

*“I know of no pursuit in which more real  
and important services can be rendered to any  
country than by improving its agriculture, its  
breed of useful animals, and other branches of  
a husbandman’s cares.”*

– GEORGE WASHINGTON



**Cape Fear**  
Farm Credit

2005 ANNUAL REPORT

RURAL AMERICA’S CUSTOMER-OWNED PARTNER

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# CAPE FEAR FARM CREDIT, ACA

# 2005 ANNUAL REPORT

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## Management

Richard A. Eason .....	Chief Executive Officer
C. Royce Edwards.....	Chief Operating Officer
Henry T. McDuffie .....	Chief Financial Officer
Michael R. Jackson .....	Chief Lending Officer
Mike Baker.....	Chief Appraiser

## Board of Directors

Ronald J. Allen.....	Chairman
Edgar V. Edens, III .....	Vice Chairman
P. R. Barker, Jr. ....	Director
William T. (Tom) Butler.....	Director
David R. Gooden .....	Director
P. Jart Hudson, Jr. ....	Director
William H. James.....	Director
Lyle R. King.....	Director
Willard Small .....	Outside Director
Harold J. Smith, Jr.....	Director
John E. Townsend.....	Director
James Lee Wilkins .....	Director
Alfred K. Wooten.....	Director

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## *Message from the Chief Executive Officer*

Cape Fear Farm Credit operates on a business model that strives for a healthy market share along with growth in loan volume, good credit quality, strong capital and above average financial results with above average distributions to our stockholders. Each year our strategic planning focuses on ways to ensure our cooperative stays on track and continues our mission...

*“To be the lender of choice to agriculture and our rural communities.”*

Our focused efforts produced the following results in 2005:

Net Income	\$15.9 Million
Return on Equity	16.75%
Growth in Net Accruing Volume	8.93%

Our strong capital position coupled with our strong 2005 financial results will enable us to distribute year 2000 surplus allocated in January 2006 in the amount of \$6.1 million.

Additionally, and more importantly, our Board has approved an estimated 2005 “all cash” patronage distribution of \$6.9 million which equals an estimated 21% of all interest earned on loans to our general pool stockholders. This will be paid in March 2006. These two actions will result in returning an estimated total of \$13.0 million to our stockholders in 2006.

As we look ahead we see challenges and opportunities. Traditional agriculture continues to consolidate. This consolidation will naturally challenge us to stay abreast of the latest market conditions to ensure we are the primary lender to our commercial farmers. Many of our commercial farmers are looking for diversification opportunities into other areas which demands we stay abreast of a wide variety of financial endeavors.

A transition is also taking place in the Cape Fear region. More and more “lifestyle” farmers are evolving providing us with new opportunities to serve our young and beginning farmer clientele. This customer group includes those involved in producing specialty crops, part time farmers and opportunities to finance farms to be used for recreational uses such as equine, hunting and fishing.

We expect vigorous competition in the future for all segments of our business. Because of our cooperative business model which includes returning our profits to our borrowers along with excellent employees who are committed to serving agriculture and rural customers in the Cape Fear region we are confident our success will continue.

Cape Fear Farm Credit will continue to strive for maximum efficiency and effectiveness while at the same time providing the very best in customer service to our stockholders.



Richard A. Eason  
Chief Executive Officer

March 1, 2006

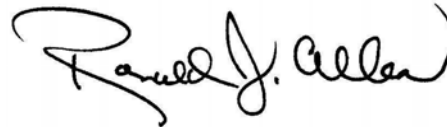
## *Report of Management*

The accompanying consolidated financial statements and related financial information appearing throughout this annual report have been prepared by management of Cape Fear Farm Credit, ACA (the Association) in accordance with generally accepted accounting principles appropriate in the circumstances. Amounts which must be based on estimates represent the best estimates and judgments of management. Management is responsible for the integrity, objectivity, consistency, and fair presentation of the consolidated financial statements and financial information contained in this report.

Management maintains and depends upon an internal accounting control system designed to provide reasonable assurance that transactions are properly authorized and recorded, that the financial records are reliable as the basis for the preparation of all financial statements, and that the assets of the Association are safeguarded. The design and implementation of all systems of internal control are based on judgments required to evaluate the costs of controls in relation to the expected benefits and to determine the appropriate balance between these costs and benefits. The Association maintains an internal audit program to monitor compliance with the systems of internal accounting control. Audits of the accounting records, accounting systems and internal controls are performed and internal audit reports, including appropriate recommendations for improvement, are submitted to the Board of Directors.

The consolidated financial statements have been examined by independent public auditors, whose report appears elsewhere in this annual report. The Association is also subject to examination by the Farm Credit Administration.

The consolidated financial statements, in the opinion of management, fairly present the financial condition of the Association. The undersigned certify that the 2005 Annual Report has been prepared 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.



Ronald J. Allen  
Chairman of the Board



Richard A. Eason  
Chief Executive Officer



Henry T. McDuffie  
Chief Financial Officer

March 1, 2006

## *Consolidated Five - Year Summary of Selected Financial Data*

(UNAUDITED)

<i>(dollars in thousands)</i>	2005	2004	December 31, 2003	2002	2001
<b>Balance Sheet Data</b>					
Cash	\$ 2,610	\$ 2,052	\$ 1,835	\$ 1,065	\$ 1,970
Loans	519,198	476,220	483,873	470,985	440,495
Less: allowance for loan losses	3,434	3,507	9,993	10,093	10,112
Net loans	515,764	472,713	473,880	460,892	430,383
Investment in other Farm Credit institutions	5,674	6,009	6,436	7,626	10,121
Other assets	38,717	20,870	14,310	14,774	16,714
Total assets	<u>\$ 562,765</u>	<u>\$ 501,644</u>	<u>\$ 496,461</u>	<u>\$ 484,357</u>	<u>\$ 459,188</u>
Notes payable to AgFirst Farm Credit Bank*	\$ 447,981	\$ 393,652	\$ 400,460	\$ 394,874	\$ 373,450
Accrued interest payable and other liabilities with maturities of less than one year	18,462	14,371	15,395	11,634	7,337
Total liabilities	<u>466,443</u>	<u>408,023</u>	<u>415,855</u>	<u>406,508</u>	<u>380,787</u>
Protected borrower equity	269	354	489	669	859
Capital stock and participation certificates	2,154	2,114	2,057	2,065	2,059
Retained earnings					
Allocated	22,035	28,250	35,025	37,208	37,553
Unallocated	72,268	63,302	47,532	42,778	37,930
Accumulated other comprehensive income (loss)	(404)	(399)	(4,497)	(4,871)	—
Total members' equity	<u>96,322</u>	<u>93,621</u>	<u>80,606</u>	<u>77,849</u>	<u>78,401</u>
Total liabilities and members' equity	<u>\$ 562,765</u>	<u>\$ 501,644</u>	<u>\$ 496,461</u>	<u>\$ 484,357</u>	<u>\$ 459,188</u>
<b>Statement of Income Data</b>					
Net interest income	\$ 16,747	\$ 15,160	\$ 14,539	\$ 13,852	\$ 14,172
Provision for (reversal of allowance for) loan losses	(65)	(6,497)	—	—	—
Noninterest income (expense), net	(937)	(533)	(2,137)	(820)	(956)
Net income	<u>\$ 15,875</u>	<u>\$ 21,124</u>	<u>\$ 12,402</u>	<u>\$ 13,032</u>	<u>\$ 13,216</u>
<b>Key Financial Ratios</b>					
Rate of return on average:					
Total assets	3.02%	4.27%	2.51%	2.79%	2.86%
Total members' equity	16.75%	26.01%	16.00%	16.59%	17.85%
Net interest income as a percentage of average earning assets	3.34%	3.13%	3.01%	3.07%	3.19%
Net chargeoffs (recoveries) to average loans	0.001%	(0.002)%	0.021%	0.004%	0.01%
Total members' equity to total assets	17.12%	18.66%	16.24%	16.07%	17.07%
Debt to members' equity (:1)	4.84	4.36	5.16	5.22	4.86
Allowance for loan losses to loans	0.66%	0.74%	2.07%	2.14%	2.30%
Permanent capital ratio	16.95%	16.95%	15.81%	15.28%	14.81%
Total surplus ratio	16.55%	16.58%	15.37%	14.82%	14.34%
Core surplus ratio	13.24%	12.73%	11.36%	10.51%	9.86%
<b>Net Income Distribution</b>					
Estimated patronage refunds:					
Cash dividend	\$ 6,942	\$ 5,413	\$ 2,860	\$ 2,287	\$ 2,414
Qualified allocated retained earnings	—	—	304	177	5,016
Nonqualified allocated retained earnings	—	—	3,986	5,159	616

\* General financing agreement is renewable on three-year cycles. The next renewal date is December 31, 2006.

# Management's Discussion & Analysis of Financial Condition & Results of Operations

(dollars in thousands, except as noted)

## GENERAL OVERVIEW

The following commentary summarizes the financial condition and results of operations of Cape Fear Farm Credit, ACA, (Association) for the year ended December 31, 2005 with comparisons to the years ended December 31, 2004, and December 31, 2003. This information should be read in conjunction with the Consolidated Financial Statements, Notes to the Consolidated Financial Statements and other sections in this Annual Report.

The Association is an institution of the Farm Credit System, (System), which was created by Congress in 1916 and has served agricultural producers for almost 90 years. The System mission is to maintain and improve the financial well being of American farmers, ranchers, and producers or harvesters of aquatic products and farm-related businesses. The System is the largest agricultural lending organization in the United States. The System is regulated by the Farm Credit Administration (FCA), which is an independent safety and soundness regulator.

The Association is a cooperative, which is owned by the members served. The territory of the Association extends across a diverse agricultural region of southeastern North Carolina. Refer to Note 1, "Organization and Operations", of the Notes to the Consolidated Financial Statements for counties in the Association's territory. The Association provides credit to farmers, ranchers, rural residents, and agribusinesses. Our success begins with our extensive agricultural experience and knowledge of the market.

The Association obtains funding from AgFirst Farm Credit Bank (Bank). The Association is materially affected by the financial condition and results of operations of the Bank. Copies of the AgFirst Farm Credit Bank's Quarterly and Annual Reports are on the AgFirst website, [www.agfirst.com](http://www.agfirst.com) or may be obtained at no charge by calling 1-800-845-1745, extension 378, or writing Jay Wise, AgFirst Farm Credit Bank, P. O. Box 1499, Columbia, SC 29202. Copies of the Association's quarterly reports are available on the Association's website, [www.capefearfarmcredit.com](http://www.capefearfarmcredit.com), or may be obtained upon request free of charge by calling 1-800-368-5819 or writing Henry McDuffie, Chief Financial Officer, Cape Fear Farm Credit, ACA, Post Office Box 2405, Fayetteville, NC 28302.

## CRITICAL ACCOUNTING POLICIES

The financial statements are reported in conformity with accounting principles generally accepted in the United States of America. We consider our significant accounting policies to be critical to the understanding of our results of operations and financial position because some accounting policies require us to make complex or subjective judgments and estimates that may affect the value of certain assets or liabilities. These policies are considered critical because we have to make judgments about matters that are inherently uncertain. For a complete discussion of significant accounting policies, see Note 2, "Summary of Significant Accounting Policies", of the Notes to the Consolidated Financial Statements. The following is a summary of certain critical policies.

- *Allowance for loan losses* — The allowance for loan losses is management's best estimate of the amount of probable losses inherent in its loan portfolio. The allowance for loan losses is increased through provisions for loan losses and loan recoveries and is decreased through allowance reversals and loan charge-offs. The allowance for loan losses is determined based on a periodic evaluation of the loan portfolio, which generally considers types of loans, credit quality, specific industry conditions, general economic and political conditions, and changes in the character, composition, and performance of the portfolio, among other factors.

Significant individual loans are evaluated based on the borrower's overall financial condition, resources, and payment record, the prospects for support from any financially responsible guarantor, and, if appropriate, the estimated net realizable value of any collateral. The allowance for loan losses attributable to these loans is established by a process that estimates the probable loss inherent in the loans, taking into account various historical and projected factors, internal risk ratings, regulatory oversight, geographic, industry and other factors.

Changes in the factors considered by management in the evaluation of losses in the loan portfolios could result in a change in the allowance for loan losses and could have a direct impact on the provision for loan losses and the results of operations.

- *Valuation methodologies* — Management applies various valuation methodologies to assets and liabilities that often involve a significant degree of judgment, particularly when liquid markets do not exist for the particular items being valued. Quoted market prices are referred to when estimating fair values for certain assets for which an observable liquid market exists, such as most investment securities. Management utilizes significant estimates and assumptions to value items for which an observable liquid market does not exist. Examples of these items include impaired loans, pension and other postretirement benefit obligations, and certain other financial instruments. These valuations require the use of various assumptions, including, among others, discount rates, rates of return on assets, repayment rates, cash flows, default rates, costs of servicing and liquidation values. The use of different assumptions could produce significantly different results, which could have material positive or negative effects on the Association's results of operations.

## ECONOMIC CONDITIONS

During 2005, Association members had a good crop year. Although some crop yields were down, overall, yields were above normal. Net income will be increased through government payments. As always, some farmers experienced more difficulties. The association anticipates, however, a limited number of difficult loans.

The nation's farmers, as a whole, will continue to face challenges over the next few years. The economy, the need for increased export of commodities, and global competition are key to agriculture's financial performance. Local areas of concern include environmental issues as they relate to livestock operations, current uncertainties as a result of the tobacco buyout, and as always, pockets of unfavorable growing conditions. While some individual members may experience financial stress, overall, the outlook remains cautiously optimistic.

During 2005, the Association targeted certain segments of our business with hopes of increasing market share. Continued efforts are being made to expand services, increase public knowledge of our services and streamline our current delivery of products to enhance our existing portfolio.

### TOBACCO BUYOUT PROGRAM

On October 22, 2004, Congress enacted the "Fair and Equitable Tobacco Reform Act of 2004" (Tobacco Act) as part of the "American Jobs Creation Act of 2004." The Tobacco Act repealed the Federal tobacco price support and quota programs, provides for payments to tobacco "quota owners" and producers for the elimination of the quota, and provides an assessment mechanism for tobacco manufacturers and importers to pay for the buyout. Tobacco quota holders and producers will receive 10 years of equal payments under a contract with the Secretary of Agriculture. The Tobacco Act also includes a provision that allows the quota holders and producers to assign or sell to a "financial institution" the right to receive the contract payments so that they may obtain a lump sum or other payment. On April 4, 2005, the United States Department of Agriculture (USDA) issued a Final Rule implementing the "Tobacco Transition Payment Program" (Tobacco Buyout).

