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# FARM CREDIT OF THE VIRGINIAS, ACA

# 2007 ANNUAL REPORT

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## Management

David E. Lawrence.....	President and Chief Executive Officer
Bette B. Brand.....	Chief Sales Officer
Dennis K. Carpenter.....	Chief Lending Officer
David G. Sauer.....	Chief Financial Officer

## Board of Directors

John E. Wells .....	Chairman
Alfred W. Stephens, Jr. ....	Vice Chairman
James H. Addington.....	Director
Ronald L. Bennett .....	Director
Donna M. Brooke – Alt .....	Director
William J. Franklin, Jr.....	Director
Paul M. House.....	Director
Melody S. Jones .....	Director
James A. Kinsey.....	Director
Charles B. Leech, IV.....	Director
Ralph L. Puckett.....	Director
Donald W. Reese .....	Director
Wallace W. Sanford, III.....	Director
Walter L. Schmidlen, Jr. ....	Director
Barry W. Shelor .....	Director
Raymond L. Simms.....	Director
Gregory A. Smith.....	Director
Thomas V. Thacker.....	Director
Joseph W. Wampler.....	Director

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## *Message from the Chief Executive Officer*

I am pleased to report your cooperative remains in a strong financial position and returning shareholder value by not only offering competitive rates, but also providing a return on your investment through the profit sharing (patronage refund) program. Once again I can make the statement that no other lender puts its profits in your pocket like Farm Credit of the Virginias!

2007 was another growth year. The association experienced good loan growth, even though the general economy had a “bumpy” trend especially in the housing industry. The agricultural commodities served by the association experienced a favorable year with some stress in operations dependent upon off the farm income.

Given the association funding comes from selling bonds in the money market, the Federal Reserve’s actions to lower the federal funds rate has made it possible for the association to maintain a relative low cost of funding. The association plans to distribute over \$18 million of its 2007 earnings in cash to its customer/stockholders. The cash distribution will exceed the amount distributed last year. As in previous years, the customer/shareholders who were active borrowers during 2007 are receiving checks.

In 2007 your association directors, employees and many customers continued to participate in the Farm Credit System HORIZONS initiative as part of the Farm Bill. The goal, while working closely with the House Agricultural Committee, is to enable Farm Credit to continue providing farmers access to capital, financial services and expertise to sustain a strong economic future.

We promise to continue the dedication practiced for over the past 90 years to strive for continuous improvement in all business lines with aggressively balanced sales, marketing and quality customer service; strong profitability through appropriate pricing, sound planning and efficient operations; and to maintain a sound credit culture. We thank you for your business and trust.

The annual report is inherently full of numbers and in-depth explanations of our 2007 financial results and how they were achieved. I hope you will read through the financial information and contact me if you have any questions pertaining to your association. I believe that your support and input are vital keys to the association’s success.



David E. Lawrence  
Chief Executive Officer

February 28, 2008

## *Report of Management*

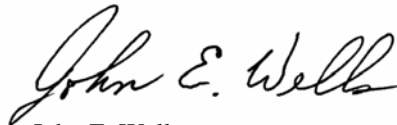
The accompanying consolidated financial statements and related financial information appearing throughout this annual report have been prepared by management of Farm Credit of the Virginias, ACA (Association) in accordance with generally accepted accounting principles appropriate in the circumstances. 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 2007 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.

The accompanying consolidated financial statements were prepared under the oversight of the Audit Committee of the Board of Directors.



John E. Wells  
Chairman of the Board



David E. Lawrence  
Chief Executive Officer



David G. Sauer  
Chief Financial Officer

February 28, 2008



# 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 the Virginias, ACA, (Association) for the year ended December 31, 2007 with comparisons to the years ended December 31, 2006 and December 31, 2005. 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 accompanying consolidated financial statements were prepared under the oversight of the Audit Committee of the Board of Directors. For a list of the Audit Committee members, refer to the "Report of the Audit Committee" reflected in this Annual Report. Information in any part of this Annual Report may be incorporated by reference in answer or partial answer to any other item of the 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 over 90 years. The System's 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 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 (also referred to throughout this Annual Report as stockholders or shareholders) served. The territory of the Association extends across a diverse agricultural region of Virginia, West Virginia and Maryland. 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 (AgFirst or Bank). The Association is materially affected and shareholder investment in the Association could be affected by the financial condition and results of operations of the Bank. Copies of the Bank's Annual and Quarterly 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 Stephen Gilbert, AgFirst Farm Credit Bank, P. O. Box 1499, Columbia, SC 29202.

Copies of the Association's Annual and Quarterly reports are also available upon request free of charge on the Association's website, [www.farmcreditofvirginias.com](http://www.farmcreditofvirginias.com), or by calling 1-540-886-3435, extension 620, or writing David Sauer, P.O. Box 899, Staunton, VA 24402-0899. The Association prepares

an electronic version of the Annual Report, which is available on the website, within 75 days after the end of the fiscal year and distributes the Annual Reports to shareholders within 90 days after the end of the fiscal year. The Association prepares an electronic version of the Quarterly report within 40 days after the end of each fiscal quarter, except that no report needs to be prepared for the fiscal quarter that coincides with the end of the fiscal year of the Association.

## FORWARD LOOKING INFORMATION

This annual information statement contains forward looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Words such as "anticipates," "believes," "could," "estimates," "may," "should," "will," or other variations of these terms are intended to identify the forward-looking statements. These statements are based on assumptions and analyses made in light of experience and other historical trends, current conditions, and expected future developments. However, actual results and developments may differ materially from our expectations and predictions due to a number of risks and uncertainties, many of which are beyond our control. These risks and uncertainties include, but are not limited to:

- political, legal, regulatory and economic conditions and developments in the United States and abroad;
- economic fluctuations in the agricultural, rural utility, international, and farm-related business sectors;
- weather-related, disease, and other adverse climatic or biological conditions that periodically occur that impact agricultural productivity and income;
- changes in United States government support of the agricultural industry; and
- actions taken by the Federal Reserve System in implementing monetary policy.

## CRITICAL ACCOUNTING POLICIES

The financial statements are reported in conformity with accounting principles generally accepted in the United States of America. Our significant accounting policies are 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. We consider these policies critical because management must 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 existing in and inherent in our loan portfolio. The allowance for loan losses is increased through provisions for loan losses and loan recoveries and is decreased through allowance reversals and loan charge-offs. The allowance for loan losses is determined based on a periodic evaluation of the loan portfolio, which generally considers relevant historical charge-off experience adjusted for relevant factors. These factors include 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, and geographic, industry and other factors.

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

- *Valuation methodologies* — Management applies various valuation methodologies to assets and liabilities that often involve a significant degree of judgment, particularly when liquid markets do not exist for the particular items being valued. Quoted market prices are referred to when estimating fair values for certain assets for which an observable liquid market exists, such as most investment securities. Management utilizes significant estimates and assumptions to value items for which an observable liquid market does not exist. Examples of these items include impaired loans, pension and other postretirement benefit obligations, and certain other financial instruments. These valuations require the use of various assumptions, including, among others, discount rates, rates of return on assets, repayment rates, cash flows, default rates, costs of servicing and liquidation values. The use of different assumptions could produce significantly different results, which could have material positive or negative effects on the Association’s results of operations.
- *Pensions* — The Bank and its related Associations participate in defined benefit retirement plans. These plans are noncontributory and benefits are based on salary and years of service. In addition, the Bank and its related Associations also participate in defined contribution retirement savings plans. Pension expense for all plans is

recorded as part of salaries and employee benefits. Pension expense for the defined benefit retirement plans is determined by actuarial valuations based on certain assumptions, including expected long-term rate of return on plan assets and discount rate. The expected return on plan assets for the year is calculated based on the composition of assets at the beginning of the year and the expected long-term rate of return on that portfolio of assets. The discount rate is used to determine the present value of our future benefit obligations. The discount rate was selected by reference to Hewitt’s (a global human resources service provider) corporate bond index, actuarial analyses and industry norms.

## ECONOMIC CONDITIONS

During 2007, economic conditions in our region continued to be favorable although the economy began to slow in the latter part of the year. The regional economy continued to expand as population in smaller towns and rural areas continued to grow. The demand for loans to purchase farms and land remained strong even as the overall housing market slowed. The agricultural economy continued to have challenges but overall it was a good year. Nationally, gross farm income increased to record levels. The farmers in the Association’s territory had a good year but were negatively impacted by higher input costs and drought conditions. Some of the higher input costs included feed, fuel, and fertilizer costs. Parts of the territory experienced drought conditions during the summer months which lowered crop yield. On a positive note, dairy farmers and cattle producers saw strong cattle prices and higher milk prices during 2007. These higher prices helped to offset the higher input costs. Timber producers were impacted by the slow down in housing construction. This led to an overall slowdown in the demand for lumber and hardwood products. Overall, the demand for most farm products continued to grow as both domestic and overseas markets expanded.

The Association has continued to grow its loan portfolio and credit quality remained at a high level. While much of the lending industry has been impacted by the downturn in the housing market, the Association, due to prudent lending practices, has not been impacted by the turmoil in the credit markets.

There have been few changes in our market base over the past year. The Association continues to look for opportunities such as buying loan participations. The Association continued to target certain segments of our business with hopes of increasing market share. We continued to place greater emphasis on sales and marketing. Continued efforts are being made to expand services, increase public knowledge of our services and streamline our current delivery of products to enhance our existing portfolio. Our members recognize the benefits of our profit-sharing program, which reduces their borrowing costs by sharing in the Association’s profits. More than \$18 million or about 61% of the Association’s 2007 net income will be distributed in cash to members in April of 2008. As a result of these efforts, the Association continued to experience increased loan volume throughout its territory.

**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 diversification of the Association loan volume by type for each of the past three years is shown below.

