
FIRST SOUTH FARM CREDIT, ACA

2003 ANNUAL REPORT

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Management

Stephen L. Rochelle	President & Chief Executive Officer
Bryan Applewhite	Chief Financial Officer/Senior Vice President/Treasurer
Sells J. Newman, Jr.	Senior Vice President/Marketing
Randy Underwood	Senior Vice President/Chief Credit Officer
Roger Chappell.....	President, North Alabama Division
Cecil Corbello.....	President, Louisiana Division
John Barnard.....	President, Mississippi Division
Camp Powers.....	President, South Alabama Division

Board of Directors

Ted S. Passmore	Chairman
Paul Clark	Vice Chairman
Larry Arnaud	Director
Billy G. Aron.....	Director
Billy Ross Brown	Director
John R. Burden	Director
Dr. Marty J. Fuller.....	Director
William T. Kyser.....	Director
R. K. Laird.....	Director
Alan Marsh.....	Director
James F. Martin, Jr	Director
Joe H. Morgan	Director
Shep Morris	Director
Thomas H. Nelson, Jr.....	Director
James M. Norsworthy, III	Director
W. S. Patrick.....	Director
Robert E. Potts.....	Director
Walter R. Richardson	Director
D. Derwood Strain.....	Director
Mike Unkel.....	Director
William H. Voss.....	Director

Message from the Chief Executive Officer

First South Farm Credit, ACA is proud to announce another successful year for our Association and its stockholder borrowers.

Because of the Association's success in 2003, the First South Board of Directors voted to approve a patronage distribution of 2003 earnings. Since 1995, First South has paid out over \$97 million in cash and allocated patronage distributions to member-stockholders that borrowed from First South. Of this amount, approximately \$34 million was paid in cash.

Earnings for 2003 were \$12.7 million, with our Association's assets reaching an all time high exceeding \$1 billion during the year.

In April 2004, the fourth consecutive rollout of patronage refunds will take place. Over \$6.9 million of 1998 earnings that had been set aside will be distributed in cash to our members. Combined with a \$2.8 million cash distribution of 2003 earnings, the Association will return approximately \$10 million in cash to its members this April.

First South is an agricultural credit association holding company consisting of a Federal Land Credit Association (FLCA) and a Production Credit Association (PCA). This structure allows First South to take advantage of Farm Credit laws and regulations that enhance First South's ability to offer a broad range of loan products, competitive interest rates and credit services, and to build capital as we continue to grow.

First South is the premier Farm Credit lending association in Alabama, Louisiana and Mississippi, and our Association has operated successfully on an ongoing basis since 1933.

First South Farm Credit is committed to working with our member/borrowers and the agricultural communities in Alabama, Louisiana and Mississippi to make well-informed business decisions that will have a positive impact on our Association and our borrowers. **We want to be sure that when it comes to agricultural financing, whether it is for land, production, or for agribusiness purposes, you have a choice. First South is committed to serving your financial needs and continuing to be the lender of choice in Alabama, Louisiana and Mississippi.**

Again, we are very fortunate and blessed at First South Farm Credit to be able to share our success with you.

On behalf of the First South Board and employees, we thank you for your loyal support.



Stephen L. Rochelle
Chief Executive Officer

February 19, 2004

Report of Management

The accompanying consolidated financial statements and related financial information appearing throughout this annual report have been prepared by management of First South Farm Credit, ACA (the Association) in accordance with generally accepted accounting principles appropriate in the circumstances. Amounts which must be based on estimates represent the best estimates and judgments of management. Management is responsible for the integrity, objectivity, consistency, and fair presentation of the consolidated financial statements and financial information contained in this report.

Management maintains and depends upon an internal accounting control system designed to provide reasonable assurance that transactions are properly authorized and recorded, that the financial records are reliable as the basis for the preparation of all financial statements, and that the assets of the Association are safeguarded. The design and implementation of all systems of internal control are based on judgments required to evaluate the costs of controls in relation to the expected benefits and to determine the appropriate balance between these costs and benefits. The Association maintains an internal audit program to monitor compliance with the systems of internal accounting control. Audits of the accounting records, accounting systems and internal controls are performed and internal audit reports including appropriate recommendations for improvement, are submitted to the Board of Directors.

The consolidated financial statements have been examined by independent public auditors, whose report appears elsewhere in this annual report. The Association is also subject to examination by the Farm Credit Administration.

The consolidated financial statements, in the opinion of management, fairly present the financial condition of the Association. The undersigned certify that the 2003 Annual Report has been prepared 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.



Ted S. Passmore
Chairman of the Board



Stephen L. Rochelle
Chief Executive Officer



Bryan Applewhite
Chief Financial Officer

February 19, 2004

Consolidated Five - Year Summary of Selected Financial Data

(UNAUDITED)

<i>(dollars in thousands)</i>	2003	2002	December 31, 2001	2000	1999
Balance Sheet Data					
Cash	\$ 7,186	\$ 5,091	\$ 7,260	\$ 9,845	\$ 2,260
Loans	839,911	844,501	708,973	605,849	550,292
Less: allowance for loan losses	20,630	20,717	19,628	17,554	16,451
Net loans	819,281	823,784	689,345	588,295	533,841
Investment in other Farm Credit institutions	62,314	63,705	64,934	64,934	64,934
Other property owned	434	56	45	327	374
Other assets	26,438	28,148	26,572	26,347	24,110
Total assets	\$ 915,653	\$ 920,784	\$ 788,156	\$ 689,748	\$ 625,519
Notes payable to AgFirst Farm Credit Bank*	\$ 708,874	\$ 718,417	\$ 589,337	\$ 493,264	\$ 435,915
Accrued interest payable and other liabilities with maturities of less than one year	24,794	25,394	25,392	24,837	24,980
Total liabilities	733,668	743,811	614,729	518,101	460,895
Protected borrower equity	147	147	175	213	218
Capital stock and participation certificates	62,952	62,260	61,448	60,723	60,660
Retained earnings					
Allocated	52,081	46,056	41,390	39,263	32,407
Unallocated	66,805	68,510	70,414	71,448	71,339
Total members' equity	181,985	176,973	173,427	171,647	164,624
Total liabilities and members' equity	\$ 915,653	\$ 920,784	\$ 788,156	\$ 689,748	\$ 625,519
Statement of Income Data					
Net interest income	\$ 25,885	\$ 23,839	\$ 22,131	\$ 22,073	\$ 20,373
Provision for (reversal of) loan losses	1,200	1,200	1,960	1,110	960
Noninterest income (expense), net	(11,944)	(9,506)	(8,690)	(9,076)	(7,874)
Net income	\$ 12,741	\$ 13,133	\$ 11,481	\$ 11,887	\$ 11,539
Key Financial Ratios					
Rate of return on average:					
Total assets	1.36%	1.58%	1.52%	1.81%	1.80%
Total members' equity	7.09%	7.92%	6.70%	6.99%	7.06%
Net interest income as a percentage of average earning assets	3.00%	2.98%	3.27%	3.80%	3.62%
Net chargeoffs (recoveries) to average loans	0.15%	0.01%	(0.02)%	0.001%	0.12%
Total members' equity to total assets	19.87%	19.22%	22.00%	24.89%	26.32%
Debt to members' equity (:1)	4.03	4.20	3.54	3.02	2.80
Allowance for loan losses to loans	2.46%	2.45%	2.77%	2.90%	2.99%
Permanent capital ratio	13.84%	13.51%	14.05%	16.82%	17.89%
Total surplus ratio	12.46%	12.17%	13.52%	15.19%	15.65%
Core surplus ratio	9.40%	9.16%	12.59%	14.07%	15.00%
Net Income Distribution					
Estimated patronage refunds:					
Cash dividend	\$ 2,800	\$ 3,727	\$ 3,685	\$ 4,718	\$ 4,409
Qualified allocated surplus	4,199	5,591	8,598	7,077	6,614
Nonqualified allocated surplus	3,069	2,244	—	—	—
Nonqualified retained surplus	4,466	3,485	—	—	—

* General financing agreement is renewable on three-year cycles. The next renewal date is December 31, 2004.

Management's Discussion & Analysis of Financial Condition & Results of Operations

(dollars in thousands, except as noted)

The following commentary reviews the financial condition and results of operations of First South Farm Credit, ACA (Association) for the years ended December 31, 2003 and December 31, 2002. This information should be read in conjunction with the Consolidated Financial Statements, Notes to the Consolidated Financial Statements and other sections in this Annual Report.

Credit quality remained strong in 2003. All credit quality measures were within Association goals and objectives. Stress in the agricultural economy put downward pressure on credit quality in the first quarter, however, favorable production conditions and improved income for many of the Association's borrowers resulted in stable credit quality for the rest of the year.

There has been little change in our market base over the past year. During 2003, the Association targeted certain segments of our business with hopes of increasing market share. Continued efforts are being made to expand services, increase public knowledge of our services and streamline our current delivery of products to enhance our existing portfolio.

Effective January 1, 2002, pursuant to a plan of restructuring approved by the Farm Credit Administration (FCA) and Association shareholders, the Association reorganized its existing organizational structure. Pursuant to this restructuring, a Federal Land Credit Association (FLCA) and Production Credit Association (PCA) were formed as wholly owned subsidiaries of the Association. The formation of these subsidiaries enables the Association to take advantage of the tax-exempt status of net income from operations of the FLCA. Please refer to Note 1 of the Notes to the Consolidated Financial Statements in this Annual Report for additional information relating to the Association organization.

LOAN PORTFOLIO

The Association provides funds to farmers, rural homeowners, and farm-related businesses for financing of short and intermediate-term loans. The geographic distribution of the loans is as follows:

State	12/31/03	12/31/02
Alabama	48.06%	46.49%
Louisiana	29.57	22.27
Mississippi	22.37	31.24
	<u>100.00%</u>	<u>100.00%</u>

The diversification of the Association loan volume by type is shown below:

Loan Type	12/31/03	12/31/02
Production and intermediate-term	95.53%	96.96%
Rural home	.36	.21
Farm-related business	1.74	1.19
Nonaccrual	.47	.44
Processing and marketing	.34	.11
Sales contracts	.04	.02
Other	.01	.02
Plus: participations purchased	5.87	4.20
Less: participations sold	(4.36)	(3.15)
	<u>100.00%</u>	<u>100.00%</u>

The Association's loan portfolio is diversified over a range of agricultural commodities in our region. Predominant commodities in the portfolio are poultry, cotton, livestock, and forestry that constitute over 60 percent of the entire portfolio. Please refer to Note 3 in the Notes to the Consolidated Financial Statements section of this Annual Report for additional information concerning the loan types and loan portfolio.

The gross loan volume of the Association as of December 31, 2003, was \$839,911, a decrease of \$4,590 or .54 percent as compared to \$844,501 at December 31, 2002. Net loans outstanding on December 31, 2003, were \$819,281 as compared to \$823,784 at December 31, 2002. Net loans accounted for 89.48 percent of total assets on December 31, 2003 as compared to 89.47 percent of total assets at December 31, 2002.

The decrease in gross and net loan volume during the reporting period is primarily attributed to favorable production conditions and improved income for many of the Association's borrowers.

The Association's portfolio, which is heavily influenced by operating-type loans, normally reaches a peak balance in September and rapidly declines in the fall months as commodities are marketed and proceeds are applied to repay operating loans.

