



# **SECOND QUARTER 2005**

Management's Discussion and Analysis of Financial Condition and Results of Operations.....	2
Consolidated Financial Statements	
Consolidated Balance Sheets.....	5
Consolidated Statements of Income.....	6
Consolidated Statements of Changes in Stockholders' Equity .....	7
Notes to the Consolidated Financial Statements.....	8



William A. Garrahan  
Chief Executive Officer



Juan A. Santiago  
Chairman of the Board

July 29, 2005

# 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 six months ended June 30, 2005. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements and the 2004 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 \$120 million or 45 percent of all outstanding loan volume at June 30, 2005.

The gross loan volume of the Association at June 30, 2005 was \$266,919, an increase of \$16,424 or 6.6 percent as compared to \$250,495 at December 31, 2004. Net loans outstanding at June 30, 2005 also increased by nearly the same amount. Net loans increased by \$16,396, as a result of the allowance for loan losses having increased by \$28 from a recovery. The improvement in gross loan volume was primarily related to a \$16,516 increase in net participation loans purchased. For the six months ended June 30, 2005, LSA loan volume decreased by \$112, primarily as a result of collections of nonaccrual loans.

Net loans at June 30, 2005 made up 97.5 percent of total assets, as compared to 97.3 percent at December 31, 2004. The composition and amount of the Association's various asset categories did not change much during the second quarter, except for loans.

As a percentage of gross loans, nonaccrual loans equaled .7 percent at June 30, 2005, compared with .99 percent and 1.4 percent at December 31 and June 30, 2004, respectively. The year-over-year decrease in the percentage was primarily the result of a series of payments 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 possible losses in the loan portfolio, based upon current and expected future conditions. The allowance for loan losses at June 30, 2005 was \$226 compared to \$198 at December 31, 2004, and was considered by management to be adequate to cover probable losses. The ratio of allowance to gross loan volume was .08 percent at June 30, 2005 and .08 percent at December 31, 2004. There was one recovery for \$28 thousand during the second quarter, and no charge-offs were recognized.

During 2004, the Association completed its study to further refine the allowance for loan losses methodology taking into account recently issued guidance by the Farm Credit Administration (FCA), the System's regulator, as well as the Securities and Exchange Commission (SEC) and Federal Financial Institutions Examination Council. As a result of this study and the resulting refinements in methodology, during the fourth quarter of 2004, the Association recorded a \$5,136 reversal of the allowance for loan losses. The Association's allowance for loan losses methodology utilized prior to the study was in accordance with generally accepted accounting principles and was consistently applied.

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

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

## RESULTS OF OPERATIONS

Net income for the six months ended June 30, 2005 totaled \$1,301, an increase of \$214 or 19.7 percent as compared to the first six months of 2004. The increase was primarily the result of interest income earned on the higher level of accruing loan volume. At June 30, 2005 net interest income was \$3,298, an increase of \$156 or 5.0 percent compared to the June 30, 2004 total of \$3,142. During the first six months of 2005, interest income on accruing loans increased by \$2,301 to \$6,742 or by 51.8 percent. This material increase was the result of not only the significant increase in accruing loan volume during the past twelve months, but also the increase in the interest rate environment. However, during the first two quarters of 2005, interest expense on notes payable to AgFirst increased by \$2,145 or 165.1 percent. The reason for such a large percentage increase was an agreement between the Association and AgFirst to change the interest rate pricing formula applied to the direct notes payable to AgFirst. This action was taken as a result of the final phase out of Section 936/30A transition relief, which expires as of December 31, 2005. The effect of this agreement was to raise the Association's cost of borrowing from AgFirst by approximately 30 basis points.

Thus, for 2005 the Association expects to record a smaller increase in net interest income. However, a portion of this reduction in net interest income will be offset as the Association begins to recognize patronage refund distributions from AgFirst, beginning in 2006. Previously, the Association received the majority of its funding from the Farm Credit Finance Corporation of Puerto Rico, which resulted in the Association not participating in the patronage distributions declared by AgFirst.

During the first six months of 2005, there was no provision addition or reduction to the allowance for loan losses.

Noninterest income for the six months ended June 30, 2005 was \$165, an increase of \$24 as compared to the first six months of 2004. Primarily this was the result of additional fee income earned from the increased level of participation loan activity.

Noninterest expense for the six months ended June 30, 2005 decreased by \$34 or 1.5 percent compared to the same period of 2004. The change was primarily related to salaries and benefits which increased \$66 or 4.8 percent due to lower deferred costs related to fewer loan originations. This was offset by a \$59 decrease in the Farm Credit System insurance fund premium expense. Management projects a second year of a significant decrease in the expense, as the announced premium on accruing loans is lower than for 2004. Other operating expenses decreased by \$46 when comparing year-over-year, as the Association did less advertising.

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 six months of 2005, like 2004, the Association did not record a provision for income tax expense.

