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**ArborOne, ACA**

**THIRD QUARTER 2009**

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**CERTIFICATION**

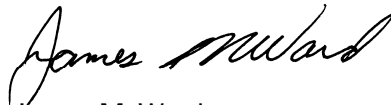
The undersigned certify that we have reviewed the September 30, 2009 quarterly report of **ArborOne, ACA**, that the report has been prepared under the oversight of the Audit Committee of the Board of Directors and in accordance with all applicable statutory or regulatory requirements, and that the information contained herein is true, accurate, and complete to the best of our knowledge and belief.



Jasper W. Shuler  
Chief Executive Officer



Tammy G. Smith  
Chief Financial Officer



James M. Ward  
Chairman of the Board

October 27, 2009

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## ArborOne, ACA

# Report on Internal Control Over Financial Reporting

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

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

The Association's management has completed an assessment of the effectiveness of internal control over financial reporting as of September 30, 2009. In making the assessment, management used the framework in *Internal Control — Integrated Framework*, promulgated by the Committee of Sponsoring Organizations of the Treadway Commission, commonly referred to as the "COSO" criteria.

Based on the assessment performed, the Association concluded that as of September 30, 2009, the internal control over financial reporting was effective based upon the COSO criteria. Additionally, based on this assessment, the Association determined that there were no material weaknesses in the internal control over financial reporting as of September 30, 2009



Jasper W. Shuler  
Chief Executive Officer



Tammy G. Smith  
Chief Financial Officer

October 27, 2009

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

*(dollars in thousands)*

The following commentary reviews the financial condition and results of operations of **ArborOne, ACA**, (Association) for the period ended September 30, 2009. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements and the 2008 Annual Report of the Association. The accompanying consolidated financial statements were prepared under the oversight of the Audit Committee of the Board of Directors.

## **LOAN PORTFOLIO**

The Association provides funds to farmers, rural homeowners and farm-related businesses for financing 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 tobacco, poultry, swine and forestry. Farm size varies and many of the borrowers in the region have diversified farming operations. These factors, along with the numerous opportunities for non-farm income in the area, somewhat impact the level of dependency on a given commodity. Approximately twenty-seven percent of the portfolio has significant outside income to diversify dependence on agriculture, consisting of lifestyle loans and loans to less than full-time farmers with retirement income, salaried income and non-agricultural business income. Further, approximately seventeen percent of the assets carry federal guarantees as a risk management tool.

The gross loan volume of the Association as of September 30, 2009, was \$292,500, a decrease of \$8,493 as compared to \$300,993 at December 31, 2008. Net loans outstanding at September 30, 2009, were \$291,108 as compared to \$299,082 at December 31, 2008. During the nine months ended September 30, 2009, the Association's sold participations to **AgFirst Farm Credit Bank** (the Bank) decreased by \$7,379. As of September 30, 2009, the Association had \$107,495 of such participations outstanding. The Association has investment securities that are classified as available for sale in the amount of \$22,432 at September 30, 2009 compared to \$27,770 at December 31, 2008. The Association entered into commitments to acquire Successor-in-Interest Contracts (SIIC), beginning in the fourth quarter of 2005. As of September 30, 2009, the Association had \$99,609 in other investments for SIIC, compared to \$111,934 at December 31,

2008. Net loans and investments accounted for 93.53 percent of total assets at September 30, 2009, as compared to 93.10 percent of total assets at December 31, 2008.

Net loans and investments decreased by \$25,651 during the reporting period. The decrease in loan volume is primarily due to a decrease in gross loan volume, and partially offset by a decrease in participations sold loan volume. The Association has tightened lending policies as well as strengthened its capital position.

Investment securities available for sale decreased by \$5,338 and investments held to maturity decreased by \$14 due to normal payments. The decrease in investment securities available for sale was due to pay downs of \$6,068 and partially offset by an improvement in fair values of \$729. The other investments for SIIC decreased by \$12,325, which was due to the annual payments on the contracts and partially offset by purchasing additional contracts. The Association continues to review and engage in investment and participation opportunities, while serving customers within the territory.

There is an inherent risk in the extension of any type of credit. However, portfolio credit quality continues to be maintained at an acceptable level, and credit administration remains satisfactory. Nonaccrual loans increased from \$6,586 at December 31, 2008, to \$14,273 at September 30, 2009. This was due to several large participation accounts that were moved to non-accrual plus several core agricultural loans. One large participation loan and two core loans totaling \$2,386 were moved from nonaccrual to Other Property Owned. The participation loan and one of the core loans were sold reducing Other Property Owned by \$2,290 for the third quarter.