The FCA determined that System institutions are "financial institutions" within the meaning of the Tobacco Act and are therefore eligible to participate in the Tobacco Buyout. FCA recognized that the Tobacco Buyout has significant implications for some System institutions and the tobacco quota holders and producers they serve. The FCA's goal is to provide System institution borrowers with the option to immediately receive Tobacco Buyout contract payments and reinvest them in future business opportunities.

For the year ended December 31, 2005, the Association had loan assignments for Tobacco Buyout borrowers and also incurred commitments to acquire Successor-in-Interest Contracts (SIIC), which started in the fourth quarter 2005. As of December 31, 2005, the Association had loan assignments of \$2,014 and SIIC of \$15,367. The loan assignments are included with Loans on the Consolidated Balance Sheets. SIIC is presented as Other Investments.

### RURAL AMERICA BONDS

In October, 2005, FCA approved a Rural America Bonds investment program for the Bank and it related associations. This investment program is consistent with the stated objectives of FCA's January 11, 2005, Informational Memorandum regarding pilot investment programs that support the financing needs of agriculture and rural America. The objectives of these pilot programs are to enable System institutions to better meet the changing financing needs of agricultural enterprises, agribusinesses, and rural communities by creating an additional source of dependable, affordable, and flexible financing through investments and partnerships. As indicated in the proposal, in recognition of the economic interdependence between agricultural and rural communities, AgFirst institutions seek to

safely and soundly invest in debt obligations that support farmers, ranchers, agribusinesses, and their rural communities and businesses. In doing so, AgFirst institutions hope to increase the well-being and prosperity of American farmers, ranchers, and rural areas and residents.

### 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 through numerous product types.

The gross loan volume of the Association as of December 31, 2005, was \$519,198, an increase of \$42,978 or 9.02 percent as compared to \$476,220 at December 31, 2004 and an increase of \$35,325 or 7.31 percent as compared to \$483,873 at December 31, 2003. Net loans outstanding (gross loans net of the allowance for loan losses) on December 31, 2005, were \$515,764 as compared to \$472,713 at December 31, 2004 and \$473,880 at December 31, 2003. Net loans accounted for 91.65 percent of total assets on December 31, 2005 as compared to 94.23 percent of total assets at December 31, 2004 and 95.45 percent of total assets at December 31, 2003.

The diversification of the Association loan volume by type for each of the past three years is shown below. See Note 4, "Loans and Allowance for Loan Losses" of the Notes to the Consolidated Financial Statements, for the loans outstanding amounts.

Loan Type	12/31/05	12/31/04	12/31/03
Production agriculture:			
Real estate mortgage	37.32%	42.58%	70.40%
Production and intermediate term	54.32	52.82	27.05
Agribusiness:			
Loans to cooperatives	0.13		
Processing and marketing	3.20	2.23	0.68
Farm related business	3.45	1.33	0.64
Energy	0.28		
Rural residential real estate	1.30	1.04	1.23
Total	100.00%	100.00%	100.00%

The following table presents the contractual maturity distribution of loans at December 31, 2005:

Loan Type	Due in 1 year or less	Due after		Total
		1 year through 5 years	5 years	
Production agriculture:				
Real estate mortgage	\$ 2,511	\$ 60,752	\$ 130,474	\$ 193,737
Production and intermediate term	71,211	80,761	130,026	281,998
Agribusiness:				
Loans to cooperatives	636	51	5	692
Processing and marketing	8,610	2,877	5,149	16,636
Farm related business	6,348	2,560	8,994	17,902
Energy	1,462			1,462
Rural residential real estate	1,219	759	4,793	6,771
Total	\$ 91,998	\$ 147,760	\$ 279,440	\$ 519,198

While we make loans and provide financially related services to qualified borrowers in the agricultural and rural sectors and to certain related entities, our loan portfolio is diversified. The following tables reflect the commodities financed and the geographic locations served.

The geographic distribution of the loans by branch for the past three years is as follows:

<b>Branch</b>	<b>12/31/05</b>	<b>12/31/04</b>	<b>12/31/03</b>
Burgaw	4.33%	5.22%	5.67%
Clinton	12.26	12.54	11.82
Dunn	6.04	5.29	4.58
Elizabethtown	10.23	10.35	10.22
Fayetteville	4.07	3.57	2.59
Kenansville	19.48	18.22	18.54
Laurinburg	2.63	2.30	2.05
Lillington	8.01	8.75	8.71
Lumberton	10.27	10.10	10.22
Raeford	2.37	2.75	2.50
Shalotte	1.76	2.21	2.02
Whiteville	3.91	4.29	4.16
Commercial Loan Division	14.33	14.08	16.60
Special Asset Management	.31	.33	.32
<b>Total</b>	<b>100.00%</b>	<b>100.00%</b>	<b>100.00%</b>

Commodity and industry categories are based upon the Standard Industrial Classification system published by the federal government. The system is used to assign commodity or industry categories based upon the largest agricultural commodity of the customer

The Association's loan portfolio is diversified over a range of agricultural commodities in our region as shown in the table below. Predominant commodities in the portfolio are swine, poultry, and tobacco that constitute over 74 percent of the entire portfolio

<b>Commodity Group</b>	<b>Percent of Portfolio</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
Swine	41%	44%	42%
Poultry	22	19	18
Tobacco	11	13	13
Row Crops	7	7	6
Field/Grain	1	1	1
Rural Home	1	1	1
Other	17	15	19
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

Repayment ability is closely related to the commodities produced by our borrowers, and increasingly, the off-farm income of borrowers. The Association's loan portfolio contains a concentration of swine, poultry, and tobacco producers. Although a large percentage of the loan portfolio is concentrated in these enterprises, many of these operations are diversified within their enterprise and/or with crop production that reduces overall risk exposure. Demand for pork and poultry, the return of tobacco to a free market structure, and international trade are some of the factors affecting the price of these commodities. Even though the concentration of large loans has increased over the past several years, the agricultural enterprise mix of these loans is diversified and similar to that of the overall portfolio. The risk in the portfolio associated with commodity concentration and large loans is reduced by the range of diversity of enterprises in the Association's territory.

The increase in gross and net loan volume during the reporting period is primarily attributed to increased demand for credit in the general loan portfolio including general expansion of farming operations. In addition to normal business, the association is experiencing increased demand for poultry facility loans. Also, there is increased interest in intermediate-term loans for equipment purchases.

For the past few years, the Association has experienced a shift in loan assets. The long-term volume trend has been downward while the short and intermediate-term loan volume trend is upward. The short-term portfolio, which is heavily influenced by operating-type loans, normally reaches a peak balance in August and rapidly declines in the fall months as commodities are marketed and proceeds are applied to repay operating loans.

During 2005, the Association continued activity in the buying and selling of loan participations within and outside of the Farm Credit System (FCS). This provides a means for the Association to spread credit concentration risk and realize non-patronage sourced interest and fee income, which may strengthen the capital position.

<b>Loan Participations</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
Participations Purchased			
– FCS Institutions	\$ 28,714	\$ 20,906	\$ 32,704
Participations Purchased			
– Non-FCS Institutions	15,964	30,507	31,886
Participations Sold	(190,614)	(218,692)	(224,839)
<b>Total</b>	<b>\$(145,936)</b>	<b>\$(167,279)</b>	<b>\$(160,249)</b>

In prior years, the Association originated and sold qualified long-term mortgage loans into the secondary market. Beginning in 2004, all qualified long-term mortgage loans originated for sale into the secondary market were originated on a fee basis on behalf of Carolina Farm Credit. For the year ended December 31, 2005, the Association originated no loans under Cape Fear Farm Credit which were sold into the secondary market, compared to \$5,042 in the previous year.

The association additionally purchased guaranteed portions of loans that are guaranteed by the United States Department of Agriculture. These loans are held for the purposes of reducing interest rate risk and managing surplus short-term funds as allowable under FCA regulations. At December 31, 2005, the balance of these loans including unamortized premium was \$2,754 compared to \$3,957 at December 31, 2004.

**RISK EXPOSURE**

Credit risk arises from the potential inability of an obligor to meet its repayment obligation. As a part of a system to evaluate the success of a loan, the Association continues to review the credit quality of the loan portfolio on an ongoing basis. With the approval of the Association Board of Directors, the Association establishes underwriting standards and lending policies that provide direction to loan officers. Underwriting standards include, among other things, an evaluation of:

- Character – borrower integrity and credit history
- Capacity – repayment capacity of the borrower based on cash flows from operations or other sources of income
- Collateral – protects the lender in the event of default and represents a potential secondary source of repayment
- Capital – ability of the operation to survive unanticipated risks
- Conditions – intended use of the loan funds

The credit risk management process begins with an analysis of the borrower's credit history, repayment capacity, and financial position. Repayment capacity focuses on the borrower's ability to repay the loan based upon cash flows from operations or other sources of income, including non-farm income. Long-term real estate loans must be secured by first liens on the real estate (collateral). As required by regulation, each institution that makes loans on a secured basis must have collateral evaluation policies and procedures. Appraisals are required for all long term loans and all

loans of more than \$1 million. In addition, each loan is assigned a credit risk weighting based upon the underwriting standards. This credit risk rating process incorporates objective and subjective criteria to identify inherent strengths, weaknesses, and risks in a particular relationship.

The Association's loan portfolio is divided into performing and high-risk categories. As a part of a system to evaluate the success of a loan, the Association continues to review the credit quality of the loan portfolio on an ongoing basis. A Special Assets Management Department is responsible for servicing loans classified as high-risk. The high-risk assets, including accrued interest, are detailed below:

	12/31/05	12/31/04	12/31/03
<b>High-risk Assets</b>			
Nonaccrual loans	\$ 1,997	\$ 1,399	\$ 1,370
Restructured loans	95	339	334
Accruing loans 90 days past due	—	—	—
Total high-risk loans	2,092	1,738	1,704
Other property owned	—	—	—
Total high-risk assets	\$ 2,092	\$ 1,738	\$ 1,704
<b>Ratios</b>			
Nonaccrual loans to total loans	.38%	.29%	.28%
High-risk assets to total assets	.37%	.35%	.34%

Nonaccrual loans represent all loans where there is a reasonable doubt as to the collection of principal and/or interest under the contractual terms of the loan. Nonaccrual loans increased \$598 or 42.74 percent in 2005. This increase resulted from normal actions associated with loan repayment problems and results primarily from one individual credit transferred to nonaccrual status. Of the \$1,997 in nonaccrual volume at December 31, 2005, \$394 or 19.71 percent, compared to 44.41 percent at December 31, 2004 was current as to scheduled principal and interest payments, but did not meet all regulatory requirements to be transferred into accrual status.

Loan restructuring is available to financially distressed borrowers. Restructuring of loans occurs when the Association grants a concession to a borrower based on either a court order or good faith in a borrower's ability to return to financial viability. The concessions can be in the form of a modification of terms or rates, a compromise of amounts owed, or deed in lieu of foreclosure. Other receipts of assets and/or equity to pay the loan in full or in part are also considered restructured loans. The type of alternative financing structure chosen is based on minimizing the loss incurred by both the Association and the borrower.

### Credit Quality

We review the credit quality of the loan portfolio on an on-going basis as part of our risk management practices. Each loan is classified according to the Uniform Classification System, which is used by all Farm Credit System institutions. Below are the classification definitions.

- Acceptable – Assets are expected to be fully collectible and represent the highest quality.
- Other Assets Especially Mentioned (OAEM) – Assets are currently collectible but exhibit some potential weakness.
- Substandard – Assets exhibit some serious weakness in repayment capacity, equity, and/or collateral pledged on the loan.
- Doubtful – Assets exhibit similar weaknesses to substandard assets. However, doubtful assets have additional weaknesses in existing facts, conditions and values that make collection in full highly questionable.
- Loss – Assets are considered uncollectible.

The following table presents selected statistics related to the credit quality of loans including accrued interest at December 31, 2005.

Credit Quality	2005	2004	2003
Acceptable & OAEM	99.09%	99.03%	98.97%
Substandard	0.91	0.97	1.02
Doubtful	—	—	0.01
Loss	—	—	—
Total	100.00%	100.00%	100.00%

### ALLOWANCE FOR LOAN LOSSES

During 2004, the Association completed its study to further refine the allowance for loan losses methodology taking into account recently issued guidance by the FCA, the System's regulator, as well as the Securities and Exchange Commission (SEC) and Federal Financial Institutions Examination Council. As a result of this study and the resulting refinements in methodology, during the fourth quarter of 2004, the Association recorded a \$6,497 reversal of the allowance for loan losses.

The Association's allowance for loan losses methodology was adjusted and revised in the late 1980s to take into account the credit losses experienced in the mid-to-late 1980s, as a result of unusually adverse economic factors affecting American agriculture. Given the long cyclical nature of the agricultural economy, loss factors utilized to determine the allowance for loan losses subsequent to 1989 continued to reflect, to some extent, the loss history of the mid-to-late 1980s, which resulted in conservative estimates of the allowance for loan losses. The Association's allowance for loan losses methodology utilized throughout the period was in accordance with generally accepted accounting principles and was consistently applied.

While conservative in estimating the allowance for loan losses, the methodology used resulted in annual provisions for loan losses over the periods that reflected changes in credit quality and loss experience. Accordingly, the reserves provided in the mid-to-late 1980s have, in effect, remained part of the allowance for loan losses. The Association's conservative approach to calculating the allowance for loan losses was supported by the FCA in its role as a "safety and soundness" regulator.

In April 2004, the FCA issued an "Informational Memorandum" to System institutions regarding the criteria and methodologies that should be used in evaluating the adequacy of a System institution's allowance for loan losses. The Farm Credit Administration endorsed the direction provided by other regulatory agencies and indicated the conceptual framework addressed in this guidance would be included as part of their examination process.

The refinement in methodology resulted in calculated allowance for loan losses that was significantly less than the previously recorded balance due to revised loss factors that are more indicative of actual loss experience in recent years and current borrower analysis. The factors considered in determining the revised level of allowance for loan losses were generally based on recent historical charge-off experience adjusted for relevant environmental factors. The Association considered the following when adjusting the historical charge-offs experience:

- changes in credit risk classifications,
- changes in collateral values,
- changes in risk concentrations,
- changes in weather related conditions, and
- changes in economic conditions.

While the reversal had a significant impact on 2004 results of operations and the previously recorded allowance for loan losses, the refinement in methodology is not expected to have a significant impact on comparative results of operations in future periods. Additionally, the refinement in methodology did not have a significant impact on the level of the risk bearing capacity of the Association, generally referred to as "risk funds" (capital plus the allowance for loan losses), which totaled \$99,756 at December 31, 2005 (19.21 percent of Association loans), as compared with \$97,128 at December 31, 2004 (20.40 percent of Association loans).

