

*“I know of no pursuit in which more real
and important services can be rendered to any
country than by improving its agriculture, its
breed of useful animals, and other branches of
a husbandman’s cares.”*

– GEORGE WASHINGTON



First South
Farm Credit

2005 ANNUAL REPORT

RURAL AMERICA'S CUSTOMER-OWNED PARTNER

FIRST SOUTH FARM CREDIT, ACA

2005 ANNUAL REPORT

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Management

Stephen L. Rochelle.....	President & Chief Executive Officer
Bryan Applewhite.....	Senior Vice President/Chief Financial Officer/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

William H. Voss.....	Chairman
James M. Norsworthy, III.....	Vice Chairman
Larry Arnaud.....	Director
Bobby G. Briscoe.....	Director
John R. Burden.....	Director
Paul Clark.....	Director
Dr. Marty J. Fuller.....	Director
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Daniel C. Mattingly.....	Director
Joe H. Morgan.....	Director
Shep Morris.....	Director
Thomas H. Nelson, Jr.....	Director
Thomas A. Parker.....	Director
Ted S. Passmore.....	Director
W. S. Patrick.....	Director
Robert E. Potts.....	Director
Walter R. Richardson.....	Director
D. Derwood Strain.....	Director
Mike Unkel.....	Director
Dan West.....	Director

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Message from the Chief Executive Officer

In August and September 2005, the three-state area of Mississippi, Louisiana and Alabama suffered two of the most extreme natural disasters in the history of the United States. As a result of Hurricanes Katrina and Rita the people, infrastructure, and economy of the coastal region of our territory experienced significant adverse effects. However, First South Farm Credit used our organizational policies and procedures as well as regulations and statutory authorities to work with our agricultural borrowers in these affected areas. As an organization, our hearts and prayers go out to these people and their families.

First South Farm Credit is a strong, well-capitalized institution with a diversified portfolio over a three-state area. Because of these strengths, your Association did not witness any abnormal portfolio stress.

First South again had record earnings of over \$20 million for 2005 with assets exceeding \$1 billion. The First South Board of Directors voted to approve the 11th consecutive patronage distribution from 2005 Association earnings. This 2005 patronage distribution puts First South at a total of approximately \$122 million in cash and allocated patronage distributions to its member/stockholders since the inception of the program. First South is proud of this patronage history and our commitment to our loyal member borrowers.

Your Association is committed to serving the credit needs of the agricultural communities in Alabama, Louisiana and Mississippi. We have 47 offices to make sure our credit delivery system is convenient and accessible to our current and potential customers.

Our Association is the premier Farm Credit System lender in our territory continuing to offer uninterrupted success in agricultural lending since 1933.

We want you to have a competitive choice when it comes to financing land, production agriculture and agribusiness in Alabama, Louisiana and Mississippi, and First South wants to be your first choice for all of your needs.



Stephen L. Rochelle
Chief Executive Officer

March 1, 2006

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 2005 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.



William H. Voss
Chairman of the Board



Stephen L. Rochelle
Chief Executive Officer



Bryan Applewhite
Chief Financial Officer

March 1, 2006

Consolidated Five - Year Summary of Selected Financial Data

(UNAUDITED)

<i>(dollars in thousands)</i>	2005	2004	December 31, 2003	2002	2001
Balance Sheet Data					
Cash	\$ 20,207	\$ 10,375	\$ 10,372	\$ 11,455	\$ 12,164
Loans	985,486	889,076	839,911	844,501	708,973
Less: allowance for loan losses	5,425	5,189	20,630	20,717	19,628
Net loans	980,061	883,887	819,281	823,784	689,345
Investment in other Farm Credit institutions	61,849	61,513	62,314	63,705	64,934
Other property owned	479	739	434	56	45
Other assets	34,797	29,042	26,438	28,148	26,572
Total assets	\$ 1,097,393	\$ 985,556	\$ 918,839	\$ 927,148	\$ 793,060
Notes payable to AgFirst Farm Credit Bank*	\$ 856,986	\$ 759,497	\$ 712,060	\$ 724,781	\$ 594,241
Accrued interest payable and other liabilities with maturities of less than one year	26,573	23,396	24,794	25,394	25,392
Total liabilities	883,559	782,893	736,854	750,175	619,633
Protected borrower equity	140	142	147	147	175
Capital stock and participation certificates	63,927	63,360	62,952	62,260	61,448
Retained earnings					
Allocated	68,020	58,064	52,081	46,056	41,390
Unallocated	81,747	81,097	66,805	68,510	70,414
Total members' equity	213,834	202,663	181,985	176,973	173,427
Total liabilities and members' equity	\$ 1,097,393	\$ 985,556	\$ 918,839	\$ 927,148	\$ 793,060
Statement of Income Data					
Net interest income	\$ 30,265	\$ 25,975	\$ 25,885	\$ 23,839	\$ 22,131
Provision for (reversal of allowance for) loan losses	305	(14,809)	1,200	1,200	1,960
Noninterest income (expense), net	(9,512)	(10,478)	(11,944)	(9,506)	(8,690)
Net income	\$ 20,448	\$ 30,306	\$ 12,741	\$ 13,133	\$ 11,481
Key Financial Ratios					
Rate of return on average:					
Total assets	1.91%	3.20%	1.36%	1.58%	1.52%
Total members' equity	9.92%	16.52%	7.09%	7.92%	6.70%
Net interest income as a percentage of					
average earning assets	3.09%	2.98%	3.00%	2.98%	3.27%
Net chargeoffs (recoveries) to average loans	0.007%	0.072%	0.148%	0.014%	(0.02)%
Total members' equity to total assets	19.49%	20.56%	19.81%	19.09%	21.87%
Debt to members' equity (:1)	4.13	3.86	4.05	4.24	3.57
Allowance for loan losses to loans	0.55%	0.58%	2.46%	2.45%	2.77%
Permanent capital ratio	13.63%	13.59%	13.84%	13.51%	14.05%
Total surplus ratio	12.43%	12.21%	12.46%	12.17%	13.52%
Core surplus ratio	10.40%	9.38%	9.40%	9.16%	12.59%
Net Income Distribution					
Estimated patronage refunds:					
Cash dividend	\$ 3,195	\$ 3,101	\$ 2,800	\$ 3,727	\$ 3,685
Qualified allocated retained earnings	4,792	4,652	4,199	5,591	8,598
Nonqualified allocated retained earnings	5,799	3,845	3,069	2,244	—
Nonqualified retained earnings	5,799	4,651	4,466	3,485	—

* General financing agreement is renewable on three-year cycles. The next renewal date is December 31, 2007.

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

(dollars in thousands, except as noted)

GENERAL OVERVIEW

The following commentary summarizes the financial condition and results of operations of First South Farm Credit, ACA, (the Association) for the year ended December 31, 2005 with comparisons to the years ended December 31, 2004 and December 31, 2003. 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.

The Association is an institution of the Farm Credit System, which was created by Congress in 1916 and has served agricultural producers for almost 90 years. The System mission is to maintain and improve the income and well-being of American farmers, ranchers, and producers or harvesters of aquatic products and farm-related businesses. The Farm Credit System is the largest agricultural lending organization in the United States. The Farm Credit System is regulated by the Farm Credit Administration, (FCA), which is an independent safety and soundness regulator.

The Association is a cooperative, which is owned by the members served. The territory of the Association extends across a diverse agricultural region of Alabama, Louisiana, and Mississippi. Refer to Note 1, "Organization and Operations," of the Notes to the Consolidated Financial Statements for further description of the Association's territory. The Association provides credit to farmers, ranchers, rural residents, and agribusinesses. Our success begins with our extensive agricultural experience and knowledge of the market.

The Association obtains funding from AgFirst Farm Credit Bank (the Bank). The Association is materially affected by the financial condition and results of operations of the Bank. Copies of the AgFirst Farm Credit Bank's Quarterly and Annual Reports are on the AgFirst website, www.agfirst.com, or may be obtained at no charge by calling 1-800-845-1745, extension 378, or writing Jay Wise, AgFirst Farm Credit Bank, P. O. Box 1499, Columbia, SC 29202. Copies of the Association's Annual and Quarterly reports are also on the Association's website, www.firstsouthfarmcredit.com, or may be obtained upon request free of charge by calling 1-800-955-1722 or writing Bryan Applewhite, First South Farm Credit, ACA, P. O. Box 6008, Ridgeland, MS 39158-6008.

CRITICAL ACCOUNTING POLICIES

The financial statements are reported in conformity with accounting principles generally accepted in the United States of America. We consider our significant accounting policies to be critical to the understanding of our results of operations and financial position because some accounting policies require us to make complex or subjective judgments and estimates that may affect the value of certain assets or liabilities. These policies are considered critical because we have to make judgments about matters that are inherently uncertain. For a complete discussion of significant accounting policies, see Note 2, "Summary of Significant Accounting Policies," of the Notes to the Consolidated Financial Statements. The following is a summary of certain critical policies.

- *Allowance for loan losses* — The allowance for loan losses is management's best estimate of the amount of probable losses inherent in its loan portfolio. The allowance for loan losses is increased through provisions for loan losses and loan recoveries and is decreased through loan loss reversals and loan charge-offs. The allowance for loan losses is determined based on a periodic evaluation of the loan portfolio, which generally considers types of loans, credit quality, specific industry conditions, general economic and political conditions, and changes in the character, composition, and performance of the portfolio, among other factors.

Significant individual loans are evaluated based on the borrower's overall financial condition, resources, and payment record, the prospects for support from any financially responsible guarantor, and, if appropriate, the estimated net realizable value of any collateral. The allowance for loan losses attributable to these loans is established by a process that estimates the probable loss inherent in the loans, taking into account various historical and projected factors, internal risk ratings, regulatory oversight, geographic, industry and other factors.

Changes in the factors considered by management in the evaluation of losses in the loan portfolios could result in a change in the allowance for loan losses and could have a direct impact on the provision for loan losses and the results of operations.

- *Valuation methodologies* — Management applies various valuation methodologies to assets and liabilities that often involve a significant degree of judgment, particularly when liquid markets do not exist for the particular items being valued. Quoted market prices are referred to when estimating fair values for certain assets for which an observable liquid market exists, such as most investment securities. Management utilizes significant estimates and assumptions to value items for which an observable liquid market does not exist. Examples of these items include impaired loans, pension and other postretirement benefit obligations, and certain derivative and other financial instruments. These valuations require the use of various assumptions, including, among others, discount rates, rates of return on assets, repayment rates, cash flows, default rates, costs of servicing and liquidation values. The use of different assumptions could produce significantly different results, which could have material positive or negative effects on the Association's results of operations.

