

# **SECOND QUARTER 2013**

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## **CERTIFICATION**

The undersigned certify that we have reviewed the June 30, 2013 quarterly report of Puerto Rico Farm Credit, ACA, that the report has been prepared under the oversight of the Audit Committee of the Board of Directors and in accordance with all applicable statutory or regulatory requirements, and that the information contained herein is true, accurate, and complete to the best of our knowledge and belief.



Robert G. Miller  
Chairman of Board of Directors



Ricardo L. Fernández  
Chief Executive Officer



Antonio Marichal  
Member of Board of Directors  
Chairman of the Audit Committee



Johana Quiñones  
Director of Finance, Risk  
Management and Internal Control

August 7, 2013

## Report on Internal Control Over Financial Reporting

The Association's principal executives and principal financial officers, or persons performing similar functions, are responsible for establishing and maintaining adequate internal control over financial reporting for the Association's Consolidated Financial Statements. For purposes of this report, "internal control over financial reporting" is defined as a process designed by, or under the supervision of the Association's principal executives and principal financial officers, or persons performing similar functions, and effected by its Board of Directors, management and other personnel. This process provides reasonable assurance regarding the reliability of financial reporting information and the preparation of the Consolidated Financial Statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

Internal control over financial reporting includes those policies and procedures that: (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Association, (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial information in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures are being made only in accordance with authorizations of management and directors of the Association, and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Association's assets that could have a material effect on its Consolidated Financial Statements.

The Association's management has completed an assessment of the effectiveness of internal control over financial reporting as of June 30, 2013. In making the assessment, management used the framework in *Internal Control — Integrated Framework*, promulgated by the Committee of Sponsoring Organizations of the Treadway Commission, commonly referred to as the "COSO" criteria.

Based on the assessment performed, the Association concluded that as of June 30, 2013, the internal control over financial reporting was effective based upon the COSO (1992) criteria. Additionally, based on this assessment, the Association determined that there were no material weaknesses in the internal control over financial reporting as of June 30, 2013.



Ricardo L. Fernández  
Chief Executive Officer



Johana Quinones  
Director of Finance  
Risk Management and Internal Control

August 7, 2013

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

*(dollars in thousands)*

The following commentary reviews the consolidated financial condition and results of operations of Puerto Rico Farm Credit, ACA (Association) for the nine months ended June 30, 2013. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements, and the 2012 annual report of the Association. The accompanying consolidated financial statements were prepared under the oversight of the Audit Committee of the Board of Directors.

## **LOAN PORTFOLIO**

The Association provides funds to farmers, rural homeowners, and farm-related businesses for financing short and intermediate-term loans and long-term real estate mortgage loans. The Association also maintains a portfolio of purchased loans, originated by other Farm Credit System entities and non-system entities. The Association's predominant chartered territory agricultural commodities were dairy, rural home, fruits and field crops which totaled approximately \$99,246 or 56.08 percent of the gross principal balance, net of sold loans, at June 30, 2013.

The outstanding loan volume of the Association at June 30, 2013 was \$169,662 for an increase of \$273 or .16 percent as compared to \$169,389 at December 31, 2012. Loans originated within the Association's chartered territory were lower by approximately \$6,479, while participation loans purchased increased by approximately \$6,752.

Net loans outstanding at June 30, 2013 totaled \$165,366 as compared to \$164,981 at December 31, 2012. The increase in the net loan volume is attributed to new loan volume closed during the period primary for the participation loans' portfolio since the local chartered territory loans continued with a reduced demand for credit in the market. Net loans made up 89.95 percent of total assets at June 30, 2013, as compared to 89.04 percent at December 31, 2012.

As a percentage of outstanding loans, non-accrual loans totaled 8.53 percent at June 30, 2013, compared with 8.22 percent at December 31, 2012. The increase in the percentage of non-accrual loan volume during the first six months of 2013 was primarily the result of six chartered territory loans amounting approximately \$1,812 being transferred to nonaccrual offset by some principal

curtailments among other payments received on various nonaccrual outstanding loans.

Several loans transferred to nonaccrual are expected to be transferred back to accrual status by year end. The overall delinquency rate for the chartered territory accruing loan portfolio has remained stable, as a result of good credit administration practices and a low interest rate environment. Management continues to monitor and remains cautious about the credit quality of certain chartered territory through 2013. The participation portfolio credit quality has improved in the first half of 2013 and is expected to continue improving in the next two quarters.

The allowance for loan losses decreased by \$112 to \$4,296 at June 30, 2013, from \$4,408 at December 31, 2012. The total allowance for loan losses to outstanding loan volume ratio decreased to 2.53 percent at June 30, 2013 from 2.60 percent at December 31, 2012. The decrease was primarily due to a \$103 charge off recorded for an ethanol nonaccrual participation loan that decrease the specific reserves. Also, the general reserve decreased due to improvement in the credit quality and increase in high quality volume of the participation's portfolio. Management will continue to monitor certain risks, such as collateral risk, and may decide to increase the allowance in 2013.

During the first six months of 2013, charge-offs recognized totaled \$105 while recoveries totaled \$2. The ACA is actively marketing acquired properties and may incur in accounting losses as sales are completed.

Prevailing economic indicators signal continued weakness in the island's economy. No growth is expected in 2014 fiscal year. On the other hand, the US economic conditions are improving with slight economic growth being expected in fiscal 2013 and 2014.

The dairy industry has been stable year-to-date with production slightly below the previous year. The ACA continues to monitor events and there potential impact on the dairy portfolio. The association lends just over 30% of total loans to this industry and is implementing risk management practices to reduce overall risk.

The local livestock industry which, relies heavily on pastures instead of feed has not been affected by increasing corn prices. The Associations' exposure in livestock is also minimal and borrowers in the industry continue to perform well.

Management expects that the ethanol industry will continue undergoing significant changes and that it will adversely impact its valuation of one loan and one acquired property in the industry. Poultry integrators and grower cash flows have improved in the U.S. as expected in mid 2013, improving margins and cash flows. Within the state-side participation portfolio, economic stress continues to be identified in industries related to and involved in developing "land-in-transition." The association has significantly reduced its exposure in such loans but, several remain in the portfolio, management continues to work together with other associations to promptly collect on these loans. The Association will continue to search for opportunities to fulfill its public mission. The Board of Directors and management remain cautious of the ACA's ability to quickly grow the portfolio under the prevailing economic environment. Management will focus on targeted marketing to viable farmers in sectors demonstrating the ability to grow and remain competitive in a changing marketplace.

## RESULTS OF OPERATIONS

### For the three months ended June 30, 2013

Net income from operations for the three months ended June 30, 2013 totaled \$188, for a decrease of \$1,266 when compared to a net income from operations of \$1,454 for the same period in 2012. The primary driver of this decline is that on the second quarter of 2012, the Association received a nonrecurrent insurance premium refund of \$679 from the Farm Credit System Insurance Corporation (FCSIC).

Net interest income for the three months ended June 30, 2013 was \$1,191 compared to \$1,145 for the same period ended June 30, 2012. Interest income on loans improved year-over-year since the accruing loan volume is increasing primarily due to new volume in the participation loan portfolio. Also, a reduction in the cost of funds and improved spreads on new and serviced loans sustained the net interest income.

Noninterest income for the three months ended June 30, 2013, including net gains or losses on other property owned, was \$169 compared to \$1,177 for the same period in 2012, resulting in a decrease of \$1,008. The decrease was mostly related to the FCSIC nonrecurrent income received in 2012.

Noninterest expense increase \$59 compared to the three months ended June 30, 2012. The increase was primary due to salaries and employee benefits being higher since several positions were filled in late 2012. This increase was offset by a decrease in other operating expenses.

### For the six months ended June 30, 2013

For the six months ended June 30, 2013, the Association recognized net income of \$300. A decrease of \$1,339 compared to a net income of \$1,639 for the first six months of 2012 primarily resulted from the nonrecurrent insurance premium refund of \$679 from the Farm Credit System Insurance Corporation (FCSIC).

During the first six months of 2013, interest income, primarily from accruing loans remains stable. Interest expense related to the notes payable to AgFirst FCB (the Bank) decreased by \$97 or 6.38 percent. Thus, net interest income increased by \$98 or 4.52 percent. The increase in net interest income was due primarily to the reduction in the cost of funds and the improvements in the spreads on loans.

Noninterest income for the first half of 2013 was \$559 or 64.95 percent lower than the \$1,595 recognized during the first half of 2012. The decrease was primarily attributable to the non-recurring income of \$679 refund distributions received from the FCSIC during the second quarter of 2013.

Noninterest expense for the six months ended June 30, 2013 increased by \$58 or 2.34 percent compared to the same six month period of 2012. The increase was primarily related to an increase of \$119 in salaries and employee benefits; and Insurance Fund Premiums of \$26, partially offset by a decrease of \$85 in other operating expenses.

Although the Association is subject to federal income tax, the Association does not expect to incur a federal tax liability in 2013 due to the taxable loss carryforward. No provision for income taxes has been recognized in 2013.

