

# **SECOND QUARTER 2008**

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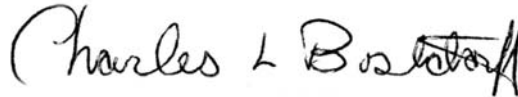
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Neil L. Jordan  
Chief Executive Officer



Daniel E. Ebert  
Chief Financial Officer



Charles L. Bostdorff  
Chairman of the Board

July 28, 2008

# 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, 2008. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements and the 2007 Annual Report of the Association. The accompanying consolidated financial statements (financial statements) were prepared under the oversight of the Audit Committee of the Board of Directors, which includes Paul N. Aley, S. Jerry Layman and Keith L. Roberts. The results for the first six months of 2008 are not necessarily indicative of results to be expected for the year.

The Association obtains funding from AgFirst Farm Credit Bank (the Bank). The Association is materially affected and shareholder investment could be affected by the financial condition and results of operations of the Bank. Copies of the Bank's Annual and Quarterly 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 Stephen Gilbert, 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 1023, or writing Dan Ebert, Chief Financial Officer, at Ag Credit, ACA, 610 W Lytle Street, Fostoria, OH 44830. The Association prepares an electronic version of the Quarterly Report within 40 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 Association.

## **LOAN PORTFOLIO**

The Association provides funds to farmers, rural homeowners, and farm-related businesses for financing of short and intermediate-term loans and long-term real estate mortgage loans. The Association's loan portfolio is diversified over a range of agricultural commodities, including general cash grain crops, livestock and horticultural products. These commodities totaled approximately \$647,700 or 77.9 percent of the loan portfolio as of June 30, 2008. The Association recognizes the commodity concentration risk exceeds normally accepted industry standards. This is partially offset by significant non-farm income sources for many borrowers, especially less than full-time farmers. A more significant offset to the commodity concentration risk is the significant use of governmental loan guarantees. The loan guarantees are obtained through the Farm Service Agency (FSA) and the U. S. Department of Agriculture (USDA). As of June 30, 2008 the Association has \$229,813 of guaranteed loan volume,

which is 27.7 percent of loans. This greatly reduces the potential of loss in the Association's loan portfolio and has proven to be effective in offsetting the concentration risk.

Gross loan volume of the Association as of June 30, 2008 was \$831,029, an increase of \$52,049 as compared to \$778,980 at December 31, 2007. The 6.7 percent increase in loan volume is related to an increase in real estate mortgage, production and intermediate-term, processing and marketing and farm-related business loans and rural home loans. The increase in production and intermediate term loans is typical for the first six months of the year. Production and intermediate term volume typically increases during the second quarter of the year as borrowers use their loans to pay crop input expenses. This increase is slightly less than for the same period in 2007 due to the additional liquidity experienced by members as a result of favorable cash grain prices and 2007 crop yields. Net loans outstanding at June 30, 2008 were \$827,207 as compared to \$775,480 at December 31, 2007. Net loans accounted for 95.8 percent of total assets at June 30, 2008 as compared to 95.0 percent at December 31, 2007.

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 \$178 from \$957 at December 31, 2007 to \$779 at June 30, 2008. The decrease resulted from payments made on loans in nonaccrual status.

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 2008 the Association recorded an increase in the allowance for loan losses of \$309 and recognized net recoveries of \$13. For the same period of 2007, the Association recorded a reversal of allowance for loan losses of \$94 and recognized net recoveries of \$22. The allowance for loan losses was \$3,822 at June 30, 2008 compared to \$3,500 at December 31, 2007.

## **RESULTS OF OPERATIONS**

### ***For the three months ending June 30, 2008***

Net income for the three months ended June 30, 2008 (Q2 2008) was \$4,762, which is a decrease of \$459 or 8.8 percent when compared to the net income of \$5,221 for the same period in 2007 (Q2 2007). The decrease in net income was primarily due to a decrease in earnings on the Association's own funds in loans, an increase in the provision for loan losses and an increase in operating expenses.

Net interest income for Q2 2008 decreased by \$71 or 1.25 percent when compared to Q2 2007. The decrease was

mainly due to a decrease in the earnings on the Association's own funds in loans as a result of the significant drop in the Prime interest rate over the past twelve months. This decrease was offset in part by increased net interest income generated on the increased loan volume previously discussed.

The Association recorded a provision for loan losses (a reduction of income) of \$18 for Q2 2008 as compared to a reversal of allowance for loan losses (an increase in income) of \$266 for Q2 2007. This results in \$284 less income for Q2 2008 when compared to Q2 2007.