Association management maintains an allowance for loan losses in an amount considered sufficient to absorb possible losses in the loan portfolio based on credit quality, current conditions, and expected future conditions. The allowance for loan losses at September 30, 2009, was \$1,392, compared to \$1,911 at December 31, 2008. This decrease was the result of recognizing charge offs of five large participation accounts in the amount of \$2,316, and eight core agricultural loans in the amount of \$951. Additions were made to the allowance in the amount of \$2,706. There were net recoveries of \$41 for the nine months ended September 30, 2009. The allowance for loan loss for the period ending September 30, 2009, is considered by management to be adequate to cover any future possible losses.

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## RESULTS OF OPERATIONS

### *For the three months ended September 30, 2009*

Net income for the three months ended September 30, 2009, totaled \$959, as compared to \$2,985 for the same period in 2008. Net interest income decreased \$657, for the three months ended September 30, 2009, as compared to the same period in 2008 due to decreased loan volume and lower interest rates. This decrease in net interest income is attributed mostly to a decrease of \$1,909 in interest income from loan volume, other investments (SIIC), and investment securities. Interest expense also decreased by \$1,252. The interest expense decrease was a result of decreased loan volume and lower interest rates which were partially offset by an increase of interest expense for the subordinated debt of \$157.

At September 30, 2009, interest income on accruing loans decreased by \$1,338 compared to \$5,187 at September 30, 2008. Interest income on investment securities was \$136 compared to \$281 for the same period in 2008. Interest income on other investments (SIIC) was \$1,294 for the three months ended September 30, 2009, and \$1,478 for the same period in 2008. These decreases in investment interest income are attributed to a decrease in volume for both investment securities and other investments (SIIC). Interest expense decreased \$1,252 for the three months ended September 30, 2009, as compared to the comparable period of 2008. The interest expense decrease was a result of decreased loan volume and lower interest rates as well as a decrease in investment volume. This decrease was partially offset by the interest expense from the subordinated debt of \$157. The Association recorded a net provision for loan loss of \$1,052 for the quarter compared to \$237 for the comparable period of 2008.

Noninterest income for the three months ended September 30, 2009, totaled \$2,610 as compared to \$3,208 for the same period of 2008, a decrease of \$598. The decrease is primarily the result of a decrease in gain on sales of premises and equipment and loan fees. This decrease was primarily attributed to the gain from the sale of the association's office building that was reported in this same period for 2008. The decrease was partially offset by an increase in patronage income for loans sold to the Bank and an increase in fees for farm related services. Noninterest expense for the three months ended September 30, 2009, decreased \$8 compared to the same period of 2008. Increases in salaries and employee benefits were primarily offset by decreases in occupancy and equipment and other operating expenses. The Association recorded a provision for income taxes of \$8 for the three months ended September 30, 2009 compared to \$44 for the three months ended September 30, 2008.

### *For the nine months ended September 30, 2009*

Net income for the nine months ended September 30, 2009, totaled \$2,141, as compared to \$6,011 for the same period in 2008. Net interest income decreased \$1,452 or 25.55 percent compared to September 30, 2008. Interest income on loans and other investments (SIIC) decreased by \$4,704 and investment securities decreased by \$536. Interest expense decreased by \$3,788 to the same period of 2008. This decrease was partially offset by an increase in interest expense from the subordinated debt of \$495. The change in net interest income is the result of both decreased loan volume and lower interest rates.

Nonaccrual income was \$45 for the nine months ended September 30, 2009, as compared to \$279 for the same period in 2008. The Association recorded a provision for loan loss of \$2,706 for the nine months ended September 30, 2009, as compared to a provision for loan loss of \$873 for the same period in 2008.

Noninterest income for the nine months ended September 30, 2009, totaled \$6,618 as compared to \$7,298 for the same period of 2008, a decrease of \$680. The decrease is primarily due to a decrease in gain on sales of premises and equipment and loan fees. The sale of the association's office building was reported in this same period for 2008. The decrease was partially offset by an increase in fees for financially related services of \$87 and an increase in patronage income for loans sold to the Bank. Noninterest expense for the nine months ended September 30, 2009, decreased \$46 compared to the same period of 2008. This decrease is attributable to a decrease in other operating expenses of \$656 which resulted from a reduction in advertising expenses. This decrease in other operating expenses was offset by a rise in occupancy and equipment expenses of \$51, insurance fund premium of \$38, and salaries and employee benefits of \$521 which was due primarily to an increase in retirement benefits. The Association recorded a provision for income taxes of \$14 for the nine months ended September 30, 2009, a decrease of \$49 as compared to the same period in 2008.

## FUNDING SOURCES

The principal source of funds for the Association is the borrowing relationship established with the Bank through a General Financing Agreement. The General Financing Agreement utilizes the Association's credit and fiscal performance as criteria for establishing a line of credit on which the Association may draw funds. The funds are advanced by the Bank to the Association in the form of notes payable. The notes payable are segmented into variable rate and fixed rate 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, 2009, was \$378,965 as compared to \$406,997 at December 31, 2008. The decrease during the period is primarily attributable to decreased loan volume and lower interest rates.