Loan Type	December 31,					
	2007		2006		2005	
	<i>(dollars in thousands)</i>					
Real estate mortgage	\$ 1,008,774	67.12%	\$ 879,204	66.12%	\$ 802,874	67.31%
Production and intermediate-term	329,683	21.93	314,180	23.63	283,723	23.78
Loans to cooperatives	-	-	-	-	611	.05
Processing and marketing	81,154	5.40	68,420	5.15	45,935	3.85
Farm-related business	23,679	1.58	17,177	1.29	10,145	.85
Communication	2,794	0.19	-	-	778	.07
Rural residential real estate	56,926	3.78	50,801	3.81	48,814	4.09
<b>Total</b>	<b>\$ 1,503,010</b>	<b>100.00%</b>	<b>\$ 1,329,782</b>	<b>100.00%</b>	<b>\$ 1,192,880</b>	<b>100.00%</b>

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

Branch/State	December 31,		
	2007	2006	2005
Abingdon, VA	5%	5%	5%
Bedford, VA	3	3	2
Charlottesville, VA	4	4	3
Chatham, VA	3	2	2
Clarksburg, WV	2	2	3
Culpeper, VA	6	6	6
Elkins, WV	2	2	3
Gate City, VA	1	1	1
Halifax, VA	2	2	2
Harrisonburg, VA	11	13	12
Leesburg, VA	7	7	8
Lewisburg, WV	2	2	2
Lexington, VA	3	3	3
Oakland, MD	4	3	3
Orange, VA	6	6	6
Petersburg, WV	4	4	4
Ripley, WV	4	4	4
Roanoke, VA	2	2	2
Rocky Mount, VA	4	4	4
Romney, WV	1	1	1
Verona, VA	5	5	5
Warrenton, VA	7	8	10
Wytheville, VA	5	5	5
Agribusiness	3	1	1
Participation Loans Purchased	6	6	4
Participation Loans Sold	(2)	(1)	(1)
	<b>100%</b>	<b>100%</b>	<b>100%</b>

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

The major commodities in the Association loan portfolio are shown below. The predominant commodities are livestock, field crops, and timber, which constitute over 62 percent of the entire portfolio.

Commodity Group	Percent of Portfolio		
	2007	2006	2005
Livestock	33%	34%	36%
Field Crops	16	15	14
Timber	13	13	12
Dairy	8	8	9
Poultry	7	7	8
Rural Home	4	4	4
Tobacco	1	2	2
Other	18	17	15
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

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

The increase in gross loan volume for the twelve months ended December 31, 2007, is primarily attributed to the continued demand in long term real estate mortgage loans and an increase in participation loans purchased from other FCS institutions.

During 2007, the Association continued to buy and sell loan participations within the System. This provides a means for the Association to spread credit concentration risk and realize non-patronage sourced interest and fee income, which may strengthen its capital position.

Loan Participations:	December 31,		
	2007	2006	2005
	<i>(dollars in thousands)</i>		
Participations Purchased			
– FCS Institutions	\$ 96,087	\$ 75,156	\$ 43,651
Participations Purchased			
– Non-FCS Institutions	318	1,033	1,364
Participations Sold	(24,147)	(8,221)	(12,134)
<b>Total</b>	<b>\$ 72,258</b>	<b>\$ 67,968</b>	<b>\$ 32,881</b>

The Association did not have any loans sold with recourse, retained subordinated participation interests in loans sold, or interests in pools of subordinated participation interests for the year ended December 31, 2007.

The Association sells qualified long-term mortgage loans into the secondary market. For the years ended December 31, 2007, 2006 and 2005, the Association originated loans for resale totaling \$53,445, \$40,117 and \$42,244, respectively, which were sold into the secondary market. The Association also participates in the Farmer Mac Long Term Stand-By program. Farmer Mac was established by Congress to provide liquidity to agricultural lenders. At December 31, 2007, 2006 and 2005, the Association had loans amounting to \$97,895, \$11,938 and \$17,202, respectively, which were 100 percent guaranteed by Farmer Mac. The Association additionally purchased 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, 2007, the balance of these loans, including the unamortized premium, was \$318, compared to \$1,033 at December 31, 2006 and \$1,364 at December 31, 2005.

### MISSION-RELATED INVESTMENTS

During 2005, the FCA initiated an investment program to stimulate economic growth and development in rural areas. The FCA outlined a program to allow System institutions to hold such investments, subject to approval by the FCA on a case-by-case basis. FCA approved the Rural America Bonds pilot and the Tobacco Buyout Program under the mission-related investments umbrella, as described below.

In October 2005, the FCA authorized AgFirst and the Associations to make investments in Rural America Bonds under a three-year pilot period. Rural America Bonds may include debt obligations issued by public and private enterprises, corporations, cooperatives, other financing institutions, or rural lenders where the proceeds would be used to support agriculture, agribusiness, rural housing, or economic development, infrastructure, or community development and revitalization projects in rural areas. Examples include investments that fund value-added food and fiber processors and marketers, agribusinesses, commercial enterprises that create and maintain employment opportunities in rural areas, community services, such as schools, hospitals, and government facilities, and other activities that sustain or revitalize rural communities and their economies. The objective of this pilot program is to help meet the growing and diverse financing needs of agricultural enterprises, agribusinesses, and rural communities by providing a flexible flow of money to rural areas through bond financing. These bonds may be classified as Loans or Investments on the Consolidated Balance Sheets depending on the nature of the investment. As of December 31, 2007, 2006, and 2005, the Association had \$1,312, \$0, and \$0, respectively, in Rural America Bonds, and they are classified as Loans on the Consolidated Balance Sheets.

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, provided for payments to tobacco "quota owners" and producers for the elimination of the quota and included an assessment mechanism for tobacco manufacturers and importers to pay for the buyout. Tobacco quota holders and producers will receive equal annual payments under a contract with the Secretary of Agriculture. The Tobacco Act also

includes a provision that allows the quota holders and producers to assign to a "financial institution" the right to receive the contract payments (Successor-in-Interest Contracts (SIIC)) so that the quota holder or producer 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). At December 31, 2007, 2006 and 2005, the Association had \$15,065, \$10,401 and \$7,415, respectively, in SIIC outstanding and these are classified as Other Investments on the Consolidated Balance Sheets.

### CREDIT RISK MANAGEMENT

Credit risk arises from the potential inability of an obligor to meet its repayment obligation. As part of the process 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 – protection for the lender in the event of default and 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. Real estate loans must be collateralized by first liens on the real estate (collateral). As required by FCA regulations, each institution that makes loans on a collateralized basis must have collateral evaluation policies and procedures. Real estate mortgage loans may be made only in amounts up to 85 percent of the original appraised value of the property taken as collateral or up to 97 percent of the appraised value if guaranteed by a state, federal, or other governmental agency. The actual loan to appraised value when loans are made is generally lower than the statutory maximum percentage. Appraisals are required for loans of more than \$250,000. In addition, each loan is assigned a credit risk rating 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.

We review the credit quality of the loan portfolio on an ongoing 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	2007	2006	2005
Acceptable & OAEM	98.30%	98.44%	98.11%
Substandard	1.67%	1.56%	1.89%
Doubtful	.03%	–%	–%
Total	100.00%	100.00%	100.00%

#### Nonperforming Assets

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:

High-risk Assets	December 31,		
	2007	2006	2005
	<i>(dollars in thousands)</i>		
Nonaccrual loans	\$ 8,211	\$ 3,886	\$ 4,323
Restructured loans	–	–	11
Accruing loans 90 days past due	–	3	9
Total high-risk loans	8,211	3,889	4,343
Other property owned	796	–	–
Total high-risk assets	\$ 9,007	\$ 3,889	\$ 4,343

#### Ratios

Nonaccrual loans to total loans	0.55%	0.29%	0.36%
High-risk assets to total assets	0.57%	0.28%	0.35%

Nonaccrual loans represent all loans where there is a reasonable doubt as to the collection of principal and/or future interest accruals, under the contractual terms of the loan. In substance, nonaccrual loans reflect loans where the accrual of interest has been suspended. Nonaccrual loans increased \$4,325 or 111.30 percent in 2007. This increase resulted from several large loans being downgraded to nonaccrual status and fewer nonaccrual loans being paid down. Of the \$8,211 in nonaccrual volume at December 31, 2007, \$1,433 or 17.45 percent, compared to 52.86 percent and 37.57 percent at December 31, 2006 and 2005, respectively, was current as to scheduled principal and interest payments, but did not meet all regulatory requirements to be transferred into accrual status.

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

#### Allowance for Loan Losses

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.

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

Allowance for Loan Losses Activity:	Year Ended December 31,		
	2007	2006	2005
	<i>(dollars in thousands)</i>		
Balance at beginning of year	\$ 2,445	\$ 2,736	\$ 2,947
Charge-offs:			
Real estate mortgage	(3)	–	(55)
Production and intermediate-term	(141)	(205)	(92)
Agribusiness	–	(98)	–
Rural residential real estate	(11)	–	(5)
Total charge-offs	(155)	(303)	(152)
Recoveries:			
Real estate mortgage	1	–	–
Production and intermediate-term	3	12	13
Agribusiness	–	–	6
Total recoveries	4	12	19
Net (charge-offs) recoveries	(151)	(291)	(133)
Provision for (reversal of allowance for) loan losses	1,400	–	(78)
Balance at end of year	\$ 3,694	\$ 2,445	\$ 2,736
Ratio of net (charge-offs) recoveries during the period to average loans outstanding during the period	(0.011)%	(0.023)%	(0.012)%

The net loan charge-offs were primarily associated with operating loans.

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

Allowance for Loan Losses by Type	December 31,		
	2007	2006	2005
	<i>(dollars in thousands)</i>		
Real estate mortgage	\$ 1,834	\$ 1,047	\$ 1,184
Production and intermediate-term	1,400	1,216	1,347
Agribusiness	150	97	130
Rural residential real estate	310	85	75
Total allowance	\$ 3,694	\$ 2,445	\$ 2,736

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

Allowance for Loan Losses as a Percentage of:	December 31,		
	2007	2006	2005
Total loans	0.25%	0.18%	0.23%
Nonaccrual loans	44.99%	62.92%	63.29%

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 3, "Loans and Allowance for Loan Losses," of the Notes to the Consolidated Financial Statements, for further information concerning the allowance for loan losses.

### RESULTS OF OPERATIONS

Net income for the year ended December 31, 2007, totaled \$29,910, an increase of \$2,113 or 7.60 percent, as compared to \$27,797 for the same period of 2006. Net income for the year ended December 31, 2006, total \$27,797, an increase of \$17 or 0.06 percent, as compared to \$27,780 for the same period of 2005. Interest income for the year ended December 31, 2007, was \$109,741, an increase of \$15,738 or 16.74 percent as compared to \$94,003 for the same period of 2006. Interest income increased by \$15,912 or 20.38 percent for the period ended December 31, 2006, compared to the same period of 2005.

