
FARM CREDIT OF THE VIRGINIAS, ACA

2003 ANNUAL REPORT

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Management

David L. Lawrence.....	President and Chief Executive Officer
C. McCheyne Swartzel	Chief Lending Officer
David G. Sauer	Chief Financial Officer

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Ronald L. Bennett	Director
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Joseph W. Wampler	Director
John E. Wells	Director

Message from the Chief Executive Officer

I am pleased to bring a report to you that supports the fact that your directors and management team have remained focused on increasing stockholder value by not only offering competitive rates, but also providing you a good return on your investment through the cash rebate program. No other lender puts its profits in your pocket like Farm Credit of the Virginias.

For Farm Credit of the Virginias, 2003 was another very successful year. Net Income for the year totaled \$18.4 million for a return on assets of 1.73 percent and a return on equity of 11.69 percent. It is difficult to imagine interest rates at the current historic low levels for the past three years. Because the association operates as a cooperative, it has been able to pass the low cost of funds on to our customers. Additionally, because of the relatively low cost structure, sound loan quality, and solid earnings, the Association has paid to the customers/stockholders a cash rebate in the aggregate amount of \$26 million during the past three years. As in the previous years, the customers/stockholders who were active borrowers during 2003 are receiving checks that amount to approximately 12 percent of the interest accrued on their loans.

The annual report is comprised of numbers and in-depth explanations of our 2003 financial results and how they were achieved. We've seen major business collapses at companies while integrity and ethical behavior came under intense scrutiny as a result of decisions made during the decade of the "90s." The result is a new regulatory environment and new legislation. The Sarbanes-Oxley Act has placed new requirements on publicly traded corporations. While Farm Credit of the Virginias is not a publicly traded corporation and not directly subject to Sarbanes-Oxley, we are voluntarily complying with as many of the requirements as are appropriate for our cooperative business structure.

In 2003 and beyond, our focus remains on three top priorities. The first is fostering an aggressive sale and marketing culture with exceptional customer service. The second is ensuring strong profitability through efficient operations, appropriate pricing, and sound financial planning. The third is to maintain a sound credit quality culture through effective credit administration, clear policy and procedural direction, and strong controls.

Being your "Lender of Choice" is our goal. Please do not hesitate to bring all of your credit needs to us and tell others to do so as well. Additional customers only make your Farm Credit and Country Mortgages stronger!



David L. Lawrence
Chief Executive Officer

February 19, 2004

Report of Management

The accompanying consolidated financial statements and related financial information appearing throughout this annual report have been prepared by management of Farm Credit of the Virginias, ACA (the Association) in accordance with generally accepted accounting principles appropriate in the circumstances. Amounts which must be based on estimates represent the best estimates and judgments of management. Management is responsible for the integrity, objectivity, consistency, and fair presentation of the consolidated financial statements and financial information contained in this report.

Management maintains and depends upon an internal accounting control system designed to provide reasonable assurance that transactions are properly authorized and recorded, that the financial records are reliable as the basis for the preparation of all financial statements, and that the assets of the Association are safeguarded. The design and implementation of all systems of internal control are based on judgments required to evaluate the costs of controls in relation to the expected benefits and to determine the appropriate balance between these costs and benefits. The Association maintains an internal audit program to monitor compliance with the systems of internal accounting control. Audits of the accounting records, accounting systems and internal controls are performed and internal audit reports including appropriate recommendations for improvement, are submitted to the Board of Directors.

The consolidated financial statements have been examined by independent public auditors, whose report appears elsewhere in this annual report. The Association is also subject to examination by the Farm Credit Administration.

The consolidated financial statements, in the opinion of management, fairly present the financial condition of the Association. The undersigned certify that the 2003 Annual Report has been prepared in accordance with all applicable statutory or regulatory requirements and that the information contained herein is true, accurate, and complete to the best of our knowledge and belief.



Wallace W. Sanford, III
Chairman of the Board



David L. Lawrence
Chief Executive Officer



David G. Sauer
Chief Financial Officer

February 19, 2004

Consolidated Five - Year Summary of Selected Financial Data

(UNAUDITED)

<i>(dollars in thousands)</i>	2003	2002	December 31, 2001	2000	1999
Balance Sheet Data					
Cash	\$ 32	\$ 665	\$ 538	\$ 2,567	\$ 276
Loans	1,069,137	1,022,513	902,555	768,278	727,062
Less: allowance for loan losses	23,302	24,505	22,100	20,400	19,472
Net loans	1,045,835	998,008	880,455	747,878	707,590
Investment in AgFirst Farm Credit Bank	13,981	15,306	17,873	20,250	19,522
Other property owned	85	—	—	—	598
Other assets	17,959	17,577	17,410	18,960	17,238
Total assets	<u>\$ 1,077,892</u>	<u>\$ 1,031,556</u>	<u>\$ 916,276</u>	<u>\$ 789,655</u>	<u>\$ 745,224</u>
Notes payable to AgFirst Farm Credit Bank*	\$ 890,426	\$ 847,329	\$ 737,512	\$ 617,781	\$ 577,092
Accrued interest payable and other liabilities with maturities of less than one year	35,956	33,569	22,094	15,136	16,561
Total liabilities	<u>926,382</u>	<u>880,898</u>	<u>759,606</u>	<u>632,917</u>	<u>593,653</u>
Capital stock and participation certificates	19,735	20,469	21,580	23,874	25,712
Retained earnings					
Allocated	58,345	57,904	55,329	55,994	48,634
Unallocated	78,727	78,146	79,761	76,870	77,225
Accumulated other comprehensive income (loss)	(5,297)	(5,861)	—	—	—
Total members' equity	<u>151,510</u>	<u>150,658</u>	<u>156,670</u>	<u>156,738</u>	<u>151,571</u>
Total liabilities and members' equity	<u>\$ 1,077,892</u>	<u>\$ 1,031,556</u>	<u>\$ 916,276</u>	<u>\$ 789,655</u>	<u>\$ 745,224</u>
Statement of Income Data					
Net interest income	\$ 24,051	\$ 21,664	\$ 23,126	\$ 23,301	\$ 21,123
Provision for (reversal of) loan losses	1,180	2,435	1,643	1,000	801
Noninterest income (expense), net	(4,422)	(3,999)	(3,413)	(5,170)	(4,691)
Net income	<u>\$ 18,449</u>	<u>\$ 15,230</u>	<u>\$ 18,070</u>	<u>\$ 17,131</u>	<u>\$ 15,631</u>
Key Financial Ratios					
Rate of return on average:					
Total assets	1.73%	1.56%	2.12%	2.28%	2.11%
Total members' equity	11.69%	9.30%	11.15%	10.84%	10.21%
Net interest income as a percentage of average earning assets	2.29%	2.25%	2.76%	3.12%	2.88%
Net chargeoffs (recoveries) to average loans	0.224%	0.003%	(0.007)%	0.010%	0.013%
Total members' equity to total assets	14.06%	14.60%	17.10%	19.85%	20.34%
Debt to members' equity (:1)	6.11	5.85	4.85	4.04	3.92
Allowance for loan losses to loans	2.18%	2.40%	2.45%	2.66%	2.68%
Permanent capital ratio	14.11%	14.70%	17.37%	19.14%	19.68%
Total surplus ratio	12.19%	12.58%	14.65%	15.04%	15.54%
Core surplus ratio	9.78%	9.12%	11.13%	12.31%	12.91%
Net Income Distribution					
Estimated patronage refunds:					
Cash dividend	\$ 8,010	\$ 8,415	\$ 9,845	\$ 5,244	\$ 4,535
Qualified allocated surplus	—	—	—	12,237	10,880
Nonqualified retained surplus	9,790	8,415	5,333	—	—

* General financing agreement is renewable on two-year cycles. The next renewal date is December 31, 2004.

Management's Discussion & Analysis of Financial Condition & Results of Operations

(dollars in thousands, except as noted)

The following commentary reviews the consolidated financial condition and results of operations of Farm Credit of the Virginias, ACA (Association) for the years ended December 31, 2003 and December 31, 2002. This information should be read in conjunction with the consolidated financial statements, notes to the consolidated financial statements and other sections in this annual report.

The Association covers a large and diverse territory. The territory covers the majority of West Virginia, the western portion of Virginia, and two counties in western Maryland. Given the size and diversity of the area covered by the Association, the economy, in general, has been favorable. Positive influences on the economy continued to be the low interest rates, the continued strength in employment levels and the growth in population. These positive influences continued to fuel the demand for land and housing in 2003. The agricultural economy remained resilient even with a severe drought of 2002 followed by an abundance rainfall during 2003. The wet weather made it very difficult for farmers to work their fields. The wet weather also negatively affected hay production and the quality of forage.

Of the major agricultural commodities served by the Association, most experienced a typical year. The local poultry industry recovered from the outbreak of avian flu and remained relatively stable. The poultry integrators were profitable and the consumer demand for poultry products increased slightly. The dairy industry continued to experience declines in milk prices. This was the second straight year of declining milk prices. The timber industry has also experienced a decline in market prices over the past several years. The cattle industry was an exception where prices hit record highs during the fall of 2003. Cattle prices are uncertain for 2004, with the discovery of the first case of bovine spongiform encephalopathy (mad cow) disease in the United States in December. As in most industries, agricultural and timber enterprises continue to implement productivity improvements to reduce the cost of production as a means to increase profitability. For the farm economy as a whole, sizable government payments continue to help strengthen the gross agriculture income for most of the agriculture sectors.

There have been few changes in our market base over the past year. The Association continues to look for opportunities such as buying loan participations. During 2003, the Association continued to target certain segments of our business with hopes of increasing market share. We continued to place greater emphasis on sales and marketing. We saw gains in the housing loan market since we introduced more options such as selling loans into the secondary market. Continued efforts are being made to expand services, increase public knowledge of our services and streamline our current delivery of products to

enhance our existing portfolio. Our members recognize the benefits of our patronage program, which reduces their borrowing costs by sharing in the Association's profits. As a result of these efforts, the Association continued to experience increased loan volume throughout its territory.