### Key Results of Operations Ratios

|  | Annualized for<br>the six months<br>ended 6/30/13 | For the<br>year ended<br>12/31/12 |
|--|---|-----------------------------------|
| Return on Average Assets   | .33%  | .37%                              |
| Return on Average Equity   | 1.29%   | 1.45%                             |
| Net Interest Income as a Percentage of<br>Average Earning Assets | 2.54%   | 2.50%                             |

## LIQUIDITY AND FUNDING SOURCES

### Liquidity

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

### *Funding Sources*

The principal source of funds for the Association is the borrowing relationship established with the Bank through a General Financing Agreement. The General Financing Agreement utilizes the Association's credit and fiscal performance as criteria for establishing a line of credit on which the Association may draw funds. The funds are advanced by the Bank to the Association in the form of notes payable. The notes payable are segmented into variable rate and fixed rate notes. The variable rate notes are utilized by the Association to fund variable rate loan advances and operating fund requirements. The fixed rate notes are used specifically to fund fixed rate loan advances made by the Association.

The total notes payable to the Bank at June 30, 2013 were \$134,119 as compared with \$135,882 at December 31, 2012. The decrease of \$1,763 or 1.30 percent for the total notes payable is primarily due to loan repayments by borrowers.

See Note 6 in the Notes to the Consolidated Financial Statements for additional information on the status of compliance with covenants under the General Financing Agreement.

The Association had no lines of credit outstanding with third parties as of June 30, 2013.

### *Funds Management*

Demand for loan types is a driving force in establishing a funds management strategy. The Association offers variable and fixed rate loan products which are competitively priced according to local market rates. Variable rate loans are generally indexed to either the Prime rate or the London Interbank Offered Rate (LIBOR). The majority of the interest rate risk in the Association balance sheet is transferred to the Bank through the notes payable structure. The Bank, in turn, actively utilizes funds management techniques to identify, quantify and control interest rate risk associated with the loan portfolio.

### **CAPITAL RESOURCES**

Total members' equity at June 30, 2013 increased by .61 percent to \$46,744 from December 31, 2012 when total members' equity was \$46,459. The increase of \$285 was primarily attributable to the year-to-date net income which totaled \$300 at June 30, 2013 partially offset by the decrease of capital stock and participation certificates.

Total capital stock and participation certificates were \$563 on June 30, 2013 compared to \$604 on December 31, 2012. The decrease of \$41 was the net result of refunding more stock to non-borrowing stockholders than new stockholders purchasing capital stock or participation certificates.

Unallocated retained earnings was \$45,869 on June 30, 2013 for an increase of \$300 or .66 percent from December 31, 2012 when unallocated retained earnings totaled \$45,569. The increase was due to the net income during the first six months of 2013.

The Association's regulatory permanent capital ratio at June 30, 2013 was 21.11 percent compared to 20.37 percent at December 31, 2012. The Association's total surplus and core surplus ratios were both 20.78 percent at June 30, 2013. All three ratios were well above the minimum regulatory ratios of 7.00 percent for permanent capital and total surplus ratios and 3.50 percent for the core surplus ratio.

### **Key financial condition ratios were as follows:**

|                                | 6/30/13 | 12/31/12 |
|--------------------------------|---------|----------|
| Total Members' Equity to Asset | 25.43%  | 25.07%   |
| Debt to Total Members' Equity  | 2.93    | 2.99     |

### **REGULATORY MATTERS**

#### ***FCA Supervisory Agreement***

On March 17, 2011 the Farm Credit Administration (FCA) entered into a written Supervisory Agreement (SA) with the Board of Directors of the Association. This agreement supersedes FCA Supervisory Letters dated July 23, 2009, March 2, 2010, and December 10, 2010 and incorporates certain requirements from these letters. The Supervisory Agreement requires the Board of Directors to take certain corrective and precautionary measures with respect to some Association practices, including board governance and operation, director fiduciary duties, nominating committee procedures, board policies, board business planning, Association earnings and liquidity, senior management and human capital development, internal audit and review, asset quality, allowance for loan losses and collateral risk management, and capital markets and participation activities. In addition, the SA prohibits the Association from distributing patronage-sourced income without FCA consent.

Conditions and events that led to the need for this agreement include portfolio credit quality deterioration, high turnover in senior management, perceived weaknesses in board governance, and, reduced earnings and liquidity.

The Board of Directors and the Association have worked together to reach several milestones. The regulator has provided the Board of Directors several interim progress reports on compliance with the SA and delivered an in person report of examination to the Board of Directors on June 13, 2012. The Association has achieved full compliance in 4 out of 17 items, substantial compliance in 8 out of 17 items and partial compliance in 5 out of 17 items. The next report is expected in the 4th quarter of 2013. Some of the results achieved in compliance with the agreement include the following:

- Hiring a board consultant and continued work with the consultant to assist the Board in fulfilling its fiduciary duties and improving board operations and governance.
- Updating its board committee charters, undergoing several training sessions and changing leadership to improve governance of the Association.
- Revising the director candidate nominating procedures to qualify new candidates, which led to stockholders electing two new directors to the Board in 2012.
- Hiring a new CEO beginning on February 1, 2011 to lead the Association after the retirement of the previous CEO on June 30, 2010.
- Building a cohesive senior management team.
- Overseeing the implementation of updated collateral risk management policies and procedures that are in line with best practices in the industry.
- Improving the methodology used to calculate the Allowance for Loan Losses of the Association.
- Hiring a specialized third party auditor that assessed the capital markets portfolio credit risk and helped, strengthened credit policies and procedures.
- Establishing a Compliance Committee to monitor management's progress in implementing the corrective actions of items identified in the SA.
- Ensuring that FCA's recommendations are incorporated in the various action plans.
- Reviewing the Association's internal audit plan to focus on areas where perceived weaknesses were identified.
- Establishing a risk assessment process to assess risks and controls in the ACA.
- Establishing an asset quality improvement plan to monitor management efforts in managing high risk loans.
- Revising the 2011 business plan to establish strategic priorities and to comply with FCA regulations governing business planning.
- Establishing a human capital plan and succession plan to assist in the long-term success of the Association.
- Revising board policies on a quarterly basis to guide management in conducting day to day operations.
- Enhancing the participation's portfolio credit underwriting and administration controls.

All required measures have not been achieved or completed as of the date of this report and the Board of Directors continues to work with the management team in improving the areas identified in the Supervisory Agreement. Besides the ongoing corrective actions already mentioned, other actions to be taken target the following areas.

- Continue execution of strategies for growing the Association's loan portfolio with high quality loans to improve asset quality and, enhance earnings and liquidity.
- Strengthening stress-testing capabilities and continuing execution of collateral risk management practices.

The Board of Directors will continue engaging a board consultant to provide advice in understanding and fulfilling its fiduciary responsibilities and to perform other advisory functions as specified in the agreement. Both the Board of Directors and Senior Management are committed to continuing the administration of the Association in a sound manner, compliant with all FCA Regulations.

The Association remained under written supervisory agreement as of the date of this report.

## RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

Please refer to Note 1, "*Organization, Significant Accounting Policies, and Recently Issued Accounting Pronouncements*", in the Notes to the Financial Statements, and the 2012 Annual Report to Shareholders for recently issued accounting pronouncements.

**NOTE:** Shareholder investment in the Association is materially affected by the financial condition and results of operations of AgFirst Farm Credit Bank. Copies of AgFirst's annual and quarterly reports are available upon request free of charge by calling 1-800-845-1745, ext. 2832, or writing Susanne Caughman, AgFirst Farm Credit Bank, P.O. Box 1499, Columbia, SC 29202. Information concerning AgFirst Farm Credit Bank can also be obtained at its website, [www.agfirst.com](http://www.agfirst.com). Copies of the Association's annual and quarterly reports are also available upon request free of charge by calling 1-800-981-3323, or writing Nydia J. Acevedo, Controller, Puerto Rico Farm Credit, ACA, PO Box 363649, San Juan, PR 00936-3649, or accessing the website, [www.puertoricofarmcredit.com](http://www.puertoricofarmcredit.com). The Association prepares a quarterly report within 40 days after the end of each fiscal quarter, except that no report need be prepared for the fiscal quarter that coincides with the end of the fiscal year of the Association.

Puerto Rico Farm Credit, ACA

# Consolidated Balance Sheets

| <i>(dollars in thousands)</i>                        | <b>June 30,<br/>2013</b><br><i>(unaudited)</i> | <b>December 31,<br/>2012</b><br><i>(audited)</i> |
|--|--|--|
| <b>Assets</b>  |  |  |
| Cash   | \$ 140   | \$ 214   |
| Loans  | 169,662  | 169,389  |
| Less: allowance for loan losses                      | 4,296  | 4,408  |
| Net loans  | 165,366  | 164,981  |
| Notes receivable from other Farm Credit institutions | 10,000   | 10,000   |
| Accrued interest receivable                          | 761  | 604  |
| Investments in other Farm Credit institutions        | 1,960  | 1,960  |
| Premises and equipment, net                          | 821  | 840  |
| Other property owned                                 | 3,281  | 3,498  |
| Due from AgFirst Farm Credit Bank                    | 545  | 1,387  |
| Other assets   | 961  | 1,804  |
| Total assets   | \$ 183,835                                     | \$ 185,288                                       |
| <b>Liabilities</b>                                   |  |  |
| Notes payable to AgFirst Farm Credit Bank            | \$ 134,119                                     | \$ 135,882                                       |
| Accrued interest payable                             | 196  | 245  |
| Other liabilities                                    | 2,776  | 2,702  |
| Total liabilities                                    | 137,091  | 138,829  |
| Commitments and contingencies                        |  |  |
| <b>Members' Equity</b>                               |  |  |
| Capital stock and participation certificates         | 563  | 604  |
| Unallocated retained earnings                        | 45,869   | 45,569   |
| Accumulated other comprehensive income               | 312  | 286  |
| Total members' equity                                | 46,744   | 46,459   |
| Total liabilities and members' equity                | \$ 183,835                                     | \$ 185,288                                       |

