


THIRD QUARTER 2009

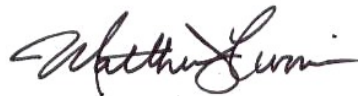
TABLE OF CONTENTS


| | |
|---|---|
| Report on Internal Control Over Financial Reporting..... | 2 |
| Management's Discussion and Analysis of Financial Condition and Results of Operations..... | 3 |
| Consolidated Financial Statements | |
| Consolidated Balance Sheets..... | 5 |
| Consolidated Statements of Income..... | 6 |
| Consolidated Statements of Changes in Members' Equity..... | 7 |
| Notes to the Consolidated Financial Statements..... | 8 |

CERTIFICATION

The undersigned certify that we have reviewed the September 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

October 28, 2009

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 September 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 September 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 September 30, 2009



Richard A. Eason
Chief Executive Officer



Matthew J. Currin
Chief Financial officer

October 28, 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 September 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 loans originated and sold.

The gross loan volume of the Association as of September 30, 2009 was \$763,434, an increase of \$933 as compared to \$762,501 at December 31, 2008. Net loans outstanding at September 30, 2009, were \$755,509 as compared to \$756,515 at December 31, 2008. Net loans accounted for 91.74 percent of total assets at September 30, 2009, as compared to 91.72 percent of total assets at December 31, 2008.

The increase in gross 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 decrease in net loans is due to the increase in allowance for loan loss related to the deterioration in the Association's credit quality. 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.

The Association has investment securities that are classified as held to maturity in the amount of \$6,200. These Mission Related Investments are investments in bonds that were

made under the Farm Credit System's Rural America Bond Program in the third quarter of 2009. The Association also has other investments in Successor In Interest Contracts (SIIC) in the amount of \$24,387. Other investments decreased from December 31, 2008 by \$4,460 as a result of a normal annual payment received from USDA on these contracts in January 2009.

There is an inherent risk in the extension of any type of credit. Portfolio credit quality has deteriorated but continues to be maintained at an acceptable level and credit administration remains satisfactory. Nonaccrual loans increased from \$11,980 at December 31, 2008 to \$24,254 at September 30, 2009. This increase was due to the transfer of a group of large loans to nonaccrual in the third quarter.

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 September 30, 2009 was \$7,925, an increase of \$1,939 from the December 31, 2008 amount of \$5,986. The allowance was increased in the third quarter to keep pace with continued growth in loan volume and due to continued deterioration in credit quality associated with the transfer of several loans to nonaccrual.

RESULTS OF OPERATIONS

For the three months ended September 30, 2009

Net income for the three months ended September 30, 2009 totaled \$2,484 as compared to \$5,459 for the same period in 2008. The decrease of \$2,975 or 54.50 percent is attributed to a decrease in net interest income as a result of decreased earnings on the Association's loanable funds credit from AgFirst Farm Credit Bank (Bank) as well as increased provision for loan losses and increased operating expenses.

Net interest income for the three months ended September 30, 2009 decreased \$523 or 8.43 percent compared to September 30, 2008. Interest income on loans decreased by \$2,838 and interest income from investments and other sources decreased by \$16, while interest expense decreased \$2,331 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 \$76 for the three months ended September 30, 2009, as compared to \$260 for the same period in 2008.

Noninterest income for the three months ended September 30, 2009 totaled \$2,287 as compared to \$2,230 for the same period of 2008, an increase of \$57. This increase was a result of increases of \$59 in Loan fee income, \$56 in Other noninterest income, and \$10 in Gains/losses on other property owned. These increases were offset by decreases of \$46 in Equity in earnings of other Farm Credit institutions and \$22 in Fees for financially related services.

Noninterest expense for the three months ended September 30, 2009 increased \$116 compared to the same period of 2008. This increase resulted from increases of \$148 in Salaries and benefits, \$80 in the Insurance Fund premium and \$18 in Occupancy and equipment expense. These increases were offset by a decrease of \$130 in Other operating expenses.

