

# **THIRD QUARTER 2003**

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David Lawrence  
Chief Executive Officer



W. W. Sanford, III  
Chairman of the Board

October 29, 2003

# 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 September 30, 2003. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements and the 2002 Annual Report of the Association.

## **LOAN PORTFOLIO**

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

The gross loan volume of the Association as of September 30, 2003, was \$1,071,244, an increase of \$48,731 as compared to \$1,022,513 at December 31, 2002. During the past nine months, loan volume has increased primarily due to the continued strong demand in loans as interest rates reached 40 year lows. During the later part of the third quarter, however, the pace of loan growth has slowed as long-term interest rates rose during the summer months which decreased the demand for loans. Net loans outstanding at September 30, 2003, were \$1,047,947 as compared to \$998,008 at December 31, 2002. Net loans were 96.82 percent of total assets at September 30, 2003.

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 decreased from \$10,351 at December 31, 2002, to \$7,239 at September 30, 2003. The decrease was primarily the

result of charge-offs taken on several loans and the continued collection efforts on loans.

Association management maintains an allowance for loan losses in an amount considered sufficient to absorb possible losses in the loan portfolio based on current and expected future conditions. The allowance for loan losses decreased \$1,208 during the nine months ended September 30, 2003. The decrease was the result of recording net charge-offs on loans totaling \$2,388 and additions to the allowance of \$1,180 during the year. The allowance for loan losses at September 30, 2003, was \$23,297 compared to \$24,505 at December 31, 2002, and was considered by management to be adequate to cover possible losses.

## **RESULTS OF OPERATIONS**

### ***For the three months ended September 30, 2003***

Net income for the three months ended September 30, 2003, totaled \$5,018, as compared to \$3,554 for the same period in 2002, an increase of \$1,464 or 41 percent. The increase in net income for the third quarter 2003 was primarily due to an increase in net interest income and noninterest income.

Net interest income increased \$505, or 9 percent for the three months ended September 30, 2003, as compared to the same period in 2002. The increase in net interest income was mainly due to an increase in loan volume and an increase in spreads on loans as compared to the same period last year.

Noninterest income for the three months ended September 30, 2003, showed an increase. Noninterest income totaled \$2,305, as compared to \$1,911 for the same period of 2002, an increase of \$394 or 21 percent. The increase was primarily due to an increase in loan fees of \$216 and an increase in equity in earnings of AgFirst Farm Credit Bank (the Bank) of \$173. The increase in loan fees was primarily the result of increased fee income from loans sold into the secondary mortgage market. The Association does not hold these loans, instead the loans are sold to third party and the

Association receives a fee for originating the loans. The Association continued to experience increased home mortgage loan originations as customers refinanced their mortgages to take advantage of the low interest rate environment.

Noninterest expense for the three months ended September 30, 2003 totaled \$3,601, as compared to \$3,081, an increase of \$520 or 17 percent. The primary reasons for the increase were higher salaries and employee benefits expenses and higher insurance fund premium. Salaries and employee benefits increased \$203 or 10 percent. The increase was primarily due to annual salary increases, additional staff, higher pension and retirement cost, and increases in medical insurance expenses. The higher insurance fund premium of \$247 was due to an overall increase in Farm Credit System loan volume.

The Association recognized a benefit for income taxes for the three months ended September 30, 2003 totaling \$373, as compared to a tax provision of \$111 during the same period last year.

#### ***For the nine months ended September 30, 2003***

Net income for the nine months ended September 30, 2003, totaled \$13,119, as compared to \$9,880 for the same period in 2002, an increase of \$3,239 or 33 percent. The increase was mainly due to an increase in net interest income and noninterest income.

Net interest income increased \$2,371, or 15 percent, for the nine months ended September 30, 2003, as compared to the same period in 2002. The increase in net interest income was mainly due to an increase in loan volume and an increase in spreads on loans when compared to the same period last year.

The Association recorded a provision for loan losses of \$1,180 for the nine months ended September 20, 2003, compared to a provision of \$1,824 for the same period last year, a decrease of \$644.

Noninterest income for the nine months ended September 30, 2003, totaled \$6,762, as compared to \$5,403 for the same period of 2002, an increase of \$1,359, or 25 percent. The increase was due primarily to an increase in loan fees of \$710 and an increase in equity in earnings of the Bank of \$577. The increase in loan fees was the result of increased fee income from loans sold into the secondary mortgage market. The increase in equity in earnings of the Bank was due to the increase in loan volume.

Noninterest expense for the nine months ended September 30, 2003, increased \$1,820 compared to the same period of 2002. The primary reasons for the increase were higher salaries and employee benefits expenses and higher insurance fund premium. Salaries and employee benefits increased \$952. The increase was primarily due to annual salary increases, additional staff, higher pension and retirement cost, and increases in medical insurance expenses. The higher insurance fund premium of \$734 was due to the overall increase in Farm Credit System loan volume.

#### **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 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 September 30, 2003, was \$901,937 as compared to \$847,329 at December 31, 2002. The increase during the period is primarily attributed to the increase in loan volume.

