

# THIRD QUARTER 2006

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Richard A. Eason  
Chief Executive Officer



Ronald J. Allen  
Chairman of the Board

October 27, 2006

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

*(dollars in thousands)*

The following commentary reviews the financial condition and results of operations of Cape Fear Farm Credit ACA, (Association) for the period ended September 30, 2006. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements and the 2005 Annual Report of the Association. The accompanying consolidated financial statements were prepared under the oversight of the Audit Committee of the Board of Directors.

## **LOAN PORTFOLIO**

The Association provides funds to farmers, rural homeowners and farm-related businesses for financing of short and intermediate-term loans and long-term real estate mortgage loans. The Association's loan portfolio is diversified over a range of agricultural commodities in our region, including tobacco, swine, poultry, and row-crop operations. Farm size varies and many of the borrowers in the region have diversified farming operations. This factor, along with the numerous opportunities for non-farm income in the area, lessens the level of dependency on any single given commodity. Concentration risk is further mitigated by a substantial portfolio of participation loans purchased or originated and sold.

The gross loan volume of the Association as of September 30, 2006, was \$604,528, an increase of \$85,330 as compared to \$519,198 at December 31, 2005. Net loans outstanding at September 30, 2006, were \$601,015 as compared to \$515,764 at December 31, 2005. Net loans accounted for 91.29 percent of total assets at September 30, 2006, as compared to 91.65 percent of total assets at December 31, 2005.

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

There is an inherent risk in the extension of any type of credit. However, portfolio credit quality continues to be maintained at an acceptable level and credit administration remains satisfactory. Nonaccrual loans decreased from \$1,997 at

December 31, 2005, to \$979 at September 30, 2006. This decrease results primarily from the liquidation of two loans and significant payments received during the first two quarters of 2006.

Association management maintains an allowance for loan losses in an amount considered sufficient to absorb possible losses in the loan portfolio based on current and expected future conditions. The allowance for loan losses at September 30, 2006, was \$3,513 as compared to \$3,434 at December 31, 2005, and was considered by management to be adequate to cover possible losses.

## **RESULTS OF OPERATIONS**

### ***For the three months ended September 30, 2006***

Net income for the three months ended September 30, 2006, totaled \$4,419 as compared to \$3,506 for the same period in 2005. The increase of \$913 or 26.04 percent is attributed primarily to an increase in net interest income resulting from growth in loan volume and an increase in market interest rates.

Net interest income for the three months ended September 30, 2006, increased \$769 or 17.94 percent compared to September 30, 2005. Interest income on loans increased by \$3,109 and interest income from other sources increased by \$397, while interest expense increased \$2,658 compared to the same period last year. These increases are both due to a rise in market interest rates and growth in loan volume and other interest bearing assets. Nonaccrual income was \$106 for the three months ended September 30, 2006, as compared to \$13 for the same period in 2005. This increase was primarily due to the liquidation of one nonaccrual loan.

Noninterest income for the three months ended September 30, 2006, totaled \$1,853 as compared to \$1,726 for the same period of 2005, an increase of \$127. The increase resulted from an increase of \$234 in patronage earnings from AgFirst Farm Credit Bank (Bank) that was offset by a decline of \$46 in loan fee income, a decline of \$28 in fees for financially related services, and a decline of \$33 in other noninterest income.

Noninterest expense for the three months ended September 30, 2006, decreased \$79 compared to the same period of 2005. This decrease resulted primarily from decreases of \$234 in salaries and benefits and \$23 in Other operating expenses. These decreases were offset by increases of \$46 in Occupancy and equipment expense and \$132 in Insurance Fund premium.

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**For the nine months ended September 30, 2006**

Net income for the nine months ended September 30, 2006, totaled \$12,319 as compared to \$10,490 for the same period in 2005. The increase of \$1,829 or 17.44 percent is attributed primarily to an increase in net interest income resulting from growth in loan volume and an increase in market interest rates.

At September 30, 2006, net interest income increased \$1,963 or 15.92 percent compared to September 30, 2005. Interest income on loans increased by \$8,116 and interest income from other sources increased by \$1,095, while interest expense increased \$7,104 compared to the same period last year. These increases are both due to a rise in market interest rates and growth in loan volume and other interest bearing assets. Nonaccrual income was \$197 for the nine months ended September 30, 2006, as compared to \$255 for the same period in 2005.

