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*AgSouth Farm Credit, ACA*

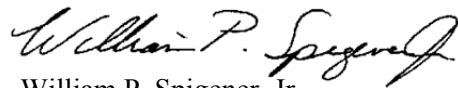
# SECOND QUARTER 2014

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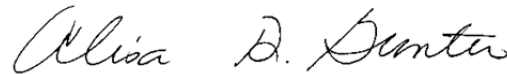
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## CERTIFICATION

The undersigned certify that we have reviewed the June 30, 2014 quarterly report of AgSouth Farm Credit, 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.



William P. Spigener, Jr.  
Chief Executive Officer



Alisa D. Gunter  
Chief Financial Officer



Charles C. Rucks  
Chairman of the Board

August 7, 2014

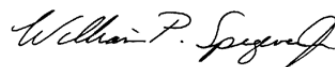
## **Report on Internal Control Over Financial Reporting**

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 affected 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 June 30, 2014. 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 June 30, 2014, the internal control over financial reporting was effective based upon the COSO (1992) criteria. Additionally, based on this assessment, the Association determined that there were no material weaknesses in the internal control over financial reporting as of June 30, 2014.



William P. Spigener  
Chief Executive Officer



Alisa D. Gunter  
Chief Financial Officer

August 7, 2014

# 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 AgSouth Farm Credit, ACA (Association) for the period ended June 30, 2014. This information should be read in conjunction with the accompanying financial statements, notes to the financial statements, and the 2013 Annual Report of AgSouth Farm Credit. The accompanying consolidated financial statements were prepared under the oversight of the Audit Committee of the Board of Directors.

## FORWARD LOOKING INFORMATION

This quarterly report contains forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Words such as “anticipates,” “believes,” “could,” “estimates,” “may,” “should,” “will,” or other variations of these terms are intended to identify the forward-looking statements. These statements are based on assumptions and analyses made in light of experience and other historical trends, current conditions, and expected future developments. However, actual results and developments may differ materially from our expectations and predictions due to a number of risks and uncertainties, many of which are beyond our control. These risks and uncertainties include, but are not limited to:

- political, legal, regulatory and economic conditions and developments in the United States and abroad;
- economic fluctuations in the agricultural, rural utility, international, and farm-related business sectors;
- weather-related, disease, and other adverse climatic or biological conditions that periodically occur that impact agricultural productivity and income;
- changes in United States government support of the agricultural industry; and
- actions taken by the Federal Reserve System in implementing monetary policy.

## 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 wide range of agricultural commodities produced in our region, including poultry (broilers, turkeys and eggs), timber, sod and nursery, field grains, soybeans and hay, cotton, horses, blueberries, fruits, nuts and beef cattle. Loans to producers of these commodities total \$1,308,816 or 86.46 percent of the Association's portfolio. Farm size varies, and many of the Association customers have diversified farming operations. These factors, along with the numerous opportunities for non-farm income in the area, reduce to some degree the level of income dependency on any given commodity.

During the second quarter of 2014 the Association originated \$22,839 in loans for the secondary market. Originations at the same period 2013 were \$72,454. The 68.48 percent decrease is the result of a reduction in the number of refinance requests during the second quarter of 2014 and the weak purchase market during the same period. AgSouth's performance mirrors the overall housing finance industry for the period. As of June 30, 2014, the Association held \$1,692 in qualifying loans for sale.

## Georgia Region

The Georgia region of AgSouth's territory has experienced a fairly good growing season so far in 2014. Early crop conditions were very good with some regions now starting to experience dry conditions and rain is needed in many of these areas. As of the first week in July, USDA rates 58 percent of Georgia cropland with adequate soil moisture and 42 percent with a soil moisture shortage. Crops have held up good thus far and a high percentage of crops have access to irrigation. USDA, through its Georgia Crop Progress Report as of June 29, rates all major row crops for our region including corn, peanuts, cotton, soybeans, tobacco, pasture, and watermelons at an average of 65 percent good to excellent and 25 percent fair. Less than 5 percent of any crop is rated as poor which at this point is a very good overall rating of crops in our area. Rains over the region during the next 30 days will be very crucial to maintaining good crop conditions.

The Vidalia onion harvest is complete and the crop yield was good with average prices overall throughout the season. Final average price is expected to be in the \$12.00 to \$14.00 per 40 lb. equivalent. This should equate to an overall fair to good season for onion growers.

The blueberry harvest is almost complete with an average yield for both high bush and rabbiteye varieties. Prices opened the season very strong but tapered off fairly quickly; however, with

fairly good yields and average prices the season should be profitable for most growers. Beef cattle continue to generate very high prices at market. Drought in the southern plains states has caused a significant drop in the US cattle herd. Texas, which ranked number one in beef cattle production for many years, lost 24 percent of its herd from 2002 to 2014 as droughts caused liquidation of herds to feedlots. There are fewer beef cattle in the US since 1950 and lower cattle numbers have created very high prices. Georgia ranks 20th in the US in beef cattle production and has seen an eight percent decline in numbers since 2010.

The poultry industry in Georgia continues to experience favorable market conditions and several integrators are expanding production by adding new contract growers as well as making plant improvements.

The dairy industry is experiencing favorable market conditions with high milk prices. Prices have risen fairly consistently since January 2014 making their way to the \$26.00 to \$28.00 per cwt. in June. Timber markets remain fairly strong as well with some strengthening in lumber prices due to increased housing starts. Framing lumber prices began the year at approximately \$350.00 per 1000 board feet, decreased in April to around \$325.00 per 1000, and have increased back up to \$340.00 per 1000 as of June 2014. Pulp wood prices remain stable as alternative uses other than paper production have increased demand.

The general economy in Georgia is increasing at a slow pace. Estimated growth is expected to be in the 2 to 3 percent range for 2014. Georgia's unemployment rate remains fairly high and well above the national average at 7.2 percent as of May 2014, but down from 8.6 percent a year ago. Building permits issued in the state are up 6 percent over the amount issued in 2013 and new construction is expected to continue to rise as inventories of existing homes have been slowly absorbed into the market. Georgia's manufacturing index (PMI) rose in June to 57.3 indicating the manufacturing sector continues to recover and expand.

The Governor's office announced several new businesses and industries to open within AgSouth's footprint in 2014 including Poppan Printing in Griffin, which plans to employ 80 new workers, and will invest \$100 million in a new plant to manufacture food packaging materials. A new Keurig Green Mountain facility will open in Douglas County, creating 550 new jobs and investing \$337 million over the next five years. Keurig Green Mountain is a leader in specialty coffee, teas, and other beverages. Kroger announced it will open a distribution center in Clayton County creating 120 new jobs. The center will be over one million square feet and located on 1,000 acres previously owned by the US Army. Southern Ionics will create 125 new jobs when it opens facilities in Charlton, Brantley and Pierce counties over the next year. Ionics is a Mississippi based chemical manufacturer. Viracon also plans expansion of its Bulloch County facilities and creation of 125 new jobs in the Statesboro area. General business activity and expansion does

appear to be on the rise in our territory of Georgia which is expected to increase employment and potential lending opportunities especially in the home and land financing markets.

### **South Carolina Region**

Unemployment data, which is a key indicator of economic activity, projects significant progress for the state of South Carolina over the past year. South Carolina unemployment as of May month end was 5.3 percent compared to 7.9 percent a year earlier and 5.5 percent at the end of the first quarter 2014. The state's decline in unemployment from the previous year marks the largest decline in the nation for that time period. Nationally, the unemployment rate was at 6.3 percent as of May month end. The number of South Carolinians working continues to trend upward, rising for ten consecutive months and reaching a historic high in May 2014. AgSouth's portfolio in South Carolina continues to be repaid primarily from nonfarm salary and business income, and the employment status of the state bodes well for acceptable performance for loans repaid from nonfarm sources.

At the end of the second quarter of 2014, crops within the region appeared to be in favorable condition. The winter wheat harvest is essentially complete compared to only being 73 percent complete a year earlier due to excess rainfall. Yields are not reported as of quarter end, but the condition of the crop was fair to excellent heading into the final stages of harvest. Corn is over 90 percent silked and over 50 percent in the dough stage. Corn acreage is down in the state by about 16 percent. The condition of the corn crop is rated 72 percent good to excellent and only 5 percent below fair. Moisture is critical to the corn crop at this stage as the crop begins to fully mature. By acreage, soybeans are the largest crop in the state at 450,000 acres planted. Soybeans are 92 percent planted which is well above 2013 progress and in line with the 5 year average. Condition of the soybean crop is rated 97 percent fair to excellent at quarter end and rain during the early third quarter would be a huge boost to keeping this crop on track for favorable yields. Peanut acreage in South Carolina is at 115,000 acres, with acreage increased by 42 percent over 2013. This year's crop is presently 64 percent pegged. The peanut crop is significantly ahead of both last year and the 5 year average as the 5 year average at this time is typically only 28 percent pegged. Peanuts are rated fair to good with over 76 percent considered good to excellent. The state's cotton crop is planted and 57 percent of the crop is squared. Similar to peanuts, the cotton crop is well ahead of schedule and planted acreage is up from 2013 at 265,000 acres. Condition of the cotton crop is rated 97 percent fair to excellent with 67 percent of the crop better than fair.

When considering the overall loan portfolio in South Carolina, poultry continues to represent the largest agricultural sector where loans are actually repaid from farm sales. The poultry integrators in the state appear to be operating at favorable returns, and in some areas of the state, new broiler houses are

being constructed. AgSouth continues to be involved with many of these construction projects. The overall outlook for broiler production appears favorable as both eggs set and chicks placed remain at stable levels. With only a 1 percent increase projected for eggs set over a year earlier and chicks placed up slightly compared to the summer of 2013, supply remains stable while demand remains strong. Assuming feed costs remain at levels comparable to present cost, the integrators project strong earnings potential for the remainder of 2014.

Forest products consisting primarily of timberland financing represents the state's largest portfolio commodity concentration. Processors within the state are enjoying very prosperous times, which leads to the potential for improved stumpage prices and ultimately better returns to the owners of timberland. Most forestry management firms believe that as housing starts continue to strengthen, both pine sawtimber and pine chip and saw prices will trend higher over the next few years, while pulpwood will react with weaker prices for the same reason.

The financing of real estate remains a core business for AgSouth within the South Carolina region and indications exist that crop and pasture land values remain stable in most areas serviced within the state. Timberland values are more difficult to evaluate as characteristics such as the value of timber located on the tract and the potential for recreation influence the valuation of these properties to a significant degree. The number of sales is increasing and discussions relating to financing likewise improving.

### **ASSOCIATION BALANCE SHEET**

The gross loan volume of the Association as of June 30, 2014, was \$1,513,698, an increase of \$17,145 or 1.15 percent as compared to \$1,496,553 at December 31, 2013. Net loans outstanding at June 30, 2014 were \$1,501,915 as compared to \$1,484,905 at December 31, 2013. Net loans accounted for 94.61 percent of total assets at June 30, 2014, as compared to 93.15 percent of total assets at December 31, 2013.

