First South Farm Credit, ACA

SECOND QUARTER 2004

Stephen L. Rochelle
Chief Executive Officer

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July 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 June 30, 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 June 30, 2004, was $909,038, an increase of $69,127 as compared to $839,911 at December 31, 2003. Net loans outstanding at June 30, 2004, were $888,824 as compared to $819,281 at December 31, 2003. Net loans accounted for 91.03 percent of total assets at June 30, 2004, as compared to 89.48 percent of total assets at December 31, 2003.

The increase in gross and net loan volume during the reporting period is attributed primarily to seasonal lending. 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 $3,473 at June 30, 2004. This decrease is primarily the result of liquidation, normal payouts, and upgrading to performing status. As of June 30, 2004, there were loans in the amount of $223 that were over 90 days past due but still accruing interest. In management's opinion, these loans are fully secured and are in the process of collection. 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, 2004, was $20,214 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' (AICPA) Accounting Standards Executive Committee (AcSEC) issued a proposed Statement of Position – 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 Statement of Position and announced that it would focus instead on improving financial statement disclosures regarding the allowance for loan losses.

System institutions have initiated studies to further refine their methodologies for calculating their respective allowances 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. These studies are likely to be completed by the fourth quarter of 2004 with any appropriate reductions to the allowance for loan losses implemented at that time. The resulting reductions in the allowance for loan losses may be significant.

In April 2004, the Farm Credit Administration, the System's regulator, issued an "Informational Memorandum" to System institutions regarding the allowance for loan losses. The memorandum addresses the status of the AICPA's project and the Securities and Exchange Commission and the Federal Financial Institutions Examination Council guidance on the subject. The objective of the Farm Credit Administration's memorandum was to clarify its expectations regarding the analysis and related documentation for the allowance for loan losses. The Farm Credit Administration endorsed the direction provided by these other regulatory agencies and will include the conceptual framework addressed in this guidance in their examination process.

RESULTS OF OPERATIONS

For the three months ended June 30, 2004

Net income for the three months ended June 30, 2004, totaled $3,187, as compared to $3,384 for the same period in 2003, a decrease of $197. Net interest income decreased $82, for the three months ended June 30, 2004, as compared to the same period in 2003.

At June 30, 2004, interest income on accruing loans decreased $470 compared to June 30, 2003. Nonaccrual income was $40 for the three months ended June 30, 2004, as compared to $214 for the same period in 2003, a decrease of $174. Interest expense decreased $562 for the three months ended June 30, 2004, as compared to the comparable period of 2003. Noninterest income for the three months ended June 30, 2004, totaled $1,973 as compared to $2,136 for the same period of 2003, a decrease of $163. Noninterest expense for the three months ended June 30, 2004, increased $130 compared to the same period of 2003. Provision for income taxes increased by $122 and provision for loan losses decreased by $300.

For the six months ended June 30, 2004

Net income for the six months ended June 30, 2004, totaled $5,848, as compared to $6,015 for the same period in 2003. This decrease of $167, or 2.78 percent, is attributed to a decrease in net interest income of $51, a decrease in noninterest income of $181, an increase in noninterest expense of $374, an increase in provision for income taxes of $161, and a decrease in provision for loan losses of $600. At June 30, 2004, interest income on accruing loans decreased $1,183 compared to June 30, 2003, as a result of a decrease in average loans outstanding of $12,820 and a decrease in the average interest rate on loans to members of 21 basis points. Nonaccrual income was $95 for the six months ended June 30, 2004, as compared to $350 for the same period in 2003. Interest expense decreased $1,387 for the six months ended June 30, 2004, as compared to the same period in 2003. This change is primarily due to a decrease in the average interest rate on notes payable to AgFirst Farm Credit Bank (the Bank) of 33 basis points, and a decrease in the average notes payable to the Bank of $18,026.

Noninterest income for the six months ended June 30, 2004, totaled $3,923, as compared to $4,104 for the same period of 2003, a decrease of $181. The decrease resulted from a decrease in loan fees of $38, a decrease in equity in earnings of the Bank of $37, an increase in losses on other property owned of $124, and a decrease in other noninterest income of $37, partially offset by an increase in fees for financially related services of $55.

Noninterest expense for the six months ended June 30, 2004, increased $374 compared to the same period of 2003. This increase is attributed to an increase in salaries and benefits expense of $416 and an increase in other operating expenses of $109, partially offset by a decrease in occupancy and equipment expense of $63 and a decrease in the Insurance Fund premium of $88.

FUNDING SOURCES

The principal source of funds for the Association is the borrowing relationship established with the Bank through a General Financing Agreement. The General Financing Agreement utilizes the Association's credit and fiscal performance as criteria for establishing a line of credit on which the Association may draw funds. The funds are advanced by the Bank to the Association in the form of notes payable. The notes payable are segmented into variable rate and fixed rate sections. The variable rate note is utilized by the Association to fund variable rate loan advances and operating funds requirements. The fixed rate note is used specifically to fund fixed rate loan advances made by the Association. The total notes payable to the Bank at June 30, 2004, was $777,743 as compared to $708,874 at December 31, 2003. The increase during the period is primarily attributed to the increase in loan volume.

CAPITAL RESOURCES

Total members' equity at June 30, 2004, decreased to $181,092 from the December 31, 2003, total of $181,985. The decrease resulted primarily from cash patronage of $6,927, partially offset by net income for the six months ended June 30, 2004, of $5,848 and an increase in capital stock and participation certificates of $133.

