# 2005
## Annual Report

Valley Farm Credit

Rural America's Customer-Owned Partner

# VALLEY FARM CREDIT, ACA

# 2005 ANNUAL REPORT

## Contents



## Management

Robert N. Carpenter ........ President and Chief Executive Officer
Luther O. Stiles ........ Executive Vice President and Chief Administrative Officer
Scott K. Swaim ........ Senior Vice President – Credit
Allan K. George ........ Senior Vice President – Lending Programs
Stephen T. Grant ........ Vice President – Member Services
Jeffrey B. Michael ........ Senior Vice President – Residential Lending
Mary S. Miller ........ Vice President – Chief Financial Officer
Ruth C. M. Boden ........ Vice President – Branch Manager
Cheryl G. Keesecker ........ Vice President – Branch Manager

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Harry M. Kable ........ Director
Jim A. Long ........ Director
Charles W. Orndoff, Sr. ........ Director
Betty H. Carroll ........ Outside Director

# *Message from the President*

Valley Farm Credit is pleased to report that its 2005 operating year was successful. The Rural Lending Division (farm loans) had another growth year in loan volume. The Residential Lending Division (home loans) increased its activity in 2005 over 2004 through an active residential construction market and increased exposure to local realtors. Operating income exceeded our expectations as 2005 income reached $2,579,000.

Our commitment to agriculture and the area's farm families has not diminished. Business development in 2005 was active with loans in the agriculture, part-time farm, and residential loan portfolio. Loan assets were $162,188,000 at December 31, 2005. During the year, the Association activity in the sold participation loan market increased. A sale of a block of loans to AgFirst Farm Credit Bank, other associations, and a commercial bank resulted in a net decrease of 5.58% in our net accruing loan volume from 2004. The sale of loans in our portfolio served to strengthen the Association's capital and liquidity position. Prior to the sale of the block of loans, our loan volume exceeded $178,380,000 at December 31, 2005, a 3.03% increase from 2004. Loan demand remains diversified and came from all branches. Commercial farm and part-time farm loan growth was complimented by residential construction lending.

The residential group had another productive year. Originations of home loans held for sale amounted to $68,085,000. The level of activity exceeded 2004 by 25% for the sales of home loans into the secondary market. Increases in property values, increased amounts requested for loans, and a general increase in the number of requests accounted for the greater dollars in closed loans in 2005.

Business goals for 2006 have been set to reflect continued growth in the portfolio and commitment to member service. Portfolio growth is expected to be in the range of 12% in 2006. Growth opportunities in the residential division are expected to remain strong, with loans sold expected to reach $114,240,000.

The Association has a well-diversified portfolio with significant benefits to members from farm and non-farm income to support loan repayments. Loan delinquencies remain well within industry standards and pose no significant risk to the Association. Loan charge-offs have been negligible. There were no non-accruing assets during 2005.

The loan economy has remained strong over the past several years. Unemployment remains below state and national averages for the Association territory. It is expected this trend will continue as the local region experiences continued residential and business growth. Favorable interest rates have provided stability to the lending environment and aided farm producers with lower costs as a result of lower total interest expense. We expect business results for the Association in 2006 to remain strong.

The Association was fortunate to add more qualified staff in 2005. Growth in assets and the successful secondary market program contributed to the need for a continued search for experienced staff. Loan assets, including the loans sold, have grown by more than 65% in the past five years. The Residential Division growth has been even more significant. Staff numbers have increased by 93% in the past five years to accommodate the increased loan activity. Commitment to service and offering of products of importance to the membership remains our top priority.

Growth of the organization created a need for facility evaluation. The board approved a capital expansion plan in late 2004. During 2005, a renovation of a new location for the Charles Town office was completed. An expansion of the Winchester Branch facility was completed in June 2005. The construction of a new office for the Martinsburg Branch was started in early 2005 with completion by the first week of 2006. The existing office site was sold earlier in the year and a lease-back option was secured with the new owner while the construction was continuing. An expansion of lease space, administrative offices and general meeting room began in mid 2005 at the Winchester facility with expected completion by March 2006. Two outpost offices were opened in leased space in Berkeley Springs, WV and Front Royal, VA during 2005.

The Association formed a new entity in December 2004. Valley Farm Credit, LLLP was registered with the State Corporation Commission for the purpose of processing title insurance services for the membership. This service will be contracted through Cameron Title, LLC of Winchester and underwritten by Lawyer's Title Insurance Corporation of Richmond. The service falls under the financially related service section of Farm Credit Administration Regulations. This limited liability partnership, owned by Valley Farm Credit, FLCA, as the limited partner, and Valley Farm Credit, ACA, as the general partner, began providing service in early 2005 to borrowers opting to purchase their title insurance through Valley Farm Credit, LLLP. Income recorded related to this new entity recorded in 2005 was $28,550. The Association expects revenue from this entity to increase over the next year as more cases are processed by the LLLP for title insurance requests.

Robert N. Carpenter
President/Chief Executive Officer

February 23, 2006

# *Report of Management*

The accompanying consolidated financial statements and related financial information appearing throughout this annual report have been prepared by management of Valley Farm Credit, ACA (the Association) in accordance with generally accepted accounting principles appropriate in the circumstances. Amounts which must be based on estimates represent the best estimates and judgments of management. Management is responsible for the integrity, objectivity, consistency, and fair presentation of the consolidated financial statements and financial information contained in this report.

Management maintains and depends upon an internal accounting control system designed to provide reasonable assurance that transactions are properly authorized and recorded, that the financial records are reliable as the basis for the preparation of all financial statements, and that the assets of the Association are safeguarded. The design and implementation of all systems of internal control are based on judgments required to evaluate the costs of controls in relation to the expected benefits and to determine the appropriate balance between these costs and benefits. The Association maintains an internal audit program to monitor compliance with the systems of internal accounting control. Audits of the accounting records, accounting systems and internal controls are performed and internal audit reports, including appropriate recommendations for improvement, are submitted to the Board of Directors.

The consolidated financial statements have been examined by independent public auditors, whose report appears elsewhere in this annual report. The Association is also subject to examination by the Farm Credit Administration.

The consolidated financial statements, in the opinion of management, fairly present the financial condition of the Association. The undersigned certify that the 2005 Annual Report has been prepared in accordance with all applicable statutory or regulatory requirements and that the information contained herein is true, accurate, and complete to the best of our knowledge and belief.

Charles W. Kackley
Chairman of the Board

Robert N. Carpenter
Chief Executive Officer

Mary S. Miller
Chief Financial Officer

February 23, 2006

# Consolidated Five - Year Summary of Selected Financial Data

*(UNAUDITED)*

| *(dollars in thousands)* | 2005 | 2004 | December 31, 2003 | 2002 | 2001 |
|---|---|---|---|---|---|
| **Balance Sheet Data** | | | | | |
| Cash | $ 602 | $ 381 | $ 706 | $ 211 | $ 612 |
| Loans | 162,188 | 171,768 | 153,411 | 137,434 | 126,075 |
| Less: allowance for loan losses | 710 | 828 | 2,826 | 2,773 | 2,547 |
| Net loans | 161,478 | 170,940 | 150,585 | 134,661 | 123,528 |
| Investment in other Farm Credit institutions | 2,173 | 2,061 | 1,393 | 1,393 | 1,393 |
| Other assets | 12,475 | 8,875 | 5,639 | 5,799 | 5,285 |
| Total assets | $ 176,728 | $ 182,257 | $ 158,323 | $ 142,064 | $ 130,818 |
| Notes payable to AgFirst Farm Credit Bank* | $ 149,339 | $ 157,765 | $ 137,721 | $ 122,606 | $ 112,024 |
| Accrued interest payable and other liabilities with maturities of less than one year | 4,209 | 3,295 | 3,626 | 3,346 | 1,869 |
| Total liabilities | 153,548 | 161,060 | 141,347 | 125,952 | 113,893 |
| Capital stock and participation certificates | 3,960 | 3,924 | 3,872 | 3,896 | 3,939 |
| Retained earnings | | | | | |
| Allocated | 4,203 | 4,388 | 4,360 | 4,343 | 4,355 |
| Unallocated | 15,017 | 12,885 | 10,066 | 9,400 | 8,631 |
| Accumulated other comprehensive income (loss) | — | — | (1,322) | (1,527) | — |
| Total members' equity | 23,180 | 21,197 | 16,976 | 16,112 | 16,925 |
| Total liabilities and members' equity | $ 176,728 | $ 182,257 | $ 158,323 | $ 142,064 | $ 130,818 |
| **Statement of Income Data** | | | | | |
| Net interest income | $ 3,957 | $ 3,517 | $ 3,119 | $ 2,661 | $ 2,366 |
| Provision for (reversal of allowance for) loan losses | (118) | (2,000) | 50 | 229 | 221 |
| Noninterest income (expense), net | (1,496) | (1,910) | (1,487) | (764) | (634) |
| Net income | $ 2,579 | $ 3,607 | $ 1,582 | $ 1,668 | $ 1,511 |
| **Key Financial Ratios** | | | | | |
| Rate of return on average: | | | | | |
| Total assets | 1.41% | 2.19% | 1.08% | 1.24% | 1.23% |
| Total members' equity | 11.70% | 20.55% | 9.42% | 9.70% | 9.04% |
| Net interest income as a percentage of average earning assets | 2.29% | 2.20% | 2.17% | 2.03% | 2.00% |
| Net chargeoffs (recoveries) to average loans | — | (0.001)% | (0.001)% | 0.002% | 0.02% |
| Total members' equity to total assets | 13.12% | 11.63% | 10.72% | 11.34% | 12.94% |
| Debt to members' equity (:1) | 6.62 | 7.60 | 8.33 | 7.82 | 6.73 |
| Allowance for loan losses to loans | 0.44% | 0.48% | 1.84% | 2.02% | 2.02% |
| Permanent capital ratio | 14.10% | 12.49% | 12.58% | 13.08% | 13.54% |
| Total surplus ratio | 11.28% | 9.68% | 9.69% | 9.83% | 9.48% |
| Core surplus ratio | 10.09% | 8.39% | 8.23% | 8.19% | 7.74% |
| **Net Income Distribution** | | | | | |
| Estimated patronage refunds: | | | | | |
| Cash dividend | $ 105 | $ 218 | $ 326 | $ 270 | $ 151 |
| Nonqualified allocated retained earnings | 420 | 508 | 664 | 630 | 352 |

* *General financing agreement is renewable on one-year cycle. The next renewal date is December 31, 2006.*

# Management's Discussion & Analysis of Financial Condition & Results of Operations

*(dollars in thousands, except as noted)*

## GENERAL OVERVIEW

The following commentary summarizes the financial condition and results of operations of Valley Farm Credit, ACA, (Association) for the year ended December 31, 2005 with comparisons to the years ended December 31, 2004 and December 31, 2003. This information should be read in conjunction with the Consolidated Financial Statements, Notes to the Consolidated Financial Statements and other sections in this Annual Report.

The Association is an institution of the Farm Credit System (System), which was created by Congress in 1916 and has served agricultural producers for almost 90 years. The System's mission is to maintain and improve the income and well-being of American farmers, ranchers, and producers or harvesters of aquatic products and farm-related businesses. The System is the largest agricultural lending organization in the United States. The System is regulated by the Farm Credit Administration, (FCA) which is an independent safety and soundness regulator.

The Association is a cooperative, which is owned by the members served. The territory of the Association extends across a diverse agricultural and rural region of five counties in Northern Virginia and three counties in the Eastern Panhandle of West Virginia. Refer to Note 1, "Organization and Operations", of the Notes to the Consolidated Financial Statements for counties in the Association's territory. The Association provides credit to full-time farmers, part-time farmers, rural homeowners, and farm-related businesses. Our success begins with our extensive agricultural and residential lending experience and knowledge of the territory served.

The Association obtains funding from AgFirst Farm Credit Bank (Bank). The Association is materially affected by the financial condition and results of operations of the Bank. Copies of the AgFirst Farm Credit Bank's Quarterly and Annual Reports are on the AgFirst website, ***www.agfirst.com*** or may be obtained at no charge by calling 1-800-845-1745, extension 378 or writing Jay Wise, AgFirst Farm Credit Bank, P.O. Box 1499, Columbia, SC 29202. Copies of the Association's Annual and Quarterly reports are available on the Association's website, ***www.valleyfc.com***, or may be obtained upon request free of charge by calling 1-800-999-5341 extension 133 or writing Mary S. Miller, Vice President and CFO, Valley Farm Credit, ACA, P. O. Box 2700, Winchester, Virginia 22604.

## CRITICAL ACCOUNTING POLICIES

The financial statements are reported in conformity with accounting principles generally accepted in the United States of America. We consider our significant accounting policies to be critical to the understanding of our results of operations and financial position because some accounting policies require us to make complex or subjective judgments and estimates that may affect the value of certain assets or liabilities. These policies are considered critical because we have to make judgments about matters that are inherently uncertain. For a complete discussion of significant accounting policies, see Note 2, "Summary of Significant Accounting Policies", of the Notes to the Consolidated Financial Statements. The following is a summary of certain critical policies:

- *Allowance for loan losses* — The allowance for loan losses is management's best estimate of the amount of probable losses inherent in its loan portfolio. The allowance for loan losses is increased through provisions for loan losses and loan recoveries and is decreased through allowance reversals and loan charge-offs. The allowance for loan losses is determined based on a periodic evaluation of the loan portfolio, which generally considers types of loans, credit quality, specific industry conditions, general economic and political conditions, and changes in the character, composition, and performance of the portfolio, among other factors.

  Significant individual loans are evaluated based on the borrower's overall financial condition, resources, and payment record, the prospects for support from any financially responsible guarantor, and, if appropriate, the estimated net realizable value of any collateral. The allowance for loan losses attributable to these loans is established by a process that estimates the probable loss inherent in the loans, taking into account various historical and projected factors, internal risk ratings, regulatory oversight, geographic, industry and other factors.

  Changes in the factors considered by management in the evaluation of losses in the loan portfolios could result in a change in the allowance for loan losses and could have a direct impact on the provision for loan losses and the results of operations.

- *Valuation methodologies* — Management applies various valuation methodologies to assets and liabilities that often involve a significant degree of judgment, particularly when liquid markets do not exist for the particular items being valued. Quoted market prices are referred to when estimating fair values for certain assets for which an observable liquid market exists, such as most investment securities. Management utilizes significant estimates and assumptions to value items for which an observable liquid market does not exist. Examples of these items include impaired loans, pension and other postretirement benefit obligations, and certain other financial instruments. These valuations require the use of various assumptions, including, among others, discount rates, rates of return on assets, repayment rates, cash flows, default rates, costs of servicing and liquidation values. The use of different assumptions could produce significantly different results, which could have material positive or negative effects on the Association's results of operations.

## ECONOMIC CONDITIONS

During 2005, economic conditions in our region remained strong. While farm commodity prices remained relatively flat in 2005, this scenario was somewhat offset with decent crop yields, despite some dry growing conditions in late summer. Forage inventories are lower than usual, but this situation is not thought to adversely affect our producers unless faced with a harsh winter.

