

# SECOND QUARTER 2009

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## CERTIFICATION

The undersigned certify that we have reviewed the June 30, 2009 quarterly report of Cape Fear Farm Credit, ACA, that the report has been prepared under the oversight of the Audit Committee of the Board of Directors and in accordance with all applicable statutory or regulatory requirements, and that the information contained herein is true, accurate, and complete to the best of our knowledge and belief.



Richard A. Eason  
Chief Executive Officer



Matthew J. Currin  
Chief Financial Officer



Ronald J. Allen  
Chairman of the Board

August 3, 2009

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*Cape Fear Farm Credit, ACA*

# Report on Internal Control Over Financial Reporting

The Association's principal executives and principal financial officers, or persons performing similar functions, are responsible for establishing and maintaining adequate internal control over financial reporting for the Association's Consolidated Financial Statements. For purposes of this report, "internal control over financial reporting" is defined as a process designed by, or under the supervision of the Association's principal executives and principal financial officers, or persons performing similar functions, and effected by its Board of Directors, management and other personnel. This process provides reasonable assurance regarding the reliability of financial reporting information and the preparation of the Consolidated Financial Statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

Internal control over financial reporting includes those policies and procedures that: (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Association, (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial information in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures are being made only in accordance with authorizations of management and directors of the Association, and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Association's assets that could have a material effect on its Consolidated Financial Statements.

The Association's management has completed an assessment of the effectiveness of internal control over financial reporting as of June 30, 2009. In making the assessment, management used the framework in *Internal Control — Integrated Framework*, promulgated by the Committee of Sponsoring Organizations of the Treadway Commission, commonly referred to as the "COSO" criteria.

Based on the assessment performed, the Association concluded that as of June 30, 2009, the internal control over financial reporting was effective based upon the COSO criteria. Additionally, based on this assessment, the Association determined that there were no material weaknesses in the internal control over financial reporting as of June 30, 2009



Richard A. Eason  
Chief Executive Officer



Matthew J. Currin  
Chief Financial officer

August 3, 2009

# 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 Cape Fear Farm Credit ACA, (Association) for the period ended June 30, 2009. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements and the 2008 Annual Report of the Association. The accompanying consolidated financial statements were prepared under the oversight of the Audit Committee of the Board of Directors.

## 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 in our region, including tobacco, swine, poultry, and row-crop operations. Farm size varies and many of the borrowers in the region have diversified farming operations. This factor, along with the numerous opportunities for non-farm income in the area, lessens the level of dependency on any single given commodity. Concentration risk is further mitigated by a portfolio of participation loans purchased or originated and sold.

The gross loan volume of the Association as of June 30, 2009 was \$777,475, an increase of \$14,974 as compared to \$762,501 at December 31, 2008. Net loans outstanding at June 30, 2009, were \$772,026 as compared to \$756,515 at December 31, 2008. Net loans accounted for 93.06 percent of total assets at June 30, 2009, as compared to 91.72 percent of total assets at December 31, 2008.

The increase in gross and net loan volume during the reporting period is attributed to a general increase in lending activity including seasonal lending sufficient to reflect overall growth despite significant paydowns from assignments on contract grower loans. The short-term portfolio, which is heavily influenced by operating-type loans, normally reaches a peak in August and declines in the fall months as farm commodities are marketed and proceeds are applied to the operating loans.

There is an inherent risk in the extension of any type of credit. Portfolio credit quality continues to be maintained at an acceptable level and credit administration remains

satisfactory. Nonaccrual loans decreased from \$11,980 at December 31, 2008 to \$11,959 at June 30, 2009. This decrease is due to loan reinstatements and transferring loans back into accrual status.

Association management maintains an allowance for loan losses in an amount considered sufficient to absorb possible losses in the loan portfolio based on current and expected future conditions. The allowance for loan losses at June 30, 2009 was \$5,449, a decrease of \$537 from the December 31, 2008 amount of \$5,986. The allowance was increased in the first quarter to keep pace with continued growth in loan volume and due to deterioration in credit quality. The reduction in the second quarter was attributed to a partial payment and charge off a participation loan which had a significant impact on the allowance balance.

