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*Farm Credit of the Virginias, ACA*

# **SECOND QUARTER 2005**

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David E. Lawrence  
Chief Executive Officer



William J. Franklin, Jr.  
Chairman of the Board

July 29, 2005

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

*(dollars in thousands)*

The following commentary reviews the consolidated financial condition and results of operations of Farm Credit of the Virginias, ACA (Association) for the period ended June 30, 2005. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements and the 2004 Annual Report of the Association.

## **LOAN PORTFOLIO**

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

As of June 30, 2005, the gross loan volume of the Association was \$1,152,728. This was an increase of \$21,866 or 1.93 percent as compared to \$1,130,862 at December 31, 2004. Net loans outstanding at June 30, 2005, were \$1,149,973 as compared to \$1,127,915 at December 31, 2004. Net loans were 96.69 percent of total assets at June 30, 2005. The demand for loans decreased slightly as compared to the same period last year as short-term interest rates continued to move up during the period.

There is an inherent risk in the extension of any type of credit. Portfolio credit quality continues to be maintained at an acceptable level, however, and credit administration remains satisfactory. Nonaccrual loans increased from \$2,511 at December 31, 2004, to \$3,572 at June 30, 2005. The increase was primarily the result of additional loans being downgraded to nonaccrual status.

Association management maintains an allowance for loan losses in an amount considered sufficient to absorb possible losses in the loan portfolio. Factors considered in determining the allowance for loan losses were generally based on recent historical charge-off experience adjusted for relevant environmental factors. The allowance for loan losses at June 30, 2005, was \$2,755.

## **RESULTS OF OPERATIONS**

### ***For the three months ended June 30, 2005***

Net income for the three months ended June 30, 2005 totaled \$6,234, as compared to \$5,196 for the same period in 2004, an increase of \$1,038 or 19.98 percent. The increase in net income was primarily due to an increase in net interest income.

Net interest income increased \$1,194, or 19.47 percent, for the three months ended June 30, 2005, as compared to the same period in 2004. The increase in net interest income was mainly due to the increase in loan volume and higher return on investments that are tied to short-term interest rates when compared to same quarter last year.

Noninterest income for the three months ended June 30, 2005, totaled \$2,255, as compared to \$2,644 for the same period of 2004, a decrease of \$389. The decrease was primarily due to the sale of an office building last year that resulted in a large one-time gain. Noninterest expenses for the three months ended June 30, 2005 totaled \$3,450. This was a decrease of \$96 compared to the same period of 2004. The decrease was mainly due to lower Farm Credit System insurance fund premium expense.

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**For the six months ended June 30, 2005**

Net income for the six months ended June 30, 2005 totaled \$12,058, as compared to \$9,753 for the same period in 2004, an increase of \$2,305 or 23.63 percent. Net interest income for the first six months increased \$2,237 compared to the same period in 2004. The increase in net interest income was primarily due to an increase in loan volume and higher return on investments that are tied to short-term interest rates when compared to same period last year.

Noninterest income for the six months ended June 30, 2005, totaled \$4,487, as compared to \$4,744 for the same period of 2004, a decrease of \$257. The decrease was primarily due to the sale of two office buildings last year that caused noninterest income to increase. Noninterest expenses for the six months ended June 30, 2005 totaled \$6,886. This was a decrease of \$157 compared to the same period of 2004. The decrease was mainly due to lower Farm Credit System insurance fund premium expense.

**FUNDING SOURCES**

The principal source of funds for the Association is the borrowing relationship established with AgFirst Farm Credit Bank (the Bank) through a General Financing Agreement. The General Financing Agreement utilizes the Association's credit and fiscal performance as criteria for establishing a line of credit on which the Association may draw funds. The Bank advances the funds to the Association in the form of notes payable. The notes payable are segmented into variable rate and fixed rate sections. The variable rate note is utilized by the Association to fund variable rate loan advances and operating funds requirements. The fixed rate note is used specifically to fund fixed rate loan advances made by the Association. The total notes payable to the Bank at June 30, 2005, was \$981,379 as compared to \$959,297 at December 31, 2004. The increase during the period is primarily attributed to the increase in loan volume.

**CAPITAL RESOURCES**

Total members' equity at June 30, 2005 totaled \$192,975, an increase of \$11,313, as compared to \$181,662 at December 31, 2004. The increase in members' equity was primarily attributed to earnings.

