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# PUERTO RICO FARM CREDIT, ACA

# **2003 ANNUAL REPORT**

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## **Management**

William A. Garrahan.....	President and Chief Executive Officer
Sonia Arteaga .....	Vice President and Chief Lending Officer
Bruce M. Hoffman.....	Vice President and Chief Financial Officer/Treasurer

## **Board of Directors**

Juan A. Santiago .....	Chairman
Damián Rivera .....	Vice Chairman
Francisco del Río .....	Director
Felipe Ozonas-Morell .....	Director
Carlos A. Rodríguez.....	Director
Carlos R. Urrutia .....	Director
Francisco I. Sella.....	External Director

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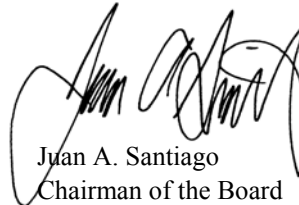
## *Report of Management*

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

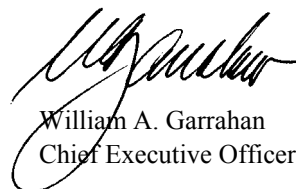
Management maintains and depends upon an internal accounting control system designed to provide reasonable assurance that transactions are properly authorized and recorded, that the financial records are reliable as the basis for the preparation of all financial statements, and that the assets of the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

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

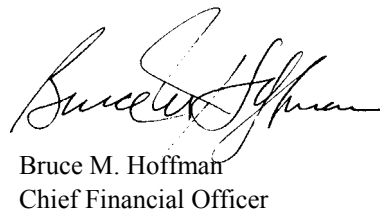
The consolidated financial statements, in the opinion of management, fairly present the financial condition of the Association. The undersigned certify that the 2003 Annual Report has been prepared in accordance with all applicable statutory or regulatory requirements and that the information contained herein is true, accurate, and complete to the best of our knowledge and belief.



Juan A. Santiago  
Chairman of the Board



William A. Garrahan  
Chief Executive Officer



Bruce M. Hoffman  
Chief Financial Officer

February 19, 2004

# Consolidated Five - Year Summary of Selected Financial Data

(UNAUDITED)

<i>(dollars in thousands)</i>	2003	2002	December 31, 2001	2000	1999
<b>Balance Sheet Data</b>					
Cash	\$ 16	\$ 92	\$ 37	\$ 56	\$ 3,319
Loans	223,321	204,510	173,043	170,229	162,380
Less: allowance for loan losses	5,983	6,498	6,674	6,680	6,500
Net loans	217,338	198,012	166,369	163,549	155,880
Investment in AgFirst Farm Credit Bank	4,712	4,712	4,712	5,236	5,236
Other property owned	—	—	10	29	216
Other assets	1,588	1,507	2,839	3,454	3,169
Total assets	\$ 223,654	\$ 204,323	\$ 173,967	\$ 172,324	\$ 167,820
Notes payable to AgFirst Farm Credit Bank*	\$ 172,671	\$ 154,689	\$ 126,564	\$ 127,119	\$ 125,076
Accrued interest payable and other liabilities with maturities of less than one year	3,716	3,550	1,638	1,938	1,883
Other liabilities with maturities of greater than one year	1,412	1,207	1,079	834	772
Total liabilities	177,799	159,446	129,281	129,891	127,731
Capital stock and participation certificates	1,022	1,001	974	1,012	1,073
Unallocated retained earnings	46,654	45,914	43,712	41,421	39,016
Accumulated other comprehensive income (loss)	(1,821)	(2,038)	—	—	—
Total stockholders' equity	45,855	44,877	44,686	42,433	40,089
Total liabilities and stockholders' equity	\$ 223,654	\$ 204,323	\$ 173,967	\$ 172,324	\$ 167,820
<b>Statement of Income Data</b>					
Net interest income	\$ 5,909	\$ 5,982	\$ 7,307	\$ 7,680	\$ 6,874
Provision for (reversal of) loan losses	(515)	(174)	—	180	—
Dividends from AgFirst Farm Credit Bank	—	1,200	—	—	—
Noninterest income (expense), net	(3,684)	(3,399)	(3,636)	(3,846)	(3,431)
Net income	\$ 2,740	\$ 3,957	\$ 3,671	\$ 3,654	\$ 3,443
<b>Key Financial Ratios</b>					
Rate of return on average:					
Total assets	1.28%	2.15%	2.18%	2.19%	1.96%
Total stockholders' equity	5.94%	8.57%	8.28%	8.72%	8.68%
Net interest income as a percentage of average earning assets	2.80%	3.34%	4.56%	4.82%	3.93%
Net chargeoffs (recoveries) to average loans	—	0.001%	0.004%	—	—
Total stockholders' equity to total assets	20.50%	21.96%	25.69%	24.62%	23.89%
Debt to members' equity (:1)	3.88	3.55	2.89	3.06	3.19
Allowance for loan losses to loans	2.68%	3.18%	3.86%	3.92%	4.00%
Permanent capital ratio	25.85%	27.10%	28.98%	27.84%	26.57%
Total surplus ratio	25.26%	26.46%	28.24%	26.99%	25.75%
Core surplus ratio	25.26%	26.46%	28.24%	26.99%	25.75%
<b>Net Income Distribution</b>					
Cash dividends declared	\$ 2,000	\$ 1,751	\$ 1,386	\$ 1,259	\$ 1,167

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

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

*(dollars in thousands, except as noted)*

The following commentary reviews the financial condition and results of operations of Puerto Rico Farm Credit, ACA (the Association) for the years ended December 31, 2003 and 2002. This information should be read in conjunction with the consolidated financial statements and other sections of this annual report.

The year 2003 proved to be very good for the Association's borrowers, who benefited from a decreasing interest rate environment. The lower rate environment also benefited island real estate values which continued to trend upward. For a fourth consecutive year the island escaped the negative impact of a hurricane, favorably influencing almost all crops and ag-industries which showed solid to good performance. During the second half of 2003 the local poultry situation changed dramatically, as new owner/operators for PICU and PAPRI arrived. The Association enters 2004 patiently waiting to see if the new integrators can find a successful market-based solution.

Agricultural initiatives implemented by the Commonwealth government continued to be programs designed to benefit individual farmers. Most of the initiatives have been direct investment to promote ag-industries that support primarily smaller farmers through production, processing and marketing groups.

## **LOAN PORTFOLIO**

The Association provides funds to farmers, rural homeowners and farm-related businesses for financing short and intermediate-term loans and long-term real estate mortgage loans. Credit and related services are available to farmers and rural homeowners in the Association's territory by visiting the office in Hato Rey, calling 1-800-981-3323 or visiting the Association's website at [www.puertoricofarmcredit.com](http://www.puertoricofarmcredit.com). The diversification of the Association's loan portfolio by type of loan is shown below:

<b>Loan Type (Volume)</b>	<b>12/31/03</b>	<b>12/31/02</b>
Long-term farm mortgage	\$ 137,265	\$ 124,000
Production and intermediate-term	20,914	29,182
Rural home	27,110	25,529
Nonaccruals	2,943	4,441
Participations purchased	38,607	25,620
Less: Participations sold	(3,518)	(4,262)
	<u>\$ 223,321</u>	<u>\$ 204,510</u>

<b>Loan Type (Percentage)</b>	<b>12/31/03</b>	<b>12/31/02</b>
Long-term farm mortgage	61.47%	60.63%
Production and intermediate-term	9.36	14.27
Rural home	12.14	12.48
Nonaccruals	1.32	2.17
Participations purchased	17.29	12.53
Less: Participations sold	(1.58)	(2.08)
	<u>100.00%</u>	<u>100.00%</u>

There continued to be significant change in the composition of the loan portfolio over the past year; particularly, with the Association buying and selling participation loans within and outside the Farm Credit System (FCS). The increase in participation loans was the continuation of a Board of Directors initiative begun during the second half of 2000 to diversify the geographical risk exposure of the loan portfolio, and realize additional sources of income. Management and the Board of Directors believe the major factor protecting the balance sheet and income statement will be continued diversification, spreading both geographic and industry risk concentrations.

As of December 31, 2003, net participation loans purchased totaled \$35,089, compared to \$21,358 at December 31, 2002. At year end 2003, participation loans purchased primarily from other FCS institutions totaled \$24,352 and participations purchased from non-FCS institutions in the secondary market totaled \$14,255, off-set by \$3,518 in participation loans sold to other FCS institutions. This compared to year-end 2002 when participations purchased totaled \$22,652 and \$2,968, respectively and was off-set by \$4,262 of participations loans sold.

