

A large, stylized black and white graphic of a leaf or plant, oriented vertically. It features a central stem with several large, rounded lobes extending outwards. The design is minimalist and geometric.

**THE LAND SPECIALISTS**  
**Providing Financial Solutions**  
**for Rural America**

A small logo consisting of a stylized four-leaf clover or flower shape.

**FARM CREDIT**

OF NORTHWEST FLORIDA

2005 ANNUAL REPORT

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# FARM CREDIT OF NORTHWEST FLORIDA, ACA

# 2005 ANNUAL REPORT

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## Management

James R. Alberts.....	Chief Executive Officer
Bruce C. Harrison .....	Chief Financial Officer
Wade Hayslip.....	Chief Lending Officer
Wesley O. Pope.....	Chief Appraiser
Jay Baker .....	Western Regional Lending Manager
Rick Hemby .....	Central Regional Lending Manager
Deandrea Barber .....	Loan Operations Manager
Lesia Andrews.....	Marketing Manager

## Board of Directors

James G. Ditty .....	Chairman
Richard Terry .....	Vice Chairman
Melvin T. Adams .....	Director
Fred Beshears .....	Director
Bobby A. Boutwell .....	Director
Janegale Boyd .....	Director
Cindy Eade .....	Director
Copeland Griswold .....	Director
William Carroll Lamb.....	Director
James C. Moulton .....	Director
George T. VanPelt .....	Director
T. B. Walker .....	Director

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## *Message from the President*

*“It’s not enough that we do our best; sometimes we have to do what’s required.”  
Sir Winston Churchill*

The ACA enjoyed a successful year, which is largely due to a continued dedication by our professional team to exceed the expectations of Association customers.

- *Strategic goals were achieved through perseverance and initiative.*
- *Sensible and prudent expense control remains a significant part of our management culture.*
- *Net loans without consideration for allowance for loan losses are up 32.18%.*
- *Net income before taxes for 2005 increased 30.15% over 2004, without consideration of a refinement in the methodology of the association’s allowance for loan losses in 2004.*

The professional staff’s primary objective is to attract successful, well-diversified clients, and absolutely contribute to their prosperity. A significant portion of our portfolio is based upon patron referrals, indicating a high regard of our exceptional customer concern.

Our organization is committed to providing financing solutions to all qualified borrowers, without whom, we would cease to exist.

Capital ratios remain within Board approved levels in accordance with our capital plan and we continue to diligently oversee capital to accommodate modest growth and continuation of the association’s patronage program.

The absolute interest of the Board and management is safety and soundness of the association, which includes positive and competent management of the organization’s capital to secure shareholder ownership.

	<u>As of 12/31/05</u>	<u>As of 12/31/04</u>	<u>Regulatory Required</u>
Permanent Capital	12.54 %	12.23 %	7.00 %
Core Surplus	11.55 %	10.84 %	3.50 %
Total Surplus	12.19 %	11.85 %	7.00 %

High-risk assets as a percentage of total assets decreased from .46% in 2004 to 0.22% in 2005, further demonstrating the Association’s financial strength.

Our exclusive publication, **LandViews**, experienced both improvement and growth with each successive issue in 2005.

The chart below validates the benefits of ownership. In excess of \$2.6 million in cash was distributed to patron borrowers during the year 2005. The Board and management preserved the steadfast objective of maintaining our remarkable patronage and allocated surplus plan.

Distribution Date	Distribution Description	Amount of Distribution
March 2005	Patronage (allocated Surplus cash portion) 2004 (30%)	\$ 2,155,199
May 2005	Allocated Surplus 1996 (25%)	\$ 534,898

Needless to say, 2006 will present intense and dynamic challenges.

Farm Credit of Northwest Florida is dedicated to achieving exceptional performance, primarily by creating an extraordinary borrowing experience for our patrons. We know the association’s strength and future will be assured due to a dedicated and talented professional team.

We established numerous goals and challenges for the year 2006. We believe these dynamic expectations will guarantee the future progress of Farm Credit of Northwest Florida. We insist on significant additional development and believe our mission statement demonstrates this optimism:



***The Land Specialists -  
providing financial solutions for Rural America.***

We envision and believe in an extraordinary future and will mandate the high standards necessary for continued achievement of a sound, prosperous Association.

Jim Alberts  
President/CEO

## YBS Update

Our Association has experienced significant improvement in our loan volume with Young, Beginning, and Small Farmers. In 2005, this very important segment of our portfolio increased in volume 89% (\$15,763,835), 84% (\$90,725,227) and 52% (\$100,752,337), respectively. We used the 2002 Agricultural census for our source of demographics and placed emphasis on our professional staff to increase our share of this market.

High quality volume growth is given great emphasis in our Association. A strategic marketing plan has been designed to target YBS loans with an emphasis on flexible terms. Furthermore, we will work closely with government agencies and other organizations to tailor loans to fit the needs of our prominent YBS clients.

**Are you a Young, Beginning or Small Farmer?**

- A young farmer is one who is 35 years of age or younger.
- A Beginning farmer is one who has 10 or fewer years farming, ranching or aquatic agriculture experience.
- A Small farmer is one who generates less than \$250,000 in annual gross agricultural or aquatic sales.

March 15, 2006

## *Report of Management*

The accompanying consolidated financial statements and related financial information appearing throughout this annual report have been prepared by management of Farm Credit of Northwest Florida, 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.

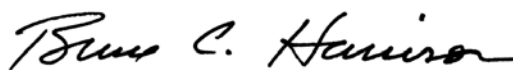
The consolidated financial statements, in the opinion of management, fairly present the financial condition of the Association. The undersigned certify that the 2005 Annual Report has been prepared in accordance with all applicable statutory or regulatory requirements and that the information contained herein is true, accurate, and complete to the best of our knowledge and belief.



James G. Ditty  
Chairman of the Board



James R. Alberts  
Chief Executive Officer



Bruce C. Harrison  
Chief Financial Officer

March 15, 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	\$ 360	\$ 555	\$ 324	\$ 1,240	\$ 1,076
Loans	419,311	317,233	298,924	256,055	239,988
Less: allowance for loan losses	1,409	1,409	5,828	5,822	5,859
Net loans	417,902	315,824	293,096	250,233	234,129
Investment in other Farm Credit institutions	4,418	4,106	3,697	4,259	5,030
Other property owned	—	—	—	—	99
Other assets	11,518	8,584	5,591	5,484	6,438
Total assets	\$ 434,198	\$ 329,069	\$ 302,708	\$ 261,216	\$ 246,772
Notes payable to AgFirst Farm Credit Bank*	\$ 370,114	\$ 274,914	\$ 260,324	\$ 222,212	\$ 209,171
Accrued interest payable and other liabilities with maturities of less than one year	8,062	5,861	5,765	6,126	5,142
Total liabilities	378,176	280,775	266,089	228,338	214,313
Protected borrower equity	45	66	200	317	360
Capital stock and participation certificates	1,419	1,376	1,370	1,300	1,298
Retained earnings					
Allocated	37,394	29,843	25,028	21,288	18,584
Unallocated	17,164	17,009	11,729	11,866	12,217
Accumulated other comprehensive income (loss)	—	—	(1,708)	(1,893)	—
Total members' equity	56,022	48,294	36,619	32,878	32,459
Total liabilities and members' equity	\$ 434,198	\$ 329,069	\$ 302,708	\$ 261,216	\$ 246,772
<b>Statement of Income Data</b>					
Net interest income	\$ 11,527	\$ 9,500	\$ 7,802	\$ 7,314	\$ 6,765
Provision for (reversal of allowance for) loan losses	—	(4,413)	—	—	225
Noninterest income (expense), net	(254)	(1,050)	(1,928)	(1,287)	(418)
Net income	\$ 11,273	\$ 12,863	\$ 5,874	\$ 6,027	\$ 6,122
<b>Key Financial Ratios</b>					
Rate of return on average:					
Total assets	2.96%	4.02%	2.11%	2.38%	2.69%
Total members' equity	21.45%	32.72%	16.83%	17.44%	18.87%
Net interest income as a percentage of average earning assets	3.12%	3.02%	2.86%	2.96%	3.08%
Net chargeoffs (recoveries) to average loans	—	0.002%	(0.002)%	0.01%	0.09%
Total members' equity to total assets	12.90%	14.68%	12.10%	12.59%	13.15%
Debt to members' equity (:1)	6.75	5.81	7.27	6.95	6.60
Allowance for loan losses to loans	0.34%	0.44%	1.95%	2.27%	2.44%
Permanent capital ratio	12.54%	12.23%	11.78%	12.53%	11.74%
Total surplus ratio	12.19%	11.85%	11.29%	11.99%	11.17%
Core surplus ratio	11.55%	10.84%	9.96%	9.47%	6.98%
<b>Net Income Distribution</b>					
Estimated patronage refunds:					
Cash dividend	\$ 2,962	\$ 2,087	\$ 1,539	\$ 1,685	\$ 1,615
Nonqualified allocated retained earnings	2,962	2,087	1,539	2,246	2,692
Nonqualified retained earnings	4,969	2,783	2,516	2,447	1,077