In September 2008, the Association issued \$7,500 of fixed rate unsecured subordinated debt due in 2018, generating proceeds that were primarily used to increase the permanent capital of the Association pursuant to the Farm Credit Administration regulations, and for general corporate purposes. The debt is payable to another association in the Farm Credit System (System). It is subordinate to all other categories of creditors, including any claims of the Bank and general creditors, and is senior to all classes of shareholders. The subordinated debt is not considered System debt, and thus is not guaranteed by the System and not insured by the Farm Credit System Insurance Corporation.

## CAPITAL RESOURCES

Total members' equity at September 30, 2009, increased to \$53,662 from the December 31, 2008, total of \$51,089. The increase is primarily attributable to the increase in retained earnings in excess of the reduction of protected stock and revolved equities, along with a decrease in other comprehensive losses.

Total capital stock and participation certificates were \$1,482 on September 30, 2009, compared to \$1,576 on December 31, 2008. This decrease is attributed to the retirement of protected stock and participation certificates on loans liquidated in the normal course of business and the annual retirement of B stock.

The Association reports other comprehensive income (loss) (OCI) in its Consolidated Statements of Changes in Members' Equity. The Association recognized OCI loss of \$(150) as of September 30, 2009, as compared to \$(225) in 2008 for FAS 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans." The Association also recognized OCI loss of \$(1,021) as of September 30, 2009, as compared to \$(1,751) in 2008 for unrealized gains (losses) on investments available for sale.

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, 2009, the Association's total surplus ratio and core surplus ratio were 15.25 percent and 12.20 percent, respectively, and the permanent capital ratio was 15.70 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.

## Recently Issued Accounting Pronouncements

Please refer to Note 1, "Organization, Significant Accounting Policies, and Recently Issued Accounting Pronouncements", in the Notes to the Financial Statements, and the 2008 Annual Report to Shareholders for recently issued accounting pronouncements.

**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 Stephen Gilbert, 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 1-800-741-7332, writing Casey Sherman, Corporate Secretary, ArborOne, ACA, P.O. Box 3699, Florence, SC 29502, or accessing the website, [www.arborone.com](http://www.arborone.com). The Association prepares a quarterly report within 40 days after the end of each fiscal quarter, except that no report need be prepared for the fiscal quarter that coincides with the end of the fiscal year of the institution.

ArborOne, ACA

# Consolidated Balance Sheets

<i>(dollars in thousands)</i>	<b>September 30, 2009</b> <i>(unaudited)</i>	<b>December 31, 2008</b> <i>(audited)</i>
<b>Assets</b>		
Cash	\$ 69	\$ 1
Investment securities:		
Available for sale (amortized cost of \$23,454 and \$29,521 respectively)	22,432	27,770
Held to maturity (fair value of \$3,733 and \$3,975 respectively)	4,376	4,390
Total investment securities	26,808	32,160
Loans	292,500	300,993
Less: allowance for loan losses	1,392	1,911
Net loans	291,108	299,082
Other investments	99,609	111,934
Accrued interest receivable	3,562	4,463
Investment in other Farm Credit institutions	17,018	17,679
Premises and equipment, net	806	848
Other property owned, net	96	—
Due from AgFirst Farm Credit Bank	4,691	6,397
Other assets	2,637	3,463
Total assets	<b>\$ 446,404</b>	<b>\$ 476,027</b>
<b>Liabilities</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 378,965	\$ 406,997
Subordinated debt payable to other Farm Credit institutions (Note 4)	7,500	7,500
Accrued interest payable	1,263	1,549
Patronage refund payable	400	2,063
Other liabilities	4,614	6,829
Total liabilities	392,742	424,938
Commitments and contingencies		
<b>Members' Equity</b>		
Protected borrower equity	325	371
Capital stock and participation certificates	1,157	1,205
Retained earnings		
Allocated	31,120	30,751
Unallocated	22,232	20,738
Accumulated other comprehensive income (loss)	(1,172)	(1,976)
Total members' equity	53,662	51,089
Total liabilities and members' equity	<b>\$ 446,404</b>	<b>\$ 476,027</b>