During 2003, the Association increased activity in the buying and selling of loan participations within and outside of the Farm Credit System (FCS). This provides a means for the Association to spread credit concentration risk and realize non-patronage sourced interest and fee income, which may strengthen its capital position. As of December 31, 2003, the Association had \$34,514 in participation loans purchased from other FCS institutions and \$14,814 in participation loans purchased from non-FCS institutions, offset by \$36,643 in participation loans sold.

The Association's loan portfolio is divided into performing and high-risk categories. The high-risk assets, including accrued interest, are detailed below:

	<u>12/31/03</u>	<u>12/31/02</u>
High-risk Assets		
Nonaccrual loans	\$ 3,965	\$ 3,683
Restructured loans	109	154
Accruing loans 90 days past due	10	105
Total high-risk loans	4,084	3,942
Other property owned	434	56
Total high-risk assets	<u>\$ 4,518</u>	<u>\$ 3,998</u>
Ratios		
Nonaccrual loans to total loans	.47%	.44%
High-risk assets to total assets	.49%	.43%

Nonaccrual loans increased \$282, or 7.66 percent in 2003. There are no significant potential credit risks within the loan portfolio that could adversely impact the performance of the loan portfolio in the near future.

Loan restructuring is available to financially distressed borrowers. Restructuring of loans occurs when the Association grants a concession to a borrower based on either a court order or good faith in a borrower's ability to return to financial viability. The concessions can be in the form of a modification of terms or rates, a compromise of amounts owed, or deed in lieu of foreclosure. Restructured loans may also involve other receipts of assets and/or equity to pay the loan in full or in part. The type of alternative financing structure chosen is based on minimizing the loss incurred by both the Association and the borrower.

There is an inherent risk in the extension of any type of credit. Association management analyzes credit quality, loan performance, concentration, and other forms of risk, maintaining an allowance for loan losses in an amount sufficient to absorb possible losses in the loan portfolio based on current and expected future conditions. The allowance for loan losses at December 31, 2003 was \$20,630, which was 2.46 percent of total loans outstanding and was considered by management to be adequate to cover possible losses. Please refer to Note 2 in the Notes to the Consolidated Financial Statements of this Annual Report for further information concerning the allowance for loan 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 dropped its proposed SOP and announced that it would focus instead on improving financial statement disclosures in this area.

System institutions plan to conduct studies to further refine their methodologies, including what are currently acceptable and permissible under generally accepted accounting principles, focusing specifically on the Securities and Exchange Commission and Federal Financial Institutions Examination Council guidelines. Such a study would likely be completed by the fourth quarter of 2004 with any appropriate changes to the allowance for loan losses implemented at that time.

RESULTS OF OPERATIONS

Net income for the year ended December 31, 2003, totaled \$12,741, a decrease of \$392 or 2.98 percent, as compared to \$13,133 for the same period of 2002. Interest income for the year ended December 31, 2003, was \$49,991, a decrease of \$901 or 1.77 percent as compared to \$50,892 for the same period of 2002. Interest expense also decreased by \$2,947 for the period ended December 31, 2003. Major components of the changes in net income for the past two years are outlined in the following table.

Changes in Net Income:

	<u>2003-2002</u>	<u>2002-2001</u>
Net income (prior year)	\$ 13,133	\$ 11,481
Increase (decrease) in net income due to:		
Interest income	(901)	(3,667)
Interest expense	2,947	5,375
Net interest income	2,046	1,708
Provision for loan losses	—	760
Noninterest income	581	1,293
Noninterest expense	(3,320)	(1,713)
Provision for income taxes	301	(396)
Total changes in income	<u>(392)</u>	<u>1,652</u>
Net income	<u>\$ 12,741</u>	<u>13,133</u>

Net interest income increased by \$2,046 or 8.58 percent in 2003 compared to 2002. The increase in net interest income is primarily due to decreasing rates experienced by the Association. Interest income on nonaccrual loans for the twelve months ended December 31, 2003, totaled \$1,078, an increase of \$470, compared to \$608 at the previous year-end. Please refer to the Consolidated Five-Year Summary of Selected Financial Data in this Annual Report to review key financial ratios pertaining to earnings and net interest income. The sources of change in net interest income are illustrated, as follows:

Change in Net Interest Income:

	<u>Volume*</u>	<u>Rate</u>	<u>Nonaccrual Income</u>	<u>Total</u>
12/31/03-12/31/02				
Interest income	\$ 4,053	\$ (5,424)	\$ 470	\$ (901)
Interest expense	2,277	(5,224)	—	2,947
Change in net interest income	<u>\$ 1,776</u>	<u>\$ (200)</u>	<u>\$ 470</u>	<u>\$ 2,046</u>
12/31/02-12/31/01				
Interest income	\$ 9,895	\$ (13,578)	\$ 16	\$ (3,667)
Interest expense	7,172	(12,547)	—	5,375
Change in net interest income	<u>\$ 2,723</u>	<u>\$ (1,031)</u>	<u>\$ 16</u>	<u>\$ 1,708</u>

* Volume variances can be the result of increased/decreased loan volume or from changes in the percentage composition of assets and liabilities between periods.

Noninterest income for the period ended December 31, 2003, increased \$581 as compared to the same period of 2002. The increase is primarily attributed to increases in loan fees of \$214, in income received from AgFirst Farm Credit Bank (the Bank) of \$490, and in gains on other property owned of \$38. The Association received \$5,733 in a patronage refund and \$401 in a special distribution from the Bank for the twelve months ended December 31, 2003. The increases referenced were offset by a decrease in financially related service income of \$150 and a decrease in other income of \$11.

Noninterest expense for the year ended December 31, 2003, totaled \$20,276, an increase of \$3,320, or 19.58 percent, compared to \$16,956 the previous year-end. Salaries and benefits accounted for \$2,753 or 82.92 percent of the increase in operating expenses. The increase in salaries and benefit expenses resulted from normal increases of \$633 and an increase in retirement expenses of \$2,120. Retirement expense increased primarily as the result of the decline in the market value of the invested plan assets. The amount of the retirement expense and corresponding funding is determined by overall plan performance which is measured as of September 30th of each year. Also contributing to the increase in operating expenses were an increase in occupancy and equipment expense of \$47 and an increase in the Insurance Fund premium of \$760, partially offset by a decrease in other operating expenses of \$240.

The Association recorded a provision for income taxes of \$649 for the twelve months ended December 31, 2003, as compared to a provision of \$950 for the same period in 2002.

A key factor in the growth of net income for future years will be continued improvement in net interest and noninterest income. Our goal is to generate earnings sufficient to fund operations, adequately capitalize the Association, and achieve an adequate rate of return for our members. To meet this goal, the agricultural economy must continue the improvement shown in recent years and the Association must meet certain objectives. These objectives are to attract and maintain high quality loan volume priced at competitive rates and to manage credit risk in our entire portfolio, while efficiently meeting the credit needs of our members.

LIQUIDITY AND FUNDING SOURCES

Liquidity

Liquidity management is the process whereby funds are made available to meet all financial commitments including the extension of credit, payment of operating expenses and payment of debt obligations. The Association receives access to funds through its borrowing relationship with AgFirst Farm Credit Bank (the Bank) and from income generated by operations.

Funding Sources

The principal source of funds for the Association is the borrowing relationship established with the Bank through a General Financing Agreement. The General Financing Agreement utilizes the Association's credit and fiscal performance as criteria for establishing a line of credit on which the Association may draw funds. The Bank advances the funds to the Association, creating notes payable to the Bank. 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 December 31, 2003, were \$708,874 as compared to \$718,417 at December 31, 2002. The decrease of 1.33 percent during the period is primarily attributable to the decrease in loan volume and the increase in retained earnings at December 31, 2003, compared to the previous year-end.

Funds Management

The Bank and the Association manage assets and liabilities to provide a broad range of loan products and funding options, which will permit the Association to be competitive in all interest rate environments. The primary objective of the asset/liability management process is to provide stable and rising earnings, while maintaining adequate capital levels by managing exposure to credit and interest rate risks.

Demand for loan types is a driving force in establishing a funds management strategy. The Association offers fixed and variable rate loan products that are marginally priced according to financial market rates. Variable rate loans may be indexed to either the Prime Rate or the 90-day London Interbank Offered Rate (LIBOR). Fixed rate loans are priced based on the current cost of Farm Credit debt of similar terms to maturity.

The Association's net interest income as a percentage of average earning assets (net interest margin) was 3.00 percent on December 31, 2003, compared to 2.98 percent on December 31, 2002.

The majority of the interest rate risk in the Association balance sheet is transferred to the Bank through the notes payable structure. The Bank, in turn, actively utilizes funds management techniques to identify, quantify and control risk associated with the loan portfolio.

CAPITAL RESOURCES

Total members' equity at December 31, 2003, increased 2.83 percent to \$181,985 from the December 31, 2002, total of \$176,973. The increase is primarily from net income, partially offset by cash patronage.

Total capital stock and participation certificates were \$63,099 on December 31, 2003, compared to \$62,407 on December 31, 2002, an increase of 1.11 percent.

The Association's permanent capital ratio as of December 31, 2003 was 13.84 percent compared to 13.51 percent on December 31, 2002. Farm Credit Administration (FCA) regulations require all Farm Credit institutions to maintain a minimum permanent capital ratio of 7 percent. The permanent capital ratio is calculated by dividing the Association's permanent capital by a risk-adjusted asset base.

FCA regulations also require all Farm Credit institutions to maintain two other minimum capital ratios: total surplus ratio of 7 percent and core surplus ratio of 3.5 percent. The total surplus and core surplus ratios are calculated by dividing total surplus and core surplus as defined in FCA regulations by a risk-adjusted asset base. As of December 31, 2003, the Association's total surplus ratio and core surplus ratio was 12.46 percent and 9.40 percent, respectively, as compared to 12.17 percent and 9.16 percent, respectively, on December 31, 2002.

Annually, the Association establishes target capital ratios. The Association's 2003 target permanent capital ratio was 13.20 percent of risk-adjusted assets. The targeted total surplus and core surplus ratios for 2003 were 12.00 percent and 9.00 percent, respectively. As of December 31, 2003, the Association exceeded all target capital ratios.

Disclosure Required by Farm Credit Administration Regulations

Description of Business

Descriptions of the territory served, persons eligible to borrow, types of lending activities engaged in, financial services offered and related Farm Credit organizations are incorporated herein by reference to Note 1 to the consolidated financial statements, "Organization and Operations," included in this annual report to stockholders.

The description of significant developments that had or could have a material impact on earnings or interest rates to borrowers, acquisitions or dispositions of material assets, material changes in the manner of conducting the business, seasonal characteristics, and concentrations of assets, if any, is incorporated in "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in this annual report to stockholders.