#### Net Interest Income

Net interest income was \$35,450, \$33,661 and \$29,708 in 2007, 2006 and 2005, respectively. Net interest income is the difference between interest income and interest expense. Net interest income is the principal source of earnings for the Association and is impacted by volume, yields on assets and cost of debt. The effects of changes in average volume and interest rates on net interest income over the past three years are presented in the following table:

#### Change in Net Interest Income:

	Volume*	Rate	Nonaccrual Income	Total
<b>12/31/07 - 12/31/06</b>				
Interest income	\$ 12,158	\$ 3,687	\$ (107)	\$ 15,738
Interest expense	9,450	4,499	-	13,949
Change in net interest income	\$ 2,708	\$ (812)	\$ (107)	\$ 1,789
<b>12/31/06 - 12/31/05</b>				
Interest income	\$ 7,250	\$ 8,441	\$ 221	\$ 15,912
Interest expense	5,194	6,765	-	11,959
Change in net interest income	\$ 2,056	\$ 1,676	\$ 221	\$ 3,953

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

#### Noninterest Income

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

Noninterest Income	For the Year Ended December 31,			Percentage Increase/(Decrease)	
	2007	2006	2005	2007/ 2006	2006/ 2005
<i>(dollars in thousands)</i>					
Loan fees	\$ 1,095	\$ 933	\$ 777	17%	20%
Fees for financially related services	219	112	93	96	20
Patronage refund from other Farm Credit Institutions	11,302	9,844	10,898	15	(10)
Gains (losses) on other property owned, net	(32)	35	(46)	(191)	176
Gains (losses) on sales of rural home loans	645	528	575	22	(8)
Gains (losses) on sales of premises and equipment, net	(4)	(16)	(12)	75	(33)
Other noninterest income	709	223	166	218	34
Total noninterest income	\$ 13,934	\$ 11,659	\$ 12,451	20%	(6)%

The increase in total noninterest income of \$2,275 for the year ended December 31, 2007 compared to the year ended December 31, 2006 was primarily due to an increase in the patronage refund from the Bank and interest on a refund of state income taxes.

#### Noninterest Expense

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

Noninterest Expense	For the Year Ended December 31,			Percentage Increase/(Decrease)	
	2007	2006	2005	2007/ 2006	2006/ 2005
<i>(dollars in thousands)</i>					
Salaries and employee benefits	\$ 10,944	\$ 10,420	\$ 9,439	5%	10%
Occupancy and equipment	1,389	1,345	1,127	3	19
Insurance Fund premiums	2,100	1,858	572	13	225
Other operating expenses	4,215	3,830	3,272	10	17
Total noninterest expense	\$ 18,648	\$ 17,453	\$ 14,410	7%	21%

Total noninterest expense increased \$1,195 in 2007 as compared to 2006. The increase was primarily due to increases in employee salaries, Insurance Fund premiums and other operating expenses. Salaries increased due to merit and cost of living raises, and incentive bonuses. The Insurance Fund premiums increased as the result of the asset growth of the Association. The increase in other operating expenses was mainly due to higher advertising expenses, an increase in purchased services expenses, and management information services expenses.

#### Income Taxes

The Association recorded a benefit for income taxes of \$574 for the year ended December 31, 2007, as compared to a provision of \$70 for 2006 and a provision of \$47 for 2005. The benefit for income taxes for 2007 was due to a refund of state income taxes. The refund was related to the federal change in taxable income resulting from a settlement agreement with the IRS in 2001. The 2001 settlement agreement with the IRS resolved the issues surrounding the taxability of earnings from the Association's long-term mortgage lending activities prior to 2001. Virginia and Maryland agreed to the changes and issued the refunds in 2007.

#### Key Results of Operations Comparisons

Key results of operations comparisons for each of the twelve months ended December 31 are shown in the following table:

Key Results of Operations Comparisons	For the 12 Months Ended		
	12/31/07	12/31/06	12/31/05
Return on average assets	2.02%	2.13%	2.33%
Return on average members' equity	15.34%	14.30%	14.48%
Net interest income as a percentage of average earning assets	2.49%	2.67%	2.57%
Net charge-offs (recoveries) to average loans	0.011%	0.023%	0.012%

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.

## LIQUIDITY AND FUNDING SOURCES

### *Liquidity and Funding*

The principal source of funds for the Association is the borrowing relationship established with the Bank through a General Financing Agreement (GFA). The GFA 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 (or direct loans) to the Bank. The Bank manages interest rate risk through direct loan pricing and asset/liability management. 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. Association capital levels effectively create a borrowing margin between the amount of loans outstanding and the amount of notes payable outstanding. This margin is commonly referred to as "Loanable Funds."

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 liquidity policy of the Association is to manage cash balances to maximize debt reduction and to increase loan volume. As borrower payments are received, they are applied to the Association's note payable to the Bank. The Association's participation in the Farmer Mac, investments, and other secondary market programs provides additional liquidity. Sufficient liquid funds have been available to meet all financial obligations. There are no known trends likely to result in a liquidity deficiency for the Association.

Total notes payable to the Bank at December 31, 2007, was \$1,341,684 as compared to \$1,168,915 at December 31, 2006 and \$1,025,160 at December 31, 2005. The increase of 14.78 percent compared to December 31, 2006 and the increase of 30.88 percent compared to December 31, 2005, was attributable to continued loan growth in the Association. The average volume of outstanding notes payable to the Bank was \$1,261,713 and \$1,090,872 for the years ended December 31, 2007 and 2006, respectively. Refer to Note 7, "Notes Payable to AgFirst Farm Credit Bank," of the Notes to the Consolidated Financial Statements, for weighted average interest rates and maturities, and additional information concerning the Association's notes payable.

The Association did not have any lines of credit with other third party financial institutions as of December 31, 2007.

### *Funds Management*

The Bank and the Association manage assets and liabilities to provide a broad range of loan products and funding options, which are designed to allow 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 market indices such as 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 System debt of similar terms to maturity.

The majority of the interest rate risk in the Association's Consolidated Balance Sheets 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

Capital serves to support asset growth and provide protection against unexpected credit and interest rate risk and operating losses. Capital is also needed for future growth and investment in new products and services.

The Association Board of Directors establishes, adopts, and maintains a formal written capital adequacy plan to ensure that adequate capital is maintained for continued financial viability, to provide for growth necessary to meet the needs of members/borrowers, and to ensure that all stockholders are treated equitably. There were no material changes to the capital plan for 2007 that would affect minimum stock purchases or would have an effect on the Association's ability to retire stock and distribute earnings.

Total members' equity at December 31, 2007, increased 6.63 percent to \$191,656 from the December 31, 2006, total of \$179,743. At December 31, 2006, total members' equity decreased 1.85 percent from the December 31, 2005 total of \$183,133. The increase at December 31, 2007 was primarily attributed to the earnings of the Association offset by the cash profit-sharing distribution (patronage dividend) to the Association's member-stockholders. The Association will distribute more than \$18 million of the 2007 net income in cash to its member-stockholders in April of 2008.

Total capital stock and participation certificates were \$18,517 on December 31, 2007, compared to \$18,318 on December 31, 2006. The increase was attributed to the increase in members who purchased stock during 2007.

FCA sets minimum regulatory capital requirements for System banks and associations. Capital adequacy is evaluated using a number of regulatory ratios. According to the FCA regulations, each institution's permanent capital ratio is calculated by

dividing permanent capital by a risk-adjusted asset base. Risk adjusted assets mean the total dollar amount of the institution's assets adjusted by an appropriate credit conversion factor as defined by regulation. For all periods represented, the Association exceeded minimum regulatory standard for all the ratios.

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

	2007	2006	2005	Regulatory Minimum
Permanent capital ratio	12.68%	13.57%	15.08%	7.00%
Total surplus ratio	11.38%	12.19%	13.49%	7.00%
Core surplus ratio	11.38%	11.73%	12.00%	3.50%

The decrease in the Association's permanent capital, total surplus, and core surplus for December 31, 2007 and December 31, 2006 was attributed to the increase in loan volume which outpaced the increase in capital. There are no trends, commitments, contingencies, or events that are likely to affect the Association's ability to meet regulatory minimum capital standards and capital adequacy requirements.

See Note 8, "Members' Equity," of the Consolidated Financial Statements, for further information concerning capital resources.

#### 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 FCA 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 are eligible for allocation to borrowers. Refer to Note 8, "Members' Equity," of the Notes to the Consolidated Financial Statements, for more information concerning the patronage distributions.

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

The Association's mission is to provide financial services to agriculture and the rural community, which includes providing credit to young\*, beginning\*\* and small\*\*\* farmers. Because of the unique needs of these individuals, and their importance to the future growth of the Association, the Association has established annual marketing goals to increase our market share of loans to YBS farmers. Specific marketing plans have been developed to target these groups, and resources have been designated to help ensure YBS borrowers have access to a stable source of credit. As a result, 2007 goals were established and met.

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

	As of December 31, 2007	
	Number of Loans	Amount of Loans
Young	2,563	\$ 178,668
Beginning	3,831	401,639
Small	13,148	1,087,826

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

The 2002 USDA (2002 is the latest USDA Ag census data available; next census will be available in 2008.) Ag census data has been used as a benchmark to measure penetration of the Association's marketing efforts. The Association currently has a high penetration in the young, beginning, and small farmer market. As of December 31, 2007, the Association was doing business with 72.8 percent of the young farmers, 21.5 percent of the beginning farmers, and 16.5 percent of small farmers identified by the 2002 Ag census.

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

- Support of 4-H, FFA, and young farmer organizations through sponsorships and donations.
- Sponsor and host seminars on farm transition planning and financial management.
- Sponsor a one-day Young Farmer Institute facilitated by nationally recognized agricultural business consultant, Dr. David Kohl.
- Sponsor and host Dairy Management seminars.
- Support young and beginning farmers through a Youth Loan program.

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

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

**REGULATORY MATTERS***Proposed Federal Legislation*

The current farm bill expired on September 30, 2007. In July 2007, the House of Representatives passed its version of a new farm bill, the Farm, Nutrition, and Bioenergy Act of 2007. Under the farm bill as passed by the House of Representatives, the Congressional Budget Office estimated that payments to farmers under the commodity programs, i.e., direct and countercycle payments and loan deficiency payments, would be reduced by an estimated \$825 million in total over the next 10 years, as compared with a current services baseline of approximately \$75 billion for commodities. However, the specific provisions of the farm bill may increase payments for certain commodities or increase them in certain years and reduce them in others. This farm bill would also revise certain income payment limitations.

