



SECOND QUARTER 2004

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William A. Garrahan
Chief Executive Officer



Juan A. Santiago
Chairman of the Board

July 29, 2004

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

(dollars in thousands)

The following commentary reviews the consolidated financial condition and results of operations of Puerto Rico Farm Credit, ACA (Association) for the period ended June 30, 2004. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements and the 2003 annual report of the Association.

LOAN PORTFOLIO

The Association provides funds to farmers, rural homeowners and farm-related business for financing short and intermediate-term loans and long-term real estate mortgage loans. The Association also maintains a portfolio of purchased loans, originated by other Farm Credit System entities and non-system entities. The Association's predominant local service area (LSA) agricultural commodities were dairy, livestock and fruits which totaled approximately \$116 million or 47 percent of all outstanding loan volume at June 30, 2004.

The gross loan volume of the Association at June 30, 2004 was \$244,060, an increase of \$20,739 or 9.3 percent as compared to \$223,321 at December 31, 2003. Net loans outstanding at June 30, 2004 also increased by the same amount, as there was no change in the allowance for loan losses. The improvement in gross loan volume was primarily related to a \$19,049 increase in net participation loans purchased. Additionally, LSA loan volume increased by \$1,690, primarily related to the fruit industry.

Net loans at June 30, 2004 made up 97.3 percent of total assets, as compared to 97.2 at December 31, 2003. However, this compared to 96.9 percent at June 30, 2003. The increase during the past year was the result of the material increase in loan assets.

As a percentage of gross loans, nonaccrual loans equaled 1.4 percent at June 30, 2004, compared with 1.3 percent and 1.8 percent at December 31 and June 30, 2003, respectively. The year-over-year decrease in the percentage was primarily the result of a partial payment received from the sale of collateral property related to a

large volume account. Due to the substantial increase in loan volume, the overall credit quality of the total portfolio continued to show improvement. Asset quality measures remained favorable due to consistent underwriting standards, the lower interest rate environment and a strong real estate market.

The Association maintained an allowance for loan losses in an amount considered by management as sufficient to absorb the estimated risk inherent in the loan portfolio. The allowance for loan losses was the same at June 30, 2004, as at December 31, 2003. The analysis for the first half of 2004 identified less risk as a result of a lower level of nonaccrual loans and improved credit quality. The ratio of allowance to gross loan volume was 2.4 percent at June 30, 2004 and 2.7 percent at December 31, 2003. There were no charge-offs or recoveries during the first half of 2004.

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

The Association and the Farm Credit System conducted a study to further refine the guidance for calculating the allowance for loan losses taking into account generally accepted accounting principles, and applicable Farm Credit Administration requirements, as well as the Securities and Exchange Commission and Federal Financial Institutions Examination Council guidelines. The guidance recommended that the Association adopt a methodology for determining the allowance for loan losses based upon the study's findings and review the methodology with its outside auditors to determine if it is in accordance with System and other related guidance. During the fourth quarter of 2004, the Association will finalize and apply the revised methodology to the loan portfolio, and determine an appropriate allowance for loan losses. The resulting reduction in the allowance for loan losses may be significant.

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

RESULTS OF OPERATIONS

Net income for the six months ended June 30, 2004 totaled \$1,087, an increase of \$67 or 6.6 percent as compared to the six months ended June 30, 2003. The increase was the result of higher levels of earning assets, primarily participation loans purchased, which enhanced interest income, offsetting higher non-interest expense.

At June 30, 2004 net interest income was \$3,142, an increase of \$234 or 8.0 percent when compared to June 30, 2003 total of \$2,908. During the first six months of 2004 interest income from LSA lending decreased by \$47, from participations purchased increased by \$432 and from the collection of nonaccrual loans decreased by \$146. As previously discussed, management continues to project reduced levels of interest income from the collection of nonaccrual loans, negatively impacting net interest income comparisons on a year-over-year basis.

