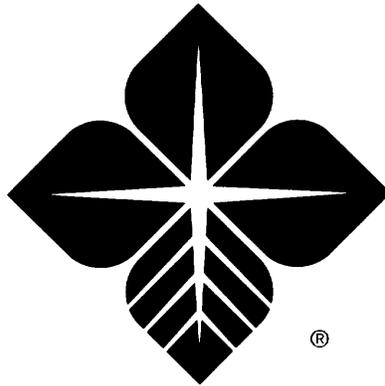


LONE STAR, ACA

**2013
Quarterly Report
Second Quarter**



For the Quarter Ended June 30, 2013

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 his or her knowledge and belief.



Steve Fowlkes, Chief Executive Officer

August 5, 2013



Tom Johnson, Chairman, Board of Directors

August 5, 2013



M'Lissa Kiel, Chief Financial Officer

August 5, 2013



Don Crawford, Chairman, Audit Committee

August 5, 2013



Troy Bussmeir, Chief Operating Officer

August 5, 2013

LONE STAR, ACA MANAGEMENT'S DISCUSSION AND ANALYSIS

The following commentary reviews the financial performance of the Lone Star, ACA (Agricultural Credit Association), referred to as the association, for the quarter ended June 30, 2013. These comments should be read in conjunction with the accompanying financial statements and the December 31, 2012 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.

Significant Events

Effective February 27, 2013, the Association entered into a Letter of Intent in order to memorialize its intent to pursue a mutually beneficial merger transaction with Texas Land Bank, ACA, pending completion of due diligence of each other's operations. This is the first step in a process for developing definitive terms and conditions for a plan of merger. The proposed effective date for merger is January 1, 2014, or as soon as practicable thereafter. Additional disclosures will be provided to stockholders during 2013 under timelines dictated by Farm Credit regulations.

In December 2012, the Lone Star, ACA board declared a \$7,000,000 cash patronage based on 2012 earnings. This patronage was paid to stockholders in April of 2013. The association's capital position continued to improve and is above 20 percent for the year ending June 2013.

For over 95 years, the association has continued to provide 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.

Loan Portfolio:

Total loans outstanding at June 30, 2013, including nonaccrual loans and sales contracts, were \$854,658,187 compared to \$831,334,481 at December 31, 2012, reflecting an increase of 2.8 percent. Nonaccrual loans as a percentage of total loans outstanding were 2.2 percent at June 30, 2013, compared to 2.9 percent at December 31, 2012.

The association recorded \$67,521 in recoveries and \$309,240 in charge-offs for the quarter ended June 30, 2013, and \$17,617 in recoveries and \$692,534 in charge-offs for the same period in 2012. The association's allowance for loan losses was 1.1 percent and 1.2 percent of total loans outstanding as of June 30, 2013, and December 31, 2012, respectively.

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, 2013 | | December 31, 2012 | |
|--|----------------------|---------------|----------------------|---------------|
| | Amount | % | Amount | % |
| Nonaccrual | \$ 18,649,348 | 92.6% | \$ 24,276,925 | 95.5% |
| 90 days past due and still accruing interest | - | 0.0% | - | 0.0% |
| Formally restructured | 59,918 | 0.3% | 67,657 | 0.3% |
| Other property owned, net | 1,431,591 | 7.1% | 1,060,973 | 4.2% |
| Total | <u>\$ 20,140,857</u> | <u>100.0%</u> | <u>\$ 25,405,555</u> | <u>100.0%</u> |

Results of Operations:

The association had net income of \$3,555,008 and \$9,247,174 for the three and six months ended June 30, 2013, as compared to net income of \$6,961,507 and \$12,787,377 for the same period in 2012, reflecting a decrease of 48.9 and 27.7 percent, respectively. Net interest income was \$6,242,989 and \$13,228,852 for the three and six months ended June 30, 2013, compared to \$6,233,298 and \$13,105,186 for the same period in 2012. The association's return on average assets for the six months ended June 30, 2013, was 2.19 percent compared to 2.92 percent for the same period in 2012. The association's return on average equity for the six months ended June 30, 2013, was 9.64 percent, compared to 14.13 percent for the same period in 2012.

| | June 30, 2013 | | June 30, 2012 | |
|-------------------------------|-----------------------|----------------------|----------------------|---------------------|
| | Average Balance | Interest | Average Balance | Interest |
| Loans | \$ 837,534,266 | \$ 18,929,363 | \$858,319,205 | \$20,420,470 |
| Investments | - | - | 4,870,195 | 211,054 |
| Total interest-earning assets | 837,534,266 | 18,929,363 | 863,189,400 | 20,631,524 |
| Interest-bearing liabilities | 648,904,058 | 5,700,511 | 691,017,895 | 7,526,338 |
| Impact of capital | <u>\$ 188,630,208</u> | | <u>\$172,171,505</u> | |
| Net interest income | | <u>\$ 13,228,852</u> | | <u>\$13,105,186</u> |

| | 2013 | 2012 |
|---|---------------|---------------|
| | Average Yield | Average Yield |
| Yield on loans | 4.56% | 4.78% |
| Yield on investments | 0.00% | 8.71% |
| Total yield on interest-earning assets | 4.56% | 4.81% |
| Cost of interest-bearing liabilities | 1.77% | 2.19% |
| Interest rate spread | 2.79% | 2.62% |
| Net interest income as a percentage of average earning assets | 3.19% | 3.05% |
| ROA | 2.19% | 2.92% |
| ROE | 9.64% | 14.13% |
| Allowance for loan losses to total loans | 1.10% | 1.24% |

Interest income for the three and six months ended June 30, 2013, decreased by \$677,239 and \$1,702,161, or 7.0 and 8.3 percent, respectively, from the same period of 2012, primarily due to a decrease in average accruing loan volume and partially driven by the change in investments, which were sold to FCBT during the 1st quarter of 2012. Interest expense for the three and six months ended June 30, 2013, decreased by \$686,930 and \$1,825,827, or 19.6 and 24.3 percent, respectively, from the same period of 2012 due to a decrease in both average interest-bearing liabilities and the average rate.

