and Monetary Policy

Banking is a business that depends on interest rate differentials. In general, the difference between the interest paid by a bank on its deposits and its other borrowings, and the interest received by a bank on its loans and securities holdings, constitutes the major portion of a bank s earnings. Thus, our earnings and growth will be subject to the influence of economic conditions generally, both domestic and foreign, and also to the monetary and fiscal policies of the United States and its agencies, particularly the Federal Reserve.

The Federal Reserve regulates the supply of money through various means, including open market dealings in United States government securities, the discount rate at which banks may borrow from the Federal Reserve, and the reserve requirements on deposits. The monetary policies of the Federal Reserve historically have had a significant effect on the operating results of commercial banks and will continue to do so in the future. The conditions in the national and international economies and money markets, as well as the actions and changes in policy by monetary and fiscal authorities, and their effect on us cannot be predicted.

Money Laundering

The International Money Laundering Abatement and Anti-Terrorism Funding Act of 2001 restricts money laundering by terrorists in the United States and abroad. This Act specifies new know your customer requirements that will obligate financial institutions to take actions to verify the identity of the account holders in connection with opening an account at any U.S. financial institution. Banking regulators will consider compliance with the act s money laundering provisions in making decisions regarding approval of acquisitions and mergers. In addition, sanctions for violations of the act can be imposed in an amount equal to twice the sum involved in the violating transaction, up to $1.0 million.

In the wake of the tragic events of September 11th, on October 26, 2001, the President signed the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, (USA PATRIOT). Under the USA PATRIOT Act, financial institutions are subject to prohibitions against specified financial transactions and account relationships as well as enhanced due diligence and know your customer standards in their dealings with foreign financial institutions and foreign customers. For example, the enhanced due diligence policies, procedures, and controls generally require financial institutions to take reasonable steps:

- to conduct enhanced scrutiny of account relationships to guard against money laundering and report any suspicious transaction;

- to ascertain the identity of the nominal and beneficial owners of, and the source of funds deposited into, each account as needed to guard against money laundering and report any suspicious transactions;

- to ascertain for any foreign bank, the shares of which are not publicly traded, the identity of the owners of the foreign bank, and the nature and extent of the ownership interest of each such owner; and

- to ascertain whether any foreign bank provides correspondent accounts to other foreign banks and, if so, the identity of those foreign banks and related due diligence information.

The USA PATRIOT Act requires financial institutions to establish anti-money laundering programs. The USA PATRIOT Act sets forth minimum standards for these programs, including:

- the development of internal policies, procedures, and controls;

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the designation of a compliance officer;

an ongoing employee training program; and

an independent audit function to test the programs.

In addition, the USA PATRIOT Act authorizes the Secretary of the Treasury to adopt rules increasing the cooperation and information sharing between financial institutions, regulators, and law enforcement authorities regarding individuals, entities and organizations engaged in, or reasonably suspected based on credible evidence of engaging in, terrorist acts or money laundering activities.

Insurance Regulation

Community Insurance and Southern Select are licensed insurance agents and brokers for various insurance companies, and are subject to regulation by the Alabama Insurance Commission.

Legislative and Regulatory Changes

Legislative and regulatory proposals regarding changes in banking laws, the regulation of banks, thrifts and other financial institutions, as well as bank and bank holding company powers are being considered by the executive branch of the Federal government, Congress and various state governments, including Alabama. Other proposals pending in Congress would, among other things, allow banks to pay interest on checking accounts and to establish interstate branches *de novo*. The Alabama Banking Department has introduced legislation in the Alabama legislature that would, among other things, permit interstate de novo branching in Alabama by out-of-state banks, regulate bank holding companies and expand the enforcement powers of the Alabama Banking Department. Certain of these proposals, if adopted, could significantly change the regulation of banks and the financial services industry. It cannot be predicted whether any of these proposals will be adopted, and, if adopted, how these proposals will affect us.

Our Previous Regulatory Restrictions

During the entire year of 2004, Community Bancshares and Community Bank were subject to four different regulatory agreements or orders. Since their inception, the Company has materially complied with the requirements and expectations contained in the documents and cooperated fully with the regulatory authorities. All of these agreements and orders, the terms of which are described in our 2003 Annual Report on Form 10-K, were terminated in March 2005.

ITEM 1A. RISK FACTORS.

The following risks are among some of the most important risks faced by us. The list of risks below is not exhaustive, and there may be other risks that significantly affect us.

Any of the following risks could significantly harm our business, results of operations and financial condition, and the price of our common stock. The risks discussed below also include forward-looking statements, and our actual results may differ substantially from those discussed in these forward-looking statements.

Risks Related to Our Business

Our future success is dependent on our ability to compete effectively in highly competitive markets.

We and our subsidiaries operate in highly competitive markets in Alabama. Our future growth and success will depend on our ability to compete effectively in these markets. We compete for loans, deposits and other financial services in our geographic markets with other local, regional and national commercial banks, thrifts, credit unions, mortgage lenders, and securities and insurance brokerage firms. Many of our competitors offer products and services different from us, and have substantially greater resources, name recognition and market presence than we do, which benefits them in attracting business. In addition, larger competitors may be able to price loans and deposits more aggressively than us and have broader customer and geographic bases to draw upon.

We face credit quality risks and our credit policies may not be sufficient to avoid losses.

A significant source of risk for us arises from the possibility that losses will result because of the risks inherent in our lending business, due to the failure of borrowers, guarantors and related parties failing to pay interest on and principal of their loans from us. Although we maintain and have improved our credit policies, credit underwriting, monitoring and collection procedures to manage these risks of loss, these policies and procedures may not prevent losses that could harm our results of operations. If our customers fail to repay their loans or pay interest when due, then our business would suffer.

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Our loan evaluation process and allowance for loan losses may not be sufficient to cover losses.

We seek to manage our credit exposure through review and monitoring of loan applicants and borrowers, and loan concentrations in particular industries, and through loan approval and credit review and risk management procedures. We have established evaluation processes to determine the adequacy of our allowance for loan losses. While this evaluation process uses historical and other objective information, the classification of loans and the establishment of the amount of loan losses is an estimate based upon experience, judgment, and expectations regarding our borrowers, current and anticipated economic conditions in the markets in which we and our borrowers operate, as well as the judgments of our regulators, which may, in part, be based upon comparisons with our peers. If our loan loss reserves are insufficient to absorb future loan losses, then our profitability and financial condition will suffer.

We are required to maintain capital to meet regulatory requirements, and if we fail to maintain sufficient capital, our financial condition, liquidity and results of operations would be adversely affected.

We must meet regulatory capital requirements. If we fail to meet these capital and other regulatory requirements, our financial condition, liquidity and results of operations would be materially and adversely affected. Our failure to remain well capitalized and well managed for regulatory purposes could affect customer confidence, our ability to grow, our costs of funds and FDIC insurance, our ability to raise brokered deposits, our ability to pay dividends on common stock in the future and our ability to make acquisitions.

Our cost of funds may increase as a result of general economic conditions, interest rates and competitive pressures.

Our cost of funds may increase as a result of general economic conditions, increased interest rates and competitive pressures. We have traditionally obtained funds principally through brokered deposits and borrowings from other institutional lenders. Generally, we believe local deposits are a cheaper and more stable source of funds than borrowings because interest rates paid for local deposits are typically lower than interest rates charged for borrowings from other institutional lenders. Brokered deposits are generally considered more likely to fluctuate in availability and rates than local deposits that may be relationship-based. Our costs of funds and our profitability and liquidity are likely to be adversely affected if we have to rely upon higher cost brokered deposits and borrowings from other institutional lenders to fund loan demand.

We could encounter operational difficulties as a result of growth.

Our loans, deposits, fee businesses and employees may increase as a result of our growth. Our failure to successfully manage and support our growth with sufficient human resources, training and operational, financial and technology resources could have a material adverse effect on our operating results and financial condition. We may not be able to sustain or manage our growth.

Additional growth may require us to raise additional capital in the future, but that capital may not be available to us on favorable terms, if at all, when it is needed.

We anticipate that our current capital resources will satisfy our capital requirements for the foreseeable future. We may, however, need to raise additional capital to support our continued growth. Our ability to raise additional capital, if needed, will depend, among other things, on conditions in the capital markets at that time, which are outside our control, and on our financial performance. If we cannot raise additional capital on acceptable terms when needed, our ability to further expand our operations through internal growth and acquisitions could be limited.

Attractive acquisition opportunities may not be available to us in the future.

While we presently expect to seek more organic growth, we will continue to consider the acquisition of other businesses. However, we may not have the opportunity to make suitable acquisitions on favorable terms in the future, which could adversely affect our growth. We expect that other banking and financial companies, many of which have significantly greater resources, will compete with us to acquire financial services businesses. This competition could increase prices for potential acquisitions that we believe are attractive. Also, acquisitions are subject to various regulatory approvals. If we fail to receive the appropriate regulatory approvals, we will not be able to consummate an acquisition that we believe is in our best interests. Among other things, our regulators consider our capital, liquidity, profitability, regulatory compliance and levels of goodwill and intangibles when considering acquisition and expansion proposals.

Our business may be harmed by inflation, price increases and changes in interest rates.

Unlike most companies, virtually all of our assets and liabilities are monetary in nature and are therefore sensitive to changes in interest rates. Our profitability depends upon net interest income, which is the difference between interest earned on assets, and interest expense on interest-bearing liabilities, such as deposits and borrowings. For example, when interest rates decline, the spread between the rate that we pay on

our customer deposits and the rate that we charge on our commercial loans typically decreases. As this spread decreases, we generally realize lower net income from our commercial banking operations.

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If interest rates increase from their current historically low levels, then our banking business may benefit from an increase in the spread between the rate that we pay on our customer deposits and the rate that we charge on our commercial loans. However, this benefit may be offset by:

- increases in the rates we have to pay on deposits;
- the inflationary effect that typically accompanies increases in interest rates, which increases the prices of goods and services that we purchase, as well as the cost of salaries, benefits, occupancy expense, and overhead;
- the decrease in the volume of our commercial loan origination that typically results from higher interest rates;
- reduction in our borrower s ability to service higher interest expenses; and
- reduced volumes of mortgage loans.

Increases in interest rates may also decrease the market value of our assets, including our investments, mortgages and loans held, which may harm our liquidity, ability to borrow funds, earnings, and stockholders equity.

Interest rates, and consequently our results of operations, are affected by general economic conditions (domestic and foreign) and fiscal and monetary policies. Monetary and fiscal policies may materially affect the level and direction of interest rates. Beginning in June 2004, the Federal Reserve has raised the federal funds rate 15 times from 1.0% to 4.75%. Increases in interest rates generally decrease the market values of fixed-rate, interest-bearing investments and loans held and the production of mortgage and other loans, and therefore may adversely affect our liquidity and earnings.

A downturn in our markets could adversely affect our business

Our principal operating subsidiary, Community Bank, is a traditional community bank operating in the market area comprised of Blount County, Alabama, and the surrounding areas of Lauderdale, Limestone, Madison and Morgan Counties in north and west-central Alabama. We also operate branches in south west Alabama in Marengo and Perry Counties, and in west Alabama in Marion and Winston counties. As a result, our financial condition and performance are affected by the general economic conditions in the markets we serve, and our ability to diversify and manage economic risks is limited by the performance of these local economies.

A significant downturn in these local economies could negatively affect our loan demand as well as the value of the collateral that secures these loans. Our market area is primarily retail-oriented and our operations are dependent upon local individuals and small- to medium-sized businesses. As a result, we may face greater lending and credit risks than financial institutions lending to larger, better-capitalized businesses with longer operating histories.

We operate in a heavily regulated environment, and changes in state and federal regulations could adversely impact our business.

Our success depends not only on competitive and market factors but also on state and federal regulations applicable to us. We operate in a highly regulated environment and are subject to supervision by several governmental regulatory agencies, including the Federal Reserve, the FDIC, the Alabama State Banking Department, the Alabama Insurance Commission, the SEC and Nasdaq. Banking regulations are primarily intended to protect depositors, not stockholders. Regulation of the financial institutions industry has undergone extensive changes in recent years and continues to change frequently. We cannot predict the effects of these changes, and the regulations now affecting us may be modified at any time. We can give no assurance that future legislation or regulations will not harm our business or decrease the profitability of our business.