For the nine months ended September 30, 2009

Net income for the nine months ended September 30, 2009 totaled \$10,943 as compared to \$16,635 for the same period in 2008. The decrease of \$5,692 or 34.21 percent is attributed primarily to four main factors including an increase in provision for loan losses of \$3,401, a decrease in net interest income in the amount of \$1,333, a decrease in noninterest income of \$618 and an increase in noninterest expense of \$282.

At September 30, 2009, net interest income decreased \$1,333 or 7.37 percent compared to September 30, 2008. Interest income on loans decreased by \$7,400 and interest income from investments and other sources decreased by \$119, while interest expense decreased \$6,186 compared to the same period last year. These decreases are both due to a lower interest rate environment on all loan products as well as on notes payable to the Bank and decreased earnings on the Association's loanable funds credit with the Bank. Nonaccrual income was \$272 for the nine months ended September 30, 2009, as compared to \$511 for the same period in 2008.

Noninterest income for the nine months ended September 30, 2009 totaled \$7,078 as compared to \$7,696 for the same period of 2008, a decrease of \$618. This decrease resulted from decreases of \$626 in Loan fee income, \$50 in Fees for financially related services, and \$27 in Equity in earnings of other Farm Credit institutions. These decreases were offset by increases of \$72 in Other noninterest income and \$13 in Gains/losses of other property owned.

Noninterest expense for the nine months ended September 30, 2009 increased \$282 compared to the same period of 2008. This increase resulted primarily from increases of \$337 Salaries and employee benefits, \$30 in Occupancy and equipment expense and \$175 in the Insurance Fund premium. These increases were offset by a decrease in Other operating expenses of \$263.

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 September 30, 2009, were \$699,186 as compared to \$695,160 at December 31, 2008.

CAPITAL RESOURCES

Total members' equity at September 30, 2009 increased to \$112,759 from the December 31, 2008 total of \$105,974. The increase is primarily due to additional net income recognized as unallocated surplus that was offset by 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 September 30, 2009, the Association's total surplus ratio and core surplus ratio were both 12.36 percent and the permanent capital ratio was 12.70 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. 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. 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> | September 30, 2009 <i>(unaudited)</i> | December 31, 2008 <i>(audited)</i> |
|--|---|--|
| Assets | | |
| Cash | \$ 3,094 | \$ 1,819 |
| Investment securities: | | |
| Held to maturity (fair value of \$7,594 and \$0 respectively) | 6,200 | — |
| Total investment securities | 6,200 | — |
| Loans | 763,434 | 762,501 |
| Less: allowance for loan losses | 7,925 | 5,986 |
| Net loans | 755,509 | 756,515 |
| Other investments | 24,387 | 28,847 |
| Accrued interest receivable | 9,349 | 9,826 |
| Investment in other Farm Credit institutions | 11,682 | 11,682 |
| Premises and equipment, net | 3,227 | 3,453 |
| Other property owned | 562 | 313 |
| Due from AgFirst Farm Credit Bank | 4,816 | 6,482 |
| Other assets | 4,709 | 5,832 |
| Total assets | \$ 823,535 | \$ 824,769 |
| Liabilities | | |
| Notes payable to AgFirst Farm Credit Bank | \$ 699,186 | \$ 695,160 |
| Accrued interest payable | 1,929 | 2,524 |
| Patronage refund payable | 95 | 11,400 |
| Other liabilities | 9,566 | 9,711 |
| Total liabilities | 710,776 | 718,795 |
| Commitments and contingencies | | |
| Members' Equity | | |
| Protected borrower equity | 58 | 73 |
| Capital stock and participation certificates | 2,655 | 2,634 |
| Retained earnings | | |
| Allocated | 13,453 | 17,699 |
| Unallocated | 96,907 | 85,891 |
| Accumulated other comprehensive income (loss) | (314) | (323) |
| Total members' equity | 112,759 | 105,974 |
| Total liabilities and members' equity | \$ 823,535 | \$ 824,769 |