Description of Property

The following table sets forth certain information regarding the properties of the reporting entity, all of which are located in Alabama, Mississippi and Louisiana:

<u>Location</u>	<u>Description</u>	<u>Form of Ownership</u>
713 S. Pear Orchard Rd. Ridgeland, MS	Administrative	Leased
713 S. Pear Orchard Rd. Ridgeland, MS	Division/Branch	Leased
700 Hwy. 80 West Demopolis, AL	Branch	Owned
2341 AL Hwy. 21 South Oxford, AL	Branch	Owned
1824 Eva Rd., NE Cullman, AL	Division/Branch	Owned
320 AL Hwy. 75 N Albertville, AL	Branch	Owned
30035 Hwy. 72 West Madison, AL	Branch	Owned
14390 South Market St. Moulton, AL	Branch	Owned
970 Hwy. 20 East Tuscumbia, AL	Branch	Owned
4210 McFarland Blvd. Northport, AL	Branch	Owned
1434 S. Union Ave. Ozark, AL	Division/Branch	Owned
1401 Forest Ave. Montgomery, AL	Branch	Owned
22 Henderson Highway Troy, AL	Branch	Leased
141 Lee St. Luverne, AL	Branch	Owned
2855 Ross Clark Circle Ste 113 Dothan, AL	Branch	Leased
209 E. Second St. Bay Minette, AL	Branch	Leased
5070 Boll Weevil Circle Enterprise, AL	Branch	Owned

<u>Location</u>	<u>Description</u>	<u>Form of Ownership</u>
1103 Bypass West Andalusia, AL	Branch	Owned
914 Van Buren Ave. Oxford, MS	Branch	Owned
Hwy. 9 North Calhoun City, MS	Branch	Owned
2216 S. Gloster St. Tupelo, MS	Branch	Owned
306 E. Jefferson St. Aberdeen, MS	Branch	Owned
103 Professional Plaza Greenwood, MS	Branch	Leased
203 Cossar Blvd. Charleston, MS	Branch	Owned
505 E. Second St. Clarksdale, MS	Branch	Owned
250 S. Shelby St. Greenville, MS	Branch	Owned
303 S. Sharpe Av. Cleveland, MS	Branch	Owned
209 Second St. Indianola, MS	Branch	Owned
105 Church St. Belzoni, MS	Closed	Owned
306 N. Main St. Newton, MS	Branch	Owned
701 Haley Barbour Pky. Yazoo City, MS	Branch	Owned
950 Brookway Blvd. Brookhaven, MS	Branch	Owned
1350 N. Clark Magnolia, MS	Branch	Owned
749 Cosby St. Centreville, MS	Branch	Owned
1711 Hardy St. Hattiesburg, MS	Branch	Owned
728 Sawmill Rd. Laurel, MS	Branch	Owned
5057 Hwy. I-49 Service Road Opelousas, LA	Division/Branch	Owned
222 N. Cedar Tallulah, LA	Branch	Owned
1211 S. Louisa Rayville, LA	Branch	Owned
109 Davis Lake Providence, LA	Branch	Owned
811 Jackson St. Winnsboro, LA	Branch	Owned
2308 S. MacArthur Dr. Alexandria, LA	Branch	Owned
321 South Main Marksville, LA	Branch	Owned
1007 Guy Dr. St. Martinville, LA	Branch	Owned
3206 South LA 13 Crowley, LA	Branch	Owned
407 N. Church Jennings, LA	Branch	Owned

<u>Location</u>	<u>Description</u>	<u>Form of Ownership</u>
4696 Hwy. 19 Zachary, LA	Branch	Owned
725 Hospital Rd. New Roads, LA	Branch	Owned
1001 N.W. Central Ave. Amite, LA	Branch	Owned
1725 St. Mary Hwy. Thibodaux, LA	Branch	Owned

Lease Information Disclosure:

<u>Location</u>	<u>Term of Lease</u>	<u>Expiration Date</u>	<u>Monthly Lease Amount</u>
Ridgeland, MS	5 yrs.	3/31/05	\$7,813.40
Ridgeland, MS	5 yrs.	3/31/05	\$4,612.00
Troy, AL	5 yrs.	12/31/08	\$952.16
Dothan, AL	3 yrs.	9/30/04	\$850.00
Bay Minette, AL	3 yrs.	8/31/05	\$1,400.00
Greenwood, MS	3 yrs.	8/31/05	\$2,850.00

Legal Proceedings

Information, if any, to be disclosed in this section is incorporated herein by reference to Note 12 to the consolidated financial statements, "Commitments and Contingencies," included in this annual report to stockholders.

Description of Capital Structure

Information to be disclosed in this section is incorporated herein by reference to Note 7 to the consolidated financial statements, "Members' Equity," included in this annual report to stockholders.

Description of Liabilities

The description of liabilities, contingent liabilities and intrasystem financial assistance rights and obligations to be disclosed in this section is incorporated herein by reference to Notes 2, 6, 10 and 12 to the consolidated financial statements included in this annual report to stockholders.

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

"Management's Discussion and Analysis of Financial Condition and Results of Operations," which appears in this annual report to stockholders and is to be disclosed in this section, is incorporated herein by reference.

Senior Officers

The following represents certain information regarding the senior officers of the Association:

<u>Senior Officer</u>	<u>Position</u>
Stephen L. Rochelle	President & Chief Executive Officer
Bryan Applewhite	Chief Financial Officer /Senior Vice President/Treasurer
Sells J. Newman, Jr.	Senior Vice President/Marketing
Randy Underwood	Senior Vice President/Chief Credit Officer
Roger Chappell	President, North Alabama Division
Cecil Corbello	President, Louisiana Division
John Barnard	President, Mississippi Division
Camp Powers	President, South Alabama Division

The business experience for the past five years for senior officers is with the Farm Credit System.

The total amount of compensation earned by all senior officers as a group during the years ended December 31, 2003, 2002 and 2001, is as follows:

<u>Aggregate Number of Senior Officers</u>	<u>Year</u>	<u>Annual</u>		<u>Total</u>
		<u>Salary</u>	<u>Bonus</u>	
Stephen L. Rochelle	2003	\$197,510	\$ 35,000	\$232,510
Stephen L. Rochelle	2002	\$188,100	\$ 17,500	\$205,600
Stephen L. Rochelle	2001	\$180,000	\$ 15,000	\$195,000
7	2003	\$735,000	\$110,250	\$845,250
7	2002	\$673,230	\$101,360	\$774,590
8	2001	\$667,920	\$ 98,570	\$766,490

The Association had an Incentive Plan for 2003. Association employees from branch office level down participate in Plan A based upon new business development and Plan C based upon lease income. Administrative employees at the division and administrative office do not participate in these two plans. Plan B of the Incentive Plan applies to all personnel including administrative. The plan runs for the 12-month calendar year and pays an incentive based upon bottom line profitability from operations. Employees share in any profits over a 6.75 percent return on equity. Employees share on a pro rata salary basis and branch level personnel are limited to a maximum of 17 percent of salaries and administrative personnel are limited to 15 percent of salaries. Incentives for senior officers are paid within 45 days of the year-end. Bonuses are shown in year earned which may be different than year of payment. Seven senior officers shared in the 2003 incentive.

Disclosure of the total compensation earned in 2003 by any senior officer, or to any other individual included in the total whose compensation exceeds \$50,000, is available to stockholders upon request.

Directors

Directors and senior officers are reimbursed on an actual cost basis for all expenses incurred in the performance of official duties. Such expenses may include transportation, lodging, meals, tips, tolls, parking of cars, laundry, registration fees, and other expenses associated with travel on official business. A copy of the policy is available to shareholders of the Association upon request.

The aggregate amount of reimbursement for travel, subsistence and other related expenses for all directors as a group was \$151,801 for 2003, \$139,605 for 2002, and \$118,133 for 2001.

Subject to approval by the board, the Association may allow directors honorarium of \$200 for attendance at meetings, committee meetings, or special assignments and \$50 for telephone conference calls. Total compensation paid to directors as a group was \$104,400.

The following represents certain information regarding the directors of the Association:

Ted S. Passmore, Chairman, primary operation for the past five years has been 5,000 acres in a row crop general partnership with his brother in Deville, Louisiana. He is a member of Farm Bureau. During 2003, he served 11 days at Association board meetings and 12 days in other official activities, and was paid \$4,000.00. His term of office is 2003 – 2005.

Paul Clark, Vice Chairman, has a row crop operation in Decatur, Alabama, which has been his primary operation for the past five years. He is a member of the National Alliance of Independent Consultants, Registry of Environmental and Agricultural Professionals and member and president of Alabama Ag Consulting Association. During 2003, he served 9 days at Association board meetings and 17 days in other official activities, and was paid \$5,400.00. His term of office is 2002 – 2004.

Larry Arnaud has a row crop operation near Arnaudville, Louisiana, which has been his primary operation for the past five years. He is a member of Louisiana Farm Bureau, Louisiana Soybean Association and National Soybean Association. During 2003, he served 14 days at Association board meetings and 29 days in other official activities, and was paid \$8,450.00. His term of office is 2003 – 2005.

Billy G. Aron has a row crop and cattle operation in Houka, Mississippi, which has been his primary operation for the past five years. He is a member of the Farm Bureau, Mississippi Cattlemen's Association and Houka Lions Club. During 2003, he served 16 days at Association board meetings and 12 days in other official activities, and was paid \$5,150.00. His term of office expired December 31, 2003.* Because of the age limitation, Mr. Aron was not eligible for re-election.

William Austin has a beef and timber operation in Union Springs, Alabama, which has been his primary operation for the past five years. During 2003, he served 4 days at Association board meetings and 4 days in other official activities, and was paid \$1,450.00. His term of office expired December 31, 2002.*

Billy Ross Brown has a timber operation in Oxford, Mississippi, which has been his primary operation for the past five years. He served on the First South PCA board for five years until he was appointed to the Farm Credit Administration Board in Washington, DC and completed his term in 1994 as Chairman of the FCA Board. During that time, he served as the first chairman of the FCSIC board. Mr. Brown is a graduate of the University of Mississippi and is former chairman of the Mississippi Soil and Water Conservation Commission, and a member of Mississippi Association of Soil Conservation Districts. During 2003, he served 12 days at Association board meetings and 12 days in other official activities, and was paid \$4,650.00. His term of office is 2002 – 2004.

John R. Burden has a dairy operation in Baileyton, Alabama, which has been his primary operation for the past five years. He is a member of Patron Council for Goldkist and former director of DHIA. During 2003, he served 7 days at Association board meetings and 4 days in other official activities, and was paid \$1,400.00. His term of office expired December 31, 2003.*

Dr. Marty J. Fuller serves as the board appointed director and is not a member of the Association. He is Associate Director for the Mississippi Agricultural & Forestry Experiment Station (MAFES) and is responsible for coordination of all MAFES branch locations and research and extension centers, as well as external affairs for MAFES. Dr. Fuller previously served as professor and economist in the Department of Agricultural Economics at Mississippi State University. He received BS, MS and PhD degrees from MSU. During 2003, he served 11 days at Association board meetings and 7 days in other official activities, and was paid \$3,600.00. His term of office is April 1, 2002 – March 31, 2005.

Stephen Guillot has a livestock operation in Thibodaux, Louisiana, and is an assistant manager of a 2,000-acre sugarcane farm, which has been his primary occupation for the past five years. He is a member of Lafourche Parish Farm Bureau, Lafourche Cattlemen's

Association, American Society of Sugarcane Technologists, and Thibodaux Volunteer Fire Department. During 2003, he served 1 day at Association board meetings and 4 days in other official activities, and was paid \$1,000.00. His term of office expired December 31, 2003. **Deceased, August 2003.**

Roy Ingraffia has a dairy farm in Loranger, Louisiana, which has been his primary operation for the past five years. He is a member of Louisiana Cattlemen's Association, Louisiana Dairy Promotion Board and Louisiana Farm Bureau. During 2003, he served 3 days at Association board meetings and 2 days in other official activities, and was paid \$1,000.00. His term expired December 31, 2002.* Because of the age limitation, Mr. Ingraffia was not eligible for re-election.