We are subject to internal control reporting requirements that increase our compliance costs and failure to comply timely could adversely affect our reputation and the value of our securities.

We are required to comply with various corporate governance and financial reporting requirements under the Sarbanes-Oxley Act of 2002, as well as rules and regulations adopted by the SEC, the Public Company Accounting Oversight Board and Nasdaq. We have evaluated our controls, including compliance with the SEC rules on internal controls, and have spent, and expect to continue to spend, significant amounts of time and money on compliance with these rules, as we continue to work on the testing and reporting on internal controls required under the Sarbanes-Oxley Act of 2002, and which are due at the end of 2006.

Our failure to comply with these internal control rules may materially adversely affect our reputation, ability to obtain the necessary certifications to financial statements, and the value of our securities. At December 31, 2005, we had identified one material weakness in our financial reporting controls related to the treatment of an interest rate swap as a hedge. Specifically, the deficiency resulted from the absence of controls designed to ensure the proper application of generally accepted accounting principles to derivative financial instruments. As a result of this deficiency and the resulting errors in accounting for derivative financial instruments, previously reported 2004 and 2005 financial information was restated. These restatements were required to properly reflect changes in the estimated fair value of certain derivative financial instruments as a component of earnings in the period of change in estimated fair value.

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Technological changes affect our business, and we may have fewer resources than many competitors to invest in technological improvements.

The financial services industry is undergoing rapid technological changes with frequent introductions of new technology-driven products and services. In addition to serving clients better, the effective use of technology may increase efficiency and may enable financial institutions to reduce costs. Our future success will depend, in part, upon our ability to use technology to provide products and services that provide convenience to customers and to create additional efficiencies in operations. We may need to make significant additional capital investments in technology in the future, and we may not be able to effectively implement new technology-driven products and services. Many competitors have substantially greater resources to invest in technological improvements than we do.

We rely heavily on our executive officers, who would be difficult to replace.

Our success depends, and is expected to continue to depend, on our executive officers. In particular, we rely on Mr. Patrick M. Frawley, the Chairman, President and Chief Executive Officer of Community Bancshares and the Chairman and Chief Executive Officer of Community Bank, and Mr. Stacey Mann, the President and Chief Operating Officer of Community Bank. Our growth will continue to place significant demands on our management, and the loss of these executive officers services could harm our future operations. If we were to lose any of these key executive officers, we may be unable to identify, attract and retain a qualified replacement on favorable terms, if at all.

Our rights to collect interest and take other actions may be limited by the Servicemembers Civil Relief Act of 2003.

The United States declared war on terrorism and National Guard and reserve forces either have been called up or may be called up for domestic and international service. Under the Servicemembers Civil Relief Act of 2003, which amended and expanded the Soldiers and Sailors Civil Relief Act of 1940, a borrower who enters military service is afforded various types of relief under their loans and other obligations, including a maximum annual interest rate of 6% during the period of the borrower s active duty status. The Act further provides that any interest in excess of 6% may not become due once the servicemember leaves active duty; any accrued interest above 6% is permanently waived. The Relief Act applies to members of the Army, Navy, Air Force, Marines, National Guard, Reserves, Coast Guard and officers of the U.S. Public Health Service assigned to active duty. Because the Relief Act applies to individuals who enter active military service after they enter into their loans, we cannot predict the effect that the Relief Act will have on our mortgage and commercial loans, if any. Under the Relief Act, we may be unable to collect the full amount of interest otherwise due on many of our loans for an indefinite period. Further, we may be unable to foreclose on these loans during, and in some cases after, the borrower s period of active duty.

We face regulatory risks related to our commercial real estate loan concentrations.

Commercial real estate, or CRE, is cyclical and poses risks of possible loss due to concentration levels and similar risks of the asset. The banking regulators have begun giving CRE lending greater scrutiny, and may require banks with higher levels of CRE loans to implement improved underwriting, internal controls, risk management policies and portfolio stress testing, as well as possibly requiring higher levels of allowances for possible loan losses and capital levels as a result of CRE lending growth and exposures.

We may be unable to meet our obligations under our outstanding indebtedness, and, in particular, under our 10.875% junior subordinated debentures.

We have several outstanding debt obligations, and, in order to repay those obligations, we must obtain adequate funds. As a holding company, we rely primarily on dividends from Community Bank to make payments of principal of, and interest on, our indebtedness, to meet debt payment obligations, including payments on our trust preferred securities and to meet other obligations. As a result, our success and our ability to make such payments and meet such obligations depends upon the earnings and capital position of Community Bank and the ability of Community Bank to pay dividends or make distributions to us.

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If we default on any debt obligation, then we may face claims by creditors to recover monies owed to them, and we may face cross-defaults under other obligations, whereupon all amounts owed by us could become immediately due, which would significantly harm our business and our ability to finance our operations and growth, and likely result in Community Bancshares being the subject of a bankruptcy proceeding.

In March 2000, we issued $10.0 million of junior subordinated debentures that back an equivalent amount of trust preferred securities. The debentures accrue and pay interest semiannually at a rate of 10.875% per annum and have a maturity date of March 8, 2030, at which time we will be obligated to repay the $10.0 million principal amount of the debentures. We have, as permitted by the instruments governing our trust preferred securities and related junior subordinated debentures, deferred interest payments on these securities. In addition, because our trust preferred securities are held by a special purpose entity in a securitized pool, we may be unable to renegotiate the terms of, or to repurchase, our outstanding trust preferred securities prior to 2010 in order to refinance these at lower interest rates and on better terms.

Some of our debt may be accelerated at any time by the lender.

Under Community bank s Convertible Advance Program line of credit with the Federal Home Loan Bank of Atlanta, or the FHLBA, we presently owe $38.0 million. In an event of default under this line of credit, the FHLBA may declare all or any part of our indebtedness to the FHLBA, together with any accrued interest, and including any prepayment fees, to be immediately due and payable. Included in the list of events of default is the situation where the FHLBA reasonably and in good faith determines that a material adverse change has occurred in the financial condition of Community Bank from that disclosed at the time of the making of any advance or from the condition of Community Bank as most recently disclosed to the FHLBA.

In the event that the FHLBA determines that, since the time that we borrowed funds under the line of credit, there has been a material adverse change in the financial condition of Community Bank, then the FHLBA may declare all amounts due under the line of credit immediately due and payable. In that case, we would need to seek additional sources of funding from deposits, borrowings, repurchase agreements or capital in order to repay amounts outstanding, which we may be unable to obtain on favorable terms, if at all, and which would significantly harm our business and our ability to finance our operations and growth. A default on our FHLBA line of credit could lead to defaults on other indebtedness and the bankruptcy, receivership or conservatorship of Community Bancshares and Community Bank.

We may be difficult to acquire, which could harm the market price of our common stock and our preferred stock and deprive you of a possible premium over the market price.

Our certificate of incorporation and bylaws contain provisions that could have the effect of discouraging a third party from acquiring control of us without the approval of our board of directors. These provisions may delay, prevent or deter a merger, acquisition, tender offer, proxy contest or other transaction that might otherwise result in our stockholders receiving a premium over the market price for their common stock or their preferred stock. Among other things, these provisions:

- authorize us to issue preferred stock, the terms of which may be determined in the sole discretion of our board of directors and may harm the voting or economic rights of the holders of our common stock or of other series of our preferred stock;

- provide for a classified board of directors having three classes, with each class serving staggered three year terms, so that no more than approximately one-third of our board of directors could be replaced at any annual meeting of our stockholders;

- restrict the persons eligible to call a special meeting of our stockholders; and

- provide that our directors may be removed only for cause by the holders of at least 80% of our outstanding common stock.

We may acquire other companies, and our business operations may suffer if we do not successfully implement and integrate our acquisitions.

We may engage in acquisitions, mergers and branch sales, either as buyers or sellers, in the future. Acquisitions, mergers and branch transactions involve a number of risks, including:

the time associated with identifying and evaluating potential transactions;

- our ability to finance the transaction and any associated costs, including possible dilution to our existing stockholders;
- the diversion of our management s attention to the integration of the assets, operations or personnel of the acquired businesses;
- entry into new markets where we lack experience;
- the introduction of new products and services into our business;
- possible adverse short-term effects on our results of operations and profitability;
- possible amortization of goodwill associated with an acquisition;
- the risk of loss of key employees and customers of the acquired business;
- risks of unknown or contingent liabilities;
- unanticipated costs and delays;
- risks that acquired new businesses do not perform consistent with our growth and profitability expectations;
- risks that growth will strain our infrastructure, staff, internal controls and management, which may require additional personnel, time and expenditures;
- exposure to potential asset quality issues with acquired institutions;
- difficulties, expenses and delays of integrating the operations and personnel of acquired institutions, and start-up delays and costs of other expansion activities; and
- potential disruptions to our business;

We may issue equity securities and other forms of common stock-based consideration in connection with future acquisitions, which could cause ownership and economic dilution to our current stockholders and to investors purchasing our common stock in this offering. There can be no assurance that, following any future mergers or acquisition, integration efforts will be successful or that our company, after giving effect to the acquisition, will be profitable.

A hedge fund shareholder seeks to elect three new directors, which could result in new management and/or the sale of our company.

One of our largest stockholders, a New York hedge fund, recently launched a proxy contest in an effort to have its own slate of directors elected as members of our board of directors, as replacements for our existing directors, in conjunction with this year s annual meeting of stockholders. If this proxy contest is successful, the new board of directors may determine to replace our existing management team and/or seek a sale of our

company. We cannot predict the outcome of the proxy contest, nor can we predict the actions, or related effects of those actions, that may be taken by the newly elected board of directors. This stockholder, which purchased shares of our common stock at a price substantially lower than that paid by many of our other stockholders, and the directors elected by this stockholder, may seek a sale transaction at a price that is lower than that which would appeal to many of our other stockholders. The hedge fund s actions may increase our costs and adversely affect our profitability.

Risks Related to Ownership of Our Common Stock

The market price of our common stock has fluctuated, and could fluctuate significantly.

The market price of our common stock has been and could be subject to wide fluctuations, including fluctuations in response to quarterly variations in our operating results, changes in our dividend payments, changes in earnings estimates by analysts, material announcements by us or our competitors, governmental or regulatory actions, acquisitions, the liquidity of the market for our common stock, changes in general economic and market conditions, changes in the securities markets, war and other conflicts, acts of terrorism, speculation raised by the actions of a hedge fund stockholder seeking a sale of the Company and the election of three new directors, market rumors and other events, many of which are beyond our control. The stock market has experienced extreme price and volume fluctuations which have affected market prices of smaller capitalization companies and which often have been unrelated to the operating performance of such companies. In addition, if our operating results fall below the expectations of securities analysts and investors, the price of our common stock would likely decline, perhaps substantially.

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Our ability to pay dividends to stockholders in the future is subject to profitability, capital, liquidity and regulatory requirements.

Cash available to pay dividends to our stockholders is derived primarily from dividends paid to us by our subsidiaries, and, principally, Community Bank. The ability of our subsidiaries to pay dividends to us, as well as our ability to pay dividends to our stockholders, will continue to be subject to and limited by the results of operations of our subsidiaries and our need to maintain appropriate liquidity and capital consistent with regulatory requirements and the needs of our businesses.

We may issue additional securities, which could affect the market price of our common stock and dilute ownership.

We may issue additional securities to raise capital to support growth or make acquisitions. Holders of our common stock do not have any preemptive rights to purchase additional shares of our common stock in future offerings. Therefore, holders of our common stock may not be able to maintain their current percentage equity interest if we decide to issue more common stock or more preferred stock, or other securities exercisable or exchangeable for, or convertible into, our common stock.

We also have made and expect to continue to make grants of equity-based compensation to retain and motivate employees, and we have issued warrants to certain outside third parties. As a result of the exercise or conversion of outstanding options and warrants, the ownership interests of our existing stockholders could be diluted.

