

# FEDERAL LAND BANK ASSOCIATION OF SOUTH ALABAMA, FLCA

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## 2008 Quarterly Report Third Quarter



**For the Quarter Ended September 30, 2008**



Part of the Farm Credit System

## REPORT OF MANAGEMENT

The financial statements of the Federal Land Bank Association of South Alabama, FLCA (Association) are prepared by management, who are responsible for the statements' integrity and objectivity, including amounts that must necessarily be based on judgments and estimates. The financial statements have been prepared in conformity with generally accepted accounting principles appropriate in the circumstances. Other financial information included in the quarterly report is consistent with that in the financial statements.

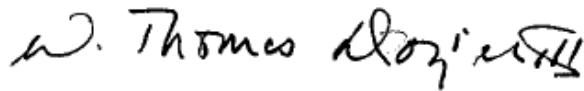
To meet its responsibility for reliable financial information, management depends on the Farm Credit Bank of Texas' (Bank) and the Association's accounting and internal control systems, which have been designed to provide reasonable, but not absolute, assurance that assets are safeguarded and transactions are properly authorized and recorded. The systems have been designed to recognize that the cost of controls must be related to the benefits derived. The annual financial statements are audited by PricewaterhouseCoopers LLP, independent accountants, who conduct a review of internal controls solely for the purpose of establishing a basis for reliance thereon in determining the nature, extent and timing of audit tests applied in the audit of the financial statements in accordance with generally accepted auditing standards. The Association is also examined by the Farm Credit Administration.

The audit committee of the board of directors has oversight responsibility for the Association's system of internal controls and financial reporting. The audit committee consults regularly with management and meets periodically with the independent auditors and the internal auditor to review the scope and results of their work. The independent auditors and internal auditor have direct access to the audit committee.

The undersigned certify that, to the best of our knowledge and belief, the financial statements and other financial information included in this quarterly report reliably present the financial condition of the Federal Land Bank Association of South Alabama, FLCA and the results of its operations for the periods shown.



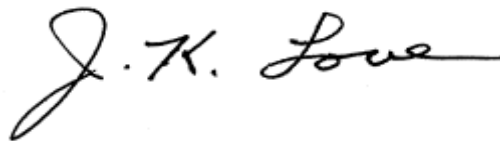
Douglas Thiessen  
Chief Executive Officer  
October 30, 2008



W. Thomas Dozier, III  
Chairman, Board of Directors  
October 30, 2008



M. Scott Sellers, CPA  
Sr.VP/Chief Financial Officer  
October 30, 2008



J.K. Love, CPA  
Chairman, Audit Committee  
October 30, 2008

## **FEDERAL LAND BANK ASSOCIATION OF SOUTH ALABAMA, FLCA MANAGEMENT'S DISCUSSION AND ANALYSIS**

The following commentary reviews the financial performance of the Federal Land Bank Association of South Alabama, FLCA (Federal Land Credit Association), referred to as the Association, for the quarter and nine months ended September 30, 2008. These comments should be read in conjunction with the accompanying financial statements and the December 31, 2007 Annual Report of the Association.

The financial statements were prepared under the oversight of the Association's audit committee.

### **Results of Operations:**

The Association had net income of \$2,586,720 and \$8,400,509 for the three and nine months ended September 30, 2008, as compared to net income of \$2,179,961 and \$5,844,124 for the same periods in 2007 reflecting an increase of 18.7 and 43.7 percent, respectively. Net interest income was \$3,959,171 and \$11,923,913, respectively, for the three and nine months ended September 30, 2008, compared to \$4,025,904 and \$11,861,565 for the same periods in 2007. Interest income for the first nine months of 2008 decreased by \$2,048,601 or 6.9 percent from the same periods of 2007, primarily due to declines in yields on earning assets, offset partially by an increase in average loan volume. Interest expense for the first nine months of 2008 decreased by \$2,110,949, or 11.8 percent, from the same periods of 2007 due to a decrease in interest rates, offset partially by an increase in average debt volume. The provision for loan losses for the first nine months of 2008 decreased by \$2,672,763, or 99.0%, over the same period of 2007, due to specific reserves recorded for two large credits in the second quarter of 2007. One of the credits and related specific reserves remains on the Association's books as of September 30, 2008, and is discussed further in the "Risk Exposure" and "Legal Proceedings" sections of Management's Discussion and Analysis, below. Average loan volume for the third quarter of 2008 was \$570,987,921, compared to \$525,171,148 in the third quarter of 2007.