\* General financing agreement is renewable on two-year cycles. The next renewal date is December 31, 2007.

# 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 Farm Credit of Northwest Florida, 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 income and well-being of American farmers, ranchers, and producers or harvesters of aquatic products and farm-related businesses. The Farm Credit 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 Northwest Florida. 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 (the 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 Annual and Quarterly reports are also on the Association's website, [www.farmcredit-fl.com](http://www.farmcredit-fl.com) or may be obtained upon request free of charge by calling 850-526-4910 ext. 103 or writing Bruce C. Harrison, Chief Financial Officer, Farm Credit of Northwest Florida, ACA, P.O. Box 7000, Marianna, FL 32447.

## 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 loan loss 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 derivative and 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 economic conditions in our region were positive. Agricultural land values experienced market increases due to the desirability of the quality of life and strong business environment.

All portfolio segments, including mini-plantations, recreational, timber, hobby farms, hunting, row crop, and country homes, experienced prosperity with considerable non-speculative interest from new purchasers and farm professionals.

Higher interest rates will, we believe, reduce demand and stabilize land prices; however we do not expect reductions in land values. This will further enhance the attractiveness of Northwest Florida rural real estate. Consequently 2006 is expected to be a very affirmative year, but less so than 2005.

The many varied sources of “outside income” available to support rural land and agricultural endeavors are quite reliable due to the healthy local economy. This fact ensures the continued financial soundness of our customers and the loan portfolio.

The association experienced substantial loan growth, which was the result of many varied factors. These included considerable rural/agricultural acreage offered for sale by large landholding entities, referrals from existing members, financing appreciating land, and strategic marketing initiatives.

During 2005, economic conditions in our region were excellent. Land values continued to increase with 2006 projections strongly pointing to additional positive changes. Change in per acre prices in all segments of the portfolio; hobby farms, mini plantations, recreational lands, hunting property, country home sites, row crops and timber have all seen prosperity with every reason to believe this will be equally buoyant in 2006. Varied sources of “outside” income supporting many agricultural loan endeavors are secure as the overall Florida panhandle economy is exceptionally healthy and has accelerated throughout 2005 and early 2006. All portions of income sources supporting the vast majority of Northwest Florida’s portfolio are robust.

During the third quarter of 2005, hurricane activity caused damage across the AgFirst District. Louisiana, Mississippi, Alabama and southern Florida were the areas impacted. Crop and commodity damage was severe in some areas, but there was no adverse impact on repayment of loans held by the Association. Insurance and government funds continue to flow into the areas that were affected by the hurricane activity, and some of these funds have positively impacted the merchants in the association’s territory as local businesses are meeting the demands for housing, building supplies, etc.

**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 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 no loan assignments for Tobacco Buyout borrowers and also entered into no commitments to acquire Successor-in-Interest Contracts (SIIC), which started in the fourth quarter 2005. As of December 31, 2005, the Association had no loan assignments and no SIIC.

**RURAL AMERICA BONDS**

In October, 2005, FCA approved a Rural America Bonds investment program for the Bank and its 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 Farm Credit 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.

As of December 31, 2005, the Association had no investments in the Rural America Bond program.

**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 \$419,311, an increase of \$102,078 or 32.18 percent as compared to \$317,233 at December 31, 2004 and an increase of \$120,387 or 40.27 percent as compared to \$298,924 at December 31, 2003. These increases are primarily due to additional loan volume and increasing land values related to the portfolio segment that includes mini-plantations, recreational land, timber, hobby farms, hunting tracts, row crops and country homes. Net loans outstanding (gross loans net of the allowance for loan losses) on December 31, 2005, were \$417,902 as compared to \$315,824 at December 31, 2004 and \$293,096 at December 31, 2003. Net loans accounted for 96.24 percent of total assets on December 31, 2005 as compared to 95.98 percent of total assets at December 31, 2004 and 96.82 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.

<b>Loan Type</b>	<b>12/31/05</b>	<b>12/31/04</b>	<b>12/31/03*</b>
Production agriculture:			
Real estate mortgage	69.03%	68.56%	*
Production and intermediate term	29.14	28.05	*
Agribusiness:			
Processing and marketing	.04	.38	*
Farm related business	.53	.86	*
Rural residential real estate	1.26	2.15	*
<b>Total</b>	<b>100.00%</b>	<b>100.00%</b>	<b>*</b>

\* Beginning with year-end 2004, loan type categories have been expanded to provide additional information on the types of loans made. As a result, three years of comparable data is not available.

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

Loan Type	Due in 1 year or less	Due after 1 year through 5 years	Due after 5 years	Total
Production agriculture:				
Real estate mortgage	\$ 18,549	\$ 118,344	\$ 152,575	\$ 289,468
Production and intermediate term	33,407	57,820	30,946	122,173
Agribusiness:				
Processing and marketing	167	—	—	167
Farm related business	—	1,546	687	2,233
Rural residential real estate	215	1,087	3,968	5,270
Total	\$ 52,338	\$ 178,797	\$ 188,176	\$ 419,311

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:

Branch	12/31/05	12/31/04	12/31/03
Milton	18.25%	18.96%	19.64%
Monticello	15.68	18.06	18.28
Madison	6.31	7.11	7.55
Commercial Credits	39.76	34.20	34.25
Marianna	20.00	21.67	20.15
Administrative	—	—	.13
Total	100.00%	100.00%	100.00%

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 primary business of the customer. Primary business is assigned if the commodity or industry accounts for 50 percent or more of the total value of the sales for its products. Otherwise, the category assigned will be considered as other.

The major commodities in the Association loan portfolio are shown below. The predominant commodities are timber, plantations, livestock, peanuts and other row crops, which constitute over 75 percent of the entire portfolio.