The farm bill as passed by the House of Representatives also contains provisions that would expand certain authorities of the Farm Credit System Insurance Corporation. The proposed changes generally would authorize the Insurance Corporation to collect higher levels of premiums and expand the base upon which premiums are charged. Premiums of up to 20 basis points could be charged against insured debt adjusted for government-guaranteed loans and up to an additional 10 basis points could be charged for any loan volume that is nonaccrual or investments that are other-than-temporarily impaired. Currently, premiums of up to 15 basis points may be charged on accruing loans and up to 25 basis points for nonaccrual loans.

The Senate Agriculture, Nutrition and Forestry Committee has submitted to the full Senate its version of the farm bill, the Food and Energy Security Act of 2007. As reported, the bill proposes adjustments to current farm policy while maintaining the basic safety net structure of current law. The bill, when combined with tax provisions previously reported by the Senate Finance Committee, would provide for a permanent disaster fund and provide new incentives for farmers to engage in soil conservation activities. Before these changes are enacted into law, the Senate must adopt the bill and conference their actions with the bill earlier approved by the House. It is premature to predict the final outcome of this process. The proposed Senate farm bill contains the same expanded authorities with respect to the Insurance Corporation as noted above.

**RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS**

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, "*Accounting for Uncertainty in Income Taxes — an Interpretation of FASB Statement No. 109*" (FIN 48 or Interpretation) that was effective for fiscal years beginning after December 15, 2006. FIN 48 clarifies how an enterprise should recognize, measure, present and disclose in its financial statements uncertain tax positions that the enterprise has taken or expects to take on a tax return. Under the Interpretation, the financial statements reflect expected future tax consequences of income tax positions presuming the relevant taxing authority's full knowledge of the position and all relevant facts, but without considering time values. FIN 48 is applicable to all uncertain positions for taxes accounted for under FASB Statement No. 109. The Association adopted FIN 48 on January 1, 2007 and determined that interest and penalties would be classified as a component of income taxes.

There were no uncertain positions for income taxes at January 1, 2007 identified as a result of the adoption and therefore no cumulative adjustment to beginning members' equity was required. The tax years that remain open for federal and major state income tax jurisdictions are 2004 and forward.

On September 29, 2006, the FASB issued Statement of Financial Accounting Standards No. 158, "*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans.*" The Standard requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and recognize changes in that funded status in the year in which the changes occur through other comprehensive income. The Standard further requires the determination of the fair value of plan assets at year-end and recognition of actuarial gains and losses, prior service costs or credits, and transition assets and obligations as a component of other comprehensive income. In addition, this Standard requires that the funded status of a plan be measured as of the date of the year-end financial statements. Currently, the District uses a measurement date of September 30th. The requirement to measure the funded status as of the fiscal year-end is effective for fiscal years ending after December 15, 2008. See Note 10, "Employee Benefit Plans," of the Consolidated Financial Statements, for the impact of the adoption of FAS 158 on the current period.

In September 2006, the FASB also issued Statement of Financial Accounting Standards No. 157, "*Fair Value Measurements.*" This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. As a result, there is now a common definition of fair value to be used throughout generally accepted accounting principles. The FASB believes that the new standard will make the measurement of fair value more consistent and comparable and improve disclosures about those measures. This Statement clarifies that the term fair value is intended to mean a market-based measure, not an entity-specific measure. In measuring fair value for a financial statement item, the Statement sets forth a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The highest priority is given to quoted prices in active markets and the lowest priority to unobservable inputs. Additional disclosure requirements will be required for the lowest priority level. The Statement became effective as of January 1, 2008, and will be applied to our consolidated financial statements on a prospective basis.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, "*Fair Value Option for Financial Assets and Financial Liabilities.*" The Standard permits entities to choose on an instrument-by-instrument basis, at specified election dates, to measure financial assets and liabilities and certain other items at fair value (the "fair value option"). Unrealized gains and losses on items for which the fair value option has been elected must be reported in earnings at each subsequent reporting date. Upfront costs and fees related to items for which the fair value option is elected shall be recognized in earnings as incurred and not deferred. This Standard became effective as of January 1, 2008. The Association has not made any elections under the fair value option, thus there will be no impact of the initial adoption of the Standard. However, the Association may elect to apply the fair value option to financial instruments acquired in future periods.

# *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 of 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.

## Description of Property

The following table sets forth certain information regarding the properties of the reporting entity, all of which are located in Virginia, West Virginia and Maryland:

<u>Location</u>	<u>Description</u>	<u>Form of Ownership</u>
106 Sangers Lane Augusta County, VA	Administrative	Owned
1237 W. Main Street Abingdon, VA	Branch	Owned
1356-B American Way Court Bedford, VA	Branch	Rented (\$1,200 per month)
1445 E. Rio Road Suite 103 Charlottesville, VA	Branch	Rented (\$1,838 per month)
29 Military Drive Chatham, VA	Branch	Owned
I-79, Exit 115, Rt. 20 S. Clarksburg, WV	Branch	Rented (\$1,788 per month)
409 James Madison Hwy. Culpeper, VA	Branch	Rented (\$3,700 per month)
308 Railroad Ave. Elkins, WV	Branch	Rented (\$650 per month)
268 E. Jackson Street Gate City, VA	Branch	Owned
161 South Main St. Halifax, VA	Branch	Rented (\$531 per month)
306 E. Market St. Harrisonburg, VA	Branch	Owned
27 Fort Evans Rd., NE Leesburg, VA	Branch	Owned
880 North Jefferson St. Lewisburg, WV	Branch	Owned
Rt. 39 Lexington, VA	Branch	Owned
Rt. 219 North Oakland, MD	Branch	Owned

<u>Location</u>	<u>Description</u>	<u>Form of Ownership</u>
Colonial Shopping Center Orange, VA	Branch	Rented (\$1,575 per month)
106 North Main Street Petersburg, WV	Branch	Owned
Route 33 West Ripley, WV	Branch	Rented (\$2,472 per month)
38 Murray Farm Road Roanoke, VA	Branch	Owned
670 Old Franklin Turnpike Rocky Mount, VA	Branch	Owned
452 North High Street Romney, WV	Branch	Owned
1557 Commerce Road Suite 202 Verona, VA	Branch	Rented (\$1,731 per month)
516 Fauquier Road Warrenton, VA	Branch	Owned
660 Pepper’s Ferry Road Wytheville, VA	Branch	Owned

## Legal Proceedings

Information, if any, to be disclosed in this section is incorporated herein by reference to Note 13 of the Consolidated Financial Statements, “*Commitments and Contingencies*,” included in this Annual Report.

## Description of Capital Structure

Information to be disclosed in this section is incorporated herein by reference to Note 8 of the Consolidated Financial Statements, “*Members’ Equity*,” included in this Annual Report.

## 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 of the Consolidated Financial Statements included in this Annual Report.

## 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 and is to be disclosed in this section, is incorporated herein by reference.

**Senior Officers**

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

<u>Senior Officer</u>	<u>Position</u>
David E. Lawrence	Chief Executive Officer since April, 2003 and had previously served as Chief Lending Officer since January 1993.
Bette B. Brand	Chief Sales Officer since October 2005 and had previously served as a Regional Sales and Lending Manager since January 2001.
Dennis K. Carpenter	Chief Lending Officer since January 2006 and had previously served as Senior Policy Analyst at Farm Credit Administration in McLean, Virginia.
David G. Sauer	Chief Financial Officer since January 1998.

The total amount of compensation earned by the chief executive officers (CEO) and the highest-paid officers as a group during the years ended December 31, 2007, 2006 and 2005, is as follows:

Name of Individual or Number in Group	Year	Annual		Deferred Comp.	Perq./ Other*	Total
		Salary	Bonus			
David E. Lawrence	2007	\$251,099	-	\$50,220	\$7,955	\$309,274
David E. Lawrence	2006	\$244,260	-	\$48,850	\$5,267	\$298,377
David E. Lawrence	2005	\$220,009	-	\$44,000	-	\$264,009
5	2007	\$592,930	\$64,177	\$88,249	\$5,595	\$750,951
5	2006	\$567,559	\$55,116	\$68,487	-	\$691,162
5	2005	\$655,864	\$41,667	\$89,501	-	\$787,032

\* Amounts in the above table classified as Perquisites include group life insurance, automobile compensation, and spousal travel.

Note: Beginning with year-end 2006, CEO compensation must be disclosed as a separate line item and is not included in the aggregate amount. The CEO salary is also included in the aggregate amount for 2005.

In addition to a base salary, all employees, except the CEO and internal reviewers, can earn additional compensation under an incentive plan. The incentive plan for 2007 is designed to motivate employees to stimulate new business development, increase loan volume, and increase Association's earnings. The incentive plan is based on a combination of individual and association goals. The 2007 incentive plan includes a deferred settlement feature. The deferred settlement feature means that part of the incentive amount will not be paid to employees until 2011. The total incentive amount, including both current and deferred, was expensed in 2007. Payment of the incentive, not including the deferred settlement, was made in the first quarter of 2008.

The CEO and internal reviewers can receive a bonus at the discretion of the Board of Directors. This bonus has a deferred settlement feature.

**Defined Benefit-Type**

The Association sponsors a non-qualified defined benefit supplemental executive retirement plan for Donald L. Shiflet, retired CEO. The purpose of the non-qualified plan is to provide benefits that supplement the qualified defined benefit plan in which the Association's employees participate. For Mr.

Shiflet, Compensation in excess of the 401(a)(17) limit and benefits in excess of the 415(b) limit in the qualified defined benefit plan will be made up through the non-qualified plan. As a non-qualified plan, assets have been allocated and separately invested for this plan, but are not isolated from the general creditors of the Association.

**Defined Contribution-Type**

The Association sponsors a non-qualified supplemental deferred compensation plan for certain key employees. The purpose of the non-qualified plan is to provide supplemental deferred compensation options to eligible key employees. As a non-qualified plan, assets have been allocated and separately invested for this plan, but are not isolated from the general creditors of the Association.

Disclosure of information on the total compensation paid during 2007 to any senior officer, or to any other individual included in the total, is available to shareholders 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 \$117,256 for 2007, \$105,265 for 2006, and \$84,803 for 2005.

