

# **THIRD QUARTER 2004**

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Neil L. Jordan  
Chief Executive Officer



Thomas L. Antesberger  
Chairman of the Board

October 29, 2004

# 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 nine months ended September 30, 2004. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements and the 2003 annual report of the Association.

## LOAN PORTFOLIO

The Association provides funds to farmers, rural homeowners, and farm-related businesses for financing of short and intermediate-term loans and long-term real estate mortgage loans. The Association's loan portfolio is diversified over a range of agricultural commodities, including corn, soybeans, field crops, livestock, and horticultural products. These commodities totaled approximately \$519,789 or 84.6 percent of the loan portfolio as of September 30, 2004.

	9/30/04	12/31/03	\$ Change	% Change
Long-term farm mortgage	\$ 310,421	\$ 299,632	\$ 10,789	3.6%
Production and intermediate-term	240,133	229,145	10,988	4.8
Rural home	44,601	40,679	3,922	9.6
Farm related business	9,749	8,067	1,682	20.9
Processing and marketing	1,669	1,757	(88)	(5.0)
Leases	1,816	2,477	(661)	(26.7)
Nonaccrual loans	2,903	4,409	(1,506)	(34.2)
Participations purchased	9,662	15,929	(6,267)	(39.3)
Less: participations sold	(6,200)	(4,572)	(1,628)	35.6
Total	\$ 614,754	\$ 597,523	\$ 17,231	2.9%

During the reporting period the Association did experience an increased demand for long-term farm mortgage loans, production and intermediate-term loans, farm related business loans and rural home loans. The production volume, which is heavily influenced by operating-type loans, typically increases during the second and third quarters of each year as borrowers draw on lines of credit to pay crop input expenses and other operating expenses. The increase for this period of 2004 was not as large as in previous years primarily due to improved farm earnings resulting from above average crop yields in 2003 and stronger commodity prices. This has improved borrower liquidity, allowing them to reduce debt that was carried over as a result of the devastating impact of the 2002 drought and reduce the amount of current operating credit needed. Participations purchased volume decreased primarily due to the pay off of a large participation loan and the pay down of term debt. Participations sold increased due to the increased borrowing of a large corporate account whose total borrowings exceeded the Association's hold position. Leases decreased as a result of scheduled payments. Nonaccrual loans decreased due to collections made on loans in nonaccrual status and the transfer of several large nonaccrual loans back to accrual status.

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:	9/30/04	12/31/03
Loans:		
Accruing restructured	\$ 379	\$ 546
Past due 90 days or more and still accruing interest	—	—
Nonaccrual	2,903	4,409
Total risk loans	\$ 3,282	\$ 4,955
Risk loans as a percentage of loans	0.5%	0.8%

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. As discussed below, the Association is reviewing its allowance for loan loss calculation, methodologies and procedures with changes anticipated for the fourth quarter 2004. For additional information refer to the Changes To Allowance for Loan Losses section included in the latter portion of this report. During the nine months ending September 30, 2004, the Association did not make any addition to the allowance. During the first nine months of 2004 the Association recognized charge offs of \$40.

The Association continues to emphasize the use of loan guarantees to help manage credit risk inherent in the Association's loan portfolio and to help reduce the potential for future loan losses. Guarantee volume outstanding as of September 30, 2004 was \$111,588 or 18.15 percent of the Association's loan portfolio. The following table presents allowance for loan loss information:

As of:	9/30/04	12/31/03
Allowance for loan losses	\$ 11,002	\$ 11,042
Allowance as a percentage of loans	1.79%	1.85%
Nonaccrual loans	378.99%	250.44%
Total risk loans	335.22%	222.85%

## RESULTS OF OPERATIONS

Net income for the nine months ending September 30, 2004 was \$9,832, an increase of \$2,131 or 27.7 percent when compared to the net income of \$7,701 for the same period in 2003.