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

Puerto Rico Farm Credit, ACA

# Consolidated Statements of Income

*(unaudited)*

| <i>(dollars in thousands)</i>   | For the three months<br>ended June 30, |          | For the six months<br>ended June 30, |          |
|---|--|----------|--------------------------------------|----------|
|   | 2013                                   | 2012     | 2013                                 | 2012     |
| <b>Interest Income</b>  |  |          |                                      |          |
| Loans   | \$ 1,674                               | \$ 1,669 | \$ 3,241                             | \$ 3,240 |
| Notes receivable from other Farm Credit institutions (Note 5)                   | 225                                    | 225      | 450                                  | 450      |
| Total interest income   | 1,899                                  | 1,894    | 3,691                                | 3,690    |
| <b>Interest Expense</b>   |  |          |                                      |          |
| Notes payable to AgFirst Farm Credit Bank                                       | 708                                    | 749      | 1,424                                | 1,521    |
| Net interest income   | 1,191                                  | 1,145    | 2,267                                | 2,169    |
| Provision for (reversal of allowance for) loan losses                           | (108)                                  | (353)    | (9)                                  | (352)    |
| Net interest income after provision for (reversal of allowance for) loan losses | 1,299                                  | 1,498    | 2,276                                | 2,521    |
| <b>Noninterest Income</b>   |  |          |                                      |          |
| Loan fees   | 35                                     | 57       | 70                                   | 78       |
| Patronage rebate fees   | 54                                     | 56       | 105                                  | 115      |
| Patronage refunds from other Farm Credit institutions                           | 368                                    | 364      | 639                                  | 643      |
| Gains (losses) on other property owned, net                                     | (299)                                  | 14       | (296)                                | 31       |
| Insurance Fund refunds  | —                                      | 679      | —                                    | 679      |
| Other noninterest income  | 11                                     | 7        | 41                                   | 49       |
| Total noninterest income  | 169                                    | 1,177    | 559                                  | 1,595    |
| <b>Noninterest Expense</b>  |  |          |                                      |          |
| Salaries and employee benefits  | 817                                    | 735      | 1,670                                | 1,551    |
| Occupancy and equipment   | 76                                     | 77       | 142                                  | 144      |
| Insurance Fund premiums   | 34                                     | 20       | 67                                   | 41       |
| Other operating expenses  | 353                                    | 389      | 656                                  | 741      |
| Total noninterest expense   | 1,280                                  | 1,221    | 2,535                                | 2,477    |
| Net income  | \$ 188                                 | \$ 1,454 | \$ 300                               | \$ 1,639 |

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

Puerto Rico Farm Credit, ACA

# Consolidated Statements of Comprehensive Income

*(unaudited)*

| <i>(dollars in thousands)</i>                | For the three months<br>ended June 30, |          | For the six months<br>ended June 30, |          |
|--|--|----------|--------------------------------------|----------|
|  | 2013                                   | 2012     | 2013                                 | 2012     |
| Net income                                   | \$ 188                                 | \$ 1,454 | \$ 300                               | \$ 1,639 |
| <b>Other comprehensive income net of tax</b> |  |          |                                      |          |
| Employee benefit plans adjustments (Note 8)  | 13                                     | 16       | 26                                   | 32       |
| Comprehensive income                         | \$ 201                                 | \$ 1,470 | \$ 326                               | \$ 1,671 |

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

Puerto Rico Farm Credit, ACA

# Consolidated Statements of Changes in Members' Equity

*(unaudited)*

| <i>(dollars in thousands)</i>                                     | <b>Capital<br/>Stock and<br/>Participation<br/>Certificates</b> | <b>Unallocated<br/>Retained<br/>Earnings</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income</b> | <b>Total<br/>Members'<br/>Equity</b> |
|---|---|--|---|--------------------------------------|
| Balance at December 31, 2011                                      | \$ 648  | \$ 44,886                                    | \$ 279  | \$ 45,813                            |
| Comprehensive income  |   | 1,639  | 32  | 1,671                                |
| Capital stock/participation<br>certificates issued/(retired), net | (22)  |  |   | (22)                                 |
| Balance at June 30, 2012  | <u>\$ 626</u>   | <u>\$ 46,525</u>                             | <u>\$ 311</u>   | <u>\$ 47,462</u>                     |
| Balance at December 31, 2012                                      | \$ 604  | \$ 45,569                                    | \$ 286  | \$ 46,459                            |
| Comprehensive income  |   | 300  | 26  | 326                                  |
| Capital stock/participation<br>certificates issued/(retired), net | (41)  |  |   | (41)                                 |
| Balance at June 30, 2013  | <u>\$ 563</u>   | <u>\$ 45,869</u>                             | <u>\$ 312</u>   | <u>\$ 46,744</u>                     |

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

# Notes to the Consolidated Financial Statements

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

## **NOTE 1 – ORGANIZATION, SIGNIFICANT ACCOUNTING POLICIES, AND RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS**

The accompanying financial statements include the accounts of Puerto Rico Farm Credit, ACA (the Association). A description of the organization and operations of the Association, the significant accounting policies followed, and the financial condition and results of operations as of and for the year ended December 31, 2012, are contained in the 2012 Annual Report of the Association. These unaudited second quarter 2013 consolidated financial statements should be read in conjunction with the 2012 Annual Report of the Association.

The accompanying consolidated financial statements contain all necessary adjustments for a fair presentation of the interim financial condition and results of operations and conform with generally accepted accounting principles (GAAP) and prevailing practices within the banking industry. The results for the six months ended June 30, 2013 are not indicative of the results to be expected for the year ending December 31, 2013.

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

The Association maintains an allowance for loan losses in accordance with GAAP. The loan portfolio is reviewed quarterly to determine the adequacy of the allowance for losses. As of June 30, 2013, the allowance for losses is adequate in management's opinion to provide for possible losses on existing loans.

### **Recently Issued Accounting Pronouncements**

In February 2013 the FASB issued Accounting Standards Update (ASU) 2013-04, "Liabilities (Topic 405): Obligations Resulting from Joint and Several Liability Arrangements for which the Total Amount of the Obligation Is Fixed at the Reporting Date," which addresses the recognition, measurement and disclosure of certain obligations including debt arrangements, other contractual obligations, and settled litigation and judicial rulings. The amendments are to be applied retrospectively to all prior periods presented for those obligations resulting from joint and several liability arrangements within the Update's scope that exist at the beginning of an entity's fiscal year of adoption. An entity may

elect to use hindsight for the comparative periods (if it changed its accounting as a result of adopting the amendments in the Update) and should disclose that fact. The amendments are effective for public entities for fiscal years, and interim periods within those years, beginning after December 15, 2013. For nonpublic entities, the amendments are effective for fiscal years ending after December 15, 2014, and interim periods and annual periods thereafter. Early application is permitted. It is not anticipated the adoption of this guidance will have a material impact on the Association's financial condition or results of operations but will result in additional disclosures.

In February 2013 the FASB issued ASU 2013-02, "Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income." The update is intended to improve the transparency of reporting reclassifications out of accumulated other comprehensive income. The amendments do not change the requirements for reporting net income or other comprehensive income in financial statements. However, the amendments require an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts. For public entities, the amendments are effective prospectively for reporting periods beginning after December 15, 2012. For nonpublic entities, the amendments are effective prospectively for reporting periods beginning after December 15, 2013. Early application is permitted.

In January 2013, the FASB issued ASU 2013-01 "Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities." The Update clarifies that ordinary trade receivables and payables are not in the scope of ASU 2011-11, "Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities." Specifically, ASU 2011-11 applies only to derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance with specific criteria or subject to a master netting

arrangement or similar agreement. The effective date is the same as that for ASU 2011-11 below.

In December 2011, the FASB issued ASU 2011-11, "Balance Sheet (Topic 210) - Disclosures about Offsetting Assets and Liabilities." The guidance requires an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. This includes the effect or potential effect of rights of setoff associated with an entity's recognized assets and recognized liabilities. The requirements apply to recognized financial instruments and derivative instruments that are offset in accordance with accounting guidance and for those

recognized financial instruments and derivative instruments that are subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset or not. This guidance is to be applied retrospectively for all comparative periods and is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. The adoption of this guidance, in conjunction with ASU 2013-01 above, will not impact the Association's financial condition or its results of operations, but will result in additional disclosures.

Other recently issued accounting pronouncements are discussed in the 2012 Annual Report to Shareholders.

