

# **SECOND QUARTER 2005**

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Neil L. Jordan  
Chief Executive Officer



Thomas L. Antesberger  
Chairman of the Board

July 29, 2005

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

(dollars in thousands)

The following commentary reviews the financial condition and results of operations of Ag Credit Agricultural Credit Association (Association) for the six months ended June 30, 2005. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements and the 2004 annual report of the Association.

The Association obtains funding from AgFirst Farm Credit Bank (the 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](http://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 quarterly and annual reports are available on the Association's website, [www.agcredit.net](http://www.agcredit.net), or may be obtained upon request free of charge by calling 1-800-837-3678 extension 123, or writing Alice M. Beers, Treasurer at Ag Credit, ACA, 610 W Lytle Street, Fostoria, OH 44830.

## LOAN PORTFOLIO

The Association provides funds to farmers, rural homeowners, and farm-related businesses for financing of short and intermediate-term loans and long-term real estate mortgage loans. The Association's loan portfolio is diversified over a range of agricultural commodities, including general cash grain crops, livestock, and horticultural products. These commodities totaled approximately \$521,047 or 83.6 percent of the loan portfolio as of June 30, 2005. The following table shows the Association's portfolio composition by loan type as of the dates shown:

	6/30/05	12/31/04	\$ Change	% Change
Long-term farm mortgage	\$325,527	\$316,159	\$ 9,368	3.0%
Production and intermediate-term	243,217	239,252	3,965	1.7
Rural home	48,853	45,605	3,248	7.1
Farm related business	9,809	9,466	343	3.6
Processing and marketing	954	1,624	(670)	-41.3
Leases	1,519	1,759	(240)	-13.6
Nonaccruals	267	2,629	(2,362)	-89.8
Participations purchased	2,377	12,495	(10,118)	-81.0
Less: participations sold	(9,201)	(7,575)	(1,626)	21.5
Total	\$623,322	\$621,414	\$ 1,908	0.3%

During the reporting period the Association did experience an increase in long-term farm mortgage (LT), production and intermediate-term (production), farm related business and rural home (RHL) loans. These increases were offset by decreases in processing and marketing, leases, nonaccrual and participation purchased volume. An increase in participations sold, a negative change in the previous table, reduces the Association's loans on the balance sheet. The production volume, which is heavily influenced by operating-

type loans, typically increases during the second and third quarters of the year as borrowers use their loans to pay crop input expenses. Strong 2004 farm earnings improved borrower liquidity allowing borrowers to pay down debt and reduce the amount of current operating credit needed. The increased LT volume is a result of an increase in land available for sale, increasing land values and the concerted effort of the Association's staff to earn the business from those who need to borrow funds for land purchases. RHL volume continues to increase as a result of the Association's increased focus in making loans to this segment of the market to enhance the Association's earnings and thereby increasing the value returned to its stockholders. Leases decreased as a result of scheduled payments and reduced new lease activity resulting from recent tax law provisions concerning depreciation. Nonaccrual loans decreased due to collections made on several large loans in nonaccrual status and several transfers back to accrual status based on corrective action and improved loan performance. Participations purchased volume decreased primarily due to the pay off of several large participation loans. Participations sold increased due to the increased borrowing of a large commercial account whose total borrowings exceeded the Association's hold position. The following table shows selected participation loan information:

	6/30/05	12/31/04
Participations Purchased		
- FCS Institutions	\$ 2,377	\$ 4,946
Participations Purchased		
- Non-FCS Institutions	-	7,549
Participations Sold	(9,201)	(7,575)
Total	\$ (6,824)	\$ 4,920

There is an inherent risk in the extension of any type of credit. There are no significant potential credit risks identified within the loan portfolio that could adversely impact the performance of the portfolio in the near future. Portfolio credit quality remains strong and credit administration is satisfactory. The following table represents risk asset information:

As of:	6/30/05	12/31/04
Loans:		
Accruing restructured	\$ 368	\$ 375
Past due 90 days or more and still accruing interest	-	-
Nonaccrual	267	2,629
Total high risk loans	\$ 635	\$ 3,004
Nonaccrual loans to total loans	-%	0.4%
High-risk loans to total assets	0.1%	0.5%

Farmers in the Association's territory experienced significant delays to the corn crop due to replanting caused by very cool temperatures during April and May. In addition, most of the

Association's territory experienced hot and dry conditions during June causing additional stress to the crops. Plant populations in some areas were hurt by both of these conditions. Current dry weather conditions were creating a positive impact on grain cash and future prices. However, varying predictions on potential rainfall in the Corn Belt has resulted in recent erratic fluctuations in grain cash and futures prices. It is too early to determine the ultimate impact the weather conditions will have on grain yields, subsequent grain prices, and farm income.