William T. (Bill) Kyser, a resident of Hale County, Alabama, has a catfish, beef cattle and timber operation. He has served as a director for Catfish Farmers of America, Alabama Farmers Federation, Auburn Agricultural Alumni Association, Greensboro Farmers Cooperative, and Hale County Cattlemen's Association. During 2003, he served 15 days at Association board meetings and 9 days in other official activities, and was paid \$4,350.00. His term of office is 2002 – 2004.

R. K. Laird has a row crop operation in Tallulah, Louisiana, which has been his primary operation for the past five years. He serves as president of Farmers Gin and as an advisory director of Hibernia National Bank and Madison Parish Farm Bureau. During 2003, he served 15 days at Association board meetings and 12 days in other official activities, and was paid \$5,100.00. His term of office expired December 31, 2003.* Because of the age limitation, Mr. Laird was not eligible for re-election.

Alan Marsh has a row crop operation near Madison, Alabama, which has been his primary operation for the past five years. He is a director of the Limestone Farmers' Federation and South Limestone Gin. During 2003, he served 10 days at Association board meetings and 15 days in other official activities, and was paid \$5,000.00. His term of office is 2002 – 2004.

James F. Martin, Jr. has a dairy and row crop operation in Enterprise, Alabama, which has been his primary operation for the past five years. He is a member and director of the Coffee County Farmers Cooperative. During 2003, he served 12 days at Association board meetings and 20 days in other official activities, and was paid \$6,250.00. His term of office expired December 31, 2003.*

Joe H. Morgan has a 2300-acre row crop operation consisting of cotton and peanuts. A member and former officer and director of Forrest County Farm Bureau, he also serves as chairman of the Forrest County FSA Committee, and is a member of Staplecotn Advisory Committee. Mr. Morgan is a former recipient of the Outstanding Young Farmer of the Year Award and the Outstanding Farmer Award for Outstanding Service in soil and Water Conservation. During 2003, he served 9 days at Association board meetings and 5 days in other official activities, and was paid \$3,200.00. His term of office expired December 31, 2003.*

Shepherd (Shep) Morris has a 2200-acre cotton and grain operation. He serves as a board member of Autauga Quality Cotton Association and the Alabama Farmers Federation. He is a supervisor for Macon County Soil and Water District, vice president of Milstead Farm Group, Inc., and serves as a delegate to the National Cotton Council. During 2003, he served 11 days at Association board meetings and 12 days in other official activities, and was paid \$4,300.00. His term of office is 2003 – 2005.

Thomas H. Nelson, Jr. has a row crop operation in Chatham, Mississippi, which has been his primary operation for the past five years. He is a director and officer of Washington County Farm Bureau. During 2003, he served 10 days at Association board meetings and 11 days in other official activities, and was paid \$4,200.00. His term of office is 2002 – 2004.

James M. Norsworthy, III has a row crop and cattle operation near Jackson, Louisiana, which has been his primary operation for the past five years. He serves as an officer/member of the Farm Bureau and Jackson Baseball Association, and a member of Jackson Assembly and Forestry Association. During 2003, he served 12 days at Association board meetings and 9 days in other official activities, and was paid \$3,900.00. His term of office is 2002 – 2004.

W. S. Patrick has a cotton and soybean operation in Canton, Mississippi, which has been his primary operation for the past five years. He is part owner of the Madison-Rankin Gin, a director and officer of the Madison County Cooperative, and Madison County FSA. During 2003, he served 15 days at Association board meetings and 9 days in other official activities, and was paid \$4,350.00. His term of office is 2003 – 2005.

Robert E. Potts has a 175 cow dairy operation on 400 acres in Tangipahoa Parish, Louisiana. He is a member of Dairy Farmers of America, Farm Bureau and Spring Creed Masonic Lodge. He is also a board member of Tangipahoa Parish School System. During 2003, he served 9 days at Association board meetings and 7 days in other official activities, and was paid \$3,200.00. His term of office is 2003 – 2005.

Walter R. Richardson's primary operation for the past five years has been row crop and cattle in Leroy, Alabama. He serves on the Washington County Soil Conservation board and is a director of Alabama Farmers Federation and past President of the Washington County Cattlemen's Association. During 2003, he served 15 days at Association board meetings and 18 days in other official activities, and was paid \$6,300.00. His term of office is 2003 – 2005.

D. Derwood Strain has a row crop, timber and aquaculture operation in Greenwood, Mississippi, which has been his primary operation for the past five years. He is a member of the Greenwood Farmers Club and Leflore County Farm Bureau. Mr. Strain is a stockholder of Delta Pride, Ag Concepts, Inc., and Leflore Hardware, Inc. During 2003, he served 13 days at Association board meetings and 11 days in other official activities, and was paid \$4,800.00. His term of office is 2003 – 2005.

Mike Unkel has a rice, soybean and cattle operation in Kinder, Louisiana, which has been his primary operation for the past five years. He is a member of Allen Parish Rice Growers and Allen Parish Cattlemen's Association, president of Allen Parish ASCS and Allen Action Agency. Mr. Unkel serves as president of Kinder Canal Company, Kinder Bean Elevator, Kinder Liquid Fertilizer, and Kinder Farm Supply. During 2003, he served 10 days at Association board meetings and 13 days in other official activities, and was paid \$4,600.00. His term of office is 2002 – 2004.

William H. Voss has cattle and timber operations in Pike and Amite Counties, Mississippi and owns a real estate and property management firm in McComb that has been his primary occupation for the past five years. He is a former agricultural commodities broker with Merrill Lynch, a member of the Pike County Chamber of Commerce and the Mississippi Forestry Association. He has also served as Chairman of the Mississippi Real Estate Commission and the Pike County Farm Service

Committee. During 2003, he served 16 days at Association board meetings and 30 days in other official activities, and was paid \$8,750.00. His term of office is 2002 – 2004.

* *Directors serve through the annual meeting following the expiration of their term.*

Transactions with Senior Officers and Directors

The reporting entity's policies on loans to and transactions with its officers and directors, to be disclosed in this section are incorporated herein by reference to Note 11 to the consolidated financial statements, "Related Party Transactions," included in this annual report to stockholders.

Involvement in Certain Legal Proceedings

There were no matters which came to the attention of management or the board of directors regarding involvement of current directors or senior officers in specified legal proceedings which should be disclosed in this section.

Relationship with Independent Public Accountants

There were no material disagreements with our independent public accountants on any matter of accounting principles or financial statement disclosure during this period.

Consolidated Financial Statements

The consolidated financial statements, together with the report thereon of PricewaterhouseCoopers LLP dated February 19, 2004, and the report of management, which appear in this annual report to stockholders are incorporated herein by reference.

Copies of the Association's quarterly reports are available upon request free of charge by calling 1-888-297-1722, or writing to Bryan Applewhite, P.O. Box 6008, Ridgeland, MS 39158-6008.

Borrower Information Regulations

Since 1972, Farm Credit Administration (FCA) regulations have required that borrower information be held in strict confidence by Farm Credit System (FCS) institutions, their directors, officers and employees. These regulations provide Farm Credit institutions clear guidelines for protecting their borrowers' nonpublic personal information.

On November 10, 1999, the FCA Board adopted a policy that requires FCS institutions to formally inform new borrowers at loan closing of the FCA regulations on releasing borrower information and to address this information in the annual report to shareholders. The implementation of these measures ensures that new and existing borrowers are aware of the privacy protections afforded them through FCA regulations and Farm Credit System institution efforts.

Stockholder Investment

Stockholder investment in the Association could be affected by the financial condition and results of operations of AgFirst Farm Credit Bank. Copies of the District annual and quarterly reports are available upon request free of charge by calling 1-800-845-1745, ext. 503, or writing Patti Trotter, AgFirst Farm Credit Bank, P. O. Box 1499, Columbia, SC 29202. Information concerning AgFirst Farm Credit Bank can also be obtained by going to AgFirst's website at www.agfirst.com.

Report of Independent Auditors



PricewaterhouseCoopers LLP
10 Tenth Street, Suite 1400
Atlanta, GA 30309
Telephone (678) 419 1000

Report of Independent Auditors

February 19, 2004

To the Board of Directors and Stockholders
of First South Farm Credit, ACA

We have audited the accompanying consolidated balance sheets of First South Farm Credit, ACA (Association) and its subsidiaries as of December 31, 2003, 2002, and 2001, and the related consolidated statements of income, of changes in members' equity, and of cash flows for each of the three years in the period ended December 31, 2003. These financial statements are the responsibility of the Association's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Association and its subsidiaries at December 31, 2003, 2002 and 2001, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003 in conformity with accounting principles generally accepted in the United States of America.

PricewaterhouseCoopers LLP

Consolidated Balance Sheets

<i>(dollars in thousands)</i>	December 31, 2003	December 31, 2002	December 31, 2001
Assets			
Cash	\$ 7,186	\$ 5,091	\$ 7,260
Loans	839,911	844,501	708,973
Less: allowance for loan losses	20,630	20,717	19,628
Net loans	819,281	823,784	689,345
Accrued interest receivable	8,593	10,067	9,636
Investment in other Farm Credit institutions	62,314	63,705	64,934
Premises and equipment, net	3,280	3,260	3,335
Other property owned	434	56	45
Deferred tax asset, net	283	288	450
Other assets	14,282	14,533	13,151
Total assets	\$ 915,653	\$ 920,784	\$ 788,156
Liabilities			
Notes payable to AgFirst Farm Credit Bank	\$ 708,874	\$ 718,417	\$ 589,337
Accrued interest payable	1,901	2,178	2,258
Patronage refund payable	2,803	3,729	3,687
Postretirement benefits other than pensions	10,472	10,015	10,037
Other liabilities	9,618	9,472	9,410
Total liabilities	733,668	743,811	614,729
Commitments and contingencies			
Members' Equity			
Protected borrower equity	147	147	175
Capital stock and participation certificates	62,952	62,260	61,448
Retained earnings			
Allocated	52,081	46,056	41,390
Unallocated	66,805	68,510	70,414
Total members' equity	181,985	176,973	173,427
Total liabilities and members' equity	\$ 915,653	\$ 920,784	\$ 788,156

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

Consolidated Statements of Income

<i>(dollars in thousands)</i>	For the year ended December 31,		
	2003	2002	2001
Interest Income			
Loans	\$ 49,991	\$ 50,892	\$ 54,559
Interest Expense			
Notes payable to AgFirst Farm Credit Bank	24,097	27,042	32,198
Other	9	11	230
Total interest expense	24,106	27,053	32,428
Net interest income	25,885	23,839	22,131
Provision for (reversal of) loan losses	1,200	1,200	1,960
Net interest income after provision for (reversal of) loan losses	24,685	22,639	20,171
Noninterest Income			
Loan fees	2,024	1,810	1,482
Fees for financially related services	585	735	1,118
Patronage refund from other Farm Credit institutions	6,134	5,644	4,335
Gains (losses) on other property owned, net	100	62	21
Other noninterest income	138	149	151
Total noninterest income	8,981	8,400	7,107
Noninterest Expense			
Salaries and employee benefits	13,959	11,206	9,810
Occupancy and equipment	1,328	1,281	1,265
Insurance Fund premium	998	238	—
Other operating expenses	3,991	4,231	4,168
Total noninterest expense	20,276	16,956	15,243
Income before income taxes	13,390	14,083	12,035
Provision (benefit) for income taxes	649	950	554
Net income	\$ 12,741	\$ 13,133	\$ 11,481