Commodity Group	Percent of Portfolio		
	2005	2004	2003
Forestry	53%	46%	43%
Row Crops	13	9	11
Livestock	7	10	9
Peanuts	4	6	6
Horticulture	3	4	4
Dairy	3	4	3
Rural Homes	1	2	3
Poultry	—	1	1
Other	16	18	20
Total	100%	100%	100%

The table above presents the concentration of risk based on the commodity category only. However, another important factor for consideration is the risk based on commodity repayment sources. The table below presents the repayment source based on the commodity and the repayment source based on resources other than the commodity. The table below indicates that 80 percent of the total loans were dependent on repayment sources based on resources

other than the commodity as of December 31, 2005 and 69 percent and 66 percent of the total loans were dependent on repayment resources other than the commodity as of December 31, 2004 and December 31, 2003, respectively. The non-commodity repayment resources represent a wide variety of diversified cash flows that commodity fluctuations could not affect.

Commodity Type	Repayment Source Based on the Commodity		Repayment Source Based on Resources Other Than the Commodity	
	12/31/05	12/31/05	12/31/05	12/31/05
Forestry	53%	8%	—	92%
Row Crops	13	18	—	82
Livestock	7	24	—	76
Peanuts	4	91	—	9
Horticulture	3	84	—	16
Dairy	3	100	—	—
Rural Homes	1	—	—	100
Poultry	—	79	—	21
Other	16	18	—	82
Total	100%	20%	—	80%

Commodity Type	Repayment Source Based on the Commodity		Repayment Source Based on Resources Other Than the Commodity	
	12/31/04	12/31/04	12/31/04	12/31/04
Forestry	46%	17%	—	83%
Row Crops	9	35	—	65
Livestock	10	26	—	74
Peanuts	6	89	—	11
Horticulture	4	89	—	11
Dairy	4	100	—	—
Rural Homes	2	—	—	100
Poultry	1	83	—	17
Other	18	19	—	81
Total	100%	31%	—	69%

Commodity Type	Repayment Source Based on the Commodity		Repayment Source Based on Resources Other Than the Commodity	
	12/31/03	12/31/03	12/31/03	12/31/03
Forestry	43%	23%	—	77%
Row Crops	11	38	—	62
Livestock	9	30	—	70
Peanuts	6	91	—	9
Horticulture	4	90	—	10
Dairy	3	100	—	—
Rural Home	3	—	—	100
Poultry	1	100	—	—
Other	20	23	—	77
Total	100%	34%	—	66%

Loan Participations	2005	2004	2003
Participations Purchased			
– FCS Institutions	\$ —	\$ —	\$ 931
Participations Purchased			
– Non-FCS Institutions	17,213	17,323	19,890
Participations Sold	(76,455)	(48,565)	(95,949)
Total	\$ (59,242)	\$ (31,242)	\$ (75,128)

The Association participates in the Farmer Mac LTSB program. Farmer Mac was established by Congress to provide liquidity to agricultural lenders. At December 31, 2005, the Association had loans amounting to \$7,783 which were 100 percent guaranteed by Farmer Mac. 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 the unamortized premium) was \$4,115, compared to \$4,251 at December 31, 2004 and \$4,719 at December 31, 2003.

**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 loans more than \$250,000. 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. 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	\$ 940	\$ 1,527	\$ 2,906
Restructured loans	–	–	244
Accruing loans 90 days past due	6	–	402
Total high-risk loans	946	1,527	3,552
Other property owned	–	–	–
Total high-risk assets	\$ 946	\$ 1,527	\$ 3,552
<b>Ratios</b>			
Nonaccrual loans to total loans	0.22%	0.48%	0.97%
High-risk assets to total assets	0.22%	0.46%	1.17%

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 decreased \$587, or

38.44 percent in 2005. This decrease resulted from repayments of \$557, returns to accrual status of \$28 and adjustments of \$2.

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.

Credit Quality	2005	2004	2003
Acceptable & OAEM	98.73%	97.62%	98.26%
Substandard	1.27	2.38	1.74
Doubtful	–	–	–
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 Farm Credit Administration (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 resulting refinements in methodology, during the fourth quarter of 2004, the Association recorded a reversal of the allowance for loan losses of \$4,413.

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 allowance for loan loss methodology has consistently adhered to proper accounting policies, under the regulatory supervision of the FCA in its role as a "safety and soundness" regulator. It was the 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, the 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. The FCA endorsed the direction provided by other bank regulators and the SEC and indicated that the conceptual framework addressed in their guidelines would be included as part of their examination process.

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. 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 risk bearing capacity of the Association, generally referred to as "risk funds" (capital plus the allowance for loan losses), which totaled \$57,431 at December 31, 2005 (13.70 percent of Association loans), as compared with \$49,703 at December 31, 2004 (15.67 percent of Association loans) and \$42,447 at December 31, 2003 (14.20 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 \$1,409 at December 31, 2005, as compared with \$1,409 and \$5,828 at December 31, 2004 and 2003, respectively.

Net loan charge-offs of \$0, \$(6) and \$6 were recorded in 2005, 2004 and 2003, respectively. Net loan charge-offs as a percentage of average loans remained at low levels of 0 percent, (.002) percent, and .002 percent for 2005, 2004 and 2003, respectively.

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	\$ 1,409	\$ 5,828	\$ 5,822
Provision for (reversal of allowance for) loan losses	-	-	-
Nonrecurring provision for loan losses reversal*	-	(4,413)	-
Charge-offs:			
Production agriculture:			
Real estate mortgage	-	(6)	-
Total charge-offs	-	(6)	-
Recoveries			
Production agriculture:			
Real estate mortgage	-	-	6
Total recoveries	-	-	6
Net (charge-offs) recoveries	-	(6)	6
Balance at end of year	<u>\$ 1,409</u>	<u>\$ 1,409</u>	<u>\$ 5,828</u>
Ratio of net charge-offs during the period to average loans outstanding during the period	-%	.002%	(.002)%

\* Represents the amount of provision 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>2005</b>	<b>December 31, 2004</b>	<b>2003*</b>
Production agriculture:			
Real estate mortgage	\$ 655	\$ 646	*
Production and intermediate term	269	264	*
Agribusiness	473	479	*
Rural residential real estate	12	20	*
Total loans	<u>\$ 1,409</u>	<u>\$ 1,409</u>	<u>\$ 5,828</u>

\* Beginning with year-end 2004, loan type categories have been expanded to provide additional information on the types of loans made. As a result, three years of comparable data is not available.

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	.34%	.44%	1.95%
Nonperforming loans	-	-	1468.01%
Nonaccrual loans	149.89%	92.27%	200.55%

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 \$434 and \$1,974, 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 component of accumulated other comprehensive income in the members' equity. See Note 10, "Employee Benefit Plans," in the Notes to the Consolidated Financial Statements for further information.

**RESULTS OF OPERATIONS**

Net income for the year ended December 31, 2005, totaled \$11,273, a decrease of \$1,590 or 12.36 percent, as compared to \$12,863 for the same period of 2004 and an increase of \$5,399 or 91.91 percent, as compared to \$5,874 for the same period of 2003. Interest income for the year ended December 31, 2005, was \$25,927, an increase of \$7,433 or 40.19 percent as compared to \$18,494 for the same period of 2004. Interest income increased by \$2,602 for the period ended December 31, 2004, compared to December 31, 2003. Major components of the changes in net income for the past two years are outlined in the following table.

**Changes in Net Income:**

	<u>2005-2004</u>	<u>2004-2003</u>
<b>Net income (prior year)</b>	\$ 12,863	\$ 5,874
<b>Increase (decrease) in net income due to:</b>		
Interest income	7,433	2,602
Interest expense	(5,406)	(904)
Net interest income	2,027	1,698
Provision for loan losses	(4,413)	4,413
Noninterest income	708	1,274
Noninterest expense	(82)	(184)
Provision for income taxes	170	(212)
Total changes in income	(1,590)	6,989
<b>Net income</b>	<u>\$ 11,273</u>	<u>\$ 12,863</u>

*Net Interest Income*

Net interest income increased in 2005 by \$2,027 or 21.34 percent and increased by \$1,698, or 21.76 percent, compared to 2004 and 2003, respectively. The primary reason for the increase compared to 2004 was a substantial increase in loan volume. The increase compared to 2003 was primarily the result of the increase in loan volume. The Association's net interest income as a percentage of average earning assets was 3.12 percent on December 31, 2005, compared to 3.02 percent on December 31, 2004 and 2.86 percent on December 31, 2003.