Beyond the farm economy, the Association keeps a watchful eye on the general economy since many of our farm loans have the benefit of off-farm income sources, and the Association is actively involved in residential lending. 2005 was another good year for the general economy in our territory. Unemployment remained low, and many people moved to the area. After several years of continued and robust growth, a slight cooling off of the real estate and residential market was observed in late 2005. Increasing interest rates in 2005 may also have been a factor. Even when considering these factors, the general economy and lending market outlook for 2006 is thought to remain active.

The Association targeted certain segments of our business in 2005, particularly part-time farmers and residential customers in an effort to better serve our territory. Continued efforts are being made to expand services, increase public knowledge of our loan product and services and streamline our current delivery of products to enhance our existing portfolio.

**LOAN PORTFOLIO**

The Association provides loan funds to full-time farmers, part-time farmers, rural homeowners, and farm-related businesses for financing of short and intermediate-term loans and long-term real estate mortgage loans through numerous product types.

The gross loan volume of the Association as of December 31, 2005, was $162,188, a decrease of $9,580 or 5.58 percent as compared to $171,768 at December 31, 2004. There was an increase of $18,357 or 11.97 percent at December 31, 2004 as compared to $153,411 at December 31, 2003. Net loans outstanding (gross loans net of the allowance for loan losses) on December 31, 2005, were $161,478 as compared to $170,940 at December 31, 2004 and $150,585 at December 31, 2003. Net loans accounted for 91.37 percent of total assets on December 31, 2005 as compared to 93.79 percent of total assets on December 31, 2004 as compared to 95.11 percent of total assets at December 31, 2003.

The decrease in gross and net loan volume for the twelve months ended December 31, 2005, is primarily attributed to selling a block of loans to the Bank in November 2005. This was done as a temporary measure to enhance the Association's liquidity ratio. The repurchase of these loans is planned during 2006.

The diversification of the Association loan volume by type for each of the past three years is shown below. See Note 4, "Loans and Allowance for Loan Losses" of the Notes to the Consolidated Financial Statements, for the loans outstanding amounts.

| Loan Type | 12/31/05 | 12/31/04 | 12/31/03* |
|---|---|---|---|
| Production agriculture: | | | |
| Real estate mortgage | 48.36% | 44.48% | * % |
| Production and intermediate term | 38.61 | 42.48 | * |
| Agribusiness: | | | |
| Processing and marketing | 1.38 | .59 | * |
| Farm related business | 1.17 | 1.13 | * |
| Communication | – | – | * |
| Rural residential real estate | 10.48 | 11.32 | * |
| Total | 100.00% | 100.00% | * % |

* *Beginning with year-end 2004, loan type categories have been expanded to provide additional information on the types of loans made.*

The following table presents the contractual maturity distribution of loans at December 31, 2005:

| Loan Type | Due in 1 year or less | Due after 1 year through 5 years | Due after 5 years | Total |
|---|---|---|---|---|
| Production agriculture: | | | | |
| Real estate mortgage | $ 5,988 | $ 18,384 | $ 54,062 | $ 78,434 |
| Production and intermediate term | 26,392 | 25,039 | 11,197 | 62,628 |
| Agribusiness: | | | | |
| Processing and marketing | 1,438 | 5 | 787 | 2,230 |
| Farm related business | 230 | 204 | 1,467 | 1,901 |
| Rural residential real estate | 7,510 | 2,738 | 6,747 | 16,995 |
| Total | $ 41,558 | $ 46,370 | $ 74,260 | $ 162,188 |

While we make loans and provide financially related services to qualified borrowers in the agricultural and rural sectors and to certain related entities, our loan portfolio is diversified. The following tables reflect the commodities financed and the geographic locations served.

The geographic distribution of the loans by branch/state for the past three years is as follows:

| Branch/State | 12/31/05 | 12/31/04 | 12/31/03 |
|---|---|---|---|
| Winchester, VA | *39% | *40% | *39% |
| Martinsburg, WV | 22 | 20 | 20 |
| Woodstock, VA | 39 | 40 | 41 |
| Total | 100% | 100% | 100% |

* *Net of participations sold*

Commodity and industry categories are based upon the Standard Industrial Classification system published by the federal government. The system is used to assign commodity or industry categories based upon the largest agricultural commodity of the customer.

The major commodities in the Association loan portfolio are shown below. The predominant commodities are poultry, livestock, and part-time farm and other, which constitute over 78 percent of the entire portfolio.

| | Percent of Portfolio | | |
|---|---|---|---|
| Commodity Group | 2005 | 2004 | 2003 |
| Part-time and other | 33% | 30% | 27% |
| Livestock | 25 | 25 | 23 |
| Poultry | 20 | 21 | 23 |
| Rural Home | 9 | 10 | 12 |
| Orchards | 7 | 8 | 8 |
| Dairy | 6 | 6 | 7 |
| Total | 100% | 100% | 100% |

Repayment ability is closely related to the commodities produced by our borrowers, and increasingly, the off-farm income of borrowers. The largest concentrations in the Association's loan portfolio are general livestock and contract poultry producers, but many of these operations are diversified with other commodities, and risk in the poultry segment is further reduced through government guarantees where warranted. Most general livestock operations have significant non-farm income support. Other farm type loan concentrations are somewhat evenly distributed among orchard, dairy, and crops, with many of these producers also having non-farm income sources to aid with repayment. Increase in loan demand over the last several years has been primarily in the part-time farm segment, with broad commodity segmentation and significant non-farm income support. Risk in the loan portfolio is managed through underwriting standards specific to areas of concentration, internal lending limits, and sound portfolio management and monitoring practices.

During 2005, the Association increased activity in the buying and selling of loan participations within and outside of the System . This provides a means for the Association to spread credit concentration risk and realize non-patronage sourced interest and fee income, which may strengthen its capital position.

| Loan Participations | 2005 | 2004 | 2003 |
|---|---|---|---|
| Participations Purchased – FCS Institutions | $ 2,184 | $ 1,336 | $ 2,754 |
| Participations Purchased – Non-FCS Institutions | – | – | – |
| Participations Sold | (16,193) | (1,372) | (2,667) |
| Total | $ (14,009) | $ (36) | $ 935 |

The Association sells qualified long-term mortgage loans into the secondary market. For the period ended December 31, 2005, the Association originated loans for resale totaling $68,085, which were sold into the secondary market. The secondary mortgage market enables the Association to compete in the residential loan market without placing the burden of building capital and generating earnings to support this business on the agricultural sector.

The Association participates in the Long-Term Standby Commitment (LTSB) with the Federal Agricultural Mortgage Corporation (Farmer Mac) program. Under this program, a loan is purchased by Farmer Mac in the event the loan becomes 120 days or more past due, thus allowing the Association to effectively reduce its existing portfolio risk. At December 31, 2005, the Association had loans amounting to $9,691, compared to $11,688 at December 31, 2004 and $0 at December 31, 2003, which were 100 percent guaranteed by Farmer Mac. The Association continues to participate in Farm Service Agency (FSA) loan guarantee programs. At December 31, 2005, FSA guaranteed loan volume was $15,538, compared to $14,503 at December 31, 2004 and $12,760 at December 31, 2003.

**RISK EXPOSURE**

Credit risk arises from the potential inability of an obligator to meet its repayment obligation. As a part of a system to evaluate the success of a loan, the Association continues to review the credit quality of the loan portfolio on an ongoing basis. With the approval of the Association Board of Directors, the Association establishes underwriting standards and lending policies that provide direction to loan officers. Underwriting standards include, among other things, an evaluation of:

- Character – borrower integrity and credit history
- Capacity – repayment capacity of the borrower based on cash flows from operations or other sources of income
- Collateral – protects the lender in the event of default and represents a potential secondary source of repayment
- Capital – ability of the operation to survive unanticipated risks
- Conditions – intended use of the loan funds and factors influencing the agriculture sector to which the loan was made or other economic conditions impacting the borrower

The credit risk management process begins with an analysis of the borrower's credit history, repayment capacity, and financial position. Repayment capacity focuses on the borrower's ability to repay the loan based upon cash flows from operations or other sources of income, including non-farm income. Long-term real estate loans must be secured by first liens on the real estate (collateral). As required by regulation, each institution that makes loans on a secured basis must have collateral evaluation policies and procedures. Appraisals are required for loans more than $250,000 (in dollars). In addition, each loan is assigned a credit risk weighting based upon the underwriting standards. This credit risk rating process incorporates objective and subjective criteria to identify inherent strengths, weaknesses, and risks in a particular relationship.

The Association's loan portfolio is divided into performing and high-risk categories. Loans classified as high risk require additional servicing time and efforts. The Association's level of high risk assets is relatively low. As a part of a system to evaluate the success of each loan, the Association continues to review the credit quality of the loan portfolio on an ongoing basis. The high-risk assets, including accrued interest, are detailed below:

| | 12/31/05 | 12/31/04 | 12/31/03 |
|---|---|---|---|
| **High-risk Assets** | | | |
| Nonaccrual loans | $ – | $ – | $ – |
| Restructured loans | – | – | – |
| Accruing loans 90 days past due | – | 84 | – |
| Total high-risk loans | – | 84 | – |
| Other property owned | – | – | – |
| Total high-risk assets | $ – | $ 84 | $ – |
| **Ratios** | | | |
| Nonaccrual loans to total loans | –% | –% | –% |
| High-risk assets to total assets | –% | 0.05% | –% |

Nonaccrual loans represent all loans where there is a reasonable doubt as to the collection of principal and/or interest under the contractual terms of the loan. There were no nonaccrual loans in 2005, 2004, or 2003.

Loan restructuring is available to financially distressed borrowers. Restructuring of loans occurs when the Association grants a concession to a borrower based on either a court order or good faith in a borrower's ability to return to financial viability. The concessions can be in the form of a modification of terms or rates, a compromise of amounts owed, or deed in lieu of foreclosure. Other receipts of assets and/or equity to pay the loan in full or in part are also considered restructured loans. The type of alternative financing structure chosen is based on minimizing the loss incurred by both the Association and the borrower.

**Credit Quality**

We review the credit quality of the loan portfolio on an on-going basis as part of our risk management practices. Each loan is classified according to the Uniform Classification System, which is used by all FCS institutions. Below are the classification definitions.

- Acceptable – Assets are expected to be fully collectible and represent the highest quality.
- Other Assets Especially Mentioned (OAEM) – Assets are currently collectible but exhibit some potential weakness.
- Substandard – Assets exhibit some serious weakness in repayment capacity, equity, and/or collateral pledged on the loan.

- Doubtful – Assets exhibit similar weaknesses to substandard assets. However, doubtful assets have additional weaknesses in existing facts, conditions and values that make collection in full highly questionable.
- Loss – Assets are considered uncollectible.

The following table presents selected statistics related to the credit quality of loans, including accrued interest, at December 31.

| Credit Quality | 2005 | 2004 | 2003 |
|---|---|---|---|
| Acceptable & OAEM | 97.96% | 96.72% | 96.49% |
| Substandard | 2.04 | 3.28 | 3.51 |
| Doubtful | – | – | – |
| Loss | – | – | – |
| Total | 100.00% | 100.00% | 100.00% |

**Allowance for Loan Losses**

During 2004, the Association completed its study to further refine the allowance for loan losses methodology, taking into account recently issued guidance by the FCA, as well as the Securities and Exchange Commission (SEC) and Federal Financial Institutions Examination Council. As a result of this study and the resulting refinements in methodology, during the fourth quarter of 2004, the Association recorded a $2,000 reversal of the allowance for loan losses.

The Association's allowance for loan losses methodology was adjusted and revised in the late 1980s to take into account the credit losses experienced in the mid-to-late 1980s, as a result of unusually adverse economic factors affecting American agriculture. Given the long cyclical nature of the agricultural economy, loss factors utilized to determine the allowance for loan losses subsequent to 1989 continued to reflect, to some extent, the loss history of the mid-to-late 1980s, which resulted in conservative estimates of the allowance for loan losses. The Association's allowance for loan losses methodology utilized throughout the period was in accordance with generally accepted accounting principles and was consistently applied.

While conservative in estimating the allowance for loan losses, the methodology used resulted in annual provisions for loan losses over the periods that reflected changes in credit quality and loss experience. Accordingly, the reserves provided in the mid-to-late 1980s have, in effect, remained part of the allowance for loan losses. The Association's allowance for loan loss methodology has consistently adhered to proper accounting policies, under the regulatory supervision of the FCA in its role as a "safety and soundness" regulator. It was the FCA's view that the allowance for loan losses should include, among others, an assessment of probable losses, historical loss experience and economic conditions.

In April 2004, the FCA issued an Informational Memorandum to System institutions regarding the criteria and methodologies that should be used in evaluating the adequacy of a System institution's allowance for loan losses. The FCA endorsed the direction provided by other bank regulators and the SEC and indicated the conceptual framework addressed in this guidance would be included as part of their examination process.

The refinement in methodology resulted in a calculated allowance for loan losses that was significantly less than the previously recorded balance due to revised loss factors that are more indicative of actual loss experience in recent years and current borrower analysis. The factors considered in determining the revised level of allowance for loan losses were generally based on recent historical charge-off experience adjusted for relevant environmental factors. The Association considered the following when adjusting the historical charge-offs experience:

- changes in credit risk classifications,
- changes in collateral values,
- changes in risk concentrations,
- changes in weather related conditions, and
- changes in economic conditions.

While the reversal had a significant impact on 2004 results of operations and the previously recorded allowance for loan losses, the refinement in methodology is not expected to have a significant impact on comparative results of operations in future periods. Additionally, the refinement in methodology did not have a significant impact on the level of the risk bearing capacity of the Association, generally referred to as "risk funds" (capital plus the allowance for loan losses), which totaled $23,890 at December 31, 2005 (14.73 percent of Association loans), as compared with $22,025 at December 31, 2004 (12.82 percent of Association loans) and $19,802 at December 31, 2003 (12.91 percent of Association loans).

The allowance for loan losses at each period end was considered by Association management to be adequate to absorb probable losses existing in and inherent to its loan portfolio. Management's evaluations consider factors including loan loss experience, portfolio quality, loan portfolio composition, current agricultural production conditions and economic conditions. The allowance for loan losses was $710 at December 31, 2005, as compared with $828 and $2,826 at December 31, 2004 and 2003, respectively.

Net loan charge-offs (recoveries) of $0, $(2) and $(3) were recorded in 2005, 2004 and 2003, respectively. Net loan charge-offs as a percentage of average loans remained at low levels of 0 percent, (0.001) percent, and (0.001) percent for 2005, 2004 and 2003, respectively.

