

LONE STAR, ACA

2018 Quarterly Report Second Quarter



For the Quarter Ended June 30, 2018

REPORT OF MANAGEMENT

The undersigned certify that we have reviewed this report, that it 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.



Troy Bussmeir, Chief Executive Officer

August 9, 2018



Amy Birt, Chief Financial Officer

August 9, 2018



Don Crawford, Chairman, Audit Committee

August 9, 2018

LONE STAR, ACA MANAGEMENT'S DISCUSSION AND ANALYSIS

The following commentary reviews the financial performance of Lone Star Ag Credit, referred to as the Association, for the quarter ended June 30, 2018. These comments should be read in conjunction with the accompanying financial statements and the December 31, 2017 Annual Report to Stockholders.

The Association is a member of the Farm Credit System (System), a nationwide network of cooperatively owned financial institutions established by and subject to the provisions of the Farm Credit Act of 1971, as amended, and the regulations of the Farm Credit Administration (FCA) promulgated thereunder.

The consolidated financial statements comprise the operations of the ACA and its wholly-owned subsidiaries. The consolidated financial statements were prepared under the oversight of the Association's Audit Committee.

Patronage:

In July 2018, the Association's board of directors approved to pay a cash patronage to be paid in September of 2018, based on 2017 earnings. The patronage will be paid to eligible borrowers based on their average outstanding loan balance for the year ending December 31, 2017. The patronage amount to be paid is \$7,049,955, reflecting an approximately 49 basis point cash patronage.

In 2017, the Association paid patronage of \$13,809,745, which represents the 100 basis point cash patronage declared in December 2016 by the board of Lone Star, ACA. Patronage was paid to eligible borrowers based on their average outstanding loan balance for the years ended December 31, 2016.

In December 2017, the Association received a direct loan patronage of \$5,355,288 from the Farm Credit Bank of Texas ('Bank'), representing 39 basis points on the average daily balance of the Association's direct loan with the Bank. During 2017, the Association received \$571,987 in patronage payments from the Bank, based on the Association's stock investment in the Bank. Also, the Association received a participation's patronage of \$18,615 in 2017 from the Bank, representing 75 basis points on the Association's average balance of participations sold into the Bank's patronage pool program.

Loan Portfolio:

Total loans outstanding at June 30, 2018, including nonaccrual loans and sales contracts, were \$1,638,821,292 compared to \$1,681,072,602 at December 31, 2017, reflecting a decrease of 2.5 percent. Nonaccrual loans as a percentage of total loans outstanding were 0.3 percent at June 30, 2018, compared to 0.3 percent at December 31, 2017.

Total loans outstanding at June 30, 2017, including nonaccrual loans and sales contracts, were \$1,692,856,246. Nonaccrual loans as a percentage of total loans outstanding were 0.6 percent at June 30, 2017.

The Association recorded \$97,275 in recoveries and \$461,650 in charge-offs for the quarter ended June 30, 2018, and \$147,361 in recoveries and \$101,993 in charge-offs for the same period in 2017. The Association's allowance for loan losses was 0.5 percent, 0.5 percent and 0.6 percent of total loans outstanding as of June 30, 2018, December 31, 2017 and June 30, 2017, respectively.

Since 1917, the Association and its predecessors have provided its members with quality financial services. The board of directors and management remain committed to maintaining the financial integrity of the Association while offering competitive loan products that meet the financial needs of agricultural producers.

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.

	June 30, 2018		December 31, 2017		June 30, 2017	
	Amount	%	Amount	%	Amount	%
Nonaccrual	\$ 5,338,294	77.2%	\$ 5,633,106	50.0%	\$ 9,479,267	59.3%
90 days past due and still accruing interest	-	0.0%	-	50.0%	3,409,994	21.3%
Formally restructured	1,574,469	22.8%	4,537,338	0.0%	3,102,452	19.4%
Other property owned, net	-	0.0%	-	0.0%	-	0.0%
Total	<u>\$ 6,912,763</u>	<u>100.0%</u>	<u>\$ 10,170,444</u>	<u>100.0%</u>	<u>\$ 15,991,713</u>	<u>100.0%</u>

Results of Operations:

The Association had net income of \$9,161,572 and \$18,735,494 for the three and six months ended June 30, 2018, as compared to net income of \$5,570,566 and \$6,009,167 for the same period in 2017, reflecting an increase of 64.5 and 211.8 percent. Net interest income was \$14,189,696 and \$26,056,763 for the three and six months ended June 30, 2018, compared to \$11,748,422 and \$23,567,280 for the same period in 2017.

	Six months ended			
	June 30, 2018		June 30, 2017	
	Average Balance	Interest	Average Balance	Interest
Loans	\$ 1,670,274,645	\$ 43,499,234	\$ 1,677,794,816	\$ 38,402,709
Total interest-earning assets	1,670,274,645	43,499,234	1,677,794,816	38,402,709
Interest-bearing liabilities	1,345,641,648	17,442,471	1,359,809,825	14,835,429
Impact of capital	<u>\$ 324,632,997</u>		<u>\$ 317,984,991</u>	
Net interest income		<u>\$ 26,056,763</u>		<u>\$ 23,567,280</u>
	2018		2017	
	Average Yield		Average Yield	
Yield on loans	5.25%		4.62%	
Total yield on interest-earning assets	5.25%		4.62%	
Cost of interest-bearing liabilities	2.61%		2.20%	
Interest rate spread	2.64%		2.42%	
Net interest income as a percentage of average earning assets	3.15%		2.83%	

	Six months ended:		
	June 30, 2018 vs. June 30, 2017		
	Increase (decrease) due to		
	Volume	Rate	Total
Interest income - loans	\$ (172,128)	\$ 5,268,653	\$ 5,096,525
Interest income - investments	-	-	-
Total interest income	(172,128)	5,268,653	5,096,525
Interest expense	(154,576)	2,761,618	2,607,042
Net interest income	<u>\$ (17,552)</u>	<u>\$ 2,507,035</u>	<u>\$ 2,489,483</u>

Interest income for the three and six months ended June 30, 2018, increased by \$3,687,401 and \$5,096,525, or 19.0 and 13.3 percent respectively, from the same period of 2017, primarily due to increases in yields on earning assets, fair value accretion recognition, and foregone interest recoveries; offset by a decrease in average loan volume. Interest expense for the three and six months ended June 30, 2018, increased by \$1,246,127 and \$2,607,042, or 16.2 and 17.6 percent, from the same period of 2017 due to an increase in cost of funds; offset by a decrease in average debt volume. Average loan volume for the second quarter of 2018 was \$1,664,737,358, compared to \$1,687,479,590 in the second quarter of 2017. The average net interest rate spread on the loan portfolio for the second quarter of 2018 was 2.89 percent, compared to 2.38 percent in the second quarter of 2017.

The Association's return on average assets for the six months ended June 30, 2018, was 2.21 percent compared to 0.71 percent for the same period in 2017. The Association's return on average equity for the six months ended June 30, 2018, was 10.81 percent, compared to 3.63 percent for the same period in 2017.

Interest income was affected by the accretion of the fair value of loan concessions recorded in response to the breach of Association policies and procedures by a former loan officer as more fully described in the Association's 2017 Annual Report. Accretion of the concessions increased interest income for the six months ended June 30, 2018 and 2017 by \$632,709 and \$58,559, respectively. The increased accretion for the six months ended June 30, 2018 compared to the three months ended June 30, 2017 reflects the acceleration of accretion due to early pay-off of three loans with concessions.

Noninterest income for the three and six months ended June 30, 2018, increased by \$47,128 and \$1,007,436, or 2.7 and 28.0 percent, respectively, compared to the same period of 2017, primarily due to increases in other noninterest income which includes \$963,257 of excess insurance funds balances in the allocated insurance reserve accounts (AIRC) from the Farm Credit System Insurance Corporation (FCSIC). Noninterest expenses for the three and six months ended June 30, 2018, decreased by \$407,141 and \$7,388,574, or 5.7 and 36.1 percent, respectively, compared to the same period of 2017, due mostly to expenses related to the breach of Association policies and procedures by a former loan officer in 2017 as more fully described in our 2017 Annual Report with no comparable expense in 2018. Provisions for loan losses for the three and six months ended June 30, 2018, decreased by \$686,705 and \$1,825,999, or 94.8 and 272.0 percent, respectively, compared to the same period of 2017 primarily due to the resolution of uncertainties with respect to loans involved in the breach of Association policies and procedures by a former loan officer in 2016 and 2017.

Liquidity and Funding Sources:

The Association secures the majority of its lendable funds from the Farm Credit Bank of Texas (the Bank), which obtains its funds through the issuance of System-wide obligations and with lendable equity. The following schedule summarizes the Association's borrowings.