Interest income on nonaccrual loans for 2005 totaled \$94, a decrease of \$220, compared to \$314 for 2004 and an increase of \$41 compared to \$53 for 2003. 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:**

	<u>Volume*</u>	<u>Rate</u>	<u>Nonaccrual</u>	
			<u>Income</u>	<u>Total</u>
<b>12/31/05 - 12/31/04</b>				
Interest income	\$ 3,204	\$ 4,449	\$ (220)	\$ 7,433
Interest expense	(1,491)	(3,915)	-	(5,406)
Change in net interest income	<u>\$ 1,713</u>	<u>\$ 534</u>	<u>\$ (220)</u>	<u>\$ 2,027</u>
<b>12/31/04 - 12/31/03</b>				
Interest income	\$ 2,175	\$ 166	\$ 261	\$ 2,602
Interest expense	1,440	(536)	-	(904)
Change in net interest income	<u>\$ 735</u>	<u>\$ 702</u>	<u>\$ 261</u>	<u>\$ 1,698</u>

\* 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 \$4,413, compared to provision expense of \$0 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:

<b>Noninterest Income</b>	<b>For the Year Ended</b>			<b>Percentage</b>	
	<b>December 31,</b>			<b>2005/</b>	<b>2004/</b>
	<b>2005</b>	<b>2004</b>	<b>2003</b>	<b>2004/</b>	<b>2003</b>
Loan fees	\$ 410	\$ 329	\$ 305	24.62%	7.87%
Fees for financially related services	3	3	4	-	(25.00)
Patronage refund from other Farm Credit Institutions	3,977	3,374	2,175	17.87	55.13
Gains (losses) on sale of rural homes	4	7	-	(42.86)	-
Gains (losses) from sale of premises & equipment, net	12	2	(6)	500.00	133.33
Other noninterest income	64	47	10	36.17	370.00
Total noninterest income	<u>\$ 4,470</u>	<u>\$ 3,762</u>	<u>\$ 2,488</u>	<u>18.82%</u>	<u>51.21%</u>

Patronage refunds from other Farm Credit Institutions increased \$603 and increased \$1,199 for the years ended December 31, 2005 and 2004, respectively. The Association received \$2,432 in a patronage refund and \$1,044 in a special distribution from the Bank for the year ended December 31, 2005, compared to \$2,071 and \$1,015 for 2004, and \$1,795 and \$260 for 2003. Loan fees increased \$81 and increased \$105 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:

<b>Noninterest Expense</b>	<b>For the Year Ended</b>			<b>Percentage</b>	
	<b>December 31,</b>			<b>2005/</b>	<b>2004/</b>
	<b>2005</b>	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Salaries and employee benefits	\$ 2,956	\$ 2,807	\$ 2,816	5.33%	(.34)%
Purchased services	326	251	262	29.83	(3.91)
Travel	193	133	101	45.75	31.57
Occupancy and equipment expense	287	280	248	2.50	12.90
Insurance Fund premium	185	159	330	16.44	(51.94)
Other operating expense	597	832	521	(28.25)	59.69
Total noninterest expense	<u>\$ 4,544</u>	<u>\$ 4,462</u>	<u>\$ 4,278</u>	<u>1.84%</u>	<u>4.30%</u>

Noninterest expense increased \$82 or 1.84 percent for December 31, 2005, as compared to the same period of 2004 and increased \$266 or 6.22 percent compared to December 31, 2003. Salaries and employee benefits expense increased \$149 or 5.31 percent for December 31, 2005, as compared to the same period of 2004 and increased \$140 or 4.97 percent compared to December 31, 2003.

Association recorded a provision for income taxes of \$180 for the year ended December 31, 2005, as compared to a provision of \$350 for 2004 and a provision of \$138 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.

<b>Key Results of Operations Comparisons</b>	<b>For the 12 Months Ended 12/31/05</b>	<b>For the 12 Months Ended 12/31/04</b>	<b>For the 12 Months Ended 12/31/03</b>
Return on Average Assets	2.96%	4.02%	2.11%
Return on Average Members' Equity	21.45%	32.72%	16.83%
Net Interest Income as a Percentage of Average Earning Assets	3.12%	3.02%	2.86%
Net Chargeoffs (Recoveries) to Average Loans	-%	0.002%	(0.002)%

## 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 the Farmer Mac and other 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 \$370,114 as compared to \$274,914 at December 31, 2004 and \$260,324 at December 31, 2003. The increase of 34.63 percent compared to December 31, 2004 and the increase of 42.17 percent compared to December 31, 2003, is attributable to increase loan volume for the years ending December 31, 2005, and December 31, 2004.

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 16.00 percent to \$56,022 from the December 31, 2004, total of \$48,294 and increased 31.88 percent from the December 31, 2003 total of \$36,619. The increase was primarily attributed to the net income for the years ended December 31, 2005 and December 31, 2004.

Total capital stock and participation certificates were \$1,464 on December 31, 2005, compared to \$1,442 on December 31, 2004 and \$1,570 on December 31, 2003. The increase in 2005 was primarily attributed to the issuance of additional stock. The decrease in 2004 was primarily attributed to the partial retirement of Class B stock.

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

	<b>2005</b>	<b>2004</b>	<b>2003</b>	<b>Regulatory Minimum</b>
Permanent Capital	12.54%	12.23%	11.78%	7.00%
Total Surplus	12.19%	11.85%	11.29%	7.00%
Core Surplus	11.55%	10.84%	9.96%	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 in excess of the 7.00 percent FCA minimum requirement. As of December 31, 2005, the Association has met the goal.

**PATRONAGE PROGRAM**

Prior to the beginning of any fiscal year, the Association’s Board of Directors, by adoption of a resolution, may establish a Patronage Allocation Program to distribute its available consolidated net earnings. This resolution provides for the application of net earnings in the manner described in the Association’s Bylaws. This includes the setting aside of funds to increase surplus to meet minimum capital adequacy standards established by Regulations, to increase surplus to meet Association capital adequacy standards to a level necessary to support competitive pricing at targeted earnings levels, and for reasonable reserves for necessary purposes of the Association. After excluding net earnings attributable to (a) the portion of loans participated to another institution, and (b) participation loans purchased, remaining consolidated net earnings will be allocated to borrowers. Refer to Note 8, “Members’ Equity”, of the Notes to the Consolidated Financial Statements, for more information concerning the patronage distributions. The Association declared patronage distributions of \$2,962 in 2005, \$2,087 in 2004, and \$1,539 in 2003.

**YOUNG, BEGINNING AND SMALL (YBS) FARMERS AND RANCHERS PROGRAM**

The Association’s mission includes providing sound and constructive credit and related services to young, beginning and small (YBS) farmers and ranchers. Annual marketing goals are established to increase market share of loans to YBS farmers and ranchers. To facilitate credit, we have adopted financing programs and use government guaranteed loan programs. We are actively involved in developing and sponsoring educational opportunities, leadership training, business financial training and insurance services for YBS farmers and ranchers.

YBS farmers and ranchers are defined as:

*Young Farmer:* A farmer, rancher, or producer or harvester of aquatic products who is age 35 or younger as of the date the loan is originally made.