Noninterest income for the three and nine months ended September 30, 2008 increased by \$135,299 and \$907,494, or 29.7 percent and 67.5 percent, respectively, over the same periods of 2007. These increases are due primarily to higher patronage income from Farm Credit Bank of Texas (the Bank) in the first nine months of 2008 as compared to the first nine months of 2007. The increase in patronage is due almost entirely to the Association accruing Direct Note patronage from the Bank on a monthly basis in 2008. Eight months of estimated Direct Note patronage, to be received at year end, have been accrued into income as of September 30, 2008. As this is the first year of accruing this income during the year, no such income was reflected for the comparable periods in 2007. However, beginning in September and for the remainder of 2008, the Association's management decided to discontinue accruing Direct Note patronage from the Bank in the event that the current market conditions would have any impact on the Bank's earnings and its ability to pay patronage to the associations. Although the Bank's earnings capacity has not been significantly impacted by market or credit conditions through the quarter and nine months ended September 30, 2008, subsequent changes in these conditions could affect the Bank's amount of patronage payment to its associations.

Noninterest expenses for the three and nine months ended September 30, 2008 increased by \$299,155 and \$1,073,745, or 18.4 percent and 23.0 percent, respectively, as compared to the same periods in 2007. These respective increases are due primarily to an increase in salaries and employee benefits. The increase in salaries and employee benefits is primarily due to an increase in contributions to the defined benefit retirement plan as part of a District-wide initiative to reduce the amount of the unfunded accumulated post-retirement benefit obligation. For more information on the defined benefit plan, see Note 5, "Employee Benefit Plans," to the financial statements included in this quarterly report. For the nine months ended September 30, 2008 purchased services increased primarily due to legal and consulting fees incurred in connection with protecting the Association's interest in a large loan, as noted below in the "Risk Exposure" section of the Management's

Discussion and Analysis and Note 6, “Commitments and Contingencies,” to the financial statements included in this quarterly report. This increase in legal and consulting fees also directly resulted in the increase in CMS expense reimbursements, since the underlying loan was originated through the CMS group, and therefore a portion of the expense was subject to reimbursement. For further discussion, see Note 4, “Capital Markets,” to the financial statements included in this quarterly report.

The Association recorded no recoveries and no charge-offs for the quarter ended September 30, 2008, and no recoveries and \$1,789,757 in charge-offs for the same period in 2007. The Association’s allowance for loan loss was 0.1 percent and 0.1 percent of total loans outstanding as of September 30, 2008, and 2007, respectively.

The Association’s return on average assets for the nine months ended September 30, 2008, was 1.94 and 1.47 percent for the same period in 2007. The Association’s return on average equity for the nine months ended September 30, 2008, was 11.52 and 8.53 percent for the same period in 2007.

**Loan Portfolio:**

The Association makes and services loans, secured by a first lien on real estate, to farmers, ranchers, rural homeowners and certain farm-related businesses. The majority of the loans serviced by the Association contain provisions for variable interest rates and are long-term. Loans serviced by the Association offer several installment payment cycles, the timing of which usually coincides with the seasonal cash-flow capabilities of the borrower.

Total loans outstanding at September 30, 2008, stated at recorded investment (principal less funds held), were \$579,367,028 compared to \$542,069,361 at December 31, 2007, reflecting an increase of 6.9 percent. The major commodities within the Association’s loan portfolio are timber, cattle, poultry, and field crops.