The following table presents the activity in the allowance for loan losses for the most recent three years:

| Allowance for Loan Loss Activity | 2005 | 2004 | 2003* |
|---|---|---|---|
| Balance at beginning of year | $ 828 | $ 2,826 | $ * |
| Provision for (reversal of allowance for) loan losses | (118) | (2,000) | * |
| Charge-offs: | | | |
| Production agriculture: | | | |
| Production and intermediate term | 2 | – | * |
| Total charge-offs | 2 | – | – |
| Recoveries | | | |
| Production agriculture: | | | |
| Production and intermediate term | 2 | 2 | * |
| Total recoveries | 2 | 2 | * |
| Net charge-offs (recoveries) | – | (2) | * |
| Balance at end of year | $ 710 | $ 828 | $ * |
| Ratio of net charge-offs during the period to average loans outstanding during the period | –% | (.001)% | (.001)% |

* *Beginning with year-end 2004, loan type categories have been expanded to provide additional information on the types of loans made.*

The allowance for loan losses by loan type for the most recent three years is as follows:

| Allowance for Loan Losses by Type | December 31, 2005 | 2004 | 2003* |
|---|---|---|---|
| Production agriculture: | | | |
| Real estate mortgage | $ 257 | $ 276 | $ * |
| Production and intermediate term | 361 | 444 | * |
| Agribusiness | 18 | 14 | * |
| Rural residential real estate | 74 | 94 | * |
| Total loans | $ 710 | $ 828 | $ * |

* *Beginning with year-end 2004, loan type categories have been expanded to provide additional information on the types of loans made.*

The allowance for loan losses as a percentage of loans outstanding and as a percentage of certain other credit quality indicators is shown below:

| Allowance for Loan Losses as a Percentage of: | December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| Total loans | .44% | .48% | 1.84% |
| Impaired loans* | N/A% | 985.71% | N/A% |
| Nonaccrual loans* | N/A% | N/A% | N/A% |

* *There were no nonaccrual loans in 2005, 2004, or 2003. There was one impaired loan for $84 in 2004, and none in 2005 or 2003.*

The financial positions of our borrowers have generally strengthened during the past decade as farmers' net cash income has been at a favorable level due, in part, to direct federal government payments and steady increases in land values over the period. With borrowers' strengthened financial positions and the continued emphasis on sound underwriting standards, the credit quality of our loan portfolio has remained healthy. Please refer to Note 4, "Loans and Allowance for Loan Losses", in the Notes to the Consolidated Financial Statements, for further information concerning the allowance for loan losses.

## EMPLOYEE RETIREMENT PLANS

For the years ended December 31, 2005 and 2004, the Association contributed $610 and $1,996 to the District-wide defined benefit retirement plan. The District-wide funding brings the retirement plan's assets to an amount exceeding the accumulated benefit obligation. The contributions in 2004 eliminated the minimum pension liability. Assuming that interest rates and returns on investments remain relatively constant, benefits to the Association in subsequent periods should include improved net income due to lower retirement expense and the elimination of the pension-related charge to accumulated other comprehensive income in the members' equity. See Note 10, "Employee Benefit Plans", in the Notes to the Consolidated Financial Statements for further information.

## RESULTS OF OPERATIONS

Net income for the year ended December 31, 2005 totaled $2,579, a decrease of $1,028 or 28.5 percent, as compared to $3,607 for the same period of 2004. There was an increase of $2,025 or 128.0 percent, as compared to $1,582 for the same period of 2003. Interest income for the year ended December 31, 2005 was $11,237, an increase of $1,787 or 18.9 percent as compared to $9,450 for the same period of 2004. There was an increase of $647 or 7.3 percent as compared to $8,803 for the same period of 2003. Major components of the changes in net income for the past three years are outlined in the following table.

**Changes in Net Income:**

| | 2005-2004 | 2004-2003 |
|---|---|---|
| **Net income (prior year)** | $ 3,607 | $ 1,582 |
| **Increase (decrease) in net income due to:** | | |
| Interest income | 1,787 | 647 |
| Interest expense | (1,347) | (249) |
| Net interest income | 440 | 398 |
| Provision for loan losses | (1,882) | 2,050 |
| Noninterest income | 1,138 | (300) |
| Noninterest expense | (719) | (228) |
| Provision for income taxes | (5) | 105 |
| Total changes in income | (1,028) | 2,025 |
| **Net income** | $ 2,579 | $ 3,607 |

*Net Interest Income*

Net interest income increased by $440 or 12.5 percent in 2005 compared to 2004, and $398 or 12.76 percent in 2004 compared to 2003. The primary reason for this increase was due to positive growth in loan volume (prior to the sale of a block of loans in November 2005). The Association's net interest income as a percentage of average earning assets was 2.29 percent on December 31, 2005, compared to 2.20 percent on December 31, 2004, and 2.17 percent on December 31, 2003.

Interest income on nonaccrual loans for 2005 and 2004 totaled $0, a decrease of $5, compared to $5 for 2003. Please refer to the Consolidated Five-Year Summary of Selected Financial Data in this Annual Report to review key financial ratios pertaining to earnings and net interest income. The sources of change in net interest income are illustrated, as follows:

**Change in Net Interest Income:**

| | Volume* | Rate | Nonaccrual Income | Total |
|---|---|---|---|---|
| **12/31/05 - 12/31/04** | | | | |
| Interest income | $ 741 | $ 1,046 | $ – | $ 1,787 |
| Interest expense | 589 | 758 | – | 1,347 |
| Change in net interest income | $ 153 | $ 287 | $ – | $ 440 |
| **12/31/04 - 12/31/03** | | | | |
| Interest income | $ 1,012 | $ (360) | $ (5) | $ 647 |
| Interest expense | 757 | (508) | – | 249 |
| Change in net interest income | $ 255 | $ 148 | $ (5) | $ 398 |

* *Volume variances can be the result of increased/decreased loan volume or from changes in the percentage composition of assets and liabilities between periods.*

A reversal of a portion of the allowance for loan losses at December 31, 2005 and December 31, 2004 resulted in a negative provision of $(118) and $(2,000), respectively, compared to a provision expense of $50 at December 31, 2003. Please refer to the Allowance for Loan Losses section discussed above.

*Noninterest Income*

Noninterest income for each of the three years ended December 31 are shown in the following table:

| Noninterest Income | For the Year Ended December 31, 2005 | 2004 | 2003 | Percentage Increase/(Decrease) 2005/ 2004 | 2004/ 2003 |
|---|---|---|---|---|---|
| Loan fees | $ 357 | $ 258 | $ 626 | 38% | (59)% |
| Fees for financially related services | 138 | 109 | 97 | 3 | 12 |
| Patronage refund from AgFirst Farm Credit Bank | 1,745 | 1,609 | 1,042 | 8 | 54 |
| Gains (losses) on sale of rural homes | 1,135 | 791 | 1,299 | 43 | (39) |
| Gains (losses) from sale of premises, net | 224 | – | – | 100 | – |
| Gains (losses) from sale of other assets, net | 283 | – | – | 100 | – |
| Other noninterest income | 109 | 86 | 89 | 27 | – |
| Total noninterest income | $ 3,991 | $ 2,853 | $ 3,153 | 40% | (10)% |

Patronage refunds from the Bank increased $136 and increased $567 for the years ended December 31, 2005 and 2004, respectively. The Association received $1,202 in a patronage refund and $543 in a special distribution from the Bank for the year ended December 31, 2005, compared to $1,082 and $527 for 2004, and $957 and $85 for 2003. Loan fees increased $99 and decreased $368 for the period ended December 31, 2005, compared to the comparable periods in 2004 and 2003, respectively.

*Noninterest Expense*

Noninterest expense for each of the three years ended December 31 are shown in the following table:

| Noninterest Expense | For the Year Ended December 31, 2005 | 2004 | 2003 | Percentage Increase/(Decrease) 2005/ 2004 | 2004/ 2003 |
|---|---|---|---|---|---|
| Salaries and employee benefits | $ 3,388 | $ 2,958 | $ 2,908 | 15% | 2% |
| Occupancy and equipment expense | 607 | 505 | 493 | 20 | 2 |
| Insurance Fund premium | 79 | 74 | 153 | 7 | (52) |
| Other operating expense | 1,409 | 1,227 | 982 | 15 | 25 |
| Total noninterest expense | $ 5,483 | $ 4,764 | $ 4,536 | 15% | 5% |

Noninterest expense increased $719 or 15 percent for December 31, 2005, as compared to the same period of 2004, and increased $228 or 5 percent compared to December 31, 2003. Salaries and employee benefits which total $3,388 or 62 percent of total operating expenses displayed an increase of $430 or 15 percent compared to 2004, and $2,958 or 62 percent of total operating expenses displayed an increase of $50 or 2 percent compared to 2003. Benefits expense for 2005 was $1,240 compared to $1,152 for 2004 and $1,155 for 2003.

The Association recorded a provision for income taxes of $4 for the year ended December 31, 2005, as compared to a benefit of $1 for 2004 and a provision of $104 for 2003.

A key factor in the growth of net income for future years will be continued improvement in net interest and noninterest income. Our goal is to generate earnings sufficient to fund operations, adequately capitalize the Association, and achieve an adequate rate of return for our members. To meet this goal, the agricultural economy must continue the improvement shown in recent years and the Association must meet certain objectives. These objectives are to attract and maintain high quality loan volume priced at competitive rates and to manage credit risk in our entire portfolio, while efficiently meeting the credit needs of our members.

| Key Results of Operations Comparisons | For the 12 Months Ended 12/31/05 | For the 12 Months Ended 12/31/04 | For the 12 Months Ended 12/31/03 |
|---|---|---|---|
| Return on Average Assets | 1.41% | 2.19% | 1.08% |
| Return on Average Members' Equity | 11.70% | 20.55% | 9.42% |
| Net Interest Income as a Percentage of Average Earning Assets | 2.29% | 2.20% | 2.17% |
| Net Chargeoffs (Recoveries) to Average Loans | –% | (0.001)% | (0.001)% |

## LIQUIDITY AND FUNDING SOURCES

*Liquidity*

Liquidity management is the process whereby funds are made available to meet all financial commitments including the extension of credit, payment of operating expenses and payment of debt obligations. The Association receives access to funds through its borrowing relationship with the Bank and from income generated by operations. The Association's participation in the Farmer Mac and other secondary market programs provides additional liquidity. Sufficient liquid funds have been available to meet all financial obligations.

*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 Bank advances the funds to the Association, creating notes payable to the Bank. The notes payable are segmented into variable rate and fixed rate components. 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 December 31, 2005 were $149,339 as compared to $157,765 at December 31, 2004 and $137,721 at December 31, 2003. The decrease of 5.34 percent compared to December 31, 2004, and the increase of 14.55 percent compared to December 31, 2003 is attributable to changes in loan volume.

The Association had no lines of credit outstanding with third parties as of December 31, 2005.

*Funds Management*

The Bank and the Association manage assets and liabilities to provide a broad range of loan products and funding options, which will permit the Association to be competitive in all interest rate environments. The primary objective of the asset/liability management process is to provide stable and rising earnings, while maintaining adequate capital levels by managing exposure to credit and interest rate risks.

Demand for loan types is a driving force in establishing a funds management strategy. The Association offers fixed, adjustable and variable rate loan products that are marginally priced according to financial market rates. Variable rate loans may be indexed to either the Prime Rate or the 90-day London Interbank Offered Rate (LIBOR). Adjustable rate mortgages are indexed to U.S. Treasury Rates. Fixed rate loans are priced based on the current cost of Farm Credit debt of similar terms to maturity.

The majority of the interest rate risk in the Association balance sheet is transferred to the Bank through the notes payable structure. The Bank, in turn, actively utilizes funds management techniques to identify, quantify, and control risk associated with the loan portfolio.

**CAPITAL RESOURCES**

Total members' equity at December 31, 2005, increased 9.36 percent to $23,180 from the December 31, 2004, total of $21,197, and increased 24.86 percent from the December 31, 2003 total of $16,976. The increase was primarily attributed to net income (and the effect of the reversal of the allowance for loan losses in 2004) partially offset by cash patronage and the revolvement of allocated earnings.

Total capital stock and participation certificates were $3,960 on December 31, 2005, compared to $3,924 on December 31, 2004 and $3,872 on December 31, 2003. The increases are attributed to the excess of stock purchases above the normal retirement of stock on loans liquidated in the normal course of business.

The Association's capital ratios as of December 31 and the FCA minimum requirements follow:

| | 2005 | 2004 | 2003 | Regulatory Minimum |
|---|---|---|---|---|
| Permanent Capital | 14.10% | 12.49% | 12.58% | 7.00% |
| Total Surplus | 11.28% | 9.68% | 9.69% | 7.00% |
| Core Surplus | 10.09% | 8.39% | 8.23% | 3.50% |

At December 31, 2005, the Association's permanent capital ratio, average at-risk capital divided by average risk adjusted assets calculated in accordance with FCA regulations, exceeded the regulatory minimum of 7.00 percent. In addition to these regulatory requirements, the Association has established a permanent capital goal range in excess of the 7.00 percent FCA minimum requirement. As of December 31, 2005, the Association has met the goal range.

**PATRONAGE PROGRAM**

Prior to the beginning of any fiscal year, the Association's Board of Directors, by adoption of a resolution, may establish a Patronage Allocation Program to distribute its available consolidated net earnings. This resolution provides for the application of net earnings in the manner described in the Association's Bylaws. This includes the setting aside of funds to increase surplus to meet minimum capital adequacy standards established by Regulations, to increase surplus to meet Association capital adequacy standards to a level necessary to support competitive pricing at targeted earnings levels, and for reasonable reserves for necessary purposes of the Association. After excluding net earnings attributable to (a) the portion of loans participated to another institution, and (b) participation loans purchased, remaining consolidated net earnings will be allocated to borrowers. Refer to Note 8, "Members' Equity," of the Notes to the Consolidated Financial Statements, for more information concerning the patronage distributions. The Association declared patronage distributions of $525 in 2005, $726 in 2004, and $990 in 2003.

**YOUNG, BEGINNING AND SMALL (YBS) FARMERS AND RANCHERS PROGRAM**

The Association's mission is to provide financial services to agriculture and the rural community, which includes providing credit to young, beginning and small (YBS) farmers. Because of the unique needs of these individuals, and their importance to the future growth of the Association, the Association has established annual marketing goals to sustain and increase our market share of loans to YBS farmers. Marketing plans have been developed to target these groups, and resources have been designated to help ensure YBS borrowers access to a stable source of credit.

YBS farmers and ranchers are defined as:

> *Young farmers* are defined as those farmers, ranchers, producers or harvesters of aquatic products who are age 35 or younger as of the date the loan is originally made.
>
> *Beginning farmers* are defined as those farmers, ranchers, producers or harvesters of aquatic products who have 10 years or less farming or ranching experience as of the date the loan is originally made.
>
> *Small farmers* are defined as those farmers, ranchers, producers or harvesters of aquatic products who normally generate less than $250,000 (in dollars) in annual gross sales of agricultural or aquatic products at the date the loan is originally made.

The Association strives to serve deserving members of these groups by weighing the strong points of an applicant's financial position against the potential risk to the Association. Loan losses that occur because of circumstances beyond a borrower's control should not deter the Association from considering credit for this group. Risk is minimized whenever possible, but it is recognized that risk cannot be avoided altogether. Loan officers are expected to review the criteria of each loan and assess that risk.

The Association promotes adequate credit availability to qualifying YBS applicants to ensure they receive all due consideration. The applicants that meet the definitions of this special group are handled as any other applicant, except that loan staff is encouraged to look beyond the primary applicant toward other forms of strengthening the package, if warranted. Loan staff will ensure the loan is properly coded according to district procedures to monitor the level of effort expended on behalf of this group of borrowers.

While credit standards apply the same to all classes of borrowers, special emphasis is given to promote YBS financing through programs including, but not limited to, FSA or other governmental guarantees; interest rate buy-down programs offered by governmental guarantors; use of cosigners, joint applicants, or pledged collateral from other individuals to reduce risk to the Association; and consideration of loan terms that may assist in cash flow development.