*Beginning Farmer:* A farmer, rancher, or producer or harvester of aquatic products who has 10 years or less farming or ranching experience as of the date loan is originally made.

*Small Farmer:* A farmer, rancher, or producer or harvester of aquatic products who normally generates less than \$250 in annual gross sales of agricultural or aquatic products at the date the loan is originally made.

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

	<b>As of December 31, 2005</b>	
	<b>Number of Loans</b>	<b>Amount of Loans</b>
Young	152	\$ 33,430
Beginning	679	199,063
Small	1,172	295,100

*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 Association currently has a high penetration in the young, beginning, and small farmer market. As of December 31, 2005, the Association was doing business with 55.88 percent of the young farmers identified by the 2002 Ag census, 32.27 percent of the beginning farmers, and 19.69 percent of small farmers identified by the same census.

The following strategies and outreach programs have been conducted which allowed the Association to meet its objectives and goals to date of the young, beginning, and small farmer program.

- Support of 4-H, FFA, and young farmer organizations through sponsorships and donations.
- Sponsor seminars and workshops on farm planning and land management.
- Gave presentations to various organizations to promote Farm Credit’s role in lending to YBS farmers.

**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 Florida:

<u>Location</u>	<u>Description</u>	<u>Form of Ownership</u>
5052 Hwy. 90 East Marianna	Administrative/ Branch	Owned
5336 Stewart Street, SE Milton	Branch	Owned
925 W. Washington Monticello	Branch	Owned
102 SE Priest Street Madison	Branch	Owned

## Legal Proceedings

Information, if any, to be disclosed in this section is incorporated herein by reference to Note 13 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 8 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, 7, 11 and 13 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 executive officers of the Association:

<u>Senior Officer</u>	<u>Position</u>
James R. Alberts	Chief Executive Officer/ President
Bruce C. Harrison	Chief Financial Officer
Wade Hayslip	Chief Lending Officer
Wesley O. Pope	Chief Appraiser
Jay Baker	Western Regional Lending Manager

The business experience for the past five years for executive officers is with the Farm Credit System with the exception of Bruce C. Harrison, who prior to 2002, practiced as a Certified Public Accountant and previously served as Controller for a commercial enterprise.

The total amount of compensation earned by 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>	
CEO	2005		\$200,008	\$ 57,000	-	-	\$257,008
5	2005		\$580,131	\$120,975	-	-	\$701,106
5	2004		\$505,436	\$ 46,200	-	-	\$551,636
5	2003		\$503,316	\$ 30,600	-	-	\$533,916

In addition to a base salary, officers may earn additional compensation under incentive plans. The Association's plans are designed to motivate employees to produce progressively higher levels of final net earnings from year to year and to support the Association's organizational objectives and financial goals. At the same time, these plans foster superior performance and team concepts. A copy of the policies is available to shareholders of the Association upon request.

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 to 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 \$54,868 for 2005, \$49,827 for 2004, and \$32,206 for 2003.

Subject to approval by the board, the Association currently allows the chairman of the board \$500 and directors \$400 honoraria for attendance at meetings or special assignments and \$200 for committee meetings. Total compensation paid to directors, as a group was \$93,200.

The following represents certain information regarding the directors of the Association:

**James G. Ditty**, Chairman, owns, operates and rents a farm in Jackson County and has been a row crop farmer with principal commodities being peanuts and other row crops for the last five years. During 2005, he served 12 days at Association board meetings and 35 days in other official activities and was paid \$17,800. Term of Office: 2004 – 2007

**Richard Terry**, Vice Chairman, owns and operates a tobacco farm in Madison County. This has been his principal occupation for the past five years. He serves on the board for Madison County Farm Bureau, Farmers' Coop, Inc., Live Oak, Florida and Madison County Tobacco Warehouse. During 2005, he served 12 days at Association board meetings and 9 days in other official activities and was paid \$8,400. Term of Office: 2005 – 2008

**Melvin T. Adams** owns and operates a farm in Jackson and Holmes Counties and has been a cattle and row crop farmer for the past five years. During 2005, he served 9 days at Association board meetings and 7 days in other official activities and was paid \$5,400. Term of Office: 2004 – 2006

**Fred H. Beshears'** primary occupation for the past five years has been owner and operator of Simpson Nurseries/Jefferson Growers. He has served as a Director for the Florida Pecan Growers Association. He is a resident of Jefferson County, Florida. During 2005, he served 11 days at Association Board Meetings, and 3 days in other official activities and was paid \$6,000. Term of Office: 2004 – 2007

**Bobby A. Boutwell** is an outside director. He operates a farm supply and fertilizer business in Santa Rosa County, has a cattle operation and rents a farm. This has been his primary occupation for the last five years. During 2005, he served 11 days at Association board meetings and 3 days in other official activities and was paid \$6,000. Term of Office: 2004 – 2007

**Janegale M. Boyd**, an outside director, is a businesswoman, registered nurse, and served as a member of the Florida Legislature for two terms. Her occupation and employment for the last five years follow. Currently, she is President/CEO of the Florida Association of Homes for the Aging. This has been her primary occupation since July 2001. Immediately prior to her current employment she was dual employed. From November 1996 through November 2000 she was a State Representative for District 10 of the State of Florida and from 1997 through July 2001 she was Area Director with Humana Health Plans.

She was twice recognized as the Outstanding Young Woman of the Year. She is active in several professional and community organizations including the Leadership Florida program, the Monticello Opera House, Challenger Learning Center, and serves on the Tallahassee Community College Advisory Board for the School of Nursing. Mrs. Boyd has also served as the Chairman of the City of Monticello Planning Agency (1989-1996), and Chairman of the Jefferson County United Way Campaign. She is a resident of Jefferson County, Florida. During 2005 she served 8 days at Association Board Meetings, and no days in other official activities and was paid \$3,200. Term of Office: 2004 – 2007

**Cindy S. Eade** has been in dairy production for the past five years. She is the co-owner and manager of Cindale Farms LLC. She is a member of S.E. Milk Women's Alliance, member of S. E. Milk Marketing Cooperative, and member of Florida Cattlewomen's Association. She is a resident of Jackson County, Florida. During 2005, she served 11 days at Association Board Meetings, and 3 days in other official activities and was paid \$6,000. Term of Office: 2005 – 2008

**Copeland Griswold** owns and operates a row crop and timber farm in Santa Rosa County, Florida and has been a farmer for the past five years. During 2005, he served 11 days at Association board meetings and 18 days in other official activities and was paid \$12,000. Term of Office: 2004 – 2007

**William Carroll Lamb** is an outside director and is a past Executive Vice President of Florida Forestry Association, Florida Agricultural Council and the Florida Society of Association Executives. He has served on the boards of Florida Future Farmers of America Foundation, Florida 4-H Foundation and the Southern Scholarship Foundation. He has been retired for the past five years. During 2005, he served 6 days at Association board meetings and 6 days in other official activities and was paid \$4,600. Term of Office: 2005 – 2008

**James C. Moulton** is involved in the management of timber holdings, he is also involved in building, leasing and management of retail shopping centers and professional buildings in Northwest Florida. This has been his principal occupation for the last five years. He is President of Moulton Properties and serves on the board for Compass Bank, Pensacola (commercial banking). During 2005, he served 10 days at Association board meetings and no days in other official activities and was paid \$4,400. Term of Office: 2004 – 2006

**George T. VanPelt's** primary occupation for the past five years has been dairy farming. He is co-owner and operator of a dairy farm in Escambia County. Small grains are also grown for feed. He serves as 4-H Camp Trustee, Board member of Pensacola Interstate Fair and a Church Finance Committee Member. During 2005, he served 12 days at Association board meetings and 20 days in other official activities and was paid \$10,600. Term of Office: 2005 – 2008

**T. B. Walker** has been a dairy, cattle and row crop farmer for the past five years and a partner with Waukeenah Feed and Fertilizer Supply (retail). He serves on the board of Farmers and Merchants Bank in Jefferson County (commercial banking). During 2004, he served 12 days at Association board meetings and 15 days in other official activities and was paid \$8,800. Term of Office: 2004 – 2006

#### **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 12 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 15, 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 1-850-526-4910 or writing Chief Financial Officer, Farm Credit of Northwest Florida, P. O. Box 7000, Marianna, Florida 32447, or accessing the website, [www.farmcredit-fl.com](http://www.farmcredit-fl.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.