## Note 2 – Loans and Allowance for Loan Losses

A summary of loans outstanding at period end were as follows:

|                                  | June 30, 2013 | December 31, 2012 |
|----------------------------------|---------------|-------------------|
| Real estate mortgage             | \$ 98,445     | \$ 102,418        |
| Production and intermediate-term | 47,033        | 42,328            |
| Agribusiness                     |               |                   |
| Processing and marketing         | 2,782         | 3,334             |
| Farm-related business            | 2,489         | 928               |
| Total agribusiness               | 5,271         | 4,262             |
| Communication                    | 946           | 970               |
| Energy                           | 2,233         | 2,479             |
| Rural residential real estate    | 15,734        | 16,932            |
| Total Loans                      | \$ 169,662    | \$ 169,389        |

The Association may purchase or sell participation interests with other parties in order to diversify risk, manage loan volume, and comply with Farm Credit Administration regulations. Participation loan balances at period end were as follows:

|                                  | June 30, 2013            |                     |                           |                     |                            |                     |                          |                     |
|----------------------------------|--------------------------|---------------------|---------------------------|---------------------|----------------------------|---------------------|--------------------------|---------------------|
|                                  | Within AgFirst District  |                     | Within Farm Credit System |                     | Outside Farm Credit System |                     | Total                    |                     |
|                                  | Participations Purchased | Participations Sold | Participations Purchased  | Participations Sold | Participations Purchased   | Participations Sold | Participations Purchased | Participations Sold |
| Real estate mortgage             | \$ -                     | \$ 11,277           | \$ -                      | \$ -                | \$ 936                     | \$ -                | \$ 936                   | \$ 11,277           |
| Production and intermediate term | 29,944                   | 965                 | -                         | -                   | 5,058                      | -                   | 35,002                   | 965                 |
| Agribusiness                     |                          |                     |                           |                     |                            |                     |                          |                     |
| Processing and marketing         | 2,119                    | -                   | -                         | -                   | 610                        | -                   | 2,729                    | -                   |
| Farm-related business            | -                        | -                   | -                         | -                   | 2,254                      | -                   | 2,254                    | -                   |
| Total agribusiness               | 2,119                    | -                   | -                         | -                   | 2,864                      | -                   | 4,983                    | -                   |
| Communication                    | 950                      | -                   | -                         | -                   | -                          | -                   | 950                      | -                   |
| Energy                           | 2,235                    | -                   | -                         | -                   | -                          | -                   | 2,235                    | -                   |
| Total                            | \$ 35,248                | \$ 12,242           | \$ -                      | \$ -                | \$ 8,858                   | \$ -                | \$ 44,106                | \$ 12,242           |

|                                  | December 31, 2012        |                     |                           |                     |                            |                     |                          |                     |
|----------------------------------|--------------------------|---------------------|---------------------------|---------------------|----------------------------|---------------------|--------------------------|---------------------|
|                                  | Within AgFirst District  |                     | Within Farm Credit System |                     | Outside Farm Credit System |                     | Total                    |                     |
|                                  | Participations Purchased | Participations Sold | Participations Purchased  | Participations Sold | Participations Purchased   | Participations Sold | Participations Purchased | Participations Sold |
| Real estate mortgage             | \$ -                     | \$ 11,523           | \$ -                      | \$ -                | \$ 972                     | \$ -                | \$ 972                   | \$ 11,523           |
| Production and intermediate term | 24,577                   | 831                 | -                         | -                   | 4,536                      | -                   | 29,113                   | 831                 |
| Agribusiness                     |                          |                     |                           |                     |                            |                     |                          |                     |
| Processing and marketing         | 2,606                    | -                   | -                         | -                   | 670                        | -                   | 3,276                    | -                   |
| Farm-related business            | -                        | -                   | -                         | -                   | 882                        | -                   | 882                      | -                   |
| Total agribusiness               | 2,606                    | -                   | -                         | -                   | 1,552                      | -                   | 4,158                    | -                   |
| Communication                    | 975                      | -                   | -                         | -                   | -                          | -                   | 975                      | -                   |
| Energy                           | 2,479                    | -                   | -                         | -                   | -                          | -                   | 2,479                    | -                   |
| Total                            | \$ 30,637                | \$ 12,354           | \$ -                      | \$ -                | \$ 7,060                   | \$ -                | \$ 37,697                | \$ 12,354           |



**December 31, 2012**

|  | <b>30 Through<br/>89 Days Past<br/>Due</b> | <b>90 Days or<br/>More Past Due</b> | <b>Total Past<br/>Due</b> | <b>Not Past Due<br/>or Less Than<br/>30 Days Past<br/>Due</b> | <b>Total Loans</b> | <b>Recorded<br/>Investment 90<br/>Days or More Past<br/>Due and Accruing<br/>Interest</b> |
|--|--|-------------------------------------|---------------------------|---|--------------------|---|
| Real estate mortgage                             | \$ 5,984                                   | \$ 5,658                            | \$ 11,642                 | \$ 91,092   | \$ 102,734         | \$ -  |
| Production and intermediate-term<br>Agribusiness | -  | 1,786                               | 1,786                     | 40,666  | 42,452             | -   |
| Processing and marketing                         | -  | -                                   | -                         | 3,360   | 3,360              | -   |
| Farm-related business                            | -  | -                                   | -                         | 934   | 934                | -   |
| Total agribusiness                               | -  | -                                   | -                         | 4,294   | 4,294              | -   |
| Communication                                    | -  | -                                   | -                         | 971   | 971                | -   |
| Energy and water/waste disposal                  | -  | -                                   | -                         | 2,491   | 2,491              | -   |
| Rural residential real estate                    | 671  | 223                                 | 894                       | 16,082  | 16,976             | -   |
| <b>Total</b>                                     | <b>\$ 6,655</b>                            | <b>\$ 7,667</b>                     | <b>\$ 14,322</b>          | <b>\$ 155,596</b>   | <b>\$ 169,918</b>  | <b>\$ -</b>   |

The recorded investment in a receivable is the face amount increased or decreased by applicable accrued interest and unamortized premium, discount, finance charges, or acquisition costs and may also reflect a previous direct write-down of the investment.

Nonperforming assets (including related accrued interest) and related credit quality statistics at period end were as follows:

|   | <b>June 30, 2013</b> | <b>December 31, 2012</b> |
|---|----------------------|--------------------------|
| <b>Non-accrual loans:</b>   |                      |                          |
| Real estate mortgage  | \$ 10,773            | \$ 9,714                 |
| Production and intermediate-term<br>Agribusiness                                | 2,852                | 2,949                    |
| Processing and marketing  | 457                  | 560                      |
| Total agribusiness  | 457                  | 560                      |
| Rural residential real estate   | 396                  | 701                      |
| <b>Total nonaccrual loans</b>   | <b>\$ 14,478</b>     | <b>\$ 13,924</b>         |
| <b>Accruing restructured loans:</b>   |                      |                          |
| Real estate mortgage  | \$ 134               | \$ -                     |
| Production and intermediate-term  | 1,262                | 1,338                    |
| <b>Total accruing restructured loans</b>  | <b>\$ 1,396</b>      | <b>\$ 1,338</b>          |
| <b>Accruing loans 90 days or more past due:</b>                                 | <b>\$ -</b>          | <b>\$ -</b>              |
| <b>Total nonperforming loans</b>  | <b>\$ 15,874</b>     | <b>\$ 15,262</b>         |
| Other property owned  | 3,281                | 3,498                    |
| <b>Total nonperforming assets</b>   | <b>\$ 19,155</b>     | <b>\$ 18,760</b>         |
| Non-accrual loans as a percentage of total loans                                | 8.53%                | 8.22%                    |
| Nonperforming assets as a percentage of total<br>loans and other property owned | 11.08%               | 10.85%                   |
| Nonperforming assets as a percentage of capital                                 | 40.98%               | 40.38%                   |

The following table presents information related to impaired loans (including accrued interest) at period end. Impaired loans are loans for which it is probable that all principal and interest will not be collected according to the contractual terms of the loan.

|   | <b>June 30, 2013</b> | <b>December 31, 2012</b> |
|---|----------------------|--------------------------|
| <b>Impaired non-accrual loans:</b>      |                      |                          |
| Current as to principal and interest    | \$ 2,196             | \$ 2,611                 |
| Past due                                | 12,282               | 11,313                   |
| <b>Total impaired non-accrual loans</b> | <b>14,478</b>        | <b>13,924</b>            |
| <b>Impaired accrual loans:</b>          |                      |                          |
| Restructured                            | 1,396                | 1,338                    |
| 90 days or more past due                | -                    | -                        |
| <b>Total impaired accrual loans</b>     | <b>1,396</b>         | <b>1,338</b>             |
| <b>Total impaired loans</b>             | <b>\$ 15,874</b>     | <b>\$ 15,262</b>         |

The following tables present additional information concerning impaired loans and related allowance by loan type at period end.

|  | June 30, 2013       |                          |                   | Quarter Ended June 30, 2013 |  | Six Months Ended June 30, 2013 |  |
|--|---------------------|--------------------------|-------------------|-----------------------------|--|--------------------------------|--|
|  | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Impaired Loans      | Interest Income Recognized on Impaired Loans | Average Impaired Loans         | Interest Income Recognized on Impaired Loans |
| <b>Impaired loans with a related allowance for credit losses:</b>  |                     |                          |                   |                             |  |                                |  |
| Real estate mortgage   | \$ 3,297            | \$ 5,665                 | \$ 670            | \$ 3,370                    | \$ 14  | \$ 3,377                       | \$ 23  |
| Production and intermediate-term Agribusiness                      | 3,581               | 6,899                    | 1,371             | 3,658                       | 16   | 3,668                          | 26   |
| Processing and marketing   | 447                 | 560                      | 177               | 457                         | 2  | 458                            | 3  |
| Rural residential real estate                                      | -                   | -                        | -                 | -                           | -  | -                              | -  |
| Total  | <u>\$ 7,325</u>     | <u>\$ 13,124</u>         | <u>\$ 2,218</u>   | <u>\$ 7,485</u>             | <u>\$ 32</u>                                 | <u>\$ 7,503</u>                | <u>\$ 52</u>                                 |
| <b>Impaired loans with no related allowance for credit losses:</b> |                     |                          |                   |                             |  |                                |  |
| Real estate mortgage   | \$ 7,610            | \$ 7,854                 | \$ -              | \$ 7,775                    | \$ 34  | \$ 7,794                       | \$ 54  |
| Production and intermediate-term Agribusiness                      | 533                 | 591                      | -                 | 546                         | 2  | 546                            | 3  |
| Processing and marketing   | 10                  | -                        | -                 | 10                          | -  | 10                             | -  |
| Rural residential real estate                                      | 396                 | 511                      | -                 | 405                         | 2  | 406                            | 3  |
| Total  | <u>\$ 8,549</u>     | <u>\$ 8,956</u>          | <u>\$ -</u>       | <u>\$ 8,736</u>             | <u>\$ 38</u>                                 | <u>\$ 8,756</u>                | <u>\$ 60</u>                                 |
| <b>Total impaired loans:</b>                                       |                     |                          |                   |                             |  |                                |  |
| Real estate mortgage   | \$ 10,907           | \$ 13,519                | \$ 670            | \$ 11,145                   | \$ 48  | \$ 11,171                      | \$ 77  |
| Production and intermediate-term Agribusiness                      | 4,114               | 7,490                    | 1,371             | 4,204                       | 18   | 4,214                          | 29   |
| Processing and marketing   | 457                 | 560                      | 177               | 467                         | 2  | 468                            | 3  |
| Rural residential real estate                                      | 396                 | 511                      | -                 | 405                         | 2  | 406                            | 3  |
| Total  | <u>\$ 15,874</u>    | <u>\$ 22,080</u>         | <u>\$ 2,218</u>   | <u>\$ 16,221</u>            | <u>\$ 70</u>                                 | <u>\$ 16,259</u>               | <u>\$ 112</u>                                |

