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COMMUNITY BANCSHARES INC /DE/  
Form 10-Q  
May 21, 2001

1

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2001

OR

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

COMMISSION FILE NO. 000-16461

COMMUNITY BANCSHARES, INC.  
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE

63-0868361

-----  
(STATE OF INCORPORATION)

-----  
(I.R.S. EMPLOYER IDENTIFICATION NO.)

68149 MAIN STREET, P. O. BOX 1000, BLOUNTSVILLE, AL

35031

-----  
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICE)

-----  
(ZIP CODE)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (205) 429-1000  
-----

NO CHANGE  
-----

(FORMER NAME, FORMER ADDRESS AND FORMER FISCAL YEAR,  
IF CHANGED SINCE LAST REPORT)

INDICATE BY CHECK MARK WHETHER THE REGISTRANT (1) HAS FILED ALL REPORTS REQUIRED  
TO BE FILED BY SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 DURING  
THE PRECEDING 12 MONTHS (OR FOR SUCH SHORTER PERIOD THAT THE REGISTRANT WAS  
REQUIRED TO FILE SUCH REPORTS), AND (2) HAS BEEN SUBJECT TO SUCH FILING  
REQUIREMENTS FOR THE PAST 90 DAYS:

YES  NO

AS OF APRIL 30, 2001, THERE WERE 4,808,331 SHARES OF THE REGISTRANT'S COMMON  
STOCK, \$.10 PAR VALUE PER SHARE, OUTSTANDING.

2

INDEX  
COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

Consolidated Statements of Financial Condition - March 31, 2001  
and December 31, 2000.....

Consolidated Statements of Income - Three months ended March 31,  
2001 and 2000.....

Consolidated Statements of Other Comprehensive Income - Three months  
ended March 31, 2001 and 2000.....

Consolidated Statements of Cash Flows - Three months ended March 31,  
2001 and 2000.....

Notes to Consolidated Financial Statements - March 31, 2001.....

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk.....

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.....

Item 2. Changes in Securities and Use of Proceeds.....

Item 5. Other Information.....

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

PART I - FINANCIAL INFORMATION  
ITEM 1 - FINANCIAL STATEMENTS  
COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

	MARCH 31, 2001	
	-----	
	(UNAUDITED)	
ASSETS		
Cash .....	\$ 5,609,583	\$
Due from banks.....	18,327,685	
Interest-bearing deposits with banks.....	700,000	
Federal funds sold .....	11,000,000	
Securities available for sale .....	104,985,252	

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Loans .....	525,470,463
Less: Unearned income .....	106,035
Allowance for loan losses .....	7,492,812
	-----
NET LOANS .....	517,871,616
Premises and equipment, net .....	39,669,614
Accrued interest .....	7,274,865
Intangibles, net .....	5,639,178
Other real estate .....	2,273,129
Other assets .....	7,063,960
	-----
TOTAL ASSETS .....	\$ 720,414,882
	=====
LIABILITIES AND SHAREHOLDERS' EQUITY	
Deposits:	
Noninterest-bearing .....	\$ 68,544,181
Interest-bearing .....	538,113,433
	-----
TOTAL DEPOSITS .....	606,657,614
Other short-term borrowings .....	1,582,394
Accrued interest .....	5,675,035
FHLB borrowings .....	38,000,000
Capitalized lease obligations .....	5,831,826
Long-term debt .....	5,435,353
Guaranteed preferred beneficial interest in the Company's junior subordinated deferrable interest debentures .....	10,000,000
Other liabilities .....	3,844,427
	-----
TOTAL LIABILITIES .....	677,026,649
Shareholders' equity	
Preferred stock, par value \$.01 per share, 200,000 shares authorized, no shares issued .....	-0-
Common stock, par value \$.10 per share, 20,000,000 shares authorized, 4,808,331 shares issued as of March 31, 2001 and 4,674,995 shares issued as of December 31, 2000 .....	480,833
Capital surplus .....	30,829,082
Treasury Stock, 20,803 shares at cost as of March 31, 2001 and December 31, 2000 .....	(396,768)
Retained earnings .....	14,295,888
Unearned ESOP shares - 194,980 and 199,877 shares as of March 31, 2001 and December 31, 2000, respectively .....	(2,525,032)
Accumulated other comprehensive income .....	704,230
	-----
TOTAL SHAREHOLDERS' EQUITY .....	43,388,233
	-----
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY .....	\$ 720,414,882
	=====

See notes to consolidated financial statements

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	Three Months Ended March 31,	
	----- 2001 -----	
REVENUE FROM EARNING ASSETS		
Interest and fees on loans.....	\$ 13,416,990	\$ 1
Interest on investment securities:		
Taxable securities.....	1,344,085	
Securities exempt from federal income taxes.....	199,809	
Interest on federal funds sold.....	127,021	
Interest on deposits in other banks.....	17,315	
	-----	-----
TOTAL REVENUE FROM EARNING ASSETS.....	15,105,220	1
	-----	-----
INTEREST EXPENSE		
Interest on deposits.....	7,697,670	
Interest on other short-term borrowings.....	36,691	
FHLB borrowings.....	569,609	
Interest on capitalized lease obligations.....	122,499	
Interest on long-term debt.....	116,208	
Interest on guaranteed preferred beneficial interest in the Company's junior subordinated deferrable interest debentures.....	271,875	
	-----	-----
TOTAL INTEREST EXPENSE.....	8,814,552	
	-----	-----
NET INTEREST INCOME	6,290,668	
Provision for loan losses.....	951,118	
	-----	-----
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES.....	5,339,550	
NONINTEREST INCOME		
Service charges on deposits.....	1,026,102	
Insurance commissions.....	540,842	
Bank club dues.....	169,431	
Debt cancellation fees.....	152,067	
Other operating income.....	420,331	
Investment securities losses.....	353,015	
	-----	-----
TOTAL NONINTEREST INCOME.....	2,661,788	
	-----	-----
NONINTEREST EXPENSES		
Salaries and employee benefits.....	4,081,442	
Occupancy expense.....	712,088	
Furniture and equipment expense.....	449,806	
Director and committee fees.....	117,498	
Other operating expense.....	1,503,755	
	-----	-----
TOTAL NONINTEREST EXPENSES.....	6,864,589	
	-----	-----
Income before income taxes.....	1,136,749	
PROVISION FOR INCOME TAXES.....	331,659	
	-----	-----
NET INCOME.....	\$ 805,090	\$
	=====	=====
NET INCOME PER COMMON SHARE - BASIC.....	\$ 0.18	\$
NET INCOME PER COMMON SHARE - DILUTED.....	\$ 0.18	\$

See notes to consolidated financial statements

4

5

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

	Three Months Ended March 31,	
	2001	2000
	-----	-----
Net income	\$ 805,090	\$ 453,937
Components of other comprehensive income:		
Unrealized holding gains (losses) arising during the period		
Before income tax and reclassification adjustments.....	864,531	(686,494)
Reclassification adjustments for net gain (losses) included		
in net income.....	(353,015)	26,886
	-----	-----
Other comprehensive gain (losses), before income tax.....	511,516	(659,608)
Income tax expense (benefit) related to other		
comprehensive income.....	204,607	(263,843)
	-----	-----
Total other comprehensive income (loss), net of income tax.....	306,909	(395,765)
	-----	-----
Comprehensive income.....	\$1,111,999	\$ 58,172
	=====	=====

See notes to consolidated financial statements

5

6

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

	Three Months Ended March 31,	
	2001	2000
	-----	-----
OPERATING ACTIVITIES		
Net income	\$ 805,090	\$ 453,937
Adjustments to reconcile net income to net cash provided by		

