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*Farm Credit of the Virginias, ACA*  
***SECOND QUARTER 2002***

Management's Discussion and Analysis of  
Financial Condition and Results of Operations .....2

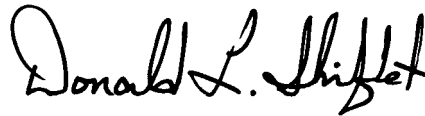
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Donald L. Shiflet  
Chief Executive Officer



Paul House  
Chairman of the Board

July 29, 2002

# 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 Farm Credit of the Virginias, ACA (Association) for the period ended June 30, 2002. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements and the 2001 Annual Report of the Association.

## **LOAN PORTFOLIO**

The Association provides funds to farmers, rural homeowners and farm-related businesses for financing of short and intermediate-term loans and long-term real estate mortgage loans. The Association's loan portfolio is diversified over a range of agricultural commodities in our region, including livestock, poultry and field crops. Farm size varies and many of the borrowers in the region have diversified farming operations. This factor, along with the numerous opportunities for non-farm income in the area, somewhat impacts the level of dependency on a given commodity.

The gross loan volume of the Association as of June 30, 2002, was \$962,287, an increase of \$59,732 as compared to \$902,555 at December 31, 2001. During the past six months, loan volume has increased primarily due to the continued strong demand in loans. With interest rates remaining at 30 year historical lows, the demand for loans has continued at a strong pace. Net loans outstanding at June 30, 2002, were \$938,987 as compared to \$880,455 at December 31, 2001. Net loans were 96.36 percent of total assets at June 30, 2002.

There is an inherent risk in the extension of any type of credit. Portfolio credit quality continues to be maintained at an acceptable level, however, and credit administration remains satisfactory. Nonaccrual loans increased from \$1,933 at December 31, 2001, to \$3,021 at June 30, 2002. This increase was primarily the result of several loans being downgraded to nonaccrual status.

Association management maintains an allowance for loan losses in an amount considered sufficient to absorb possible losses in the loan portfolio based on current and expected future conditions. The Association made a \$1,223 addition to the allowance for loan losses during the six months ended June 30, 2002. The addition was

mainly due to an increase in portfolio risk as the economy continued to show some weakness and an increase in loan volume. The allowance for loan losses at June 30, 2002, was \$23,300 compared to \$22,100 at December 31, 2001, and was considered by management to be adequate to cover possible losses.

## **RESULTS OF OPERATIONS**

### *For the three months ended June 30, 2002*

Net income for the three months ended June 30, 2002, totaled \$3,087, as compared to \$8,808 for the same period in 2001, a decrease of \$5,721. The decrease in net income for the second quarter 2002, was primarily due to the recognition last year of the refund of federal income tax and interest on the refund as a result of the IRS tax settlement, the decrease in net interest income and higher noninterest expense.

Net interest income decreased \$915, for the three months ended June 30, 2002, as compared to the same period in 2001. The decrease in net interest income was mainly due to lower interest rates on the Association's loan portfolio. Although the Association experienced growth in loan volume exceeding 13 percent when compared to the second quarter of 2001, the historical low interest rates have resulted in reducing the Association's earnings on its lendable capital.

Noninterest income for the three months ended June 30, 2002, totaled \$1,759, as compared to \$2,853 for the same period of 2001, a decrease of \$1,094. The decrease was primarily due to the recognition last year of interest on the IRS tax refund of \$1,250.

Noninterest expense for the three months ended June 30, 2002 totaled \$3,094. This was an increase of \$625 compared to the same period of 2001. The primary reason for increase was higher salaries and employee benefits expense and insurance fund premiums.

The Association recognized a provision for income taxes for the three months ended June 30, 2002 totaling \$10, as compared to a tax benefit of \$2,995 during the same period last year. Last year's income tax benefit was primarily due to the refund of federal income taxes from the IRS tax settlement.

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***For the six months ended June 30, 2002***

Net income for the six months ended June 30, 2002, totaled \$6,326, as compared to \$9,293 for the same period in 2001, a decrease of \$2,967. The decrease was mainly due to:

- ◆ a decrease in net interest income
- ◆ an increase in the provision of loan losses, and
- ◆ the recognition in 2001 of the tax refund and interest on the refund from the IRS tax settlement.

Net interest income decreased \$1,928, for the six months ended June 30, 2002, as compared to the same period in 2001. The decrease in net interest income was due primarily to the historical low interest rates in 2002, which resulted in reducing the Association's earnings on its lendable capital as compared to the first six months last year.

The Association recorded a provision for loan losses of \$1,223 for the six months ended June 20, 2002, compared to a provision of \$638 for the same period last year, an increase of \$585.

Noninterest income for the six months ended June 30, 2002, totaled \$3,492, as compared to \$4,327 for the same period of 2001, a decrease of \$835. The decrease was due primarily to a decrease in miscellaneous income of \$1,220. The decrease in miscellaneous income was due to the accrual during last year of the estimated interest income on the refund of federal income tax from IRS tax settlement.