|  | December 31, 2012   |                          |                   | Year Ended December 31, 2012 |  |
|--|---------------------|--------------------------|-------------------|------------------------------|--|
|  | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Impaired Loans       | Interest Income Recognized on Impaired Loans |
| <b>Impaired loans with a related allowance for credit losses:</b>  |                     |                          |                   |                              |  |
| Real estate mortgage   | \$ 2,199            | \$ 2,300                 | \$ 529            | \$ 2,692                     | \$ 44  |
| Production and intermediate-term Agribusiness                      | 3,653               | 6,961                    | 1,226             | 4,473                        | 72   |
| Processing and marketing   | 550                 | 560                      | 280               | 673                          | 11   |
| Rural residential real estate                                      | 378                 | 408                      | 38                | 462                          | 8  |
| Total  | <u>\$ 6,780</u>     | <u>\$ 10,229</u>         | <u>\$ 2,073</u>   | <u>\$ 8,300</u>              | <u>\$ 135</u>                                |
| <b>Impaired loans with no related allowance for credit losses:</b> |                     |                          |                   |                              |  |
| Real estate mortgage   | \$ 7,515            | \$ 9,886                 | \$ -              | \$ 9,201                     | \$ 150                                       |
| Production and intermediate-term Agribusiness                      | 634                 | 665                      | -                 | 776                          | 13   |
| Processing and marketing   | 10                  | -                        | -                 | 13                           | -  |
| Rural residential real estate                                      | 323                 | 400                      | -                 | 396                          | 6  |
| Total  | <u>\$ 8,482</u>     | <u>\$ 10,951</u>         | <u>\$ -</u>       | <u>\$ 10,386</u>             | <u>\$ 169</u>                                |
| <b>Total impaired loans:</b>                                       |                     |                          |                   |                              |  |
| Real estate mortgage   | \$ 9,714            | \$ 12,186                | \$ 529            | \$ 11,893                    | \$ 194                                       |
| Production and intermediate-term Agribusiness                      | 4,287               | 7,626                    | 1,226             | 5,249                        | 85   |
| Processing and marketing   | 560                 | 560                      | 280               | 686                          | 11   |
| Rural residential real estate                                      | 701                 | 808                      | 38                | 858                          | 14   |
| Total  | <u>\$ 15,262</u>    | <u>\$ 21,180</u>         | <u>\$ 2,073</u>   | <u>\$ 18,686</u>             | <u>\$ 304</u>                                |

Unpaid principal balance represents the contractual principal balance of the loan.

There were no material commitments to lend additional funds to debtors whose loans were classified as impaired at each reporting period.

A summary of changes in the allowance for loan losses and recorded investment in loans at period end were as follows:

|  | Real Estate<br>Mortgage | Production and<br>Intermediate-<br>term | Agribusiness | Communication | Energy and<br>Water/Waste<br>Disposal | Rural<br>Residential<br>Real Estate | Total      |
|--|-------------------------|---|--------------|---------------|---------------------------------------|-------------------------------------|------------|
| <b>Allowance for credit losses:</b>              |                         |   |              |               |                                       |                                     |            |
| Balance at March 31, 2013                        | \$ 1,453                | \$ 1,656                                | \$ 1,242     | \$ 16         | \$ 3                                  | \$ 137                              | \$ 4,507   |
| Charge-offs                                      | -                       | -                                       | (103)        | -             | -                                     | -                                   | (103)      |
| Recoveries                                       | (1)                     | 1                                       | -            | -             | -                                     | -                                   | -          |
| Provision for loan losses                        | (497)                   | 321                                     | -            | -             | -                                     | 68                                  | (108)      |
| Balance at June 30, 2013                         | \$ 955                  | \$ 1,978                                | \$ 1,139     | \$ 16         | \$ 3                                  | \$ 205                              | \$ 4,296   |
| Balance at December 31, 2012                     | \$ 1,336                | \$ 1,685                                | \$ 1,241     | \$ 16         | \$ 3                                  | \$ 127                              | \$ 4,408   |
| Charge-offs                                      | (2)                     | -                                       | (103)        | -             | -                                     | -                                   | (105)      |
| Recoveries                                       | 1                       | 1                                       | -            | -             | -                                     | -                                   | 2          |
| Provision for loan losses                        | (380)                   | 292                                     | 1            | -             | -                                     | 78                                  | (9)        |
| Balance at June 30, 2013                         | \$ 955                  | \$ 1,978                                | \$ 1,139     | \$ 16         | \$ 3                                  | \$ 205                              | \$ 4,296   |
| Balance at March 31, 2012                        | \$ 1,740                | \$ 789                                  | \$ 719       | \$ 8          | \$ 3                                  | \$ 187                              | \$ 3,446   |
| Charge-offs                                      | (8)                     | (46)                                    | -            | -             | -                                     | -                                   | (54)       |
| Recoveries                                       | 151                     | -                                       | -            | -             | -                                     | -                                   | 151        |
| Provision for loan losses                        | (174)                   | (128)                                   | (49)         | 2             | 9                                     | (13)                                | (353)      |
| Balance at June 30, 2012                         | \$ 1,709                | \$ 615                                  | \$ 670       | \$ 10         | \$ 12                                 | \$ 174                              | \$ 3,190   |
| Balance at December 31, 2011                     | \$ 1,359                | \$ 657                                  | \$ 1,273     | \$ 7          | \$ 2                                  | \$ 184                              | \$ 3,482   |
| Charge-offs                                      | (47)                    | (46)                                    | -            | -             | -                                     | -                                   | (93)       |
| Recoveries                                       | 153                     | -                                       | -            | -             | -                                     | -                                   | 153        |
| Provision for loan losses                        | 244                     | 4                                       | (603)        | 3             | 10                                    | (10)                                | (352)      |
| Balance at June 30, 2012                         | \$ 1,709                | \$ 615                                  | \$ 670       | \$ 10         | \$ 12                                 | \$ 174                              | \$ 3,190   |
| Loans individually evaluated for impairment      | \$ 670                  | \$ 1,371                                | \$ 177       | \$ -          | \$ -                                  | \$ -                                | \$ 2,218   |
| Loans collectively evaluated for impairment      | 285                     | 607                                     | 962          | 16            | 3                                     | 205                                 | 2,078      |
| Balance at June 30, 2013                         | \$ 955                  | \$ 1,978                                | \$ 1,139     | \$ 16         | \$ 3                                  | \$ 205                              | \$ 4,296   |
| Loans individually evaluated for impairment      | \$ 529                  | \$ 1,226                                | \$ 280       | \$ -          | \$ -                                  | \$ 38                               | \$ 2,073   |
| Loans collectively evaluated for impairment      | 807                     | 459                                     | 961          | 16            | 3                                     | 89                                  | 2,335      |
| Balance at December 31, 2012                     | \$ 1,336                | \$ 1,685                                | \$ 1,241     | \$ 16         | \$ 3                                  | \$ 127                              | \$ 4,408   |
| <b>Recorded investment in loans outstanding:</b> |                         |   |              |               |                                       |                                     |            |
| Loans individually evaluated for impairment      | \$ 10,598               | \$ 4,032                                | \$ 457       | \$ -          | \$ -                                  | \$ 234                              | \$ 15,321  |
| Loans collectively evaluated for impairment      | 88,254                  | 43,190                                  | 4,855        | 947           | 2,233                                 | 15,548                              | 155,027    |
| Ending balance at June 30, 2013                  | \$ 98,852               | \$ 47,222                               | \$ 5,312     | \$ 947        | \$ 2,233                              | \$ 15,782                           | \$ 170,348 |
| Loans individually evaluated for impairment      | \$ 9,251                | \$ 4,221                                | \$ 560       | \$ -          | \$ -                                  | \$ 491                              | \$ 14,523  |
| Loans collectively evaluated for impairment      | 93,483                  | 38,231                                  | 3,734        | 971           | 2,491                                 | 16,485                              | 155,395    |
| Ending balance at December 31, 2012              | \$ 102,734              | \$ 42,452                               | \$ 4,294     | \$ 971        | \$ 2,491                              | \$ 16,976                           | \$ 169,918 |