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operating activities:		
Provision for loan losses.....	951,118	1,008
Provision for depreciation and amortization.....	632,593	610
Amortization of investment security premiums and accretion of discounts.....	20,335	38
Deferred tax (benefit)/expense.....	(146,684)	(97)
Loss/(gain) on sale of premises and equipment.....	13,195	
Realized investment security (gains)/losses.....	(353,015)	26
(Increase)/decrease in accrued interest receivable.....	1,157,456	(156)
Increase/(decrease) in accrued interest payable.....	299,310	314
Other.....	(1,417,245)	(2,145)
NET CASH PROVIDED BY OPERATING ACTIVITIES	1,962,153	53
INVESTING ACTIVITIES:		
Proceeds from sales of investment securities - AFS.....	9,652,796	4,684
Proceeds from maturity of investment securities - AFS.....	15,692,087	16,893
Purchase of investment securities - AFS.....	(27,916,121)	(22,469)
Net decrease/(increase) in loans to customers.....	2,385,997	(17,347)
Proceeds from sale of premises and equipment.....	87,478	117
Net proceeds from sale of other real estate.....	-0-	210
Capital expenditures.....	(959,358)	(1,692)
NET CASH (USED) BY INVESTING ACTIVITIES	(1,057,121)	(19,603)
FINANCING ACTIVITIES:		
Net (decrease)/increase in demand deposits, NOW accounts, and savings accounts.....	(2,975,141)	7,260
Net increase/(decrease) in certificates of deposit.....	8,731,988	10,595
Net(decrease)/increase in short-term borrowings.....	(682,837)	(1,256)
Decrease in FHLB borrowings.....	-0-	(2,000)
Decrease in capitalized lease obligations.....	(18,399)	
Decrease in long-term debt.....	(239,851)	(194)
Issuance of guaranteed preferred beneficial interest in junior subordinated deferrable interest debentures.....	-0-	10,000
Proceeds from issuance of common stock.....	209,865	222
Cash dividends.....	-0-	(3,499)
NET CASH PROVIDED BY FINANCING ACTIVITIES	5,025,625	21,129
Net increase in cash and cash equivalents.....	\$ 5,930,657	\$ 1,578
Cash and cash equivalents at beginning of period.....	29,006,611	26,797
CASH AND CASH EQUIVALENTS AT END OF PERIOD.....	\$ 34,937,268	\$ 28,376

See notes to consolidated financial statements

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Three Months Ended  
March 31,

	2001	2000
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Supplemental disclosures of cash flow information:

Cash paid during the period for:

Interest.....	\$9,122,290	\$7,779,228
Income taxes.....	3,530	4,110

SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:

UPON THE PLEDGING OF PURCHASED SHARES TO OBTAIN ADDITIONAL ESOP DEBT OF \$1,076,958 ON DECEMBER 1, 1998, LONG-TERM DEBT WAS INCREASED AND EQUITY WAS DECREASED. THE DEBT WAS REDUCED AND SHARES AMOUNTING TO \$48,970 AND \$38,143 WERE RELEASED DURING THE THREE MONTH PERIODS ENDED MARCH 31, 2001 AND 2000, RESPECTIVELY, AS A RESULT OF PAYMENTS MADE BY THE COMPANY'S ESOP ON THE OUTSTANDING ESOP DEBT.

NET UNREALIZED LOSSES ON INVESTMENT SECURITIES AVAILABLE FOR SALE INCREASED BY \$511,516 AND \$659,608 DURING THE THREE MONTHS ENDED MARCH 31, 2001 AND 2000, RESPECTIVELY.

See notes to consolidated financial statements

7

8

COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)  
MARCH 31, 2001

NOTE A - BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Certain amounts in 2000 have been reclassified to conform with the 2001 presentation. Operating results for the three month period ending March 31, 2001 are not necessarily indicative of the results that may be expected for the year ending December 31, 2001. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2000.

NOTE B - INVESTMENT SECURITIES

At March 31, 2001 and December 31, 2000, the Company's investment securities were categorized as available for sale and, as a result, are stated at fair value based generally on quoted market prices. Unrealized holding gains and losses, net of applicable deferred taxes, are included as a component of shareholders' equity (Accumulated Other Comprehensive Income) until realized.

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At March 31, 2001, the Company's available-for-sale investment securities reflected net unrealized gains of \$1,173,718, which resulted in an increase in shareholders' equity of \$704,230, net of a deferred tax asset. The net increase in shareholders' equity as a result of this adjustment in the fair value of the available-for-sale investment securities from December 31, 2000 to March 31, 2001 was \$306,909.

### NOTE C - SHAREHOLDERS' EQUITY

The Company did not declare or pay a dividend on its common stock during the first quarter of 2001. An annual dividend of \$.75 per share was declared by the Company's Board of Directors on the Company's common stock and paid in January 2000. The payment of dividends on the Company's common stock is subject to the prior payment of principal and interest on the Company's long-term debt, maintenance of sufficient earnings and capital of the Company's subsidiaries and regulatory restrictions. In April 2001, the Company entered into a memorandum of understanding with the Federal Reserve Bank of Atlanta (the "Reserve Bank") in which the Company agreed not to declare or pay a dividend to its shareholders without the prior written approval of the Reserve Bank.

In March 1996, the Company issued options to purchase a total of 270,000 shares of the Company's common stock. The options were issued to the directors based upon their years of service and their positions with the Company. Each of the options has an exercise price of \$10.00 per share, the market value (as determined by the Board of Directors) of the Company's common stock at the time of issuance. The options were exercisable through March 27, 2001. In March 1997, the Company issued options to purchase a total of 103,000 shares of the Company's common stock to the Company's directors with an exercise price of \$12.50 per share, the market value (as determined by the Board of Directors) of the Company's common stock at the time of issuance. These options are exercisable through March 26, 2002. In March 1998, options to purchase a total of 203,331 shares of the Company's common stock were issued to directors and certain senior officers with an exercise price of \$15.00 per share, the market value (as determined by the Board of Directors) of the Company's common stock at the time of

8

9

### NOTE C - SHAREHOLDERS' EQUITY (CONTINUED)

issuance. These options are exercisable through March 25, 2003. In December 1999, options to purchase a total of 204,000 shares of the Company's common stock were issued to directors and certain senior officers with an exercise price of \$20.00 per share, the market value (as determined by the Board of Directors) of the Company's common stock at the time of issuance. These options are exercisable through December 3, 2004. In August 2000, the Company granted options to purchase an aggregate of 15,000 shares of the Company's common stock to certain senior officers of Community Bank. Each of these options has an exercise price of \$18.00 per share, the market value (as determined by the Board of Directors) of the Company's common stock at the time of issuance. These options are exercisable through August 24, 2005. The Company did not receive any payment in exchange for granting any of such options, which were granted in reliance upon an exemption from registration under Section 4(2) of the Securities Act of 1933.

In March 2001, options to purchase 329,561 shares of the Company's common stock were exercised with a total exercise price of \$3,741,915. These options were exercised in transactions whereby 207,886 shares of the Company's common stock owned by the grantees of the options and valued at \$18.00 per share (as



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determined by the Board of Directors) were delivered to the Company in payment of the exercise price under the options. The cash portion of these transactions was immaterial and related almost entirely to the settlement of fractional shares. These transactions resulted in a net increase of 121,675 shares in the total outstanding shares of the Company's common stock at March 31, 2001. In addition, options to purchase 35,000 shares of the Company's common stock expired during the first quarter of 2001 without being exercised.

Options that have an exercise price below the current fair value of the Company's common stock are assumed to be exercised in the calculation of diluted average shares of common stock outstanding, causing the equivalent average number of shares outstanding on a diluted basis for the three months ended March 31, 2001 to be 30,101 shares greater than that used to calculate basic earnings per share for the three months ended March 31, 2001. Average shares outstanding when assuming dilution were greater than average shares outstanding for basic earnings per share by 207,749 shares for the three months ended March 31, 2000.

### NOTE D - EMPLOYEE STOCK OWNERSHIP PLAN

The Company adopted an Employee Stock Ownership Plan (the "ESOP") effective as of January 1, 1985, which enables eligible employees of the Company and its subsidiaries to own shares of the Company's common stock. An employee becomes a participant in the ESOP on June 30 or December 31 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 the debt service on the ESOP loan. The Company's contributions are allocated to eligible participants in proportion to their compensation, which equals W-2 wages plus pre-tax reductions for the Company's cafeteria plan. The Internal Revenue Code imposes a limit (\$170,000 in 2001) on the amount of compensation which may be considered under the ESOP.

