

**2019**  
**ANNUAL REPORT**  
**AGPREFERENCE, ACA**

## Five-Year Summary of Selected Consolidated Financial Data

(Dollars in Thousands)

	December 31				
	2019	2018	2017	2016	2015
<b>Statement of Condition Data</b>					
Loans	\$ 238,954	\$ 259,620	\$ 239,185	\$ 230,050	\$ 219,824
Less allowance for loan losses	498	702	723	675	451
Net loans	238,456	258,918	238,462	229,375	219,373
Investment in CoBank, ACB	8,310	8,307	7,968	7,527	7,252
Other property owned	-	-	4	-	-
Other assets	9,080	10,064	8,501	8,233	7,655
<b>Total assets</b>	<b>\$ 255,846</b>	<b>\$ 277,289</b>	<b>\$ 254,935</b>	<b>\$ 245,135</b>	<b>\$ 234,280</b>
Obligations with maturities of one year or less	\$ 3,707	\$ 3,267	\$ 1,720	\$ 1,803	\$ 2,278
Obligations with maturities longer than one year	199,080	222,857	204,673	196,855	187,432
Reserve for unfunded commitments	89	94	94	57	20
<b>Total liabilities</b>	<b>202,876</b>	<b>226,218</b>	<b>206,487</b>	<b>198,715</b>	<b>189,730</b>
Protected borrower stock	10	10	10	10	10
Capital stock	355	364	372	376	374
Unallocated retained earnings	52,605	50,697	48,066	46,034	44,166
<b>Total shareholders' equity</b>	<b>52,970</b>	<b>51,071</b>	<b>48,448</b>	<b>46,420</b>	<b>44,550</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 255,846</b>	<b>\$ 277,289</b>	<b>\$ 254,935</b>	<b>\$ 245,135</b>	<b>\$ 234,280</b>

	For the Year Ended December 31				
	2019	2018	2017	2016	2015
<b>Statement of Income/(Expense) Data</b>					
Net interest income	\$ 6,524	\$ 6,418	\$ 6,221	\$ 5,850	\$ 5,657
Patronage distribution from Farm Credit institutions	842	1,068	906	968	845
Credit loss reversal/(Provision for credit losses)	210	21	(98)	(303)	13
Noninterest expense, net	(4,941)	(4,238)	(4,331)	(4,021)	(3,724)
(Provision for)/Benefit from income taxes	(133)	32	(63)	(33)	(59)
<b>Net income/Comprehensive income</b>	<b>\$ 2,502</b>	<b>\$ 3,301</b>	<b>\$ 2,635</b>	<b>\$ 2,461</b>	<b>\$ 2,732</b>

### Key Financial Ratios

#### For the Year

Return on average assets	0.95%	1.27%	1.06%	1.05%	1.21%
Return on average shareholders' equity	4.77%	6.60%	5.54%	5.38%	6.26%
Net interest income as a percentage of average earning assets	2.66%	2.63%	2.65%	2.64%	2.65%
Net (recoveries)/charge-offs as a percentage of average net loans	<(0.01%)	-	0.01%	0.02%	-

#### At Year End

Shareholders' equity as a percentage of total assets	20.70%	18.42%	19.00%	18.94%	19.02%
Debt as a ratio to shareholders' equity	3.83:1	4.43:1	4.26:1	4.28:1	4.26:1
Allowance for loan losses as a percentage of loans	0.21%	0.27%	0.30%	0.29%	0.21%
Common equity tier 1 (CET1) capital ratio	21.65%	20.19%	19.73%	N/A	N/A
Tier 1 capital ratio	21.65%	20.19%	19.73%	N/A	N/A
Total regulatory capital ratio	22.00%	20.55%	20.21%	N/A	N/A
Tier 1 leverage ratio	17.90%	16.18%	16.18%	N/A	N/A
Unallocated retained earnings and URE equivalents (UREE) leverage ratio	18.86%	16.97%	16.82%	N/A	N/A
Permanent capital ratio	21.71%	20.25%	19.82%	21.14%	21.08%
Total surplus ratio	N/A	N/A	N/A	20.94%	20.86%
Core surplus ratio	N/A	N/A	N/A	20.94%	20.86%

#### Net Income Distribution

Cash patronage distributions paid	\$ 670	\$ 604	\$ 592	\$ 575	\$ -
Cash patronage declared	\$ 594	\$ 670	\$ 604	\$ 593	\$ 575

# MANAGEMENT'S DISCUSSION AND ANALYSIS

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## **INTRODUCTION**

The following discussion summarizes the financial position and results of operations of AgPreference, ACA (Association) for the year ended December 31, 2019. Comparisons with prior years are included. We have emphasized material known trends, commitments, events, or uncertainties that have impacted, or are reasonably likely to impact our financial condition and results of operations. The discussion and analysis should be read in conjunction with the accompanying consolidated financial statements, footnotes and other sections of this report. The accompanying consolidated financial statements were prepared under the oversight of our Audit Committee. The Management's Discussion and Analysis includes the following sections:

- Business Overview
- Economic Overview
- Loan Portfolio
- Credit Risk Management
- Results of Operations
- Liquidity
- Capital Resources
- Regulatory Matters
- Governance
- Forward-Looking Information
- Critical Accounting Policies and Estimates
- Merger
- Customer Privacy

Our quarterly reports to shareholders are available approximately 40 days after the calendar quarter end and annual reports are available approximately 75 days after the calendar year end. The reports may be obtained free of charge on our website, [www.agpreference.com](http://www.agpreference.com), or upon request. We are located at 3120 N. Main Street, Altus, Oklahoma 73521-1305 or may be contacted by calling (580) 482-3030 or (800) 727-3276.

## **BUSINESS OVERVIEW**

### ***Farm Credit System Structure and Mission***

We are one of 68 associations in the Farm Credit System (System), which was created by Congress in 1916 and has served agricultural producers for over 100 years. The System mission is to provide sound and dependable credit to American farmers, ranchers, and producers or harvesters of aquatic products and farm-related businesses through a member-owned cooperative system. This is done by making loans and providing financial services. Through its commitment and dedication to agriculture, the System continues to have the largest portfolio of agricultural loans of any lender in the United States. The Farm Credit Administration (FCA) is the System's independent safety and soundness federal regulator and was established to supervise, examine and regulate System institutions.

### ***Our Structure and Focus***

As a cooperative, we are owned by the members we serve. Our territory served extends across a diverse agricultural region of Kiowa County south to the Red River (Oklahoma-Texas State Line), and from Cotton County west to the Oklahoma-Texas State Line. The counties in our territory are listed in Note 1 of the accompanying consolidated financial statements. We make long-term real estate mortgage loans to farmers, ranchers, rural residents and agribusinesses, and production and intermediate-term loans for agricultural production or operating purposes. Additionally, we provide other related services to our borrowers, such as credit life and term life insurance, advance conditional payment accounts, leasing and fee appraisals. Our success begins with our extensive agricultural experience and knowledge of the market and is dependent on the level of satisfaction we provide to our borrowers.

As part of the System, we obtain the funding for our lending and operations from a Farm Credit Bank. Our funding bank, CoBank, ACB (CoBank), is a cooperative of which we are a member. CoBank, its related associations, and AgVantis, Inc. (AgVantis) are referred to as the District.

We, along with the borrower's investment in our Association, are materially affected by CoBank's financial condition and results of operations. The CoBank quarterly and annual reports are available free of charge by accessing CoBank's website, [www.cobank.com](http://www.cobank.com), or may be obtained at no charge by contacting us at 3120 N. Main Street,

Altus, Oklahoma 73521-1305 or by calling (580) 482-3030 or (800) 727-3276. Annual reports are available within 75 days after year end and quarterly reports are available within 40 days after the calendar quarter end.

We purchase technology and other operational services from AgVantis, which is a technology service corporation. We entered into a new agreement effective January 1, 2019, that was scheduled to expire on December 31, 2021. However, a revised service agreement was signed effective January 1, 2020 and will expire on December 31, 2022. We are a shareholder in AgVantis, along with other AgVantis customers. Farm Credit Foundations, a human resource shared service provider for a number of Farm Credit institutions, provides administration for our payroll and benefits and may provide related human resource offerings.

## **ECONOMIC OVERVIEW**

### ***Lending Service Area***

Weather conditions during 2019 experienced wide variations in rainfall with wet conditions in the early spring with drought conditions taking affect in the last half of the year. Total rainfall for the year was near average, although the variability did affect the summer crops. The January 14, 2020 U.S. Drought Monitor indicates almost all of Southwest Oklahoma is in the Moderate Drought (D1) category. Recent rains in the first two weeks of January have improved conditions.

Irrigated cotton produced good yields while a number of dry land acres were abandoned due to drought in 2019. Planted wheat acres continue to be less and less as farmers rotate to cotton and other more profitable crops. Winter wheat pasture available for grazing is limited as generally the crop was planted late and lack of rainfall limited fall growth and development. Many cow/calf operators have sold calves earlier than usual due to the lack of wheat pasture. Forage and pasture conditions were slightly below normal but remained in near average condition given the sporadic rains in 2019. Hay production was below normal for the year with some producers having to purchase hay.

Cash wheat prices have seen slight increases and are hovering around the \$4.50 to \$4.60 per bushel range, depending on location. Recent progress on trade policy including approval of the United States Mexico Canada Agreement (USMCA) and a phase one deal with China have created optimism for export markets and possible price strength. Cotton prices have rebounded from lows in the \$0.50/lb. range and are now in the upper \$0.60/lb. range. Livestock prices are slightly stronger in late 2019 but remain only slightly stronger than 2018. Livestock producers are also hopeful that the progress in trade issues will result in increased demand from export markets.

Farmland values remain relatively stable with changes +/- 3.00% indicated. Lower interest rates in 2019 continued to provide stability in the land market even though farm income was lower. Overall, crop insurance and demand have provided a support level for the land market.

The Federal Open Market Committee (Committee) voted to lower the target funds range at the October meeting by ¼ percent to 1½ – 1¾ percent; this was the third consecutive rate cut in 2019. The Committee justified the action “in light of implications of global developments for economic outlook as well as muted inflation pressures”. There were two dissents who favored no change to the target rate. In the latest meeting held December 10-11, 2019, the Committee maintained the current rates with no changes.

### ***Participation Loan Service Area***

The continued overproduction of corn, soybeans and wheat coupled with the negative effects of tariffs led to a continuance of low grain prices in 2019. Corn, soybeans and wheat prices remain depressed throughout the year with only seasonal movements noted. Significant worldwide inventory stock levels also continued to suppress commodity prices in general. Even though 2019 saw slightly decreased cotton prices, the nation's cotton acreage continues to increase as many farmers have found cotton to be an attractive alternative crop in many nontraditional cotton growing areas. Successful trade negotiations could have an immediate positive impact on commodity prices in general. Wet planting conditions in the spring and early summer of 2019 caused significant problems for the nation's corn and soybean farmers.

National and worldwide politics continued to play a major role in trade policy and commodity prices during 2019 as a result of the U.S. withdrawing from the North American Free Trade Agreement (NAFTA). Over the past few years, the Trump Administration has been engaged in negotiations with Mexico and Canada in an effort to replace the original NAFTA agreement. Additionally, the U.S. and China have been engaged in a trade policy dispute which has resulted in tariffs being imposed on a variety of agricultural commodities, with the soybean industry being especially hard hit. A favorable resolution to these trade policy disputes is critical in order to restore stability into the affected sectors of the agricultural economy. At this time, it appears as though the USMCA is about to become a reality. Passage of this agreement should provide some immediate relief to America's dairy industry, as well as increased marketing abilities for other agricultural commodities. In addition, it appears as though the US-China agreement is also about to become

a reality. This agreement could have a substantial positive affect on a wide variety of agricultural commodities, especially for soybeans and corn. Removal of the tariffs should provide much needed stability in the commodity markets as a whole.

For the past few years, the renewable fuel standard has created a significant demand for corn and ethanol production. Over the past few years, the renewable fuel standard has been the source of much political dialogue, both pro and con, and with the changing administration, it remains to be seen if it will enjoy the same amount of political support. It is thought by many in the industry that a lack of political support for the continuation of the renewable fuel standard would have a negative effect on the price of corn. Livestock producers and dairy operations have greatly benefitted from ethanol production as a result of the distillers grains by-products being a readily available feed supply. As it stands now, it appears as though the renewable fuel standard is here to stay, at least for the foreseeable future.

As a result of depressed commodity prices, net farm income for 2019 is projected to reflect continued financial stress when compared to highly profitable years early in the decade. With a large portion of our loan participations portfolio being located in the U.S. Corn Belt, corn and soybean prices are important to the overall health and quality of that segment of our loan portfolio. Additionally, with the downturn in the agricultural economy as a whole, the existing Farm Bill will be tested to see if it will provide an acceptable "safety net" for the industry. While national agricultural policy is important to all of agriculture, it is especially important to grain producers in the Corn Belt and Upper Midwest.

After reaching record high levels in 2014, depressed fluid milk prices continued into 2019, although some increase has been noted in the final quarter of 2019. Continued losses over the past few years have severely eroded the financial condition of the nation's dairy farmers. It is critical that this segment of the agricultural economy return to a profitable level in order to ensure that we have a dependable and stable supply of dairy products. International trade policy and its effect on U.S. imports and exports is a critical component of price fluctuation, especially as it relates to powdered milk and cheese. It is hoped that the passage of the proposed USMCA trade agreement will help to open up the Canadian markets to U.S. producers. Most of the dairy operations we finance have a significant land base which allows them to produce most of their feed supply. As a result, these operations remain on solid financial footing. These operations are primarily located in Wisconsin, Michigan, New York, and California. The reduction in corn and soybean prices has had a positive impact on the dairy industry, as they are a primary component of feed expense and helped to ease some of the decrease in the fluid milk price. It is anticipated that the nation's dairy industry will continue to see additional consolidation in order to operate at profitable levels.

After operating at record profit levels for several consecutive years, the nation's cattle industry suffered significant price declines during the latter part of 2016. All segments of the cattle industry were affected by the downturn in the cattle market, but feeder cattle and stocker cattle operations were greatly impacted and incurred significant losses. Even though they also incurred price declines, cow-calf producers remain on a more solid financial footing as a result of several consecutive years of record high calf prices. The overall price decline was caused by a number of factors, chief among them was a significant increase in the nation's cow herd inventory as a result of heifer retention. Additional concerns for the global economy, oil prices, global stock markets, and commodities in general, coupled with an increase in poultry and pork products, all contributed to the decline. Even with the larger national herd inventory, the 2019 cattle market remained resilient to further declines, based primarily upon strong domestic demand and a healthy export demand. The recent growth in the nation's cow herd inventory has slowed to the point that some price recovery is expected to begin in 2020, which should help all segments of the cattle industry. A major concern for the immediate future is an abundant supply of poultry and pork products, which could place pressure on beef demand. Drought conditions in Montana and the Dakotas remain a concern as this is an area where we have a large portion of our cattle portfolio.

### **Association Operations**

Over the last few years, our pension expense has been decreasing; however, due to certain assumptions utilized in estimating plan expenses, our 2020 pension expense is anticipated to increase significantly.

### **Agricultural Improvement Act of 2018**

The Agricultural Improvement Act of 2018 (Farm Bill) was signed into law on December 20, 2018. This new Farm Bill will govern an array of federal farm and food programs, including commodity price support payments, farm credit, conservation programs, research, rural development and foreign and domestic food programs for five years through 2023. The new Farm Bill continues to provide support for crop insurance programs and commodity support programs, strengthen livestock disaster programs, and provides dairy producers with an updated voluntary margin protection program that will provide additional risk management options to dairy operations. The Farm Bill also clarifies the Insurance Corporation's authority, role and procedures for acting as a conservator or receiver of a troubled System institution. The Farm Bill provides a range of statutory options to the Insurance Corporation including, but not limited

to, marshalling and liquidating assets, satisfying claims of creditors and using interim devices such as bridge banks. Many provisions of the Farm Bill will require the United States Department of Agriculture (USDA) to develop rules and procedures to fully implement these authorities. The timing for the issuance of those rules is uncertain.

## **LOAN PORTFOLIO**

Total loans outstanding were \$239.0 million at December 31, 2019, a decrease of \$20.7 million, or 8.0%, from loans at December 31, 2018 of \$259.6 million, and a decrease of \$231 thousand, or 0.1%, from loans at December 31, 2017 of \$239.2 million. The decrease in loans in 2019 was due to loan pay downs and loan pay offs. The types of loans outstanding at December 31 are reflected in the following table.

<i>(dollars in thousands)</i>	<b>2019</b>		2018		2017	
	<b>Volume</b>	<b>Percent</b>	Volume	Percent	Volume	Percent
Real estate mortgage loans	<b>\$ 183,033</b>	<b>76.6%</b>	\$ 196,400	75.6%	\$ 174,151	72.8%
Production and intermediate-term loans	<b>34,396</b>	<b>14.4%</b>	41,727	16.1%	42,046	17.6%
Agribusiness loans	<b>19,976</b>	<b>8.3%</b>	18,468	7.1%	16,887	7.1%
Rural infrastructure loans	<b>1,416</b>	<b>0.6%</b>	2,803	1.1%	4,124	1.7%
Agricultural export finance loans	<b>—</b>	<b>—</b>	—	—	1,721	0.7%
Rural residential real estate loans	<b>133</b>	<b>0.1%</b>	222	0.1%	256	0.1%
<b>Total</b>	<b>\$ 238,954</b>	<b>100.0%</b>	\$ 259,620	100.0%	\$ 239,185	100.0%

Real estate mortgage loans outstanding decreased 6.8% to \$183.0 million, compared with \$196.4 million at year-end 2018, primarily due to loan pay downs and loan pay offs. Long-term mortgage loans are primarily used to purchase, refinance or improve real estate. These loans have maturities ranging from 5 to 40 years. Real estate mortgage loans are also made to rural homeowners. By federal regulation, a real estate mortgage loan must be secured by a first lien and may only be made in an amount up to 85% of the original appraised value of the property, or up to 97% of the appraised value, if the loan is guaranteed by certain state, federal, or other governmental agencies. Under our current underwriting standards, we loan less than the regulatory limit of 85% of the appraised value of the property.

