

# **SECOND QUARTER 2007**

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Neil L. Jordan  
Chief Executive Officer



Charles L. Bostdorff  
Chairman of the Board

July 24, 2007

# 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, 2007. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements and the 2006 annual report of the Association. The accompanying consolidated financial statements were prepared under the oversight of the Audit Committee of the Board of Directors.

The Association obtains funding from AgFirst Farm Credit Bank (the Bank). Shareholder investment and the Association could be 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 316, or writing Wanda Martin, 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 1022, or writing Greg Siebenaller, Assistant Treasurer at Ag Credit, ACA, 610 W Lytle Street, Fostoria, OH 44830. 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 Association's fiscal yearend.

## 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 \$610,398 or 82.57 percent of the loan portfolio as of June 30, 2007. Farm size varies and many of the Association's borrowers have diversified operations. These factors, along with non-farm income and the use of loan guarantees somewhat reduces the level of commodity concentration risk in the Association's loan portfolio.

Gross loan volume of the Association as of June 30, 2007 was \$739,266, an increase of \$31,432 as compared to \$707,834 at December 31, 2006. The 4.44 percent increase in loan volume is related to an increase in real estate mortgage

volume, processing and marketing volume and production and intermediate-term volume, which were offset by reductions in farm-related business, rural residential and lease volume. The increase in production and intermediate term volume is typical for the first six months of the year. Operating loans typically increase during the second quarter of the year as borrowers use their loans to pay crop input expenses. Net loans outstanding at June 30, 2007 were \$735,906 as compared to \$704,402 at December 31, 2006. Net loans accounted for 95.6 percent of total assets at June 30, 2007 as compared to 94.2 percent at December 31, 2006.

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. Nonaccrual loans decreased by \$215 from \$651 at December 31, 2006 to \$436 at June 30, 2007.

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 2007 the Association recorded a reversal of allowance for loan losses of \$94 and recognized net recoveries of \$22. For the same period of 2006, the Association recognized net recoveries of \$23 and did not record a provision for loan losses. The allowance for loan losses was \$3,360 at June 30, 2007 compared to \$3,432 at December 31, 2006.

The Association continues to emphasize the use of loan guarantees to help manage capital and credit risk in the loan portfolio and to help reduce the potential for future loan losses. The guaranteed portion of loan volume outstanding as of June 30, 2007 was \$200,312 or 27.1 percent of loans.

What risk factors are on the immediate horizon? One, more immediate, risk factor is beginning to develop for the 2007 grain production year. Much of our service territory is experiencing mild drought conditions during a critical period of the growing season. Full effects of this mild drought will not be known until the fall harvest. However, it is anticipated that the yields may be much lower than the high-end yields predicted earlier in the growing season. The Association has the tools and experience to deal with the affects of the drought through its many credit servicing options. Other primary risk factors impacting future farm income and debt repayment ability continue to be increasing federal deficits,

interest rates, high energy prices, higher input costs and land values along with the potential for reductions in governmental farm support payments. The Association does not anticipate these factors to have a near-term adverse impact on farmers. However, the Association is aware of the potential impact and is positioning itself to manage the impact by using sound lending and risk management practices including the use of loan guarantees and crop insurance.

## RESULTS OF OPERATIONS

### *For the three months ending June 30, 2007*

Net income for the three months ended June 30, 2007 (Q2 2007) was \$5,221 for an increase of \$932 or 21.73 percent when compared to the net income of \$4,289 for the same period in 2006 (Q2 2006). The increase in net income was primarily due to an increase in net interest income, reversal of allowance for loan loss income, an increase in noninterest income and a reduction in noninterest expense.

Net interest income for Q2 2007 increased by \$447 or 8.51 percent when compared to Q2 2006. The increase was mainly due to increased loan volume and increased earnings on the Association's own funds in loans.

The Association recorded income from the reversal of allowance for loan losses of \$266 during Q2 2007 but did not record a provision for loan losses during Q2 2006.