| | June 30, 2013 vs. June 30, 2012 | | |
|-------------------------------|---------------------------------|-------------------|-------------------|
| | Increase (decrease) due to | | |
| | Volume | Rate | Total |
| Interest income - loans | \$ (493,131) | \$ (997,976) | \$ (1,491,107) |
| Interest income - investments | (210,470) | (584) | (211,054) |
| Total interest income | (703,600) | (998,561) | (1,702,161) |
| Interest expense | (457,419) | (1,368,408) | (1,825,827) |
| Net interest income | <u>\$ (246,181)</u> | <u>\$ 369,847</u> | <u>\$ 123,666</u> |

Average loan volume for the second quarter of 2013 was \$841,866,572, compared to \$850,221,771 in the second quarter of 2012. The average net interest rate spread on the loan portfolio for the second quarter of 2013 was 2.59 percent, compared to 2.52 percent in the second quarter of 2012.

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 Systemwide obligations and with lendable equity. The following schedule summarizes the association's borrowings.

| | June 30, 2013 | December 31, 2012 |
|----------------------------------|-----------------------|-----------------------|
| Note payable to the bank | \$ 667,543,845 | \$ 643,933,881 |
| Accrued interest on note payable | 932,122 | 1,036,026 |
| Total | <u>\$ 668,475,967</u> | <u>\$ 644,969,907</u> |

The association operates under a general financing agreement (GFA) with the bank. The current GFA is effective through September 30, 2015. The primary source of liquidity and funding for the association is a direct loan from the bank. The outstanding balance of \$667,543,845 as of June 30, 2013, is recorded as a liability on the association's balance sheet. The note carried a weighted average interest rate of 1.69 percent at June 30, 2013. The indebtedness is collateralized by a pledge of substantially all of the association's assets to the bank and is governed by a general financing agreement. The increase in note payable to the bank correlates directly with the growth in association loan volume since December 31, 2012; however, the related accrued interest payable decreased slightly during the same period due to a decrease in the association's weighted average interest rate. The association's own funds, which represent the amount of the association's loan portfolio funded by the association's equity, were \$186,811,907 at June 30, 2013. The maximum amount the association may borrow from the bank as of June 30, 2013, was \$840,994,257 as defined by the general financing agreement. The indebtedness continues in effect until the expiration date of the general financing agreement, which is September 30, 2015, 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.

The liquidity policy of the association is to manage cash balances to maximize debt reduction and to increase accrual loan volume. This policy will continue to be pursued during 2013. As borrower payments are received, they are applied to the association's note payable to the bank.

The association will continue to fund its operations through direct borrowings from the bank, capital surplus from prior years and borrower stock. It is management's opinion that funds available to the association are sufficient to fund its operations for the coming year.

Capital Resources:

The association's capital position increased by \$8,771,160 to \$197,185,331 at June 30, 2013, compared to \$188,414,171 at December 31, 2012. The association's debt as a percentage of members' equity was 3.42:1 as of June 30, 2013, compared to 3.48:1 as of December 31, 2012.

Under regulations governing minimum permanent capital adequacy and other capitalization issues, the association is required to maintain a minimum adjusted permanent capital of 7.0 percent of risk-adjusted assets as defined by the FCA. The association's permanent capital ratio at June 30, 2013, was 20.8 percent, which is in compliance with the FCA's minimum permanent capital standard. The association's core surplus ratio and total surplus ratio at June 30, 2013, were 20.4 and 20.4 percent, respectively, which is in compliance with the FCA's minimum surplus standard.

Significant Recent Accounting Pronouncements:

In December 2011, the Financial Accounting Standards Board (FASB) issued guidance entitled "Balance Sheet – Disclosures about Offsetting Assets and Liabilities." The guidance requires an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. This includes the effect or potential effect of rights of offset associated with an entity's recognized assets and recognized liabilities. The requirements apply to recognized financial instruments and derivative instruments that are offset in accordance with the rights of offset set forth in accounting guidance and for those recognized financial instruments and derivative instruments that are subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset or not. This guidance is to be applied retrospectively for all comparative periods and is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. The adoption of this guidance did not impact financial condition or results of operations, but resulted in additional disclosures.

In February 2013, the FASB issued guidance, "Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income." The guidance requires entities to present either parenthetically on the face of the financial statements or in the notes to the financial statements, significant amounts reclassified from each component of accumulated other comprehensive income and the income statement line items affected by the reclassification. The guidance is effective for public entities for annual periods beginning after December 15, 2012, and for nonpublic entities for annual periods beginning after December 15, 2013. The association has adopted this guidance, which did not impact the financial condition or results of operations, but resulted in additional disclosures which are included in Note 6 – Employee Benefit Plans.

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 2012 Annual Report of Lone Star, ACA 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. Copies of the association's quarterly stockholder reports can also be requested by e-mailing selita.sprunger@lonestaragcredit.com.

LONE STAR, ACA

CONSOLIDATED BALANCE SHEET

| | June 30, 2013 (unaudited) | December 31, 2012 |
|---|---------------------------------|-----------------------|
| <u>ASSETS</u> | | |
| Cash | \$ 95,377 | \$ 77,431 |
| Loans | 854,658,187 | 831,334,481 |
| Less: allowance for loan losses | (9,361,095) | (10,233,599) |
| Net loans | <u>845,297,092</u> | <u>821,100,882</u> |
| Accrued interest receivable | 5,789,162 | 4,873,844 |
| Investment in and receivable from the Farm Credit Bank of Texas: | | |
| Capital stock | 13,922,385 | 13,922,385 |
| Other | 1,952,461 | 1,468,168 |
| Other property owned, net | 1,431,591 | 1,060,973 |
| Premises and equipment | 1,470,304 | 1,615,834 |
| Other assets | 861,965 | 574,206 |
| Total assets | <u>\$ 870,820,337</u> | <u>\$ 844,693,723</u> |
| <u>LIABILITIES</u> | | |
| Note payable to the Farm Credit Bank of Texas | \$ 667,543,845 | \$ 643,933,881 |
| Accrued interest payable | 932,122 | 1,036,026 |
| Drafts outstanding | 46,529 | 142,345 |
| Patronage distributions payable | 329 | 7,000,000 |
| Other liabilities | 5,112,181 | 4,167,300 |
| Total liabilities | <u>673,635,006</u> | <u>656,279,552</u> |
| <u>MEMBERS' EQUITY</u> | | |
| Capital stock and participation certificates | 3,731,660 | 3,772,180 |
| Unallocated retained earnings | 194,760,154 | 185,512,981 |
| Accumulated other comprehensive income (loss) | (1,306,483) | (870,990) |
| Total members' equity | <u>197,185,331</u> | <u>188,414,171</u> |
| Total liabilities and members' equity | <u>\$ 870,820,337</u> | <u>\$ 844,693,723</u> |