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

Consolidated Statements of Changes in Members' Equity

<i>(dollars in thousands)</i>	Protected Borrower Equity	Capital Stock and Participation Certificates	Retained Earnings		Total Members' Equity
			Allocated	Unallocated	
Balance at December 31, 2000	\$ 213	\$ 60,723	\$ 39,263	\$ 71,448	\$ 171,647
Net income				11,481	11,481
Protected borrower equity retired	(38)				(38)
Capital stock/participation certificates issued		1,858			1,858
Capital stock/participation certificates retired		(1,133)			(1,133)
Patronage distribution					
Cash				(3,685)	(3,685)
Qualified allocated surplus			8,598	(8,598)	—
Retained earnings retired			(6,617)		(6,617)
Distribution adjustment			146	(232)	(86)
Balance at December 31, 2001	175	61,448	41,390	70,414	173,427
Net income				13,133	13,133
Protected borrower equity retired	(28)				(28)
Capital stock/participation certificates issued		1,922			1,922
Capital stock/participation certificates retired		(1,110)			(1,110)
Patronage distribution					
Cash				(3,727)	(3,727)
Qualified allocated surplus			5,591	(5,591)	—
Nonqualified allocated surplus			2,244	(2,244)	—
Nonqualified retained surplus			3,485	(3,485)	—
Retained earnings retired			(6,660)		(6,660)
Distribution adjustment			6	10	16
Balance at December 31, 2002	147	62,260	46,056	68,510	176,973
Net income				12,741	12,741
Capital stock/participation certificates issued		1,936			1,936
Capital stock/participation certificates retired		(1,244)			(1,244)
Patronage distribution					
Cash				(2,800)	(2,800)
Qualified allocated surplus			4,199	(4,199)	—
Nonqualified allocated surplus			3,069	(3,069)	—
Nonqualified retained surplus			4,466	(4,466)	—
Retained earnings retired			(5,669)		(5,669)
Distribution adjustment			(40)	88	48
Balance at December 31, 2003	\$ 147	\$ 62,952	\$ 52,081	\$ 66,805	\$ 181,985

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

Consolidated Statements of Cash Flows

<i>(dollars in thousands)</i>	For the year ended December 31,		
	2003	2002	2001
Cash flows from operating activities:			
Net income	\$ 12,741	\$ 13,133	\$ 11,481
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation on premises and equipment	330	298	312
Provision for (reversal of) loan losses	1,200	1,200	1,960
(Gains) losses on other property owned, net	(100)	(62)	(21)
(Gains) losses from sale of premises and equipment, net	(30)	—	—
Changes in operating assets and liabilities:			
(Increase) decrease in accrued interest receivable	1,474	(431)	1,222
(Increase) decrease in deferred tax asset, net	5	162	(45)
(Increase) decrease in other assets	251	(1,382)	(1,566)
Increase (decrease) in accrued interest payable	(277)	(80)	(714)
Increase (decrease) in postretirement benefits other than pensions	457	(22)	(5)
Increase (decrease) in other liabilities	146	62	2,310
Total adjustments	3,456	(255)	3,453
Net cash provided by (used in) operating activities	16,197	12,878	14,934
Cash flows from investing activities:			
Net (increase) decrease in loans	1,864	(135,742)	(103,031)
(Increase) decrease in investment in other Farm Credit institutions	1,391	1,229	—
Purchase of premises and equipment, net	(379)	(223)	(148)
Proceeds from sale of premises and equipment, net	59	—	—
Proceeds from sale of other property owned	1,161	154	324
Net cash provided by (used in) investing activities	4,096	(134,582)	(102,855)
Cash flows from financing activities:			
Advances on (repayment of) notes payable to AgFirst Farm Credit Bank, net	(9,543)	129,080	96,073
Protected borrower equity retired	—	(28)	(38)
Capital stock and participation certificates issued	1,936	1,922	1,858
Capital stock and participation certificates retired	(1,244)	(1,110)	(1,133)
Patronage refunds paid	(3,678)	(3,669)	(4,807)
Retained earnings retired	(5,669)	(6,660)	(6,617)
Net cash provided by (used in) financing activities	(18,198)	119,535	85,336
Net increase (decrease) in cash	2,095	(2,169)	(2,585)
Cash, beginning of period	5,091	7,260	9,845
Cash, end of period	\$ 7,186	\$ 5,091	\$ 7,260
Supplemental schedule of non-cash investing and financing activities:			
Loans transferred to other property owned	\$ 1,439	\$ 103	\$ 21
Cash dividends or patronage distributions declared or payable	2,800	3,727	3,685
Supplemental information:			
Interest paid	\$ 24,383	\$ 27,133	\$ 33,142
Taxes paid, net	913	102	509

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

Notes to the Consolidated Financial Statements

(dollars in thousands, except as noted)

Note 1 — Organization and Operations

A. **Organization:** First South Farm Credit, ACA (the Association) is a member-owned cooperative which provides credit and credit-related services to or for the benefit of eligible borrowers/stockholders for qualified agricultural purposes in the states of Alabama and Mississippi, Marion County in the state of Tennessee, and all but certain parishes within the northwestern portion of Louisiana.

The Association is a lending institution of the Farm Credit System (the System), a nationwide system of cooperatively owned Banks and Associations, which was established by Acts of Congress to meet the credit needs of American agriculture and is subject to the provisions of the Farm Credit Act of 1971, as amended (the Farm Credit Act). The most recent significant amendment to the Farm Credit Act was the Agricultural Credit Act of 1987. At December 31, 2003, the System was comprised of four Farm Credit Banks and one Agricultural Credit Bank and numerous Associations.

Effective January 1, 2002, pursuant to a plan of restructuring approved by the Farm Credit Administration (FCA) and Association shareholders, the Association reorganized its existing organizational structure. Pursuant to this restructuring, an FLCA and a PCA were formed as wholly owned subsidiaries of the Association. The formation of these subsidiaries enables the Association to take advantage of the tax-exempt status of net income from operations of the FLCA. This restructuring was accounted for as a reorganization of entities under common control similar to a pooling of interests.

Prior to the restructuring, the ACA was subject to federal and state income tax. As a result of the restructuring, long-term participation lending activity was separated into a wholly owned FLCA subsidiary, which is exempt from federal and state income tax. The ACA, which is the holding company, along with the wholly owned PCA subsidiary, continue to be subject to income tax.

AgFirst Farm Credit Bank (Bank) and its related Associations are collectively referred to as the "District." The Bank provides funding to all associations within the District and is responsible for supervising certain activities of the District Associations, as well as the other associations operating within the AgFirst District. The District consists of the Bank and twenty-four ACAs, twenty-two of which have reorganized as ACA parent-

companies, which have two wholly owned subsidiaries, an FLCA and a PCA.

The Association makes short- and intermediate-term loans for agricultural production or operating purposes and secured real estate loans.

The FCA is delegated authority by Congress to regulate the System banks and associations. The activities of the associations are examined by the FCA and certain actions by the associations are subject to the prior approval of the FCA and the supervising Bank.

The Farm Credit Act established the Farm Credit System Insurance Corporation (Insurance Corporation) to administer the Farm Credit Insurance Fund (Insurance Fund). The Insurance Fund is required to be used to (1) ensure the timely payment of principal and interest on Systemwide debt obligations (Insured debt), (2) ensure the retirement of protected borrower capital at par or stated value, and (3) for other specified purposes. The Insurance Fund is also available for discretionary uses by the Insurance Corporation of providing assistance to certain troubled System institutions and to cover the operating expenses of the Insurance Corporation. Each System bank is required to pay premiums into the Insurance Fund, based on its annual average loan principal outstanding until the monies in the Insurance Fund reach the "secure base amount," which is defined in the Farm Credit Act as 2.0 percent of the aggregate insured obligations (Systemwide debt obligations). When the amount in the Insurance Fund exceeds the secure base amount, the Insurance Corporation is required to reduce premiums, but it still must ensure that reduced premiums are sufficient to maintain the level of the Insurance Fund at the secure base amount.

B. **Operations:** The Farm Credit Act sets forth the types of authorized lending activity, persons eligible to borrow, and financial services which can be offered by the Association. The Association is authorized to provide, either directly or in participation with other lenders, credit, credit commitments and related services to eligible borrowers. Eligible borrowers include farmers, ranchers, producers or harvesters of aquatic products, rural residents, and farm-related businesses.

The Association may sell to any Farm Credit borrowing member, on an optional basis, credit or term life insurance appropriate to protect the loan commitment in the event of death of the debtor(s). The sale of other insurance necessary to protect a member's farm or

aquatic unit is permitted, but limited to hail and multi-peril crop insurance, and insurance necessary to protect the facilities and equipment of aquatic borrowers.

Upon request, stockholders of the Association will be provided with an AgFirst Farm Credit Bank Annual Report to Stockholders, which includes the combined financial statements of the Bank and its related Associations. The Association's financial condition may be impacted by factors that affect the Bank. The AgFirst Annual Report discusses the material aspects of the District's financial condition, changes in financial condition, and results of operations. In addition, the AgFirst Annual Report identifies favorable and unfavorable trends, significant events, uncertainties and the impact of activities of the Financial Assistance Corporation Assistance Board (Assistance Board) and Insurance Corporation.

The lending and financial services offered by the Bank are described in Note 1 of the District's Annual Report to Stockholders.

Note 2 — Summary of Significant Accounting Policies

The accounting and reporting policies of the Association conform with accounting principles generally accepted in the United States of America (GAAP) and prevailing practices within the banking industry. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Significant estimates are discussed in these footnotes, as applicable. Actual results may differ from these estimates.

Certain amounts in prior years' financial statements have been reclassified to conform to current consolidated financial statement presentation. Such reclassifications had no effect on net income or total members' equity of prior years. The consolidated financial statements include the accounts of the FLCA and the PCA. All significant inter-company transactions have been eliminated in consolidation.

- A. **Cash:** Cash, as included in the statement of cash flows, represents cash on hand and on deposit at banks.
- B. **Loans and Allowance for Loan Losses:** Substantially all short- and intermediate-term loans for agricultural production or operating purposes have maturities of 10 years or less.

Loans are carried at their principal amount outstanding less unearned income. Interest on loans is accrued and credited to interest income based upon the principal amount outstanding. Loans are generally placed in nonaccrual status when principal or interest is delinquent for 90 days or more (unless adequately secured and in the process of collection) or circumstances indicate that

collection of principal and/or interest is in doubt. When a loan is placed in nonaccrual status, accrued interest deemed uncollectible is either reversed (if accrued in the current year) or charged against the allowance for loan losses (if accrued in prior years).

When loans are in nonaccrual status, the interest portion of payments received in cash is generally recognized as interest income if collection of the recorded investment in the loan is fully expected and the loan does not have a remaining unrecovered prior charge-off associated with it. Otherwise, loan payments are applied against the recorded investment in the loan asset. Nonaccrual loans may be transferred to accrual status when principal and interest are current, prior charge-offs have been recovered, the ability of the borrower to fulfill the contractual repayment terms is fully expected and the loan is not classified "doubtful" or "loss."