Sales of a substantial number of shares of our common stock, or the perception by the market that those sales could occur, could cause the market price of our common stock to decline or could make it more difficult for us to raise capital through the sale of common stock or to the use of common stock as currency in future acquisitions.

Future potential debt incurred by us, and future debt or preferred stock issuances by us, may negatively affect the holders of our common stock.

Any existing or future debt or preferred securities of our Company will require the payment of interest or dividends prior to the payment of dividends on our common stock. Debt and preferred securities also will have a senior claim on our assets relative to our common stockholders. Therefore, in the event of our bankruptcy, liquidation or dissolution, our assets must be used to pay off our debt and preferred obligations in full before making any distributions to our common stockholders.

ITEM 2. PROPERTIES.

Our corporate headquarters is owned by Community Bank and located at 68149 Main Street (U.S. Highway 231) in Blountsville, Alabama. Community Bank s administrative, operational, accounting and legal functions are housed in three buildings which were constructed in 1997, all of which are located on the same property as the corporate headquarters. These buildings, which collectively provide a total of approximately 72,500 square feet of office space on seven acres of land, are in good condition.

The main commercial banking office of Community Bank is located at 69156 Main Street, Blountsville, Alabama. The premises are owned by Community Bank. This building offers a total of 7,500 square feet of office space and is in good condition.

At December 31, 2005, Community Bank owned or leased buildings that were used in the normal course of business in nine counties in Alabama, including Blount, Lauderdale, Limestone, Madison, Marengo, Marion, Morgan, Perry and Winston Counties. Community Credit owned or leased buildings that were used in the normal course of business in eleven counties in Alabama, including Blount, Cullman, Marshall, Morgan, Limestone, Etowah, Madison, DeKalb, Walker, Talladega and St. Clair Counties. Community Insurance and Southern Select leased space in a building that is used in the normal course of business in Madison County, Alabama. We presently believe that none of these other facilities are, individually, material to our operations, and, if forced for any reason to vacate or sell any of these other facilities, we presently believe that we would be able to timely identify and occupy suitable alternative locations on equally favorable terms.

On March 23, 2006, Community Bank entered into an Acquisition Agreement to sell its branch office located in Demopolis, Alabama. As a result, the Company s fixed assets located in Demopolis, Alabama will be sold.

For information about the amounts at which bank premises, equipment and other real estate are recorded in our financial statements and information relating to commitments under leases, see our consolidated financial statements and the accompanying notes to consolidated financial statements included elsewhere in this report.

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ITEM 3. LEGAL PROCEEDINGS.

Background

At a June 20, 2000, meeting of the board of directors of Community Bank, one of Community Bank s directors brought to the attention of the board of directors the total amount of money that Community Bank had paid to subcontractors in connection with the construction of a new Community Bank branch office in Guntersville, Alabama. Questions were subsequently raised about a number of Community Bank construction projects. A joint committee of the boards of directors of Community Bancshares and Community Bank conducted an investigation as did law enforcement and bank regulatory authorities. Following these investigations, the boards of directors terminated the employment of Kennon R. Patterson, Sr., former Chairman, President and Chief Executive Officer of Community Bancshares and Chairman and Chief Executive Officer of Community Bank, and Larry Bishop, former Vice President of Community Bank and the FDIC commenced administrative proceedings against Mr. Patterson and Mr. Bishop which are still pending. On March 10, 2005 Mr. Patterson and Mr. Bishop were convicted in the United States District Court for the Northern District of Alabama of conspiracy, bank fraud and causing false entries to be made in bank records. Mr. Patterson was also convicted of filing false income tax returns. On December 13, 2005, Mr. Patterson was sentenced to five years in federal prison, and on January 26, 2006, Mr. Bishop was sentenced to four years in federal prison. On January 30, 2006, Mr. Patterson and Mr. Bishop were ordered, jointly and severally, to pay restitution of approximately $1.8 million, of which approximately $1.3 million is payable to Community Bank.

Patterson Employment Litigation

Plaintiffs: Community Bancshares, Inc. and Community Bank

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

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

- Mr. Patterson breached his employment agreement with Community Bancshares by failing to faithfully perform the duties assigned to him;
- Mr. Patterson made fraudulent misrepresentations to, or suppressed material information from, Community Bancshares and Community Bank and/or their officers, directors and agents concerning his bankruptcy, the release of mortgages which Community Bank held on his house, and payments made by Community Bancshares and Community Bank to companies owned by Mr. Patterson and members of his family;
- Mr. Patterson removed property belonging to Community Bancshares and Community Bank following the termination of his employment; and
- Mr. Patterson breached a duty of loyalty and other fiduciary duties owed to Community Bancshares and Community Bank.

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

- Community Bancshares breached its employment agreement with Mr. Patterson by terminating his employment;
- Community Bancshares failed to pay to Mr. Patterson compensation and benefits of $2.4 million which had allegedly accrued prior to the termination of his employment;

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

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

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

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Patterson ESOP Litigation

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

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

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

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

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

On July 7, 2004, the Court denied Mr. Patterson s motion to dismiss the case. On or about July 23, 2004, Mr. Patterson filed a counterclaim seeking a judgment that he is entitled to benefits from the ESOP and declaratory and injunctive relief compelling the payment of such benefits. On July 26, 2004 the Court, at Mr. Patterson s request, stayed discovery in the case pending the disposition of the criminal charges against Mr. Patterson. On December 14, 2005, the stay was lifted.

Patterson Benefit Restoration Plan Litigation

Plaintiff: Kennon R. Patterson, Sr.

Defendant: Community Bancshares, Inc. Benefit Restoration Plan

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

Patterson Pension Plan Litigation

Plaintiff: Kennon R. Patterson, Sr.

Defendant: Community Bancshares, Inc. Revised Pension Plan

On December 16, 2005, Mr. Patterson filed suit in the United States District Court for the Northern District of Alabama to compel payment of his accrued benefits under the Community Bancshares, Inc. Revised Pension Plan. The complaint seeks a judgment against the plan and an order compelling the payment of benefits. On March 23, 2006, the Pension Plan filed a motion for summary judgment seeking dismissal of the lawsuit on the grounds that the retroactive payments sought by Mr. Patterson are not permitted under the terms of the Pension Plan and Mr. Patterson both failed to exhaust his administrative remedies before filing the lawsuit and failed to complete the forms required to receive a distribution.

Employee Litigation

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

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

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

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

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

Other Litigation

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

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

We have incurred no penalties for failing to include on our tax returns any information required to be disclosed under Section 6011 of the Internal Revenue Code 1988, as amended (the Code) with respect to a reportable transaction under the Code and that is required to be reported under Code Section 6707A(e).

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

No matter was submitted to a vote of our security holders by solicitation of proxies or otherwise during the fourth quarter of 2005.

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PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

Number of Shares and Holders

We presently have no shares of our preferred stock outstanding. At March 30, 2006, we had approximately 8.8 million shares of our common stock outstanding and held by approximately 2,238 stockholders of record.

Market Information

On September 20, 2005, our common stock began being traded on the NASDAQ Capital Market under the symbol COMB. It had previously, since February 26, 2004, been traded on the over-the-counter market under the same symbol. Share price data for 2004 and 2005 presented below is based on reported information on the over-the-counter and NASDAQ markets.

Before February 26, 2004, there was no trading market for our common stock. Our common stock was purchased and sold infrequently in private transactions, and there was no reliable information available as to trades of our common stock, or as to the prices at which our common stock had traded.

	Estimated Price Range Per Share	
	High	Low
2005:		
Fourth Quarter	$ 8.74	$ 8.07
Third Quarter	8.25	7.95
Second Quarter	8.00	7.25
First Quarter	7.98	6.75
2004:		
Fourth Quarter	$ 7.25	$ 6.60
Third Quarter	7.25	6.56
Second Quarter	8.25	6.80
First Quarter	6.80	5.25

In addition, we engaged Alex Sheshunoff & Co. Investment Banking, LP, to perform independent valuations of the fair market value of our common stock held by our Employee Stock Ownership Program, or ESOP, as of December 31, 2004 and 2003, and, at each of those dates, Alex Sheshunoff determined the value of the shares of our common stock held by the ESOP to be $6.00 and $5.35 per share, respectively. Since our stock is now listed on NASDAQ, we have not engaged an outside firm to perform an independent valuation of the fair market value of our common stock as of December 31, 2005 nor do we intend to do so going forward.

Dividends

We have not declared or paid any dividends on our common stock since December 31, 2000. Generally, the payment of dividends on our common stock is subject to the prior payment of principal and interest on our long-term debt, the retention of sufficient earnings and capital in our operating subsidiaries and regulatory restrictions. Dividends from Community Bank historically have been the primary source of cash and income to Community Bancshares and, consequently, any restrictions on Community Bank s ability to pay dividends may and have limited our liquidity and ability to pay dividends on our common stock.

Recent Sales of Unregistered Securities

During the fourth quarter of 2003, we commenced a private placement of our common stock, and, as of December 31, 2003, we had sold 2,151,552 shares of our common stock at a price of $5.35 per share, resulting in net proceeds of approximately $10.4 million. In addition, we granted to those investors who purchased shares in the offering prior to December 31, 2003, as well as to one investor who purchased an

additional 40,345 shares after December 31, 2003, an option to exchange by December 31, 2008, in whole but not in part, the shares of our common stock purchased in the offering for shares of our newly designated Series 2003 noncumulative preferred stock. We completed the private placement on February 20, 2004, selling an additional 1,586,771 shares of our common stock at a price of $5.35 per share after December 31, 2003, for $7.9 million of additional net proceeds, resulting in the sale of a total of 3,738,323 shares for total net proceeds from the offering of $18.3 million.

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

- The Series 2003 noncumulative preferred stock has terms consistent with the Company s Tier 1 capital treatment for regulatory purposes;
- The Series 2003 noncumulative preferred stock is noncumulative and is not entitled to the payment of, or otherwise accrue, any dividends;
- The Series 2003 noncumulative preferred stock is not entitled to the benefit of any sinking fund or similar arrangement;
- The Series 2003 noncumulative preferred stock has no preemptive, preferential or other right to purchase, subscribe for or convert into any other of the Company s securities;
- The Company is not required to purchase the shares of Series 2003 noncumulative preferred stock;
- Holders of the Series 2003 noncumulative preferred stock do not have registration rights requiring the Company to register the shares of the Series 2003 noncumulative preferred stock; and
- The Series 2003 noncumulative preferred stock has no voting power with respect to any Company matters, except in the case of a merger or a significant acquisition or sales transaction, in which case, the Series 2003 noncumulative preferred stock will be entitled to one vote per whole share, and will vote together, as one class, with the holders of our common stock.

The complete terms of the Series 2003 noncumulative preferred stock are set forth in the Certificate of Designation of the Series 2003 Noncumulative Preferred Stock of Community Bancshares, Inc., which the Company has filed with the Secretary of State of the State of Delaware as part of our certificate of incorporation.

No underwriters were involved in the private placement. The investors in the offering were comprised entirely of accredited investors, as that term is defined in Rule 501 of Regulation D promulgated under the Securities Act. The common stock and options we issued in the offering were not registered under the Securities Act, in reliance upon the exemption from registration under Section 4(2) and the safe harbor afforded by Rule 506 of Regulation D. The certificates evidencing the shares of common stock and the options sold in the offering bear restrictive legends permitting the transfer of the underlying securities only upon registration of the securities or an exemption under the Securities Act, together with an opinion of counsel.

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

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ITEM 6. SELECTED FINANCIAL DATA.

The following table sets forth selected financial data for the last five years, and should be read in conjunction with the section in this report entitled Management s Discussion and Analysis of Financial Condition and Results of Operations, as well as our consolidated financial statements and related notes contained elsewhere herein. All averages are daily averages.