The increase in gross loan volume during the reporting period is attributed to advances on operating funds as well as new term loans exceeding payments and payoffs. Commercial bank competition for good, quality loans continues to be a challenge for the lending staff as it has increased substantially within the Association's territory.

The Association typically structures loans to meet the needs of the borrower. Many term loans are made for ten years or less allowing the borrower to build equity faster and thus reducing the risk in the loan portfolio.

At December 31, 2013, the Association held Investment securities totaling \$7,193. These investments are Rural America Bonds made under the authority for Mission Related Investments granted by the Farm Credit Administration. At

June 30, 2014, investment securities totaled \$12,055, an increase of \$4,862. The 67.59 percent increase is from two new investments purchased in the second quarter of 2014.

There is an inherent risk in the extension of any type of credit. Portfolio credit quality continues to be maintained at an acceptable level and credit administration remains satisfactory. Nonaccrual loans decreased from \$20,071 at December 31, 2013, to \$18,318 at June 30, 2014. The balance of nonaccrual loans is reduced by liquidations, returning loans to accrual status, or transferring assets to other property owned. These activities exceeded any transfers to nonaccrual status during the quarter ending June 30, 2014. Association staff is working diligently to work out all nonaccrual debt situations, and additional transfers may occur as the economy remains sluggish.

Other property owned decreased to \$970 at June 30, 2014 from \$1,731 at December 31, 2013. The decrease of \$761 or 43.96 percent in other property owned is the result of sales or write downs of property exceeding transfers to other property owned during the reporting period. The Association is actively marketing all properties for sale. For details, please visit our website at [www.agsouthfc.com](http://www.agsouthfc.com) and click on Property For Sale.

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 at June 30, 2014, was \$11,783 compared to \$11,648 at December 31, 2013, and was considered by management to be adequate to cover possible losses. The slight increase in the allowance account is the result of a reduction in the amount of reserves needed to cover potential losses on undrawn commitment. The Asset/Liability Committee (ALCO) of the Association, which is comprised of members of senior management and staff assigned to special assets management, met in June to review the allowance account. The ALCO determined that an addition to the allowance account was not needed at this time. As a result of the decrease in undrawn commitment, the amount of reserve, recorded as a liability, was reduced. The ALCO considered the general economic conditions, the potential for further deterioration in the existing portfolio and the possibility for some loan growth in the next quarter in determining the level of allowance.

Premises and equipment, net decreased \$98 from \$15,894 at December 31, 2013 to \$15,796 at June 30, 2014. The decrease is the result of normal activity within the premises and equipment accounts.

Accounts receivable decreased \$22,197 from \$28,008 at December 31, 2013 to \$5,811 at June 30, 2014. This line item includes the accrual of patronage income year to date from AgFirst to the Association. As of June 30, 2014 only two quarters of accrual had been recorded.

Other assets decreased \$2,647 from \$13,154 at December 31, 2013 to \$10,507 at June 30, 2014. The majority of other assets

is made up of prepaid retirement expense which decreased \$2,930 between December 31, 2013 and June 30, 2014.

On the liability side of the balance sheet, Patronage refunds payable decreased \$8,597 from \$8,799 at December 31, 2013 to \$202 at June 30, 2014. The decrease is the result of checks clearing the Association's commercial bank account during the quarter.

Accounts payable decreased \$490 from \$1,674 at December 31, 2013 to \$1,184 at June 30, 2014. The 29.27 percent decrease is due to the payable established to pay the insurance premiums on loans to the FCSIC. At December 31, 2013, this payable was \$1,147 and at June 30, 2014 the payable had been reduced to \$672 due to the cash payment made in January 2014.

Other liabilities decreased \$950 from \$23,774 at December 31, 2013 to \$22,824 at June 30, 2014. The 3.99 percent decrease is due to the liability of \$3,019 set aside in December 2013 to pay incentive earned in 2013. As of June 30, 2014, this liability amount was \$1,104 based upon calculations completed at quarter end.

Protected borrower stock decreased from \$16 at December 31, 2013 to \$4 at June 30, 2014. In October 2013, the Association's board of directors elected to retire the remaining protected borrower stock where possible.

Unprotected borrower stock increased from \$7,192 at December 31, 2013 to \$7,361 at June 30, 2014. The increase of \$169 or 2.35 percent is due to new borrowers purchasing stock during the reporting period.

Allocated surplus decreased from \$110,391 at December 31, 2013 to \$91,792 at June 30, 2014. This is a decrease of \$18,599 or 16.85 percent. The decrease in allocated surplus is due to the revolvment of allocated equities from the December 2008 fiscal year. These equities were retired in April 2014 and totaled \$19,727.

Unallocated surplus increased \$16,470 or 9.78 percent. The balance of \$184,872 at June 30, 2014 includes the retention of 2013 fiscal year end earnings.

## RESULTS OF OPERATIONS

### *For the three months ended June 30, 2014*

Net income for the three months ended June 30, 2014, totaled \$8,540 as compared to \$9,128 for the same period in 2013. This is a decrease of \$588 or 6.44 percent. The following commentary explains the variance.

At June 30, 2014, interest income increased \$230 from \$21,927 at June 30, 2013 to \$22,157. This increase of 1.05 percent is primarily due to the collection of interest income on several nonaccrual loans that were reinstated to accruing status or paid

out during the accounting period. Nonaccrual income, which is included in interest income, was \$208 for the three months ended June 30, 2014, as compared to \$75 for the same period in 2013.

Interest expense for the three months ended June 30, 2014 decreased \$129 from \$7,975 at June 30, 2013 to \$7,846 at June 30, 2014. The decrease is tied to a reduction in the average direct note rate. The average direct note rate was 6.01 percent and 5.91 percent at June 30, 2013 and 2014, respectively.

Net interest income before the provision for loan loss increased \$359 for the three months ended June 30, 2014, as compared to the same period in 2013 due primarily to the factors discussed above. Net interest income after the provision for loan losses increased \$337 during the quarter ending June 30, 2014.

A small reversal of the provision was made in the quarter ending June 30, 2013. The reversal was necessary to move general allowance to Other Liabilities to cover potential losses on undrawn loan commitment. In the same period in 2014, no provision entry was necessary.

Noninterest income decreased \$937 over the same period last year. Loan fees decreased \$194 or 22.05 percent. The loan fee variance can be tied to the decrease in demand for loans sold on the secondary market. The volume of loans sold decreased between the two reporting periods due to the weak purchase market and the lack of refinancing due to a higher interest rate environment. These two events in the secondary mortgage market caused a decline in secondary mortgage market activity resulting fewer originations and lower fee income.

Fees for financially related services decreased \$79 from \$190 at June 30, 2013 compared to \$111 at June 30, 2014. The decrease of 41.58 percent is due to timing of collection of commissions from the sale of multi-peril insurance and an experience refund from the sale of life insurance between the two reporting periods.

Patronage refunds from other Farm Credit institutions decreased \$618 from \$3,768 at June 30, 2013 to \$3,150 at June 30, 2014. This is a decrease of 16.40 percent and is the result of a special distribution earned in 2013 that did not reoccur in 2014. In June 2013, AgFirst distributed \$859 as special distribution due to their higher than normal earnings at that time.

Gains on the sale of rural home loans decreased \$184 from \$421 at June 30, 2013 compared to \$237 at June 30, 2014. The decrease is the result of the decrease in originations between the two reporting periods. Demand for home loans has declined due to the weak purchase market and the higher interest rate environment which has slowed refinance activity.

Gains on the sale of premises and equipment for the period ending June 30, 2014 totaled \$37 compared to \$33 for the period ending June 30, 2013. During both reporting periods, the Association recorded gains on the sale of several Association automobiles that were replaced.

Gains on the sale of other transactions totaled \$122. This is an increase of \$127 over a loss of \$5 in the same period in 2013. In 2014, the Association had gains on investments in the Rabbi Trust and a gain on the provision established for unfunded commitments.

Other noninterest income was \$28 during the three months ended June 30, 2014, compared to \$21 for the three months ending June 30, 2013. During the 2014 reporting period, the Association booked a refund from the Farm Credit Captive Insurance Company that totaled \$153. The refund was received in the first quarter of 2013.

Noninterest expense for the three months ended June 30, 2014, decreased \$10 or less than one percent when compared to the same period of 2013. Salaries and employee benefit expense increased \$415 between the two reporting periods. The increase in salaries and employee benefits is due to the increase in health care expense for employees and retirees.

Occupancy and equipment expense at June 30, 2014 was \$485 compared to \$462 for the same period in 2013. The increase of \$23 is the result of maintenance and repairs completed in the 2014 time frame.

The Insurance Fund premium increased \$57 from \$284 at June 30, 2013 to \$341 at June 30, 2014. The variance is due to the higher premium on accruing loans assessed in 2014 by the Insurance Fund.

In the three months ending June 30, 2014, the Association experienced losses and expenses on the sale of Other Property Owned in the amount of \$113. During the same period of 2013, the Association booked losses and expenses on the sale of Other Property Owned of \$804. The losses and expenses in the 2013 reporting period were an accumulation of write downs on several pieces of Other Property Owned held by the Association as well as losses recorded at the time of the sale. Some pieces are under contract for less than the current carrying value, while other write downs were needed due to new appraisals. The inventory of Other Property Owned has decreased substantially since the 2013 reporting period and expenses and losses have not been as prevalent in the 2014 reporting period.

Other operating expenses increased \$186 from \$1,591 at June 30, 2013, compared to \$1,777 at June 30, 2014. The increase of 11.69 percent is attributed to an increase in travel, purchased services, training, and public and member relations expenses between the reporting periods. The Association continues to experience higher travel expense due to the increase in the cost of operating Association automobiles. Other operating expenses also include communications, data processing, and all other expenses necessary to run the business.

#### ***For the six months ended June 30, 2014***

Net income for the six months ended June 30, 2014, totaled \$17,374 as compared to \$17,926 for the same period in 2013. This is a decrease of \$552 or 3.08 percent. The following narrative will explain the variance.

At June 30, 2014, interest income increased \$423 compared to the same period in 2013. The increase was due to the increase in investment interest income and an increase in nonaccrual interest income earned. The investment interest income is generated from several Rural America Bonds made under the Farm Credit Administration's (FCA) Mission Related Investment Program. In the first two quarters of 2014, the Association booked two new bond investments which generated interest income. Nonaccrual income, which is included in interest income, was \$562 for the six months ended June 30, 2014, as compared to \$100 for the same period in 2013. The increase of \$462 is the result of the recognition of interest income when nonaccrual loans pay off or are reinstated to accrual status.

Interest expense decreased \$562 for the six months ended June 30, 2014. The decrease is attributable to the lower interest rate paid on the direct note.

Net interest income before the provision for loan loss increased \$985 or 3.55 percent for the six months ended June 30, 2014 as compared to the same period in 2013 primarily due to the increase in loan volume and nonrecurring income earned in 2014. Net interest income after the provision for loan losses increased \$813 in the period ending June 30, 2014. This increase is the result of investment income and nonaccrual income earned in 2014 described above.