	June 30, 2018	December 31, 2017	June 30, 2017
Note payable to the bank	\$ 1,307,375,558	\$ 1,358,683,640	\$ 1,379,373,832
Accrued interest on note payable	2,909,452	2,807,131	2,531,742
Total	<u>\$ 1,310,285,010</u>	<u>\$ 1,361,490,771</u>	<u>\$ 1,381,905,574</u>

The Association operates under a general financing agreement (GFA) with the bank. The current GFA is effective through September 30, 2018. The primary source of liquidity and funding for the Association is a direct loan from the Bank. The outstanding balance of \$1,307,375,558 as of June 30, 2018, is recorded as a liability on the Association's balance sheet. The note carried a weighted average interest rate of 2.68 percent at March 31, 2018. The indebtedness is collateralized by a pledge of substantially all of the Association's assets to the Bank and is governed by the GFA. The decrease in note payable to the Bank and related increase in accrued interest payable since December 31, 2017, correlates directly with the overall decrease in Association accrual loan volume and increased cost of funds for the period. The Association's own funds, which represent the amount of the Association's loan portfolio funded by the Association's equity, were \$331,396,549 at June 30, 2018. The maximum amount the Association may borrow from the Bank as of June 30, 2018, was \$1,570,375,157 as defined by the GFA. The indebtedness continues in effect until the expiration date of the GFA, which is September 30, 2018, unless sooner terminated by the Bank upon the occurrence of an event of default, or by the Association, in the event of a breach of this agreement by the Bank, upon giving the Bank 30 calendar days' prior written notice, or in all other circumstances, upon giving the Bank 120 days' prior written notice.

On August 28, 2017 the Association received a "Notice of Default of General Financing Agreement" from the Bank. The default was due to the Association's nonperformance as it relates to financial reporting. Additionally, the Association was subject to development of action plans for remediation of the Association's material weaknesses noted in the Report on Internal Controls Over Financial Reporting. The Association was granted a Waiver of Default of the GFA. The Bank granted the waiver with conditions that the restated financials for fiscal years 2016 and 2017 were provided no later than May 31, 2018. The Association was able to meet the documented requirements of the Waiver.

During the preparation of the 2017 and restated 2016 financial statements, the Association became aware of a financial performance covenant violation of its GFA with the Bank. Specifically, the ROA was revealed to fall below the 1.0% required level. The Association sought and received a temporary waiver of this violation. As of June 30, 2018 the Association is in compliance with this GFA covenant.

Capital Resources:

The Association's capital position increased by \$11,511,406 at June 30, 2018, compared to December 31, 2017 and by \$16,466,321 compared to June 30, 2017. The Association's debt as a percentage of members' equity was 3.77:1 as of June 30, 2018, compared to 4.03:1 as of December 31, 2017 and 4.14:1 as of June 30, 2017.

Farm Credit Administration regulations require us to maintain minimums for various regulatory capital ratios. New regulations became effective January 1, 2017, which replaced the previously required core surplus and total surplus ratios with common equity tier 1, tier 1 capital, and total capital risk-based capital ratios. The new regulations also added tier 1 leverage and unallocated retained earnings and equivalents (UREE) ratios. The permanent capital ratio continues to remain in effect, with some modifications to align with the new regulations. As of June 30, 2018, the Association exceeded all regulatory capital requirements.

The Association's capital position remains strong at 18.78 percent for the period ended June 30, 2018.

Significant Recent Accounting Pronouncements:

In February 2018, the Financial Accounting Standards Board (FASB) issued guidance entitled “Income Statement — Reporting Comprehensive Income — Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income.” This guidance allows for the reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the recently issued tax legislation, Tax Cuts and Jobs Act (TCJA) that lowered the federal corporate tax rate from 35% to 21%. The amount of the reclassification shall include the effect of the change in the tax rate on gross deferred tax amounts and related valuation allowances at the date of enactment of the TCJA related to items remaining in accumulated other comprehensive income. The guidance becomes effective for financial statements issued for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. The Association is evaluating the impact of adoption on the Association’s financial condition and its results of operations.

In August 2017, the FASB issued guidance entitled “Targeted Improvements to Accounting for Hedging Activities.” The guidance better aligns an entity’s risk management activities and financial reporting for hedging relationships through changes to both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. The amendments in this guidance require an entity to present the earnings effect of the hedging instrument in the same income statement line item in which the earnings effect of the hedged item is reported. This guidance also addresses the timing of effectiveness testing, qualitative and quantitative effectiveness testing and components that can be excluded from effectiveness testing. This guidance becomes effective for interim and annual periods beginning after December 15, 2018. The Association is evaluating the impact of adoption on the Association’s financial condition and its results of operations.

In March 2017, the FASB issued guidance entitled “Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Cost.” The guidance requires that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. Other components are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. This guidance becomes effective for interim and annual periods beginning after December 15, 2017. The adoption of this guidance did not impact the Association’s financial condition but did change the classification of certain items in the results of operations.

In August 2016, the FASB issued guidance entitled “Classification of Certain Cash Receipts and Cash Payments.” The guidance addresses specific cash flow issues with the objective of reducing the diversity in the classification of these cash flows. Included in the cash flow issues are debt prepayment or debt extinguishment costs and settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing. This guidance becomes effective for interim and annual periods beginning after December 15, 2017. The adoption of this guidance did not impact the Association’s financial condition or its results of operations but did change the classification of certain items in the statement of cash flows.

In June 2016, the FASB issued guidance entitled “Measurement of Credit Losses on Financial Instruments.” The guidance replaces the current incurred loss impairment methodology with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. Credit losses relating to available-for-sale securities would also be recorded through an allowance for credit losses. For public business entities that are not U.S. Securities and Exchange Commission filers this guidance becomes effective for interim and annual periods beginning after December 15, 2020, with early application permitted. The Association is evaluating the impact of adoption on its financial condition and results of operations.

In February 2016, the FASB issued guidance entitled “Leases.” The guidance requires the recognition by lessees of lease assets and lease liabilities on the balance sheet for the rights and obligations created by those leases. Leases with lease terms of more than 12 months are impacted by this guidance. This guidance becomes effective for interim and annual periods beginning after December 15, 2018, with early application permitted. The Association is evaluating the impact of adoption on its financial condition and results of operations.

In January 2016, the FASB issued guidance entitled “Recognition and Measurement of Financial Assets and Liabilities.” The guidance affects, among other things, the presentation and disclosure requirements for financial instruments. For public entities, the guidance eliminates the requirement to disclose the methods and significant assumptions used to estimate the fair value of financial instruments carried at amortized cost. This guidance becomes effective for interim and annual periods beginning after December 15, 2017. The adoption of this guidance did not impact the Association’s financial condition or its results of operations but did impact the Association’s fair value disclosures.

In May 2014, the FASB issued guidance entitled, “Revenue from Contracts with Customers.” The guidance governs revenue recognition from contracts with customers and requires an entity to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods

or services. Financial instruments and other contractual rights within the scope of other guidance issued by the FASB are excluded from the scope of this new revenue recognition guidance. The guidance sets forth the requirement for new and enhanced disclosures. The Association adopted the new standard-effective January 1, 2018, using the modified retrospective approach. As the majority of the Association’s revenues are not subject to the new guidance, the adoption of the guidance did not have a material impact on the financial position, results of operations, equity or cash flows.

Regulatory Matters:

The Association is currently operating under a Special Supervision letter issued by the Farm Credit Administration (FCA). Lone Star is cooperating and complying with the requirements of the Special Supervision letter and has not been assessed any monetary penalties by the FCA. However, there can be no assurances that future monetary penalties that would affect our financial condition will not be assessed by the FCA.

On March 10, 2016, the Farm Credit Administration approved a final rule to modify the regulatory capital requirements for System Banks and Association’s. The stated objectives of the proposed rule are as follows:

- To modernize capital requirements while ensuring that the institutions continue to hold sufficient regulatory capital to fulfill their mission as a government-sponsored enterprise,
- To ensure that the System’s capital requirements are comparable to the Basel III framework and the standardized approach that the federal banking regulatory agencies have adopted, but also to ensure that the rules recognize the cooperative structure and the organization of the System,
- To make System regulatory capital requirements more transparent and
- To meet the requirements of section 939A of the Dodd-Frank Act.

The Association implemented the new regulatory capital ratios effective on January 1, 2017. The Association’s regulatory ratios remained well above regulatory minimums, including the conservation and leverage buffers as of June 30, 2018 and December 31, 2017. Previous regulatory capital ratio information for year’s 2016 to 2012 are presented as follows:

<u>Capital Ratios at Year End</u>	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>
Core surplus ratio	18.3%	19.3%	21.0%	21.1%	20.2%
Total surplus ratio	18.5%	19.3%	21.0%	21.1%	20.2%

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 stockholder’s investment in the Association. The Management’s Discussion and Analysis and Notes to Financial Statements contained in the 2017 Annual Report of the Association more fully describe the Association’s relationship with the Bank.

The Texas Farm Credit District’s (district) annual and quarterly stockholder reports, as well as those of the Bank, 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) 483-9204. Copies of the district’s quarterly and annual stockholder reports also can be requested by e-mail at fcdb@farmcreditbank.com. The annual and quarterly stockholder reports for the Bank and the district are also available on its website at www.farmcreditbank.com.

The Association’s quarterly stockholder reports are also available free of charge, upon request. These reports can be obtained by writing to Lone Star, ACA, 1612 Summit Avenue, Suite 300, Fort Worth, Texas 76102 or calling (817) 332-6565. The annual and quarterly stockholder reports for the Association are also available on its website at www.lonestaragcredit.com. Copies of the Association’s quarterly stockholder reports can also be requested by e-mailing Tonya.Arvin@lonestaragcredit.com.