Noninterest expense for the six months ended June 30, 2002, decreased \$2,651 compared to the same period of 2001. The primary reason for decrease was the merger-related expenses of \$3,571 recorded in 2001. There were no merger-related expenses recorded during the period for 2002. Without the merger-related expenses, noninterest expense increased \$920. The increase was mainly due to increases in salaries and employee benefits and insurance fund premium.

The Association recognized a provision for income taxes for the six months ended June 30, 2002 totaling \$10, as compared to a tax benefit of \$2,260 during the same period last year. Last year's tax benefit was due to the accrual of the refund on federal income taxes from the IRS tax settlement.

**FUNDING SOURCES**

The principal source of funds for the Association is the borrowing relationship established with AgFirst Farm Credit Bank (the Bank) through a General Financing Agreement. The General Financing Agreement utilizes the Association's credit and fiscal performance as criteria for establishing a line of credit on which the Association

may draw funds. The Bank advances the funds to the Association in the form of notes payable. The notes payable are segmented into variable rate and fixed rate sections. The variable rate note is utilized by the Association to fund variable rate loan advances and operating funds requirements. The fixed rate note is used specifically to fund fixed rate loan advances made by the Association. The total notes payable to the Bank at June 30, 2002, was \$796,524 as compared to \$737,512 at December 31, 2001. The increase during the period is primarily attributed to the increase in loan volume.

**CAPITAL RESOURCES**

Total members' equity at June 30, 2002 totaled \$164,125, an increase of \$7,455, as compared to \$156,670 at December 31, 2001. The increase in members' equity was primarily attributed to earnings.

Farm Credit Administration (FCA) regulations require all Farm Credit institutions to maintain minimum permanent capital, total surplus and core surplus ratios. These ratios are calculated by dividing the Association's permanent capital, total surplus and core surplus as defined in FCA regulations, by a risk-adjusted asset base. As of June 30, 2002, the Association's permanent capital ratio was 15.76 percent, total surplus ratio was 13.46 percent and core surplus ratio was 10.52 percent. All three ratios were well above the minimum regulatory ratios of 7.00 percent for permanent capital and total surplus ratios and 3.50 percent for the core surplus ratio.

**IRS TAX SETTLEMENT**

As previously disclosed in the 2001 Annual Report of the Association, Farm Credit System Agricultural Credit Associations (ACA) entered into a settlement process with the IRS to resolve conclusively the status of all claimed refunds and the ongoing tax status of the ACA using another ACA as a model. In August 2000, the model ACA reached a settlement agreement with the IRS, which established the collectibility of a portion of the claimed refunds of taxes previously paid, plus interest, related to income earned in prior years from the mortgage lending activities of the ACA. This agreement also confirmed that all income generated by an ACA will be taxable in future periods. However, an ACA may reorganize to operate their long-term mortgage lending activities through a newly created FLCA subsidiary and their short- and intermediate-term lending activities through a newly created PCA subsidiary. Income earned by the FLCA subsidiary is exempt from taxation. The Association reorganized in such a manner effective January 1, 2001. As a result, the Association recognized \$4,113 in tax refunds and \$1,834 of interest on those refunds in 2001.

*Farm Credit of the Virginias, ACA*  
**Consolidated Balance Sheets**

<i>(dollars in thousands)</i>	<b>June 30, 2002</b>	<b>December 31, 2001</b>
	<i>(unaudited)</i>	
<b>Assets</b>		
Cash	\$ 8	\$ 538
Loans	962,287	902,555
Less: allowance for loan losses	23,300	22,100
Net loans	938,987	880,455
Accrued interest receivable	8,572	6,386
Investment in AgFirst Farm Credit Bank	17,873	17,873
Premises and equipment, net	3,811	3,873
Deferred tax asset, net	25	13
Other assets	5,138	7,138
Total assets	\$ 974,414	\$ 916,276
<b>Liabilities</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 796,524	\$ 737,512
Accrued interest payable	4,025	3,831
Patronage refund payable	9	9,886
Postretirement benefits other than pensions	3,961	3,771
Other liabilities	5,770	4,606
Total liabilities	810,289	759,606
Commitments and contingencies		
<b>Members' Equity</b>		
Capital stock and participation certificates	20,931	21,580
Retained earnings		
Allocated	57,122	55,329
Unallocated	86,072	79,761
Total members' equity	164,125	156,670
Total liabilities and members' equity	\$ 974,414	\$ 916,276

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

*Farm Credit of the Virginias, ACA*  
**Consolidated Statements of Income**  
*(unaudited)*