ECONOMIC CONDITIONS

During 2005, economic conditions in our region were mixed. Some areas experienced significant stress, while others had generally favorable conditions. There has been some change in our market base over the past year, with the Association buying and selling loan participations as well as the Association's involvement in real estate lending. During 2005, 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.

During the third quarter of 2005, hurricane activity caused damage across the Association's territory. Crop and commodity damage was significant, but the impact on repayment of loans will not be known, in most cases, for several months. However, risk of loss appears to be mitigated by insurance proceeds, loan guarantees and the overall financial health of the borrowers' balance sheets.

LOAN PORTFOLIO

The Association provides funds to farmers, rural homeowners, and farm-related businesses for financing of short and intermediate-term loans through numerous product types.

The gross loan volume of the Association as of December 31, 2005, was \$985,486, an increase of \$96,410 or 10.84 percent as compared to \$889,076 at December 31, 2004 and an increase of \$145,575 or 17.33 percent as compared to \$839,911 at December 31, 2003. Net loans outstanding (gross loans net of the allowance for loan losses) on December 31, 2005, were \$980,061 as compared to \$883,887 at December 31, 2004 and \$819,281 at December 31, 2003. Net loans accounted for 89.31 percent of total assets on December 31, 2005 as compared to 89.68 percent of total assets at December 31, 2004 and 89.16 percent of total assets at December 31, 2003.

The diversification of the Association loan volume by type for each of the past three years is shown below. See Note 4, "Loans and Allowance for Loan Losses" of the Notes to the Consolidated Financial Statements, for the loans outstanding amounts.

Loan Type	12/31/05	12/31/04	12/31/03*
Production and intermediate term	97.03%	96.38%	* %
Agribusiness:			
Loans to cooperatives	.06	—	*
Processing and marketing	.49	.81	*
Farm-related business	1.73	1.86	*
Communication	.08	.18	*
Energy	.40	.44	*
Rural residential real estate	.21	.33	*
Total	100.00%	100.00%	100.00%

* Note: Beginning with year-end 2004, loan type categories have been expanded to provide additional information on the types of loans made. As a result, three years of comparable data is not available.

The following table presents the contractual maturity distribution of loans at December 31, 2005:

Loan Type	Due in 1 year or less	Due after 1 year through 5 years	Due after 5 years	Total
Production and intermediate-term	\$ 224,494	\$ 547,154	\$ 184,626	\$ 956,274
Agribusiness:				
Loans to cooperatives	492	91	—	583
Processing and marketing	325	2,262	2,212	4,799
Farm related business	4,436	5,702	6,903	17,041
Communication	778	—	—	778
Energy	3,906	—	—	3,906
Rural residential real estate	152	1,503	450	2,105
Total	\$ 234,583	\$ 556,712	\$ 194,191	\$ 985,486

While we make loans and provide financially related services to qualified borrowers in the agricultural and rural sectors and to certain related entities, our loan portfolio is diversified. The following tables reflect the commodities financed and the geographic locations served.

The geographic distribution of the loans by state for the past three years is as follows:

State	12/31/05	12/31/04	12/31/03
Alabama	46.91%	46.82%	48.06%
Louisiana	22.72	22.54	22.37
Mississippi	30.37	30.64	29.57
Total	100.00%	100.00%	100.00%

Commodity and industry categories are based upon the Standard Industrial Classification system published by the federal government. The system is used to assign commodity or industry categories based upon the largest agricultural commodity of the customer.

The major commodities in the Association loan portfolio are shown below. The predominant commodities are poultry, forestry, and cotton, which constitute over 62 percent of the entire portfolio.

Commodity Group	Percent of Portfolio		
	2005	2004	2003
Poultry	31%	31%	32%
Forestry	18	16	15
Cotton	13	14	13
Livestock	8	8	9
Sugar Cane	7	7	6
Catfish	4	5	5
Rice	4	4	3
Peanuts	2	2	2
Soybeans	2	2	2
Dairy	1	1	1
Other	10	10	12
Total	100%	100%	100%

Repayment ability is closely related to the commodities produced by our borrowers, and increasingly, the off-farm income of borrowers. The Association's loan portfolio contains a concentration of poultry, forestry and cotton producers. Although a large percentage of the loan portfolio is concentrated in these enterprises, many of these operations are diversified within their enterprise and/or with crop production that reduces overall risk exposure. Demand for beef, prices of field grains, and international trade are some of the factors affecting the price of these commodities. Even though the concentration of large loans has increased over the past several years, the agricultural enterprise mix of these loans is diversified and similar to that of the overall portfolio. The risk in the portfolio associated with commodity concentration and large loans is reduced by the range of diversity of enterprises in the Association's territory.

The increase in gross and net loan volume for the twelve months ended December 31, 2005, is primarily attributed to the growth in new loan volume across several commodity groups, especially forestry.

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 and winter months as commodities are marketed and proceeds are applied to repay operating loans.

During 2005, 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 our capital position.

Loan Participations	2005	2004	2003
Participations Purchased			
– FCS Institutions	\$ 41,155	\$ 26,979	\$ 34,514
Participations Purchased			
– Non-FCS Institutions	38,792	41,762	14,814
Participations Sold	(7,435)	(44,272)	(36,643)
Total	\$ 72,512	\$ 24,469	\$ 12,685

RISK EXPOSURE

Credit risk arises from the potential inability of an obligor to meet its repayment obligation. As a part of a system to evaluate the success of a loan, the Association continues to review the credit quality of the loan portfolio on an ongoing basis. With the approval of the Association Board of Directors, the Association establishes underwriting standards and lending policies that provide direction to loan officers. Underwriting standards include, among other things, an evaluation of:

- Character – borrower integrity and credit history
- Capacity – repayment capacity of the borrower based on cash flows from operations or other sources of income
- Collateral – protects the lender in the event of default and represents a potential secondary source of repayment
- Capital – ability of the operation to survive unanticipated risks
- Conditions – intended use of the loan funds

The credit risk management process begins with an analysis of the borrower’s credit history, repayment capacity, and financial position. Repayment capacity focuses on the borrower’s ability to repay the loan based upon cash flows from operations or other sources of income, including non-farm income. As required by regulation, each institution that makes loans on a secured basis must have collateral evaluation policies and procedures. Appraisals are required for loans more than \$250,000. In addition, each loan is assigned a credit risk weighting based upon the underwriting standards. This credit risk rating process incorporates objective and subjective criteria to identify inherent strengths, weaknesses, and risks in a particular relationship.

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

	12/31/05	12/31/04	12/31/03
High-risk Assets			
Nonaccrual loans	\$ 2,484	\$ 3,311	\$ 3,965
Restructured loans	842	145	109
Accruing loans 90 days past due	195	–	10
Total high-risk loans	3,521	3,456	4,084
Other property owned	479	739	434
Total high-risk assets	\$ 4,000	\$ 4,195	\$ 4,518
Ratios			
Nonaccrual loans to total loans	.25%	.37%	.47%
High-risk assets to total assets	.36%	.43%	.49%

Nonaccrual loans represent all loans where there is a reasonable doubt as to the collection of principal and/or interest under the contractual terms of the loan. Nonaccrual loans decreased \$827, or 24.98 percent in 2005. This decrease resulted from liquidation, normal payouts, and upgrading to accrual status. Of the \$2,484 in nonaccrual volume at December 31, 2005, \$1,193 or 48.03%, compared to 22.71% and 32.51% at December 31, 2004 and 2003, respectively, was current as to scheduled principal and interest payments, but did not meet all regulatory requirements to be transferred into accrual status.

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. Other receipts of assets and/or equity to pay the loan in full or in part are also considered restructured loans. The type of alternative financing structure chosen is based on minimizing the loss incurred by both the Association and the borrower.

Credit Quality

We review the credit quality of the loan portfolio on an on-going basis as part of our risk management practices. Each loan is classified according to the Uniform Classification System, which is used by all Farm Credit System institutions. Below are the classification definitions.

- Acceptable – Assets are expected to be fully collectible and represent the highest quality.
- Other Assets Especially Mentioned (OAEM) – Assets are currently collectible but exhibit some potential weakness.
- Substandard – Assets exhibit some serious weakness in repayment capacity, equity, and/or collateral pledged on the loan.
- Doubtful – Assets exhibit similar weaknesses to substandard assets. However, doubtful assets have additional weaknesses in existing facts, conditions and values that make collection in full highly questionable.
- Loss – Assets are considered uncollectible.

The following table presents selected statistics related to the credit quality of loans including accrued interest at December 31.

Credit Quality	2005	2004	2003
Acceptable & OAEM	98.49%	97.79%	97.56%
Substandard	1.51	2.21	2.44
Doubtful	–	–	–
Loss	–	–	–
Total	100.00%	100.00%	100.00%

Allowance for Loan Losses

During 2004, the Association completed its study to further refine the allowance for loan losses methodology, taking into account recently issued guidance by the Farm Credit Administration (FCA), the System’s regulator, as well as the Securities and Exchange Commission (SEC) and Federal Financial Institutions Examination Council. As a result of this study and resulting refinements in methodology, during the fourth quarter of 2004, the Association recorded a reversal of the allowance for loan losses of \$14,809.

The Association's allowance for loan losses methodology was adjusted and revised in the late 1980s to take into account the credit losses experienced in the mid-to-late 1980s, as a result of unusually adverse economic factors affecting American agriculture. Given the long cyclical nature of the agricultural economy, loss factors utilized to determine the allowance for loan losses subsequent to 1989 continued to reflect, to some extent, the loss history of the mid-to-late 1980s, which resulted in conservative estimates of the allowance for loan losses. The Association's allowance for loan losses methodology utilized throughout the period was in accordance with generally accepted accounting principles and was consistently applied.

While conservative in estimating the allowance for loan losses, the methodology used resulted in annual provisions for loan losses over the periods that reflected changes in credit quality and loss experience. Accordingly, the reserves provided in the mid-to-late 1980s have, in effect, remained part of the allowance for loan losses. The Association's allowance for loan loss methodology has consistently adhered to proper accounting policies, under the regulatory supervision of the FCA in its role as a "safety and soundness" regulator. It was the FCA's view that the allowance for loan losses should include, among others, an assessment of probable losses, historical loss experience and economic conditions.

