Valley Farm Credit, ACA

THIRD QUARTER 2004

Robert N. Carpenter
Chief Executive Officer

Charles W. Kackley
Chairman of the Board

October 29, 2004

Valley Farm Credit, ACA

Management's Discussion and Analysis of Financial Condition and Results of Operations

(dollars in thousands)

The following commentary reviews the financial condition and results of the consolidated operations of Valley Farm Credit, ACA, Valley Farm Credit, FLCA and Valley Farm Credit, PCA (Association) for the period ended September 30, 2004. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements and the 2003 Annual Report of the Association.

LOAN PORTFOLIO

The Association provides funds to farmers, rural homeowners, and farm-related businesses for financing of short and intermediate-term loans and long-term real estate mortgage loans. The Association's loan portfolio is diversified over a range of agricultural commodities in our region, including livestock, poultry, beef, orchards, dairy and rural home loans. Those major farm commodities totaled approximately $118,445 or 70.64 percent of the loan volume as of September 30, 2004. Farm size varies and many of the borrowers in the region have diversified farming operations. This factor, along with the numerous opportunities for non-farm income in the area, somewhat diminishes the level of dependency on a given commodity.

The gross loan volume of the Association as of September 30, 2004 was $163,033, an increase of $9,622 as compared to $153,411 at December 31, 2003. Net loans outstanding at September 30, 2004 were $160,206 as compared to $150,585 at December 31, 2003. Net loans accounted for 95.02 percent of total assets at September 30, 2004 as compared to 95.53 percent of total assets at December 31, 2003.

The increase in gross and net loan volume during the reporting period is attributed primarily to new loans to several different sectors of the Association's agricultural portfolio and new loans to the residential portion of the portfolio.

There is an inherent risk in the extension of any type of credit. Portfolio credit quality continues to be maintained at an acceptable level, and credit administration remains satisfactory. Nonaccrual loans were $0 at September 30, 2004 and December 31, 2003. Association management maintains an allowance for loan losses in an amount sufficient to absorb possible losses inherent in the loan portfolio at the balance sheet date based on current conditions. The allowance for loan losses was $2,827 at September 30, 2004 compared to $2,826 at December 31, 2003.

In June 2003, the American Institute of Certified Public Accountants' (AICPA) Accounting Standards Executive Committee (AcSEC) issued a proposed Statement of Position – Allowance for Credit Losses, which was intended to clarify the methodology for estimating the allowance for credit losses and to enhance financial statement disclosures related to the allowance for credit losses. In January 2004, AcSEC abandoned its proposed Statement of Position and announced that it would focus instead on improving financial statement disclosures regarding the allowance for loan losses.

System institutions have initiated studies to further refine their methodologies for calculating their respective allowances for loan losses, taking into account generally accepted accounting principles and applicable Farm Credit Administration requirements, as well as the Securities and Exchange Commission and Federal Financial Institutions Examination Council guidelines. These studies will be completed by the fourth quarter of 2004 with any appropriate reductions to the allowance for loan losses implemented at that time. The resulting reductions in the allowance for loan losses may be significant.

In April 2004, the Farm Credit Administration, the System's regulator, issued an "Informational Memorandum" to System institutions regarding the allowance for loan losses. The memorandum addresses the status of the AICPA's project and the Securities and Exchange Commission and the Federal Financial Institutions Examination Council guidance on the subject. The objective of the Farm Credit Administration's memorandum was to clarify its expectations regarding the analysis and related documentation for the allowance for loan losses. The Farm Credit Administration endorsed the direction provided by these other regulatory agencies and will include the conceptual framework addressed in this guidance in their examination process.

RESULTS OF OPERATIONS

For the three months ended September 30, 2004

Net income for the three months ended September 30, 2004, totaled $407, as compared to $560 for the same period in 2003. Net interest income increased $74 for the three months ended September 30, 2004 as compared to the same period in 2003.

At September 30, 2004 interest income on loans increased $195 as compared to the same period in 2003. Nonaccrual income was $0 for the three months ended September 30, 2004 and for the same period in 2003. Interest expense increased $121 for the three months ended September 30, 2004 as compared to the comparable period of 2003. Noninterest income for the three months ended September 30, 2004 totaled $596 as compared to $856 for the same period of 2003, a decrease of $260. Noninterest expense for the three months ended September 30, 2004 decreased $33 compared to the same period of 2003. There was no provision (benefit) for income taxes at September 30, 2004 or the same period in 2003.

For the nine months ended September 30, 2004

Net income for the nine months ended September 30, 2004, totaled $969, as compared to $1,474 for the same period in 2003. Net interest income increased $321 for the nine months ended September 30, 2004 as compared to the same period in 2003.