A restructuring of a debt constitutes a troubled debt restructuring (TDR) if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. The following tables present additional information regarding TDRs as of the restructuring date that occurred during the period presented. There were no TDRs for the three month periods ended June 30, 2013 or 2012.

| Six months ended June 30, 2013                   |                         |                          |                      |        |
|--|-------------------------|--------------------------|----------------------|--------|
| Pre-modification Outstanding Recorded Investment |                         |                          |                      |        |
|  | Interest<br>Concessions | Principal<br>Concessions | Other<br>Concessions | Total  |
| <b>Troubled debt restructurings:</b>             |                         |                          |                      |        |
| Real estate mortgage                             | \$ -                    | \$ 128                   | \$ -                 | \$ 128 |
| Total  | \$ -                    | \$ 128                   | \$ -                 | \$ 128 |

| Six months ended June 30, 2013       |   |                       |                   |        | Effects of Modification |             |
|--------------------------------------|---|-----------------------|-------------------|--------|-------------------------|-------------|
|                                      | Post-modification Outstanding Recorded Investment |                       |                   |        | Provisions              | Charge-offs |
|                                      | Interest Concessions                              | Principal Concessions | Other Concessions | Total  |                         |             |
| <b>Troubled debt restructurings:</b> |   |                       |                   |        |                         |             |
| Real estate mortgage                 | \$ -  | \$ 128                | \$ -              | \$ 128 | \$ 1                    | \$ -        |
| Total                                | \$ -  | \$ 128                | \$ -              | \$ 128 | \$ 1                    | \$ -        |

| Six months ended June 30, 2012       |  |                       |                   |       |
|--------------------------------------|--|-----------------------|-------------------|-------|
|                                      | Pre-modification Outstanding Recorded Investment |                       |                   |       |
|                                      | Interest Concessions                             | Principal Concessions | Other Concessions | Total |
| <b>Troubled debt restructurings:</b> |  |                       |                   |       |
| Real estate mortgage                 | \$ -   | \$ -                  | \$ 34             | \$ 34 |
| Total                                | \$ -   | \$ -                  | \$ 34             | \$ 34 |

| Six months ended June 30, 2012       |   |                       |                   |       | Effects of Modification |             |
|--------------------------------------|---|-----------------------|-------------------|-------|-------------------------|-------------|
|                                      | Post-modification Outstanding Recorded Investment |                       |                   |       | Provisions              | Charge-offs |
|                                      | Interest Concessions                              | Principal Concessions | Other Concessions | Total |                         |             |
| <b>Troubled debt restructurings:</b> |   |                       |                   |       |                         |             |
| Real estate mortgage                 | \$ -  | \$ -                  | \$ 19             | \$ 19 | \$ (12)                 | \$ -        |
| Total                                | \$ -  | \$ -                  | \$ 19             | \$ 19 | \$ (12)                 | \$ -        |

Interest concessions may include interest forgiveness and interest deferment. Principal concessions may include principal forgiveness, principal deferment, and maturity extension. Other concessions may include additional compensation received which might be in the form of cash or other assets.

There were no TDRs that occurred during the previous twelve months and for which there was a subsequent payment default during the periods presented. Payment default is defined as a payment that was thirty days or more past due.

The following table provides information at period end on outstanding loans restructured in troubled debt restructurings. These loans are included as impaired loans in the impaired loan table:

|   | Total TDRs    |                   | Nonaccrual TDRs |                   |
|---|---------------|-------------------|-----------------|-------------------|
|   | June 30, 2013 | December 31, 2012 | June 30, 2013   | December 31, 2012 |
| Real estate mortgage                          | \$ 4,514      | \$ 4,779          | \$ 4,380        | \$ 4,779          |
| Production and intermediate-term Agribusiness | 2,399         | 2,529             | 1,137           | 1,191             |
| Processing and marketing                      | 457           | 560               | 457             | 560               |
| Total Loans                                   | \$ 7,370      | \$ 7,868          | \$ 5,974        | \$ 6,530          |

At June 30, 2013 and December 31, 2012, there were no additional commitments to lend to borrowers whose loans have been modified in troubled debt restructurings.

### NOTE 3 – COMMITMENTS AND CONTINGENT LIABILITIES

Actions are pending against the Association in which money damages are sought. However, on the basis of information now at hand, management and legal counsel are of the opinion that the ultimate liability, if any, resulting therefrom, would not be material in relation to the overall financial position of the Association.

### NOTE 4 – EMPLOYEE BENEFIT PLANS

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

|                               | For the three months ended June 30, |        | For the six months ended June 30, |        |
|-------------------------------|-------------------------------------|--------|-----------------------------------|--------|
|                               | 2013                                | 2012   | 2013                              | 2012   |
| Pension                       | \$ 248                              | \$ 262 | \$ 497                            | \$ 525 |
| 401(k)                        | 19                                  | 14     | 38                                | 26     |
| Other postretirement benefits | 39                                  | 46     | 78                                | 91     |
| Total                         | \$ 306                              | \$ 322 | \$ 613                            | \$ 642 |

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

|                               | Actual<br>YTD<br>Through<br>6/30/13 | Projected<br>Contributions<br>For Remainder<br>of 2013 | Projected<br>Total<br>Contributions<br>2013 |
|-------------------------------|-------------------------------------|--|---|
| Pension                       | \$ -                                | \$ 963   | \$ 963                                      |
| Other postretirement benefits | 57                                  | 44   | 101   |
| <b>Total</b>                  | <b>\$ 57</b>                        | <b>\$ 1,007</b>  | <b>\$ 1,064</b>                             |

Contributions in the above table include an allocated estimate of funding for the multi-employer pension plan in which the Association participates. The projected amount may change when a total funding amount and allocation is determined by the pension Plan's Sponsor Committee. Also, market conditions could impact discount rates and return on plan assets which could change the contribution necessary before the next plan measurement date of December 31, 2013.

Further details regarding employee benefit plans are contained in the 2012 Annual Report to Shareholders.

#### **NOTE 5 – NOTES RECEIVABLE FROM OTHER FARM CREDIT INSTITUTIONS**

In September 2008, the Association used capital reserves to purchase \$10,000 total of fixed rate unsecured subordinated notes issued by two other associations in the District, both notes due in 2018. The notes receivable are subordinate to all other categories of creditors of the issuing associations, including any claims of the Bank and general creditors, but are senior to all classes of shareholders of the issuing associations. The notes receivable are not considered System debt, and thus are not guaranteed by the System and not insured by the Insurance Corporation. Since the notes receivable are only guaranteed by the issuing associations, repayment could be negatively impacted by funding, credit, and/or counterparty risks encountered by the two issuing associations in their business operations. As of the end of 2012, one of the two associations had merged with another association in the district and is considered by management to be acceptable risk as when the debt was issued. The second association continues to perform at an acceptable level and management does not consider it to carry higher than average risk. Both associations are expected to pay their principal debt in October 2013, when the prepayment option can be exercised. Management will continue to inform the Board of Directors on the financial performance of the Associations on a quarterly basis.

The notes receivable bear interest at an annual fixed rate of 9.00 percent, payable on the fifteenth day of each month, beginning on October 15, 2008. Interest will be deferred if, as of the fifth business day prior to an interest payment date, any applicable minimum regulatory capital ratios are not satisfied by the issuing association(s). A deferral period may not last for more than five consecutive years or beyond the maturity

date of the note(s). During such a period, the issuing association(s) may not declare or pay any dividends or patronage refunds, among other certain restrictions, until interest payments are resumed and all deferred interest has been paid. The note(s) may be redeemed, at the issuing Association's option, on October 15, 2013, or upon the occurrence of certain defined regulatory events, at a redemption price of 100 percent of the principal amount, plus any accrued but unpaid interest to the date of redemption, provided the issuing association(s) have made payment in full of all amounts then due in respect of their senior indebtedness.

#### **NOTE 6 – NOTES PAYABLE TO AGFIRST FARM CREDIT BANK**

The Association's indebtedness to the Bank represents borrowings by the Association primarily 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 line of credit are governed by the General Financing Agreement (GFA). The GFA defines Association performance criteria for borrowing from the Bank, which includes borrowing base margin, earnings and capital covenants. The Association failed to meet its earnings covenant under the GFA at December 31, 2012. The default allows the Bank to accelerate repayment of all indebtedness. The Bank approved a waiver of the GFA default and allowed the Association to continue to borrow under the GFA pursuant to a special credit agreement (SCA). At March 31, 2013, the Association failed to meet its earnings covenant under the SCA, and the Bank provided a waiver of the SCA earning covenant default effective March 31, 2013, subject to certain terms and conditions. Such waiver expires December 31, 2013.

#### **NOTE 7 – FAIR VALUE MEASUREMENT**

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability in an orderly transaction between market participants in the principal or most advantageous market for the asset or liability.

Accounting guidance establishes a fair value hierarchy for disclosure of fair value measurements to maximize the use of observable inputs, that is, inputs that reflect the assumptions market participants would use in pricing an asset or liability based on market data obtained from sources independent of the reporting entity. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Estimating the fair value of the Association's investment in the Bank and Other Farm Credit Institutions is not practicable because the stock is not traded. The net investment is a requirement of borrowing from the Bank and is carried at cost plus allocated equities in the accompanying Consolidated Balance Sheets. The Association owns 0.70 percent of the issued stock of the Bank as of June 30, 2013 net of any reciprocal investment. As of that date, the Bank's assets totaled \$28.1 billion and shareholders' equity totaled \$2.3 billion. The Bank's earnings were \$232 million for the first six months of 2013. In addition, the Association has no investment related to other Farm Credit institutions.