The provision reversal amount in the 2013 reporting period totaled \$172 and there was no provision or reversal in the 2014 reporting period. In June 2014, the Association's ALCO made the decision that the allowance account was adequate and that no adjustment was necessary. This decision was made after analyzing the risk in the current portfolio. The ALCO analysis included reviewing historical trends, loan size, loan performance and credit quality reports.

Noninterest income decreased \$1,691 over the same period last year. Loan fees decreased \$529 or 29.67 percent. In the first six months of 2014, fees earned on loans sold in the secondary market have been significantly lower. The volume of loans sold decreased between the two reporting periods due to the weak purchase market and the lack of refinancing due to a higher interest rate environment. These two events in the secondary mortgage market caused a decline in secondary mortgage market activity resulting in lower fee income.

Fees for financially related services decreased \$166 from \$474 at June 30, 2013 compared to \$308 at June 30, 2014. The 35.02 percent decrease in fees for financially related services is the result of a decrease in fee appraisal income between the two reporting periods and timing in the collection of commissions earned on the sale of crop insurance.

The patronage refunds from other Farm Credit institutions decreased \$593 from \$6,507 at June 30, 2013 to \$5,914 at June 30, 2014. The decrease is the result of a special patronage distribution of \$859 due to their 2013 year-to-date earnings. No special distribution was received in 2014. The amount of special

distribution is determined by the AgFirst Farm Credit Board of Directors and based upon the financial results of the AgFirst Farm Credit Bank.

Gains on the sale of rural home loans decreased \$478 from \$881 at June 30, 2013 to \$403 at June 30, 2014. Gains decreased due to the decline in loan originations to be sold between the reporting periods.

Gains on the sale of premises and equipment were \$37 for the period ending June 30, 2014 compared to \$50 for the period ending June 30, 2013. The gains were recorded when Association automobiles were replaced.

Gains on other transactions totaled \$24 for the six months ended June 30, 2014 compared to a loss of \$126 for the same period in 2013. The loss recorded in 2013 was the result of the need to establish a contingent liability for undrawn commitment loans. This loss totaled \$176 in 2013. It was not necessary to increase the liability in the 2014 reporting period.

Other noninterest income decreased \$62 from \$253 at June 30, 2013 compared to \$191 at June 30, 2014. The variance of 24.51 percent is due to volume premiums paid by AgFirst for secondary market activity. In 2013, the Association earned \$86 in volume premiums and for the period ending June 30, 2014, the Association has only earned \$14 in volume premiums.

Noninterest expense for the six months ended June 30, 2014, decreased \$300 compared to the same period of 2013. Salaries and employee benefit expense increased \$304 between the two reporting periods. The 2.23 percent increase in salaries and employee benefits is tied to the increase in merit pay and medical benefits, between the two reporting periods.

The Association booked an accrual for the 2014 incentive payment based upon plan results which is included in salary and benefit expense. The Association evaluated 2014 performance measures for incentive purposes and determined that some employees would earn incentive in 2014. Based upon this information, the Association accrued \$1,104 in incentive in June 2014. Association staff will be re-evaluated prior to the end of the third quarter 2014 to determine if an additional accrual is warranted.

Occupancy and equipment expense at June 30, 2014 was \$1,185 compared to \$1,134 for the same period in 2013. The increase is from the normal cost of operations and some timing differences of expenses.

The Insurance Fund premium increased from \$562 at June 30, 2013 to \$672 at June 30, 2014. The increase of 19.57 percent is tied to the increase in the premium on loans in accrual. In 2013, the FCSIC was 5 basis points for accruing volume and 15 basis points for nonaccrual volume. In 2014, the charge for accruing volume increased to 10 basis points.

Losses on the sale or write down of other property owned totaled \$136 for the six months ending June 30, 2014. When compared

to the same period in 2013, losses on other property owned totaled \$1,061. The losses or write downs were required after new contracts, sale closings, and/or new appraisals were obtained and the book value needed to more accurately reflect the current market value. The variance is due to the lower balance of other property owned held by the Association during the 2014 reporting period.

Other operating expenses increased \$160 from June 30, 2013, \$3,395 compared to \$3,555 at June 30, 2014. The increase is primarily timing differences between the two reporting periods. Additional purchased services expense for legal and consulting fees have been incurred in 2014 when compared to the same period in 2013.

## 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, 2014 was \$1,276,785 as compared to \$1,271,311 at December 31, 2013. The increase in the notes payable correlates to the increase in gross loans during the reporting period.

See Note 4 in the Notes to the Consolidated Financial Statements for information on the status of compliance with covenants under the General Financing Agreement.

## CAPITAL RESOURCES

Total members' equity at December 31, 2013 totaled \$285,777. At June 30, 2014 total members' equity had decreased by \$1,961 to \$283,816. The decrease in total members' equity is due to the decrease in allocated retained earnings offset by an increase in unallocated retained earnings between the two reporting periods. At December 31, 2013, allocated retained earnings totaled \$110,391. At June 30, 2014, the allocated retained earnings had decreased to \$91,792. The decrease in allocated retained earnings is due to the revolvment of allocated surplus from the 2008 fiscal year. This revolvment totaled \$19,727.

Unallocated equities increased \$16,470 from \$168,402 at December 31, 2013 to \$184,872 at June 30, 2014. The increase is the result of earnings retained for capital purposes at year end 2013 and year to date earnings in 2014.



Total capital stock and participation certificates were \$7,365 on June 30, 2014, compared to \$7,208 on December 31, 2013. The increase is attributed to the purchase of new stock and participation certificates for new borrowing entities offset by the retirement of stock and participation certificates on loans liquidated in the normal course of business.

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, 2014, the Association's total surplus ratio and core surplus ratio were 18.15 percent and 14.20 percent, respectively, and the permanent capital ratio was 18.67 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. The Association has a portion of the portfolio in an in-portfolio guarantee program with Farmer Mac. The purpose of these guarantees is to improve the Association's capital position. At June 30, 2014, the Association had loans totaling \$22,230 in this program. The cost of the guarantees year to date was \$62. The use of the Farmer Mac in-portfolio guarantee had a positive effect on the Association's capital ratios.

At the present time, the Association's capital position remains strong and well above regulatory minimums. At December 31, 2013, the Association's permanent capital ratio was 18.69 percent. The slight decrease to 18.67 percent permanent capital at June 30, 2014 is the result of the slight growth in the Association's balance sheet offset by the Association's decision to retain income in unallocated surplus. The Association continues to utilize various loan guarantee programs, including FSA, SBA and Farmer Mac to offset risk and improve the capital position. The Association has other tools available to strengthen the capital position. These options include selling additional loans to AgFirst and others, placing additional pools of loans with Farmer Mac in the in-portfolio guarantee program, and participating with AgFirst in a capitalized participation pool. Should additional measures be needed to improve the Association's capital ratios, Association management will study all options and make a recommendation to the Board for consideration.

## REGULATORY MATTERS

On October 11, 2012, the Board entered into a Supervisory Agreement with the FCA. The Supervisory Agreement requires the Association to take corrective actions with respect to certain areas of its operations including standards of conduct, acquired property, borrower rights and board policies. Conditions and events that led to the need for this agreement include ineffective controls that resulted in the failure to comply with FCA Regulations in the sale of acquired property; violations of FCA Borrower Rights Regulations at 12 C.F.R. Part 612, Subpart G; ineffective controls over board and employee standards of

conduct; an inadequate Standards of Conduct program which resulted in violations of FCA Regulations; and a lack of controls regarding standards of conduct for agents. The requirements of this agreement include, but are not limited to:

- Appointment of a new Standards of Conduct Official (SOCO)
- Appointment of a Board Compliance Committee as it relates to the Supervisory Agreement and ongoing Standards of Conduct issues
- Establishment of a standards of conduct program for directors, employees, and agents of the Association which is to include a review of applicable policies and procedures, training for directors and employees and comprehensive audits
- Establishment for a defined process for handling borrower rights issues, including updates to Association policy and procedures
- Policies and procedures revisions and updates around the disposition of other property owned
- Special requirements for properties under contract as of the date of the agreement
- Board approval and certification of future contracts on other properties owned to ensure compliance with FCA Regulations and Association policies and procedures

The Association has developed action plans to correct the weaknesses identified with assignments and due dates. The following action steps are complete as of this writing:

- A Compliance Committee was appointed by the Board of Directors. This committee is comprised of the Board chairman and vice chairman, Audit Committee chairman, and two other directors. The Board chairman will serve as the chairman of the Compliance Committee.
- The Board named Wesley D. Sutton as the Association Standards of Conduct Official. This action was approved by the Director, Risk Supervision Division at the FCA.
- Reports of required task completion outlined in the Supervisory Agreement have been made and published to the Director, Risk Supervision Division.
- Standards of Conduct policies and procedures have been updated, revised, and approved by the Board of Directors.
- Training on Standards of Conduct policies and procedures for all directors and employees has been completed.
- Director disclosures were completed and meetings were held with the SOCO to discuss the same. Following completion of the meetings, the SOCO presented a comprehensive report to the Board.
- Employee disclosures were completed and meetings were held with the SOCO to discuss the same. The SOCO presented a comprehensive report to the Board at the April 2013 meeting.
- The Board of Directors have completed subsequent disclosures in June 2013, December 2013, and June 2014.
- Employees have completed subsequent disclosures in July 2013, January 2014 and July 2014.

- The 4<sup>th</sup> quarter 2012 SOCO report was presented to the Board of Directors at the January 2013 Board meeting.
- The SOCO report was presented quarterly to the Board of Directors at the Board meetings held in January, April, July and October 2013 and January, April, and July 2014.
- A report of acquired property and other borrower's rights activities during each quarter was presented to the Board of Directors at the Board meetings held in January, April, July and October 2013 and January, April, and July 2014.
- The Board adopted a revised Code of Ethics and all board members signed in August 2013. All employees completed the same Code of Ethics in August 2013. All board members subsequently reviewed and signed the Association's Code of Ethics for Directors in June 2014 and all employees subsequently reviewed and acknowledged the Association's Code of Ethics in July 2014.
- An independent accounting firm was hired to complete a comprehensive audit of all acquired property sales from December 31, 2009 forward. The final report was presented to the Board at its' March 2013 meeting. No new exceptions to policy or regulation were identified.
- An independent law firm was hired to complete a comprehensive review of the Association's Standard of Conduct programs for directors, employees and agents, including policies and procedures, training materials, and disclosure documents. The final report was presented to the Board of Directors at the February 2013 Board meeting. Additional suggested revisions to Standards of Conduct policies and procedures have been made and approved by the Board of Directors. A subsequent audit was completed and presented to the Board of Directors at the March 2014 meeting. Additional suggested revisions to Standards of Conduct policies and procedures have been made and will be presented to the Board of Directors at the April 2014 meeting.
- As of June 30, 2014, the FCA has determined that the Association is in full compliance in 6 of 12 articles of the agreement.