Additionally, the Association encourages the responsible transition of farm ownership to younger generations by providing access to estate and financial planners through alliance partnerships, use of credit terms that would assist in such a transition, and promotion of other available resources for farm transition assistance, such as the Cooperative Extension Management Specialists.

The Association has a very respectable penetration in the young, beginning, and small farmer market. As of December 31, 2005, the Association was doing business with 233 young farmer households, yet only 183 young farmers were identified in the 2002 United States Department of Agriculture (USDA) Agricultural (Ag) census for the Association's eight counties served. Similarly, the Association had loans with 557 beginning farmer households versus 1,221 such farmers reported in the 2002 census as being on the farm less than ten years. This translates to 46% beginning farmer penetration for the Association. The Association had loans with 987 small farmer households versus 4,146 small farmers reported in the 2002 USDA Ag Census, or 24% small farmer penetration.

The following table outlines the loan volume and number of YBS loans in the loan portfolio for the Association as of December 31, 2005.

| | As of December 31, 2005 | |
|---|---|---|
| | Number of Loans | Amount of Loans |
| Young | 331 | $ 16,852 |
| Beginning | 818 | 66,349 |
| Small | 1,669 | 118,715 |

For purposes of the above table, a loan could be classified in more than one category depending upon the characteristics of the respective borrower.

The Association had volume goals of $16,000, $67,000 and $125,000 respectively for the YBS categories for 2005. As shown in the table above, the Association's volume goals at the end of the year were slightly below the goals. There were several YBS loans included in the block of loans sold to the Bank in November 2005. Including these loans, all of the Association's YBS volume goals for the year would have been met.

The following strategies and outreach programs have been conducted to assist the Association to meet its young, beginning, and small farmer program goals and objectives. Continued work and enhancement of these strategies and programs are ongoing as the Association strives to meet its commitment to the future success of young, beginning and small farmers.

- Promotion of the "Youth in Agriculture" initiative includes supporting student and youth projects with the intent to educate youth about various career options and opportunities in agriculture. This includes, but is not limited to, numerous donations and sponsorships to 4-H, Future Farmers of America (FFA), and young farmer organization activities. Additionally, Association staff is encouraged to volunteer time to assist with youth activities.
- Promotion of further education of current YBS customers (or potential customers) through hosting, sponsoring, or presenting agriculturally related workshops, seminars, and interactive meetings. Such meetings may range in topic from farm transition to operational issues such as beef management, crop insurance, or hay and pasture management.
- The Association actively utilizes FSA guaranteed programs to find methods to extend constructive credit to YBS farmers in proactive ways. Almost 10% of total Association loan volume consists of guaranteed loans to young, beginning, and small farmers.

**FORWARD LOOKING INFORMATION**

Certain information included in this discussion constitutes forward-looking statements and information that are based upon management's belief as well as certain assumptions made by and information currently available to management. When used in this discussion, the words "anticipate," "project," "expect," "believe," and similar expressions are intended to identify forward-looking statements. Although management of the Association believes that the expectations reflected in such forward-looking statements are reasonable, it can give no assurance that such expectations and projections will prove to have been correct. Such forward-looking statements are subject to certain risks, uncertainties and assumptions. Should one or more of these risks materialize, or should such underlying assumptions prove to be incorrect, actual results may vary materially from those anticipated, projected, or expected. Among key factors that may have a direct bearing on the Association's operating results are fluctuations in the economy, the relative strengths and weaknesses in the agricultural credit sectors and in the real estate market, the actions taken by the Federal Reserve for the purpose of managing the economy, and the continued growth of the agricultural market consistent with recent historical experience.

# Disclosure Required by Farm Credit Administration Regulations

**Description of Business**

Descriptions of the territory served, persons eligible to borrow, types of lending activities engaged in, financial services offered and related Farm Credit organizations are incorporated herein by reference to Note 1 to the consolidated financial statements, "Organization and Operations," included in this annual report to shareholders.

The description of significant developments that had or could have a material impact on earnings or interest rates to borrowers, acquisitions or dispositions of material assets, material changes in the manner of conducting the business, seasonal characteristics, and concentrations of assets, if any, is incorporated in "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in this annual report to shareholders.

**Description of Property**

The following table sets forth certain information regarding the properties of the reporting entity, all of which are located in Virginia or West Virginia:

| Location | | Description | Form of Ownership |
|---|---|---|---|
| 125 Prosperity Drive<br>Winchester, VA | (1) | Administrative/Branch<br>17,300 square feet | Owned |
| 1288 Winchester Avenue<br>Martinsburg, WV | (2) | Branch<br>2,060 square feet | Leased |
| 1270 Winchester Avenue<br>Martinsburg, WV | (3) | Branch<br>450 square feet | Leased |
| 1031 S. Main Street<br>Woodstock, VA | | Branch<br>3,456 square feet | Owned |
| South Main Street<br>Woodstock, VA | (4) | Unimproved one acre lot – number 2 Shenandoah Square. | Owned |
| Ridgefield Business Park<br>Martinsburg, WV | (5) | Unimproved lots (numbers 1, 2, 3, 4 and 6)<br>Approx. two and a half acres | Owned |
| 2064 Valley Road, Suite 2<br>Berkeley Springs, WV | (6) | Satellite Office<br>Approx. 200 square feet | Leased |
| 114 East Liberty Street<br>Charles Town, WV | (7) | Satellite Office<br>Approx. 1,000 square feet | Leased |
| 621-A South Royal Avenue<br>Front Royal, VA | (8) | Satellite Office<br>Approx. 132 square feet | Leased |

(1) *During 2005, the Association added approximately 1,800 square feet to expand the branch portion of the headquarter's building. Additionally, a one acre unimproved lot (number 15 Kernstown Business Park) was consolidated into the present headquarter's location to expand parking facilities. Approximately 2,600 square feet of space (representing two office suites) are rented to Association Alliances. Alliances are A New Century Realty and Farm Bureau. Alliances were formed to create opportunities for the Association membership to have real estate and insurance services available within one building.*

*The New Century Realty lease is for a period of five years commencing on March 1, 2001 (adjusted from an original date of March 16, 2000) and ending on April 30, 2005 (extended to the second quarter, 2006).*

*The Farm Bureau lease is for a period of five years commencing on May 1, 2005 and ending on April 30, 2010.*

(2) *The property was previously owned by the Association, but sold to Fitzco, LLC. The property was sold due to the Association's construction of a new branch office building to be completed January 2006. The Association has leased back the office building from Fitzco, LLC. The lease is effective April 19, 2005.*

(3) *The property was previously owned by the Association, but sold to Fitzco, LLC. The property was sold due to the Association's construction of a new branch office building to be completed January 2006. The Association has leased back three offices totaling approximately 450 square feet. The lease is effective April 19, 2005.*

(4) *Adjoining lot to the present Branch Office Building.*

(5) *Relocation site of the Martinsburg branch office on lot numbers 2, 3 and 6. Lot numbers 1 and 4 were purchased for investment and resale.*

(6) *The Association has leased office space to enhance the Secondary Mortgage Market presence. The lease is effective October 1, 2005 through September 30, 2007.*

(7) *The Association has leased office space to enhance the Secondary Mortgage Market presence. The lease is effective January 1, 2005 through December 31, 2017.*

(8) *The Association has leased office space to enhance the Secondary Mortgage Market presence. The lease is effective June 1, 2005 through May 31, 2006.*

**Legal Proceedings**

Information, if any, to be disclosed in this section is incorporated herein by reference to Note 13 to the consolidated financial statements, "Commitments and Contingencies," included in this annual report to shareholders.

**Description of Capital Structure**

Information to be disclosed in this section is incorporated herein by reference to Note 8 to the consolidated financial statements, "Members' Equity," included in this annual report to shareholders.

**Description of Liabilities**

The description of liabilities, contingent liabilities and intrasystem financial assistance rights and obligations to be disclosed in this section is incorporated herein by reference to Notes 2, 7, 11 and 13 to the consolidated financial statements included in this annual report to shareholders.

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

"Management's Discussion and Analysis of Financial Condition and Results of Operations," which appears in this annual report to shareholders and is to be disclosed in this section, is incorporated herein by reference.

**Senior Officers**

The following represents certain information regarding the senior officers of the Association:

| Senior Officer | Position |
|---|---|
| Robert N. Carpenter | President and Chief Executive Officer |
| Luther O. Stiles | Executive Vice President and Chief Administrative Officer |
| Scott K. Swaim | Senior Vice President – Credit |
| Allan K. George | Senior Vice President – Lending Programs |
| Jeffrey B. Michael | Senior Vice President – Residential Lending |
| Stephen T. Grant | Vice President – Member Services |
| Mary S. Miller | Vice President – Chief Financial Officer |
| Ruth C.M. Boden | Vice President – Branch Manager |
| Cheryl G. Keesecker | Vice President – Branch Manager |

The business experience for the past five years for senior officers is with the Farm Credit System with the exception of Mary S. Miller, who has been employed with Farm Credit approximately three and a half years. Mary S. Miller is a Certified Public Accountant and her prior business experience was with a manufacturing company and an international not-for-profit health organization.

The total amount of compensation earned by all senior officers as a group during the past three years will be included in the Association's 2006 Annual Meeting Information Statement.

Directors and senior officers are reimbursed on an actual cost basis for all expenses incurred in the performance of official duties. Such expenses may include transportation, lodging, meals, tips, tolls, parking of cars, laundry, registration fees, and other expenses associated with travel on official business. A copy of the policy is available to shareholders of the Association upon request.

The aggregate amount of reimbursement for travel, subsistence and other related expenses for all directors as a group was $47,379 for 2005, $41,125 for 2004, and $30,197 for 2003.

Subject to approval by the Board, the Association may allow directors honorarium for attendance at meetings, committee meetings, or special assignments. The following table outlines 2005 honorariums:

| Description | Honorarium |
|---|---|
| Board Retainer | $1,500/annually |
| Board meetings, official board functions | $300/day |
| Board committees | $200/day |
| Board meetings via conference call | $75/day |

Total compensation paid to directors as a group totaled $50,325. A majority of the Board attended a Farm Credit Council Conference for three days in 2005. The honorarium was waived.

The following represents certain information regarding the directors of the Association and their business experience for the past five years:

***Charles W. Kackley***, Chairman, is a beef cattle, small grain farmer and owner of a small mowing business. Mr. Kackley serves on the Boards of the Clarke County Zoning Appeals (Chairman), Clarke County Fair (Vice Chairman), and Clarke County Education Foundation, Berryville, Virginia. Mr. Kackley is a member of the Clarke County Ruritan Club, Clarke County Chamber of Commerce, and Berryville Baptist Church (past deacon), Berryville, Virginia. During 2005, he served eight days at Association board meetings and twenty days in other official activities and was paid $8,975. His term of office is 2005 – 2008.

***John P. Burns, Jr.***, Vice Chairman, is a beef cattle and grain farmer. He is a director on the Boards of the Bank of Charles Town and Southern States Cooperative, Charles Town, West Virginia, and Jefferson County Fair (Director 43 years; Past President 39 years), Jefferson County, West Virginia. Mr. Burns is also a member of the Jefferson County Farm Bureau, Jefferson County, West Virginia and past elder and deacon (20 years) in the Charles Town Presbyterian Church, Charles Town, West Virginia. During 2005, he served eight days at Association board meetings and fourteen days in other official activities and was paid $7,275. His term of office is 2003 – 2006.

***Gary W. Bushong*** is a 250 herd dairy farmer. He is a member of the Rockingham Cooperative Farm Bureau (past director), Harrisonburg, Virginia; Broadway-Timberville Young Farmers, Broadway, Virginia; Raders Lutheran Church, Timberville, Virginia and National Young Farmers Association. During 2005, he served eight days at Association board meetings and seven days in other official activities and was paid $5,175. His term of office is 2004 – 2007.

***T. Jeffery Jennings*** is a beef and poultry farmer. He is a director on the Board of the Culpeper Farmers' Cooperative, Culpeper, Virginia. Mr. Jennings is active in the Luray United Methodist Mens Group and Mission Teams. During 2003, Mr. Jennings was the recipient of the Pilgrim's Pride Environmental Excellence Award for Virginia for superior commitment to environmental practices. In 2004, Mr. Jennings was one of five winners of the Virginia Poultry Federation's Environmental Stewardship Award. During 2005, he served seven days at Association board meetings and fifteen days in other official activities and was paid $7,475. His term of office is 2004 – 2007.

***Harry M. (Marty) Kable*** is a crop farmer, auctioneer and land developer. He is a director on the Boards of the Jefferson County Public Service District (Chairman), Jefferson County, West Virginia and Harpers Ferry Cooking Club, (Past President), Harpers Ferry, West Virginia. Mr. Kable is a member of the Jefferson County Farm Bureau (Past President), Jefferson County, West Virginia; the Presbyterian Church, Charles Town, West Virginia and Creek Hill Hunting Club (President), Baker, West Virginia. Mr. Kable is also Vice President of Sunrise Shale, Incorporated, Jefferson County, West Virginia. During 2005, he served seven days at Association Board Meetings and eight days in other official activities and was paid $5,175. His term of office is 2005 – 2008.

***Jim A. Long*** is a beef and poultry farmer and wholesale nursery owner / operator. He is a director on the Boards of the Shenandoah Memorial Hospital (Vice Chairman), Woodstock, Virginia and Valley Health Systems, Winchester, Virginia. During 2005, he served eight days at Association board meetings and five days in other official activities and was paid $5,300. His term of office is 2003 – 2006.

***Charles W. Orndoff, Sr.*** is a beef cattle farmer. He is a director on the Boards of the Farmer's Livestock Exchange, Incorporated, Winchester, Virginia and the Clearbrook Volunteer Fire Company, Clearbrook, Virginia. Mr. Orndoff is also a member of the Frederick County Farm Bureau, Stonewall Ruritan Club and White Hall Methodist Church, Frederick County, Virginia. During 2005, he served eight days at Association board meetings and ten days in other official activities and was paid $5,975. His term of office is 2003 – 2006.

***Betty H. Carroll***, Outside Director, is a retired commercial banker. She is a former Chief Executive Officer, President and Vice-Chairman of the commercial bank's Board of Directors. She is currently a director on the Advisory Board for the Blue Ridge Region of Branch Banking and Trust Company and the Handley High School Museum and Archive of Winchester, Winchester, Virginia. She is a member of the Board of Trustees, Shenandoah University (serves as their Secretary; member of the Executive Committee, Endowment Committee and Finance Committee of the University) and a member of the Winchester Medical Center's Advisory Group, Winchester, Virginia. She has served on the boards of the Winchester-Frederick County Chamber of Commerce, Salvation Army, Shalom et Benedictus (a drug rehabilitation center) and The Free Medical Clinic, Winchester, Virginia. She also served on the Board of the Virginia Bankers Association, Richmond, Virginia and is past chairman of the Group III, Virginia Bankers Association. She is a former member of the Financial Bank Women International – Virginia Valley Group. Mrs. Carroll was appointed to serve on the Center for Rural Development by the Governor of Virginia. During 2005, she served four days at Association board meetings and eight days in other official activities and was paid $4,975. Her term of office is 2003 – 2006.