#### **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 Farm Credit 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*

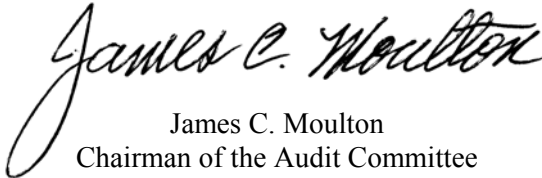
The Audit Committee of the Board of Directors (the Committee) is comprised of the directors named below. None of the directors who serve on the Audit Committee is an employee of Farm Credit of Northwest Florida, ACA (the Association) and in the opinion of the Board of Directors, each is free of any relationship 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:



James C. Moulton  
Chairman of the Audit Committee

### **Members of Audit Committee**

Bobby Boutwell  
Janegale Boyd

# 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 Farm Credit of Northwest Florida, 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 Farm Credit of Northwest Florida, 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 15, 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	\$ 360	\$ 555	\$ 324
Loans	419,311	317,233	298,924
Less: allowance for loan losses	1,409	1,409	5,828
Net loans	417,902	315,824	293,096
Accrued interest receivable	3,707	1,934	1,974
Investment in other Farm Credit institutions	4,418	4,106	3,697
Premises and equipment, net	1,337	1,212	1,274
Prepaid retirement expense	2,425	2,292	—
Due from AgFirst Farm Credit Bank	3,680	3,139	2,146
Other assets	369	7	197
Total assets	<u>\$ 434,198</u>	<u>\$ 329,069</u>	<u>\$ 302,708</u>
<b>Liabilities</b>			
Notes payable to AgFirst Farm Credit Bank	\$ 370,114	\$ 274,914	\$ 260,324
Accrued interest payable	1,564	851	700
Patronage refund payable	2,995	2,122	1,581
Minimum pension liability	—	—	1,003
Other liabilities	3,503	2,888	2,481
Total liabilities	<u>378,176</u>	<u>280,775</u>	<u>266,089</u>
Commitments and contingencies			
<b>Members' Equity</b>			
Protected borrower equity	45	66	200
Capital stock and participation certificates	1,419	1,376	1,370
Retained earnings			
Allocated	37,394	29,843	25,028
Unallocated	17,164	17,009	11,729
Accumulated other comprehensive income (loss)	—	—	(1,708)
Total members' equity	<u>56,022</u>	<u>48,294</u>	<u>36,619</u>
Total liabilities and members' equity	<u>\$ 434,198</u>	<u>\$ 329,069</u>	<u>\$ 302,708</u>

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

## *Consolidated Statements of Income*

<i>(dollars in thousands)</i>	For the year ended December 31,		
	2005	2004	2003
<b>Interest Income</b>			
Loans	\$ 25,927	\$ 18,494	\$ 15,892
<b>Interest Expense</b>			
Notes payable to AgFirst Farm Credit Bank	14,338	8,982	8,080
Other	62	12	10
Total interest expense	14,400	8,994	8,090
Net interest income	11,527	9,500	7,802
Provision for (reversal of allowance for) loan losses	—	(4,413)	—
Net interest income after provision for (reversal of allowance for) loan losses	11,527	13,913	7,802
<b>Noninterest Income</b>			
Loan fees	410	329	305
Fees for financially related services	3	3	4
Patronage refund from other Farm Credit institutions	3,977	3,374	2,175
Other noninterest income	80	56	4
Total noninterest income	4,470	3,762	2,488
<b>Noninterest Expense</b>			
Salaries and employee benefits	2,956	2,807	2,816
Occupancy and equipment	287	280	248
Insurance Fund premium	185	159	330
Other operating expenses	1,116	1,216	884
Total noninterest expense	4,544	4,462	4,278
Income before income taxes	11,453	13,213	6,012
Provision for income taxes	180	350	138
Net income	\$ 11,273	\$ 12,863	\$ 5,874

*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	\$ 317	\$ 1,300	\$ 21,288	\$ 11,866	\$ (1,893)	\$ 32,878
Comprehensive income						
Net income				5,874		5,874
Minimum pension liability adjustment					185	185
Total comprehensive income						6,059
Protected borrower equity retired	(117)					(117)
Capital stock/participation certificates issued		223				223
Capital stock/participation certificates retired		(153)				(153)
Patronage distribution						
Cash				(1,539)		(1,539)
Nonqualified allocated retained earnings			1,539	(1,539)		—
Nonqualified retained earnings			2,516	(2,516)		—
Retained earnings retired			(606)			(606)
Distribution adjustment			291	(417)		(126)
Balance at December 31, 2003	200	1,370	25,028	11,729	(1,708)	36,619
Comprehensive income						
Net income				12,863		12,863
Minimum pension liability adjustment					1,708	1,708
Total comprehensive income						14,571
Protected borrower equity retired	(134)					(134)
Capital stock/participation certificates issued		163				163
Capital stock/participation certificates retired		(157)				(157)
Patronage distribution						
Cash				(2,087)		(2,087)
Nonqualified allocated retained earnings			2,087	(2,087)		—
Nonqualified retained earnings			2,783	(2,783)		—
Retained earnings retired			(628)			(628)
Distribution adjustment			573	(626)		(53)
Balance at December 31, 2004	66	1,376	29,843	17,009	—	48,294
Net income				11,273		11,273
Protected borrower equity retired	(21)					(21)
Capital stock/participation certificates issued		211				211
Capital stock/participation certificates retired		(168)				(168)
Patronage distribution						
Cash				(2,962)		(2,962)
Nonqualified allocated retained earnings			2,962	(2,962)		—
Nonqualified retained earnings			4,969	(4,969)		—
Retained earnings retired			(550)			(550)
Distribution adjustment			170	(225)		(55)
Balance at December 31, 2005	\$ 45	\$ 1,419	\$ 37,394	\$ 17,164	\$ —	\$ 56,022