Net income for the three months ended September 30, 2004 (Q3 2004) totaled \$3,613, an increase of \$571, or 18.8 percent, as compared to \$3,042 for the same period of 2003 (Q3 2003). The major components of the changes in net income for the nine months and three months ended September 30, 2004 compared to September 30, 2003 are presented below:

	For the three months ending September 30 2004-2003	For the nine months ending September 30 2004-2003
<b>Increase (decrease) in net income due to:</b>		
Net interest income	\$ 219	\$ 1,251
Provision for loan losses	-	840
Loan fees	(43)	(276)
Financially related services	121	146
Equity earnings of AgFirst Farm Credit Bank	1	34
Other noninterest income	11	32
Salaries and employee benefits	87	(19)
Occupancy and equipment	13	42
Insurance Fund premiums	221	279
Other operating expenses	(46)	(182)
Provision for income taxes	(13)	(16)
<b>Total change in net income</b>	<b>\$ 571</b>	<b>\$ 2,131</b>

Net interest income was \$12,077 and \$4,132 for the nine months and three months ending September 30, 2004, respectively. Net interest income was \$10,826 and \$3,913 for the same periods ending September 30, 2003, respectively. The following table quantifies changes in the net interest income for these two periods for 2004 compared to 2003:

	For the nine months ending September 30 2004-2003	For the three months ending September 30 2004-2003
<b>Changes in net interest income created by changes in:</b>		
Volume	\$ 492	\$ 155
Rate	733	170
Loan purchase discount	(130)	(56)
Nonaccrual loan income	156	(50)
<b>Total change in net interest income</b>	<b>\$ 1,251</b>	<b>\$ 219</b>

The Association has benefited from significant loan re-pricing activities experienced primarily over the course of the last nine months of 2003 and first six months of 2004. The re-pricing activities and the lower general market interest rates allowed for increased earning spreads on loans and significant reduction in borrowing costs. In addition, the Association has been able to add new volume at competitive earnings spreads resulting in increased income to the Association. The lower market rates continued to have an adverse impact on the earnings generated on the Association's own funds in loans. Nonaccrual income increased due to the collection of one nonaccrual loan and the transfer of several significant nonaccrual loans back to accrual status during the second quarter of 2004.

The Association recorded a provision for loan losses of \$0 during Q3 2003 and \$840 for the first nine months of 2003, but did not record any provision for loan losses for either period in 2004. Without this difference, the YTD increase in net income for 2004 would be \$1,291 or 15.1 percent.

Noninterest income is comprised of loan fee income, fees for financially related services (FRS), equity in earnings from AgFirst Farm Credit Bank (the Bank) and miscellaneous income. The changes in these areas are illustrated in the table shown above. Loan fee income decreased YTD and for the quarter due to decreased loan servicing fees and origination fees collected. Late charges on loans also decreased due to improved efforts to keep loans from going past due. FRS income increased YTD due to increased income from multi-peril crop insurance and appraisal income. FRS income increased slightly for the quarter due to increased multi-peril crop insurance, credit life insurance and appraisal income. The equity in earnings of the AgFirst Farm Credit Bank (the Bank) is based on the Association's average note payable to the Bank. The YTD average note payable to the Bank was \$506,016 and \$503,187 as of September 30, 2004 and 2003, respectively.

Noninterest expense is comprised of salaries and employee benefits, occupancy and equipment expense, Insurance Fund premiums and general operating expenses. YTD Salaries and benefits increased due primarily to regular salary increases and increased pension expenses, which were offset by lower group health insurance and accrued incentive related expenses. The Farm Credit System Insurance Corporation (FCSIC) decreased premiums rates for 2004 when compared to 2003. There was a decrease in premiums for Q3 2004 when compared to Q2 2004. The decreased premiums offset the increased loan volume discussed above. Occupancy and equipment expenses decreased primarily due to lower software depreciation and information management equipment lease expenses. Other operating expenses increased due to increased FSA guarantee fees paid.

QTD salaries and employee benefits decreased by \$87. The primary reason for the decrease is the decrease in group health insurance expenses. Group health insurance premiums increased when compared to the same period in 2003. However, the Association, along with Jackson Purchase ACA, Central Kentucky ACA and Chattanooga ACA, was part of a former Louisville Farm Credit Bank benefit plan (the former plan). The former plan's assets are being used to pay the current health insurance premiums for these associations. The funds from the former plan are anticipated to pay the health insurance premiums through mid-year 2005. The length of time that the funds will pay the premiums will depend on interest rates, health insurance premiums and other market factors that impact health insurance premiums.