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

LONE STAR, ACA

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(unaudited)

| | Quarter Ended | | Six Months Ended | |
|---|---------------------|---------------------|---------------------|----------------------|
| | June 30, | | June 30, | |
| | 2013 | 2012 | 2013 | 2012 |
| <u>INTEREST INCOME</u> | | | | |
| Loans | \$ 9,067,304 | \$ 9,744,543 | \$ 18,929,363 | \$ 20,420,470 |
| Investments | - | - | - | 211,054 |
| Total interest income | <u>9,067,304</u> | <u>9,744,543</u> | <u>18,929,363</u> | <u>20,631,524</u> |
| <u>INTEREST EXPENSE</u> | | | | |
| Note payable to the Farm Credit Bank of Texas | 2,824,290 | 3,511,224 | 5,700,476 | 7,526,308 |
| Advance conditional payments | 25 | 21 | 35 | 30 |
| Total interest expense | <u>2,824,315</u> | <u>3,511,245</u> | <u>5,700,511</u> | <u>7,526,338</u> |
| Net interest income | <u>6,242,989</u> | <u>6,233,298</u> | <u>13,228,852</u> | <u>13,105,186</u> |
| <u>PROVISION FOR LOAN LOSSES</u> | | | | |
| | <u>345,096</u> | <u>(1,957,194)</u> | <u>(598,027)</u> | <u>(1,312,718)</u> |
| Net interest income after provision for loan losses | <u>5,897,893</u> | <u>8,190,492</u> | <u>13,826,879</u> | <u>14,417,904</u> |
| <u>NONINTEREST INCOME</u> | | | | |
| Income from the Farm Credit Bank of Texas: | | | | |
| Patronage income | 474,798 | 529,885 | 960,020 | 1,054,204 |
| Loan fees | 52,095 | 193,976 | 176,909 | 521,528 |
| Financially related services income | 2,042 | (8,570) | 4,248 | (5,585) |
| Gain (loss) on other property owned, net | 112,382 | 10,895 | 239,728 | 2,045,824 |
| Other noninterest income | 7,891 | 1,001,892 | 106,530 | 1,107,090 |
| Total noninterest income | <u>649,208</u> | <u>1,728,078</u> | <u>1,487,435</u> | <u>4,723,061</u> |
| <u>NONINTEREST EXPENSES</u> | | | | |
| Salaries and employee benefits | 1,676,616 | 1,611,428 | 3,439,855 | 3,500,206 |
| Directors' expense | 120,181 | 112,294 | 233,090 | 215,241 |
| Purchased services | 225,305 | 255,768 | 515,330 | 442,263 |
| Travel | 215,941 | 174,177 | 357,814 | 334,357 |
| Occupancy and equipment | 170,704 | 177,741 | 330,357 | 326,723 |
| Communications | 41,435 | 44,007 | 82,940 | 87,251 |
| Advertising | 62,012 | 64,706 | 135,642 | 177,149 |
| Public and member relations | 149,988 | 88,424 | 247,819 | 207,793 |
| Supervisory and exam expense | 74,524 | 100,374 | 149,048 | 200,748 |
| Insurance Fund premiums | 163,325 | 93,565 | 428,309 | 330,454 |
| Provisions for acquired property losses | 3,190 | 154,360 | 3,190 | 364,548 |
| Other noninterest expense | 76,961 | 76,309 | 119,750 | 161,873 |
| Total noninterest expenses | <u>2,980,182</u> | <u>2,953,153</u> | <u>6,043,144</u> | <u>6,348,606</u> |
| Income before income taxes | <u>3,566,919</u> | <u>6,965,417</u> | <u>9,271,170</u> | <u>12,792,359</u> |
| Provision for (benefit from) income taxes | <u>11,911</u> | <u>3,910</u> | <u>23,996</u> | <u>4,982</u> |
| NET INCOME | <u>3,555,008</u> | <u>6,961,507</u> | <u>9,247,174</u> | <u>12,787,377</u> |
| Other comprehensive income: | | | | |
| Change in postretirement benefit plans | (217,747) | (124,672) | (435,494) | (249,345) |
| Other comprehensive income, net of tax | <u>(217,747)</u> | <u>(124,672)</u> | <u>(435,494)</u> | <u>(249,345)</u> |
| COMPREHENSIVE INCOME | <u>\$ 3,337,261</u> | <u>\$ 6,836,835</u> | <u>\$ 8,811,680</u> | <u>\$ 12,538,032</u> |