The production and intermediate-term loans decreased 17.6% to \$34.4 million, compared with 2018 loans of \$41.7 million, primarily due to loan pay downs and loan pay offs. Production loans are used to finance the ongoing operating needs of agricultural producers and generally match the borrower's normal production and marketing cycle, which is typically 12 months. Intermediate-term loans are generally used to finance depreciable capital assets of a farm or ranch. Intermediate-term loans are written for a specific term, 1 to 15 years, with most loans being less than 10 years. Our production and intermediate-term loan portfolio shows some seasonality. Borrowings increase throughout the planting and growing seasons to meet farmers' operating and capital needs. These loans are normally at their lowest levels following the harvest and then increase in the spring and throughout the rest of the year as borrowers fund operating needs.

Decreases were also noted in rural infrastructure loan volume, where all the loan volume was due to loan participations. Additionally, at December 31, 2019 approximately 27% of agribusiness, and 100% of rural infrastructure volume were a result of loan participations.

### ***Portfolio Diversification***

While we make loans and provide financially related services to qualified borrowers in agricultural and rural sectors and to certain related entities, our loan portfolio is diversified by loan participations purchased and sold, geographic locations served, commodities financed and loan size as illustrated in the following four tables.

We purchase loan participations from other System and non-System entities to generate additional earnings and diversify risk related to existing commodities financed and our geographic area served. In addition, we sell a portion of certain large loans to other System and non-System entities to reduce risk and comply with lending limits we have established.

Our volume of participations purchased and sold as of December 31 follows.

<i>(dollars in thousands)</i>	2019	2018	2017
Participations purchased			
System entities	\$ 15,659	\$ 16,745	\$ 16,136
Non-System entities	97,721	105,570	96,335
Total participations purchased	\$ 113,380	\$ 122,315	\$ 112,471
Participations sold			
System entities	\$ 6,505	\$ 7,480	\$ 8,510
Non-System entities	—	—	429
Total participations sold	\$ 6,505	\$ 7,480	\$ 8,939

We have no loans sold with recourse, retained subordinated participation interests in loans sold, or interests in pools of subordinated participation interests that are held in lieu of retaining a subordinated participation interest in the loans sold.

The geographic distribution of loans by county at December 31 follows. As previously mentioned we purchase loan participations outside our territory. In the following table, the states listed each year comprise the largest volume outside our territory. The Other categories comprise the remaining volume outside our territory.

	County/State	2019	2018	2017
Oklahoma Counties	Cotton	4.88%	4.63%	5.12%
	Greer	2.94%	2.84%	3.53%
	Harmon	5.90%	5.91%	6.68%
	Jackson	9.47%	10.59%	11.06%
	Kiowa	11.39%	10.29%	8.79%
	Tillman	11.93%	13.01%	12.47%
	Other Oklahoma Counties	6.51%	6.78%	6.19%
	Oklahoma Total	53.02%	54.05%	53.84%
	California	2.06%	—	1.61%
	Illinois	6.55%	6.02%	5.18%
	Indiana	3.10%	3.73%	4.74%
	Kansas	2.76%	—	—
	Kentucky	3.89%	5.91%	6.34%
	Michigan	5.63%	5.27%	5.17%
	Montana	5.18%	4.13%	4.25%
	South Dakota	3.21%	2.28%	2.54%
	Texas	2.39%	1.88%	2.36%
	North Dakota	2.20%	2.03%	—
	Other States	10.01%	14.70%	13.97%
	Total	100.00%	100.00%	100.00%

We are party to a Territorial Approval Agreement (Agreement) with five other associations in the states of Oklahoma, Colorado, Kansas and New Mexico. The Agreement eliminates territorial restrictions and allows associations that are a party to the Agreement to make loans in any other association's territory regardless of a borrower's place of residence, location of operations, location of loan security or location of headquarters. This Agreement can be terminated upon the earlier to occur of:

- 1) the time when all but one association has withdrawn as a party to the Agreement; or
- 2) December 31, 2025, or
- 3) when requested by FCA.

The following table shows the primary agricultural commodities produced by our borrowers based on the Standard Industrial Classification System (SIC) published by the federal government. This system is used to assign commodity or industry categories based on the primary business of the customer. A primary business category is assigned when the commodity or industry accounts for 50% or more of the total value of sales for a business; however, a large percentage of agricultural operations typically includes more than one commodity.

SIC Category	December 31		
	2019	2018	2017
Cow/Calf	<b>20.19%</b>	19.00%	19.27%
Crops - Other	<b>16.47%</b>	16.96%	13.77%
Corn	<b>14.24%</b>	14.56%	16.06%
Wheat	<b>13.18%</b>	14.08%	15.83%
Cotton	<b>9.74%</b>	9.61%	8.03%
Rural Business	<b>9.26%</b>	8.72%	10.71%
Stockers	<b>6.61%</b>	7.63%	7.67%
Dairy	<b>4.62%</b>	3.49%	3.00%
Feedlot Cattle	<b>0.73%</b>	0.57%	0.73%
Others	<b>4.96%</b>	5.38%	4.93%
Total	<b>100.00%</b>	100.00%	100.00%

Our loan portfolio contains a concentration of cow and calf, wheat and corn producers. Repayment ability of our borrowers is closely related to the production and profitability of the commodities they raise. If a loan fails to perform, restructuring and/or other servicing alternatives are influenced by the underlying value of the collateral, which is impacted by industry economics. Our future performance would be negatively impacted by adverse agricultural conditions. The degree of the adverse impact would be correlated to the commodities negatively affected and the magnitude and duration of the adverse agricultural conditions to our borrowers.

In addition to commodity diversification noted in the previous table, further diversification is also achieved from loans to rural residents and part-time farmers, which typically derive most of their earnings from non-agricultural sources. These borrowers are less subject to agricultural cycles and would likely be more affected by weaknesses in the general economy. Of our outstanding loan volume at December 31, 2019, approximately 12% consists of borrowers with income not solely from agricultural sources, compared with 12% for 2018 and 2017.

The loans outstanding at December 31, 2019 for loans \$250 thousand or less accounted for 22.3% of loan volume and 72.1% of the number of loans. Credit risk on small loans, in many instances, may be reduced by non-farm income sources. The following table details loans outstanding by dollar size at December 31 for the last three years.

(dollars in thousands)	2019		2018		2017	
	Amount outstanding	Number of loans	Amount outstanding	Number of loans	Amount outstanding	Number of loans
\$1 - \$250	<b>\$ 53,344</b>	<b>665</b>	\$ 57,625	701	\$ 60,420	714
\$251 - \$500	<b>47,532</b>	<b>135</b>	44,224	123	42,699	120
\$501 - \$1,000	<b>57,748</b>	<b>80</b>	66,249	95	61,843	89
\$1,001 - \$5,000	<b>75,042</b>	<b>41</b>	80,170	46	68,627	41
\$5,001 - \$25,000	<b>5,288</b>	<b>1</b>	11,352	2	5,596	1
Total	<b>\$ 238,954</b>	<b>922</b>	\$ 259,620	967	\$ 239,185	965

Approximately 16% of our loans outstanding is attributable to 10 borrowers. Due to their size, the loss of any of these loans or the failure of any of these loans to perform would adversely affect the portfolio and our future operating results.

The credit risk of some long-term real estate loans has been reduced by entering into agreements that provide long-term standby commitments by Federal Agricultural Mortgage Corporation (Farmer Mac) to purchase the loans in the event of default. The amount of loans subject to these Farmer Mac credit enhancements was \$41.7 million at December 31, 2019, \$49.6 million at December 31, 2018 and \$42.6 million at December 31, 2017. Included in other operating expenses were fees paid for these Farmer Mac commitments totaling \$221 thousand in 2019, \$220 thousand in 2018 and \$217 thousand in 2017. Under the Farmer Mac long-term standby commitment to purchase agreements, we continue to hold the loans in our portfolio, and we pay commitment fees to Farmer Mac for the right to put a loan designated in these agreements to Farmer Mac at par in the event the loan becomes significantly delinquent (typically four months past due). If the borrower cures the default, we must repurchase the loan and the commitment remains in place. Farmer Mac long-term standby commitments to purchase agreements are further described in Note 3. Other than the contractual obligations arising from these business transactions with Farmer Mac, Farmer Mac is not liable for any debt or obligation of ours and we are not liable for any debt or obligation of Farmer Mac. For more information on Farmer Mac, refer to their website at [www.farmermac.com](http://www.farmermac.com).

Credit guarantees with government agencies of \$22.8 million at year-end 2019, \$24.3 million at year-end 2018 and \$19.8 million at year-end 2017 were outstanding. Farm Service Agency (FSA) loan guarantees are utilized when



appropriate to manage credit risk. Typically, we have a 90% guarantee from the FSA which would insure that our loss on a guaranteed loan would not exceed 10% of the loss in the event that we instituted foreclosure and collected the loan after liquidation of all loan collateral secured.

### Credit Commitments

We may participate in financial instruments with off-balance-sheet risk to satisfy the financing needs of our borrowers. These financial instruments include commitments to extend credit. The instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in our consolidated financial statements. Commitments to extend credit are agreements to lend to a borrower as long as there is not a violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee by the borrower. The following table summarizes the maturity distribution of unfunded credit commitments on loans at December 31, 2019.

<i>(dollars in thousands)</i>	<b>Less than 1 year</b>	<b>1 – 3 years</b>	<b>3 – 5 years</b>	<b>Over 5 years</b>	<b>Total</b>
Commitments to extend credit	\$ 8,131	\$ 15,039	\$ 3,726	\$ 807	\$ 27,703

Since many of these commitments are expected to expire without being drawn upon, the total commitments do not necessarily represent future cash requirements. However, these credit-related financial instruments have off-balance-sheet credit risk because their amounts are not reflected on the Consolidated Statement of Condition until funded or drawn upon. The credit risk associated with issuing commitments is substantially the same as that involved in extending loans to borrowers and we apply the same credit policies to these commitments. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on our credit evaluation of the borrower. We consider potential losses related to unfunded commitments, and a reserve for unfunded commitments is included in the liabilities section of the Consolidated Statement of Condition. The related provision for the reserve for unfunded commitment is included as part of the provision for credit losses on the Consolidated Statement of Comprehensive Income.

### High Risk Assets

Nonperforming loan volume is comprised of nonaccrual loans, restructured loans, and loans 90 days past due still accruing interest and are referred to as impaired loans. High risk assets consist of impaired loans and other property owned. Comparative information regarding high risk assets in the portfolio, including accrued interest, follows.

<i>(dollars in thousands)</i>	<b>2019</b>	<b>2018</b>	<b>2017</b>
Nonaccrual loans:			
Real estate mortgage	\$ 1,610	\$ 1,338	\$ 1,033
Production and intermediate-term	475	38	33
Total nonaccrual loans	<b>2,085</b>	1,376	1,066
Accruing loans 90 days past due:			
Real estate mortgage	–	5,774	–
Total accruing loans 90 days past due	–	5,774	–
Total impaired loans	<b>\$ 2,085</b>	\$ 7,150	\$ 1,066
Other property owned	–	–	4
Total high risk assets	<b>\$ 2,085</b>	\$ 7,150	\$ 1,070
Nonaccrual loans to total loans	<b>0.87%</b>	0.53%	0.45%
High risk assets to total loans	<b>0.87%</b>	2.75%	0.45%
High risk assets to total shareholders' equity	<b>3.94%</b>	14.00%	2.21%

We had no loans classified as restructured for any of the years presented.

Total high risk assets decreased \$5.1 million, or 70.8%, to \$2.1 million at December 31, 2019 compared with year-end 2018. The reduction in high risk assets was primarily due to the payoff of the loan that was 90 days past due at year-end 2018.

Nonaccrual loans represent all loans where there is a reasonable doubt as to collection of all principal and/or interest. Nonaccrual volume increased \$709 thousand compared with December 31, 2018 due primarily to 8 new nonaccrual loans.

The following table provides additional information on nonaccrual loans as of December 31 for the last three fiscal years.

<i>(dollars in thousands)</i>	<b>2019</b>	<b>2018</b>	<b>2017</b>
Nonaccrual loans current as to principal and interest	<b>\$ 1,317</b>	\$ 1,337	\$ 688
Restructured loans in nonaccrual status	<b>\$ –</b>	\$ 14	\$ 33

For the years presented, we had no cash basis nonaccrual loans.

Other property owned is real or personal property that has been acquired through foreclosure, deed in lieu of foreclosure, or other means. We had no other property owned at December 31, 2019 and December 31, 2018. We had other property owned at December 31, 2017 of \$4 thousand, which was one piece of equipment.

High risk asset volume is anticipated to increase in the future.

### **Credit Quality**

We review the credit quality of the loan portfolio on an on-going basis as part of our risk management practices. Each loan is classified according to the Uniform Classification System (UCS), which is used by all System institutions. Following are the classification definitions.

- 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 as substandard assets. However, doubtful assets have additional weaknesses in existing facts that make collection in full highly questionable.
- Loss – Assets are not considered collectible.

The following table presents statistics based on UCS related to the credit quality of the loan portfolio, including accrued interest at December 31 for the last three fiscal years.

	<b>2019</b>	<b>2018</b>	<b>2017</b>
Acceptable	<b>94.91%</b>	95.75%	94.49%
OAEM	<b>3.41%</b>	2.76%	3.60%
Substandard	<b>1.68%</b>	1.49%	1.91%
Total	<b>100.00%</b>	100.00%	100.00%

Recent economic conditions have created challenges for some borrowers and our credit quality has declined. Loans classified as Acceptable and OAEM were 98.32% at December 31, 2019, 98.51% at December 31, 2018 and 98.09% at December 31, 2017. We had no loans classified as Doubtful or Loss for any of the three years presented. The financial position of most agricultural producers strengthened during the past decade, and most of our borrowers have maintained generally strong financial positions. As such, our credit quality is anticipated to remain sound in the near term. However, agriculture remains a cyclical business that is heavily influenced by production, operating costs and commodity prices. Each of these can be significantly impacted by uncontrollable events. If less favorable economic conditions continue, it will likely lead to weakening in the loan portfolio. As of December 31, 2019, we had no loan delinquencies (accruing loans 30 days or more past due) as a percentage of accruing loans, compared with 2.29% at December 31, 2018 and 0.58% at December 31, 2017.

### **Allowance for Loan Losses**

We maintain an allowance for loan losses at a level consistent with the probable and estimable losses inherent in the loan portfolio identified by management. The allowance for loan losses at each period end was considered to be adequate to absorb probable losses existing in the loan portfolio. Because the allowance for loan losses considers factors such as current agricultural and economic conditions, loan loss experience, portfolio quality and loan portfolio composition, there will be a direct impact to the allowance for loan losses and our income statement when there is a change in any of those factors.

The following table provides relevant information regarding the allowance for loan losses as of December 31 for the last three fiscal years.

<i>(dollars in thousands)</i>	<b>2019</b>	<b>2018</b>	<b>2017</b>
Balance at beginning of year	<b>\$ 702</b>	\$ 723	\$ 675
Charge-offs:			
Production and intermediate-term	<b>3</b>	—	13
Recoveries:			
Production and intermediate-term	<b>4</b>	—	—
Net (recoveries)/charge-offs	<b>(1)</b>	—	13
(Loan loss reversal)/Provision for loan losses	<b>(205)</b>	(21)	61
Balance at December 31	<b>\$ 498</b>	\$ 702	\$ 723
Net (recoveries)/charge-offs to average net loans	<b>&lt;(0.01%)</b>	—	0.01%

The following table presents the allowance for loan losses by loan type as of December 31 for the last three fiscal years.

<i>(dollars in thousands)</i>	<b>2019</b>	<b>2018</b>	<b>2017</b>
Real estate mortgage	<b>\$ 182</b>	\$ 270	\$ 208
Production and intermediate-term	<b>262</b>	387	452
Agribusiness	<b>44</b>	25	36
Rural infrastructure	<b>9</b>	19	20
Rural residential real estate	<b>1</b>	1	1
Agricultural export finance	<b>—</b>	—	6
Total	<b>\$ 498</b>	\$ 702	\$ 723

The allowance for loan losses decreased \$204 thousand from December 31, 2018, to \$498 thousand at December 31, 2019. The decrease in allowance for loan losses was primarily due to the loan loss reversals totaling \$205 thousand that was recorded due to changes in the loan's probability of default (PD) and loss given default (LGD) ratings. Net recoveries of \$1 thousand were recorded during 2019. During 2018, our allowance for loan losses decreased \$21 thousand from 2017 primarily due to the loan loss reversals totaling \$21 thousand that were recorded due to changes in the loan's probability of default (PD) and loss given default (LGD) ratings. Comparative allowance for loan losses coverage as a percentage of loans and certain other credit quality indicators as of December 31 are presented in the following table.