In April 2004, the FCA issued an Informational Memorandum to System institutions regarding the criteria and methodologies that would be used in evaluating the adequacy of a System institution's allowance for loan losses. The FCA endorsed the direction provided by other bank regulators and the SEC and indicated that the conceptual framework addressed in their guidelines would be included as part of their examination process.

The refinement in methodology resulted in a calculated allowance for loan losses that was significantly less than the previously recorded balance due to revised loss factors that are more indicative of actual loss experience in recent years and current borrower analysis. The factors considered in determining the revised level of allowance for loan losses were generally based on recent historical charge-off experience adjusted for relevant environmental factors. The Association considered the following when adjusting the historical charge-offs experience:

- changes in credit risk classifications,
- changes in collateral values,
- changes in risk concentrations,
- changes in weather related conditions and
- changes in economic conditions.

While the reversal had a significant impact on 2004 results of operations and the previously recorded allowance for loan losses, the refinement in methodology is not expected to have a significant impact on comparative results of operations in future periods. Additionally, the refinement in methodology did not have a significant impact on the level of risk bearing capacity of the Association, generally referred to as "risk funds" (capital plus the allowance for loan losses), which totaled \$219,259 at December 31, 2005 (22.25 percent of Association loans), as compared with \$207,852 at December 31, 2004 (23.38 percent of Association loans) and \$202,615 at December 31, 2003 (24.12 percent of Association loans).

The allowance for loan losses at each period end was considered by Association management to be adequate to absorb probable losses existing in and inherent to its loan portfolio. Management's evaluations consider factors including loan loss experience, portfolio quality, loan portfolio composition, current agricultural production

conditions and economic conditions. The allowance for loan losses was \$5,425 at December 31, 2005, as compared with \$5,189 and \$20,630 at December 31, 2004 and 2003, respectively.

Net loan charge-offs of \$69, \$632 and \$1,287 were recorded in 2005, 2004 and 2003, respectively. Net loan charge-offs as a percentage of average loans remained at low levels of .01 percent, .07 percent, and .15 percent for 2005, 2004 and 2003, respectively. The net loan charge-offs were primarily associated with the normal credit risk within the loan portfolio.

The following table presents the activity in the allowance for loan losses for the most recent three years:

The changes in the allowance for loan losses are as follows:

	Year Ended December 31,		
	2005	2004	2003
Balance at beginning of year	\$ 5,189	\$ 20,630	\$ 20,717
Provision for (reversal of allowance for) loan losses	\$ 305	\$ -	\$ 1,200
Nonrecurring provision for loan losses reversal	-	(14,809)	-
	305	(14,809)	1,200
Charge-offs:			
Production agriculture:			
Production and intermediate term	\$ 217	\$ 815	\$ 1,449
Total charge-offs	217	815	1,449
Recoveries			
Production agriculture:			
Production and intermediate term	\$ 148	\$ 183	\$ 162
Total recoveries	148	183	162
Net charge-offs (recoveries)	69	632	1,287
Balance at end of year	\$ 5,425	\$ 5,189	\$ 20,630
Ratio of net charge-offs during the period to average loans outstanding during the period	0.007%	0.072%	0.148%

The allowance for loan losses by loan type for the most recent three years is as follows:

Allowance for Loan Losses by Type	December 31,		
	2005	2004	2003*
Production and intermediate term	\$ 5,281	\$ 5,031	\$ *
Agribusiness	116	118	*
Communication	3	7	*
Energy	16	17	*
Rural residential real estate	9	16	*
Total loans	\$ 5,425	\$ 5,189	\$ 20,630

* Note: Beginning with year-end 2004, loan type categories have been expanded to provide additional information on the types of loans made. As a result, three years of comparable data is not available.

The allowance for loan losses as a percentage of loans outstanding and as a percentage of certain other credit quality indicators is shown below:

Allowance for Loan Losses as a Percentage of:	December 31,		
	2005	2004	2003
Total loans	.55%	.58%	2.46%
Nonperforming loans	154.08%	150.14%	505.14%
Nonaccrual loans	218.40%	156.72%	520.30%

The financial positions of our borrowers have generally strengthened during the past decade as farmers' net cash income has been at a favorable level due, in part, to direct federal government payments and steady increases in land values over the period. With borrowers' strengthened financial positions and the continued emphasis on sound underwriting standards, the credit quality of our loan portfolio has remained healthy. Please refer to Note 4, "Loans and Allowance for Loan Losses," in the Notes to the Consolidated Financial Statements, for further information concerning the allowance for loan losses.

RESULTS OF OPERATIONS

Net income for the year ended December 31, 2005, totaled \$20,448, a decrease of \$9,858 or 32.53 percent, as compared to \$30,306 for the same period of 2004 and an increase of \$7,707 or 60.49 percent, as compared to \$12,741 for the same period of 2003. As noted earlier, the net income for 2003 reflects a \$14,809 reversal of the allowance for loan losses. Interest income for the year ended December 31, 2005, was \$64,762, an increase of \$15,093 or 30.39 percent as compared to \$49,669 for the same period of 2004. Interest income decreased by \$322 for the period ended December 31, 2004, compared to December 31, 2003. Major components of the changes in net income for the past three years are outlined in the following table.

Changes in Net Income:

	2005-2004	2004-2003
Net income (prior year)	\$ 30,306	\$ 12,741
Increase (decrease) in net income due to:		
Interest income	15,093	(322)
Interest expense	(10,803)	412
Net interest income	4,290	90
Provision for loan losses	(15,114)	16,009
Noninterest income	1,305	1,947
Noninterest expense	(1,075)	(376)
Provision for income taxes	736	(105)
Total changes in income	(9,858)	17,565
Net income	\$ 20,448	\$ 30,306

Net Interest Income

Net interest income for the year ended December 31, 2005 increased by \$4,290 or 16.52 percent and by \$4,380, or 16.92 percent, compared to 2004 and 2003, respectively. The primary reason for the increase compared to 2004 was an increase in average accruing loans outstanding of \$109,937 or 12.63 percent. The increase compared to 2003 was primarily the result of an increase in average loans outstanding of \$116,276 or 13.45 percent. The Association's net interest income as a percentage of average earning assets was 3.09 percent on December 31, 2005, compared to 2.98 percent on December 31, 2004 and 3.00 percent on December 31, 2003.

Interest income on nonaccrual loans for 2005 totaled \$312, a decrease of \$39, compared to \$351 for 2004 and a decrease of \$766 compared to \$1,078 for 2003. 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:

	Volume*	Rate	Nonaccrual	
			Income	Total
12/31/05 - 12/31/04				
Interest income	\$ 6,228	\$ 8,904	\$ (39)	\$ 15,093
Interest expense	3,251	7,552	-	10,803
Change in net interest income	<u>\$ 2,977</u>	<u>\$ 1,352</u>	<u>\$ (39)</u>	<u>\$ 4,290</u>
12/31/04 - 12/31/03				
Interest income	\$ 359	\$ 46	\$ (727)	\$ (322)
Interest expense	107	(519)	-	(412)
Change in net interest income	<u>\$ 252</u>	<u>\$ 565</u>	<u>\$ (727)</u>	<u>\$ 90</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.

A reversal of a portion of the allowance for loan losses at December 31, 2004 resulted in a negative provision of \$(14,809), compared to provision expense of \$305 and \$1,200 at December 31, 2005 and 2003, respectively. Please refer to the Allowance for Loan Losses section discussed above.

Noninterest Income

Noninterest income for each of the three years ended December 31 is shown in the following table:

Noninterest Income	For the Year Ended			Percentage Increase/(Decrease)	
	December 31,			2005/	2004/
	2005	2004	2003	2004	2003
Loan fees	\$ 2,134	\$ 1,977	\$ 2,024	7.94%	(2.32)%
Fees for financially related services	590	643	585	(8.24)	9.91
Patronage refund from AgFirst Farm Credit Bank	9,318	8,562	6,134	8.83	39.58
Gains (losses) on sale of other property owned	40	(351)	100	113.96	(451.00)
Other noninterest income	151	97	138	55.67	(29.71)
Total noninterest income	<u>\$ 12,233</u>	<u>\$ 10,928</u>	<u>\$ 8,981</u>	<u>11.94%</u>	<u>21.68%</u>

Patronage refunds from other Farm Credit Institutions increased \$756 and \$2,428 for the years ended December 31, 2005 and 2004, respectively. The Association received \$6,512 in a patronage refund and \$2,806 in a special distribution from the Bank for the year ended December 31, 2005, compared to \$5,772 and \$2,790 for 2004, and \$5,733 and \$401 for 2003. Loan fees increased \$157 and increased \$110 for the period ended December 31, 2005, compared to the comparable periods in 2004 and 2003, respectively.

Noninterest Expense

Noninterest expense for each of the three years ended December 31 is shown in the following table:

Noninterest Expense	For the Year Ended			Percentage Increase/(Decrease)	
	December 31,			2005/	2004/
	2005	2004	2003	2004	2003
Salaries and employee benefits	\$ 15,639	\$ 14,845	\$ 13,959	5.35%	6.35%
Occupancy and equipment expense	1,149	1,142	1,328	.61	(14.01)
Insurance Fund premium	466	423	998	10.17	(57.62)
Other operating expense	4,473	4,242	3,991	5.45	6.29
Total noninterest expense	<u>\$ 21,727</u>	<u>\$ 20,652</u>	<u>\$ 20,276</u>	<u>5.21%</u>	<u>1.85%</u>

Noninterest expense increased \$1,075 or 5.21 percent for December 31, 2005, as compared to the same period of 2004 and increased \$1,451 or 7.16 percent compared to December 31, 2003. Salaries and employee benefits expense increased \$794 or 5.35 percent for December 31, 2005, as compared to the same period of 2004 and increased \$1,680 or 12.04 percent as compared to December 31, 2003. Benefits expense for 2005 was \$4,524 compared to \$4,962 for 2004 and \$4,650 for 2003.

The Association recorded a provision for income taxes of \$18 for the year ended December 31, 2005, as compared to a provision of \$754 for 2004 and a provision of \$649 for 2003.