On November 3, 1993, the ESOP's Trustees executed a promissory note of \$1,200,000 in order to purchase shares of the Company's common stock in the Company's initial public offering. The note was originally secured by 80,000 shares of purchased stock. The promissory note has been refinanced in years subsequent to 1993 as additional shares were purchased by the ESOP. On December 1, 1998, this note was refinanced and an additional 56,682 shares of the Company's common stock were obtained by the ESOP. This refinanced note, in the original principal of \$2,963,842, was secured by 261,433 shares of the Company's common stock, and bears interest at a floating rate, with principal and interest payments due monthly through November 16, 2010, with the remaining principal, if any, due on that date. The initial monthly principal and interest payment on this debt in December 1998 was \$31,677. As changes occur in the interest rate on the loan, appropriate adjustments are made to the monthly principal and interest payments. At March 31, 2001, the monthly payment was \$33,852. The Company has

### NOTE D - EMPLOYEE STOCK OWNERSHIP PLAN (CONTINUED)

guaranteed this debt and, in accordance with applicable accounting and reporting guidelines, the debt has been recognized on the Company's consolidated balance sheet, with an offsetting charge against equity. As principal payments are made by the ESOP, the debt and offsetting charge against equity are reduced. The shares securing the note are released on a pro rata basis by the lender as monthly payments of principal and interest are made. As of March 31, 2001, there were 194,980 unreleased shares with a fair value, based on an independent valuation of \$18 per share, of approximately \$3,510,000. These shares are subtracted from outstanding shares of the Company's common stock for earnings

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per share calculations. Effective January 1, 1994, the Company applied the accounting and reporting requirements of Statement of Position No. 93-6, Employers' Accounting for Employee Stock Ownership Plans ("SOP 93-6"). Under the provisions of SOP 93-6, the employer must recognize the indebtedness of its sponsored ESOP on its financial statements and reduce its shareholders' equity for shares of stock which have not been released by a lender to the ESOP for allocation to its participating employees. The portion of payments made by the Company to the ESOP on behalf of its participating employees which is used to pay interest on the ESOP debt (\$57,488 and \$59,541 during the first quarter of 2001 and 2000, respectively) is classified as interest expense on the Company's income statement.

Dividends paid on released ESOP shares are credited to the accounts of the participants to whom the shares are allocated. Dividends on unreleased shares may be used to repay debt associated with the ESOP or treated as other income of the ESOP and allocated to the participants.

At March 31, 2001 and December 31, 2000, the Company's financial statements reflect long-term debt and a corresponding contra-equity account, as a result of the ESOP debt, of \$2,525,032 and \$2,574,002, respectively.

Company contributions to the ESOP amounted to \$101,556 and \$97,684 for the three months ended March 31, 2001 and 2000, respectively.

### NOTE E - CONTINGENCIES

At a meeting of Community Bank's Board of Directors on June 20, 2000, a director brought to the attention of the Board the total amount of money Community Bank had paid subcontractors in connection with the construction of a new Community Bank office. Management of the Company commenced an investigation of the expenditures. At the request of management, the architects and subcontractors involved in the construction project made presentations to the Boards of Directors of the Company and Community Bank on July 15 and July 18, 2000, respectively. At the July 18, 2000 meeting of the Board of Directors of Community Bank, another director made a presentation alleging that Community Bank had been overcharged by subcontractors on that construction project and another current construction project. On July 18, 2000, the Boards of Directors of the Company and Community Bank appointed a joint committee comprised of independent directors of the Company and of Community Bank to investigate the alleged overcharges. Upon completion of its investigation, the joint committee is to inform the Boards of Directors of the Company and Community Bank of its findings and recommendations. The joint committee has retained legal counsel and an independent accounting firm to assist the committee in its investigation. Management has also been informed that the directors of Community Bank who alleged the construction overcharges have contacted bank regulatory agencies and law enforcement authorities. Management believes that these agencies and authorities either have conducted or are currently conducting investigations regarding this matter.

On July 21, 2000, three shareholders of the Company, M. Lewis Benson, Doris E. Benson and John M. Packard, Jr., filed a lawsuit in the state Circuit Court of Marshall County, Alabama against the Company, Community Bank, certain directors and officers of the Company and Community Bank, an employee of Community Bank and two construction subcontractors. The plaintiffs purported to file the lawsuit as a shareholder derivative action, which relates to the alleged construction overcharges being investigated by the joint committee of the Boards of Directors of the Company and Community Bank. The complaint alleges that the directors, officers and employee named as

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### NOTE E - CONTINGENCIES (CONTINUED)

defendants in the complaint breached their fiduciary duties, failed to properly supervise officers and agents of the Company and Community Bank, and permitted waste of corporate assets by allegedly permitting the subcontractor defendants to overcharge Community Bank in connection with the construction of two new Community Bank offices, and to perform the construction work without written contracts, budgets, performance guarantees and assurances of indemnification. In addition, the complaint alleges that Kennon R. Patterson, Sr., the Chairman, President and Chief Executive Officer of the Company, breached his fiduciary duties by allegedly permitting the two named subcontractors to overcharge for work performed on the two construction projects in exchange for allegedly discounted charges for work these subcontractors performed in connection with the construction of Mr. Patterson's residence. The complaint further alleges that the director defendants knew or should have known of this alleged arrangement between Mr. Patterson and the subcontractors. The complaint also alleges that Mr. Patterson, the Community Bank employee and the two subcontractor defendants made false representations and suppressed information about the alleged overcharges and arrangement between Mr. Patterson and the subcontractors. On August 15, 2000, the plaintiffs filed an amended complaint adding Andy C. Mann, a shareholder of the Company, as a plaintiff and adding a former director of the Company and Community Bank as a defendant. The amended complaint generally reiterates the allegations of the original complaint. In addition, the amended complaint alleges that Community Bank was overcharged on all construction projects from January 1997 to the present. The amended complaint also alleges that the defendants breached their fiduciary duties and are guilty of gross financial mismanagement, including allegations concerning the making or approval of certain loans and taking allegedly improper actions to conceal the fact that certain loans were uncollectible. On September 18, 2000 the plaintiffs filed a second amended complaint. The second amended complaint generally reiterates the allegations of the original and first amended complaints. In addition, the second amended complaint alleges that the plaintiffs were improperly denied their rights to inspect and copy certain records of the Company and Community Bank. The second amended complaint also alleges that the directors of the Company abdicated their roles as directors either by express agreement or as a result of wantonness and gross negligence. The second amended complaint asserts that the counts involving inspection of corporate records and director abdication are individual, nonderivative claims. The second amended complaint seeks, on behalf of the Company, an unspecified amount of compensatory damages in excess of \$1 million, punitive damages, disgorgement of allegedly improperly paid profits and appropriate equitable relief. Upon motion of the defendants, the case was transferred to the state Circuit Court in Blount County, Alabama by order dated September 21, 2000, as amended on October 12, 2000. On August 24, 2000, the Board of Directors of the Company designated the directors of the Company who serve on the joint investigative committee as a special litigation committee to investigate and evaluate the allegations and issues raised in this lawsuit and to arrive at such decisions and take such action as the special litigation committee deems appropriate. At a hearing on February 23, 2001 the court stayed discovery with respect to the Company, Community Bank and the directors, officers and employees of each until May 24, 2001, at which time the court expects to receive a report from the special litigation committee. Because the special litigation committee has not yet completed its investigation, and as a result of the inherent uncertainties of the litigation process, the Company is unable at this time to predict the outcome of this lawsuit and its effect on the Company's financial condition and results of operations. Regardless of the outcome, however, this lawsuit could be costly, time-consuming and a diversion of management's attention.