Association management maintains an allowance for loan losses sufficient to cover the possible losses in the loan portfolio based on current and expected future conditions. During the first six months of 2005 the Association recognized net recoveries of \$6.

The Association continues to emphasize the use of FSA guarantees to help manage credit risk in the loan portfolio and to help reduce the potential for future loan losses. FSA volume outstanding as of June 30, 2005 was \$136,153 or 21.8 percent of the Association's loan portfolio. The following table presents allowance for loan loss information:

As of:	6-30-05	12-31-04
Allowance for loan losses	\$ 4,439	\$ 4,433
Provision for (reversal of) loan losses	—	(6,618)
Net charge-offs/(recoveries)	(6)	(9)
Allowance for loan losses to loans	0.71%	0.71%
Allowance for loan losses to nonaccrual loans	1662.55%	168.62%
Allowance for loan losses to impaired loans	699.06%	147.57%
Net charge-offs/(recoveries) to average loans	(.001)%	(.002)%

We review the credit quality of the loan portfolio on an on-going basis as part of the Association's risk management practices. The following table presents selected statistics related to the credit quality of loans, including accrued interest, as of the dates shown.

	6-30-05	12-31-04
Acceptable & OAEM	99.17%	98.70%
Substandard	0.83	1.27
Doubtful	—	0.03
Loss	—	—
	100.00%	100.00%

What risk factors are on the immediate horizon? Increasing federal deficits, interest rates, oil prices, input costs and land values along with the potential for reductions in governmental farm support payments have the potential to have an adverse impact on future farm income and debt repayment ability. While the Association does not anticipate these factors to have a near-term adverse impact on farmers, the Association is cognizant of the potential impact and is positioning itself to manage the impact by using loan guarantees and sound lending and risk management practices.

## RESULTS OF OPERATIONS

Net income for the three months ended June 30, 2005 (Q2 2005) was \$3,957 for an increase of \$705 or 21.7 percent when compared to the net income of \$3,252 for the same period in 2004 (Q2 2004). Net income for the six months ended June 30, 2005 was \$7,849 for an increase of \$1,630 or 26.2 percent when compared to the net income of \$6,219 for the same period in 2004.

The major components of the changes in net income for the three and six months ended June 30, 2005 compared to June 30, 2004 are presented below:

### Changes in Net Income:

	For the three months ending June 30 2005 vs 2004	For the six months ending June 30 2005 vs 2004
<b>Increase (decrease) in net income due to:</b>		
Net interest income	\$ 703	\$ 1,429
Provision for loan losses	—	—
Loan fees	32	52
Financially related services	(63)	(24)
Equity earnings of AgFirst Farm Credit Bank	35	62
Other noninterest income	(29)	(9)
Salaries and employee benefits	15	59
Occupancy and equipment	2	4
Insurance Fund premium	76	155
Other operating expenses	(38)	(59)
Provision for income taxes	(28)	(39)
Total change in net income	\$ 705	\$ 1,630

Net interest income was \$4,785 and \$4,082 for the three months ending June 30, 2005 and June 30, 2004, respectively. Net interest income was \$9,374 and \$7,945 for the six months ending June 30, 2005 and June 30, 2004, respectively. The following table quantifies changes in the net interest income for these periods for 2005 compared to 2004:

### Changes in Net Interest Income:

	For the three months ending June 30 2005 - 2004	For the six months ending June 30 2005 - 2004
<b>Created by changes in:</b>		
Volume	\$ 200	\$ 389
Rate	575	974
Loan purchase discount	53	47
Nonaccrual loan income	(125)	19
Total change in net interest income	\$ 703	\$ 1,429

The \$575 and \$974 increases related to rate resulted in part from significant loan re-pricing activities experienced primarily over the course of the last nine months of 2003 and first six months of 2004 and the significant increase in the general short-term interest rate market over the last year. The re-pricing activities and the lower general market interest rates in 2003 and 2004 allowed Association staff to reduce the members' borrowing costs on fixed rate loans while also reducing the Association's borrowing cost on these loans. This re-pricing activity increased earnings spreads on loans. In addition, the Association has been able to add new volume at competitive earnings spreads resulting in increased income to the Association. Increasing market interest rates are also increasing net interest income by generating increased earnings on the Association's own funds in loans.