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 increase in noninterest income of \$86 or 5.7 percent is primarily attributed to a \$142 increase in loan fees and a \$155 increase in equity in earnings from the Bank offset by a \$193 decrease in FRS income. The increase in loan fee income primarily resulted from loan servicing fees generated by increased loan re-pricing activities. The equity in earnings from the Bank increased as a result of increased borrowing from the Bank to fund the increased loan activity previously discussed. FRS income is less due to a reduction in crop insurance income, which is primarily related to the delayed planting and reporting of crop insurance acreage.

Noninterest expense for Q2 2008 was \$2,387 as compared to \$2,206 for Q2 2007. The \$181 or 8.2 percent increase is primarily a result of increased expenses for guaranteed loan fees, new employees, scheduled salary increases, insurance premiums, bank service charges, purchased services, travel, communications, data processing services, printing and supplies and employee training.

The provision for income taxes was \$48 and \$39 for Q2 2008 and Q2 2007, respectively.

**For the six months ending June 30, 2008**

Net income for the six months ended June 30, 2008 was \$9,404 for a decrease of \$393 or 4.0 percent when compared to the net income of \$9,797 for the same period in 2007. The decrease in net income was primarily due to an increase in the provision for loan losses and an increase in operating expenses offset by an increase in noninterest income.

Net interest income for the first six months of 2008 increased by \$190 or 1.7 percent when compared to the same period of 2007. The increase is a result of an increase in net interest income from the increase in loan volume previously discussed, offset by a decrease in earnings from the Association's own funds in loans as previously discussed.

Noninterest income for the first half of 2008 was \$3,132 and \$2,796 for the same period of 2007. The \$336 or 12.0 percent increase was due to the same reasons as previously discussed.

Noninterest expense for the first half of 2008 was \$4,814 as compared to \$4,305 for the first half of 2007. The \$509 or 11.8 percent increase is primarily a result of increased expenses for guaranteed loan fees, new employees, scheduled salary increases, insurance premiums, bank service charges, purchased services, travel, communications, data processing services, printing and supplies, public and member relations

and employee training.

The provision for income taxes was \$85 and \$78 for the first half of 2008 and 2007, respectively.

The following table shows the key results of operations ratios for the six months ended June 30, 2008 and June 30, 2007, respectively.

	6/30/08	6/30/07
Return on average assets	2.31%	2.64%
Return on average equity	14.21%	15.85%
Net interest margin	2.92%	3.16%

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 (GFA). The 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, liquidity and funding process and funding management is found on pages 13 and 14 of the 2007 Annual Report. The total notes payable to the Bank at June 30, 2008 was \$714,823 as compared to \$672,645 at December 31, 2007. The \$42,178 or 6.3 percent increase is primarily attributed to borrowing from the Association's loan with the Bank to fund the increase in loan volume and the cash portion of the 2007 patronage refund offset by 2008 year-to-date earnings, reduced accrued interest receivable and the receipt of the Bank's 2007 patronage refund to the Association.

**CAPITAL RESOURCES**

Total members' equity increased by \$10,796 or 8.5 percent to \$138,022 at June 30, 2008 as compared to the December 31, 2007 total of \$127,226. The increase is primarily related to current year earnings and an increase in capital stock and participation certificates.

At June 30, 2008, 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, 2008 our ratio was 18.54 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, 2008 our ratio was 16.97 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, 2008 our ratio was 15.27 percent.

*AgCredit Agricultural Credit Association*  
**Consolidated Balance Sheets**

<i>(dollars in thousands)</i>	<b>June 30, 2008</b> <i>(unaudited)</i>	<b>December 31, 2007</b> <i>(audited)</i>
<b>Assets</b>		
Cash	\$ 3,872	\$ 4,445
Loans	831,029	778,980
Less: allowance for loan losses	3,822	3,500
Net loans	827,207	775,480
Accrued interest receivable	16,552	18,248
Investment in other Farm Credit institutions	10,678	10,678
Premises and equipment, net	1,782	1,688
Due from AgFirst Farm Credit Bank	2,580	5,702
Other assets	581	349
Total assets	<u>\$ 863,252</u>	<u>\$ 816,590</u>
<b>Liabilities</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 714,823	\$ 672,645
Accrued interest payable	2,741	3,008
Patronage refund payable	126	7,172
Advanced conditional payments	1,333	342
Other liabilities	6,207	6,197
Total liabilities	<u>725,230</u>	<u>689,364</u>
Commitments and contingencies		
<b>Members' Equity</b>		
Capital stock and participation certificates	10,664	9,171
Retained earnings		
Allocated	65,403	65,418
Unallocated	61,955	52,637
Total members' equity	<u>138,022</u>	<u>127,226</u>
Total liabilities and members' equity	<u>\$ 863,252</u>	<u>\$ 816,590</u>