*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	\$ 11,273	\$ 12,863	\$ 5,874
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation on premises and equipment	173	184	155
Provision for (reversal of allowance for) loan losses	—	(4,413)	—
(Gains) losses from sale of premises and equipment, net	—	—	6
Changes in operating assets and liabilities:			
(Increase) decrease in accrued interest receivable	(1,773)	40	219
(Increase) decrease in prepaid retirement expense	(133)	(2,292)	—
(Increase) decrease in due from AgFirst Farm Credit Bank	(541)	(993)	(213)
(Increase) decrease in other assets	(362)	1,898	166
Increase (decrease) in accrued interest payable	713	151	19
Increase (decrease) in minimum pension liability	—	(1,003)	(93)
Increase (decrease) in other liabilities	615	407	5
Total adjustments	(1,308)	(6,021)	264
Net cash provided by (used in) operating activities	9,965	6,842	6,138
<b>Cash flows from investing activities:</b>			
Net (increase) decrease in loans	(102,078)	(18,315)	(42,863)
(Increase) decrease in investment in other Farm Credit institutions	(312)	(409)	562
Purchase of premises and equipment, net	(298)	(122)	(448)
Proceeds from sale of premises and equipment, net	—	—	8
Net cash provided by (used in) investing activities	(102,688)	(18,846)	(42,741)
<b>Cash flows from financing activities:</b>			
Advances on (repayment of) notes payable to AgFirst Farm Credit Bank, net	95,200	14,590	38,112
Protected borrower equity retired	(21)	(134)	(117)
Capital stock and participation certificates issued	211	163	223
Capital stock and participation certificates retired	(168)	(157)	(153)
Patronage refunds paid	(2,144)	(1,599)	(1,772)
Retained earnings retired	(550)	(628)	(606)
Net cash provided by (used in) financing activities	92,528	12,235	35,687
Net increase (decrease) in cash	(195)	231	(916)
Cash, beginning of period	555	324	1,240
Cash, end of period	\$ 360	\$ 555	\$ 324
<b>Supplemental schedule of non-cash activities:</b>			
Cash dividends or patronage distributions declared or payable	\$ 2,962	\$ 2,087	\$ 1,539
Decrease (increase) in accumulated other comprehensive income related to minimum pension liability	—	1,708	185
<b>Supplemental information:</b>			
Interest paid	\$ 13,687	\$ 8,843	\$ 8,071
Taxes paid, net	—	27	17
Federal tax refunds related to long-term operations (Note 9)	—	198	—

*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:** Farm Credit of Northwest Florida, ACA (the 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 Bay, Calhoun, Escambia, Franklin, Gadsden, Gulf, Holmes, Jackson, Jefferson, Leon, Liberty, Madison, Okaloosa, Santa Rosa, Taylor, Wakulla, Walton, and Washington in the state of Florida.

The Association is a lending institution of the Farm Credit System (the 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 and 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 AgFirst 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 intercompany 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.

Loan origination fees and direct loan origination costs are deferred as part of the carrying amount of the loan and the net fee or cost is amortized over the life of the related loan as an adjustment to yield.

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. 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 on 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 reversals of provisions for loan losses 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. Investment in AgFirst Farm Credit Bank and Other Farm Credit Institutions:** 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 included in other assets classified as Due from AgFirst Farm Credit Bank.

**D. 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.

**E. 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.

**F. 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 (the Plan) of the AgFirst 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. 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. 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.

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 and Other Financial Institutions:** The Association records patronage refunds from the Bank and certain District Associations 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, the System's regulator, 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 \$4,413 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 \$57,431 at December 31, 2005 (13.70 percent of Association loans), as compared with \$49,703 at December 31, 2004 (15.67 percent of Association loans), and \$42,447 at December 31, 2003 (14.20 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	\$ 289,468	\$ 217,483	*
Production and intermediate term	122,173	88,995	*
Agribusiness:			
Processing and marketing	167	1,205	*
Farm related business	2,233	2,715	*
Rural residential real estate	5,270	6,835	*
<b>Total loans</b>	<b>\$ 419,311</b>	<b>\$ 317,233</b>	<b>\$298,924</b>

\* Beginning with year-end 2004, loan type categories have been expanded to provide additional information on the types of loans made. As a result, three years of comparable data is not available.

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 Type	December 31,		
	2005	2004	2003
Forestry	53%	46%	43%
Row Crops	13	9	11
Livestock	7	10	9
Peanuts	4	6	6
Dairy	3	4	3
Horticulture	3	4	4
Rural Home	1	2	3
Poultry	-	1	1
Other	16	18	20
Total	100%	100%	100%

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.

Impaired loans are loans for which it is probable that not all principal and interest will be collected according to the contractual terms.

The following table presents information relating to impaired loans.

	December 31,		
	2005	2004	2003
Nonaccrual loans:			
Current as to principal and interest	\$ 940	\$ 1,180	\$ 968
Past due	-	347	1,938
Total nonaccrual loans	940	1,527	2,906
Impaired accrual loans:			
Restructured accrual loans	-	-	244
Accrual loans 90 days or more past due	6	-	402
Total impaired accrual loans	6	-	646
Total impaired loans	\$ 946	\$ 1,527	\$ 3,552

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	\$ 94	\$ 314	\$ 53
Interest income on impaired accrual loans	2	7	81
Interest income recognized on impaired loans	\$ 96	\$ 321	\$ 134

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

	2005	2004	2003
Impaired loans with related allowance	\$ 940	\$ 944	\$ -
Impaired loans with no related allowance	6	583	3,552
Total impaired loans	\$ 946	\$ 1,527	\$ 3,552
Allowance on impaired loans	\$ 470	\$ 470	\$ -

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

	2005	2004	2003
Average impaired loans	\$ 1,255	\$ 2,600	\$ 3,856

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	\$ 509	\$ 886
Less: interest income recognized	94	314
Foregone interest income	\$ 415	\$ 572

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

	Year Ended December 31,		
	2005	2004	2003
Balance at beginning of year	\$ 1,409	\$ 5,828	\$ 5,822
Provision for (reversal of allowance for) loan losses	\$ -	\$ -	\$ -
Nonrecurring provision for loan losses reversal	-	(4,413)	-
Charge-offs:			
Production agriculture:			
Real estate mortgage	\$ -	\$ 6	\$ -
Total charge-offs	-	6	-
Recoveries			
Production agriculture:			
Real estate mortgage	\$ -	\$ -	\$ (6)
Total recoveries	-	-	(6)
Net (charge-offs) recoveries	-	6	(6)
Balance at end of year	\$ 1,409	\$ 1,409	\$ 5,828
Ratio of net charge-offs during the period to average loans outstanding during the period	-%	0.002%	(0.002)%

As previously discussed in Note 3, the nonrecurring provision for loan losses reversal 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	\$ 656	46.56%	\$ 646	45.85%	*	*
Production and intermediate term	269	19.09	264	18.74	*	*
Agribusiness	473	33.57	479	33.99	*	*
Rural residential real estate	11	0.78	20	1.42	*	*
Total	<u>\$ 1,409</u>	<u>100.00%</u>	<u>\$ 1,409</u>	<u>100.00%</u>	<u>\$ 5,828</u>	<u>100.00%</u>

\* Beginning with year-end 2004, loan type categories have been expanded to provide additional information on the types of loans made. As a result, three years of comparable data is not available.

To mitigate the risk of loan losses, the Association may enter into long-term standby "commitment to purchase" agreements with the Federal Agricultural Mortgage Corporation (Farmer Mac). The agreements, which are effectively credit guarantees that will remain in place until the loans are paid in full, give the Association the right to sell the loans identified in the agreements to Farmer Mac in the event of default (typically four months past due), subject to certain conditions. The balance of loans under long-term standby commitments was \$7,783, \$12,012 and \$13,720 at December 31, 2005, 2004 and 2003, respectively. Fees paid to Farmer Mac for such commitments totaled \$45, \$57 and \$11 for the years ended December 31, 2005, 2004 and 2003, respectively. These amounts are classified as noninterest expense.

**Note 5 — 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 6 — Premises and Equipment**

Premises and equipment consisted of the following:

	December 31,		
	2005	2004	2003
Land	\$ 187	\$ 185	\$ 117
Buildings and improvements	1,557	1,367	1,444
Furniture and equipment	880	851	765
	<u>2,624</u>	<u>2,403</u>	<u>2,326</u>
Less: accumulated depreciation	<u>1,287</u>	<u>1,191</u>	<u>1,052</u>
Total	<u>\$ 1,337</u>	<u>\$ 1,212</u>	<u>\$ 1,274</u>

**Note 7 — 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 8.4 years and 8.4 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 4.97 percent and the weighted average remaining maturity was 5.8 years at December 31, 2005. The weighted average interest rate on all interest-bearing notes payable was 5.08 percent and the weighted average remaining maturity was 7.1 years at December 31, 2005.