LONESTAR, ACA

CONSOLIDATED BALANCE SHEET

	June 30, 2018 (unaudited)	December 31, 2017	June 30, 2017 (unaudited)
<u>ASSETS</u>			
Cash	\$ 313,284	\$ 90,437	\$ 238,740
Loans	1,638,821,292	1,681,072,602	1,692,856,246
Less: allowance for loan losses	<u>(7,866,373)</u>	<u>(9,181,997)</u>	<u>(10,882,401)</u>
Net loans	1,630,954,919	1,671,890,605	1,681,973,845
Accrued interest receivable	9,615,378	9,321,322	9,502,505
Investment in and receivable from the Farm Credit Bank of Texas:			
Capital stock	27,562,030	27,562,030	26,002,180
Other	5,165,375	1,334,685	4,293,848
Premises and equipment, net	2,875,413	2,835,580	3,014,074
Other assets	<u>1,650,023</u>	<u>961,471</u>	<u>1,518,230</u>
Total assets	<u>\$ 1,678,136,422</u>	<u>\$ 1,713,996,130</u>	<u>\$ 1,726,543,422</u>
<u>LIABILITIES</u>			
Note payable to the Farm Credit Bank of Texas	\$ 1,307,375,558	\$ 1,358,683,640	\$ 1,379,373,832
Accrued interest payable	2,909,452	2,807,131	2,531,742
Drafts outstanding	124,108	137,903	118,941
Dividends payable	7,049,955	-	-
Other liabilities	<u>8,522,391</u>	<u>11,723,904</u>	<u>8,830,270</u>
Total liabilities	<u>1,325,981,464</u>	<u>1,373,352,578</u>	<u>1,390,854,785</u>
<u>MEMBERS' EQUITY</u>			
Capital stock and participation certificates	6,183,110	6,386,865	6,481,855
Additional paid-in capital	91,343,553	91,343,553	91,343,553
Unallocated retained earnings	255,956,442	244,270,903	238,692,127
Accumulated other comprehensive income (loss)	<u>(1,328,147)</u>	<u>(1,357,769)</u>	<u>(828,898)</u>
Total members' equity	<u>352,154,958</u>	<u>340,643,552</u>	<u>335,688,637</u>
Total liabilities and members' equity	<u>\$ 1,678,136,422</u>	<u>\$ 1,713,996,130</u>	<u>\$ 1,726,543,422</u>

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

LONESTAR, ACA

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(unaudited)

	Quarter ended		Six months ended	
	June 30,		June 30,	
	2018	2017	2018	2017
<u>INTEREST INCOME</u>				
Loans	\$ 23,138,013	\$ 19,450,612	\$ 43,499,234	\$ 38,402,709
Total interest income	23,138,013	19,450,612	43,499,234	38,402,709
<u>INTEREST EXPENSE</u>				
Note payable to the Farm Credit Bank of Texas	8,948,290	7,702,179	17,442,437	14,835,411
Advance conditional payments	27	11	34	18
Total interest expense	8,948,317	7,702,190	17,442,471	14,835,429
Net interest income	14,189,696	11,748,422	26,056,763	23,567,280
<u>PROVISION FOR LOAN LOSSES</u>				
	38,058	724,763	(1,154,591)	671,408
Net interest income after provision for loan losses	14,151,638	11,023,659	27,211,354	22,895,872
<u>NONINTEREST INCOME</u>				
Income from the Farm Credit Bank of Texas:				
Patronage income	1,577,029	1,593,657	3,162,210	3,146,784
Loan fees	68,205	73,090	146,150	196,461
Financially related services income	1,747	1,794	4,383	4,598
Gain (loss) on other property owned, net	17,118	11,734	26,318	25,130
Gain (loss) on sale of premises and equipment, net	21,968	(571)	80,468	(671)
Other noninterest income	117,292	76,527	1,186,980	226,771
Total noninterest income	1,803,359	1,756,231	4,606,509	3,599,073
<u>NONINTEREST EXPENSES</u>				
Salaries and employee benefits	3,505,866	3,242,880	7,020,019	6,762,732
Directors' expense	167,651	136,303	236,579	263,395
Purchased services	1,438,512	700,640	2,500,525	968,421
Travel	222,643	223,015	396,434	399,357
Occupancy and equipment	341,858	329,079	760,617	633,700
Communications	91,684	78,866	186,343	147,585
Advertising	146,792	185,736	228,089	341,053
Public and member relations	186,050	286,186	422,790	545,492
Supervisory and exam expense	164,321	109,862	328,640	243,795
Insurance Fund premiums	280,094	475,647	563,866	939,700
Other noninterest expense	241,886	1,426,284	426,638	9,213,883
Total noninterest expenses	6,787,357	7,194,498	13,070,540	20,459,113
Income before income taxes	9,167,640	5,585,392	18,747,323	6,035,832
Provision for (benefit from) income taxes	6,068	14,826	11,829	26,664
NET INCOME	9,161,572	5,570,566	18,735,494	6,009,168
Other comprehensive income:				
Change in postretirement benefit plans	14,811	2,055	29,622	4,110
Other comprehensive income, net of tax	14,811	2,055	29,622	4,110
COMPREHENSIVE INCOME	\$ 9,176,383	\$ 5,572,621	\$ 18,765,116	\$ 6,013,278

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

LONESTAR, ACA

CONSOLIDATED STATEMENT OF CHANGES IN MEMBERS' EQUITY

(unaudited)

	<u>Capital Stock/ Participation Certificates</u>	<u>Additional Paid-in-Capital</u>	<u>Retained Earnings Unallocated</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Total Members' Equity</u>
Balance at December 31, 2016 (Restated)	\$ 6,431,805	\$ 91,343,553	\$ 232,668,103	\$ (833,008)	\$ 329,610,453
Comprehensive income			6,009,167	4,110	6,013,277
Preferred Stock Issued					
Capital stock/participation certificates and allocated retained earnings issued	444,445				444,445
Capital stock/participation certificates and allocated retained earnings retired	(394,395)				(394,395)
Dividend adjustments			14,857		14,857
Balance at June 30, 2017	<u>\$ 6,481,855</u>	<u>\$ 91,343,553</u>	<u>\$ 238,692,127</u>	<u>\$ (828,898)</u>	<u>\$ 335,688,637</u>
Balance at December 31, 2017	\$ 6,386,865	\$ 91,343,553	\$ 244,270,903	\$ (1,357,769)	\$ 340,643,552
Comprehensive income			18,735,494	29,622	18,765,116
Capital stock/participation certificates and allocated retained earnings issued	227,395				227,395
Preferred Stock retired					
Capital stock/participation certificates and allocated retained earnings retired	(431,150)				(431,150)
Dividends declared			(7,049,955)		(7,049,955)
Balance at June 30, 2018	<u>\$ 6,183,110</u>	<u>\$ 91,343,553</u>	<u>\$ 255,956,442</u>	<u>\$ (1,328,147)</u>	<u>\$ 352,154,958</u>

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

LONE STAR, ACA
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 1 — ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES:

Lone Star, ACA, including its wholly-owned subsidiaries, Lone Star, PCA and Lone Star, FLCA (collectively referred to as “the Association”), is a member-owned cooperative which provides credit and credit-related services to, or for the benefit of, eligible borrowers/stockholders for qualified agricultural purposes in the counties of Bell, Borden, Bosque, Bowie, Burnet, Camp, Cass, Cooke, Coryell, Dallas, Delta, Denton, Eastland, Ellis, Erath, Falls, Fannin, Fisher, Freestone, Grayson, Hamilton, Hill, Hood, Johnson, Kent, Lamar, Lampasas, Limestone, McLennan, Milam, Mitchell, Morris, Navarro, Nolan, Palo Pinto, Parker, Red River, Scurry, Shackelford, Somervell, Stephens, Tarrant, Taylor, Throckmorton, Titus, Williamson, Wise and Young in the state of Texas. 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.

The accompanying unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the U.S. (GAAP) for interim financial information. Accordingly, they do not include all of the disclosures required by GAAP for annual financial statements and should be read in conjunction with the audited financial statements as of and for the year ended December 31, 2017, as contained in the 2017 Annual Report to Stockholders.

In the opinion of management, 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 (GAAP), except for the inclusion of a statement of cash flows. GAAP 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. 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 consolidated financial statements. The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. The results of operations for interim periods are not necessarily indicative of the results to be expected for the full year ending December 31, 2017. Descriptions of the significant accounting policies are included in the 2017 Annual Report to Stockholders. In the opinion of management, these policies and the presentation of the interim financial condition and results of operations conform with GAAP and prevailing practices within the banking industry.

In February 2018, the Financial Accounting Standards Board (FASB) issued guidance entitled “Income Statement — Reporting Comprehensive Income — Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income.” This guidance allows for the reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the recently issued tax legislation, Tax Cuts and Jobs Act (TCJA) that lowered the federal corporate tax rate from 35% to 21%. The amount of the reclassification shall include the effect of the change in the tax rate on gross deferred tax amounts and related valuation allowances at the date of enactment of the TCJA related to items remaining in accumulated other comprehensive income. The guidance becomes effective for financial statements issued for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. The Association is evaluating the impact of adoption on the Association’s financial condition and its results of operations.