Both the Board and Senior Management are committed to continuing the administration of the Association in a safe and sound manner, compliant with all FCA Regulations.

The Association remained under written Supervisory Agreement as of the date of this report.

#### **Other Matters**

On March 31, 2014, the FCA published an interim final rule rescinding all requirements for nonbinding advisory votes on senior officer compensation at System Banks and Associations. The comment period for the interim rule ended on April 30, 2014 and the final rule became effective on June 18, 2014.

On May 8, 2014, the FCA approved a proposed rule to modify the regulatory capital requirements for System Banks and Associations. The stated objectives of the proposed rule are as follows:

- To modernize capital requirements while ensuring that institutions continue to hold sufficient regulatory capital to fulfill their mission as a government-sponsored enterprise.
- To ensure that the System's capital requirements are comparable to the Basel III framework and the standardized approach that the federal banking regulatory agencies have adopted, but also to ensure that the rules recognize the cooperative structure and the organization of the System.
- To make System regulatory capital requirements more transparent.
- To meet the requirements of section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

Once the proposed rule is published in the Federal Register, the 120-day public comment period will commence.

On June 12, 2014, the FCA approved a proposed rule to revise the requirements governing the eligibility of investments for System Banks and Associations. The stated objectives of the proposed rule are as follows:

- To strengthen the safety and soundness of System Banks and Associations.
- To ensure that System Banks hold sufficient liquidity to continue operations and pay maturing obligations in the event of market disruption.
- To enhance the ability of the System Banks to supply credit to agricultural and aquatic producers.
- To comply with the requirements of section 939A of the Dodd-Frank Act.
- To modernize the investment eligibility criteria for System Banks.
- To revise the investment regulation for System Associations to improve their investment management practices so they are more resilient to risk.

The public comment period ends on October 23, 2014.

#### **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 2013 Annual Report to Shareholders for recently issued accounting pronouncements.

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**NOTE:** Shareholder investment in the Association is materially 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. 2832, or writing Susanne Caughman, 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 1-800-310-4805, ext. 6737, writing Alisa D. Gunter, CFO, AgSouth Farm Credit, ACA, PO Box 4966, Spartanburg, SC 29305, or accessing the website [www.agsouthfc.com](http://www.agsouthfc.com). The Association prepares an electronic version of the Annual Report which is available on the Association's web site within 75 days after the end of the fiscal year and distributes the Annual report to Shareholders within 90 days after the end of the fiscal year. The Association prepares an electronic version of the 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.

# AgSouth Farm Credit, ACA

## Consolidated Balance Sheets

<i>(dollars in thousands)</i>	<b>June 30, 2014</b>	<b>December 31, 2013</b>
	<i>(unaudited)</i>	<i>(audited)</i>
<b>Assets</b>		
Cash	\$ 2,838	\$ 7,061
Investment securities:		
Held to maturity (fair value of \$12,098 and \$7,132, respectively)	12,055	7,193
Loans	1,513,698	1,496,553
Allowance for loan losses	(11,783)	(11,648)
Net loans	1,501,915	1,484,905
Loans held for sale	1,692	535
Accrued interest receivable	14,308	14,148
Investments in other Farm Credit institutions	21,560	21,507
Premises and equipment, net	15,796	15,894
Other property owned	970	1,731
Accounts receivable	5,811	28,008
Other assets	10,507	13,154
Total assets	<u>\$ 1,587,452</u>	<u>\$ 1,594,136</u>
<b>Liabilities</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 1,276,785	\$ 1,271,311
Accrued interest payable	2,641	2,801
Patronage refunds payable	202	8,799
Accounts payable	1,184	1,674
Other liabilities	22,824	23,774
Total liabilities	<u>1,303,636</u>	<u>1,308,359</u>
Commitments and contingencies		
<b>Members' Equity</b>		
Protected borrower stock	4	16
Capital stock and participation certificates	7,361	7,192
Retained earnings		
Allocated	91,792	110,391
Unallocated	184,872	168,402
Accumulated other comprehensive income (loss)	(213)	(224)
Total members' equity	<u>283,816</u>	<u>285,777</u>
Total liabilities and members' equity	<u>\$ 1,587,452</u>	<u>\$ 1,594,136</u>

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

# AgSouth Farm Credit, ACA

## Consolidated Statements of Income

(unaudited)

<i>(dollars in thousands)</i>	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
<b>Interest Income</b>				
Loans	\$ 21,975	\$ 21,863	\$ 43,735	\$ 43,534
Investments	182	64	350	128
Total interest income	22,157	21,927	44,085	43,662
<b>Interest Expense</b>				
Notes payable to AgFirst Farm Credit Bank	7,821	7,970	15,336	15,918
Other	25	5	29	9
Total interest expense	7,846	7,975	15,365	15,927
Net interest income	14,311	13,952	28,720	27,735
Provision for (reversal of allowance for) loan losses	—	(22)	—	(172)
Net interest income after provision for (reversal of allowance for) loan losses	14,311	13,974	28,720	27,907
<b>Noninterest Income</b>				
Loan fees	686	880	1,254	1,783
Fees for financially related services	111	190	308	474
Patronage refunds from other Farm Credit institutions	3,150	3,768	5,914	6,507
Gains (losses) on sales of rural home loans, net	237	421	403	881
Gains (losses) on sales of premises and equipment, net	37	33	37	50
Gains (losses) on other transactions	122	(5)	24	(126)
Other noninterest income	28	21	191	253
Total noninterest income	4,371	5,308	8,131	9,822
<b>Noninterest Expense</b>				
Salaries and employee benefits	7,425	7,010	13,928	13,624
Occupancy and equipment	485	462	1,185	1,134
Insurance Fund premiums	341	284	672	562
(Gains) losses on other property owned, net	113	804	136	1,061
Other operating expenses	1,777	1,591	3,555	3,395
Total noninterest expense	10,141	10,151	19,476	19,776
Income before income taxes	8,541	9,131	17,375	17,953
Provision for income taxes	1	3	1	27
Net income	\$ 8,540	\$ 9,128	\$ 17,374	\$ 17,926

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

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**AgSouth Farm Credit, ACA**  
**Consolidated Statements of**  
**Comprehensive Income**

*(unaudited)*

<i>(dollars in thousands)</i>	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
Net income	\$ 8,540	\$ 9,128	\$ 17,374	\$ 17,926
<b>Other comprehensive income net of tax</b>				
Employee benefit plans adjustments	6	22	11	44
Comprehensive income	\$ 8,546	\$ 9,150	\$ 17,385	\$ 17,970

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

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

*(unaudited)*

<i>(dollars in thousands)</i>	<b>Protected Borrower Stock</b>	<b>Capital Stock and Participation Certificates</b>	<b>Retained Earnings</b>		<b>Accumulated Other Comprehensive Income (Loss)</b>	<b>Total Members' Equity</b>
			<b>Allocated</b>	<b>Unallocated</b>		
Balance at December 31, 2012	\$ 78	\$ 7,030	\$ 113,193	\$ 146,871	\$ (607)	\$ 266,565
Comprehensive income				17,926	44	17,970
Protected borrower stock issued/(retired), net	(18)					(18)
Capital stock/participation certificates issued/(retired), net		52				52
Retained earnings retired			(22,617)			(22,617)
Patronage distribution adjustment			(24)	34		10
<b>Balance at June 30, 2013</b>	<b>\$ 60</b>	<b>\$ 7,082</b>	<b>\$ 90,552</b>	<b>\$ 164,831</b>	<b>\$ (563)</b>	<b>\$ 261,962</b>
Balance at December 31, 2013	\$ 16	\$ 7,192	\$ 110,391	\$ 168,402	\$ (224)	\$ 285,777
Comprehensive income				17,374	11	17,385
Protected borrower stock issued/(retired), net	(12)					(12)
Capital stock/participation certificates issued/(retired), net		169				169
Retained earnings retired			(19,232)			(19,232)
Patronage distribution adjustment			633	(904)		(271)
<b>Balance at June 30, 2014</b>	<b>\$ 4</b>	<b>\$ 7,361</b>	<b>\$ 91,792</b>	<b>\$ 184,872</b>	<b>\$ (213)</b>	<b>\$ 283,816</b>

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

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*AgSouth Farm Credit, 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**

### **Organization**

The accompanying financial statements include the accounts of AgSouth Farm Credit, ACA (the Association). A description of the organization and operations, the significant accounting policies followed, and the financial condition and results of operations for the Association as of and for the year ended December 31, 2013, are contained in the 2013 Annual Report to Shareholders. These unaudited interim consolidated financial statements should be read in conjunction with the latest Annual Report to Shareholders.

### **Basis of Presentation**

In the opinion of management, 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.

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

The results of any interim period are not necessarily indicative of the results to be expected for a full year.

### **Significant Accounting Policies**

The Association maintains an allowance for loan losses at a level considered adequate by management to provide for probable and estimable losses inherent in the loan portfolio as of the report date. The allowance for loan losses is increased through provisions for loan losses and loan recoveries and is decreased through loan charge-offs and allowance reversals. A review of individual loans in each respective portfolio is performed periodically to determine the appropriateness of risk ratings and to ensure loss exposure to the Association has been identified.

### **Recently Issued Accounting Pronouncements**

In May 2014 the Financial Accounting Standards Board (FASB), responsible for U.S. Generally Accepted Accounting Principles (U.S. GAAP), and the International Accounting

Standards Board (IASB), responsible for International Financial Reporting Standards (IFRS), jointly issued converged standards on the recognition of revenue from contracts with customers. Accounting Standards Update (ASU) 2014-09, "Revenue from Contracts with Customers (Topic 606)" and IFRS 15 "Revenue from Contracts with Customers" are intended to improve the financial reporting of revenue and comparability of the top line in financial statements globally and supersede substantially all previous revenue recognition guidance. The core principle of the new standards is for companies to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration (that is, payment) to which the company expects to be entitled in exchange for those goods or services. The new standard also will result in enhanced disclosures about revenue, provide guidance for transactions that were not previously addressed comprehensively (for example, service revenue and contract modifications) and improve guidance for multiple-element arrangements. Because of the pervasive nature of the new guidance, the boards have established a joint transition resource group in order to aid transition to the new standard. For public entities reporting under U.S. GAAP, the amendments in the Update are effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early application is not permitted. For nonpublic entities, the amendments are effective for annual reporting periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. A nonpublic entity may elect to adopt this guidance earlier under certain circumstances. The amendments are to be applied retrospectively. Because financial instruments are not within the scope of the guidance, it is expected that adoption will not have a material impact on the Association's financial condition or results of operations, but may result in additional disclosures.