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 September 30, | | For the nine months ended September 30, | |
|--|---|-------------|--|-------------|
| | 2009 | 2008 | 2009 | 2008 |
| Interest Income | | | | |
| Investment securities | \$ 39 | \$ — | \$ 39 | \$ — |
| Loans | 11,201 | 14,039 | 34,176 | 41,576 |
| Other | 354 | 409 | 1,063 | 1,221 |
| Total interest income | 11,594 | 14,448 | 35,278 | 42,797 |
| Interest Expense | | | | |
| Notes payable to AgFirst Farm Credit Bank | 5,916 | 8,247 | 18,517 | 24,703 |
| Net interest income | 5,678 | 6,201 | 16,761 | 18,094 |
| Provision for (reversal of allowance for) loan losses | 2,565 | 230 | 4,016 | 615 |
| Net interest income after provision for (reversal of allowance for) loan losses | 3,113 | 5,971 | 12,745 | 17,479 |
| Noninterest Income | | | | |
| Loan fees | 617 | 558 | 2,012 | 2,638 |
| Fees for financially related services | 38 | 60 | 109 | 159 |
| Equity in earnings of other Farm Credit institutions | 1,588 | 1,634 | 4,828 | 4,855 |
| Gains (losses) on other property owned, net | — | (10) | 2 | (11) |
| Other noninterest income | 44 | (12) | 127 | 55 |
| Total noninterest income | 2,287 | 2,230 | 7,078 | 7,696 |
| Noninterest Expense | | | | |
| Salaries and employee benefits | 1,790 | 1,642 | 5,639 | 5,302 |
| Occupancy and equipment | 288 | 270 | 695 | 662 |
| Insurance Fund premium | 328 | 248 | 954 | 779 |
| Other operating expenses | 413 | 543 | 1,495 | 1,758 |
| Total noninterest expense | 2,819 | 2,703 | 8,783 | 8,501 |
| Income before income taxes | 2,581 | 5,498 | 11,040 | 16,674 |
| Provision (benefit) for income taxes | 97 | 39 | 97 | 39 |
| Net income | \$ 2,484 | \$ 5,459 | \$ 10,943 | \$ 16,635 |

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 | | | | 16,635 | | 16,635 |
| Employee benefit plans adjustments | | | | (9) | 11 | 2 |
| Total comprehensive income | | | | | | 16,637 |
| Protected borrower equity retired | (43) | | | | | (43) |
| Capital stock/participation certificates issued/(retired), net | | 101 | | | | 101 |
| Retained earnings retired | | | (5,651) | | | (5,651) |
| Patronage distribution adjustment | | | 387 | (328) | | 59 |
| Balance at September 30, 2008 | \$ 81 | \$ 2,643 | \$ 11,367 | \$ 99,840 | \$ (326) | \$ 113,605 |
| Balance at December 31, 2008 | \$ 73 | \$ 2,634 | \$ 17,699 | \$ 85,891 | \$ (323) | \$ 105,974 |
| Comprehensive income | | | | | | |
| Net income | | | | 10,943 | | 10,943 |
| Employee benefit plans adjustments | | | | | 9 | 9 |
| Total comprehensive income | | | | | | 10,952 |
| Protected borrower equity retired | (15) | | | | | (15) |
| Capital stock/participation certificates issued/(retired), net | | 21 | | | | 21 |
| Retained earnings retired | | | (4,234) | | | (4,234) |
| Patronage distribution adjustment | | | (12) | 73 | | 61 |
| Balance at September 30, 2009 | \$ 58 | \$ 2,655 | \$ 13,453 | \$ 96,907 | \$ (314) | \$ 112,759 |

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 third 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 nine months ended September 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 September 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 accounting guidance for fair value measurements of nonfinancial assets and nonfinancial liabilities. The impact of adoption resulted in additional fair value disclosures (see Note 5), 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 Financial Accounting Standards Board (FASB) issued guidance, "Interim Disclosures about Fair Value of Financial Instruments." This guidance requires

disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. The Association adopted this guidance effective June 30, 2009 (see Note 6).