On November 19, 1998, Mr. William Towns, a shareholder of the Company, filed a shareholder derivative action against the directors of the Company in the state

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

11

12

### NOTE E - CONTINGENCIES (CONTINUED)

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

On September 14, 2000, an action was filed in the state Circuit Court of Blount County, Alabama, against the Company, Community Bank and certain directors and officers of the Company and Community Bank by seven shareholders of the Company, alleging that the directors actively participated in or ratified the misappropriation of corporate income. The action was not styled as a shareholder derivative action. On January 3, 2001, the defendants filed a motion for summary judgment on the basis that these claims are derivative in nature and cannot be brought on behalf of individual shareholders. The court has not ruled on the motion. The Company and its directors believe that this lawsuit is without merit and intend to defend the action vigorously. Although management currently believes that this action will not have a material adverse effect on the

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Company's financial condition or results of operations, regardless of the outcome, the action could be costly, time consuming and a diversion of management's attention.

On November 15, 2000, Michael W. Alred and Michael A. Bean, two former directors and executive officers of Community Bank, filed suit against Community Bank in the United States District Court for the Northern District of Alabama alleging that their employment was wrongfully terminated for allegedly providing information to bank regulatory and law enforcement authorities concerning possible violations of laws and regulations, gross mismanagement, gross waste of funds and abuse of authority by Community Bank, its directors, officers and employees. According to the complaint, the information which these two individuals provided to authorities concerned certain bank construction projects, specific loans, charge-offs, expenses and past due accounts. The complaint seeks reinstatement of the plaintiffs to their former positions as officers and directors of Community Bank as well as compensatory and punitive damages. Community Bank and its directors believe this lawsuit is without merit and intend to defend the action vigorously. Management of the Company believes that this action will not have a material adverse effect on the Company's financial condition or results of operations.

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

12

13

### NOTE E - CONTINGENCIES (CONTINUED)

On June 28, 2000, Community Bank filed an action in the United States District Court for the Northern District of Alabama against Carl Gregory Ford L-M, Inc., an automobile dealership located in Ft. Payne, Alabama, Carl Gregory and Doug Broadus, the owners of the dealership, several employees and former employees of the dealership and Gerald Scot Parrish, a former employee of Community Bank, with respect to certain loans originated during 1998 in Community Bank's Wal-Mart office in Ft. Payne, Alabama. In the complaint Community Bank alleged that the defendants willingly and knowingly conducted, participated in, were employed by or associated with, or aided and abetted an enterprise within the meaning of the Racketeer Influenced and Corrupt Organizations Act (RICO) for the purpose of defrauding Community Bank. The complaint also asserted that the defendants committed fraud, misrepresentation and deceit by submitting to Community Bank and/or approving applications for automobile loans which contained false and/or fraudulent information for the purpose of deceiving, influencing and persuading Community Bank to provide loans to customers of the automobile dealership who were otherwise not qualified to receive such loans, and suppressed material facts regarding the veracity of information contained in loan applications and the ability of persons seeking the loans to repay them. Community Bank also alleged in the complaint that the automobile dealership is responsible for the acts of its officers, agents and employees, and that the dealership and its management failed to adequately train and/or supervise its employees. The complaint stated that the defendants participated in a conspiracy to violate RICO and Alabama statutes dealing with fraud, misrepresentation and suppression of material facts, and asserted civil liability under Alabama law for violation of federal statutes dealing with financial institution fraud, mail and wire fraud and making false statements for the purpose of influencing the actions of a financial institution upon an application or loan. On June 29, 2000 and August 31, 2000 the court granted Community Bank's motions to dismiss

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without prejudice two of the employees of the automobile dealership as defendants in the action. On September 13, 2000, the court granted Mr. Parrish's motion to dismiss the complaint, but granted Community Bank 15 days to amend the complaint. On September 27, 2000, Community Bank filed an amended complaint which generally reiterated the allegations of the original complaint and added specific information concerning the allegedly fraudulent activity and the use of the United States mail, telephone and other wire transmissions in the conduct of such activity. On December 1, 2000, the court dismissed Community Bank's claims based upon mail and wire fraud in the amended complaint but otherwise denied Mr. Parrish's motion to dismiss the complaint. The defendants have filed answers to the amended complaint which generally deny the material allegations in the complaint and allege that any injury suffered by Community Bank was the result of the contributory negligence of Community Bank, its officers, employees and agents. In the lawsuit, Community Bank seeks damages of an unspecified amount to recover losses incurred in connection with the loans made at Community Bank's Wal-Mart office in Ft. Payne, Alabama, along with all costs associated with the lawsuit. Any amounts received by Community Bank as a result of this litigation will be treated as a recovery on loan losses.

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

13

14

### NOTE F - SUBSEQUENT EVENTS

On April 18, 2001, the Board of Directors of Community Bank (the "Bank"), a wholly owned subsidiary of Community Bancshares, Inc. (the "Company"), made written assurances to the Regional Director of the Federal Deposit Insurance Corporation's Atlanta Regional Office and the Alabama Superintendent of Banks (the "Supervisory Agencies"). In making these written assurances, the Bank committed to take certain actions. The Bank committed to adopt a management plan relating to bank officers, change the composition of the Bank's Board to include a majority of outside directors who are neither bank officers nor relatives of bank officers or principal shareholders, develop an educational program for bank directors, provide for periodic review of bank policies by the Board, require periodic reporting of policy exceptions to the Board, and adopt an ethics policy for bank officers and directors. The Bank also committed to adopt and implement policies and procedures relating to certain areas of bank operations including: strategic planning, budgeting, acquisition of property for future expansion, loan approval, loan documentation, loan review, the allowance for loan and lease losses, reduction and charge-off of nonperforming loans, liquidity and interest rate risk, and internal routine and controls. The Bank has also committed to certain financial goals relating to capital ratios, dependence upon potentially volatile liabilities, and adequacy of the allowance for loan and lease losses. In connection with these financial goals, the Bank committed to pay no cash dividends without the concurrence of its Supervisory Agencies. It should also be noted that the Bank may, at various times, be subject to the provisions of Section 5-5A-21 of the Alabama Banking Code requiring the prior approval of cash dividends by the Alabama Superintendent of Banks. Management of the Company cannot currently estimate the effects of these commitments on the financial condition, liquidity and results of operations of the Bank or the Company.

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ITEM 2.  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION  
AND RESULTS OF OPERATIONS

This discussion is intended to assist in an understanding of the financial condition and results of operations of Community Bancshares, Inc. (the "Company") and its subsidiaries. Unless the context otherwise indicates, the Company shall include the Company and its subsidiaries. This analysis should be read in conjunction with the financial statements and related notes appearing in Item 1 of this Report and Management's Discussion and Analysis of Financial Condition and Results of Operations appearing in the Company's Annual Report on Form 10-K for the year ended December 31, 2000.

Certain statements in this Report are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements are not based on historical facts and may be identified by their reference to a future period or by the use of forward-looking terminology, such as "anticipate," "estimate," "expect," "may" and "should." These forward-looking statements include, without limitation, those relating to the Company's future growth and profitability, pending litigation, non-compliant and impaired loans originated in Community Bank's Double Springs, Alabama office, capital resources operating strategy, deposits, consumer base, allowance for loan losses, noninterest expenses, market risk and commitments to regulatory authorities. We caution you not to place undue reliance on these forward-looking statements. Actual results could differ materially from those indicated in such forward-looking statements due to a variety of factors. These factors include, but are not limited to, changes in economic conditions and government fiscal and monetary policies, changes in prevailing interest rates and effectiveness of the Company's interest rate strategies, laws, regulations and regulatory authorities affecting financial institutions, changes in and effectiveness of the Company's operating or expansion strategies, geographic concentration of the Company's assets and operations, competition from other financial services companies, unexpected financial results or outcomes of legal proceedings, the Company's ability to obtain reimbursement from its fidelity bond insurance carrier or other persons responsible for originating non-compliant and impaired loans in Community Bank's Ft. Payne, Alabama and Double Springs, Alabama offices and other risks detailed from time to time in the Company's press releases and filings with the Securities and Exchange Commission. We undertake no obligation to update these forward-looking statements to reflect events or circumstances occurring after the date of this Report.