The current increasing interest rate environment may bring additional competition for loans, as Association borrowers evaluate variable rate loans indexed to the more market oriented and responsive LIBOR index as compared to the (lagging) prime rate index.

The Association did not record a provision for loan losses during the second quarter or the first six months of 2005 or 2004.

Noninterest income is comprised of loan fee income, fees for financially related services (FRS), equity in earnings from the Bank and other noninterest income. The changes in these areas are previously listed in the changes in net income table. Loan fee income increased during Q2 2005 when compared to Q2 2004 due to increased loan servicing fees, origination fees and home loan secondary market origination fees. Loan fees increased for the first six months of 2005 when compared to the same period in 2004 for the same reasons. FRS income decreased in Q2 2005 when compared to Q2 2004 due to lower multi-peril insurance, appraisal and credit life experience refund income. The reduced multi-peril and experience refund income was due to payment timing. FRS income for the first six months of 2005 was lower for the same reasons. The equity in earnings of the Bank is based on the Association's average note payable to the Bank. The YTD average note payable to the Bank was \$515,452 and \$498,139 as of June 30, 2005 and 2004, respectively, resulting in higher earnings for both the three months and six months ending June 30, 2005 when compared to the same periods of 2004. Miscellaneous income was higher in Q2 2004 versus the same period of 2005 due to the recording of prior years' Captive Insurance income in Q2 2004.

Noninterest expense is comprised of salaries and employee benefits, occupancy and equipment expense, Insurance Fund premiums and general operating expenses. When comparing both the three months and six months ending June 30, 2005 to the same periods of 2004, salaries and benefits decreased due primarily to lower group health insurance premiums offset by scheduled annual salary increases and increased retirement expenses. The Farm Credit System Insurance Corporation (FCSIC) premiums were lower for both periods of 2005 when compared to the same periods of 2004. Other operating expenses increased due to increased FSA guarantee fees paid and increased supervisory fees offset by reduced data processing costs.

The provision for income taxes was \$67 and \$117 for Q2 and the first half of 2005, respectively as compared to \$39 and \$78 for the same respective periods of 2004.

**Key Results of Operations Ratios:**

	6/30/05	12/31/04	6/30/04
Return on average assets	2.50%	3.62%	2.09%
Return on average equity	14.70%	23.60%	13.53%
Net interest margin	3.09%	2.74%	2.73%

The changes in these ratios are directly related to the changes in income discussed in the Results of Operations section, changes in assets discussed in the Loan Portfolio section and changes in capital discussed in the Capital Resources section.

**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 (GFA) utilizes the Association's credit and fiscal performance as criteria for establishing a line of credit on which the Association may draw funds. Additional information on the GFA and the funding process is found on pages 10 and 11 of the 2004 Annual Report. The total notes payable to the Bank at

June 30, 2005 was \$529,023 as compared to \$538,674 at December 31, 2004. The \$9,651 or 1.8 percent decrease is primarily attributed to the increased earnings, the pay down of the participation loan volume as described in the Loan Portfolio section and the receipt of the Bank's 2004 patronage refund to the Association totaling \$5,810. These decreases were offset by the increased overall loan volume as described in the Loan Portfolio section and the cash portion of the 2004 patronage of \$2,371 paid in March 2005.

**CAPITAL RESOURCES**

The following table shows the changes in components of the Association's members' equity.

	6/30/05	12/31/04	\$ Change	% Change
Class A Preferred Stock	\$ 7,754	\$ 8,180	\$ (426)	-5.21%
C Stock and				
Participation Certificates	4,313	4,282	31	0.72
Qualified Surplus Allocated	13,648	13,652	(4)	-0.03
Nonqualified Surplus Retained	18,543	18,436	107	0.58
Nonqualified Surplus Allocated	9,750	9,755	(5)	-0.05
Unallocated Retained Earnings	56,408	48,815	7,593	15.55
Total change in net income	\$110,416	\$103,120	\$ 7,296	7.08%

The increase in unallocated retained earnings was generated through net income less dividends on Class A preferred stock (Class A Stock) of \$118 and a \$137 adjustment for the actual 2004 patronage increase over the estimated amount reflected in the 2004 annual report. The reduction in Class A Stock resulted from member requested stock retirements. The Association is limiting the purchase of additional Class A Stock.