The allowance for loan losses at each period end was considered by Association management to be adequate to absorb probable losses existing in and inherent to its loan portfolio. Management's evaluations consider factors including loan loss experience, portfolio quality, loan portfolio composition, current agricultural production conditions and economic conditions. The allowance for loan losses was \$3,434 at December 31, 2005, as compared with \$3,507 and \$9,993 at December 31, 2004 and 2003, respectively.

Net loan charge-offs of \$8 and \$100 were recorded in 2005 and 2003 respectively, while net loan recoveries of \$11 were recorded in 2004. Net loan charge-offs (recoveries) as a percentage of average loans remained at low levels of 0.001 percent, (0.002) percent, and 0.021 percent for 2005, 2004 and 2003, respectively. The net loan charge-offs were primarily associated with liquidation of nonaccrual loans through sale of assets at values below outstanding nonaccrual balances.

The following table presents the activity in the allowance for loan losses for the most recent three years:

<b>Allowance for Loan Loss Activity</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
Balance at beginning of year	\$ 3,507	\$ 9,993	\$ 10,093
Provision for (reversal of allowance for) loan losses	(65)	-	-
Nonrecurring reversal of allowance for loan losses *	-	(6,497)	-
Charge-offs			
Production agriculture:			
Production and intermediate term	21	-	160
Total charge-offs	21	-	160
Recoveries			
Production agriculture:			
Real estate mortgage	-	(11)	-
Production and intermediate term	(13)	-	(60)
Total recoveries	(13)	(11)	(60)
Net charge-offs (recoveries)	8	(11)	100
Balance at end of year	<u>\$ 3,434</u>	<u>\$ 3,507</u>	<u>\$ 9,993</u>
Ratio of net charge-offs during the period to average loans outstanding during the period	.001%	(.002)%	.021%

\* Represents the amount of allowance reversal due to the change in methodology.

The allowance for loan losses by loan type for the most recent three years is as follows:

<b>Allowance for Loan Losses by Type</b>	<b>December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
Production agriculture:			
Real estate mortgage	\$ 1,457	\$ 1,480	\$ 7,045
Production and intermediate term	1,770	1,820	2,698
Agribusiness:	157	157	130
Energy	12	12	-
Rural residential real estate	38	38	120
Total loans	<u>\$ 3,434</u>	<u>\$ 3,507</u>	<u>\$ 9,993</u>

The allowance for loan losses as a percentage of loans outstanding and as a percentage of certain other credit quality indicators is shown below:

<b>Allowance for Loan Losses as a Percentage of:</b>	<b>2005</b>	<b>December 31, 2004</b>	<b>2003</b>
Total loans	.66%	.74%	2.07%
Nonperforming loans	164%	202%	586%
Nonaccrual loans	172%	251%	729%

The financial positions of our borrowers have generally strengthened during the past decade as farmers' net cash income has been at a favorable level due, in part, to direct federal government payments and steady increases in land values over the period. With borrowers' strengthened financial positions and the continued emphasis on sound underwriting standards, the credit quality of our loan portfolio has remained healthy. Please refer to Note 4, "Loans and Allowance for Loan Losses", in the Notes to the Consolidated Financial Statements, for further information concerning the allowance for loan losses.

#### EMPLOYEE RETIREMENT PLANS

For the years ended December 31, 2005 and 2004, the Association contributed \$1,008 and \$4,196, respectively, to the District-wide defined benefit retirement plan. The District-wide funding brings the retirement plan's assets to an amount exceeding the accumulated benefit obligation. The contributions in 2004 eliminated the minimum pension liability. Assuming that interest rates and returns on investments remain relatively constant, benefits to the Association in subsequent periods should include improved net income due to lower retirement expense and the elimination of the pension-related change in accumulated other comprehensive income in the members' equity.

The Association also has a non-qualified supplemental retirement benefit plan for certain key employees. Weaker investment performance by the retirement plan assets and lower discount rates have resulted in an under-funded status for the non-qualified plan. Since the fund assets are owned by the Association, full funding as accomplished with the District-wide benefit plan was not possible. Therefore, the Association reflects an accumulated other comprehensive income adjustment of \$(404), the funding of which will be amortized over coming years.

See Note 11, "Employee Benefit Plans", in the Notes to the Consolidated Financial Statements of this report for further information.

**RESULTS OF OPERATIONS**

Net income for the year ended December 31, 2005, totaled \$15,875, a decrease of \$5,249, or 24.8 percent, as compared to \$21,124 for the same period of 2004. This was largely due to a reversal in the provision for loan losses in 2004. Interest income for the year ended December 31, 2005, was \$35,710, an increase of \$6,776 or 23.42 percent as compared to \$28,934 for the same period of 2004. Major components of the changes in net income for the past two years are outlined in the following table.

**Changes in Net Income:**

	<b>2005-2004</b>	<b>2004-2003</b>
<b>Net income (prior year)</b>	\$ 21,124	\$ 12,402
<b>Increase (decrease) in net income due to:</b>		
Interest income	6,776	977
Interest expense	(5,189)	(356)
Net interest income	1,587	621
Provision for loan losses	(6,432)	6,497
Noninterest income	(78)	843
Noninterest expense	(20)	151
Provision for income taxes	(306)	610
Total changes in income	(5,249)	8,722
<b>Net income</b>	<b>\$ 15,875</b>	<b>\$ 21,124</b>

Net interest income increased by \$1,587, or 10.47 percent in 2005 compared to 2004. The Association's net interest income as a percentage of average earning assets was 3.34 percent on December 31, 2005, compared to 3.13 percent on December 31, 2004. The increase of net interest income and net interest income as a percentage of average earning assets is attributed to growth in loan volume and an increase in market interest rates.

Interest income on nonaccrual loans for 2005, totaled \$369 a decrease of \$233, compared to \$602 for 2004. Please refer to the Consolidated Five-Year Summary of Selected Financial Data in this Annual Report to review key financial ratios pertaining to earnings and net interest income. The sources of change in net interest income are illustrated, as follows:

**Change in Net Interest Income:**

	Volume*	Rate	Nonaccrual	
			Income	Total
<b>12/31/05 - 12/31/04</b>				
Interest income	\$ 1,035	\$ 5,974	\$ (233)	\$ 6,776
Interest expense	594	4,595	-	5,189
Change in net interest income	\$ 441	\$ 1,379	\$ (233)	\$ 1,587
<b>12/31/04 - 12/31/03</b>				
Interest income	\$ 68	\$ 482	\$ 427	\$ 977
Interest expense	(125)	481	-	356
Change in net interest income	\$ 193	\$ 1	\$ 427	\$ 621

\* Volume variances can be the result of increased/decreased loan volume or from changes in the percentage composition of assets and liabilities between periods.

A reversal of a portion of the allowance for loan losses at December 31, 2004 resulted in a negative provision of \$(6,497), compared to negative provision of \$(65) and \$0 at December 31, 2005 and 2003, respectively. Please refer to the Allowance for Loan Losses section discussed above.

**Noninterest Income**

Noninterest income for each of the three years ended December 31 are shown in the following table:

Noninterest Income	For the Year Ended			Percentage	
	December 31,			Increase/(Decrease)	
	2005	2004	2003	2005/ 2004	2004/ 2003
Loan fees	\$ 2,283	\$ 1,953	\$ 2,335	16.9%	(16.4)%
Fees for financially related services	350	385	451	(9.1)	(14.6)
Patronage refund from other Farm Credit Institutions	5,596	5,732	4,642	(2.4)	23.5
Gains (losses) from sale of other property owned (net)	8	8	9	-	(11.1)
Other noninterest income	124	361	159	(65.6)	127.0
Total noninterest income	<b>\$ 8,361</b>	<b>\$ 8,439</b>	<b>\$ 7,596</b>	<b>(0.9)%</b>	<b>11.1%</b>

Patronage refunds from other Farm Credit Institutions decreased \$136 and increased \$1,090 for the years ended December 31, 2005 and 2004, respectively. The Association received \$4,050 in a patronage refund and \$1,417 in a special distribution from the Bank for the year ended December 31, 2005, compared to \$4,118 and \$1,538 for 2004, and \$4,176 and \$466 for 2003. Loan fees increased \$330 and decreased \$52 for the period ended December 31, 2005, compared to the comparable periods in 2004 and 2003, respectively.

**Noninterest Expense**

Noninterest expense for each of the three years ended December 31 are shown in the following table:

Noninterest Expense	For the Year Ended			Percentage	
	December 31,			Increase/(Decrease)	
	2005	2004	2003	2005/ 2004	2004/ 2003
Salaries and employee benefits	\$ 6,440	\$ 6,710	\$ 6,473	(4.0)%	3.7%
Occupancy and equipment expense	747	719	796	3.9	(9.7)
Insurance Fund premium	243	235	563	3.4	(58.3)
Other operating expense	1,762	1,508	1,491	16.8	1.1
Total noninterest expense	<b>\$ 9,192</b>	<b>\$ 9,172</b>	<b>\$ 9,323</b>	<b>0.2%</b>	<b>(1.6)%</b>

Noninterest expense increased \$20 or 0.2 percent for December 31, 2005, as compared to the same period of 2004 and decreased \$131 or 1.4 percent compared to December 31, 2003. Salaries and employee benefits expense for 2005 was \$6,440 compared to \$6,710 for 2004 and \$6,473 for 2003.

The Association recorded a provision for income taxes of \$106 for the year ended December 31, 2005, as compared to a benefit of \$200 for 2004 and a provision of \$410 for 2003.

A key factor in the growth of net income for future years will be continued improvement in net interest and noninterest income. Our goal is to generate earnings sufficient to fund operations, adequately capitalize the Association, and achieve an adequate rate of return for our members. To meet this goal, the agricultural economy must continue the improvement shown in recent years and the Association must meet certain objectives. These objectives are to attract and maintain high quality loan volume priced at competitive rates and to manage credit risk in our entire portfolio, while efficiently meeting the credit needs of our members.

Key Results of Operations Comparisons	For the 12 Months Ended 12/31/05	For the 12 Months Ended 12/31/04	For the 12 Months Ended 12/31/03
Return on Average Assets	3.02%	4.27%	2.51%
Return on Average Members' Equity	16.75%	26.01%	16.00%
Net Interest Income as a Percentage of Average Earning Assets	3.34%	3.13%	3.01%
Net Chargeoffs (Recoveries) to Average Loans	0.001%	(0.002)%	0.021%

## LIQUIDITY AND FUNDING SOURCES

### Liquidity

Liquidity management is the process whereby funds are made available to meet all financial commitments including the extension of credit, payment of operating expenses and payment of debt obligations. The Association receives access to funds through its borrowing relationship with the Bank and from income generated by operations. The Association's participation in secondary market programs provides additional liquidity. Sufficient liquid funds have been available to meet all financial obligations.

### 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 Bank advances the funds to the Association, creating notes payable to the Bank. The notes payable are segmented into variable rate and fixed rate components. 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 December 31, 2005, were \$447,981 as compared to \$393,652 at December 31, 2004, and \$400,460 at December 31, 2003. The increase of 13.80 percent at December 31, 2005, over December 31, 2004, is attributable to the increase in loan volume and the increase in total capital, which affects the notes payable to the bank.

The Association had no lines of credit outstanding with third parties as of December 31, 2005.

### Funds Management

The Bank and the Association manage assets and liabilities to provide a broad range of loan products and funding options, which will permit the Association to be competitive in all interest rate environments. The primary objective of the asset/liability management process is to provide stable and rising earnings, while maintaining adequate capital levels by managing exposure to credit and interest rate risks.

Demand for loan types is a driving force in establishing a funds management strategy. The Association offers fixed, adjustable and variable rate loan products that are marginally priced according to financial market rates. Variable rate loans may be indexed to either the Prime Rate or the 90-day London Interbank Offered Rate (LIBOR). Adjustable rate mortgages are indexed to U.S. Treasury Rates. Fixed rate loans are priced based on the current cost of Farm Credit debt of similar terms to maturity.

The majority of the interest rate risk in the Association balance sheet is transferred to the Bank through the notes payable structure. The Bank, in turn, actively utilizes funds management techniques to identify, quantify and control risk associated with the loan portfolio.

## CAPITAL RESOURCES

Total members' equity at December 31, 2005, increased 2.89 percent to \$96,322 from the December 31, 2004, total of \$93,621. The December 31, 2004, total of \$93,621 increased 16.15 percent from the December 31, 2003, total of \$80,606. The increases were primarily attributed to increases in retained earnings.

Total capital stock and participation certificates were \$2,154 on December 31, 2005, compared to \$2,114 on December 31, 2004, and \$2,057 on December 31, 2003. This 1.89 percent increase for 2005 is attributed to purchases of stock related to new loans.

The Association's capital ratios as of December 31 and the FCA minimum requirements follow:

	2005	2004	2003	Regulatory Minimum
Permanent Capital	16.95%	16.95%	15.81%	7.00%
Total Surplus	16.55%	16.58%	15.37%	7.00%
Core Surplus	13.24%	12.73%	11.36%	3.50%

At December 31, 2005, the Association's permanent capital ratio, average at-risk capital divided by average risk adjusted assets calculated in accordance with FCA regulations, exceeded the regulatory minimum of 7.00 percent. In addition to these regulatory requirements, the Association has established a permanent capital goal of 15.00 percent, which is in excess of the regulatory requirement. Also the Association has established total surplus and core surplus goals of 14.00 percent and 11.00 percent, respectively, which are also in excess of the regulatory requirements. As of December 31, 2005, the Association has met and exceeded its permanent capital, total surplus, and core surplus ratio goals.

## PATRONAGE PROGRAM

Prior to the beginning of any fiscal year, the Association's Board of Directors, by adoption of a resolution, may obligate the Association to distribute to borrowers on a patronage basis all or any portion of available consolidated net earnings of the Association and its subsidiaries for such fiscal year or for that and subsequent fiscal years. Refer to Note 9 of the Notes to the Consolidated Financial Statements for more information concerning the patronage distributions. The Association declared patronage distributions of \$6,942 in 2005, \$5,413 in 2004, and \$7,150 in 2003.

## YOUNG, BEGINNING, AND SMALL FARMERS AND RANCHERS PROGRAM

The Association's mission is to provide financial services to agriculture and the rural community, which includes providing credit to young\*, beginning\*\* and small\*\*\* farmers. Because of the unique needs of these individuals, and their importance to the future growth of the Association, the Association has established annual marketing goals to increase our market share of loans to YBS farmers. Specific marketing plans have been developed to target these groups, and resources have been designated to help ensure YBS borrowers access to a stable source of credit.

The following table outlines the loan volume and number of YBS loans in the loan portfolio as of December 31 for the Association.