## RESULTS OF OPERATIONS

### For the three months ended June 30, 2009

Net income for the three months ended June 30, 2009 totaled \$4,547 as compared to \$4,856 for the same period in 2008. The decrease of \$309 or 6.36 percent is attributed to a decrease in net interest income and noninterest income as a result of decreased earnings on the Association's loanable funds credit from AgFirst Farm Credit Bank (Bank) and reduced fee income, respectively.

Net interest income for the three months ended June 30, 2009 decreased \$291 or 4.90 percent compared to June 30, 2008. Interest income on loans decreased by \$2,378 and interest income from other sources decreased by \$62, while interest expense decreased \$2,087 compared to the same period last year. The decrease in net interest income was a result of decreased earnings on the Association's loanable funds credit with the (Bank). Nonaccrual income was \$110 for the three months ended June 30, 2009, as compared to \$125 for the same period in 2008.

Noninterest income for the three months ended June 30, 2009 totaled \$2,236 as compared to \$2,495 for the same period of 2008, a decrease of \$259. These decreases were a result of \$136 in Loan fee income, \$51 in Other noninterest income, \$40 in Equity in earnings of other Farm Credit institutions and \$26 in Fees for financially related services.

Noninterest expense for the three months ended June 30, 2009 decreased \$301 compared to the same period of 2008.

This decrease resulted from decreases of \$276 in Salaries and benefits and \$78 in Other operating expenses that were offset by increases in the Insurance Fund premium of \$50 and Occupancy and equipment of \$3.

#### **For the six months ended June 30, 2009**

Net income for the six months ended June 30, 2009 totaled \$8,459 as compared to \$11,176 for the same period in 2008. The decrease of \$2,717 or 24.31 percent is attributed primarily to a decrease in net interest income resulting from decreased earnings on the Association's loanable funds credit with the Bank.

At June 30, 2009, net interest income decreased \$810 or 6.81 percent compared to June 30, 2008. Interest income on loans decreased by \$4,562 and interest income from other sources decreased by \$103, while interest expense increased \$166 compared to the same period last year. These decreases are both due to a lower interest rate environment on loan products as well as notes payable to the Bank. Nonaccrual income was \$196 for the six months ended June 30, 2009, as compared to \$251 for the same period in 2008.

Noninterest income for the six months ended June 30, 2009 totaled \$4,791 as compared to \$5,466 for the same period of 2008, a decrease of \$675. This decrease resulted from a decrease of \$685 in Loan fee income and \$28 in Fees for financially related services. These decreases were offset by increases of \$19 in Equity in earnings from the Bank, \$16 in other noninterest income and \$3 in gains/losses of other property owned.

Noninterest expense for the six months ended June 30, 2009 increased \$166 compared to the same period of 2008. This increase resulted primarily from increases of \$189 Salaries and employee benefits, \$15 in Occupancy and equipment expense and \$95 in the Insurance Fund premium. These increases were offset by a decrease in Other operating expenses of \$133.

#### **FUNDING SOURCES**

The principal source of funds for the Association is the borrowing relationship established with the Bank through a General Financing Agreement. The General Financing Agreement utilizes the Association's credit and fiscal performance as criteria for establishing a line of credit on which the Association may draw funds. The funds are advanced by the Bank to the Association in the form of notes payable. The notes payable are segmented into variable rate and fixed rate sections. The variable rate note is utilized by the Association to fund variable rate loan advances and operating funds requirements. The fixed rate note is used specifically to fund fixed rate loan advances made by the Association. The total notes payable to the Bank at March 31, 2009, were \$682,235 as compared to \$695,160 at December 31, 2008.

#### **CAPITAL RESOURCES**

Total members' equity at March 31, 2009 decreased to \$257 from the December 31, 2008 total of \$105,974. The decrease is primarily due to a reduction in net income due to items mentioned above as well as the retirement of surplus allocated in the first quarter of 2009.