### ***For the three months ended June 30, 2005***

Net income for the second quarter of 2005 was \$697 compared to \$529 for the second quarter of 2004. Net interest income for the three months ended June 30, 2005 totaled \$1,694 compared to \$1,595 for the three months ended June 30, 2004, reflecting increased accruing loan volume, and a higher rate environment.

Noninterest income for the three months ended June 30, 2005 was \$87, an increase of \$12 from the second quarter of 2004 when noninterest income totaled \$75.

For the second quarter of 2005, noninterest expense decreased by \$57 to total \$1,084 compared to the second quarter of 2004 which totaled \$1,141. The decrease, during the second quarter, was primarily the result of lower insurance fund premium expense and reduced other operating expenses.

### ***Key Results of Operations Ratios:***

	<b>Annualized for the six months ended 6/30/05</b>	<b>For the year ended 12/31/04</b>
Return on Average Assets	.99%	3.22%
Return on Average Stockholders' Equity	4.86%	16.38%
Net Interest Income as a Percentage of Average Earning Assets	2.60%	2.76%

## 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 AgFirst Farm Credit Bank (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, 2005 was \$214,289 as compared with \$199,477 at December 31, 2004. The increase of \$14,812 or 7.4 percent corresponded to the increase in gross loan volume and the funding of the year-end 2004 dividend.

The Association had no lines of credit outstanding with third parties as of June 30, 2005.

#### *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, 2005 increased 2.4 percent to \$54,181 from December 31, 2004 when total stockholders' equity was \$52,904. The increase was primarily attributable to net income retained as unallocated surplus during the quarter.

Total capital stock and participation certificates were \$973 on June 30, 2005 compared to \$998 on December 31, 2004. The decrease of \$25 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 \$1,302 or 2.5 percent from December 31, 2004 when unallocated retained earnings totaled \$51,906. The increase was primarily from net income earned during the first two quarters of 2005.

The Board of directors intends to continue its policy of declaring cash dividends. 2004 was the twelfth consecutive year of paying dividends. The table below sets forth the recent dividends declared:

<b>Year</b>	<b>Type</b>	<b>Amount Declared</b>
2004	Patronage	\$ 2,500
2003	Patronage Equity	\$ 1,847 153
2002	Patronage Equity	\$ 1,602 149

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, 2005 was 24.55 percent compared to 24.12 percent at December 31, 2004. The Association's total surplus and core surplus ratios were both 24.08 percent at June 30, 2005. 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:**

	<b>6/30/05</b>	<b>12/31/04</b>
Stockholders' Equity to Assets	19.81%	20.50%
Debt to Stockholders' Equity	4.05:1	3.88:1

**NOTE:** Shareholder investment in the Association could be affected by the financial condition and results of operations of AgFirst Farm Credit Bank. Copies of AgFirst's annual and quarterly reports are available upon request free of charge by calling 1-800-845-1745, ext. 378, or writing Jay Wise, AgFirst Farm Credit Bank, P.O. Box 1499, Columbia, SC 29202. Information concerning AgFirst Farm Credit Bank can also be obtained at their website, [www.agfirst.com](http://www.agfirst.com). Copies of the Association's annual and quarterly reports are also available upon request free of charge by calling 1-800-981-3323, writing Bruce M Hoffman, CFO, Puerto Rico Farm Credit, ACA, PO Box 363649, San Juan PR 00936, or accessing the website, [www.puertoricofarmcredit.com](http://www.puertoricofarmcredit.com). The Association prepares a quarterly report within 45 days after the end of each fiscal quarter, except that no report need be prepared for the fiscal quarter that coincides with the end of the fiscal year of the institution.

*Puerto Rico Farm Credit, ACA*  
**Consolidated Balance Sheets**

<i>(dollars in thousands)</i>	<b>June 30,</b>		<b>December 31,</b>
	<b>2005</b>	<b>2004</b>	<b>2004</b>
	<i>(unaudited)</i>	<i>(unaudited)</i>	<i>(audited)</i>
<b>Assets</b>			
Cash	\$ —	\$ 38	\$ 322
Loans	266,919	244,060	250,495
Less: allowance for loan losses	226	5,983	198
Net loans	266,693	238,077	250,297
Accrued interest receivable	1,609	1,087	1,262
Investment in other Farm Credit institutions	2,712	4,712	2,712
Premises and equipment, net	461	544	439
Other property owned	150	—	150
Prepaid retirement expense	1,790	—	1,954
Other assets	152	213	144
Total assets	<u>\$ 273,567</u>	<u>\$ 244,671</u>	<u>\$ 257,280</u>
<b>Liabilities</b>			
Notes payable to AgFirst Farm Credit Bank	\$ 214,289	\$ 194,142	\$ 199,477
Accrued interest payable	653	239	439
Dividend payable	—	—	2,500
Postretirement benefits other than pensions	1,559	1,306	1,423
Minimum pension liability	—	1,206	—
Other liabilities	2,885	866	537
Total liabilities	<u>219,386</u>	<u>197,759</u>	<u>204,376</u>
Commitments and contingencies			
<b>Stockholders' Equity</b>			
Capital stock and participation certificates	973	1,005	998
Unallocated retained earnings	53,208	47,741	51,906
Accumulated other comprehensive income (loss)	—	(1,834)	—
Total stockholders' equity	<u>54,181</u>	<u>46,912</u>	<u>52,904</u>
Total liabilities and stockholders' equity	<u>\$ 273,567</u>	<u>\$ 244,671</u>	<u>\$ 257,280</u>