	Years ended December 31,				
	2005	2004 (restated)	2003	2002	2001
	(dollars in thousands, except per share data)				
Selected consolidated operations data:					
Net interest income	$ 18,423	$ 17,301	$ 18,362	$ 23,505	$ 22,853
Provision for loan losses	796	987	11,381	10,033	6,096
Income (loss) from continuing operations	1,649	4	(13,100)	(5,023)	(2,381)
Income (loss) from discontinued operations				5,927	958
Net income (loss)	1,649	4	(13,100)	904	(1,423)
Selected per share data:					
Earnings (loss) per share from continuing operations basic	0.19	0.00	(2.79)	(1.08)	(0.52)
Earnings (loss) per share from continuing operations - diluted	0.19	0.00	(2.79)	(1.08)	(0.52)
Earnings (loss) per share basic	0.19	0.00	(2.79)	0.19	(0.31)
Earnings (loss) per share diluted	0.19	0.00	(2.79)	0.19	(0.31)
Cash dividends					
Selected consolidated balance sheet data:					
Loans	336,462	300,380	316,207	359,184	501,519
Total assets	572,468	553,539	558,555	567,596	727,591
Deposits	438,904	448,915	453,946	459,464	617,706
FHLBA long-term debt	67,200	38,000	38,000	38,000	38,000
Other long-term debt			3,169	3,578	4,667
Trust preferred securities			10,000	10,000	10,000
Junior subordinated debt	10,310	10,310			
Average equity	43,393	46,903	36,984	42,848	42,938
Average earning assets	479,950	485,859	488,227	526,025	530,717
Average assets	548,360	549,816	556,591	629,481	725,461
Selected ratios:					
Return on average assets	0.30%	0.00%	(2.35)%	0.14%	(0.20)%
Return on average equity	3.80	0.01	(35.42)	2.11	(3.31)
Average equity to average assets	7.91	8.53	6.64	6.81	5.92

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The purpose of this discussion is to assist in the understanding of the significant changes in the financial condition and results of operations of the Company and its subsidiaries during each of 2003, 2004 and 2005. This discussion and analysis is intended to supplement and highlight information contained in, and should be read in conjunction with, the Company s consolidated financial statements and related notes and the selected financial data presented elsewhere in this report.

Overview

During 2005, many positive developments occurred at our Company. A summary of several key 2005 developments include:

- Approval of the pro tanto settlements of the Benson and Packard derivative lawsuits on January 31, 2005, resulting in a $0.6 million payment to the Company;
- The conviction of our former Chairman, Kennon R. Patterson, Sr. on March 11, 2005, on 15 counts of conspiracy to commit fraud, bank fraud, false entries in bank records and filing false income tax returns, among others, which we view as another positive development for ongoing litigation;
- Notice during March 2005 from the FDIC, the Federal Reserve Bank of Atlanta, and the Alabama State Banking Department that all regulatory agreements, memoranda, plans and/or orders have been terminated, which actions we expect to substantially reduce costs.
- Purchase of American Family Mortgage, LLC effective on March 1, 2005 which we anticipate will increase fee income through the origination and sale of residential mortgage loans;
- Opening of a full service Financial Center in Huntsville, Alabama on August 10, 2005, the first banking office to open as part of our expansion plans in this growing market;
- Improvement in our net interest margin from 3.56% for 2004 to 3.84% for 2005, an important development in our strategy to increase core earnings;
- The sale of our Double Springs, Alabama branch on November 9, 2005 as part of our branch rationalization strategies resulting in a gain of $0.4 million;
- A contract on Heritage Valley Ranch, our largest piece of other real estate owned for $9.8 million; and
- A substantial reduction in loan charge-offs.

Management believes the combined effect of these developments helps position the Company for a renewed focus on customer attraction and retention, improved marketing of competitive products and services, expansion into higher growth markets, and management of an improved balance sheet. On March 23, 2006, Community Bank entered into an agreement to sell its Demopolis, Alabama branch office. The branch was not profitable for our Company; therefore, we believe this to be a good strategy in our branch rationalization efforts.

Restatement

Community Bancshares, Inc. has restated its consolidated financial statements for the year ended December 31, 2004 and each of the quarters in 2005 and 2004 to restate financial statements and other financial information previously filed with the Securities and Exchange Commission (SEC). The restatements correct errors in the originally filed Form 10-K and Forms 10-Q related to the Company s derivative accounting under Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS No. 133).

In December 2003, the Company entered into an interest rate swap agreement relating to a pool of certificates of deposit (CD swap) that was accounted for as a fair value hedge under SFAS No. 133. The company elected an abbreviated method (the short-cut method) of documenting the effectiveness of the swap as a hedge, which allowed the Company to assume no ineffectiveness in the transaction as long as critical terms did not change. The Company recently concluded that the CD swap did not qualify for this method in prior periods. Although, historical effectiveness testing performed in January 2006 demonstrated that the CD swap would have qualified for hedge accounting under the long-haul method, hedge accounting under SFAS No. 133 is not allowed retrospectively because the hedge documentation required for the long-haul method was not in place at the inception of the hedge. Eliminating the application of fair value hedge accounting reverses the fair value adjustments that were made to the hedged item and the certificates of deposit. This reversal of fair value hedge accounting also results in reclassification of swap net settlements from interest expense to noninterest income as well as recording of swap mark-to-market adjustments in trading gains (losses) on economic hedges. Any gains or losses resulting from changes in the fair market value of the swap will reverse as the swap gets closer to maturity. The swap will mature at a fair market value of zero.

This restatement increased (decreased) income statement captions for the affected periods as follows (unaudited) (in thousands, except per share data):

	Total	Nine Months Ended September 30, 2005	Year Ended December 31, 2004
Interest expense	$ 288	$ (11)	$ 299
Noninterest income	(222)	(233)	11
Provision for income taxes	(204)	(89)	(115)
Net income	$ (306)	$ (133)	$ (173)
Diluted net income per share	$ (0.04)	$ (0.02)	$ (0.02)

		For the Quarters Ended		
	Total	September 30, 2005	June 30, 2005	March 31, 2005
Interest expense	$ (11)	$ (30)	$ 1	$ 18
Noninterest income	(233)	(144)	135	(224)
Provision for income taxes	(89)	(46)	54	(97)
Net income	$ (133)	$ (68)	$ 80	$ (145)
Diluted net income per share	$ (0.02)	$ (0.01)	$ 0.01	$ (0.02)

		For the Quarters Ended			
	Total	December 31, 2004	September 30, 2004	June 30, 2004	March 31, 2004
Interest expense	$ 299	$ 61	$ 61	$ 88	$ 89
Noninterest income	11	(125)	369	(620)	387
Provision for income taxes	(115)	(74)	123	(283)	119
Net income	$ (173)	$ (112)	$ 185	$ (425)	$ 179
Diluted net income per share	$ (0.02)	$ (0.01)	$ 0.02	$ (0.05)	$ 0.02

We have identified this failure to ensure the correct application of generally accepted accounting principles as described above as a material weakness in our internal control over financial reporting with respect to accounting for hedge transactions. See Item 9A Controls and Procedures. The information presented in this Item 7, and elsewhere in this report, reflects the effects of this restatement. We are confident that as of the date of this filing, we have fully remediated the material weakness in our internal control over financial reporting with respect to accounting for derivative transactions.

Primary Sources of Revenues and Expenses

Net Interest Income

While Community Bank provides most traditional banking services, its principal activities as a community bank are the taking of demand and time deposits and the making of secured and unsecured consumer loans and commercial loans in its markets. As a result, our principal source of

revenue is net interest income at Community Bank. Net interest income is the difference between:

- income we receive on our interest-earning assets, such as investment securities and loans; and
- payments we make on our interest-bearing sources of funds, such as deposits and borrowings.

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

- increases or decreases in the volumes of interest-earning assets and interest-bearing liabilities;
- increases or decreases in the average rates earned and paid on those assets and liabilities;
- our ability to manage the interest-earning asset portfolio, which includes loans;

- the availability and costs of particular sources of funds, such as noninterest-bearing deposits; and
- our ability to match our liabilities to fund our assets.

Net Noninterest Income

Our noninterest revenues consist primarily of:

- service charges on customer deposit accounts;
- insurance commissions;
- securities gains or losses; and
- other service fees charged to customers.

Our noninterest expenses consist primarily of:

- salaries and employee benefits;
- costs to hold and maintain premises and equipment;
- insurance;
- director and committee fees;
- professional service fees, especially legal and accounting; and
- cost of foreclosed assets.

Critical Accounting Policies

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

We recognize the following as our critical accounting policies:

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

- our past loan loss experience;
- known and inherent risks in the loan portfolio, including past due and nonperforming loans;
- adverse situations that may affect the borrowers ability to repay those loans;
- the estimated value of any underlying collateral;
- our internal loan reviews;
- the reviews of regulators; and
- an analysis of current economic conditions.

The consideration and application of many of these factors involve assumptions, estimates and judgments that are inherently uncertain and are subject to change. We believe that the allowance for loan losses was adequate at December 31, 2005. While we use available information to recognize losses on loans, future additions to the allowance for loan losses may be necessary

based on economic changes and changes to various borrowers. Certain economic and interest rate factors could have a material effect on the determination of the allowance for loan losses. Our allowance for loan losses is also subject to regulatory examinations and determinations as to adequacy, which may take into account such factors as the methodology used to calculate the allowance for loan losses and the size of the allowance for loan losses in comparison to a group of peer banks identified by our regulators. During their routine examinations of banks, the Federal Deposit Insurance Corporation and the Alabama State Banking Department may require us to make additional provisions to our allowance for loan losses where, in the opinion of the regulators, credit evaluations and allowance for loan loss methodology differ materially from ours.

Accounting for Income Taxes. We use the asset and liability method of accounting for income taxes. Our determination of the deferred and current provision for income taxes requires analysis of certain transactions and the related tax laws and regulations applicable to those transactions. We exercise significant judgment in evaluating the amount and timing of the recognition of the resulting tax liabilities and assets. Our judgments and estimates are re-evaluated on a continual basis as regulatory and business factors change. However, because our judgments and estimates are inherently subjective and subject to change, there can be no assurance that our determination of the provision for income taxes will not be changed, upward or downward, in future periods. Significant judgments are also made in determining the amount, if any, of valuation allowance accounts established to reduce the value of deferred tax assets for amounts estimated to be of no future benefit. As of December 31, 2005, we have no such valuation allowances established against our deferred tax assets. Although we believe that as of December 31, 2005, a valuation allowance on our deferred tax asset is not necessary because we believe they do represent future tax benefits, it is possible that results of operations could affect our judgments and estimates whereby we believe it to be necessary to establish a valuation allowance in the future.

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

- probable meaning that the future event or events are likely to occur;
- reasonably possible meaning that the chance of the future event or events occurring is more than remote but less than likely; or
- remote meaning that the chance of the future event or events is slight.

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

As discussed in Note 16 to our consolidated financial statements, legal proceedings are pending or threatened against us, our subsidiaries as well as their respective indemnities. Except as discussed in Note 16:

- we have not concluded that it is probable that a loss has been incurred in any pending litigation;
- we are unable to make a meaningful estimate of the amount or range of loss that could result from an unfavorable outcome of pending litigation; and
- accordingly, we have not provided any amounts in the consolidated financial statements for unfavorable outcome, if any.

As discussed in Note 16, as of December 31, 2003, we had accrued $2.5 million for potential losses on pending litigation, where in our best judgment, losses were both probable and reasonably estimated. The estimates were based on current circumstances of pending matters. As of December 31, 2004, $0.3 million of this reserve remained and is reported in other liabilities on our balance sheet. As of December 31, 2005, there were no reserves for pending litigation since we believe no contingent losses are probable nor can be reasonably estimated.

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

Accounting for Impaired Assets. Statement of Financial Accounting Standard No. 144 (SFAS 144), Accounting for the Impairment or Disposal of Long-Lived Assets, requires long-lived assets to be sold to be classified as held for sale when certain criteria are met. A long-lived asset classified as held for sale is measured at the lower of its carrying amount or fair value less cost to sell and no longer depreciated while it is classified as held for sale. As discussed in Note 5 to our consolidated financial statements, we classified three properties as held for sale during 2003. Consequently, we incurred a loss of $0.9 million for the year ended December 31, 2003 on these assets in transferring them to held for sale.