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.

Key Results of Operations Comparisons	For the 12 Months Ended 12/31/05	For the 12 Months Ended 12/31/04	For the 12 Months Ended 12/31/03
Return on Average Assets	1.91%	3.20%	1.36%
Return on Average Members' Equity	9.92%	16.52%	7.09%
Net Interest Income as a Percentage of Average Earning Assets	3.09%	2.98%	3.00%
Net Chargeoffs (Recoveries) to Average Loans	.01%	.07%	.15%

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 the Bank and from income generated by operations. Sufficient liquid funds have been available to meet all financial obligations.

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 components. 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, 2005, were \$856,986 as compared to \$759,497 at December 31, 2004 and \$712,060 at December 31, 2003. The increase of 12.84 percent compared to December 31, 2004 and the increase of 20.35 percent compared to December 31, 2003, is attributable to the increase in loan volume.

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, adjustable 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). Adjustable rate mortgages are indexed to U.S. Treasury Rates. Fixed rate loans are priced based on the current cost of Farm Credit debt of similar terms to maturity.

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, 2005, increased 5.51 percent to \$213,834 from the December 31, 2004, total of \$202,663 and increased 17.50 percent from the December 31, 2003 total of \$181,985. The increase was primarily attributed to net income partially offset by cash patronage.

Total capital stock and participation certificates were \$64,067 on December 31, 2005, compared to \$63,502 on December 31, 2004 and \$63,099 on December 31, 2003. The increase was attributed to the increase in the Association's loan volume.

The Association's capital ratios as of December 31 and the FCA minimum requirements follow:

	2005	2004	2003	Regulatory Minimum
Permanent Capital	13.63%	13.59%	13.84%	7.00%
Total Surplus	12.43%	12.21%	12.46%	7.00%
Core Surplus	10.40%	9.38%	9.40%	3.50%

At December 31, 2005, the Association's permanent capital ratio, average at-risk capital divided by average risk adjusted assets calculated in accordance with FCA regulations, exceeded the regulatory minimum of 7.00 percent. In addition to these regulatory requirements, the Association has established a permanent capital goal in excess of the 7.00 percent FCA minimum requirement. As of December 31, 2005, the Association has met the goal.

PATRONAGE PROGRAM

Prior to the beginning of any fiscal year, the Association's Board of Directors, by adoption of a resolution, may establish a Patronage Allocation Program to distribute its available consolidated net earnings. This resolution provides for the application of net earnings in the manner described in the Association's Bylaws. This includes the setting aside of funds to increase surplus to meet minimum capital adequacy standards established by Regulations, to increase surplus to meet Association capital adequacy standards to a level necessary to support competitive pricing at targeted earnings levels, and for reasonable reserves for necessary purposes of the

Association. After excluding net earnings attributable to (a) the portion of loans participated to another institution, and (b) participation loans purchased, remaining consolidated net earnings will be allocated to borrowers. Refer to Note 8, "Members' Equity," of the Notes to the Consolidated Financial Statements, for more information concerning the patronage distributions. The Association declared patronage distributions of \$19,585 in 2005, \$16,249 in 2004, and \$14,534 in 2003.

YOUNG, BEGINNING AND SMALL (YBS) FARMERS AND RANCHERS PROGRAM

The Association's mission includes providing sound and constructive credit and related services to young, beginning and small (YBS) farmers and ranchers. First South's mission is directed by board and management to ensure that our Association is making every effort possible to implement our YBS program.

The Association has in place a flexible YBS program with policies and procedures that are designed to meet the needs of YBS farmers in our Association's territory. The First South Board approves the YBS policy as well as the annual business plan which outlines practices to accomplish the First South YBS mission.

YBS farmers and ranchers are defined as:

Young Farmer: A farmer, rancher, or producer or harvester of aquatic products who is age 35 or younger as of the date the loan is originally made.

Beginning Farmer: A farmer, rancher, or producer or harvester of aquatic products who has 10 years or less farming or ranching experience as of the date the loan is originally made.

Small Farmer: A farmer, rancher, or producer or harvester of aquatic products who normally generates less than \$250 in annual gross sales of agricultural or aquatic products at the date the loan is originally made.

The Association's young, beginning, and small farmer and rancher program (YBS) complies with statutory and regulatory requirements which includes qualitative and quantitative goals. Goals include coordinating with government agencies that offer loan guarantees for risk management purposes. First South has been an FSA certified lender since 1994.

The Association business plan also outlines strategies to increase market share success, a market outreach program that generates participation, and involvement by Association staff at the field level. Strategies include (1) YBS Program on the Association website, (2) First South Market Outreach Program, (3) Country Loan and Small Loan Program, (4) demographic information by state and county, and (5) sponsorships and educational programs. The results of these outreach and education programs are reported to the Association Board of Directors on an annual basis.

The Association business plan also includes a budget recommended by management that is sufficient to carry out the Association's YBS mission and performance goals.

The following table outlines the loan volume and number of YBS loans in the loan portfolio as of December 31, 2005 for the Association.

	As of December 31, 2005	
	Number of Loans	Amount of Loans
Young	1,268	\$ 132,260
Beginning	1,655	180,507
Small	5,001	364,574

For purposes of the above table, a loan could be included in more than one of the categories depending on the characteristics of the underlying borrower.

The 2002 USDA Ag Census data has been used as a benchmark to measure penetration of the Association YBS marketing efforts. The census data indicates the number of farmers that, by definition, were young, beginning or small within our three-state territory. First South then makes a comparative analysis of the ag census data to our December 31, 2005 data for young, beginning and small farmers within our portfolio. This analysis is reported to the Board of Directors and to the regulator. As of December 31, 2005, the Association was doing business with 21.68 percent of young farmers, 4.63 percent of beginning farmers, and 4.71 percent of small farmers identified by the same census information covering First South's territory in Alabama, Louisiana and Mississippi.

FORWARD LOOKING INFORMATION

Certain information included in this discussion constitutes forward-looking statements and information that are based upon management's belief as well as certain assumptions made by and information currently available to management. When used in this discussion, the words "anticipate," "project," "expect," "believe," and similar expressions are intended to identify forward-looking statements. Although management of the Association believes that the expectations reflected in such forward-looking statements are reasonable, it can give no assurance that such expectations and projections will prove to have been correct. Such forward-looking statements are subject to certain risks, uncertainties and assumptions. Should one or more of these risks materialize, or should such underlying assumptions prove to be incorrect, actual results may vary materially from those anticipated, projected, or expected. Among key factors that may have a direct bearing on the Association's operating results are fluctuations in the economy, the relative strengths and weaknesses in the agricultural credit sectors and in the real estate market, the actions taken by the Federal Reserve for the purpose of managing the economy, and the continued growth of the agricultural market consistent with recent historical experience.

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 shareholders.

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 shareholders.

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 Tusculumbia, AL	Branch	Owned
4210 McFarland Blvd. Northport, AL	Branch	Owned
1434 S. Union Ave. Ozark, AL	Branch	Owned
1401 Forest Ave. Montgomery, AL	Division/Branch	Owned
141 Lee St. Luverne, AL	Branch	Owned
209 E. Second St. Bay Minette, AL	Branch	Leased
5070 Boll Weevil Circle Enterprise, AL	Branch	Owned
1103 Bypass West Andalusia, AL	Branch	Owned
914 Van Buren Ave. Oxford, MS	Branch	Owned

<u>Location</u>	<u>Description</u>	<u>Form of Ownership</u>
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	Owned
203 Cossar Blvd. Charleston, MS	Branch	Owned
505 E. Second St. Clarksdale, MS	Branch	Owned
250 S. Shelby St. Greenville, MS	Closed	Owned
1021 Highway 82 East Leland, MS	Branch	Owned
303 S. Sharpe St. 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	Closed	Owned
501 Apache Drive McComb, MS	Branch	Owned
1350 N. Clark Magnolia, MS	Closed	Owned
749 Cosby St. Centreville, MS	Closed	Owned
1711 Hardy St. Hattiesburg, MS	Branch	Owned
728 Sawmill Rd. Laurel, MS	Branch	Owned
5057 Hwy. 1-49 South Service Rd. Opelousas, LA	Division/Branch	Owned
222 N. Cedar Tallulah, LA	Branch	Owned
1211 S. Louisa Rayville, LA	Closed	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
4696 Hwy. 19 Zachary, LA	Branch	Owned

<u>Location</u>	<u>Description</u>	<u>Form of Ownership</u>
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.	03/01/10	\$8,070.00
Ridgeland, MS	3 yrs.	03/01/08	\$5,658.00
Bay Minette, AL	3 yrs.	08/02/08	\$1,500.00

Legal Proceedings

Information, if any, to be disclosed in this section is incorporated herein by reference to Note 13 to the consolidated financial statements, "Commitments and Contingencies," included in this annual report to shareholders.

Description of Capital Structure

Information to be disclosed in this section is incorporated herein by reference to Note 8 to the consolidated financial statements, "Members' Equity," included in this annual report to shareholders.

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, 7, 11 and 13 to the consolidated financial statements included in this annual report to shareholders.

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 shareholders 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, 2005, 2004 and 2003, 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>	<u>Deferred/-Perquisites</u>	<u>Other</u>	
Stephen L. Rochelle	2005	\$212,604	\$ 46,000	—	—	\$ 258,604	
Stephen L. Rochelle	2004	\$204,920	\$ 43,000	—	—	\$ 247,920	
Stephen L. Rochelle	2003	\$197,510	\$ 35,000	—	—	\$ 232,510	
	7	2005	\$836,557	\$179,003	—	—	\$1,015,560
	7	2004	\$780,965	\$117,141	—	—	\$ 898,106
	7	2003	\$735,000	\$110,250	—	—	\$ 845,250

The Association had an Incentive Plan for 2005. The Incentive Plan consists of three different plans within the overall incentive plan. Plan A is based upon new business development, Plan B is based upon bottom line profitability from operations for the 12-month calendar year and Plan C is based upon lease income development. Employees share on a pro rata salary basis at the branch level and an average basis at the administrative level and are limited to a maximum of 25 percent of individual salaries. Incentives are paid within 45 days of the year end. The incentives/bonuses are shown in year earned which may be different than the year of payment. Seven senior officers shared in the 2005 incentive.