Subject to approval by the board, the Association may allow directors honorarium of \$400 for attendance at meetings, committee meetings, or special assignments, and \$100 for telephone conferences. In addition to the honoraria, the board chairman was paid a quarterly retainer fee of \$1,000 and the directors were paid a quarterly retainer fee of \$750. Total compensation paid to directors as a group was \$234,000. The following represents certain information regarding the directors of the Association, including their principal occupation for the past five years:

**John E. Wells, Chairman**, is a full-time beef farmer. He is a member of the West Virginia Cattlemen's Association, Wirt County Farm Bureau, and is vice president of Jackson County Calf Pool Cooperative. During 2007, he served 13 days at Association board meetings and 31 days in other official activities and was paid \$21,300. His term of office is 2005-2007.

**Alfred W. Stephens, Jr., Vice Chairman**, is a dairy farmer. He serves as secretary on the Wythe/Bland DHIA and serves on the Wythe County Farm Bureau Board. During 2007, he served 13 days at Association board meetings and 15 days in other official activities and was paid \$14,200. His term of office is 2005-2008.

**James H. Addington** is the outside director. He is president of Addington Oil Corporation. He serves on the board of directors for Scott County Chamber of Commerce; Daniel Boone Trail Association; and the Cove Ridge Foundation. During 2007, he served 13 days at Association board meetings and 5 days in other

official activities and was paid \$10,200. His term of office is 2006-2008.

**Ronald L. Bennett** operates a dairy farm. He serves on the Alleghany County Farm Bureau Board and Rockbridge/-Alleghany/Bath FSA Committee. During 2007, he served 13 days at Association board meetings and 6 days in other official activities and was paid \$10,600. His term of office is 2006-2009.

**Donna M. Brooke-Alt** owns and operates a dairy farm. She serves as the FSA county committee advisor and on the Mineral County Farm Preservation Board. During 2007, she served 10 days at Association board meetings and 19 days in other official activities and was paid \$14,600. Her term of office is 2006-2009.

**William J. Franklin, Jr.**, is a beef cattle farmer. He is the chief executive officer of the Scott County Telephone Cooperative. He serves on the Carolina-Virginia's Telephone Association Board and the Tennessee Industry Telecommunications, LLC Board. During 2007, he served 13 days at Association board meetings and 10 days in other official activities and was paid \$12,200. His term of office is 2007-2010.

**Paul M. House** is president of Kettle Wind Farm, LLC., a dairy, grain, and sod farm. He is also a shareholder in Dutchland Farm Inc., a family dairy farm. He serves on the AgFirst Farm Credit Bank Board. During 2007, he served 13 days at Association board meetings and was paid \$8,200. His term of office is 2005-2008.

**Melody S. Jones** is the outside director. She is a self-employed sole practitioner Certified Public Accountant. Ms. Jones serves on the BC Bank, Inc. Board; Barbour County Chamber of Commerce and Barbour County Office for Economic Development Boards. During 2007, she served 13 days at Association board meetings and 16 days in other official activities and was paid \$14,000. Her term of office is 2007-2010.

**James A. Kinsey** operates a forage based purebred angus cattle operation. He serves on the CoBank, ACB Board and the Federal Farm Credit Funding Corporation Board. During 2007, he served 13 days at Association board meetings and 5 days in other official activities and was paid \$9,900. His term of office is 2006-2009.

**Charles B. Leech, IV** is an owner-operator with his family of a dairy farm. He serves on the Virginia State Dairymen's Association Board, Rockbridge Farmers Cooperative Board and the Rockbridge Augusta Dairy Herd Improvement Association Board. During 2007, he served 13 days at Association board meetings and 15 days in other official activities and was paid \$14,200. His term of office is 2004-2007.

**Ralph L. Puckett** operates a cow/calf and feeder cattle operation. He is a field sales associate for Southern States, Inc. He serves on the Washington County Farm Bureau Board, on the Southwest VA Agricultural Association and Smyth-Washington Cattlemen Association. During 2007, he served 13 days at Association board meetings and 13 days in other official activities and was paid \$12,800. His term of office is 2007-2010.

**Donald W. Reese** is a partner in Reese Farm's, Inc., a produce farm with retail and wholesale operations. He is also owner of

Don and Sara Reese, LLC, a retail produce operation. He serves on the Virginia Baptist Mission Board. During 2007, he served 13 days at Association board meetings and 11 days in other official activities and was paid \$12,000. His term of office is 2006-2009.

**Wallace W. Sanford, III**, is a dairy and beef farmer in partnership with his family. He serves on the Maryland-Virginia Milk Producers Board and is director for the Orange County Fair and for Battlefield DHIA as well as director for the Orange Madison Coop and director for the VA State Dairymen Association. During 2007, he served 11 days at Association board meetings and 14 days in other official activities and was paid \$12,400. His term of office is 2007-2010.

**Walter L. Schmidlen, Jr.** is a beef farmer and owns a farm machinery dealership. He serves on the AgFirst Farm Credit Bank Board. During 2007, he served 13 days at Association board meetings and was paid \$8,200. His term of office is 2005-2007.

**Barry W. Shelor** operates a dairy farm. He serves on the Patrick County Farm Bureau Board. During 2007, he served 13 days at Association board meetings and 7 days in other official activities and was paid \$10,400. His term of office is 2006-2008.

**Raymond L. Simms** is a beef cattle farmer. He serves on the Spotsylvania County Farm Bureau Board, the Virginia Cattlemen's Association Board, the Tri-County/City Soil and Water Conservation District, Virginia Soil and Water Conservation Board and the Fredericksburg Feeder Calf Association. During 2007, he served 13 days at Association board meetings and 13 days in other official activities and was paid \$13,400. His term of office is 2007-2010.

**Gregory A. Smith** operates a dairy farm in partnership with his brother. He is president of Ashland Farms, Inc. He is also president of the Culpeper Farmers' Cooperative. During 2007, he served 13 days at Association board meetings and 9 days in other official activities and was paid \$11,800. His term of office is 2005-2007.

**Thomas V. Thacker** is a poultry farmer. He serves on the Weyers Cave Recreation Association Board and on the Weyers Cave Community Center Board. During 2007, he served 13 days at Association board meetings and 18 days in other official activities and was paid \$15,400. His term of office is 2006-2009.

**Joseph W. Wampler** is a general livestock and poultry farmer. During 2007, he served 13 days at Association board meetings and was paid \$8,200. His term of office is 2006-2008.

#### Transactions with Senior Officers and Directors

The reporting entity's policies on loans to and transactions with its officers and directors, to be disclosed in this section are incorporated herein by reference to Note 12 of the Consolidated Financial Statements, "Related Party Transactions," included in this Annual Report. There have been no transactions between the Association and senior officers or directors which require reporting per FCA regulations.

**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. No directors or senior officers have been involved in any legal proceedings during the last five years which require reporting per FCA regulations.

**Relationship with Independent Auditors and Other Qualified Public Accountants**

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

Aggregate fees paid by the Association for services rendered by its independent auditors and other qualified public accountants for the year ended December 31, 2007 were as follows:

	<u>2007</u>
<b>Independent Auditor</b>	
PricewaterhouseCoopers LLP	
Audit services	\$ 54,667
Tax services	22,950
All other	5,964
<b>Qualified Public Accountant</b>	
Harper, Rains, Knight & Company	
Nonaudit services	86,500
J. Robin Haynes, CPA	
Tax services	<u>7,500</u>
Total	<u>\$ 177,581</u>

Audit fees were for the annual audit of the consolidated financial statements.

Nonaudit fees were for the annual evaluation of asset quality and credit administration.

All other fees were for services rendered in connection with creating a trust under the FLCA Subsidiary to act as an intermediary between the United States Department of Agriculture Foreign Agricultural Services and the newly created Farm Credit Armenia.

All nonaudit service fees incurred by the Association were approved by the Audit Committee.

**Consolidated Financial Statements**

The consolidated financial statements, together with the report thereon of PricewaterhouseCoopers LLP dated February 28, 2008 and the report of management, which appear in this Annual Report are incorporated herein by reference.

Copies of the Association's quarterly reports are available on the Association's website, [www.farmcreditofvirginias.com](http://www.farmcreditofvirginias.com), or may be obtained upon request free of charge by calling 1-540-886-3435, extension 620, or writing David Sauer, Farm Credit of the Virginias, P.O. Box 899, Staunton, VA 24402-0899.

The Association prepares an electronic version of the Annual Report which is available on the Association's web site within 75 days after the end of the fiscal year and distributes the Annual Reports to shareholders within 90 days after the end of the fiscal year. The Association prepares an electronic version of the Quarterly report within 40 days after the end of each fiscal quarter, except that no report need be prepared for the fiscal quarter that coincides with the end of the fiscal year of the institution.

**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. 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.

**Credit and Services to Young, Beginning, and Small Farmers and Ranchers and Producers or Harvesters of Aquatic Products**

Information to be disclosed in this section is incorporated herein by reference to the similarly named section in the Management's Discussion and Analysis of Financial Condition and Results of Operations section included in this Annual Report to the shareholders.

**Shareholder Investment**

Shareholder investment in the Association could be affected by the financial condition and results of operations of AgFirst Farm Credit Bank (Bank or AgFirst). Copies of the Bank's Annual and Quarterly reports are available upon request free of charge by calling 1-800-845-1745, ext. 378, or writing Stephen Gilbert, AgFirst Farm Credit Bank, P. O. Box 1499, Columbia, SC 29202. Information concerning AgFirst Farm Credit Bank can also be obtained by going to AgFirst's web site at [www.agfirst.com](http://www.agfirst.com). The Bank prepares an electronic version of the Annual Report, which is available on the website, within 75 days after the end of the fiscal year and distributes the Annual Reports to shareholders within 90 days after the end of the fiscal year. The Bank prepares an electronic version of the Quarterly report within 40 days after the end of each fiscal quarter, except that no report needs to be prepared for the fiscal quarter that coincides with the end of the fiscal year of the Bank.