In cases where a borrower experiences financial difficulties and the Association makes certain monetary concessions to the borrower through modifications to the contractual terms of the loan, the loan is classified as a restructured loan. If the borrower's ability to meet the revised payment schedule is uncertain, the loan is classified as a nonaccrual loan.

The allowance for loan losses is maintained at a level considered adequate by management to provide for probable losses inherent in the loan portfolio. The allowance is based on a periodic evaluation of the loan portfolio by management in which numerous factors are considered, including economic conditions, loan portfolio composition and prior loan loss experience. It is based on estimates, appraisals and evaluations of loans which, by their nature, contain elements of uncertainty and imprecision. The possibility exists that changes in the economy and its impact on borrower repayment capacity will cause these estimates, appraisals and evaluations to change.

A specific allowance may be established for impaired loans under SFAS No. 114. Impairment of these loans is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as practically expedient, at the loan's observable market price or fair value of the collateral if the loan is collateral dependent. The Bank and Associations record specific allowances to reduce the carrying amount of the impaired loan to the lower of book value or the fair market value of collateral.

- C. **Investment in AgFirst Farm Credit Bank and Other Farm Credit Institutions:** The Association is required to maintain ownership in the Bank in the form of Class C stock. Accounting for this investment is on the cost plus allocated equities basis. Patronage refunds from the Bank are accrued as earned. The receivable for such patronage refunds is included in other assets.

D. Other Property Owned: Other property owned, consisting of real and personal property acquired through a collection action, is recorded at fair value less estimated selling costs upon acquisition. Revised estimates to the fair value less costs to sell are reported as adjustments to the carrying amount of the asset, provided that such adjusted value is not in excess of the carrying amount at acquisition. Income and expenses from operations and carrying value adjustments are included in gains (losses) on other property owned.

E. Premises and Equipment: Premises and equipment are carried at cost less accumulated depreciation. Depreciation is provided on the straight-line method over the estimated useful lives of the assets. Gains and losses on dispositions are reflected in current operations. Maintenance and repairs are charged to operating expense and improvements are capitalized.

F. Advanced Conditional Payments: The Association is authorized under the Farm Credit Act to accept advance payments from borrowers. To the extent the borrower's access to such advance payments is restricted, the advanced conditional payments are netted against the borrower's related loan balance. Advanced conditional payments are not insured. Interest is generally paid by the Association on such accounts.

G. Employee Benefit Plans: The employees of the Association participate in a defined benefit retirement plan (the Plan). The "Projected Unit Credit" actuarial method is used for financial reporting purposes and the "Entry-Age Normal Cost" method for funding purposes.

The employees of the Association are eligible to participate in the District's thrift/deferred compensation plan (Thrift Plan); a percentage of employee contributions is matched by the Association. Thrift Plan costs are expensed as funded.

The Association provides certain health care and life insurance benefits to eligible retired employees. Substantially all employees may become eligible for these benefits if they reach normal retirement age while working for the Association. Expenses of \$963, \$563 and \$543 for the years ended December 31, 2003, 2002 and 2001, respectively, were classified as salaries and employee benefits.

H. Income Taxes: The Association is generally subject to Federal and certain other income taxes. The Association is eligible to operate as a cooperative that qualifies for tax treatment under Subchapter T of the Internal Revenue Code. Accordingly, under specified conditions, the Association can exclude from taxable income amounts distributed as qualified patronage refunds in the form of cash, stock or allocated surplus. Provisions for income taxes are made only on those taxable earnings that will not be distributed as qualified patronage refunds. The Association distributes patronage on the basis of book income. The Association recognizes deferred tax assets

and liabilities for the expected future tax consequences of the temporary differences between the carrying amounts and tax bases of assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be realized or settled.

Effective January 1, 2002, the Association formed a tax exempt subsidiary as described in Note 1.

I. Patronage Refund from AgFirst and Other Financial Institutions: The Association records patronage refunds from the Bank and certain District Associations on an accrual basis.

Note 3 — Loans and Allowance for Loan Losses

A summary of loans follows:

	December 31,		
	2003	2002	2001
Production and intermediate-term	\$ 802,366	\$ 818,843	\$ 709,546
Rural home	3,038	1,808	883
Farm related business	14,621	10,061	2,037
Processing and marketing	2,819	957	1,641
Sales contracts	332	141	175
Nonaccruals	3,965	3,683	3,040
Other	85	160	178
Plus: participations purchased	49,328	35,463	27,777
Less: participations sold	(36,643)	(26,615)	(36,304)
Total	\$ 839,911	\$ 844,501	\$ 708,973

The Association's concentration of credit risk in various agricultural commodities is shown in the following table. While the amounts represent the Association's maximum potential credit risk as it relates to recorded loan principal, a substantial portion of the Association's lending activities is collateralized and the Association's exposure to credit loss associated with lending activities is reduced accordingly. An estimate of the Association's credit risk exposure is considered in the determination of the allowance for loan losses.

Total loans at December 31, 2003, 2002 and 2001 consisted of the following commodity types:

Commodity Type	December 31,		
	2003	2002	2001
Poultry	32%	30%	32%
Forestry	15	13	11
Cotton	13	14	15
Livestock	9	9	9
Sugar Cane	6	6	6
Catfish	5	7	7
Rice	3	3	2
Peanuts	2	3	3
Soybeans	2	2	2
Dairy	1	1	1
Other	12	12	12
Total	100%	100%	100%

The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the borrower. Collateral held varies, but typically includes farmland and income-producing property, such as crops and livestock, as well as receivables. Real estate loans are secured by the first liens on the underlying real property. Federal regulations state that long-term real estate loans are not to exceed 85 percent (97 percent if guaranteed by a government agency) of the property's appraised value. However, a decline in a property's market value subsequent to loan origination or advances, or other actions necessary to protect the financial interest of the Association in the collateral, may result in the loan to value ratios in excess of the regulatory maximum.

Impaired loans are loans for which it is probable that not all principal and interest will be collected according to the contractual terms.

The following table presents information relating to impaired loans.

	December 31,		
	2003	2002	2001
Nonaccrual loans:			
Current as to principal and interest	\$ 1,289	\$ 1,361	\$ 1,493
Past due	2,676	2,322	1,547
Total nonaccrual loans	<u>3,965</u>	<u>3,683</u>	<u>3,040</u>
Impaired accrual loans:			
Restructured accrual loans	109	154	117
Accrual loans 90 days or more past due	10	105	47
Total impaired accrual loans	<u>119</u>	<u>259</u>	<u>164</u>
Total impaired loans	<u>\$ 4,084</u>	<u>\$ 3,942</u>	<u>\$ 3,204</u>

There were no material commitments to lend additional funds to debtors whose loans were classified as impaired at December 31, 2003.

Interest income is recognized and cash payments are applied on nonaccrual impaired loans as described in Note 2. The following table presents interest income recognized on impaired loans.

	Year Ended December 31,		
	2003	2002	2001
Interest income recognized on nonaccrual loans	\$ 1,078	\$ 608	\$ 592
Interest income on impaired accrual loans	58	174	43
Interest income recognized on impaired loans	<u>\$ 1,136</u>	<u>\$ 782</u>	<u>\$ 635</u>

The following table presents information concerning impaired loans as of December 31,

	2003	2002	2001
Impaired loans with related allowance	\$ 1,275	\$ 1,407	\$ 440
Impaired loans with no related allowance	2,809	2,535	2,764
Total impaired loans	<u>\$ 4,084</u>	<u>\$ 3,942</u>	<u>\$ 3,204</u>
Allowance on impaired loans	<u>\$ 276</u>	<u>\$ 306</u>	<u>\$ 207</u>

The following table summarizes impaired loan information for the year ended December 31,

	2003	2002	2001
Average impaired loans	<u>\$ 4,208</u>	<u>\$ 4,634</u>	<u>\$ 3,430</u>

A summary of the changes in the allowance for loan losses follows:

	Year Ended December 31,		
	2003	2002	2001
Balance at beginning of year	\$ 20,717	\$ 19,628	\$ 17,554
Provision for (reversal of) loan losses	1,200	1,200	1,960
Loans charged off	(1,449)	(393)	(141)
Recoveries	162	282	255
Balance at end of year	<u>\$ 20,630</u>	<u>\$ 20,717</u>	<u>\$ 19,628</u>
Ratio of net charge-offs during the period to average loans outstanding during the period	<u>.15%</u>	<u>.01%</u>	<u>(.02)%</u>

Note 4 — Investment in AgFirst Farm Credit Bank

The Association is required to maintain ownership in the Bank of Class C stock (net of any investment by the Bank in the Association) as determined by the Bank. The Bank may require additional capital contributions to maintain its capital requirements.

The Bank has a reciprocal investment in the Association of \$50,589 representing 10,117,847 shares of its nonvoting common stock.

Note 5 — Premises and Equipment

Premises and equipment consisted of the following:

	December 31,		
	2003	2002	2001
Land	\$ 967	\$ 983	\$ 983
Buildings and improvements	5,287	5,235	5,116
Furniture and equipment	2,113	2,101	2,252
	<u>8,367</u>	<u>8,319</u>	<u>8,351</u>
Less: accumulated depreciation	5,087	5,059	5,016
Total	<u>\$ 3,280</u>	<u>\$ 3,260</u>	<u>\$ 3,335</u>

The Association is obligated under various noncancellable operating leases for automobiles and offices. At December 31, 2003, future minimum lease payments for all noncancellable operating leases are as follows:

2004	\$ 719
2005	392
2006	99
2007	30
2008	14
Subsequent years	—
Total minimum lease payments	<u>\$ 1,254</u>

Total rental expenses for 2003, 2002 and 2001 including all leases amounted to \$1,054, \$1,007 and \$966, respectively. There are no contingent rentals. The leases generally provide for the payment of property taxes, insurance and maintenance costs by the Association.

Note 6 — Notes Payable to AgFirst Farm Credit Bank

The Association's indebtedness to 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 and the terms of the revolving lines of credit are governed by a general financing agreement. Interest rates on both variable and fixed rate notes payable are generally established loan-by-loan based on the Bank's marginal cost of funds, capital position, operating costs and return objectives. The interest rate is periodically adjusted by the Bank based upon agreement between the Bank and Association. The weighted average interest rates on the variable rate notes were 2.32 percent for LIBOR-based loans, 2.22 percent for Prime-based loans, and the weighted average remaining maturities were 2.3 years and 3.0 years, respectively, at December 31, 2003. The weighted average interest rate on the fixed rate and adjustable rate mortgage (ARM) notes payable which are match funded by the Bank was 3.50 percent and the weighted average remaining maturity was 3.8 years at December 31, 2003. The weighted average interest rate on all interest-bearing notes payable was 2.98 percent and the weighted average remaining maturity was 3.4 years at December 31, 2003.

Variable rate and fixed rate notes payable represent approximately 31.11 percent and 68.89 percent, respectively, of total notes payable at December 31, 2003.

The Bank, consistent with FCA regulations, has established limitations on the Association's ability to borrow funds based on specified factors or formulas relating primarily to credit quality and financial condition. At December 31, 2003, the Association's notes payable were within the specified limitations.