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

ArborOne, 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>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
<b>Interest Income</b>				
Investment securities	\$ 136	\$ 281	\$ 437	\$ 973
Loans	3,821	5,401	11,687	15,785
Other	1,294	1,478	3,829	4,435
Total interest income	5,251	7,160	15,953	21,193
<b>Interest Expense</b>				
Notes payable to AgFirst Farm Credit Bank	3,684	5,093	11,217	15,500
Subordinated debt payable to other Farm Credit institutions (Note 4)	168	11	506	11
Total interest expense	3,852	5,104	11,723	15,511
Net interest income	1,399	2,056	4,230	5,682
Provision for (reversal of allowance for) loan losses	1,052	237	2,706	873
Net interest income after provision for (reversal of allowance for) loan losses	347	1,819	1,524	4,809
<b>Noninterest Income</b>				
Loan fees	497	626	1,230	1,386
Fees for financially related services	402	385	499	412
Equity in earnings of other Farm Credit institutions	1,678	1,531	4,701	4,685
Gains (losses) on other property owned, net	(11)	—	(11)	(22)
Gains (losses) on sale of rural home loans, net	(1)	8	—	24
Gains (losses) on sales of premises and equipment, net	1	594	18	599
Other noninterest income	44	64	181	214
Total noninterest income	2,610	3,208	6,618	7,298
<b>Noninterest Expense</b>				
Salaries and employee benefits	1,260	1,100	3,817	3,296
Occupancy and equipment	230	245	733	682
Insurance Fund premium	116	107	330	292
Other operating expenses	384	546	1,107	1,763
Total noninterest expense	1,990	1,998	5,987	6,033
Income before income taxes	967	3,029	2,155	6,074
Provision (benefit) for income taxes	8	44	14	63
Net income	\$ 959	\$ 2,985	\$ 2,141	\$ 6,011

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

ArborOne, ACA

# Consolidated Statements of Changes in Members' Equity

*(unaudited)*

*(dollars in thousands)*

	Protected Borrower Capital	Capital Stock and Participation Certificates	Retained Earnings		Accumulated Other Comprehensive Income	Total Members' Equity
			Allocated	Unallocated		
Balance at December 31, 2007	\$ 412	\$ 1,196	\$ 29,195	\$ 18,105	\$ (494)	\$ 48,414
Comprehensive income						
Net income				6,011		6,011
Unrealized gains (losses) on investments available for sale, net of reclassification adjustments					(860)	(860)
Employee benefit plans adjustments				(45)	101	56
Total comprehensive income						5,207
Protected borrower equity retired	(39)					(39)
Capital stock/participation certificates issued/(retired), net		11				11
Patronage distribution adjustment			(262)	167		(95)
Balance at September 30, 2008	\$ 373	\$ 1,207	\$ 28,933	\$ 24,238	\$ (1,253)	\$ 53,498
Balance at December 31, 2008	\$ 371	\$ 1,205	\$ 30,751	\$ 20,738	\$ (1,976)	\$ 51,089
Comprehensive income						
Net income				2,141		2,141
Unrealized gains (losses) on investments available for sale, net of reclassification adjustments					729	729
Employee benefit plans adjustments					75	75
Total comprehensive income						2,945
Protected borrower equity retired	(46)					(46)
Capital stock/participation certificates issued/(retired), net		(48)				(48)
Patronage distribution adjustment			369	(647)		(278)
Balance at September 30, 2009	\$ 325	\$ 1,157	\$ 31,120	\$ 22,232	\$ (1,172)	\$ 53,662

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

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## ArborOne, ACA

# Notes to the Consolidated Financial Statements

*(dollars in thousands, except as noted)*

*(unaudited)*

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

The accompanying financial statements include the accounts of **ArborOne, ACA** (the Association). A description of the organization and operations of the Association, the significant accounting policies followed, and the financial condition and results of operations as of and for the year ended December 31, 2008, are contained in the 2008 Annual Report to Shareholders. These unaudited third quarter 2009 consolidated financial statements should be read in conjunction with the 2008 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 (GAAP) and prevailing practices within the banking industry. The results for the nine months ended September 30, 2009, are not necessarily indicative of the results to be expected for the year ending December 31, 2009.

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

The Association maintains an allowance for loan losses in accordance with GAAP. The loan portfolio is reviewed quarterly to determine the adequacy of the allowance for losses. As of September 30, 2009 the allowance for losses is adequate in management's opinion to provide for possible losses on existing loans.

In addition to the recently issued accounting pronouncements discussed in the 2008 Annual Report to Shareholders, effective January 1, 2009, the Association adopted accounting guidance for fair value measurements of nonfinancial assets and nonfinancial liabilities. The impact of adoption resulted in additional fair value disclosures (see Note 6), primarily regarding other property owned, but does not have an impact on the Association's financial condition or results of operations.