The classifications of the Association's financial instruments within the fair value hierarchy are as follows:

#### **Level 1**

Level 1 inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets. The Association had no Level 1 assets or liabilities at June 30, 2013. For cash, the carrying value is primarily utilized as a reasonable estimate of fair value.

#### **Level 2**

Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets; quoted prices in markets that are not active; and inputs that are observable, or can be corroborated, for substantially the full term of the asset or liability. The Association had no Level 2 assets or liabilities measured at fair value on a recurring basis at June 30, 2013.

#### **Level 3**

Level 3 inputs to the valuation methodology are unobservable and supported by little or no market activity. Valuation is determined using pricing models, discounted cash flow methodologies, or similar techniques, and could include significant management judgment or estimation. Level 3 assets and liabilities also could include instruments whose price has been adjusted based on dealer quoted pricing that is different than the third-party valuation or internal model pricing.

Because no active market exists for the Association's accruing loans, fair value is estimated by discounting the expected future cash flows using the Association's current interest rates at which similar loans currently would be made to borrowers with similar credit risk. 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 values of loans in a non-accrual status are estimated to be the carrying amount of the loan less specific reserves. Level 3 assets include impaired loans which represent the fair value of certain loans that were evaluated for impairment under FASB guidance. The fair value was based upon the underlying collateral since these were collateral-dependent. When the value of the collateral, less estimated costs to sell, is less than the principal balance of the loan, a specific reserve is established. The fair value measurement process uses independent appraisals and other market-based information, but in many cases it also requires significant input based on management's knowledge of and judgment about current market conditions, specific issues relating to the collateral and other matters.

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. This assumption implies that earnings on the Association's interest margin are used to fund operating expenses and capital expenditures.

Other property owned is classified as a level 3 asset. The fair value is generally determined using formal appraisals of each individual property. These assets are held for sale. Costs to sell represent transaction costs and are not included as a component of the fair value of other property owned. Other property owned consists of real and personal property acquired through foreclosure or deed in lieu of foreclosure and is carried as an asset held for sale, which is generally not its highest and best use. These properties are part of the Association's credit risk mitigation efforts, not its ongoing business. In addition, FCA regulations require that these types of property be disposed of within a reasonable period of time.

For commitments to extend credit, the estimated market value of off-balance-sheet commitments is minimal since the committed rate approximates current rates offered for commitments with similar rate and maturity characteristics; therefore, the related credit risk is not significant.

For notes receivable from other Farm Credit institutions, fair value is determined by discounting the expected future cash flows using appropriate interest rates for similar assets.

Other fair value measurements may use contractual payments and a risk adjusted discount rate, which is generated using the Association's 14-point risk rating scale. An increase in risk rating will generally produce a lower fair value measurement.

The following tables present the changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the periods presented. The Association had no transfers of assets or liabilities into or out of Level 1 or Level 2 during the periods presented.

|   | <b>Standby<br/>Letters<br/>Of Credit</b> |
|---|--|
| Balance at January 1, 2013                          | \$ 17                                    |
| <b>Total gains or (losses) realized/unrealized:</b> |  |
| Included in earnings                                | -  |
| Included in other comprehensive income              | -  |
| Purchases   | -  |
| Sales   | -  |
| Issuances   | -  |
| Settlements   | (5)                                      |
| Transfers in and/or out of level 3                  | -  |
| Balance at June 30, 2013                            | <u>\$ 12</u>                             |

|   | <b>Standby<br/>Letters<br/>Of Credit</b> |
|---|--|
| Balance at January 1, 2012                          | \$ 22                                    |
| <b>Total gains or (losses) realized/unrealized:</b> |  |
| Included in earnings                                | -  |
| Included in other comprehensive income              | -  |
| Purchases   | -  |
| Sales   | -  |
| Issuances   | -  |
| Settlements   | (2)                                      |
| Transfers in and/or out of level 3                  | -  |
| Balance at June 30, 2012                            | <u>\$ 20</u>                             |

### INFORMATION ABOUT SENSITIVITY TO CHANGES IN SIGNIFICANT UNOBSERVABLE INPUTS

Discounted cash flow or similar modeling techniques are generally used to determine the recurring fair value measurements for Level 3 assets and liabilities. Use of these techniques requires determination of relevant inputs and assumptions, some of which represent significant unobservable inputs as indicated in the tables that follow. Accordingly, changes in these unobservable inputs may have a significant impact on fair value.

Certain of these unobservable inputs will (in isolation) have a directionally consistent impact on the fair value of the instrument for a given change in that input. Alternatively, the

fair value of the instrument may move in an opposite direction for a given change in another input. Where multiple inputs are used within the valuation technique of an asset or liability, a change in one input in a certain direction may be offset by an opposite change in another input having a potentially muted impact to the overall fair value of that particular instrument. Additionally, a change in one unobservable input may result in a change to another unobservable input (that is, changes in certain inputs are interrelated with one another), which may counteract or magnify the fair value impact.

### Other Property Owned/Impaired Loans

Other property owned and impaired loans are valued using appraisals, market comparable sales, replacement costs and income and expense (cash flow) techniques. Certain unobservable inputs are used within these techniques to determine the level 3 fair value of these properties. The significant unobservable inputs are primarily sensitive only to industry, geographic and overall economic conditions, and/or specific attributes of each property.

### Inputs to Valuation Techniques

Management determines the Association's valuation policies and procedures. The Bank performs the majority of the Association's valuations, and its valuation processes are calibrated annually by an independent consultant. The fair value measurements are analyzed on a quarterly basis. For other valuations, documentation is obtained for third party information, such as pricing, and periodically evaluated alongside internal information and pricing that is available.

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.

### Quantitative Information about Recurring and Nonrecurring Level 3 Fair Value Measurements

|   | <b>Fair Value</b> | <b>Valuation Technique(s)</b> | <b>Unobservable Input</b> | <b>Range</b> |
|---|-------------------|-------------------------------|---------------------------|--------------|
| Impaired loans and other property owned | \$ 17,126         | Appraisal                     | Income and expense        | *            |
|   |                   |                               | Comparable sales          | *            |
|   |                   |                               | Replacement costs         | *            |
|   |                   |                               | Comparability adjustments | *            |

\* Ranges for this type of input are not useful because each collateral property is unique.

**Information about Other Financial Instrument Fair Value Measurements**

|  | <b>Valuation Technique(s)</b> | <b>Input</b>   |
|--|-------------------------------|--|
| Cash   | Carrying Value                | Par/Principal and appropriate interest yield   |
| Loans  | Discounted cash flow          | Prepayment rates<br>Probability of default<br>Loss severity<br>Annualized volatility |
| Notes receivable from other Farm Credit institutions | Discounted cash flow          | Probability of default<br>Risk adjusted discount rate                                |
| Notes payable to AgFirst Farm Credit Bank            | Discounted cash flow          | Prepayment rates<br>Probability of default<br>Loss severity<br>Annualized volatility |

The following table presents the carrying amounts and fair values of assets and liabilities that are measured at fair value on a recurring and nonrecurring basis, as well as, those financial instruments not measured at fair value, for each of the hierarchy levels at the period ended:

|  | <b>At or for the Six Months Ended June 30, 2013</b> |                |                |                |                         |            | <b>Fair Value Effects On Earnings</b> |
|--|---|----------------|----------------|----------------|-------------------------|------------|---------------------------------------|
|  | <b>Total Carrying Amount</b>                        | <b>Level 1</b> | <b>Level 2</b> | <b>Level 3</b> | <b>Total Fair Value</b> |            |                                       |
| <b>Recurring Measurements</b>                        |   |                |                |                |                         |            |                                       |
| <b>Assets:</b>                                       |   |                |                |                |                         |            |                                       |
| Recurring Assets                                     | \$ -  | \$ -           | \$ -           | \$ -           | \$ -                    | \$ -       |                                       |
| <b>Liabilities:</b>                                  |   |                |                |                |                         |            |                                       |
| Standby letters of credit                            | \$ 12   | \$ -           | \$ -           | \$ 12          | \$ 12                   | \$ 12      |                                       |
| Recurring Liabilities                                | \$ 12   | \$ -           | \$ -           | \$ 12          | \$ 12                   | \$ 12      |                                       |
| <b>Nonrecurring Measurements</b>                     |   |                |                |                |                         |            |                                       |
| <b>Assets:</b>                                       |   |                |                |                |                         |            |                                       |
| Impaired loans                                       | \$ 13,656   | \$ -           | \$ -           | \$ 13,656      | \$ 13,656               | \$ 13,656  | \$ (248)                              |
| Other property owned                                 | 3,281   | -              | -              | 3,470          | 3,470                   | 3,470      | (304)                                 |
| Nonrecurring Assets                                  | \$ 16,937   | \$ -           | \$ -           | \$ 17,126      | \$ 17,126               | \$ 17,126  | \$ (552)                              |
| <b>Other Financial Instruments</b>                   |   |                |                |                |                         |            |                                       |
| <b>Assets:</b>                                       |   |                |                |                |                         |            |                                       |
| Cash   | \$ 140  | \$ 140         | \$ -           | \$ -           | \$ 140                  | \$ 140     |                                       |
| Loans  | 151,710   | -              | -              | 150,423        | 150,423                 | 150,423    |                                       |
| Notes receivable from other Farm Credit institutions | 10,000  | -              | -              | 10,088         | 10,088                  | 10,088     |                                       |
| Other Assets   | \$ 161,850  | \$ 140         | \$ -           | \$ 160,511     | \$ 160,651              | \$ 160,651 |                                       |
| <b>Liabilities:</b>                                  |   |                |                |                |                         |            |                                       |
| Notes payable to AgFirst Farm Credit Bank            | \$ 134,119  | \$ -           | \$ -           | \$ 134,356     | \$ 134,356              | \$ 134,356 |                                       |
| Other Liabilities                                    | \$ 134,119  | \$ -           | \$ -           | \$ 134,356     | \$ 134,356              | \$ 134,356 |                                       |