During the first six months of 2004, there was no change in the allowance, resulting in no impact to net income. Noninterest income for the six months ended June 30, 2004 totaled \$141 a decrease of \$30 or 17.5 percent as compared to the first six months of 2003. This was primarily the result of a timing difference related to an experience dividend related to credit life insurance services. 2003's dividend was recognized during the second quarter and 2004's will be recorded during the third quarter.

Noninterest expense for the six months ended June 30, 2004 was \$2,196 compared to \$2,058 at June 30, 2003. The increase of \$138 or 6.7 percent was primarily related to salaries and other operating expenses. Other operating expenses increased due to the higher cost of outside consultants/auditors and the cost of the 2004 advertising

campaign in support of island ag-products and young/beginning/small farmers. Other expenses also increased due to higher legal fees related to additional consulting engagements. The increase in other operating expenses was partially offset by small decreases in other categories. Specifically, management projects a material decrease in the insurance fund premium expense during the second half of 2004. The Farm Credit System Insurance Fund has announced a 40 percent decrease in the premium rate assigned to accruing loan volume, beginning July 1, 2004.

As a result of the 2001 restructuring, a majority of the Association's business has been conducted in the tax-exempt subsidiary or as possession-sourced activity eligible for tax credits. During the first half of 2004, like 2003, the Association did not record a provision for income tax expense.

For the three months ended June 30, 2004.

Net income for the second quarter of 2004 was \$529 compared to \$580 for the second quarter of 2003. Net interest income for the three months ended June 30, 2004 totaled \$1,595 compared to \$1,515 for the three months ended June 30, 2003, reflecting increased accruing loan volume.

Noninterest income for the three months ended June 30, 2004 was \$75, a decrease of \$7 from the second quarter of 2003 when noninterest income totaled \$82. As previously mentioned, this was the result of a timing difference in the recognition of a dividend related to credit life insurance services.

For the second quarter of 2004, noninterest expense increased by \$124 to total \$1,141 compared to the second quarter of 2003, which totaled \$1,017. The quarterly increase, like the year-over-year increase, was related to salaries and benefits and other operating expenses.

Key Results of Operations Ratios:

	Annualized for the three months ended 6/30/04	For the year ended 12/31/03
Return on Average Assets	.93%	1.28%
Return on Average Stockholders' Equity	4.68%	5.94%
Net Interest Income as a Percentage of Average Earning Assets	2.73%	2.80%

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 funds are advanced by the Bank to the Association in the form of notes payable. The notes payable are segmented into variable rate and fixed rate sections. The variable rate notes are utilized by the Association to fund variable rate loan advances and operating funds requirements. The total notes payable to the Bank at June 30, 2004 was \$194,142 as compared with \$172,671 at December 31, 2003. The increase of \$21,471 or 12.4 percent corresponded to the increase in gross loan volume and the funding of the year-end 2003 dividend.

The Association had no lines of credit outstanding with third parties as of June 30, 2004.

Funds Management

Demand for loan types is a driving force in establishing a funds management strategy. The Association offers variable rate loan products which are competitively 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 majority of the interest rate risk in the Association balance sheet is transferred to the Bank through the notes payable structure. The Bank, in turn, actively utilizes funds management techniques to identify, quantify and control interest rate risk associated with the loan portfolio.

CAPITAL RESOURCES

Total stockholders' equity at June 30, 2004 increased 2.3 percent to \$46,912 from December 31, 2003 when total stockholders' equity was \$45,855. The increase was primarily attributable to net income retained as unallocated surplus during the quarter.

Total capital stock and participation certificates were \$1,005 on June 30, 2004 compared to \$1,022 on December 31, 2003. The decrease of \$17 was the net result of refunding more stock to non-borrowing stockholders than new stockholders purchasing capital stock or participation certificates.

Retained earnings unallocated increased \$1,087 or 2.3 percent to \$47,741 from December 31, 2003 when unallocated retained earnings totaled \$46,654. The increase was due to net income earned during the first two quarters of 2004.