In April 2009, the Financial Accounting Standards Board (FASB) issued guidance, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are

Not Orderly". The guidance emphasizes that even if there has been a significant decrease in the volume and level of activity for the asset or liability and regardless of the valuation technique and inputs used, the objective for the fair value measurement is unchanged from what it would be if markets were operating at normal activity levels or transactions were orderly; that is, to determine the current exit price. It sets forth additional factors that should be considered to determine whether there has been a significant decrease in volume and level of activity when compared with normal market activity. The reporting entity shall evaluate the significance and relevance of the factors to determine whether, based on the weight of evidence, there has been a significant decrease in activity and volume. The guidance indicates that if an entity determines that either the volume or level of activity for an asset or liability has significantly decreased (from normal conditions for that asset or liability) or price quotations or observable inputs are not associated with orderly transactions, increased analysis and management judgment will be required to estimate fair value. It is further noted that a fair value measurement should include a risk adjustment to reflect the amount market participants would demand because of the risk (uncertainty) in the cash flows.

This guidance also requires a reporting entity to make additional disclosures in interim and annual periods. Revisions resulting from a change in valuation techniques or their application are accounted for as a change in accounting estimate. The Association adopted this guidance effective June 30, 2009 (see Note 2 and Note 6).

In April 2009, the FASB issued guidance, "Recognition and Presentation of Other-Than-Temporary Impairments", which amends the other-than-temporary impairment guidance for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt securities in the financial statements. It does not change existing recognition and measurement guidance related to other-than-temporary impairments of equity securities.

This guidance changes existing impairment guidance related to accounting for certain investments in debt and equity securities by eliminating the "ability and intent to hold" provision. In addition, impairment is now considered to be other than temporary if an entity 1) intends to sell the security, 2) more likely than not will be required to sell the security before recovering its cost, or 3) does not expect to recover the security's entire amortized cost basis (even if the

entity does not intend to sell). The "probability" standard relating to the collectability of cash flows is also eliminated, and impairment is now considered to be other-than-temporary if the present value of cash flows expected to be collected from the debt security is less than the amortized cost basis of the security (any such shortfall is referred to as a "credit loss"). If an entity intends to sell an impaired debt security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the impairment is other-than-temporary and should be recognized currently in earnings in an amount equal to the entire difference between fair value and amortized cost. If a credit loss exists, but an entity does not intend to sell the impaired debt security and is not more likely than not to be required to sell before recovery, the impairment is other-than-temporary and should be separated into 1) the estimated amount relating to credit loss, and 2) the amount relating to all other factors. Only the estimated credit loss amount is recognized currently in earnings, with the remainder of the loss amount recognized in other comprehensive income. For held-to-maturity securities, the portion of the other-than-temporary impairment not related to a credit loss will be recognized in a new category of other comprehensive income and amortized over the remaining life of the debt security as an increase in the security's carrying amount. Disclosure requirements for impaired debt and equity securities are expanded and will now be required quarterly (see Note 2), as well as annually.

The Association adopted this guidance effective June 30, 2009. For securities held at the beginning of the interim period of adoption for which an other-than-temporary impairment was previously recognized, if an entity does not intend to sell and it is not more likely than not that it will be required to sell before recovery of its amortized cost basis, the entity shall recognize the cumulative effect of initially applying this guidance as an adjustment to the opening balance of retained earnings with a corresponding adjustment to accumulated other comprehensive income. There was no initial adjustment to apply this guidance for the Association since no other-than-temporary impairment was previously recognized by the Association.

In April 2009, the FASB issued guidance, "Interim Disclosures about Fair Value of Financial Instruments." This guidance requires disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. The Association adopted this guidance effective June 30, 2009 (see Note 7).

In May 2009, the FASB issued guidance, "Subsequent Events," which sets forth general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. There are two types of subsequent events: the first type consists of events or transactions that

provide additional evidence about conditions that existed at the balance sheet date (recognized subsequent events) and the second type consists of events that provide evidence about conditions that did not exist at the balance sheet date but arose after that date (nonrecognized subsequent events). Recognized subsequent events should be included in the financial statements since the conditions existed at the date of the balance sheet. Nonrecognized subsequent events are not included in the financial statements since the conditions arose after the balance sheet date but before the financial statements are issued or are available to be issued. This guidance, which includes a required disclosure of the date through which an entity has evaluated subsequent events, was adopted by the Association effective June 30, 2009 (see Note 8).

In June 2009, the FASB issued guidance, "The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles." This Codification became the source of authoritative U.S. generally accepted accounting principles recognized by the FASB. This guidance was adopted by the Association effective July 1, 2009 and had no impact on the Association's financial condition or results of operations.