At June 30, 2005, the Association's permanent capital ratio, total surplus ratio and core surplus ratio exceeded the regulatory minimum requirements of 7 percent, 7 percent and 3.5 percent, respectively. These ratios are calculated in accordance with Farm Credit Administration (FCA) regulations and are defined below:

- ≠# The permanent capital ratio is average at-risk capital divided by average risk-adjusted assets.
- ≠# The total surplus ratio is average unallocated and allocated surplus less any deductions made in the permanent capital divided by average risk-adjusted assets.
- ≠# The core surplus ratio is average unallocated surplus and eligible allocated surplus less the Association's average investment in the Bank divided by average risk-adjusted assets.

The actual ratios are shown in the chart below:

**Regulatory Capital Ratios:**

	6/30/05	12/31/04	6/30/04
Permanent Capital Ratio	18.73%	16.24%	16.54%
Total Surplus Ratio	16.46%	13.81%	13.70%
Core Surplus Ratio	14.29%	11.62%	12.57%

The increase in the ratios is related to an increase in average guaranteed loan volume, rural home volume and risk-adjusted capital offset by the increase in loan volume as described above.

*Ag Credit Agricultural Credit Association*  
**Consolidated Balance Sheets**

<i>(dollars in thousands)</i>	<b>June 30, 2005</b> <i>(unaudited)</i>	<b>December 31, 2004</b> <i>(audited)</i>
<b>Assets</b>		
Cash	\$ 2,409	\$ 5,772
Loans	623,322	621,414
Less: allowance for loan losses	4,439	4,433
Net loans	618,883	616,981
Accrued interest receivable	12,482	11,435
Investment in other Farm Credit institutions	7,557	7,557
Premises and equipment, net	1,616	1,592
Other assets	3,586	7,527
Total assets	<u>\$ 646,533</u>	<u>\$ 650,864</u>
<b>Liabilities</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 529,023	\$ 538,674
Accrued interest payable	1,847	1,680
Patronage refund payable	89	2,503
Other liabilities	5,158	4,887
Total liabilities	<u>536,117</u>	<u>547,744</u>
Commitments and contingencies		
<b>Members' Equity</b>		
Capital stock and participation certificates	12,067	12,462
Retained earnings		
Allocated	41,941	41,843
Unallocated	56,408	48,815
Total members' equity	<u>110,416</u>	<u>103,120</u>
Total liabilities and members' equity	<u>\$ 646,533</u>	<u>\$ 650,864</u>

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

*Ag Credit Agricultural Credit Association*  
**Consolidated Statements of Income**

*(unaudited)*

<i>(dollars in thousands)</i>	<b>For the three months ended June 30,</b>		<b>For the six months ended June 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
<b>Interest Income</b>				
Loans	\$ 10,248	\$ 8,232	\$ 19,859	\$ 16,177
<b>Interest Expense</b>				
Notes payable to AgFirst Farm Credit Bank	5,463	4,150	10,485	8,232
Net interest income	4,785	4,082	9,374	7,945
Provision for (reversal of) loan losses	—	—	—	—
Net interest income after provision for (reversal of) loan losses	4,785	4,082	9,374	7,945
<b>Noninterest Income</b>				
Loan fees	143	111	254	202
Fees for financially related services	19	82	115	139
Equity in earnings of other Farm Credit institutions	985	950	1,946	1,884
Gains (losses) on other property owned, net	—	(1)	—	(2)
Other noninterest income	4	34	27	38
Total noninterest income	1,151	1,176	2,342	2,261
<b>Noninterest Expense</b>				
Salaries and employee benefits	1,275	1,290	2,574	2,633
Occupancy and equipment	107	109	236	240
Insurance Fund premium	50	126	103	258
Other operating expenses	480	442	837	778
Total noninterest expense	1,912	1,967	3,750	3,909
Income before income taxes	4,024	3,291	7,966	6,297
Provision (benefit) for income taxes	67	39	117	78
Net income	\$ 3,957	\$ 3,252	\$ 7,849	\$ 6,219

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

*Ag Credit Agricultural Credit Association*  
**Consolidated Statements of Changes in  
Members' Equity**