	<b>2019</b>	<b>2018</b>	<b>2017</b>
Allowance as a percentage of:			
Loans	<b>0.21%</b>	0.27%	0.30%
Impaired loans	<b>23.88%</b>	9.82%	67.82%
Nonaccrual loans	<b>23.88%</b>	51.02%	67.82%

We maintain a separate reserve for unfunded commitment, which is included in Liabilities on our Consolidated Statement of Condition. The related provision for the reserve for unfunded commitments is included as part of the provision for credit losses on the Consolidated Statement of Comprehensive Income, along with the provision for loan losses.

A summary of changes in the reserve for unfunded commitment follows.

	<b>2019</b>	<b>2018</b>	<b>2017</b>
Balance at beginning of year	<b>\$ 94</b>	\$ 94	\$ 57
(Reversal of)/Provision for reserve for unfunded commitments	<b>(5)</b>	—	37
Total	<b>\$ 89</b>	\$ 94	\$ 94

The decrease in provision for reserve for unfunded commitments in 2019 is due to loan's probability of default (PD) and loss given default (LGD) factors applicable to individual loans with undisbursed commitments.

#### ***Young, Beginning and Small Farmers and Ranchers Program***

As part of the Farm Credit System, we are committed to providing sound and dependable credit and related services to young, beginning and small (YBS) farmers and ranchers. We recognize the critical nature of the "young,"

“beginning,” and “small” farmer and rancher customer base to the overall future well-being of the agricultural industry as well as to the Association. We provide responsive, specially designed credit, financially related services and guidance. Following are FCA regulatory definitions for YBS farmers and ranchers.

- Young Farmer: A farmer, rancher, or producer or harvester of aquatic products who was age 35 or younger as of the date the loan was originally made.
- Beginning Farmer: A farmer, rancher, or producer or harvester of aquatic products who had 10 years or less farming or ranching experience as of the date the loan was originally made.
- Small Farmer: A farmer, rancher, or producer or harvester of aquatic products who normally generated less than \$250 thousand in annual gross sales of agricultural or aquatic products at the date the loan was originally made.

The following table outlines our percentage of YBS loans as a percentage of the number of loans in our loan portfolio while the USDA column represents the percent of farmers and ranchers classified as YBS within our territory per the 2017 USDA Agricultural Census, which is the most current data available. Due to FCA regulatory definitions, a farmer/rancher may be included in multiple categories as they would be included in each category in which the definition was met.

	USDA	2019	2018	2017
Young	13.33%	<b>20.86%</b>	20.81%	20.46%
Beginning	25.39%	<b>18.86%</b>	19.59%	21.40%
Small	74.53%	<b>59.43%</b>	58.11%	58.13%

Our percentages are based on the number of loans in our portfolio, while the USDA percentages are based on the number of farmers and ranchers. While this definition difference does exist, the information is the best comparative information available.

We establish annual marketing goals to increase market share of loans to YBS farmers and ranchers. Our goals are as follows:

- Offer related services either directly or in coordination with others that are responsive to the needs of YBS farmers and ranchers in our territory;
- Take full advantage of opportunities for coordinating credit and services offered with other System institutions in the territory and other governmental and private sources of credit who offer credit and services to those who qualify as YBS farmers and ranchers in our territory; and
- Implement effective outreach programs to attract YBS farmers and ranchers.

Special programs and events we have held or sponsored to meet this need include:

- **Red River Crops Conference** – This is a two-day conference that we sponsor financially, as well as having a booth space to interact with producers to gain information about the industry and provide information about lending.
- **Campus visits** – Our staff has continued to visit and make presentations as requested to college and university campuses in our territory that have agriculture programs. Those campuses included Western Oklahoma State College in Altus and Cameron University in Lawton.

Our 2019 outreach activities were considered successful. The 2019 Red River Crops Conference was held in Childress, Texas and will be held in January 2020 in Altus at Southwest Technology Center. The conference rotates between Childress and Altus. The college visit made to Western Oklahoma State College in 2019 was considered successful.

Quarterly reports are provided to our Board of Directors detailing the number, volume and credit quality of our YBS customers. We have developed quantitative targets to monitor our progress.

- Loan volume and loan number goals for YBS farmers and ranchers in our territory;
- Percentage goals representative of the demographics of YBS farmers and ranchers in our territory;
- Percentage goals for loans made to new borrowers qualifying as YBS farmers and ranchers in our territory; and
- Goals for capital committed to loans made to YBS farmers and ranchers in our territory.

## As of December 31, 2019

	Loans	% of Loans in Portfolio	Volume	Capital
Young < or = 35 yrs. old	35	17.5%	\$ 5,000,000	\$ 750,000
Beginning < or = 10 yrs. on farm	35	19.5%	\$ 5,000,000	\$ 750,000
Small < or = \$250,000 farm sales	75	50.7%	\$ 6,500,000	\$ 975,000

We met the number and volume goals for small farmer category. Year-end figures fell short on meeting young and beginning farmer goals. Young farmer loans achieved 65% of the number goal, 102% of the percentage goal, and 75% of the volume goal. In the beginning category, 45% of the number goal, 65% of the percentage goal and 45% of the volume goal were achieved. This data indicates that we continue to do an effective job of meeting the credit needs for the identified categories of producers in our territory.

To ensure that credit and services offered to our YBS farmers and ranchers are provided in a safe and sound manner and within our risk-bearing capacity, we utilize FSA loan guarantee program. Additionally, we are actively involved in developing and sponsoring educational opportunities, leadership training, business financial training and insurance services for YBS farmers and ranchers.

### **CREDIT RISK MANAGEMENT**

Credit risk arises from the potential failure of a borrower to meet repayment obligations that result in a financial loss to the lender. Credit risk exists in our loan portfolio and also in our unfunded loan commitments. Credit risk is actively managed on an individual and portfolio basis through application of sound lending and underwriting standards, policies and procedures.

Underwriting standards are utilized to determine an applicant's operational, financial, and managerial resources available for repaying debt within the terms of the note and loan agreement. Underwriting standards include among other things, an evaluation of:

- character – borrower integrity and credit history;
- capacity – repayment capacity of the borrower based on cash flows from operations or other sources of income;
- collateral – to protect the lender in the event of default and also serve as a secondary source of loan repayment;
- capital – ability of the operation to survive unanticipated risks; and
- conditions – intended use of the loan funds, terms, restrictions, etc.

Processes for information gathering, balance sheet and income statement verification, loan analysis, credit approvals, disbursements of proceeds and subsequent loan servicing actions are established and followed. Underwriting standards vary by industry and are updated periodically to reflect market and industry conditions.

By regulation, we cannot have loan commitments to one borrower for more than 15% of our lending and lease limit base. The lending and lease limit base is defined as permanent capital with any applicable adjustments related to preferred stock and any investment held in connection with the sale of loan participation interest. Additionally, we set our own lending limits to manage loan concentration risk. Lending limits have been established for individual loan size, commodity type, special lending programs and geographic concentrations. We have adopted an individual lending limit maximum of 10% of our lending and lease limit base for our highest quality borrowers.

We have established internal lending delegations to properly control the loan approval process. Delegations to staff are based on our risk-bearing ability, loan size, complexity, type and risk, as well as the expertise and position of the credit staff member. Larger and more complex loans or loans perceived to have higher risk are typically approved by our Chief Executive Officer.

The majority of our lending is first mortgage real estate loans, which must be secured by a first lien on real estate. Production and intermediate-term lending accounts for most of the remaining volume and is typically secured by livestock, crops and equipment. Collateral evaluations are completed in compliance with FCA and Uniform Standards of Professional Appraisal Practices requirements. All property is appraised at market value. All collateral evaluations

must be performed by a qualified appraiser. Certain appraisals must be performed by individuals with a state certification or license.

We use a two-dimensional risk rating model (Model) based on the Farm Credit System's Combined System Risk Rating Guidance. The Model estimates each loan's probability of default (PD) and loss given default (LGD). PD estimates the probability that a borrower will experience a default within twelve months from the date of determination. We adjust the PD factors in the Combined System Risk Rating Guidance to account for our loss emergence period which has been determined to be 21 months. LGD provides an estimation of the anticipated loss with respect to a specific financial obligation of a borrower assuming a default has occurred or will occur within the next twelve months. The Model uses objective and subjective criteria to identify inherent strengths, weaknesses, and risks in each loan. PDs and LGDs are utilized in loan and portfolio management processes and are utilized for the allowance for loan losses estimate.

The Model's 14-point probability of default scale provides for nine acceptable categories, one OAEM category, two substandard categories, one doubtful category and one loss category; each carrying a distinct percentage of default probability. The Model's LGD scale provides 6 categories, A through F, that have the following anticipated principal loss and range of economic loss expectations:

- A 0% anticipated principal loss; 0% to 5% range of economic loss
- B 0% to 3% anticipated principal loss; >5% to 15% range of economic loss
- C > 3% to 7% anticipated principal loss; >15% to 20% range of economic loss
- D > 7% to 15% anticipated principal loss; >20% to 25% range of economic loss
- E > 15% to 40% anticipated principal loss; >25% to 50% range of economic loss
- F above 40% anticipated loss; above 50% range of economic loss

## **RESULTS OF OPERATIONS**

### ***Earnings Summary***

In 2019, we recorded net income of \$2.5 million, compared with \$3.3 million in 2018, and \$2.6 million in 2017. The decrease in 2019 was primarily due to an increase in noninterest expense and a decrease in noninterest income. The increase in 2018 was primarily due to an increase in net interest income and an increase in noninterest income. The following table presents the changes in the significant components of net income from the previous year.

<i>(dollars in thousands)</i>	<b>2019 vs. 2018</b>	<b>2018 vs. 2017</b>
Net income, prior year	<b>\$ 3,301</b>	\$ 2,635
Increase/(Decrease) from changes in:		
Interest income	<b>500</b>	1,273
Interest expense	<b>(394)</b>	(1,076)
Net interest income	<b>106</b>	197
Provision for credit losses	<b>189</b>	119
Noninterest income	<b>(197)</b>	332
Noninterest expense	<b>(732)</b>	(77)
Provision for income taxes	<b>(165)</b>	95
Total (decrease)/increase in net income	<b>(799)</b>	666
Net income, current year	<b>\$ 2,502</b>	\$ 3,301

Return on average assets decreased to 0.95% from 1.27% in 2018, and return on average shareholders' equity decreased to 4.77% from 6.60% in 2018, primarily as a result of decrease in net income.

### ***Net Interest Income***

Net interest income for 2019 was \$6.5 million compared with \$6.4 million for 2018 and \$6.2 million for 2017. Net interest income is our principal source of earnings and is impacted by interest earning asset volume, yields on assets and cost of debt. The increase in net interest income was largely due to a decrease in interest rates paid.

The following table provides an analysis of the individual components of the change in net interest income during 2019 and 2018.

<i>(dollars in thousands)</i>	<b>2019 vs. 2018</b>	<b>2018 vs. 2017</b>
Net interest income, prior year	<b>\$ 6,418</b>	<b>\$ 6,221</b>
Increase/(Decrease) in net interest income from changes in:		
Interest rates earned	<b>520</b>	696
Interest rates paid	<b>(388)</b>	(817)
Volume of interest-bearing assets and liabilities	<b>66</b>	255
Interest income on nonaccrual loans	<b>(92)</b>	63
Increase in net interest income	<b>106</b>	197
Net interest income, current year	<b>\$ 6,524</b>	<b>\$ 6,418</b>

The following table illustrates net interest margin and the average interest rates on loans and debt cost and interest rate spread.

	<b>For the Year Ended December 31</b>		
	<b>2019</b>	<b>2018</b>	<b>2017</b>
Net interest margin	<b>2.66%</b>	2.63%	2.65%
Interest rate on:			
Average loan volume	<b>5.31%</b>	5.14%	4.81%
Average debt	<b>3.13%</b>	2.94%	2.53%
Interest rate spread	<b>2.18%</b>	2.20%	2.28%

The decrease in interest rate spread resulted from a 19 basis point increase in interest rates on average debt offset by a 17 basis point increase in interest rates on average loan volume. The increase in net interest margin was due to higher earnings on our own capital.

#### ***Provision for Credit Losses/(Credit Loss Reversals)***

We monitor our loan portfolio and unfunded commitments on a regular basis to determine if any increase through provision for credit losses or decrease through a credit loss reversal in our allowance for loan losses or reserve for unfunded commitment is warranted based on our assessment of the probable and estimable losses inherent in our loan portfolio and unfunded commitments. We recorded net credit loss reversals of \$210 thousand in 2019, compared with \$21 thousand in 2018 and net provision for credit losses of \$98 thousand in 2017. The loan loss reversals of \$205 thousand recorded during 2019 were primarily due to changes in the loan's probability of default (PD) and loss given default (LGD) ratings. The reversal of reserve for unfunded commitments of \$5 thousand was recorded during 2019 due to loan's probability of default (PD) and loss given default (LGD) factors applicable to individual loans with undisbursed commitments. The loan loss reversals of \$21 thousand recorded during 2018 was primarily due to changes in the loans' probability of default (PD) and loss given default (LGD) ratings. The provision for loan losses of \$61 thousand recorded during 2017 was primarily due to combination of changes in the loan's probability of default (PD) and the loss given default (LGD) ratings and new loans. We recorded no provision for reserve for unfunded commitments in 2018. The provision for reserve for unfunded commitments of \$37 thousand was recorded during 2017 due to increase in commitment amounts.

#### ***Noninterest Income***

During 2019, we recorded noninterest income of \$1.5 million, compared with \$1.7 million in 2018 and \$1.3 million in 2017. Patronage distributions from CoBank are our primary source of noninterest income. Patronage is accrued in the year earned and then received from CoBank in the following year. CoBank patronage is distributed in cash and stock. The total patronage from CoBank is comprised of two sources: patronage based on our borrowing balance (direct note patronage) and patronage based on loans we originate and then sell a portion to them as a participant (sold volume patronage). Patronage earned from CoBank was \$836 thousand in 2019, \$1.1 million in 2018, which includes a one-time cash patronage distribution of \$123 thousand relating to tax reform changes, and \$901 thousand in 2017.

During August 2017, CoBank management announced changes to their capital plans and patronage programs for eligible customer-owners designed to address a number of market place challenges. The changes were intended to strengthen CoBank's long-term capacity to serve customers' borrowing needs, enhance CoBank's ability to capitalize future customer growth, and ensure equitability among different customer segments. The plan included a reduction to our patronage income in 2018 of 5 basis points on participation loans with CoBank. Additionally, the changes include a reduction in patronage related to our direct note with CoBank for all other loans of 5 basis points in 2019 and a

further reduction of 4 basis points in 2020. During 2019, we received 95 basis points on participation loans and 40 basis points on our direct note with CoBank for all other loans. In 2018, we received 95 basis points on participation loans and 45 basis points on our direct note with CoBank for all other loans.

In 2019, we recorded a cash patronage of \$6 thousand from Farm Credit Foundations, the organization that provides our payroll and human resource services, which will be paid in the following year. This compares with \$5 thousand recorded in 2018 and \$5 thousand in 2017. Patronage from Farm Credit Foundations and CoBank is included in patronage distribution from Farm Credit institutions on the Consolidated Statement of Comprehensive Income.

We received a refund of \$60 thousand during 2019 and \$157 thousand during 2018 from Farm Credit System Insurance Corporation (FCSIC). The FCSIC refund is our portion of excess funds above the secure base amount in the FCSIC Allocated Insurance Reserve Accounts.

We received mineral income of \$212 thousand during 2019, which is distributed to us quarterly by CoBank. Mineral income increased from \$195 thousand in 2018 and \$175 thousand in 2017. The increase is attributed to an increase in production revenue resulting from additional wells being brought online.

Noninterest income also includes loan fees, financially related services income and other noninterest income. Loan fees in 2019 were \$217 thousand, an increase of \$52 thousand from 2018, primarily due to an increase in appraisal fee income and a reduction in the deferral of loan fee income.

### **Noninterest Expense**

Noninterest expense for 2019 increased \$732 thousand, or 15.2%, to \$5.6 million compared with 2018 and \$809 thousand, or 17.0% compared with 2017. Noninterest expense for each of the three years ended December 31 is summarized as follows:

<i>(dollars in thousands)</i>	<b>Percent of Change</b>				
	<b>2019</b>	<b>2018</b>	<b>2017</b>	<b>2019/2018</b>	<b>2018/2017</b>
Salaries & employee benefits	\$ 2,557	\$ 2,393	\$ 2,453	6.85%	(2.45%)
Occupancy & equipment	179	125	133	43.20%	(6.02%)
Purchased services from AgVantis	914	740	617	23.51%	19.94%
Supervisory & examination costs	91	83	80	9.64%	3.75%
Other	1,651	1,318	1,201	25.27%	9.74%
Total operating expense	5,392	4,659	4,484	15.73%	3.90%
Losses on other property owned, net	–	1	–	(100.00%)	100.00%
Farm Credit Insurance Fund premium	162	162	261	–	(37.93%)
Total noninterest expense	\$ 5,554	\$ 4,822	\$ 4,745	15.18%	1.62%

For the year ended December 31, 2019, total operating expense increased \$733 thousand, or 15.7%, compared with the year ended December 31, 2018, primarily due to increases in salaries and benefits, purchased services from AgVantis and unforeseen legal and audit costs. Insurance Fund premium remained constant due to the premium rate remaining constant from 2018.

### **Provision for income taxes/Benefit from income taxes**

We recorded \$133 thousand in provision for income taxes during 2019, compared with benefit from income taxes of \$32 thousand in 2018 and provision for income taxes of \$63 thousand in 2017. The increase in 2019 was primarily due to reevaluation of our deferred tax asset and the resulting impact of establishing a valuation allowance. Tax expense was also impacted by our patronage refund program. We operate as a Subchapter T cooperative for tax purposes and thus may deduct from taxable income certain amounts that are distributed from net earnings to borrowers. See Note 2 for additional details.