	As of December 31, 2005	
	Number of Loans	Amount of Loans
Young	851	\$ 79,416
Beginning	1,046	93,824
Small	3,003	155,317
	4,900	\$328,557

*Note: For purposes of the above table, a loan could be classified in more than one category, depending upon the characteristics of the underlying borrower.*

The 2002 USDA Ag Census data has been used as a benchmark to measure penetration of the Association's marketing efforts. The census data indicated that within the Association's chartered territory (counties) there were 6,832 reported farmers of which by definition 366 or 5.4 percent were Young, 1,924 or 28.2 percent were Beginning, and 5,204 or 76.2 percent were Small. Comparatively, as of December 31, 2005, the demographics of the Association's agricultural portfolio contained 2,129 farmers, of which by definition 224 or 10.5 percent were Young, 574 or 27.0 percent were Beginning and 1,495 or 70.2 percent were Small.

The following strategies and outreach programs have been conducted which allowed the Association to increase lending to young, beginning, and small farmers.

- Support of 4-H, FFA, and young farmer organizations through sponsorships and donations.
- Sponsor seminars on farm transition planning and financial management.
- At least one Young, Beginning, or Small Farmer required on each Branch Advisory Committee
- Implementation of reduced documentation loans

The Chief Operating Officer coordinates the Association's YBS efforts. The Association includes YBS goals in the annual strategic plan, and reports on those goals and achievements to the board of directors on a quarterly basis.

The Association is committed to the future success of young, beginning and small farmers.

- \* Young farmers are defined as those farmers, ranchers, producers or harvesters of aquatic products who are age 35 or younger as of the date the loan is originally made.
- \*\* Beginning farmers are defined as those farmers, ranchers, producers or harvesters of aquatic products who have 10 years or less farming or ranching experience as of the date the loan is originally made.
- \*\*\* Small farmers are defined as those farmers, ranchers, producers or harvesters of aquatic products who normally generate less than \$250 in annual gross sales of agricultural or aquatic products at the date the loan is originally made.

## FORWARD LOOKING INFORMATION

Certain information included in this discussion constitutes forward-looking statements and information that are based upon management's belief as well as certain assumptions made by and information currently available to management. When used in this discussion, the words "anticipate," "project," "expect," "believe," and similar expressions are intended to identify forward-looking statements. Although management of the Association believes that the expectations reflected in such forward-looking statements are reasonable, it can give no assurance that such expectations and projections will prove to have been correct. Such forward-looking statements are subject to certain risks, uncertainties and assumptions. Should one or more of these risks materialize, or should such underlying assumptions prove to be incorrect, actual results may vary materially from those anticipated, projected, or expected. Among key factors that may have a direct bearing on the Association's operating results are fluctuations in the economy, the relative strengths and weaknesses in the agricultural credit sectors and in the real estate market, the actions taken by the Federal Reserve for the purpose of managing the economy, and the continued growth of the agricultural market consistent with recent historical experience.

# *Disclosure Required by Farm Credit Administration Regulations*

## **Description of Business**

Descriptions of the territory served, persons eligible to borrow, types of lending activities engaged in, financial services offered and related Farm Credit organizations are incorporated herein by reference to Note 1 to the consolidated financial statements, "Organization and Operations," included in this annual report to shareholders.

The description of significant developments that had or could have a material impact on earnings or interest rates to borrowers, acquisitions or dispositions of material assets, material changes in the manner of conducting the business, seasonal characteristics, and concentrations of assets, if any, is incorporated in "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in this annual report to shareholders.

## **Description of Property**

The following table sets forth certain information regarding the properties of the reporting entity, all of which are located in North Carolina:

<u>Location</u>	<u>Description</u>	<u>Form of Ownership</u>
333 East Russell Street Fayetteville	Administrative/ Branch	Owned
103 East Front Street Lillington	Branch	Owned
400 West Broad Street Dunn	Branch	Owned
1780 Southeast Boulevard Clinton	Branch	Owned
127 Beasley Street Kenansville	Branch	Owned
811 South Walker Street Burgaw	Branch	Owned
108 North Poplar Street Elizabethtown	Branch	Owned
500 South Main Street Laurinburg	Branch	Owned
331 South Main Street Raeford	Branch	Owned
1902 North Cedar Street Lumberton	Branch	Owned
1407 Liberty Street Whiteville	Branch	Owned
4631 Main Street Shallotte	Branch	Owned

## **Legal Proceedings**

Information, if any, to be disclosed in this section is incorporated herein by reference to Note 14 to the consolidated financial statements, "Commitments and Contingencies," included in this annual report to shareholders.

## **Description of Capital Structure**

Information to be disclosed in this section is incorporated herein by reference to Note 9 to the consolidated financial statements, "Members' Equity," included in this annual report to shareholders.

## **Description of Liabilities**

The description of liabilities, contingent liabilities and intrasystem financial assistance rights and obligations to be disclosed in this section is incorporated herein by reference to Notes 2, 8, 12, and 14 to the consolidated financial statements included in this annual report to shareholders.

## **Management's Discussion and Analysis of Financial Condition and Results of Operations**

"Management's Discussion and Analysis of Financial Condition and Results of Operations," which appears in this annual report to shareholders and is to be disclosed in this section, is incorporated herein by reference.

## **Senior Officers**

The following represents certain information regarding the senior officers of the Association:

<u>Senior Officer</u>	<u>Position</u>
Richard A. Eason	Chief Executive Officer
C. Royce Edwards	Chief Operating Officer
Henry T. McDuffie	Chief Financial Officer
Michael R. Jackson	Chief Lending Officer
N. Michael Baker	Chief Appraiser

The business experience for the past five years for senior officers is with the Farm Credit System.

The total amount of compensation earned by all senior officers as a group during the years ended December 31, 2005, 2004 and 2003, is as follows:

<u>Senior Officers</u>	<u>Year</u>	<u>Aggregate Number of</u>	<u>Annual</u>				<u>Total</u>
			<u>Salary</u>	<u>Bonus</u>	<u>Deferred/- Perquisites</u>	<u>Other</u>	
Richard A. Eason	2005		\$248,073	\$ 10,000	—	—	\$258,073
Richard A. Eason	2004		\$236,259	\$ 11,813	—	—	\$248,072
Richard A. Eason	2003		\$225,000	\$ 10,000	—	—	\$235,000
5 Senior Officers	2005		\$718,527	\$ 76,504	—	—	\$795,031
5 Senior Officers	2004		\$690,972	\$124,284	—	—	\$815,256
5 Senior Officers	2003		\$647,721	\$ 52,015	—	—	\$699,736

In addition to a base salary, senior officers earn additional compensation under an incentive plan. The Association incentive plan is designed to motivate employees to exceed the business plan goals during the fiscal year. These goals include return on equity, return on assets, credit quality, credit administration, delinquencies and other key ratios. All Association employees are covered by the plan. Payment of the incentive is in the first quarter of 2005. Bonuses are shown in the year earned, which may be different than the year of payment.

Disclosure of the total compensation earned in 2005 by any senior officer, or any other individual included in the total whose compensation exceeds \$50,000, is available to stockholders upon request.

#### Directors

Directors and senior officers are reimbursed on an actual cost basis for all expenses incurred in the performance of official duties. Such expenses may include transportation, lodging, meals, tips, tolls, parking of cars, laundry, registration fees, and other expenses associated with travel on official business. A copy of the policy is available to shareholders of the Association upon request.

The aggregate amount of reimbursement for travel, subsistence and other related expenses for all directors as a group was \$83,967 for 2005, \$59,421 for 2004, and \$97,636 for 2003.

Subject to approval by the board, the Association may allow the Chairman of the Board a quarterly retainer of \$5,500 and regular Board members a quarterly retainer of \$5,000. Total compensation paid to directors as a group during 2005 was \$235,650.

The following represents certain information regarding the directors of the Association and their principal occupations for the past five years:

**Mr. Ronald J. Allen**, Chairman, is a poultry, swine, cattle and hay farmer. His principal occupation and employment for the past five years was self-employed farming and Executive Director of Materials Management for Southeastern Regional Medical Center (hospital). During 2005, he served 11 days at Association board meetings and 19 days in other official activities and was paid \$20,650. His term of office is 2003 – 2006.

**Mr. Edgar V. Edens, III**, Vice Chairman, is a cotton, tobacco and row crop farmer who is co-owner of Hoke Robeson Gin (crop processing). His principal occupation and employment for the past five years was self-employed farming. During 2005, he served 11 days at Association board meetings and 1 day in other official activities and was paid \$12,050. His term of office is 2004 – 2007.

**Mr. P. R. Barker, Jr.** is a row crop farmer. His principal occupation and employment for the past five years was self-employed farming. During 2005, he served 12 days at Association board meetings and 18 days in other official activities and was paid \$20,200. His term of office is 2003 – 2006.

**Mr. William T. (Tom) Butler** is a contract swine farmer. His principal occupation and employment for the past five years was self-employed farming and as a self-employed commercial building sub-contractor. During 2005, he served 12 days at Association board meetings and 20 days in other official activities and was paid \$19,850. His term of office is 2003 – 2006.

**Mr. David R. Gooden** is a tobacco, row crop and contract swine farmer. His principal occupation and employment for the past five years was self-employed farming. During 2005, he served 9 days at Association board meetings and 15 days in other official activities and was paid \$15,000. His term of office is 2005 – 2008.

**Mr. P. Jart Hudson, Jr.** is a cotton, row crop and contract swine farmer. His principal occupation and employment for the past five years was self-employed farming. He serves on the board of the Tobacco Growers Association of NC (crop promotion). During 2005, he served 12 days at Association board meetings and 5 days in other official activities and was paid \$17,750. His term of office is 2004 – 2007.

**Mr. William H. James** is a contract swine and turkey farmer. His principal occupation and employment for the past five years was self-employed farming. During 2005, he served 12 days at Association board meetings and 13 days in other official activities and was paid \$18,800. His term of office is 2003 – 2006.

**Mr. Lyle R. King** is a tobacco and row crop farmer who serves on the boards of AgFirst Farm Credit Bank (bank), Atlantic Telephone Coop (a telephone utility cooperative) and Landbank Resource Management, LLC (real estate). His principal occupation and employment for the past five years was self-employed farming. During 2005, he served 10 days at Association board meetings and 19 days in other official activities and was paid \$17,750. His term of office is 2005 – 2008.

**Mr. Willard Small** was appointed as the Association's outside director in 2002. He is an automobile dealer and is owner of Fair Bluff Motors, Lumberton Motors, and Mullins Motors. He serves on the Board of Southeastern Community College (education) and Campbell University (education), serves on the Tobacco Trust Fund Commission (trust administration), and is a Commissioner for the Town of Fair Bluff (government). His principal occupation and employment for the past five years was self-employed automobile sales. During 2005, he served 11 days at Association board meetings and 9 days in other official activities and was paid \$17,750. His term of office is 2005 – 2008.

**Mr. Harold J. Smith, Jr.** is a tobacco, row crop, swine and cattle farmer. His principal occupation and employment for the past five years was self-employed farming. During 2005, he served 12 days at Association board meetings and 12 days in other official activities and was paid \$18,800. His term of office is 2004 – 2007.

**Mr. John E. Townsend** is a tobacco and row crop farmer. His principal occupation and employment for the past five years was self-employed farming. During 2005, he served 12 days at Association board meetings and 12 days in other official activities and was paid \$17,750. His term of office is 2004 – 2007.

**Mr. Wilbur C. Ward** is a peanut and row crop farmer who serves on the boards of Southern States Cooperative (farm supplies), First Citizens Bank in Elizabethtown (bank), and Bladen County Farm Bureau (insurance). His principal occupation and employment for the past five years was self-employed farming. During 2005, he served 2 days at Association board meetings and 4 days in other official activities and was paid \$3,100. His term of office was 2002 – 2005.

**Mr. James Lee Wilkins** is a tobacco and row crop farmer. His principal occupation and employment for the past five years was self-employed farming. During 2005, he served 11 days at Association board meetings and 7 days in other official activities and was paid \$17,400. His term of office is 2004 – 2007.

**Mr. Alfred K Wooten** is a commercial producer of turf grass. His principal occupation and employment for the past five years was self-employed farming. He serves on the board of Pender County Farm Bureau (insurance). During 2005, he served 10 days at Association board meetings and 11 days in other official activities and was paid \$18,800. His term of office is 2005 – 2008.

#### **Transactions with Senior Officers and Directors**

The reporting entity's policies on loans to and transactions with its officers and directors, to be disclosed in this section are incorporated herein by reference to Note 13 to the consolidated financial statements, "Related Party Transactions," included in this annual report to shareholders.

#### **Involvement in Certain Legal Proceedings**

There were no matters which came to the attention of management or the board of directors regarding involvement of current directors or senior officers in specified legal proceedings which should be disclosed in this section.

#### **Relationship with Independent Public Accountants**

There were no material disagreements with our independent public accountants on any matter of accounting principles or financial statement disclosure during this period.

#### **Consolidated Financial Statements**

The consolidated financial statements, together with the report thereon of PricewaterhouseCoopers LLP dated March 1, 2006, and the report of management, which appear in this annual report to shareholders are incorporated herein by reference.

Copies of the Association's quarterly reports are available upon request free of charge by calling 1-910-323-9188, or writing Henry T. McDuffie, Chief Financial Officer, Cape Fear Farm Credit, ACA, P. O. Box 2405, Fayetteville, NC 28302. The Association prepares a quarterly report within 45 days after the end of each fiscal quarter, except that no report need be prepared for the fiscal quarter that coincides with the end of the fiscal year of the institution.

#### **Borrower Information Regulations**

Since 1972, Farm Credit Administration (FCA) regulations have required that borrower information be held in strict confidence by Farm Credit System (FCS) institutions, their directors, officers and employees. These regulations provide FCS institutions clear guidelines for protecting their borrowers' nonpublic personal information.

On November 10, 1999, the FCA Board adopted a policy that requires FCS institutions to formally inform new borrowers at loan closing of the FCA regulations on releasing borrower information and to address this information in the annual report to shareholders. The implementation of these measures ensures that new and existing borrowers are aware of the privacy protections afforded them through FCA regulations and Farm Credit System institution efforts.

#### **Stockholder Investment**

Stockholder investment in the Association could be affected by the financial condition and results of operations of AgFirst Farm Credit Bank. Copies of the District annual and quarterly reports are available upon request free of charge by calling 1-800-845-1745, ext. 378, or writing Jay Wise, AgFirst Farm Credit Bank, P. O. Box 1499, Columbia, SC 29202. Information concerning AgFirst Farm Credit Bank can also be obtained by going to AgFirst's website at [www.agfirst.com](http://www.agfirst.com).

## *Report of the Audit Committee*

The Audit Committee of the Board of Directors (the Committee) is comprised of the directors named below. None of the directors who serve on the Audit Committee is an employee of Cape Fear Farm Credit (the Association) and in the opinion of the Board of Directors, each is free of any relationship with the Association or management that would interfere with the director's independent judgment on the Committee.