LOAN PORTFOLIO

The Association provides funds to farmers, rural homeowners, and farm-related businesses for financing of short and intermediate-term loans and long-term real estate mortgage loans. The geographic distribution of the loans is as follows:

Branch	12/31/03	12/31/02
Abingdon, Va	4%	4%
Bedford, Va	2	2
Charlottesville, Va	4	4
Chatham, Va	2	2
Clarksburg, Wv	3	3
Culpeper, Va	6	7
Elkins, Wv	4	4
Gate City, Va	2	2
Halifax, Va	2	2
Harrisonburg, Va	14	13
Leesburg, Va	8	8
Lewisburg, Wv	2	2
Lexington, Va	3	3
Oakland, Md	2	2
Orange, Va	5	5
Petersburg, Wv	4	4
Ripley, Wv	3	3
Roanoke, Va	2	1
Rocky Mount, Va	4	3
Romney, Wv	1	1
Verona, Va	6	6
Warrenton, Va	9	9
Wytheville, Va	4	4
Agribusiness	1	3
Participation Loans Purchased	6	5
Participation Loans Sold	(3)	(2)
	<u>100%</u>	<u>100%</u>

The diversification of the Association loan volume by type is shown below:

Loan Type	12/31/03	12/31/02
Long-term farm mortgage	66.8%	65.1%
Production and intermediate-term	19.7	20.7
Rural home	4.5	4.8
Farm-related business	.7	.9
Processing and marketing	4.0	4.0
Nonaccrual	.7	1.0
Participation loans purchased	6.2	5.1
Less: participation loans sold	(2.6)	(1.6)
	<u>100.0%</u>	<u>100.0%</u>

Predominant commodities in the portfolio are livestock, timber and field crops, which constitute 60 percent of the entire portfolio. Please refer to Note 3 in the Notes to the Consolidated Financial Statements section of this annual report for additional information concerning the loan type and loan portfolio.

The gross loan volume of the Association as of December 31, 2003, was \$1,069,137, an increase of \$46,624 or 4.56 percent as compared to \$1,022,513 at December 31, 2002. Net loans outstanding on December 31, 2003, were \$1,045,835 as compared to \$998,008 at December 31, 2002. Net loans accounted for 97.03 percent of total assets on December 31, 2003 as compared to 96.75 percent of total assets at December 31, 2002.

The increase in both gross and net loan volume during the reporting period was primarily attributed to the continued demand in long-term real estate mortgage loans as interest rates dropped during the first half of the year. The interest rates have remained low in response to the low inflation rate and the Federal Reserve maintaining the federal funds rates at historical low levels. Long-term interest rates began to move higher during the summer and fall, which slowed the loan origination and refinancing activity. In addition to the low interest rates, loan activity was also spurred on by the Association's ability to offer competitive loan products that meet members' credit needs and by an increased emphasis on marketing and customer service.

During 2003, the Association increased activity in the buying of loan participations within and outside of the Farm Credit System (FCS). This provides a means for the Association to spread credit concentration risk and realize non-patronage sourced interest and fee income, which may strengthen its capital position. In 2002, the Association joined three other Farm Credit Associations in the AgFirst District to form AgriCapital Group. The AgriCapital Group was formed so the Associations could pool their purchasing power when dealing with financial institutions that have large participation loans they want to sell. The Association buys the loans and sells an agreed amount to the other members of the AgriCapital Group. As of December 31, 2003, the Association had \$63,376 in participation loans purchased from other FCS institutions and \$2,864 participation loans purchased from non-FCS institutions, offset by \$27,601 in participation loans sold.

The Association sells qualified long-term mortgage loans into the secondary market. For the period ended December 31, 2003, the Association originated loans for resale totaling \$57,490 that were sold into the secondary market as compared to \$48,314 during 2002.

The Association's loan portfolio is divided into performing and high-risk categories. The high-risk assets, including accrued interest, are detailed below:

	<u>12/31/03</u>	<u>12/31/02</u>
High-risk Assets		
Nonaccrual loans	\$ 7,955	\$ 10,351
Restructured loans	20	24
Accruing loans 90 days past due	14	2,045
Total high-risk loans	<u>7,989</u>	<u>12,420</u>
Other property owned	85	—
Total high-risk assets	<u>\$ 8,074</u>	<u>\$ 12,420</u>
Ratios		
Nonaccrual loans to total loans	0.74%	1.01%
High-risk assets to total assets	0.75%	1.21%

Nonaccrual loans decreased \$2,396, or 23.15 percent in 2003. The decrease was primarily due to charge-offs taken on several loans, fewer loans being downgraded to nonaccrual status, and increased collection effort including using an outside collection agency.

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

There is an inherent risk in the extension of any type of credit. Association management analyzes credit quality, loan performance, concentration, and other forms of risk, maintaining an allowance for loan losses in an amount sufficient to absorb possible losses in the loan portfolio based on current and expected future conditions. The Association made an addition of \$1,180 to the allowance for loan losses in 2003, primarily due to risk associated with the continued low commodity prices in several of the agricultural sectors. Charge-offs for the period ended December 31, 2003 amounted to \$2,438 and recoveries of past charge-offs amounted to \$55. The ratio of net charge-offs to average loans was 0.224 percent at December 31, 2003. The allowance for loan losses at December 31, 2003 was \$23,302, which was 2.18 percent of total loans outstanding and was considered by management to be adequate to cover possible losses. Please refer to Note 2 in the Notes to the Consolidated Financial Statements of this Annual Report for further information concerning the allowance for loan losses.

In June 2003, the American Institute of Certified Public Accountants' Accounting Standards Executive Committee (AcSEC) issued a proposed Statement of Position (SOP) – Allowance for Credit Losses, which was intended to clarify the methodology for estimating the allowance for credit losses and to enhance financial statement disclosures related to the allowance for credit losses. In January 2004, AcSEC dropped its proposed SOP and announced that it would focus instead on improving financial statement disclosures in this area.

System institutions plan to conduct studies to further refine their methodologies, including what are currently acceptable and permissible under generally accepted accounting principles, focusing specifically on the Securities and Exchange Commission and Federal Financial Institutions Examination Council guidelines. Such a study would likely be completed by the fourth quarter of 2004 with any appropriate changes to the allowance for loan losses implemented at that time.

RESULTS OF OPERATIONS

Net income for the year ended December 31, 2003, totaled \$18,449, an increase of \$3,219 or 21.14 percent, as compared to \$15,230 for the same period of 2002. Interest income for the year ended December 31, 2003, was \$64,384, a decrease of \$513 or 0.79 percent as compared to \$64,897 for the same period of 2002. Interest expense also decreased by \$2,900 for the period ended December 31, 2003. Major components of the changes in net income for the past two years are outlined in the following table.

Changes in Net Income:

	<u>2003-2002</u>	<u>2002-2001</u>
Net income (prior year)	\$ 15,230	\$ 18,070
Increase (decrease) in net income due to:		
Interest income	(513)	(3,603)
Interest expense	2,900	2,141
Net interest income	2,387	(1,462)
Provision for loan losses	1,255	(792)
Noninterest income	1,388	319
Noninterest expense	(2,467)	1,858
Provision for income taxes	656	(2,763)
Total changes in income	<u>3,219</u>	<u>(2,840)</u>
Net income	<u>\$ 18,449</u>	<u>\$ 15,230</u>

Net interest income increased by \$2,387 or 11.02 percent in 2003 as compared to 2002. The primary reasons for this increase was an increase in interest margin on loans and growth in loan volume. Interest income on nonaccrual loans for the twelve months ended December 31, 2003, totaled \$199, an increase of \$32, compared to \$167 during the previous year. Please refer to the Five-Year Summary of Selected Financial Data in this annual report to review key financial ratios pertaining to earnings and net interest income. The sources of change in net interest income are illustrated, as follows:

Change in Net Interest Income:

	<u>Volume*</u>	<u>Rate</u>	<u>Nonaccrual Income</u>	<u>Total</u>
12/31/03 - 12/31/02				
Interest income	\$ 5,920	\$ (6,465)	\$ 32	\$ (513)
Interest expense	4,989	(7,889)	—	(2,900)
Change in net interest income	<u>\$ 931</u>	<u>\$ 1,424</u>	<u>\$ 32</u>	<u>\$ 2,387</u>
12/31/02 - 12/31/01				
Interest income	\$ 6,503	\$ (9,777)	\$ (329)	\$ (3,603)
Interest expense	5,249	(7,390)	—	(2,141)
Change in net interest income	<u>\$ 1,254</u>	<u>\$ (2,387)</u>	<u>\$ (329)</u>	<u>\$ (1,462)</u>

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

Noninterest income for the period ended December 31, 2003, totaled \$9,838, an increase of \$1,388, or 16.43 percent, as compared to \$8,450 for 2002. The increase in noninterest income was primarily attributed to increases in income received from AgFirst Farm Credit Bank (Bank) of \$697 and in loan fees of \$623. The Association received \$6,682 in a patronage refund and \$936 in a special distribution from the Bank for the twelve months ended December 31, 2003 as compared to \$5,993 in a patronage refund and \$928 in a special distribution during 2002. The increase in loans fees was primarily due to fees earned on loans sold into the secondary market.

Noninterest expense increased \$2,467, or 20.51 percent for the twelve months ended December 31, 2003, as compared to the same period of 2002. The increase was primarily attributed to increases in the salaries and employee benefits of \$1,268 and an increase in the premium paid to the FCS Insurance Fund of \$977. Employee salaries, which included performance based incentives, increased \$317 or 4.94 percent. Employee benefits which include retirement expense and post-retirement healthcare expense saw a large increase over the past two years. The retirement expense as of December 31, 2003 was \$1,325 compared to \$837 the prior year. The retirement expense has increased over the last two years primarily as the result of the decline in market value of the invested plan assets. The amount of retirement funding and expense is determined by overall plan performance, which is measured as of September 30th of each year. Increasing healthcare expense and lower discount rates had a similar impact on post-retirement healthcare expense which increased to \$970 for 2003 from \$675 in 2002. In 2002, the Association adopted changes in benefits plans in an effort to moderate future increases.

The Association recorded a benefit for income taxes of \$238 for the twelve months ended December 31, 2003, compared to a provision of \$418 for the same period in 2002.