The following table reflects the credit quality of the Association’s loan volume as of:

	<u>September 30, 2008</u>	<u>December 31, 2007</u>
Acceptable	98.1 %	99.0 %
Special Mention	0.6 %	0.4 %
Substandard	1.3 %	0.6 %
Total	<u>100.0 %</u>	<u>100.0 %</u>

**Risk Exposure:**

High-risk assets include nonaccrual loans, loans that are past due 90 days or more and still accruing interest, formally restructured loans and other property owned. The following table illustrates the Association’s components and trends of high-risk assets.

	<b>September 30, 2008</b>		December 31, 2007	
	<b>Amount</b>	<b>%</b>	Amount	%
Nonaccrual	<b>\$ 4,438,237</b>	<b>100.0%</b>	\$ 2,942,308	97.0%
90 days past due and still accruing interest	-	<b>0.0%</b>	-	0.0%
Formally restructured	-	<b>0.0%</b>	-	0.0%
Other property owned, net	-	<b>0.0%</b>	92,075	3.0%
<b>Total</b>	<b>\$ 4,438,237</b>	<b>100.0%</b>	<b>\$ 3,034,383</b>	<b>100.0%</b>

At September 30, 2008 loans that were considered impaired were \$4,438,237, compared to \$2,942,308 at December 31, 2007. This represents 0.8 percent and 0.5 percent of loan volume, respectively. Impaired loans consist of all high-risk assets except other property owned, net.

The Association originated a loan to one borrower through the Capital Markets of the South (CMS) and participated the loan to 13 other Farm Credit associations, with the Association serving as the lead lender. The original funded balance of the loan was \$68,500,000, and the Association retained 5.56% of the loan. During the second quarter of 2007, the loan was deemed to be nonaccrual due to its significant under collateralized position and a credit default. The Association is currently pursuing collection efforts, and in the third quarter of 2007 liquidated part of the loan's collateral, which was applied to the outstanding balance for all participants. In addition, in the second half of 2007 the Association, along with the four other CMS member associations, repurchased, on a pro-rata basis, the portions of the loan held by all other non-CMS participants. During 2007, charge-offs of \$30,245,000 were recognized, and specific reserves of \$1,460,000 remain on the books related to this loan. The Association's portion of charge-offs and specific reserves were \$4,814,212 and \$279,022, respectively. No further charge-offs or allowance reserves have been required to be recognized in 2008, and as of September 30, 2008, the Association's portion of the loan's remaining book balance is \$2,040,876. For more information on impaired loans and the allowance for loan losses, see Note 2 to the financial statements, "Allowance for Loan Losses," included in this quarterly report. As part of loan repurchase transactions noted above, the Association received a general release from the non-CMS participants for claims related to the loan, and agreed to indemnify the non-CMS participants from any liability arising from legal proceedings related to the loan.

### **Liquidity and Funding Sources:**

The Association secures the majority of its lendable funds from the Bank, which obtains its funds primarily through the issuance of Systemwide obligations. The following schedule summarizes the Association's borrowings.

	<b>September 30,</b>	<b>December 31,</b>
	<b>2008</b>	<b>2007</b>
Note payable to the Bank	<b>\$ 494,208,724</b>	\$ 463,189,388
Accrued interest on note payable	<b>1,708,881</b>	2,065,294
<b>Total</b>	<b>\$ 495,917,605</b>	<b>\$ 465,254,682</b>

### **Capital Resources:**

The Association's capital position increased by \$5,275,027 at September 30, 2008, compared to December 31, 2007. The Association's debt as a ratio to members' equity was 4.97:1 as of September 30, 2008, compared to 4.92:1 as of December 31, 2007.

In March 2008, the board declared a \$3,200,000 cash patronage to be paid to stockholders from the Association's 2007 earnings. The patronage distribution was completed in April 2008. See Note 3, "Capital," to the financial statements included in this quarterly report for further discussion.