Tax expense in 2017 was impacted by the enactment of federal tax legislation in late December 2017 which, among other things, lowered the federal corporate tax rate from 35 percent to 21 percent beginning in 2018. In accordance with accounting principles generally accepted in the United States (GAAP), the change to the lower corporate tax rate led to a revaluation of our deferred tax assets and deferred tax liabilities in the period of enactment (2017). This change is a provisional estimate based on nuances within our operations.

### **LIQUIDITY**

Liquidity is necessary to meet our financial obligations. Liquidity is needed to pay our note with CoBank, fund loans and other commitments, and fund business operations in a cost-effective manner. Our liquidity policy is intended to



manage short-term cash flow, maximize debt reduction and liquidate nonearning assets. Our direct loan with CoBank, cash on hand and borrower loan repayments provide adequate liquidity to fund our on-going operations and other commitments.

### ***Funding Sources***

Our primary source of liquidity is the ability to obtain funds for our operations through a borrowing relationship with CoBank. Our note payable to CoBank is collateralized by a pledge to CoBank of substantially all of our assets. Substantially all cash received is applied to the note payable and all cash disbursements are drawn on the note payable. The indebtedness is governed by a General Financing Agreement (GFA) with CoBank, which matures on December 31, 2022. The annual average principal balance of the note payable to CoBank was \$207.4 million in 2019, \$207.5 million in 2018 and \$198.9 million in 2017.

We plan to continue to fund lending operations through the utilization of our funding arrangement with CoBank, retained earnings from current and prior years and from borrower stock investments. CoBank's primary source of funds is the ability to issue Systemwide Debt Securities to investors through the Federal Farm Credit Bank Funding Corporation. This access has traditionally provided a dependable source of competitively priced debt that is critical for supporting our mission of providing credit to agriculture and rural America. Although financial markets experienced significant volatility in the last few years, we were able to obtain sufficient funding to meet the needs of our customers.

### ***Interest Rate Risk***

The interest rate risk inherent in our loan portfolio is substantially mitigated through our funding relationship with CoBank which allows for loans to be match-funded. Borrowings from CoBank match the pricing, maturity, and option characteristics of our loans to borrowers. CoBank manages interest rate risk through the direct loan pricing and its asset/liability management processes. Although CoBank incurs and manages the primary sources of interest rate risk, we may still be exposed to interest rate risk through the impact of interest rate changes on earnings generated from our loanable funds. To stabilize earnings from loanable funds, we have committed excess loanable funds with CoBank at a fixed rate for a specified term as a part of CoBank's Association Equity Positioning Program (AEPP). This enables us to reduce our overall cost of funds with CoBank without significantly increasing our overall interest rate risk position.

### ***Funds Management***

We offer variable, fixed, adjustable prime-based and LIBOR-based rate loans to borrowers. Our Board of Directors determines the interest rate charged based on the following factors: 1) the interest rate charged by CoBank; 2) our existing rates and spreads; 3) the competitive rate environment; and 4) our profitability objectives.

### ***Uncertainty Surrounding the Future of LIBOR***

In 2017, the United Kingdom's Financial Conduct Authority, which regulates the London Inter-Bank Offered Rate (LIBOR), announced its intention to stop persuading or compelling the group of major banks that sustains LIBOR to submit rate quotations after 2021. As a result, it is uncertain whether LIBOR will continue to be quoted after 2021.

In the United States, efforts to identify a set of alternative U.S. dollar reference interest rates include proposals by the Alternative Reference Rates Committee (ARRC) of the Federal Reserve Board and the Federal Reserve Bank of New York. Specifically, the ARRC has proposed the Secured Overnight Financing Rate (SOFR) as the recommended alternative to LIBOR and the Federal Reserve Bank of New York began publishing SOFR in April 2018.

In September 2018, the FCA issued guidance for System institutions to follow as they prepare for the expected phase-out of LIBOR.

We continue to analyze potential risks associated with the LIBOR transition, including financial, operational, legal, tax, reputational and compliance risks. At this time, we are unable to predict whether or when LIBOR will cease to be available or if SOFR or any other alternative reference rate will become the benchmark to replace LIBOR. Because we engage in transactions involving financial instruments that reference LIBOR, these developments could have a material impact on the Association and our borrowers.

## **CAPITAL RESOURCES**

Capital supports asset growth and provides protection for unexpected credit and operating losses. Capital is also needed for investments in new products and services. We believe a sound capital position is critical to our long-term financial success due to the volatility and cycles in agriculture. Over the past several years, we have been able to build capital primarily through net income retained after patronage. Shareholders' equity at December 31, 2019

totaled \$53.0 million, compared with \$51.1 million at December 31, 2018 and \$48.4 million at December 31, 2017. The increase of \$1.9 million in shareholders' equity reflects net income partially offset by patronage refunds and net stock retirements. Our capital position is reflected in the following ratio comparisons.

	2019	2018	2017
Debt to shareholders' equity	3.83:1	4.43:1	4.26:1
Shareholders' equity as a percent of net loans	22.21%	19.72%	20.32%
Shareholders' equity as a percent of total assets	20.70%	18.42%	19.00%

Debt to shareholders' equity decreased and shareholders' equity as a percent of net loans and of total assets increased from 2018 primarily due to an increase in retained earnings and decrease in net loans and total assets.

### ***Retained Earnings***

Our retained earnings increased \$1.9 million to \$52.6 million at December 31, 2019 from \$50.7 million at December 31, 2018 and increased \$4.5 million from \$48.1 million at December 31, 2017. The increase in 2019 was a result of net income of \$2.5 million, partially offset by \$594 thousand of patronage distributions declared.

### ***Patronage Program***

We have a Patronage Program that allows us to distribute our available net earnings to our shareholders. This program provides for the application of net earnings in the manner described in our Bylaws. In addition to determining the amount and method of patronage to be distributed, the Bylaws address increasing surplus to meet capital adequacy standards established by Regulations; increasing surplus to a level necessary to support competitive pricing at targeted earnings levels; and increasing surplus for reasonable reserves. Patronage distributions are based on business done with us during the year. We paid cash patronage of \$670 thousand in 2019, \$604 thousand in 2018 and \$592 thousand in 2017. During 2019, we declared patronage distributions of \$594 thousand to be paid in April 2020.

### ***Stock***

Our total stock decreased \$9 thousand to \$365 thousand at December 31, 2019, from \$374 thousand at December 31, 2018 and decreased from \$382 thousand at December 31, 2017. The decrease during 2019 was due to \$22 thousand of stock retirements, partially offset by \$13 thousand of stock issuances. We require a stock investment for each borrower. The current initial investment requirement is 2.00% of the amount of the borrower's combined loan volume. We have a Borrower Level Stock Program which allows stock to be assigned to each borrower instead of each loan. This reduces the stock requirements for borrowers with multiple loans. The current stock requirement for each borrower is the lesser of one thousand dollars or 2.00% of the collective total balance of each borrower's loan(s).

### ***Capital Plan and Regulatory Requirements***

Our Board of Directors establishes a formal capital adequacy plan that addresses capital goals in relation to risks. The capital adequacy plan assesses the capital level necessary for financial viability and to provide for growth. Our plan is updated annually and approved by our Board of Directors. FCA regulations require the plan consider the following factors in determining optimal capital levels, including:

- Regulatory capital requirements;
- Asset quality;
- Needs of our customer base; and
- Other risk-oriented activities, such as funding and interest rate risks, contingent and off-balance sheet liabilities and other conditions warranting additional capital.

As shown in the following table, at December 31, 2019, our capital and leverage ratios exceeded regulatory minimums. If these capital standards are not met, the FCA can impose restrictions, including limiting our ability to pay patronage distributions, retire equities and pay preferred stock dividends.

	2019	2018	2017	Minimum Requirement with Buffer
Common equity tier 1 capital ratio	<b>21.65%</b>	20.19%	19.73%	7.00%
Tier 1 capital ratio	<b>21.65%</b>	20.19%	19.73%	8.50%
Total regulatory capital ratio	<b>22.00%</b>	20.55%	20.21%	10.50%
Tier 1 leverage ratio	<b>17.90%</b>	16.18%	16.18%	5.00%
Unallocated retained earnings and URE equivalents (UREE) leverage ratio	<b>18.86%</b>	16.97%	16.82%	1.50%
Permanent capital ratio	<b>21.71%</b>	20.25%	19.82%	7.00%

The minimum ratios established were not meant to be adopted as the optimum capital level, so we have established goals in excess of the regulatory minimum. As of December 31, 2019, we have met our goals. Due to our strong capital position, we will continue to be able to retire at-risk stock.

As displayed in the following table we exceeded the minimum regulatory capital requirements in effect through December 31, 2016.

	2016	2015	2014	2013	2012	Regulatory Minimum
Permanent capital ratio	21.14%	21.08%	20.98%	20.37%	19.43%	7.00%
Total surplus ratio	20.94%	20.86%	20.76%	20.13%	19.19%	7.00%
Core surplus ratio	20.94%	20.86%	20.76%	20.11%	18.85%	3.50%

Refer to Note 7, Shareholders' Equity, in this report for additional information on our capital and related requirements and restrictions.

## **REGULATORY MATTERS**

As of December 31, 2019, we had no enforcement actions in effect and FCA took no enforcement actions on us during the year.

## **GOVERNANCE**

### ***Board of Directors***

We are governed by a seven member board that provides direction and oversees our management. Of these directors, six are elected by the shareholders and one is appointed by the elected directors. Our Board of Directors represents the interests of our shareholders. The Board of Directors meets regularly to perform the following functions, among others:

- selects, evaluates and compensates the chief executive officer;
- approves the strategic plan, capital plan, financial plan and the annual operating budget;
- oversees the lending operations;
- directs management on significant issues; and
- oversees the financial reporting process, communications with shareholders and our legal and regulatory compliance.

### ***Director Independence***

All directors must exercise sound judgment in deciding matters in our interest. All our directors are independent from the perspective that none of our management or staff serves as Board members. However, we are a financial services cooperative, and the Farm Credit Act and FCA Regulations require our elected directors to have a loan relationship with us.

The elected directors, as borrowers, have a vested interest in ensuring our Association remains strong and successful. However, our borrowing relationship could be viewed as having the potential to compromise the independence of an elected director. For this reason, the Board has established independence criteria to ensure that a loan relationship does not compromise the independence of our Board. Annually, in conjunction with our independence analysis and reporting on our loans to directors, each director provides financial information and any other documentation and/or assertions needed for the Board to determine the independence of each Board member.

### **Audit Committee**

The Audit Committee reports to the Board of Directors. The Audit Committee is composed of three members of the Board of Directors. During 2019, five meetings were held. The Audit Committee responsibilities generally include, but are not limited to:

- oversight of the financial reporting risk and the accuracy of the quarterly and annual shareholder reports;
- the oversight of the system of internal controls related to the preparation of quarterly and annual shareholder reports;
- the review and assessment of the impact of accounting and auditing developments on the consolidated financial statements; and
- the establishment and maintenance of procedures for the receipt, retention and treatment of confidential and anonymous submission of concerns regarding accounting, internal accounting controls or auditing matters.

### **Compensation Committee**

The Compensation Committee is responsible for the oversight of employee and director compensation. The Compensation Committee is composed of three members of the Board of Directors. The Committee annually reviews, evaluates and approves the compensation policies, programs and plans for senior officers and employees including benefits programs.

### **Other Governance**

The Board has monitored the requirements of public companies under the Sarbanes-Oxley Act. While we are not subject to the requirements of this law, we are striving to implement steps to strengthen governance and financial reporting. We strive to maintain strong governance and financial reporting through the following actions:

- a system for the receipt and treatment of whistleblower complaints;
- a code of ethics for our President/CEO, Chief Financial Officer and Chief Credit Officer;
- open lines of communication between the independent auditors, management, and the Audit Committee;
- "plain English" disclosures;
- officer certification of accuracy and completeness of the consolidated financial statements; and
- information disclosure through our website.

### **Code of Ethics**

Our directors and employees are responsible for maintaining the highest of standards in conducting our business. In that regard, we established a Code of Ethics for the Board of Directors and a Code of Ethics for the Chief Executive Officer, Chief Financial Officer, Chief Credit Officer, and other senior financial professionals who are involved, directly or indirectly, with the preparation of our financial statements and the maintenance of financial records supporting the financial statements. These Codes of Ethics supplement our Standards of Conduct Policies for Directors and Employees. Annually, each employee and director files a written and signed disclosure statement as required under the Standards of Conduct Policies.

### **Whistleblower Program**

We maintain a program for employee complaints related to accounting, financial reporting, internal accounting controls, or auditing matters. This program allows employees to submit confidential, anonymous concerns regarding accounting, financial reporting, internal accounting controls, fraud or auditing matters without the fear of reprisal, retaliation or adverse action being taken against any employee who, in good faith, reports or assists in the investigation of a violation or suspected violation, or who makes an inquiry about the appropriateness of an anticipated or actual course of action.

### **FORWARD-LOOKING INFORMATION**

Our discussion contains forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Words such as "anticipates," "believes," "could," "estimates," "may," "should," and "will," or other variations of these terms are intended to identify forward-looking statements. These statements are based on assumptions and analyses made in light of experience and other historical trends, current conditions, and expected future developments. However, actual results and developments may differ materially from our expectations and predictions due to a number of risks and uncertainties, many of which are beyond our control. These risks and uncertainties include, but are not limited to:

- political, legal, regulatory and economic conditions and developments in the United States and abroad;
- economic fluctuations in the agricultural, rural utility, international, and farm-related business sectors;

- weather, disease, including the recent outbreak of the coronavirus, and other adverse climatic or biological conditions that periodically occur that impact agricultural productivity and income;
- changes in United States government support of the agricultural industry and/or the Farm Credit System; and
- actions taken by the Federal Reserve System in implementing monetary policy.

## **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Our consolidated financial statements are based on accounting principles generally accepted in the United States of America. Our significant accounting policies are critical to the understanding of our results of operations and financial position because some accounting policies require us to make complex or subjective judgments and estimates that may affect the value of certain assets or liabilities. We consider these policies critical because we have to make judgments about matters that are inherently uncertain. For a complete discussion of significant accounting policies, see Note 2 of the accompanying consolidated financial statements. The development and selection of critical accounting policies, and the related disclosures, have been reviewed by our Audit Committee. A summary of critical policies relating to the determination of the allowance for loan losses follows.

### ***Allowance for Loan Losses/Reserve for Unfunded Commitment***

The allowance for loan losses is our best estimate of the amount of probable loan losses existing in and inherent in our loan portfolio as of the balance sheet date. The allowance for loan losses is increased through provisions for loan losses and loan recoveries and is decreased through loan loss reversals and loan charge-offs. Additionally, we provide line of credit financing to our customers. We have established a reserve for unfunded commitment to cover probable losses. This reserve is reported as a liability in our consolidated balance sheet. The reserve for unfunded commitment is increased through provision for the reserve for unfunded commitments and is decreased through reversals of the reserve for unfunded commitments. Provision for loan losses and provision for reserve for unfunded commitments are referred to as a provision for credit losses on the Consolidated Statement of Comprehensive Income. We determine the allowance for loan losses and the reserve for unfunded commitment based on a regular evaluation of the loan and commitment portfolios, which generally considers recent historical charge-off experience adjusted for relevant factors.

Loans are evaluated based on the borrower's overall financial condition, resources, and payment record; the prospects for support from any financially responsible guarantor; and, if appropriate, the estimated net realizable value of any collateral. The allowance for loan losses attributable to these loans is established by a process that estimates the probable loss inherent in the loans, taking into account various historical factors, internal risk ratings, regulatory oversight, and geographic, industry and other factors.

Changes in the factors we consider in the evaluation of losses in the loan portfolio could occur for various credit related reasons and could result in a change in the allowance for loan losses, which would have a direct impact on the provision for loan losses and results of operations. See Notes 2 and 3 to the accompanying consolidated financial statements for detailed information regarding the allowance for loan losses.

## **MERGER**

On March 3, 2020 and March 4, 2020, respectively, the boards of directors of Farm Credit of Western Oklahoma, ACA and Ag Preference, ACA approved a letter of intent to pursue a merger. The Associations will be completing due diligence over the next few months in order to develop definitive terms of the merger. The Associations anticipate a merger date of January 1, 2021 or as soon as practicable thereafter, subject to receiving all regulatory and shareholder approvals required. The Association does not expect there to be any material negative impact to its operations as a result of the merger.

## **CUSTOMER PRIVACY**

FCA regulations require that borrower information be held in confidence by Farm Credit institutions, their directors, officers and employees. FCA regulations and our Standards of Conduct Policies specifically restrict Farm Credit institution directors and employees from disclosing information not normally contained in published reports or press releases about the institution or its borrowers or members. These regulations also provide Farm Credit institutions clear guidelines for protecting their borrowers' nonpublic information.

## REPORT OF MANAGEMENT

The consolidated financial statements of AgPreference, ACA (Association) are prepared by management, who is responsible for their integrity and objectivity, including amounts that must necessarily be based on judgments and estimates. The consolidated financial statements have been prepared in conformity with generally accepted accounting principles appropriate in the circumstances, and in the opinion of management, fairly present the financial condition of the Association. Other financial information included in the 2019 annual report is consistent with that in the financial statements.

To meet its responsibility for reliable financial information, management depends on the Association's accounting and internal control systems, which have been designed to provide reasonable, but not absolute, assurance that assets are safeguarded and transactions are properly authorized and recorded. To monitor compliance, management engaged Harper, Rains, Knight Company Certified Public Accountants to perform audits of the accounting records, review accounting systems and internal controls, and recommend improvements as appropriate. The Association is also examined by the Farm Credit Administration.