## NOTE 2 – INVESTMENT SECURITIES

A summary of the amortized cost and fair value of investment securities held as available-for-sale at September 30, 2009 and December 31, 2008 follows:

	<b>September 30, 2009</b>				
	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>	<b>Yield</b>
Commercial MBS	\$ 11,113	\$ -	\$ (865)	\$ 10,248	1.43%
Asset-backed Securities	12,341	-	(157)	12,184	1.17
<b>Total investment securities</b>	<b>\$ 23,454</b>	<b>\$ -</b>	<b>\$(1,022)</b>	<b>\$ 22,432</b>	<b>2.61%</b>

	<b>December 31, 2008</b>				
	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>	<b>Yield</b>
Commercial MBS	\$ 13,271	\$ -	\$ (1,504)	\$ 11,767	1.89%
Asset-backed Securities	16,250	-	(247)	16,003	2.59
<b>Total investment securities</b>	<b>\$ 29,521</b>	<b>\$ -</b>	<b>\$(1,751)</b>	<b>\$ 27,770</b>	<b>2.27%</b>

A summary of the amortized cost and fair value of investment securities held-to-maturity at September 30, 2009 and December 31, 2008 follows:

	September 30, 2009				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Yield
Other Investments	\$ 4,376	\$ -	\$ (643)	\$ 3,733	6.23%

	December 31, 2008				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Yield
Other Investments	\$ 4,390	\$ -	\$ (415)	\$ 3,975	6.23%

A summary of the expected maturity, amortized cost and estimated fair value of investment securities at September 30, 2009 follows:

**Available-for-Sale:**

	September 30, 2009		
	Amortized Cost	Fair Value	Weighted Average Yield
In one year or less	\$ -	\$ -	-%
After one year through five years	1,009	998	1.24
After five years through ten years	11,332	11,186	1.17
After ten years	11,113	10,248	1.43
Total	\$ 23,454	\$ 22,432	1.30%

**Held-to-Maturity:**

	September 30, 2009		
	Amortized Cost	Fair Value	Weighted Average Yield
In one year or less	\$ -	\$ -	-%
After one year through five years	-	-	-
After five years through ten years	986	1,005	7.75
After ten years	3,390	2,728	5.78
Total	\$ 4,376	\$ 3,733	6.23%

Expected maturities for collateralized mortgage obligations will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

The Association's investments consist primarily of mortgage-backed securities (MBSs) and asset backed securities (ABSs). MBSs are collateralized by U.S. government or U.S. agency guaranteed residential mortgages and all but one have a AAA credit rating. One MBS, with an amortized cost of \$1,300 and fair value of \$715 is rated below AAA. ABSs are all rated AAA due to the senior/subordinate structure and/or a credit wrap by a bond insurer. All unrealized losses referenced above are

primarily due to reduced liquidity in the securities markets stemming from general adversity in the financial markets and are not credit related.

The following table shows the fair value and gross unrealized losses for investments in a loss position aggregated by investment category and the length of time the securities have been in a continuous unrealized loss position at September 30, 2009. The continuous loss position is based on the date the impairment occurred. The Association performs periodic credit reviews, including an other-than-temporary impairment analysis, on its investment securities portfolio. The objective is to quantify any future possible loss of principal or interest due on each security identified for additional analysis. Based on the results of all analyses, the Association has not recognized any other-than-temporary impairment in connection with these investments. The unrealized losses on these investments resulted primarily from reduced liquidity in the securities markets stemming from general adversity in the financial markets and are not credit related. The Association has the ability and intent to hold these investments until a recovery of unrealized losses occurs, which may be at maturity, and at this time expects to collect the full principal amount and interest due on these securities, especially after considering credit enhancements. All securities continue to perform. Substantially all of these investments were in U. S. government securities and the Association expects that these securities would not be settled at a price less than their amortized cost.

	Less than 12 Months		Greater than 12 Months	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Other investments	\$ 3,733	\$ (643)	\$ -	\$ -
Commercial MBS	-	-	10,248	(865)
Asset-backed securities	-	-	12,184	(157)
Total	\$ 3,733	\$ (643)	\$ 22,432	\$ (1,022)

**NOTE 3 – ALLOWANCE FOR LOAN LOSSES AND IMPAIRED LOANS**

An analysis of the allowance for loan losses follows:

	For the nine months ended September 30,	
	2009	2008
Balance at beginning of period	\$ 1,911	\$ 53
Provision for (reversal of) loan losses	2,706	873
Charge-offs	(3,266)	(20)
Recoveries	41	16
Balance at end of period	\$ 1,392	\$ 922

The following table presents information concerning impaired loans as of September 30,

	<u>2009</u>	<u>2008</u>
Impaired loans with related allowance	\$ 1,743	\$ 2,574
Impaired loans with no related allowance	12,549	2,196
Total impaired loans	<u>14,292</u>	<u>4,770</u>
Allowance on impaired loans	<u>\$ 113</u>	<u>\$ 367</u>

The following table summarizes impaired loan information for the nine months ended September 30,

	<u>2009</u>	<u>2008</u>
Average impaired loans	\$ 10,412	\$ 3,330
Interest income recognized on impaired loans	51	291