The provision for income taxes was \$134 at September 30, 2004 as compared to \$118 at the same time in 2003.

#### **Key Results of Operations Ratios:**

	9/30/04	12/31/03	9/30/03
Return on average assets	2.17%	1.90%	1.74%
Return on average equity	14.07%	13.61%	12.63%
Net interest margin	2.73%	2.53%	2.50%

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

## 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 page 9 of the 2003 Annual Report. The total notes payable to the Bank at September 30, 2004 was \$526,224 as compared to \$511,870 at December 31, 2003. The \$14,354 or 2.80 percent increase is primarily attributed to increased loan volume as described above, the payment of the cash portion of the 2003 patronage refund in April 2004 of \$2,349 and the pay out of the last half of the 1998 and half of the 1999 Qualified Surplus Allocated totaling \$3,839. These increases were offset by the payment of \$4,081 to the Association by the Bank representing the Bank's 2003 patronage refund to the Association, the increased investment in Class A preferred stock and Association earnings.

## CAPITAL RESOURCES

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

	9/30/04	12/31/03	\$ Change	% Change
Class A Preferred Stock	\$ 8,919	\$ 8,083	\$ 836	10.34%
C Stock and				
Participation Certificates	4,267	4,187	80	1.91
Qualified Surplus Allocated	11,282	15,360	(4,078)	(26.55)
Nonqualified Surplus Allocated	7,883	10,414	222	2.13
Nonqualified Surplus Retained	10,636	7,729	154	1.99
Unallocated retained earnings	51,055	41,661	9,394	22.55
Total	\$ 94,042	\$ 87,434	\$ 6,608	7.56%

The increase in unallocated retained earnings was generated through YTD net income. The reduction in Qualified Surplus Allocated (QSA) is related to the QSA revolvment discussed above.

At September 30, 2004, 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

	9/30/04	12/31/03	9/30/03
Permanent Capital Ratio	16.40%	14.91%	14.05%
Total Surplus Ratio	13.94%	12.67%	12.37%
Core Surplus Ratio	11.97%	11.57%	11.02%

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

## CHANGES TO ALLOWANCE FOR LOAN LOSSES

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

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

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

The Association is reviewing and revising its allowance for loan loss calculation methodologies, procedures, validation process and board reporting process to ensure compliance with the regulatory requirements and other guidelines discussed above. This process is anticipated to be completed by the end of the fourth quarter of 2004.

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

<i>(dollars in thousands)</i>	<b>September 30, 2004</b>	<b>December 31, 2003</b>
	<i>(unaudited)</i>	
<b>Assets</b>		
Cash	\$ 354	\$ 363
Loans	614,754	597,523
Less: allowance for loan losses	11,002	11,042
Net loans	603,752	586,481
Accrued interest receivable	14,106	10,543
Investment in other Farm Credit institutions	5,906	4,206
Premises and equipment, net	1,653	1,757
Other assets	4,583	5,029
Total assets	\$ 630,354	\$ 608,379
<b>Liabilities</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 526,224	\$ 511,870
Accrued interest payable	1,524	1,406
Patronage refund payable	97	2,587
Other liabilities	8,467	5,082
Total liabilities	536,312	520,945
Commitments and contingencies		
<b>Members' Equity</b>		
Capital stock and participation certificates	13,186	12,270
Retained earnings		
Allocated	29,801	33,503
Unallocated	51,055	41,661
Total members' equity	94,042	87,434
Total liabilities and members' equity	\$ 630,354	\$ 608,379