The Association's local service area (LSA) loan portfolio continued to be diversified over a range of agricultural commodities. The predominant agricultural commodities in the Association's LSA portfolio were dairy, livestock (primarily beef cattle), fruits and field crops. These four industries constituted approximately \$130.3 million or 57.9 percent of the total loan portfolio. This compared to 2002 when the same four industries comprised approximately \$125.3 million or 60.4 percent of the total loan portfolio. Please refer to Note 3 in the Notes to the Consolidated Financial Statements section of this Annual Report for additional information concerning loan types and loan portfolio.

The gross loan volume of the Association as of December 31, 2003 was \$223,321, an increase of \$18,811 or 9.2 percent, as compared to \$204,510 at December 31, 2002. Net loans outstanding at December 31, 2003 were \$217,338 as compared to \$198,012 at December 31, 2002. The change in net loans of \$19,326 resulted from the increase in gross loans and a decrease in the allowance for loan losses.

Net loans accounted for 97.2 percent of total assets at December 31, 2003, as compared to 96.9 percent at December 31, 2002. Besides the material increase in net loan volume, most all other asset classifications remained at all-time low levels. Given the record low interest rate environment, accrued interest receivable only increased by \$57 to \$876. Also, management worked diligently to reduce other non-earning and non-productive assets.

During 2002 other assets decreased by \$788 due to the underfunded status of the retirement plan. The underfunded status resulted in eliminating a prepaid asset, recording a minimum pension liability and reducing stockholder's equity for the unrealized loss classified as other comprehensive income. See further discussion in Note 10 in the Notes to the Consolidated Financial Statements.

There is inherent risk in the extension of any type of credit. Association management maintains an allowance for loan losses in an amount sufficient to absorb losses inherent in the loan portfolio. The allowance is determined based on regular quarterly assessments of the probable estimated losses and is in compliance with applicable regulatory standards and generally accepted accounting principles. The methodology for measuring the level of allowance consists of several elements, including specific loan allocations, general allocations to pools of loans and unallocated reserves. While allocations are made to specific loans and pools of loans, the total amount reserved is available for all credit related losses. The allowance for loan losses at December 31, 2003 was \$5,983 and was considered by management to be adequate to cover the estimated risk of loss. This was a decrease of \$515 or 7.9 percent from December 31, 2002. The reductions, during the third and fourth quarters of 2003, continued a trend begun back in 2001. As interest rates trended downward, delinquency rates declined and the overall credit quality of the portfolio improved. Additionally, the Association benefited from a 35.5 percent decline in the amount of high-risk assets, primarily nonaccrual loans. The ratio of the allowance for loan losses to gross loans outstanding at December 31, 2003 was 2.68 percent, a decrease from December 31, 2002 when the ratio was 3.18 percent.

The decrease in the ratio reflected not only the reduction in the level of allowance, but also the increase in loan volume. However, the allowance for loan losses does continue to reflect management's conservative approach to estimating probable loan losses, and the relevant factors impacting the LSA poultry industry.

There were no charge-offs and no recoveries during 2003. This compared to net charge-offs for the twelve months ended December 31, 2002 of \$2. Please refer to Note 2 in the Notes to the Consolidated Financial Statements of this Annual Report for additional information concerning the allowance for loan losses.

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

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

The Association's loan portfolio is segregated into performing asset and high-risk asset categories. The loan portfolio's high-risk assets, including accrued interest, were categorized as follows:

	<u>12/31/03</u>	<u>12/31/02</u>
<b>High-risk Assets</b>		
Nonaccrual loans	\$ 2,943	\$ 4,441
Restructured loans	—	—
Accruing loans 90 days past due	—	126
Total high-risk loans	<u>2,943</u>	<u>4,567</u>
Other property owned	—	—
Total high-risk assets	<u>\$ 2,943</u>	<u>\$ 4,567</u>
<b>Ratios</b>		
Nonaccrual loans to total loans	1.32%	2.17%
High-risk assets to total assets	1.32%	2.23%

Nonaccrual loans decreased by \$1,498 or 33.7 percent during 2003 primarily due to repayments and payoffs. The nonaccrual investment balance at December 31, 2003 continued to be comprised mostly of one large loan which totaled \$1,252 or 42.5 percent of total nonaccrual loans. This compared to December 31, 2002 when this one large nonaccrual loan totaled \$2,521 or 56.8 percent of total nonaccrual loans. Additionally, another \$977 or 33.2 percent involved poultry growers mostly related with the bankrupt integrator PAPRI.

Loan restructuring is available to financially distressed borrowers. Restructuring of loans occurs when the Association grants a concession to a borrower based on either a court order or good faith in a borrower's ability to return to financial viability. The concessions can be in the form of a modification of terms or rates, a compromise of amounts owed, or deed in lieu of foreclosure.

Restructured loans may also involve receipt of other assets and/or equity to pay the loan fully or partially. The type of alternative financing structure chosen is based on minimizing the estimated loss to be incurred by both the Association and the borrower.

**RESULTS OF OPERATIONS**

Net income for the twelve months ended December 31, 2003 totaled \$2,740, a decrease of \$1,217 or 30.8 percent compared to net income of \$3,957 for the twelve months ended December 31, 2002. Primarily the decrease was related to the lack of a dividend distribution from AgFirst Farm Credit Bank (the Bank). During 2002, the Association received a dividend which totaled \$1,200.

Interest income for the year ended December 31, 2003 was \$8,462, an increase of \$257 or 3.1 percent as compared to \$8,205 for the year ended December 31, 2002. Similarly, interest expense on notes payable to the Bank increased to \$2,553 for the twelve months ended December 31, 2003. This compared to \$2,223 in interest expense for the twelve months ended December 31, 2002. The increase in interest expense totaled \$330 or a 14.8 percent change from 2002. Major components of the change in net income for the past two years are outlined in the following table:

*Changes in Net Income:*

	<u>2003-2002</u>	<u>2002-2001</u>
<b>Net income (prior year)</b>	\$ 3,957	\$ 3,671
<b>Increase (decrease) in net income due to:</b>		
Interest income accruing loans	368	(3,364)
Interest income nonaccruing loans	(112)	(154)
Interest income investments	1	—
Interest expense direct notes	(337)	3,285
Interest credit loanable funds	7	(1,092)
Net interest income	(73)	(1,325)
Dividend from AgFirst	(1,200)	1,200
Provision for loan losses	341	174
Noninterest income	44	32
Noninterest expense	(142)	(484)
Restructuring charges	—	532
Benefit (provision) for income taxes	(187)	157
Total changes in income	<u>(1,217)</u>	<u>286</u>
Net income	<u>\$ 2,740</u>	<u>\$ 3,957</u>

Net interest income for 2003 decreased \$73 or 1.2 percent, primarily as a result of a \$112 decrease in the collection of memo interest income from nonaccrual loans. Otherwise, net interest income increased by \$39, principally due to the increase in gross accruing loans outstanding.

Interest income is composed of interest income from accruing loans and interest income collected and recognized from nonaccrual loans. Interest income from nonaccrual loans for the twelve months ended December 31, 2003 was \$234, a decrease of \$112 or 32.4 percent when compared to \$346 for the twelve months of 2002. Given the significantly lower level of nonaccrual loans, management continues to project that nonaccrual interest income recognized in future years will not match the amounts recorded during prior years.

Unlike 2002 and 2001, when the interest rate environment decreased so significantly, 2003 resulted in a more level rate environment. Thus, for 2003 the interest credit earned on loanable funds from the Bank was basically the same as 2002, actually increasing by \$7.

Management expects a protracted lower rate environment, lasting several years. In response, action was taken during the fourth quarter of 2003 to extend the maturity on a portion of the loanable funds balance in order to obtain a higher rate of return. Projections for 2004 indicate that this action should enhance net interest income by at least \$150.

Refer to page 5 of this report for the Consolidated Five Year Summary of Selected Financial Data to review key financial ratios pertaining to net interest income and final net income. The sources of change in net interest income are illustrated as follows:

**Change in Net Interest Income:**

	<u>Volume*</u>	<u>Rate</u>	<u>Nonaccrual Income</u>	<u>Total</u>
<b>12/31/03 - 12/31/02</b>				
Interest income	\$ 1,391	\$ (1,022)	\$ (112)	\$ 257
Interest expense	473	(143)	—	330
Change in net interest income	<u>\$ 918</u>	<u>\$ (879)</u>	<u>\$ (112)</u>	<u>\$ (73)</u>
<b>12/31/02 - 12/31/01</b>				
Interest income	\$ 1,335	\$ (4,699)	\$ (154)	\$ (3,518)
Interest expense	516	(2,709)	—	(2,193)
Change in net interest income	<u>\$ 819</u>	<u>\$ (1,990)</u>	<u>\$ (154)</u>	<u>\$ (1,325)</u>

\* *Volume variances can be either the result of decreases in loans outstanding or from changes in the composition of loan assets and related liabilities.*

During 2003, due to improved credit quality and delinquency, management reduced the allowance for loan losses. This resulted in a reversal of provision which totaled \$515, favorably impacting net income. This compared to 2002, when a reversal of provision which totaled \$174 was recorded, also enhancing net income.