The Board of directors intends to continue its policy of declaring cash dividends. 2003 was eleventh consecutive year of paying dividends. At its June 2004, meeting, the Board of Directors voted to eliminate quarterly equity dividend, and to only make an annual dividend declaration in December. The table below sets forth the recent dividends declared:

<u>Year</u>	<u>Type</u>	<u>Amount Declared</u>
2003	Patronage Equity	\$ 1,847
		153
		<u>\$ 2,000</u>
2002	Patronage Equity	\$ 1,602
		149
		<u>\$ 1,751</u>

The amount of dividends, as always, will depend on continued strong earnings, the overall financial condition of the Association and other factors.

The Association's regulatory permanent capital ratio at June 30, 2004 was 23.25 percent compared to 25.83 percent at December 31, 2003. The Association's total surplus and core surplus ratios were both 22.72 percent at June 30, 2004. All three ratios were well above the minimum regulatory ratios of 7.00 percent for permanent capital and total surplus ratios and 3.50 percent for the core surplus ratio.

Key financial condition ratios were as follows:

	6/30/04	12/31/03
Stockholders' Equity to Assets	19.17%	20.50%
Debt to Stockholders' Equity	4.22:1	3.88:1

Puerto Rico Farm Credit, ACA
Consolidated Balance Sheets

<i>(dollars in thousands)</i>	June 30,		December 31,
	2004	2003	2003
	<i>(unaudited)</i>		
Assets			
Cash	\$ 38	\$ 273	\$ 16
Loans	244,060	222,158	223,321
Less: allowance for loan losses	5,983	6,498	5,983
Net loans	238,077	215,660	217,338
Accrued interest receivable	1,087	1,053	876
Investment in other Farm Credit institutions	4,712	4,712	4,712
Premises and equipment, net	544	547	482
Other property owned	—	22	—
Other assets	213	191	230
Total assets	\$ 244,671	\$ 222,458	\$ 223,654
Liabilities			
Notes payable to AgFirst Farm Credit Bank	\$ 194,142	\$ 173,436	\$ 172,671
Accrued interest payable	239	230	199
Dividend payable	—	51	1,849
Postretirement benefits other than pensions	1,306	1,084	1,188
Minimum pension liability	1,206	1,187	1,223
Other liabilities	866	658	669
Total liabilities	197,759	176,646	177,799
Commitments and contingencies			
Stockholders' Equity			
Capital stock and participation certificates	1,005	1,018	1,022
Retained earning unallocated	47,741	46,832	46,654
Accumulated other comprehensive income (loss)	(1,834)	(2,038)	(1,821)
Total stockholders' equity	46,912	45,812	45,855
Total liabilities and stockholders' equity	\$ 244,671	\$ 222,458	\$ 223,654

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

Puerto Rico Farm Credit, ACA

Consolidated Statements of Income

(unaudited)

<i>(dollars in thousands)</i>	For the three months ended June 30,		For the six months ended June 30,	
	2004	2003	2004	2003
Interest Income				
Loans	\$ 2,280	\$ 2,181	\$ 4,441	\$ 4,202
Interest Expense				
Notes payable to AgFirst Farm Credit Bank	685	666	1,299	1,294
Net interest income	1,595	1,515	3,142	2,908
Provision for (reversal of) loan losses	—	—	—	—
Net interest income after provision for (reversal of) loan losses	1,595	1,515	3,142	2,908
Noninterest Income				
Loan fees	71	57	118	124
Fees for financially related services	3	24	6	28
Other noninterest income	1	1	17	19
Total noninterest income	75	82	141	171
Noninterest Expense				
Salaries and employee benefits	699	648	1,389	1,345
Occupancy and equipment	62	53	118	106
Insurance Fund premium	55	62	107	122
Guarantee fee	48	59	100	116
Other operating expenses	277	195	482	369
Total noninterest expense	1,141	1,017	2,196	2,058
Income before income taxes	529	580	1,087	1,021
Provision (benefit) for income taxes	—	—	—	1
Net income	\$ 529	\$ 580	\$ 1,087	\$ 1,020