Total capital stock and participation certificates were $63,232 on June 30, 2004, compared to $63,099 on December 31, 2003. This increase is attributed to the issuance of member stock associated with the increase in gross loan volume at June 30, 2004, compared to 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 June 30, 2004, the Association's total surplus ratio and core surplus ratio were 12.87 percent and 9.52 percent, respectively, and the permanent capital ratio was 14.33 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

(dollars in thousands)	**June 30, 2004**	**December 31, 2003**
	(unaudited)	
Assets		
Cash	$ 1,724	$ 7,186
Loans	909,038	839,911
Less: allowance for loan losses	20,214	20,630
Net loans	888,824	819,281
Accrued interest receivable	9,642	8,593
Investment in other Farm Credit institutions	62,315	62,314
Premises and equipment, net	3,495	3,280
Other property owned	344	434
Deferred tax asset, net	282	283
Other assets	9,762	14,282
Total assets	$ 976,388	$ 915,653
Liabilities		
Notes payable to AgFirst Farm Credit Bank	$ 777,743	$ 708,874
Accrued interest payable	1,908	1,901
Patronage refund payable	4	2,803
Postretirement benefits other than pensions	10,763	10,472
Other liabilities	4,878	9,618
Total liabilities	795,296	733,668
Commitments and contingencies		
Members' Equity		
Protected borrower equity	142	147
Capital stock and participation certificates	63,090	62,952
Retained earnings		
Allocated	44,993	52,081
Unallocated	72,867	66,805
Total members' equity	181,092	181,985
Total liabilities and members' equity	$ 976,388	$ 915,653

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

First South Farm Credit, ACA

Consolidated Statements of Income

(unaudited)

(dollars in thousands)	For the three months ended June 30, 2004	For the three months ended June 30, 2003	For the six months ended June 30, 2004	For the six months ended June 30, 2003
Interest Income				
Loans	$ 11,702	$ 12,346	$ 22,603	$ 24,041
Interest Expense				
Notes payable to AgFirst Farm Credit Bank	5,481	6,042	10,615	12,000
Other	1	2	3	5
Total interest expense	5,482	6,044	10,618	12,005
Net interest income	6,220	6,302	11,985	12,036
Provision for (reversal of) loan losses	—	300	—	600
Net interest income after provision for (reversal of) loan losses	6,220	6,002	11,985	11,436
Noninterest Income				
Loan fees	529	562	1,100	1,138
Fees for financially related services	160	104	177	122
Equity in earnings of other Farm Credit institutions	1,381	1,403	2,654	2,691
Gains (losses) on other property owned, net	(99)	22	(102)	22
Other noninterest income	2	45	94	131
Total noninterest income	1,973	2,136	3,923	4,104
Noninterest Expense				
Salaries and employee benefits	3,426	3,230	6,863	6,447
Occupancy and equipment	268	299	534	597
Insurance Fund premium	202	247	394	482
Other operating expenses	1,020	1,010	2,018	1,909
Total noninterest expense	4,916	4,786	9,809	9,435
Income before income taxes	3,277	3,352	6,099	6,105
Provision (benefit) for income taxes	90	(32)	251	90
Net income	$ 3,187	$ 3,384	$ 5,848	$ 6,015

The accompanying notes are an intergral 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 Allocated	Retained Earnings Unallocated	Total Members' Equity
Balance at December 31, 2002	$ 147	$ 62,260	$ 46,056	$ 68,510	$ 176,973
Net income				6,015	6,015
Protected borrower equity retired	6				6
Capital stock/participation certificates issued		1,120			1,120
Capital stock/participation certificates retired		(637)			(637)
Retained earnings retired			(5,507)		(5,507)
Distribution adjustment			(40)	52	12
Balance at June 30, 2003	$ 153	$ 62,743	$ 40,509	$ 74,577	$ 177,982
Balance at December 31, 2003	$ 147	$ 62,952	$ 52,081	$ 66,805	$ 181,985
Net income				5,848	5,848
Protected borrower equity retired	(5)				(5)
Capital stock/participation certificates issued		894			894
Capital stock/participation certificates retired		(756)			(756)
Retained earnings retired			(6,927)		(6,927)
Distribution adjustment			(161)	214	53
Balance at June 30, 2004	$ 142	$ 63,090	$ 44,993	$ 72,867	$ 181,092

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

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 second 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 six months ended June 30, 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 June 30, 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	600
Loans (charged off), net of recoveries	(155)
Balance at 6-30-03	$ 21,162
Balance at 12-31-03	$ 20,630
(Reversal of) provision for loan losses	–
Loans (charged off), net of recoveries	(416)
Balance at 6-30-04	$ 20,214

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 the six months ended June 30, 2004:

	For the six months ended June 30,	
	2004	**2003**
Service cost	$ 577	$ 489
Interest cost	1.116	1,032
Expected return on plan assets	(1,171)	(1,050)
Amortization of net (gain) loss	(169)	(169)
Amortization of prior service cost	132	132
Recognized net actuarial (gain) loss	443	401
Net periodic benefit (income) cost	$ 928	$ 835

As of June 30, 2004, no contributions have been made to the pension plan. The Association presently anticipates contributing $762 to fund its pension plan in the remainder of 2004.

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 six months ended June 30, 2004:

	For the three months ended June 30,	
	2004	**2003**
Pension	$ 928	$ 835
Thrift/deferred compensation	110	104
Other postretirement benefits	580	482
Total	$ 1,618	$ 1,421