Under regulations governing minimum permanent capital adequacy and other capitalization issues, the Association is required to maintain a minimum adjusted permanent capital of seven percent of risk-adjusted assets as defined by the FCA. The Association's permanent capital ratio at September 30, 2008, was 15.8 percent, which is in compliance with the FCA's minimum permanent capital standard. The Association's core surplus ratio and total surplus ratio at September 30, 2008, were 15.2 and 15.2 percent, respectively, which is in compliance with the FCA's minimum surplus standards.

### **Legal Proceedings:**

In relation to the loan described in the "Risk Exposure" section of Management's Discussion and Analysis, above, the Association is involved in two lawsuits as of the date of this report. The overall character of the lawsuits is of collection of the principal and interest from the borrower and control of the loan's collateral. These legal proceedings are described in more detail in Note 6, "Commitments and Contingencies," to the financial statements included in this quarterly report.

These legal proceedings have been lengthy and the outcome is still unknown at this time as to a portion of the proceedings – in particular, those dealing with the counterclaims of the borrower. However, in mid-September the Kentucky Court, where the Association's suit on the debt was pending, granted summary judgment in favor of the Association for the debt plus interest, costs and fees. This step allowed the Association to have a foreclosure sale of its real estate collateral located in Bell/Harlan Counties, which sale was conducted on October 10, 2008, resulting in a purchase by a third party of such collateral for \$7,001,000. The Association is expecting that sale to be consummated by the end of October 2008. Proceedings have been commenced in Muhlenberg County to have a foreclosure sale conducted there as well. The Association has been and will remain vigorous in pursuit of collection of the loan balances outstanding and other potential sources of recovery, and in defense of the counterclaims asserted by the borrower and others against the Association. The Association's legal counsel believes that the Association's claims are supported by facts and applicable law, and have a reasonable chance of success, and at the same time believes that the claims of the borrower and other defendants are without merit and the Association will likely be successful in its defense against such claims.

### **Relationship with the Farm Credit Bank of Texas:**

The Association's financial condition may be impacted by factors that affect the Bank. The financial condition and results of operations of the Bank may materially affect the stockholders' investment in the Association. The Management's Discussion and Analysis and Notes to Financial Statements contained in the December 31, 2007 Annual Report of Federal Land Bank Association of South Alabama, FLCA more fully describe the Association's relationship with the Bank.

The Tenth Farm Credit District's (District) annual and quarterly stockholder reports are available free of charge, upon request. These reports can be obtained by writing to Farm Credit Bank of Texas, The Ag

Agency, P.O. Box 202590, Austin, Texas 78720, or by calling (512) 483-9260. Copies of the District's quarterly and annual stockholder reports also can be requested by e-mail at [fcb@farmcreditbank.com](mailto:fcb@farmcreditbank.com). The District makes its annual and quarterly stockholder reports available on its web site at [www.farmcreditbank.com](http://www.farmcreditbank.com).

The Association's annual and quarterly stockholder reports are also available free of charge, upon request. These reports can be obtained by writing to the Federal Land Bank Association of South Alabama, FLCA, P.O. Box 241687, Montgomery, Alabama, 36124-1687, or by calling (334) 270-8687. Copies of the reports can also be requested by e-mailing [awolf@farmcreditbank.com](mailto:awolf@farmcreditbank.com). The Association's quarterly stockholder reports are available on its website at [www.alabamalandloan.com](http://www.alabamalandloan.com) approximately 40 days after each quarter end, and the annual stockholder report is available on its website 75 days after fiscal year end. Copies of the annual stockholder report can also be requested 90 days after fiscal year end.