A key factor in the growth of net income for future years will be continued improvement in net interest and noninterest income. Our goal is to generate earnings sufficient to fund operations, adequately capitalize the Association, and achieve an adequate rate of return for our members. To meet this goal, the Association must attract and maintain high quality loan volume priced at competitive rates and manage credit risk in our entire portfolio, while efficiently meeting the credit needs of our members.

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 Bank advances the funds to the Association, creating notes payable to the Bank. 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 December 31, 2003, were \$890,426 as compared to \$847,329 at December 31, 2002. The increase of 5.09 percent during the period is mainly attributable to the increase in loan volume.

Funds Management

The Bank and the Association manage assets and liabilities to provide a broad range of loan products and funding options, which will permit the Association to be competitive in all interest rate environments. The primary objective of the asset/liability management process is to provide stable and rising earnings, while maintaining adequate capital levels by managing exposure to credit and interest rate risks.

Demand for loan types is a driving force in establishing a funds management strategy. The Association offers fixed, adjustable and variable rate loan products that are marginally priced according to financial market rates. Variable rate loans may be indexed to either the Prime Rate or the 90-day London Interbank Offered Rate (LIBOR). Adjustable rate mortgages are indexed to U.S. Treasury Rates. Fixed rate loans are priced based on the current cost of Farm Credit debt of similar terms to maturity.

The Association's net interest income as a percentage of average earning assets (net interest margin) was 2.29 percent on December 31, 2003, compared to 2.25 percent on December 31, 2002. The increase is mainly attributed to increased margin on loans.

The majority of the interest rate risk in the Association balance sheet is transferred to the Bank through the notes payable structure. The Bank, in turn, actively utilizes funds management techniques to identify, quantify and control risk associated with the loan portfolio.

CAPITAL RESOURCES

Total members' equity at December 31, 2003, increased 0.57 percent to \$151,510, from the December 31, 2002, total of \$150,658. The Association continued to return members' equity to its members through the cash patronage program (cash interest rebate), retirement of qualified allocated surplus and retirement of stock. A total of \$20,083 in members' equity was returned to members in cash during 2003. This included \$8,413 in cash interest rebate, \$9,383 in 1997 qualified allocated surplus and \$2,287 in capital stock and participation certificates. It will be a challenge for the Association to continue to return this level of members' equity in future years. As a result, it may be necessary to extend the revolvement cycle of the remaining three years of qualified allocated surplus.

With the implementation of the holding company structure, the Association changed its patronage refund so a higher percentage was paid in cash. The Association issued nonqualified retained allocated earnings instead of qualified allocated surplus. The allocation of nonqualified retained allocated earnings is not taxable income to members so they will not incur a tax liability. The nonqualified retained allocated surplus will remain as permanent members' equity in the Association.

Total capital stock and participation certificates were \$19,735 on December 31, 2003, compared to \$20,469 on December 31, 2002. This 3.59 percent decrease is attributed to the refund of stock as loans are paid in full and lower stock requirement on new loans. The Association's Consolidated Statement of Changes in Members Equity reflects a comprehensive loss resulting from the underfunded status of the AgFirst Farm Credit District's defined benefit retirement plan for the years ended December 31, 2003 and December 31, 20002. See further discussion about this comprehensive loss in Note 9 to the Consolidated Financial Statements.

The Association's permanent capital ratio as of December 31, 2003 was 14.11 percent compared to 14.70 percent on December 31, 2002. Farm Credit Administration (FCA) regulations require all Farm Credit institutions maintain a minimum permanent capital ratio of 7 percent. The permanent capital ratio is calculated by dividing the Association's permanent capital by a risk-adjusted asset base.

FCA regulations also require all Farm Credit institutions to maintain two other minimum capital ratios: total surplus ratio of 7 percent and core surplus ratio of 3.5 percent. The total surplus and core surplus ratios are calculated by dividing total surplus and core surplus as defined in FCA regulations by a risk-adjusted asset base. As of December 31, 2003, the Association's total surplus ratio and core surplus ratio were 12.19 percent and 9.78 percent, respectively, as compared to 12.58 percent and 9.12 percent, respectively, on December 31, 2002.

Annually, the Association establishes target capital ratios. The Association's 2003 target permanent capital ratio was 14 percent of risk-adjusted assets. The targeted total surplus and core surplus ratios for 2003 were 12.00 percent and 10.00 percent, respectively. As of December 31, 2003, the Association exceeded the target capital ratios except for the core surplus ratio. The Association's capital ratios have declined over the past three years due to loan volume growth which has outpaced the growth in members' equity.

Disclosure Required by Farm Credit Administration Regulations

Description of Business

Descriptions of the territory served, persons eligible to borrow, types of lending activities engaged in, financial services offered and related Farm Credit organizations are incorporated herein by reference to Note 1 to the consolidated financial statements, "Organization and Operations," included in this annual report to stockholders.

The description of significant developments that had or could have a material impact on earnings or interest rates to borrowers, acquisitions or dispositions of material assets, material changes in the manner of conducting the business, seasonal characteristics, and concentrations of assets, if any, is incorporated in "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in this annual report to stockholders.

Description of Property

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

<u>Location</u>	<u>Description</u>	<u>Form of Ownership</u>
106 Sangers Lane Augusta County, VA	Administrative	Owned
1237 W. Main Street Abingdon, VA	Branch	Owned
410 W. Main Street Abingdon, VA	Former branch	Owned
801-B Blue Ridge Ave. Bedford, VA	Branch	Rented (\$475 per month)
1445 E. Rio Road Suite 103 Charlottesville, VA	Branch	Rented (\$1,633 per month)
421 Park Street Charlottesville, VA	Former Branch	Owned
29 Military Drive Chatham, VA	Branch	Owned
I-79, Exit 115, Rt. 20 S. Clarksburg, WV	Branch	Rented (\$1,620 per month)
409 James Madison Hwy. Culpeper, VA	Branch	Rented (\$3,400 per month)
308 Railroad Ave. Elkins, WV	Branch	Rented (\$650 per month)
241 E. Jackson Street Gate City, VA	Branch	Owned
161 South Main St. Halifax, VA	Branch	Rented (\$531 per month)
306 E. Market St. Harrisonburg, VA	Branch	Owned
27 Fort Evans Rd., NE Leesburg, VA	Branch	Owned
880 North Jefferson St. Lewisburg, WV	Branch	Owned

<u>Location</u>	<u>Description</u>	<u>Form of Ownership</u>
Rt. 39 Lexington, VA	Branch	Owned
Rt. 219 North Oakland, MD	Branch	Rented (\$980 per month)
Colonial Shopping Center Orange, VA	Branch	Rented (\$1,500 per month)
106 North Main Street Petersburg, WV	Branch	Owned
Route 33 West Ripley, WV	Branch	Rented (\$2,205 per month)
38 Murray Farm Road Roanoke, VA	Branch	Owned
115 Floyd Avenue Rocky Mount, VA	Branch	Rented (\$800 per month)
452 North High Street Romney, WV	Branch	Owned
1557 Commerce Road Suite 202 Verona, VA	Branch	Rented (\$1,731 per month)
516 Fauquier Road Warrenton, VA	Branch	Owned
660 Pepper's Ferry Road Wytheville, VA	Branch	Owned

Legal Proceedings

Information, if any, to be disclosed in this section is incorporated herein by reference to Note 12 to the consolidated financial statements, "Commitments and Contingencies," included in this annual report to stockholders.

Description of Capital Structure

Information to be disclosed in this section is incorporated herein by reference to Note 7 to the consolidated financial statements, "Members' Equity," included in this annual report to stockholders.

Description of Liabilities

The description of liabilities, contingent liabilities and intrasystem financial assistance rights and obligations to be disclosed in this section is incorporated herein by reference to Notes 2, 6, 10 and 12 to the consolidated financial statements included in this annual report to stockholders.

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

"Management's Discussion and Analysis of Financial Condition and Results of Operations," which appears in this annual report to stockholders and is to be disclosed in this section, is incorporated herein by reference.

Senior Officers

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

<u>Senior Officer</u>	<u>Position</u>
David L. Lawrence	Chief Executive Officer
C. McCheyne Swartzel	Chief Lending Officer
David G. Sauer	Chief Financial Officer
Carolyn L. Hite	Corporate Secretary

The business experience for the past five years for senior officers is with the Farm Credit System.

The total amount of compensation earned by the Chief executive officers (CEO) and the highest-paid officers as a group (including the CEOs) during the years ended December 31, 2003, 2002 and 2001, is as follows:

Name of Individual or Number in Group	Year	Annual		Deferred Comp.	Total
		Salary	Bonus		
David L. Lawrence	2003	\$165,211	—	\$33,042	\$198,253
Donald L. Shiflet	2003	\$ 55,002	\$ 13,305	—	\$ 68,307*
Donald L. Shiflet	2002	\$206,674	\$ 41,333	—	\$248,007
Donald L. Shiflet	2001	\$180,004	\$ 36,000	—	\$216,004
6	2003	\$625,711	\$ 74,405	\$53,042	\$753,158
5	2002	\$636,133	\$104,522	\$22,725	\$763,380
5	2001	\$567,011	\$113,400	—	\$680,411

* Donald L. Shiflet retired on March 31, 2003. The Compensation shown is for 3 months.

In addition to a base salary, all employees except the CEO and internal reviewers can earn additional compensation under an incentive plan. The Association incentive plan adopted for 2003, which has not changed since 2001, is designed to motivate employees to stimulate new business development, increase loan volume, and increase Association's earnings. The incentive plan is based on a combination of individual and association goals. The incentive payments are accrued in the plan year. Payment of the incentive was made in the first quarter of 2004. Employees eligible for the deferred compensation plan may elect to defer the incentive or bonus. The CEO and internal reviewers can receive a bonus at the discretion of the Board of Directors.

Disclosure of the total compensation earned in 2003 by any senior officer, or to any other individual included in the total whose compensation exceeds \$50,000, is available to stockholders upon request.

Directors

Directors and senior officers are reimbursed on an actual cost basis for all expenses incurred in the performance of official duties. Such expenses may include transportation, lodging, meals, tips, tolls, parking of cars, laundry, registration fees, and other expenses associated with travel on official business. A copy of the policy is available to shareholders of the Association upon request.