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We used estimates in determining the fair values of these assets and, although we believe the fair values established are reasonable, it is possible that our results of operations, cash flows or financial position could be materially affected by the eventual sale of the assets.

Derivative Instruments. In various segments of its business, the Company uses derivative financial instruments to reduce exposure to changes in interest rates and market prices for financial instruments. The application of the hedge accounting policy requires judgment in the assessment of hedge effectiveness, identification of similar hedged item groupings and measurement of changes in the fair value of hedged items. The Company believes that its methods for addressing these judgmental areas are in accordance with generally accepted accounting principles in the United States and are in line with industry practices in assessing hedge effectiveness. However, if in the future, the derivative financial instruments used by the Company no longer qualify for hedge accounting treatment and, consequently, the change in fair value of hedged items could not be recognized in earnings, the impact on the consolidated results of operations and reported earnings could be significant. Management believes hedge effectiveness is evaluated properly in preparation of the financial statements. All of the derivative financial instruments used by the Company have active markets and indications of fair value can be readily obtained.

FINANCIAL CONDITION

General

Our total assets at December 31, 2005 were $572.5 million, an increase of $19.0 million, or 3.4%, from $553.5 million at December 31, 2004. Net loans (excluding loans held for sale) grew by $35.9 million to $331.7 million in 2005, compared to $295.8 million in 2004. Total loans (before deducting the allowance for loan losses) grew by $36.1 million to $336.5 million in 2005 due to new loan production, net of paydowns. We experienced a $10.0 million, or 2.2%, decline in deposits from December 31, 2004 to December 31, 2005, primarily due to management s decision not to pursue higher priced certificates of deposits. Management s decision was based upon funding needs, as well as our focus on building profitable relationships. Community Bank currently is not in need of funding for its liquidity. Noninterest-bearing deposits increased by $1.1 million, or 1.6%, from December 31, 2004 to December 31, 2005, where they were $71.4 million and interest-bearing deposits decreased by $11.1 million, or 2.9%, to $367.5 million during that same period.

On March 23, 2006, Community Bank entered into an agreement to sell its Demopolis, Alabama branch office. As consideration for the purchase, we will receive the net book value of the loans, equal to approximately $6.6 million, and an agreed upon price of $1.0 million for the fixed assets and deposits which is the equivalent of the net book value of the fixed assets and a premium of approximately 7.4% on the core deposits assumed based on a 30-day average of account balances. As of the date of this report, our Demopolis branch had $7.1 million in total deposits.

Earning Assets

Our earning assets are mainly comprised of:

- loans;
- investment securities;
- interest-bearing balances in other banks; and
- federal funds sold.

Our average total assets in 2005 were $548.4 million, representing a decrease of $1.4 million, or 0.3%, from average total assets of $549.8 million in 2004. Average total assets decreased $6.8 million, or 1.2% from $556.6 million in 2003. Average earning assets were $480.0 million, $485.9 million and $488.2 million in each of 2005, 2004 and 2003, respectively, accounting for approximately 87.5%, 88.4% and 87.7% of our average total assets for the respective years. Average earning assets have decreased primarily as an effect from lower average deposit balances.

Average loans, net of unearned income, were $321.2 million, $312.9 million and $330.9 million, representing 66.9%, 64.4% and 67.8% of average earning assets during 2005, 2004 and 2003, respectively. Because of loan production efforts, average loans increased during 2005. Average investment securities were $143.2 million in 2005, representing 29.8% of average earning assets for the year and a decrease of $9.6 million, or 6.3%, from the average investment securities for 2004. This decrease was due to our reinvestment of funds into higher yielding loans and the decline in higher cost deposits. Our average investment securities were $152.8 million in 2004 and represented 31.5% of average earning assets in 2004, compared to 26.6% in 2003. The change in the mix of loans and securities has been

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attributable to our intended strategy to increase loans with funding from the investment portfolio. Average federal funds sold as a percent of average earning assets was 2.3%, 2.5% and 4.9% for 2005, 2004 and 2003, respectively. The average dollar amount invested in federal funds sold during 2005 was relatively level to that of 2004. The decrease in average federal funds from $23.9 million to $11.9 million in 2004 was related to the increased securities investments as we sought higher yields. The other earning asset categories accounted for less than 3.0% of average earning assets for all three periods.

Loans comprise the largest single category of our assets. The following table shows the classification of loans by major category at December 31, 2005, and at the end of each of the preceding four years:

LOAN PORTFOLIO

	December 31,									
	2005		2004		2003		2002		2001	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
	(dollars in thousands)									
Commercial, financial and agricultural (1)	**$ 111,578**	**33.2%**	$ 86,604	28.8%	$ 73,746	23.3%	$ 101,841	28.3%	$ 146,210	29.1%
Real estate - construction	**22,638**	**6.7**	4,702	1.6	3,386	1.1	2,017	0.6	3,126	0.6
Real estate - mortgage	**152,453**	**45.3**	157,350	52.4	176,097	55.7	174,775	48.7	233,216	46.5
Installment loans to individuals	**49,732**	**14.8**	51,603	17.2	62,826	19.9	80,596	22.4	119,031	23.8
Unamortized premiums in loans	**63**		122		184					
Unearned income	**(2)**		(1)		(32)		(45)		(64)	
Loans, net of unearned income	**336,462**	**100.00%**	300,380	100.0%	316,207	100.0%	359,184	100.0%	501,519	100.0%
Allowance for loan losses	**(4,736)**		(4,625)		(14,358)		(9,784)		(7,292)	
Net loans	**$ 331,726**		$ 295,755		$ 301,849		$ 349,400		$ 494,227	

(1) Includes commercial loans secured by real estate.

The following table provides maturities of certain loan classifications and an analysis of these loans maturing in over one year as of December 31, 2005:

SELECTED LOAN MATURITY AND INTEREST RATE SENSITIVITY

	One Year or	Maturity Over One Year	Over	Total	Rate Structure for Loans Maturing Over One Year	
					Predetermined Interest	Floating or Adjustable

	Less	Through Five Years	Five Years		Rate	Rate
			(in thousands)			
Commercial, financial and agricultural (1)	$ 42,181	$ 32,657	$ 36,740	$ 111,578	$ 27,199	$ 84,379
Real estate - construction	17,200	2,843	2,595	22,638		22,638
Total	$ 59,381	$ 35,500	$ 39,335	$ 134,216	$ 27,199	$ 107,017

(1) Includes commercial loans secured by real estate.

Nonperforming Assets and Past Due Loans

Our nonperforming assets are comprised of:

- nonaccruing loans;
- loans 90 days past due or greater;
- restructured loans;
- nonaccruing securities; and
- other real estate owned.

Total nonperforming assets as of December 31, 2005 were $13.8 million, comprised primarily of other real estate owned, represented an increase of $1.0 million, or 7.8%, from the $12.8 million of nonperforming assets at December 31, 2004. The increase in nonperforming assets resulted mostly from an increase in nonaccrual loans. During 2004, we charged down $4.1 million in loans transferred to held for sale and sold the remaining net value of $16.2 million in order to purge problem assets. In addition, loans classified as held for sale at December 31, 2003 of $1.8 million were sold.

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At December 31, 2005, other real estate owned of $10.2 million accounted for 73.9% of our $13.8 million in nonperforming assets and decreased $0.9 million from December 31, 2004. During 2004, progress was made in selling other real estate owned; however, on December 8, 2004, another financial institution foreclosed on the property owned by our former Chief Executive Officer, Kennon R. Patterson, Sr. The Company had a nonaccrual real estate loan on a mansion and twenty acres of land in the amount of $5.4 million outstanding to Mr. Patterson and in prior years had charged off $0.2 million. On the date of foreclosure, the remaining loan balance was $5.2 million, of which $2.2 million was reserved for in the allowance for loan losses. The Company charged off $2.2 million and transferred $3.0 million to other real estate owned. Then, on December 30, 2004, in order to protect its interest and facilitate an orderly sale of the property, the Company purchased at the foreclosure of another financial institution, the surrounding land (approximately 900 acres) and attached buildings to Mr. Patterson s property for $3.4 million. After giving effect to this purchase, the total property formerly owned by Mr. Patterson was carried at $6.4 million; accordingly, the Company had $8.6 million in principal exposure on the property. The Company focused all efforts to sell the property during 2005 and successfully did so in the first quarter of 2006, recording a gain of $2.3 million also in the first quarter of 2006.

At December 31, 2005, total nonaccruing loans amounted to $3.1 million, an increase of $2.0 million, from total nonaccruing loans at December 31, 2004 of $1.1 million. This increase is the result of recent changes in bankruptcy law that caused an acceleration in bankruptcy filings. The Company s policy is to take loans to nonaccrual status whenever a customer files for bankruptcy. During 2004, nonaccruing loans decreased 92.2%, from $14.1 million at December 31, 2003 to $1.1 million at December 31, 2004. This decrease primarily resulted from the loan sales as well as the foreclosure discussed in the previous paragraph. Loans past due 90 days or more remained relatively level from December 31, 2004 to December 31, 2005 at $0.3 million. Our credit standards have improved significantly over the past several years through various enhancements and initiatives including but not limited to the following:

- improvements in lending personnel and credit administration process;
- establishment of a Special Assets division to focus on nonperforming loans, other real estate owned and other foreclosed assets;
- centralized loan processing to ensure that loan policies and procedures and documentation are applied consistently and accurately;
- improved collection and analysis of updated financial data on borrowers;
- tighter lending authority limits for lenders;
- improved credit training, risk selection and loan underwriting;
- renewed focus on reducing past due loans;
- ongoing improvements and updates to overall loan policies; and
- written, comprehensive strategies and policies required for all problem assets above $150,000.

Although we presently believe that we have improved our asset quality, we can give no assurance that continued deterioration will not occur. However, it is our policy to adequately reserve for losses in the loan portfolio. See Results of Operations Provision for Loan Losses, Net Charge-Offs and Allowance for Loan Losses for more information and detail below.

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The following table summarizes our nonperforming assets at December 31 during each of the last five years:

NONPERFORMING ASSETS

	December 31,				
	2005	**2004**	**2003**	**2002**	**2001**
	(dollars in thousands)				
Nonaccruing loans	**$ 3,078**	$ 1,115	$ 14,138	$ 10,099	$ 5,859
Loans past due 90 days or more	**318**	290	611	1,241	2,346
Restructured loans	**235**	238	2,390	3,244	
Total nonperforming loans	**3,631**	1,643	17,139	14,584	8,205
Other real estate	**10,185**	11,126	6,945	7,676	4,287
Total nonperforming assets	**$ 13,816**	$ 12,769	$ 24,084	$ 22,260	$ 12,492
Ratios:					
Allowance for loan losses to total nonperforming assets	**34.28%**	36.22%	59.62%	43.95%	58.37%
Total nonperforming loans to total loans	**1.08**	0.55	5.42	4.06	1.64
Total nonperforming assets to total assets	**2.41**	2.31	4.31	3.92	1.72

If nonaccrual loans had performed in accordance with their original contractual terms, gross interest income on these loans would have been an estimated $0.2 million for the year ended December 31, 2005, compared to $0.6 million for the year ended December 31, 2004 and $0.9 million for the year ended December 31, 2003.

Investment Portfolio

The composition of our investment securities portfolio reflects the Company s investment strategy of maximizing portfolio yields subject to risk and liquidity considerations. Our entire portfolio is classified as available for sale. The primary objectives of our investment strategy are to maintain an appropriate level of liquidity and to provide a tool to assist in controlling our interest rate position, while at the same time producing adequate levels of interest income. Managing the maturity of the portfolio is necessary to provide liquidity and to reduce interest rate risk. During 2005, gross investment securities sales, calls and pay downs were approximately $50.8 million and maturities totaled $5.0 million, compared to $72.2 million of sales, calls and paydowns and no maturities in 2004, and $113.5 million and $18.4 million, respectively in 2003. The decrease in gross investment securities in 2005 was due to increases in the loan portfolio funded by cash flows from the investment portfolio. The decrease in gross investment securities in 2004 resulted from increased cash balances at year end reinvested again in early 2005.