At September 30, 2004 interest income on loans increased $378 as compared to the same period in 2003. Nonaccrual income was $0 for the nine months ended September 30, 2004 compared to $5 for the same period in 2003. Interest expense increased $57 for the nine months ended September 30, 2004 as compared to the comparable period of 2003. Noninterest income for the nine months ended September 30, 2004 totaled $1,719 as compared to $2,505 for the same period of 2003, a decrease of $786. Noninterest expense for the nine months ended September 30, 2004 increased $90 compared to the same period of 2003. The increase during the reporting period is mostly attributed to additional staffing and higher costs absorbed by the Association pertaining to post-retirement benefits as directed by the AgFirst Farm Credit Bank (the Bank). There was no provision (benefit) for income taxes at September 30, 2004 or the same period in 2003.

FUNDING SOURCES

The principal source of funds for the Association is the borrowing relationship established with the Bank through a General Financing Agreement. The General Financing Agreement utilizes the Association's credit and fiscal performance as criteria for establishing a line of credit on which the Association may draw funds. The funds are advanced by the Bank to the Association in the form of notes payable. The notes payable are segmented into variable rate and fixed rate sections. The variable rate note is utilized by the Association to fund variable rate loan advances and operating funds requirements. The fixed rate note is used specifically to fund fixed rate loan advances made by the Association. The total notes payable to the Bank at September 30, 2004 was $148,312 as compared to $137,021 at December 31, 2003. The increase during the period is primarily attributed to an increase in loan volume and additional contributions to the Districtwide defined benefit retirement plan.

CAPITAL RESOURCES

Total members' equity at September 30, 2004 increased to $17,447 from the December 31, 2003 total of $16,976. The rise in members' equity is attributed to the increase in retained earnings in addition to the increase in capital stock and participation certificates.

Total capital stock and participation certificates were $3,895 on September 30, 2004 compared to $3,872 on December 31, 2003. This increase is attributed to an excess of stock purchases above the normal retirement of stock on loans liquidated in the normal course of business.

Farm Credit Administration (FCA) regulations require all Farm Credit institutions to maintain minimum permanent capital, total surplus and core surplus ratios. These ratios are calculated by dividing the Association's permanent capital, total surplus and core surplus as defined in FCA regulations, by a risk-adjusted asset base. As of September 30, 2004, the Association's total surplus ratio and core surplus ratio were 9.24 percent and 7.96 percent, respectively, and the permanent capital ratio was 12.02 percent. During this quarter, permanent capital ratio increased due to the approval of a block of loans for the Farmer Mac standby guarantee purchase agreement program. All three ratios were well above the minimum regulatory ratios of 7.00 percent for permanent capital and total surplus ratios and 3.50 percent for the core surplus ratio.

Valley Farm Credit, ACA

Consolidated Balance Sheets

(dollars in thousands)	September 30, 2004 *(unaudited)*	December 31, 2003
Assets		
Cash	$ 6	$ 6
Loans	163,033	153,411
Less: allowance for loan losses	2,827	2,826
Net loans	160,206	150,585
Accrued interest receivable	1,364	935
Investment in other Farm Credit institutions	1,393	1,393
Premises and equipment, net	3,712	3,458
Other assets	1,928	1,246
Total assets	$ 168,609	$ 157,623
Liabilities		
Notes payable to AgFirst Farm Credit Bank	$ 148,312	$ 137,021
Accrued interest payable	505	466
Patronage refund payable	2	334
Minimum pension liability	—	1,104
Other liabilities	2,343	1,722
Total liabilities	151,162	140,647
Commitments and contingencies		
Members' Equity		
Capital stock and participation certificates	3,895	3,872
Retained earnings		
Allocated	3,902	4,360
Unallocated	10,972	10,066
Accumulated other comprehensive income (loss)	(1,322)	(1,322)
Total members' equity	17,447	16,976
Total liabilities and members' equity	$ 168,609	$ 157,623

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

Valley Farm Credit, ACA

Consolidated Statements of Income

(unaudited)