The aggregate amount of reimbursement for travel, subsistence and other related expenses for all directors as a group was \$70,834 for 2003, \$58,305 for 2002, and \$52,051 for 2001.

Subject to approval by the board, the Association may allow directors honoraria of \$300 for attendance at meetings, committee meetings, or special assignments, and \$100 for telephone conferences. In addition to the honoraria, directors are paid a quarterly retainer fee of \$750. Total compensation paid to directors as a group was \$163,850.

The following represents certain information regarding the directors of the Association, including their principal occupation for the past five years:

Wallace W. Sanford, III, Chairman, is a dairy and beef farmer in partnership with his family. He is a director of Maryland-Virginia Milk Producers and serves on the Contingency Planning Committee for Orange-Madison Cooperative. During 2003, he served 13 days at Association board meetings and 19 days in other official activities and was paid \$11,800. His term of office is 2004-2006.

William J. Franklin, Jr., Vice Chairman, is a beef cattle farmer. He serves as CEO of Scott County Telephone. He serves on Virginia Telecommunications and Industry Association, Carolina-Virginia's Telephone Association, Scott County Cellular, and Tenn. Industry Telecommunications Company. During 2003, he served 12 days at Association board meetings and 8 days in other official activities and was paid \$9,000. His term of office is 2004-2006.

James H. Addington is the Outside Director. He is president of Addington Oil Corporation. During 2003, he served 13 days at Association board meetings and 11 days in other official activities and was paid \$9,400. His term of office is 2003-2005.

T. Harry Arnold is a beef cattle farmer. He serves on the Washington County Fair Tobacco Festival Board. During 2003, he served 10 days at Association board meetings and 3 days in other official activities and was paid \$6,550. His term of office is 1999-2003.

Ronald L. Bennett operates a dairy farm. During 2003, he served 13 days at Association board meetings and 18 days in other official activities and was paid \$11,700. His term of office is 2003-2005.

Donna M. Brooke-Alt operates a dairy farm. During 2003, she served 11 days at Association board meetings and 18 days in other official activities and was paid \$11,100. Her term of office is 2003-2005.

Paul M. House, operates a dairy farm. He serves on the AgFirst Farm Credit Bank Board. During 2003, he served 13 days at Association board meetings and 5 days in other official activities and was paid \$7,600. His term of office is 2002-2004.

James Kinsey operates a forage based purebred Angus Operation. He serves as a director of CoBank, ACB. During 2003, he served 11 days at Association board meetings and 11 days in other official activities and was paid \$9,100. His term of office is 2003-2005.

Walter L. Schmidlen, Jr. is a dairy and beef farmer and owns a farm machinery dealership. He serves on the AgFirst Farm Credit Bank Board. During 2003, he served 13 days at Association board meetings and 5 days in other official activities and was paid \$7,600. His term of office is 2002-2004.

Barry W. Shelor operates a dairy farm. He serves on the Patrick County Farm Bureau Board. During 2003, he served 13 days at Association board meetings and 19 days in other official activities and was paid \$11,800. His term of office is 2003-2005.

Gregory A. Smith operates a dairy and steer-fattening farm in partnership with his brother. He is president of Ashland Farms, Inc. He is also president of the Culpeper Farmers Cooperative and a board member of the Madison Livestock Exchange. During 2003, he served 13 days at Association board meetings and 3 days in other official activities and was paid \$7,500. His term of office is 2002-2004.

Dr. Nickolas J. Sojka was owner/operator of a registered Angus and commercial cow/calf operation. He passed away 6/16/03. He served on the Advisory Committee of Charlottesville-Albemarle Metropolitan Planning Organization. During 2003, he served 4 days at Association board meetings and 3 days in other official activities and was paid \$3,300. His term of office was 1999-2003.

James Solomon, Jr. is a tobacco, crop and beef cattle farmer. During 2003, he served 13 days at Association board meetings and 8 days in other official activities and was paid \$9,000. His term of office is 2003-2005.

Alfred W. Stephens, Jr. is a dairy farmer. He serves as secretary on the Wythe/Bland DHIA and serves on the board of directors for the Wythe County Farm Bureau. During 2003, he served 11 days at Association board meetings and 13 days in other official activities and was paid \$9,600. His term of office is 2002-2004.

Thomas V. Thacker is a poultry farmer. During 2003, he served 13 days at Association board meetings and 19 days in other official activities and was paid \$12,000. His term of office is 2003-2005.

Allan T. Thorburn is a beef cow, hay and grain farmer. He serves on the Culpeper Farmers Cooperative Board. During 2003, he served 13 days at Association board meetings and 9 days in other official activities and was paid \$8,800. His term of office is 1999-2003.

Joseph W. Wampler is a general livestock and poultry farmer. He serves on the Virginia Beef Industry Council, and is a board member for the Rockingham County Fair Association. During 2003, he served 10 days at Association board meetings and 6 days in other official activities and was paid \$6,900. His term of office is 2003-2005.

John E. Wells is a full-time beef farmer. He is a member of the West Virginia Cattlemen's Association, Wirt County Farm Bureau, and is vice president of Jackson County Calf Pool Co-op. During 2003, he served 13 days at Association board meetings and 16 days in other official activities and was paid \$11,100. His term of office is 2002-2004.

Transactions with Senior Officers and Directors

The reporting entity's policies on loans to and transactions with its officers and directors, to be disclosed in this section are incorporated herein by reference to Note 11 to the consolidated financial statements, "Related Party Transactions," included in this annual report to stockholders.

Involvement in Certain Legal Proceedings

There were no matters which came to the attention of management or the board of directors regarding involvement of current directors or senior officers in specified legal proceedings which should be disclosed in this section.

Relationship with Independent Public Accountants

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

Consolidated Financial Statements

The consolidated financial statements, together with the report thereon of PricewaterhouseCoopers LLP dated February 19, 2004, and the report of management, which appear in this annual report to stockholders are incorporated herein by reference.

Copies of the Association's quarterly reports are available upon request free of charge by calling 1-540-886-3435, or writing David Sauer, Farm Credit of the Virginias, P. O. Box 899, Staunton, VA 24402-0899. Information concerning Farm Credit of the Virginias can also be obtained by going to Farm Credit of the Virginias' website at www.farmcreditofvirginias.com.

Borrower Information Regulations

Since 1972, Farm Credit Administration (FCA) regulations have required that borrower information be held in strict confidence by Farm Credit System (FCS) institutions, their directors, officers and employees. These regulations provide Farm Credit institutions clear guidelines for protecting their borrowers' nonpublic personal information.

On November 10, 1999, the FCA Board adopted a policy that requires FCS institutions to formally inform new borrowers at loan closing of the FCA regulations on releasing borrower information and to address this information in the annual report to shareholders. The implementation of these measures ensures that new and existing borrowers are aware of the privacy protections afforded them through FCA regulations and Farm Credit System institution efforts.

Stockholder Investment

Stockholder investment in the Association could be affected by the financial condition and results of operations of AgFirst Farm Credit Bank. Copies of the District annual and quarterly reports are available upon request free of charge by calling 1-800-845-1745, ext. 503, or writing Patti Trotter, AgFirst Farm Credit Bank, P. O. Box 1499, Columbia, SC 29202. Information concerning AgFirst Farm Credit Bank can also be obtained by going to AgFirst's website at www.agfirst.com.

Report of Independent Auditors



PricewaterhouseCoopers LLP
10 Tenth Street, Suite 1400
Atlanta, GA 30309
Telephone (678) 419 1000

Report of Independent Auditors

February 19, 2004

To the Board of Directors and Stockholders
of Farm Credit of the Virginias, ACA

We have audited the accompanying consolidated balance sheets of Farm Credit of the Virginias, ACA (Association) and its subsidiaries as of December 31, 2003, 2002, and 2001, and the related consolidated statements of income, of changes in members' equity, and of cash flows for each of the three years in the period ended December 31, 2003. These financial statements are the responsibility of the Association's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Association and its subsidiaries at December 31, 2003, 2002 and 2001, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003 in conformity with accounting principles generally accepted in the United States of America.

PricewaterhouseCoopers LLP

Consolidated Balance Sheets

<i>(dollars in thousands)</i>	December 31, 2003	December 31, 2002	December 31, 2001
Assets			
Cash	\$ 32	\$ 665	\$ 538
Loans	1,069,137	1,022,513	902,555
Less: allowance for loan losses	23,302	24,505	22,100
Net loans	1,045,835	998,008	880,455
Accrued interest receivable	6,180	6,281	6,386
Investment in AgFirst Farm Credit Bank	13,981	15,306	17,873
Premises and equipment, net	3,756	3,628	3,873
Other property owned	85	—	—
Deferred tax asset, net	21	19	13
Other assets	8,002	7,649	7,138
Total assets	<u>\$ 1,077,892</u>	<u>\$ 1,031,556</u>	<u>\$ 916,276</u>
Liabilities			
Notes payable to AgFirst Farm Credit Bank	\$ 890,426	\$ 847,329	\$ 737,512
Accrued interest payable	3,734	3,890	3,831
Patronage refund payable	8,098	8,467	9,886
Postretirement benefits other than pensions	4,870	4,155	3,771
Minimum pension liability	3,769	3,899	—
Other liabilities	15,485	13,158	4,606
Total liabilities	<u>926,382</u>	<u>880,898</u>	<u>759,606</u>
Commitments and contingencies			
Members' Equity			
Capital stock and participation certificates	19,735	20,469	21,580
Retained earnings			
Allocated	58,345	57,904	55,329
Unallocated	78,727	78,146	79,761
Accumulated other comprehensive income (loss)	(5,297)	(5,861)	—
Total members' equity	<u>151,510</u>	<u>150,658</u>	<u>156,670</u>
Total liabilities and members' equity	<u>\$ 1,077,892</u>	<u>\$ 1,031,556</u>	<u>\$ 916,276</u>