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

Puerto Rico Farm Credit, ACA

Consolidated Statements of Changes in Stockholders' Equity

(unaudited)

<i>(dollars in thousands)</i>	Capital Stock and Participation Certificates	Retained Earnings Unallocated	Accumulated Other Comprehensive Income	Total Stockholders' Equity
Balance at December 31, 2002	\$ 1,001	\$ 45,914	\$ (2,038)	\$ 44,877
Net income		1,020		1,020
Capital stock/participation certificates issued	50			50
Capital stock/participation certificates retired	(33)			(33)
Cash dividends declared		(102)		(102)
Balance at June 30, 2003	<u>\$ 1,018</u>	<u>\$ 46,832</u>	<u>\$ (2,038)</u>	<u>\$ 45,812</u>
Balance at December 31, 2003	\$ 1,022	\$ 46,654	\$ (1,821)	\$ 45,855
Net income		1,087		1,087
Minimum pension liability adjustment			(13)	(13)
Total comprehensive income				1,074
Capital stock/participation certificates issued	27			27
Capital stock/participation certificates retired	(44)			(44)
Balance at June 30, 2004	<u>\$ 1,005</u>	<u>\$ 47,741</u>	<u>\$ (1,834)</u>	<u>\$ 46,912</u>

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

Notes to the Consolidated Financial Statements

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

NOTE 1 – ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

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

The accompanying consolidated financial statements contain all adjustments necessary for a fair presentation of the interim financial condition and results of operations and conform with generally accepted accounting principles. The results for the six months ended June 30, 2004, are not necessarily indicative of the results to be expected for the year ending December 31, 2004.

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

The Association maintains an allowance for loan losses in accordance with generally accepted accounting principles. The loan portfolio is reviewed quarterly to determine the adequacy of the allowance for losses. As of June 30, 2004, the allowance for losses is adequate in management's opinion to provide for possible losses on existing loans.

NOTE 2 – ALLOWANCE FOR LOAN LOSSES

An analysis of the allowance for loan losses follows:

Balance at 12-31-02	\$ 6,498
(Reversal of) provision for loan losses	—
Recoveries, net of loans charged off	—
Balance at 6-30-03	<u>\$ 6,498</u>
Balance at 12-31-03	\$ 5,983
(Reversal of) provision for loan losses	—
Recoveries, net of loans charged off	—
Balance at 6-30-04	<u>\$ 5,983</u>

NOTE 3 – COMMITMENTS AND CONTINGENT LIABILITIES

Actions are pending against the Association in which money damages are sought. However, on the basis of information now at hand, management and legal counsel are of the opinion that the ultimate liability, if any, resulting therefrom, would not be material in relation to the overall financial position of the Association.

NOTE 4 – EMPLOYEE BENEFIT PLANS

The Association participates in a Districtwide defined benefit retirement plan. The 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 each institution's salary expense as a percentage of the District's salary expense. The Association also participates in a Districtwide Thrift Plan.

The Association sponsors a plan providing certain benefits (primarily health care) to its retirees. The following table sets forth the components of net periodic benefit costs of the other postretirement benefits plan for the six months ended June 30, 2004:

	For the six months ended June 30,	
	2004	2003
Service cost	\$ 25	\$ 21
Interest cost	85	82
Amortization of net (gain) loss	17	17
Recognized net actuarial (gain) loss	34	29
Net periodic benefit cost	<u>\$ 161</u>	<u>\$ 149</u>

The following is a table of retirement and postretirement benefit expense for the six months ended June 30, 2004:

	For the six months ended June 30,	
	2004	2003
Pension	\$ 188	\$ 214
Thrift	32	27
Other postretirement benefits	161	149
Total	<u>\$ 381</u>	<u>\$ 390</u>

As of June 30, 2004, the Association had contributed \$205 to the Districtwide defined benefit retirement plan. The Association anticipates making additional contributions prior to September 30, 2004 in amounts sufficient to eliminate its accrued benefit obligation.