The Audit Committee of the Board of Directors has overall responsibility for the Association's system of internal control and financial reporting. The Audit Committee consults regularly with management and reviews the results of the examinations by the various entities named above. The independent auditors have direct access to the Audit Committee.

The undersigned certify the AgPreference, ACA Annual Report has been reviewed and 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.

  
\_\_\_\_\_  
Joe T. Kelly  
Chairman of the Board  
\_\_\_\_\_  
Cecil H. Sheperson  
President and Chief Executive Officer  
\_\_\_\_\_  
Jana S. Turner  
Chief Financial Officer

March 24, 2020

## **AUDIT COMMITTEE REPORT**

The Audit Committee (Committee) includes three members from the Board of Directors of AgPreference, ACA (Association). In 2019, five Committee meetings were held. The Committee oversees the scope of the Association's internal audit program, the independence of the outside auditors, the adequacy of the Association's system of internal controls and procedures, and the adequacy of management's action with respect to recommendations arising from those auditing activities. The Committee's responsibilities are described more fully in the Internal Control Policy and the Audit Committee Charter. The Committee approved the appointment of PricewaterhouseCoopers, LLP (PwC) as the Association's independent auditors for 2019.

The fees for professional services rendered for the Association by its independent auditor, PwC, during 2019 were \$62,200 for audit services, \$8,800 for tax services and \$13,000 for the 2018 incremental bill.

The Committee reviewed the non-audit services provided by PwC and concluded these services were not incompatible with maintaining the independent auditor's independence.

Management is responsible for the Association's internal controls and the preparation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. PwC is responsible for performing an independent audit of the Association's consolidated financial statements in accordance with auditing standards generally accepted in the United States of America and to issue a report thereon. The Committee's responsibilities include monitoring and overseeing these processes.

In this context, the Committee reviewed and discussed the Association's Quarterly Reports and the Association's audited financial statements for the year ended December 31, 2019 (the "Financial Statements") with management. The Committee also reviews with PwC the matters required to be discussed by Statements on Auditing Standards. Both PwC and the Association's internal auditors directly provide reports on significant matters to the Committee.

Based on the foregoing review and discussions and relying thereon, the Committee recommended that the Board of Directors include the Financial Statements in the Association's Annual Report to Shareholders for the year ended December 31, 2019 and for filing with the Farm Credit Administration.

  
Lonnie Olson, Chairman of the Audit Committee

### Audit Committee Members

Roger Fischer  
Robert Williams

March 24, 2020



## **Report of Independent Auditors**

To the Board of Directors of  
AgPreference, ACA

We have audited the accompanying consolidated financial statements of AgPreference, ACA and its subsidiaries (the Association), which comprise the consolidated statements of condition as of December 31, 2019, 2018 and 2017, and the related consolidated statements of comprehensive income, of changes in shareholders' equity, and of cash flows for the years then ended.

### ***Management's Responsibility for the Consolidated Financial Statements***

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### ***Auditors' Responsibility***

Our responsibility is to express an opinion on the consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the Association's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Association's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### ***Opinion***

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of AgPreference, ACA and its subsidiaries as of December 31, 2019, 2018 and 2017, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

*PricewaterhouseCoopers LLP*

March 24, 2020



**Consolidated Statement of Condition**

(Dollars in Thousands)

	December 31		
	2019	2018	2017
<b>ASSETS</b>			
Loans	\$ 238,954	\$ 259,620	\$ 239,185
Less allowance for loan losses	498	702	723
Net loans	238,456	258,918	238,462
Cash	717	777	418
Accrued interest receivable	4,664	5,747	4,799
Investment in CoBank, ACB	8,310	8,307	7,968
Premises and equipment, net	1,376	1,303	1,338
Other property owned	-	-	4
Prepaid benefit expense	960	679	489
Deferred tax asset	-	133	100
Other assets	1,363	1,425	1,357
<b>Total assets</b>	<b>\$ 255,846</b>	<b>\$ 277,289</b>	<b>\$ 254,935</b>
<b>LIABILITIES</b>			
Note payable to CoBank, ACB	\$ 198,653	\$ 222,336	\$ 204,270
Advance conditional payments	2,386	2,182	547
Accrued interest payable	427	521	403
Patronage distributions payable	594	670	604
Accrued benefits liability	117	120	123
Reserve for unfunded commitments	89	94	94
Other liabilities	610	295	446
<b>Total liabilities</b>	<b>\$ 202,876</b>	<b>\$ 226,218</b>	<b>\$ 206,487</b>
<b>Commitments and Contingencies (See Note 13)</b>			
<b>SHAREHOLDERS' EQUITY</b>			
Protected borrower stock	10	10	10
Capital stock	355	364	372
Unallocated retained earnings	52,605	50,697	48,066
<b>Total shareholders' equity</b>	<b>52,970</b>	<b>51,071</b>	<b>48,448</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 255,846</b>	<b>\$ 277,289</b>	<b>\$ 254,935</b>

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

**Consolidated Statement of Comprehensive Income**

(Dollars in Thousands)

	For the Year Ended December 31		
	2019	2018	2017
<b>INTEREST INCOME</b>			
Loans	\$ 13,048	\$ 12,547	\$ 11,275
Other	1	2	1
<b>Total interest income</b>	<b>13,049</b>	<b>12,549</b>	<b>11,276</b>
<b>INTEREST EXPENSE</b>			
Note payable to CoBank, ACB	6,494	6,109	5,045
Other	31	22	10
<b>Total interest expense</b>	<b>6,525</b>	<b>6,131</b>	<b>5,055</b>
Net interest income	6,524	6,418	6,221
(Credit loss reversal)/Provision for credit losses	(210)	(21)	98
Net interest income after (credit loss reversal)/provision for credit losses	6,734	6,439	6,123
<b>NONINTEREST INCOME</b>			
Loan fees	217	165	165
Patronage distribution from Farm Credit institutions	842	1,068	906
Farm Credit Insurance Fund distribution	60	157	-
Mineral income	212	195	175
Other noninterest income	124	67	74
<b>Total noninterest income</b>	<b>1,455</b>	<b>1,652</b>	<b>1,320</b>
<b>NONINTEREST EXPENSE</b>			
Salaries and employee benefits	2,557	2,393	2,453
Occupancy and equipment	179	125	133
Purchased services from AgVantis, Inc.	914	740	617
Losses on other property owned, net	-	1	-
Farm Credit Insurance Fund premium	162	162	261
Supervisory and examination costs	91	83	80
Other noninterest expense	1,651	1,318	1,201
<b>Total noninterest expense</b>	<b>5,554</b>	<b>4,822</b>	<b>4,745</b>
Income before income taxes	2,635	3,269	2,698
Provision for/(Benefit from)income taxes	133	(32)	63
<b>Net income/Comprehensive Income</b>	<b>\$ 2,502</b>	<b>\$ 3,301</b>	<b>\$ 2,635</b>

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

## Consolidated Statement of Changes in Shareholders' Equity

(Dollars in Thousands)

	Protected Borrower Stock	Capital Stock	Unallocated Retained Earnings	Total Shareholders' Equity
<b>Balance at December 31, 2016</b>	\$ 10	\$ 376	\$ 46,034	\$ 46,420
Net income/Comprehensive income			2,635	2,635
Stock issued	-	20		20
Stock retired	-	(24)		(24)
Patronage distributions:				
Cash			(604)	(604)
Reversal of Patronage			1	1
<b>Balance at December 31, 2017</b>	10	372	48,066	48,448
Net income/Comprehensive income			3,301	3,301
Stock issued	-	20		20
Stock retired	-	(28)		(28)
Patronage distributions: Cash			(670)	(670)
<b>Balance at December 31, 2018</b>	10	364	50,697	51,071
Net income/Comprehensive income			2,502	2,502
Stock issued	-	13		13
Stock retired	-	(22)		(22)
Patronage distributions: Cash			(594)	(594)
<b>Balance at December 31, 2019</b>	<b>\$ 10</b>	<b>\$ 355</b>	<b>\$ 52,605</b>	<b>\$ 52,970</b>

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

**Consolidated Statement of Cash Flows**

(Dollars in Thousands)

	For the Year Ended December 31		
	2019	2018	2017
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income	\$ 2,502	\$ 3,301	\$ 2,635
Adjustments to reconcile net income to net cash provided by/(used in) operating activities:			
Depreciation	136	95	109
(Credit loss reversal)/Provision for credit losses	(210)	(21)	98
Stock patronage from CoBank, ACB	(1)	(1)	(1)
Gains on sales of premises and equipment	(84)	-	(19)
Losses on sales of other property owned	-	1	-
Change in assets and liabilities:			
Decrease/(Increase) in deferred tax asset	133	(33)	(4)
Decrease/(Increase) in accrued interest receivable	1,083	(948)	(478)
Increase in prepaid benefit expense	(281)	(190)	(141)
Decrease/(Increase) in other assets	63	(67)	(52)
(Decrease)/Increase in accrued interest payable	(94)	118	52
Decrease in accrued benefits liability	(3)	(3)	(4)
Increase/(Decrease) in other liabilities	315	(151)	11
Total adjustments	1,057	(1,200)	(429)
Net cash provided by operating activities	3,559	2,101	2,206
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Decrease/(Increase) in loans, net	20,667	(20,435)	(9,155)
Increase in investment in CoBank, ACB	(3)	(339)	(441)
Expenditures for premises and equipment	(209)	(60)	(111)
Proceeds from sales of premises and equipment	84	-	19
Proceeds from sales of other property owned	-	3	3
Net cash provided by/(used in) investing activities	20,539	(20,831)	(9,685)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Net (repayment of)/draw on note payable to CoBank, ACB	(23,683)	18,066	7,766
Increase/(Decrease) in advance conditional payments	204	1,635	(101)
Capital stock retired	(22)	(28)	(24)
Capital stock issued	13	20	20
Cash patronage distributions paid	(670)	(604)	(592)
Net cash (used in)/provided by financing activities	(24,158)	19,089	7,069
Net (decrease)/increase in cash	(60)	359	(410)
Cash at beginning of year	777	418	828
Cash at end of year	\$ 717	\$ 777	\$ 418

**SUPPLEMENTAL CASH INFORMATION:**

Cash paid during the year for:

Interest	\$ 6,619	\$ 6,013	\$ 5,003
Income taxes	\$ -	\$ 33	\$ 128

**SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:**

Stock patronage from CoBank, ACB	\$ 1	\$ 1	\$ 1
Loans transferred to other property owned	\$ -	\$ -	\$ 7
Net (recoveries)/charge-offs	\$ (1)	\$ -	\$ 13
Patronage distributions payable	\$ 594	\$ 670	\$ 604

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

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in Thousands, Except as Noted)

## NOTE 1 – ORGANIZATION AND OPERATIONS

- A. Organization: AgPreference, ACA and its subsidiaries, AgPreference Credit Association, FLCA, (Federal Land Credit Association (FLCA)) and AgPreference Credit Association, PCA, (Production Credit Association (PCA)), (collectively called “the Association”) are member-owned cooperatives which provide credit and credit-related services to or for the benefit of eligible borrowers/shareholders for qualified agricultural purposes in the counties of Jackson, Tillman, Kiowa, Cotton, Harmon and Greer in the state of Oklahoma.

The Association is a lending institution of the Farm Credit System (System), a nationwide system of cooperatively owned banks and associations, which was established by Acts of Congress to meet the credit needs of American agriculture and is subject to the provisions of the Farm Credit Act of 1971, as amended (the Farm Credit Act). At December 31, 2019, the System was comprised of three Farm Credit Banks and one Agricultural Credit Bank (System Banks) and 68 associations.

CoBank, ACB (funding bank or the “Bank”), its related associations and AgVantis, Inc. (AgVantis) are collectively referred to as the District. CoBank provides the funding to associations within the District and is responsible for supervising certain activities of the District Associations. AgVantis, which is owned by the entities it serves, provides technology and other operational services to certain associations and to CoBank. The CoBank District consists of CoBank, 21 Agricultural Credit Associations (ACA), which each have two wholly owned subsidiaries, (a FLCA and a PCA) and AgVantis.

ACA parent companies provide financing and related services through their FLCA and PCA subsidiaries. Generally, the FLCA makes secured long-term agricultural real estate and rural home mortgage loans and the PCA makes short- and intermediate-term loans for agricultural production or operating purposes.

The Farm Credit Administration (FCA) is delegated authority by Congress to regulate the System Banks and Associations. The FCA examines the activities of System institutions to ensure their compliance with the Farm Credit Act, FCA regulations and safe and sound banking practices.

The Farm Credit Act established the Farm Credit System Insurance Corporation (Insurance Corporation) to administer the Farm Credit Insurance Fund (Insurance Fund). The Insurance Fund is required to be used (1) to ensure the timely payment of principal and interest on Systemwide debt obligations (Insured Debt), (2) to ensure the retirement of protected stock at par or stated value, and (3) for other specified purposes. The Insurance Fund is also available for discretionary use by the Insurance Corporation to provide assistance to certain troubled System institutions and to cover the operating expenses of the Insurance Corporation. Each System Bank has been required to pay premiums, which may be passed on to the Association, into the Insurance Fund based on its annual average adjusted outstanding insured debt until the monies in the Insurance Fund reach the “secure base amount,” which is defined in the Farm Credit Act as 2.0% of the aggregate Insured obligations (adjusted to reflect the reduced risk on loans or investments guaranteed by federal or state governments) or such other percentage of the aggregate obligations as the Insurance Corporation, in its sole discretion, determines to be actuarially sound. When the amount in the Insurance Fund exceeds the secure base amount, the Insurance Corporation is required to reduce premiums, as necessary to maintain the Insurance Fund at the 2.0% level. As required by the Farm Credit Act, as amended, the Insurance Corporation may return excess funds above the secure base amount to System institutions.

- B. Operations: The Farm Credit Act sets forth the types of authorized lending activity, persons eligible to borrow, and financial services which can be offered by the Association. The Association is authorized to provide, either directly or in participation with other lenders, credit, credit commitments and related services to eligible borrowers. Eligible borrowers include farmers, ranchers, producers or harvesters of aquatic products, their cooperatives, rural residents and farm-related businesses.

The Association also serves as an intermediary in offering credit life and term life insurance, advance conditional payment accounts, leasing and fee appraisal services.

The Association’s financial condition may be impacted by factors affecting CoBank. The CoBank Annual Report is available free of charge on CoBank’s website, [www.cobank.com](http://www.cobank.com); or may be obtained at no charge by contacting the Association at 3120 North Main, Altus, Oklahoma 73521-1305 or calling (580) 482-3030 or (800) 727-3276. Upon request, Association shareholders will be provided with a copy of the CoBank Annual Report.

The CoBank Annual Report discusses the material aspects of CoBank's and District's financial condition, changes in financial condition, and results of operations. In addition, the CoBank Annual Report identifies favorable and unfavorable trends, significant events, uncertainties and the impact of activities of the Insurance Corporation.

In addition, the Farm Credit Council acts as a full-service federated trade association, which represents the System before Congress, the Executive Branch and others, and provides support services to System institutions on a fee basis.

## **NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

### ***Basis of Presentation and Consolidation***

The consolidated financial statements (the "financial statements") of the Association have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP). The consolidated financial statements include the accounts of AgPreference Credit Association, PCA and AgPreference Credit Association, FLCA and reflect the investments in and allocated earnings of the service organizations in which the Association has partial ownership interests. Inter-company transactions have been eliminated in consolidation.

### ***Reclassifications***

Certain amounts in prior year's financial statements have been reclassified to conform to current financial statement presentation. The accounting and reporting policies of the Association conform to GAAP and prevailing practices within the banking industry.

### ***Use of Estimates***

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the valuation of deferred tax assets and the determination of fair value of financial instruments.

### ***Recently Issued Accounting Pronouncements***

In August 2018, the Financial Accounting Standards Board (FASB) issued guidance entitled "Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Cost." The guidance aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal-use software license). The accounting for the service element of a hosting arrangement that is a service contract is not affected by this guidance. This guidance became effective for interim and annual periods beginning after December 15, 2019. The guidance also requires an entity (customer) to expense the capitalized implementation costs of a hosting arrangement that is a service contract over the term of the hosting arrangement. It further specifies where to present expense and payments in the financial statements. Early adoption is permitted. The guidance is to be applied on a retrospective or prospective basis to all implementation costs incurred after the date of adoption. The Association has evaluated the impact of adoption on the Association's financial condition and its results of operations and determined the impact to be immaterial.

In August 2018, the FASB issued guidance entitled "Disclosure Framework — Changes to the Disclosure Requirements for Defined Benefit Plans." The guidance modifies the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. This guidance becomes effective for fiscal years ending after December 15, 2020. Early adoption is permitted. The guidance is to be applied on a retrospective basis for all periods. The adoption of this guidance will not impact the Association's financial condition or its results of operations, but will impact the employee benefit plan disclosures.

In August 2018, the FASB issued guidance entitled "Disclosure Framework — Changes to the Disclosure Requirements for Fair Value Measurement." The guidance modifies the requirements on fair value measurements by removing, modifying or adding to the disclosures. This guidance became effective for interim and annual periods beginning after December 15, 2019. Early adoption is permitted and an entity is permitted to early adopt any removal or modified disclosures and delay adoption of the additional disclosures until their effective date. The adoption of this guidance will not impact the Association's financial condition or its results of operations, but will impact the fair value measurements disclosures. The Association early adopted the removal and modified disclosures during the fourth quarter of 2018.

