

# **FIRST QUARTER 2004**

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Stephen L. Rochelle  
Chief Executive Officer



Ted S. Passmore  
Chairman of the Board

April 29, 2004

# 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 First South Farm Credit, ACA, (Association) for the period ended March 31, 2004. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements and the 2003 Annual Report of the Association.

## **LOAN PORTFOLIO**

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

The gross loan volume of the Association as of March 31, 2004, was \$789,660, a decrease of \$50,251 as compared to \$839,911 at December 31, 2003. Net loans outstanding at March 31, 2004, were \$769,047 as compared to \$819,281 at December 31, 2003. Net loans accounted for 89.80 percent of total assets at March 31, 2004, as compared to 89.48 percent of total assets at December 31, 2003.

The decrease in gross and net loan volume during the reporting period is primarily attributed to seasonal loan payments increased by an excellent crop year in 2003. The short-term portfolio is heavily influenced by operating-type loans that normally peak in September and rapidly decline in the fall and winter months when farm commodities are marketed.

There is an inherent risk in the extension of any type of credit. Portfolio credit quality continues to be maintained at an acceptable level, however, and credit administration remains satisfactory. Nonaccrual loans decreased from \$3,965 at December 31, 2003, to \$3,425 at March 31, 2004. This decrease is primarily the result of liquidation, normal payouts, and upgrading to performing status. As of March 31, 2004, there were no loans that were over 90 days past due. 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 March 31, 2004, was \$20,613 compared to \$20,630 at December 31, 2003, and was considered by management to be adequate to cover possible losses.

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

We plan to conduct a study to further refine our methodology for calculating the allowance for loan losses taking into account generally accepted accounting principles, and applicable Farm Credit Administration requirements, as well as the Securities and Exchange Commission and Federal Financial Institutions Examination Council guidelines. The study is likely to be completed by the fourth quarter of 2004 with any appropriate reduction to the allowance for loan losses implemented at that time, which reduction may be significant.

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## RESULTS OF OPERATIONS

### *For the three months ended March 31, 2004*

Net income for the three months ended March 31, 2004, totaled \$2,661, as compared to \$2,631 for the same period in 2003. Net interest income increased \$31 for the three months ended March 31, 2004, as compared to the same period in 2003.

At March 31, 2004, interest income on accruing loans decreased \$712 compared to March 31, 2003. Nonaccrual income was \$55 for the three months ended March 31, 2004, as compared to \$136 for the same period in 2003, a decrease of \$81. Interest expense decreased \$824 for the three months ended March 31, 2004, as compared to the comparable period in 2003. Noninterest income for the three months ended March 31, 2004, totaled \$1,950 as compared to \$1,968 for the same period of 2003, a decrease of \$18. Noninterest expense for the three months ended March 31, 2004, increased \$244 compared to the same period of 2003.

The Association did not record a provision for loan losses for the three months ended March 31, 2004, as compared to \$300 for the same period in 2003.

## 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 funds are advanced by the Bank to the Association in the form of notes payable. The notes payable are segmented into variable rate and fixed rate sections. The variable rate note is utilized by the Association to fund variable rate loan advances and operating funds requirements. The fixed rate note is used specifically to fund fixed rate loan advances made by the Association. The total notes payable to the Bank at March 31, 2004, was \$652,132 as compared to \$708,874 at December 31, 2003. The decrease during the period is primarily attributed to the decrease in loan volume.

## CAPITAL RESOURCES

Total members' equity at March 31, 2004, increased to \$184,689 from the December 31, 2003, total of \$181,985. The increase is primarily attributed to the Association's net income for the three months ended March 31, 2004.

Total capital stock and participation certificates were \$63,098 on March 31, 2004, compared to \$63,099 on December 31, 2003.

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 March 31, 2004, the Association's total surplus ratio and core surplus ratio were 14.14 percent and 10.82 percent, respectively, and the permanent capital ratio was 15.67 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.

*First South Farm Credit, ACA*  
**Consolidated Balance Sheets**

<i>(dollars in thousands)</i>	<b>March 31, 2004</b>	<b>December 31, 2003</b>
	<i>(unaudited)</i>	
<b>Assets</b>		
Cash	\$ 3,683	\$ 7,186
Loans	789,660	839,911
Less: allowance for loan losses	20,613	20,630
Net loans	769,047	819,281
Accrued interest receivable	8,086	8,593
Investment in other Farm Credit institutions	62,314	62,314
Premises and equipment, net	3,490	3,280
Other property owned	706	434
Deferred tax asset, net	283	283
Other assets	8,771	14,282
Total assets	\$ 856,380	\$ 915,653
<b>Liabilities</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 652,132	\$ 708,874
Accrued interest payable	1,730	1,901
Patronage refund payable	4	2,803
Postretirement benefits other than pensions	10,616	10,472
Other liabilities	7,209	9,618
Total liabilities	671,691	733,668
Commitments and contingencies		
<b>Members' Equity</b>		
Protected borrower equity	142	147
Capital stock and participation certificates	62,956	62,952
Retained earnings		
Allocated	51,941	52,081
Unallocated	69,650	66,805
Total members' equity	184,689	181,985
Total liabilities and members' equity	\$ 856,380	\$ 915,653