Noninterest income is comprised of loan fee income, fees for financially related services (FRS), equity in earnings from the Bank and other non-interest income. The increase in noninterest income of \$189 is primarily attributed to a \$188 increase in FRS income and a \$127 increase in equity in earnings from the Bank offset by a \$129 decrease in loan fee income. Loan fee income recognition decreased primarily as a result of the implementation of Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (FAS 91), lower participation loan origination fees and lower home loan secondary mortgage market origination fees. Rather than recording loan origination fees as loan fee income, FAS 91 amortizes loan origination fees into loan interest income over the life of the respective loans. The Association implemented FAS 91 accounting effective January 1, 2007. Prior to this time, the Association determined that FAS 91 accounting was immaterial to the Association's results of operations. FRS income increased due to higher crop insurance income. The equity in earnings from the Bank increased as a result of increased borrowing from the Bank to fund the increased loan activity.

Noninterest expense is comprised of salaries and employee benefits, occupancy and equipment expense, Insurance Fund premiums and general operating expenses. Salaries and benefits for Q2 2007 decreased by \$103 when compared to Q2 2006 due primarily to the decreased retirement expense

and decreases resulting from the implementation of FAS 91 as previously discussed. FAS 91 accounting establishes deferred costs for each qualifying new loan. These deferred costs reduce salary and benefit expenses when they are set up at the inception of the loan. The deferred costs amortize each month over the life of the loan and reduce interest income and the loan's effective yield. The Association did have scheduled increases in salaries, salary related benefits and group health insurance expense during Q2 2007. Occupancy and equipment expenses increased by \$33 primarily due to increased maintenance and repairs expense, depreciation and cost of space expenses. The Insurance Fund expenses increased due to increased loan volume, which were partially offset by increased guaranteed loan volume. The Association does not pay any insurance premium on guaranteed loan volume. Other operating expenses increased due to increased FSA guarantee fees paid, data processing, printing/supplies, and travel expenses offset by reduced directors, purchased services, public relations, training and FCA supervisory expenses incurred during Q2 2007.

The provision for income taxes was \$39 and \$46 for Q2 2007 and Q2 2006, respectively.

### *For the six months ending June 30, 2007*

The following discussion compares the results of operations for the first six months of 2007 (YTD 2007) to the same period in 2006 (YTD 2006).

Net income for YTD 2007 was \$9,797 for an increase of \$1,381 or 16.41 percent when compared to the net income of \$8,416 for YTD 2006. The increase in net income was primarily due to an increase in net interest income, reversal of allowance for loan loss income, an increase in noninterest income and a slight reduction in noninterest expense.

Net interest income increased by \$913 or 8.8 percent for YTD 2007 as compared to YTD 2006. The increase was mainly due to increased loan volume and increased earnings on the Association's own funds in loans.

The Association recorded income from the reversal of allowance for loan losses of \$94 for YTD 2007 but did not record a provision for loan losses during the YTD 2006.

Noninterest income is comprised of loan fee income, fees for financially related services (FRS), equity in earnings from the Bank and other non-interest income. The increase in YTD 2007 noninterest income when compared to YTD 2006 was \$205. This increase is primarily attributed to a \$142 increase in FRS income and a \$250 increase in equity in earnings from the Bank offset by a \$195 decrease in loan fee income. Loan fee income recognition decreased primarily as a result of the FAS91 implementation as previously discussed. FRS income and equity in earnings from the Bank both increased for the reasons previously discussed.

Noninterest expense is comprised of salaries and employee benefits, occupancy and equipment expense, Insurance Fund premiums and general operating expenses. When comparing YTD 2007 to YTD 2006, salaries and benefits decreased by \$222, occupancy and equipment increased by \$70 and the Insurance fund premiums increased by \$21. These changes were primarily for the same reasons as previously discussed. Other operating expenses for YTD 2007 when compared to YTD 2006 decreased by \$18 primarily as a result of increased directors, travel, communications and other miscellaneous expenses offset by reduced advertising, public relations, training and FCA Supervisory expenses.

The provision for income taxes was \$78 and \$98 for YTD 2007 and YTD 2006, respectively.

The following table shows the key results of operations ratios for the six months ended June 30, 2007 and June 30, 2006, respectively.