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

Consolidated Statements of Income

<i>(dollars in thousands)</i>	For the year ended December 31,		
	2003	2002	2001
Interest Income			
Loans	\$ 64,384	\$ 64,897	\$ 68,500
Interest Expense			
Notes payable to AgFirst Farm Credit Bank	40,333	43,233	45,374
Net interest income	24,051	21,664	23,126
Provision for (reversal of) loan losses	1,180	2,435	1,643
Net interest income after provision for (reversal of) loan losses	22,871	19,229	21,483
Noninterest Income			
Loan fees	1,937	1,314	835
Fees for financially related services	113	60	73
Patronage refund from AgFirst Farm Credit Bank	7,618	6,921	5,235
Gains (losses) on other property owned, net	—	—	4
Other noninterest income	170	155	1,984
Total noninterest income	9,838	8,450	8,131
Noninterest Expense			
Salaries and employee benefits	9,459	8,191	6,762
Occupancy and equipment	911	941	975
Insurance Fund premium	1,266	289	—
Other operating expenses	2,862	2,610	2,581
Restructuring charge	—	—	3,571
Total noninterest expense	14,498	12,031	13,889
Income before income taxes	18,211	15,648	15,725
Provision (benefit) for income taxes	(238)	418	(2,345)
Net income	\$ 18,449	\$ 15,230	\$ 18,070

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

Consolidated Statements of Changes in Members' Equity

<i>(dollars in thousands)</i>	Capital Stock and Participation Certificates	Retained Earnings		Accumulated Other Comprehensive Income	Total Members' Equity
		Allocated	Unallocated		
Balance at December 31, 2000	\$ 23,874	\$ 55,994	\$ 76,870	\$ —	\$156,738
Net income			18,070		18,070
Capital stock/participation certificates issued	1,066				1,066
Capital stock/participation certificates retired	(3,360)				(3,360)
Patronage distribution					
Cash			(9,845)		(9,845)
Nonqualified retained surplus		5,333	(5,333)		—
Retained earnings retired		(5,998)			(5,998)
Distribution adjustment		—	(1)		(1)
Balance at December 31, 2001	21,580	55,329	79,761	—	156,670
Comprehensive income					
Net income			15,230		15,230
Minimum pension liability adjustment				(5,861)	(5,861)
Total comprehensive income					9,369
Capital stock/participation certificates issued	1,233				1,233
Capital stock/participation certificates retired	(2,344)				(2,344)
Patronage distribution					
Cash			(8,415)		(8,415)
Nonqualified retained surplus		8,415	(8,415)		—
Retained earnings retired		(7,647)			(7,647)
Distribution adjustment		1,807	(15)		1,792
Balance at December 31, 2002	20,469	57,904	78,146	(5,861)	150,658
Comprehensive income					
Net income			18,449		18,449
Minimum pension liability adjustment				564	564
Total comprehensive income					19,013
Capital stock/participation certificates issued	1,553				1,553
Capital stock/participation certificates retired	(2,287)				(2,287)
Patronage distribution					
Cash			(8,010)		(8,010)
Nonqualified retained surplus		9,790	(9,790)		—
Retained earnings retired		(9,383)			(9,383)
Distribution adjustment		34	(68)		(34)
Balance at December 31, 2003	\$ 19,735	\$ 58,345	\$ 78,727	\$ (5,297)	\$151,510

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

Consolidated Statements of Cash Flows

<i>(dollars in thousands)</i>	For the year ended December 31,		
	2003	2002	2001
Cash flows from operating activities:			
Net income	\$ 18,449	\$ 15,230	\$ 18,070
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation on premises and equipment	449	528	565
Provision for (reversal of) loan losses	1,180	2,435	1,643
(Gains) losses on other property owned, net	—	—	(4)
Changes in operating assets and liabilities:			
(Increase) decrease in accrued interest receivable	101	105	1,156
(Increase) decrease in deferred tax asset, net	(2)	(6)	716
(Increase) decrease in other assets	(353)	(511)	(374)
Increase (decrease) in accrued interest payable	(156)	59	110
Increase (decrease) in postretirement benefits other than pensions	715	384	996
Increase (decrease) in minimum pension liability	(130)	3,899	—
Increase (decrease) in other liabilities	2,891	2,691	1,266
Total adjustments	4,695	9,584	6,074
Net cash provided by (used in) operating activities	23,144	24,814	24,144
Cash flows from investing activities:			
Net (increase) decrease in loans	(49,092)	(119,988)	(134,220)
(Increase) decrease in investment in AgFirst Farm Credit Bank	1,325	2,567	2,377
Purchase of premises and equipment, net	(577)	(283)	(513)
Proceeds from sale of other property owned	—	—	4
Net cash provided by (used in) investing activities	(48,344)	(117,704)	(132,352)
Cash flows from financing activities:			
Advances on (repayment of) notes payable to AgFirst Farm Credit Bank, net	43,097	109,817	119,731
Capital stock and participation certificates issued	1,553	1,233	1,066
Capital stock and participation certificates retired	(2,287)	(2,344)	(3,360)
Patronage refunds paid	(8,413)	(8,042)	(5,260)
Retained earnings retired	(9,383)	(7,647)	(5,998)
Net cash provided by (used in) financing activities	24,567	93,017	106,179
Net increase (decrease) in cash	(633)	127	(2,029)
Cash, beginning of period	665	538	2,567
Cash, end of period	\$ 32	\$ 665	\$ 538
Supplemental schedule of non-cash investing and financing activities:			
Loans transferred to other property owned	\$ 85	\$ —	\$ —
Cash dividends or patronage distributions declared or payable	8,010	8,415	9,845
Supplemental information:			
Interest paid	\$ 40,489	\$ 43,174	\$ 45,264
Taxes paid, net	109	621	205
Federal tax refunds related to long-term operations (Note 9)	7	—	4,113

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

Notes to the Consolidated Financial Statements

(dollars in thousands, except as noted)

Note 1 — Organization and Operations

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

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

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

Maryland: Counties of Allegany and Garrett.

The Association is a lending institution of the Farm Credit System (the System), a nationwide system of cooperatively owned Banks and Associations, which was established by Acts of Congress to meet the credit needs of American agriculture and is subject to the provisions of the Farm Credit Act of 1971, as amended (the Farm Credit Act). The most recent significant amendment to the Farm Credit Act was the Agricultural Credit Act of 1987.

At December 31, 2003, the System was comprised of four Farm Credit Banks and one Agricultural Credit Bank and numerous Associations.

Effective January 1, 2001, pursuant to a plan of restructuring approved by the Farm Credit Administration (FCA) and Association shareholders, the Association reorganized its existing organizational structure. Pursuant to this restructuring, an FLCA and a 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 net income from long-term mortgage operations of 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 ACA was subject to federal and state income tax. As a result of the restructuring, long-term lending activity was 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, continue to be subject to income tax.

AgFirst Farm Credit Bank (Bank) and its related Associations are collectively referred to as the "District." The Bank provides funding to all associations within the District and is responsible for supervising certain activities of the District Associations, as well as the other associations operating within the AgFirst District. The District consists of the Bank and twenty-four ACAs, twenty-two of which have reorganized as ACA parent-companies, which have two wholly owned subsidiaries, a FLCA and a PCA.

ACA parent-companies provide financing and related services through its FLCA and PCA subsidiaries. The FLCA makes secured long-term agricultural real estate and rural home mortgage loans. The PCA makes short-and intermediate-term loans for agricultural production or operating purposes.

The FCA is delegated authority by Congress to regulate the System banks and associations. The activities of the associations are examined by the FCA and certain actions by the associations are subject to the prior approval of the FCA and the supervising Bank.

The Farm Credit Act established the Farm Credit System Insurance Corporation (Insurance Corporation) to administer the Farm Credit Insurance Fund (Insurance Fund). The Insurance Fund is required to be used to (1) ensure the timely payment of principal and interest on Systemwide debt obligations (Insured debt), (2) ensure the retirement of protected borrower capital at par or stated value, and (3) for other specified purposes. The Insurance Fund is also available for discretionary uses by the Insurance Corporation of providing assistance to certain troubled System institutions and to cover the operating expenses of the Insurance Corporation. Each System bank is required to pay premiums into the Insurance Fund, based on its annual average loan principal outstanding until the monies in the Insurance Fund reach the "secure base amount," which is defined in the Farm Credit Act as 2.0 percent of the aggregate insured obligations (Systemwide debt obligations). When the amount in the

Insurance Fund exceeds the secure base amount, the Insurance Corporation is required to reduce premiums, but it still must ensure that reduced premiums are sufficient to maintain the level of the Insurance Fund at the secure base amount.

B. Operations: The Farm Credit Act sets forth the types of authorized lending activity, persons eligible to borrow, and financial services which can be offered by the Association. The Association is authorized to provide, either directly or in participation with other lenders, credit, credit commitments and related services to eligible borrowers. Eligible borrowers include farmers, ranchers, producers or harvesters of aquatic products, rural residents, and farm-related businesses.

The Association may sell to any Farm Credit borrowing member, on an optional basis, credit or term life insurance appropriate to protect the loan commitment in the event of death of the debtor(s). The sale of other insurance necessary to protect a member's farm or aquatic unit is permitted, but limited to hail and multi-peril crop insurance, and insurance necessary to protect the facilities and equipment of aquatic borrowers.

Upon request, stockholders of the Association will be provided with an AgFirst Farm Credit Bank Annual Report to Stockholders, which includes the combined financial statements of the Bank and its related Associations. The Association's financial condition may be impacted by factors that affect the Bank. The AgFirst Annual Report discusses the material aspects of the District's financial condition, changes in financial condition, and results of operations. In addition, the AgFirst Annual Report identifies favorable and unfavorable trends, significant events, uncertainties and the impact of activities of the Financial Assistance Corporation Assistance Board (Assistance Board) and Insurance Corporation.

The lending and financial services offered by the Bank are described in Note 1 of the District's Annual Report to Stockholders.

Note 2 — Summary of Significant Accounting Policies

The accounting and reporting policies of the Association conform with accounting principles generally accepted in the United States of America (GAAP) and prevailing practices within the banking industry. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Significant estimates are discussed in these footnotes, as applicable. Actual results may differ from these estimates.