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

LONE STAR, ACA

CONSOLIDATED STATEMENT OF CHANGES IN MEMBERS' EQUITY

(unaudited)

| | <u>Capital Stock/ Participation Certificates</u> | <u>Retained Earnings Unallocated</u> | <u>Accumulated Other Comprehensive Income (Loss)</u> | <u>Total Members' Equity</u> |
|---|--|--|--|--------------------------------------|
| Balance at December 31, 2011 | \$ 4,043,055 | \$ 172,748,498 | \$ (498,689) | \$ 176,292,864 |
| Comprehensive income | - | 12,787,377 | (249,345) | 12,538,032 |
| Capital stock/participation certificates and allocated retained earnings issued | 189,725 | - | - | 189,725 |
| Capital stock/participation certificates and allocated retained earnings retired | (348,800) | - | - | (348,800) |
| Balance at June 30, 2012 | <u>\$ 3,883,980</u> | <u>\$ 185,535,875</u> | <u>\$ (748,034)</u> | <u>\$ 188,671,821</u> |
| | | | | |
| Balance at December 31, 2012 | \$ 3,772,180 | \$ 185,512,981 | \$ (870,990) | \$ 188,414,171 |
| Comprehensive income | - | 9,247,174 | (435,494) | 8,811,680 |
| Capital stock/participation certificates and allocated retained earnings issued | 251,745 | - | - | 251,745 |
| Capital stock/participation certificates and allocated retained earnings retired | (292,265) | - | - | (292,265) |
| Balance at June 30, 2013 | <u>\$ 3,731,660</u> | <u>\$ 194,760,155</u> | <u>\$ (1,306,484)</u> | <u>\$ 197,185,331</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:

The Lone Star, ACA (Agricultural 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 Hood, Johnson, Somervell, Tarrant, Denton, Wise, Dallas, Bowie, Camp, Cass, Morris, Titus, Delta, Lamar, Red River, Cooke, Fannin, Grayson, Eastland, Erath, Palo Pinto, Parker, Shackelford, Stephens, Throckmorton, Young, Borden, Fisher, Kent, Mitchell, Nolan, Scurry and Taylor 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 significant accounting policies followed and the financial condition and results of operations of the association as of and for the year ended December 31, 2012, are contained in the 2012 Annual Report to Stockholders. These unaudited second quarter 2013 financial statements should be read in conjunction with the 2012 Annual Report to Stockholders.

In December 2011, the Financial Accounting Standards Board (FASB) issued guidance entitled “Balance Sheet – Disclosures about Offsetting Assets and Liabilities.” The guidance requires an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. This includes the effect or potential effect of rights of offset associated with an entity’s recognized assets and recognized liabilities. The requirements apply to recognized financial instruments and derivative instruments that are offset in accordance with the rights of offset set forth in accounting guidance and for those recognized financial instruments and derivative instruments that are subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset or not. This guidance is to be applied retrospectively for all comparative periods and is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. The adoption of this guidance will not impact financial condition or results of operations, but will result in additional disclosures.

In February 2013, the FASB issued guidance, “Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income.” The guidance requires entities to present either parenthetically on the face of the financial statements or in the notes to the financial statements, significant amounts reclassified from each component of accumulated other comprehensive income and the income statement line items affected by the reclassification. The guidance is effective for public entities for annual periods beginning after December 15, 2012, and for nonpublic entities for annual periods beginning after December 15, 2013. The adoption of this guidance did not impact the financial condition or results of operations, but resulted in additional disclosures (See Note 6 – Employee Benefit Plans).

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, 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. 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 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, 2013, are not necessarily indicative of the results to be expected for the year ended December 31, 2013. Certain amounts in the prior period’s financial statements have been reclassified to conform to current financial statement presentation.

NOTE 2 — LOANS AND ALLOWANCE FOR LOAN LOSSES:

A summary of loans follows:

| Loan Type | June 30, 2013 Amount | December 31, 2012 Amount |
|----------------------------------|----------------------------|--------------------------------|
| Production agriculture: | | |
| Real estate mortgage | \$ 641,084,974 | \$ 641,681,563 |
| Production and intermediate term | 88,255,276 | 77,797,798 |
| Agribusiness: | | |
| Loans to cooperatives | 3,236,608 | 156,067 |
| Processing and marketing | 64,066,861 | 57,413,674 |
| Farm-related business | 3,520,457 | 4,848,876 |
| Communication | 1,340,151 | 1,676,270 |
| Energy | 39,796,473 | 33,441,681 |
| Water and waste water | 514,985 | 548,300 |
| Rural residential real estate | 12,842,402 | 13,770,252 |
| Total | <u>\$ 854,658,187</u> | <u>\$ 831,334,481</u> |

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, 2013:

| | Other Farm Credit Institutions | | Total | |
|----------------------------------|--------------------------------|------------------------|-----------------------------|------------------------|
| | Participations Purchased | Participations Sold | Participations Purchased | Participations Sold |
| | Real estate mortgage | \$ 7,692,455 | \$ 12,982,281 | \$ 7,692,455 |
| Production and intermediate term | 37,289,409 | - | 37,289,409 | - |
| Agribusiness | 65,581,430 | 197,622 | 65,581,430 | 197,622 |
| Communication | 1,340,151 | - | 1,340,151 | - |
| Energy | 39,796,473 | - | 39,796,473 | - |
| Water and waste water | 514,985 | - | 514,985 | - |
| Total | <u>\$ 152,214,903</u> | <u>\$ 13,179,903</u> | <u>\$ 152,214,903</u> | <u>\$ 13,179,903</u> |

For the quarter ended June 30, 2013 the association had no participations with any non-Farm Credit Institutions.

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 \$3,674,912 and \$2,832,433 at June 30, 2013, and December 31, 2012, respectively.