**Key Results of Operations Ratios:**

	<b>6/30/07</b>	<b>6/30/06</b>
Return on average assets	2.64%	2.51%
Return on average equity	15.85%	14.68%
Net interest margin	3.16%	3.22%

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 13 and 14 of the 2006 Annual Report. The total notes payable to the Bank at June 30, 2007 was \$632,650 as compared to \$614,175 at December 31, 2006. The \$18,475 or 3.01 percent increase is primarily attributed to increased loan volume and the cash portion of the 2006 patronage refund of \$5,941 offset by earnings, the pay down of loan interest, the reduction of cash and the receipt of the Bank’s 2006 patronage refund to the Association totaling \$5,188.

**CAPITAL RESOURCES**

Total members’ equity increased by \$8,556 to \$127,859 at June 30, 2007 as compared to the December 31, 2006 total of \$119,303. The increase is primarily related to current year earnings offset by equity adjustments made for the actual patronage refund amounts compared to the estimated amounts used in the December 31, 2006 equity balances.

At June 30, 2007, 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. As of June 30, 2007 our ratio was 19.41 percent.
- The total surplus ratio is average unallocated and allocated surplus less any deductions made in the permanent capital divided by average risk-adjusted assets. As of June 30, 2007 our ratios was 17.85 percent.
- 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. As of June 30, 2007 our ratio was 15.66 percent.

**ACCOUNTING FOR DEFINED BENEFIT PENSION AND OTHER POSTRETIREMENT PLANS**

On September 29, 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 158 – Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans. The Standard requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and recognize changes in that funded status in the year in which the changes occur through comprehensive income. The Standard is effective for employers with publicly traded securities for the fiscal year ending after December 15, 2006 and for employers without publicly traded securities for the fiscal year ending after June 15, 2007. The Association will be required to implement the Standard for the year ended December 31, 2007. In addition, this Standard requires that the funded status of a plan be measured as of the date of the year-end financial statements. Currently, the Association uses a measurement date of September 30<sup>th</sup>. The requirement to measure the funded status as of the fiscal year-end is effective for fiscal years ending after December 15, 2008. The Association is currently evaluating the impact of implementing this Standard. It is anticipated the impact from the implementation of the Standard will have no impact on the consolidated income statement and, based on the current funded status of the defined benefit plans, it is not expected to have a material or significant impact on the consolidated balance sheet.

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

<i>(dollars in thousands)</i>	<b>June 30, 2007</b> <i>(unaudited)</i>	<b>December 31, 2006</b> <i>(audited)</i>
<b>Assets</b>		
Cash	\$ 1,930	\$ 7,741
Loans	739,266	707,834
Less: allowance for loan losses	3,360	3,432
Net loans	735,906	704,402
Accrued interest receivable	17,506	18,295
Investment in other Farm Credit institutions	9,638	9,638
Premises and equipment, net	1,675	1,615
Prepaid retirement expense	278	521
Due from AgFirst Farm Credit Bank	2,312	5,188
Other assets	528	375
Total assets	\$ 769,773	\$ 747,775
<b>Liabilities</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 632,650	\$ 614,175
Accrued interest payable	2,870	2,756
Patronage refund payable	56	4,965
Other liabilities	6,338	6,576
Total liabilities	641,914	628,472
Commitments and contingencies		
<b>Members' Equity</b>		
Capital stock and participation certificates	9,261	9,241
Retained earnings		
Allocated	57,402	58,986
Unallocated	61,196	51,076
Total members' equity	127,859	119,303
Total liabilities and members' equity	\$ 769,773	\$ 747,775

*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>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
<b>Interest Income</b>				
Loans	\$ 14,284	\$ 12,447	\$ 28,075	\$ 24,127
<b>Interest Expense</b>				
Notes payable to AgFirst Farm Credit Bank	8,578	7,190	16,775	13,743
Other	5	3	10	7
Total interest expense	8,583	7,193	16,785	13,750
Net interest income	5,701	5,254	11,290	10,377
Reversal of allowance for loan losses	(266)	—	(94)	—
Net interest income after reversal of allowance for loan losses	5,967	5,254	11,384	10,377
<b>Noninterest Income</b>				
Loan fees	82	211	165	360
Fees for financially related services	225	37	266	124
Equity in earnings of other Farm Credit institutions	1,174	1,047	2,312	2,062
Gains on other property owned, net	18	15	18	13
Other noninterest income	—	—	35	32
Total noninterest income	1,499	1,310	2,796	2,591
<b>Noninterest Expense</b>				
Salaries and employee benefits	1,290	1,393	2,590	2,812
Occupancy and equipment	133	100	286	216
Insurance Fund premium	199	189	394	373
Other operating expenses	584	547	1,035	1,053
Total noninterest expense	2,206	2,229	4,305	4,454
Income before income taxes	5,260	4,335	9,875	8,514
Provision for income taxes	39	46	78	98
Net income	\$ 5,221	\$ 4,289	\$ 9,797	\$ 8,416