Certain amounts in prior years' financial statements have been reclassified to conform to current consolidated financial statement presentation. Such reclassifications had no effect on net income or total members' equity of prior years. The

consolidated financial statements include the accounts of the FLCA and the PCA. All significant inter-company transactions have been eliminated in consolidation.

A. Cash: Cash, as included in the statement of cash flows, represents cash on hand and on deposit at banks.

B. Loans and Allowance for Loan Losses: Long-term real estate mortgage loans generally have maturities ranging up to 30 years. Substantially all short- and intermediate-term loans for agricultural production or operating purposes have maturities of 10 years or less.

Loans are carried at their principal amount outstanding less unearned income. Interest on loans is accrued and credited to interest income based upon the principal amount outstanding. Loans are generally placed in nonaccrual status when principal or interest is delinquent for 90 days or more (unless adequately secured and in the process of collection) or circumstances indicate that collection of principal and/or interest is in doubt. When a loan is placed in nonaccrual status, accrued interest deemed uncollectible is either reversed (if accrued in the current year) or charged against the allowance for loan losses (if accrued in prior years).

When loans are in nonaccrual status, the interest portion of payments received in cash is generally recognized as interest income if collection of the recorded investment in the loan is fully expected and the loan does not have a remaining unrecovered prior charge-off associated with it. Otherwise, loan payments are applied against the recorded investment in the loan asset. Nonaccrual loans may be transferred to accrual status when principal and interest are current, prior charge-offs have been recovered, the ability of the borrower to fulfill the contractual repayment terms is fully expected and the loan is not classified "doubtful" or "loss."

In cases where a borrower experiences financial difficulties and the Association makes certain monetary concessions to the borrower through modifications to the contractual terms of the loan, the loan is classified as a restructured loan. If the borrower's ability to meet the revised payment schedule is uncertain, the loan is classified as a nonaccrual loan.

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

The allowance for loan losses is maintained at a level considered adequate by management to provide for probable losses inherent in the loan portfolio. The allowance is based on a periodic evaluation of the loan portfolio by management in which numerous factors are considered, including economic conditions, loan portfolio composition and prior loan loss experience. It is based on estimates, appraisals and evaluations of loans which, by their nature, contain elements of uncertainty and imprecision. The possibility exists that changes in the economy and its impact on borrower repayment capacity will cause these estimates, appraisals and evaluations to change.

A specific allowance may be established for impaired loans under SFAS No. 114. Impairment of these loans is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as practically expedient, at the loan's observable market price or fair value of the collateral if the loan is collateral dependent. The Bank and Associations record specific allowances to reduce the carrying amount of the impaired loan to the lower of book value or the fair market value of collateral.

- C. **Investment in AgFirst Farm Credit Bank:** The Association is required to maintain ownership in the Bank in the form of Class C stock. Accounting for this investment is on the cost plus allocated equities basis. Patronage refunds from the Bank are accrued as earned. The receivable for such patronage refunds is included in other assets.
- D. **Other Property Owned:** Other property owned, consisting of real and personal property acquired through a collection action, is recorded at fair value less estimated selling costs upon acquisition. Revised estimates to the fair value less cost to sell are reported as adjustments to the carrying amount of the asset, provided that such adjusted value is not in excess of the carrying amount at acquisition. Income and expenses from operations and carrying value adjustments are included in gains (losses) on other property owned.
- E. **Premises and Equipment:** Premises and equipment are carried at cost less accumulated depreciation. Depreciation is provided on the straight-line method over the estimated useful lives of the assets. Gains and losses on dispositions are reflected in current operations. Maintenance and repairs are charged to operating expense and improvements are capitalized.
- F. **Advanced Conditional Payments:** The Association is authorized under the Farm Credit Act to accept advance payments from borrowers. To the extent the borrower's access to such advance payments is restricted, the advanced conditional payments are netted against the borrower's related loan balance. Advanced conditional payments are not insured.
- G. **Employee Benefit Plans:** The employees of the Association participate in the Retirement Plan (the Plan) of the AgFirst District, which is a defined benefit plan. The District utilizes the "Projected Unit Credit" actuarial method for financial reporting purposes and the "Entry Age Normal Cost" actuarial method for funding purposes. As a result of the funded status at the Plan's measurement date (September 30) of the underlying Plan, the Association may record a minimum liability, an intangible asset relating to unrecognized prior service cost and other comprehensive income (loss). The adjustment to other comprehensive income (loss) would be net of deferred taxes, if significant. For participants hired before January 1, 2003, benefits are determined based on a final average pay formula. For those participants hired on or after January 1, 2003, benefits are determined using a cash balance formula.

The employees of the Association are eligible to participate in the District's thrift plan (Thrift Plan), which qualifies as a 401(k) plan as defined by the Internal Revenue Code. For employees hired on or prior to December 31, 2002, the Association will contribute \$.50 for each \$1.00 of the maximum employee contribution of 6 percent of total compensation. For employees hired after January 1, 2003, the Association will contribute \$1.00 for each \$1.00 of the maximum employee contribution of 6 percent of total compensation. Employee deferrals are not to exceed the maximum deferral as adjusted by the Internal Service. Thrift Plan costs are expensed as funded.

The Association provides certain health care and life insurance benefits to eligible retired employees. Substantially all employees may become eligible for these benefits if they reach normal retirement age while working for the Association. Expenses of \$970, \$675 and \$1,108 for the years ended December 31, 2003, 2002 and 2001, respectively, were classified as salaries and employee benefits.

- H. **Income Taxes:** The Association is generally subject to federal and certain other income taxes. The Association is eligible to operate as a cooperative that qualifies for tax treatment under Subchapter T of the Internal Revenue Code. Accordingly, under specified conditions, the Association can exclude from taxable income amounts distributed as qualified patronage refunds in the form of cash, stock or allocated surplus. Provisions for income taxes are made only on those taxable earnings that will not be distributed as qualified patronage refunds. The Association distributes patronage on the basis of book income. The Association recognizes deferred tax assets and liabilities for the expected future tax consequences of the temporary differences between the carrying amounts and tax bases of assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be realized or settled.

Effective January 1, 2001, the Association formed a tax exempt subsidiary as described in Note 1.

- I. **Patronage Refund from AgFirst:** The Association records patronage refunds from the Bank on an accrual basis.

Note 3 — Loans and Allowance for Loan Losses

A summary of loans follows:

	2003	December 31, 2002	2001
Long-term farm mortgage	\$ 714,373	\$ 665,878	\$ 583,484
Production and intermediate-term	210,076	211,610	179,920
Rural home	47,667	49,161	46,690
Farm related business	7,438	8,648	8,884
Processing and marketing	42,767	41,360	50,652
Sales contracts	222	147	158
Nonaccruals	7,955	10,351	1,933
Plus: participations purchased	66,240	51,882	30,834
Less: participations sold	(27,601)	(16,524)	—
Total	<u>\$ 1,069,137</u>	<u>\$ 1,022,513</u>	<u>\$ 902,555</u>

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

Total loans at December 31, 2003, 2002 and 2001 consisted of the following commodity types:

Commodity Type	December 31,		
	2003	2002	2001
Livestock	35%	33%	36%
Timber	13	14	13
Field Crops	12	12	12
Dairy	10	9	9
Poultry	9	10	10
Rural Home	4	5	5
Tobacco	3	3	3
Other	14	14	12
Total	100%	100%	100%

The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the borrower. Collateral held varies, but typically includes farmland and income-producing property, such as crops and livestock, as well as receivables. Long-term real estate loans are secured by the first liens on the underlying real property. Federal regulations state that long-term real estate loans are not to exceed 85% (97% if guaranteed by a government agency) of the property's appraised value. However, a decline in a property's market value subsequent to loan origination or advances, or other actions necessary to protect the financial interest of the Association in the collateral, may result in the loan to value ratios in excess of the regulatory maximum.

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

The following table presents information relating to impaired loans.

	December 31,		
	2003	2002	2001
Nonaccrual loans:			
Current as to principal and interest	\$ 390	\$ 2,321	\$ 379
Past due	7,565	8,030	1,554
Total nonaccrual loans	7,955	10,351	1,933
Impaired accrual loans:			
Restructured accrual loans	20	24	29
Accrual loans 90 days or more past due	14	2,045	29
Total impaired accrual loans	34	2,069	58
Total impaired loans	\$ 7,989	\$ 12,420	\$ 1,991

There were no material commitments to lend additional funds to debtors whose loans were classified as impaired at December 31, 2003.

Interest income is recognized and cash payments are applied on nonaccrual impaired loans as described in Note 2. The following table presents interest income recognized on impaired loans.

	Year Ended December 31,		
	2003	2002	2001
Interest income recognized on nonaccrual loans	\$ 199	\$ 167	\$ 497
Interest income on impaired accrual loans	119	128	30
Interest income recognized on impaired loans	\$ 318	\$ 295	\$ 527

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

	2003	2002	2001
Impaired loans with related allowance	\$ 5,018	\$ 57	\$ 74
Impaired loans with no related allowance	2,971	12,363	1,917
Total impaired loans	\$ 7,989	\$ 12,420	\$ 1,991
Average impaired loans	\$ 11,097	\$ 3,917	\$ 1,544
Allowance on impaired loans	\$ 984	\$ 52	\$ 69

A summary of the changes in the allowance for loan losses follows:

	Year Ended December 31,		
	2003	2002	2001
Balance at beginning of year	\$ 24,505	\$ 22,100	\$ 20,400
Provision for (reversal of) loan losses	1,180	2,435	1,643
Loans charged off	(2,438)	(30)	(5)
Recoveries	55	—	62
Balance at end of year	\$ 23,302	\$ 24,505	\$ 22,100
Ratio of net charge-offs during the period to average loans outstanding during the period	.224%	.003%	(.007)%

Note 4 — Investment in AgFirst Farm Credit Bank

The Association is required to maintain ownership in the Bank of Class C stock as determined by the Bank. The Bank may require additional capital contributions to maintain its capital requirements.