Farm Credit Administration (FCA) regulations require all Farm Credit institutions to maintain minimum permanent capital, total surplus and core surplus ratios. These ratios are calculated by dividing the Association's permanent capital, total surplus and core surplus as defined in FCA regulations, by a risk-adjusted asset base. As of March 31, 2009, the Association's total surplus ratio and core surplus ratio were 11.86 percent and 11.77 percent, respectively, and the permanent capital ratio was 12.20 percent. All three ratios were well above the minimum regulatory ratios of 7.00 percent for permanent capital and total surplus ratios and 3.50 percent for the core surplus ratio.

**NOTE:** Shareholder investment in the Association could be affected by the financial condition and results of operations of AgFirst Farm Credit Bank. Copies of AgFirst's annual and quarterly reports are available upon request free of charge by calling 1-800-845-1745, ext. 378, or writing Stephen Gilbert, AgFirst Farm Credit Bank, P.O. Box 1499, Columbia, SC 29202. Information concerning AgFirst Farm Credit Bank can also be obtained at their website, [www.agfirst.com](http://www.agfirst.com). Copies of the Association's annual and quarterly reports are also available upon request free of charge by calling 1-800-368-5819 ext. 3243, writing Matthew J. Currin, Cape Fear Farm Credit, P. O. Box 2405, Fayetteville, NC 28302, or accessing the website, [www.capefearfarmcredit.com](http://www.capefearfarmcredit.com). The Association prepares a 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 institution.

# Cape Fear Farm Credit, ACA

## Consolidated Balance Sheets

<i>(dollars in thousands)</i>	<b>June 30, 2009</b> <i>(unaudited)</i>	<b>December 31, 2008</b> <i>(audited)</i>
<b>Assets</b>		
Cash	\$ 1,454	\$ 1,819
Loans	777,475	762,501
Less: allowance for loan losses	5,449	5,986
Net loans	772,026	756,515
Other investments	24,033	28,847
Accrued interest receivable	8,258	9,826
Investment in other Farm Credit institutions	11,682	11,682
Premises and equipment, net	3,350	3,453
Other property owned	496	313
Due from AgFirst Farm Credit Bank	—	6,482
Other assets	8,301	5,832
Total assets	<u>\$ 829,600</u>	<u>\$ 824,769</u>
<b>Liabilities</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 710,112	\$ 695,160
Accrued interest payable	1,941	2,524
Patronage refund payable	137	11,400
Other liabilities	7,166	9,711
Total liabilities	<u>719,356</u>	<u>718,795</u>
Commitments and contingencies		
<b>Members' Equity</b>		
Protected borrower equity	58	73
Capital stock and participation certificates	2,647	2,634
Retained earnings		
Allocated	13,464	17,699
Unallocated	94,392	85,891
Accumulated other comprehensive income (loss)	(317)	(323)
Total members' equity	<u>110,244</u>	<u>105,974</u>
Total liabilities and members' equity	<u>\$ 829,600</u>	<u>\$ 824,769</u>

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

# Cape Fear Farm Credit, ACA

## Consolidated Statements of Income

*(unaudited)*

<i>(dollars in thousands)</i>	For the three months ended June 30,		For the six months ended June 30,	
	2009	2008	2009	2008
<b>Interest Income</b>				
Loans	\$ 11,269	\$ 13,585	\$ 22,975	\$ 27,537
Other	355	417	709	812
Total interest income	11,624	14,002	23,684	28,349
<b>Interest Expense</b>				
Notes payable to AgFirst Farm Credit Bank	5,973	8,060	12,601	16,456
Net interest income	5,651	5,942	11,083	11,893
Provision for (reversal of allowance for) loan losses	445	385	1,451	385
Net interest income after provision for (reversal of allowance for) loan losses	5,206	5,557	9,632	11,508
<b>Noninterest Income</b>				
Loan fees	574	710	1,395	2,080
Fees for financially related services	16	42	71	99
Equity in earnings of other Farm Credit institutions	1,620	1,660	3,240	3,221
Gains (losses) on other property owned, net	(5)	1	2	(1)
Other noninterest income	31	82	83	67
Total noninterest income	2,236	2,495	4,791	5,466
<b>Noninterest Expense</b>				
Salaries and employee benefits	1,872	2,148	3,849	3,660
Occupancy and equipment	197	194	407	392
Insurance Fund premium	322	272	626	531
Other operating expenses	504	582	1,082	1,215
Total noninterest expense	2,895	3,196	5,964	5,798
Income before income taxes	4,547	4,856	8,459	11,176
Provision (benefit) for income taxes	—	—	—	—
Net income	\$ 4,547	\$ 4,856	\$ 8,459	\$ 11,176