In May 2009, the FASB issued guidance, "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. There are two types of subsequent events: the first type consists of events or transactions that provide additional evidence about conditions that existed at the balance sheet date (recognized subsequent events) and the second type consists of events that provide evidence about conditions that did not exist at the balance sheet date but arose after that date (nonrecognized subsequent events). Recognized subsequent events should be included in the financial statements since the conditions existed at the date of the balance sheet. Nonrecognized subsequent events are not included 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 guidance, which includes a required disclosure of the date through which an entity has evaluated subsequent events, was adopted by the Association effective June 30, 2009 (see Note 7).

In June 2009, the FASB issued guidance, "The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles." This Codification became the source of authoritative U.S. generally accepted accounting principles recognized by the FASB. This guidance was adopted by the Association effective July 1, 2009 and had no impact on the Association's financial condition or results of operations.

NOTE 2 – INVESTMENT SECURITIES

A summary of the amortized cost and fair value of investment securities held-to-maturity at September 30, 2009 follows:

| | September 30, 2009 | | | | |
|-------|--------------------|------------------------|-------------------------|------------|-------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Yield |
| Other | \$ 6,200 | \$ 1,394 | \$ - | \$ 7,594 | 5.39% |

A summary of the expected maturity, amortized cost and estimated fair value of investment securities at September 30, 2009 follows:

| | September 30, 2009 | | |
|------------------------------------|---------------------------|-------------------|-------------------------------|
| | Amortized Cost | Fair Value | Weighted Average Yield |
| In one year or less | \$ 500 | \$ 514 | 4.50% |
| After one year through five years | - | - | - |
| After five years through ten years | - | - | - |
| After ten years | 5,700 | 7,080 | 5.47 |
| Total | <u>\$ 6,200</u> | <u>\$ 7,594</u> | <u>5.39%</u> |

The Association's investments were purchased during the third quarter of 2009 and consist of private placement securities purchased as Mission Related Investments under the Rural America Bond Program approved by the Farm Credit Administration. The Association performs periodic credit reviews, including other-than-temporary impairment analysis, on its investment securities portfolio. The objective is to quantify any future possible loss of principal or interest due on each security identified for additional analysis. Based on the results of all analyses, the Association has not recognized any other-than-temporary impairment in connection with these investments. The Association has the ability and intent to hold these investments until maturity and at this time expects to collect the full principal amount and interest due on these securities. All securities continue to perform and are in an unrealized gain position at September 30, 2009.

NOTE 3 – ALLOWANCE FOR LOAN LOSSES AND IMPAIRED LOANS

An analysis of the allowance for loan losses follows:

| | For the nine months ended September 30, | |
|---|--|-----------------|
| | 2009 | 2008 |
| Balance at beginning of period | \$ 5,986 | \$ 3,993 |
| Provision for (reversal of) loan losses | 4,016 | 615 |
| Charge-offs | (2,121) | (34) |
| Recoveries | 44 | 10 |
| Balance at end of period | <u>\$ 7,925</u> | <u>\$ 4,584</u> |

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

| | 2009 | 2008 |
|--|-----------------|---------------|
| Impaired loans with related allowance | \$12,323 | \$ 723 |
| Impaired loans with no related allowance | 11,951 | 1,517 |
| Total impaired loans | <u>24,274</u> | <u>2,240</u> |
| Allowance on impaired loans | <u>\$ 4,692</u> | <u>\$ 633</u> |

The following table summarizes impaired loan information for the nine months ended September 30,

| | 2009 | 2008 |
|--|-------------|-------------|
| Average impaired loans | \$ 12,924 | \$ 4,830 |
| Interest income recognized on impaired loans | 285 | 512 |