Noninterest income for the nine months ended September 30, 2006, totaled \$5,546 as compared to \$5,075 for the same period of 2005, an increase of \$471. This increase resulted from increases in loan fee income of \$82 and in patronage earnings from the Bank of \$547, which were offset by declines of \$90 in fees for financially related services and \$68 in other noninterest income.

Noninterest expense for the nine months ended September 30, 2006, increased \$584 compared to the same period of 2005. This increase resulted primarily from an increase of \$83 in salaries and benefits, an increase of \$63 in occupancy and equipment expense, an increase of \$431 in Insurance Fund premium, and an increase in other operating expense of \$7.

**FUNDING SOURCES**

The principal source of funds for the Association is the borrowing relationship established with the Bank through a General Financing Agreement. The General Financing Agreement utilizes the Association's credit and fiscal performance as criteria for establishing a line of credit on which the Association may draw funds. The funds are advanced by the Bank to the Association in the form of notes payable. The notes payable are segmented into variable rate and fixed rate sections. The variable rate note is utilized by the Association to fund variable rate loan advances and operating funds requirements. The fixed rate note is used specifically to fund fixed rate loan advances made by the Association. The total notes payable to the Bank at September 30, 2006, were \$544,466 as compared to \$447,981 at December 31, 2005.

**CAPITAL RESOURCES**

Total members' equity at September 30, 2006, increased to \$102,696 from the December 31, 2005, total of \$96,322. The increase results primarily from earnings retained from the prior year in excess of the current year rollout of allocated surplus.

Farm Credit Administration (FCA) regulations require all Farm Credit institutions to maintain minimum permanent capital,

total surplus and core surplus ratios. These ratios are calculated by dividing the Association's permanent capital, total surplus and core surplus as defined in FCA regulations, by a risk-adjusted asset base. As of September 30, 2006, the Association's total surplus ratio and core surplus ratio were 14.76 percent and 12.18 percent, respectively, and the permanent capital ratio was 15.12 percent. All three ratios were well above the minimum regulatory ratios of 7.00 percent for permanent capital and total surplus ratios and 3.50 percent for the core surplus ratio.

**ACCOUNTING FOR DEFINED BENEFIT PENSION AND OTHER POSTRETIREMENT PLANS**

On September 29, 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 158 – Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans. The Standard requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and recognize changes in that funded status in the year in which the changes occur through comprehensive income. The Standard is effective for employers with publicly traded securities for the fiscal year ending after December 15, 2006 and for employers without publicly traded securities for the fiscal year ending after June 15, 2007. The Association will be required to implement the Standard for the year ended December 31, 2007. In addition, this Standard requires that the funded status of a plan be measured as of the date of the year-end financial statements. Currently, the Association uses a measurement date of September 30th. The requirement to measure the funded status as of the fiscal year-end is effective for fiscal years ending after December 15, 2008. The Association is currently evaluating the impact of implementing this Standard. It is anticipated that the impact from the implementation of this Standard will have no impact on the consolidated income statement and, based on the current funded status of the defined benefit plans, it is not expected to have a material or significant impact on the consolidated balance sheet.

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**NOTE:** Shareholder investment in the Association could be affected by the financial condition and results of operations of AgFirst Farm Credit Bank. Copies of AgFirst's annual and quarterly reports are available upon request free of charge by calling 1-800-845-1745, ext. 316, or writing Wanda Martin, AgFirst Farm Credit Bank, P.O. Box 1499, Columbia, SC 29202. Information concerning AgFirst Farm Credit Bank can also be obtained at their website, [www.agfirst.com](http://www.agfirst.com). Copies of the Association's annual and quarterly reports are also available upon request free of charge by calling 910-323-9188, writing Matthew J. Currin, Chief Financial Officer, Cape Fear Farm Credit, P. O. Box 2405, Fayetteville, NC 28302, or accessing the website, [www.capefearfarmcredit.com](http://www.capefearfarmcredit.com). The Association prepares a quarterly report within 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.