## *Report of the Audit Committee*

The Audit Committee of the Board of Directors (Committee) is comprised of the directors named below. None of the directors who serve on the Committee is an employee of Farm Credit of the Virginias, ACA (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 2007, is responsible for expressing an opinion on the conformity of the Association's audited financial statements with accounting principles generally accepted in the United States of America. The Committee has discussed with PwC the matters that are required to be discussed by Statement on Auditing Standards No. 114 (*The Auditor's Communication With Those Charged With Governance*). 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 2007. The foregoing report is provided by the following independent directors, who constitute the Committee:



Melody S. Jones  
Chairman of the Audit Committee

### **Members of Audit Committee**

James A. Kinsey  
Ralph L Puckett  
Wallace W. Sanford, III  
Walter L. Schmidlen, Jr.  
Barry W. Shelor

February 28, 2008

# 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 the Virginias, 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 the Virginias, ACA (the Association) and its subsidiaries at December 31, 2007, 2006 and 2005, and the results of their operations and their cash flows for the years then ended 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

February 28, 2008









# Notes to the Consolidated Financial Statements

(dollars in thousands, except as noted)

## Note 1 — Organization and Operations

A. **Organization:** Farm Credit of the Virginias, ACA (Association) is a member-owned cooperative which provides credit and credit-related services to or for the benefit of eligible borrowers/shareholders for qualified purposes in forty-six counties in the state of Virginia, forty-eight counties in the state of West Virginia, and two counties in the state of Maryland as follows:

*Virginia:* Counties of Albemarle, Alleghany, Arlington, Augusta, Bath, Bedford, Bland, Botetourt, Buchanan, Carroll, Craig, Culpeper, Dickenson, Fairfax, Fauquier, Floyd, Franklin, Giles, Grayson, Greene, Halifax, Henry, Highland, Lee, Loudoun, Madison, Montgomery, Nelson, Orange, Patrick, Pittsylvania, Prince William, Pulaski, Rappahannock, Roanoke, Rockbridge, Rockingham, Russell, Scott, Smyth, Spotsylvania, Stafford, Tazewell, Washington, Wise, and Wythe;

*West Virginia:* Counties of Barbour, Boone, Braxton, Cabell, Calhoun, Clay, Doodridge, Fayette, Gilmer, Grant, Greenbrier, Hampshire, Hardy, Harrison, Jackson, Kanawha, Lewis, Lincoln, Logan, Marion, Mason, McDowell, Mercer, Mineral, Mingo, Monongalia, Monroe, Nicholas, Pendleton, Pleasants, Pocahontas, Preston, Putnam, Raleigh, Randolph, Ritchie, Roane, Summers, Taylor, Tucker, Tyler, Upshur, Wayne, Webster, Wetzel, Wirt, Wood, and Wyoming; and

*Maryland:* Counties of Allegany and Garrett.

The Association is a lending institution of the Farm Credit System (System), a nationwide system of cooperatively owned banks and associations, which was established by Acts of Congress to meet the credit needs of American agriculture and is subject to the provisions of the Farm Credit Act of 1971, as amended (Farm Credit Act). The most recent significant amendment to the Farm Credit Act was the Agricultural Credit Act of 1987. At December 31, 2007, the System was comprised of four Farm Credit Banks, one Agricultural Credit Bank and ninety-four Associations.

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

ACA parent-companies provide financing and related services through its FLCA and PCA subsidiaries. The FLCA makes collateralized 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 to provide assistance to certain troubled System institutions and to cover the operating expenses of the Insurance Corporation. Each System bank is required to pay premiums, which may be passed on to the Association, into the Insurance Fund, based on its annual average loan principal outstanding until the monies in the Insurance Fund reach the "secure base amount." The secure base amount 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 System 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.

**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 the current year's presentation. Such reclassifications had no effect on net income or total members' equity of prior years. The Consolidated Financial Statements include the accounts of the FLCA and the PCA. All significant inter-company transactions have been eliminated in consolidation.

A. **Cash:** Cash, as included in the statements 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 5 to 40 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.

Loans are generally placed in nonaccrual status when principal or interest is delinquent for 90 days (unless adequately collateralized 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 interest income using the effective interest method.

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 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.

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.

A specific allowance may be established for impaired loans under Statement of Financial Accounting Standards No. 114. Impairment of these loans is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as practically expedient, at the loan's observable market price or fair value of the collateral if the loan is collateral dependent.

The allowance for loan losses is maintained at a level considered adequate by management to provide for probable and estimable losses inherent in the loan portfolio. The allowance is increased through provisions for loan losses and loan recoveries and is decreased through allowance reversals and loan charge-offs.

- C. **Gains/(Losses) on Loans Held for Sale:** Certain rural home loans originated by the Association are sold on a servicing released basis primarily to the Bank or into the secondary market to unrelated third parties. Gains or losses on sales of these mortgage loans are recognized based on the difference between the selling price and the carrying value of the related mortgage loans sold.
- D. **Other Investments:** Other investments include Tobacco Buyout Successor-in-Interest Contracts (SIIC), which qualify as mission related investments under FCA regulations. Under the SIIC, the tobacco quota holders and producers may sell their rights to receive SIIC contract payments to a third party. The successor purchases the entire contract and all related rights and obligations associated with the contract. These investments in SIIC are purchased at a discount. Contract payments are made by the United States Department of Agriculture (USDA) in equal annual payments. Interest income is recognized from the accretion of discounts using the effective interest method.
- E. **Investment in AgFirst Farm Credit Bank:** The Association is required to maintain ownership in the Bank in the form of Class C stock. Accounting for this investment is on the cost plus allocated equities basis. Patronage refunds from the Bank are accrued as earned. The receivable for such patronage refunds is classified as due from AgFirst Farm Credit Bank.
- F. **Other Property Owned:** Other property owned, consisting of real and personal property acquired through a collection action, is recorded upon acquisition at fair value less estimated selling costs. 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, expenses, and carrying value adjustments related to other property owned are included in gains (losses) on other property owned, net.
- G. **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 earnings. Maintenance and repairs are charged to expense and improvements are capitalized.

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

I. **Employee Benefit Plans:** Substantially all employees of the Association may participate in the AgFirst Farm Credit Retirement Plan (Plan), which is a defined benefit plan and is considered a multi-employer plan. The Plan is noncontributory and includes eligible District employees. The "Projected Unit Credit" actuarial method is used for financial reporting purposes. 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 cost of the Plan is allocated based on a percentage of each institution's salary expense to the total salary expense for all Plan participants.

Substantially all 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 contributes \$.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 contributes \$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.

J. **Income Taxes:** The Association is generally subject to Federal and certain other income taxes. As previously described, the ACA holding company has two wholly-owned subsidiaries, a PCA and a FLCA. The FLCA subsidiary is exempt from federal and state income taxes as provided in the Farm Credit Act. The ACA holding company and the PCA subsidiary are subject to federal, state 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 accounts for income taxes under the asset and liability method, recognizing deferred tax assets and liabilities for the expected future tax consequences of the temporary differences between the carrying amounts and tax basis 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.

The Association records a valuation allowance at the balance sheet dates against that portion of the Association's deferred tax assets that, based on management's best estimates of future events and circumstances, more likely than not (a likelihood of more than 50 percent) will not be realized. The consideration of valuation allowances involves various estimates and assumptions as to future taxable earnings, including the effects of our expected patronage program, which reduces taxable earnings.

- K. Patronage Refund from AgFirst:** The Association records patronage refunds from the Bank on an accrual basis.
- L. Recently Issued Accounting Pronouncements:** In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, "*Accounting for Uncertainty in Income Taxes — an Interpretation of FASB Statement No. 109*" (FIN 48 or Interpretation) that was effective for fiscal years beginning after December 15, 2006. FIN 48 clarifies how an enterprise should recognize, measure, present and disclose in its financial statements uncertain tax positions that the enterprise has taken or expects to take on a tax return. Under the Interpretation, the financial statements reflect expected future tax consequences of income tax positions presuming the relevant taxing authority's full knowledge of the position and all relevant facts, but without considering time values. FIN 48 is applicable to all uncertain positions for taxes accounted for under FASB Statement No. 109. The Association adopted FIN 48 on January 1, 2007 and determined that interest and penalties would be classified as a component of income taxes.

There were no uncertain positions for income taxes at January 1, 2007 identified as a result of the adoption and therefore no cumulative adjustment to beginning members' equity was required. The tax years that remain open for federal and major state income tax jurisdictions are 2004 and forward.

On September 29, 2006, the FASB issued Statement of Financial Accounting Standards No. 158, "*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans.*" The Standard requires an

employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and recognize changes in that funded status in the year in which the changes occur through other comprehensive income. The Standard further requires the determination of the fair value of plan assets at year-end and recognition of actuarial gains and losses, prior service costs or credits, and transition assets and obligations as a component of other comprehensive income. In addition, this Standard requires that the funded status of a plan be measured as of the date of the year-end financial statements. Currently, the District uses a measurement date of September 30th. The requirement to measure the funded status as of the fiscal year-end is effective for fiscal years ending after December 15, 2008. See Note 10, *Employee Benefit Plans*, for the impact of the adoption of FAS 158 on the current period.

In September 2006, the FASB also issued Statement of Financial Accounting Standards No. 157, "*Fair Value Measurements.*" This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. As a result, there is now a common definition of fair value to be used throughout generally accepted accounting principles. The FASB believes that the new standard will make the measurement of fair value more consistent and comparable and improve disclosures about those measures. This Statement clarifies that the term fair value is intended to mean a market-based measure, not an entity-specific measure. In measuring fair value for a financial statement item, the Statement sets forth a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The highest priority is given to quoted prices in active markets and the lowest priority to unobservable inputs. Additional disclosure requirements will be required for the lowest priority level. The Statement became effective as of January 1, 2008, and will be applied to the Association's Consolidated Financial Statements on a prospective basis.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, "*Fair Value Option for Financial Assets and Financial Liabilities.*" The Standard permits entities to choose on an instrument-by-instrument basis, at specified election dates, to measure financial assets and liabilities and certain other items at fair value (the "fair value option"). Unrealized gains and losses on items for which the fair value option has been elected must be reported in earnings at each subsequent reporting date. Upfront costs and fees related to items for which the fair value option is elected shall be recognized in earnings as incurred and not deferred. This Standard became effective as of January 1, 2008. The Association has not made any elections under the fair value option, thus there will be no impact of the initial adoption of the Standard. However, the Association may elect to apply the fair value option to financial instruments acquired in future periods.