Noninterest income for the period ending December 31, 2003 was \$295 compared to \$1,438 for the period ending December 31, 2002. The decrease of \$1,143 was primarily the result of the Bank not declaring a dividend during 2003. If the \$1,200 dividend was not considered for 2002, then noninterest income would have increased by \$57, as a result of higher loan fees from the larger number and volume of participation loans.

Noninterest expense increased by \$156 or 4.1 percent for the twelve months ended December 31, 2003, as compared to the same period of 2002. Primarily, material increases in the insurance fund premium and guarantee fee paid to the Bank, which together totaled \$231, were partially offset by a decrease in other operating expenses totaling \$73.

The increase in salaries and employee benefits for 2003 and 2002, when compared to 2001, primarily related to increased employee benefits expense. During 2003 and 2002 retirement related expenses totaled \$725 and \$432, respectively, compared to only \$152 in retirement related expenses incurred during 2001. Specifically, retirement plan expense increased during the past two years as a result of the decline in the market value of the invested plan assets. The amount of retirement plan funding is determined by overall plan performance, which is measured as of September 30 of each year.

During 2003, the Association recorded a provision for income tax which totaled \$3, as compared to a benefit for income tax of \$183 for the twelve months of 2002. The benefit recognized during 2002 was the result of recording a prior period adjustment for a refund received from the IRS, as discussed in Note 9 of the Notes to the Consolidated Financial Statements in this Annual Report.

The Association's financial goals continue to be the same as in previous years: the generation of sufficient net income to maintain a highly capitalized Association and declare and pay an attractive dividend to the LSA stockholders/borrowers of the Association. To accomplish this the Association must achieve its objectives, which include attracting and retaining quality loan volume, which is competitively priced, and effectively manage risk within the balance sheet and income statement.

**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 funds to the Association, creating notes payable to the Bank. The notes payable are segmented into variable rate and fixed rate sections. The variable rate notes are utilized by the Association to fund variable rate loan advances and operating funds requirements. The fixed rate notes are used to specifically fund fixed rate loan advances made by the Association. The total notes payable to the Bank at December 31, 2003 were \$172,671 as compared to \$154,689 at December 31, 2002. The increase of \$17,982 or 11.6 percent very closely corresponded to the increase in gross loan volume of \$18,811.

The Association had no lines of credit outstanding with third parties as of December 31, 2003.

*Funds Management*

The Bank and the Association manage assets and liabilities to provide a range of variable rate 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 variable rate loan products, which 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).

The Association's net interest income as a percentage of average earning assets (net interest margin) was 2.80 percent on December 31, 2003, compared to 3.34 percent on December 31, 2002. The decline was mainly attributable to the lower interest rate environment experienced during 2003 and a highly competitive market place. Additionally, the Bank through its subsidiary the Farm Credit Finance Corporation of Puerto Rico (FCFCPR), changed the formula assigned to price variable rate notes payable to the Bank. This action by the Bank, effective January 1, 2003, was responsible for approximately a 50 basis point increase in prime indexed notes and a 39 basis point increase in LIBOR indexed notes.

The majority of the operational interest rate risk in the Association's 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 interest rate risk associated with the loan portfolio.

**CAPITAL RESOURCES**

Total stockholders' equity at December 31, 2003 was \$45,855, an increase of \$978 or 2.2 percent from the December 31, 2002 total of \$44,877. The increase was primarily from the retention of net income as unallocated retained earnings, and was augmented by an increase of \$217 in accumulated other comprehensive income/(loss) related to the minimum pension liability. The Association's Consolidated Statement of Changes in Member's Equity reflects a comprehensive loss resulting from the underfunded status of the AgFirst Farm Credit District's defined

benefit retirement plan for the years ended December 31, 2003 and 2002. See further discussion about this comprehensive loss in Note 10 to the Consolidated Financial Statements.

Total capital stock and participation certificates were \$1,022 on December 31, 2003 compared to \$1,001 on December 31, 2002. The net increase of \$21 or 2.1 percent during 2003 compared to a net increase of \$27 or 2.8 percent during 2002. The Board of Directors continued its commitment to maintain the equity investment requirement at the regulatory minimum amount of 2 percent of the original loan or \$1,000, whichever is less.

For the seventh consecutive year, the Board of Directors declared increased dividends. Dividends were declared on a stockholder's equity investment during the first three quarters and during the fourth quarter dividends were declared on a patronage basis. The Association's recorded dividend activity for the last three years was as follows:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Dividends declared	\$2,000	\$1,751	\$1,386
Percent of net income	73.0%	44.3%	37.7%

The Association's permanent capital ratio as of December 31, 2003 was 25.85 percent compared to 27.10 percent as of December 31, 2002. Farm Credit Administration (FCA) regulations require that all Farm Credit institutions maintain a minimum permanent capital ratio of 7 percent. The permanent capital ratio is calculated by dividing the Association's permanent capital by a risk-adjusted asset base. The decline in the ratio was primarily related to a material increase in the risk-adjusted asset base, a result of the growth in the loan portfolio.

FCA regulations also require all Farm Credit institutions to maintain two other minimum capital ratios: total surplus ratio of 7 percent and core surplus ratio of 3.5 percent. The total surplus and core surplus ratios are calculated by dividing total surplus and core surplus as defined in FCA regulations by the risk-adjusted asset base. As of December 31, 2003, the Association's total surplus and core surplus ratios were both 25.26 percent, as compared to 26.46 percent for both ratios as of December 31, 2002.

Annually, the Association establishes target capital ratios. The Association's 2003 target minimum permanent capital ratio was 20 percent of risk-adjusted assets. The target minimum total and core surplus ratios for 2003 were 19 percent. As of December 31, 2003, the Association exceeded all internally established minimum target capital ratios.

# *Disclosure Required by Farm Credit Administration Regulations*

## **Description of Business**

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

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

## **Description of Property**

The following table sets forth certain information regarding the property of the reporting entity, which is located in San Juan, Puerto Rico:

<u>Location</u>	<u>Description</u>	<u>Form of Ownership</u>
213 Domenech Ave Hato Rey	Administrative/ San Juan Branch	Owned

## **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 stockholders.

## **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 stockholders.

## **Description of Liabilities**

The description of liabilities, contingent liabilities and intrasystem financial assistance rights and obligations to be disclosed in this section is incorporated herein by reference to Notes 2, 7, 11 and 13 to the consolidated financial statements included in this annual report to stockholders.

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

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

## **Senior Officers**

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

<u>Senior Officer</u>	<u>Position</u>
William A. Garrahan	President and Chief Executive Officer
Sonia Arteaga	Vice President and Chief Lending Officer
Bruce M. Hoffman	Vice President and Chief Financial Officer/Treasurer

The business experience for the past five years for the senior officers listed above has been with Puerto Rico Farm Credit, ACA.

The total amount of compensation earned by the five most highly paid officers as a group, including specific detail for the Chief Executive Officer, during years ended December 31, 2003, 2002 and 2001, is as follows:

<u>Aggregate Number of Senior Officers</u>	<u>Year</u>	<u>Annual</u>				<u>Total</u>
		<u>Salary</u>	<u>Bonus</u>	<u>Executive Compensation</u>		
CEO	2003	\$275,000	\$ 400	\$ 47,510	\$322,910	
CEO	2002	\$275,000	\$ 400	\$ 76,436	\$351,836	
CEO	2001	\$275,005	\$ 400	\$ 43,750	\$319,155	
5	2003	\$700,000	\$2,000	\$120,527	\$822,527	
5	2002	\$700,000	\$2,000	\$167,703	\$869,703	
5	2001	\$687,512	\$2,000	\$113,750	\$803,262	

Bonus payments equate to the mandatory payment of a Christmas Bonus required by Commonwealth law. For all three years, the Board authorized payment of executive compensation in December of the year earned, as performance measures were finalized.

The Executive Compensation Plan is adopted annually for the current year. Actual payment is decided either before or right after year-end, based upon whether performance measures are calculable and reportable. Compensation amounts are estimated, accrued and expensed on a monthly basis. The Plan not only covers the Association's three senior officers, but also includes five department managers. The objectives of the Plan are to tie management compensation directly to organizational performance, focusing attention on both short-term and long-term results. The Board has narrowed its focus and established three quantifiable performance categories. Each performance area has a defined payout amount assigned with measurable performance ranges established for either a minimum or maximum payout.