**Transactions with Senior Officers and Directors**

The reporting entity's policies on loans to and transactions with its officers and directors, to be disclosed in this section are incorporated herein by reference to Note 12 to the consolidated financial statements, "Related Party Transactions," included in this annual report to shareholders.

**Involvement in Certain Legal Proceedings**

There were no matters which came to the attention of management or the board of directors regarding involvement of current directors or senior officers in specified legal proceedings which should be disclosed in this section.

**Relationship with Independent Public Accountants**

There were no material disagreements with our independent public accountants on any matter of accounting principles or financial statement disclosure during this period.

**Consolidated Financial Statements**

The consolidated financial statements, together with the report thereon of PricewaterhouseCoopers LLP dated February 23, 2006, and the report of management, which appear in this annual report to shareholders are incorporated herein by reference.

Copies of the Association's quarterly reports are available upon request free of charge by calling 1-800-999-5341 or writing Mary S. Miller, Vice President and CFO, Valley Farm Credit, ACA, PO Box 2700, Winchester, VA 22604 or accessing the website, *www.valleyfc.com.* The Association prepares a quarterly report within 45 days after the end of each fiscal quarter, except that no report need be prepared for the fiscal quarter that coincides with the end of the fiscal year of the institution.

**Borrower Information Regulations**

Since 1972, FCA regulations have required that borrower information be held in strict confidence by System institutions, their directors, officers and employees. These regulations provide Farm Credit institutions clear guidelines for protecting their borrowers' nonpublic personal information.

On November 10, 1999, the FCA Board adopted a policy that requires FCS institutions to formally inform new borrowers at loan closing of the FCA regulations on releasing borrower information and to address this information in the annual report to shareholders. The implementation of these measures ensures that new and existing borrowers are aware of the privacy protections afforded them through FCA regulations and Farm Credit System institution efforts.

**Shareholder Investment**

Shareholder investment in the Association could be affected by the financial condition and results of operations of AgFirst Farm Credit Bank. Copies of the District annual and quarterly reports are available upon request free of charge by calling 1-800-845-1745, ext. 378, or writing Jay Wise, AgFirst Farm Credit Bank, P. O. Box 1499, Columbia, SC 29202. Information concerning AgFirst Farm Credit Bank can also be obtained by going to AgFirst's website at *www.agfirst.com*.

# *Report of the Audit Committee*

The Audit Committee of the Board of Directors (the Committee) is comprised of the directors named below. None of the directors who serve on the Audit Committee is an employee of Valley Farm Credit, ACA (the Association) and in the opinion of the Board of Directors, each is free of any relationship with the Association or management that would interfere with the director's independent judgment on the Committee.

The Committee has adopted a written charter that has been approved by the Board of Directors. The Committee has reviewed and discussed the Association's audited financial statements with management, which has primary responsibility for the financial statements.

PricewaterhouseCoopers LLP (PwC), the Association's independent auditor for 2005, is responsible for expressing an opinion on the conformity of the Association's audited financial statements with generally accepted accounting principles. The Committee has discussed with PwC the matters that are required to be discussed by Statement on Auditing Standards No. 61 *(Communication With Audit Committees)*. PwC has provided to the Committee the written disclosures and the letter required by Independence Standards Board Standard No. 1 *(Independence Discussions with Audit Committees)*, and the Committee has discussed with PwC that firm's independence.

The Committee has also concluded that PwC's provision of non-audit services, if any, to the Association is compatible with PwC's independence.

Based on the considerations referred to above, the Committee recommended to the Board of Directors that the audited financial statements be included in the Association's Annual Report for 2005. The foregoing report is provided by the following independent directors, who constitute the Audit Committee:

John P. Burns, Jr.
Chairman of the Audit Committee

**Members of Audit Committee**

Betty H. Carroll
Charles W. Kackley
Charles W. Orndoff, Sr.

# Report of Independent Auditors

PRICEWATERHOUSECOOPERS

**PricewaterhouseCoopers LLP**
10 Tenth Street, Suite 1400
Atlanta, GA 30309
Telephone (678) 419 1000

## Report of Independent Auditors

To the Board of Directors and Members
of Valley Farm Credit, ACA

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of changes in members' equity and of cash flows present fairly, in all material respects, the financial position of Valley Farm Credit, ACA (the Association) and its subsidiaries at December 31, 2005, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Association's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

February 23, 2006

# Consolidated Balance Sheets

| (dollars in thousands) | December 31, 2005 | December 31, 2004 | December 31, 2003 |
|---|---|---|---|
| **Assets** | | | |
| Cash | $ 602 | $ 381 | $ 706 |
| Loans | 162,188 | 171,768 | 153,411 |
| Less: allowance for loan losses | 710 | 828 | 2,826 |
| Net loans | 161,478 | 170,940 | 150,585 |
| Accrued interest receivable | 1,165 | 879 | 935 |
| Investment in other Farm Credit institutions | 2,173 | 2,061 | 1,393 |
| Premises and equipment, net | 6,933 | 3,908 | 3,458 |
| Prepaid retirement expense | 1,963 | 1,751 | — |
| Due from AgFirst Farm Credit Bank | 1,745 | 1,609 | 1,042 |
| Other assets | 669 | 728 | 204 |
| Total assets | $ 176,728 | $ 182,257 | $ 158,323 |
| **Liabilities** | | | |
| Notes payable to AgFirst Farm Credit Bank | $ 149,339 | $ 157,765 | $ 137,721 |
| Accrued interest payable | 594 | 546 | 466 |
| Patronage refund payable | 121 | 229 | 334 |
| Postretirement benefits other than pensions | 897 | 761 | 606 |
| Minimum pension liability | — | — | 1,104 |
| Other liabilities | 2,597 | 1,759 | 1,116 |
| Total liabilities | 153,548 | 161,060 | 141,347 |
| Commitments and contingencies | | | |
| **Members' Equity** | | | |
| Capital stock and participation certificates | 3,960 | 3,924 | 3,872 |
| Retained earnings | | | |
| Allocated | 4,203 | 4,388 | 4,360 |
| Unallocated | 15,017 | 12,885 | 10,066 |
| Accumulated other comprehensive income (loss) | — | — | (1,322) |
| Total members' equity | 23,180 | 21,197 | 16,976 |
| Total liabilities and members' equity | $ 176,728 | $ 182,257 | $ 158,323 |

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

# Consolidated Statements of Income

| *(dollars in thousands)* | For the year ended December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| **Interest Income** | | | |
| Loans | $ 11,237 | $ 9,450 | $ 8,803 |
| **Interest Expense** | | | |
| Notes payable to AgFirst Farm Credit Bank | 7,280 | 5,933 | 5,684 |
| Net interest income | 3,957 | 3,517 | 3,119 |
| Provision for (reversal of allowance for) loan losses | (118) | (2,000) | 50 |
| Net interest income after provision for (reversal of allowance for) loan losses | 4,075 | 5,517 | 3,069 |
| **Noninterest Income** | | | |
| Loan fees | 357 | 258 | 626 |
| Fees for financially related services | 138 | 109 | 97 |
| Patronage refund from AgFirst Farm Credit Bank | 1,745 | 1,609 | 1,042 |
| Gains (losses) from sale of rural home loans | 1,135 | 791 | 1,299 |
| Gains (losses) from sale of premises, net | 224 | — | — |
| Gains (losses) from sale of other assets, net | 283 | — | — |
| Other noninterest income | 109 | 86 | 89 |
| Total noninterest income | 3,991 | 2,853 | 3,153 |
| **Noninterest Expense** | | | |
| Salaries and employee benefits | 3,388 | 2,958 | 2,908 |
| Occupancy and equipment | 607 | 505 | 493 |
| Insurance Fund premium | 79 | 74 | 153 |
| Other operating expenses | 1,409 | 1,227 | 982 |
| Total noninterest expense | 5,483 | 4,764 | 4,536 |
| Income before income taxes | 2,583 | 3,606 | 1,686 |
| Provision (benefit) for income taxes | 4 | (1) | 104 |
| Net income | $ 2,579 | $ 3,607 | $ 1,582 |

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

# Consolidated Statements of Changes in Members' Equity

| (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 |
| Comprehensive income | | | | | |
| Net income | | | 1,582 | | 1,582 |
| Minimum pension liability adjustment | | | | 205 | 205 |
| Total comprehensive income | | | | | 1,787 |
| Capital stock/participation certificates issued | 231 | | | | 231 |
| Capital stock/participation certificates retired | (255) | | | | (255) |
| Patronage distribution | | | | | |
| Cash | | | (326) | | (326) |
| Nonqualified allocated retained earnings | | 664 | (664) | | — |
| Retained earnings retired | | (574) | | | (574) |
| Distribution adjustment | | (73) | 74 | | 1 |
| Balance at December 31, 2003 | 3,872 | 4,360 | 10,066 | (1,322) | 16,976 |
| Comprehensive income | | | | | |
| Net income | | | 3,607 | | 3,607 |
| Minimum pension liability adjustment | | | | 1,322 | 1,322 |
| Total comprehensive income | | | | | 4,929 |
| Capital stock/participation certificates issued | 316 | | | | 316 |
| Capital stock/participation certificates retired | (264) | | | | (264) |
| Patronage distribution | | | | | |
| Cash | | | (218) | | (218) |
| Nonqualified allocated retained earnings | | 508 | (508) | | — |
| Retained earnings retired | | (561) | | | (561) |
| Distribution adjustment | | 81 | (62) | | 19 |
| Balance at December 31, 2004 | 3,924 | 4,388 | 12,885 | — | 21,197 |
| Net income | | | 2,579 | | 2,579 |
| Capital stock/participation certificates issued | 685 | | | | 685 |
| Capital stock/participation certificates retired | (649) | | | | (649) |
| Patronage distribution | | | | | |
| Cash | | | (105) | | (105) |
| Nonqualified allocated retained earnings | | 420 | (420) | | — |
| Retained earnings retired | | (551) | | | (551) |
| Distribution adjustment | | (54) | 78 | | 24 |
| Balance at December 31, 2005 | $ 3,960 | $ 4,203 | $ 15,017 | $ — | $ 23,180 |

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

# Consolidated Statements of Cash Flows

| | For the year ended December 31, | | |
|---|---|---|---|
| *(dollars in thousands)* | **2005** | **2004** | **2003** |
| **Cash flows from operating activities:** | | | |
| Net income | $ 2,579 | $ 3,607 | $ 1,582 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | | |
| Depreciation on premises and equipment | 377 | 323 | 317 |
| Provision for (reversal of allowance for) loan losses | (118) | (2,000) | 50 |
| (Gains) losses from sale of premises, net | (224) | — | — |
| (Gains) losses from sale of other assets, net | (283) | — | — |
| (Gains) losses from sale of rural home loans | (1,135) | (791) | (1,299) |
| Originations of rural home loans held for sale | (68,085) | (54,284) | (89,807) |
| Proceeds from sale of rural home loans held for sale | 69,220 | 55,075 | 91,106 |
| Changes in operating assets and liabilities: | | | |
| (Increase) decrease in accrued interest receivable | (286) | 56 | (57) |
| (Increase) decrease in prepaid retirement expense | (212) | (1,751) | — |
| (Increase) decrease in due from AgFirst Farm Credit Bank | (136) | (567) | (95) |
| (Increase) decrease in other assets | (68) | 798 | 260 |
| Increase (decrease) in accrued interest payable | 48 | 80 | (54) |
| Increase (decrease) in postretirement benefits other than pensions | 136 | 155 | 167 |
| Increase (decrease) in minimum pension liability | — | (1,104) | (72) |
| Increase (decrease) in other liabilities | 838 | 643 | 384 |
| Total adjustments | 72 | (3,367) | 900 |
| Net cash provided by (used in) operating activities | 2,651 | 240 | 2,482 |
| **Cash flows from investing activities:** | | | |
| Net (increase) decrease in loans | 9,580 | (18,355) | (15,974) |
| (Increase) decrease in investment in AgFirst Farm Credit Bank | (112) | (668) | — |
| Purchase of premises and equipment | (3,538) | (773) | (265) |
| Purchase of other assets | (148) | — | — |
| Proceeds from sale of premises | 360 | — | — |
| Proceeds from sale of other assets | 558 | — | — |
| Net cash provided by (used in) investing activities | 6,700 | (19,796) | (16,239) |
| **Cash flows from financing activities:** | | | |
| Advances on (repayment of) notes payable to AgFirst Farm Credit Bank, net | (8,426) | 20,044 | 15,115 |
| Capital stock and participation certificates issued | 685 | 316 | 231 |
| Capital stock and participation certificates retired | (649) | (264) | (255) |
| Patronage refunds paid | (189) | (304) | (265) |
| Retained earnings retired | (551) | (561) | (574) |
| Net cash provided by (used in) financing activities | (9,130) | 19,231 | 14,252 |
| Net increase (decrease) in cash | 221 | (325) | 495 |
| Cash, beginning of period | 381 | 706 | 211 |
| Cash, end of period | $ 602 | $ 381 | $ 706 |
| | | | |
| **Supplemental schedule of non-cash activities:** | | | |
| Cash dividends or patronage distributions declared or payable | $ 105 | $ 218 | $ 326 |
| Decrease (increase) in accumulated other comprehensive income related to minimum pension liability | — | 1,322 | 205 |
| **Supplemental information:** | | | |
| Interest paid | $ 7,232 | $ 5,853 | $ 5,738 |
| Taxes paid | 2 | — | — |
| Federal tax refunds related to long-term operations (Note 9) | — | — | 4 |

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

# Notes to the Consolidated Financial Statements

*(dollars in thousands, except as noted)*

**Note 1 — Organization and Operations**

A. **Organization:** Valley Farm Credit, ACA (Association or ACA) is a member-owned cooperative which provides credit and credit-related services to or for the benefit of eligible borrowers/stockholders for qualified purposes in the counties of Clarke, Frederick, Warren, Shenandoah and Page in the state of Virginia, and Berkeley, Morgan and Jefferson in the state of West Virginia.

The Association is a lending institution of the Farm Credit System (System), a nationwide system of cooperatively owned Banks and Associations, which was established by Acts of Congress to meet the credit needs of American agriculture and is subject to the provisions of the Farm Credit Act of 1971, as amended (the Farm Credit Act). The most recent significant amendment to the Farm Credit Act was the Agricultural Credit Act of 1987. At December 31, 2005, the System was comprised of four Farm Credit Banks, one Agricultural Credit Bank and ninety-six Associations.

AgFirst Farm Credit Bank (Bank) and its related Associations are collectively referred to as the "District." The Bank provides funding to all associations within the District and is responsible for supervising certain activities of the District Associations, as well as the other associations operating within the AgFirst District. The District consists of the Bank and twenty-three ACAs, all of which have reorganized as ACA parent-companies, which have two wholly owned subsidiaries, a Federal Land Credit Association (FLCA) and a Production Credit Association (PCA).

ACA parent-companies provide financing and related services through its FLCA and PCA subsidiaries. The FLCA makes secured long-term agricultural real estate and rural home mortgage loans. The PCA makes short- and intermediate-term loans for agricultural production or operating purposes.

The Farm Credit Administration (FCA) is delegated authority by Congress to regulate the System banks and associations. The FCA examines the activities of the associations and certain actions by the associations are subject to the prior approval of the FCA and the supervising Bank.