Disclosure of the total compensation earned in 2005 by any senior officer, or to any other individual included in the total whose compensation exceeds \$50,000, is available to shareholders 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 \$172,274 for 2005, \$155,525 for 2004, and \$151,801 for 2003.

Subject to approval by the board, the Association may allow directors honorarium of \$500 per day for attendance at official board meetings, \$250 per day for auxiliary board and committee meetings, \$50 for telephone conference calls and \$100 to \$400 travel on a pro rata mileage basis. Total compensation paid to directors as a group was \$173,627.

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

William H. Voss, Chairman, has cattle and timber operations in Pike and Amite Counties, Mississippi and owns a real estate and property management firm in McComb which 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 2005, he served 14 days at Association board meetings and 28 days in other official activities, and was paid \$11,470. His term of office is 2005 – 2007.

James M. Norsworthy, III, Vice Chairman, 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 2005, he served 10 days at Association board meetings and 16 days in other official activities, and was paid \$8,250. His term of office is 2005 – 2007.

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 2005, he served 12 days at Association board meetings and 23 days in other official activities, and was paid \$11,490. His term of office expired December 31, 2005.* Because of the age limitation, Mr. Arnaud was not eligible for re-election.

Bobby G. Briscoe has a row crop, cattle and timber operation in Lafayette and Panola counties in Mississippi, which has been his primary operation for the past five years. He is also owner of Briscoe Construction Company. Mr. Briscoe has served three terms as president of Northeast Mississippi Homebuilders Association and is a member of the Rural Housing Commission. During 2005, he served 7 days at Association board meetings and 6 days in other official activities, and was paid \$5,550. His term of office is 2005 – 2007.

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 2005, he served 3 days at Association board meetings and 4 days in other official activities, and was paid \$2,150. His term of office expired December 31, 2004.* Because of the age limitation, Mr. Brown was not eligible for re-election.

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 2005, he served 8 days at Association board meetings and 6 days in other official activities, and was paid \$6,600. His term of office is 2004 – 2006.

Paul Clark has a row crop operation in Decatur, Alabama, which has been his primary operation for the past five years. He is also co-owner of Clark and Reed, an ag consulting firm. 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 2005, he served 15 days at Association board meetings and 32 days in other official activities, and was paid \$12,750. His term of office is 2005 – 2007.

Dr. Marty J. Fuller serves as the board appointed director and is not a member of the Association. He is the Director of Federal Relations for Mississippi State University (MSU) and serves as the primary MSU contact with Congress and federal agencies. Prior to this role he served as the Associate Director of the Mississippi Agricultural & Forestry Experiment Station (MAFES). Dr. Fuller is also a Professor in the Department of Agricultural Economics at Mississippi State University. He received his B.S., M.S. and Ph.D. degrees in Agricultural Economics from MSU. During 2005, he served 9 days at Association board meetings and 16 days in other official activities, and was paid \$7,150. His term of office is April 1, 2005 – March 31, 2008.

William T. (Bill) Kyser, a resident of Hale County, Alabama, has a catfish, beef cattle and timber operation which has been his primary operation for the past five years. 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 2005, he served 8 days at Association board meetings and 12 days in other official activities, and was paid \$6,050. His term of office is 2005 – 2007.

Alan Marsh is a partner of Marsh Farms, a 3,000-acre family farming operation consisting of 2,000 acres of cotton, along with corn, soybeans, and wheat which has been his primary operation for the past five years. He is a director of the Limestone Farmers' Federation and President of South Limestone Gin. During 2005, he served 10 days at Association board meetings and 13 days in other official activities, and was paid \$9,150. His term of office is 2005 – 2007.

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 2005, he served 9 days at Association board meetings and 15 days in other official activities, and was paid \$8,050. His term of office is 2004 – 2006.

Daniel Mattingly is the Agricultural Manager for Lula-Westfield, L.L.C. Lula Factory Division (raw sugar factory). He also manages 9,500 acres of farmland owned by Savoie Industries, Inc., and is the voting member of the company for First South. This has been his primary operation for the past five years. Mr. Mattingly serves as treasurer of Assumption Parish Farm Bureau where he has been a member for eight years. He is a member and secretary of the Board of Directors of Savoie Industries, having served on that board for the past five years. He is active in the Assumption Area Chamber of Commerce, Knights of Columbus, and is Vice President of West Ascension Recreation Board. During 2005, he served 11 days at Association board meetings and 14 days in other official activities, and was paid \$8,600. His term of office is 2004 – 2006.

Joe H. Morgan has a 2,300-acre row crop operation consisting of cotton and peanuts which has been his primary operation for the past five years. 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 2005, he served 6 days at Association board meetings and 3 days in other official activities, and was paid \$3,530. His term of office is 2004 – 2006.

Shepherd (Shep) Morris, has a 2,400-acre cotton and grain operation which has been his primary operation for the past five years. 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 on the National Cotton Council. During 2005, he served 11 days at Association board meetings and 16 days in other official activities, and was paid \$9,860. His term of office expired December 31, 2005.*

Thomas H. Nelson, Jr. has a 4,700-acre 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 2005, he served 12 days at Association board meetings and 12 days in other official activities, and was paid \$7,200. His term of office is 2005 – 2007.

Thomas A. Parker has a 4,000-acre farming operation in Lake Providence, Louisiana, consisting of cotton, corn, rice and soybeans which has been his primary operation for the past five years. He also manages an 8,000-acre farm in Arkansas, and is part owner of 300 acres of catfish ponds in Arkansas. Mr. Parker serves as a director on the Hibernia Bank City Board and on the Staplcotn Board. He is the Louisiana member on the Cotton Board, President of East Carroll Farm Bureau and President of Louisiana Cotton Producers. During 2005, he served 9 days at Association board meetings and 2 days in other official activities, and was paid \$5,600. His term of office is 2004 – 2006.

Ted S. Passmore's 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 Louisiana Farm Bureau. During 2005, he served 8 days at Association board meetings and 10 days in other official activities, and was paid \$5,910. His term of office expired December 31, 2005.

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 2005, he served 11 days at Association board meetings and 13 days in other official activities, and was paid \$8,250. His term of office expired December 31, 2005.*

Robert E. Potts operates a 220-acre beef cattle operation, after owning and operating a dairy for the past 37 years. 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 2005, he served 12 days at Association board meetings and 8 days in other official activities, and was paid \$7,750. His term of office expired December 31, 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 2005, he served 10 days at Association board meetings and 15 days in other official activities, and was paid \$8,400. His term of office expired December 31, 2005.*

D. Derwood Strain has a row crop 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 shareholder of Ag Concepts, Inc., and Leflore Hardware, Inc. During 2005, he served 11 days at Association board meetings and 12 days in other official activities, and was paid \$7,330. His term of office expired December 31, 2005.* Because of the age limitation, Mr. Strain was not eligible for re-election.

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 2005, he served 7 days at Association board meetings and 4 days in other official activities, and was paid \$4,730. His term of office is 2005 – 2007.

Dan West's primary operation for the past five years has been a row crop and timber operation in Monroe County, Mississippi, consisting of 2,500 acres cropland and 1,100 acres of timber. Mr. West is part owner of Hamilton Electric Gin and Warehouse. He is a member of Southern Ginners Association, and is a regional

director of Staplcotn. He has served on the board of Monroe County Farm Bureau, Mississippi Bollweevil Management Corporation and is past president of the Mississippi Ginners Association. During 2005, he served 12 days at Association board meetings and 13 days in other official activities, and was paid \$8,310. His term of office is 2004-2006.

* *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 12 to the consolidated financial statements, "Related Party Transactions," included in this annual report to shareholders.

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 March 1, 2006, and the report of management, which appear in this annual report to shareholders 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. The Association prepares a quarterly report within 45 days after the end of each fiscal quarter, except that no report need be prepared for the fiscal quarter that coincides with the end of the fiscal year of the institution.

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.

Shareholder Investment

Shareholder 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. 378, or writing Jay Wise, 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 the Audit Committee

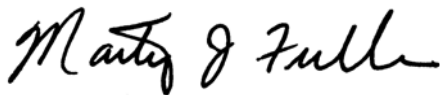
The Audit Committee of the Board of Directors (the Committee) is comprised of the directors named below. None of the directors who serve on the Audit Committee is an employee of First South Farm Credit, ACA (the Association) and in the opinion of the Board of Directors, each is free of any relationship with the Association or management that would interfere with the director's independent judgment on the Committee.

The Committee has adopted a written charter that has been approved by the Board of Directors. The Committee has reviewed and discussed the Association's audited financial statements with management, which has primary responsibility for the financial statements.

PricewaterhouseCoopers LLP (PwC), the Association's independent auditor for 2005, is responsible for expressing an opinion on the conformity of the Association's audited financial statements with generally accepted accounting principles. The Committee has discussed with PwC the matters that are required to be discussed by Statement on Auditing Standards No. 61 (*Communication With Audit Committees*). PwC has provided to the Committee the written disclosures and the letter required by Independence Standards Board Standard No. 1 (*Independence Discussions with Audit Committees*), and the Committee has discussed with PwC that firm's independence.

The Committee has also concluded that PwC's provision of non-audit services, if any, to the Association is compatible with PwC's independence.