NOTE 4 – EMPLOYEE BENEFIT PLANS

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

| | For the nine months ended September 30, | |
|-------------------------------|--|---------------|
| | 2009 | 2008 |
| Pension | \$ 1,389 | \$ 290 |
| 401(k) | 148 | 136 |
| Other postretirement benefits | 270 | 255 |
| Total | <u>\$ 1,807</u> | <u>\$ 681</u> |

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

| | Actual YTD Through 9/30/09 | Projected Contributions For Remainder of 2009 | Projected Total Contributions 2009 |
|-------------------------------|-----------------------------------|--|---|
| | Pension | \$ 21 | \$ 7 |
| Other postretirement benefits | 201 | 81 | 282 |
| Total | <u>\$ 222</u> | <u>\$ 88</u> | <u>\$ 310</u> |

As of September 30, 2009, no contributions have been made for 2009 by the Association to the qualified District pension plan in which the Association participates. Actuarial calculations as of the last plan measurement date (December 31, 2008) projected total contributions of \$52.0 million to the qualified District pension plan for all participating institutions for 2009. The funding policy for this plan is to fund the accumulated benefit obligation (ABO) service cost plus the seven year amortization of the unfunded ABO using the discount rate determined as of December 31st of the preceding year. This aggregate contribution will be allocated to the participating District institutions, including the Association, based upon each institution's pro rata share of ABO service cost. 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 5 – FAIR VALUE MEASUREMENT

Effective January 1, 2008, the Association adopted FASB guidance on fair value measurements. This guidance 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.

This guidance 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.

This guidance 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 September 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 September 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 September 30, 2009 include impaired loans which represent the fair value of certain loans that were evaluated for impairment under FASB guidance. 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 market conditions, specific issues relating to the collateral and other matters. As a result, these fair value measurements fall within Level 3 of the hierarchy. When the value of the collateral, less estimated costs to sell, is less than the principal balance of the loan, a specific reserve is established. Other property owned is classified as a level 3 asset at September 30, 2009. The fair value for other property owned is based upon the collateral less estimated costs to sell. Level 3 liabilities at September 30, 2009 include standby letters of credit whose market value is internally calculated based on information that is not observable either directly or indirectly in the marketplace.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following table presents the assets and liabilities that are measured at fair value on a recurring basis at September 30, 2009 for each of the fair value hierarchy levels:

| | September 30, 2009 | | | Total |
|----------------------------|--------------------|---------|---------|------------|
| | Level 1 | Level 2 | Level 3 | Fair Value |
| Assets: | | | | |
| Assets held in trust funds | \$ 166 | \$ - | \$ - | \$ 166 |
| Total Assets | \$ 166 | \$ - | \$ - | \$ 166 |
| Liabilities: | | | | |
| Standby letters of credit | \$ - | \$ - | \$ 109 | \$ 109 |
| Total Liabilities | \$ - | \$ - | \$ 109 | \$ 109 |

The following table presents the changes in Level 3 assets and liabilities measured at fair value on a recurring basis:

| | Standby Letters Of Credit |
|---|--|
| Balance at January 1, 2009 | \$ 127 |
| Total gains or (losses) realized/unrealized: | |
| Included in earnings | - |
| Included in other comprehensive loss | - |
| Purchases, sales, issuances and settlements, net | (18) |
| Transfers in and/or out of level 3 | - |
| Balance at September 30, 2009 | <u>\$ 109</u> |

Assets and Liabilities Measured at Fair Value on a Non-recurring Basis

Assets and liabilities measured at fair value on a non-recurring basis at September 30, 2009 for each of the fair value hierarchy values are summarized below:

| | September 30, 2009 | | | | YTD Total Gains (Losses) |
|----------------------|--------------------|------------|------------|------------------------|-----------------------------------|
| | Level 1 | Level 2 | Level 3 | Total Fair Value | |
| Assets: | | | | | |
| Impaired loans | \$ - | \$ - | \$ 7,631 | \$ 7,631 | \$ (3,575) |
| Other property owned | \$ - | \$ - | \$ 357 | \$ 357 | \$ 9 |

NOTE 6 — DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS

The following table presents the carrying amounts and fair values of the Association's financial instruments at September 30, 2009.