In August 2017, the Financial Accounting Standards Board (FASB) issued guidance entitled “Targeted Improvements to Accounting for Hedging Activities.” The guidance better aligns an entity’s risk management activities and financial reporting for hedging relationships through changes to both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. The amendments in this guidance require an entity to present the earnings effect of the hedging instrument in the same income statement line item in which the earnings effect of the hedged item is reported. This guidance also addresses the timing of effectiveness testing, qualitative and quantitative effectiveness testing and components that can be excluded from effectiveness testing. This guidance becomes effective for interim and annual periods beginning after December 15, 2018. The Association is evaluating the impact of adoption on the Association’s financial condition and its results of operations.

In March 2017, the FASB issued guidance entitled “Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Cost.” The guidance requires that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. Other components are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. This guidance becomes effective for interim and annual periods beginning after December 15, 2017. The adoption of this guidance did not impact the Association’s financial condition but did change the classification of certain items in the results of operations.

In August 2016, the FASB issued guidance entitled “Classification of Certain Cash Receipts and Cash Payments.” The guidance addresses specific cash flow issues with the objective of reducing the diversity in the classification of these cash flows. Included in

the cash flow issues are debt prepayment or debt extinguishment costs and settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing. This guidance becomes effective for interim and annual periods beginning after December 15, 2017. The adoption of this guidance did not impact the Association's financial condition or its results of operations but did change the classification of certain items in the statement of cash flows.

In June 2016, FASB issued guidance entitled "Measurement of Credit Losses on Financial Instruments." The guidance replaces the current incurred loss impairment methodology with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. Credit losses relating to available-for-sale securities would also be recorded through an allowance for credit losses. For public business entities that are not U.S. Securities and Exchange Commission filers this guidance becomes effective for interim and annual periods beginning after December 15, 2020, with early application permitted. The Association is evaluating the impact of adoption on its financial condition and results of operations.

In February 2016, the FASB issued guidance entitled "Leases." The guidance requires the recognition by lessees of lease assets and lease liabilities on the balance sheet for the rights and obligations created by those leases. Leases with lease terms of more than 12 months are impacted by this guidance. This guidance becomes effective for interim and annual periods beginning after December 15, 2018, with early application permitted. The Association is evaluating the impact of adoption on its financial condition and results of operations.

In January 2016, the FASB issued guidance entitled "Recognition and Measurement of Financial Assets and Liabilities." This guidance affects, among other things, the presentation and disclosure requirements for financial instruments. For public entities, the guidance eliminates the requirement to disclose the methods and significant assumptions used to estimate the fair value of financial instruments carried at amortized cost. This guidance becomes effective for interim and annual periods beginning after December 15, 2017. The adoption of this guidance did not impact the Association's financial condition or its results of operations but did impact the Association's fair value disclosures.

The consolidated financial statements comprise the operations of the ACA and its wholly-owned subsidiaries. The preparation of these consolidated financial statements requires the use of management's estimates. The results for the quarter ended June 30, 2018, are not necessarily indicative of the results to be expected for the year ended December 31, 2018. Certain amounts in the prior period's financial statements have been reclassified to conform to current financial statement presentation.

NOTE 2 – RESTATEMENT:

As discussed in the 2017 Annual Report, a breach of the Association's policies and procedures by a former loan officer resulted in certain misstatements in previously issued financial statements for the year ended December 31, 2016 and quarter-ending March 31, 2017.

NOTE 3 — LOANS AND ALLOWANCE FOR LOAN LOSSES:

A summary of loans follows:

Loan Type	June 30, 2018 Amount	December 31, 2017 Amount	June 30, 2017 Amount
Production agriculture:			
Real estate mortgage	\$ 1,305,238,951	\$ 1,349,434,350	\$ 1,338,799,018
Production and intermediate term	97,744,341	106,690,588	116,992,965
Agribusiness:			
Loans to cooperatives	17,753,091	14,281,948	14,771,876
Processing and marketing	136,602,747	127,788,252	134,871,551
Farm-related business	16,436,981	15,113,769	13,776,508
Communication	8,473,263	8,729,168	8,241,241
Energy	40,299,594	41,992,131	43,761,724
Water and waste water	4,305,164	3,357,911	6,520,060
Rural residential real estate	11,967,160	13,684,485	15,121,303
Total	\$ 1,638,821,292	\$ 1,681,072,602	\$ 1,692,856,246

The Association purchases or sells participation interests with other parties in order to diversify risk, manage loan volume and comply with Farm Credit Administration regulations. The following table presents information regarding the balances of participations purchased and sold at June 30, 2018:

	District Farm Credit Bank		Other Farm Credit & Non-Farm Credit Institutions		Total	
	Participations Purchased	Participations Sold	Participations Purchased	Participations Sold	Participations Purchased	Participations Sold
	Real estate mortgage	\$ 11,233,459	\$ 6,549,252	\$ -	\$ -	\$ 11,233,459
Production and intermediate term	39,667,207	-	-	-	39,667,207	-
Agribusiness	155,892,101	-	-	-	155,892,101	-
Communication	8,473,263	-	-	-	8,473,263	-
Energy	40,299,594	-	-	-	40,299,594	-
Water and waste water	2,618,036	-	1,687,128	-	4,305,164	-
Total	<u>\$258,183,660</u>	<u>\$ 6,549,252</u>	<u>\$ 1,687,128</u>	<u>\$ -</u>	<u>\$259,870,788</u>	<u>\$ 6,549,252</u>

The Association is authorized under the Farm Credit Act to accept “advance conditional payments” (ACPs) from borrowers. To the extent the borrower’s access to such ACPs is restricted and the legal right of setoff exists, the ACPs are netted against the borrower’s related loan balance. Unrestricted advance conditional payments are included in other liabilities. ACPs are not insured, and interest is generally paid by the Association on such balances. Balances of ACPs were \$10,051,055, \$13,111,538 and \$13,331,823 at June 30, 2018, December 31, 2017 and June 30, 2017, respectively.

Nonperforming assets (including related accrued interest) and related credit quality statistics are as follows:

	<u>June 30, 2018</u>	December 31, 2017	June 30, 2017
Nonaccrual loans:			
Real estate mortgage	\$ 4,893,984	\$ 3,893,283	\$ 5,358,577
Production and intermediate term	281,460	1,511,642	3,285,627
Rural residential real estate	162,850	228,181	835,063
Total nonaccrual loans	<u>5,338,294</u>	5,633,106	9,479,267
Accruing restructured loans:			
Real estate mortgage	112,763	3,078,911	3,102,452
Production and intermediate term	1,461,706	1,458,427	-
Total accruing restructured loans	<u>1,574,469</u>	4,537,338	3,102,452
Accruing loans 90 days or more past due:			
Real estate mortgage	-	-	3,336,688
Production and intermediate term	-	-	73,306
Total accruing loans 90 days or more past due	<u>-</u>	<u>-</u>	<u>3,409,994</u>
Total nonperforming loans	<u>6,912,763</u>	<u>10,170,444</u>	<u>15,991,713</u>
Total nonperforming assets	<u>\$ 6,912,763</u>	<u>\$ 10,170,444</u>	<u>\$ 15,991,713</u>

One credit quality indicator utilized by the Association is the Farm Credit Administration Uniform Loan Classification System that categorizes loans into five categories. The categories are defined as follows:

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

The following table shows loans and related accrued interest as a percentage of total loans and related accrued interest receivable by loan type as of:

	June 30, 2018	December 31, 2017	June 30, 2017
Real estate mortgage			
Acceptable	95%	95%	97%
OAEM	4%	4%	2%
Substandard/doubtful	1%	1%	1%
	100%	100%	100%
Production and intermediate term			
Acceptable	91%	86%	95%
OAEM	7%	11%	2%
Substandard/doubtful	2%	3%	3%
	100%	100%	100%
Agribusiness			
Acceptable	100%	99%	96%
OAEM	0%	0%	3%
Substandard/doubtful	0%	1%	1%
	100%	100%	100%
Energy and water/waste water			
Acceptable	98%	98%	98%
OAEM	2%	2%	2%
Substandard/doubtful	0%	0%	0%
	100%	100%	100%
Communication			
Acceptable	100%	100%	100%
OAEM	0%	0%	0%
Substandard/doubtful	0%	0%	0%
	100%	100%	100%
Rural residential real estate			
Acceptable	96%	95%	92%
OAEM	1%	1%	1%
Substandard/doubtful	3%	4%	7%
	100%	100%	100%
Total loans			
Acceptable	95%	95%	97%
OAEM	4%	4%	2%
Substandard/doubtful	1%	1%	1%
	100%	100%	100%

The following tables provide an age analysis of past due loans (including accrued interest) as of:

<u>June 30, 2018</u>	30-89 Days Past Due	90 Days or More Past Due	Total Past Due	Not Past Due or Less Than 30 Days Past Due	Total Loans	Recorded Investment >90 Days and Accruing
Real estate mortgage	\$ 1,223,114	\$ 1,429,358	\$ 2,652,472	\$ 1,311,127,178	\$ 1,313,779,650	\$ -
Production and intermediate term	276,562	124,577	401,139	97,974,057	98,375,196	-
Loans to cooperatives	-	-	-	17,789,785	17,789,785	-
Processing and marketing	-	-	-	136,749,659	136,749,659	-
Farm-related business	-	-	-	16,513,813	16,513,813	-
Communication	-	-	-	8,475,274	8,475,274	-
Energy	-	-	-	40,443,050	40,443,050	-
Water and waste water	-	-	-	4,310,945	4,310,945	-
Rural residential real estate	157,298	-	157,298	11,842,000	11,999,298	-
Total	\$ 1,656,974	\$ 1,553,935	\$ 3,210,909	\$ 1,645,225,761	\$ 1,648,436,670	\$ -