Based on the considerations referred to above, the Committee recommended to the Board of Directors that the audited financial statements be included in the Association's Annual Report for 2005. The foregoing report is provided by the following independent directors, who constitute the Audit Committee:



Dr. Marty J. Fuller
Chairman of the Audit Committee

Members of Audit Committee

Paul Clark
James M. Norsworthy, III
W.S. Patrick

Report of Independent Auditors



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

Report of Independent Auditors

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

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of changes in members' equity and of cash flows present fairly, in all material respects, the financial position of First South Farm Credit, ACA (the Association) and its subsidiaries at December 31, 2005, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. 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 of these statements 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

March 1, 2006

Consolidated Balance Sheets

<i>(dollars in thousands)</i>	December 31, 2005	December 31, 2004	December 31, 2003
Assets			
Cash	\$ 20,207	\$ 10,375	\$ 10,372
Loans	985,486	889,076	839,911
Less: allowance for loan losses	5,425	5,189	20,630
Net loans	980,061	883,887	819,281
Accrued interest receivable	12,621	9,504	8,593
Investment in other Farm Credit institutions	61,849	61,513	62,314
Premises and equipment, net	4,351	3,897	3,280
Other property owned	479	739	434
Prepaid retirement expense	7,523	6,581	7,425
Due from AgFirst Farm Credit Bank	9,311	8,555	6,131
Other assets	991	505	1,009
Total assets	<u>\$ 1,097,393</u>	<u>\$ 985,556</u>	<u>\$ 918,839</u>
Liabilities			
Notes payable to AgFirst Farm Credit Bank	\$ 856,986	\$ 759,497	\$ 712,060
Accrued interest payable	3,334	2,253	1,901
Patronage refund payable	3,199	3,105	2,803
Postretirement benefits other than pensions	11,560	11,204	10,472
Other liabilities	8,480	6,834	9,618
Total liabilities	<u>883,559</u>	<u>782,893</u>	<u>736,854</u>
Commitments and contingencies			
Members' Equity			
Protected borrower equity	140	142	147
Capital stock and participation certificates	63,927	63,360	62,952
Retained earnings			
Allocated	68,020	58,064	52,081
Unallocated	81,747	81,097	66,805
Total members' equity	<u>213,834</u>	<u>202,663</u>	<u>181,985</u>
Total liabilities and members' equity	<u>\$ 1,097,393</u>	<u>\$ 985,556</u>	<u>\$ 918,839</u>

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,		
	2005	2004	2003
Interest Income			
Loans	\$ 64,762	\$ 49,669	\$ 49,991
Interest Expense			
Notes payable to AgFirst Farm Credit Bank	34,497	23,686	24,097
Other	—	8	9
Total interest expense	34,497	23,694	24,106
Net interest income	30,265	25,975	25,885
Provision for (reversal of allowance for) loan losses	305	(14,809)	1,200
Net interest income after provision for (reversal of allowance for) loan losses	29,960	40,784	24,685
Noninterest Income			
Loan fees	2,134	1,977	2,024
Fees for financially related services	590	643	585
Patronage refund from other Farm Credit institutions	9,318	8,562	6,134
Gains (losses) on other property owned, net	40	(351)	100
Other noninterest income	151	97	138
Total noninterest income	12,233	10,928	8,981
Noninterest Expense			
Salaries and employee benefits	15,639	14,845	13,959
Occupancy and equipment	1,149	1,142	1,328
Insurance Fund premium	466	423	998
Other operating expenses	4,473	4,242	3,991
Total noninterest expense	21,727	20,652	20,276
Income before income taxes	20,466	31,060	13,390
Provision (benefit) for income taxes	18	754	649
Net income	\$ 20,448	\$ 30,306	\$ 12,741

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, 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 retained earnings			4,199	(4,199)	—
Nonqualified allocated retained earnings			3,069	(3,069)	—
Nonqualified retained earnings			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
Net income				30,306	30,306
Protected borrower equity retired	(5)				(5)
Capital stock/participation certificates issued		1,600			1,600
Capital stock/participation certificates retired		(1,192)			(1,192)
Patronage distribution					
Cash				(3,101)	(3,101)
Qualified allocated retained earnings			4,652	(4,652)	—
Nonqualified allocated retained earnings			3,845	(3,845)	—
Nonqualified retained earnings			4,651	(4,651)	—
Retained earnings retired			(7,004)		(7,004)
Distribution adjustment			(161)	235	74
Balance at December 31, 2004	142	63,360	58,064	81,097	202,663
Net income				20,448	20,448
Protected borrower equity retired	(2)				(2)
Capital stock/participation certificates issued		1,700			1,700
Capital stock/participation certificates retired		(1,133)			(1,133)
Patronage distribution					
Cash				(3,195)	(3,195)
Qualified allocated retained earnings			4,792	(4,792)	—
Nonqualified allocated retained earnings			5,799	(5,799)	—
Nonqualified retained earnings			5,799	(5,799)	—
Retained earnings retired			(6,589)		(6,589)
Distribution adjustment			155	(213)	(58)
Balance at December 31, 2005	\$ 140	\$ 63,927	\$ 68,020	\$ 81,747	\$ 213,834

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,		
	2005	2004	2003
Cash flows from operating activities:			
Net income	\$ 20,448	\$ 30,306	\$ 12,741
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation on premises and equipment	282	344	330
Provision for (reversal of allowance for) loan losses	305	(14,809)	1,200
(Gains) losses on other property owned, net	(40)	351	(100)
(Gains) losses from sale of premises and equipment, net	—	—	(30)
Changes in operating assets and liabilities:			
(Increase) decrease in accrued interest receivable	(3,117)	(911)	1,474
(Increase) decrease in prepaid retirement expense	(942)	844	649
(Increase) decrease in due from AgFirst Farm Credit Bank	(756)	(2,424)	(500)
(Increase) decrease in other assets	(486)	504	107
Increase (decrease) in accrued interest payable	1,081	352	(277)
Increase (decrease) in postretirement benefits other than pensions	356	732	457
Increase (decrease) in other liabilities	1,646	(2,784)	146
Total adjustments	(1,671)	(17,801)	3,456
Net cash provided by (used in) operating activities	18,777	12,505	16,197
Cash flows from investing activities:			
Net (increase) decrease in loans	(96,792)	(50,713)	1,864
(Increase) decrease in investment in other Farm Credit institutions	(336)	801	1,391
Purchase of premises and equipment, net	(736)	(1,501)	(379)
Proceeds from sale of premises and equipment, net	—	540	59
Proceeds from sale of other property owned	613	260	1,161
Net cash provided by (used in) investing activities	(97,251)	(50,613)	4,096
Cash flows from financing activities:			
Advances on (repayment of) notes payable to AgFirst Farm Credit Bank, net	97,489	47,437	(12,721)
Protected borrower equity retired	(2)	(5)	—
Capital stock and participation certificates issued	1,700	1,600	1,936
Capital stock and participation certificates retired	(1,133)	(1,192)	(1,244)
Patronage refunds paid	(3,159)	(2,725)	(3,678)
Retained earnings retired	(6,589)	(7,004)	(5,669)
Net cash provided by (used in) financing activities	88,306	38,111	(21,376)
Net increase (decrease) in cash	9,832	3	(1,083)
Cash, beginning of period	10,375	10,372	11,455
Cash, end of period	\$ 20,207	\$ 10,375	\$ 10,372
Supplemental schedule of non-cash activities:			
Financed sales of other property owned	\$ 161	\$ —	\$ —
Loans transferred to other property owned	474	916	1,439
Cash dividends or patronage distributions declared or payable	3,195	3,101	2,800
Supplemental information:			
Interest paid	\$ 33,416	\$ 23,342	\$ 24,383
Taxes paid, net	399	526	913

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 or ACA) is a member-owned cooperative which provides credit and credit-related services to or for the benefit of eligible borrowers/shareholders 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, 2005, the System was comprised of four Farm Credit Banks and one Agricultural Credit Bank and ninety-six Associations.

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-three ACAs, all of which have reorganized as ACA parent-companies, which have two wholly owned subsidiaries, a Federal Land Credit Association (FLCA) and a Production Credit Association (PCA).

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

The Farm Credit Administration (FCA) is delegated authority by Congress to regulate the System banks and associations. The FCA examines the activities of the associations 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 (1) to ensure the timely payment of principal and interest on Systemwide debt obligations (Insured debt), (2) to 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) or such other percentage of the aggregate obligations as the Insurance Corporation in its sole

discretion determines to be actuarially sound. 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.

The AgFirst Annual Report to Shareholders, the AgFirst District Annual Report to Shareholders, and the AgFirst District's quarterly reports are available on its web site, www.agfirst.com. Upon request, shareholders of the Association will be provided with copies of these reports at no charge by calling 1-800-845-1745, Ext. 378. The Association's financial condition may be impacted by factors that affect the Bank. The Bank's Annual Report discusses the material aspects of the District's financial condition, changes in financial condition, and results of operations. In addition, the District's Annual Report identifies favorable and unfavorable trends, significant events, uncertainties and the impact of activities of the Insurance Corporation.

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

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 intercompany 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 daily principal amount outstanding.

Impaired loans are loans for which it is probable that not all principal and interest will be collected according to the contractual terms of the loan. Impaired loans include nonaccrual loans, restructured loans, and loans past due 90 days or more and still accruing interest. A loan is considered contractually past due when any principal repayment or interest payment required by the loan instrument is not received on or before the due date. A loan shall remain contractually past due until it is formally restructured or until the entire amount past due, including principal, accrued interest, and penalty interest incurred as the result of past due status, is collected or otherwise discharged in full.

Loans are generally placed in nonaccrual status when principal or interest is delinquent for 90 days (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 reversed (if accrued in the current year) or charged against the allowance for loan losses (if accrued in the prior year).

When loans are in nonaccrual status, the interest portion of payments received in cash is 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. Nonaccrual loans may be returned 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."

Loans are charged-off, wholly or partially, as appropriate, at the time they are determined to be uncollectible.

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 a valuation account used to reasonably estimate loan and lease losses existing as of the financial statement date. Determining the appropriate allowance for loan losses balance involves significant judgment about when a loss has been incurred and the amount of that loss. The determination of the allowance for loan losses is based on management's current judgments about the credit quality of its loan and lease portfolio. A specific allowance may be established for impaired loans. 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. See Note 3 for a discussion on the refinement of the allowance for loan losses methodology.

The allowance for loan losses is maintained at a level considered adequate by management to provide for probable and estimable

losses inherent in the loan portfolio. The allowance is increased through provisions for loan losses and loan recoveries and is decreased through reversals of provisions for loan losses and loan charge-offs.

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.

The level of allowance for loan losses is generally based on recent charge-off experience adjusted for relevant environmental factors. The Association considers the following factors when adjusting the historical charge-offs experience:

- Changes in credit risk classifications,
- Changes in collateral values,
- Changes in risk concentrations,
- Changes in weather related conditions, and
- Changes in economic conditions.

- 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 classified as Due from AgFirst Farm Credit Bank.
- 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 cost 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. Land is carried at cost. 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. Amounts in excess of the related loan balance and amounts to which the borrower has unrestricted access are presented as interest-bearing liabilities in the accompanying Balance Sheet. 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 may participate in a defined benefit retirement plan. The "Projected Unit Credit" actuarial method is used for financial reporting purposes and the "Entry-Age Normal Cost" method for funding purposes. As a result of the funded status at the Plan's

measurement date (September 30) of the underlying Plan, the Association may record a minimum liability, an intangible asset relating to unrecognized prior service cost and other comprehensive income (loss). The adjustment to other comprehensive income (loss) would be net of deferred taxes, if significant.