The following chart describes the weighted significance each performance category was assigned by the Board of Directors during the last three years.

	<u>2001</u>	<u>2002</u>	<u>2003</u>
Business loan volume	40%	40%	40%
Quality control	50%	50%	50%
Financial performance	10%	10%	10%

Within each major performance category there were specific objectives established which were designed to motivate performance that exceeded the most likely goals of the related annual business plan. These objectives typically include return on assets, credit quality, delinquency, growth in loan volume, examination results and control of operating expenses.

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

**Directors**

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

A copy of the policy is available to stockholders of the Association upon request.

The aggregate amount of reimbursement for travel, subsistence and other related expenses for all directors as a group was \$23,805 for 2003, \$32,563 for 2002 and \$32,871 for 2001.

Subject to approval by the Board of Directors, individual directors were compensated at a per diem rate of \$300 for all official activities during 2003. Official activities include, but are not limited to, board meetings, committee meetings or special assignments. Directors are also paid honorarium at the per diem rate on a full-day basis for normal travel to and from conferences and meetings, when the distance and schedule requires travel on any portion of the day prior to or following the scheduled activity. In addition, all directors are paid quarterly a \$500 retainer fee as compensation for incidental services and review/preparation for meetings and assignments.

Additional information for each Director is provided below:

	<u>No. of Days Served at Board Meetings</u>	<u>No. of Days Served at Other Official Activities</u>	<u>Total Honoraria During 2003</u>
Juan A. Santiago	12	12	\$ 9,200
Damián Rivera	10	6	6,800
Carlos R. Urrutia	11	1	5,600
Francisco del Río	12	6	7,400
Felipe Ozonas-Morell	10	12	8,600
Carlos A. Rodríguez	12	6	7,400
Eduardo J. Criado*	2	-	1,100
Francisco I. Sella	2	-	1,100
			<u>\$ 47,200</u>

\* Resigned as of April 2003; in August 2003, Mr. Sella was appointed to fill the vacancy as external director.

The following represents certain information regarding the directors of the Association, including their principal occupation and employment for the past five years:

**Mr. Juan A. Santiago**, Chairman, owns and operates a 240-acre floriculture and beef cattle farm. Mr. Santiago is an agronomist and is a member of the Puerto Rico Farm Bureau Association, the Puerto Rico Agronomist Association, the Audubon Society and the Ornamental Plants Producers Association. His term of office is 2001 – 2004.

**Mr. Damián Rivera**, Vice Chairman, owns and operates a 414-acre coffee, plantains and dairy herd replacement farm. He is an agronomist and is a member of the Puerto Rico Agronomist Association. His term of office is 2003 – 2006.

**Mr. Francisco del Río** is a producer of hay, hogs and cattle. Mr. del Río is the former President of Puerto Rico Farm Bureau Association. His term of office is 2001 – 2004.

**Mr. Felipe Ozonas-Morell** owns and operates a farm in Castañer, Adjuntas, producing Arábiga and Robusta coffee and production packing and marketing of Valencia and mandarin oranges. He made advanced studies in livestock engineering in Spain and is a member of the Puerto Rico Farm Bureau. His term of office is 2003 – 2006.

**Mr. Carlos R. Urrutia** owns and operates four dairy farms in Gurabo, Juncos and Humacao. He attended Pennsylvania Military College. His former memberships include National Guard, Indulac Board and Criadores de Caballos de Paso Fino of América Association. His term of office is 2001 – 2004.

**Mr. Carlos A. Rodríguez** owns and operates a dairy farm in Morovis. He has a bachelor degree in Administration from the University of Puerto Rico. His memberships include board member of the “Junta Fondo Estabilización de Precios de la Industria Lechera” and Puerto Rico Dairy Herd Improvement Association. His term of office is 2002 – 2005.

**Mr. Francisco I. Sella**, External Director, is an agronomist and has occupied different positions related to agriculture and non-agricultural industries. He owns a business offering consulting services to farmers. His memberships include President of Ponce Chapter of “Colegio de Agrónomos”, Member of “Club de Rotarios”, President Caribbean District of “Soil Conservation”. His term of office is 2003 – 2004.

#### **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 stockholders.

#### **Involvement in Certain Legal Proceedings**

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

#### **Relationship with Independent Public Accountants**

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

#### **Consolidated Financial Statements**

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

The Association’s quarterly consolidated financial statements are posted on the Association’s website at “[www.puertoricofarmcredit.com](http://www.puertoricofarmcredit.com)”. To access the reports click on the last button in the menu.

Otherwise, copies of the Association’s quarterly reports are available upon request free of charge by calling 1-787-753-5435, or writing Bruce M. Hoffman, Vice President, Puerto Rico Farm Credit, ACA, PO Box 363649, San Juan, PR 00936.

#### **Borrower Information Regulations**

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

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

#### **Stockholder Investment**

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

# Report of Independent Auditors



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

## Report of Independent Auditors

February 19, 2004

To the Board of Directors and Stockholders  
of Puerto Rico Farm Credit, ACA

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

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

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

*PricewaterhouseCoopers* LLP

# Consolidated Balance Sheets

<i>(dollars in thousands)</i>	December 31, 2003	December 31, 2002	December 31, 2001
<b>Assets</b>			
Cash	\$ 16	\$ 92	\$ 37
Loans	223,321	204,510	173,043
Less: allowance for loan losses	5,983	6,498	6,674
Net loans	217,338	198,012	166,369
Accrued interest receivable	876	816	1,026
Investment in AgFirst Farm Credit Bank	4,712	4,712	4,712
Premises and equipment, net	482	474	808
Other property owned	—	—	10
Other assets	230	217	1,005
Total assets	\$ 223,654	\$ 204,323	\$ 173,967
<b>Liabilities</b>			
Notes payable to AgFirst Farm Credit Bank	\$ 172,671	\$ 154,689	\$ 126,564
Accrued interest payable	199	153	154
Dividends payable	1,849	1,602	1,233
Postretirement benefits other than pensions	1,136	958	886
Minimum pension liability	1,223	1,260	—
Other liabilities	721	784	444
Total liabilities	177,799	159,446	129,281
Commitments and contingencies			
<b>Stockholders' Equity</b>			
Capital stock and participation certificates	1,022	1,001	974
Unallocated retained earnings	46,654	45,914	43,712
Accumulated other comprehensive income (loss)	(1,821)	(2,038)	—
Total stockholders' equity	45,855	44,877	44,686
Total liabilities and stockholders' equity	\$ 223,654	\$ 204,323	\$ 173,967

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

# Consolidated Statements of Income

<i>(dollars in thousands)</i>	For the year ended December 31,		
	2003	2002	2001
<b>Interest Income</b>			
Loans	\$ 8,462	\$ 8,205	\$ 11,723
<b>Interest Expense</b>			
Notes payable to AgFirst Farm Credit Bank	2,553	2,223	4,416
Net interest income	5,909	5,982	7,307
Provision for (reversal of) loan losses	(515)	(174)	—
Net interest income after provision for (reversal of) loan losses	6,424	6,156	7,307
<b>Noninterest Income</b>			
Loan fees	239	186	176
Fees for financially related services	35	15	15
Dividends from AgFirst Farm Credit Bank	—	1,200	—
Other noninterest income	21	37	42
Total noninterest income	295	1,438	233
<b>Noninterest Expense</b>			
Salaries and employee benefits	2,585	2,581	2,165
Occupancy and equipment	204	224	239
Insurance Fund premium	249	63	3
Guarantee fee	227	182	141
Other operating expenses	697	770	780
Losses on other property owned, net	14	—	27
Restructuring charge	—	—	540
Total noninterest expense	3,976	3,820	3,895
Income before income taxes	2,743	3,774	3,645
Provision (benefit) for income taxes	3	(183)	(26)
Net income	\$ 2,740	\$ 3,957	\$ 3,671