Note 7 — Members' Equity

A description of the Association's capitalization requirements, protection mechanisms, regulatory capitalization requirements and restrictions, and equities are provided below.

A. Protected Borrower Equity

Protection of certain borrower equity is provided under the Farm Credit Act which requires the Association, when retiring protected borrower equity, to retire such equity at par or stated value regardless of its book value. Protected borrower equity includes capital stock, participation certificates and allocated equities which were outstanding as of January 6, 1988, or were issued or allocated prior to October 6, 1988. If an Association

is unable to retire protected borrower equity at par value or stated value, amounts required to retire this equity would be obtained from the Insurance Fund.

B. Capital Stock and Participation Certificates

In accordance with the Farm Credit Act and the Association's capitalization bylaws, each borrower is required to invest in Class C stock for agricultural loans, or participation certificates in the case of rural home and farm related business loans, as a condition of borrowing. The initial borrower investment, through either purchase or transfer, must be in an amount equal to 2 percent of the loan or \$5 thousand, whichever is less. The Board of Directors may increase the amount of investment if necessary to meet the Association's capital needs. Loans designated for sale or sold into the Secondary Market on or after April 16, 1996 will have no voting stock or participation certificate purchase requirement if sold within 180 days following the date of designation.

The borrower acquires ownership of the capital stock or participation certificates at the time the loan is made, but usually does not make a cash investment. The aggregate par value is generally added to the principal amount of the related loan obligation. The Association retains a first lien on the stock or participation certificates owned by borrowers. Retirement of such equities will generally be at the lower of par or book value, and repayment of a loan does not automatically result in retirement of the corresponding stock or participation certificates.

C. Regulatory Capitalization Requirements and Restrictions

FCA's capital adequacy regulations require the Association to achieve permanent capital of seven percent of risk-adjusted assets and off-balance-sheet commitments. Failure to meet the seven percent capital requirement can initiate certain mandatory and possibly additional discretionary actions by FCA that, if undertaken, could have a direct material effect on the Association's consolidated financial statements. The Association is prohibited from reducing permanent capital by retiring stock or making certain other distributions to shareholders unless prescribed capital standards are met. FCA regulations also require that additional minimum standards for capital be achieved. These standards require all System institutions to achieve and maintain ratios as defined by FCA regulations. These required ratios are total surplus as a percentage of risk-adjusted assets of seven percent and of core surplus as a percentage of risk-adjusted assets of three and one-half percent. The Association's permanent capital, total surplus and core surplus ratios at December 31, 2003 were 13.84 percent, 12.46 percent and 9.40 percent, respectively.

An FCA regulation empowers it to direct a transfer of funds or equities by one or more System institutions to another System institution under specified circumstances.

The Association has not been called upon to initiate any transfers and is not aware of any proposed action under this regulation.

D. Description of Equities

The Association is authorized to issue or have outstanding Class A Nonvoting Common Stock, Class C Voting Common Stock, and Class D Preferred Stock, and nonvoting Participation Certificates. All shares of stock and participation certificates have a par or face value of five dollars (\$5.00) per share.

The Association had the following shares outstanding at December 31, 2003:

Class	Protected	Shares Outstanding	
		Number	Aggregate Par Value
A Common/Nonvoting	Yes	29,332	\$ 147
A Common/Nonvoting	No	12,563	63
C Common/Voting	No	2,420,595	12,103
Common Issued to Bank/Nonvoting	No	10,117,847	50,589
C Participation Certificates/Nonvoting	No	39,492	197
Total Capital Stock and Participation Certificates		12,619,829	\$ 63,099

Protected common stock is retired at par or face value in the ordinary course of business. At-risk common stock and participation certificates are retired at the sole discretion of the Board at book value not to exceed par or face amounts, provided the minimum capital adequacy standards established by the Board are met.

Surplus Accounts

The Association maintains an unallocated surplus account and an allocated surplus account. The minimum aggregate amounts of these two accounts shall be prescribed by the Farm Credit Act and the FCA regulations. The allocated surplus account consists of earnings held therein and allocated to borrowers on a patronage basis.

In the event of a net loss for any fiscal year, such loss shall be absorbed by, first, charges to the unallocated surplus account; second, impairment of paid-in surplus; and third, impairment of the allocated surplus account on the basis of latest allocations first.

The Association shall have a first lien on all surplus account allocations owned by any borrower, and all distributions thereof, as additional collateral for such borrower's indebtedness to the Association. When the debt of a borrower is in default or is in the process of final liquidation, the Association may, upon notice to the borrower, order any and all surplus account allocations owned by such borrower to be applied against the indebtedness. Any such retirement and application against indebtedness of surplus account

allocations shall be before similar retirement and application of stock or participation certificates owned by the borrower.

When all of the stock and participation certificates of the Association owned by a borrower are retired or otherwise disposed of, any surplus account allocations owned by such borrower may also be retired upon request by the borrower and subject to the approval of the Board, and the proceeds paid to the borrower. Alternatively, if the Board so directs, upon notice to the borrower such surplus account allocations may be applied against any of the borrower's indebtedness to the Association.

Subject to the Farm Credit Act and FCA regulations, allocated surplus may be distributed in cash, oldest allocations first. The cash proceeds may be applied against the indebtedness of the borrower to the Association. In no event shall such distributions reduce the surplus account below the minimum amount prescribed by the Farm Credit Act and FCA regulations. Distributions of less than the full amount of all allocations issued as of the same date shall be on a pro rata basis.

At December 31, 2003, allocated members' equity consisted of \$38,847 of qualified surplus, \$5,299 of nonqualified allocated surplus and \$7,935 of nonqualified retained surplus.

Patronage Distributions

Prior to the beginning of any fiscal year, the Board, by adoption of a resolution, may obligate the Association to distribute to borrowers on a patronage basis all or any portion of available net earnings for such fiscal year or for that and subsequent fiscal years. Patronage distributions are based on the proportion of the borrower's interest to the amount of interest earned by the Association on its total loans unless another proportionate patronage basis is approved by the Board.

If the Association meets its capital adequacy standards after making the patronage distributions, the patronage distributions may be in cash, authorized stock of the Association, allocations of earnings retained in an allocated members' equity account, or any one or more of such forms of distribution. Patronage distributions of the Association's earnings may be paid on either a qualified or nonqualified basis, or a combination of both, as determined by the Board. A minimum of 20 percent of the total qualified patronage distribution to any borrower for any fiscal year shall always be paid in cash.

Transfer

Stock and participation certificates may be transferred only to persons eligible to purchase and hold such stock or participation certificates.

Impairment

Any losses which result in an impairment of the Association's capital shall be borne ratably by, first, each share of Class A Nonvoting Common Stock and Class C Voting Common Stock and unit of participation certificates outstanding; and, second, by each share of Class D Preferred Stock outstanding, if any, all as of the date such losses are determined.

Liquidation

In the event of liquidation or dissolution of the Association, any assets of the Association remaining after payment or retirement of all liabilities shall be distributed to the holders of stock and participation certificates in the following order of priority:

1. To the holders of Class D Preferred Stock, if any, pro rata in proportion to the number of shares then issued and outstanding until an amount equal to the aggregate par value of all such shares has been distributed to all such holders.
2. To the holders of Class A Nonvoting Common Stock and Class C Voting Common Stock and participation certificates, pro rata in proportion to the number of shares or units of each such class of stock or participation certificates then issued and outstanding until an amount equal to the aggregate par value of all such shares or units has been distributed to all such holders.
3. Any remaining assets of the Association after such distributions shall be distributed to the holders of Class A Nonvoting Common Stock and Class C Voting Common Stock, and participation certificates, pro rata in proportion to the number of shares or units then outstanding.

Note 8 — Income Taxes

The provision (benefit) for income taxes follows:

	<u>Year Ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
Current:			
Federal	\$ 574	\$ 737	\$ 583
State	70	51	17
	<u>644</u>	<u>788</u>	<u>600</u>
Deferred:			
Federal	5	162	(46)
State	<u>—</u>	<u>—</u>	<u>—</u>
	5	162	(46)
Total provision (benefit) for income taxes	<u>\$ 649</u>	<u>\$ 950</u>	<u>\$ 554</u>

In connection with the restructuring in 2002 discussed in Note 1, the net deferred tax asset relating to the long-term lending activities was written off during the first quarter of 2002 to reflect the change in tax status. The amount of this write-off was not significant.

The provision (benefit) for income tax differs from the amount of income tax determined by applying the applicable U.S. statutory federal income tax rate to pretax income as follows:

	<u>December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
Federal tax at statutory rate	\$ 4,553	\$ 4,788	\$ 4,092
State tax, net	46	34	42
Patronage distributions	(1,841)	(2,515)	(3,602)
Tax-exempt FLCA earnings	(2,163)	(1,539)	—
Deferred tax asset adjustment	—	84	—
Other	54	98	22
Provision (benefit) for income taxes	<u>\$ 649</u>	<u>\$ 950</u>	<u>\$ 554</u>

Deferred tax assets and liabilities result from the following at:

	<u>December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
Allowance for loan losses	\$ 578	\$ 577	\$ 746
Nonaccrual loan interest	32	32	42
Postretirement benefits other than pensions	442	444	469
Gross deferred tax assets	<u>1,052</u>	<u>1,053</u>	<u>1,257</u>
Future Bank equity redemption	(413)	(410)	(430)
Loan fees	(1)	—	(1)
Pensions	(355)	(355)	(375)
Depreciation	—	—	(1)
Gross deferred tax liability	<u>(769)</u>	<u>(765)</u>	<u>(807)</u>
Net deferred tax asset (liability)	<u>\$ 283</u>	<u>\$ 288</u>	<u>\$ 450</u>

At December 31, 2003, deferred income taxes have not been provided by the Association on approximately \$55.7 million of patronage refunds received from the Bank prior to January 1, 1993. Such refunds, distributed in the form of stock, are subject to tax only upon conversion to cash. The tax liability related to future conversions is not expected to be material.

Note 9 — 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. Benefits are based on salary and years of service. The measurement date for the plan is September 30.

The following table sets forth the obligation and funded status of the retirement plan:

	As of December 31,		
	2003	2002	2001
Change in projected benefit obligation			
Benefit obligation at beginning of year	\$ 31,162	\$ 25,946	\$ 24,373
Service cost	978	803	757
Interest cost	2,064	1,898	1,902
Actuarial loss/(gain)	3,502	3,748	108
Benefits paid	(1,319)	(1,233)	(1,194)
Benefit obligations at end of year	\$ 36,387	\$ 31,162	\$ 25,946
Change in plan assets			
Fair value of plan assets at beginning of year	\$ 26,991	\$ 30,729	\$ 34,421
Actual return on plan assets	3,576	(2,220)	(2,251)
Employer contributions	1,021	—	—
Benefits paid	(1,318)	(1,234)	(1,195)
Expenses	(214)	(284)	(246)
Fair value of plan assets at end of year	\$ 30,056	\$ 26,991	\$ 30,729
Funded status (benefit obligation less FV of plan assets)			
Unrecognized net actuarial loss/(gain)	\$ (6,331)	\$ (4,171)	\$ 4,783
Unrecognized prior service cost	13,664	12,226	3,295
Unrecognized net (asset) or obligation	1,457	1,721	1,985
Net amount recognized	(1,364)	(1,702)	(2,040)
Prepaid benefit costs	\$ 7,426	\$ 8,074	\$ 8,023

The accumulated benefit obligation for all defined benefit pension plans was \$28,776, \$24,872 and \$21,095 at December 31, 2003, 2002 and 2001, respectively.