Net gains (losses) realized on investment security sales totaled ($41,000) in 2005, compared to $193,000 during 2004, and $1.1 million in 2003. At December 31, 2005, gross unrealized gains in our investment portfolio were $39,000, compared to $173,000 at December 31, 2004. Gross unrealized losses amounted to $4.3 million at December 31, 2005 and $2.5 million at December 31, 2004. These fluctuations in the gross unrealized gains and losses in our investment portfolio resulted from changing bond prices. Unrealized losses on a bond occur when the bond s yield is less than we could currently receive in the market. The opposite is true when a bond is paying more yield than the current market resulting in unrealized gains.

Mortgage-backed securities have varying degrees of risk of impairment of principal, compared to U.S. Treasury and U.S. government agency obligations, which are considered to contain virtually no default or prepayment risk for the Company. Impairment risk is primarily associated with accelerated prepayments, particularly with respect to longer maturities purchased at a premium and interest-only strip securities. At each of December 31, 2005, 2004 and 2003 our mortgage-backed securities portfolio had no interest-only strips, and the amount of unamortized premium on mortgage-backed securities was $1.6 million, $1.8 million and $2.2 million respectively. As prepayment rates on mortgage-backed securities change, the speed at which unamortized premiums are amortized will change as well, in order to amortize the premium over the expected life of the security. This change will be reflected in the overall yield on the security. The recoverability of our investment in mortgage-backed securities is reviewed periodically by management, and, if necessary, appropriate adjustments for impaired value are made to income.

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The carrying amount of investment securities at the end of each of the last three years is set forth in the following table:

INVESTMENT PORTFOLIO

	December 31, 2005	2004 (in thousands)	2003
U. S. Treasury and agency securities	**$ 49,981**	$ 58,529	$ 61,216
Mortgage-backed securities	**80,245**	79,353	86,623
State and municipal securities	**1,092**	5,454	6,427
Corporate bonds	**970**	1,006	
Federal Home Loan Bank stock	**4,117**	2,826	2,005
Total investment securities	**$ 136,405**	$ 147,168	$ 156,271

Total investment securities decreased approximately $10.8 million, or 7.3%, from approximately $147.2 at December 31, 2004, to approximately $136.4 million at December 31, 2005. This decrease primarily was due to new loan production and the funding of such with cash flows from the investment portfolio. In 2004, total investment securities decreased $9.1 million, or 5.8%, from approximately $156.3 million at December 31, 2003, to approximately $147.2 million at December 31, 2004. This decrease primarily was due to the implementation of strategies in the third and fourth quarters of 2004 to reduce investment securities and make more funds available for lending. At December 31, 2005, non-taxable investment securities were $1.1 million, representing a decrease of $4.3 million in 2005 related to the payoff of one security and no reinvestment into additional non-taxable investment securities as a result of the Company operating with tax loss carryforwards that would limit the potential benefit of these investments.

The composition of the Company s investment securities portfolio stayed relatively constant during 2005 and 2004, but changed in 2003 primarily as the result of the Company selling certain collateralized mortgage obligations due to (i) their price volatility, (ii) their high extension risk in an increasing rate environment, and (iii) their high prepayment risk in a decreasing rate environment, and also as the result of the Company reinvesting the resulting funds into government agency and mortgage-backed securities with shorter average maturities. At December 31, 2005, U.S. government and agency securities (including mortgage-backed securities) represented 95.5% of the Company s total investment securities portfolio, compared to 93.7% at December 31, 2004 and 94.6% at December 31, 2003, while state and municipal securities represented 0.8%, 3.7% and 4.1% of the investment securities portfolio at December 31, 2005, 2004 and 2003, respectively. During 2005, the Company s investment strategy has been to seek the best yield while maintaining acceptable price risk volatility in an expected future rising rate environment.

The maturities and weighted average yields of the investments in the December 31, 2005 portfolio of investment securities are presented below. The weighted average life of the investment portfolio was 4.43 years at December 31, 2005, compared to 4.39 years at December 31, 2004 and 5.12 years at December 31, 2003, with an average yield of 3.77%, 3.70% and 4.00% at December 31, 2005, 2004 and 2003, respectively. Mortgage-backed securities are included in U.S. Government agencies and are based upon the guaranteed payoff date of each security.

INVESTMENT PORTFOLIO MATURITY SCHEDULE

	Maturing (dollars in thousands)							
	Within One Year		After One but within Five Years		After Five but within Ten Years		After Ten Years	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
December 31, 2005:								
Securities - available-for-sale:								
U. S. Government agencies	$ 12,867	2.22%	$ 34,063	3.06%	$ 26,006	4.37%	$ 57,290	4.60%
State and municipal securities							1,092	4.85
Corporate bonds			970	5.99				
FHLBA stock							4,117	

	$ 12,867	2.22	$ 35,033	3.14	$ 26,006	4.37	$ 62,499	4.61

With the exception of some securities issued by U.S. Government agencies, at December 31, 2004 the Company held one municipal bond, which exceeded 10% of the Company s consolidated stockholders equity. This bond was called in early 2005 and is no longer owned by the Company as of December 31, 2005.

Cash and amounts due from banks along with interest-bearing deposits in banks decreased $8.5 million during 2005, from $52.5 million at December 31, 2004 to $44.0 million at December 31, 2005. Cash balances were high on December 31, 2004 because of a bulk sale of loans on December 30, 2004. As a result, approximately $12.6 million was received in cash and had not yet been redeployed into

earnings assets. We invested these funds into securities in early 2005. Average balances in cash and due from banks for the year ended December 31, 2005 and 2004 were $18.3 million and $27.8 million, respectively. Cash and due from banks balances were high during 2004 primarily due to earnings credit rates, which are applied to balances held in our correspondent bank accounts that are maintained with other banks. We receive credits based on balances at these correspondent banks, and the credits are used to offset the service charges experienced. We ultimately received a larger credit against the service charges that would have been paid compared to the interest income that otherwise would have been received had the funds been held in federal funds sold. During 2005, we lowered cash in our correspondent accounts as the federal funds rate increased. The balance of interest-bearing deposits held by the Company with other banks was $2.2 million at December 31, 2005, and $5.4 million at December 31, 2004.

Federal funds sold increased $11.9 million, or 88.1%, during 2005, from $13.5 million at December 31, 2004 to $25.4 million at December 31, 2005, as a result of the Company taking advantage of favorable FHLBA rates and borrowing to lock in cost on funds to make available for future loan funding needs. Federal funds sold decreased $0.8 million, or 5.6%, during 2004, from $14.3 million at December 31, 2003 to $13.5 million at December 31, 2004.

Deposits

Dividends from Community Bank have historically been Community Bancshares primary source of funds, and Community Bank s primary source of funds for dividends comes from its deposits. Community Bank began geographic expansion in August 2005, which we believe will lead to deposit increases. Community Bank intends to expand its consumer base into higher growth markets than those it currently serves, such as Huntsville, Alabama. To achieve future deposit growth, the Bank intends to enhance existing products and emphasize better customer service in all markets.

During 2005, the Company s average total deposits decreased approximately $5.1 million, or 1.1%, from $444.6 million at December 31, 2004, to approximately $439.5 million at December 31, 2005. During 2004, the Company s average total deposits decreased approximately $7.8 million, or 1.7%, from $452.4 million at December 31, 2003. The Company s total deposits at December 31, 2005 were $438.9 million, a decrease of $10.0 million from December 31, 2004. The decreases have been due not only to the sale of our Double Springs, Alabama branch in November 2005 which attributed to $7.9 million of the decline in deposits, but also to lowering of high priced deposit rates leading to decreases in more volatile deposits. The Company lowered its rates on interest bearing transaction and savings accounts in March 2005 which were high compared to other banks in our markets. As a result, deposits declined as some of those customers were only seeking higher rates. Some of the customers maintained their relationships with our bank, but shifted deposits into higher yielding time deposits.

We have also better managed our rates on time deposits or certificates of deposits as part of our strategy to improve our net interest margin. As we have implemented our strategy to attract customers by means other than rate, we have also maintained our focus to build our noninterest-bearing deposit base. Although these accounts generally carry lower balances, they offer more noninterest income opportunities, they improve our net interest margin, they tend to be a more stable deposit base and they generally offer more opportunities for building customer relationships through ancillary services.

The following table presents the average deposit balances and the average rates paid for each of the major classifications of deposits for the 12 month periods ending December 31, 2005, 2004 and 2003:

	Average Deposit Balances and Rates Paid					
	2005		2004 (restated)		2003	
	Average Balance	Average Rate Paid	Average Balance	Average Rate Paid	Average Balance	Average Rate Paid
	(dollars in thousands)					
Noninterest-bearing demand	**$ 67,292**	**0.00%**	$ 61,872	0.00%	$ 55,463	0.00%
Interest-bearing demand	**103,190**	**2.15**	106,743	1.90	86,053	1.62
Savings	**64,542**	**1.35**	71,102	1.40	63,464	1.47
Time	**204,432**	**3.50**	204,893	2.97	247,417	3.24
Total (1)	**$ 439,456**	**2.75**	$ 444,610	2.38	$ 452,397	2.60

(1) The rate paid on total average deposits represents the rate paid on total average interest-bearing deposits only.

Our average interest-bearing deposits decreased $10.5 million, or 2.7%, in 2005 from $382.7 million at December 31, 2004 to $372.2 million at December 31, 2005. This decrease occurred in interest-bearing demand and savings deposits for the reasons discussed above. Average interest-bearing deposits decreased in 2004 by $14.2 million, or 3.6%, from $396.9 million at December 31, 2003. Average savings deposits and average time deposits decreased 9.3% and 0.2%, respectively, during 2005, compared to an increase of 12.0% and a decrease of 17.2%, respectively, during 2004. As also discussed above, we have placed significant focus on increasing our noninterest-bearing deposits. Average noninterest-bearing demand deposits increased 8.7% during 2005, compared to 11.5% in 2004. Total average

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deposits decreased 1.1% in 2005 and decreased 1.7% in 2004. The two categories of the Company s lowest cost deposits, noninterest-bearing demand deposits and interest-bearing demand deposits, comprised the following percentages of the Company s total average deposits during 2005, 2004 and 2003, respectively: (i) 15.3%, 13.9% and 12.3% of average noninterest-bearing demand deposits; and (ii) 23.5%, 24.0% and 19.0% of average interest-bearing demand deposits. Of total time deposits at December 31, 2005, approximately 34.4% were large denomination certificates of deposit and other time deposits of $100,000 or more, up slightly from 32.4% at December 31, 2004.

The maturities of the time certificates of deposit and other time deposits of $100,000 or more issued by the Company at December 31, 2005 are summarized in the table below:

MATURITIES OF TIME DEPOSITS OF $100,000 OR MORE

	December 31, 2005		
	Time Certificates of Deposit	Other Time Deposits	Total
		(in thousands)	
Maturing in three months or less	$ 4,585	$ 15,385	$ 19,970
Maturing in over three through six months.	4,826		4,826
Maturing in over six through twelve months	9,959		9,959
Maturing in over twelve months	37,000		37,000
Total	$ 56,370	$ 15,385	$ 71,755

Borrowed Funds

Borrowed funds consist primarily of short-term borrowings and long-term debt. Total short-term borrowings remained relatively even at $0.5 million at December 31, 2005 and $0.6 million at December 31, 2004.

Line of Credit

On May 6, 2004, the Company established a line of credit with a commercial bank in the amount of $3.0 million. The rate on any used portion of the line of credit is the prime rate plus 50 basis points. The line of credit will mature on May 1, 2009, and only interest is due on outstanding amounts until May 1, 2006, with principal payments to begin thereafter. At December 31, 2005, no balance was outstanding on this line of credit. The loan is secured by 100% of the common stock of Community Bank.