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

# Consolidated Statements of Changes in Stockholders' Equity

<i>(dollars in thousands)</i>	Capital Stock and Participation Certificates	Retained Earnings Unallocated	Accumulated Other Comprehensive Income	Total Stockholders' Equity
Balance at December 31, 2000	\$ 1,012	\$ 41,421	\$ —	\$ 42,433
Net income		3,671		3,671
Capital stock/participation certificates issued	74			74
Capital stock/participation certificates retired	(112)			(112)
Cash dividends declared		(1,386)		(1,386)
Distribution adjustment		6		6
Balance at December 31, 2001	974	43,712	—	44,686
Comprehensive income				
Net income		3,957		3,957
Minimum pension liability adjustment			(2,038)	(2,038)
Total comprehensive income				1,919
Capital stock/participation certificates issued	108			108
Capital stock/participation certificates retired	(81)			(81)
Cash dividends declared		(1,751)		(1,751)
Distribution adjustment		(4)		(4)
Balance at December 31, 2002	1,001	45,914	(2,038)	44,877
Comprehensive income				
Net income		2,740		2,740
Minimum pension liability adjustment			217	217
Total comprehensive income				2,957
Capital stock/participation certificates issued	96			96
Capital stock/participation certificates retired	(75)			(75)
Cash dividends declared		(2,000)		(2,000)
Balance at December 31, 2003	\$ 1,022	\$ 46,654	\$ (1,821)	\$ 45,855

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

# Consolidated Statements of Cash Flows

<i>(dollars in thousands)</i>	For the year ended December 31,		
	2003	2002	2001
<b>Cash flows from operating activities:</b>			
Net income	\$ 2,740	\$ 3,957	\$ 3,671
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation on premises and equipment	157	178	217
Provision for (reversal of) loan losses	(515)	(174)	—
(Gains) losses on other property owned, net	14	—	27
(Gains) losses from sale of premises and equipment, net	—	(22)	—
Changes in operating assets and liabilities:			
(Increase) decrease in accrued interest receivable	(60)	210	694
(Increase) decrease in other assets	(13)	788	(128)
Increase (decrease) in accrued interest payable	46	(1)	(405)
Increase (decrease) in postretirement benefits other than pensions	178	72	271
Increase (decrease) in minimum pension liability	(37)	1,260	—
Increase (decrease) in other liabilities	154	(1,701)	(52)
Total adjustments	(76)	610	624
Net cash provided by (used in) operating activities	2,664	4,567	4,295
<b>Cash flows from investing activities:</b>			
Net (increase) decrease in loans	(18,834)	(31,469)	(2,830)
(Increase) decrease in investment in AgFirst Farm Credit Bank	—	—	524
Purchase of premises and equipment, net	(165)	(95)	(168)
Proceeds from sale of premises and equipment, net	—	273	—
Proceeds from sale of other property owned	9	10	2
Net cash provided by (used in) investing activities	(18,990)	(31,281)	(2,472)
<b>Cash flows from financing activities:</b>			
Advances on (repayment of) notes payable to AgFirst Farm Credit Bank, net	17,982	28,125	(555)
Capital stock and participation certificates issued	96	108	74
Capital stock and participation certificates retired	(75)	(81)	(112)
Cash dividend paid	(1,753)	(1,386)	(1,249)
Net cash provided by (used in) financing activities	16,250	26,766	(1,842)
Net increase (decrease) in cash	(76)	52	(19)
Cash, beginning of period	92	37	56
Cash, end of period	\$ 16	\$ 89	\$ 37
FALSE			
<b>Supplemental schedule of non-cash investing and financing activities:</b>			
Loans transferred to other property owned	\$ 23	\$ —	\$ 10
Cash dividends declared	2,000	1,751	1,386
<b>Supplemental information:</b>			
Interest paid	\$ 2,507	\$ 2,224	\$ 4,821
Taxes paid, net	—	24	74
Federal tax refunds related to long-term operations (Note 9)	—	193	153

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, Operations and the Farm Credit Finance Corporation of Puerto Rico

A. **Organization:** Puerto Rico Farm Credit, ACA (the Association) is a stockholder-owned cooperative which provides credit and credit-related services to or for the benefit of eligible borrowers/stockholders for qualified purposes within the Commonwealth of Puerto Rico. The Association is also authorized by its charter from the Farm Credit Administration to provide the same credit and credit-related services for qualified purposes within the territory of the U.S. Virgin Islands.

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

Effective July 1, 2001, pursuant to a plan of restructuring approved by the Farm Credit Administration (FCA) and Association shareholders, the Association reorganized its existing organizational structure. Pursuant to this restructuring, an FLCA and a PCA were formed as wholly owned subsidiaries of the Association. The formation of these subsidiaries enables the Association to take advantage of the tax-exempt status of net income from long-term mortgage operations of the FLCA. This restructuring was accounted for as a reorganization of entities under common control similar to a pooling of interests.

Prior to the restructuring, the ACA was subject to federal income tax. As a result of the restructuring, long-term lending activity has been participated into a wholly owned FLCA subsidiary, which is exempt from federal income tax. The ACA, which is the holding company, continues to be subject to income tax.

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

The Association makes short and intermediate term loans for agricultural production or operating purposes, and secured long-term real estate mortgage loans, with funding from the Bank.

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

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

When the amount in the Insurance Fund exceeds the secure base amount, the Insurance Corporation is required to reduce premiums, but it still must ensure that reduced premiums are sufficient to maintain the level of the Insurance Fund at the secure base amount.

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

The Association may sell to any Farm Credit borrowing member, on an optional basis, credit or term life insurance appropriate to protect the loan commitment in the event of death of the debtor(s). The sale of other insurance necessary to protect a member's farm or aquatic unit is permitted, but limited to hail and multi-peril crop insurance, and insurance necessary to protect the facilities and equipment of aquatic borrowers.

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

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

- C. The Farm Credit Finance Corporation of Puerto Rico:** The Farm Credit Finance Corporation of Puerto Rico (the Finance Corporation) is a wholly-owned subsidiary of the Bank. The Finance Corporation borrows eligible funds from qualified companies doing business in Puerto Rico under Section 2(j) of the Puerto Rico Tax Incentive Act of 1987. The Finance Corporation uses the eligible funds proceeds to acquire the Association's direct note obligations from the Bank.

**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 stockholders' equity of prior years. The consolidated financial statements include the accounts of Puerto Rico Farm Credit, FLCA. All significant inter-company transactions have been eliminated in consolidation.

- A. Cash:** Cash as included in the statement of cash flows, represents cash on hand and on deposit at the Association's depository bank.
- B. Loans and Allowance for Loan Losses:** Long-term real estate mortgage loans for agricultural purposes generally have maturities that extend up to 20 years. Long-term real estate loans made for the purpose of rural housing may have maturities that range up to 30 years. Substantially all short- and intermediate-term loans for agricultural production or operating purposes have maturities of 10 years or less.

Loans originated within the Association's local service area, Puerto Rico, are generally carried at the principal amount outstanding, net of the amortized cost to originate. The related loan origination fees and direct loan origination costs are netted and deferred and the net fee or cost is amortized over the life of the related loan as an adjustment to yield. Certain participation loans, acquired in the USDA Secondary Market, are purchased at a premium, with the principal and the interest unconditionally guaranteed by the United States government. These loans are carried at the principal amount outstanding, plus the unamortized premium. The premium is amortized as an adjustment to yield.

Interest on loans is accrued and credited to interest income based upon the principal amount outstanding. Loans are generally placed in nonaccrual status when principal or interest is delinquent for 90 days or more (unless adequately secured and in the process of collection) or circumstances indicate that collection of principal and/or interest is in doubt. When a loan is placed in nonaccrual status, accrued interest deemed uncollectible is either reversed (if accrued in the current year) or charged against the allowance for loan losses (if accrued in prior years).

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

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

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

A specific allowance may be established for impaired loans under SFAS No. 114. Impairment of these loans is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as practically expedient, at the loan's observable market price or fair value of the collateral if the loan is

collateral dependent. The Association records specific allowances to reduce the carrying amount of the impaired loan to the lower of book value or the fair market value of collateral.

- C. **Investment in AgFirst Farm Credit Bank:** The Association is required to maintain ownership in the Bank. Such ownership investment in the Bank is in the form of Class C stock. This investment may be adjusted periodically based upon the recognition that the Association is the sole beneficiary of the operations of the Farm Credit Finance Corporation of Puerto Rico. Thus, the Association maintains a similar level of investment in the Bank, as the Bank maintains in the Finance Corporation. Accounting for this investment is on the purchased cost basis.
- 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 of the fair value less costs to sell are reported as adjustments to the carrying amount of the asset, provided that such adjusted value is not in excess of the carrying amount at acquisition. Income and expenses from operations and carrying value adjustments are included in gains (losses) on other property owned.
- E. **Premises and Equipment:** Premises and equipment are carried at cost less accumulated depreciation. Depreciation is provided on the straight-line method over the estimated useful lives of the assets. Gains and losses on dispositions are reflected in current operations. Maintenance and repairs are charged to operating expense and improvements are capitalized.
- F. **Advanced Conditional Payments:** The Association is authorized under the Farm Credit Act to accept advance payments from borrowers. To the extent the borrower's access to such advance payments is restricted, the advanced conditional payments are netted against the borrower's related loan balance. Advanced conditional payments are not insured.
- G. **Employee Benefit Plans:** The employees of the Association participate in the Retirement Plan (the Plan) of the AgFirst District, which is a defined benefit plan. The District utilizes the "Projected Unit Credit" actuarial method for financial reporting purposes and the "Entry Age Normal Cost" actuarial 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. For participants hired before January 1, 2003, benefits are determined based on a final average pay formula. For those participants hired on or after January 1, 2003, benefits are determined using a cash balance formula.