The Committee has adopted a written charter that has been approved by the Board of Directors. The Committee has reviewed and discussed the Association's audited financial statements with management, which has primary responsibility for the financial statements.

PricewaterhouseCoopers LLP (PwC), the Association's independent auditor for 2005, is responsible for expressing an opinion on the conformity of the Association's audited financial statements with generally accepted accounting principles. The Committee has discussed with PwC the matters that are required to be discussed by Statement on Auditing Standards No. 61 (*Communication With Audit Committees*). PwC has provided to the Committee the written disclosures and the letter required by Independence Standards Board Standard No. 1 (*Independence Discussions with Audit Committees*), and the Committee has discussed with PwC that firm's independence.

The Committee has also concluded that PwC's provision of non-audit services, if any, to the Association is compatible with PwC's independence.

Based on the considerations referred to above, the Committee recommended to the Board of Directors that the audited financial statements be included in the Association's Annual Report for 2005. The foregoing report is provided by the following independent directors, who constitute the Audit Committee:



John Townsend  
Chairman of the Audit Committee

### **Members of Audit Committee**

P. R. Barker, Jr.  
Tom Butler  
David Gooden  
Lyle Ray King  
Willard Small

# Report of Independent Auditors



PricewaterhouseCoopers LLP  
10 Tenth Street, Suite 1400  
Atlanta, GA 30309  
Telephone (678) 419 1000

## Report of Independent Auditors

To the Board of Directors and Members  
of Cape Fear Farm Credit, ACA

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of changes in members' equity and of cash flows present fairly, in all material respects, the financial position of Cape Fear Farm Credit, ACA (the Association) and its subsidiaries at December 31, 2005, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Association's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

*PricewaterhouseCoopers* LLP

March 1, 2006

## *Consolidated Balance Sheets*

<i>(dollars in thousands)</i>	<b>December 31, 2005</b>	<b>December 31, 2004</b>	<b>December 31, 2003</b>
<b>Assets</b>			
Cash	\$ 2,610	\$ 2,052	\$ 1,835
Loans	519,198	476,220	483,873
Less: allowance for loan losses	3,434	3,507	9,993
Net loans	515,764	472,713	473,880
Other investments	15,367	—	—
Accrued interest receivable	7,802	5,466	5,094
Investment in other Farm Credit institutions	5,674	6,009	6,436
Premises and equipment, net	3,403	3,472	3,668
Prepaid retirement expense	5,787	5,485	203
Due from AgFirst Farm Credit Bank	5,579	5,656	4,634
Other assets	779	791	711
Total assets	<u>\$ 562,765</u>	<u>\$ 501,644</u>	<u>\$ 496,461</u>
<b>Liabilities</b>			
Notes payable to AgFirst Farm Credit Bank	\$ 447,981	\$ 393,652	\$ 400,460
Accrued interest payable	1,868	1,277	1,096
Patronage refund payable	7,016	5,553	2,972
Postretirement benefits other than pensions	3,778	3,352	2,812
Minimum pension liability	409	392	2,410
Other liabilities	5,391	3,797	6,105
Total liabilities	<u>466,443</u>	<u>408,023</u>	<u>415,855</u>
Commitments and contingencies			
<b>Members' Equity</b>			
Protected borrower equity	269	354	489
Capital stock and participation certificates	2,154	2,114	2,057
Retained earnings			
Allocated	22,035	28,250	35,025
Unallocated	72,268	63,302	47,532
Accumulated other comprehensive income (loss)	(404)	(399)	(4,497)
Total members' equity	<u>96,322</u>	<u>93,621</u>	<u>80,606</u>
Total liabilities and members' equity	<u>\$ 562,765</u>	<u>\$ 501,644</u>	<u>\$ 496,461</u>

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

## *Consolidated Statements of Income*

<i>(dollars in thousands)</i>	<b>For the year ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
<b>Interest Income</b>			
Loans	\$ 35,571	\$ 28,934	\$ 27,957
Other	139	—	—
Total interest income	<u>35,710</u>	<u>28,934</u>	<u>27,957</u>
<b>Interest Expense</b>			
Notes payable to AgFirst Farm Credit Bank	18,963	13,774	13,418
Net interest income	16,747	15,160	14,539
Provision for (reversal of allowance for) loan losses	(65)	(6,497)	—
Net interest income after provision for (reversal of allowance for) loan losses	<u>16,812</u>	<u>21,657</u>	<u>14,539</u>
<b>Noninterest Income</b>			
Loan fees	2,283	1,953	2,335
Fees for financially related services	350	385	451
Patronage refund from AgFirst Farm Credit Bank	5,596	5,732	4,642
Gains (losses) on other property owned, net	8	8	9
Other noninterest income	124	361	159
Total noninterest income	<u>8,361</u>	<u>8,439</u>	<u>7,596</u>
<b>Noninterest Expense</b>			
Salaries and employee benefits	6,440	6,710	6,473
Occupancy and equipment	747	719	796
Insurance Fund premium	243	235	563
Other operating expenses	1,762	1,508	1,491
Total noninterest expense	<u>9,192</u>	<u>9,172</u>	<u>9,323</u>
Income before income taxes	15,981	20,924	12,812
Provision (benefit) for income taxes	106	(200)	410
Net income	<u>\$ 15,875</u>	<u>\$ 21,124</u>	<u>\$ 12,402</u>

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

## *Consolidated Statements of Changes in Members' Equity*

<i>(dollars in thousands)</i>	Protected Borrower Equity	Capital Stock and Participation Certificates	Retained Earnings		Accumulated Other Comprehensive Income	Total Members' Equity
			Allocated	Unallocated		
Balance at December 31, 2002	\$ 669	\$ 2,065	\$37,208	\$ 42,778	\$ (4,871)	\$ 77,849
Comprehensive income						
Net income				12,402		12,402
Minimum pension liability adjustment					374	374
Total comprehensive income						12,776
Protected borrower equity retired	(180)					(180)
Capital stock/participation certificates issued		205				205
Capital stock/participation certificates retired		(213)				(213)
Patronage distribution						
Cash				(2,860)		(2,860)
Qualified allocated retained earnings			304	(304)		—
Nonqualified allocated retained earnings			3,986	(3,986)		—
Retained earnings retired			(6,833)			(6,833)
Distribution adjustment			360	(498)		(138)
Balance at December 31, 2003	489	2,057	35,025	47,532	(4,497)	80,606
Comprehensive income						
Net income				21,124		21,124
Minimum pension liability adjustment					4,098	4,098
Total comprehensive income						25,222
Protected borrower equity retired	(135)					(135)
Capital stock/participation certificates issued		241				241
Capital stock/participation certificates retired		(184)				(184)
Patronage distribution						
Cash				(5,413)		(5,413)
Retained earnings retired			(6,737)			(6,737)
Distribution adjustment			(38)	59		21
Balance at December 31, 2004	354	2,114	28,250	63,302	(399)	93,621
Comprehensive income						
Net income				15,875		15,875
Minimum pension liability adjustment					(5)	(5)
Total comprehensive income						15,870
Protected borrower equity retired	(85)					(85)
Capital stock/participation certificates issued		345				345
Capital stock/participation certificates retired		(305)				(305)
Patronage distribution						
Cash				(6,942)		(6,942)
Retained earnings retired			(6,236)			(6,236)
Distribution adjustment			21	33		54
Balance at December 31, 2005	\$ 269	\$ 2,154	\$22,035	\$ 72,268	\$ (404)	\$ 96,322

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

# Consolidated Statements of Cash Flows

<i>(dollars in thousands)</i>	For the year ended December 31,		
	2005	2004	2003
<b>Cash flows from operating activities:</b>			
Net income	\$ 15,875	\$ 21,124	\$ 12,402
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation on premises and equipment	428	443	506
Provision for (reversal of allowance for) loan losses	(65)	(6,497)	—
(Gains) losses on other property owned, net	(8)	(8)	(9)
Changes in operating assets and liabilities:			
(Increase) decrease in accrued interest receivable	(2,336)	(372)	163
(Increase) decrease in prepaid retirement expense	(302)	(5,282)	—
(Increase) decrease in due from AgFirst Farm Credit Bank	77	(1,022)	(263)
(Increase) decrease in other assets	12	4,018	365
Increase (decrease) in accrued interest payable	591	181	(59)
Increase (decrease) in postretirement benefits other than pensions	426	540	383
Increase (decrease) in minimum pension liability	17	(2,018)	(174)
Increase (decrease) in other liabilities	1,597	(2,300)	3,343
Total adjustments	437	(12,317)	4,255
Net cash provided by (used in) operating activities	16,312	8,807	16,657
<b>Cash flows from investing activities:</b>			
Net (increase) decrease in loans	(42,986)	7,664	(12,988)
(Increase) decrease in investment in AgFirst Farm Credit Bank	335	427	1,190
(Increase) decrease in other investments	(15,367)	—	—
Purchase of premises and equipment, net	(359)	(247)	(307)
Net cash provided by (used in) investing activities	(58,377)	7,844	(12,105)
<b>Cash flows from financing activities:</b>			
Advances on (repayment of) notes payable to AgFirst Farm Credit Bank, net	54,329	(6,808)	5,586
Protected borrower equity retired	(85)	(135)	(180)
Capital stock and participation certificates issued	345	241	205
Capital stock and participation certificates retired	(305)	(184)	(213)
Patronage refunds paid	(5,425)	(2,811)	(2,347)
Retained earnings retired	(6,236)	(6,737)	(6,833)
Net cash provided by (used in) financing activities	42,623	(16,434)	(3,782)
Net increase (decrease) in cash	558	217	770
Cash, beginning of period	2,052	1,835	1,065
Cash, end of period	\$ 2,610	\$ 2,052	\$ 1,835
<b>Supplemental schedule of non-cash activities:</b>			
Cash dividends or patronage distributions declared or payable	\$ 6,942	\$ 5,413	\$ 2,860
Decrease (increase) in accumulated other comprehensive income related to minimum pension liability	(5)	4,098	374
<b>Supplemental information:</b>			
Interest paid	\$ 18,372	\$ 13,593	\$ 13,477
Taxes paid, net	128	(200)	—
Federal tax refunds related to long-term operations (Note 10)	—	—	1

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

# Notes to the Consolidated Financial Statements

(dollars in thousands, except as noted)

## Note 1 — Organization and Operations

- A. **Organization:** Cape Fear Farm Credit, ACA (Association or ACA) is a member-owned cooperative which provides credit and credit-related services to or for the benefit of eligible borrowers/stockholders for qualified purposes in the counties of Bladen, Brunswick, Columbus, Cumberland, Duplin, Harnett, Hoke, New Hanover, Pender, Robeson, Sampson, and Scotland in the state of North Carolina.

The Association is a lending institution of the Farm Credit System (System), a nationwide system of cooperatively owned Banks and Associations, which was established by Acts of Congress to meet the credit needs of American agriculture and is subject to the provisions of the Farm Credit Act of 1971, as amended (the Farm Credit Act). The most recent significant amendment to the Farm Credit Act was the Agricultural Credit Act of 1987. At December 31, 2005, the System was comprised of four Farm Credit Banks, one Agricultural Credit Bank and ninety-six Associations.

AgFirst Farm Credit Bank (Bank) and its related Associations are collectively referred to as the "District." The Bank provides funding to all associations within the District and is responsible for supervising certain activities of the Association, as well as the other associations operating within the District. The District consists of the Bank and twenty-three ACAs, all of which have reorganized as ACA parent-companies, which have two wholly owned subsidiaries, a Federal Land Credit Association (FLCA) and a Production Credit Association (PCA).

ACA parent-companies provide financing and related services through its FLCA and PCA subsidiaries. The FLCA makes secured long-term agricultural real estate and rural home mortgage loans. The PCA makes short-and intermediate-term loans for agricultural production or operating purposes.

The Farm Credit Administration (FCA) is delegated authority by Congress to regulate the System banks and associations. The FCA examines the activities of the associations and certain actions by the associations are subject to the prior approval of the FCA and the supervising Bank.

The Farm Credit Act established the Farm Credit System Insurance Corporation (Insurance Corporation) to administer the Farm Credit Insurance Fund (Insurance Fund). The Insurance Fund is required to be used (1) to ensure the timely payment of principal and interest on Systemwide debt obligations (Insured debt), (2) to ensure the retirement of protected borrower capital at par or stated value, and (3) for other specified purposes. The Insurance Fund is also available for discretionary uses by the Insurance Corporation of providing assistance to certain troubled System institutions and to cover the operating expenses of the Insurance Corporation. Each System bank is required to pay premiums into the Insurance Fund, based on its annual average loan principal outstanding until the monies in the Insurance Fund reach the "secure base amount," which is defined in the Farm Credit Act as 2.0 percent of the aggregate insured obligations (Systemwide debt obligations) or such other percentage of the aggregate obligations as the Insurance Corporation in its sole

discretion determines to be actuarially sound. When the amount in the Insurance Fund exceeds the secure base amount, the Insurance Corporation is required to reduce premiums, but it still must ensure that reduced premiums are sufficient to maintain the level of the Insurance Fund at the secure base amount.

- B. **Operations:** The Farm Credit Act sets forth the types of authorized lending activity, persons eligible to borrow, and financial services which can be offered by the Association. The Association is authorized to provide, either directly or in participation with other lenders, credit, credit commitments and related services to eligible borrowers. Eligible borrowers include farmers, ranchers, producers or harvesters of aquatic products, rural residents, and farm-related businesses.

The Association may sell to any Farm Credit borrowing member, on an optional basis, credit or term life insurance appropriate to protect the loan commitment in the event of death of the debtor(s). The sale of other insurance necessary to protect a member's farm or aquatic unit is permitted, but limited to hail and multi-peril crop insurance, and insurance necessary to protect the facilities and equipment of aquatic borrowers.

The AgFirst Annual Report to Shareholders, the AgFirst District Annual Report to Shareholders, and the AgFirst District's quarterly reports are available on its web site, [www.agfirst.com](http://www.agfirst.com). Upon request, shareholders of the Association will be provided with copies of these reports at no charge by calling 1-800-845-1745, Ext. 378. The Association's financial condition may be impacted by factors that affect the Bank. The Bank's Annual Report discusses the material aspects of the District's financial condition, changes in financial condition, and results of operations. In addition, the District's Annual Report identifies favorable and unfavorable trends, significant events, uncertainties and the impact of activities of the Insurance Corporation.

The lending and financial services offered by the Bank are described in Note 1 of the Bank's Annual Report to Shareholders.

## Note 2 — Summary of Significant Accounting Policies

The accounting and reporting policies of the Association conform with accounting principles generally accepted in the United States of America (GAAP) and prevailing practices within the banking industry. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Significant estimates are discussed in these footnotes, as applicable. Actual results may differ from these estimates.