#### NOTE 4 – EMPLOYEE BENEFIT PLANS

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

	<u>For the nine months ended September 30,</u>	
	<u>2009</u>	<u>2008</u>
Pension	\$ 875	\$ 304
401(k)	86	85
Other postretirement benefits	179	170
Total	<u>\$ 1,140</u>	<u>\$ 559</u>

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

	<u>Actual YTD Through 9/30/09</u>	<u>Projected Contributions For Remainder of 2009</u>	<u>Projected Total Contributions 2009</u>
Other postretirement benefits	\$ 142	\$ 80	\$ 222

As of September 30, 2009, no contributions have been made for 2009 by the Association to the qualified District pension plan in which the Association participates. Actuarial calculations as of the last plan measurement date (December 31, 2008) projected total contributions of \$52.0 million to the qualified District pension plan for all participating institutions for 2009. The funding policy for this plan is to fund the accumulated benefit obligation (ABO) service cost plus the seven year amortization of the unfunded ABO using the discount rate determined as of December 31st of the preceding year. This aggregate contribution will be allocated to the participating District institutions, including the Association, based upon each institution's pro rata share of

ABO service cost. Market conditions could impact discount rates and return on plan assets which could make additional contributions necessary before the next plan measurement date of December 31, 2009.

Further details regarding employee benefit plans are contained in the 2008 Annual Report to Shareholders.

#### NOTE 5 – SUBORDINATED DEBT

In September 2008, the Association issued \$7,500 of fixed rate unsecured subordinated debt due in 2018, generating proceeds that were primarily used to increase the permanent capital of the Association pursuant to the Farm Credit Administration regulations, and for general corporate purposes. The debt is payable to another association in the District. It is subordinate to all other categories of creditors, including any claims of the Bank and general creditors, and is senior to all classes of shareholders. The subordinated debt is not considered Farm Credit System (System) debt, and thus is not guaranteed by the System and not insured by the Farm Credit System Insurance Corporation.

The subordinated debt bears interest at an annual fixed rate of 9 percent, payable on the fifteenth day of each month, beginning on October 15, 2008. Interest will be deferred if, as of the fifth business day prior to an interest payment date of the debt, any applicable minimum regulatory capital ratios are not satisfied. A deferral period may not last for more than five consecutive years or beyond the maturity date of the subordinated debt. During such a period, the Association may not declare or pay any dividends or patronage refunds, among other certain restrictions, until interest payments are resumed and all deferred interest has been paid. The subordinated debt may be redeemed, at the Association's option, on October 15, 2013, or upon the occurrence of certain defined regulatory events, at a redemption price of 100 percent of the principal amount, plus any accrued but unpaid interest to the date of redemption, provided the Association has made payment in full of all amounts then due in respect of its senior indebtedness.

#### NOTE 6 – FAIR VALUE MEASUREMENT

Effective January 1, 2008, the Association adopted FASB guidance on, fair value measurements. This guidance defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements for certain assets and liabilities measured at fair value on a recurring and non-recurring basis. These assets and liabilities primarily consist of investments available-for-sale, assets held in trust funds, standby letters of credit, impaired loans, and other property owned.

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

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

The three levels of inputs and the classification of the Association's financial instruments within the fair value hierarchy are as follows:

#### **Level 1**

Level 1 inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets. The Association's Level 1 assets at September 30, 2009 consist of assets held in trust funds related to deferred compensation and supplemental retirement plans. The trust funds include investments in securities that are actively traded and have quoted net asset value prices that are directly observable in the marketplace.

#### **Level 2**

Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets; quoted prices in markets that are not active; and inputs that are observable, or can be corroborated, for substantially the full term of the asset or liability. The Association has Level 2 assets and no Level 2 liabilities measured at fair value on a recurring basis. Level 2 assets include available-for-sale investment securities that are traded in active, non-exchange markets. These securities are U.S. government and agency mortgage-backed securities, non-agency mortgage-backed securities, and U.S. agency debt securities, all of which have unadjusted values from third-party or internal pricing models. The fair value of substantially all of the Association's available-for-sale investment securities is determined from third-party valuation services that estimate current market prices. Inputs and assumptions related to third-party market valuation services are typically observable in the marketplace. Such services incorporate prepayment assumptions and underlying mortgage- or asset-backed collateral information to generate cash flows that are discounted using appropriate benchmark interest rate curves and volatilities. Third-party valuations also incorporate information regarding broker/dealer quotes, available trade information, historical

cash flows, credit ratings, and other market information. Such valuations represent an estimated exit price, or price to be received by a seller in active markets to sell the investment securities to a willing participant.