The employees of the Association are eligible to participate in the District's thrift plan (Thrift Plan), which qualifies as a 401(k) plan as defined by the Internal Revenue Code.

The Thrift Plan also qualifies in Puerto Rico with the Department of the Treasury (Hacienda) as a 1165(e) plan. For employees hired on or prior to December 31, 2002, the Association will contribute \$.50 for each \$1.00 of the maximum employee contribution of 6 percent of total compensation. For employees hired after January 1, 2003, the Association will contribute \$1.00 for each \$1.00 of the maximum employee contribution of 6 percent of total compensation. Employee deferrals are not to exceed the maximum deferral as established by Hacienda. On a monthly basis Thrift Plan administrative costs are accrued and/or expensed when incurred, depending upon the individual vendor providing services.

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

Refer to Note 10 for more detail on costs directly related to employee benefit plans.

- H. **Income Taxes:** Prior to 1996, the Association filed the federal tax return under Section 936 of the Internal Revenue Code. Under Section 936, the Association utilized a wage-based credit to offset federal income tax computed on Puerto Rico sourced income.

In 1996, Congress amended Section 936 to repeal the Puerto Rico and possessions tax credit for taxable years beginning after December 31, 1995. However, a newly created Section 30(A) provided an economic activity credit for Puerto Rico. As signed into law, Section 30(A) contained a ten-year phase-out period. Furthermore, Section 30(A) imposed a cap on corporate possession business income eligible for wage tax credits beginning in 2002. Through 2003 the provisions of Section 30(A) have not subjected the Association's possession sourced income to additional taxation.

Management does not anticipate that the income cap will limit use of wage credits during the years 2004 and 2005.

During the first half of 2001, the Association took actions which resulted in the restructuring of the ACA into a holding company with a wholly-owned FLCA subsidiary. As a result, the Association has had sufficient tax credits under Section 30-A to offset the estimated federal tax liability from possession-sourced income for 2001, 2002 and 2003.

In connection with the restructuring into a holding company, the net deferred tax asset relating to the long-term lending activities was written off during the third quarter of 2001 to reflect the change in tax status. The amount of the write-off was \$62 and was charged to provision for federal income tax. There were no deferred tax adjustments during 2002 and 2003 related to the restructuring into a holding company.

The Association is exempt from Puerto Rico income tax under Puerto Rico Annotated Law No. 5, Sections 915, 916 and 917.

**Note 3 — Loans and Allowance for Loan Losses**

A summary of loans follows:

	December 31,		
	2003	2002	2001
Long-term farm mortgage	\$ 137,265	\$ 124,000	\$ 110,199
Production and intermediate-term	20,914	29,182	24,391
Rural home	27,110	25,529	22,948
Nonaccruals	2,943	4,441	4,348
Plus: participations purchased	38,607	25,620	11,157
Less: participations sold	(3,518)	(4,262)	—
<b>Total</b>	<b>\$ 223,321</b>	<b>\$ 204,510</b>	<b>\$ 173,043</b>

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

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

Commodity Type	December 31,		
	2003	2002	2001
Dairy	33%	34%	38%
Participations Purchased, Net	15	10	6
Rural Home	12	13	14
Fruits	10	10	7
Livestock	8	8	9
Field Crops	7	7	8
Poultry	4	5	5
Ornamentals/Nursery	3	4	3
Plantains	3	3	3
Coffee	2	2	2
Horses	1	2	3
Other Ag-Purpose	2	2	2
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

The significant concentration of loan volume in the dairy industry partially resulted from transactions with a single borrower. At December 31, 2003 this borrower's total relationship equaled 10.1 percent of the Association's total outstanding loan volume as of December 31, 2003. This relationship generated interest income which amounted to 7.9 percent, 7.4 percent and 8.5 percent of interest income from accruing loans during 2003, 2002 and 2001, respectively.

The FCA has in place regulations which limit the total amount of principal and commitment a direct lender association may make available to a single/individual loan relationship. The regulatory limit is 25 percent of permanent capital. In response to these regulations, the Association and the Bank have entered into an agreement which permits the Association to sell and the Bank to purchase the potential loan loss risk in a single/individual loan relationship in excess

of the Association's administratively established lending limit. The Bank purchases such risk in consideration of the Association's payment of a guarantee fee. The Association paid guarantee fees totaling \$227, \$182 and \$141 in 2003, 2002 and 2001, respectively.

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. Long-term real estate loans are secured by first liens on the underlying real property. Federal regulations state that long-term real estate loans are not to exceed 85 percent (97 percent if guaranteed by a government agency) of the property's appraised value. However, a decline in a property's market value subsequent to loan origination or advances, or other actions necessary to protect the financial interest of the Association in the collateral, may result in the loan to value ratios in excess of the regulatory maximum.

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

The following table presents information relating to impaired loans.

	December 31,		
	2003	2002	2001
Nonaccrual loans:			
Current as to principal and interest	\$ 1,411	\$ 2,714	\$ 2,918
Past due	1,532	1,727	1,430
<b>Total nonaccrual loans</b>	<b>2,943</b>	<b>4,441</b>	<b>4,348</b>
Impaired accrual loans:			
Accrual loans 90 days or more past due	—	126	13
<b>Total impaired accrual loans</b>	<b>—</b>	<b>126</b>	<b>13</b>
<b>Total impaired loans</b>	<b>\$ 2,943</b>	<b>\$ 4,567</b>	<b>\$ 4,361</b>

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

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

	Year Ended December 31,		
	2003	2002	2001
Interest income recognized on nonaccrual loans	\$ 234	\$ 346	\$ 500
Interest income on impaired accrual loans	7	5	6
<b>Interest income recognized on impaired loans</b>	<b>\$ 241</b>	<b>\$ 351</b>	<b>\$ 506</b>

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

	2003	2002	2001
Impaired loans with related allowance	\$ 1,746	\$ 2,242	\$ 208
Impaired loans with no related allowance	1,197	2,325	4,153
Total impaired loans	<u>\$ 2,943</u>	<u>\$ 4,567</u>	<u>\$ 4,361</u>
Allowance on impaired loans	<u>\$ 342</u>	<u>\$ 258</u>	<u>\$ 10</u>

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

	2003	2002	2001
Average impaired loans	<u>\$ 4,145</u>	<u>\$ 4,459</u>	<u>\$ 6,209</u>

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

	Year Ended December 31,		
	2003	2002	2001
Balance at beginning of year	\$ 6,498	\$ 6,674	\$ 6,680
Provision for (reversal of) loan losses	(515)	(174)	—
Loans charged off	—	(3)	(6)
Recoveries	—	1	—
Balance at end of year	<u>\$ 5,983</u>	<u>\$ 6,498</u>	<u>\$ 6,674</u>
Ratio of net charge-offs during the period to average loans outstanding during the period	<u>—%</u>	<u>.001%</u>	<u>.004%</u>

#### Note 4 — Investment in AgFirst Farm Credit Bank

The Association is required to maintain ownership in AgFirst Farm Credit Bank of Class C stock in an amount similar to the Bank's investment in the Finance Corporation. The Finance Corporation, and thus the Bank, may require additional capital contributions to maintain its capital requirements.

At December 31, 2003, the Association's investment in the Bank was composed of purchased Class C stock of AgFirst and totaled \$4,712. At December 31, 2002 and 2001, the Association's investment in the Bank was composed of purchased Class C stock of AgFirst and totaled \$4,712. At December 31, 2000 the Association's investment totaled \$5,236 and consisted of \$4,712 of purchased Class C stock and \$524 of allocated Class C stock. During the fourth quarter of 2001, the Bank redeemed the total of allocated Class C stock.