Certain amounts in prior years' financial statements have been reclassified to conform to current consolidated financial statement presentation. Such reclassifications had no effect on net income or total members' equity of prior years. The consolidated financial statements include the accounts of the FLCA and the PCA. All significant inter-company transactions have been eliminated in consolidation.

- A. **Cash:** Cash, as included in the statement of cash flows, represents cash on hand and on deposit at banks.

**B. Loans and Allowance for Loan Losses:** Long-term real estate mortgage loans generally have original maturities ranging from five to 30 years. Substantially all short- and intermediate-term loans for agricultural production or operating purposes have maturities of 10 years or less. Loans are carried at their principal amount outstanding less unearned income. Interest on loans is accrued and credited to interest income based upon the daily principal amount outstanding.

Impaired loans are loans for which it is probable that not all principal and interest will be collected according to the contractual terms of the loan. Impaired loans include nonaccrual loans, restructured loans, and loans past due 90 days or more and still accruing interest. A loan is considered contractually past due when any principal repayment or interest payment required by the loan instrument is not received on or before the due date. A loan shall remain contractually past due until it is formally restructured or until the entire amount past due, including principal, accrued interest, and penalty interest incurred as the result of past due status, is collected or otherwise discharged in full.

Loans are generally placed in nonaccrual status when principal or interest is delinquent for 90 days (unless adequately secured and in the process of collection) or circumstances indicate that collection of principal and/or interest is in doubt. When a loan is placed in nonaccrual status, accrued interest deemed uncollectible is reversed (if accrued in the current year) or charged against the allowance for loan losses (if accrued in the prior year).

When loans are in nonaccrual status, the interest portion of payments received in cash is recognized as interest income if collection of the recorded investment in the loan is fully expected and the loan does not have a remaining unrecovered prior charge-off associated with it. Otherwise, loan payments are applied against the recorded investment in the loan. Nonaccrual loans may be returned to accrual status when principal and interest are current, prior charge-offs have been recovered, the ability of the borrower to fulfill the contractual repayment terms is fully expected and the loan is not classified "doubtful" or "loss."

Loans are charged-off, wholly or partially, as appropriate, at the time they are determined to be uncollectible.

In cases where a borrower experiences financial difficulties and the Association makes certain monetary concessions to the borrower through modifications to the contractual terms of the loan, the loan is classified as a restructured loan. If the borrower's ability to meet the revised payment schedule is uncertain, the loan is classified as a nonaccrual loan.

The allowance for loan losses is a valuation account used to reasonably estimate loan and lease losses existing as of the financial statement date. Determining the appropriate allowance for loan losses balance involves significant judgment about when a loss has been incurred and the amount of that loss. The determination of the allowance for loan losses is based on management's current judgments about the credit quality of its loan and lease portfolio. A specific allowance may be established for impaired loans under Statement of Financial Accounting Standards No. 114. Impairment of these loans is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as practically expedient, at the loan's observable market price or fair value of the collateral if the loan is collateral dependent. See Note 3 for a discussion of the refinement of the allowance for loan losses methodology.

The allowance for loan losses is maintained at a level considered adequate by management to provide for probable and estimable losses inherent in the loan portfolio. The allowance is increased

through provisions for loan losses and loan recoveries and is decreased through allowance reversals and loan charge-offs.

The allowance is based on a periodic evaluation of the loan portfolio by management in which numerous factors are considered, including economic conditions, loan portfolio composition and prior loan loss experience. It is based on estimates, appraisals and evaluations of loans which, by their nature, contain elements of uncertainty and imprecision. The possibility exists that changes in the economy and its impact on borrower repayment capacity will cause these estimates, appraisals and evaluations to change.

The level of allowance for loan losses is generally based on recent charge-off experience adjusted for relevant environmental factors. The Association considers the following factors when adjusting the historical charge-offs experience:

- Changes in credit risk classifications,
- Changes in collateral values,
- Changes in risk concentrations,
- Changes in weather related conditions, and
- Changes in economic conditions.

**C. Other Investments:** Other Investments include Tobacco Buyout Successor-in-Interest Contracts (SIIC), which qualify as Mission Related Investments under FCA regulations. Under the SIIC, the Tobacco quota holders and producers may sell their rights to receive SIIC contract payments to a third party. The successor purchases the entire contract and all related rights and obligations associated with the contract. These investments in SIIC are purchased at a discount. Contract payments are made by the United States Department of Agriculture (USDA) in equal annual payments. Interest income is recognized from the accretion of discounts using the effective interest method.

**D. Investment in AgFirst Farm Credit Bank:** The Association is required to maintain ownership in the Bank in the form of Class B and Class C stock. Accounting for this investment is on the cost plus allocated equities basis. Patronage refunds from the Bank are accrued as earned. The receivable for such patronage refunds is classified as Due from AgFirst Farm Credit Bank.

**E. Other Property Owned:** Other property owned, consisting of real and personal property acquired through a collection action, is recorded at fair value less estimated selling costs upon acquisition. Revised estimates to the fair value less cost to sell are reported as adjustments to the carrying amount of the asset, provided that such adjusted value is not in excess of the carrying amount at acquisition. Income and expenses from operations and carrying value adjustments are included in gains (losses) on other property owned.

**F. Premises and Equipment:** Premises and equipment are carried at cost less accumulated depreciation. Land is carried at cost. Depreciation is provided on the straight-line method over the estimated useful lives of the assets. Gains and losses on dispositions are reflected in current operations. Maintenance and repairs are charged to operating expense and improvements are capitalized.

**G. Advanced Conditional Payments:** The Association is authorized under the Farm Credit Act to accept advance payments from borrowers. To the extent the borrower's access to such advance payments is restricted, the advanced conditional payments are netted against the borrower's related loan balance. Amounts in excess of the related loan balance and amounts to which the borrower has unrestricted access are presented as interest-bearing liabilities in the accompanying Balance Sheet.

Advanced conditional payments are not insured. Interest is generally paid by the Association on such accounts.

- G. Employee Benefit Plans:** The employees of the Association may participate in the Retirement Plan ( Plan) of the District, which is a defined benefit plan. The District utilizes the “Projected Unit Credit” actuarial method for financial reporting purposes and for funding purposes. As a result of the funded status at the Plan’s measurement date (September 30) of the underlying Plan, the Association may record a minimum liability, an intangible asset relating to unrecognized prior service cost and other comprehensive income (loss). The adjustment to other comprehensive income (loss) would be net of deferred taxes, if significant. For participants hired before January 1, 2003, benefits are determined based on a final average pay formula. For those participants hired on or after January 1, 2003, benefits are determined using a cash balance formula.

The employees of the Association may also be eligible to participate in the District’s thrift plan (Thrift Plan), which qualifies as a 401(k) plan as defined by the Internal Revenue Code. Thrift Plan costs are expensed as funded.

Effective January 1, 2006 the Districtwide 401(k) Plan known as the AgFirst Farm Credit Employee Thrift Plan merged with the Farm Credit Bank of Texas Thrift Plus Plan. The new plan is known as the AgFirst/FCBT 401 (k) Employee Benefit Plan.

The Association may provide certain health care and life insurance benefits to eligible retired employees. Substantially all employees may become eligible for these benefits if they reach early retirement age while working for the Association.

- H. Income Taxes:** The Association is generally subject to Federal and certain other income taxes. The Association is eligible to operate as a cooperative that qualifies for tax treatment under Subchapter T of the Internal Revenue Code. Accordingly, under specified conditions, the Association can exclude from taxable income amounts distributed as qualified patronage refunds in the form of cash, stock or allocated surplus. Provisions for income taxes are made only on those taxable earnings that will not be distributed as qualified patronage refunds. The Association distributes patronage on the basis of book income. The Association recognizes deferred tax assets and liabilities for the expected future tax consequences of the temporary differences between the carrying amounts and tax bases of assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be realized or settled. A valuation allowance is provided at the balance sheet dates against that portion of the Association’s deferred tax assets that it is more likely than not (50 percent probability), based on management’s best estimates of future events and circumstances, that will not be realized.

As previously described, the ACA holding company operates through two wholly-owned subsidiaries. The FLCA subsidiary is exempt from federal and other income taxes as provided in the Farm Credit Act. The ACA and the PCA subsidiary are subject to federal and state income taxes. The Association accounts for income taxes under the asset and liability method. Accordingly, deferred taxes are recognized for estimated taxes ultimately payable or recoverable based on federal, state or local laws.

- I. Patronage Refund from AgFirst:** The Association records patronage refunds from the Bank on an accrual basis.

### **Note 3 — Refinement of the Allowance for Loan Losses Methodology**

During 2004, the Association conducted a study to further refine its allowance for loan losses methodology taking into account recently issued guidance by FCA as well as the Securities and Exchange Commission (SEC) and Federal Financial Institutions Examination Council guidelines.

The Association’s allowance for loan losses methodology was adjusted and revised in the late 1980s to take into account credit losses in that period. Given the long cyclical nature of the agricultural economy, loss factors utilized to determine the allowance for loan losses subsequent to 1989 continued to reflect, to some extent, the loss history of the mid-to-late 1980s, which resulted in conservative estimates of the allowance for loan losses. The Association’s allowance for loan losses methodology utilized throughout the period was in accordance with generally accepted accounting principles and was consistently applied.

While conservative in estimating the allowance for loan losses, the methodology used resulted in annual provisions for loan losses over the periods that reflected changes in credit quality and loss experience. Accordingly, the reserves provided in the mid-to-late 1980s have, in effect, remained part of the allowance for loan losses. The Association’s allowance for loan losses methodology has consistently adhered to proper accounting policies, under the regulatory supervision of FCA in its role as a “safety and soundness” regulator. It was FCA’s view that the allowance for loan losses should include among others, an assessment of: probable losses, historical loss experience and economic conditions.

In April 2004, FCA issued an “Informational Memorandum” to System institutions regarding the criteria and methodologies that would be used in evaluating the adequacy of a System institution’s allowance for loan losses. FCA endorsed the direction provided by other bank regulators and the SEC and indicated the conceptual framework addressed in their guidance would be included as part of their examination process.

During the fourth quarter of 2004, the Association completed its study and refined its methodology to be in compliance with the guidance discussed in the previous paragraph. The refinement in methodology resulted in a calculated allowance for loan losses that was significantly less than the previously recorded balance due to revised loss factors that are more indicative of actual loss experience in recent years and current borrower analysis.

While the \$6,497 reversal had a significant impact on 2004 results of operations and the previously recorded allowance for loan losses, the refinement in methodology did not have a significant impact on 2005 comparative results of operations and is not expected to have a significant impact in future periods. Additionally, the refinement in methodology did not have a significant impact on the level of the risk bearing capacity of the Association, generally referred to as “risk funds” (capital plus the allowance for loan losses), which totaled \$99,756 at December 31, 2005 (19.21 percent of Association loans), as compared with \$97,128 at December 31, 2004 (20.40 percent of Association loans), and \$90,599 at December 31, 2003 (18.72 percent of Association loans).

**Note 4 — Loans and Allowance for Loan Losses**

A summary of loans follows:

	December 31,		
	2005	2004	2003
Production agriculture:			
Real estate mortgage	\$ 193,737	\$ 202,761	\$ 340,672
Production and intermediate term	281,997	251,499	130,868
Agribusiness:			
Loans to cooperatives	692	—	—
Processing and marketing	16,636	10,630	3,294
Farm related business	17,903	6,353	3,086
Energy	1,462	3	—
Rural residential real estate	6,771	4,974	5,953
<b>Total loans</b>	<b>\$ 519,198</b>	<b>\$ 476,220</b>	<b>\$ 483,873</b>

The Association's concentration of credit risk in various agricultural commodities is shown in the following table. While the amounts represent the Association's maximum potential credit risk as it relates to recorded loan principal, a substantial portion of the Association's lending activities is collateralized and the Association's exposure to credit loss associated with lending activities is reduced accordingly. An estimate of the Association's credit risk exposure is considered in the determination of the allowance for loan losses.

Total loans at December 31, 2005, 2004 and 2003 consisted of the following commodity types:

Commodity Group	Percent of Portfolio		
	2005	2004	2003
Swine	41%	44%	42%
Poultry	22	19	18
Tobacco	11	13	13
Row Crops	7	7	6
Field/Grain	1	1	1
Rural Home	1	1	1
Other	17	15	19
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the borrower. Collateral held varies, but typically includes farmland and income-producing property, such as crops and livestock, as well as receivables. Long-term real estate loans are secured by the first liens on the underlying real property. Federal regulations state that long-term real estate loans are not to exceed 85 percent (97 percent if guaranteed by a government agency) of the property's appraised value. However, a decline in a property's market value subsequent to loan origination or advances, or other actions necessary to protect the financial interest of the Association in the collateral, may result in the loan to value ratios in excess of the regulatory maximum.

The following table presents information relating to impaired loans.

	December 31,		
	2005	2004	2003
Nonaccrual loans:			
Current as to principal and interest	\$ 394	\$ 621	\$ 451
Past due	1,603	778	917
Total nonaccrual loans	1,997	1,399	1,368
Impaired accrual loans:			
Restructured accrual loans	95	339	334
Accrual loans 90 days or more past due	—	—	9
Total impaired accrual loans	95	339	343
<b>Total impaired loans</b>	<b>\$ 2,092</b>	<b>\$ 1,738</b>	<b>\$ 1,711</b>

There were no material commitments to lend additional funds to debtors whose loans were classified as impaired at December 31, 2005.

Interest income is recognized and cash payments are applied on nonaccrual impaired loans as described in Note 2. The following table presents interest income recognized on impaired loans.

	Year Ended December 31,		
	2005	2004	2003
Interest income recognized on nonaccrual loans	\$ 369	\$ 602	\$ 175
Interest income on impaired accrual loans	6	15	21
<b>Interest income recognized on impaired loans</b>	<b>\$ 375</b>	<b>\$ 617</b>	<b>\$ 196</b>

The following table presents information concerning impaired loans as of December 31,

	2005	2004	2003
Impaired loans with related allowance	\$ 205	\$ 258	\$ 31
Impaired loans with no related allowance	1,887	1,481	1,680
<b>Total impaired loans</b>	<b>\$ 2,092</b>	<b>\$ 1,739</b>	<b>\$ 1,711</b>
Allowance on impaired loans	\$ 123	\$ 132	\$ 14

The following table summarizes impaired loan information for the year ended December 31,

	2005	2004	2003
Average impaired loans	\$ 2,047	\$ 1,549	\$ 1,727

The following table summarizes interest income on nonaccrual and accruing restructured loans that would have been recognized under the original terms of the loans:

	Year Ended December 31	
	2005	2004
Interest income which would have been recognized under the original loan terms	\$ 555	\$ 733
Less: interest income recognized	369	602
<b>Foregone interest income</b>	<b>\$ 186</b>	<b>\$ 131</b>

The changes in the allowance for loan losses are as follows:

	Year Ended December 31,		
	2005	2004	2003
Balance at beginning of year	\$ 3,507	\$ 9,993	\$ 10,093
Provision for (reversal of allowance for) loan losses	\$ (65)	\$ —	\$ —
Nonrecurring provision for loan losses reversal	—	(6,497)	—
	(65)	(6,497)	—
Charge-offs:			
Production agriculture:			
Production and intermediate term	\$ 21	\$ —	\$ 160
Total charge-offs	21	—	160
Recoveries			
Production agriculture:			
Real estate mortgage	\$ —	\$ 11	\$ —
Production and intermediate term	13	—	60
Total recoveries	13	11	60
Net charge-offs (recoveries)	8	(11)	100
Balance at end of year	\$ 3,434	\$ 3,507	\$ 9,993
Ratio of net charge-offs during the period to average loans outstanding during the period	0.001%	(0.002)%	0.021%

As previously discussed in Note 3, the nonrecurring partial reversal of the allowance for loan losses resulted from the refinement of the Association's allowance for loan losses methodology.