**FEDERAL LAND BANK ASSOCIATION OF SOUTH ALABAMA, FLCA**

**BALANCE SHEET**

	<b>September 30, 2008 (unaudited)</b>	<b>December 31, 2007</b>
	<hr/>	<hr/>
<b><u>ASSETS</u></b>		
Cash	\$ 362,320	\$ 1,250,729
Loans	579,367,028	542,069,361
Less: allowance for loan losses	544,128	552,564
Net loans	<hr/> 578,822,900	<hr/> 541,516,797
Accrued interest receivable	8,928,234	9,361,142
Investment in and receivable from the Bank:		
Capital stock	8,736,625	8,736,625
Accrued patronage receivable	926,667	351,309
Other property owned, net	-	92,075
Premises and equipment	1,638,477	1,630,274
Other assets	401,814	258,982
Total assets	<hr/> <b>\$ 599,817,037</b> <hr/>	<hr/> <b>\$ 563,197,933</b> <hr/>
 <b><u>LIABILITIES</u></b>		
Note payable to the Bank	\$ 494,208,724	\$ 463,189,388
Accrued interest payable	1,708,881	2,065,294
Drafts outstanding	1,201,572	324,967
Other liabilities	2,275,498	2,470,949
Total liabilities	<hr/> <b>499,394,675</b> <hr/>	<hr/> <b>468,050,598</b> <hr/>
 <b><u>MEMBERS' EQUITY</u></b>		
Capital stock and participation certificates	3,448,230	3,326,230
Unallocated retained earnings	96,720,869	91,538,558
Accumulated other comprehensive income	253,263	282,547
Total members' equity	<hr/> <b>100,422,362</b> <hr/>	<hr/> <b>95,147,335</b> <hr/>
Total liabilities and members' equity	<hr/> <b>\$ 599,817,037</b> <hr/>	<hr/> <b>\$ 563,197,933</b> <hr/>

The accompanying notes are an integral part of these financial statements

**FEDERAL LAND BANK ASSOCIATION OF SOUTH ALABAMA, FLCA**

**STATEMENT OF INCOME**

(unaudited)

	Quarter Ended		Nine Months Ended	
	September 30,		September 30,	
	2008	2007	2008	2007
<b><u>INTEREST INCOME</u></b>				
Loans	\$ 9,036,998	\$ 10,156,170	\$ 27,638,045	\$ 29,686,646
<b><u>INTEREST EXPENSE</u></b>				
Note payable to the Bank	5,077,827	6,130,266	15,714,132	17,825,081
Net interest income	<b>3,959,171</b>	4,025,904	<b>11,923,913</b>	11,861,565
<b><u>PROVISION FOR LOSSES</u></b>				
Provision for loan losses	49,449	678,797	26,568	2,699,331
Provision for (reversal of) acquired property losses	(8,000)	-	12,475	-
Net interest income after provision for loan losses	<b>3,917,722</b>	3,347,107	<b>11,884,870</b>	9,162,234
<b><u>NONINTEREST INCOME</u></b>				
Patronage income from the Bank	322,614	110,828	1,213,674	329,582
Loan fees	266,758	334,546	977,234	961,568
Financially related services income	1,603	1,991	4,137	4,732
Gain (loss) on sale of premises and equipment, net	500	3,811	2,772	(2,183)
Other noninterest income	-	5,000	53,254	49,878
Total noninterest income	<b>591,475</b>	456,176	<b>2,251,071</b>	1,343,577
<b><u>NONINTEREST EXPENSES</u></b>				
Salaries and employee benefits	1,188,730	797,654	3,346,395	2,639,999
Directors' expense	57,982	28,092	184,799	152,280
Purchased services	305,247	524,612	1,670,840	916,694
Travel	116,623	88,999	281,456	218,948
Occupancy and equipment	73,925	64,342	197,164	179,448
Communications	21,036	22,196	68,417	61,512
Advertising	49,783	56,812	125,139	96,480
Public and member relations	32,529	23,302	99,296	78,745
Supervisory and exam expense	55,569	54,386	164,339	147,695
FCSIC insurance expense	168,076	213,007	631,164	630,581
Other noninterest expense	25,548	49,316	73,052	104,894
Loss on other property owned, net	25,790	1,925	25,790	1,925
CMS expense reimbursements	(198,361)	(301,321)	(1,132,419)	(567,514)
Total noninterest expenses	<b>1,922,477</b>	1,623,322	<b>5,735,432</b>	4,661,687
Net income	<b>\$ 2,586,720</b>	\$ 2,179,961	<b>\$ 8,400,509</b>	\$ 5,844,124