The Farm Credit Act established the Farm Credit System Insurance Corporation (Insurance Corporation) to administer the Farm Credit Insurance Fund (Insurance Fund). The Insurance Fund is required to be used (1) to ensure the timely payment of principal and interest on Systemwide debt obligations (Insured debt), (2) to ensure the retirement of protected borrower capital at par or stated value, and (3) for other specified purposes. The Insurance Fund is also available for discretionary uses by the Insurance Corporation of providing assistance to certain troubled System institutions and to cover the operating expenses of the Insurance Corporation. Each System bank is required to pay premiums into the Insurance Fund, based on its annual average loan principal outstanding until the monies in the Insurance Fund reach the "secure base amount," which is defined in the Farm Credit Act as 2.0 percent of the aggregate insured obligations (Systemwide debt obligations) or such other percentage of the aggregate obligations as the Insurance Corporation in its sole discretion determines to be actuarially sound. When the amount in the Insurance Fund exceeds the secure base amount, the Insurance Corporation is required to reduce premiums, but it still must ensure that reduced premiums are sufficient to maintain the level of the Insurance Fund at the secure base amount.

B. **Operations:** The Farm Credit Act sets forth the types of authorized lending activity, persons eligible to borrow, and financial services which can be offered by the Association. The Association is authorized to provide, either directly or in participation with other lenders, credit, credit commitments and related services to eligible borrowers. Eligible borrowers include farmers, ranchers, producers or harvesters of aquatic products, rural residents, and farm-related businesses.

The Association may sell to any Farm Credit borrowing member, on an optional basis, credit or term life insurance appropriate to protect the loan commitment in the event of death of the debtor(s). The sale of other insurance necessary to protect a member's farm or aquatic unit is permitted, but limited to hail and multi-peril crop insurance, and insurance necessary to protect the facilities and equipment of aquatic borrowers.

The AgFirst Annual Report to Shareholders, the AgFirst District Annual Report to Shareholders, and the AgFirst District's quarterly reports are available on its web site, *www.agfirst.com*. Upon request, shareholders of the Association will be provided with copies of these reports at no charge by calling 1-800-845-1745, Ext. 378. The Association's financial condition may be impacted by factors that affect the Bank. The Bank's Annual Report discusses the material aspects of the District's financial condition, changes in financial condition, and results of operations. In addition, the District's Annual Report identifies favorable and unfavorable trends, significant events, uncertainties and the impact of activities of the Insurance Corporation.

The lending and financial services offered by the Bank are described in Note 1 of the Bank's Annual Report to Shareholders.

**Note 2 — Summary of Significant Accounting Policies**

The accounting and reporting policies of the Association conform with accounting principles generally accepted in the United States of America (GAAP) and prevailing practices within the banking industry. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Significant estimates are discussed in these footnotes, as applicable. Actual results may differ from these estimates.

Certain amounts in prior years' financial statements have been reclassified to conform to current consolidated financial statement presentation. Such reclassifications had no effect on net income or total members' equity of prior years. The consolidated financial statements include the accounts of the FLCA and the PCA. All significant inter-company transactions have been eliminated in consolidation.

A. **Cash:** Cash, as included in the statement of cash flows, represents cash on hand and on deposit at banks.

B. **Loans and Allowance for Loan Losses:** Long-term real estate mortgage loans generally have original maturities ranging from five to 30 years. Substantially all short- and intermediate-term loans for agricultural production or operating purposes have maturities of 10 years or less. Loans are carried at their principal amount outstanding less unearned income. Interest on loans is accrued and credited to interest income based upon the daily principal amount outstanding.

Impaired loans are loans for which it is probable that not all principal and interest will be collected according to the contractual terms of the loan. Impaired loans include nonaccrual loans, restructured loans, and loans past due 90 days or more and still accruing interest. A loan is considered contractually past due when any principal repayment or interest payment required by the loan instrument is not received on or before the due date. A loan shall remain contractually past due until it is formally restructured or until the entire amount past due, including principal, accrued interest, and penalty interest incurred as the result of past due status, is collected or otherwise discharged in full.

Loans are generally placed in nonaccrual status when principal or interest is delinquent for 90 days (unless adequately collateralized and in the process of collection) or circumstances indicate that collection of principal and/or interest is in doubt. When a loan is placed in nonaccrual status, accrued interest deemed uncollectible is reversed (if accrued in the current year) or charged against the allowance for loan losses (if accrued in the prior year).

When loans are in nonaccrual status, the interest portion of payments received in cash is recognized as interest income if collection of the recorded investment in the loan is fully expected and the loan does not have a remaining unrecovered prior charge-off associated with it. Otherwise, loan payments are applied against the recorded investment in the loan. Nonaccrual loans may be returned to accrual status when principal and interest are current, prior charge-offs have been recovered, the ability of the borrower to fulfill the contractual repayment terms is fully expected and the loan is not classified “doubtful” or “loss.”

Loans are charged-off, wholly or partially, as appropriate, at the time they are determined to be uncollectible.

In cases where a borrower experiences financial difficulties and the Association makes certain monetary concessions to the borrower through modifications to the contractual terms of the loan, the loan is classified as a restructured loan. If the borrower’s ability to meet the revised payment schedule is uncertain, the loan is classified as a nonaccrual loan.

Loan origination fees and direct loan origination costs are deferred as part of the carrying amount of the loan and the net fee or cost is amortized over the life of the related loan as an adjustment to yield.

The allowance for loan losses is a valuation account used to reasonably estimate loan and lease losses existing as of the financial statement date. Determining the appropriate allowance for loan losses balance involves significant judgment about when a loss has been incurred and the amount of that loss. The determination of the allowance for loan losses is based on management’s current judgments about the credit quality of its loan and lease portfolio. A specific allowance may be established for impaired loans under Statement of Financial Accounting Standards No. 114. Impairment of these loans is measured based on the present value of expected future cash flows discounted at the loan’s effective interest rate or, as practically expedient, at the loan’s observable market price or fair value of the collateral if the loan is collateral dependent. See Note 3 for a discussion on the refinement of the allowance for loan losses methodology.

The allowance for loan losses is maintained at a level considered adequate by management to provide for probable and estimable losses inherent in the loan portfolio. The allowance is increased through provisions for loan losses and loan recoveries and is decreased through allowance reversals and loan charge-offs.

The allowance is based on a periodic evaluation of the loan portfolio by management in which numerous factors are considered, including economic conditions, loan portfolio composition and prior loan loss experience. It is based on estimates, appraisals and evaluations of loans which, by their nature, contain elements of uncertainty and imprecision. The possibility exists that changes in the economy and its impact on borrower repayment capacity will cause these estimates, appraisals and evaluations to change.

The level of allowance for loan losses is generally based on recent charge-off experience adjusted for relevant environmental factors. The Association considers the following factors when adjusting the historical charge-offs experience:

- Changes in credit risk classifications,
- Changes in collateral values,
- Changes in risk concentrations,
- Changes in weather related conditions, and
- Changes in economic conditions.

C. **Gains/(Losses) on Loans Held for Sale:** Certain rural home loans originated by the Association are sold on a servicing released basis primarily to the Bank or into the secondary market to unrelated third parties. For loans sold to the Bank, the Association locks into a selling price with the Bank at the time that the Association enters into a commitment to lend to the potential borrower. Gains or losses on sales of mortgage loans are recognized based on the difference between the selling price and the carrying value of the related mortgage loans sold.

D. **Investment in AgFirst Farm Credit Bank:** The Association is required to maintain ownership in the Bank in the form of Class C stock. Accounting for this investment is on the cost plus allocated equities basis. Patronage refunds from the Bank are accrued as earned. The receivable for such patronage refunds is classified as due from AgFirst Farm Credit Bank.

E. **Other Property Owned:** Other property owned, consisting of real and personal property acquired through a collection action, is recorded at fair value less estimated selling costs upon acquisition. Revised estimates to the fair value less cost to sell are reported as adjustments to the carrying amount of the asset, provided that such adjusted value is not in excess of the carrying amount at acquisition. Income and expenses from operations and carrying value adjustments are included in gains (losses) on other property owned. The Association did not have any other property owned during 2005, 2004 or 2003.

F. **Premises and Equipment:** Premises and equipment are carried at cost less accumulated depreciation. Land is carried at cost. Depreciation is provided on the straight-line method over the estimated useful lives of the assets. Gains and losses on dispositions are reflected in current operations. Maintenance and repairs are charged to operating expense and improvements are capitalized.

G. **Advanced Conditional Payments:** The Association is authorized under the Farm Credit Act to accept advance payments from borrowers. To the extent the borrower’s access to such advance payments is restricted, the advanced conditional payments are netted against the borrower's related loan balance. Amounts in excess of the related loan balance and amounts to which the borrower has unrestricted access are presented as interest-bearing liabilities in the accompanying Balance Sheet. Advanced conditional payments are not insured. Interest is generally paid by the Association on such accounts. The Association did not have any advanced conditional payments during 2005, 2004 or 2003.

H. **Employee Benefit Plans:** The employees of the Association may participate in the Retirement Plan (Plan) of the AgFirst District, which is a defined benefit plan. The District utilizes the "Projected Unit Credit" actuarial method for financial reporting purposes and for funding purposes. As a result of the funded status at the Plan's measurement date (September 30) of the underlying Plan, the Association may record a minimum liability, an intangible asset relating to unrecognized prior service cost and other comprehensive income (loss). The adjustment to other comprehensive income (loss) would be net of deferred taxes, if significant. For participants hired before January 1, 2003, benefits are determined based on a final average pay formula. For those participants hired on or after January 1, 2003, benefits are determined using a cash balance formula.

The employees of the Association are eligible to participate in the District's thrift plan (Thrift Plan), which qualifies as a 401(k) plan as defined by the Internal Revenue Code. The Association contributes $1.00 for each $1.00 of the maximum employee contribution of 6 percent of total compensation. Employee deferrals are not to exceed the maximum deferral as adjusted by the Internal Revenue Service. Thrift Plan costs are expensed as funded.

Effective January 1, 2006 the Districtwide 401(k) Plan known as the AgFirst Farm Credit Employee Thrift Plan merged with the Farm Credit Bank of Texas Thrift Plus Plan. The new plan is known as the AgFirst/FCBT 401(k) Employee Benefit Plan.

The Association may provide certain health care and life insurance benefits to eligible retired employees. Substantially all employees may become eligible for these benefits if they reach early retirement age while working for the Association.

I. **Income Taxes:** The Association is generally subject to Federal and certain other income taxes. The Association is eligible to operate as a cooperative that qualifies for tax treatment under Subchapter T of the Internal Revenue Code. Accordingly, under specified conditions, the Association can exclude from taxable income amounts distributed as qualified patronage refunds in the form of cash, stock or allocated surplus. Provisions for income taxes are made only on those taxable earnings that will not be distributed as qualified patronage refunds. The Association distributes patronage on the basis of book income. The Association recognizes deferred tax assets and liabilities for the expected future tax consequences of the temporary differences between the carrying amounts and tax basis of assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be realized or settled. A valuation allowance is provided at the balance sheet dates against that portion of the Association's deferred tax assets that it is more likely than not (50 percent probability), based on management's best estimates of future events and circumstances, that will not be realized.

As previously described, the ACA holding company operates through two wholly-owned subsidiaries. The FLCA subsidiary is exempt from Federal and other income taxes as provided in the Farm Credit Act. The ACA and the PCA subsidiary are subject to Federal and state income taxes. The Association accounts for income taxes under the asset and liability method. Accordingly, deferred taxes are recognized for estimated taxes ultimately payable or recoverable based on Federal, state or local laws.

J. **Patronage Refund from AgFirst:** The Association records patronage refunds from the Bank on an accrual basis.

**Note 3 — Refinement of the Allowance for Loan Losses Methodology**

During 2004, the Association conducted a study to further refine its allowance for loan losses methodology taking into account recently issued guidance by FCA as well as the Securities and Exchange Commission (SEC) and Federal Financial Institutions Examination Council guidelines.

The Association's allowance for loan losses methodology was adjusted and revised in the late 1980s to take into account credit losses in that period. Given the long cyclical nature of the agricultural economy, loss factors utilized to determine the allowance for loan losses subsequent to 1989 continued to reflect, to some extent, the loss history of the mid-to-late 1980s, which resulted in conservative estimates of the allowance for loan losses. The Association's allowance for loan losses methodology utilized throughout the period was in accordance with generally accepted accounting principles and was consistently applied.

While conservative in estimating the allowance for loan losses, the methodology used resulted in annual provisions for loan losses over the periods that reflected changes in credit quality and loss experience. Accordingly, the reserves provided in the mid-to-late 1980s have, in effect, remained part of the allowance for loan losses. The Association's allowance for loan losses methodology has consistently adhered to proper accounting policies, under the regulatory supervision of FCA in its role as a "safety and soundness" regulator. It was FCA's view that the allowance for loan losses should include among others, an assessment of probable losses, historical loss experience and economic conditions.

In April 2004, FCA issued an "Informational Memorandum" to System institutions regarding the criteria and methodologies that would be used in evaluating the adequacy of a System institution's allowance for loan losses. FCA endorsed the direction provided by other bank regulators and the SEC and indicated the conceptual framework addressed in their guidance would be included as part of their examination process.

During the fourth quarter of 2004, the Association completed its study and refined its methodology to be in compliance with the guidance discussed in the previous paragraph. The refinement in methodology resulted in a calculated allowance for loan losses that was significantly less than the previously recorded balance due to revised loss factors that are more indicative of actual loss experience in recent years and current borrower analysis.

While the $2,000 reversal had a significant impact on 2004 results of operations and the previously recorded allowance for loan losses, the refinement in methodology did not have a significant impact on 2005 comparative results of operations and is not expected to have a significant impact in future periods. Additionally, the refinement in methodology did not have a significant impact on the level of the risk bearing capacity of the Association, generally referred to as "risk funds" (capital plus the allowance for loan losses), which totaled $23,890 at December 31, 2005 (14.73 percent of Association loans), as compared with $22,025 at December 31, 2004 (12.82 percent of Association loans), and $19,802 at December 31, 2003 (12.91 percent of Association loans).

**Note 4 — Loans and Allowance for Loan Losses**

A summary of loans follows:

| | December 31, 2005 | 2004 | 2003* |
|---|---|---|---|
| Production agriculture: | | | |
| Real estate mortgage | $ 78,434 | $ 76,400 | $ * |
| Production and intermediate term | 62,628 | 72,971 | * |
| Agribusiness: | | | |
| Processing and marketing | 2,230 | 1,005 | * |
| Farm related business | 1,901 | 1,945 | * |
| Communication | – | – | * |
| Rural residential real estate | 16,995 | 19,447 | * |
| Total loans | $ 162,188 | $ 171,768 | $ * |

* *Note: Beginning with year-end 2004, loan type categories have been expanded to provide additional information on the types of loans made.*

The Association's concentration of credit risk in various agricultural commodities is shown in the following table. While the amounts represent the Association's maximum potential credit risk as it relates to recorded loan principal, a substantial portion of the Association's lending activities is collateralized and the Association's exposure to credit loss associated with lending activities is reduced accordingly. An estimate of the Association's credit risk exposure is considered in the determination of the allowance for loan losses.