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

| | June 30, 2013 | December 31, 2012 |
|-------------------------------------|----------------------|----------------------|
| Nonaccrual loans: | | |
| Real estate mortgage | \$ 14,175,652 | \$ 17,821,115 |
| Production and intermediate term | 2,472,781 | 3,838,693 |
| Agribusiness | 326,283 | 588,546 |
| Communication | 1,340,151 | 1,676,270 |
| Rural residential real estate | 334,481 | 352,301 |
| Total nonaccrual loans | <u>18,649,348</u> | <u>24,276,925</u> |
| Accruing restructured loans: | | |
| Real estate mortgage | 35,233 | 35,233 |
| Production and intermediate term | 24,685 | 32,424 |
| Total accruing restructured loans | <u>59,918</u> | <u>67,657</u> |
| Total nonperforming loans | <u>18,709,266</u> | <u>24,344,582</u> |
| Other property owned | 1,431,591 | 1,060,973 |
| Total nonperforming assets | <u>\$ 20,140,857</u> | <u>\$ 25,405,555</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, 2013 | December 31, 2012 |
|----------------------------------|--------------------------|----------------------|
| Real estate mortgage | | |
| Acceptable | 92 % | 90 % |
| OAEM | 4 | 5 |
| Substandard/doubtful | 4 | 5 |
| | 100 | 100 |
| Production and intermediate term | | |
| Acceptable | 96 | 92 |
| OAEM | 1 | 1 |
| Substandard/doubtful | 3 | 7 |
| | 100 | 100 |
| Agribusiness | | |
| Acceptable | 99 | 99 |
| OAEM | - | - |
| Substandard/doubtful | 1 | 1 |
| | 100 | 100 |
| Energy and water/waste water | | |
| Acceptable | 100 | 100 |
| OAEM | - | - |
| Substandard/doubtful | - | - |
| | 100 | 100 |
| Communication | | |
| Acceptable | - | - |
| OAEM | - | - |
| Substandard/doubtful | 100 | 100 |
| | 100 | 100 |
| Rural residential real estate | | |
| Acceptable | 86 | 86 |
| OAEM | 4 | 4 |
| Substandard/doubtful | 10 | 10 |
| | 100 | 100 |
| Total loans | | |
| Acceptable | 93 | 91 |
| OAEM | 3 | 4 |
| Substandard/doubtful | 4 | 5 |
| | 100 % | 100 % |

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

| June 30, 2013 | 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 |
|----------------------------------|---------------------------|--------------------------------|----------------------|--|-----------------------|
| Real estate mortgage | \$ 1,991,820 | \$ 1,259,466 | \$ 3,251,286 | \$ 642,855,096 | \$ 646,106,382 |
| Production and intermediate term | 208,713 | 1,384,152 | 1,592,865 | 87,062,537 | 88,655,402 |
| Loans to cooperatives | - | - | - | 3,241,938 | 3,241,938 |
| Processing and marketing | - | 326,283 | 326,283 | 63,914,984 | 64,241,267 |
| Farm-related business | - | - | - | 3,525,101 | 3,525,101 |
| Communication | - | - | - | 1,340,151 | 1,340,151 |
| Energy | - | - | - | 39,931,755 | 39,931,755 |
| Water and waste water | - | - | - | 515,537 | 515,537 |
| Rural residential real estate | 107,761 | - | 107,761 | 12,782,055 | 12,889,816 |
| Total | <u>\$ 2,308,294</u> | <u>\$ 2,969,901</u> | <u>\$ 5,278,195</u> | <u>\$ 855,169,154</u> | <u>\$ 860,447,349</u> |

| December 31, 2012 | 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 |
|----------------------------------|---------------------------|--------------------------------|----------------------|--|-----------------------|
| Real estate mortgage | \$ 1,280,010 | \$ 3,630,666 | \$ 4,910,676 | \$ 641,145,513 | \$ 646,056,189 |
| Production and intermediate term | 99,221 | 2,163,830 | 2,263,051 | 75,877,324 | 78,140,375 |
| Loans to cooperatives | - | - | - | 157,146 | 157,146 |
| Processing and marketing | - | 588,546 | 588,546 | 56,870,041 | 57,458,587 |
| Farm-related business | - | - | - | 4,851,038 | 4,851,038 |
| Communication | - | - | - | 1,676,270 | 1,676,270 |
| Energy | - | - | - | 33,510,829 | 33,510,829 |
| Water and waste water | - | - | - | 549,010 | 549,010 |
| Rural residential real estate | 47,315 | - | 47,315 | 13,761,565 | 13,808,880 |
| Total | <u>\$ 1,426,546</u> | <u>\$ 6,383,042</u> | <u>\$ 7,809,588</u> | <u>\$ 828,398,736</u> | <u>\$ 836,208,324</u> |

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.

Troubled Debt Restructuring: 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, 2013, the total recorded investment of troubled debt restructured loans was \$9,953,667, including \$9,893,749 classified as nonaccrual and \$59,918 classified as accrual, with specific allowance for loan losses of \$1,983,399. The specific allowance is determined quarterly through a net realizable value analysis for each individual loan asset. As of June 30, 2013, commitments to lend funds to borrowers whose loan terms have been modified in a troubled debt restructuring were \$0.

There were no loans with troubled debt restructuring designation that occurred during the six months ended June 30, 2013. Loans formally restructured prior to January 1, 2013, were \$11,118,892.

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 quarter ended June 30, 2013.

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.

There were no loans that met the accounting criteria as a troubled debt restructuring and that occurred from July 1, 2012, through June 30, 2013, and for which there was a payment default during that same period. A payment default is defined as a payment that is 30 days past due after the date the loan was restructured.

Additional impaired loan information is as follows:

| | June 30, 2013 | | | At December 31, 2012 | | |
|---|--------------------------------|---|------------------------------|------------------------|---|----------------------|
| | Recorded Investment | Unpaid Principal Balance^a | Related Allowance | Recorded Investment | Unpaid Principal Balance ^a | Related Allowance |
| Impaired loans with a related allowance for credit losses: | | | | | | |
| Real estate mortgage | \$ 10,481,460 | \$ 10,498,167 | \$ 2,389,436 | \$12,723,644 | \$12,859,757 | \$ 2,233,786 |
| Production and intermediate term | 1,769,857 | 2,007,214 | 723,716 | 3,020,104 | 3,245,869 | 1,177,535 |
| Farm-related business | - | - | - | - | - | - |
| Communication | 1,340,151 | 1,340,151 | 721,438 | 1,676,270 | 1,676,270 | 741,182 |
| Rural residential real estate | 44,316 | 44,316 | 3,921 | 208,721 | 208,721 | 21,341 |
| Total | <u>\$ 13,635,784</u> | <u>\$ 13,889,848</u> | <u>\$ 3,838,511</u> | <u>\$17,628,739</u> | <u>\$17,990,617</u> | <u>\$ 4,173,844</u> |
| Impaired loans with no related allowance for credit losses: | | | | | | |
| Real estate mortgage | \$ 3,729,425 | \$ 3,796,295 | \$ - | \$ 5,132,705 | \$ 5,200,475 | \$ - |
| Production and intermediate term | 727,609 | 1,246,100 | - | 851,013 | 4,628,619 | - |
| Processing and marketing | 326,283 | 326,283 | - | 588,546 | 588,546 | - |
| Farm-related business | - | - | - | - | - | - |
| Communication | - | - | - | - | - | - |
| Rural residential real estate | 290,165 | 290,165 | - | 143,579 | 143,581 | - |
| Total | <u>\$ 5,073,482</u> | <u>\$ 5,658,843</u> | <u>\$ -</u> | <u>\$ 6,715,843</u> | <u>\$10,561,221</u> | <u>\$ -</u> |
| Total impaired loans: | | | | | | |
| Real estate mortgage | \$ 14,210,885 | \$ 14,294,462 | \$ 2,389,436 | \$17,856,349 | \$18,060,232 | \$ 2,233,786 |
| Production and intermediate term | 2,497,466 | 3,253,314 | 723,716 | 3,871,117 | 7,874,488 | 1,177,535 |
| Processing and marketing | 326,283 | 326,283 | - | 588,546 | 588,546 | - |
| Farm-related business | - | - | - | - | - | - |
| Communication | 1,340,151 | 1,340,151 | 721,438 | 1,676,270 | 1,676,270 | 741,182 |
| Rural residential real estate | 334,481 | 334,481 | 3,921 | 352,300 | 352,302 | 21,341 |
| Total | <u>\$ 18,709,266</u> | <u>\$ 19,548,691</u> | <u>\$ 3,838,511</u> | <u>\$24,344,582</u> | <u>\$28,551,838</u> | <u>\$ 4,173,844</u> |

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

| | For the Quarter Ended June 30, 2013 | | For the Quarter Ended June 30, 2012 | |
|---|--|----------------------------------|--|----------------------------------|
| | Average Impaired Loans | Interest Income Recognized | Average Impaired Loans | Interest Income Recognized |
| | | | | |
| Impaired loans with a related allowance for credit losses: | | | | |
| Real estate mortgage | \$ 10,758,902 | \$ 1,190 | \$ 6,971,919 | \$ 45 |
| Production and intermediate term | 1,874,514 | - | 9,781,247 | 2,540 |
| Farm-related business | - | - | 1,120,357 | 14,115 |
| Communication | 1,435,000 | 53,760 | - | - |
| Rural residential real estate | 44,557 | - | 104,429 | - |
| Total | \$ 14,112,973 | \$ 54,950 | \$ 17,977,952 | \$ 16,700 |
| Impaired loans with no related allowance for credit losses: | | | | |
| Real estate mortgage | \$ 3,772,669 | \$ 685 | \$ 26,972,771 | \$ 35,802 |
| Production and intermediate term | 744,402 | 1,596 | 4,208,189 | 33,188 |
| Processing and marketing | 517,193 | - | 432,036 | - |
| Farm-related business | - | 2,506 | - | 3,009 |
| Communication | 583,021 | - | - | - |
| Rural residential real estate | 293,784 | 171 | 307,651 | - |
| Total | \$ 5,911,069 | \$ 4,958 | \$ 31,920,647 | \$ 71,999 |
| Total impaired loans: | | | | |
| Real estate mortgage | \$ 14,531,571 | \$ 1,875 | \$ 33,944,690 | \$ 35,847 |
| Production and intermediate term | 2,618,916 | 1,596 | 13,989,436 | 35,728 |
| Processing and marketing | 517,193 | - | 432,036 | - |
| Farm-related business | - | 2,506 | 1,120,357 | 17,124 |
| Communication | 2,018,021 | 53,760 | - | - |
| Rural residential real estate | 338,341 | 171 | 412,080 | - |
| Total | \$ 20,024,042 | \$ 59,908 | \$ 49,898,599 | \$ 88,699 |

| | For the Six Months Ended June 30, 2013 | | For the Six Months Ended June 30, 2012 | |
|---|---|----------------------------------|---|----------------------------------|
| | Average Impaired Loans | Interest Income Recognized | Average Impaired Loans | Interest Income Recognized |
| | | | | |
| Impaired loans with a related allowance for credit losses: | | | | |
| Real estate mortgage | \$ 11,508,812 | \$ 2,679 | \$ 6,933,193 | \$ 24 |
| Production and intermediate term | 2,164,874 | - | 11,375,743 | 3,148 |
| Processing and marketing | - | - | 2,487 | - |
| Farm-related business | - | - | 1,129,080 | 35,511 |
| Communication | 1,550,190 | 53,760 | - | - |
| Rural residential real estate | 45,437 | - | 91,881 | - |
| Total | \$ 15,269,313 | \$ 56,439 | \$ 19,532,384 | \$ 38,683 |
| Impaired loans with no related allowance for credit losses: | | | | |
| Real estate mortgage | \$ 4,189,298 | \$ 1,065 | \$ 27,410,940 | \$ 185,342 |
| Production and intermediate term | 768,159 | 3,260 | 4,605,338 | 69,275 |
| Processing and marketing | 527,886 | - | 2,776,143 | 5,221 |
| Farm-related business | - | 4,699 | - | - |
| Communication | 291,511 | - | - | - |
| Rural residential real estate | 297,929 | 512 | 313,617 | - |
| Total | \$ 6,074,783 | \$ 9,536 | \$ 35,106,038 | \$ 259,838 |
| Total impaired loans: | | | | |
| Real estate mortgage | \$ 15,698,110 | \$ 3,744 | \$ 34,344,133 | \$ 185,366 |
| Production and intermediate term | 2,933,033 | 3,260 | 15,981,081 | 72,423 |
| Processing and marketing | 527,886 | - | 2,778,630 | 5,221 |
| Farm-related business | - | 4,699 | 1,129,080 | 35,511 |
| Communication | 1,841,701 | 53,760 | - | - |
| Rural residential real estate | 343,366 | 512 | 405,498 | - |
| Total | \$ 21,344,096 | \$ 65,975 | \$ 54,638,422 | \$ 298,521 |