#### **CAPITAL RESOURCES**

Total members' equity at September 30, 2003 totaled \$163,048, an increase of \$12,390, as compared to \$150,658 at December 31, 2002. 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 September 30, 2003, the Association's permanent capital ratio was 14.28 percent, total surplus ratio was 12.42 percent and core surplus ratio was 9.53 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.

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

<i>(dollars in thousands)</i>	<b>September 30, 2003</b>	<b>December 31, 2002</b>
	<i>(unaudited)</i>	
<b>Assets</b>		
Cash	\$ 33	\$ 665
Loans	1,071,244	1,022,513
Less: allowance for loan losses	23,297	24,505
Net loans	1,047,947	998,008
Accrued interest receivable	9,006	6,281
Investment in AgFirst Farm Credit Bank	15,306	15,306
Premises and equipment, net	3,561	3,628
Other property owned	85	—
Deferred tax asset, net	19	19
Other assets	6,365	7,649
Total assets	\$ 1,082,322	\$ 1,031,556
<b>Liabilities</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 901,937	\$ 847,329
Accrued interest payable	3,743	3,890
Patronage refund payable	28	8,467
Postretirement benefits other than pensions	4,673	4,155
Minimum pension liability	4,001	3,899
Other liabilities	4,892	13,158
Total liabilities	919,274	880,898
Commitments and contingencies		
<b>Members' Equity</b>		
Capital stock and participation certificates	19,916	20,469
Retained earnings		
Allocated	57,796	57,904
Unallocated	91,197	78,146
Accumulated other comprehensive income (loss)	(5,861)	(5,861)
Total members' equity	163,048	150,658
Total liabilities and members' equity	\$ 1,082,322	\$ 1,031,556

*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 September 30,</b>		<b>For the nine months ended September 30,</b>	
	<b>2003</b>	<b>2002</b>	<b>2003</b>	<b>2002</b>
<b>Interest Income</b>				
Loans	\$ 16,100	\$ 16,635	\$ 48,479	\$ 48,330
<b>Interest Expense</b>				
Notes payable to AgFirst Farm Credit Bank	9,897	10,937	30,481	32,703
Net interest income	6,203	5,698	17,998	15,627
Provision for (reversal of) loan losses	—	601	1,180	1,824
Net interest income after provision for (reversal of) loan losses	6,203	5,097	16,818	13,803
<b>Noninterest Income</b>				
Loan fees	557	341	1,537	827
Fees for financially related services	11	13	98	46
Equity in earnings of AgFirst Farm Credit Bank	1,713	1,540	4,981	4,404
Miscellaneous	24	17	146	126
Total noninterest income	2,305	1,911	6,762	5,403
<b>Noninterest Expense</b>				
Salaries and employee benefits	2,258	2,055	7,057	6,105
Occupancy and equipment	232	244	698	696
Insurance Fund premium	320	73	947	213
Other operating expenses	788	709	2,058	1,929
Losses on other property owned, net	3	—	3	—
Total noninterest expense	3,601	3,081	10,763	8,943
Income before income taxes	4,907	3,927	12,817	10,263
Provision (benefit) for income taxes	(111)	373	(302)	383
Net income	\$ 5,018	\$ 3,554	\$ 13,119	\$ 9,880

*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, 2001	\$ 21,580	\$ 55,329	\$ 79,761	\$ —	\$ 156,670
Net income			9,880		9,880
Capital stock/participation certificates issued	925				925
Capital stock/participation certificates retired	(1,797)				(1,797)
Retained earnings retired		(76)			(76)
Distribution adjustment		1,807	(15)		1,792
Balance at September 30, 2002	\$ 20,708	\$ 57,060	\$ 89,626	\$ —	\$ 167,394
Balance at December 31, 2002	\$ 20,469	\$ 57,904	\$ 78,146	\$ (5,861)	\$ 150,658
Net income			13,119		13,119
Capital stock/participation certificates issued	1,214				1,214
Capital stock/participation certificates retired	(1,767)				(1,767)
Retained earnings retired		(143)			(143)
Distribution adjustment		35	(68)		(33)
Balance at September 30, 2003	\$ 19,916	\$ 57,796	\$ 91,197	\$ (5,861)	\$ 163,048

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

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*Farm Credit of the Virginias, ACA*

# Notes to the Consolidated Financial Statements

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

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

A description of the organization and operations of Farm Credit of the Virginias, ACA (the Association), the significant accounting policies followed, and the financial condition and results of operations as of and for the year ended December 31, 2002, are contained in the 2002 Annual Report to Stockholders. These unaudited third quarter 2003 consolidated financial statements should be read in conjunction with the 2002 Annual Report to Stockholders.

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 nine months ended September 30, 2003, are not necessarily indicative of the results to be expected for the year ending December 31, 2003.

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 September 30, 2003, 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 12-31-01	\$ 22,100
(Reversal of) provision for loan losses	1,824
Loans (charged off), net of recoveries	<u>(24)</u>
Balance at 9-30-02	<u>\$ 23,900</u>
Balance at 12-31-02	\$ 24,505
(Reversal of) provision for loan losses	1,180
Loans (charged off), net of recoveries	<u>(2,388)</u>
Balance at 9-30-03	<u>\$ 23,297</u>