Quoted market prices are generally not available for certain System financial instruments, as described below. Accordingly fair values are based on judgments regarding anticipated cash flows, future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates involve uncertainties and matters of judgment, and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

The estimated fair values of the Association's financial instruments are as follows:

| | September 30, 2009 | |
|---|--------------------|-------------------------|
| | Carrying Amount | Estimated Fair Value |
| Financial assets: | | |
| Cash | \$ 3,094 | \$ 3,094 |
| Loans, net of allowance | \$ 755,509 | \$ 780,825 |
| Investment Securities | \$ 6,200 | \$ 7,594 |
| Tobacco Buyout SIIC | \$ 24,387 | \$ 26,453 |
| Assets held in trust funds | \$ 166 | \$ 166 |
| Financial liabilities: | | |
| Notes payable to AgFirst Farm Credit Bank | \$ 699,186 | \$ 713,059 |

A description of the methods and assumptions used to estimate the fair value of each class of the Association's financial instruments for which it is practicable to estimate that value follows:

- A. **Cash:** The carrying value is a reasonable estimate of fair value.
- B. **Loans:** Because no active market exists for the Association's loans, fair value is estimated by discounting the expected future cash flows using the Association's current interest rates at which similar loans would be made to borrowers with similar credit risk. As the discount rates are based on the Bank's loan rates, as well as management estimates, management has no basis to determine whether the fair values presented would be indicative of the value negotiated in an actual sale.

For purposes of determining fair value of accruing loans, the loan portfolio is segregated into pools of loans with homogeneous characteristics based upon repricing and credit risk. Expected future cash flows and interest rates reflecting appropriate credit risk are separately determined for each individual pool.

Fair value of loans in a nonaccrual status is estimated to be the carrying amount less specific reserves.

The carrying value of accrued interest approximates its fair value.
- C. **Investment in AgFirst Farm Credit Bank:** Estimating the fair value of the Association's investment in the Bank is not practicable because the stock is not traded. The net investment is a requirement of borrowing from the Bank and is carried at cost plus allocated equities in the accompanying Consolidated Balance Sheets. The Association owns 3.06 percent of the issued stock of the Bank as of September 30, 2009 net of any reciprocal investment. As of that date, the Bank's assets totaled

\$30.08 billion and shareholders' equity totaled \$1.60 billion. The Bank's earnings were \$194.0 million during the first nine months of 2009.

- D. **Notes Payable to AgFirst Farm Credit Bank:** The notes payable are segregated into pricing pools according to the types and terms of the loans (or other assets) which they fund. Fair value of the notes payable is estimated by discounting the anticipated cash flows of each pricing pool using the current rate that would be charged for additional borrowings. For purposes of this estimate it is assumed the cash flow on the notes is equal to the principal payments on the Association's loan receivables plus accrued interest on the notes payable. This assumption implies that earnings on the Association's interest margin are used to fund operating expenses and capital expenditures.
- E. **Commitments to Extend Credit:** The estimated market value of off-balance-sheet commitments is minimal since the committed rate approximates current rates offered for commitments with similar rate and maturity characteristics and since the related credit risk is not significant.
- F. **Tobacco Buyout SIIC:** Fair value is determined by discounting the expected future cash flows using current interest rates for similar assets.
- G. **Assets Held in Trust Funds:** See Note 5 for discussion of estimation of fair value for this instrument.
- H. **Investment Securities:** Fair value is determined by discounting the expected future cash flows using appropriate interest rates for similar assets.

NOTE 7 – SUBSEQUENT EVENTS

The Association has evaluated subsequent events and has determined there are none requiring disclosure through November 3, 2009, which is the date the financial statements were available to be issued.