In March 2014 the FASB issued ASU 2014-06, "Technical Corrections and Improvements Related to Glossary Terms (Master Glossary)." The amendments in this Update relate to glossary terms, cover a wide range of Topics in the Codification and are presented in four sections: Deletion of Master Glossary Terms, Addition of Master Glossary Term Links, Duplicate Master Glossary Terms, and Other Technical Corrections Related to Glossary Terms. These amendments did not have transition guidance and were effective upon issuance for both public entities and nonpublic entities.

In January 2014 the FASB issued ASU 2014-04, "Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40) - Reclassification of Residential Real Estate



Collateralized Consumer Mortgage Loans upon Foreclosure.” The objective of the amendments in this Update is to reduce diversity by clarifying when an in substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The amendments are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. For entities other than public business entities, the amendments in this Update are effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. An entity can elect to adopt the amendments in this Update using either a modified retrospective transition method or a prospective transition method. Early adoption is permitted.

Other recently issued accounting pronouncements are discussed in the 2013 Annual Report to Shareholders.

## Note 2 — Loans and Allowance for Loan Losses

For a complete description of the Association’s accounting for loans (including impaired loans and the allowance for loan losses) and definitions of loan types, see the 2013 Annual Report to Shareholders.

Credit risk arises from the potential inability of an obligor to meet its repayment obligation. The Association manages credit risk associated with lending activities through an assessment of the credit risk profile of an individual obligor. The Association sets its own underwriting standards and lending policies that provide direction to loan officers and are approved by the board of directors.

A summary of loans outstanding at period end follows:

	June 30, 2014	December 31, 2013
Real estate mortgage	\$ 1,215,256	\$ 1,206,662
Production and intermediate-term	243,859	238,212
Processing and marketing	5,953	4,458
Farm-related business	8,858	9,501
Rural residential real estate	39,224	37,160
Other (including Mission Related)	548	560
Total Loans	\$ 1,513,698	\$ 1,496,553

A substantial portion of the Association’s lending activities is collateralized, and exposure to credit loss associated with lending activities is reduced accordingly.

The Association may purchase or sell participation interests with other parties in order to diversify risk, manage loan volume, and comply with Farm Credit Administration (FCA) regulations. The following tables present participation loan balances at periods ended:

	June 30, 2014							
	Within AgFirst District		Within Farm Credit System		Outside Farm Credit System		Total	
	Participations Purchased	Participations Sold	Participations Purchased	Participations Sold	Participations Purchased	Participations Sold	Participations Purchased	Participations Sold
Real estate mortgage	\$ 426	\$ 106,278	\$ —	\$ 16,488	\$ —	\$ —	\$ 426	\$ 122,766
Production and intermediate-term	—	52,963	1,418	—	1,548	40	2,966	53,003
Processing and marketing	—	6,748	—	7,709	—	—	—	14,457
Farm-related business	—	5,000	—	—	—	—	—	5,000
Total	\$ 426	\$ 170,989	\$ 1,418	\$ 24,197	\$ 1,548	\$ 40	\$ 3,392	\$ 195,226

	December 31, 2013							
	Within AgFirst District		Within Farm Credit System		Outside Farm Credit System		Total	
	Participations Purchased	Participations Sold	Participations Purchased	Participations Sold	Participations Purchased	Participations Sold	Participations Purchased	Participations Sold
Real estate mortgage	\$ 436	\$ 113,058	\$ —	\$ 7,117	\$ —	\$ —	\$ 436	\$ 120,175
Production and intermediate-term	—	64,867	1,089	—	1,668	40	2,757	64,907
Processing and marketing	—	7,499	—	6,770	—	—	—	14,269
Farm-related business	—	5,417	—	—	—	—	—	5,417
Total	\$ 436	\$ 190,841	\$ 1,089	\$ 13,887	\$ 1,668	\$ 40	\$ 3,193	\$ 204,768

A significant source of liquidity for the Association is the repayments and maturities of loans. The following table presents the contractual maturity distribution of loans by loan type at the latest period end:

June 30, 2014				
	Due less than 1 year	Due 1 Through 5 years	Due after 5 years	Total
Real estate mortgage	\$ 78,448	\$ 255,360	\$ 881,448	\$ 1,215,256
Production and intermediate-term	109,995	90,309	43,555	243,859
Processing and marketing	2,686	2,456	811	5,953
Farm-related business	1,749	3,935	3,174	8,858
Rural residential real estate	6,353	3,224	29,647	39,224
Other (including Mission Related)	-	-	548	548
Total Loans	<u>\$ 199,231</u>	<u>\$ 355,284</u>	<u>\$ 959,183</u>	<u>\$ 1,513,698</u>
Percentage	<u>13.16%</u>	<u>23.47%</u>	<u>63.37%</u>	<u>100.00%</u>

The following table shows loans and related accrued interest, classified under the FCA Uniform Loan Classification System, as a percentage of total loans and related accrued interest receivable by loan type as of:

	June 30, 2014	December 31, 2013		June 30, 2014	December 31, 2013
<b>Real estate mortgage:</b>			<b>Farm-related business:</b>		
Acceptable	94.90%	94.34%	Acceptable	99.72%	94.25%
OAEM	2.77	3.09	OAEM	0.22	5.68
Substandard/doubtful/loss	2.33	2.57	Substandard/doubtful/loss	0.06	0.07
	<u>100.00%</u>	<u>100.00%</u>		<u>100.00%</u>	<u>100.00%</u>
<b>Production and intermediate-term:</b>			<b>Rural residential real estate:</b>		
Acceptable	93.42%	93.65%	Acceptable	97.24%	97.07%
OAEM	3.53	2.60	OAEM	1.06	1.16
Substandard/doubtful/loss	3.05	3.75	Substandard/doubtful/loss	1.70	1.77
	<u>100.00%</u>	<u>100.00%</u>		<u>100.00%</u>	<u>100.00%</u>
<b>Processing and marketing:</b>			<b>Other (including Mission Related):</b>		
Acceptable	100.00%	100.00%	Acceptable	100.00%	100.00%
OAEM	-	-	OAEM	-	-
Substandard/doubtful/loss	-	-	Substandard/doubtful/loss	-	-
	<u>100.00%</u>	<u>100.00%</u>		<u>100.00%</u>	<u>100.00%</u>
			<b>Total Loans:</b>		
			Acceptable	94.77%	94.31%
			OAEM	2.82	2.97
			Substandard/doubtful/loss	2.41	2.72
				<u>100.00%</u>	<u>100.00%</u>

The following tables provide an age analysis of past due loans and related accrued interest as of:

June 30, 2014						
	30 Through 89 Days Past Due	90 Days or More Past Due	Total Past Due	Not Past Due or Less Than 30 Days Past Due	Total Loans	Recorded Investment 90 Days or More Past Due and Accruing Interest
Real estate mortgage	\$ 14,628	\$ 2,213	\$ 16,841	\$ 1,209,131	\$ 1,225,972	\$ -
Production and intermediate-term	3,864	4,866	8,730	238,244	246,974	-
Processing and marketing	-	-	-	6,006	6,006	-
Farm-related business	-	1	1	8,927	8,928	-
Rural residential real estate	309	86	395	39,046	39,441	-
Other (including Mission Related)	-	-	-	551	551	-
Total	<u>\$ 18,801</u>	<u>\$ 7,166</u>	<u>\$ 25,967</u>	<u>\$ 1,501,905</u>	<u>\$ 1,527,872</u>	<u>\$ -</u>

December 31, 2013						
	30 Through 89 Days Past Due	90 Days or More Past Due	Total Past Due	Not Past Due or Less Than 30 Days Past Due	Total Loans	Recorded Investment 90 Days or More Past Due and Accruing Interest
Real estate mortgage	\$ 6,908	\$ 4,379	\$ 11,287	\$ 1,205,879	\$ 1,217,166	\$ -
Production and intermediate-term	4,021	906	4,927	236,606	241,533	-
Processing and marketing	-	-	-	4,487	4,487	-
Farm-related business	-	1	1	9,603	9,604	-
Rural residential real estate	549	198	747	36,576	37,323	-
Other (including Mission Related)	-	-	-	561	561	-
Total	<u>\$ 11,478</u>	<u>\$ 5,484</u>	<u>\$ 16,962</u>	<u>\$ 1,493,712</u>	<u>\$ 1,510,674</u>	<u>\$ -</u>

The recorded investment in a receivable is the face amount increased or decreased by applicable accrued interest, unamortized premium, discount, finance charges, or acquisition costs and may also reflect a previous direct write-down of the investment.

Nonperforming assets (including related accrued interest) and related credit quality statistics at period end were as follows:

	June 30, 2014	December 31, 2013
<b>Nonaccrual loans:</b>		
Real estate mortgage	\$ 10,871	\$ 12,944
Production and intermediate-term	6,824	6,517
Farm-related business	5	7
Rural residential real estate	618	603
Total nonaccrual loans	<u>\$ 18,318</u>	<u>\$ 20,071</u>
<b>Accruing restructured loans:</b>		
Real estate mortgage	\$ 12,511	\$ 12,751
Production and intermediate-term	1,009	1,038
Farm-related business	192	196
Total accruing restructured loans	<u>\$ 13,712</u>	<u>\$ 13,985</u>
<b>Accruing loans 90 days or more past due:</b>		
Total accruing loans 90 days or more past due	<u>\$ —</u>	<u>\$ —</u>
Total nonperforming loans	\$ 32,030	\$ 34,056
Other property owned	970	1,731
Total nonperforming assets	<u>\$ 33,000</u>	<u>\$ 35,787</u>
Nonaccrual loans as a percentage of total loans	1.21%	1.34%
Nonperforming assets as a percentage of total loans and other property owned	2.18%	2.39%
Nonperforming assets as a percentage of capital	<u>11.63%</u>	<u>12.52%</u>

The following table presents information relating to impaired loans (including accrued interest) at period end. Impaired loans are loans for which it is probable that all principal and interest will not be collected according to the contractual terms of the loan.

	June 30, 2014	December 31, 2013
<b>Impaired nonaccrual loans:</b>		
Current as to principal and interest	\$ 6,643	\$ 9,249
Past due	11,675	10,822
Total impaired nonaccrual loans	<u>18,318</u>	<u>20,071</u>
<b>Impaired accrual loans:</b>		
Restructured	13,712	13,985
90 days or more past due	—	—
Total impaired accrual loans	<u>13,712</u>	<u>13,985</u>
Total impaired loans	<u>\$ 32,030</u>	<u>\$ 34,056</u>

The following tables present additional impaired loan information at period end. Unpaid principal balance represents the contractual principal balance of the loan.