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

**FEDERAL LAND BANK ASSOCIATION OF SOUTH ALABAMA, FLCA**

**STATEMENT OF CHANGES IN MEMBERS' EQUITY**

(unaudited)

	<u>Capital Stock/ Participation Certificates</u>	<u>Unallocated Retained Earnings</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Total Members' Equity</u>
Balance at December 31, 2006	\$ 3,150,865	\$ 87,388,071	\$ -	\$ 90,538,936
Net income	-	5,844,124	-	5,844,124
Capital stock/participation certificates issued	516,845	-	-	516,845
Capital stock/participation certificates retired	(362,420)	-	-	(362,420)
Patronage refunds:				
Cash	-	(3,000,000)	-	(3,000,000)
Change in patronage declared and paid		15,143		15,143
Balance at September 30, 2007	<u>\$ 3,305,290</u>	<u>\$ 90,247,338</u>	<u>\$ -</u>	<u>\$ 93,552,628</u>
Balance at December 31, 2007	\$ 3,326,230	\$ 91,538,558	\$ 282,547	\$ 95,147,335
Comprehensive income				
Net income	-	8,400,509	-	8,400,509
Other comprehensive income:				
Amortization of costs included in net periodic pension costs	-	-	(29,284)	(29,284)
Comprehensive income	-	8,400,509	(29,284)	8,371,225
Effects of accounting change regarding measurement date of postretirement benefits plans pursuant to FASB Statement No. 158 (See Note 5)		(18,492)		(18,492)
Capital stock/participation certificates issued	469,835	-	-	469,835
Capital stock/participation certificates retired	(347,835)	-	-	(347,835)
Patronage refunds:				
Cash	-	(3,200,000)	-	(3,200,000)
Change in patronage declared and paid		294		294
<b>Balance at September 30, 2008</b>	<u><b>\$ 3,448,230</b></u>	<u><b>\$ 96,720,869</b></u>	<u><b>\$ 253,263</b></u>	<u><b>\$ 100,422,362</b></u>

The accompanying notes are an integral part of these financial statements

**FEDERAL LAND BANK ASSOCIATION OF SOUTH ALABAMA, FLCA**  
**NOTES TO THE FINANCIAL STATEMENTS**  
(UNAUDITED)

**NOTE 1 — ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES:**

The Federal Land Bank Association of South Alabama, FLCA (Federal Land Credit Association), referred to as the Association, is a member-owned cooperative that provides credit and credit-related services to or for the benefit of eligible borrowers/stockholders for qualified agricultural purposes. The Association serves the counties of Autauga, Baldwin, Barbour, Bibb, Bullock, Butler, Chambers, Chilton, Choctaw, Clarke, Coffee, Conecuh, Coosa, Covington, Crenshaw, Dale, Dallas, Elmore, Escambia, Geneva, Greene, Hale, Henry, Houston, Lee, Lowndes, Macon, Marengo, Mobile, Monroe, Montgomery, Perry, Pickens, Pike, Russell, Sumter, Tallapoosa, Tuscaloosa, Washington and Wilcox in the state of Alabama. The Association is a lending institution of the Farm Credit System (the System), which was established by Acts of Congress to meet the needs of American agriculture.

A description of the Association's significant accounting policies and the financial condition and results of operations as of December 31, 2007 are contained in the 2007 Annual Report to the stockholders. These unaudited third quarter 2008 financial statements should be read in conjunction with the 2007 Annual Report to the stockholders.

The accompanying 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, except for the inclusion of a statement of cash flows. Generally accepted accounting principles require a business enterprise that provides a set of financial statements reporting both financial position and results of operations to also provide a statement of cash flows for each period for which results of operations are provided. However, in regulations issued by FCA, associations have the option to exclude statements of cash flows in interim financial statements. Therefore, the Association has elected not to include a statement of cash flows in these financial statements.

The preparation of these financial statements requires the use of management's estimates. The results for the quarter ended September 30, 2008 are not necessarily indicative of the results to be expected for the year ended December 31, 2008. Certain amounts in the prior period's financial statements have been reclassified to conform to current financial statement presentation.