<u>December 31, 2017</u>	30-89 Days Past Due	90 Days or More Past Due	Total Past Due	Not Past Due or Less Than 30 Days Past Due	Total Loans	Recorded Investment >90 Days and Accruing
Real estate mortgage	\$ 2,631,648	\$ 846,122	\$ 3,477,770	\$ 1,354,146,637	\$ 1,357,624,407	\$ -
Production and intermediate term	131,182	1,302,507	1,433,689	105,968,882	107,402,571	-
Loans to cooperatives	-	-	-	14,295,656	14,295,656	-
Processing and marketing	-	-	-	127,947,843	127,947,843	-
Farm-related business	-	-	-	15,154,992	15,154,992	-
Communication	-	-	-	8,731,512	8,731,512	-
Energy	-	-	-	42,156,596	42,156,596	-
Water and waste water	-	-	-	3,362,464	3,362,464	-
Rural residential real estate	209,009	92,443	301,452	13,416,431	13,717,883	-
Total	\$ 2,971,839	\$ 2,241,072	\$ 5,212,911	\$ 1,685,181,013	\$ 1,690,393,924	\$ -

<u>June 30, 2017</u>	30-89 Days Past Due	90 Days or More Past Due	Total Past Due	Not Past Due or Less Than 30 Days Past Due	Total Loans	Recorded Investment >90 Days and Accruing
Real estate mortgage	\$ 9,242,640	\$ 3,700,286	\$ 12,942,926	\$ 1,333,819,658	\$ 1,346,762,584	\$ 3,336,688
Production and intermediate term	487,022	2,290,665	2,777,687	115,344,169	118,121,856	73,306
Loans to cooperatives	-	-	-	14,797,293	14,797,293	-
Processing and marketing	-	-	-	134,987,341	134,987,341	-
Farm-related business	-	-	-	13,833,320	13,833,320	-
Communication	-	-	-	8,241,922	8,241,922	-
Energy	-	-	-	43,931,022	43,931,022	-
Water and waste water	-	-	-	6,530,559	6,530,559	-
Rural residential real estate	-	674,098	674,098	14,478,756	15,152,854	-
Total	\$ 9,729,662	\$ 6,665,049	\$ 16,394,711	\$ 1,685,964,040	\$ 1,702,358,751	\$ 3,409,994

Note: The recorded investment in the receivable is the face amount increased or decreased by applicable accrued interest and unamortized premium, discount, finance charges or acquisition costs, and may also reflect a previous direct write-down of the investment.

A restructuring of a debt constitutes a troubled debt restructuring if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. Troubled debt restructurings are undertaken in order to improve the likelihood of recovery on the loan and may include, but are not limited to, forgiveness of principal or interest, interest rate reductions that are lower than the current market rate for new debt with similar risk, or significant term or payment extensions.

As of June 30, 2018, the total recorded investment of troubled debt restructured loans was \$2,076,180, including \$501,712 classified as nonaccrual and \$1,574,469 classified as accrual, with specific allowance for loan losses of \$43,018. As of June 30, 2018, commitments to lend funds to borrowers whose loan terms have been modified in a troubled debt restructuring were \$0 at period end and \$0 at December 31, 2017 and June 30, 2017.

The following tables present additional information regarding troubled debt restructurings, which includes both accrual and nonaccrual loans with troubled debt restructuring designation, that occurred during the six months ended June 30, 2018. The premodification outstanding recorded investment represents the recorded investment of the loans as of the quarter end prior to the restructuring. The postmodification outstanding recorded investment represents the recorded investment of the loans as of the quarter end the restructuring occurred. Loans formally restructured prior to January 1, 2018, were \$1,895,764.

<u>For the Three Months Ended June 30, 2018</u>	<u>Premodification Outstanding Recorded Investment</u>	<u>Postmodification Outstanding Recorded Investment</u>
Troubled debt restructurings:		
Real estate mortgage	\$ 180,415	\$ 180,415
Total	<u>\$ 180,415</u>	<u>\$ 180,415</u>

There were no loans with troubled debt restructuring designation that occurred during the three months ended June 30, 2017.

<u>For the Six Months Ended June 30, 2018</u>	<u>Premodification Outstanding Recorded Investment</u>	<u>Postmodification Outstanding Recorded Investment</u>
Troubled debt restructurings:		
Real estate mortgage	\$ 180,415	\$ 180,415
Total	<u>\$ 180,415</u>	<u>\$ 180,415</u>

There were no loans with troubled debt restructuring designation that occurred during the six months ended June 30, 2017.

In restructurings where principal is forgiven, the amount of the forgiveness is immediately charged off. In restructurings where accrued interest is forgiven, the interest is reversed (if current year interest) or charged off (if prior year interest). There were no restructurings where principal was forgiven that required a charge off, at the modification date, for the three months and six months ending June 30, 2018 and 2017, respectively.

The predominate form of concession granted for troubled debt restructuring includes a delay in the repayment of principal. At times these terms might be offset with incremental payments, collateral or new borrower guarantees, in which case the Association assesses all of the modified terms to determine if the overall modification qualifies as a troubled debt restructuring.

At June 30, 2018, December 31, 2017 and June 30, 2017, the Association had no loans that met the accounting criteria as a troubled debt restructuring and that occurred within the previous 12 months of that year and for which there was a payment default during the period. A payment default is defined as a payment that is 30 days past due after the date the loan was restructured.

The following table provides information on outstanding loans restructured in troubled debt restructurings at period end. These loans are included as impaired loans in the impaired loan table at:

	<u>Loans Modified as TDRs</u>			<u>TDRs in Nonaccrual Status*</u>		
	December 31,			December 31,		
	June 30, 2018	2017	June 30, 2017	June 30, 2018	2017	June 30, 2017
Real estate mortgage	\$ 493,947	\$ 3,297,717	\$ 3,337,276	\$ 381,185	\$ 218,806	\$ 234,823
Production and intermediate term	1,582,233	1,708,217	-	120,527	249,790	-
Total	<u>\$ 2,076,180</u>	<u>\$ 5,005,934</u>	<u>\$ 3,337,276</u>	<u>\$ 501,712</u>	<u>\$ 468,596</u>	<u>\$ 234,823</u>

*represents the portion of loans modified as TDRs that are in nonaccrual status

Additional impaired loan information is as follows:

	June 30, 2018			December 31, 2017			June 30, 2017		
	Recorded Investment	Unpaid		Recorded Investment	Unpaid		Recorded Investment	Unpaid	
		Principal Balance ^a	Related Allowance		Principal Balance ^a	Related Allowance		Principal Balance ^a	Related Allowance
Impaired loans with a related allowance for credit losses:									
Real estate mortgage	\$ 867,079	\$ 978,242	\$ 233,202	\$ 160,483	\$ 214,343	\$ 46,363	\$ 363,598	\$ 363,598	\$ 10,073
Production and intermediate term	202,161	444,187	66,986	797,585	1,465,175	302,611	1,043,315	1,134,435	305,199
Rural residential real estate	120,214	168,070	50,699	-	-	-	-	-	-
Total	<u>\$1,189,454</u>	<u>\$ 1,590,499</u>	<u>\$ 350,887</u>	<u>\$ 958,068</u>	<u>\$ 1,679,518</u>	<u>\$ 348,974</u>	<u>\$ 1,563,002</u>	<u>\$ 1,563,711</u>	<u>\$ 370,337</u>
Impaired loans with no related allowance for credit losses:									
Real estate mortgage	\$4,139,668	\$4,194,920	\$ -	\$ 6,811,711	\$ 6,810,197	\$ -	\$11,434,119	\$11,439,833	\$ -
Production and intermediate term	1,541,005	2,654,759	-	2,172,484	2,797,932	-	2,315,617	2,713,580	-
Rural residential real estate	42,636	42,832	-	228,181	228,377	-	835,063	835,259	-
Total	<u>\$5,723,309</u>	<u>\$ 6,892,511</u>	<u>\$ -</u>	<u>\$ 9,212,376</u>	<u>\$ 9,836,506</u>	<u>\$ -</u>	<u>\$ 9,526,824</u>	<u>\$ 9,878,421</u>	<u>\$ -</u>
Total impaired loans:									
Real estate mortgage	\$5,006,747	\$ 5,173,162	\$ 233,202	\$ 6,972,194	\$ 7,024,540	\$ 46,363	\$11,797,717	\$11,803,431	\$ 10,073
Production and intermediate term	1,743,166	3,098,946	66,986	2,970,069	4,263,107	302,611	3,358,932	3,848,015	305,199
Rural residential real estate	162,850	210,902	50,699	228,181	228,377	-	835,063	835,259	-
Total	<u>\$6,912,763</u>	<u>\$ 8,483,010</u>	<u>\$ 350,887</u>	<u>\$10,170,444</u>	<u>\$11,516,024</u>	<u>\$ 348,974</u>	<u>\$11,089,826</u>	<u>\$11,442,132</u>	<u>\$ 370,337</u>

^a Unpaid principal balance represents the recorded principal balance of the loan.