RESULTS OF OPERATIONS

THREE MONTHS ENDED MARCH 31, 2001 AND 2000

SUMMARY

The Company's net income for the three months ended March 31, 2001 was approximately \$805,000, an increase of \$351,000, or 77.3%, from \$454,000 for the same period in 2000. Basic net income per share was \$.18 for the three months ended March 31, 2001, as compared to \$.10 for the same period in 2000. Diluted net income per share was \$.18 and \$.10 for the three months ended March 31, 2001 and 2000, respectively. This increase during the first quarter of 2001 compared to the same period of 2000 primarily resulted from an increase of approximately \$167,000, or 6.7%, in noninterest income and a reduction of approximately

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\$804,000, or 10.5%, in noninterest expense during the first quarter of 2001 compared to the first quarter of 2000, which offset a decline of approximately \$560,000, or 8.2%, in net interest income, before provision for loan losses during the first quarter of 2001 compared to the first quarter of 2000. The provision for loan losses decreased \$57,000, or 5.7%, to approximately \$951,000 during the three months ended March 31, 2001, from approximately \$1,008,000 in the same period of 2000.

15

16

### NET INTEREST INCOME

Net interest income, the difference between interest earned on assets and the cost of interest-bearing liabilities, is the largest component of the Company's net income. Net interest income, before provision for loan losses, decreased \$560,000, or 8.2%, to approximately \$6,290,000 for the three months ended March 31, 2001, from approximately \$6,850,000 for the same period of 2000.

Revenues from interest earning assets of the Company increased \$790,000, or 5.5%, to approximately \$15,105,000 for the three months ended March 31, 2001 from approximately \$14,315,000 for the same period in 2000. This increase was due to both higher average outstanding balances of earning assets coupled with a slight increase in the average yield on these balances. Average earning assets outstanding during the first quarter of 2001 were approximately \$638,829,000, which represents an increase of approximately \$35,483,000, or 5.9%, from approximately \$603,346,000 for the first quarter of 2000. In addition, the Company's fully taxable equivalent yield on its average earning assets increased eight basis points to 9.69% for the first three months of 2001, compared to 9.61% for the same period of 2000. Interest expense for the three months ended March 31, 2001 increased approximately \$1,350,000, or 18.1%, to \$8,815,000 from \$7,465,000 for the corresponding period of 2000. This increase was due to both higher average outstanding balances of interest-bearing liabilities and an increase in the average rate paid on these balances. Average interest-bearing liabilities during the first quarter of 2001 were approximately \$596,803,000, which represents an increase of \$32,903,000, or 5.8%, from approximately \$563,900,000 for the same period of 2000. The rate paid on average interest-bearing liabilities increased 67 basis points to 5.99% for the three month period ended March 31, 2001, compared to 5.32% for the first three months of 2000. A portion of this increase in the rate paid on average interest-bearing liabilities was attributable to the Company's junior subordinated deferrable interest debentures, which carry an annual interest rate of 10.875% and were outstanding for the entire first quarter of 2001, compared to only nine days during the first quarter of 2000. In addition, during the first and second quarters of 2000 Community Bank offered several special certificate of deposit products at higher rates with maturities ranging from 11 to 24 months.

The Company's net interest margin, on a fully taxable equivalent basis, for the three months ended March 31, 2001 decreased 55 basis points to 4.09%, from 4.64% for the three months ended March 31, 2000, due to a decline in net interest income, on a fully taxable equivalent basis, coupled with an increase in average interest earning assets. Net interest margin is computed by dividing net interest income, on a fully taxable equivalent basis, by average interest earning assets. This ratio represents the difference between the average yield returned on average interest earning assets and the average rate paid on funds used to support those interest earning assets, including both interest-bearing and noninterest-bearing sources.

The Company's net interest spread, on a fully taxable equivalent basis, for the



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three months ended March 31, 2001 decreased 59 basis points to 3.7%, from 4.29% for the three months ended March 31, 2000, as the average cost of interest-bearing sources of funds increased 67 basis points while the fully taxable equivalent average yield on interest earning assets increased eight basis points. Net interest spread measures the difference between the average yield on interest earning assets and the average rate paid on interest-bearing sources of funds.

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

The Company maintains an allowance for loans losses to absorb losses inherent in the loan portfolio. The allowance is based upon management's estimated range of those losses. Actual losses for these loans may vary significantly from this estimate. At March 31, 2001, the allowance for loan losses was approximately \$7,493,000, which represented a \$386,000, or 5.4%, increase over the December 31, 2000 amount of \$7,107,000. This increase was primarily due to a provision made in connection with certain loans originated in Community Bank's Double Springs, Alabama, office, which are discussed below. As a percentage of total loans, net of unearned income, the allowance for loan losses increased to 1.43% at March 31, 2001 from 1.35% at December 31, 2000. Management believes that the allowance for loan losses at March 31, 2001 is adequate to absorb known risks in the Company's loan portfolio based upon the Company's historical experience. No assurance can be given, however, that increased loan volume, adverse economic conditions or other circumstances will not result in increased losses in the Company's loan portfolio or additional provisions to the allowance for loan losses.

16

17

In assessing the adequacy of the allowance for loan losses, management relies predominantly on its ongoing review of the loan portfolio, which is undertaken both to ascertain whether there are probable losses which must be charged off and to assess the risk characteristics of the portfolio in the aggregate. This review takes into consideration the judgments of the responsible lending officers and senior management, and also those of bank regulatory agencies that review the loan portfolio as part of the regular bank examination process. Loans identified as having increased credit risk are classified in accordance with the Company's loan policy and appropriate reserves are established for each loan classification category based on pre-determined reserve percentages. Reserves are established for the remaining unclassified portion of the loan portfolio based on actual historical loss factors associated with certain loan types.

The provision for loan losses is charged to current earnings to bring the allowance for loan losses to a level deemed appropriate by management. Actual loan losses are charged directly to the allowance for loan losses while recoveries on charged-off loans are credited to the allowance for loan losses. The amount of the provision for loan losses is based on the growth of the loan portfolio, the amount of net loan losses incurred and management's estimation of potential future losses based on an evaluation of the risk in the loan portfolio. The provision for loan losses decreased \$57,000, or 5.7%, to approximately \$951,000 for the three months ended March 31, 2001 from approximately \$1,008,000 for the same period of 2000. This decrease in the provision for loan losses reflects a 17.7% decline in gross loans charged-off during the first quarter of 2001 compared to the same period of 2000. The decline in charge-offs is primarily due to the high level of loan losses recognized in 2000. Charge-offs exceeded recoveries by approximately \$565,000 for the three months ended March 31, 2001, compared to approximately \$770,000

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for the same period of 2000.

In March 2001, management of Community Bank became aware that an employee in Community Bank's Double Springs, Alabama location had improperly originated approximately \$1,200,000 in loans primarily during 2000 and the first quarter of 2001, in violation of Community Bank's lending policies, and had manipulated loan payments to make it falsely appear that payments under the loans were current. The bank employee has admitted wrongdoing in connection with the loans and his employment with Community Bank has been terminated. Management has notified federal and state banking regulatory authorities, law enforcement authorities and the Company's fidelity bond carrier, and is cooperating with law enforcement authorities in their investigation of the matter. While the Company has not completed its investigation of these loans, management's estimate of the impairment of such loans at March 31, 2001 was approximately \$839,000. As of December 31, 2000, the Company had made a provision and increased its allowance for loan losses by approximately \$501,000 to reflect the estimated impairment of these loans at year-end 2000. The Company made a additional provision and increased its allowance for loan losses by approximately \$338,000 to reflect this increase in the estimated impairment of these loans at March 31, 2001. An appropriate charge with respect to actual losses determined will be made to the Company's allowance for loan losses.