	2003	2002	2001
Components of net periodic pension cost			
Service cost	\$ 978	\$ 803	\$ 757
Interest cost	2,064	1,898	1,902
Expected return on plan assets	(2,101)	(2,697)	(3,034)
Amortization of transition (asset)	(338)	(338)	(338)
Amortization of prior service cost	264	264	265
Recognized actuarial (gain)/loss	803	20	—
Net periodic benefit (income) cost	\$ 1,670	\$ (50)	\$ (448)

Weighted-average assumptions used to determine net benefit obligations at December 31			
Discount rate	6.25%	6.75%	7.50%
Rate of compensation increase	4.00%	4.00%	4.00%

Weighted-average assumptions used to determine periodic cost at December 31			
Discount rate	6.25%	6.75%	7.50%
Expected long-term return on plan assets	8.00%	8.00%	9.00%
Rate of compensation increase	4.00%	4.00%	4.00%

In 2003 and 2002 the Association used a long-term rate of return of 8 percent and used a 9 percent return in 2001. These returns were based on expectations that the equity portfolio can provide a 5-8 percent return over the life of the plan and the debt portfolio can provide an additional 1-3 percent over the life of the plan. Prevailing market conditions, historical trends and peer comparisons were also utilized in assigning the 8 percent expected rate of return.

PLAN ASSETS	2003	2002	2001
Asset Category			
Equity securities	\$ 19,778	\$ 14,980	\$ 16,348
Debt securities	9,677	10,958	12,476
Other	601	1,053	1,905
	\$ 30,056	\$ 26,991	\$ 30,729

The primary investment objective of the retirement plan is to invest pension fund assets and contributions to assure that there will be no erosion of funds and the purchasing power thereof. The Association recognizes that risk, volatility and the possibility of loss in purchasing power are present in all type of investment vehicles. The Association has taken a conservative approach to achieve these goals by limiting

equity investments to 70 percent of the total portfolio and limiting debt securities to 60 percent of the total portfolio.

Target allocation for asset categories for 2004 are as follows:

Asset Category	
Equity securities	60% – 70%
Debt securities	30% – 40%

The Association also participates in a districtwide Thrift Plan. The Thrift Plan requires the Association to match 50 percent of employee optional contributions up to a maximum employee contribution of 6 percent of total compensation.

The District sponsors a plan providing certain benefits (primarily health care) to its retirees. Certain Association charges related to this plan are an allocation of District charges based on the Association's proportional share of the plan liability.

On December 8, 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (Medicare Act) was signed into law. This act introduces a prescription drug benefit under Medicare (Medicare Part D) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. Subsidies under the Medicare Act will reduce the current period measurements of benefits expected to be provided in future periods. These financial statements and disclosures do not reflect the effects of the Act. Specific authoritative guidance on the accounting for the federal subsidy is pending and that guidance, when issued, could require changes to previously reported information.

The following is a table of retirement and postretirement benefits expenses (credits):

	2003	2002	2001
Pension	\$ 1,670	\$ (50)	\$ (448)
Thrift/deferred compensation	241	236	199
Other Postretirement benefits	963	563	543
Total	\$ 2,874	\$ 749	\$ 294

Note 10 — Intra-System Financial Assistance

The Farm Credit System Financial Assistance Corporation (Financial Assistance Corporation) was established in 1988 primarily to provide capital to institutions of the System experiencing financial difficulty. Such assistance was funded through the Financial Assistance Corporation's issuance of \$1.261 billion of 15-year U.S. Treasury-guaranteed debt. The interest rates on these issuances range from 8.80 percent to 9.45 percent. The repayment of this debt and related interest is the responsibility of System banks. At December 31, 2003, only \$325 million of Financial Assistance Corporation debt remains outstanding. All other debt has either matured or was called and redeemed.

Each System bank may be required to pay premiums into the Insurance Fund based on its annual average loan

principal outstanding. The Bank, in turn, may also assess the Association for insurance premiums based on the average principal outstanding of accrual and nonaccrual loans of the Association for each year. At December 31, 2003, the assets in the Insurance Fund aggregated \$2.033 billion. However, due to the authorized uses of the Insurance Fund, there is no assurance that Fund assets will be available or sufficient to ensure the payment of principal of, or interest on, insured debt securities in the event of a default by any System bank having primary liability thereon.

Note 11 — Related Party Transactions

In the ordinary course of business, the Association enters into loan transactions with officers and directors of the Association, their immediate families and other organizations with which such persons may be associated. Such loans are subject to special approval requirements contained in the FCA regulations and are made on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated borrowers.

Total loans to such persons at December 31, 2003 amounted to \$9,711. During 2003, \$11,656 of new loans were made and repayments totaled \$12,448. In the opinion of management, none of these loans outstanding at December 31, 2003 involved more than a normal risk of collectibility.

Note 12 — Commitments and Contingencies

The Association has various commitments outstanding and contingent liabilities.

The Association may participate in financial instruments with off-balance-sheet risk to satisfy the financing needs of its borrowers and to manage their exposure to interest-rate risk. These financial instruments include commitments to extend credit and commercial letters of credit. The instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the financial statements. Commitments to extend credit are agreements to lend to a borrower as long as there is not a violation of any condition established in the contract. Commercial letters of credit are agreements to pay a beneficiary under conditions specified in the letter of credit. Commitments and letters of credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. At December 31, 2003, \$216,408 of commitments to extend credit and \$7,953 of standby letters of credit were outstanding.

Since many of these commitments are expected to expire without being drawn upon, the total commitments do not necessarily represent future cash requirements. However, these credit-related financial instruments have off-balance-sheet credit risk because their amounts are not reflected on the Balance Sheet until funded or drawn upon. The credit risk associated with issuing commitments and letters of credit is substantially the same as that involved in extending loans

to borrowers and management applies the same credit policies to these commitments. Upon fully funding a commitment, the credit risk amounts are equal to the contract amounts, assuming that borrowers fail completely to meet their obligations and the collateral or other security is of no value. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the borrower.

The Association also participates in standby letters of credit to satisfy the financing needs of its borrowers. These letters of credit are irrevocable agreements to guarantee payments of specified financial obligations. Outstanding standby letters of credit have expiration dates ranging from February 26, 2004 to February 26, 2008.

Note 13 — Disclosures About Fair Value Of Financial Instruments

The following table presents the carrying amounts and fair values of the Association's financial instruments at December 31, 2003, 2002 and 2001. The fair value of a financial instrument is generally defined as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Quoted market prices are generally not available for certain System financial instruments, as described below. Accordingly fair values are based on judgments regarding anticipated cash flows, future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates involve uncertainties and matters of judgment, and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

The estimated fair values of the Association's financial instruments are as follows:

	December 31, 2003		December 31, 2002	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash	\$ 7,186	\$ 7,186	\$ 5,091	\$ 5,091
Loans	\$ 839,911	\$ 849,656	\$ 844,501	\$ 861,790
Allowance for loan losses	20,630	—	20,717	—
Loans, net	\$ 819,281	\$ 849,656	\$ 823,784	\$ 861,790
Financial liabilities:				
Notes payable to AgFirst Farm Credit Bank	\$ 708,874	\$ 709,636	\$ 718,417	\$ 727,619
December 31, 2001				
Financial assets:				
Cash	\$ 7,260	\$ 7,260		
Loans	\$ 708,973	\$ 714,874		
Allowance for loan losses	19,628	—		
Loans, net	\$ 689,345	\$ 714,874		
Financial liabilities:				
Notes payable to AgFirst Farm Credit Bank	\$ 589,337	\$ 592,840		

A description of the methods and assumptions used to estimate the fair value of each class of the Association's financial instruments for which it is practicable to estimate that value follows:

- A. **Cash:** The carrying value is a reasonable estimate of fair value.
- B. **Loans:** Because no active market exists for the Association's loans, fair value is estimated by discounting the expected future cash flows using the Association's current interest rates at which similar loans would be made to borrowers with similar credit risk. As the discount rates are based on the Bank's loan rates, as well as management estimates, management has no basis to determine whether the fair values presented would be indicative of the value negotiated in an actual sale.

For purposes of determining fair value of accruing loans, the loan portfolio is segregated into pools of loans with homogeneous characteristics based upon repricing and credit risk. Expected future cash flows and interest rates reflecting appropriate credit risk are separately determined for each individual pool.

Fair value of loans in a nonaccrual status is estimated to be the carrying amount less specific reserves.

The carrying value of accrued interest approximates its fair value.

- C. **Investment in AgFirst Farm Credit Bank and Other Farm Credit Institutions:** Estimating the fair value of the Association's investment in the Bank is not practicable because the stock is not traded. As described in Note 4, the net investment is a requirement of borrowing from the Bank and is carried at cost plus allocated equities in the accompanying balance sheet. The Association owns 6.91 percent of the issued stock of the Bank as of December 31, 2003 net of any reciprocal investment. As of that date, the Bank's assets totaled \$15.9 billion and shareholders' equity totaled \$955 million. The Bank's earnings were \$177 million during 2003.

In addition, the Association has an investment of \$17 related to other Farm Credit institutions.

- D. **Notes Payable to AgFirst Farm Credit Bank:** The notes payable are segregated into pricing pools according to the types and terms of the loans (or other assets) which they fund. Fair value of the notes payable is estimated by discounting the anticipated cash flows of each pricing pool using the current rate that would be charged for additional borrowings. For purposes of this estimate it is assumed the cash flow on the notes is equal to the principal payments on the Association's loan receivables plus accrued interest on the notes payable. This assumption implies that earnings on the Association's interest margin are used to fund operating expenses and capital expenditures.

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

Note 14 — Quarterly Financial Information (Unaudited)

Quarterly results of operations for the years ended December 31, 2003, 2002 and 2001 follow:

	2003				
	First	Second	Third	Fourth	Total
Net interest income	\$ 5,734	\$ 6,302	\$ 7,509	\$ 6,340	\$ 25,885
Provision for (reversal of) loan losses	300	300	300	300	1,200
Noninterest income (expense), net	(2,803)	(2,618)	(2,654)	(3,869)	(11,944)
Net income (loss)	\$ 2,631	\$ 3,384	\$ 4,555	\$ 2,171	\$ 12,741

	2002				
	First	Second	Third	Fourth	Total
Net interest income	\$ 5,046	\$ 5,698	\$ 6,628	\$ 6,467	\$ 23,839
Provision for (reversal of) loan losses	300	300	300	300	1,200
Noninterest income (expense), net	(2,269)	(1,908)	(2,090)	(3,239)	(9,506)
Net income (loss)	\$ 2,477	\$ 3,490	\$ 4,238	\$ 2,928	\$ 13,133

	2001				
	First	Second	Third	Fourth	Total
Net interest income	\$ 5,204	\$ 5,432	\$ 5,961	\$ 5,534	\$ 22,131
Provision for (reversal of) loan losses	240	240	240	1,240	1,960
Noninterest income (expense), net	(2,216)	(2,135)	(2,117)	(2,222)	(8,690)
Net income (loss)	\$ 2,748	\$ 3,057	\$ 3,604	\$ 2,072	\$ 11,481