The employees of the Association may also be 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.

Effective January 1, 2006 the Districtwide 401(k) Plan known as the AgFirst Farm Credit Employee Thrift Plan merged with the Farm Credit Bank of Texas Thrift Plus Plan. The new plan is known as the AgFirst/FCBT 401(k) Employee Benefit Plan.

The Association may provide certain health care and life insurance benefits to eligible retired employees. Substantially all employees may become eligible for these benefits if they reach early retirement age while working for the Association.

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.

As previously described, the ACA holding company operates through two wholly-owned subsidiaries. The FLCA subsidiary is exempt from federal and other income taxes as provided in the Farm Credit Act. The ACA and the PCA subsidiary are subject to federal and state income taxes. The Association accounts for income taxes under the asset and liability method. Accordingly, deferred taxes are recognized for estimated taxes ultimately payable or recoverable based on federal, state or local laws.

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 — Refinement of the Allowance for Loan Losses Methodology

During 2004, the Association conducted a study to further refine its allowance for loan losses methodology taking into account recently issued guidance by FCA, the System's regulator, as well as the Securities and Exchange Commission (SEC) and Federal Financial Institutions Examination Council guidelines.

The Association's allowance for loan losses methodology was adjusted and revised in the late 1980s to take into account credit losses in that period. Given the long cyclical nature of the agricultural economy, loss factors utilized to determine the allowance for loan losses subsequent to 1989 continued to reflect,

to some extent, the loss history of the mid-to-late 1980s, which resulted in conservative estimates of the allowance for loan losses. The Association's allowance for loan losses methodology utilized throughout the period was in accordance with generally accepted accounting principles and was consistently applied.

While conservative in estimating the allowance for loan losses, the methodology used resulted in annual provisions for loan losses over the periods that reflected changes in credit quality and loss experience. Accordingly, the reserves provided in the mid-to-late 1980s have, in effect, remained part of the allowance for loan losses. The Association's allowance for loan losses methodology has consistently adhered to proper accounting policies, under the regulatory supervision of FCA in its role as a "safety and soundness" regulator. It was FCA's view that the allowance for loan losses should include among others, an assessment of: probable losses, historical loss experience and economic conditions.

In April 2004, FCA issued an "Informational Memorandum" to System institutions regarding the criteria and methodologies that would be used in evaluating the adequacy of a System institution's allowance for loan losses. FCA endorsed the direction provided by other bank regulators and the SEC and indicated the conceptual framework addressed in their guidance would be included as part of their examination process.

During the fourth quarter of 2004, the Association completed its study and refined its methodology to be in compliance with the guidance discussed in the previous paragraph. The refinement in methodology resulted in a calculated allowance for loan losses that was significantly less than the previously recorded balance due to revised loss factors that are more indicative of actual loss experience in recent years and current borrower analysis.

While the \$14,809 reversal had a significant impact on 2004 results of operations and the previously recorded allowance for loan losses, the refinement in methodology did not have a significant impact on 2005 comparative results of operations and is not expected to have a significant impact in future periods. Additionally, the refinement in methodology did not have a significant impact on the level of the risk bearing capacity of the Association, generally referred to as "risk funds" (capital plus the allowance for loan losses), which totaled \$219,259 at December 31, 2005 (22.25 percent of Association loans), as compared with \$207,852 at December 31, 2004 (23.38 percent of Association loans), and \$202,615 at December 31, 2003 (24.12 percent of Association loans).

Note 4 — Loans and Allowance for Loan Losses

A summary of loans follows:

	December 31,		
	2005	2004	2003*
Production and intermediate term	\$ 956,274	\$ 856,865	\$ *
Agribusiness:			
Loans to cooperatives	583	-	*
Processing and marketing	4,799	7,224	*
Farm related business	17,041	16,562	*
Communication	778	1,556	*
Energy	3,906	3,937	*
Rural residential real estate	2,105	2,932	*
Total loans	<u>\$ 985,486</u>	<u>\$ 889,076</u>	<u>\$ 839,911</u>

* Note: Beginning with year-end 2004, loan type categories have been expanded to provide additional information on the types of loans made. As a result, three years of comparable data is not available.

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, 2005, 2004 and 2003 consisted of the following commodity types:

Commodity Type	December 31,		
	2005	2004	2003
Poultry	31%	31%	32%
Forestry	18	16	15
Cotton	13	14	13
Livestock	8	8	9
Sugar Cane	7	7	6
Catfish	4	5	5
Rice	4	4	3
Peanuts	2	2	2
Soybeans	2	2	2
Dairy	1	1	1
Other	10	10	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,		
	2005	2004	2003
Nonaccrual loans:			
Current as to principal and interest	\$ 1,193	\$ 752	\$ 1,289
Past due	1,291	2,559	2,676
Total nonaccrual loans	2,484	3,311	3,965
Impaired accrual loans:			
Restructured accrual loans	842	145	109
Accrual loans 90 days or more past due	195	-	10
Total impaired accrual loans	1,037	145	119
Total impaired loans	\$ 3,521	\$ 3,456	\$ 4,084

There were no material commitments to lend additional funds to debtors whose loans were classified as impaired at December 31, 2005.

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,		
	2005	2004	2003
Interest income recognized on nonaccrual loans	\$ 312	\$ 351	\$ 1,078
Interest income on impaired accrual loans	267	425	58
Interest income recognized on impaired loans	\$ 579	\$ 776	\$ 1,136

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

	2005	2004	2003
Impaired loans with related allowance	\$ 865	\$ 1,312	\$ 1,275
Impaired loans with no related allowance	2,656	2,144	2,809
Total impaired loans	\$ 3,521	\$ 3,456	\$ 4,084
Allowance on impaired loans	\$ 251	\$ 348	\$ 276

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

	2005	2004	2003
Average impaired loans	\$ 4,321	\$ 5,582	\$ 4,208

The following table summarizes interest income on nonaccrual and accruing restructured loans that would have been recognized under the original terms of the loans:

	Year Ended December 31	
	2005	2004
Interest income which would have been recognized under the original loan terms	\$ 508	\$ 714
Less: interest income recognized	312	351
Foregone interest income	\$ 196	\$ 363

The changes in the allowance for loan losses are as follows:

	Year Ended December 31,		
	2005	2004	2003
Balance at beginning of year	\$ 5,189	\$ 20,630	\$ 20,717
Provision for (reversal of allowance for) loan losses	\$ 305	\$ -	\$ 1,200
Nonrecurring provision for loan losses reversal	-	(14,809)	-
	305	(14,809)	1,200
Charge-offs:			
Production agriculture:			
Production and intermediate term	\$ 217	\$ 815	\$ 1,449
Total charge-offs	217	815	1,449
Recoveries			
Production agriculture:			
Production and intermediate term	\$ 148	\$ 183	\$ 162
Total recoveries	148	183	162
Net charge-offs (recoveries)	69	632	1,287
Balance at end of year	\$ 5,425	\$ 5,189	\$ 20,630
Ratio of net charge-offs during the period to average loans outstanding during the period	0.007%	0.072%	0.148%

As previously discussed in Note 3, the nonrecurring provision for loan losses reversal resulted from the refinement of the Association's allowance for loan losses methodology.

In addition, the following is a breakdown of the allowance for loan losses for the end of the last three fiscal years:

	December 31,					
	2005		2004		2003*	
	Amount	%	Amount	%	Amount	%
Production and intermediate term	\$ 5,281	97.3%	\$ 5,031	97.0%	\$ *	* %
Agribusiness	116	2.1	118	2.3	*	*
Communication	3	0.1	7	0.1	*	*
Energy	16	0.3	17	0.3	*	*
Rural residential real estate	9	0.2	16	0.3	*	*
Total	<u>\$ 5,425</u>	<u>100.0%</u>	<u>\$ 5,189</u>	<u>100.0%</u>	<u>\$ 20,630</u>	<u>100.0%</u>

*Note: Beginning with year-end 2004, loan type categories have been expanded to provide additional information on the types of loans made. As a result, three years of comparable data is not available.

Note 5 — 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 6 — Premises and Equipment

Premises and equipment consisted of the following:

	December 31,		
	2005	2004	2003
Land	\$ 1,320	\$ 1,339	\$ 967
Buildings and improvements	6,156	5,560	5,287
Furniture and equipment	2,158	2,250	2,113
	<u>9,634</u>	<u>9,149</u>	<u>8,367</u>
Less: accumulated depreciation	5,283	5,252	5,087
Total	<u>\$ 4,351</u>	<u>\$ 3,897</u>	<u>\$ 3,280</u>

Note 7 — 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 5.30 percent for LIBOR-based loans, 5.17 percent for Prime-based loans, and the weighted average remaining maturities were 2.5 years and 2.7 years, respectively, at December 31, 2005. The weighted average interest rate on the fixed rate and adjustable rate mortgage (ARM) notes payable which are match funded by the Bank was 4.32 percent and the weighted average remaining maturity was 4.0 years at December 31, 2005. The weighted average interest rate on all interest-bearing notes

payable was 4.65 percent and the weighted average remaining maturity was 3.5 years at December 31, 2005.

Variable rate and fixed rate notes payable represent approximately 26.55 percent and 73.45 percent, respectively, of total notes payable at December 31, 2005.

Under the Farm Credit Act, the Association is obligated to borrow only from the Bank, unless the Bank approves borrowing from other funding sources. 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, 2005, the Association's notes payable were within the specified limitations.