Note 5 — Premises and Equipment

Premises and equipment consisted of the following:

	December 31,		
	2003	2002	2001
Land	\$ 1,108	\$ 1,008	\$ 1,009
Buildings and improvements	3,492	3,304	3,290
Furniture and equipment	3,362	3,124	3,123
	7,962	7,436	7,422
Less: accumulated depreciation	4,206	3,808	3,549
Total	<u>\$ 3,756</u>	<u>\$ 3,628</u>	<u>\$ 3,873</u>

Note 6 — Notes Payable to AgFirst Farm Credit Bank

The Association's indebtedness to the Bank represents borrowings by the Association to fund its loan portfolio. This indebtedness is collateralized by a pledge of substantially all of the Association's assets and the terms of the revolving lines of credit are governed by a general financing agreement. Interest rates on both variable and fixed rate notes payable are generally established loan-by-loan based on the Bank's marginal cost of funds, capital position, operating costs and return objectives. The interest rate is periodically adjusted by the Bank based upon agreement between the Bank and Association. The weighted average interest rates on the variable rate notes were 2.32 percent for LIBOR-based loans, 2.22 percent for Prime-based loans, and the weighted average remaining maturities were 6.5 years and 4.4 years, respectively, at December 31, 2003. The weighted average interest rate on the fixed rate and adjustable rate mortgage (ARM) notes payable which are match funded by the Bank was 4.62 percent and the weighted average remaining maturity was 11.0 years at December 31, 2003. The weighted average interest rate on all interest-bearing notes payable was 3.99 percent and the weighted average remaining maturity was 9.7 years at December 31, 2003.

Variable rate and fixed rate notes payable represent approximately 10.68 percent and 89.32 percent, respectively, of total notes payable at December 31, 2003.

The Bank, consistent with FCA regulations, has established limitations on the Association's ability to borrow funds based on specified factors or formulas relating primarily to credit quality and financial condition. At December 31, 2003, the Association's notes payable were within the specified limitations.

Note 7 — Members' Equity

A description of the Association's capitalization requirements, protection mechanisms, regulatory capitalization requirements and restrictions, and equities are provided below.

A. Capital Stock and Participation Certificates

In accordance with the Farm Credit Act and the Association's capitalization bylaws, each borrower is required to invest in Class C Common Stock for agricultural loans, or Participation Certificates in the case of rural home and farm related business loans, as a condition of borrowing.

The initial borrower investment, through either purchase or transfer, must be a minimum of two percent of the loan amount or \$1 thousand, or such higher amount as determined by the Board. The Board of Directors may increase the amount of investment if necessary to meet the Association's capital needs. Loans designated for sale or sold into the Secondary Market on or after April 16, 1996 will have no voting stock or participation certificate purchase requirement if sold within 180 days following the date of designation.

The borrower acquires ownership of the capital stock or participation certificates at the time the loan is made, but usually does not make a cash investment. The aggregate par value is generally added to the principal amount of the related loan obligation. The Association retains a first lien on the stock or participation certificates owned by borrowers. Retirement of such equities will generally be at the lower of par or book value, and repayment of a loan does not automatically result in retirement of the corresponding stock or participation certificates.

B. Regulatory Capitalization Requirements and Restrictions

FCA's capital adequacy regulations require the Association to achieve permanent capital of seven percent of risk-adjusted assets and off-balance-sheet commitments. Failure to meet the seven percent capital requirement can initiate certain mandatory and possibly additional discretionary actions by FCA that, if undertaken, could have a direct material effect on the Association's financial statements. The Association is prohibited from reducing permanent capital by retiring stock or making certain other distributions to shareholders unless prescribed capital standards are met. FCA regulations also require that additional minimum standards for capital be achieved. These standards require all System institutions to achieve and maintain ratios as defined by FCA regulations. These required ratios are total surplus as a percentage of risk-adjusted assets of seven percent and of core surplus as a percentage of risk-adjusted assets of three and one-half percent. The Association's permanent capital, total surplus and core surplus ratios at December 31, 2003 were 14.11 percent, 12.19 percent and 9.78 percent, respectively.

A FCA regulation empowers it to direct a transfer of funds or equities by one or more System institutions to another System institution under specified circumstances. The Association has not been called upon to initiate any transfers and is not aware of any proposed action under this regulation.

C. Description of Equities

The Association is authorized to issue or have outstanding Class D Preferred Stock, Classes A and C Common Stock, Participation Certificates and such other classes of equity as may be provided for in amendments to the bylaws in such amounts as may be necessary to conduct the Association's business. All stock and participation certificates have a par or face value of five dollars (\$5.00) per share.

The Association had the following shares outstanding at December 31, 2003:

Class	Protected	Shares Outstanding	
		Number	Aggregate Par Value
A Common/Nonvoting	No	359,466	\$ 1,797
C Common/Voting	No	3,338,441	16,692
C Participation Certificates/Nonvoting	No	249,010	1,246
Total Capital Stock and Participation Certificates		3,946,917	\$ 19,735

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

Retained Earnings

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

The Association maintains an allocated retained earnings account consisting of earnings held and allocated to borrowers on a patronage basis. In the event of a net loss for any fiscal year, such allocated retained earnings account will be subject to full impairment in the order specified in the bylaws beginning with the most recent allocation.

The Association has a first lien and security interest on all retained earnings account allocations owned by any borrowers, and all distributions thereof, as additional collateral for their indebtedness to the Association. When the debt of a borrower is in default or is in the process of final liquidation by payment or otherwise, the Association, upon approval of the Board, may order any and all retained earnings account allocations owned by such borrower to be applied on the indebtedness.

Allocated equities shall be retired solely at the discretion of the Board; provided, however, that minimum capital standards established by the FCA and the Board are met. Nonqualified retained surplus is considered to be permanently invested in the Association and as such, there is no plan to revolve or retire this surplus. All nonqualified distributions are tax deductible only when redeemed.

At December 31, 2003, allocated members' equity consisted of \$32,965 of qualified surplus and \$25,380 of nonqualified retained surplus.

Patronage Distributions

Prior to the beginning of any fiscal year, the Board, by adoption of a resolution, may obligate the Association to distribute to borrowers on a patronage basis all or any portion of available net earnings for such fiscal year or for that and subsequent fiscal years. Patronage distributions are based on the proportion of the borrower's interest to the amount of interest earned by the Association on its total loans unless another proportionate patronage basis is approved by the Board.

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

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

Dividends

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

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

Transfer

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

Impairment

Any net losses recorded by the Association shall first be applied against unallocated members' equity. To the extent that such losses would exceed unallocated members' equity, such losses would be applied consistent with the Association's bylaws and distributed pro rata to each share and/or unit outstanding in the class, in the following order:

1. Nonqualified allocated members equity beginning with the most recent allocation
2. Qualified allocated members equity beginning with the most recent allocation
3. Classes A and C Common Stock and Participation Certificates
4. Class D Preferred Stock

Liquidation

In the event of liquidation or dissolution of the Association, any assets of the Association remaining after payment or retirement of all liabilities should be distributed to the holders of the outstanding stock and participation certificates in the following order:

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

D. Other Comprehensive Income (Loss)

The Association reports other comprehensive income (loss) in its Statement of Changes in Members' Equity. For the years ended December 31, 2003 and 2002, other comprehensive income (loss) is related to the minimum pension liability recorded as a result of the funded status of the underlying plan. See Note 9 for further information.

Note 8 — Income Taxes

The provision (benefit) for income taxes follows:

	Year Ended December 31,		
	2003	2002	2001
Current:			
Federal	\$ (279)	\$ 467	\$ 855
State	43	(43)	197
Federal refunds related to long-term lending	—	—	(4,113)
	<u>(236)</u>	<u>424</u>	<u>(3,061)</u>
Deferred:			
Federal	(2)	(5)	18
State	—	(1)	(2)
Deferred tax write-off	—	—	700
	<u>(2)</u>	<u>(6)</u>	<u>716</u>
Total provision (benefit) for income taxes	<u>\$ (238)</u>	<u>\$ 418</u>	<u>\$ (2,345)</u>

On January 1, 2001, in connection with the merger to form the Association, the Association recorded a \$700 adjustment to the net deferred tax asset of Southwest Virginia Farm Credit, ACA, to conform the patronage policy to that of the Association. In addition, in connection with the restructuring discussed in Note 1, the net deferred tax asset relating to the long-term lending activities was written off during the first quarter of 2001 to reflect the change in tax status. The amount of this write-off was not significant. During 2001, the Association signed a settlement agreement with the IRS resolving the taxability of the prior years' earnings from its long-term mortgage lending activities. This settlement agreement was modeled after one used by another System ACA to reach a settlement agreement with the IRS in August 2000. As a result of this settlement, the Association recorded a tax refund of \$4,113, which is included as a component of the 2001 current income tax provision. In addition, the Association recorded \$1,834 in interest related to these refunds, which is included in Miscellaneous Income in the accompanying Consolidated Statements of Income. All such refunds have been received by the Association.

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

	December 31,		
	2003	2002	2001
Federal tax at statutory rate	\$ 6,192	\$ 5,320	\$ 5,347
State tax, net	29	(29)	129
Bank equity redemption	—	—	703
Patronage distributions	(1,593)	(1,445)	(1,929)
Tax-exempt FLCA earnings	(4,478)	(3,767)	(3,418)
Long-term lending related refunds	—	—	(4,113)
Deferred tax asset adjustment	—	—	700
Other	(388)	339	236
Provision (benefit) for income taxes	<u>\$ (238)</u>	<u>\$ 418</u>	<u>\$ (2,345)</u>

Deferred tax assets and liabilities result from the following at:

	December 31,		
	2003	2002	2001
Annual leave	\$ (13)	\$ (18)	\$ (14)
Postretirement benefits other than pensions	87	100	80
Gross deferred tax assets	<u>74</u>	<u>82</u>	<u>66</u>
Future Bank equity redemption	(3)	(3)	(4)
Pensions	(45)	(55)	(45)
Depreciation	(5)	(5)	(4)
Gross deferred tax liability	<u>(53)</u>	<u>(63)</u>	<u>(53)</u>
Net deferred tax asset (liability)	<u>\$ 21</u>	<u>\$ 19</u>	<u>\$ 13</u>

At December 31, 2003, deferred income taxes have not been provided by the Association on approximately \$1.6 million of patronage refunds received from the Bank prior to January 1, 1993. Such refunds, distributed in the form of stock, are subject to tax only upon conversion to cash. The tax liability related to future conversions is not expected to be material.