### NONINTEREST INCOME

Noninterest income for the three months ended March 31, 2001 increased \$167,000, or 6.7%, to approximately \$2,662,000, from approximately \$2,495,000 for the same period of 2000, due to gains recognized on the sale of investment securities. Service charges on deposit accounts increased \$44,000, or 4.5%, to approximately \$1,026,000 for the first quarter of 2001 from approximately \$982,000 in the first quarter of 2000. Other noninterest income decreased \$169,000, or 28.7%, to approximately \$420,000 for the first quarter of 2001 from approximately \$589,000 for the same period of 2000. This decrease was primarily due to decreases in service fees through the Company's appraisal company subsidiary and profit sharing income through the Company's insurance company subsidiary. During the first quarter of 2001, insurance commissions decreased approximately \$38,000, or 6.6%, to approximately \$541,000 and debt cancellation fees decreased approximately \$44,000, or 22.4%, to approximately \$152,000, compared to the same period of 2000. The Company recorded net gains on the sale of investment securities of approximately \$353,000 during the three months ended March 31, 2001, compared to net losses on the sale of investment securities of approximately \$27,000 for the same period of 2000.

17

18

### NONINTEREST EXPENSES

Noninterest expenses for the three months ended March 31, 2001 were approximately \$6,865,000, representing a \$804,000, or 10.5%, decrease from \$7,669,000 for the same period of 2000. This decrease reflects efforts begun by management in the first quarter of 2000 to limit noninterest expenses. The primary components of noninterest expenses are salaries and employee benefits, which decreased \$755,000, or 15.6%, to approximately \$4,081,000 for the three months ended March 31, 2001 from approximately \$4,836,000 for the same period of 2000. The decrease in salaries and employee benefits was primarily due to salary reductions at the executive officer level of Community Bank and the Company and staff reductions through attrition and down-sizing. Occupancy costs increased \$67,000, or 10.4%, to approximately \$712,000 for the first quarter of 2001 from

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approximately \$645,000 for the same period of 2000, primarily due to higher costs associated with the Company's expansion activities during 2000. Furniture and equipment expenses for the three month periods ended March 31, 2001 declined \$13,000, or 2.8%, to approximately \$450,000 for the three months ended March 31, 2001 from approximately \$463,000 for the same period of 2000, primarily due to a reduction in the number of automobiles owned or leased by the Company and its subsidiaries. Director and committee fees decreased \$31,000, or 20.9%, to approximately \$117,000 for the first quarter of 2001 from approximately \$148,000 for the first quarter of 2000. Other operating expenses were approximately \$1,504,000 and \$1,576,000 for the three month periods ended March 31, 2001 and 2000, respectively. This decrease of approximately \$72,000, or 4.6%, was primarily due to reductions in advertising and promotions, travel and entertainment, civic and social dues and donations.

### INCOME TAXES

The Company attempts to maximize its net income through active tax planning. The provision for income taxes increased \$118,000, or 55.1%, to approximately \$332,000 for the three months ended March 31, 2001 from approximately \$214,000 for the same period of 2000. The effective tax rate of approximately 29.2% for the first quarter of 2001 was 85.9% of the statutory Federal tax rate and represents a decrease from the effective tax rate of approximately 32.0% for the same period of 2000. This decrease is in part due to the effect of an increase in tax-exempt interest income.

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18

19

### FINANCIAL CONDITION

MARCH 31, 2001 COMPARED TO DECEMBER 31, 2000

#### LOANS

Loans comprised the largest single category of the Company's earning assets at March 31, 2001. Loans, net of unearned income and reserve for loan losses, were 71.9% and 73.1% of total assets at March 31, 2001 and December 31, 2000, respectively. Loans, net of unearned income and allowance for loan losses, were approximately \$517,872,000 at March 31, 2001, representing a \$3,337,000, or 0.6%, decrease from the December 31, 2000 total of approximately \$521,209,000. This decrease primarily resulted from a decline in outstanding loans originated by 1st Community Credit Corporation, the Company's finance company subsidiary.

Commercial, financial and agricultural loans increased by approximately \$6,411,000, or 4.6%, to approximately \$147,184,000 at March 31, 2001 from approximately \$140,773,000 at December 31, 2000, and represented 28.0% of total loans at March 31, 2001, compared to 26.6% at December 31, 2000. Real estate-mortgage loans decreased by approximately \$2,864,000, or 1.2%, to approximately \$233,728,000 at March 31, 2001 from approximately \$236,592,000 at December 31, 2000, and represented 44.5% of total loans at March 31, 2001, compared to 44.8% at December 31, 2000. Consumer loans decreased by approximately \$5,259,000, or 3.6%, to approximately \$140,414,000 at March 31,

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2001 from \$145,673,000 at December 31, 2000, and represented 26.7% of total loans at March 31, 2000, compared to 27.6% at December 31, 2000. Real estate-construction loans decreased by approximately \$1,284,000, or 23.7%, to approximately \$4,145,000 at March 31, 2001 from approximately \$5,429,000 at December 31, 2000, and represented 0.8% of total loans at March 31, 2001, compared to 1.0% at December 31, 2000.

### INVESTMENT SECURITIES AND OTHER EARNING ASSETS

Investment securities increased \$3,415,000, or 3.4%, to approximately \$104,985,000 at March 31, 2001 from approximately \$101,570,000 at December 31, 2000. The investment securities portfolio is used to make various term investments, to provide a source of liquidity and to serve as collateral to secure certain government deposits. Short-term investments in the form of interest-bearing deposits with banks were \$700,000 at both March 31, 2001 and December 31, 2000. The Company had \$11,000,000 in federal funds sold at March 31, 2001, compared to \$3,000,000 at December 31, 2000, representing an increase of \$8,000,000, or 266.7%. The increase in federal funds sold was primarily due to growth in deposits coupled with the decline in outstanding loans during the first quarter of 2001.

### ASSET QUALITY

Between December 31, 2000 and March 31, 2001, the ratio of the allowance for loan losses to total nonperforming assets (defined as nonaccruing loans, loans past due 90 days or greater, restructured loans, nonaccruing securities, and other real estate) declined from 112.3% at year-end 2000 to 105.3% at March 31, 2001. The ratio of total nonperforming assets to total assets increased to 1.0% at March 31, 2001 from 0.9% at year-end 2000, while the ratio of nonperforming loans to total loans, net of unearned income, increased to 0.9% at March 31, 2001 from 0.8% at December 31, 2000. These changes were primarily due to an increase in nonaccruing loans of \$897,000, or 47.8%, to approximately \$2,774,000 at March 31, 2001 from \$1,877,000 at December 31, 2000 and an increase in other real estate of \$392,000, or 20.8%, to approximately \$2,273,000 at March 31, 2001 from approximately \$1,881,000 at December 31, 2000. These increases were partially offset by a decline in loans past due 90 days or more of \$501,000, or 19.5%, to approximately \$2,070,000 at March 31, 2001 from approximately \$2,571,000 at December 31, 2000. Total nonperforming assets increased \$788,000, or 12.5%, to approximately \$7,117,000 at March 31, 2001 from approximately \$6,329,000 at December 31, 2000.

In March 2001, management of Community Bank became aware that an employee in Community Bank's Double Springs, Alabama location had improperly originated approximately \$1,200,000 in loans, primarily during 2000 and the first quarter of 2001, in violation of Community Bank's lending policies, and had manipulated loan payments to make it falsely appear that payments under the loans were current. The bank employee has admitted wrongdoing in connection with the loans and his employment with Community Bank has been terminated. Management has notified federal and state banking regulatory authorities, law enforcement authorities and the Company's fidelity bond carrier, and is cooperating with law enforcement authorities in their investigation of the matter. While the Company has not completed its investigation of these loans, management's estimate of the impairment of such loans at March 31, 2001 was approximately \$839,000. As of December 31, 2000, the Company had made a provision and increased its allowance for loan losses by approximately \$501,000 to reflect the estimated impairment of

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these loans at year-end 2000. The Company made an additional provision and increased its allowance for loan losses by approximately \$338,000 to reflect the increase in the estimated impairment of these loans at March 31, 2001. An appropriate charge with respect to actual losses determined will be made to the Company's allowance for loan losses. See "- Results of Operations - Provision for Loan Losses and Allowance for Loan Losses" above.