Note 8 — 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, 2005 were 13.63 percent, 12.43 percent and 10.40 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, 2005:

Class	Protected	Shares Outstanding	
		Number	Aggregate Par Value
A Preferred/Nonvoting	Yes	11,257	\$ 56
A Common/Nonvoting	No	28,062	140
C Common/Voting	No	2,603,930	13,020
Common Issued to Bank/Nonvoting	No	10,117,847	50,589
C Participation Certificates/Nonvoting	No	52,328	262
Total Capital Stock and Participation Certificates		12,813,424	\$ 64,067

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, 2005, allocated members’ equity consisted of \$34,746 of qualified surplus, \$14,895 of nonqualified allocated surplus and \$18,379 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 9 — Income Taxes

The provision (benefit) for income taxes follows:

	Year Ended December 31,		
	2005	2004	2003
Current:			
Federal	\$ (20)	\$ 298	\$ 574
State	35	(18)	70
	15	280	644
Deferred:			
Federal	3	474	5
State	—	—	—
	3	474	5
Total provision (benefit) for income taxes	<u>\$ 18</u>	<u>\$ 754</u>	<u>\$ 649</u>

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:

	December 31,		
	2005	2004	2003
Federal tax at statutory rate	\$ 6,959	\$ 10,560	\$ 4,553
State tax, net	23	(12)	46
Patronage distributions	(2,716)	(2,362)	(1,841)
Tax-exempt FLCA earnings	(4,146)	(4,397)	(2,163)
Reversal of allowance for loan losses	—	(3,352)	—
Other	(102)	317	54
Provision (benefit) for income taxes	<u>\$ 18</u>	<u>\$ 754</u>	<u>\$ 649</u>

Deferred tax assets and liabilities result from the following at:

	December 31,		
	2005	2004	2003
Allowance for loan losses	\$ 1,061	\$ 114	\$ 578
Nonaccrual loan interest	323	32	32
Postretirement benefits other than pensions	2,237	472	442
Depreciation	57	—	—
Other	11	—	—
Gross deferred tax assets	3,689	618	1,052
Valuation allowance	(2,079)	(432)	(413)
Net deferred tax assets	1,610	186	639
Loan fees	(6)	(1)	(1)
Pensions	(1,799)	(377)	(355)
Gross deferred tax liability	(1,805)	(378)	(356)
Net deferred tax asset (liability)	<u>\$ (195)</u>	<u>\$ (192)</u>	<u>\$ 283</u>

The Association recorded a valuation allowance of \$2,079 during 2005. The valuation allowance was \$432 and \$413 for 2004 and 2003, respectively. The Association will continue to evaluate the realizability of these deferred tax assets and adjust the valuation allowance accordingly.

At December 31, 2005, 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 10 — Employee Benefit Plans

The employees of the Association may 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 obligations and funded status of the retirement plan:

	As of December 31,		
	2005	2004	2003
Change in projected benefit obligation			
Benefit obligation at beginning of year	\$ 38,737	\$ 36,387	\$ 31,162
Service cost	1,238	1,155	978
Interest cost	2,281	2,232	2,064
Actuarial loss (gain)	4,625	339	3,502
Benefits paid	(1,403)	(1,376)	(1,319)
Benefit obligation at end of year	\$ 45,478	\$ 38,737	\$ 36,387
Change in plan assets			
Fair value of plan assets at beginning of year	\$ 32,402	\$ 30,056	\$ 26,991
Actual return on plan assets	3,513	3,014	3,576
Employer contributions	2,500	1,012	1,021
Benefits paid	(1,403)	(1,376)	(1,318)
Expenses	(272)	(303)	(214)
Fair value of plan assets at end of year	\$ 36,740	\$ 32,403	\$ 30,056
Funded status (benefit obligation less FV of plan assets)	\$ (8,738)	\$ (6,334)	\$ (6,331)
Unrecognized net actuarial loss (gain)	17,328	12,749	13,664
Unrecognized prior service cost	(379)	1,192	1,457
Unrecognized net (asset) or obligation	(688)	(1,026)	(1,364)
Net amount recognized	\$ 7,523	\$ 6,581	\$ 7,426
Prepaid benefit costs	\$ 7,523	\$ 6,581	\$ 7,426
Accumulated benefit obligation for the defined benefit plan at December 31			
Projected benefit obligation	\$ 45,478	\$ 38,737	\$ 36,387
Accumulated benefit obligation	36,529	32,126	28,776
Fair value of plan assets	36,740	32,403	30,056
Components of net periodic benefit/(income) cost			
Service cost	\$ 1,239	\$ 1,155	\$ 978
Interest cost	2,281	2,232	2,064
Expected return on plan assets	(2,523)	(2,342)	(2,101)
Amortization of net (gain) loss	(338)	(338)	(338)
Amortization of prior service cost	143	264	264
Recognized net actuarial (gain)/loss	756	885	803
Net periodic benefit (income) cost	\$ 1,558	\$ 1,856	\$ 1,670
Assumptions:			
Weighted-average assumptions used to determine benefit obligations at December 31			
Discount rate	5.25%	6.00%	6.25%
Rate of compensation increase	5.00%	5.00%	5.00%
Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31			
Discount rate	6.00%	6.25%	6.75%
Expected long-term return on plan assets	8.00%	8.00%	8.00%
Rate of compensation increase	5.00%	5.00%	5.00%

In 2005, 2004 and 2003 the Association used a long-term rate of return of 8 percent. The Association utilizes a weighted average of expected returns for each major class based on the asset allocation percentages for the plan assets. Prevailing market conditions, historical trends and peer comparisons were also utilized in assigning the 8 percent expected rate of return.

PLAN ASSETS	2005	2004	2003
Asset Category			
Equity securities	67%	64%	66%
Debt securities	29%	31%	32%
Other	4%	5%	2%
	100%	100%	100%

Target allocation for asset categories for 2006 are as follows:

Asset Category	
Equity securities	60-70%
Debt securities	30-40%
	100%

Expected Benefit Payments: The total employer contribution expected during 2006 is \$1,250. Estimated future benefit payments are as follows:

Fiscal 2006	\$ 1,553
Fiscal 2007	\$ 1,542
Fiscal 2008	\$ 1,562
Fiscal 2009	\$ 1,759
Fiscal 2010	\$ 2,111
Fiscal 2011 – 2015	\$ 14,406

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. In May 2004, the FASB issued FASB Staff Position (FSP) 106-2, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act). This Staff Position provides guidance on the accounting for the effects of the Act for employers that sponsor postretirement health care plans that provide prescription drug benefits. The District sponsored plan adopted FSP 106-2 effective July 1, 2004 (measured as of March 31, 2004). The benefit obligation valuation as of December 31, 2005 and 2004 reflects the impact of the Medicare Act.

In determining the benefit obligation as of December 31, 2004, the expected per capita claims cost were estimated to be reduced by 12 percent beginning in 2006, for Medicare-eligible participants receiving actuarially equivalent drug benefits, due to a government reimbursement of a portion of prescription drug benefits. The District reduced its accumulated postretirement benefit obligation (APBO) for the subsidy related to benefits attributed to past service. The effect of the subsidy on the measurement of net periodic postretirement cost for 2005 was a reduction of 2005 expense. The effect included lower amortization of actuarial losses, lower service costs and lower interest costs on the APBO.

Medical and prescription drug coverage for Medicare-eligible participants was changed effective January 1, 2006. Beginning in 2006, the AgFirst Farm Credit District Welfare Benefit Plan will provide medical and prescription drug coverage to Medicare-eligible retirees and spouses through fully-insured AARP endorsed Medicare Supplement policies and basic Medicare D coverage through a selected Prescription Drug Plan. Dental coverage was not changed.

For further information on postretirement costs, see "Postretirement Benefits" section in the Notes to the AgFirst Farm Credit District Consolidated Financial Statements.

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

	2005	2004	2003
Pension	\$ 1,558	\$ 1,856	\$ 1,670
Thrift/deferred compensation	270	259	241
Other postretirement benefits	835	1,163	963
Total	\$2,663	\$3,278	\$2,874

Note 11 — 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 was the responsibility of System banks. In June 2005, the last outstanding Financial Assistance Corporation debt of \$325 million matured and was 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, 2005, the assets in the Insurance Fund aggregated \$2.062 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 12 — 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, 2005 amounted to \$14,549. During 2005, \$16,962 of new loans were made and repayments totaled \$16,715. In the opinion of management, none of these loans outstanding at December 31, 2005 involved more than a normal risk of collectibility.

Note 13 — 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/or 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, 2005, \$269,257 of commitments to extend credit and no commercial 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 April 2006 to July 2011. The maximum potential amount of future payments the Association is required to make under the guarantees is \$1,594.

Note 14 — 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, 2005, 2004 and 2003. 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, 2005		December 31, 2004	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash	\$ 20,207	\$ 20,207	\$ 10,375	\$ 10,375
Loans	\$ 985,486	\$ 988,645	\$ 889,076	\$ 898,482
Allowance for loan losses	5,425	—	5,189	—
Loans, net	\$ 980,061	\$ 988,645	\$ 883,887	\$ 898,482
Financial liabilities:				
Notes payable to AgFirst Farm Credit Bank	\$ 856,986	\$ 851,290	\$ 759,497	\$ 758,074
December 31, 2003				
	Carrying Amount	Estimated Fair Value		
Financial assets:				
Cash	\$ 10,372	\$ 10,372		
Loans	\$ 839,911	\$ 849,656		
Allowance for loan losses	20,630	—		
Loans, net	\$ 819,281	\$ 849,656		
Financial liabilities:				
Notes payable to AgFirst Farm Credit Bank	\$ 712,060	\$ 712,822		

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 5, 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 6.76 percent of the issued stock of the Bank as of December 31, 2005 net of any reciprocal investment. As of that date, the Bank's assets totaled \$20.5 billion and shareholders' equity totaled \$1,037 million. The Bank's earnings were \$164 million during 2005.

In addition, the Association has an investment of \$29 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 15 — Quarterly Financial Information (Unaudited)

Quarterly results of operations for the years ended December 31, 2005, 2004 and 2003 follow:

	2005				
	First	Second	Third	Fourth	Total
Net interest income	\$ 6,611	\$ 7,282	\$ 8,336	\$ 8,036	\$ 30,265
Provision for (reversal of) loan losses	—	—	305	—	305
Noninterest income (expense), net	(2,613)	(2,639)	(2,698)	(1,562)	(9,512)
Net income (loss)	\$ 3,998	\$ 4,643	\$ 5,333	\$ 6,474	\$ 20,448

	2004				
	First	Second	Third	Fourth	Total
Net interest income	\$ 5,765	\$ 6,220	\$ 6,969	\$ 7,021	\$ 25,975
Provision for (reversal of) loan losses	—	—	—	(14,809)	(14,809)
Noninterest income (expense), net	(3,104)	(3,033)	(2,362)	(1,979)	(10,478)
Net income (loss)	\$ 2,661	\$ 3,187	\$ 4,607	\$ 19,851	\$ 30,306

	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