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, 2013 | \$ 6,403,506 | \$ 1,354,786 | \$ 449,307 | \$ 721,438 | \$ 135,437 | \$ 193,244 | \$ 9,257,718 |
| Charge-offs | (262,361) | (46,879) | - | - | - | - | (309,240) |
| Recoveries | 1,175 | 44,733 | 21,613 | - | - | - | 67,521 |
| Provision for loan losses | 238,701 | 50,502 | 16,749 | 26,893 | 5,049 | 7,203 | 345,096 |
| Balance at | | | | | | | |
| June 30, 2013 | \$ 6,574,250 | \$ 1,331,941 | \$ 398,004 | \$ 721,438 | \$ 150,660 | \$ 184,802 | \$ 9,361,095 |
| Balance at | | | | | | | |
| December 31, 2012 | \$ (1,221,112) | \$ 10,548,903 | \$ 914,969 | \$ 4,403 | \$ 5,018 | \$ (18,582) | \$ 10,233,599 |
| Charge-offs | (322,303) | (79,098) | - | - | - | - | (401,401) |
| Recoveries | 2,742 | 70,149 | 54,033 | - | - | - | 126,924 |
| Provision for loan losses | 8,114,923 | (9,208,013) | (570,998) | 717,035 | 145,642 | 203,384 | (598,027) |
| Balance at | | | | | | | |
| June 30, 2013 | \$ 6,574,250 | \$ 1,331,941 | \$ 398,004 | \$ 721,438 | \$ 150,660 | \$ 184,802 | \$ 9,361,095 |
| Ending Balance: | | | | | | | |
| Individually evaluated for impairment | \$ 2,389,436 | \$ 723,716 | \$ - | \$ 721,438 | \$ - | \$ 3,921 | \$ 3,838,511 |
| Collectively evaluated for impairment | (3,858,750) | 9,199,785 | 915,533 | (717,292) | 4,725 | (21,417) | 5,522,584 |
| Balance at | | | | | | | |
| June 30, 2013 | \$ (1,469,314) | \$ 9,923,501 | \$ 915,533 | \$ 4,146 | \$ 4,725 | \$ (17,496) | \$ 9,361,095 |
| Balance at | | | | | | | |
| March 31, 2012 | \$ 1,607,543 | \$ 10,814,346 | \$ 634,079 | \$ 4,396 | \$ 5,010 | \$ (3,142) | \$ 13,062,232 |
| Charge-offs | (1,186) | (691,348) | - | - | - | - | (692,534) |
| Recoveries | (54,988) | 72,605 | - | - | - | - | 17,617 |
| Provision for loan losses | (240,037) | (1,620,108) | (94,679) | (656) | (748) | (965) | (1,957,193) |
| Balance at | | | | | | | |
| June 30, 2012 | \$ 1,311,332 | \$ 8,575,495 | \$ 539,400 | \$ 3,740 | \$ 4,262 | \$ (4,107) | \$ 10,430,122 |
| Balance at | | | | | | | |
| December 31, 2011 | \$ 1,528,527 | \$ 10,316,634 | \$ 602,902 | \$ 4,180 | \$ 4,764 | \$ 6,143 | \$ 12,463,150 |
| Charge-offs | (1,211) | (877,313) | - | - | - | (9,603) | (888,127) |
| Recoveries | (54,988) | 222,804 | - | - | - | - | 167,816 |
| Provision for loan losses | (160,996) | (1,086,630) | (63,502) | (440) | (502) | (647) | (1,312,717) |
| Balance at | | | | | | | |
| June 30, 2012 | \$ 1,311,332 | \$ 8,575,495 | \$ 539,400 | \$ 3,740 | \$ 4,262 | \$ (4,107) | \$ 10,430,122 |
| Ending Balance: | | | | | | | |
| Individually evaluated for impairment | \$ 409,154 | \$ 2,675,675 | \$ 168,300 | \$ 1,167 | \$ 1,330 | \$ (1,281) | \$ 3,254,345 |
| Collectively evaluated for impairment | 902,178 | 5,899,820 | 371,100 | 2,573 | 2,932 | (2,826) | 7,175,777 |
| Balance at | | | | | | | |
| June 30, 2012 | \$ 1,311,332 | \$ 8,575,495 | \$ 539,400 | \$ 3,740 | \$ 4,262 | \$ (4,107) | \$ 10,430,122 |
| Recorded Investments in Loans Outstanding: | | | | | | | |
| Ending Balance at | | | | | | | |
| June 30, 2013 | \$646,106,381 | \$ 88,655,403 | \$71,008,306 | \$ 1,340,151 | \$ 40,447,292 | \$ 12,889,816 | \$ 860,447,349 |
| Individually evaluated for impairment | \$ 14,210,767 | \$ 2,497,368 | \$ 326,283 | \$ 1,340,151 | \$ - | \$ 334,481 | \$ 18,709,050 |
| Collectively evaluated for impairment | \$631,895,614 | \$ 86,158,035 | \$70,682,023 | \$ - | \$ 40,447,292 | \$ 12,555,335 | \$ 841,738,299 |
| Ending Balance at | | | | | | | |
| June 30, 2012 | \$664,136,752 | \$ 77,811,904 | \$70,444,160 | \$ 5,951,979 | \$ 14,659,941 | \$ 14,449,208 | \$ 847,453,944 |
| Individually evaluated for impairment | \$ 34,041,696 | \$ 13,158,739 | \$ 1,516,891 | \$ - | \$ - | \$ 408,840 | \$ 49,126,166 |
| Collectively evaluated for impairment | \$630,095,056 | \$ 64,653,165 | \$68,927,269 | \$ 5,951,979 | \$ 14,659,941 | \$ 14,040,368 | \$ 798,327,778 |

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 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.