**NOTE 2 — ALLOWANCE FOR LOAN LOSSES:**

The allowance for loan losses is maintained at a level considered adequate by management to provide for estimated 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. An analysis of the allowance for loan losses follows:

	<b>September 30, 2008</b>	September 30, 2007
Balance at beginning of quarter	\$ 494,679	\$ 1,450,921
Provision for loan losses	49,449	678,797
Charge-offs	-	(1,789,757)
Recoveries	-	-
Balance at end of quarter	<u>\$ 544,128</u>	<u>\$ 339,961</u>

The following table presents information concerning impaired loans:

	<b>September 30, 2008</b>	September 30, 2007
Impaired loans with related allowance	\$ 3,321,733	\$ 1,152,479
Impaired loans with no related allowance	1,116,504	296,492
Total impaired loans	<u>\$ 4,438,237</u>	<u>\$ 1,448,971</u>
Allowance on impaired loans	\$ 327,887	\$ 171,590
Average impaired loans	\$ 3,334,982	\$ 2,568,983
Interest income on impaired loans for the quarter	\$ 3,329	\$ 1,609

### NOTE 3 — CAPITAL:

The Association's board of directors has established a Capital Adequacy Plan (Plan) that includes the capital targets that are necessary to achieve the institution's capital adequacy goals as well as the minimum permanent capital standards. The Plan monitors projected dividends, equity retirements and other actions that may decrease the Association's permanent capital. In addition to factors that must be considered in meeting the minimum standards, the board of directors also monitors the following factors: capability of management; quality of operating policies, procedures, and internal controls; quality and quantity of earnings; asset quality and the adequacy of the allowance for losses to absorb losses inherent within the loan portfolio; sufficiency of liquid funds; needs of an institution's customer base; and any other risk-oriented activities, such as funding and interest rate risk, potential obligations under joint and several liability, contingent and off-balance-sheet liabilities or other conditions warranting additional capital. At least quarterly, management reviews the Association's goals and objectives with the board.

In March 2008, the board declared a \$3,200,000 cash patronage to be paid to stockholders from the Association's 2007 earnings. The patronage distribution was completed in April 2008.

### NOTE 4 — CAPITAL MARKETS:

Until the second quarter of 2007, the Association participated in the Capital Markets of the South (CMS), a joint venture created in 2003 for the purpose of expanding the participants' lending opportunities. The CMS group was comprised of the Association, the Federal Land Bank Association of North Alabama, FLCA, the Land Bank of North Mississippi, FLCA, Land Bank South, FLCA, and the Louisiana Federal Land Bank Association, FLCA. During the second quarter of 2007, the CMS members decided to discontinue the joint venture. The Association will continue to service the existing CMS loan portfolio, with revenue and expenses continuing to be shared accordingly as noted below, until such time as all of the loans are fully matured or paid off.

Pursuant to the terms of the alliance, each of the five CMS participating associations generally share equally in the costs of operating the venture. All CMS noninterest expenses are recorded gross on the Association's books and then reimbursed 80% by the other four associations. The total amount of reimbursements is included on the statement of income in the line item entitled "CMS expense reimbursements." The Association's pro-rata share of income from CMS operations are recorded in the statement of income in their respective line items.

**NOTE 5 — EMPLOYEE BENEFIT PLANS:**

The following table summarizes the components of net periodic benefit costs for the nine months ended September 30,:

	Other Benefits	
	2008	2007
Service cost	\$ 32,304	\$ 33,726
Interest cost	52,458	47,091
Expected return on plan assets	-	-
Amortization of prior service costs	(29,742)	(32,625)
Amortizations of net (gain) loss	456	591
Net periodic benefit cost	<u>\$ 55,476</u>	<u>\$ 48,783</u>

In September 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 158 "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" (SFAS 158), which required the recognition of the overfunded or underfunded status of pension and other postretirement benefit plans on the balance sheet. The balance sheet recognition provisions of SFAS 158 were adopted at December 31, 2007. SFAS 158 also requires that employers measure the benefit obligation and plan assets as of the fiscal year end for fiscal years ending after December 15, 2008. In fiscal 2007 and earlier, the Association used a September 30 measurement date for other postretirement benefit plans. The Standard provides two approaches for an employer to transition to a fiscal year end measurement date. The Association has applied the second approach, which allows for the use of the measurements determined for the prior year end.