	For the Three Months Ended				For the Six Months Ended			
	June 30, 2018		June 30, 2017		June 30, 2018		June 30, 2017	
	Average Impaired Loans	Interest Income Recognized	Average Impaired Loans	Interest Income Recognized	Average Impaired Loans	Interest Income Recognized	Average Impaired Loans	Interest Income Recognized
Impaired loans with a related allowance for credit losses:								
Real estate mortgage	\$ 530,136	\$ 5,153	\$ 367,121	\$ -	\$ 365,129	\$ 11,207	\$ 367,289	\$ -
Production and intermediate term	157,064	818	1,085,582	-	495,693	2,325	1,052,660	-
Farm-related business	-	-	-	-	-	-	-	-
Rural residential real estate	59,323	1,423	-	-	29,662	2,243	28,102	-
Total	<u>\$ 746,523</u>	<u>\$ 7,394</u>	<u>\$ 1,452,703</u>	<u>\$ -</u>	<u>\$ 890,484</u>	<u>\$ 15,775</u>	<u>\$ 1,448,051</u>	<u>\$ -</u>
Impaired loans with no related allowance for credit losses:								
Real estate mortgage	\$3,826,862	\$ 12,080	\$ 9,162,509	\$ 311,917	\$5,089,589	\$ 19,541	\$ 7,518,793	\$ 605,867
Production and intermediate term	1,666,287	27,494	1,214,649	12,181	1,720,274	59,297	1,163,689	11,680
Farm-related business	-	5,439	-	2,439	-	8,803	-	4,055
Rural residential real estate	44,953	-	846,434	-	48,166	-	859,056	-
Total	<u>\$5,538,102</u>	<u>\$ 45,013</u>	<u>\$11,223,592</u>	<u>\$ 326,537</u>	<u>\$6,858,029</u>	<u>\$ 87,641</u>	<u>\$ 9,541,538</u>	<u>\$ 621,602</u>
Total impaired loans:								
Real estate mortgage	\$4,356,998	\$ 17,233	\$ 9,529,630	\$ 311,917	\$5,454,718	\$ 30,748	\$ 7,886,082	\$ 605,867
Production and intermediate term	1,823,351	28,312	2,300,231	12,181	2,215,967	61,622	2,216,349	11,680
Farm-related business	-	5,439	-	2,439	-	8,803	-	4,055
Rural residential real estate	104,276	1,423	846,434	-	77,828	2,243	887,158	-
Total	<u>\$6,284,625</u>	<u>\$ 52,407</u>	<u>\$12,676,295</u>	<u>\$ 326,537</u>	<u>\$7,748,513</u>	<u>\$ 103,416</u>	<u>\$10,989,589</u>	<u>\$ 621,602</u>

A summary of changes in the allowance for loan losses and period end recorded investment in loans is as follows:

	Real Estate Mortgage	Production and Intermediate Term	Agribusiness	Communications	Energy and Water/Waste Water	Rural Residential Real Estate	Total
Allowance for Credit Losses:							
Balance at March 31, 2018	\$ 5,905,375	\$ 1,462,440	\$ 507,270	\$ 12,455	\$ 170,609	\$ 146,677	\$ 8,204,826
Charge-offs	(108,113)	(305,680)	(47,857)	-	-	-	(461,650)
Recoveries	-	25,649	71,626	-	-	-	97,275
Provision for loan losses	41,566	47,441	(27,823)	(272)	16,521	(39,375)	38,058
Other	3,270	(11,525)	(2,552)	(274)	(1,055)	-	(12,136)
Balance at June 30, 2018	<u>\$ 5,842,098</u>	<u>\$ 1,218,325</u>	<u>\$ 500,664</u>	<u>\$ 11,909</u>	<u>\$ 186,075</u>	<u>\$ 107,302</u>	<u>\$ 7,866,373</u>
Balance at							
December 31, 2017	\$ 6,775,679	\$ 1,510,355	\$ 530,851	\$ 15,578	\$ 188,448	\$ 161,086	\$ 9,181,997
Charge-offs	(108,113)	(360,721)	(47,857)	-	-	-	(516,691)
Recoveries	-	52,596	143,252	-	-	-	195,848
Provision for loan losses	(829,915)	(110,423)	(151,201)	(3,601)	(5,667)	(53,784)	(1,154,591)
Other	4,447	126,518	25,619	(68)	3,294	-	159,810
Balance at June 30, 2018	<u>\$ 5,842,098</u>	<u>\$ 1,218,325</u>	<u>\$ 500,664</u>	<u>\$ 11,909</u>	<u>\$ 186,075</u>	<u>\$ 107,302</u>	<u>\$ 7,866,373</u>
Ending Balance:							
Individually evaluated for impairment	\$ 233,202	\$ 66,986	\$ -	\$ -	\$ -	\$ 50,699	\$ 350,887
Collectively evaluated for impairment	5,608,896	1,151,339	500,664	11,909	186,075	56,603	7,515,486
Balance at June 30, 2018	<u>\$ 5,842,098</u>	<u>\$ 1,218,325</u>	<u>\$ 500,664</u>	<u>\$ 11,909</u>	<u>\$ 186,075</u>	<u>\$ 107,302</u>	<u>\$ 7,866,373</u>
Balance at							
March 31, 2017 (Restated)	\$ 7,229,823	\$ 2,066,406	\$ 680,963	\$ 15,486	\$ 132,765	\$ 78,080	\$ 10,203,523
Charge-offs	(56,355)	(91,006)	-	-	-	-	(147,361)
Recoveries	784	13,458	87,751	-	-	-	101,993
Provision for loan losses	65,301	811,302	(151,897)	(420)	10,681	(10,204)	724,763
Other	3,267	960	(7,229)	(422)	2,907	-	(517)
Balance at June 30, 2017 (Restated)	<u>\$ 7,242,820</u>	<u>\$ 2,801,120</u>	<u>\$ 609,588</u>	<u>\$ 14,644</u>	<u>\$ 146,353</u>	<u>\$ 67,876</u>	<u>\$ 10,882,401</u>
Balance at							
December 31, 2016 (Restated)	\$ 7,306,321	\$ 1,966,085	\$ 584,077	\$ 14,320	\$ 138,081	\$ 62,863	\$ 10,071,747
Charge-offs	(61,673)	(91,006)	-	-	-	-	(152,679)
Recoveries	19,231	36,679	233,724	-	-	-	289,634
Provision for loan losses	(21,387)	889,663	(209,450)	163	7,407	5,013	671,409
Other	328	(301)	1,237	161	865	-	2,290
Balance at June 30, 2017 (Restated)	<u>\$ 7,242,820</u>	<u>\$ 2,801,120</u>	<u>\$ 609,588</u>	<u>\$ 14,644</u>	<u>\$ 146,353</u>	<u>\$ 67,876</u>	<u>\$ 10,882,401</u>
Ending Balance:							
Individually evaluated for impairment	\$ 10,073	\$ 305,199	\$ -	\$ -	\$ -	\$ -	\$ 315,272
Collectively evaluated for impairment	7,232,747	2,495,921	609,588	14,644	146,353	67,876	10,567,129
Balance at June 30, 2017 (Restated)	<u>\$ 7,242,820</u>	<u>\$ 2,801,120</u>	<u>\$ 609,588</u>	<u>\$ 14,644</u>	<u>\$ 146,353</u>	<u>\$ 67,876</u>	<u>\$ 10,882,401</u>

	Real Estate Mortgage	Production and Intermediate Term	Agribusiness	Communications	Energy and Water/Waste Water	Rural Residential Real Estate	Total
Recorded Investments							
in Loans Outstanding:							
Ending Balance at							
June 30, 2018	\$ 1,313,779,650	\$ 98,375,196	\$ 171,053,257	\$ 8,475,274	\$ 44,753,995	\$ 11,999,298	\$ 1,648,436,670
Individually evaluated for impairment	\$ 5,006,748	\$ 1,743,166	\$ -	\$ -	\$ -	\$ 162,849	\$ 6,912,763
Collectively evaluated for impairment	\$ 1,308,772,902	\$ 96,632,030	\$ 171,053,257	\$ 8,475,274	\$ 44,753,995	\$ 11,836,449	\$ 1,641,523,907
Loans acquired with deteriorated credit quality	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Ending Balance at							
December 31, 2017	\$ 1,357,624,407	\$ 107,402,571	\$ 157,398,491	\$ 8,731,512	\$ 45,519,060	\$ 13,717,883	\$ 1,690,393,924
Individually evaluated for impairment	\$ 6,950,507	\$ 2,970,069	\$ -	\$ -	\$ -	\$ 228,182	\$ 10,148,758
Collectively evaluated for impairment	\$ 1,350,652,214	\$ 104,432,502	\$ 157,398,491	\$ 8,731,512	\$ 45,519,060	\$ 13,489,701	\$ 1,680,223,480
Loans acquired with deteriorated credit quality	\$ 21,686	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 21,686
Ending Balance at							
March 31, 2017 (restated)	\$ 1,346,762,584	\$ 118,121,856	\$ 163,617,954	\$ 8,241,922	\$ 50,461,581	\$ 15,152,854	\$ 1,702,358,751
Individually evaluated for impairment	\$ 8,461,029	\$ 3,285,627	\$ -	\$ -	\$ -	\$ 835,063	\$ 12,581,719
Collectively evaluated for impairment (restated)	\$ 1,338,301,555	\$ 114,836,229	\$ 163,617,953	\$ 8,241,922	\$ 50,461,581	\$ 14,317,791	\$ 1,689,777,031
Loans acquired with deteriorated credit quality	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -

NOTE 4 — 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 potential loss within the loan and lease portfolios; 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.