In addition, the following is a breakdown of the allowance for loan losses for the end of the last three fiscal years:

	December 31,					
	2005		2004		2003	
	Amount	%	Amount	%	Amount	%
Production agriculture						
Real estate mortgage	\$ 1,457	42.4%	\$ 1,479	42.2%	\$ 7,035	70.5%
Production and intermediate term	1,770	51.6	1,821	51.9	2,703	27.0
Agribusiness	157	4.6	157	4.5	132	1.3
Energy	12	0.3	12	0.3	-	-
Rural residential real estate	38	1.1	38	1.1	123	1.2
Total	<u>\$ 3,434</u>	<u>100.0%</u>	<u>\$ 3,507</u>	<u>100.0%</u>	<u>\$ 9,993</u>	<u>100.0%</u>

#### Note 5 — Other Investments

On October 22, 2004, Congress enacted the “Fair and Equitable Tobacco Reform Act of 2004” (Tobacco Act) as part of the “American Jobs Creation Act of 2004.” The Tobacco Act repealed the Federal tobacco price support and quota programs, provides for payments to tobacco “quota owners” and producers for the elimination of the quota, and provides an assessment mechanism for tobacco manufacturers and importers to pay for the buyout. Tobacco quota holders and producers will receive 10 equal annual payments under a contract with the Secretary of Agriculture. The Tobacco Act also includes a provision that allows the quota holders and producers to assign to a “financial institution” the right to receive the contract payments so that they may obtain a lump sum or other payment. On April 4, 2005, the USDA issued a Final Rule implementing the “Tobacco Transition Payment Program” (Tobacco Buyout).

The FCA determined that System institutions are “financial institutions” within the meaning of the Tobacco Act and are, therefore, eligible to participate in the Tobacco Buyout. The FCA recognized that the Tobacco Buyout has significant implications for some System institutions and the tobacco quota holders and producers they serve. The FCA’s goal is to provide System institution borrowers with the option to immediately receive Tobacco Buyout contract payments and reinvest them in future business opportunities.

For the year ended December 31, 2005, the Association held Tobacco Buyout SIIC of \$15,367, net of discount.

#### Note 6 — Investment in AgFirst Farm Credit Bank

The Association is required to maintain ownership in the Bank of Class B and Class C stock as determined by the Bank. The Bank may require additional capital contributions to maintain its capital requirements.

#### Note 7 — Premises and Equipment

Premises and equipment consisted of the following:

	December 31,		
	2005	2004	2003
Land	\$ 950	\$ 950	\$ 625
Buildings and improvements	3,300	3,253	3,561
Furniture and equipment	2,264	2,350	2,321
	6,514	6,553	6,507
Less: accumulated depreciation	3,111	3,081	2,839
Total	<u>\$ 3,403</u>	<u>\$ 3,472</u>	<u>\$ 3,668</u>

#### Note 8 — Notes Payable to AgFirst Farm Credit Bank

The Association’s indebtedness to the Bank represents borrowings by the Association to fund its loan portfolio. This indebtedness is collateralized by a pledge of substantially all of the Association’s assets and the terms of the revolving lines of credit are governed by a general financing agreement. Interest rates on both variable and fixed rate notes payable are generally established loan-by-loan based on the Bank’s marginal cost of funds, capital position, operating costs and return objectives. The interest rate is periodically adjusted by the Bank based upon agreement between the Bank and Association. The weighted average interest rates on the variable rate notes were 5.30 percent for LIBOR-based loans, 5.17 percent for Prime-based loans, and the weighted average remaining maturities were 3.3 years and 5.1 years, respectively, at December 31, 2005. The weighted average interest rate on the fixed rate and adjustable rate mortgage (ARM) notes payable which are match funded by the Bank was 4.98 percent and the weighted average remaining maturity was 6.9 years at December 31, 2005. The weighted average interest rate on all interest-bearing notes payable was 5.06 percent and the weighted average remaining maturity was 6.1 years at December 31, 2005.

Variable rate and fixed rate notes payable represent approximately 24.13 percent and 75.87 percent, respectively, of total notes payable at December 31, 2005.

Under the Farm Credit Act, the Association is obligated to borrow only from the Bank, unless the Bank approves borrowing from other funding sources. The Bank, consistent with FCA regulations, has established limitations on the Association’s ability to borrow funds based on specified factors or formulas relating primarily to credit quality and financial condition. At December 31, 2005, the Association’s notes payable were within the specified limitations.

#### Note 9 — Members’ Equity

A description of the Association’s capitalization requirements, protection mechanisms, regulatory capitalization requirements and restrictions, and equities are provided below.

##### A. Protected Borrower Stock

Protection of certain borrower stock is provided under the Farm Credit Act which requires the Association, when retiring protected borrower stock, to retire such stock at par or stated value regardless of its book value. Protected borrower stock includes capital stock and participation certificates which were outstanding as of January 6, 1988, or were issued or allocated prior to October 6, 1988. If an Association is unable to retire protected borrower stock at par value or stated value, amounts required to retire this equity would be obtained from the Insurance Fund.

**B. Capital Stock and Participation Certificates**

In accordance with the Farm Credit Act and the Association’s capitalization bylaws, each borrower is required to invest in Class C stock for agricultural loans, or participation certificates in the case of rural home and farm related business loans, as a condition of borrowing. The initial borrower investment, through either purchase or transfer, must be in an amount equal to 200 shares (\$1,000.00) or one (1) share for each \$250.00 (or fraction thereof) of the amount of the loan. The Board of Directors may increase the amount of investment if necessary to meet the Association’s capital needs. Loans designated for sale or sold into the Secondary Market on or after April 16, 1996 will have no voting stock or participation certificate purchase requirement if sold within 180 days following the date of designation.

The borrower acquires ownership of the capital stock or participation certificates at the time the loan is made, but usually does not make a cash investment. The aggregate par value is generally added to the principal amount of the related loan obligation. The Association retains a first lien on the stock or participation certificates owned by borrowers. Retirement of such equities will generally be at the lower of par or book value, and repayment of a loan does not automatically result in retirement of the corresponding stock or participation certificates.

**C. Regulatory Capitalization Requirements and Restrictions**

The FCA’s capital adequacy regulations require the Association to achieve permanent capital of seven percent of risk-adjusted assets and off-balance-sheet commitments. Failure to meet the seven percent capital requirement can initiate certain mandatory and possibly additional discretionary actions by the FCA that, if undertaken, could have a direct material effect on the Association’s financial statements. The Association is prohibited from reducing permanent capital by retiring stock or making certain other distributions to shareholders unless prescribed capital standards are met. The FCA regulations also require that additional minimum standards for capital be achieved. These standards require all System institutions to achieve and maintain ratios as defined by FCA regulations. These required ratios are total surplus as a percentage of risk-adjusted assets of seven percent and of core surplus as a percentage of risk-adjusted assets of three and one-half percent. The Association’s permanent capital, total surplus and core surplus ratios at December 31, 2005 were 16.95 percent, 16.55 percent and 13.24 percent, respectively.

An FCA regulation empowers it to direct a transfer of funds or equities by one or more System institutions to another System institution under specified circumstances. The Association has not been called upon to initiate any transfers and is not aware of any proposed action under this regulation.

**D. Description of Equities**

The Association is authorized to issue or have outstanding Classes A and D Preferred Stock, Classes A, B and C Common Stock, Classes B and C Participation Certificates and such other classes of equity as may be provided for in amendments to the bylaws in such amounts as may be necessary to conduct the Association’s business. All stock and participation certificates have a par or face value of five dollars (\$5.00) per share.

The Association had the following shares outstanding at December 31, 2005:

Class	Protected	Shares Outstanding	
		Number	Aggregate Par Value
B Common/Nonvoting	Yes	48,355	\$ 242
C Common/Voting	No	419,239	2,096
B Participation Certificates/Nonvoting	Yes	5,447	27
C Participation Certificates/Nonvoting	No	11,656	58
Total Capital Stock and Participation Certificates		484,697	\$ 2,423

Protected common stock and participation certificates are retired at par or face value in the normal course of business. At-risk common stock and participation certificates are retired at the sole discretion of the Board at book value not to exceed par or face amounts, provided the minimum capital adequacy standards established by the Board are met.

*Retained Earnings*

The Association maintains an unallocated retained earnings account and an allocated retained earnings account. The minimum aggregate amount of these two accounts is determined by the Board. At the end of any fiscal year, if the retained earnings accounts otherwise would be less than the minimum amount determined by the Board as necessary to maintain adequate capital reserves to meet the commitments of the Association, the Association shall apply earnings for the year to the unallocated retained earnings account in such amounts as may be determined necessary by the Board. Unallocated retained earnings are maintained for each borrower to permit liquidation on a patronage basis.

The Association maintains an allocated retained earnings account consisting of earnings held and allocated to borrowers on a patronage basis. In the event of a net loss for any fiscal year, such allocated retained earnings account will be subject to full impairment in the order specified in the bylaws beginning with the most recent allocation.

The Association has a first lien and security interest on all retained earnings account allocations owned by any borrowers, and all distributions thereof, as additional collateral for their indebtedness to the Association. When the debt of a borrower is in default or is in the process of final liquidation by payment or otherwise, the Association, upon approval of the Board, may order any and all retained earnings account allocations owned by such borrower to be applied on the indebtedness.

Allocated equities shall be retired solely at the discretion of the Board; provided, however, that minimum capital standards established by the FCA and the Board are met. All nonqualified distributions are tax deductible only when redeemed.

At December 31, 2005, allocated members’ equity consisted of \$12,134 of qualified surplus and \$9,901 of nonqualified allocated surplus.

*Dividends*

The Association may declare noncumulative dividends on its capital stock and participation certificates provided the dividend rate does not exceed 20 percent of the par value of the respective capital stock and participation certificates. Such dividends may be paid solely on Classes A and D Preferred Stock, or on all classes of stock and participation certificates.

The rate of dividends paid on Class A Preferred Stock for any fiscal year may not be less than the rate of dividends paid on Classes A, B or C Common Stock or participation certificates for such year. The rate of dividends on Classes A, B and C Common Stock and participation certificates shall be at the same rate per share.

Dividends may not be declared if, after recording the liability, the Association would not meet its capital adequacy standards. No dividends were declared by the Association for any of the periods included in these financial statements.

*Patronage Distributions*

Prior to the beginning of any fiscal year, the Board, by adoption of a resolution, may obligate the Association to distribute to borrowers on a patronage basis all or any portion of available net earnings for such fiscal year or for that and subsequent fiscal years. Patronage distributions are based on the proportion of the borrower's interest to the amount of interest earned by the Association on its total loans unless another proportionate patronage basis is approved by the Board.

If the Association meets its capital adequacy standards after making the patronage distributions, the patronage distributions may be in cash, authorized stock of the Association, allocations of earnings retained in an allocated members' equity account, or any one or more of such forms of distribution. Patronage distributions of the Association's earnings may be paid on either a qualified or nonqualified basis, or a combination of both, as determined by the Board. A minimum of 20 percent of the total qualified patronage distribution to any borrower for any fiscal year shall always be paid in cash.

*Transfer*

Class D Preferred, Classes A, B and C Common Stocks, and Classes B and C Participation Certificates may be transferred to persons or entities eligible to purchase or hold such equities.

*Impairment*

Any net losses recorded by the Association shall first be applied against unallocated members' equity. To the extent that such losses would exceed unallocated members' equity, such losses would be applied consistent with the Association's bylaws and distributed pro rata to each share and/or unit outstanding in the class, in the following order:

- (a) **First**, allocated surplus evidenced by nonqualified written notices of allocation, in its entirety, with application to most recent allocation first and then in reverse order until all such allocated surplus has been exhausted;
- (b) **Second**, allocated surplus evidenced by qualified written notices of allocation, in its entirety, with application to most recent allocation first and then in reverse order until all such allocated surplus has been exhausted;
- (c) **Third**, Class A Common Stock, Class B Common Stock, Class C Common Stock and Class C Participation Certificates issued and outstanding, pro rata until such stock is fully impaired; and
- (d) **Fourth**, Class A Preferred and Class D Preferred Stock issued and outstanding, if any.

Impairments shall be considered as being applied pro rata to each share and/or unit outstanding in the class.

*Liquidation*

In the event of liquidation or dissolution of the Association, any assets of the Association remaining after payment or retirement of all liabilities should be distributed to the holders of the outstanding stock and participation certificates in the following order:

- (a) **First**, to the holders of Class D Preferred Stock until an amount equal to the aggregate par value of all shares of said stock then issued and outstanding has been distributed to such holders;
- (b) **Second**, to the holders of Class A Common, Class B Common, Class C Common, Class B Participation Certificates and Class C Participation Certificates, pro rata in proportion to the number of shares or units of each such class of stock or participation certificates then issued and outstanding, until an amount equal to the aggregate par value or face amount of all such shares or units has been distributed to such holders;
- (c) **Third**, to the holders of allocated surplus evidenced by qualified written notices of allocation, in the order of year of issuance and pro rata by year of issuance, until the total amount of such allocated surplus has been distributed;
- (d) **Fourth**, to the holders of allocated surplus evidenced by nonqualified written notices of allocation, in the order of year of issuance and pro rata by year of issuance, until the total amount of such allocated surplus has been distributed; and
- (e) **Fifth**, any remaining assets of the Association after such distributions shall be distributed to past and present Patrons on a patronage basis, to the extent practicable.

**E. Other Comprehensive Income (Loss)**

The Association reports other comprehensive income (loss) in its Consolidated Statements of Changes in Members' Equity. For the years ended December 31, 2003 and 2002, other comprehensive income (loss) was related to the minimum pension liability recorded as a result of the funded status of the underlying plan. During 2004, the District Associations funded the pension plans sufficiently to eliminate the pension-related charge to other comprehensive income (loss) at December 31, 2004. The remaining amounts at December 31, 2005 and 2004 relate to the funded status of a supplemental retirement plan. See Note 11 for further information.