FHLBA Long-Term Debt

Community Bank is a member of the Federal Home Loan Bank of Atlanta, or the FHLBA, and is approved to borrow up to $84.7 million under the FHLBA s Convertible Advance Program. As of December 31, 2005, Community Bank had borrowed $67.2 million. These borrowings are secured under a blanket lien agreement on qualifying mortgage instruments in Community Bank s loan and investment portfolios. Under this lien agreement, in an event of default, the FHLBA may declare all or any part of the indebtedness and accrued interest, including any prepayment fees, to be immediately due and payable. Included in the list of events of default is the situation where the FHLBA reasonably and in good faith determines that a material adverse change has occurred in the financial condition of Community Bank from that disclosed at the time of the making of any advance or from the condition of Community Bank as most recently disclosed to the FHLBA.

The Company s borrowings from the FHLBA as of December 31, 2005 are as follows:

Principal (in thousands)	Rate	Maturity	Options
$ 38,000	3-month LIBOR	August 10, 2015	Convertible by the FHLBA on August 10, 2007. If not converted, rate flips to 5.75% and will be fixed until maturity.

$	9,200	4.02%	August 23, 2010	Convertible by the FHLBA on August 23, 2007.
$	20,000	3.91%	September 16, 2015	Convertible by the FHLBA on September 16, 2015.

At December 31, 2004, Community Bank had borrowed from the FHLBA $38.0 million at a fixed rate of 5.93% per annum with a final maturity of March 1, 2010. The borrowing was callable by the FHLBA on every quarterly payment date during the life of the obligation. On August 8, 2005, the Bank restructured this borrowing into the $38.0 million listed in the table above. This restructure was considered to be a modification of debt; therefore, no gain or loss was recognized.

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

Junior Subordinated Debt

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

- the Company organized a Delaware statutory business trust called Community (AL) Capital Trust I, or the Trust, governed by an Amended and Restated Declaration of Trust;
- the Company issued and sold to the Trust approximately $10.3 million in aggregate principal amount of unsecured junior subordinated debentures, or debentures, which were issued under an Indenture, and which represent the sole assets of the Trust;
- the Trust issued and sold:
  - $10.0 million of preferred capital securities, or trust preferred securities, representing undivided beneficial interests in the assets of the Trust, to a third party special purpose company, which in turn pooled the trust preferred securities together with similar securities of other issuers and sold certificates representing interests in that closed-end, unmanaged pool to investors; and the Trust used the proceeds from the sale of the trust preferred securities to the pool to purchase the debentures from the Company; and
  - $0.3 million of its common securities to the Company, which represent all of the Trust s outstanding common securities; and
- pursuant to a Guarantee Agreement, the Company fully and unconditionally guaranteed the payments of all amounts due on the trust preferred securities, which guarantee is limited to the extent the Trust has funds available for payment of distributions.

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

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

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

- in whole or in part, on or after, but not at any time before, March 8, 2010; and
- in whole, but not in part, at any time within 90 days following the occurrence and during the continuation of a tax event, capital treatment event or investment company event, as those terms are defined in the indenture.

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

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

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

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

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

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

ESOP

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

The Company has a loan to the ESOP that bears interest at a floating rate equal to the prime rate of interest. As of December 31, 2005, the interest rate on the note was 7.25%. Principal and interest payments on the ESOP loan are due monthly through July 16, 2011, based on the current amortization schedule, with the remaining principal and interest, if any, due upon that date. The ESOP loan may be prepaid in whole or in part without penalty under the loan agreement, subject to applicable ERISA and tax restrictions. The Company makes contributions to the ESOP that enables the ESOP to make payments due under the ESOP loan. Under Statement of Position No. 93-6 (SOP 93-6), Employer s Accounting for Employee Stock Ownership Plans, employers that sponsor an ESOP with an employer loan should not report the ESOP s note payable or the employer s note receivable in the employer s balance sheet, nor should interest cost or interest income be recognized on the employer loan. The Company has followed SOP 93-6 accordingly. The principal balance of the Company s loan to the ESOP at December 31, 2005 was $1.3 million.

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

Mr. Kennon R. Patterson, Sr., whose employment with the Company terminated in January 2003, has demanded to receive from the ESOP a total of approximately $298,000, representing the total amount accrued by Mr. Patterson during his participation in the ESOP. The Company evaluated its obligations to Mr. Patterson in light of Mr. Patterson s indictment and subsequent conviction of certain crimes involving the Company, as well as other requirements of law applicable to ESOPs, and, as a result, on March 15, 2004, the ESOP and the ESOP trustee, North Star Trust Company, filed suit in the United States District Court for the Northern District of Alabama against Kennon R. Patterson, Sr. In the lawsuit, the ESOP seeks damages for alleged breaches of fiduciary duty by Mr. Patterson, and both the ESOP and the trustee seek a declaratory judgment that the ESOP has a right of set-off against Mr. Patterson s account in the ESOP, and the ESOP is not required to make a distribution of funds to Mr. Patterson. Mr. Patterson has since been convicted on various counts including bank fraud. Prior to September 20, 2005, the Company could have been required to contribute cash to the ESOP in order to enable the ESOP to make this lump sum cash payment. However, on September 20, 2005, the Company s stock was approved for trading on NASDAQ Capital Market, and as a result, the Company has amended its ESOP to no longer permit cash distributions, but rather require stock to be distributed. The Company now believes that should the ESOP be required to distribute the $298,000 to Mr. Patterson, it can do so in stock thus eliminating the potential need for a cash contribution from the Company.

The Company also evaluated its obligations to Mr. Patterson under a supplemental nonqualified retirement plan and as a result has denied his request for payment of benefits under the plan. Our denial has been challenged by Mr. Patterson in pending litigation and therefore we have not removed the accrued liability for the benefit from the Company s consolidated balance sheet.

MATURITIES OF LONG-TERM DEBT

	2006	2007	2008	2009	2010
			(in thousands)		
Interest on:					
FHLBA long-term debt	$ 2,789	$ 2,789	$ 2,789	$ 2,789	$ 2,789

Junior subordinated debt	1,088	1,088	1,088	1,088	1,088
	$ 3,877	$ 3,877	$ 3,877	$ 3,877	$ 3,877

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Liquidity

Liquidity is defined as the ability of a Company to convert assets into cash or cash equivalents without significant loss. Liquidity management involves maintaining the Company s ability to meet the day-to-day cash flow requirements of Community Bank s customers, whether they are depositors wishing to withdraw funds or borrowers requiring funds to meet their credit needs. Without proper liquidity management, the Company would not be able to perform the primary function of a financial intermediary and would, therefore, not be able to meet the production and growth needs of the communities it serves.

The primary function of asset and liability management is not only to assure adequate liquidity in order for the Company to meet the needs of its customer base, but to maintain an appropriate balance between interest-sensitive assets and interest-sensitive liabilities so that the Company can also meet the investment objectives of its stockholders. Daily monitoring of the sources and uses of funds is necessary to maintain an acceptable cash position that meets both its customers needs and its stockholders objectives. In a banking environment, both assets and liabilities are considered sources of liquidity funding and both are, therefore, monitored on a daily basis.

The following is a discussion of the Company s current cash flows and liquidity. The Company experienced an approximate $8.5 million decrease in cash and cash equivalents during 2005, due primarily to cash used by investing activities. Cash provided by operating activities during 2005 was $3.3 million, compared to $2.0 million and $6.7 million for the years ended December 31, 2004 and December 31, 2003, respectively. Investing activities used cash of $32.0 million during 2005, mostly through loan origination net of principal collections. Financing activities provided $20.3 million of cash and cash equivalents during 2005, compared to its providing of $0.3 million and $3.2 million during 2004 and 2003, respectively. Certificates of deposits increased $9.5 million during 2005, but this was more than offset by decreases in cash from the growth of demand deposits, NOW deposits, and other savings deposits totaling $19.5 million. The issuance of common stock (from both the capital raise in 2004 and stock options exercised in 2004 and 2005), net of transaction costs brought cash inflow of $1.2 million and $8.5 million in 2005 and 2004, respectively and an increase in long-term debt provided $29.2 million of cash flows from financing activities.

Community Bank represents the Company s principal operating subsidiary and source of cash. Dividends paid by Community Bank historically have been the primary source of funds available to the Company to pay expenses, service debt and pay dividends to stockholders. Generally, the Federal Reserve Act, Section 23A, limits loans and extensions of credit from banks to their affiliated holding companies. The Company also receives cash from its subsidiaries for its portion of tax benefit on intercompany income tax settlements. The intercompany tax settlements, however, are only possible if the subsidiaries generate taxable income sufficient to pay income taxes. Community Bank does not pay the Company a management fee.

In addition to debt service, as described above, the Company also will expend capital to settle, resolve and pay legal and other professionals to assist it in defending against, the litigation to which it presently is subject, as described in Note 16 to the Company s consolidated financial statements included in this report. The Company also may apply cash to maintain and improve capital levels at the parent Company and at each subsidiary, as described below under Capital Resources. The Company also may use cash if it determines to review and possibly sell any of its branches that do not contribute to the Company s improved operations, or if it determines to resolve its non-performing assets.

At the end of 2003, the Company s management evaluated various alternatives to improve its cash flows, liquidity, and capital position. Since the Bank could not make payments to the Company without prior regulatory approval, the Company had relied, since April 2001, upon income tax refunds to fund its obligations. Such refunds resulted from carrybacks to prior years. Accordingly, to pay its ordinary expenses, as well as debt service requirements and the expenses of litigation and restructuring, it was determined the Company needed additional capital. In addition, management believed, that as part of its plan to restore Community Bank s profitability and grow in its core markets, it needed capital in order to dispose of other real estate owned and non-performing assets, to rationalize and/or sell certain branches and to refinance or repay approximately $3.2 million of long-term indebtedness. Management believed that new capital was needed for these purposes.

As a result, during the fourth quarter of 2003, the Company commenced a private placement of its common stock, which it completed in the first quarter of 2004 raising total net capital of $18.3 million. The Company granted to those investors who initially purchased shares in the offering prior to December 31, 2003, as well as to one investor who purchased an additional 40,345 shares after December 31, 2003, an option to exchange by December 31, 2008, in whole but not in part, the shares of the Company s common stock purchased in the offering for shares of the Company s newly designated Series 2003 noncumulative preferred stock.

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

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

As of December 31, 2003, the Company had used approximately $5.1 million of the net proceeds from this offering as follows:

- $3.0 million to replace capital in Community Bank; and
- $2.1 million to capitalize Community Funding which will purchase certain nonperforming assets from Community Bank thus lowering its level of nonperforming assets.

As of December 31, 2004, the Company had used an additional $11.3 million of the net proceeds from this offering as follows:

- $3.2 million to pay off long-term debt;
- $2.0 million to further supplement capital in Community Bank;
- $4.3 million to pay deferred and accrued interest on junior subordinated debt; and
- $1.8 million to further capitalize Community Funding so that it could purchase other real estate to protect Community Bank s property acquired in the foreclosure of Kennon R. Patterson, Sr. s real estate loan.

As of December 31, 2005, the Company had used an additional $0.1 million of the net proceeds from the offering to further capitalize Community Funding to support its operations. In addition, the Company has used and will continue to use any remaining proceeds from this offering for general corporate purposes and other capital needs, in each case as permitted by the Company s regulatory authorities and as determined by the Company s Board of Directors and/or management to be in the best interests of the Company and its stockholders.

Capital

The Company s total stockholders equity at December 31, 2005 was 7.74% of total assets, as compared to 7.71% at December 31, 2004 and 6.32% at December 31, 2003. The increase in 2005 is primarily a result of net income which reduced the Company s retained deficit. The increase in 2004 was primarily due to capital raised in early 2004.

The following table summarizes the equity-to assets and dividend payout ratios for each of the last three years:

CAPITAL GROWTH RATIOS

	Years ended December 31,		
	2005	**2004**	**2003**
Dividend payout ratio	0%	0%	0%
Average equity to average assets ratio	7.91	8.53	6.64

The Company s return on average assets ratio, which is computed by dividing net income (loss) by average assets was 0.30%, 0.00% and (2.35)% for 2005, 2004 and 2003, respectively. The Company s return on average equity ratio, which is computed by dividing net income (loss) by average stockholders equity, was 3.80%, representing an increase from 0.01% for 2004 due to net income of $1.6 million. The increase in 2004 from (35.42)% for 2003 was due to the break even in earnings compared to a net loss of $13.1 million in 2003.