**Note 3 — Loans and Allowance for Loan Losses**

A summary of loans follows:

	December 31,		
	2007	2006	2005
Real estate mortgage	\$ 1,008,774	\$ 879,204	\$ 802,874
Production and intermediate term	329,683	314,180	283,723
Loans to cooperatives	—	—	611
Processing and marketing	81,154	68,420	45,935
Farm related business	23,679	17,177	10,145
Communication	2,794	—	778
Rural residential real estate	56,926	50,801	48,814
<b>Total loans</b>	<b>\$ 1,503,010</b>	<b>\$ 1,329,782</b>	<b>\$ 1,192,880</b>

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

Total loans at December 31, 2007, 2006 and 2005 consisted of the following commodity types:

Commodity Type	December 31,		
	2007	2006	2005
Livestock	33%	34%	36%
Field Crops	16	15	14
Timber	13	13	12
Dairy	8	8	9
Poultry	7	7	8
Rural Home	4	4	4
Tobacco	1	2	2
Other	18	17	15
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the borrower. Collateral held varies, but typically includes farmland and income-producing property, such as crops and livestock, as well as receivables. Long-term real estate loans are collateralized 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,		
	2007	2006	2005
Nonaccrual loans:			
Current as to principal and interest	\$ 1,432	\$ 2,053	\$ 1,624
Past due	6,779	1,833	2,699
<b>Total nonaccrual loans</b>	<b>8,211</b>	<b>3,886</b>	<b>4,323</b>
Impaired accrual loans:			
Restructured accrual loans	—	—	11
Accrual loans 90 days or more past due	—	3	9
<b>Total impaired accrual loans</b>	<b>—</b>	<b>3</b>	<b>20</b>
<b>Total impaired loans</b>	<b>\$ 8,211</b>	<b>\$ 3,889</b>	<b>\$ 4,343</b>

There were no material commitments to lend additional funds to debtors whose loans were classified as impaired at December 31, 2007.

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,		
	2007	2006	2005
Interest income recognized on nonaccrual loans	\$ 271	\$ 378	\$ 157
Interest income on impaired accrual loans	36	23	39
<b>Interest income recognized on impaired loans</b>	<b>\$ 307</b>	<b>\$ 401</b>	<b>\$ 196</b>

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

	2007	2006	2005
	Impaired loans with related allowance	\$ 4,670	\$ 457
Impaired loans with no related allowance	3,541	3,432	3,308
<b>Total impaired loans</b>	<b>\$ 8,211</b>	<b>\$ 3,889</b>	<b>\$ 4,343</b>
<b>Allowance on impaired loans</b>	<b>\$ 1,395</b>	<b>\$ 220</b>	<b>\$ 368</b>

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

	2007	2006	2005
Average impaired loans	\$ 6,030	\$ 5,043	\$ 3,938

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,		
	2007	2006	2005
Interest income which would have been recognized under the original loan terms	\$ 722	\$ 682	\$ 412
Less: interest income recognized	271	378	157
<b>Foregone interest income</b>	<b>\$ 451</b>	<b>\$ 304</b>	<b>\$ 255</b>

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

	Year Ended December 31,		
	2007	2006	2005
Balance at beginning of year	\$ 2,445	\$ 2,736	\$ 2,947
Charge-offs:			
Real estate mortgage	(3)	–	(55)
Production and intermediate term	(141)	(205)	(92)
Agribusiness	–	(98)	–
Rural residential real estate	(11)	–	(5)
Total charge-offs	(155)	(303)	(152)
Recoveries:			
Real estate mortgage	1	–	–
Production and intermediate term	3	12	13
Agribusiness	–	–	6
Total recoveries	4	12	19
Net (charge-offs) recoveries	(151)	(291)	(133)
Provision for (reversal of allowance for) loan losses	1,400	–	(78)
Balance at end of year	\$ 3,694	\$ 2,445	\$ 2,736
Ratio of net (charge-offs) recoveries during the period to average loans outstanding during the period	(0.011%)	(0.023%)	(0.012%)

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

	December 31, 2007		December 31, 2006	
	Amount	%	Amount	%
Real estate mortgage	\$ 1,834	50%	\$ 1,047	43%
Production and intermediate term	1,400	38	1,216	50
Agribusiness	150	4	97	4
Rural residential real estate	310	8	85	3
Total	\$ 3,694	100%	\$ 2,445	100%

	December 31, 2005	
	Amount	%
Real estate mortgage	\$ 1,184	43%
Production and intermediate term	1,347	49
Agribusiness	130	5
Rural residential real estate	75	3
Total	\$ 2,736	100%

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 \$97,895, \$11,938 and \$17,202 at December 31, 2007, 2006 and 2005, respectively. Fees paid to Farmer Mac for such commitments totaled \$57, \$74 and \$92 for the years ended December 31, 2007, 2006 and 2005, respectively. These amounts are classified as noninterest expense.

#### Note 4 — Other Investments

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

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

For the years ended December 31, 2007, 2006 and 2005, the Association held Tobacco Buyout SIIC of \$15,065, \$10,401 and \$7,415, respectively, net of discount.

#### Note 5 — Investment in AgFirst Farm Credit Bank

The Association is required to maintain ownership in the Bank of 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,		
	2007	2006	2005
Land	\$ 2,736	\$ 2,731	\$ 1,849
Buildings and improvements	3,953	3,920	3,217
Furniture and equipment	4,087	3,970	3,693
	10,776	10,621	8,759
Less: accumulated depreciation	4,868	4,374	4,174
Total	\$ 5,908	\$ 6,247	\$ 4,585

**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 5.81 percent for LIBOR-based loans, 5.74 percent for Prime-based loans, and the weighted average remaining maturities were 5.1 years and 2.5 years, respectively, at December 31, 2007. The weighted average interest rate on the fixed rate and adjustable rate mortgage (ARM) notes payable which are match funded by the Bank was 5.88 percent and the weighted average remaining maturity was 11.9 years at December 31, 2007. The weighted average interest rate on all interest-bearing notes payable was 5.87 percent and the weighted average remaining maturity was 10.8 years at December 31, 2007.

Variable rate and fixed rate notes payable represent approximately 11.01 percent and 88.99 percent, respectively, of total notes payable at December 31, 2007.

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, 2007, 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. 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 Common 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 a minimum of two percent of the loan amount or \$1 thousand, or such higher amount as determined by the Board. 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.

**B. Regulatory Capitalization Requirements and Restrictions**

FCA’s capital adequacy regulations require the Association to achieve permanent capital of 7.00 percent of risk-adjusted assets and off-balance-sheet commitments. Failure to meet the 7.00 percent capital requirement can initiate certain mandatory and possibly additional discretionary actions by 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. 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 7.0 percent and of core surplus as a percentage of risk-adjusted assets of 3.50 percent. The Association’s permanent capital, total surplus and core surplus ratios at December 31, 2007 were 12.68 percent, 11.38 percent and 11.38 percent, respectively.

A 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.

**C. Description of Equities**

The Association is authorized to issue or have outstanding Class D Preferred Stock, Classes A and C Common Stock, 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, 2007:

Class	Protected	Shares Outstanding	
		Number	Aggregate Par Value
A Common/Nonvoting	No	549,843	\$ 2,749
C Common/Voting	No	2,931,481	14,657
Participation Certificates/Nonvoting	No	222,125	1,111
Total Capital Stock and Participation Certificates		3,703,449	\$ 18,517

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

#### *Retained Earnings*

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

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, 2007, allocated members' equity consisted of \$63,629 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 another proportionate patronage basis is approved by the Board.

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

The patronage distributions accrued at year-end are based on estimates. The actual amounts distributed may vary from these estimates. Differences are reflected as distribution adjustments in the Consolidated Statements of Changes in Members' Equity.

#### *Dividends*

Dividends may be paid on stock and participation certificates as determined by the Board's resolution. Dividends may not be paid on common stock and participation certificates during any fiscal year with respect to which the Association has obligated itself to distribute earnings on a patronage basis pursuant to the bylaws. The rate of dividend paid on Class D Preferred Stock for any fiscal year may not be less than the rate of dividend paid on common stock or participation certificates for such year. All dividends shall be paid on a per share basis. Dividends on common stock and participation certificates shall be noncumulative without preference between classes.

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

#### *Transfer*

Common stocks and participation certificates may be transferred to persons or entities eligible to purchase or hold such equities under the bylaws. Class D Preferred Stock may be transferred in the manner set forth in the resolution authorizing its issuance.

#### *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. Nonqualified allocated members equity beginning with the most recent allocation
2. Qualified allocated members equity beginning with the most recent allocation
3. Classes A and C Common Stock and Participation Certificates
4. Class 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. Holders of Class D Preferred Stock until an amount equal to the aggregate par value of shares of Class D Preferred Stock then outstanding has been distributed to the holders;
2. Holders of Class A Stock, Class C Stock, and Participation Certificates pro rata in proportion to the number of shares or units each such class of stock and participation certificates then outstanding until an amount equal to the aggregate par value (or face value) of such shares or units has been distributed to the holders;
3. Holders of Allocated Surplus to the extent evidenced by qualified written notices of allocation, pro rata, on the basis of the oldest allocations first, until an amount equal to the total account has been distributed to such holders;
4. Holders of Allocated Surplus to the extent evidenced by nonqualified written notice of allocation, pro rata, on the basis of the oldest allocations first, until an amount equal the total account has been distributed to such holders;
5. Any remaining assets of the Association after such distributions shall be distributed to Patron, past and present, in proportion to which the aggregate patronage of each such Patron bears to the total patronage of all such parties insofar as practicable, unless as otherwise provided by law.

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

The Association reports other comprehensive income (loss) (OCI) in its Consolidated Statements of Changes in Members' Equity. The Association recognized OCI of \$8 in 2007 adopting FAS 158 (see note 10, Employee Benefit Plans, for further information).