NOTE 4 — INCOME TAXES:

Lone Star, ACA and its subsidiary are subject to federal and certain other income taxes. The associations are eligible to operate as cooperatives that qualify for tax treatment under Subchapter T of the Internal Revenue code. Under specified conditions, the associations can exclude from taxable income amounts distributed as qualified patronage refunds in the form of cash, stock or allocated surplus. Provisions for income taxes are made only on those earnings that will not be distributed as qualified patronage refunds. During the six months ended June 30, 2013, the association did not participate in a patronage program. 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. For the six months ended June 30, 2013, and 2012, net income for tax purposes the association carries a deferred tax asset of \$13,260,154 and \$14,372,718, respectively, with full valuation allowance recorded against the asset each year.

The subsidiary, Lone Star, FLCA, is exempt from federal and other income taxes as provided in the Farm Credit Act of 1971.

NOTE 5 — 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 14 to the 2012 Annual Report to Stockholders for a more complete description.

Sensitivity to Changes in Significant Unobservable Inputs

For recurring fair value measurements categorized within Level 3 of the fair value hierarchy, the significant unobservable inputs used in the fair value measurement of the mortgage-backed securities are prepayment rates, probability of default, and loss severity in the event of default. Significant increases (decreases) in any of those inputs in isolation would result in a significantly lower (higher) fair value measurement.

Generally, a change in the assumption used for the probability of default is accompanied by a directionally similar change in the assumption used for the loss severity and a directionally opposite change in the assumption used for prepayment rates.

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

Quantitative Information About Recurring and Nonrecurring Level 3 Fair Value Measurements

| | <u>Fair Value at June 30, 2013</u> | <u>Fair Value at December 31, 2012</u> | <u>Valuation Technique(s)</u> | <u>Unobservable Input</u> |
|---------------------------|--|--|-------------------------------|---|
| Standby letters of credit | \$ 2,347,613 | \$ 2,558,198 | Discounted cash flow | Rate of funding Risk-adjusted spread |

With regard to 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.

Information About Other Financial Instrument Fair Value Measurements

| | <u>Valuation Technique(s)</u> | <u>Input</u> |
|------------------------------------|-------------------------------|---|
| Cash | Carrying value | Par/principal and appropriate interest yield |
| Loans | Discounted cash flow | Prepayment forecasts Probability of default Loss severity |
| Other interest bearing liabilities | Carrying value | Par/principal and appropriate interest yield |

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

| <u>June 30, 2013</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 | <u>58,815</u> | <u>-</u> | <u>-</u> | <u>58,815</u> |
| Total assets | <u>58,815</u> | <u>-</u> | <u>-</u> | <u>58,815</u> |
| Liabilities: | | | | |
| Standby letters of credit | <u>2,347,613</u> | <u>-</u> | <u>-</u> | <u>2,347,613</u> |
| Total liabilities | <u>\$ 2,347,613</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 2,347,613</u> |

| <u>December 31, 2012</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 | <u>38,984</u> | <u>-</u> | <u>-</u> | <u>38,984</u> |
| Total assets | <u>38,984</u> | <u>-</u> | <u>-</u> | <u>38,984</u> |
| Liabilities: | | | | |
| Standby letters of credit | <u>2,558,198</u> | <u>-</u> | <u>-</u> | <u>2,558,198</u> |
| Total liabilities | <u>\$ 2,558,198</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 2,558,198</u> |

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, 2013</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: | | | | |
| Loans* | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 9,797,489</u> | <u>\$ 9,797,489</u> |
| Other property owned | <u>-</u> | <u>-</u> | <u>1,431,591</u> | <u>1,431,591</u> |
| <u>December 31, 2012</u> | | | | |
| Assets: | | | | |
| Loans* | <u>\$ -</u> | <u>\$ -</u> | <u>\$13,454,295</u> | <u>\$13,454,295</u> |
| Other property owned | <u>-</u> | <u>-</u> | <u>1,060,973</u> | <u>1,060,973</u> |

*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.

Valuation Techniques

As more fully discussed in Note 14 to the 2012 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 2012 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.

NOTE 6 — EMPLOYEE BENEFIT PLANS:

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

| | Other Benefits | |
|---|------------------|------------------|
| | 2013 | 2012 |
| Service cost | \$ 20,857 | \$ 15,447 |
| Interest cost | 29,782 | 30,110 |
| Amortization of prior service (credits) costs | (34,921) | (32,432) |
| Amortizations of net actuarial (gain) loss | 15,639 | 19,136 |
| Net periodic benefit cost | <u>\$ 31,357</u> | <u>\$ 32,261</u> |

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 | |
|---|------------------|------------------|
| | 2013 | 2012 |
| Service cost | \$ 41,714 | \$ 30,895 |
| Interest cost | 59,564 | 60,220 |
| Amortization of prior service (credits) costs | (69,842) | (64,865) |
| Amortizations of net actuarial (gain) loss | 31,278 | 38,122 |
| Net periodic benefit cost | <u>\$ 62,714</u> | <u>\$ 64,372</u> |

The association's liability for the unfunded accumulated obligation for these benefits at June 30, 2013, was \$3,301,226 and is included in "Other Liabilities" in the balance sheet.

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, 2012, that it expected to contribute \$83,731 to the district's defined benefit pension plan in 2013. As of June 30, 2013, \$41,866 of contributions have been made. The association presently anticipates contributing an additional \$41,865 to fund the defined benefit pension plan in 2013 for a total of \$83,731.

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:

| | 2013 | 2012 |
|--|-----------------------|---------------------|
| Accumulated other comprehensive income (loss) at January 1 | \$ (870,990) | \$ (498,689) |
| Amortization of prior service (credit) costs included in net periodic postretirement benefit cost | 201,888 | 266,752 |
| Amortization of actuarial (gain) loss included in net periodic postretirement benefit cost | (637,381) | (516,096) |
| Other comprehensive income (loss), net of tax | (435,493) | (249,345) |
| Accumulated other comprehensive income at June 30 | <u>\$ (1,306,483)</u> | <u>\$ (748,034)</u> |

NOTE 7 — 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 8 — SUBSEQUENT EVENTS:

The association has evaluated subsequent events through August 5, 2013, which is the date the financial statements were issued. There are no other significant events requiring disclosure as of August 5, 2013.