Note 9 — Employee Benefit Plans

The Association participates in a Districtwide defined benefit retirement plan. This plan is noncontributory and covers substantially all Association employees. Benefits are based on salary and years of service. The assets, liabilities and costs of the plan are not segregated by participating entities but are allocated among the participating entities. Pension costs are allocated by multiplying the District's net pension expense times the Association's salary expense as a percentage of the District's salary expense.

At December 31, 2003 and 2002, the Accumulated Benefit Obligation (ABO) of the District's defined benefit plan exceeded the fair value of plan assets. In accordance with the provisions of SFAS No. 87, "Employers' Accounting for Pensions," (SFAS No. 87), the Association's allocated amount of the minimum pension liability was recorded in the Consolidated Balance Sheets in the amount of the excess of the ABO over the fair value of plan assets. In conjunction with the minimum pension liability, other comprehensive loss was \$5,297 and \$5,861 for the years ended December 31, 2003 and 2002, respectively. The impact on deferred taxes was not significant.

In addition, supplemental retirement benefits and deferred compensation options are provided to certain key employees under a supplemental defined benefit executive plan and the AgFirst Farm Credit District Deferred Compensation Plan, which are not qualified under the Internal Revenue Code. As nonqualified plans, assets have been allocated and separately invested for this plan but are not considered in the assets of the plan as they are not isolated from the general creditors of the Association.

The Association participates in a Districtwide Thrift Plan. For employees hired on or prior to December 31, 2002, the Association will contribute \$.50 for each \$1.00 of the maximum employee contribution of 6 percent of total compensation. For employees hired after January 1, 2003, the Association will

contribute \$1.00 for each \$1.00 of the maximum employee contribution of 6 percent of total compensation. Employee deferrals are not to exceed the maximum deferral as adjusted by the Internal Revenue Service.

The District sponsors a plan providing certain benefits (primarily health care) to its retirees. Certain Association charges related to this plan are an allocation of District charges based on the Association's proportional share of the plan liability.

On December 8, 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (Medicare Act) was signed into law. This act introduces a prescription drug benefit under Medicare (Medicare Part D) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. Subsidies under the Medicare Act will reduce the current period measurements of benefits expected to be provided in future periods. These financial statements and disclosures do not reflect the effects of the Act. Specific authoritative guidance on the accounting for the federal subsidy is pending and that guidance, when issued, could require changes to previously reported information.

The following is a table of retirement and postretirement benefits expenses (credits):

	2003	2002	2001
Pension	\$ 1,325	\$ 837	\$ 1,332
Thrift/deferred compensation	188	179	156
Other postretirement benefits	<u>970</u>	<u>675</u>	<u>1,108</u>
Total	<u>\$ 2,483</u>	<u>\$ 1,691</u>	<u>\$ 2,596</u>

Note 10 — Intra-System Financial Assistance

The Farm Credit System Financial Assistance Corporation (Financial Assistance Corporation) was established in 1988 primarily to provide capital to institutions of the System experiencing financial difficulty. Such assistance was funded through the Financial Assistance Corporation's issuance of \$1.261 billion of 15-year U.S. Treasury-guaranteed debt. The interest rates on these issuances range from 8.80 percent to 9.45 percent. The repayment of this debt and related interest is the responsibility of System banks. At December 31, 2003, only \$325 million of Financial Assistance Corporation debt remains outstanding. All other debt has either matured or was called and redeemed.

Each System bank may be required to pay premiums into the Insurance Fund based on its annual average loan principal outstanding. The Bank, in turn, may also assess the Association for insurance premiums based on the average principal outstanding of accrual and nonaccrual loans of the Association for each year. At December 31, 2003, the assets in the Insurance Fund aggregated \$2.033 billion. However, due to the authorized uses of the Insurance Fund, there is no assurance that Fund assets will be available or sufficient to ensure the payment of principal of, or interest on, insured debt securities in the event of a default by any System bank having primary liability thereon.

Note 11 — Related Party Transactions

In the ordinary course of business, the Association enters into loan transactions with officers and directors of the Association, their immediate families and other organizations with which such persons may be associated. Such loans are subject to special approval requirements contained in the FCA regulations and are made on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated borrowers.

Total loans to such persons at December 31, 2003 amounted to \$2,824. During 2003, \$1,184 of new loans were made and repayments totaled \$1,343. In the opinion of management, none of these loans outstanding at December 31, 2003 involved more than a normal risk of collectibility.

Note 12 — Commitments and Contingencies

The Association has various commitments outstanding and contingent liabilities.

The Association may participate in financial instruments with off-balance-sheet risk to satisfy the financing needs of its borrowers and to manage their exposure to interest-rate risk. These financial instruments include commitments to extend credit and commercial letters of credit. The instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the financial statements. Commitments to extend credit are agreements to lend to a borrower as long as there is not a violation of any condition established in the contract. Commercial letters of credit are agreements to pay a beneficiary under conditions specified in the letter of credit. Commitments and letters of credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. At December 31, 2003, \$137,035 of commitments to extend credit and \$1,929 of standby letters of credit were outstanding.

Since many of these commitments are expected to expire without being drawn upon, the total commitments do not necessarily represent future cash requirements. However, these credit-related financial instruments have off-balance-sheet credit risk because their amounts are not reflected on the Balance Sheet until funded or drawn upon. The credit risk associated with issuing commitments and letters of credit is substantially the same as that involved in extending loans to borrowers and management applies the same credit policies to these commitments. Upon fully funding a commitment, the credit risk amounts are equal to the contract amounts, assuming that borrowers fail completely to meet their obligations and the collateral or other security is of no value. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the borrower.

The Association also participates in standby letters of credit to satisfy the financing needs of its borrowers. These letters of credit are irrevocable agreements to guarantee payments of specified financial obligations. Outstanding standby letters of credit have expiration dates ranging from August 26, 2004 to August 6, 2008.

Note 13 — Disclosures About Fair Value Of Financial Instruments

The following table presents the carrying amounts and fair values of the Association's financial instruments at December 31, 2003, 2002 and 2001. The fair value of a financial instrument is generally defined as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Quoted market prices are generally not available for certain System financial instruments, as described below. Accordingly fair values are based on judgments regarding anticipated cash flows, future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates involve uncertainties and matters of judgment, and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

The estimated fair values of the Association's financial instruments are as follows:

	December 31, 2003		December 31, 2002	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash	\$ 32	\$ 32	\$ 665	\$ 665
Loans	\$ 1,069,137	\$ 1,075,084	\$ 1,022,513	\$ 1,049,034
Allowance for loan losses	23,302	—	24,505	—
Loans, net	\$ 1,045,835	\$ 1,075,084	\$ 998,008	\$ 1,049,034
Financial liabilities:				
Notes payable to AgFirst Farm Credit Bank	\$ 890,426	\$ 876,750	\$ 847,329	\$ 857,824

	December 31, 2001	
	Carrying Amount	Estimated Fair Value
Financial assets:		
Cash	\$ 538	\$ 538
Loans	\$ 902,555	\$ 895,120
Allowance for loan losses	22,100	—
Loans, net	\$ 880,455	\$ 895,120
Financial liabilities:		
Notes payable to AgFirst Farm Credit Bank	\$ 737,512	\$ 734,271

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

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

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

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

The carrying value of accrued interest approximates its fair value.

- C. **Investment in AgFirst Farm Credit Bank:** Estimating the fair value of the Association's investment in the Bank is not practicable because the stock is not traded. As described in Note 4, the net investment is a requirement of borrowing from the Bank and is carried at cost plus allocated equities in the accompanying balance sheet. The Association owns 8.25 percent of the issued stock of the Bank as of December 31, 2003 net of any reciprocal investment. As of that date, the Bank's assets totaled \$15.9 billion and shareholders' equity totaled \$955 million. The Bank's earnings were \$177 million during 2003.
- D. **Notes Payable to AgFirst Farm Credit Bank:** The notes payable are segregated into pricing pools according to the types and terms of the loans (or other assets) which they fund. Fair value of the notes payable is estimated by discounting the anticipated cash flows of each pricing pool using the current rate that would be charged for additional borrowings. For purposes of this estimate it is assumed the cash flow on the notes is equal to the principal payments on the Association's loan receivables plus accrued interest on the notes payable. This assumption implies that earnings on the Association's interest margin are used to fund operating expenses and capital expenditures.
- E. **Commitments to Extend Credit and Standby Letters of Credit:** The estimated market value of off-balance-sheet commitments is minimal since the committed rate approximates current rates offered for commitments with similar rate and maturity characteristics and since the related credit risk is not significant.

Note 14 — Quarterly Financial Information (Unaudited)

Quarterly results of operations for the years ended December 31, 2003, 2002 and 2001 follow:

	2003				
	First	Second	Third	Fourth	Total
Net interest income	\$ 5,721	\$ 6,074	\$ 6,203	\$ 6,053	\$ 24,051
Provision for (reversal of) loan losses	514	666	—	—	1,180
Noninterest income (expense), net	(1,230)	(1,284)	(1,185)	(723)	(4,422)
Net income (loss)	\$ 3,977	\$ 4,124	\$ 5,018	\$ 5,330	\$ 18,449

	2002				
	First	Second	Third	Fourth	Total
Net interest income	\$ 4,874	\$ 5,055	\$ 5,698	\$ 6,037	\$ 21,664
Provision for (reversal of) loan losses	600	623	601	611	2,435
Noninterest income (expense), net	(1,035)	(1,345)	(1,543)	(76)	(3,999)
Net income (loss)	\$ 3,239	\$ 3,087	\$ 3,554	\$ 5,350	\$ 15,230

	2001				
	First	Second	Third	Fourth	Total
Net interest income	\$ 5,887	\$ 5,970	\$ 5,510	\$ 5,759	\$ 23,126
Provision for (reversal of) loan losses	97	541	500	505	1,643
Noninterest income (expense), net	(5,305)	3,379	92	(1,579)	(3,413)
Net income (loss)	\$ 485	\$ 8,808	\$ 5,102	\$ 3,675	\$ 18,070