Under this alternative, postretirement benefit expense measured for the three-month period October 1, 2007 to December 31, 2007 (determined using the September 2007 measurement date) was recorded as an adjustment to beginning 2008 retained earnings. As result, the Association decreased retained earnings by \$18,492, and increased the postretirement benefit liability by \$18,492.

The Association previously disclosed in its Annual Report to the stockholders for the year ended December 31, 2007, that it expected to contribute \$22,548 to its postretirement health and welfare benefits plan in 2008. As of September 30, 2008, \$15,748 of contributions have been made. The Association's liability for the plan's unfunded accumulated benefit obligation at September 30, 2008 was \$1,171,076 and is included in "Other liabilities" in the balance sheet.

**NOTE 6 — COMMITMENTS AND CONTINGENCIES:**

As of September 30, 2008, the Association was party to two lawsuits related to a large loan. The loan was originated by the Association to one borrower through CMS and was participated to 13 other Farm Credit

associations, with the Association serving as the lead lender. The original funded balance of the loan was \$68.5 million, and the Association retained 5.56% of the loan. During 2007 the loan, which is significantly undercollateralized, was declared to be in default and transferred to nonaccrual status, and collection actions were commenced by the Association. Also during 2007, the Association along with the other CMS member associations, repurchased on a pro-rata basis the portions of the loan held by all other non-CMS participants. As part of the repurchase transactions, the Association received a general release from the non-CMS participants for claims related to the loan, and agreed to indemnify the non-CMS participants from any liability arising from legal proceedings related to the loan.

An initial lawsuit brought in Texas State Court, the domicile state of the Borrower, was commenced for the purpose of obtaining access to collateral for the loan. Such suit was successful and has now been dismissed.

The overall character of the two remaining lawsuits is of collection of the principal and interest from the borrower, control of the loan's remaining collateral and an effort to recover property purchased with the Association's loan proceeds. One of the lawsuits was filed in the borrower's domicile state of Texas in US Federal District Court and involved civil complaints by the Association against the borrower and other related individuals as well as third parties for damages incurred as a consequence of alleged wrongful acts by the respective parties and an effort to recover assets acquired with proceeds of the loan from such parties. The borrower and all related defendants in this action have agreed to an injunction precluding the transfer of any assets acquired with proceeds of the loan. The remaining lawsuit was filed in the state of Kentucky, where the primary real estate collateral is located, for the purpose of gaining access to and foreclosing the lien of its mortgages on the real estate and commencing an action for collection of the debt. The Kentucky state court has appointed a receiver to protect the Association's collateral and preserve the status quo pending resolution of the suit. The borrower and other related individuals have responded by filing a counterclaim seeking damages against the Association, alleging various claims, including breach of contract.

These legal proceedings have been lengthy and the outcome as to the counterclaims is unknown at this time. However, the Kentucky Court has granted summary judgment in favor of the Association for the debt plus interest, costs and fees. This Judgment on the debt dispenses with a major portion of the Association's action in Kentucky and allows the Association to realize on its real estate collateral through foreclosure sales.

**NOTE 7 — SUBSEQUENT EVENT:**

In connection with the legal proceedings described in Note 6, "Commitments and Contingencies," above, the Association conducted its first foreclosure sale on October 10<sup>th</sup>, at which a third party purchased the Bell/Harlan County property, one of two primary parcels of real estate collateral in Kentucky, for \$7,001,000. This sale is expected to be consummated in the fourth quarter 2008. The other primary parcel of real estate collateral, located in Muhlenberg County, is expected to be sold at foreclosure sale in the near future.