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. On October 16, 2019, the FASB approved deferral of the effective date for certain entities for this guidance by two years, which will result in the new credit loss standard becoming effective for interim and annual reporting periods beginning after December 15, 2022. The Association qualifies for the delay in the adoption date. The Association continues to evaluate the impact of adoption on its financial condition and its 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. The guidance became effective for interim and annual periods beginning after December 15, 2018. The adoption of this guidance did not materially impact the Association’s financial condition or its results of operations.

### **Summary of the Association’s Significant Accounting Policies**

- A. Loans and Allowance for Loan Losses: Long-term real estate mortgage loans generally have original maturities ranging from five to 40 years. Substantially all short- and intermediate-term loans made for agricultural production or operating purposes have maturities of ten years or less. Loans are carried at their principal amount outstanding adjusted for charge-offs and deferred loan fees or costs. Interest on loans is accrued and credited to interest income based upon the daily principal amount outstanding. Loan origination fees and direct loan origination costs are capitalized and the net fee or cost is amortized over the life of the related loan as an adjustment to yield.

Impaired loans are loans for which it is probable that not all principal and interest will be collected according to the contractual terms of the loan and are generally considered substandard or doubtful, which is in accordance with the loan rating model, as described below. Impaired loans include nonaccrual loans, restructured loans and loans past due 90 days or more and still accruing interest. A loan is considered contractually past due when any principal repayment or interest payment required by the loan contract is not received on or before the due date. A loan shall remain contractually past due until it is formally restructured or until the entire amount past due, including principal, accrued interest, and penalty interest incurred is collected or otherwise discharged in full.

Loans are generally placed in nonaccrual status when principal or interest is delinquent for 90 days or more (unless adequately collateralized and in the process of collection) or when circumstances indicate that collection of principal and/or interest is in doubt. Additionally, all loans over 180 days past due are placed in nonaccrual status. When a loan is placed in nonaccrual status, accrued interest deemed uncollectible is reversed (if accrued in the current year) and/or included in the recorded nonaccrual balance (if accrued in prior years). Loans are charged-off at the time they are determined to be uncollectible.

A restructured loan constitutes a troubled debt restructuring if for economic or legal reasons related to the debtor’s financial difficulties the Association grants a concession to the debtor that it would not otherwise consider. A concession is generally granted in order to minimize the Association’s economic loss and avoid foreclosure. Concessions vary by program and are borrower-specific and may include interest rate reductions, term extensions, payment deferrals or the acceptance of additional collateral in lieu of payments. In limited circumstances, principal may be forgiven. A loan restructured in a troubled debt restructuring is an impaired loan.

When loans are in nonaccrual status, loan payments are generally applied against the recorded nonaccrual balance. A nonaccrual loan may, at times, be maintained on a cash basis. As a cash basis nonaccrual loan, the recognition of interest income from cash payments received is allowed when the collectability of the recorded investment in the loan is no longer in doubt and the loan does not have a remaining unrecovered charge-off associated with it. Nonaccrual loans may be returned to accrual status when all contractual principal and interest is current, the borrower has demonstrated payment performance, there are no unrecovered prior charge-offs and collection of future payments is no longer in doubt. If previously unrecognized interest income exists at the time the loan is transferred to accrual status, cash received at the time of or subsequent to the transfer is first recorded as interest income until such time as the recorded balance equals the contractual indebtedness of the borrower.

In cases where a borrower experiences financial difficulties and the Association makes certain monetary concessions to the borrower through modifications to the contractual term of the loan, the loan is classified as a troubled debt restructuring. If the borrower’s ability to meet the revised payment schedule is uncertain, the loan is classified as a nonaccrual loan.

The Association purchases loan participations from other System and non-System entities to generate additional earnings and diversify risk. Additionally, the Association sells a portion of certain large loans to other System entities to reduce risk and comply with established lending limits. Loans are sold and the sale terms comply with requirements under Accounting Standards Codification (ASC) 860 "Transfers and Servicing."

The Association uses a two-dimensional loan rating model based on internally generated combined System risk rating guidance that incorporates a 14-point risk-rating scale to identify and track the probability of borrower default and a separate scale addressing loss given default over a period of time. Probability of default is the probability that a borrower will experience a default within 12 months from the date of the determination of the risk rating. A default is considered to have occurred if the lender believes the borrower will not be able to pay its obligation in full or the borrower is past due more than 90 days. We adjust the PD factors in the combined System risk rating guidance to account for our loss emergence period, which has been determined to be 21 months. The loss given default is management's estimate as to the anticipated economic loss on a specific loan assuming default has occurred or is expected to occur within the next 12 months.

Each of the probability of default categories carries a distinct percentage of default probability. The 14-point risk rating scale provides for granularity of the probability of default, especially in the acceptable ratings. There are nine acceptable categories that range from a borrower of the highest quality to a borrower of minimally acceptable quality. The probability of default between 1 and 9 is very narrow and would reflect almost no default to a minimal default percentage. The probability of default grows more rapidly as a loan moves from a "9" to other assets especially mentioned and grows significantly as a loan moves to a substandard (viable) level. A substandard (non-viable) rating indicates that the probability of default is almost certain.

The credit risk rating methodology is a key component of the Association's allowance for loan losses evaluation, and is generally incorporated into its loan underwriting standards and internal lending limit. The allowance for loan losses is maintained at a level considered adequate by management to provide for probable and estimable losses inherent in the loan portfolio. The allowance is increased through provision for loan losses and loan recoveries and is decreased through loan loss reversals and loan charge-offs. The allowance is based on a periodic evaluation of the loan portfolio by management in which numerous factors are considered, including economic conditions, environmental conditions, loan portfolio composition, collateral value, portfolio quality, current production conditions and prior loan loss experience. The allowance for loan losses encompasses various judgments, evaluations and appraisals with respect to the loans and their underlying collateral that, by their nature, contain elements of uncertainty, imprecision and variability. Changes in the agricultural economy and environment and their impact on borrower repayment capacity will cause various judgments, evaluations and appraisals to change over time. Management considers the following macro-economic factors in determining and supporting the level of allowance for loan losses: the concentration of lending in agriculture, combined with uncertainties associated with farmland values, commodity prices, exports, government assistance programs, regional economic effects and weather-related influences.

The allowance for loan losses includes components for loans individually evaluated for impairment and loans collectively evaluated for impairment. Generally, for loans individually evaluated, the allowance for loan losses represents the difference between the recorded investment in the loan and the present value of the cash flows expected to be collected discounted at the loan's effective interest rate, or at the fair value of the collateral, if the loan is collateral dependent. For those loans collectively evaluated for impairment, the allowance for loan losses is determined using the risk-rating model as previously discussed.

- B. **Cash:** Cash, as included in the consolidated financial statements, represents cash on hand and on deposit at financial institutions. At times, cash deposits may be in excess of federally insured limits.
- C. **Investment in CoBank:** The Association's required investment in CoBank is in the form of Class A Stock. The minimum required investment is 4.00 percent of the prior year's average direct loan volume. The investment in CoBank is comprised of patronage based stock and purchased stock. The requirement for capitalizing patronage-based participation loans sold to CoBank is 8.00 percent of the prior ten-year average of such participations sold to CoBank.
- D. **Premises and Equipment:** Land is carried at cost. Premises and equipment are carried at cost less accumulated depreciation. Depreciation is provided on the straight-line method over the estimated useful lives of the assets. Estimated useful life for the building is 30 to 50 years and ranges from 1 to 10 years for furniture, equipment and automobiles. Gains and losses on dispositions are reflected in current operating results. Maintenance and repairs are expensed and improvements above certain thresholds are capitalized.
- E. **Other Property Owned:** Other property owned, consisting of real and personal property acquired through foreclosure or deed in lieu of foreclosure, is recorded at fair value less estimated selling costs upon acquisition.



Any initial reduction in the carrying amount of a loan to the fair value of the collateral received is charged to the allowance for loan losses. On at least an annual basis, revised estimates to the fair value are reported as adjustments to the carrying amount of the asset, provided that such adjusted value is not in excess of the carrying amount at acquisition. Income and expenses from operations and carrying value adjustments are included in net gains/(losses) on other property owned in the Consolidated Statement of Comprehensive Income.

- F. Other Assets and Other Liabilities: Other assets are comprised primarily of accounts receivable, prepaid expenses, and investment in Farm Credit institutions other than CoBank. Significant components of other liabilities primarily include accounts payable and employee benefits.
- G. Advance Conditional Payments: The Association is authorized under the Farm Credit Act to accept advance payments from borrowers. To the extent the borrower's access to such advance payments is restricted, the advance conditional payments are netted against the borrower's related loan balance. Unrestricted advance conditional payments are included in liabilities. Restricted advance conditional payments are primarily associated with mortgage loans, while unrestricted are primarily related to production and intermediate-term loans and insurance proceeds on mortgage loans. Advance conditional payments are not insured. Interest is generally paid by the Association on advance conditional payments.
- H. Employee Benefit Plans: Substantially all employees of the Association participate in the Ninth Farm Credit District Pension Plan (Pension Plan) and/or the Farm Credit Foundations Defined Contribution/401(k) Plan (401(k) Plan). The Pension Plan is a non-contributory defined benefit plan. Benefits are based on compensation and years of service. The Association recognizes its proportional share of expense and contributes its proportional share of funding. The Pension Plan was closed to employees beginning January 1, 2007.

The 401(k) Plan has two components. Employees who do not participate in the Pension Plan may receive benefits through the Employer Contribution portion of the Defined Contribution Plan. In this plan, the Association provides a monthly contribution based on a defined percentage of the employee's salary. Employees may also participate in a Salary Deferral Plan governed by Section 401(k) of the Internal Revenue code. The Association matches a certain percentage of employee contributions. All defined contribution costs are expensed in the same period that participants earn employer contributions.

The Association also participates in the Farm Credit Foundations Retiree Medical Plan. These postretirement benefits (other than pensions) are provided to eligible retired employees of the Association. The anticipated costs of these benefits were accrued during the period of the employee's active service. The authoritative accounting guidance requires the accrual of the expected cost of providing postretirement benefits during the years that the employee renders service necessary to become eligible for these benefits.

- I. Patronage Distribution from CoBank: Patronage distributions from CoBank are accrued by the Association in the year earned.
- J. Income Taxes: As previously described, the ACA holding company conducts its business activities through two wholly owned subsidiaries. Long-term mortgage lending activities are operated through a wholly owned FLCA subsidiary which is exempt from federal and state income tax. Short- and intermediate-term lending activities are operated through a wholly owned PCA subsidiary. Operating expenses are allocated to each subsidiary based on estimated relative service. All significant transactions between the subsidiaries and the parent company have been eliminated in consolidation. The ACA, along with the PCA subsidiary, is subject to income taxes. The Association accounts for income taxes under the liability method. Accordingly, deferred taxes are recognized for estimated taxes ultimately payable or recoverable based on federal, state or local laws.

The Association elected to operate as a cooperative that qualifies for tax treatment under Subchapter T of the Internal Revenue Code. Accordingly, under specified conditions, the Association can exclude from taxable income amounts distributed as qualified patronage refunds in the form of cash, stock or allocated retained earnings. Provisions for income taxes are made only on those earnings that will not be distributed as qualified patronage distributions. Deferred taxes are recorded on the tax effect of all temporary differences based on the assumption that such temporary differences are retained by the Association 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 (over 50 percent probability), based on management's estimate, the deferred tax assets will not be realized. The consideration of valuation allowances involves various estimates and assumptions as to future taxable earnings, including the effects of the Association's expected patronage program, which reduces taxable earnings.

Deferred income taxes have not been recorded by the Association on stock patronage distributions received from the Bank prior to January 1, 1993, the adoption date of accounting guidance on income taxes. Association

management's intent is to permanently invest these and other undistributed earnings in CoBank, or if converted to cash, to pass through any such earnings to Association borrowers through qualified patronage allocations.

The Association has not provided deferred income taxes on amounts allocated to the Association which relate to the Bank's post-1992 earnings to the extent that such earnings will be passed through to Association borrowers through qualified patronage allocations. Additionally, deferred income taxes have not been provided on the Bank's post-1992 unallocated earnings.

- K. Fair Value Measurement: Accounting guidance defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. It describes three levels of inputs that may be used to measure fair value:

Level 1 — Quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 1 assets include assets held in trust funds which relate to the Association's deferred compensation plan and supplemental retirement plan. The trust funds include investments that are actively traded and have quoted net asset values that are observable in the marketplace.

Level 2 — Observable inputs other than quoted prices included within Level 1 that are observable for the asset or liability either directly or indirectly. Level 2 inputs include the following: (a) quoted prices for similar assets or liabilities in active markets; (b) quoted prices for identical or similar assets or liabilities in markets that are not active so that they are traded less frequently than exchange-traded instruments, the prices are not current or principal market information is not released publicly; (c) inputs other than quoted prices that are observable such as interest rates and yield curves, prepayment speeds, credit risks and default rates; and, (d) inputs derived principally from or corroborated by observable market data by correlation or other means.

Level 3 — Unobservable inputs are those that are supported by little or no market activity and that are significant to the determination of the fair value of the assets or liabilities. These unobservable inputs reflect the reporting entity's own assumptions about factors that market participants would use in pricing the asset or liability. Level 3 assets and liabilities include financial instruments whose values are determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. Level 3 assets include other property owned.

The fair value disclosures are presented in Note 14.

- L. Off-balance-sheet credit exposures: Commitments to extend credit are agreements to lend to customers, generally having fixed expiration dates or other termination clauses that may require payment of a fee. Commercial letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. These letters of credit are issued to facilitate commerce and typically result in the commitment being funded when the underlying transaction is consummated between the customer and third party. The credit risk associated with commitments to extend credit and commercial letters of credit is essentially the same as that involved with extending loans to customers and is subject to normal credit policies. Collateral may be obtained based on management's assessment of the customer's creditworthiness.

### **NOTE 3 – LOANS AND ALLOWANCE FOR LOAN LOSSES**

A summary of loans follows.

	December 31		
	2019	2018	2017
Real estate mortgage	\$ 183,033	\$ 196,400	\$ 174,151
Production and intermediate-term	34,396	41,727	42,046
Agribusiness	19,976	18,468	16,887
Rural infrastructure	1,416	2,803	4,124
Rural residential real estate	133	222	256
Agricultural export finance	—	—	1,721
Total loans	\$ 238,954	\$ 259,620	\$ 239,185

The Association purchases or sells loan participations with other parties in order to diversify risk, manage loan volume and comply with FCA regulations. The following table presents information regarding participations purchased and sold as of December 31, 2019.

	Other Farm Credit Institutions		Non-Farm Credit Institutions		Total	
	Purchased	Sold	Purchased	Sold	Purchased	Sold
Real estate mortgage	\$ 5,668	\$ 1,703	\$ 97,606	\$ –	\$103,274	\$ 1,703
Production and intermediate-term	1,830	–	115	–	1,945	–
Agribusiness	6,745	4,802	–	–	6,745	4,802
Rural infrastructure	1,416	–	–	–	1,416	–
Total	\$ 15,659	\$ 6,505	\$ 97,721	\$ –	\$113,380	\$ 6,505

A substantial portion of the Association's loans are collateralized. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the borrower. Collateral held varies, but typically includes farmland and income-producing property, such as crops and livestock, as well as receivables. Long-term real estate loans are secured by first liens on the underlying real property. Federal regulations state that long-term real estate loans are not to exceed 85 percent (97 percent if guaranteed or enhanced by a government agency) of the property's appraised value. However, a decline in a property's market value subsequent to loan origination or advances, or other actions necessary to protect the financial interest of the Association in the collateral, may result in loan to value ratios in excess of the regulatory maximum.

The Association has obtained credit enhancements by entering into Standby Commitment to Purchase Agreements (Agreements) with Federal Agricultural Mortgage Corporation (Farmer Mac), covering loans with principal balance outstanding of \$41.7 million, \$49.5 million and \$42.6 million at December 31, 2019, 2018 and 2017, respectively. Under the Agreements, Farmer Mac agrees to purchase loans from the Association in the event of default (typically four months past due), subject to certain conditions, thereby mitigating the risk of loss from covered loans. In return, the Association pays Farmer Mac commitment fees based on the outstanding balance of loans covered by the Agreements. Such fees, totaling \$221 for 2019, \$220 for 2018 and \$217 in 2017 are reflected in noninterest expense.

In addition to Farmer Mac, credit enhancements with federal government agencies of \$22.8 million at year-end 2019, \$24.3 million at year-end 2018 and \$19.8 million at year-end 2017 were outstanding. Farm Service Agency (FSA) loan guarantees are utilized when appropriate to manage credit risk. Typically, we have a 90 percent guarantee from the FSA which would insure that our loss on a guaranteed loan would not exceed 10 percent of the loss in the event that we instituted foreclosure and collected the loan after liquidation of all loan collateral secured.

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.
- Loss – assets are considered uncollectible.

The following table shows loans and related accrued interest classified under the FCA Uniform Loan Classification system as a percentage of total loans and related accrued interest receivable by loan type as of December 31.