#### Note 5 — Premises and Equipment

Premises and equipment consisted of the following:

	December 31,		
	2003	2002	2001
Land	\$ 51	\$ 51	\$ 155
Buildings and improvements	792	749	904
Furniture and equipment	1,212	1,232	1,363
	<u>2,055</u>	<u>2,032</u>	<u>2,422</u>
Less: accumulated depreciation	<u>1,573</u>	<u>1,558</u>	<u>1,614</u>
Total	<u>\$ 482</u>	<u>\$ 474</u>	<u>\$ 808</u>

#### Note 6 — Other Property Owned

Net loss (gain) on other property owned consists of the following:

	December 31,		
	2003	2002	2001
Carrying value adjustments	\$ 14	\$ —	\$ 21
Operating expense (income), net	<u>—</u>	<u>—</u>	<u>6</u>
Net loss (gain) on other property owned, net	<u>\$ 14</u>	<u>\$ —</u>	<u>\$ 27</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 1.29 percent for LIBOR-based loans, 1.20 percent for Prime-based loans, and the weighted average remaining maturities were 2.6 years and 8.9 years, respectively, at December 31, 2003. The weighted average interest rate on the fixed rate notes payable which were match funded by the Bank was 2.85 percent and the weighted average remaining maturity was 9.7 years at December 31, 2003. The weighted average interest rate on all interest-bearing notes payable was 1.47 percent and the weighted average remaining maturity was 7.7 years at December 31, 2003.

Variable rate and fixed rate notes payable represented approximately 85.10 percent and 14.90 percent, respectively, of total notes payable at December 31, 2003.

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

#### Note 8 — Members' Equity

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

##### A. 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 Class C 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 two percent or \$1 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 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 is at par (\$5 per share). Repayment of a loan does not automatically result in retirement of the corresponding stock or participation certificates. Retirements of equity investments are subject to approval by the Board, at its sole discretion. Subject to any limitations of the Farm Credit Act, when the debt of a borrower/stockholder is in default, the Association may order retirement of stock or participation certificates owned by the borrower and apply the proceeds to the indebtedness.

**B. Regulatory Capitalization Requirements and Restrictions**

FCA's capital adequacy regulations require the Association to maintain 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 financial statements.

The Association is prohibited from reducing permanent capital by retiring equity 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 core surplus as a percentage of risk-adjusted assets of three and one-half percent. The Association's permanent capital, total surplus and core surplus ratios at December 31, 2003 were 25.83 percent, 25.24 percent and 25.24 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.

**C. Description of Equities**

The Association is authorized to issue or have outstanding Class D Preferred Stock, Classes A and C Common Stock, Class C Participation Certificates and such other classes of equity as may be provided for in amendments to the bylaws in such amounts as may be necessary to conduct the Association's business. All classes of stock and participation certificates have a par or face value of five dollars (\$5.00) per share.

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

Class	Protected	Shares Outstanding	
		Number	Aggregate Par Value
C Common/Voting	No	122,946	\$ 615
C Participation Certificates/Nonvoting	No	81,557	407
Total Capital Stock and Participation Certificates		204,503	\$ 1,022

Common stock and participation certificates are retired at the sole discretion of the Board at book value not to exceed par or face amount, provided the minimum capital adequacy standards established by the Board are met.

*Retained Earnings*

The Association maintains an unallocated retained earnings account. The minimum amount is determined annually by the Board. At the end of any fiscal year, if the retained earnings account would be less than the minimum amount determined by the Board as necessary to maintain adequate capital reserves to meet the commitments of the Association, the Association shall apply earnings for the year to the unallocated retained earnings account in such amounts as may be determined necessary by the Board.

*Equity Dividends*

Equity dividends may be declared and paid on stock and participation certificates as determined by the Board's resolution. The rate of dividend paid on Class D Preferred Stock for any fiscal year may not be less than the rate of dividend paid on common stock or participation certificates for such year. All equity dividends shall be paid on a per share basis. Dividends on common stock and participation certificates shall be noncumulative without preference between classes.

Quarterly equity dividends were declared and paid for the periods ending March 31, June 30 and September 30 for all three years included in these financial statements. Beginning in 2004, the Association's Board of Directors has approved declaring and paying only one quarterly equity dividend. Thus, for 2004, the dividend declared in June and paid in July will equal the total of the three quarters paid in prior years.

*Patronage Dividends*

The Board, by adoption of a resolution, may obligate the Association to distribute to borrowers on a patronage basis any portion of available net earnings for the fiscal year. During 2003, 2002, and 2001 the Board declared a year-end patronage based dividend. The Board declared that patronage dividends would be paid based upon a pooled, proportionate basis using the percentage of net interest margin each pool contributed toward the Association's total net interest margin.

If the Association meets its capital adequacy standards after adopting the patronage dividend resolution, the patronage dividend distribution may be paid in cash, authorized stock of the Association, allocations of earnings retained in an allocated equity account, or any one or more of such forms of distribution. The Board determined that 100 percent of all three year-end patronage dividends would be paid in cash by Association check.

*Transfer*

Each owner or joint owners of Class C Common Stock is entitled to a single vote, regardless of the number of shares owned, while Class A Common Stock, Class D Preferred Stock and Class C Participation Certificates provide no voting rights to their owners. Voting stock may not be transferred to another person unless such person is eligible to hold voting stock. Common stock and participation certificates may be transferred to any person eligible to hold such class of equity under the bylaws. Class D Preferred Stock may be transferred in the manner set forth in the resolution authorizing its issuance.

*Impairment*

Under the capitalization bylaw of the Association, all stock and participation certificates are considered to be issued "at risk" and are not protected under the Farm Credit Act. Any net losses recorded by the Association shall first be applied against unallocated retained earnings. To the extent that such losses would exceed unallocated retained earnings, resulting in impairment of the Association's capital stock, such losses would be applied pro rata to each share and/or unit outstanding in the class, in the following order:

1. Classes A and C Common Stock and Class C Participation Certificates
2. Class D Preferred Stock

*Liquidation*

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

1. Class D Preferred Stock
2. Classes A and C Common Stock and Participation Certificates

**D. Other Comprehensive Income (Loss)**

The Association reports other comprehensive income (loss) in its Statement of Changes in Members' Equity. For the years ended December 31, 2003 and 2002, other comprehensive income (loss) is related to the minimum pension liability recorded as a result of the funded status of the underlying plan. See Note 10 for further information.

**Note 9 — Income Taxes**

The provision (benefit) for federal income taxes follows:

	<b>Year Ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
Current:			
Federal	\$ 2	\$ —	\$ 53
Prior year adjustment	1	6	11
Federal refunds related to long-term lending	—	(193)	(153)
	<u>3</u>	<u>(187)</u>	<u>(89)</u>
Deferred:			
Federal	(1)	5	62
Prior year adjustment	1	(1)	1
	<u>—</u>	<u>4</u>	<u>63</u>
Total provision (benefit) for income taxes	<u>\$ 3</u>	<u>\$ (183)</u>	<u>\$ (26)</u>

In connection with the restructuring discussed in Note 1, deferred tax assets of \$62 relating to the corporate restructuring and long-term lending activities were written off as of July 1, 2001 to reflect the change in tax status. Additionally, during 2001, the Association signed a settlement agreement with the IRS resolving the taxability of the prior years' earnings from its long-term mortgage lending activities. This settlement agreement was modeled after one used by another System ACA to reach a settlement agreement with the IRS in August 2000. As a result of this settlement, the Association recorded tax refunds of \$193 and \$153, during 2002 and 2001, respectively. Both of the refunds were included as components of the respective years' current income tax provision. In addition, the Association recorded \$14 and \$13, respectively in 2002 and 2001, in interest related to the refunds. The interest was included in Other Income in the accompanying Consolidated Statements of Income.

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:

	<b>December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
Federal tax at statutory rate	\$ 929	\$ 1,282	\$ 1,242
Impact of future tax credits	14	(117)	70
Possessions credit	(511)	(690)	(1,046)
Tax-exempt FLCA earnings	(446)	(489)	(345)
Long-term lending related refunds	—	(193)	(153)
Bank stock redemption	—	—	178
Other	17	24	28
Provision (benefit) for income taxes	<u>\$ 3</u>	<u>\$ (183)</u>	<u>\$ (26)</u>

Deferred tax assets and liabilities result from the following at:

	December 31,		
	2003	2002	2001
Allowance for loan losses	\$ 19	\$ 22	\$ 28
Annual leave	3	3	3
Nonaccrual loan interest	12	14	15
Postretirement benefits other than pensions	16	14	12
Depreciation	2	2	2
Pensions (reclassified)	30	(10)	(11)
Gross deferred tax assets	<u>82</u>	<u>45</u>	<u>49</u>
Loan fees	—	(1)	(1)
Gross deferred tax liability	<u>—</u>	<u>(1)</u>	<u>(1)</u>
Net deferred tax asset (liability)	<u>\$ 82</u>	<u>\$ 44</u>	<u>\$ 48</u>

Deferred taxes are provided on the Association's taxable income on the basis of a proportionate share of the tax effect of temporary differences from nonpossession-sourced income. The calculation of tax assets and liabilities involves various management estimates and assumptions including the future impact of Section 30(A) possession tax credits. The rate of tax actually paid in future years may differ if the amount of possession credits differs from current estimates. The expected future tax rates and credits are based upon enacted tax laws.