*Cape Fear Farm Credit, ACA*  
**Consolidated Balance Sheets**

<i>(dollars in thousands)</i>	<b>September 30, 2006</b> <i>(unaudited)</i>	<b>December 31, 2005</b> <i>(audited)</i>
<b>Assets</b>		
Cash	\$ 735	\$ 2,610
Loans	604,528	519,198
Less: allowance for loan losses	3,513	3,434
Net loans	601,015	515,764
Other investments	26,060	15,367
Accrued interest receivable	12,202	7,802
Investment in other Farm Credit institutions	5,674	5,674
Premises and equipment, net	3,318	3,403
Prepaid retirement expense	5,255	5,787
Due from AgFirst Farm Credit Bank	3,436	5,579
Other assets	631	779
Total assets	\$ 658,326	\$ 562,765
<b>Liabilities</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 544,466	\$ 447,981
Accrued interest payable	2,603	1,868
Patronage refund payable	106	7,016
Postretirement benefits other than pensions	3,932	3,778
Minimum pension liability	416	409
Other liabilities	4,107	5,391
Total liabilities	555,630	466,443
Commitments and contingencies		
<b>Members' Equity</b>		
Protected borrower equity	209	269
Capital stock and participation certificates	2,282	2,154
Retained earnings		
Allocated	15,883	22,035
Unallocated	84,726	72,268
Accumulated other comprehensive income (loss)	(404)	(404)
Total members' equity	102,696	96,322
Total liabilities and members' equity	\$ 658,326	\$ 562,765

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

*Cape Fear Farm Credit, ACA*

# Consolidated Statements of Income

(unaudited)

<i>(dollars in thousands)</i>	<b>For the three months ended September 30,</b>		<b>For the nine months ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
<b>Interest Income</b>				
Loans	\$ 12,522	\$ 9,413	\$ 33,857	\$ 25,741
Other	397	—	1,095	—
Total interest income	12,919	9,413	34,952	25,741
<b>Interest Expense</b>				
Notes payable to AgFirst Farm Credit Bank	7,785	5,127	20,580	13,476
Net interest income	5,134	4,286	14,372	12,265
Provision for (reversal of) loan losses	79	—	79	(65)
Net interest income after provision for (reversal of) loan losses	5,055	4,286	14,293	12,330
<b>Noninterest Income</b>				
Loan fees	520	566	1,854	1,772
Fees for financially related services	94	122	191	281
Equity in earnings of other Farm Credit institutions	1,252	1,018	3,449	2,902
Gains (losses) on other property owned, net	2	2	6	6
Other noninterest income	(15)	18	46	114
Total noninterest income	1,853	1,726	5,546	5,075
<b>Noninterest Expense</b>				
Salaries and employee benefits	1,548	1,782	4,928	4,845
Occupancy and equipment	256	210	609	546
Insurance Fund premium	219	87	610	179
Other operating expenses	404	427	1,292	1,285
Total noninterest expense	2,427	2,506	7,439	6,855
Income before income taxes	4,481	3,506	12,400	10,550
Provision (benefit) for income taxes	62	—	81	60
Net income	\$ 4,419	\$ 3,506	\$ 12,319	\$ 10,490