(dollars in thousands)	For the three months ended September 30, 2004	For the three months ended September 30, 2003	For the nine months ended September 30, 2004	For the nine months ended September 30, 2003
Interest Income				
Loans	$ 2,387	$ 2,192	$ 6,937	$ 6,559
Interest Expense				
Notes payable to AgFirst Farm Credit Bank	1,503	1,382	4,342	4,285
Net interest income	884	810	2,595	2,274
Provision for (reversal of) loan losses	—	—	—	50
Net interest income after provision for (reversal of) loan losses	884	810	2,595	2,224
Noninterest Income				
Loan fees	78	175	197	521
Fees for financially related services	44	6	69	21
Equity in earnings of other Farm Credit institutions	274	245	796	701
Gain (loss) on sale of rural home loans	185	412	585	1,204
Other noninterest income	15	18	72	58
Total noninterest income	596	856	1,719	2,505
Noninterest Expense				
Salaries and employee benefits	714	688	2,211	2,041
Occupancy and equipment	123	123	379	368
Insurance Fund premium	(17)	40	55	111
Other operating expenses	253	255	700	735
Total noninterest expense	1,073	1,106	3,345	3,255
Income before income taxes	407	560	969	1,474
Provision (benefit) for income taxes	—	—	—	—
Net income	$ 407	$ 560	$ 969	$ 1,474

The accompanying notes are an intergral part of these financial statements.

Valley Farm Credit, ACA

Consolidated Statements of Changes in Members' Equity

(unaudited)

(dollars in thousands)	Capital Stock and Participation Certificates	Retained Earnings: Allocated	Retained Earnings: Unallocated	Accumulated Other Comprehensive Income	Total Members' Equity
Balance at December 31, 2002	$ 3,896	$ 4,343	$ 9,400	$ (1,527)	$ 16,112
Net income			1,474		1,474
Capital stock/participation certificates issued	177				177
Capital stock/participation certificates retired	(188)				(188)
Retained earnings retired		(574)			(574)
Distribution adjustment		21	(29)		(8)
Balance at September 30, 2003	$ 3,885	$ 3,790	$ 10,845	$ (1,527)	$ 16,993
Balance at December 31, 2003	$ 3,872	$ 4,360	$ 10,066	$ (1,322)	$ 16,976
Net income			969		969
Protected borrower equity retired					
Capital stock/participation certificates issued	244				244
Capital stock/participation certificates retired	(221)				(221)
Retained earnings retired		(561)			(561)
Distribution adjustment		103	(63)		40
Balance at September 30, 2004	$ 3,895	$ 3,902	$ 10,972	$ (1,322)	$ 17,447

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

Valley Farm Credit, ACA

Notes to the Consolidated Financial Statements

(dollars in thousands, except as noted)
(unaudited)

NOTE 1 — ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

A description of the organization and operations of Valley Farm Credit, ACA (the Association), the significant accounting policies followed, and the financial condition and results of operations as of and for the year ended December 31, 2003, are contained in the 2003 Annual Report to Stockholders. These unaudited third quarter 2004 consolidated financial statements should be read in conjunction with the 2003 Annual Report to Stockholders.

The accompanying consolidated financial statements contain all adjustments necessary for a fair presentation of the interim financial condition and results of operations and conform with generally accepted accounting principles. The results for the nine months ended September 30, 2004, are not necessarily indicative of the results to be expected for the year ending December 31, 2004.

Certain amounts in prior period consolidated financial statements have been reclassified to conform to current consolidated financial statement presentation. Such reclassifications had no effect on the prior period net income or total capital as previously reported.

The Association maintains an allowance for loan losses in accordance with generally accepted accounting principles. The loan portfolio is reviewed quarterly to determine the adequacy of the allowance for losses. As of September 30, 2004, the allowance for losses is adequate in management's opinion to provide for possible losses on existing loans.

NOTE 2 — ALLOWANCE FOR LOAN LOSSES

An analysis of the allowance for loan losses follows:

Balance at 12-31-02	$ 2,773
(Reversal of) provision for loan losses	50
Recoveries, net of loans charged off	3
Balance at 9-30-03	$ 2,826
Balance at 12-31-03	$ 2,826
(Reversal of) provision for loan losses	–
Recoveries, net of loans charged off	1
Balance at 9-30-04	$ 2,827

NOTE 3 — EMPLOYEE BENEFIT PLANS

The Association participates in a Districtwide defined benefit retirement plan. The costs of the plan are not segregated by participating entities but are allocated among the participating entities. Pension costs are allocated by multiplying the District's net pension expense times each institution's salary expense as a percentage of the District's salary expense. The Association also participates in Districtwide Thrift and other postretirement benefit plans.

The following is a table of retirement and postretirement benefit expense for the nine months ended September 30, 2004:

	For the nine months ended September 30,	
	2004	**2003**
Pension	$ 351	$ 292
Thrift/deferred compensation	89	77
Other postretirement benefits	142	142
Total	$ 582	$ 511

As of September 30, 2004, the Association had contributed $1,996 to the Districtwide defined benefit retirement plan, which was sufficient to meet its accumulated benefit obligation. The contributions eliminated the minimum pension liability with $541 of the contributions being classified as prepaid retirement expense in Other Assets on the Consolidated Balance Sheets. The Association does not anticipate making additional contributions for the remainder of 2004.