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

*First South Farm Credit, ACA*  
**Consolidated Statements of Income**  
*(unaudited)*

<i>(dollars in thousands)</i>	<b>For the three months ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
<b>Interest Income</b>		
Loans	\$ 10,901	\$ 11,695
<b>Interest Expense</b>		
Notes payable to AgFirst Farm Credit Bank	5,134	5,958
Other	2	3
Total interest expense	5,136	5,961
Net interest income	5,765	5,734
Provision for (reversal of) loan losses	—	300
Net interest income after provision for (reversal of) loan losses	5,765	5,434
<b>Noninterest Income</b>		
Loan fees	571	576
Fees for financially related services	17	18
Equity in earnings of other Farm Credit institutions	1,273	1,288
Gains (losses) on other property owned, net	(3)	—
Other noninterest income	92	86
Total noninterest income	1,950	1,968
<b>Noninterest Expense</b>		
Salaries and employee benefits	3,437	3,217
Occupancy and equipment	266	298
Insurance Fund premium	192	235
Other operating expenses	998	899
Total noninterest expense	4,893	4,649
Income before income taxes	2,822	2,753
Provision (benefit) for income taxes	161	122
Net income	\$ 2,661	\$ 2,631

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

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

*(unaudited)*

*(dollars in thousands)*

	Protected Borrower Capital	Capital Stock and Participation Certificates	Retained Earnings		Total Members' Equity
			Allocated	Unallocated	
Balance at December 31, 2002	\$ 147	\$ 62,260	\$ 46,056	\$ 68,510	\$ 176,973
Net income				2,631	2,631
Protected borrower equity issued/retired	6				6
Capital stock/participation certificates issued		494			494
Capital stock/participation certificates retired		(335)			(335)
Retained earnings retired			(16)		(16)
Distribution adjustment			(41)	47	6
Balance at March 31, 2003	\$ 153	\$ 62,419	\$ 45,999	\$ 71,188	\$ 179,759
Balance at December 31, 2003	\$ 147	\$ 62,952	\$ 52,081	\$ 66,805	\$ 181,985
Net income				2,661	2,661
Protected borrower equity retired	(5)				(5)
Capital stock/participation certificates issued		431			431
Capital stock/participation certificates retired		(427)			(427)
Retained earnings retired			(1)		(1)
Distribution adjustment			(139)	184	45
Balance at March 31, 2004	\$ 142	\$ 62,956	\$ 51,941	\$ 69,650	\$ 184,689

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

First South Farm Credit, ACA

# Notes to the Consolidated Financial Statements

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

## NOTE 1 – ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

A description of the organization and operations of First South Farm Credit, ACA (the Association), the significant accounting policies followed, and the financial condition and results of operations as of and for the year ended December 31, 2003, are contained in the 2003 Annual Report to Stockholders. These unaudited first quarter 2004 consolidated financial statements should be read in conjunction with the 2003 Annual Report to Stockholders.

The accompanying consolidated financial statements contain all adjustments necessary for a fair presentation of the interim financial condition and results of operations and conform with generally accepted accounting principles. The results for the three months ended March 31, 2004, are not necessarily indicative of the results to be expected for the year ending December 31, 2004.

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

The Association maintains an allowance for loan losses in accordance with generally accepted accounting principles. The loan portfolio is reviewed quarterly to determine the adequacy of the allowance for losses. As of March 31, 2004, the allowance for losses is adequate in management's opinion to provide for possible losses on existing loans.

## NOTE 2 – ALLOWANCE FOR LOAN LOSSES

An analysis of the allowance for loan losses follows:

Balance at 12-31-02	\$ 20,717
(Reversal of) provision for loan losses	300
Loans (charged off), net of recoveries	<u>(16)</u>
Balance at 3-31-03	<u>\$ 21,001</u>
Balance at 12-31-03	\$ 20,630
(Reversal of) provision for loan losses	–
Loans (charged off), net of recoveries	<u>(17)</u>
Balance at 3-31-04	<u>\$ 20,613</u>

## NOTE 3 – EMPLOYEE BENEFIT PLANS

The Association's employees participate in a defined benefit retirement plan. This plan is noncontributory and covers substantially all employees of the Association.

The following is a table of the components of net periodic benefit (income) cost for the defined benefit retirement plan for three months ended March 31, 2004:

	<b>For the three months ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
Service cost	\$ 289	\$ 245
Interest cost	558	516
Expected return on plan assets	(586)	(525)
Amortization of net (gain) loss	(84)	(85)
Amortization of prior service cost	66	66
Recognized net actuarial (gain) loss	221	200
Net periodic benefit (income) cost	<u>\$ 464</u>	<u>\$ 417</u>

The Association also participates in Districtwide thrift and other postretirement benefit plans. The other postretirement benefit plan provides certain benefits (primarily health care) to its retirees.

The following is a table of retirement and postretirement benefit expense for the three months ended March 31, 2004:

	<b>For the three months ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
Pension	\$ 464	\$ 417
Thrift/deferred compensation	52	49
Other postretirement benefits	290	241
Total	<u>\$ 806</u>	<u>\$ 707</u>