The Company s dividend payout ratio is determined by dividing the dividends per share by the basic net earnings or loss per share for the relevant period. The Company did not pay dividends in 2005, 2004 or 2003, and, therefore, the payout ratio remained zero.

The Company s average equity to average assets ratio, which is computed by dividing average stockholders equity by average assets, is presented above. The decrease in 2005 resulted from a 7.5% decrease in average equity and a 0.3% decrease in average assets, while the increase in 2004 resulted from a 26.8% increase in average stockholders equity, while average assets decreased by 1.2%.

In addition, the Company must satisfy the capital requirements established by the Company s regulatory authorities, as described under Business Our Regulatory Environment and Our Current Regulatory Restrictions.

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RESULTS OF OPERATIONS

Net Income and Earnings per Share

For the year ended December 31, 2005, the Company had net income of $1.6 million which was a $1.6 million increase over 2004 and consisted of the following:

- an increase of $1.1 million in net interest income, primarily due to higher levels of loans, resulting from the Company s loan production efforts, as well as a higher interest rate environment;

- a decrease of $0.2 million in the provision for loan losses, reflecting the Company s continued improvement in asset quality;

- an increase in noninterest income of $0.5 million as a result of the settlement of certain litigation and resulting in a $0.6 million payment to the Company;

- a decrease of $0.4 million in noninterest expenses despite expansion into new markets due to: (i) decreased professional fees associated with continued litigation and regulatory issues the Company was confronting, (ii) decreased foreclosed assets and related costs, as the Company successfully disposed of foreclosed assets, (iii) declines in salaries and benefits, and (iv) declines in insurance costs; and

- an increase in taxes of $0.6 million as a result of increased net income before taxes.

The Company s net income broke even for 2004 and represented an increase of $13.1 million from its net loss of $13.1 million for 2003. When stated as changes in basic earnings (losses) per share, the basic earnings per share for the Company in 2004 was $0.00, an increase of $2.79 from the 2003 basic loss per share of $(2.79). There are various factors contributing to the $13.1 million increase in 2004, including positive changes such as:

- a decrease of $11.7 million in noninterest expenses due to: (i) significant reductions in professional fees in 2004; (ii) decreased foreclosed assets and related costs in 2004 resulting from addressing identified problems in our loan portfolio; (iii) impairments on fixed assets recorded in 2003 as part of the Company s branch rationalization decisions, and (iv) losses that were realized on certain pending litigation matters in 2003; and

- a decrease of a $10.4 million in the provision for loan losses, reflecting our significant improvement in asset quality.

The above positive results were somewhat offset by negative factors including:

- a decrease in noninterest income of $0.2 million as a result of a $0.9 million decrease in securities gains of which were mostly offset by increases in service charges and other noninterest income items;

- a decline of $0.5 million in net interest income occurred in 2004, primarily due to: (i) lower levels of earning assets, resulting from the Company s sale of sub-par and delinquent assets, as well as charge-offs, and (ii) lower yields on earning assets due to: (x) loans repricing at lower rates and (y) increased levels of investment securities, which typically have lower yields than loans; and

a decrease in tax benefits recognized of $8.3 million.

Net Interest Income

Net interest income generally is the principal source of a financial institution s earnings stream and represents the difference or spread between interest income generated from the Company s earning assets and the cost born by the Company on its interest-bearing liabilities. Fluctuations in interest rates as well as volume and mix changes in earning assets and interest-bearing liabilities impact net interest income.

Net interest income for 2005 increased approximately $1.1 million, or 6.4%, to approximately $18.4 million from approximately $17.3 million in 2004, compared to a decrease of approximately $1.1 million, or 6.0%, during 2004 from approximately $18.4 million in 2003. The increase in net interest income for 2005 was a result of an increase in interest income due to higher volumes of loans, and higher rates earned on assets, offset by increases in interest expense as a result of higher rates paid on those liabilities. The Rate/Volume Variance Analysis provided on the following pages contains additional information regarding changes in the Company s interest income, interest expense and net interest income due to changes in average balances and rates.

The Company s interest income for 2005 increased approximately $2.2 million, or 7.3%, to $32.4 million in 2005 from $30.2 million in 2004. This increase was due to higher average balances of loans which earn more yield, versus securities and higher rates during 2005.

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Rate increases accounted for 95.7% of the increase in interest income. For the year ended December 31, 2005, the Company experienced interest income on loans of $26.2 million, which was an 8.3% increase from the interest income on loans in 2004 of $24.2 million. Interest income for the year ended December 31, 2004 was $30.2 million, representing a decrease of $2.4 million, or 7.4%, from interest income during 2003. This decrease was due to a decrease of 46 basis points in the yield on average earning assets during 2004 together with a decrease of $2.3 million in the volume of average earning assets. Volume attributed to 23.8% of the decrease in interest income for 2004, while rate attributed to 76.2%.

During 2005, the Company s interest expense increased approximately $1.0 million, or 7.8%, to approximately $13.9 million from approximately $12.9 million in 2004. Interest-bearing deposits are the major component of the Company s interest-bearing liabilities, representing 85.8% in 2005, 87.8% in 2004 and 87.7% in 2003 of average total interest-bearing liabilities outstanding. Average interest-bearing deposits outstanding decreased in both 2004 and 2005 by $14.2 million and $10.5 million, respectively, and the rate paid on these average balances reflected an increase of 37 basis points during 2005 and a decrease of 22 basis points during 2004. For the year ended December 31, 2004, the Company s interest expense totaled $12.9 million, representing a decrease of $1.4 million from the interest expense incurred during 2003. This decrease resulted from a 3.7% decrease in average interest-bearing liabilities outstanding during 2004 due to lower levels of time deposits and other long-term debt, coupled with a decrease in the average rate paid on interest-bearing liabilities during 2004 of 19 basis points due to time deposits repricing at lower rates. The decrease in interest expense on long-term debt during 2005 was in most part the result of our payment of all deferred interest on the Company s junior subordinated debt in 2004. Interest expense was high on junior subordinated debt in 2004 at an average cost of 12.60% due to the fact that the Company was accruing interest on interest. On September 8, 2004, the Company paid all deferred and accrued interest and during 2005 that cost is in line with the debt instrument s stated rate of 10.875% at an average yield of 10.51%.

The trend in net interest income is also evaluated in terms of average rates using the net interest margin and the interest rate spread. The net interest margin, or the net yield on the Company s earning assets, is computed by dividing net interest income by average earning assets. This ratio represents the difference between the average yield returned on average earning assets and the average rate paid for funds used to support those earning assets, including both interest-bearing and noninterest-bearing sources. The Company s net interest margin for 2005 was 3.84%, compared to 3.56% and 3.76% for 2004 and 2003, respectively. The main factor contributing to the increase in the net interest margin for 2005 was an improved balance sheet mix which was accomplished by reinvesting securities cash flows into higher yielding loans and shifting deposits from interest-bearing to noninterest-bearing.

The interest rate spread measures the difference between the average yield on earning assets and the average rate paid on interest-bearing sources of funds. The interest rate spread eliminates the impact of noninterest-bearing funds and gives a more direct perspective to the effect of market interest rate movements. The net interest spread in 2005 was 3.53%, an increase of 27 basis points from 2004, primarily as a result of a larger increase in asset yields than the increase in rates paid on deposits. The net interest spread for 2004 decreased 27 basis points to 3.26% from the Company s 2003 spread of 3.53% as the cost of interest-bearing sources of funds decreased only 19 basis points, but the yield on earning assets decreased 46 basis points. See the tables following in this section entitled Consolidated Average Balances, Interest Income/Expenses and Yields/Rates and Rate/Volume Variance Analysis for more information.

The following tabulation presents certain net interest income data without modification for assumed tax equivalency:

	Years ended December 31,				
	2005	**2004 (restated)**	**2003**	**2002**	**2001**
Rate earned on earning assets	**6.74%**	6.22%	6.68%	7.73%	8.95%
Rate paid on borrowed funds	**3.21**	2.96	3.15	3.66	5.23
Interest rate spread	**3.53**	3.26	3.53	4.07	3.72
Net interest margin	**3.84**	3.56	3.76	4.47	4.31

The Consolidated Average Balances, Interest Income/Expenses and Yields/Rates and the Rate/Volume Variance Analysis tables are presented on the following two pages. The Consolidated Average Balances/Interest Income/Expenses and Yields/Rates table presents, for the periods shown, the average balance of certain balance sheet items, the dollar amount of interest income from average earning assets and resultant yields, the interest expense and rate paid on average interest-bearing liabilities, and the net-interest margin. The Rate/Volume Variance Analysis table presents an analysis of changes in interest income, interest expense and net interest income attributable to changes in volume and interest rate.

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CONSOLIDATED AVERAGE BALANCES, INTEREST INCOME/EXPENSE AND YIELDS/RATES

	Years ended December 31,								
	2005			2004 (restated)			2003		
	Average Balance	Income/ Expense	Yield/ Rate	Average Balance	Income/ Expense	Yield/ Rate	Average Balance	Income/ Expense	Yield/ Rate
	(dollars in thousands)								
Assets									
Earning assets:									
Loans, (1)(2)	**$ 321,190**	**$ 26,201**	**8.16%**	$ 312,876	$ 24,176	7.73%	$ 330,941	$ 26,971	8.15%
Investment securities:									
Taxable	**141,805**	**5,330**	**3.76**	147,289	5,374	3.65	123,402	4,861	3.94
Tax-exempt	**1,419**	**70**	**4.93**	5,560	284	5.11	6,680	342	5.12
Total investment securities	**143,224**	**5,400**	**3.77**	152,849	5,658	3.70	130,082	5,203	4.00
Other interest-bearing assets	**4,502**	**366**	**8.13**	8,185	236	2.87	3,252	198	6.09
Federal funds sold	**11,034**	**390**	**3.53**	11,949	156	1.31	23,952	255	1.06
Total earning assets	**479,950**	**32,357**	**6.74**	485,859	30,226	6.22	488,227	32,627	6.68
Noninterest-bearing assets:									
Cash and due from banks	**18,254**			27,779			28,315		
Premises and equipment	**22,585**			21,678			24,456		
Accrued interest and other assets	**32,220**			26,098			26,544		
Allowance for loan losses	**(4,649)**			(11,598)			(10,951)		
Total assets	**$ 548,360**			$ 549,816			$ 556,591		
Liabilities and stockholders equity									
Interest-bearing liabilities:									
Demand deposits	**$ 103,190**	**2,223**	**2.15%**	$ 106,743	2,026	1.90	$ 86,053	1,391	1.62
Savings deposits	**64,542**	**873**	**1.35**	71,102	997	1.40	63,464	930	1.47
Time deposits	**204,432**	**7,145**	**3.50**	204,893	6,092	2.97	247,417	8,017	3.24
	372,164	**10,241**	**2.75**	382,738	9,115	2.38	396,934	10,338	2.60
Short-term borrowings	**535**	**9**	**1.68**	364	4	1.10	365	3	0.82
FHLBA long-term debt	**46,948**	**2,356**	**5.02**	38,000	2,291	6.03	38,000	2,285	6.01
Capitalized lease obligations	**3,869**	**242**	**6.25**	3,937	169	4.29	4,020	166	4.13
Junior subordinated debt	**10,310**	**1,084**	**10.51**	10,282	1,296	12.60	10,000	1,283	12.83
Other long-term debt		**2**		798	50	6.27	3,369	190	5.64
Total interest-bearing liabilities	**433,826**	**13,934**	**3.21**	436,119	12,925	2.96	452,688	14,265	3.15
Noninterest-bearing liabilities:									
Demand deposits	**67,292**			61,872			55,463		
Accrued interest and other liabilities	**3,849**			4,922			11,456		
Stockholders equity	**43,393**			46,903			36,984		
Total liabilities and stockholders equity	**$ 548,360**			$ 549,816			$ 556,591		