*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>	<b>For the three months ended June 30,</b>		<b>For the six months ended June 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
<b>Interest Income</b>				
Loans	\$ 3,546	\$ 2,280	\$ 6,742	\$ 4,441
<b>Interest Expense</b>				
Notes payable to AgFirst Farm Credit Bank	1,852	685	3,444	1,299
Net interest income	1,694	1,595	3,298	3,142
Provision for (reversal of) loan losses	—	—	—	—
Net interest income after provision for (reversal of) loan losses	1,694	1,595	3,298	3,142
<b>Noninterest Income</b>				
Loan fees	83	71	145	118
Fees for financially related services	3	3	6	6
Other noninterest income	1	1	14	17
Total noninterest income	87	75	165	141
<b>Noninterest Expense</b>				
Salaries and employee benefits	707	699	1,455	1,389
Occupancy and equipment	65	62	124	118
Insurance Fund premium	24	55	48	107
Guarantee fee	47	48	97	100
Other operating expenses	239	277	436	482
Losses on other property owned, net	2	—	2	—
Total noninterest expense	1,084	1,141	2,162	2,196
Income before income taxes	697	529	1,301	1,087
Provision (benefit) for income taxes	—	—	—	—
Net income	\$ 697	\$ 529	\$ 1,301	\$ 1,087

*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>	<b>Capital Stock and Participation Certificates</b>	<b>Retained Earnings Unallocated</b>	<b>Accumulated Other Comprehensive Income</b>	<b>Total Stockholders' Equity</b>
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	\$ 1,005	\$ 47,741	\$ (1,834)	\$ 46,912
Balance at December 31, 2004	\$ 998	\$ 51,906	\$ —	\$ 52,904
Net income		1,301		1,301
Capital stock/participation certificates issued	18			18
Capital stock/participation certificates retired	(43)			(43)
Distribution adjustment		1		1
Balance at June 30, 2005	\$ 973	\$ 53,208	\$ —	\$ 54,181

*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, 2004, are contained in the 2004 Annual Report to Shareholders. These unaudited second quarter 2005 consolidated financial statements should be read in conjunction with the 2004 Annual Report to Shareholders.

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, 2005, are not necessarily indicative of the results to be expected for the year ending December 31, 2005.

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, 2005, 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 12-31-03	\$ 5,983
(Reversal of) provision for loan losses	—
Recoveries, net of loans charged off	—
Balance at 6-30-04	<u>\$ 5,983</u>
Balance at 12-31-04	\$ 198
(Reversal of) provision for loan losses	—
Recoveries, net of loans charged off	28
Balance at 6-30-05	<u>\$ 226</u>

As discussed in the 2004 Annual Report, the Association recorded a loan loss reversal of \$5,136 in the fourth quarter of 2004 that resulted in a decrease in the allowance for loan losses.

## NOTE 3 – CAPITAL

During the second quarter, at the Association's annual meeting which was held on April 3, 2005, the shareholders approved changes to the capitalization bylaw, which will permit the Association to operate under sub-chapter T for federal tax purposes. The bylaw changes will become effective January 1, 2006, unless Sections 936/30A are extended and do not expire as

of December 31, 2005. Management is of the opinion that any tax impact, as it relates to net deferred tax assets, will not be material.

## NOTE 4 – 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 5 – 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, 2005:

	For the six months ended June 30,	
	2005	2004
Service cost	\$ 22	\$ 25
Interest cost	98	85
Amortization of net (gain) loss	17	17
Recognized net actuarial (gain) loss	49	34
Net periodic benefit cost	<u>\$ 186</u>	<u>\$ 161</u>

The following is a table of retirement and postretirement benefit expense for the six months ended June 30, 2005:

	For the six months ended June 30,	
	2005	2004
Pension	\$ 163	\$ 188
Thrift	32	32
Other postretirement benefits	186	161
Total	<u>\$ 381</u>	<u>\$ 381</u>

As of June 30, 2005, no contributions have been made to the pension plan for 2005. Actuarial projections as of the last plan measurement date (September 30, 2004) did not anticipate any contributions for 2005; however, market conditions could impact discount rates and return on plan assets which could change this expectation, making contributions necessary before the next plan measurement date.