**Note 9 — Income Taxes**

The provision (benefit) for income taxes follows:

	<b>Year Ended December 31,</b>		
	<b>2007</b>	<b>2006</b>	<b>2005</b>
Current:			
Federal	\$ 12	\$ 58	\$ 62
State	6	10	12
State refunds related to long-term lending	(601)	—	—
	<u>(583)</u>	<u>68</u>	<u>74</u>
Deferred:			
Federal	9	2	(23)
State	—	—	(4)
	<u>9</u>	<u>2</u>	<u>(27)</u>
Total provision (benefit) for income taxes	<u>\$ (574)</u>	<u>\$ 70</u>	<u>\$ 47</u>

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

	<b>December 31,</b>		
	<b>2007</b>	<b>2006</b>	<b>2005</b>
Federal tax at statutory rate	\$ 9,974	\$ 9,475	\$ 9,461
State tax, net	6	7	5
Patronage distributions	(6,191)	(6,141)	(4,882)
Tax-exempt FLCA earnings	(5,330)	(3,625)	(4,692)
Long-term lending related refunds	(601)	—	—
Change in valuation allowance	1,750	145	—
Other	(182)	209	155
Provision (benefit) for income taxes	<u>\$ (574)</u>	<u>\$ 70</u>	<u>\$ 47</u>

Deferred tax assets and liabilities result from the following at:

	<b>December 31,</b>		
	<b>2007</b>	<b>2006</b>	<b>2005</b>
Deferred income tax assets:			
Allowance for loan losses	\$ 532	\$ 437	\$ 548
Annual leave	332	142	137
Nonaccrual loan interest	120	99	140
Pensions and other postretirement benefits	2,567	1,058	1,021
Deferred incentive	737	159	219
Other	—	8	—
Gross deferred tax assets	<u>4,288</u>	<u>1,903</u>	<u>2,065</u>
Less: valuation allowance	<u>(2,643)</u>	<u>(893)</u>	<u>(748)</u>
Gross deferred tax assets, net of valuation allowance	<u>1,645</u>	<u>1,010</u>	<u>1,317</u>
Deferred income tax liabilities:			
Loan origination fees	(51)	(100)	(230)
Pensions and other postretirement benefits	(1,568)	(832)	(1,055)
Depreciation	(26)	(69)	(20)
Gross deferred tax liability	<u>(1,645)</u>	<u>(1,001)</u>	<u>(1,305)</u>
Net deferred tax asset (liability)	<u>\$ —</u>	<u>\$ 9</u>	<u>\$ 12</u>

At December 31, 2007, deferred income taxes have not been provided by the Association on approximately \$1.6 million of patronage refunds received from the Bank prior to January 1, 1993. Such refunds, distributed in the form of stock, are subject to tax only upon conversion to cash. The tax liability related to future conversions is not expected to be material.

The Association recorded a valuation allowance of \$2,643, \$893 and \$748 during 2007, 2006 and 2005, respectively. The Association will continue to evaluate the realizability of these deferred tax assets and adjust the valuation allowance accordingly.

The Association adopted the provisions of the Financial Accounting Standards Board Interpretation No. 48, "Accounting for Uncertainty in Income Taxes," on January 1, 2007. As a result of the adoption, there were no uncertain positions for income taxes identified and therefore the Association recognized no change in the liability for unrecognized tax benefits and no reduction to the January 1, 2007 balance of retained earnings. The Association recognizes interest and penalties related to unrecognized tax benefits as a component of

income tax expense. There were no uncertain tax positions identified related to the current year. The tax years that remain open for federal and major state income tax jurisdictions are 2004 and forward.

#### **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. As a participant in the District's defined benefit plan, the Association funded \$0 for 2007 and 2006, and \$1,500 for 2005, through its note payable to the Bank. Plan expenses included in salaries and employee benefits were \$991 for 2007, \$1,121 for 2006, and \$1,076 for 2005. Additional financial information for the Plan may be found in the District's Annual Report.

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. Postretirement benefits other than pensions (primarily health care benefits) included in salaries and employee benefits were \$584 for 2007, \$590 for 2006 and \$851 for 2005. Additional financial information for the Plan may be found in the District's Annual Report.

Under FAS 158, accounting for the impact of the adoption of the standard follows the plan sponsor, which is at the District entity level for the Districtwide benefit plans in which the Association participates. Therefore, there is no impact to the Association's financial statements for the adoption of FAS 158 for the two defined benefit plans discussed above. Additional financial information for the District sponsored plans may be found in Notes to the Combined Financial Statements of AgFirst Farm Credit Bank and District Associations' 2007 Annual Report.

On December 31, 2007, the Association adopted FAS 158 for the supplemental defined benefit executive plan. The supplemental defined benefit executive plan is unfunded and had a projected benefit obligation of \$111 and a net under-funded status of \$109 at December 31, 2007. Net periodic pension cost for the period was \$7. The weighted average assumptions used to determine the projected benefit obligation included a discount rate of 6.40 percent. For the supplemental defined benefit executive plan sponsored by the Association, adoption of FAS 158 is reflected as an adjustment to accumulated other comprehensive income of \$(8) in the Association's Consolidated Statements of Changes in Members' Equity.

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. Employer contributions to this plan were \$274, \$259, and \$197 for the years ended December 31, 2007, 2006 and 2005, respectively.

#### **Note 11 — Intra-System Financial Assistance**

The Farm Credit Act provided for capital assistance to System institutions experiencing severe financial stress through the issuance, prior to October 1, 1992, by the Financial Assistance Corporation of U.S. Treasury-guaranteed 15-year bonds, of which \$1.261 billion in principal amount was originally issued. The last remaining Financial Assistance Corporation bonds matured and were repaid on June 10, 2005.

Pursuant to the Farm Credit Act, the U.S. Treasury paid \$440 million, on behalf of the System, in interest costs on \$844 million of the Financial Assistance Corporation bonds issued for purposes other than funding Capital Preservation Agreement accruals. The Banks had irrevocably set aside funds, including interest earned, that totaled the \$440 million needed to repay the interest advanced by the U.S. Treasury. On June 10, 2005, the Banks repaid the U.S. Treasury the interest advanced. The Farm Credit Administrative Board cancelled the Financial Assistance Corporation's charter as of December 31, 2006.

#### **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, 2007 amounted to \$5,256. During 2007, \$2,757 of new loans were made and repayments totaled \$2,874. In the opinion of management, none of these loans outstanding at December 31, 2007 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, 2007, \$259,920 of commitments to extend credit and \$172 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 Consolidated Balance Sheets 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.

The Association also participates in standby letters of credit to satisfy the financing needs of its borrowers. These letters of credit are irrevocable agreements to guarantee payments of specified financial obligations. At December 31, 2007, the Association had outstanding \$7,242 of standby letters of credit, with expiration dates ranging from January 12, 2008 to April, 2, 2012. The maximum potential amount of future payments the Association may be required to make under these existing guarantees is \$7,242.

A guarantor is required to recognize at the inception of a guarantee, a liability for the fair value of the guarantee commitment. The Association has determined the fair value of the guarantee commitment based upon the fees to be earned over the life of the guarantee. The fair value is updated periodically to reflect changes in individual guarantee amounts and the remaining life to maturity of the individual guarantees in the Association's inventory. At December 31, 2007, the Association's inventory of standby letters of credit had a fair value of \$225 and was included in other liabilities.

#### 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, 2007, 2006 and 2005. 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, 2007		December 31, 2006	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<b>Financial assets:</b>				
Cash	\$ 3,627	\$ 3,627	\$ 2,716	\$ 2,716
Loans	\$ 1,503,010	\$ 1,514,342	\$ 1,329,782	\$ 1,333,260
Allowance for loan losses	3,694	—	2,445	—
Loans, net	\$ 1,499,316	\$ 1,514,342	\$ 1,327,337	\$ 1,333,260
Tobacco Buyout SIC	\$ 15,065	\$ 15,143	\$ 10,401	\$ 10,262
<b>Financial liabilities:</b>				
Notes payable to AgFirst Farm Credit Bank	\$ 1,341,684	\$ 1,346,607	\$ 1,168,915	\$ 1,150,881

	December 31, 2005	
	Carrying Amount	Estimated Fair Value
<b>Financial assets:</b>		
Cash	\$ 2,757	\$ 2,757
Loans	\$ 1,192,880	\$ 1,180,089
Allowance for loan losses	2,736	—
Loans, net	\$ 1,190,144	\$ 1,180,089
Tobacco Buyout SIC	\$ 7,415	\$ 7,343
<b>Financial liabilities:</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 1,025,160	\$ 996,239

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

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

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

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

The carrying value of accrued interest approximates its fair value.

- C. Investment in AgFirst Farm Credit Bank:** Estimating the fair value of the Association's investment in the Bank is not practicable because the stock is not traded. As described in Note 4, the net investment is a requirement of borrowing from the Bank and is carried at cost plus allocated equities in the accompanying Consolidated Balance Sheets. The Association owns 6.79 percent of the issued stock of the Bank as of December 31, 2007 net of any reciprocal investment. As of that date, the Bank's assets totaled \$26.9 billion and shareholders' equity totaled \$1,457 million. The Bank's earnings were \$192 million during 2007.
- 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 and Standby Letters of Credit:** The estimated market value of off-balance-sheet commitments is minimal since the committed rate approximates current rates offered for commitments with similar rate and maturity characteristics and since the related credit risk is not significant.
- F. Tobacco Buyout SIIC:** Fair value is determined by discounting the expected future cash flows using current interest rates for similar assets.

#### Note 15 — Quarterly Financial Information (Unaudited)

Quarterly results of operations for the years ended December 31, 2007, 2006 and 2005 follow:

	2007				
	First	Second	Third	Fourth	Total
Net interest income	\$ 8,580	\$ 8,830	\$ 8,759	\$ 9,281	\$ 35,450
Provision for (reversal of allowance for) loan losses	—	150	100	1,150	1,400
Noninterest income (expense), net	(1,794)	(620)	(2,013)	287	(4,140)
Net income (loss)	\$ 6,786	\$ 8,060	\$ 6,646	\$ 8,418	\$ 29,910
	2006				
	First	Second	Third	Fourth	Total
Net interest income	\$ 7,983	\$ 8,327	\$ 8,568	\$ 8,783	\$ 33,661
Provision for (reversal of allowance for) loan losses	—	—	—	—	—
Noninterest income (expense), net	(1,892)	(1,939)	(1,708)	(325)	(5,864)
Net income (loss)	\$ 6,091	\$ 6,388	\$ 6,860	\$ 8,458	\$ 27,797
	2005				
	First	Second	Third	Fourth	Total
Net interest income	\$ 7,033	\$ 7,328	\$ 7,606	\$ 7,741	\$ 29,708
Provision for (reversal of allowance for) loan losses	—	(78)	—	—	(78)
Noninterest income (expense), net	(1,209)	(1,172)	(1,496)	1,871	(2,006)
Net income (loss)	\$ 5,824	\$ 6,234	\$ 6,110	\$ 9,612	\$ 27,780