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

Cape Fear Farm Credit, ACA  
**Consolidated Statements of Changes in  
Members' Equity**

*(unaudited)*

*(dollars in thousands)*

	Protected Borrower Capital	Capital Stock and Participation Certificates	Retained Earnings		Accumulated Other Comprehensive Income	Total Members' Equity
			Allocated	Unallocated		
Balance at December 31, 2007	\$ 124	\$ 2,542	\$ 16,631	\$ 83,542	\$ (337)	\$ 102,502
Comprehensive income						
Net income				11,176		11,176
Employee benefit plans adjustments				(9)	7	(2)
Total comprehensive income						11,174
Protected borrower equity retired	(37)					(37)
Capital stock/participation						
certificates issued/(retired), net		73				73
Retained earnings retired			(5,651)			(5,651)
Patronage distribution adjustment			387	(327)		60
Balance at June 30, 2008	\$ 87	\$ 2,615	\$ 11,367	\$ 94,382	\$ (330)	\$ 108,121
Balance at December 31, 2008	\$ 73	\$ 2,634	\$ 17,699	\$ 85,891	\$ (323)	\$ 105,974
Comprehensive income						
Net income				8,459		8,459
Employee benefit plans adjustments					6	6
Total comprehensive income						8,465
Protected borrower equity retired	(15)					(15)
Capital stock/participation						
certificates issued/(retired), net		13				13
Retained earnings retired			(4,234)			(4,234)
Patronage distribution adjustment			(1)	42		41
Balance at June 30, 2009	\$ 58	\$ 2,647	\$ 13,464	\$ 94,392	\$ (317)	\$ 110,244

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

## Cape Fear Farm Credit, ACA

# Notes to the Consolidated Financial Statements

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

### NOTE 1 – ORGANIZATION, SIGNIFICANT ACCOUNTING POLICIES, AND RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

The accompanying financial statements include the accounts of Cape Fear Farm Credit, ACA (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, 2008, are contained in the 2008 Annual Report to Shareholders. These unaudited second quarter 2009 consolidated financial statements should be read in conjunction with the 2008 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, 2009, are not necessarily indicative of the results to be expected for the year ending December 31, 2009.

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, 2009, the allowance for losses is adequate in management's opinion to provide for possible losses on existing loans.

In addition to the recently issued accounting pronouncements discussed in the 2008 Annual Report to Shareholders, effective January 1, 2009, the Association adopted Financial Accounting Standards Board (FASB) Statement of Position (FSP) No. 157-2, "Effective Date of FASB Statement No. 157." This FSP delayed the effective date of Statement No. 157 for nonfinancial assets and nonfinancial liabilities until fiscal years beginning after November 15, 2008. The impact of adoption requires additional fair value disclosures (see Note 4), primarily regarding other property owned, but does not have an impact on the Association's financial condition or results of operations.

In April 2009, the FASB issued FSP No. 107-1 and Accounting Principles Board (APB) No. 28-1, "Interim Disclosures about Fair Value of Financial Instruments." This FSP requires disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. The FSP is effective for interim periods ending after June 15, 2009 (see Note 5).

In May 2009, the FASB issued SFAS No. 165, "Subsequent Events," which sets forth general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. Recognized subsequent events should be recognized in the financial statements since the conditions existed at the date of the balance sheet. Nonrecognized subsequent events are not recognized in the financial statements since the conditions arose after the balance sheet date but before the financial statements are issued or are available to be issued. This Standard, which includes a required disclosure of the date through which an entity has evaluated subsequent events, is effective for interim or annual periods ending after June 15, 2009 (see Note 6).