	June 30, 2014			Quarter Ended June 30, 2014		Six Months Ended June 30, 2014	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Impaired Loans	Interest Income Recognized on Impaired Loans	Average Impaired Loans	Interest Income Recognized on Impaired Loans
<b>Impaired loans with a related allowance for credit losses:</b>							
Real estate mortgage	\$ 772	\$ 774	\$ 39	\$ 786	\$ 9	\$ 799	\$ 21
Production and intermediate-term	492	791	10	501	5	509	13
Farm-related business	—	—	—	—	—	—	—
Rural residential real estate	—	—	—	—	—	—	—
Total	\$ 1,264	\$ 1,565	\$ 49	\$ 1,287	\$ 14	\$ 1,308	\$ 34
<b>Impaired loans with no related allowance for credit losses:</b>							
Real estate mortgage	\$ 22,610	\$ 25,620	\$ —	\$ 23,017	\$ 249	\$ 23,390	\$ 604
Production and intermediate-term	7,341	8,987	—	7,474	82	7,595	196
Farm-related business	197	220	—	201	2	204	5
Rural residential real estate	618	760	—	630	7	640	17
Total	\$ 30,766	\$ 35,587	\$ —	\$ 31,322	\$ 340	\$ 31,829	\$ 822
<b>Total impaired loans:</b>							
Real estate mortgage	\$ 23,382	26,394	39	\$ 23,803	\$ 258	\$ 24,189	\$ 625
Production and intermediate-term	7,833	9,778	10	7,975	87	8,104	209
Farm-related business	197	220	—	201	2	204	5
Rural residential real estate	618	760	—	630	7	640	17
Total	\$ 32,030	\$ 37,152	\$ 49	\$ 32,609	\$ 354	\$ 33,137	\$ 856

	December 31, 2013			Year Ended December 31, 2013	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Impaired Loans	Interest Income Recognized on Impaired Loans
<b>Impaired loans with a related allowance for credit losses:</b>					
Real estate mortgage	\$ 704	\$ 1,028	\$ 295	\$ 629	\$ 43
Production and intermediate-term	113	211	56	102	7
Farm-related business	—	—	—	—	—
Rural residential real estate	—	—	—	—	—
Total	\$ 817	\$ 1,239	\$ 351	\$ 731	\$ 50
<b>Impaired loans with no related allowance for credit losses:</b>					
Real estate mortgage	\$ 24,991	\$ 27,739	\$ —	\$ 22,363	\$ 1,525
Production and intermediate-term	7,442	9,336	—	6,659	454
Farm-related business	203	226	—	181	12
Rural residential real estate	603	719	—	539	37
Total	\$ 33,239	\$ 38,020	\$ —	\$ 29,742	\$ 2,028
<b>Total impaired loans:</b>					
Real estate mortgage	\$ 25,695	\$ 28,767	\$ 295	\$ 22,992	\$ 1,568
Production and intermediate-term	7,555	9,547	56	6,761	461
Farm-related business	203	226	—	181	12
Rural residential real estate	603	719	—	539	37
Total	\$ 34,056	\$ 39,259	\$ 351	\$ 30,473	\$ 2,078

There were no material commitments to lend additional funds to debtors whose loans were classified as impaired at each reporting period. A summary of changes in the allowance for loan losses and recorded investment in loans for each reporting period follows:

	Real Estate Mortgage	Production and Intermediate- term	Agribusiness*	Rural Residential Real Estate	Other (including Mission Related)	Total
<b>Allowance for credit losses:</b>						
Balance at March 31, 2014	\$ 9,510	\$ 1,715	\$ 113	\$ 292	\$ 4	\$ 11,634
Charge-offs	(108)	(16)	—	(4)	—	(128)
Recoveries	198	45	22	4	8	277
Provision for loan losses	(146)	163	(20)	11	(8)	—
Balance at June 30, 2014	\$ 9,454	\$ 1,907	\$ 115	\$ 303	\$ 4	\$ 11,783
Balance at December 31, 2013	\$ 9,397	\$ 1,862	\$ 106	\$ 279	\$ 4	\$ 11,648
Charge-offs	(226)	(50)	(1)	(4)	—	(281)
Recoveries	255	56	89	4	12	416
Provision for loan losses	28	39	(79)	24	(12)	—
Balance at June 30, 2014	\$ 9,454	\$ 1,907	\$ 115	\$ 303	\$ 4	\$ 11,783
Balance at March 31, 2013	\$ 8,154	\$ 2,255	\$ 106	\$ 232	\$ 4	\$ 10,751
Charge-offs	(194)	(80)	—	—	—	(274)
Recoveries	223	72	28	19	—	342
Provision for loan losses	(166)	183	(25)	(14)	—	(22)
Balance at June 30, 2013	\$ 8,017	\$ 2,430	\$ 109	\$ 237	\$ 4	\$ 10,797
Balance at December 31, 2012	\$ 8,008	\$ 2,483	\$ 148	\$ 230	\$ 4	\$ 10,873
Charge-offs	(219)	(80)	—	—	—	(299)
Recoveries	230	86	29	50	—	395
Provision for loan losses	(2)	(59)	(68)	(43)	—	(172)
Balance at June 30, 2013	\$ 8,017	\$ 2,430	\$ 109	\$ 237	\$ 4	\$ 10,797
Loans individually evaluated for impairment	\$ 39	\$ 10	\$ —	\$ —	\$ —	\$ 49
Loans collectively evaluated for impairment	9,415	1,897	115	303	4	11,734
Balance at June 30, 2014	\$ 9,454	\$ 1,907	\$ 115	\$ 303	\$ 4	\$ 11,783
Loans individually evaluated for impairment	\$ 295	\$ 56	\$ —	\$ —	\$ —	\$ 351
Loans collectively evaluated for impairment	9,102	1,806	106	279	4	11,297
Balance at December 31, 2013	\$ 9,397	\$ 1,862	\$ 106	\$ 279	\$ 4	\$ 11,648
<b>Recorded investment in loans outstanding:</b>						
Loans individually evaluated for impairment	\$ 10,833	\$ 6,822	\$ 4	\$ 615	\$ —	\$ 18,274
Loans collectively evaluated for impairment	1,215,139	240,152	14,930	38,826	551	1,509,598
Ending balance at June 30, 2014	\$ 1,225,972	\$ 246,974	\$ 14,934	\$ 39,441	\$ 551	\$ 1,527,872
Loans individually evaluated for impairment	\$ 12,938	\$ 6,530	\$ 6	\$ 601	\$ —	\$ 20,075
Loans collectively evaluated for impairment	1,204,228	235,003	14,085	36,722	561	1,490,599
Ending balance at December 31, 2013	\$ 1,217,166	\$ 241,533	\$ 14,091	\$ 37,323	\$ 561	\$ 1,510,674

\*Includes the loan types; Loans to cooperatives, Processing and marketing, and Farm-related business.

A restructuring of a debt constitutes a troubled debt restructuring (TDR) if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. The following tables present additional information about pre-modification and post-modification outstanding recorded investment and the effects of the modifications that occurred during the periods presented.

Three months ended June 30, 2014						
	Interest Concessions	Principal Concessions	Other Concessions	Total		Charge-offs
<b>Pre-modification Outstanding Recorded Investment</b>						
Real estate mortgage	\$ 374	\$ 303	\$ -	\$ 677		
Production and intermediate-term	-	49	-	49		
Rural residential real estate	71	-	93	164		
Total	\$ 445	\$ 352	\$ 93	\$ 890		
<b>Post-modification Outstanding Recorded Investment</b>						
Real estate mortgage	\$ 375	\$ 303	\$ -	\$ 678	\$ -	
Production and intermediate-term	-	49	-	49	-	
Rural residential real estate	71	-	93	164	(4)	
Total	\$ 446	\$ 352	\$ 93	\$ 891	\$ (4)	

Six months ended June 30, 2014						
	Interest Concessions	Principal Concessions	Other Concessions	Total		Charge-offs
<b>Pre-modification Outstanding Recorded Investment</b>						
Real estate mortgage	\$ 666	\$ 303	\$ -	\$ 969		
Production and intermediate-term	-	154	-	154		
Rural residential real estate	71	-	93	164		
Total	\$ 737	\$ 457	\$ 93	\$ 1,287		
<b>Post-modification Outstanding Recorded Investment</b>						
Real estate mortgage	\$ 671	\$ 303	\$ -	\$ 974	\$ -	
Production and intermediate-term	-	117	-	117	-	
Rural residential real estate	71	-	93	164	(4)	
Total	\$ 742	\$ 420	\$ 93	\$ 1,255	\$ (4)	

Three months ended June 30, 2013						
	Interest Concessions	Principal Concessions	Other Concessions	Total		Charge-offs
<b>Pre-modification Outstanding Recorded Investment</b>						
Real estate mortgage	\$ 100	\$ 94	\$ 428	\$ 622		
Production and intermediate-term	-	-	48	48		
Rural residential real estate	139	-	-	139		
Total	\$ 239	\$ 94	\$ 476	\$ 809		
<b>Post-modification Outstanding Recorded Investment</b>						
Real estate mortgage	\$ 103	\$ 95	\$ 422	\$ 620	\$ -	
Production and intermediate-term	-	-	41	41	-	
Rural residential real estate	139	-	-	139	-	
Total	\$ 242	\$ 95	\$ 463	\$ 800	\$ -	

Six months ended June 30, 2013						
	Interest	Principal	Other	Total	Charge-offs	
	Concessions	Concessions	Concessions			
<b>Pre-modification Outstanding</b>						
<b>Recorded Investment</b>						
Real estate mortgage	\$ 2,504	\$ 94	\$ 428	\$ 3,026		
Production and intermediate-term	–	41	48	89		
Rural residential real estate	139	–	–	139		
Total	\$ 2,643	\$ 135	\$ 476	\$ 3,254		
<b>Post-modification Outstanding</b>						
<b>Recorded Investment</b>						
Real estate mortgage	\$ 2,509	\$ 95	\$ 422	\$ 3,026	\$ –	
Production and intermediate-term	–	42	41	83	–	
Rural residential real estate	139	–	–	139	–	
Total	\$ 2,648	\$ 137	\$ 463	\$ 3,248	\$ –	

Interest concessions may include interest forgiveness and interest deferment. Principal concessions may include principal forgiveness, principal deferment, and maturity extension. Other concessions may include additional compensation received which might be in the form of cash or other assets.

The following table presents outstanding recorded investment for TDRs that occurred during the previous twelve months and for which there was a subsequent payment default during the period. Payment default is defined as a payment that was thirty days or more past due.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Real estate mortgage	\$ 5,618	\$ 3,087	\$ 5,617	\$ 3,113
Production and intermediate-term	1,683	118	1,705	118
Total	\$ 7,301	\$ 3,205	\$ 7,322	\$ 3,231

The following table provides information on outstanding loans restructured in troubled debt restructurings at period end. These loans are included as impaired loans in the impaired loan table:

	Total TDRs		Nonaccrual TDRs	
	June 30, 2014	December 31, 2013	June 30, 2014	December 31, 2013
Real estate mortgage	\$ 16,748	\$ 18,013	\$ 4,237	\$ 5,262
Production and intermediate-term	2,991	3,028	1,982	1,990
Farm-related business	193	197	1	1
Rural residential real estate	405	261	405	261
Total Loans	\$ 20,337	\$ 21,499	\$ 6,625	\$ 7,514
Additional commitments to lend	\$ –	–		

### Note 3 — Investment Securities

The Association's held-to-maturity investments consist primarily of Rural America Bonds, which are private placement securities purchased under the Mission Related Investment program approved by the FCA. In its Conditions of Approval for the program, the FCA considers a Rural America Bond ineligible if its investment rating, based on the internal 14-point risk rating scale used to also grade loans, falls below 9 and requires System institutions to provide notification to FCA when a security becomes ineligible.