*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 September 30,</b>		<b>For the nine months ended September 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
<b>Interest Income</b>				
Loans	\$ 8,706	\$ 8,154	\$ 24,883	\$ 23,964
<b>Interest Expense</b>				
Notes payable to AgFirst Farm Credit Bank	4,574	4,240	12,806	13,137
Other	—	1	—	1
Total interest expense	4,574	4,241	12,806	13,138
Net interest income	4,132	3,913	12,077	10,826
Provision for (reversal of) loan losses	—	—	—	840
Net interest income after provision for (reversal of) loan losses	4,132	3,913	12,077	9,986
<b>Noninterest Income</b>				
Loan fees	72	115	274	550
Fees for financially related services	151	30	290	144
Equity in earnings of other Farm Credit institutions	996	995	2,880	2,846
Gains (losses) on other property owned, net	1	(2)	(1)	(2)
Other noninterest income	6	(2)	44	13
Total noninterest income	1,226	1,136	3,487	3,551
<b>Noninterest Expense</b>				
Salaries and employee benefits	1,191	1,278	3,824	3,805
Occupancy and equipment	88	101	328	370
Insurance Fund premium	(61)	160	197	476
Other operating expenses	471	425	1,249	1,067
Total noninterest expense	1,689	1,964	5,598	5,718
Income before income taxes	3,669	3,085	9,966	7,819
Provision (benefit) for income taxes	56	43	134	118
Net income	\$ 3,613	\$ 3,042	\$ 9,832	\$ 7,701

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

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

*(unaudited)*

<i>(dollars in thousands)</i>	<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, 2002	\$ 8,908	\$ 27,254	\$ 41,335	\$ 77,497
Net income			7,701	7,701
Capital stock/participation certificates issued	1,523			1,523
Capital stock/participation certificates retired	(750)			(750)
Cash dividends declared/paid			(95)	(95)
Retained earnings retired		(2,096)		(2,096)
Distribution adjustment		29	(73)	(44)
Balance at September 30, 2003	<u>\$ 9,681</u>	<u>\$ 25,187</u>	<u>\$ 48,868</u>	<u>\$ 83,736</u>
Balance at December 31, 2003	\$ 12,270	\$ 33,503	\$ 41,661	\$ 87,434
Net income			9,832	9,832
Capital stock/participation certificates issued	4,737			4,737
Capital stock/participation certificates retired	(3,821)			(3,821)
Dividends declared/paid		74	(213)	(139)
Retained earnings retired		(4,056)		(4,056)
Distribution adjustment		280	(225)	55
Balance at September 30, 2004	<u>\$ 13,186</u>	<u>\$ 29,801</u>	<u>\$ 51,055</u>	<u>\$ 94,042</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, 2003, are contained in the 2003 Annual Report to Stockholders. These unaudited third quarter 2004 consolidated financial statements should be read in conjunction with the 2003 Annual Report to Stockholders.

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

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

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

**NOTE 2 – ALLOWANCE FOR LOAN LOSSES**

An analysis of the allowance for loan losses follows:

Balance at 12-31-02	\$ 10,262
(Reversal of) provision for loan losses	840
Loans (charged off), net of recoveries	<u>(41)</u>
Balance at 9-30-03	<u>\$ 11,061</u>
Balance at 12-31-03	\$ 11,042
(Reversal of) provision for loan losses	–
Loans (charged off), net of recoveries	<u>(40)</u>
Balance at 9-30-04	<u>\$ 11,002</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 for the nine months ended September 30, 2004:

	<b>For the nine months ended September 30,</b>	
	<b>2004</b>	<b>2003</b>
Service cost	\$ 275	\$ 215
Interest cost	293	244
Expected return on plan assets	(349)	(271)
Amortization of prior service cost	59	58
Recognized net actuarial (gain) loss	<u>52</u>	<u>36</u>
Net periodic benefit (income) cost	<u>\$ 330</u>	<u>\$ 282</u>

The Association previously disclosed in its financial statements that it expected to contribute \$380 to its pension plan in 2004. As of September 30, 2004, the Association had contributed \$1,076 to the defined benefit retirement plan, which was sufficient to meet its accumulated benefit obligation. The Association does not anticipate making additional contributions for the remainder of 2004.

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 nine months ended September 30, 2004:

	<b>For the nine months ended September 30,</b>	
	<b>2004</b>	<b>2003</b>
Pension	\$ 330	\$ 282
Thrift/deferred compensation	136	133
Other postretirement benefits	<u>347</u>	<u>354</u>
Total	<u>\$ 813</u>	<u>\$ 769</u>