Farm Credit Administration (FCA) regulations require all Farm Credit institutions to maintain minimum permanent capital, total surplus and core surplus ratios. These ratios are calculated by dividing the Association's permanent capital, total surplus and core surplus as defined in FCA regulations, by a risk-adjusted asset base. As of June 30, 2005, the Association's total surplus ratio and core surplus ratio were 13.75 percent and 11.73 percent, respectively, and the permanent capital ratio was 15.42 percent. All three ratios were well above the minimum regulatory ratios of 7.00 percent for permanent capital and total surplus ratios and 3.50 percent for the core surplus ratio.

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**NOTE:** Shareholder investment in the Association could be affected by the financial condition and results of operations of AgFirst Farm Credit Bank. Copies of AgFirst's annual and quarterly reports are available upon request free of charge by calling 1-800-845-1745, ext. 378, or writing Jay Wise, AgFirst Farm Credit Bank, P.O. Box 1499, Columbia, SC 29202. Information concerning AgFirst Farm Credit Bank can also be obtained at their website, [www.agfirst.com](http://www.agfirst.com). Copies of the Association's annual and quarterly reports are also available upon request free of charge by calling 1-540-886-3435, writing David Sauer, CFO, Farm Credit of the Virginias, ACA, P.O. Box 899, Staunton, VA 24402, or accessing the website, [www.farmcreditofvirginias.com](http://www.farmcreditofvirginias.com). The Association prepares a quarterly report within 45 days after the end of each fiscal quarter, except that no report need be prepared for the fiscal quarter that coincides with the end of the fiscal year of the institution.

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

<i>(dollars in thousands)</i>	<b>June 30, 2005</b> <i>(unaudited)</i>	<b>December 31, 2004</b> <i>(audited)</i>
<b>Assets</b>		
Cash	\$ 1,321	\$ 2,039
Loans	1,152,728	1,130,862
Less: allowance for loan losses	2,755	2,947
Net loans	1,149,973	1,127,915
Accrued interest receivable	9,868	6,348
Investment in other Farm Credit institutions	13,524	13,524
Premises and equipment, net	4,523	4,116
Other property owned	89	—
Other assets	10,079	18,157
Total assets	<u>\$ 1,189,377</u>	<u>\$ 1,172,099</u>
<b>Liabilities</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 981,379	\$ 959,297
Accrued interest payable	3,976	3,651
Patronage refund payable	49	10,072
Postretirement benefits other than pensions	5,881	5,630
Other liabilities	5,117	11,787
Total liabilities	<u>996,402</u>	<u>990,437</u>
Commitments and contingencies		
<b>Members' Equity</b>		
Capital stock and participation certificates	18,926	19,094
Retained earnings		
Allocated	59,182	58,640
Unallocated	114,867	103,928
Total members' equity	<u>192,975</u>	<u>181,662</u>
Total liabilities and members' equity	<u>\$ 1,189,377</u>	<u>\$ 1,172,099</u>

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

*Farm Credit of the Virginias, ACA*  
**Consolidated Statements of Income**

*(unaudited)*

<i>(dollars in thousands)</i>	<b>For the three months ended June 30,</b>		<b>For the six months ended June 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
<b>Interest Income</b>				
Loans	\$ 19,106	\$ 16,117	\$ 37,317	\$ 31,929
<b>Interest Expense</b>				
Notes payable to AgFirst Farm Credit Bank	11,778	9,983	22,956	19,805
Net interest income	7,328	6,134	14,361	12,124
Provision for (reversal of) loan losses	(78)	—	(78)	—
Net interest income after provision for (reversal of) loan losses	7,406	6,134	14,439	12,124
<b>Noninterest Income</b>				
Loan fees	194	138	377	303
Fees for financially related services	12	12	24	23
Equity in earnings of other Farm Credit institutions	1,863	1,718	3,679	3,399
Gains (losses) on other property owned, net	7	—	7	—
Other noninterest income	179	776	400	1,019
Total noninterest income	2,255	2,644	4,487	4,744
<b>Noninterest Expense</b>				
Salaries and employee benefits	2,227	2,255	4,677	4,619
Occupancy and equipment	269	240	536	487
Insurance Fund premium	114	271	223	538
Other operating expenses	840	780	1,450	1,399
Total noninterest expense	3,450	3,546	6,886	7,043
Income before income taxes	6,211	5,232	12,040	9,825
Provision (benefit) for income taxes	(23)	36	(18)	72
Net income	\$ 6,234	\$ 5,196	\$ 12,058	\$ 9,753