#### **Level 3**

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

Level 3 assets could include impaired loans which represent the fair value of certain loans that were evaluated for impairment under FASB guidance. The fair value was based upon the underlying collateral since these were collateral-dependent loans. The fair value measurement process uses independent appraisals and other market-based information, but in many cases it also requires significant input based on management's knowledge of and judgment about current market conditions, specific issues relating to the collateral and other matters. As a result, these fair value measurements fall within Level 3 of the hierarchy. When the value of the collateral, less estimated costs to sell, is less than the principal balance of the loan, a specific reserve is established. Impaired loans with related specific reserves, previously held by the Association, have been charged off during 2009. Other property owned is classified as a level 3 asset at September 30, 2009. The fair value for other property owned is based upon the collateral less estimated costs to sell. Level 3 liabilities at September 30, 2009 include standby letters of credit whose market value is internally calculated based on information that is not observable either directly or indirectly in the marketplace.

**Assets and Liabilities Measured at Fair Value on a Recurring Basis**

The following table presents the assets and liabilities that are measured at fair value on a recurring basis at September 30, 2009 for each of the fair value hierarchy levels:

	September 30, 2009			Total Fair Value
	Level 1	Level 2	Level 3	
<b>Assets:</b>				
Investments available-for-sale	\$ -	\$ 22,432	\$ -	\$ 22,432
Assets held in Trust funds	\$ 3	\$ -	\$ -	\$ 3
Total Assets	\$ 3	\$ 22,432	\$ -	\$ 22,435
<b>Liabilities:</b>				
Standby letters of credit	\$ -	\$ -	\$ 54	\$ 54
Total Liabilities	\$ -	\$ -	\$ 54	\$ 54

The following table presents the changes in Level 3 assets and liabilities measured at fair value on a recurring basis:

	Standby Letters Of Credit
Balance at January 1, 2009	\$ 22
<b>Total gains or (losses) realized/unrealized:</b>	
Included in earnings	-
Included in other comprehensive loss	-
Purchases, sales, issuances and settlements, net	32
Transfers in and/or out of level 3	-
Balance at September 30, 2009	\$ 54

**Assets and Liabilities Measured at Fair-Value on a Non-recurring Basis**

Assets and liabilities measured at fair value on a non-recurring basis at September 30, 2009 for each of the fair value hierarchy values are summarized below:

	September 30, 2009			Total Fair Value	YTD Total Gains (Losses)
	Level 1	Level 2	Level 3		
<b>Assets:</b>					
Impaired loans	\$ -	\$ -	\$ 1,630	\$ 1,630	\$ (2,288)
Other property owned	\$ -	\$ -	\$ 96	\$ 96	\$ (5)

**NOTE 7 — DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS**

The following table presents the carrying amounts and fair values of the Association's financial instruments at September 30, 2009.

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:

	September 30, 2009	
	Carrying Amount	Estimated Fair Value
<b>Financial assets:</b>		
Cash	\$ 69	\$ 69
Loans, net of allowance	\$ 291,108	\$ 297,797
Investment securities	\$ 26,808	\$ 26,165
Tobacco Buyout SIIC	\$ 99,609	\$ 106,799
<b>Financial liabilities:</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 378,965	\$ 393,709
Subordinate debt payable to other Farm Credit institutions	\$ 7,500	\$ 8,072

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.

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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 Securities:** Fair value is primarily based upon prices obtained from a third party valuation service. See Note 6 for additional information.
- D. **Investment in AgFirst Farm Credit Bank and Other Farm Credit Institutions:** Estimating the fair value of the Association's investment in the Bank and Other Farm Credit Institutions is not practicable because the stock is not traded. The net investment is a requirement of borrowing from the Bank and is carried at cost plus allocated equities in the accompanying Consolidated Balance Sheets. The Association owns 4.26 percent of the issued stock of the Bank as of September 30, 2009 net of any reciprocal investment. As of that date, the Bank's assets totaled \$30.08 billion and shareholders' equity totaled \$1.60 billion. The Bank's earnings were \$194.0 million during the first nine months of 2009.

In addition, the Association has an investment of \$760 related to other Farm Credit institutions.

- E. **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.
- F. **Commitments to Extend Credit:** The estimated market value of off-balance-sheet commitments is minimal since the committed rate approximates current rates offered for commitments with similar rate and maturity characteristics and since the related credit risk is not significant.

G. **Tobacco Buyout SIIC:** Fair value is determined by discounting the expected future cash flows using current interest rates for similar assets.

H. **Subordinate Debt Payable to Other Farm Credit Institutions:** Fair value is determined by discounting the expected future cash flows using appropriate interest rates for similar liabilities.

#### **NOTE 8 – SUBSEQUENT EVENTS**

The Association has evaluated subsequent events and has determined there are none requiring disclosure through November 3, 2009, which is the date the financial statements were available to be issued.