### DEPOSITS

Total deposits of approximately \$606,658,000 at March 31, 2001 reflected an increase of \$5,757,000, or 1.0%, from approximately \$600,901,000 at year-end 2000. Deposits are Community Bank's primary source of funds. Noninterest-bearing deposits increased \$1,258,000, or 1.9%, to approximately \$68,544,000 at March 31, 2001 from approximately \$67,286,000 at December 31, 2000, while interest-bearing deposits increased \$4,498,000, or 0.8%, to approximately \$538,113,000 at March 31, 2001 from approximately \$533,615,000 at December 31, 2000. Certificates of deposit of \$100,000 or more increased \$2,774,000, or 2.7%, to approximately \$103,786,000 at March 31, 2001 from, approximately \$101,012,000 at December 31, 2000.

### BORROWINGS

Community Bank uses borrowed funds as a source of funds for asset growth in excess of deposit growth and for short-term liquidity needs. The mixture of borrowed funds and deposits as sources of funds depends on the relative availability and cost of those funds and Community Bank's need for funding. Borrowed funds consist primarily of short-term borrowings, borrowings from the Federal Home Loan Bank of Atlanta, Georgia (FHLB-Atlanta) and long-term debt.

Other short-term borrowings totaled approximately \$1,582,000 at March 31, 2001, a \$683,000, or 30.1%, decrease from approximately \$2,265,000 at December 31, 2000. At March 31, 2001, short-term borrowings primarily consisted of the U. S. Treasury Tax and Loan Note Option account and securities sold under agreement to repurchase. Balances under the U. S. Treasury Tax and Loan Note Option are subject to call at any time by the U. S. Treasury. The decrease during the first quarter of 2001 was due to a decrease of approximately \$1,165,000 in balances outstanding under the U. S. Treasury Tax and Loan Note Option, which was partially offset by an increase of approximately \$482,000 in securities sold under agreement to repurchase.

At March 31, 2001 and December 31, 2000, the Company had notes payable totaling approximately \$5,435,000 and \$5,675,000, respectively.

In December 1992, the Company entered into a loan agreement with a regional bank for amounts up to \$6,500,000. At March 31, 2001 and December 31, 2000, the amounts outstanding under this loan agreement were approximately \$1,245,000 and \$1,423,000, respectively, due December 2002, bearing interest at a floating prime rate, and collateralized by 100% of the common stock of Community Bank, the Company's subsidiary bank. The note agreement contains provisions which limit the Company's right to transfer or issue shares of Community Bank's stock. Principal payments of \$59,292 are due monthly; however, the Company has the option of postponing up to 24 monthly principal payments, provided that no more than six consecutively scheduled installments are deferred. The Company did not postpone any principal payments under this loan agreement during the first quarter of 2001.

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On November 3, 1993, the ESOP's Trustees executed a promissory note of \$1,200,000 in order to purchase shares of the Company's common stock in the Company's initial public offering. The note was originally secured by 80,000 shares of purchased stock. The promissory note has been refinanced as additional shares were purchased by the ESOP. On December 1, 1998, this note was refinanced and an additional 56,682 shares of the Company's common stock were obtained by the ESOP. This refinanced note, in the original principal of \$2,963,842, was secured by 261,433 shares of the Company's common stock, and bears interest at a floating rate, with principal and interest payments due monthly through November 16, 2010, with the remaining principal, if any, due on that date. The initial monthly principal and interest payment on this debt in December 1998 was \$31,677. As changes occur in the interest rate on the loan, appropriate adjustments are made to the monthly principal and interest payments. At March 31, 2001, the monthly payment was \$33,852. The Company has guaranteed this debt and, in accordance with applicable accounting and reporting guidelines, the debt has been recognized on the Company's consolidated balance sheet, with an offsetting charge against equity. As principal payments are made by the ESOP, the debt and offsetting charge against equity are reduced. The shares securing the note are released on a pro rata basis by the lender as monthly payments of principal and interest are made. The outstanding balance of this note was approximately \$2,562,000 at March 31, 2001 and approximately \$2,606,000 at December 31, 2000, and was secured by 194,980 and 199,877 unreleased shares of the Company's common stock at March 31, 2001 and December 31, 2000, respectively.

On October 4, 1994, the Company entered into a 20-year subordinated installment capital note due October 1, 2014 for the purchase of treasury stock. Monthly principal and interest payments of \$15,506 are made on the note, which bears interest at the fixed rate of 7%. The Company maintains the right to prepay the note at its sole discretion. The balance of the note was approximately \$1,628,000 at March 31, 2001 and \$1,646,000 at December 31, 2000.

Since June 1999, Community Bank has borrowed funds under the Federal Home Loan Bank of Atlanta's (FHLB-Atlanta) "Convertible Advance Program." These advances have had original maturities of 10 years, with stated call features during the life of the obligation, at fixed interest rates for the life of the obligations. Principal is due at final maturity or on stated call dates, with interest payable each quarter. On June 1, 1999, Community Bank, the Company's bank subsidiary, borrowed \$30,000,000 under the FHLB-Atlanta's "Convertible Advance Program." This advance had a final maturity of June 1, 2009 (120 months), with a call feature every three months during the life of the obligation, and carried a fixed interest rate of 4.62% per annum. These funds were used to replace \$20,000,000 in FHLB-Atlanta overnight borrowings and to fund loan growth. This obligation was called on September 1, 1999 due to an increase in market interest rates. As a result of this call, Community Bank refinanced the original advance and borrowed an additional \$10,000,000 under the same "Convertible Advance Program." This advance, totaling \$40,000,000 at December 31, 1999, had a final maturity of September 1, 2009 (120 months), with a call feature every six months during the life of the obligation, and carried a fixed rate of 4.99% per annum. Due to the call of this obligation on March 1, 2000, Community Bank made a \$2,000,000 reduction in the amount advanced under the FHLB-Atlanta "Convertible Advance Program" and refinanced \$38,000,000. This new obligation has a final maturity of March 1, 2010 (120 months), a call feature every 12 months during the life of the obligation, and a fixed interest rate of 5.93% per annum. This advance was not called on March 1, 2001. Outstanding funds advanced to Community Bank under the FHLB-Atlanta "Convertible Advance Program" totaled \$38,000,000 at March 31, 2001.

In March 2000, the Company formed a wholly-owned Delaware statutory business trust, Community (AL) Capital Trust I (the "Trust"), which issued \$10,000,000 of guaranteed preferred securities representing undivided beneficial interests in

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the assets of the Trust ("Capital Securities"). The proceeds from the issuance of the Capital Securities and common securities (\$310,000) were used by the Trust to purchase \$10,310,000 of junior subordinated deferrable interest debentures of the Company which carry an annual interest rate of 10.875%. The principal balance outstanding is due at maturity on March 8, 2030. However, as specified in the indenture, the debentures can be redeemed prior to maturity at a redemption price equal to a percentage of the principal amount, ranging from 105.438% in the year 2010 to 100.00% in and after the year 2020, plus accrued but unpaid interest. As of March 31, 2001, the Company's consolidated financial statements reflected \$10,000,000 in junior subordinated deferrable interest debentures, after the effects of elimination.

21

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Maturities and stated calls of long-term debt and FHLB borrowings for the years ending December 31, are as follows:

	Notes Payable	Subordinated Debt	FHLB Borrowi
	-----	-----	-----
2001.....	\$ 655,311	\$ 55,354	\$
2002.....	893,705	78,461	38,0
2003.....	200,287	84,133	
2004.....	220,165	90,215	
2005.....	242,015	96,737	
Thereafter.....	1,595,710	1,223,260	
	-----	-----	-----
	\$ 3,807,193	\$ 1,628,160	\$ 38,0
	=====	=====	=====

### SHAREHOLDERS' EQUITY

The Company's shareholders' equity increased \$2,198,000, or 5.3%, to approximately \$43,388,000 at March 31, 2001 from approximately \$41,190,000 at December 31, 2000, due to net earnings of approximately \$805,000, a reduction in unearned ESOP shares of approximately \$49,000 coupled with an increase in capital surplus of approximately \$39,000 resulting from compensation expense recorded on released ESOP shares, the issuance of additional common stock of approximately \$210,000, an increase in unrealized losses, net of a deferred tax assets, on securities available for sale totaling approximately \$307,000 and an increase in capital surplus of approximately \$788,000 for the tax benefit associated with the exercise of stock options in March 2001.