**Note 10 — Employee Benefit Plans**

The Association participates in a Districtwide defined benefit retirement plan. This plan is noncontributory and covers substantially all Association employees. Benefits are based on salary and years of service. The assets, liabilities and costs of the plan are not segregated by participating entities but are allocated among the participating entities. Pension costs are allocated by multiplying the District's net pension expense times the Association's salary expense as a percentage of the District's salary expense.

At December 31, 2003 and 2002, the Accumulated Benefit Obligation (ABO) of the District's defined benefit plan exceeded the fair value of plan assets. In accordance with the provisions of SFAS No. 87, "Employers' Accounting for Pensions," (SFAS No. 87), the Association's allocated amount of the minimum pension liability was recorded in the Consolidated Balance Sheets in the amount of the excess of the ABO over the fair value of plan assets. In conjunction with the minimum pension liability, other comprehensive loss was \$1,821 and \$2,038 for the years ended December 31, 2003 and 2002, respectively. The impact on deferred taxes was not significant.

The Association participates in a Districtwide Thrift Plan. For employees hired on or prior to December 31, 2002, the Association will contribute \$.50 for each \$1.00 of the maximum employee contribution of 6 percent of total compensation. For employees hired after January 1, 2003, the Association will contribute \$1.00 for each \$1.00 of the maximum employee contribution of 6 percent of total compensation. Employee deferrals are not to exceed the maximum deferral as established by Hacienda.

The following is a table of retirement benefits expenses:

	2003	2002	2001
Pension	\$ 428	\$ 274	\$ 2
Thrift			
Contributions	44	48	46
Fees	9	7	3
Total	<u>\$ 481</u>	<u>\$ 329</u>	<u>\$ 51</u>

The Association also sponsors a fully insured plan providing certain benefits, primarily health and dental care, for its active and retired employees. The measurement date for the plan is September 30.

The following table sets forth the obligations and funded status of the other postretirement benefits plan:

	As of December 31,		
	2003	2002	2001
<b>Change in projected benefit obligation</b>			
Benefit obligation at beginning of year	\$ 2,488	\$ 1,206	\$ 1,011
Service cost	41	24	27
Interest cost	164	88	78
Actuarial loss/(gain)	335	1,328	240
Benefits paid	(257)	(158)	(150)
Benefit obligations at end of year	<u>\$ 2,771</u>	<u>\$ 2,488</u>	<u>\$ 1,206</u>
Fair value of plan assets	\$ —	\$ —	\$ —
Funded status (benefit obligation less FV of plan assets)	\$ (2,771)	\$ (2,488)	\$ (1,206)
Unrecognized transition obligation	336	370	403
Unrecognized net loss (gain)	1,247	1,140	(100)
Net amount recognized	<u>\$ (1,188)</u>	<u>\$ (978)</u>	<u>\$ (903)</u>
Accrued benefit liability	\$ (1,188)	\$ (978)	\$ (903)
<b>Components of net periodic benefit (income) cost</b>			
Service cost	\$ 41	\$ 24	\$ 27
Interest cost	164	88	78
Amortization of transition obligation	34	34	36
Amortization of net loss (gain)	58	11	—
Net periodic benefit cost	<u>\$ 297</u>	<u>\$ 157</u>	<u>\$ 141</u>
<b>Weighted-average assumptions:</b>			
Discount rate for funded status at December 31	6.25%	6.75%	7.50%
Discount rate for Fiscal Year expense determination	6.75%	7.50%	8.00%

The assumed health care cost trend rates used in measuring the accumulated postretirement benefit obligation for the medical plans for participants aged less than 65 are 10 percent for 2003 and 9.25 percent for 2004, declining gradually to 5 percent in 2011 and remaining at that level thereafter. For those participants aged greater than 65, the assumed health care cost trend rates are 12 percent for 2003 and 11.25 percent for 2004, declining gradually to 5 percent in 2013 and remaining at that level thereafter.

On December 8, 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (Medicare Act) was signed into law. This act introduces a prescription drug benefit under Medicare (Medicare Part D) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D.

Subsidies under the Medicare Act will reduce the current period measurements of benefits expected to be provided in future periods. These financial statements and disclosures do not reflect the effects of the Act. Specific authoritative guidance on the accounting for the federal subsidy is pending and that guidance, when issued, could require changes to previously reported information.

The following table sets forth the annual cost for post-retirement benefits and the actual contributions paid for the fully insured health plan:

	2003	2002	2001
Benefit cost	\$ 297	\$ 158	\$ 150
Employer contributions	135	134	136
Plan participants' contributions	88	84	60

**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 is the responsibility of System banks. At December 31, 2003, only \$325 million of Financial Assistance Corporation debt remains outstanding. All other debt has either matured or was called and redeemed.

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

**Note 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, 2003 amounted to \$6,124. During 2003, \$1,875 of new loans were made and repayments totaled \$1,839. In the opinion of management, none of these loans outstanding at December 31, 2003 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 commercial letters of credit. The instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the financial statements.

Commitments to extend credit are agreements to lend to a borrower as long as there is not a violation of any condition established in the contract. Commercial letters of credit are agreements to pay a beneficiary under conditions specified in the letter of credit. Commitments and letters of credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. At December 31, 2003, \$28,530 of commitments to extend credit and \$892 of standby letters of credit were outstanding.

The Association participates in standby letters of credits 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 March 24, 2004 to November 7, 2008.

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.

Actions are pending against the Association in which claims for money damages are asserted. Upon the basis of current information, management and legal counsel are of the opinion that the ultimate liability, if any, resulting there from, would not be material in relation to the financial position of the Association.

**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, 2003, 2002 and 2001. The fair value of a financial instrument is generally defined as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

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

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

	December 31, 2003		December 31, 2002	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<b>Financial assets:</b>				
Cash	\$ 16	\$ 16	\$ 92	\$ 92
Loans	\$ 223,321	\$ 222,440	\$ 204,510	\$ 204,684
Allowance for loan losses	5,983	—	6,498	—
Loans, net	\$ 217,338	\$ 222,440	\$ 198,012	\$ 204,684
<b>Financial liabilities:</b>				
Notes payable to AgFirst Farm Credit Bank	\$ 172,671	\$ 172,553	\$ 154,689	\$ 154,882

	December 31, 2001	
	Carrying Amount	Estimated Fair Value
<b>Financial assets:</b>		
Cash	\$ 37	\$ 37
Loans	\$ 173,043	\$ 173,142
Allowance for loan losses	6,674	—
Loans, net	\$ 166,369	\$ 173,142
<b>Financial liabilities:</b>		
Notes payable to AgFirst Farm Credit Bank	\$ 126,564	\$ 126,654

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:** Estimating the fair value of the Association's investment in the Bank is not practicable because the stock is not traded. As described in Note 4, the net investment is a requirement of borrowing from the Bank and is carried at cost plus allocated equities in the accompanying balance sheet. The Association owns 2.78 percent of the issued stock of the Bank as of December 31, 2003, net of any reciprocal investment. As of that date, the Bank's assets totaled \$15.9 billion and shareholders' equity totaled \$955 million. The Bank's earnings were \$177 million during 2003.
- 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, 2003, 2002 and 2001 follow:

	2003				
	First	Second	Third	Fourth	Total
Net interest income	\$ 1,393	\$ 1,515	\$ 1,440	\$ 1,561	\$ 5,909
Provision for (reversal of) loan losses	—	—	(351)	(164)	(515)
Noninterest income (expense), net	(953)	(935)	(826)	(970)	(3,684)
Net income (loss)	\$ 440	\$ 580	\$ 965	\$ 755	\$ 2,740
	<b>2002</b>				
	First	Second	Third	Fourth	Total
Net interest income	\$ 1,530	\$ 1,482	\$ 1,454	\$ 1,516	\$ 5,982
Provision for (reversal of) loan losses	(174)	—	—	—	(174)
Noninterest income (expense), net	(892)	(915)	(659)	267	(2,199)
Net income (loss)	\$ 812	\$ 567	\$ 795	\$ 1,783	\$ 3,957
	<b>2001</b>				
	First	Second	Third	Fourth	Total
Net interest income	\$ 2,008	\$ 1,989	\$ 1,649	\$ 1,661	\$ 7,307
Provision for (reversal of) loan losses	—	—	—	—	—
Noninterest income (expense), net	(1,146)	(932)	(734)	(824)	(3,636)
Net income (loss)	\$ 862	\$ 1,057	\$ 915	\$ 837	\$ 3,671