	2019	2018	2017
Real estate mortgage			
Acceptable	95.31%	96.46%	96.51%
OAEM	2.97%	1.83%	1.04%
Substandard	1.72%	1.71%	2.45%
Total	100.00%	100.00%	100.00%
Production and intermediate-term			
Acceptable	89.74%	90.31%	83.34%
OAEM	7.77%	8.44%	16.01%
Substandard	2.49%	1.25%	0.65%
Total	100.00%	100.00%	100.00%
Agribusiness			
Acceptable	100.00%	100.00%	100.00%
Total	100.00%	100.00%	100.00%
Rural infrastructure			
Acceptable	100.00%	100.00%	100.00%
Total	100.00%	100.00%	100.00%
Rural residential real estate			
Acceptable	100.00%	100.00%	85.74%
Substandard	—	—	14.26%
Total	100.00%	100.00%	100.00%
Agricultural export finance			
Acceptable	—	—	100.00%
Total	—	—	100.00%
Total Loans			
Acceptable	94.91%	95.75%	94.49%
OAEM	3.41%	2.76%	3.60%
Substandard	1.68%	1.49%	1.91%
Total	100.00%	100.00%	100.00%

Impaired loans are loans for which it is probable that all principal and interest will not be collected according to the contractual terms. The following presents information relating to impaired loans including accrued interest.

	December 31		
	2019	2018	2017
Nonaccrual loans:			
Current as to principal and interest	\$ 1,317	\$ 1,337	\$ 688
Past due	768	39	378
Total nonaccrual loans	2,085	1,376	1,066
Accrual loans 90 days or more past due	—	5,774	—
Total impaired accrual loans	—	5,774	—
Total impaired loans	\$ 2,085	\$ 7,150	\$ 1,066

The Association had no loans classified as accruing restructured for the years presented.

There were no material commitments to lend additional funds to debtors whose loans were classified impaired for the years presented.

High risk assets consist of impaired loans and other property owned. The following table presents these in a more detailed manner than the previous table. These nonperforming assets (including related accrued interest) are as follows:

	December 31		
	2019	2018	2017
Nonaccrual loans			
Real estate mortgage	<b>\$ 1,610</b>	\$ 1,338	\$ 1,033
Production and intermediate-term	<b>475</b>	38	33
Total nonaccrual loans	<b>2,085</b>	1,376	1,066
Accruing loans 90 days past due			
Real estate mortgage	–	5,774	–
Total accruing loans 90 days past due	–	5,774	–
Total impaired loans	<b>2,085</b>	7,150	1,066
Other property owned	–	–	4
Total high risk assets	<b>\$ 2,085</b>	\$ 7,150	\$ 1,070

Additional impaired loan information is as follows:

	Recorded Investment at 12/31/19	Unpaid Principal Balance*	Related Allowance	Average Impaired Loans	Interest Income Recognized
Impaired loans with a related allowance for credit losses:					
Production and intermediate-term	\$ 474	\$ 469	\$ 57	\$ 239	\$ –
Total	\$ 474	\$ 469	\$ 57	\$ 239	\$ –
Impaired loans with no related allowance for credit losses:					
Real estate mortgage	\$ 1,610	\$ 1,754		\$ 2,720	\$ 73
Production and intermediate-term	1	218		41	3
Total	\$ 1,611	\$ 1,972		\$ 2,761	\$ 76
Total impaired loans:					
Real estate mortgage	\$ 1,610	\$ 1,754	\$ –	\$ 2,720	\$ 73
Production and intermediate-term	475	687	57	280	3
Total	\$ 2,085	\$ 2,441	\$ 57	\$ 3,000	\$ 76

	Recorded Investment at 12/31/18	Unpaid Principal Balance*	Related Allowance	Average Impaired Loans	Interest Income Recognized
Impaired loans with a related allowance for credit losses:					
Real estate mortgage	\$ –	\$ –	\$ –	\$ 122	\$ –
Production and intermediate-term	4	57	3	3	–
Total	\$ 4	\$ 57	\$ 3	\$ 125	\$ –
Impaired loans with no related allowance for credit losses:					
Real estate mortgage	\$ 7,112	\$ 6,968		\$ 4,617	\$ 214
Production and intermediate-term	34	243		272	17
Total	\$ 7,146	\$ 7,211		\$ 4,889	\$ 231
Total impaired loans:					
Real estate mortgage	\$ 7,112	\$ 6,968	\$ –	\$ 4,739	\$ 214
Production and intermediate-term	38	300	3	275	17
Total	\$ 7,150	\$ 7,268	\$ 3	\$ 5,014	\$ 231

	Recorded Investment at 12/31/17	Unpaid Principal Balance*	Average Impaired Loans	Interest Income Recognized
Impaired loans with no related allowance for credit losses:				
Real estate mortgage	\$ 1,033	\$ 1,080	\$ 946	\$ 40
Production and intermediate-term	33	280	59	—
Total	\$ 1,066	\$ 1,360	\$ 1,005	\$ 40

\* Unpaid principal balance represents the recorded principal balance of the loan

There were no impaired loans with a related allowance for credit losses at December 31, 2017.

Interest income is recognized and cash payments are applied on nonaccrual impaired loans as described in Note 2. The following table presents interest income recognized on impaired loans.

	Year Ended December 31		
	2019	2018	2017
Interest income recognized on:			
Nonaccrual loans	\$ 3	\$ 95	\$ 31
Accrual loans 90 days or more past due	73	136	9
Interest income recognized on impaired loans	\$ 76	\$ 231	\$ 40

Interest income on nonaccrual and accruing restructured loans that would have been recognized under the original terms of the loans follows.

	Year Ended December 31		
	2019	2018	2017
Interest income which would have been recognized under the original loan terms	\$ 135	\$ 144	\$ 88
Less: interest income recognized	3	95	31
Interest income not recognized	\$ 132	\$ 49	\$ 57

The following table provides an age analysis of past due loans (including accrued interest).

	30-89 Days Past Due	90 Days or More Past Due	Total Past Due	Not Past Due or less than 30 Days Past Due	Recorded Investment in Loans Outstanding	Recorded Investment > 90 Days and Accruing
<b>December 31, 2019</b>						
Real estate mortgage	\$ —	\$ 293	\$ 293	\$ 186,035	\$ 186,328	\$ —
Production and intermediate-term	6	475	481	35,150	35,631	—
Agribusiness	—	—	—	20,110	20,110	—
Rural infrastructure	—	—	—	1,416	1,416	—
Rural residential real estate	—	—	—	133	133	—
Total	\$ 6	\$ 768	\$ 774	\$ 242,844	\$ 243,618	\$ —

	30-89 Days Past Due	90 Days or More Past Due	Total Past Due	Not Past Due or less than 30 Days Past Due	Recorded Investment in Loans Outstanding	Recorded Investment > 90 Days and Accruing
<b>December 31, 2018</b>						
Real estate mortgage	\$ 260	\$ 5,797	\$ 6,057	\$ 194,763	\$ 200,820	\$ 5,774
Production and intermediate-term	14	3	17	42,926	42,943	—
Agribusiness	—	—	—	18,581	18,581	—
Rural infrastructure	—	—	—	2,800	2,800	—
Rural residential real estate	—	—	—	223	223	—
Total	\$ 274	\$ 5,800	\$ 6,074	\$ 259,293	\$ 265,367	\$ 5,774

	30-89 Days Past Due	90 Days or More Past Due	Total Past Due	Not Past Due or less than 30 Days Past Due	Recorded Investment in Loans Outstanding	Recorded Investment > 90 Days and Accruing
December 31, 2017						
Real estate mortgage	\$ 861	\$ 345	\$ 1,206	\$ 176,465	\$ 177,671	\$ —
Production and intermediate-term	539	33	572	42,644	43,216	—
Agribusiness	—	—	—	16,977	16,977	—
Rural infrastructure	—	—	—	4,136	4,136	—
Rural residential real estate	—	—	—	257	257	—
Mission-related	—	—	—	1,727	1,727	—
Total	\$ 1,400	\$ 378	\$ 1,778	\$ 242,206	\$ 243,984	\$ —

Note: The recorded investment in the loan 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 loan receivable.

A restructuring of a debt constitutes a troubled debt restructuring (TDR) 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.

The following table presents additional information regarding troubled debt restructurings (whether accrual or nonaccrual) that occurred during the year.

	Year Ended December 31					
	2019		2018		2017	
	Outstanding Recorded Investment					
	Pre-modification	Post-modification	Pre-modification	Post-modification	Pre-modification	Post-modification
Troubled debt restructurings:						
Real estate mortgage	\$ 408	\$ 408	\$ –	\$ –	\$ –	\$ –
Total	\$ 408	\$ 408	\$ –	\$ –	\$ –	\$ –

Note: Pre-modification represents the recorded investment in the loan receivable just prior to restructuring and post-modification represents the recorded investment in the loan receivable immediately following the restructuring. The recorded investment is the face amount of the loan receivable 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 loan receivable.

The Association had no TDRs that occurred within the previous 12 months of that year and for which there was a payment default. There were no additional commitments to lend to borrowers whose loans have been modified in TDRs at December 31, 2019, 2018 and 2017.

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 December 31.

	Loans modified as TDRs			TDRs in Nonaccrual Status*		
	2019	2018	2017	2019	2018	2017
Real estate mortgage	\$ 351	\$ —	\$ —	\$ 351	\$ —	\$ —
Production and intermediate-term	—	14	33	—	14	33
Total	\$ 351	\$ 14	\$ 33	\$ 351	\$ 14	\$ 33

\*Represents the portion of loans modified as TDRs that are in nonaccrual status.

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

	Balance at December 31, 2018	Charge- offs	Recoveries	Provision for Loan Losses/(Loan Loss Reversals)	Balance at December 31, 2019
Real estate mortgage	\$ 270	\$ —	\$ —	\$ (88)	\$ 182
Production and intermediate-term	387	3	4	(126)	262
Agribusiness	25	—	—	19	44
Rural infrastructure	19	—	—	(10)	9
Rural residential real estate	1	—	—	—	1
<b>Total</b>	<b>\$ 702</b>	<b>\$ 3</b>	<b>\$ 4</b>	<b>\$ (205)</b>	<b>\$ 498</b>

	Balance at December 31, 2017	Charge- offs	Recoveries	Provision for Loan Losses/(Loan Loss Reversals)	Balance at December 31, 2018
Real estate mortgage	\$ 208	\$ —	\$ —	\$ 62	\$ 270
Production and intermediate-term	452	—	—	(65)	387
Agribusiness	36	—	—	(11)	25
Rural infrastructure	20	—	—	(1)	19
Rural residential real estate	1	—	—	—	1
Agricultural export finance	6	—	—	(6)	—
<b>Total</b>	<b>\$ 723</b>	<b>\$ —</b>	<b>\$ —</b>	<b>\$ (21)</b>	<b>\$ 702</b>

	Balance at December 31, 2016	Charge- offs	Recoveries	Provision for Loan Losses/(Loan Loss Reversals)	Balance at December 31, 2017
Real estate mortgage	\$ 295	\$ —	\$ —	\$ (87)	\$ 208
Production and intermediate-term	337	13	—	128	452
Agribusiness	20	—	—	16	36
Rural infrastructure	19	—	—	1	20
Rural residential real estate	1	—	—	—	1
Agricultural export finance	3	—	—	3	6
<b>Total</b>	<b>\$ 675</b>	<b>\$ 13</b>	<b>\$ —</b>	<b>\$ 61</b>	<b>\$ 723</b>

The Association maintains a separate reserve for unfunded commitments, which is included in Liabilities on our Consolidated Statement of Condition. The related provision for the reserve for unfunded commitments is included as part of the provision for credit losses on the Consolidated Statement of Comprehensive Income, along with the provision for loan losses.

A summary of changes in the reserve for unfunded commitments follows:

	For the Year Ended December 31		
	2019	2018	2017
Balance at beginning of period	\$ 94	\$ 94	\$ 57
(Reversal of)/Provision for reserve for unfunded commitments	(5)	—	37
<b>Total</b>	<b>\$ 89</b>	<b>\$ 94</b>	<b>\$ 94</b>



Additional information on the allowance for loan losses follows:

	Allowance for Loan Losses Ending Balance at December 31, 2019		Recorded Investment in Loans Outstanding Ending Balance at December 31, 2019	
	Individually evaluated for impairment	Collectively evaluated for impairment	Individually evaluated for impairment	Collectively evaluated for impairment
Real estate mortgage	\$ —	\$ 182	\$ 1,610	\$ 184,718
Production and intermediate-term	57	205	475	35,156
Agribusiness	—	44	—	20,110
Rural infrastructure	—	9	—	1,416
Rural residential real estate	—	1	—	133
Total	\$ 57	\$ 441	\$ 2,085	\$ 241,533

	Allowance for Loan Losses Ending Balance at December 31, 2018		Recorded Investment in Loans Outstanding Ending Balance at December 31, 2018	
	Individually evaluated for impairment	Collectively evaluated for impairment	Individually evaluated for impairment	Collectively evaluated for impairment
Real estate mortgage	\$ —	\$ 270	\$ 7,112	\$ 193,708
Production and intermediate-term	3	384	38	42,905
Agribusiness	—	25	—	18,581
Rural infrastructure	—	19	—	2,800
Rural residential real estate	—	1	—	223
Total	\$ 3	\$ 699	\$ 7,150	\$ 258,217

	Allowance for Loan Losses Ending Balance at December 31, 2017		Recorded Investment in Loans Outstanding Ending Balance at December 31, 2017	
	Individually evaluated for impairment	Collectively evaluated for impairment	Individually evaluated for impairment	Collectively evaluated for impairment
Real estate mortgage	\$ —	\$ 208	\$ 1,033	\$ 176,638
Production and intermediate-term	—	452	33	43,183
Agribusiness	—	36	—	16,977
Rural infrastructure	—	20	—	4,136
Rural residential real estate	—	1	—	257
Agricultural export finance	—	6	—	1,727
Total	\$ —	\$ 723	\$ 1,066	\$ 242,918

#### **NOTE 4 – INVESTMENT IN COBANK**

At December 31, 2019, the Association's investment in CoBank is in the form of Class A stock with a par value of \$100.00 per share. The Association is required to own stock in CoBank to capitalize its direct loan balance and participation loans sold to CoBank. The current requirement for capitalizing its direct loan from CoBank is 4.00 percent of the Association's prior year average direct loan balance. The current requirement for capitalizing patronage-based participation loans sold to CoBank is 8.00 percent of the Association's prior ten-year average balance of such participations sold to CoBank. Under the current CoBank capital plan, patronage from CoBank related to these participations sold is paid 75 percent cash and 25 percent Class A stock on participations for agricultural cooperatives and communications customers and 80 percent cash and 20 percent Class A stock on participations for electric distribution and generation cooperatives and rural water customers. The capital plan is evaluated annually by CoBank's board of directors and management and is subject to change.

CoBank may require the holders of its equities to subscribe for such additional capital as may be needed to meet its capital requirements for its joint and several liability under the Farm Credit Act and regulations. In making such a capital call, CoBank shall take into account the financial condition of each such holder and such other considerations, as it deems appropriate.

The Association owned approximately 0.23 percent of the outstanding common stock of CoBank at December 31, 2019, compared with 0.24 percent at December 31, 2018 and 0.25 percent at December 31, 2017.

## **NOTE 5 – PREMISES AND EQUIPMENT**

Premises and equipment consisted of the following.

	<b>December 31</b>		
	<b>2019</b>	<b>2018</b>	<b>2017</b>
Land	\$ 55	\$ 55	\$ 55
Buildings and leasehold improvements	2,035	2,029	1,977
Furniture, equipment and automobiles	937	944	902
Construction in progress	—	—	40
	<b>3,027</b>	<b>3,028</b>	<b>2,974</b>
Less: accumulated depreciation	1,651	1,725	1,636
<b>Total</b>	<b>\$ 1,376</b>	<b>\$ 1,303</b>	<b>\$ 1,338</b>

## **NOTE 6 – NOTE PAYABLE TO COBANK**

The Association's indebtedness to CoBank represents borrowings by the Association to fund its loan portfolio. This indebtedness is collateralized by a pledge of substantially all of the Association's assets and is governed by a General Financing Agreement (GFA). According to the agreement, the aggregate outstanding amount of principal and accrued interest shall not at any time exceed the line of credit. The GFA is subject to periodic renewals in the normal course of business. The GFA will mature on December 31, 2022. The Association was in compliance with the terms and conditions of the GFA as of December 31, 2019. Substantially all borrower loans are match-funded with CoBank. Payments and disbursements are made on the note payable to CoBank on the same basis the Association collects payments from and disburses on borrower loans. The interest rate may periodically be adjusted by CoBank based on the terms and conditions of the borrowing.

	<b>December 31</b>		
	<b>2019</b>	<b>2018</b>	<b>2017</b>
Line of credit	\$ 260,000	\$ 245,000	\$ 225,000
Outstanding principal and accrued interest balance	\$ 199,076	\$ 222,851	\$ 204,672
Average outstanding principal balance under the line of credit	\$ 207,393	\$ 207,487	\$ 198,902
Weighted average interest rate	3.13%	2.94%	2.54%

Under the Farm Credit Act, the Association is obligated to borrow only from CoBank, unless CoBank gives approval to borrow elsewhere. Other than the funding relationship with the Bank, and our advanced conditional payments, the Association has no other uninsured or insured debt. See Note 2 for additional information. CoBank, consistent with FCA regulations, has established limitations on the Association's ability to borrow funds based on specified factors or formulas relating primarily to credit quality and financial condition. At December 31, 2019, the Association's notes payable was within the specified limitations.

The Association has the opportunity to commit loanable funds with CoBank under a variety of programs at either fixed or variable rates for specified timeframes. Participants in the program receive a credit on the committed loanable funds balance classified as a reduction of interest expense. These committed funds are netted against the note payable to the Bank. The average committed funds as of December 31 are as follows.

	<b>2019</b>	<b>2018</b>	<b>2017</b>
Average committed funds	\$ 39,649	\$ 38,599	\$ 36,527
Average rates	2.12%	1.73%	0.93%

## **NOTE 7 – SHAREHOLDERS' EQUITY**

Descriptions of the Association's capitalization, protection mechanisms, regulatory capitalization requirements and restrictions, and equities are provided below.