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

*Cape Fear Farm Credit, ACA*

# Consolidated Statements of Changes in Members' Equity

*(unaudited)*

*(dollars in thousands)*

	<b>Protected Borrower Capital</b>	<b>Capital Stock and Participation Certificates</b>	<b>Retained Earnings</b>		<b>Accumulated Other Comprehensive Income</b>	<b>Total Members' Equity</b>
			<b>Allocated</b>	<b>Unallocated</b>		
Balance at December 31, 2004	\$ 354	\$ 2,114	\$ 28,250	\$ 63,302	\$ (399)	\$ 93,621
Net income				10,490		10,490
Protected borrower equity retired	(73)					(73)
Capital stock/participation certificates issued		280				280
Capital stock/participation certificates retired		(252)				(252)
Retained earnings retired			(6,236)			(6,236)
Distribution adjustment			21	34		55
<b>Balance at September 30, 2005</b>	<b>\$ 281</b>	<b>\$ 2,142</b>	<b>\$ 22,035</b>	<b>\$ 73,826</b>	<b>\$ (399)</b>	<b>\$ 97,885</b>
Balance at December 31, 2005	\$ 269	\$ 2,154	\$ 22,035	\$ 72,268	\$ (404)	\$ 96,322
Net income				12,319		12,319
Protected borrower equity retired	(60)					(60)
Capital stock/participation certificates issued		268				268
Capital stock/participation certificates retired		(140)				(140)
Retained earnings retired			(6,155)			(6,155)
Distribution adjustment			3	139		142
<b>Balance at September 30, 2006</b>	<b>\$ 209</b>	<b>\$ 2,282</b>	<b>\$ 15,883</b>	<b>\$ 84,726</b>	<b>\$ (404)</b>	<b>\$ 102,696</b>

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

## Cape Fear Farm Credit, ACA

# Notes to the Consolidated Financial Statements

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

### NOTE 1 – ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

A description of the organization and operations of Cape Fear Farm Credit, ACA (the Association), the significant accounting policies followed, and the financial condition and results of operations as of and for the year ended December 31, 2005, are contained in the 2005 Annual Report to Shareholders. These unaudited third quarter 2006 consolidated financial statements should be read in conjunction with the 2005 Annual Report to Shareholders.

On September 29, 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 158 – Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans. The Standard requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and recognize changes in that funded status in the year in which the changes occur through comprehensive income. The Standard is effective for employers with publicly traded securities for the fiscal year ending after December 15, 2006 and for employers without publicly traded securities for the fiscal year ending after June 15, 2007. The Association will be required to implement the Standard for the year ended December 31, 2007. In addition, this Standard requires that the funded status of a plan be measured as of the date of the year-end financial statements. Currently, the Association uses a measurement date of September 30th. The requirement to measure the funded status as of the fiscal year-end is effective for fiscal years ending after December 15, 2008. The Association is currently evaluating the impact of implementing this Standard. It is anticipated that the impact from the implementation of this Standard will have no impact on the consolidated income statement and, based on the current funded status of the defined benefit plans, it is not expected to have a material or significant impact on the consolidated balance sheet.

The accompanying consolidated financial statements contain all adjustments necessary for a fair presentation of the interim financial condition and results of operations and conform with generally accepted accounting principles. The results for the nine months ended September 30, 2006, are not necessarily indicative of the results to be expected for the year ending December 31, 2006.

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

The Association maintains an allowance for loan losses in accordance with generally accepted accounting principles.

The loan portfolio is reviewed quarterly to determine the adequacy of the allowance for losses. As of September 30, 2006, the allowance for losses is adequate in management's opinion to provide for possible losses on existing loans.

### NOTE 2 – ALLOWANCE FOR LOAN LOSSES

An analysis of the allowance for loan losses follows:

	For the nine months ended September 30,	
	2006	2005
Balance at beginning of period	\$ 3,434	\$ 3,507
Provision for (reversal of) loan losses	79	(65)
Loans (charged off), net of recoveries	—	(8)
Balance at end of period	<u>\$ 3,513</u>	<u>\$ 3,434</u>

### NOTE 3 – EMPLOYEE BENEFIT PLANS

The Association participates in a Districtwide defined benefit retirement plan. The 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 each institution's salary expense as a percentage of the District's salary expense. The Association also participates in Districtwide Thrift and other postretirement benefit plans.

The following is a table of retirement and postretirement benefit expense for the nine months ended September 30, 2006:

	For the nine months ended September 30,	
	2006	2005
Pension	\$ 560	\$ 559
Thrift/deferred compensation	104	102
Other postretirement benefits	300	463
Total	<u>\$ 964</u>	<u>\$1,124</u>

As of September 30, 2006, no contributions have been made to the pension plan for 2006. The Association does not anticipate making additional contributions for the remainder of 2006.

The Association also sponsors a supplemental retirement plan for certain key employees. The expenses of this plan are included in the pension costs above. The Association contributed \$21 to this plan during the first nine months of 2006. The Association anticipates making additional contributions of \$7 to the supplemental retirement plan during the remainder of 2006.