Total loans at December 31, 2005, 2004 and 2003 consisted of the following commodity types:

| Commodity Type | December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| Part-time and Other | 33% | 30% | 27% |
| Livestock | 25 | 25 | 23 |
| Poultry | 20 | 21 | 23 |
| Rural Home | 9 | 10 | 12 |
| Orchard | 7 | 8 | 8 |
| Dairy | 6 | 6 | 7 |
| Total | 100% | 100% | 100% |

The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the borrower. Collateral held varies, but typically includes farmland and income-producing property, such as crops and livestock, as well as receivables. Long-term real estate loans are collateralized by the first liens on the underlying real property. Federal regulations state that long-term real estate loans are not to exceed 85 percent (97 percent if guaranteed by a government agency) of the property's appraised value. However, a decline in a property's market value subsequent to loan origination or advances, or other actions necessary to protect the financial interest of the Association in the collateral, may result in the loan to value ratios in excess of the regulatory maximum.

The following table presents information relating to impaired loans.

| | December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| Nonaccrual loans: | | | |
| Current as to principal and interest | $ – | $ – | $ – |
| Past due | – | – | – |
| Total nonaccrual loans | – | – | – |
| Impaired accrual loans: | | | |
| Restructured accrual loans | – | – | – |
| Accrual loans 90 days or more past due | – | 84 | – |
| Total impaired accrual loans | – | 84 | – |
| Total impaired loans | $ – | $ 84 | $ – |

There were no material commitments to lend additional funds to debtors whose loans were classified as impaired at December 31, 2005.

Interest income is recognized and cash payments are applied on nonaccrual impaired loans as described in Note 2. The following table presents interest income recognized on impaired loans.

| | Year Ended December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| Interest income recognized on nonaccrual loans | $ – | $ – | $ 5 |
| Interest income on impaired accrual loans | 7 | 1 | 16 |
| Interest income recognized on impaired loans | $ 7 | $ 1 | $ 21 |

The following table presents information concerning impaired loans as of December 31,

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Impaired loans with related allowance | $ – | $ 4 | $ – |
| Impaired loans with no related allowance | – | 80 | – |
| Total impaired loans | $ – | $ 84 | $ – |
| Allowance on impaired loans | $ – | $ 4 | $ – |

The following table summarizes impaired loan information for the year ended December 31,

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Average impaired loans | $ 92 | $ 8 | $ 166 |

The following table summarizes interest income on nonaccrual and accruing restructured loans that would have been recognized under the original terms of the loans:

| | Year Ended December 31, 2005 | 2004 |
|---|---|---|
| Interest income which would have been recognized under the original loan terms | $ – | $ 1 |
| Less: interest income recognized | – | – |
| Foregone interest income | $ – | $ 1 |

The changes in the allowance for loan losses are as follows:

| | Year Ended December 31, 2005 | 2004 | 2003* |
|---|---|---|---|
| Balance at beginning of year | $ 828 | $ 2,826 | $ * |
| Provision for (reversal of allowance for) loan losses | $ (118) | $ – | $ * |
| Nonrecurring reversal of allowance | – | (2,000) | – |
| | (118) | (2,000) | * |
| Charge-offs: | | | |
| Production agriculture: | | | |
| Production and intermediate term | $ 2 | $ – | $ * |
| Total charge-offs | 2 | – | * |
| Recoveries | | | |
| Production agriculture: | | | |
| Production and intermediate term | $ 2 | $ 2 | $ * |
| Total recoveries | 2 | 2 | * |
| Net charge-offs (recoveries) | – | (2) | * |
| Balance at end of year | $ 710 | $ 828 | $ * |
| Ratio of net charge-offs during the period to average loans outstanding during the period | –% | (0.001)% | (0.001)% |

* *Note: Beginning with year-end 2004, loan type categories have been expanded to provide additional information on the types of loans made.*

As previously discussed in Note 3, the nonrecurring partial reversal of the allowance resulted from the refinement of the Association's allowance for loan losses methodology.

In addition, the following is a breakdown of the allowance for loan losses for the end of the last three fiscal years:

| | December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2005 | | 2004 | | 2003* | |
| | Amount | % | Amount | % | Amount | % |
| Production agriculture | | | | | | |
| Real estate mortgage | $ 257 | 36% | $ 276 | 33% | $ * | *% |
| Production and intermediate term | 361 | 51 | 444 | 54 | * | * |
| Agribusiness | 18 | 3 | 14 | 2 | * | * |
| Communication | – | – | – | – | * | * |
| Rural residential real estate | 74 | 10 | 94 | 11 | * | * |
| Total | $ 710 | 100% | $ 828 | 100% | $ * | *% |

* *Note: Beginning with year-end 2004, loan type categories have been expanded to provide additional information on the types of loans made.*

To mitigate the risk of loan losses, the Association entered into long-term standby "commitment to purchase" agreements with the Federal Agricultural Mortgage Corporation (Farmer Mac). The agreements, which are effectively credit guarantees that will remain in place until the loans are paid in full, give the Association the right to sell the loans identified in the agreements to Farmer Mac in the event of default (typically four months past due), subject to certain conditions. The balance of loans under long-term standby commitments was $9,691, $11,688 and $0 at December 31, 2005, 2004 and 2003, respectively. Fees paid to Farmer Mac for such commitments totaled $59, $17 and $0 for the years ended December 31, 2005, 2004 and 2003, respectively. These amounts are classified as noninterest expense.

**Note 5 — Investment in AgFirst Farm Credit Bank**

The Association is required to maintain ownership in the Bank of Class C stock as determined by the Bank. The Bank may require additional capital contributions to maintain its capital requirements.

**Note 6 — Premises and Equipment**

Premises and equipment consisted of the following:

| | December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| Land and improvements | $ 1,130 | $ 842 | $ 521 |
| Buildings and improvements | 5,448 | 2,796 | 2,602 |
| Furniture and equipment | 1,905 | 1,603 | 1,444 |
| | 8,483 | 5,241 | 4,567 |
| Less: accumulated depreciation | 1,550 | 1,333 | 1,109 |
| Total | $ 6,933 | $ 3,908 | $ 3,458 |

**Note 7 — Notes Payable to AgFirst Farm Credit Bank**

The Association's indebtedness to the Bank represents borrowings by the Association to fund its loan portfolio. This indebtedness is collateralized by a pledge of substantially all of the Association's assets and the terms of the revolving lines of credit are governed by a general financing agreement. Interest rates on both variable and fixed rate notes payable are generally established loan-by-loan based on the Bank's marginal cost of funds, capital position, operating costs and return objectives. The interest rate is periodically adjusted by the Bank based upon agreement between the Bank and Association. The weighted average interest rates on the variable rate notes were 5.30 percent for LIBOR-based loans, 5.17 percent for Prime-based loans, and the weighted average remaining maturities were 5.2 years and 2.2 years, respectively, at December 31, 2005. The weighted average interest rate on the fixed rate and adjustable rate mortgage (ARM) notes payable which are match funded by the Bank was 4.91 percent and the weighted average remaining maturity was 8.5 years at December 31, 2005. The weighted average interest rate on all interest-bearing notes payable was 5.01 percent and the weighted average remaining maturity was 7.1 years at December 31, 2005.

Variable rate and fixed rate notes payable represent approximately 23.01 percent and 76.99 percent, respectively, of total notes payable at December 31, 2005.

Under the Farm Credit Act, the Association is obligated to borrow only from the Bank, unless the Bank approves borrowing from other funding sources. The Bank, consistent with FCA regulations, has established limitations on the Association's ability to borrow funds based on specified factors or formulas relating primarily to credit quality and financial condition. At December 31, 2005, the Association's notes payable were within the specified limitations.

**Note 8 — Members' Equity**

A description of the Association's capitalization requirements, protection mechanisms, regulatory capitalization requirements and restrictions, and equities are provided below.

**A. Capital Stock and Participation Certificates**

In accordance with the Farm Credit Act and the Association's capitalization bylaws, each borrower is required to invest in Class C stock for agricultural loans, or participation certificates in the case of rural home and farm related business loans, as a condition of borrowing. The statutory minimum investment is $1 thousand or two percent of the amount of the loan, whichever is less. At December 31, 2004, the Association had a borrower capitalization requirement of $2 thousand (except rural home loans which are $1 thousand), or two percent of the loan amount, whichever is less. The Board of Directors may increase the amount of investment if necessary to meet the Association's capital needs. The bylaws of the Association provide for a maximum not to exceed ten percent (10 percent) of the loan amount. Loans designated for sale or sold into the Secondary Market on or after February 10, 1996 will have no voting stock or participation certificate purchase requirement if sold within 180 days following the date of designation.

The borrower acquires ownership of the capital stock or participation certificates at the time the loan is made, but usually does not make a cash investment. The aggregate par value is generally added to the principal amount of the related loan obligation. The Association retains a first lien on the stock or participation certificates owned by borrowers. Retirement of such equities will generally be at the lower of par or book value, and repayment of a loan does not automatically result in retirement of the corresponding stock or participation certificates.

**B. Regulatory Capitalization Requirements and Restrictions**

The FCA's capital adequacy regulations require the Association to achieve permanent capital of seven percent of risk-adjusted assets and off-balance-sheet commitments. Failure to meet the seven percent capital requirement can initiate certain mandatory and possibly additional discretionary actions by the FCA that, if undertaken, could have a direct material effect on the Association's financial statements. The Association is prohibited from reducing permanent capital by retiring stock or making certain other distributions to shareholders unless prescribed capital standards are met. The FCA regulations also require that additional minimum standards for capital be achieved. These standards require all System institutions to achieve and maintain ratios as defined by FCA regulations. These required ratios are total surplus as a percentage of risk-adjusted assets of seven percent and of core surplus as a percentage of risk-adjusted assets of three and one-half percent. The Association's permanent capital, total surplus and core surplus ratios at December 31, 2005 were 14.10 percent, 11.28 percent and 10.09 percent, respectively.

An FCA regulation empowers it to direct a transfer of funds or equities by one or more System institutions to another System institution under specified circumstances. The Association has not been called upon to initiate any transfers and is not aware of any proposed action under this regulation.

**C. Description of Equities**

The Association is authorized to issue or have outstanding Classes A and C Common Stock and nonvoting Class C Participation Certificates and such other classes of equity as may be provided for in amendments to the bylaws in such amounts as may be necessary to conduct the Association's business. All stock and participation certificates have a par or face value of five dollars ($5.00) per share.

The Association had the following shares outstanding at December 31, 2005:

| | | Shares Outstanding | |
|---|---|---|---|
| **Class** | **Protected** | **Number** | **Aggregate Par Value** |
| A Preferred/Nonvoting | No | 118,956 | $ 595 |
| C Common/Voting | No | 598,107 | 2,991 |
| Participation Certificates/Nonvoting | No | 74,890 | 374 |
| Total Capital Stock and Participation Certificates | | 791,953 | $ 3,960 |

At-risk common stock and participation certificates are retired at the sole discretion of the Board at book value not to exceed par or face amounts, provided the minimum capital adequacy standards established by the Board are met.

*Retained Earnings*

The Association maintains an unallocated retained earnings account and an allocated retained earnings account. The minimum aggregate amount of these two accounts is determined by the Board. At the end of any fiscal year, if the retained earnings accounts otherwise would be less than the minimum amount determined by the Board as necessary to maintain adequate capital reserves to meet the commitments of the Association, the Association shall apply earnings for the year to the unallocated retained earnings account in such amounts as may be determined necessary by the Board.

The Association maintains an allocated retained earnings account consisting of earnings held and allocated to borrowers on a patronage basis. In the event of a net loss for any fiscal year, such allocated retained earnings account will be subject to full impairment in the order specified in the bylaws beginning with the most recent allocation.

The Association has a first lien and security interest on all retained earnings account allocations owned by any borrowers, and all distributions thereof, as additional collateral for their indebtedness to the Association. When the debt of a borrower is in default or is in the process of final liquidation by payment or otherwise, the Association, upon approval of the Board, may order any and all retained earnings account allocations owned by such borrower to be applied on the indebtedness.

Allocated equities shall be retired solely at the discretion of the Board; provided, however, that minimum capital standards established by the FCA and the Board are met.

At December 31, 2005, allocated members' equity consisted of $1,237 of qualified surplus and $2,966 of nonqualified allocated surplus.

*Patronage Distributions*

Prior to the beginning of any fiscal year, the Board, by adoption of a resolution, may obligate the Association to distribute to borrowers on a patronage basis all or any portion of available consolidated net earnings of the Association and it subsidiaries for such fiscal year or for that and subsequent fiscal years. Patronage distributions are based on the proportion of the borrower's interest to the amount of interest earned by the Association on its total loans unless another proportionate patronage basis is approved by the Board.

If the Association meets its capital adequacy standards after making the patronage distributions, the patronage distributions may be in cash, authorized stock of the Association, allocations of earnings retained in an allocated members' equity account, or any one or more of such forms of distribution. Patronage distributions of the Association's earnings may be paid on either a qualified or nonqualified basis, or a combination of both, as determined by the Board. A minimum of 20 percent of the total qualified patronage distribution to any borrower for any fiscal year shall always be paid in cash.

Earnings' pools, if any, that may be established upon approval by the Board for the payment of patronage distributions, shall be established on a rational and equitable basis and shall insure that each patron of the Association receives its fair share of the earnings of the Association and bears its fair share of the expenses of the Association.

*Dividends*

The Association may declare noncumulative dividends on its stock and participation certificates as determined by the Board's resolution. No dividend shall exceed eight percent (8 percent) per annum of the par value of the respective stock and Participation Certificates.

The rate of dividends paid on Class A Common Stock, Class C Common Stock and Participation Certificates shall be the same for any fiscal year.

Dividends may not be declared if, after recording the liability, the Association would not meet its capital adequacy standards. No dividends were declared by the Association for any of the periods included in these financial statements.

*Transfer*

Common Stocks and Participation Certificates may be transferred to persons or entities eligible to purchase or hold such equities.

*Impairment*

Any losses which result in an impairment of the Association's capital shall be borne ratably by each share of Class A Common Stock, Class C Common Stock, and unit of Participation Certificates outstanding until the full par value or face amount of each such share or unit has been fully impaired; and then to preferred stock outstanding, if any, until the full par value of such has been impaired, all as of the date such losses are determined.

*Liquidation*

In the event of liquidation or dissolution of the Association, any assets of the Association remaining after payment or retirement of all liabilities should be distributed to the holders of the outstanding stock and participation certificates in the following order:

1. Preferred Stock, if any.
2. Classes A and C Common Stock and Participation Certificates.
3. Holders of allocated retained earnings evidenced by qualified written notices of allocation, in the order of year of issuance until an amount equal to the total account has been distributed.
4. Holders of allocated retained earnings evidenced by nonqualified written notices of allocation, in the order of the year of issuance, until an amount equal to the total account has been distributed.
5. Remaining assets shall be distributed to all past and present patrons in proportion to which the aggregate patronage of each party bears to the total patronage of all such parties, to the extent practicable, unless otherwise provided by law.

**D. Other Comprehensive Income (Loss)**

The Association reports other comprehensive income (loss) in its Consolidated Statements of Changes in Members' Equity. For the year ended December 31, 2003, other comprehensive income (loss) was related to the minimum pension liability recorded as a result of the funded status of the underlying plan. During 2004, the District Associations funded the pension plans sufficiently to eliminate the pension-related charge to other comprehensive income (loss) at December 31, 2004. See Note 10 for further information.