**At or for the Year Ended December 31, 2012**

|  | <b>Total Carrying Amount</b> | <b>Level 1</b> | <b>Level 2</b> | <b>Level 3</b> | <b>Total Fair Value</b> | <b>Fair Value Effects On Earnings</b> |
|--|------------------------------|----------------|----------------|----------------|-------------------------|---------------------------------------|
| <b>Recurring Measurements</b>                        |                              |                |                |                |                         |                                       |
| <b>Assets:</b>                                       |                              |                |                |                |                         |                                       |
| Recurring Assets                                     | \$ -                         | \$ -           | \$ -           | \$ -           | \$ -                    |                                       |
| <b>Liabilities:</b>                                  |                              |                |                |                |                         |                                       |
| Standby letters of credit                            | \$ 17                        | \$ -           | \$ -           | \$ 17          | \$ 17                   |                                       |
| Recurring Liabilities                                | \$ 17                        | \$ -           | \$ -           | \$ 17          | \$ 17                   |                                       |
| <b>Nonrecurring Measurements</b>                     |                              |                |                |                |                         |                                       |
| <b>Assets:</b>                                       |                              |                |                |                |                         |                                       |
| Impaired loans                                       | \$ 13,189                    | \$ -           | \$ -           | \$ 13,189      | \$ 13,189               | \$ (785)                              |
| Other property owned                                 | 3,498                        | -              | -              | 3,672          | 3,672                   | (533)                                 |
| Nonrecurring Assets                                  | \$ 16,687                    | \$ -           | \$ -           | \$ 16,861      | \$ 16,861               | \$ (1,318)                            |
| <b>Other Financial Instruments</b>                   |                              |                |                |                |                         |                                       |
| <b>Assets:</b>                                       |                              |                |                |                |                         |                                       |
| Cash   | \$ 214                       | \$ 214         | \$ -           | \$ -           | \$ 214                  |                                       |
| Loans  | 151,792                      | -              | -              | 150,685        | 150,685                 |                                       |
| Notes receivable from other Farm Credit institutions | 10,000                       | -              | -              | 10,330         | 10,330                  |                                       |
| Other Assets   | \$ 162,006                   | \$ 214         | \$ -           | \$ 161,015     | \$ 161,229              |                                       |
| <b>Liabilities:</b>                                  |                              |                |                |                |                         |                                       |
| Notes payable to AgFirst Farm Credit Bank            | \$ 135,882                   | \$ -           | \$ -           | \$ 136,384     | \$ 136,384              |                                       |
| Other Liabilities                                    | \$ 135,882                   | \$ -           | \$ -           | \$ 136,384     | \$ 136,384              |                                       |

**NOTE 8 - ACCUMULATED OTHER COMPREHENSIVE INCOME**

| <b>Changes in Accumulated Other Comprehensive income by Component (a)</b> |                               |
|---|-------------------------------|
|   | <b>Employee Benefit Plans</b> |
| Balance at March 31, 2013   | \$ 299                        |
| Other comprehensive income before reclassifications                       | -                             |
| Amounts reclassified from AOCI  | 13                            |
| Net current period other comprehensive income                             | 13                            |
| Balance at June 30, 2013  | \$ 312                        |
| Balance at December 31, 2012  | \$ 286                        |
| Other comprehensive income before reclassifications                       | -                             |
| Amounts reclassified from AOCI  | 26                            |
| Net current period other comprehensive income                             | 26                            |
| Balance at June 30, 2013  | \$ 312                        |
| Balance at March 31, 2012   | \$ 295                        |
| Other comprehensive income before reclassifications                       | -                             |
| Amounts reclassified from AOCI  | 16                            |
| Net current period other comprehensive income                             | 16                            |
| Balance at June 30, 2012  | \$ 311                        |
| Balance at December 31, 2011  | \$ 279                        |
| Other comprehensive income before reclassifications                       | -                             |
| Amounts reclassified from AOCI  | 32                            |
| Net current period other comprehensive income                             | 32                            |
| Balance at June 30, 2012  | \$ 311                        |

|                                       | <b>Reclassifications Out of Accumulated Other Comprehensive Income (b)</b> |             |  |             | <b>Income Statement Line Item</b> |
|---------------------------------------|--|-------------|--|-------------|-----------------------------------|
|                                       | <b>For the three months ended June 30,</b>                                 |             | <b>For the six months ended June 30,</b> |             |                                   |
|                                       | <b>2013</b>  | <b>2012</b> | <b>2013</b>                              | <b>2012</b> |                                   |
| <b>Defined Benefit Pension Plans:</b> |  |             |  |             |                                   |
| Periodic pension costs                | \$ (13)  | \$ (16)     | \$ (26)                                  | \$ (32)     | See footnote 4.                   |
| Net amounts reclassified              | \$ (13)  | \$ (16)     | \$ (26)                                  | \$ (32)     |                                   |

(a) Amounts in parentheses indicate debits to AOCI.

(b) Amounts in parentheses indicate debits to profit/loss.

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## NOTE 9 – REGULATORY ENFORCEMENT MATTERS

As previously disclosed, on March 17, 2011 the Farm Credit Administration (FCA) entered into a written Supervisory Agreement (SA) with the Board of Directors of the Association. This agreement supersedes FCA Supervisory Letters dated July 23, 2009, March 2, 2010, and December 10, 2010 and incorporates certain requirements from these letters. The Supervisory Agreement requires the Board of Directors to take certain corrective and precautionary measures with respect to some Association practices, including board governance and operation, director fiduciary duties, nominating committee procedures, board policies, board business planning, Association earnings and liquidity, senior management and human capital development, internal audit and review, asset quality, allowance for loan losses and collateral risk management, and capital markets and participation activities. In addition, the SA prohibits the Association from distributing patronage-sourced income without FCA consent.

Conditions and events that led to the need for this agreement include portfolio credit quality deterioration, high turnover in senior management, perceived weaknesses in board governance, and, reduced earnings and liquidity.

The Board of Directors and the Association have worked together to reach several milestones. The regulator has provided the Board of Directors several interim progress reports on compliance with the SA and delivered an in person report of examination to the Board of Directors on June 13, 2012. The Association has achieved full compliance in 4 out of 17 items, substantial compliance in 8 out of 17 items and partial compliance in 5 out of 17 items. Some of the results achieved in compliance with the agreement include the following:

- Hiring a board consultant and continued work with the consultant to assist the Board in fulfilling its fiduciary duties and improving board operations and governance.
- Updating its board committee charters, undergoing several training sessions and changing leadership to improve governance of the Association.
- Revising the director candidate nominating procedures to qualify new candidates, which led to stockholders electing two new directors to the Board in 2012.
- Hiring a new CEO beginning on February 1, 2011 to lead the Association after the retirement of the previous CEO on June 30, 2010.
- Building a cohesive senior management team.
- Overseeing the implementation of updated collateral risk management policies and procedures that are in line with best practices in the industry.
- Improving the methodology used to calculate the Allowance for Loan Losses of the Association.
- Hiring a specialized third party auditor that assessed the capital markets portfolio credit risk and helped, strengthened credit policies and procedures.

- Establishing a Compliance Committee to monitor management's progress in implementing the corrective actions of items identified in the SA.
- Ensuring that FCA's recommendations are incorporated in the various action plans.
- Reviewing the Association's internal audit plan to focus on areas where perceived weaknesses were identified.
- Establishing a risk assessment process to assess risks and controls in the ACA.
- Establishing an asset quality improvement plan to monitor management efforts in managing high risk loans.
- Revising the 2011 business plan to establish strategic priorities and to comply with FCA regulations governing business planning.
- Establishing a human capital plan and succession plan to assist in the long-term success of the Association.
- Revising board policies on a quarterly basis to guide management in conducting day to day operations.
- Enhancing the participation's portfolio credit underwriting and administration controls.

All required measures have not been achieved or completed as of the date of this report and the Board of Directors continues to work with the management team in improving the areas identified in the Supervisory Agreement. Besides the ongoing corrective actions already mentioned, other actions to be taken target the following areas.

- Continue execution of strategies for growing the Association's loan portfolio with high quality loans to improve asset quality and, enhance earnings and liquidity.
- Strengthening stress-testing capabilities and continuing execution of collateral risk management practices.

The Board of Directors will continue engaging a board consultant to provide advice in understanding and fulfilling its fiduciary responsibilities and to perform other advisory functions as specified in the agreement. Both the Board of Directors and Senior Management are committed to continuing the administration of the Association in a sound manner, compliant with all FCA Regulations.

The Association remained under written supervisory agreement as of the date of this report.

## NOTE 10 – SUBSEQUENT EVENTS

The Association has evaluated subsequent events and has determined there are none requiring disclosure through August 7, 2013, which is the date the financial statements were issued.