<i>(dollars in thousands)</i>	<b>For the three months ended June 30,</b>		<b>For the six months ended June 30,</b>	
	<b>2002</b>	<b>2001</b>	<b>2002</b>	<b>2001</b>
<b>Interest Income</b>				
Loans	\$ 16,084	\$ 17,562	\$ 31,695	\$ 34,817
<b>Interest Expense</b>				
Notes payable to AgFirst Farm Credit Bank	11,029	11,592	21,766	22,960
Net interest income	5,055	5,970	9,929	11,857
Provision for (reversal of) loan losses	623	541	1,223	638
Net interest income after provision for (reversal of) loan losses	4,432	5,429	8,706	11,219
<b>Noninterest Income</b>				
Loan fees	245	273	486	417
Fees for financially related services	15	18	33	39
Equity in earnings of AgFirst Farm Credit Bank	1,475	1,303	2,864	2,542
Miscellaneous	24	1,259	109	1,329
Total noninterest income	1,759	2,853	3,492	4,327
<b>Noninterest Expense</b>				
Salaries and employee benefits	2,110	1,607	4,050	3,352
Occupancy and equipment	236	225	452	459
Insurance Fund premium	71	—	140	—
Other operating expenses	677	611	1,220	1,131
Merger-related expenses	—	26	—	3,571
Total noninterest expense	3,094	2,469	5,862	8,513
Income before income taxes	3,097	5,813	6,336	7,033
Provision (benefit) for income taxes	10	(2,995)	10	(2,260)
Net income	\$ 3,087	\$ 8,808	\$ 6,326	\$ 9,293

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

*Farm Credit of the Virginias, ACA*

# Consolidated Statements of Changes in Members' Equity

(unaudited)

<i>(dollars in thousands)</i>	Capital	<u>Retained Earnings</u>		Total Members' Equity
	Stock and Participation Certificates	Allocated	Unallocated	
Balance at December 31, 2000	\$ 23,874	\$ 55,994	\$ 76,870	\$ 156,738
Net income			9,293	9,293
Capital stock/participation certificates issued	491			491
Capital stock/participation certificates retired	(1,198)			(1,198)
Retained earnings retired		(84)		(84)
Distribution adjustment		(1)	(1)	(2)
Balance at June 30, 2001	<u>\$ 23,167</u>	<u>\$ 55,909</u>	<u>\$ 86,162</u>	<u>\$ 165,238</u>
Balance at December 31, 2001	\$ 21,580	\$ 55,329	\$ 79,761	\$ 156,670
Net income			6,326	6,326
Capital stock/participation certificates issued	627			627
Capital stock/participation certificates retired	(1,276)			(1,276)
Retained earnings retired		(15)		(15)
Distribution adjustment		1,808	(15)	1,793
Balance at June 30, 2002	<u>\$ 20,931</u>	<u>\$ 57,122</u>	<u>\$ 86,072</u>	<u>\$ 164,125</u>

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

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*Farm Credit of the Virginias, ACA*

# Notes to the Consolidated Financial Statements

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

## **NOTE 1 — ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES**

A description of the organization and operations of Farm Credit of the Virginias, ACA (the Association), the significant accounting policies followed, and the financial condition and results of operations as of and for the year ended December 31, 2001, are contained in the 2001 Annual Report to Stockholders. These unaudited second quarter 2002 consolidated financial statements should be read in conjunction with the 2001 Annual Report to Stockholders.

As disclosed in the 2001 Annual Report, pursuant to a plan of restructuring approved by the Farm Credit Administration and Association shareholders, the Association reorganized its corporate structure effective January 1, 2001. Pursuant to this restructuring, a Federal Land Credit Association (FLCA) and Production Credit Association (PCA) were formed as wholly owned subsidiaries of the Association. The formation of these subsidiaries enables the Association to take advantage of the tax-exempt status of long-term mortgage interest for loans held by the FLCA. This restructuring was accounted for as a reorganization of entities under common control similar to a pooling of interests.

Prior to the restructuring, the Association was subject to federal and state income tax. As a result of the restructuring, long-term lending activity has been separated into a wholly owned FLCA subsidiary which is exempt from federal and state income tax. The ACA, which is the holding company, along with the wholly owned PCA subsidiary, will continue to be subject to income tax.

The accompanying consolidated financial statements contain all adjustments necessary for a fair presentation of the interim financial condition and results of operations and conform with generally accepted accounting principles. The results for the six months ended June 30, 2002, are not necessarily indicative of the results to be expected for the year ending December 31, 2002.

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

The Association maintains an allowance for loan losses in accordance with generally accepted accounting principles. The loan portfolio is reviewed quarterly to determine the adequacy of the allowance for losses. As of June 30, 2002, the allowance for losses is adequate in management's opinion to provide for possible losses on existing loans.

## **NOTE 2 — ALLOWANCE FOR LOAN LOSSES**

An analysis of the allowance for loan losses follows:

Balance at 12-31-00	\$20,400
(Reversal of) provision for loan losses	638
Recoveries, net of loans charged off	<u>62</u>
Balance at 6-30-01	<u>\$21,100</u>
Balance at 12-31-01	\$22,100
(Reversal of) provision for loan losses	1,223
Loans (charged off), net of recoveries	<u>(23)</u>
Balance at 6-30-02	<u>\$23,300</u>