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

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

*(unaudited)*

*(dollars in thousands)*

	<b>Capital Stock and Participation Certificates</b>	<b>Retained Earnings</b>		<b>Total Members' Equity</b>
		<b>Allocated</b>	<b>Unallocated</b>	
Balance at December 31, 2005	\$ 10,420	\$ 49,673	\$ 51,039	\$ 111,132
Net income			8,416	8,416
Capital stock/participation certificates issued	357			357
Capital stock/participation certificates retired	(1,166)			(1,166)
Stock dividends declared/paid	(3)		(97)	(100)
Retained earnings retired		(15)		(15)
Distribution adjustment		391	(893)	(502)
Balance at June 30, 2006	<u>\$ 9,608</u>	<u>\$ 50,049</u>	<u>\$ 58,465</u>	<u>\$ 118,122</u>
Balance at December 31, 2006	\$ 9,241	\$ 58,986	\$ 51,076	\$ 119,303
Net income			9,797	9,797
Capital stock/participation certificates issued	487			487
Capital stock/participation certificates retired	(467)			(467)
Stock dividends declared/paid			(92)	(92)
Retained earnings retired		(20)		(20)
Distribution adjustment		(1,564)	415	(1,149)
Balance at June 30, 2007	<u>\$ 9,261</u>	<u>\$ 57,402</u>	<u>\$ 61,196</u>	<u>\$ 127,859</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, 2006, are contained in the 2006 Annual Report to Shareholders. These unaudited second quarter 2007 consolidated financial statements should be read in conjunction with the 2006 Annual Report to Shareholders.

On September 29, 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 158 – Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans. The Standard requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and recognize changes in that funded status in the year in which the changes occur through comprehensive income. The Standard is effective for employers with publicly traded securities for the fiscal year ending after December 15, 2006 and for employers without publicly traded securities for the fiscal year ending after June 15, 2007. The Association will be required to implement the Standard for the year ended December 31, 2007. In addition, this Standard requires that the funded status of a plan be measured as of the date of the year-end financial statements. Currently, the Association uses a measurement date of September 30th. The requirement to measure the funded status as of the fiscal year-end is effective for fiscal years ending after December 15, 2008. The Association is currently evaluating the impact of implementing this Standard. It is anticipated that the impact from the implementation of this Standard will have no impact on the consolidated income statement and, based on the current funded status of the defined benefit plans, it is not expected to have a material or significant impact on the consolidated balance sheet.

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, 2007, are not necessarily indicative of the results to be expected for the year ending December 31, 2007.

Certain amounts in prior period consolidated financial statements may 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, 2007, 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:

	<b>For the six months ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
Balance at beginning of period	\$ 3,432	\$ 3,039
Provision for (reversal of) loan losses	(94)	–
Recoveries, net of loans charged off	22	23
Balance at end of period	<u>\$ 3,360</u>	<u>\$ 3,062</u>

**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 the components of net periodic benefit (income) cost for the defined benefit retirement plan:

	<b>For the six months ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
Service cost	\$ 194	\$ 217
Interest cost	283	250
Expected return on plan assets	(329)	(307)
Amortization of prior service cost	63	57
Recognized net actuarial (gain) loss	33	83
Net periodic benefit (income) cost	<u>\$ 244</u>	<u>\$ 300</u>

As of June 30, 2007, no contributions have been made to the pension plan for 2007. Actuarial projections as of the last plan measurement date (September 30, 2006) did not anticipate any contributions for 2007; 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:

	<b>For the six months ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
Pension	\$ 244	\$ 300
Thrift/deferred compensation	102	99
Other postretirement benefits	152	145
Total	<u>\$ 498</u>	<u>\$ 544</u>