Regulatory Capitalization Requirements

Risk-adjusted:	Regulatory Conservation			As of June 30, 2018
	Minimums	Buffer	Total	
Common equity tier 1 ratio	4.50%	2.50%	7.00%	18.78%
Tier 1 capital ratio	6.00%	2.50%	8.50%	18.78%
Total capital ratio	8.00%	2.50%	10.50%	19.25%
Permanent capital ratio	7.00%	0.00%	7.00%	18.87%
<hr/>				
Non-risk-adjusted:				
Tier 1 leverage ratio	4.00%	1.00%	5.00%	19.58%
UREE leverage ratio	1.50%	0.00%	1.50%	20.85%
<hr/>				
Risk-adjusted:	Regulatory Conservation			As of June 30, 2017
	Minimums	Buffer	Total	
Common equity tier 1 ratio	4.50%	2.50%	7.00%	18.15%
Tier 1 capital ratio	6.00%	2.50%	8.50%	18.15%
Total capital ratio	8.00%	2.50%	10.50%	18.55%
Permanent capital ratio	7.00%	0.00%	7.00%	18.22%
<hr/>				
Non-risk-adjusted:				
Tier 1 leverage ratio	4.00%	1.00%	5.00%	18.91%
UREE leverage ratio	1.50%	0.00%	1.50%	20.05%

Risk-adjusted assets have been defined by FCA Regulations as the Statement of Condition assets and off-balance-sheet commitments adjusted by various percentages, depending on the level of risk inherent in the various types of assets. The primary changes which generally have the impact of increasing risk-adjusted assets (decreasing risk-based regulatory capital ratios) were as follows:

- Inclusion of off-balance-sheet commitments less than 14 months
- Increased risk-weighting of most loans 90 days past due or in nonaccrual status

Risk-adjusted assets is calculated differently for the permanent capital ratio (referred herein as PCR risk-adjusted assets) compared to the other risk-based capital ratios. The primary difference is the deduction of the allowance for loan losses from risk-adjusted assets for the permanent capital ratio.

The ratios are based on a three-month average daily balance in accordance with FCA regulations and are calculated as follows:

- Common equity tier 1 ratio is statutory minimum purchased borrower stock, other required borrower stock held for a minimum of 7 years, allocated equities held for a minimum of 7 years or not subject to revolving, unallocated retained earnings, paid-in capital, less certain regulatory required deductions including the amount of allocated investments in other

System institutions, and the amount of purchased investments in other System institutions under the corresponding deduction approach, divided by average risk-adjusted assets.

- Tier 1 capital ratio is common equity tier 1 plus non-cumulative perpetual preferred stock, divided by average risk-adjusted assets.
- Total capital is tier 1 capital plus other required borrower stock held for a minimum of 5 years, allocated equities held for a minimum of 5 years, subordinated debt and limited-life preferred stock greater than 5 years to maturity at issuance subject to certain limitations, allowance and reserve for credit losses under certain limitations less certain investments in other System institutions under the corresponding deduction approach, divided by average risk-adjusted assets.
- Permanent capital ratio (PCR) is all at-risk borrower stock, any allocated excess stock, unallocated retained earnings, paid-in capital, subordinated debt and preferred subject to certain limitations, less certain allocated and purchased investments in other System institutions, divided by PCR risk-adjusted assets.
- Tier 1 leverage ratio is tier 1 capital, including regulatory deductions, divided by average assets less regulatory deductions subject to tier 1 capital.
- UREE leverage ratio is unallocated retained earnings, paid-in capital, allocated surplus not subject to revolvement less certain regulatory required deductions including the amount of allocated investments in other System institutions divided by average assets less regulatory deductions subject to tier 1 capital.

If the capital ratios fall below the minimum regulatory requirements, including the capital conservation and leverage buffer amounts, capital distributions (equity redemptions, dividends, and patronage) and discretionary bonus payments to senior officers are restricted or prohibited without prior FCA approval.

The components of the Association's risk-adjusted capital, based on 90 day average balances, were as follows at June 30, 2018:

(dollars in thousands)	Common equity tier 1 ratio	Tier 1 capital ratio	Total capital ratio	Permanent capital ratio
Numerator:				
Unallocated retained earnings	191,827,661	191,827,661	191,827,661	191,827,661
Paid-in capital	91,343,553	91,343,553	91,343,553	91,343,553
Common Cooperative Equities:				
Statutory minimum purchased borrower stock	6,252,671	6,252,671	6,252,671	6,252,671
Nonqualified allocated equities not subject to retirement	65,733,966	65,733,966	65,733,966	65,733,966
Allowance for loan losses and reserve for credit losses subject to certain limitations			8,309,747	
Regulatory Adjustments and Deductions:				
Amount of allocated investments in other System institutions	(27,561,152)	(27,561,152)	(27,561,152)	(27,561,152)
	<u>327,596,699</u>	<u>327,596,699</u>	<u>335,906,446</u>	<u>327,596,699</u>
Denominator:				
Risk-adjusted assets excluding allowance	1,772,165,360	1,772,165,360	1,772,165,360	1,772,165,360
Regulatory Adjustments and Deductions:				
Regulatory deductions included in total capital	(27,561,152)	(27,561,152)	(27,561,152)	(27,561,152)
Allowance for loan losses				(8,152,283)
	<u>1,744,604,208</u>	<u>1,744,604,208</u>	<u>1,744,604,208</u>	<u>1,736,451,925</u>

The components of the Association's risk-adjusted capital, based on 90 day average balances, were as follows at June 30, 2017:

(dollars in thousands)	Common equity tier 1 ratio	Tier 1 capital ratio	Total capital ratio	Permanent capital ratio
Numerator:				
Unallocated retained earnings	186,022,332	186,022,332	186,022,332	186,022,332
Paid-in capital	91,343,553	91,343,553	91,343,553	91,343,553
Common Cooperative Equities:				
Statutory minimum purchased borrower stock	6,457,226	6,457,226	6,457,226	6,457,226
Nonqualified allocated equities not subject to retirement	65,733,966	65,733,966	65,733,966	65,733,966
Allowance for loan losses and reserve for credit losses subject to certain limitations			7,120,513	
Regulatory Adjustments and Deductions:				
Amount of allocated investments in other System institutions	(26,001,180)	(26,001,180)	(26,001,180)	(26,001,180)
	<u>323,555,897</u>	<u>323,555,897</u>	<u>330,676,410</u>	<u>323,555,897</u>
Denominator:				
Risk-adjusted assets excluding allowance	1,808,815,345	1,808,815,345	1,808,815,345	1,808,815,345
Regulatory Adjustments and Deductions:				
Regulatory deductions included in total capital	(26,001,180)	(26,001,180)	(26,001,180)	(26,001,180)
Allowance for loan losses				(6,906,489)
	<u>1,782,814,165</u>	<u>1,782,814,165</u>	<u>1,782,814,165</u>	<u>1,775,907,676</u>

The components of the Association's non-risk-adjusted capital, based on 90 day average balances, were as follows at June 30, 2018:

(dollars in thousands)	Tier 1 leverage ratio	UREE leverage ratio
Numerator:		
Unallocated retained earnings	191,827,661	191,827,661
Paid-in capital	91,343,553	91,343,553
Common Cooperative Equities:		
Statutory minimum purchased borrower stock	6,252,671	-
Nonqualified allocated equities not subject to retirement	65,733,966	65,733,966
Regulatory Adjustments and Deductions:		
Amount of allocated investments in other System institutions	(27,561,030)	(122)
	<u>327,596,821</u>	<u>348,905,058</u>
Denominator:		
Total Assets	1,702,090,360	1,702,090,360
Regulatory Adjustments and Deductions:		
Regulatory deductions included in tier 1 capital	(28,972,596)	(28,972,596)
	<u>1,673,117,764</u>	<u>1,673,117,764</u>

The components of the Association's non-risk-adjusted capital, based on 90 day average balances, were as follows at June 30, 2017:

(dollars in thousands)	Tier 1 leverage ratio	UREE leverage ratio
Numerator:		
Unallocated retained earnings	186,022,332	186,022,332
Paid-in capital	91,343,553	91,343,553
Common Cooperative Equities:		
Statutory minimum purchased borrower stock	6,457,226	-
Nonqualified allocated equities not subject to retirement	65,733,966	65,733,966
Amount of allocated investments in other System institutions	(26,001,180)	-
	<u>323,555,897</u>	<u>343,099,851</u>
Denominator:		
Total Assets	1,737,024,761	1,737,024,761
Regulatory Adjustments and Deductions:		
Regulatory deductions included in tier 1 capital	(26,001,180)	(26,001,180)
	<u>1,711,023,581</u>	<u>1,711,023,581</u>