A summary of the amortized cost and fair value of investment securities held-to-maturity follows:

	June 30, 2014				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Yield
Mission Related Investments	\$ 12,055	\$ 151	\$ (108)	\$ 12,098	5.96%
	December 31, 2013				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Yield
Mission Related Investments	\$ 7,193	\$ 35	\$ (96)	\$ 7,132	5.47%

A summary of the contractual maturity, amortized cost and estimated fair value of investment securities held-to-maturity follows:

	June 30, 2014		
	Amortized Cost	Fair Value	Weighted Average Yield
In one year or less	\$ —	\$ —	—%
After one year through five years	3,195	3,087	4.95
After five years through ten years	—	—	—
After ten years	8,860	9,011	6.33
Total	\$ 12,055	\$ 12,098	5.96 %

A portion of these investments have contractual maturities in excess of ten years. However, expected maturities for these types of securities can differ from contractual maturities because borrowers may have the right to prepay obligations with or without prepayment penalties.

An investment is considered impaired if its fair value is less than its cost. A continuous unrealized loss position for an investment is based on the date the impairment was first identified. The following tables show the fair value and gross unrealized losses for investments that were in a continuous unrealized loss position aggregated by investment category.

	June 30, 2014			
	Less than 12 Months		Greater than 12 Months	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mission Related Investments	\$ 3,087	\$ (108)	\$ —	\$ —

	December 31, 2013			
	Less than 12 Months		Greater than 12 Months	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mission Related Investments	\$ 3,098	\$ (96)	\$ —	\$ —

FASB guidance contemplates numerous factors in determining whether an impairment is other-than-temporary. These factors include: (1) whether or not management intends to sell the security, (2) whether it is more likely than not that management would be required to sell the security before recovering its costs, and (3) whether management expects to recover the security's entire amortized cost basis (even if there is no intention to sell). If the Association intends to sell the security or it is more likely than not that it would be required to sell the security, the impairment loss equals the full difference between amortized cost and fair value of the security. When the Association does not intend to sell securities in an unrealized loss position and it is not more likely than not that it would be required to sell the securities, other-than-temporary impairment loss is separated into credit loss and non-credit loss. Credit loss is defined as the shortfall of the present value of the cash flows expected to be collected in relation to the amortized cost basis.

The Association performs periodic credit reviews, including other-than-temporary impairment analyses, on its investment securities portfolio. The objective is to quantify future possible loss of principal or interest due on securities in the portfolio. Factors considered in determining whether an impairment is other-than-temporary include among others: (1) the length of time and the extent to which the fair value is less than cost, (2) adverse conditions specifically related to the industry, (3) geographic area and the condition of the underlying collateral, (4) payment structure of the security, (5) ratings by rating agencies, (6) the credit worthiness of bond insurers, and (7) volatility of the fair value changes.

The Association uses the present value of cash flows expected to be collected from each debt security to determine the amount of credit loss. This technique requires assumptions related to the underlying collateral, including default rates, amount and timing of prepayments, and loss severity. Assumptions can vary widely from security to security and are influenced by such factors as loan interest rate, geographical location of the borrower, borrower characteristics, and collateral type.

Significant inputs used to estimate the amount of credit loss include, but are not limited to, performance indicators of the underlying assets in the security (including default rates, delinquency rates, and percentage of nonperforming assets), loan-to-collateral value ratios, third-party guarantees, current levels of subordination, vintage, geographic concentration, and credit ratings. The Association may obtain assumptions for the default rate, prepayment rate, and loss severity rate from an independent third party, or generate the assumptions internally.

The Association has not recognized any credit losses as any impairments were deemed temporary and resulted from non-credit related factors. The Association has the ability and intent to hold these temporarily impaired 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.

#### Note 4 — Debt

##### Notes Payable to AgFirst Farm Credit Bank

The Association's indebtedness to AgFirst Farm Credit Bank (AgFirst or 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. The contractual terms of the revolving line of credit are contained in the General Financing Agreement (GFA). The GFA also defines Association performance criteria for borrowing from the Bank, which includes borrowing base margin, earnings and capital covenants, among others.



Certain conditions and events that led to the need for the Association to enter into a Supervisory Agreement with the Farm Credit Administration (FCA) as discussed in Note 9, *Regulatory Enforcement Matters*, constituted events of default under the GFA as the Association was not able to remedy the defaults within 30

days of written notice from the Bank. The Bank has waived the Association's events of default under the GFA provided the Association remains compliant with the requirements of the Supervisory Agreement with the FCA.

## Note 5 — Members' Equity

### Accumulated Other Comprehensive Income

The following tables present activity related to AOCI for the periods presented:

	Changes in Accumulated Other Comprehensive Income by Component (a)			
	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
<b>Employee Benefit Plans:</b>				
Balance at beginning of period	\$ (219)	\$ (585)	\$ (224)	\$ (607)
Other comprehensive income before reclassifications	—	—	—	—
Amounts reclassified from AOCI	6	22	11	44
Net current period other comprehensive income	6	22	11	44
Balance at end of period	\$ (213)	\$ (563)	\$ (213)	\$ (563)

	Reclassifications Out of Accumulated Other Comprehensive Income (b)				
	For the three months ended June 30,		For the six months ended June 30,		Income Statement Line Item
	2014	2013	2014	2013	
<b>Defined Benefit Pension Plans:</b>					
Periodic pension costs	\$ (6)	\$ (22)	\$ (11)	\$ (44)	See Note 7.
Net amounts reclassified	\$ (6)	\$ (22)	\$ (11)	\$ (44)	

(a) Amounts in parentheses indicate debits to AOCI.

(b) Amounts in parentheses indicate debits to profit/loss.

## Note 6 — Fair Value Measurement

Fair value is defined 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.

Accounting guidance establishes a 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 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 hierarchy tiers is based upon the lowest level of input that is significant to the fair value measurement.

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 7.01 percent of the issued stock of the Bank as of June 30, 2014 net of any reciprocal investment. As of that date, the Bank's assets totaled \$28.2 billion and shareholders' equity totaled \$2.3 billion. The Bank's earnings were \$183 million for the first six months of

2014. In addition, the Association has an investment of \$3,900 related to other Farm Credit institutions.

The classifications within the fair value hierarchy are as follows:

Level 1 inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets.

Level 2 inputs 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.

Level 3 inputs 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.

For a complete discussion of the inputs and other assumptions considered in assigning various assets and liabilities to the fair value hierarchy levels, see the latest Annual Report to Shareholders.

The following table presents the changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the periods presented. The Association had no transfers of assets or liabilities into or out of Level 1 or Level 2 during the periods presented.

	<b>Standby Letters of Credit</b>	
	<b>For the six months ended June 30,</b>	
	<b>2014</b>	<b>2013</b>
Balance at beginning of period	\$ 2	\$ 5
Issuances	1	–
Settlements	–	–
Balance at end of period	<u>\$ 3</u>	<u>\$ 5</u>

### SENSITIVITY TO CHANGES IN SIGNIFICANT UNOBSERVABLE INPUTS

Discounted cash flow or similar modeling techniques are generally used to determine the recurring fair value measurements for Level 3 assets and liabilities. Use of these techniques requires determination of relevant inputs and assumptions, some of which represent significant unobservable inputs as indicated in the tables that follow. Accordingly, changes in these unobservable inputs may have a significant impact on fair value.

Certain of these unobservable inputs will (in isolation) have a directionally consistent impact on the fair value of the instrument for a given change in that input. Alternatively, the fair value of the instrument may move in an opposite direction for a given change in another input. Where multiple inputs are used within the valuation technique of an asset or liability, a change in one input in a certain direction may be offset by an opposite change in another input having a potentially muted impact to the overall fair value of that particular instrument. Additionally, a change in one unobservable input may result in a change to another unobservable input (that is, changes in certain inputs are interrelated with one another), which may counteract or magnify the fair value impact.

#### Investment Securities

The fair values of predominantly all level 3 investment securities have consistent inputs, valuation techniques and correlation to

changes in underlying inputs. The models used to determine fair value for these instruments use certain significant unobservable inputs within a discounted cash flow or market comparable pricing valuation technique. Such inputs generally include discount rate components including risk premiums, prepayment estimates, default estimates and loss severities.

These level 3 assets would decrease (increase) in value based upon an increase (decrease) in discount rates, defaults, or loss severities. Conversely, the fair value of these assets would generally increase (decrease) in value if the prepayment input were to increase (decrease).

#### Other Property Owned/Impaired Loans

Other property owned and impaired loans are valued using appraisals, market comparable sales, replacement costs and income and expense (cash flow) techniques. Certain unobservable inputs are used within these techniques to determine the level 3 fair value of these properties. The significant unobservable inputs are primarily sensitive only to industry, geographic and overall economic conditions, and/or specific attributes of each property.

#### Inputs to Valuation Techniques

Management determines the Association's valuation policies and procedures. The Bank performs the majority of the Association's valuations, and its valuation processes are calibrated annually by an independent consultant. The fair value measurements are analyzed on a quarterly basis. For other valuations, documentation is obtained for third party information, such as pricing, and periodically evaluated alongside internal information and pricing that is available.

Quoted market prices are generally not available for the instruments presented 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.

#### Quantitative Information about Recurring and Nonrecurring Level 3 Fair Value Measurements

	<b>Fair Value</b>	<b>Valuation Technique(s)</b>	<b>Unobservable Input</b>	<b>Range</b>
Impaired loans and other property owned	\$ 33,125	Appraisal	Income and expense	*
			Comparable sales	*
			Replacement cost	*
			Comparability adjustments	*

\* Ranges for this type of input are not useful because each collateral property is unique.