**Note 10 — Income Taxes**

The provision (benefit) for income taxes follows:

	<b>Year Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
Current:			
Federal	\$ 83	\$ (459)	\$ 272
State	23	(150)	51
	<u>106</u>	<u>(609)</u>	<u>323</u>
Deferred:			
Federal	—	326	73
State	—	83	14
	<u>—</u>	<u>409</u>	<u>87</u>
Total provision (benefit) for income taxes	<u>\$ 106</u>	<u>\$ (200)</u>	<u>\$ 410</u>

The provision (benefit) for income tax differs from the amount of income tax determined by applying the applicable U.S. statutory federal income tax rate to pretax income as follows:

	December 31,		
	2005	2004	2003
Federal tax at statutory rate	\$ 5,433	\$ 7,114	\$ 4,217
State tax, net	15	(44)	57
Patronage distributions	(2,360)	(1,840)	(2,401)
Tax-exempt FLCA earnings	(3,831)	(5,029)	(904)
Change in valuation allowance	612	(537)	(905)
Other	237	136	346
Provision (benefit) for income taxes	<u>\$ 106</u>	<u>\$ (200)</u>	<u>\$ 410</u>

Deferred tax assets and liabilities result from the following at:

	December 31,		
	2005	2004	2003
Allowance for loan losses	\$ 645	\$ 690	\$ 1,426
Net operating loss – carryforward	906	370	–
Nonaccrual loan interest	131	80	58
Nonqualified patronage distributions	–	–	–
Gross deferred tax assets	<u>1,682</u>	<u>1,140</u>	<u>1,484</u>
Valuation allowance	<u>(1,108)</u>	<u>(496)</u>	<u>(392)</u>
Net Deferred Tax Assets	<u>574</u>	<u>644</u>	<u>1,092</u>
Future Bank equity redemption	(111)	–	–
State income tax	–	65	–
Loan fees	(403)	(649)	(623)
Other	–	–	–
Gross deferred tax liability	<u>(514)</u>	<u>(584)</u>	<u>(623)</u>
Net deferred tax asset (liability)	<u>\$ 60</u>	<u>\$ 60</u>	<u>\$ 469</u>

At December 31, 2005, deferred income taxes have not been provided by the Association on approximately \$3.6 million of patronage refunds received from the Bank prior to January 1, 1993. Such refunds, distributed in the form of stock, are subject to tax only upon conversion to cash. The tax liability related to future conversions is not expected to be material.

The Association recorded a valuation allowance of \$1,108, \$496 and \$392 during 2005, 2004 and 2003, respectively. The Association will continue to evaluate the realizability of these deferred tax assets and adjust the valuation allowance accordingly.

#### Note 11 — Employee Benefit Plans

The employees of the Association may participate in a Districtwide defined benefit retirement plan. This plan is noncontributory and covers substantially all Association employees. Benefits are based on salary and years of service. The assets, liabilities and costs of the plan are not segregated by participating entities but are allocated among the participating entities. Pension costs are allocated by multiplying the District's net pension expense times the Association's salary expense as a percentage of the District's salary expense.

At December 31, 2005 and 2004, the fair value of the plan assets of the District's defined benefit plan exceeded the Accumulated Benefit Obligation (ABO), while at December 31, 2003, the ABO of the District's defined benefit plan exceeded the fair value of plan assets. The fair value of the plan assets and the ABO were measured as of September 30, 2005. At December 31, 2003, the Association's allocated amount of the minimum pension liability was recorded in the Consolidated Balance Sheets in the amount of the excess of the ABO over the fair value of plan assets. In

conjunction with the minimum pension liability, accumulated other comprehensive loss was \$4,497 at December 31, 2003. The impact on deferred taxes was not significant.

In addition, supplemental retirement benefits are provided to certain key employees under a supplemental defined benefit executive plan, which is not qualified under the Internal Revenue Code. As a nonqualified plan, assets have been allocated and separately invested for this plan but are not isolated from the general creditors of the Association.

The Association participates in a Districtwide Thrift Plan. For employees hired on or prior to December 31, 2002, the Association will contribute \$.50 for each \$1.00 of the maximum employee contribution of 6 percent of total compensation. For employees hired on or after January 1, 2003, the Association will contribute \$1.00 for each \$1.00 of the maximum employee contribution of 6 percent of total compensation. Employee deferrals are not to exceed the maximum deferral as adjusted by the Internal Revenue Service.

The District sponsors a plan providing certain benefits (primarily health care) to its retirees. Certain Association charges related to this plan are an allocation of District charges based on the Association's proportional share of the plan liability.

On December 8, 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (Medicare Act) was signed into law. This act introduces a prescription drug benefit under Medicare (Medicare Part D) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. In May 2004, the FASB issued FASB Staff Position (FSP) 106-2, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003" (the Act). This Staff Position provides guidance on the accounting for the effects of the Act for employers that sponsor postretirement health care plans that provide prescription drug benefits. The District sponsored plan adopted FSP 106-2 effective July 1, 2004 (measured as of March 31, 2004). The benefit obligation valuation as of December 31, 2004 reflects the impact of the Medicare Act.

In determining the benefit obligation as of December 31, 2004, the expected per capita claims cost were estimated to be reduced by 12 percent beginning in 2006, for Medicare-eligible participants receiving actuarially equivalent drug benefits, due to a government reimbursement of a portion of prescription drug benefits. The District reduced its accumulated postretirement benefit obligation (APBO) for the subsidy related to benefits attributed to past service. The effect of the subsidy on the measurement of net periodic postretirement cost for 2005 was a reduction of 2005 expense. The effect included lower amortization of actuarial losses, lower service costs and lower interest costs on the APBO.

The Retiree and Disabled Medical Plan was amended effective January 1, 2006 to change the medical and prescription drug coverage for Medicare-eligible retirees and/or eligible spouses 65 years and older. Beginning in 2006, the AgFirst/FCBT Retiree and Disabled Medical Plan will provide medical and prescription drug coverage to Medicare-eligible retirees and/or eligible spouses 65 years and older through fully-insured AARP endorsed Medicare Supplement policies and subsidized basic Medicare D coverage through a selected Prescription Drug Plan. Dental coverage was not changed. Certain other retirees who are grandfathered under insured arrangements were not impacted by the change. The benefit obligation valuation as of December 31, 2005 reflects the impact of this plan amendment.

In determining the benefit obligation as of December 31, 2005, there was no impact due to government reimbursement of prescription drug benefits. After the plan amendment, the plan no longer provides prescription drug benefits directly for retirees

and/or eligible spouses 65 years and older. Instead, the District subsidizes the cost of coverage obtained under the Medicare D program through the selected Prescription Drug Provider.

For further information on postretirement costs, see "Postretirement Benefits" section in the Notes to the AgFirst Farm Credit District Consolidated Financial Statements.

The following is a table of retirement and postretirement benefits expenses:

	2005	2004	2003
Pension	\$ 745	\$ 798	\$ 866
Thrift/deferred compensation	119	108	103
Other postretirement benefits	618	698	694
Total	<u>\$1,482</u>	<u>\$1,604</u>	<u>\$1,663</u>

As of December 31, 2005 and 2004, the Association had contributed \$1,008 and \$4,196, respectively, to the Districtwide defined benefit retirement plan, which was sufficient to meet its accumulated benefit obligation. For 2004, the contributions eliminated the minimum pension liability and the pension-related charge to accumulated other comprehensive income (OCI) in members' equity. As a result of the fundings and the reclassification of the OCI, the Association ended 2005 and 2004 with \$5,787 and \$5,485, respectively, in prepaid retirement expense on the Consolidated Balance Sheets. Weaker investment performance by the retirement plan assets and lower discount rates have resulted in an under-funded status for the non-qualified plan. Since the fund assets are owned by the Association, full funding as accomplished with the Districtwide benefit plan was not possible. Therefore, the Association reflects an accumulated other comprehensive income adjustment of \$(404) and \$(399) for the years ended December 31, 2005 and 2004, respectively, the funding of which will be amortized over coming years.

#### Note 12 — Intra-System Financial Assistance

The Farm Credit System Financial Assistance Corporation (Financial Assistance Corporation) was established in 1988 primarily to provide capital to institutions of the System experiencing financial difficulty. Such assistance was funded through the Financial Assistance Corporation's issuance of \$1.261 billion of 15-year U.S. Treasury-guaranteed debt. The interest rates on these issuances range from 8.80 percent to 9.45 percent. The repayment of this debt and related interest was the responsibility of System banks. In June 2005, the last outstanding Financial Assistance Corporation debt of \$325 million matured and was redeemed.

Each System bank may be required to pay premiums into the Insurance Fund based on its annual average loan principal outstanding. The Bank, in turn, may also assess the Association for insurance premiums based on the average principal outstanding of accrual and nonaccrual loans of the Association for each year. At December 31, 2005, the assets in the Insurance Fund aggregated \$2.062 billion. However, due to the authorized uses of the Insurance Fund, there is no assurance that Insurance Fund assets will be available or sufficient to ensure the payment of principal of, or interest on, insured debt securities in the event of a default by any System bank having primary liability thereon.

#### Note 13 — Related Party Transactions

In the ordinary course of business, the Association enters into loan transactions with officers and directors of the Association, their immediate families and other organizations with which such persons may be associated. Such loans are subject to special approval requirements contained in the FCA regulations and are made on the same terms, including interest rates and collateral, as

those prevailing at the time for comparable transactions with unrelated borrowers.

Total loans to such persons at December 31, 2005 amounted to \$15,140. During 2005, \$9,829 of new loans were made and repayments totaled \$7,192. In the opinion of management, none of these loans outstanding at December 31, 2005 involved more than a normal risk of collectibility.

#### Note 14 — Commitments and Contingencies

The Association has various commitments outstanding and contingent liabilities.

The Association may participate in financial instruments with off-balance-sheet risk to satisfy the financing needs of its borrowers and to manage their exposure to interest-rate risk. These financial instruments include commitments to extend credit and/or commercial letters of credit. The instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the financial statements. Commitments to extend credit are agreements to lend to a borrower as long as there is not a violation of any condition established in the contract. Commercial letters of credit are agreements to pay a beneficiary under conditions specified in the letter of credit. Commitments and letters of credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. At December 31, 2005, \$81,423 of commitments to extend credit and \$4,871 of commercial letters of credit were outstanding.

Since many of these commitments are expected to expire without being drawn upon, the total commitments do not necessarily represent future cash requirements. However, these credit-related financial instruments have off-balance-sheet credit risk because their amounts are not reflected on the Balance Sheet until funded or drawn upon. The credit risk associated with issuing commitments and letters of credit is substantially the same as that involved in extending loans to borrowers and management applies the same credit policies to these commitments. Upon fully funding a commitment, the credit risk amounts are equal to the contract amounts, assuming that borrowers fail completely to meet their obligations and the collateral or other security is of no value. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the borrower.

As of December 31, 2005, the Association had commitments to purchase \$6,738 in additional Tobacco Buyout SIIC in 2006.

#### Note 15 — Disclosures About Fair Value of Financial Instruments

The following table presents the carrying amounts and fair values of the Association's financial instruments at December 31, 2005, 2004 and 2003. The fair value of a financial instrument is generally defined as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

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:

	December 31, 2005		December 31, 2004	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<b>Financial assets:</b>				
Cash	\$ 2,610	\$ 2,610	\$ 2,052	\$ 2,052
Loans	\$ 519,198	\$ 524,241	\$ 476,220	\$ 483,518
Allowance for loan losses	3,434	—	3,507	—
Loans, net	\$ 515,764	\$ 524,241	\$ 472,713	\$ 483,518
Other Investments	\$ 15,367	\$ 15,590	\$ —	\$ —
<b>Financial liabilities:</b>				
Notes payable to AgFirst Farm Credit Bank	\$ 447,981	\$ 444,444	\$ 393,652	\$ 394,002

	December 31, 2003	
	Carrying Amount	Estimated Fair Value
<b>Financial assets:</b>		
Cash	\$ 1,835	\$ 1,835
Loans	\$ 483,873	\$ 489,481
Allowance for loan losses	9,993	—
Loans, net	\$ 473,880	\$ 489,481
Other Investments	\$ —	\$ —
<b>Financial liabilities:</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 400,460	\$ 399,174

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. As described in Note 6, the net investment is a requirement of borrowing from the Bank and is carried at cost plus allocated equities in the accompanying balance sheet. The Association owns 3.42 percent of the issued stock of the Bank as of December 31, 2005 net of any reciprocal investment. As of that date, the Bank's

assets totaled \$20.5 billion and shareholders' equity totaled \$1,037 million. The Bank's earnings were \$164 million during 2005.

- 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. **Other Investments:** Other Investments includes Tobacco Buyout Successor-in-Interest Contracts (SIIC) which come under the FCA's Mission Related Investments. Under the SIIC, the tobacco quota holders and producers may assign their rights to receive Tobacco Buyout contract payments to a third party. The successor purchases the entire contract and all related rights and obligations associated with contract.

Fair value of the SIIC is estimated by discounting future annual cash flows using prevailing rates for similar instruments at year-end.

#### Note 16 — Quarterly Financial Information (Unaudited)

Quarterly results of operations for the years ended December 31, 2005, 2004 and 2003 follow:

	2005				
	First	Second	Third	Fourth	Total
Net interest income	\$ 3,996	\$ 3,983	\$ 4,286	\$ 4,482	\$ 16,747
Provision for (reversal of allowance for) loan losses	—	(65)	—	—	(65)
Noninterest income (expense), net	(508)	(552)	(780)	903	(937)
Net income (loss)	\$ 3,488	\$ 3,496	\$ 3,506	\$ 5,385	\$ 15,875

	2004				
	First	Second	Third	Fourth	Total
Net interest income	\$ 4,095	\$ 3,733	\$ 3,561	\$ 3,771	\$ 15,160
Provision for (reversal of allowance for) loan losses	—	—	—	(6,497)	(6,497)
Noninterest income (expense), net	(495)	(421)	(327)	710	(533)
Net income (loss)	\$ 3,600	\$ 3,312	\$ 3,234	\$ 10,978	\$ 21,124

	2003				
	First	Second	Third	Fourth	Total
Net interest income	\$ 3,567	\$ 3,617	\$ 3,691	\$ 3,664	\$ 14,539
Provision for (reversal of allowance for) loan losses	—	—	—	—	—
Noninterest income (expense), net	(385)	(460)	(639)	(653)	(2,137)
Net income (loss)	\$ 3,182	\$ 3,157	\$ 3,052	\$ 3,011	\$ 12,402