An additional component of equity is accumulated other comprehensive income, which is reported net of taxes, is as follows:

June 30, 2018	<u>Before Tax</u>	<u>Deferred Tax</u>	<u>Net of Tax</u>
Non-pension postretirement benefits	\$ 29,622	\$ -	\$ 14,811
Total	\$ 14,811	\$ -	\$ 14,811
June 30, 2017	<u>Before Tax</u>	<u>Deferred Tax</u>	<u>Net of Tax</u>
Non-pension postretirement benefits	\$ 4,110	\$ -	\$ 4,110
Total	\$ 4,110	\$ -	\$ 4,110

The Association's accumulated other comprehensive income (loss) relates entirely to its nonpension other postretirement benefits. Amortization of prior service (credits) cost and of actuarial (gain) loss are reflected in "Salaries and employee benefits" in the Consolidated Statement of Comprehensive Income. The following table summarizes the changes in accumulated other comprehensive income (loss) for the six months ended June 30:

	<u>2018</u>	<u>2017</u>
Accumulated other comprehensive income (loss) at January 1	\$ (1,357,769)	\$ (833,008)
Amortization of prior service (credit) costs included in salaries and employee benefits	(13,034)	(17,378)
Amortization of actuarial (gain) loss included in salaries and employee benefits	42,656	21,488
Other comprehensive income (loss), net of tax	29,622	4,110
Accumulated other comprehensive income at June 30	\$ (1,328,147)	\$ (828,898)

NOTE 5 — INCOME TAXES:

Lone Star, ACA conducts its business activities through two wholly-owned subsidiaries. Long-term mortgage lending activities are conducted through a wholly-owned FLCA subsidiary which is exempt from federal and state income tax. Short- and intermediate-term lending activities are conducted through a wholly-owned PCA subsidiary. The PCA subsidiary and the ACA holding company are subject to income tax. Lone Star, ACA operates as a cooperative that qualifies for tax treatment under Subchapter T of the Internal Revenue Code. Accordingly, under specified conditions, Lone Star, ACA can exclude from taxable income amounts distributed as qualified patronage dividends in the form of cash, stock or allocated retained earnings. Provisions for income taxes are made only on those taxable earnings that will not be distributed as qualified patronage dividends. Deferred taxes are recorded at the tax effect of all temporary differences based on the assumption that such temporary differences are retained by the institution and will therefore impact future tax payments. A valuation allowance is provided against deferred tax assets to the extent that it is more likely than not (more than 50 percent probability), based on management's estimate, that they will not be realized.

NOTE 6 — FAIR VALUE MEASUREMENTS:

FASB guidance defines fair value as the exchange price that would be received for an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability. See Note 15 to the 2017 Annual Report to Stockholders for a more complete description.

Assets and liabilities measured at fair value on a recurring basis are summarized below:

<u>June 30, 2018</u>	<u>Fair Value Measurement Using</u>			<u>Total Fair Value</u>
	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	
Assets:				
Assets held in nonqualified benefit trusts	\$169,034	\$ -	\$ -	\$ 169,034
Total assets	\$169,034	\$ -	\$ -	\$ 169,034
<u>December 31, 2017</u>	<u>Fair Value Measurement Using</u>			<u>Total Fair Value</u>
	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	
Assets:				
Assets held in nonqualified benefit trusts	\$ 164,094	\$ -	\$ -	\$ 164,094
Total assets	\$ 164,094	\$ -	\$ -	\$ 164,094
<u>June 30, 2017</u>	<u>Fair Value Measurement Using</u>			<u>Total Fair Value</u>
	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	
Assets:				
Assets held in nonqualified benefit trusts	\$ 151,805	\$ -	\$ -	\$ 151,805
Total assets	\$ 151,805	\$ -	\$ -	\$ 151,805

Assets and liabilities measured at fair value on a nonrecurring basis for each of the fair value hierarchy values are summarized below:

<u>June 30, 2018</u>	<u>Fair Value Measurement Using</u>			<u>Total Fair Value</u>	<u>Total Gains (Losses)</u>
	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>		
Assets:					
Loans*	\$ -	\$ -	\$ 838,565	\$ 838,565	\$ -
<u>December 31, 2017</u>	<u>Fair Value Measurement Using</u>			<u>Total Fair Value</u>	<u>Total Gains (Losses)</u>
	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>		
Assets:					
Loans*	\$ -	\$ -	\$ 609,094	\$ 609,094	\$ -
<u>June 30, 2017</u>	<u>Fair Value Measurement Using</u>			<u>Total Fair Value</u>	<u>Total Gains (Losses)</u>
	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>		
Assets:					
Loans*	\$ -	\$ -	\$1,066,040	\$ 1,066,040	\$ -

*Represents the fair value of certain loans that were evaluated for impairment under authoritative guidance "Accounting by Creditors for Impairment of a Loan." The fair value was based upon the underlying collateral since these were collateral-dependent loans for which real estate is the collateral.

With regard to nonrecurring measurements for impaired loans and other property owned, it is not practicable to provide specific information on inputs, as each collateral property is unique. System institutions utilize appraisals to value these loans and other property owned and take into account unobservable inputs, such as income and expense, comparable sales, replacement cost and comparability adjustments.

Valuation Techniques

As more fully discussed in Note 2 to the 2017 Annual Report to Stockholders, authoritative guidance establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The following represent a brief summary of the valuation techniques used for the Association's assets and liabilities. For a more complete description, see Notes to the 2017 Annual Report to Stockholders.

Investment Securities

Where quoted prices are available in an active market, available-for-sale securities would be classified as Level 1. If quoted prices are not available in an active market, the fair value of securities is estimated using pricing models that utilize observable inputs, quoted prices for similar securities received from pricing services or discounted cash flows. Generally, these securities would be classified as Level 2. This would include certain mortgage-backed and asset-backed securities. Where there is limited activity or less transparency around inputs to the valuation, the securities are classified as Level 3. Securities classified within Level 3 include asset-based securities and certain mortgage-backed securities, including private label-FHA/VA securities and those issued by Farmer Mac.

Assets Held in Nonqualified Benefits Trusts

Assets held in trust funds related to deferred compensation and supplemental retirement plans are classified within Level 1. The trust funds include investments that are actively traded and have quoted net asset values that are observable in the marketplace.

Standby Letters of Credit

The fair value of letters of credit approximate the fees currently charged for similar agreements or the estimated cost to terminate or otherwise settle similar obligations.

Loans

For certain loans evaluated for impairment under impairment guidance, the fair value is based upon the underlying collateral since the loans are collateral-dependent loans for which real estate is the collateral. The fair value measurement process uses independent appraisals and other market-based information, but in many cases it also requires significant input based on management's knowledge of and judgment about current market conditions, specific issues relating to the collateral and other matters. As a result, these fair value measurements fall within Level 3 of the hierarchy. When the value of the real estate, less estimated costs to sell, is less than the principal balance of the loan, a specific reserve is established.

Other Property Owned

Other property owned is generally classified as Level 3. The process for measuring the fair value of other property owned involves the use of appraisals or other market-based information. Costs to sell represent transaction costs and are not included as a component of the asset's fair value. As a result, these fair value measurements fall within Level 3 of the hierarchy.

The fair value of commitments is estimated using the fees currently charged for similar agreements, taking into account the remaining terms of the agreements and the creditworthiness of the counterparties. For fixed-rate loan commitments, estimated fair value also considers the difference between current levels of interest rates and the committed rates.

NOTE 7 — EMPLOYEE BENEFIT PLANS:

The following table summarizes the components of net periodic benefit costs of nonpension other postretirement employee benefits for the six months ended June 30:

	Other Benefits	
	2018	2017
Service cost	\$ 44,830	\$ 38,869
Interest cost	107,701	105,742
Amortization of prior service (credits) costs	(17,379)	(17,379)
Amortization of net actuarial (gain) loss	21,486	24,351
Net periodic benefit cost	<u>\$ 156,638</u>	<u>\$ 151,583</u>

The Association's liability for the unfunded accumulated obligation for these benefits at June 30, 2018 and 2017, was \$5,524,797 and \$4,833,965, respectively, and is included in "Other Liabilities" in the balance sheet.

The components of net periodic benefit cost other than the service cost component are included in the line item "other components of net periodic postretirement benefit cost" in the income statement.

The structure of the district's defined benefit pension plan is characterized as multiemployer since the assets, liabilities and cost of the plan are not segregated or separately accounted for by participating employers (Bank and associations). The Association recognizes its amortized annual contributions to the plan as an expense. The Association previously disclosed in its financial statements for the year ended December 31, 2017, that it expected to contribute \$160,964 to the district's defined benefit pension plan in 2018. As of June 30, 2018, \$372,467 of contributions have been made. The Association presently anticipates contributing an additional \$372,467 to fund the defined benefit pension plan in 2018 for a total of \$744,934.

NOTE 8 — COMMITMENTS AND CONTINGENT LIABILITIES:

The Association is involved in various legal proceedings in the normal course of business. In the opinion of legal counsel and management, there are no legal proceedings at this time that are likely to materially affect the Association.

NOTE 9 — SUBSEQUENT EVENTS:

The Association has evaluated subsequent events through August 9, 2018, which is the date the financial statements were issued. There are no other significant events requiring disclosure as of August 9, 2018.