#### Information about Other Financial Instrument Fair Value Measurements

	<b>Valuation Technique(s)</b>	<b>Input</b>
Cash	Carrying Value	Par/Principal and appropriate interest yield
Loans	Discounted cash flow	Prepayment forecasts
		Probability of default
		Loss severity
Investment securities, held-to-maturity	Discounted cash flow	Risk adjusted discount rate
Notes payable to AgFirst Farm Credit Bank	Discounted cash flow	Prepayment forecasts
		Probability of default
		Loss severity

The following tables present the carrying amounts and fair values of assets and liabilities that are measured at fair value on a recurring and nonrecurring basis, as well as those financial instruments not measured at fair value, for each of the hierarchy levels at the period ended:

At or for the Six Months Ended June 30, 2014							
	Total Carrying Amount	Level 1	Level 2	Level 3	Total Fair Value	Fair Value Effects On Earnings	
<b>Recurring Measurements</b>							
<b>Assets:</b>							
Assets held in Trust funds	\$ 1,252	\$ 1,252	\$ –	\$ –	\$ 1,252		
Recurring Assets	\$ 1,252	\$ 1,252	\$ –	\$ –	\$ 1,252		
<b>Liabilities:</b>							
Standby letters of credit	\$ 3	\$ –	\$ –	\$ 3	\$ 3		
Recurring Liabilities	\$ 3	\$ –	\$ –	\$ 3	\$ 3		
<b>Nonrecurring Measurements</b>							
<b>Assets:</b>							
Impaired loans	\$ 31,981	\$ –	\$ –	\$ 31,981	\$ 31,981	\$	437
Other property owned	970	–	–	1,144	1,144		(36)
Nonrecurring Assets	\$ 32,951	\$ –	\$ –	\$ 33,125	\$ 33,125	\$	401
<b>Other Financial Instruments</b>							
<b>Assets:</b>							
Cash	\$ 2,838	\$ 2,838	\$ –	\$ –	\$ 2,838		
Investment securities, held-to-maturity	12,055	–	–	12,098	12,098		
Loans	1,471,626	–	–	1,475,511	1,475,511		
Other Financial Assets	\$ 1,486,519	\$ 2,838	\$ –	\$ 1,487,609	\$ 1,490,447		
<b>Liabilities:</b>							
Notes payable to AgFirst Farm Credit Bank	\$ 1,276,785	\$ –	\$ –	\$ 1,270,856	\$ 1,270,856		
Other Financial Liabilities	\$ 1,276,785	\$ –	\$ –	\$ 1,270,856	\$ 1,270,856		

At or for the Year ended December 31, 2013							
	Total Carrying Amount	Level 1	Level 2	Level 3	Total Fair Value	Fair Value Effects On Earnings	
<b>Recurring Measurements</b>							
<b>Assets:</b>							
Assets held in Trust funds	\$ 1,003	\$ 1,003	\$ –	\$ –	\$ 1,003		
Recurring Assets	\$ 1,003	\$ 1,003	\$ –	\$ –	\$ 1,003		
<b>Liabilities:</b>							
Standby letters of credit	\$ 2	\$ –	\$ –	\$ 2	\$ 2		
Recurring Liabilities	\$ 2	\$ –	\$ –	\$ 2	\$ 2		
<b>Nonrecurring Measurements</b>							
<b>Assets:</b>							
Impaired loans	\$ 33,705	\$ –	\$ –	\$ 33,705	\$ 33,705	\$	(276)
Other property owned	1,731	–	–	1,920	1,920		(1,647)
Nonrecurring Assets	\$ 35,436	\$ –	\$ –	\$ 35,625	\$ 35,625	\$	(1,923)
<b>Other Financial Instruments</b>							
<b>Assets:</b>							
Cash	\$ 7,061	\$ 7,061	\$ –	\$ –	\$ 7,061		
Investment securities, held-to-maturity	7,193	–	–	7,132	7,132		
Loans	1,451,735	–	–	1,452,649	1,452,649		
Other Financial Assets	\$ 1,465,989	\$ 7,061	\$ –	\$ 1,459,781	\$ 1,466,842		
<b>Liabilities:</b>							
Notes payable to AgFirst Farm Credit Bank	\$ 1,271,311	\$ –	\$ –	\$ 1,257,195	\$ 1,257,195		
Other Financial Liabilities	\$ 1,271,311	\$ –	\$ –	\$ 1,257,195	\$ 1,257,195		

## Note 7 — Employee Benefit Plans

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

	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
Pension	\$ 1,535	\$ 1,577	\$ 3,069	\$ 3,154
401(k)	168	149	326	287
Other postretirement benefits	265	255	530	511
Total	\$ 1,968	\$ 1,981	\$ 3,925	\$ 3,952

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

	Actual YTD Through 6/30/14	Projected Contributions For Remainder of 2014	Projected Total Contributions 2014
Pension	\$ 43	\$ 4,712	\$ 4,755
Other postretirement benefits	388	425	813
Total	\$ 431	\$ 5,137	\$ 5,568

Contributions in the above table include allocated estimates of funding for multi-employer plans in which the Association participates. These amounts may change when a total funding amount and allocation is determined by the respective Plan's Sponsor Committee. Also, market conditions could impact discount rates and return on plan assets which could change contributions necessary before the next plan measurement date of December 31, 2014.

Further details regarding employee benefit plans are contained in the 2013 Annual Report to Shareholders.

In May 2014, the AgFirst Plan Sponsor Committee voted to approve changes to certain employee benefit plans as follows:

- (1) On January 1, 2015, the AgFirst Farm Credit Cash Balance Retirement Plan (Cash Balance Plan) will be frozen, employer contributions will cease, and the Cash Balance Plan will be closed to new entrants.
- (2) In lieu of participation in and contributions to the Cash Balance Plan, additional employer contributions will be made to the Farm Credit Benefits Alliance 401(k) Plan.

The above changes are expected to become officially executed Plan amendments in November 2014. The Cash Balance Plan will not be terminated on January 1, 2015, but is expected to be terminated in 2015 or 2016 once all necessary actions have been performed and approvals obtained. Participants in the Cash Balance Plan will continue to receive employer contributions to their hypothetical cash balance accounts through the end of 2014, at which time contributions will cease. Participants will continue receiving interest credits on the same basis as currently being provided until the Cash Balance Plan is terminated. Participants who are not already fully vested in their accounts will automatically become 100% vested on December 31, 2014. Following the termination of the Cash Balance Plan, vested benefits will be distributed to participants.

Beginning on January 1, 2015, for participants in the Cash Balance Plan and eligible employees hired on or after this date, an additional employer contribution will be made to the Farm Credit Benefits Alliance 401(k) Plan equal to 3% of the participants' eligible compensation.

Accounting related to the curtailment of future benefit service under the Cash Balance Plan, as prescribed in ASC 715 "Compensation – Retirement Benefits", is expected to be triggered in November 2014 when the plan amendments are officially executed. This accounting is not expected to have a material impact on the Association's financial condition or results of operations.

## **Note 8 — Commitments and Contingent Liabilities**

From time to time, legal actions are pending against the Association in which claims for money damages are asserted. On at least a quarterly basis, the Association assesses its liabilities and contingencies in connection with outstanding legal proceedings utilizing the latest information available. While the outcome of legal proceedings is inherently uncertain, on the basis of information presently available, management, after consultation with legal counsel, is of the opinion that the ultimate liability, if any, from these actions, would not be material in relation to the financial position of the Association. Because it is not probable that the Association will incur a loss or the loss is not estimable, no liability has been recorded for any claims that may be pending.

## **Note 9 — Regulatory Enforcement Matters**

On October 11, 2012, the Board entered into a Supervisory Agreement with the FCA. The Supervisory Agreement requires the Association to take corrective actions with respect to certain areas of its operations including standards of conduct, acquired property, borrower rights and board policies. Conditions and events that led to the need for this agreement include ineffective controls that resulted in the failure to comply with FCA Regulations in the sale of acquired property; violations of FCA Borrower Rights Regulations at 12 C.F.R. Part 612, Subpart G; ineffective controls over board and employee standards of conduct; an inadequate Standards of Conduct program which resulted in violations of FCA Regulations; and a lack of controls regarding standards of conduct for agents. The requirements of this agreement include, but are not limited to:

- Appointment of a new Standards of Conduct Official (SOCO)
- Appointment of a Board Compliance Committee as it relates to the Supervisory Agreement and ongoing Standards of Conduct issues
- Establishment of a standards of conduct program for directors, employees, and agents of the Association which is to include a review of applicable policies and procedures, training for directors and employees and comprehensive audits
- Establishment for a defined process for handling borrower rights issues, including updates to Association policy and procedures
- Policies and procedures revisions and updates around the disposition of other property owned
- Special requirements for properties under contract as of the date of the agreement
- Board approval and certification of future contracts on other properties owned to ensure compliance with FCA Regulations and Association policies and procedures

The Association has developed action plans to correct the weaknesses identified with assignments and due dates. The following action steps are complete as of this writing:

- A Compliance Committee was appointed by the Board of Directors. This committee is comprised of the Board chairman and vice chairman, Audit Committee chairman, and two other directors. The Board chairman will serve as the chairman of the Compliance Committee.
- The Board named Wesley D. Sutton as the Association Standards of Conduct Official. This action was approved by the Director, Risk Supervision Division at the FCA.
- Reports of required task completion outlined in the Supervisory Agreement have been made and published to the Director, Risk Supervision Division.
- Standards of Conduct policies and procedures have been updated, revised, and approved by the Board of Directors.
- Training on Standards of Conduct policies and procedures for all directors and employees has been completed.
- Director disclosures were completed and meetings were held with the SOCO to discuss the same. Following completion of the meetings, the SOCO presented a comprehensive report to the Board.
- Employee disclosures were completed and meetings were held with the SOCO to discuss the same. The SOCO presented a comprehensive report to the Board at the April 2013 meeting.
- The Board of Directors have completed subsequent disclosures in June 2013, December 2013, and June 2014.
- Employees have completed subsequent disclosures in July 2013, January 2014 and July 2014.
- The 4<sup>th</sup> quarter 2012 SOCO report was presented to the Board of Directors at the January 2013 Board meeting.
- The SOCO report was presented quarterly to the Board of Directors at the Board meetings held in January, April, July and October 2013 and January, April, and July 2014.
- A report of acquired property and other borrower's rights activities during each quarter was presented to the Board of Directors at the Board meetings held in January, April, July and October 2013 and January, April, and July 2014.
- The Board adopted a revised Code of Ethics and all board members signed in August 2013. All employees completed the same Code of Ethics in August 2013. All board members subsequently reviewed and signed the Association's Code of Ethics for Directors in June 2014 and all employees subsequently reviewed and acknowledged the Associations Code of Ethics in July 2014.
- An independent accounting firm was hired to complete a comprehensive audit of all acquired property sales from December 31, 2009 forward. The final report was presented to the Board at its' March 2013 meeting. No new exceptions to policy or regulation were identified.
- An independent law firm was hired to complete a comprehensive review of the Association's Standard of Conduct programs for directors, employees and agents, including policies and procedures, training materials, and disclosure documents. The final report was presented to the Board of Directors at the February 2013 Board meeting. Additional suggested revisions to Standards of Conduct policies and procedures have been made and approved by

the Board of Directors. A subsequent audit was completed and presented to the Board of Directors at the March 2014 meeting. Additional suggested revisions to Standards of Conduct policies and procedures have been made and will be presented to the Board of Directors at the April 2014 meeting.

- As of June 30, 2014, the FCA has determined that the Association is in full compliance in 6 of 12 articles of the agreement.

Both the Board and Senior Management are committed to continuing the administration of the Association in a safe and sound manner, compliant with all FCA Regulations.

The Association remained under written Supervisory Agreement as of the date of this report.

#### **Note 10 — Subsequent Events**

The Association has evaluated subsequent events and has determined there are none requiring disclosure through August 7, 2014, which is the date the financial statements were issued.