*(unaudited)*

	<b>Capital Stock and Participation Certificates</b>	<b>Retained Earnings</b>		<b>Total Members' Equity</b>
		<b>Allocated</b>	<b>Unallocated</b>	
<i>(dollars in thousands)</i>				
Balance at December 31, 2003	\$ 12,270	\$ 33,503	\$ 41,661	\$ 87,434
Net income			6,219	6,219
Capital stock/participation certificates issued	3,921			3,921
Capital stock/participation certificates retired	(2,744)			(2,744)
Cash dividends declared/paid		6	(145)	(139)
Retained earnings retired		(72)		(72)
Distribution adjustment		280	(225)	55
Balance at June 30, 2004	<u>\$ 13,447</u>	<u>\$ 33,717</u>	<u>\$ 47,510</u>	<u>\$ 94,674</u>
Balance at December 31, 2004	\$ 12,462	\$ 41,843	\$ 48,815	\$ 103,120
Net income			7,849	7,849
Capital stock/participation certificates issued	1,201			1,201
Capital stock/participation certificates retired	(1,596)			(1,596)
Cash dividends declared/paid			(119)	(119)
Retained earnings retired		(38)		(38)
Distribution adjustment		136	(137)	(1)
Balance at June 30, 2005	<u>\$ 12,067</u>	<u>\$ 41,941</u>	<u>\$ 56,408</u>	<u>\$ 110,416</u>

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

*Ag Credit Agricultural Credit Association*

# Notes to the Consolidated Financial Statements

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

**NOTE 1 – ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES**

A description of the organization and operations of Ag Credit Agricultural Credit Association (the Association), the significant accounting policies followed, and the financial condition and results of operations as of and for the year ended December 31, 2004, are contained in the 2004 Annual Report to Shareholders. These unaudited second quarter 2005 consolidated financial statements should be read in conjunction with the 2004 Annual Report to Shareholders.

The accompanying consolidated financial statements contain all adjustments necessary for a fair presentation of the interim financial condition and results of operations and conform with generally accepted accounting principles. The results for the six months ended June 30, 2005, are not necessarily indicative of the results to be expected for the year ending December 31, 2005.

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

The Association maintains an allowance for loan losses in accordance with generally accepted accounting principles. The loan portfolio is reviewed quarterly to determine the adequacy of the allowance for losses. As of June 30, 2005, the allowance for losses is adequate in management's opinion to provide for possible losses on existing loans.

**NOTE 2 – ALLOWANCE FOR LOAN LOSSES**

An analysis of the allowance for loan losses follows:

Balance at 12-31-03	\$ 11,042
(Reversal of) provision for loan losses	—
Loans (charged off), net of recoveries	<u>(2)</u>
Balance at 6-30-04	<u>\$ 11,040</u>
Balance at 12-31-04	\$ 4,433
(Reversal of) provision for loan losses	—
Recoveries, net of loans charged off	<u>6</u>
Balance at 6-30-05	<u>\$ 4,439</u>

As discussed in the 2004 Annual Report, the Association recorded a loan loss reversal of \$6,618 in the fourth quarter of 2004 that resulted in a decrease in the allowance for loan losses.

**NOTE 3 – EMPLOYEE BENEFIT PLANS**

The Association participates in a defined benefit retirement plan with three other District associations. Pension costs were determined by an actuary on a separate entity basis.

The following is a table of retirement and postretirement benefit expense for the six months ended June 30, 2005:

	<b>For the six months ended June 30,</b>	
	<b>2005</b>	<b>2004</b>
Service cost	\$ 178	\$ 184
Interest cost	238	195
Expected return on plan assets	(278)	(233)
Amortization of prior service cost	39	39
Recognized net actuarial (gain) loss	<u>78</u>	<u>35</u>
Net periodic benefit (income) cost	<u>\$ 255</u>	<u>\$ 220</u>

As of June 30, 2005, no contributions have been made to the pension plan for 2005. Actuarial projections as of the last plan measurement date (September 30, 2004) did not anticipate any contributions for 2005; however, market conditions could impact discount rates and return on plan assets which could change this expectation, making contributions necessary before the next plan measurement date.

The Association also participates in Districtwide thrift and other postretirement benefit plans. The other postretirement benefit plan provides certain benefits (primarily health care) to its retirees.

The following is a table of retirement and postretirement benefit expense for the six months ended June 30, 2005:

	<b>For the six months ended June 30,</b>	
	<b>2005</b>	<b>2004</b>
Pension	\$ 255	\$ 220
Thrift/deferred compensation	95	91
Other postretirement benefits	<u>219</u>	<u>232</u>
Total	<u>\$ 569</u>	<u>\$ 543</u>