Variable rate and fixed rate notes payable represent approximately 45.45 percent and 54.55 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 8 — 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 the 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 the lesser of

\$1 thousand or two percent 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 12.54 percent, 12.19 percent and 11.55 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	7,646	\$ 38
C Common/Voting	No	260,824	1,304
B Participation Certificates/Nonvoting	Yes	1,300	7
C Participation Certificates/Nonvoting	No	22,950	115
Total Capital Stock and Participation Certificates		292,720	\$ 1,464

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 Board determines the minimum aggregate amount of these two accounts. 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. Nonqualified retained surplus is considered to be permanently invested in the Association and as such, there is no plan to revolve or retire this surplus. All nonqualified distributions are tax deductible only when redeemed.

At December 31, 2005, allocated members' equity consisted of \$11,130 of qualified surplus, \$11,923 of nonqualified allocated surplus and \$14,341 of nonqualified retained surplus.

*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 the Board approves another proportionate patronage basis.

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. Amounts not distributed are retained as unallocated members' equity.

*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 or 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. The Association declared no dividends for any of the periods included in these financial statements.

*Transfer*

Classes A and 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:

1. Class C Common Stock and Class C Participation Certificates
2. Classes A and B Common Stock and Class B Participation Certificates
3. Classes A and D Preferred Stock

*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:

1. Classes A and D Preferred Stock
2. Classes A, B and C Common Stock, and Classes B and C Participation Certificates
3. Holders of allocated surplus evidenced by qualified written notices of allocation
4. Holders of allocated surplus evidenced by nonqualified written notices of allocation
5. All unallocated surplus issued after January 1, 1995, shall be distributed to past and present Patrons on a patronage basis
6. Any remaining assets of the Association after such distribution shall be distributed ratably to the holders of all classes of stock and participation certificates

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

The Association reports other comprehensive income (loss) in its Statement 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. See Note 10 for further information.

**Note 9 — Income Taxes**

The provision (benefit) for income taxes follows:

	Year Ended December 31,		
	2005	2004	2003
Current:			
Federal	\$ 89	\$ (2)	\$ (30)
State	15	-	(10)
Federal refunds	-	(198)	-
Other refunds	-	(27)	-
	104	(227)	(40)
Deferred:			
Federal	22	504	199
State	54	73	(21)
	76	577	178
Total provision (benefit) for income taxes	\$ 180	\$ 350	\$ 138

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	\$ 3,894	\$ 4,492	\$ 1,950
State tax, net	45	48	(20)
Patronage distributions	(1,007)	(710)	(1,047)
Tax-exempt FLCA earnings	(3,080)	(3,641)	(1,891)
Long-term lending refunds	-	(225)	-
Change in valuation allowance	257	590	1,187
Other	71	(204)	(41)
Provision (benefit) for income taxes	\$ 180	\$ 350	\$ 138

Deferred tax assets and liabilities result from the following at:

	December 31,		
	2005	2004	2003
Allowance for loan losses	\$ 289	\$ 305	\$ 836
Net operating loss – carryforward	1,497	1,023	433
Loan origination fees	-	13	102
Nonaccrual loan interest	-	134	57
Depreciation (reclassified)	19	19	-
Other	-	5	5
Gross deferred tax assets	1,805	1,499	1,433
Valuation allowance	(1,736)	(1,479)	(889)
Deferred tax assets, net of valuation allowance	69	20	544
Future Bank equity redemption	(302)	(302)	(302)
State income tax	(308)	(236)	(183)
Loan origination fees (reclassified)	(52)	-	-
Gross deferred tax liability	(662)	(538)	(485)
Net deferred tax asset (liability)	\$ (593)	\$ (518)	\$ 59

At December 31, 2005, deferred income taxes have not been provided by the Association on approximately \$56 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 maintained a valuation allowance of \$1,736, \$1,479 and \$889 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 10 — 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 \$1,708 at December 31, 2003. The impact on deferred taxes was not significant.

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. 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, 2005 and 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.

Medical and prescription drug coverage for Medicare-eligible participants was changed effective January 1, 2006. Beginning in 2006, the AgFirst Farm Credit District Welfare Benefit Plan will provide medical and prescription drug coverage to Medicare-eligible retirees and spouses through fully-insured AARP endorsed Medicare Supplement policies and basic Medicare D coverage through a selected Prescription Drug Plan. Dental coverage was not changed.

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 (credits):

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Pension	\$ 302	\$ 387	\$ 402
Thrift/deferred compensation	46	44	42
Other postretirement benefits	175	234	236
Total	<u>\$ 523</u>	<u>\$ 665</u>	<u>\$ 680</u>

For the years ended December 31, 2005 and 2004, the Association had contributed \$434 and \$1,974, 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 shareholders’ equity. As a result of the findings and the reclassification of the OCI, the Association ended 2005 and 2004 with \$2,425 and \$2,292, respectively, in prepaid retirement expense on the consolidated balance sheets.

**Note 11 — 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 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 12 — 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 \$26,798. During 2005, \$11,206 of new loans were made and repayments totaled \$12,905. In the opinion of management, none of these loans outstanding at December 31, 2005 involved more than a normal risk of collectibility.

**Note 13 — 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, \$29,081 of commitments to extend credit and \$0 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.

**Note 14 — 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	\$ 360	\$ 360	\$ 555	\$ 555
Loans	\$ 419,311	\$ 419,758	\$ 317,233	\$ 318,508
Allowance for loan losses	1,409	—	1,409	—
Loans, net	\$ 417,902	\$ 419,758	\$ 315,824	\$ 318,508

<b>Financial liabilities:</b>				
Notes payable to AgFirst Farm Credit Bank	\$ 370,114	\$ 366,868	\$ 274,914	\$ 273,389

	December 31, 2003	
	Carrying Amount	Estimated Fair Value
<b>Financial assets:</b>		
Cash	\$ 324	\$ 324
Loans	\$ 298,924	\$ 301,535
Allowance for loan losses	5,828	—
Loans, net	\$ 293,096	\$ 301,535

<b>Financial liabilities:</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 260,324	\$ 259,649

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 and Other Farm Credit Institutions:**

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 5, 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 2.52 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.

In addition, the Association has an investment of \$237 related to other Farm Credit institutions.

**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.

**Note 15 — 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	\$ 2,408	\$ 2,742	\$ 3,172	\$ 3,205	\$ 11,527
Provision for (reversal of) loan losses	-	-	-	-	-
Noninterest income (expense), net	(187)	(455)	(529)	917	(254)
Net income (loss)	\$ 2,221	\$ 2,287	\$ 2,643	\$ 4,122	\$ 11,273

	2004				
	First	Second	Third	Fourth	Total
Net interest income	\$ 2,100	\$ 2,232	\$ 2,380	\$ 2,788	\$ 9,500
Provision for (reversal of) loan losses	-	-	-	(4,413)	(4,413)
Noninterest income (expense), net	(429)	(526)	(433)	338	(1,050)
Net income (loss)	\$ 1,671	\$ 1,706	\$ 1,947	\$ 7,539	\$ 12,863

	2003				
	First	Second	Third	Fourth	Total
Net interest income	\$ 1,787	\$ 1,917	\$ 2,013	\$ 2,085	\$ 7,802
Provision for (reversal of) loan losses	-	-	-	-	-
Noninterest income (expense), net	(589)	(521)	(469)	(349)	(1,928)
Net income (loss)	\$ 1,198	\$ 1,396	\$ 1,544	\$ 1,736	\$ 5,874