### CAPITAL RESOURCES

Bank regulatory authorities have placed increased emphasis on the maintenance of adequate capital, and subsequently developed risk-based capital guidelines. The guidelines take into consideration risk factors, as defined by regulators, associated with various categories of assets, both on and off the balance sheet. Under the guidelines, capital strength is measured in two tiers which are used

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in conjunction with risk-adjusted assets to determine the risk-based capital ratios. The Company's Tier I capital, which consists of common equity and junior subordinated deferrable interest debentures, less goodwill and unrealized gains on debt securities, amounted to approximately \$47,944,000 at March 31, 2001. Tier II capital components, totaling approximately \$7,770,000 at March 31, 2001, include supplemental capital components such as qualifying allowance for loan losses and qualifying subordinated debt. Tier I capital plus Tier II capital components are referred to as Total Risk-Based capital and were approximately \$55,714,000 at March 31, 2001.

As of March 31, 2001, the Company and Community Bank, its banking subsidiary, were classified as well capitalized under the financial institutions regulatory framework. Management has reviewed and will continue to monitor the Company's asset mix, product pricing and loan loss allowance, which are the areas determined to be most affected by these requirements.

22

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On April 9, 2001, the Company's Board of Directors entered into a memorandum of understanding with the Federal Reserve Bank of Atlanta. As part of this agreement, the Company agreed to maintain a quarterly Tier I leverage capital ratio (the ratio of Tier I capital to average assets, less goodwill) of at least 6.5%. At March 31, 2001, the Company's Tier I leverage capital ratio was 6.78%. On April 18, 2001, the Board of Directors of Community Bank, the Company's subsidiary bank, also made a commitment to the Regional Director of the Federal Deposit Insurance Corporation's Atlanta Regional Office and the Alabama Superintendent of Bank's with regard to certain financial goals related to Community Bank's capital ratios.

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

The Company's net interest income, and the fair value of its financial instruments, are influenced by changes in the level of interest rates. Interest rate sensitivity is a function of the repricing characteristics of the Company's interest-earning assets and interest-bearing liabilities. Management monitors



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its interest rate risk exposure through the use of a Static Gap analysis and an Interest Rate Shock analysis.

The static gap analysis measures the amount of repricing risk embedded in the balance sheet at a specific point in time, by comparing the difference in the volume of interest-earning assets and interest-bearing liabilities that are subject to repricing within specific time periods. During the first quarter of 2001, Community Bank experienced increases in both its interest earning assets and its interest bearing liabilities repricing within one year compared to year-end 2000. While the Company remained more liability sensitive at March 31, 2001, indicating that it had more interest bearing liabilities than interest earning assets repricing during the twelve months ending March 31, 2002, rate sensitive assets increased more than rate sensitive liabilities during the first quarter of 2000 and resulted in a slight improvement in the Company's static gap position. The cumulative static gap position of rate sensitive assets to rate sensitive liabilities at March 31, 2000 was: i) 68% at 30 days; ii) 65% at 90 days; iii) 62% at 180 days; and iv) 56% at 365 days.

The interest rate shock analysis measures the impact on Community Bank's net interest income as a result of immediate and sustained shift in interest rates. The movement in market rates are based on statistical regression analyses while management makes assumptions concerning balance sheet growth and the magnitude of interest rate movements for certain interest earning asset and interest-bearing liabilities. Using actual maturity and repricing opportunities of Community Bank's portfolio, in conjunction with management's assumptions, a rate shock analysis is performed using a plus 200 basis points shift and a minus 200 basis points shift in interest rates. Based on the Company's March 31, 2001 Asset/Liability Analysis, the improvement in net interest income, over the next 12 months, resulting from a 200 basis points decrease in the interest rate environment would result in a \$1,598,000, or 5.9%, decrease in net interest income. Conversely, a 200 basis points increase in interest rates would result in a \$171,000, or 0.6%, decrease in net interest income for the same period.

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24

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### PART II - OTHER INFORMATION

#### ITEM 1 - LEGAL PROCEEDINGS

There have been no material developments in the legal proceedings disclosed in the section captioned "Item 3 - Legal Proceedings" in the Company's Annual Report on Form 10-K for the year ended December 31, 2000.

The Company and its subsidiaries are from time to time parties to other legal proceedings arising from the ordinary course of business. Management believes, after consultation with legal counsel, that no such proceedings, if resulting in an outcome unfavorable to the Company, will, individually or in the aggregate,

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have a material adverse effect on the Company's financial condition or results of operations.

### ITEM 2 - CHANGES IN SECURITIES AND USE OF PROCEEDS

In February 2001, the Company issued an aggregate of 11,661 shares of its common stock to certain of Community Bank's city directors in payment of director fees, in reliance upon an exemption from registration under Section 4(2) of the Securities Act of 1933.

### ITEM 5 - OTHER INFORMATION

On April 18, 2001, the Board of Directors of Community Bank (the "Bank"), a wholly owned subsidiary of Community Bancshares, Inc. (the "Company"), made written assurances to the Regional Director of the Federal Deposit Insurance Corporation's Atlanta Regional Office and the Alabama Superintendent of Banks (the "Supervisory Agencies"). In making these written assurances, the Bank committed to take certain actions. The Bank committed to adopt a management plan relating to bank officers, change the composition of the Bank's Board to include a majority of outside directors who are neither bank officers nor relatives of bank officers or principal shareholders, develop an educational program for bank directors, provide for periodic review of bank policies by the Board, require periodic reporting of policy exceptions to the Board, and adopt an ethics policy for bank officers and directors. The Bank also committed to adopt and implement policies and procedures relating to certain areas of bank operations including: strategic planning, budgeting, acquisition of property for future expansion, loan approval, loan documentation, loan review, the allowance for loan and lease losses, reduction and charge-off of nonperforming loans, liquidity and interest rate risk, and internal routine and controls. The Bank has also committed to certain financial goals relating to capital ratios, dependence upon potentially volatile liabilities, and adequacy of the allowance for loan and lease losses. In connection with these financial goals, the Bank committed to pay no cash dividends without the concurrence of its Supervisory Agencies. It should also be noted that the Bank may, at various times, be subject to the provisions of Section 5-5A-21 of the Alabama Banking Code requiring the prior approval of cash dividends by the Alabama Superintendent of Banks. Management of the Company cannot currently estimate the effects of these commitments on the financial condition, liquidity and results of operations of the Bank or the Company.

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### ITEM 6 - EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits:

Exhibit Number	Description of Exhibit
-----	-----
3.1	Certificate of incorporation, as amended and restated May 2000 (Filed as Exhibit 3.2 to Form 10-Q for the quarter June 30, 2000, and incorporated herein by reference)

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- 3.2 By-laws of Registrant, as amended and restated May 2000 (Filed as Exhibit 3.1 to Form 10-Q for the quarter June 30, 2000, and incorporated herein by reference)
- 4.1 Rights Agent Agreement, dated January 13, 1999, between Community Bancshares, Inc. and the Bank of New York (Filed as Exhibit 4.1 to Form 8-A, filed January 21, 1999, and incorporated herein by reference)
- 4.2 Indenture, dated March 23, 2000, by and between Community Bancshares, Inc. and the Bank of New York (Filed as Exhibit 4.4 to Form 10-Q for the quarter ended March 31, 2000, and incorporated herein by reference)
- 11 Computation of Earnings Per Share

(b) Reports on Form 8-K

The Company filed the following current report on Form 8-K during the quarter ended March 31, 2001:

- 1. Current Report on Form 8-K filed February 15, 2001, and reporting changes in certifying accountant under "Item 4. Changes in Registrant's Certifying Accountant."

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26

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

COMMUNITY BANCSHARES, INC

May 21, 2001

/s/ Kennon R. Patterson, Sr.

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Date

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

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May 21, 2001

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Date

/s/ William E. Blackmon

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William E. Blackmon  
Acting Chief Financial Officer

27