## Note 9 — Income Taxes

The provision (benefit) for income taxes follows:

| | Year Ended December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| Current: | | | |
| Federal | $ 3 | $ (1) | $ – |
| State | 1 | – | – |
| Federal refunds related to long-term lending | – | – | (4) |
| | 4 | (1) | (4) |
| Deferred: | | | |
| Federal | – | – | 108 |
| State | – | – | – |
| | – | – | 108 |
| Total provision (benefit) for income taxes | $ 4 | $ (1) | $ 104 |

The provision (benefit) for income tax differs from the amount of income tax determined by applying the applicable U.S. statutory federal income tax rate to pretax income as follows:

| | December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| Federal tax at statutory rate | $ 878 | $ 1,226 | $ 573 |
| Patronage distributions | (36) | (322) | (298) |
| Tax-exempt FLCA earnings | (838) | (569) | (627) |
| Allowance for loan loss adjustment | – | (370) | – |
| Change in deferred tax asset valuation allowance | 40 | 108 | 590 |
| Net operating loss – carryback | – | – | (72) |
| Other | (40) | (74) | (62) |
| Provision (benefit) for income taxes | $ 4 | $ (1) | $ 104 |

Deferred tax assets and liabilities result from the following at:

| | December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| Allowance for loan losses | $ 124 | $ 184 | $ 210 |
| Net operating loss – carryforward | 1,073 | 1,237 | 1,132 |
| Organizational costs | 6 | 9 | 12 |
| Nonaccrual loan interest | – | – | 2 |
| Gross deferred tax assets | 1,203 | 1,430 | 1,356 |
| Valuation allowance | (1,043) | (1,003) | (1,143) |
| Net deferred tax assets | 160 | 427 | 213 |
| State income tax | – | (125) | (118) |
| Loan fees | (160) | (302) | (95) |
| Gross deferred tax liability | (160) | (427) | (213) |
| Net deferred tax asset (liability) | $ – | $ – | $ – |

At December 31, 2005, deferred income taxes have not been provided by the Association on approximately $1.3 million of patronage refunds received from the Bank prior to January 1, 1993. Such refunds, distributed in the form of stock, are subject to tax only upon conversion to cash. The tax liability related to future conversions is not expected to be material.

The Association recorded a valuation allowance of $1,144, $1,003 and $1,143 during 2005, 2004 and 2003, respectively. The Association will continue to evaluate the realizability of these deferred tax assets and adjust the valuation allowance accordingly.

**Note 10 — Employee Benefit Plans**

The employees of the Association may participate in a Districtwide defined benefit retirement plan. This plan is noncontributory and covers substantially all Association employees. Benefits are based on salary and years of service. The assets, liabilities and 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 the Association's salary expense as a percentage of the District's salary expense.

At December 31, 2005 and 2004, the fair value of the plan assets of the District's defined benefit plan exceeded the Accumulated Benefit Obligation (ABO), while at December 31, 2003, the ABO of the District's defined benefit plan exceeded the fair value of plan assets. The fair value of the plan assets and the ABO were measured as of September 30, 2005. At December 31, 2003, the Association's allocated amount of the minimum pension liability was recorded in the Consolidated Balance Sheets in the amount of the excess of the ABO over the fair value of plan assets. In conjunction with the minimum pension liability, accumulated other comprehensive loss was $1,322 at December 31, 2003. The impact on deferred taxes was not significant.

The Association also participates in a Districtwide Thrift Plan. The Thrift Plan requires the Association to match 100 percent of employee optional contributions up to a maximum employee contribution of 6 percent of total compensation. Expenses of $126, $125 and $114 for the years ended December 31, 2005, 2004 and 2003, respectively, were classified as salaries and employee benefits.

The District sponsors a plan providing certain benefits (primarily health care) to its retirees. Certain Association charges related to this plan are an allocation of District charges based on the Association's proportional share of the plan liability.

On December 8, 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (Medicare Act) was signed into law. This act introduces a prescription drug benefit under Medicare (Medicare Part D) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. In May 2004, the FASB issued FASB Staff Position (FSP) 106-2, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003" (the Act). This Staff Position provides guidance on the accounting for the effects of the Act for employers that sponsor postretirement health care plans that provide prescription drug benefits. The District sponsored plan adopted FSP 106-2 effective July 1, 2004 (measured as of March 31, 2004). The benefit obligation valuation as of December 31, 2004 reflects the impact of the Medicare Act.

In determining the benefit obligation as of December 31, 2004, the expected per capita claims cost were estimated to be reduced by 12 percent beginning in 2006, for Medicare-eligible participants receiving actuarially equivalent drug benefits, due to a government reimbursement of a portion of prescription drug benefits. The District reduced its accumulated postretirement benefit obligation (APBO) for the subsidy related to benefits attributed to past service. The effect of the subsidy on the measurement of net periodic postretirement cost for 2005 was a reduction of 2005 expense. The effect included lower amortization of actuarial losses, lower service costs and lower interest costs on the APBO.

The Retiree and Disabled Medical Plan was amended effective January 1, 2006 to change the medical and prescription drug coverage for Medicare-eligible retirees and/or eligible spouses 65 years and older. Beginning in 2006, the AgFirst/FCBT Retiree and Disabled Medical Plan will provide medical and prescription drug coverage to Medicare-eligible retirees and/or eligible spouses 65 years and older through fully-insured AARP endorsed Medicare Supplement policies and subsidized basic Medicare D coverage through a selected Prescription Drug Plan. Dental coverage was not changed. Certain other retirees who are grandfathered under insured arrangements were not impacted by the change. The benefit obligation valuation as of December 31, 2005 reflects the impact of this plan amendment.

In determining the benefit obligation as of December 31, 2005, there was no impact due to government reimbursement of prescription drug benefits. After the plan amendment, the plan no longer provides prescription drug benefits directly for retirees and/or eligible spouses 65 years and older. Instead, the District subsidizes the cost of coverage obtained under the Medicare D program through the selected Prescription Drug Provider.

For further information on postretirement costs, see "Postretirement Benefits" section in the Notes to the AgFirst Farm Credit District Consolidated Financial Statements.

The following is a table of retirement and postretirement benefits expenses:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Pension | $ 398 | $ 463 | $ 389 |
| Thrift/deferred compensation | 126 | 125 | 114 |
| Other postretirement benefits | 176 | 187 | 189 |
| Total | $ 700 | $ 775 | $ 692 |

For the years ended December 31, 2005 and 2004, the Association had contributed $610 and $1,996, respectively, to the Districtwide defined benefit retirement plan, which was sufficient to meet its accumulated benefit obligation. For 2004, the contributions eliminated the minimum pension liability and the pension-related charge to accumulated other comprehensive income (OCI) in members' equity. As a result of the fundings and the reclassification of the OCI, the Association ended 2005 and 2004 with $1,963 and $1,751, respectively, in prepaid retirement expense on the Consolidated Balance Sheets.

**Note 11 — Intra-System Financial Assistance**

The Farm Credit System Financial Assistance Corporation (Financial Assistance Corporation) was established in 1988 primarily to provide capital to institutions of the System experiencing financial difficulty. Such assistance was funded through the Financial Assistance Corporation's issuance of $1.261 billion of 15-year U.S. Treasury-guaranteed debt. The interest rates on these issuances range from 8.80 percent to 9.45 percent. The repayment of this debt and related interest was the responsibility of System banks. In June 2005, the last outstanding Financial Assistance Corporation debt of $325 million matured and was redeemed.

Each System bank may be required to pay premiums into the Insurance Fund based on its annual average loan principal outstanding. The Bank, in turn, may also assess the Association for insurance premiums based on the average principal outstanding of accrual and nonaccrual loans of the Association for each year. At December 31, 2005, the assets in the Insurance Fund aggregated $2.062 billion. However, due to the authorized uses of the Insurance Fund, there is no assurance that Fund assets will be available or sufficient to ensure the payment of principal of, or interest on, insured debt securities in the event of a default by any System bank having primary liability thereon.

**Note 12 — Related Party Transactions**

In the ordinary course of business, the Association enters into loan transactions with officers and directors of the Association, their immediate families and other organizations with which such persons may be associated. Such loans are subject to special approval requirements contained in the FCA regulations and are made on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated borrowers.

Total loans to such persons at December 31, 2005 amounted to $4,318. During 2005, $2,882 of new loans were made and repayments totaled $1,285. In the opinion of management, none of these loans outstanding at December 31, 2005 involved more than a normal risk of collectibility.

**Note 13 — Commitments and Contingencies**

The Association has various commitments outstanding and contingent liabilities.

The Association may participate in financial instruments with off-balance-sheet risk to satisfy the financing needs of its borrowers and to manage their exposure to interest-rate risk. These financial instruments include commitments to extend credit and/or commercial letters of credit. The instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the financial statements. Commitments to extend credit are agreements to lend to a borrower as long as there is not a violation of any condition established in the contract. Commercial letters of credit are agreements to pay a beneficiary under conditions specified in the letter of credit. Commitments and letters of credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. At December 31, 2005, $27,088 of commitments to extend credit and $0 of commercial letters of credit were outstanding.

Since many of these commitments are expected to expire without being drawn upon, the total commitments do not necessarily represent future cash requirements. However, these credit-related financial instruments have off-balance-sheet credit risk because their amounts are not reflected on the Consolidated Balance Sheets until funded or drawn upon. The credit risk associated with issuing commitments and letters of credit is substantially the same as that involved in extending loans to borrowers and management applies the same credit policies to these commitments. Upon fully funding a commitment, the credit risk amounts are equal to the contract amounts, assuming that borrowers fail completely to meet their obligations and the collateral or other security is of no value. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the borrower.

The Association also participates in standby letters of credit to satisfy the financing needs of its borrowers. These letters of credit are irrevocable agreements to guarantee payments of specified financial obligations. Outstanding standby letters of credit have expiration dates ranging from February 28, 2006 to June 23, 2009. The maximum potential amount of future payments the Association is required to make under the guarantees is $241.

**Note 14 — Disclosures About Fair Value of Financial Instruments**

The following table presents the carrying amounts and fair values of the Association's financial instruments at December 31, 2005, 2004 and 2003. The fair value of a financial instrument is generally defined as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Quoted market prices are generally not available for certain System financial instruments, as described below. Accordingly fair values are based on judgments regarding anticipated cash flows, future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates involve uncertainties and matters of judgment, and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

The estimated fair values of the Association's financial instruments are as follows:

| | December 31, 2005 | | December 31, 2004 | |
|---|---|---|---|---|
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| **Financial assets:** | | | | |
| Cash | $ 602 | $ 602 | $ 381 | $ 381 |
| Loans | $ 162,188 | $ 161,073 | $ 171,768 | $ 172,323 |
| Allowance for loan losses | 710 | – | 828 | – |
| Loans, net | $ 161,478 | $ 161,073 | $ 170,940 | $ 172,323 |
| **Financial liabilities**: | | | | |
| Notes payable to AgFirst Farm Credit Bank | $ 149,339 | $ 145,895 | $ 157,765 | $ 155,834 |

| | December 31, 2003 | |
|---|---|---|
| | Carrying Amount | Estimated Fair Value |
| **Financial assets:** | | |
| Cash | $ 706 | $ 706 |
| Loans | $ 153,411 | $ 154,879 |
| Allowance for loan losses | 2,826 | – |
| Loans, net | $ 150,585 | $ 154,879 |
| **Financial liabilities**: | | |
| Notes payable to AgFirst Farm Credit Bank | $ 137,721 | $ 136,232 |

A description of the methods and assumptions used to estimate the fair value of each class of the Association's financial instruments for which it is practicable to estimate that value follows:

A. **Cash:** The carrying value is a reasonable estimate of fair value.

B. **Loans:** Because no active market exists for the Association's loans, fair value is estimated by discounting the expected future cash flows using the Association's current interest rates at which similar loans would be made to borrowers with similar credit risk. As the discount rates are based on the Bank's loan rates, as well as management estimates, management has no basis to determine whether the fair values presented would be indicative of the value negotiated in an actual sale.

   For purposes of determining fair value of accruing loans, the loan portfolio is segregated into pools of loans with homogeneous characteristics based upon repricing and credit risk. Expected future cash flows and interest rates reflecting appropriate credit risk are separately determined for each individual pool.

   Fair value of loans in a nonaccrual status is estimated to be the carrying amount less specific reserves.

   The carrying value of accrued interest approximates its fair value.

C. **Investment in AgFirst Farm Credit Bank:** Estimating the fair value of the Association's investment in the Bank is not practicable because the stock is not traded. As described in Note 5, the net investment is a requirement of borrowing from the Bank and is carried at cost plus allocated equities in the accompanying balance sheet. The Association owns 1.37 percent of the issued stock of the Bank as of December 31, 2005 net of any reciprocal investment. As of that date, the Bank's assets totaled $20.5 billion and shareholders' equity totaled $1,037 million. The Bank's earnings were $164 million during 2005.

D. **Notes Payable to AgFirst Farm Credit Bank:** The notes payable are segregated into pricing pools according to the types and terms of the loans (or other assets) which they fund. Fair value of the notes payable is estimated by discounting the anticipated cash flows of each pricing pool using the current rate that would be charged for additional borrowings. For purposes of this estimate it is assumed the cash flow on the notes is equal to the principal payments on the Association's loan receivables plus accrued interest on the notes payable. This assumption implies that earnings on the Association's interest margin are used to fund operating expenses and capital expenditures.

E. **Commitments to Extend Credit and Standby Letters of Credit:** The estimated market value of off-balance-sheet commitments is minimal since the committed rate approximates current rates offered for commitments with similar rate and maturity characteristics and since the related credit risk is not significant.

**Note 15 — Quarterly Financial Information (Unaudited)**

Quarterly results of operations for the years ended December 31, 2005, 2004 and 2003 follow:

| 2005 | First | Second | Third | Fourth | Total |
|---|---|---|---|---|---|
| Net interest income | $ 962 | $ 982 | $ 1,017 | $ 996 | $ 3,957 |
| Provision for (reversal of allowance for) loan losses | – | – | – | (118) | (118) |
| Noninterest income (expense), net | (682) | (33) | (608) | (173) | (1,496) |
| Net income (loss) | $ 280 | $ 949 | $ 409 | $ 941 | $ 2,579 |

| 2004 | First | Second | Third | Fourth | Total |
|---|---|---|---|---|---|
| Net interest income | $ 854 | $ 857 | $ 884 | $ 922 | $ 3,517 |
| Provision for (reversal of allowance for) loan losses | – | – | – | (2,000) | (2,000) |
| Noninterest income (expense), net | (632) | (517) | (477) | (284) | (1,910) |
| Net income (loss) | $ 222 | $ 340 | $ 407 | $ 2,638 | $ 3,607 |

| 2003 | First | Second | Third | Fourth | Total |
|---|---|---|---|---|---|
| Net interest income | $ 729 | $ 735 | $ 810 | $ 845 | $ 3,119 |
| Provision for (reversal of allowance for) loan losses | – | 50 | – | – | 50 |
| Noninterest income (expense), net | (312) | (188) | (250) | (737) | (1,487) |
| Net income (loss) | $ 417 | $ 497 | $ 560 | $ 108 | $ 1,582 |