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

*Farm Credit of the Virginias, ACA*  
**Consolidated Statements of Changes in  
Members' Equity**

*(unaudited)*

	Capital Stock and Participation Certificates	Retained Earnings		Accumulated Other Comprehensive Income	Total Members' Equity
		Allocated	Unallocated		
<i>(dollars in thousands)</i>					
Balance at December 31, 2003	\$ 19,735	\$ 58,345	\$ 78,727	\$ (5,297)	\$ 151,510
Net income			9,753		9,753
Capital stock/participation certificates issued	719				719
Capital stock/participation certificates retired	(1,017)				(1,017)
Retained earnings retired		(34)			(34)
Distribution adjustment		298	257		555
Balance at June 30, 2004	\$ 19,437	\$ 58,609	\$ 88,737	\$ (5,297)	\$ 161,486
Balance at December 31, 2004	\$ 19,094	\$ 58,640	\$ 103,928	\$ —	\$ 181,662
Net income			12,058		12,058
Capital stock/participation certificates issued	631				631
Capital stock/participation certificates retired	(799)				(799)
Retained earnings retired		(18)			(18)
Distribution adjustment		560	(1,119)		(559)
Balance at June 30, 2005	\$ 18,926	\$ 59,182	\$ 114,867	\$ —	\$ 192,975

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

*Farm Credit of the Virginias, ACA*

# Notes to the Consolidated Financial Statements

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

**NOTE 1 – ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES**

A description of the organization and operations of Farm Credit of the Virginias, ACA (the Association), the significant accounting policies followed, and the financial condition and results of operations as of and for the year ended December 31, 2004, are contained in the 2004 Annual Report to Shareholders. These unaudited second quarter 2005 consolidated financial statements should be read in conjunction with the 2004 Annual Report to Shareholders.

The accompanying consolidated financial statements contain all adjustments necessary for a fair presentation of the interim financial condition and results of operations and conform with generally accepted accounting principles. The results for the six months ended June 30, 2005, are not necessarily indicative of the results to be expected for the year ending December 31, 2005.

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

The Association maintains an allowance for loan losses in accordance with generally accepted accounting principles. The loan portfolio is reviewed quarterly to determine the adequacy of the allowance for losses. As of June 30, 2005, the allowance for losses is adequate in management's opinion to provide for possible losses on existing loans.

**NOTE 2 – ALLOWANCE FOR LOAN LOSSES**

An analysis of the allowance for loan losses follows:

Balance at 12-31-03	\$ 23,302
(Reversal of) provision for loan losses	—
Recoveries, net of loans charged off	<u>241</u>
Balance at 6-30-04	<u>\$ 23,543</u>
Balance at 12-31-04	\$ 2,947
(Reversal of) provision for loan losses	(78)
Loans (charged off), net of recoveries	<u>(114)</u>
Balance at 6-30-05	<u>\$ 2,755</u>

As discussed in the 2004 Annual Report, the Association recorded a loan loss reversal of \$20,858 in the fourth quarter of 2004 that resulted in a decrease in the allowance for loan losses.

**NOTE 3 – EMPLOYEE BENEFIT PLANS**

The Association participates in a Districtwide defined benefit retirement plan. The 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 each institution's salary expense as a percentage of the District's salary expense. The Association also participates in Districtwide Thrift and other postretirement benefit plans.

The following is a table of retirement and postretirement benefit expense for the six months ended June 30, 2005:

	<b>For the six months ended June 30,</b>	
	<b>2005</b>	<b>2004</b>
Pension	\$ 534	\$ 606
Thrift/deferred compensation	119	113
Other postretirement benefits	<u>426</u>	<u>504</u>
Total	<u>\$1,079</u>	<u>\$1,223</u>

As of June 30, 2005, no contributions have been made to the pension plan for 2005. Actuarial projections as of the last plan measurement date (September 30, 2004) did not anticipate any contributions for 2005; however, market conditions could impact discount rates and return on plan assets which could change this expectation, making contributions necessary before the next plan measurement date.