### NOTE 2 – ALLOWANCE FOR LOAN LOSSES AND IMPAIRED LOANS

An analysis of the allowance for loan losses follows:

	<b>For the six months ended June 30,</b>	
	<b>2009</b>	<b>2008</b>
Balance at beginning of period	\$ 5,986	\$ 3,993
Provision for (reversal of) loan losses	1,451	385
Charge-offs	(2,032)	–
Recoveries	44	9
Balance at end of period	<u>\$ 5,449</u>	<u>\$ 4,387</u>

The following table presents information concerning impaired loans as of June 30,

	<b>2009</b>	<b>2008</b>
Impaired loans with related allowance	\$ 3,483	\$ 610
Impaired loans with no related allowance	<u>8,496</u>	<u>4,570</u>
Total impaired loans	<u>\$ 11,979</u>	<u>\$ 5,180</u>
Allowance on impaired loans	<u>\$ 1,958</u>	<u>\$ 510</u>

The following table summarizes impaired loan information for the six months ended June 30,

	<u>2009</u>	<u>2008</u>
Average impaired loans	\$ 12,985	\$ 5,379
Interest income recognized on impaired loans	209	251

### NOTE 3 – EMPLOYEE BENEFIT PLANS

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

	<u>For the six months ended June 30,</u>	
	<u>2009</u>	<u>2008</u>
Pension	\$ 926	\$ 194
401(k)	113	101
Other postretirement benefits	180	170
Total	<u>\$ 1,219</u>	<u>\$ 465</u>

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

	<u>Actual YTD Through 6/30/09</u>	<u>Projected Contributions For Remainder of 2009</u>	<u>Projected Total Contributions 2009</u>
Pension	\$ 14	\$ 14	\$ 28
Other postretirement benefits	133	149	282
Total	<u>\$ 147</u>	<u>\$ 163</u>	<u>\$ 310</u>

Actuarial calculations as of the last plan measurement date (December 31, 2008) projected contributions of \$28 to the pension plan for 2009. However, market conditions could impact discount rates and return on plan assets which could make additional contributions necessary before the next plan measurement date of December 31, 2009.

Further details regarding employee benefit plans are contained in the 2008 Annual Report to Shareholders.

### NOTE 4 – FAIR VALUE MEASUREMENT

Effective January 1, 2008, the Association adopted Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" (SFAS No. 157). This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements for certain assets and liabilities measured at fair value on a recurring and non-recurring basis. These assets and liabilities primarily consist of assets held in trust funds, standby letters of credit, impaired loans, and other property owned.

SFAS No. 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability in an orderly transaction between market participants in the principal or most advantageous market for the asset or liability.

SFAS No. 157 establishes a fair value hierarchy for disclosure of fair value measurements to maximize the use of observable inputs, that is, inputs that reflect the assumptions market participants would use in pricing an asset or liability based on market data obtained from sources independent of the reporting entity. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

The three levels of inputs and the classification of the Association's financial instruments within the fair value hierarchy are as follows:

#### Level 1

Level 1 inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets. The Association's Level 1 assets at June 30, 2009 consist of assets held in trust funds related to deferred compensation and supplemental retirement plans. The trust funds include investments in securities that are actively traded and have quoted net asset value prices that are directly observable in the marketplace.

#### Level 2

Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets; quoted prices in markets that are not active; and inputs that are observable, or can be corroborated, for substantially the full term of the asset or liability. The Association has no Level 2 assets and liabilities measured at fair value on a recurring basis at June 30, 2009.

#### Level 3

Level 3 inputs to the valuation methodology are unobservable and supported by little or no market activity. Valuation is determined using pricing models, discounted cash flow methodologies, or similar techniques, and could include significant management judgment or estimation. Level 3 assets and liabilities also could include instruments whose price has been adjusted based on dealer quoted pricing that is different than the third-party valuation or internal model pricing.

Level 3 assets at June 30, 2009 include impaired loans which represent the fair value of certain loans that were evaluated for impairment under SFAS No. 114. The fair value was based upon the underlying collateral since these were collateral-dependent loans. The fair value measurement process uses independent appraisals and other market-based information, but in many cases it also requires significant input based on management's knowledge of and judgment about current