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

*AgCredit 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>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
<b>Interest Income</b>				
Loans	\$ 13,715	\$ 14,284	\$ 27,801	\$ 28,075
<b>Interest Expense</b>				
Notes payable to AgFirst Farm Credit Bank	8,082	8,578	16,313	16,775
Other	3	5	8	10
Total interest expense	8,085	8,583	16,321	16,785
Net interest income	5,630	5,701	11,480	11,290
Provision for (reversal of allowance for) loan losses	18	(266)	309	(94)
Net interest income after provision for (reversal of allowance for) loan losses	5,612	5,967	11,171	11,384
<b>Noninterest Income</b>				
Loan fees	224	82	422	165
Fees for financially related services	32	225	89	266
Equity in earnings of other Farm Credit institutions	1,329	1,174	2,580	2,312
Gains (losses) on other property owned, net	—	18	—	18
Other noninterest income	—	—	41	35
Total noninterest income	1,585	1,499	3,132	2,796
<b>Noninterest Expense</b>				
Salaries and employee benefits	1,388	1,290	2,762	2,590
Occupancy and equipment	147	133	301	286
Insurance Fund premium	222	199	436	394
Other operating expenses	630	584	1,315	1,035
Total noninterest expense	2,387	2,206	4,814	4,305
Income before income taxes	4,810	5,260	9,489	9,875
Provision for income taxes	48	39	85	78
Net income	\$ 4,762	\$ 5,221	\$ 9,404	\$ 9,797

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

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

*(unaudited)*

*(dollars in thousands)*

	Capital Stock and Participation Certificates	Retained Earnings		Total Members' Equity
		Allocated	Unallocated	
Balance at December 31, 2006	\$ 9,241	\$ 58,986	\$ 51,076	\$ 119,303
Net income			9,797	9,797
Capital stock/participation certificates issued/(retired), net	20			20
Dividends declared/paid			(92)	(92)
Retained earnings retired		(20)		(20)
Patronage distribution adjustment		(1,564)	415	(1,149)
Balance at June 30, 2007	\$ 9,261	\$ 57,402	\$ 61,196	\$ 127,859
Balance at December 31, 2007	\$ 9,171	\$ 65,418	\$ 52,637	\$ 127,226
Net income			9,404	9,404
Capital stock/participation certificates issued/(retired), net	1,495			1,495
Dividends declared/paid	(2)		(82)	(84)
Retained earnings retired		(18)		(18)
Patronage distribution adjustment		3	(4)	(1)
Balance at June 30, 2008	\$ 10,664	\$ 65,403	\$ 61,955	\$ 138,022

*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

The accompanying financial statements include the accounts of Ag Credit Agricultural Credit Association (the Association). A description of the organization and operations of the Association, the significant accounting policies followed, and the financial condition and results of operations as of and for the year ended December 31, 2007, are contained in the 2007 Annual Report to Shareholders. These unaudited second quarter 2008 consolidated financial statements should be read in conjunction with the 2007 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 (GAAP) and prevailing practices within the banking industry. The results for the six months ended June 30, 2008 are not necessarily indicative of the results to be expected for the year ending December 31, 2008.

Certain amounts in the prior period's consolidated financial statements may have been reclassified to conform to the current period's 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 GAAP. The loan portfolio is reviewed quarterly to determine the adequacy of the allowance for losses. As of June 30, 2008 the allowance for losses is adequate in management's opinion to provide for possible losses on existing loans.

In December 2007, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards No. 141R, "Business Combinations" (SFAS No. 141R). SFAS No. 141R requires business combinations to be accounted for under the acquisition method of accounting (previously called the purchase method). The acquisition method requires (a) identifying the acquirer, (b) determining the acquisition date, (c) recognizing and measuring the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree, at their acquisition date fair values, and (d) recognizing and measuring goodwill or a gain from a bargain purchase.

SFAS No. 141R should be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Early application is prohibited. The Association is still evaluating the provisions of SFAS No. 141R, but believes that its adoption will significantly impact its accounting for combinations/acquisitions that may occur in 2009 and beyond.

## NOTE 2 – ALLOWANCE FOR LOAN LOSSES

An analysis of the allowance for loan losses follows:

	For the six months ended June 30,	
	2008	2007
Balance at beginning of period	\$ 3,500	\$ 3,432
Provision for (reversal of) loan losses	309	(94)
Recoveries, net of loans (charged off)	13	22
Balance at end of period	<u>\$ 3,822</u>	<u>\$ 3,360</u>

## NOTE 3 – EMPLOYEE BENEFIT PLANS

The following is a table of retirement and other postretirement benefit expenses for the Association:

	For the six months ended June 30,	
	2008	2007
Pension	\$ 191	\$ 244
401(k)	114	102
Other postretirement benefits	141	152
Total	<u>\$ 446</u>	<u>\$ 498</u>

As of June 30, 2008 no contributions have been made to the pension plan for 2008. The Association does not project making additional contributions for the remainder of 2008.

Market conditions could impact discount rates and return on plan assets which could change the above contribution projections by making additional contributions necessary before the next plan measurement date.