### **A. Protected Borrower Stock**

Protection of certain stock is provided under the Farm Credit Act which requires the Association, when retiring protected stock, to retire it at par or stated value regardless of its book value. Protected stock includes stock and allocated equities which were outstanding as of January 6, 1988, or were issued or allocated prior to October 6, 1988. If the Association is unable to retire protected stock at par value or stated value, amounts required to retire this stock would be obtained from the Insurance Fund.

### **B. Capital Stock**

In accordance with the Farm Credit Act, each borrower is required to invest in the Association as a condition of borrowing. The borrower normally acquires ownership of the stock at the time the loan is made, but usually does not make a cash investment. Generally, the aggregate par value of the stock is added to the principal amount of the related loan obligation. The Association has a first lien on the stock owned by its borrowers. Retirement of such equities will generally be at the lower of par or book value, and repayment of a loan does not automatically result in retirement of the corresponding stock. Our bylaws generally permit stock to be retired at the discretion of the Board of Directors and in compliance with our capitalization plans, provided prescribed capital standards have been met. At December 31, 2019, we exceeded the prescribed standards. We do not anticipate any significant changes in capital that would affect the normal retirement of stock.

Capitalization bylaws allow stock requirements to range from the lesser of one thousand dollars or 2.00 percent of the amount of the loan to 10.00 percent of the loan. The Board of Directors has the authority to change the minimum required stock level of a shareholder as long as the change is within this range. Currently, the Association has a stock requirement of the lesser of one thousand dollars or 2.00 percent of the amount of the borrower's combined loan volume.

### **C. Regulatory Capitalization Requirements and Restrictions**

The Farm Credit Administration sets minimum regulatory capital requirements for Banks and Associations. Effective January 1, 2017, new regulatory capital surplus requirements for Banks and Associations were adopted. These new requirements replaced the core surplus and total surplus requirements with Common Equity Tier 1, Tier 1 Capital and Total Capital risk-based capital ratio requirements. The new requirements also replaced the existing net collateral ratio for System Banks with a Tier 1 Leverage ratio and an Unallocated Retained Earnings (URE) and URE Equivalents Leverage ratio that are applicable to both the Banks and Associations. The Permanent Capital Ratio continues to remain in effect; however, the risk-adjusted assets are calculated differently than in the past.

The following sets forth the regulatory capital ratio requirements and ratios at December 31.

Ratio	Primary Components of Numerator	Denominator	2019	2018	2017	Minimum with Buffer*	Minimum Requirement
Common Equity Tier 1 (CET1) Capital	Unallocated retained earnings (URE), common cooperative equities (qualifying capital stock and allocated equity) <sup>1</sup>	Risk-adjusted assets	21.65%	20.19%	19.73%	7.0%	4.5%
Tier 1 Capital	CET1 Capital, noncumulative perpetual preferred stock	Risk-adjusted assets	21.65%	20.19%	19.73%	8.5%	6.0%
Total Capital	Tier 1 Capital, allowance for loan losses <sup>2</sup> , common cooperative equities <sup>3</sup> , and term preferred stock and subordinated debt <sup>4</sup>	Risk-adjusted assets	22.00%	20.55%	20.21%	10.5%	8.0%
Tier 1 Leverage**	Tier 1 Capital	Total assets	17.90%	16.18%	16.18%	5.0%	4.0%
Unallocated Retained Earnings and URE Equivalents (UREE) Leverage	URE and URE Equivalents	Total assets	18.86%	16.97%	16.82%	—	1.5%
Permanent Capital	Retained earnings, common stock, non-cumulative perpetual preferred stock and subordinated debt, subject to certain limits	Risk-adjusted assets	21.71%	20.25%	19.82%	—	7.0%

\* The new capital requirements have a three-year phase-in of the capital conservation buffer applied to the risk-adjusted capital ratios. There is no phase-in of the leverage buffer. Amounts shown reflect the full capital conservation buffer.

\*\* Must include the regulatory minimum requirement for the URE and UREE Leverage ratio.

<sup>1</sup> Equities outstanding 7 or more years

<sup>2</sup> Capped at 1.25% of risk-adjusted assets

<sup>3</sup> Outstanding 5 or more years, but less than 7 years

<sup>4</sup> Outstanding 5 or more years

If the capital ratios fall below the total requirements, including the buffer amounts, capital distributions (equity redemptions, dividends and patronage) and discretionary senior executive bonuses are restricted or prohibited without prior FCA approval.

An FCA regulation empowers it to direct a transfer of funds or equities by one or more System institutions to another System institution under specified circumstances. This regulation has not been utilized to date. The Association has not been called upon to initiate any transfers and is not aware of any proposed action under this regulation.

#### D. Description of Equities

The following paragraphs describe the attributes of each class of stock authorized by the Association bylaws and indicate the number of shares outstanding at December 31, 2019. Unless otherwise indicated, all classes of stock have a par value of \$5.00. All classes of stock are transferable to other customers who are eligible to hold such class of stock. Transfers of stock are only allowed as long as the Association meets the regulatory minimum capital requirements. Refer to the Management's Discussion and Analysis Capital Resources discussion for further information.

- Class A Common Stock (Nonvoting, at-risk, no shares outstanding) - Issued in exchange for Class B Common Stock or Class C Common Stock; as a patronage refund; as a dividend; or in exchange for allocated surplus. Retirement is at the sole discretion of the Board of Directors.
- Class B Common Stock (Voting, at-risk, 70,151 shares outstanding) - Issued solely to, and shall be acquired by, borrowers and other applicants who are farmers, ranchers, or producers or harvesters of aquatic products and who are eligible to vote. Class B Common Stock may also be held by those borrowers who exchanged one share of Class F Common Stock for one share of Class B Common Stock. Each Class B Common shareholder shall hold at least one share as long as the holder continues business with the Association. Within two years after the holder terminates its relationship with the Association, any outstanding Class B Common Stock shall be converted to Class A Common Stock. Retirement is at the sole discretion of the Board of Directors.
- Class C Common Stock (Nonvoting, at-risk, 725 shares outstanding) - Class C Common Stock may be issued to borrowers or applicants who are: (a) rural residents, including persons eligible to hold voting stock, to capitalize rural housing loans; (b) persons or organizations furnishing farm-related services; (c) other persons or organizations who are eligible to borrow from or participate with the Association but who are not eligible to hold voting stock. Class C Common Stock may be issued to any person who is not a shareholder but who is eligible to borrow from the Association for the purpose of qualifying such person for technical assistance, financially related services and leasing services offered by the Association. Within two years after the holder terminates its relationship with the Association, any outstanding Class C Common Stock shall be converted to Class A Common Stock. Retirement is at the sole discretion of the Board of Directors.
- Class D Investor Stock (Nonvoting, at-risk, no shares outstanding, par value of one thousand dollars) - Available to outside parties.
- Class E Common Stock (Nonvoting, at-risk, no shares outstanding, par value as may be determined by any agreement of financial assistance between the Association and CoBank) - Issued only to CoBank in consideration of financial assistance to the Association from CoBank. Retirement is at the sole discretion of the Board of Directors.
- Class F Common Stock (Voting, protected, no shares outstanding) - Shall be issued to those individuals and entities who held the same class of stock in a predecessor to the Association. The Association shall not issue any additional Class F Common Stock. Each Class F Common shareholder shall hold at least one share as long as the holder continues business with the Association. Within two years after the holder terminates its relationship with the Association, any outstanding Class F Common Stock shall be converted to Class G Common Stock. Retirement is at the sole discretion of the Board of Directors.
- Class G Common Stock (Nonvoting, protected, 2,042 shares outstanding) - Issued only to those individuals and entities who held the same class of stock in a predecessor to the Association and as necessary for conversions from Class F Common Stock. No further shares of Class G Common Stock will be issued. It must be retired upon repayment of the loan.

The changes in the number of shares of protected and capital stock outstanding during 2019 are summarized in the following table.

<i>Shares in whole numbers</i>	Protected	Capital
Balance outstanding at January 1, 2019	2,042	72,856
Issuances	—	2,511
Retirements	—	(4,491)
Balance outstanding at December 31, 2019	2,042	70,876

#### E. Patronage and/or Dividends

Dividends may be declared or patronage distributions allocated to holders of Class B, F and G Stock out of the whole or any part of net earnings which remain at the end of the fiscal year, as the Board of Directors may determine, in accordance with the regulations for banks and associations of the System. Additionally, patronage distributions may be allocated to System institutions with whom or for whom the Association conducts specified business transactions. However, distributions and retirements are precluded by regulation until the minimum capital adequacy standards have been attained. Amounts not distributed are retained as unallocated retained earnings. The Association made a cash patronage distribution of \$670 in 2019, \$604 in 2018 and \$592 in 2017. The Association declared a \$594 cash patronage during 2019 to be distributed during 2020.

In the event of liquidation or dissolution of the Association, any assets of the Association remaining after payment or retirement of all liabilities shall be distributed in the following order of priority: first, to the holders pro rata of any classes of preferred stock until an amount equal to the aggregate par value of all such shares then issued and outstanding has been distributed to such holders; second, to the holders, pro rata of all classes of common stock, until an amount equal to the aggregate par value of all such shares then issued and outstanding had been distributed to such holders; third, to the holders of allocated surplus evidenced by qualified written notices of allocation, in the order of year of issuance and pro rata by year of issuance; fourth, to the holders of allocated surplus evidenced by non-qualified written notices of allocation, in the order of year of issuance and pro rata by year of issuance; fifth, any remaining assets of the Association after such distributions shall be distributed to present and former members and other patrons on a patronage basis, to the extent practicable. Any remaining assets of the Association after such distributions shall be distributed to holders of all classes of common stock, pro rata.

At each year end, the Board of Directors evaluates whether to retain the Association's net income to strengthen its capital position or to distribute a portion of the net income to customers by declaring a qualified/cash patronage refund. For 2019, the Association allocated 22.54 percent of its patronage-sourced net income to its patrons.

### **NOTE 8 – PATRONAGE DISTRIBUTION FROM FARM CREDIT INSTITUTIONS**

Patronage income recognized from Farm Credit institutions to the Association follows.

	2019	2018	2017
CoBank	\$ 836	\$ 1,063	\$ 901
Farm Credit Foundations	6	5	5
Total	\$ 842	\$ 1,068	\$ 906

Patronage distributed from CoBank was in cash and stock. The amount earned in 2019 was accrued and will be paid by CoBank in March 2020. The amount earned and accrued in 2018 and 2017 was paid by CoBank in March of the following year. In 2018, we received a one-time cash patronage distribution from CoBank of \$123 relating to tax reform changes.

Patronage distributed by Farm Credit Foundations was accrued at the end of the year and will be paid in March 2020. Farm Credit Foundations, a human resource service provider for a number of Farm Credit institutions, provides our payroll and human resource services.

**NOTE 9 – INCOME TAXES**

The provision for/(benefit from) income taxes follows.

	Year Ended December 31		
	2019	2018	2017
Current:			
Federal	\$ –	\$ –	\$ 55
State	–	–	12
Deferred:			
Federal	108	(31)	4
State	25	(1)	(8)
Total provision for/(benefit from) income taxes	\$ 133	\$ (32)	\$ 63

The provision for/(benefit from) income tax differs from the amount of income tax determined by applying the applicable U.S. statutory federal income tax rate to pretax income as follows.

	Year Ended December 31		
	2019	2018	2017
Federal tax at statutory rate	\$ 553	\$ 686	\$ 917
State tax, net	19	(1)	2
Effect of nontaxable entity	(464)	(617)	(830)
Change in valuation allowance	55	–	–
Qualified patronage refunds to borrowers	(75)	(95)	(67)
Change in tax rates	–	–	48
Provision to return difference	40	–	–
Other	5	(5)	(7)
Provision for/(Benefit from) income taxes	\$ 133	\$ (32)	\$ 63

Deferred tax assets and liabilities are comprised of the following.

	December 31		
	2019	2018	2017
Deferred income tax assets:			
Allowance for loan losses	\$ 96	\$ 126	\$ 146
Nonaccrual loan interest	42	33	28
Gross deferred tax assets	138	159	174
Less: valuation allowance	(67)	–	–
Deferred income tax liabilities:			
Bank patronage allocations	(40)	–	(52)
Excess book depreciation > Tax depreciation	(24)	(19)	(15)
Sale of fixed assets	(7)	(7)	(7)
Gross deferred tax liability	(71)	(26)	(74)
Net deferred tax asset	\$ –	\$ 133	\$ 100

The calculation of deferred tax assets and liabilities involves various management estimates and assumptions as to future taxable earnings, including the amount of non-patronage income and patronage income retained. The expected future tax rates are based upon enacted tax laws.

The Association recorded a valuation allowance of \$67 thousand in 2019. The Association will continue to evaluate the realizability of the deferred tax assets and adjust the valuation allowance accordingly.

Tax expense in 2017 resulted from the enactment of federal tax legislation in late December 2017, which, among other things, lowered the federal corporate tax rate from 35 percent to 21 percent beginning in 2018. In accordance with GAAP, the change to the lower corporate tax rate led to a revaluation of the Association's deferred tax assets and deferred tax liabilities in the period of enactment (2017).

The Association has no uncertain tax positions as of December 31, 2019, 2018 or 2017. The Association recognizes interest and penalties related to unrecognized tax positions as an adjustment to income tax expense. The tax years that remain open for federal and major state income tax jurisdictions are 2016 and forward.

**NOTE 10 – EMPLOYEE BENEFIT PLANS**

Certain employees participate in the Ninth Retirement Plan, a multi-employer defined benefit retirement plan. The Department of Labor has determined the plan to be a governmental plan; therefore, the plan is not subject to the provisions of the Employee Retirement Income Security Act of 1974, as amended (ERISA). As the plan is not subject to ERISA, the plan's benefits are not insured by the Pension Benefit Guaranty Corporation. Accordingly, the amount of accumulated benefits that participants would receive in the event of the plan's termination is contingent on the sufficiency of the plan's net assets to provide benefits at that time. This Plan is noncontributory and covers eligible employees. The assets, liabilities, and costs of the plan are not segregated by participating entities. As such, plan assets are available for any of the participating employers' retirees at any point in time. Additionally, if a participating employer stops contributing to the plan, the unfunded obligations of the plan may be borne by the remaining participating employers. Further, if the Association chooses to stop participating in the plan, the Association may be required to pay an amount based on the underfunded status of the plan, referred to as a withdrawal liability. Because of the multi-employer nature of the plan, any individual employer is not able to unilaterally change the provisions of the plan. If an employee moves to another employer within the same plan, the employee benefits under the plan transfer. Benefits are based on salary and years of service. There is no collective bargaining agreement in place as part of this plan.

The defined benefit pension plan reflects an unfunded liability totaling \$81.2 million at December 31, 2019. The pension benefits funding status reflects the net of the fair value of the plan assets and the projected benefit obligation at the date of these consolidated financial statements. The projected benefit obligation is the actuarial present value of all benefits attributed by the pension benefit formula to employee service rendered prior to the measurement date based on assumed future compensation levels. The projected benefit obligation of the plan was \$333.7 million at December 31, 2019, \$274.4 million at December 31, 2018 and \$292.6 million at December 31, 2017. The fair value of the plan assets was \$252.5 million at December 31, 2019, \$204.9 million at December 31, 2018 and \$208.0 million at December 31, 2017. The amount of the pension benefits funding status is subject to many variables including performance of plan assets and interest rate levels. Therefore, changes in assumptions could significantly affect these estimates.

Costs are determined for each individual employer based on costs directly related to its current employees as well as an allocation of the remaining costs based proportionately on the estimated ownership percentage of the employer under this plan. The Association recognizes its proportional share of expense and contributes a proportional share of funding. Total plan expense for participating employers was \$6.8 million in 2019, \$10.8 million in 2018 and \$12.7 million in 2017. The Association's allocated share of plan expenses included in salaries and employee benefits was \$145 in 2019, \$223 in 2018 and \$246 in 2017. Participating employers contributed \$20.0 million in 2019, \$20.0 million in 2018 and \$20.0 million in 2017 to the plan. The Association's allocated share of these pension contributions was \$426 in 2019, \$413 in 2018 and \$387 in 2017. While the plan is a governmental plan and is not subject to minimum funding requirements, the employers contribute amounts necessary on an actuarial basis to provide the plan with sufficient assets to meet the benefits to be paid to participants. The amount of the total employer contributions expected to be paid into the pension plans during 2020 is \$30.0 million. The Association's allocated share of these pension contributions is expected to be \$669. The amount ultimately to be contributed and the amount ultimately recognized as expense as well as the timing of those contributions and expenses, are subject to many variables including performance of plan assets and interest rate levels. These variables could result in actual contributions and expenses being greater than or less than anticipated.

Postretirement benefits other than pensions are provided through the Farm Credit Foundations Retiree Medical Plan to retired employees of the Association. Benefits provided are determined on a graduated scale based on years of service. The anticipated costs of these benefits were accrued during the period of the employee's active service. Postretirement benefits (primarily health care benefits) included in salaries and employee benefits were income of \$2 in 2019, \$1 in 2018 and \$2 in 2017. The Association made cash contributions of \$1 in 2019, \$2 in 2018 and \$2 in 2017.

The Association also participates in the Farm Credit Foundations Defined Contribution/401(k) Plan. Employees who do not participate in the Pension Plan may receive benefits through the Employer Contribution portion of the Contribution Plan. In this plan, the Association provides a monthly contribution based on a defined percentage of the employee's salary. Employees may also participate in a Salary Deferral Plan governed by Section 401(k) of the Internal Revenue Code. The Association matches a certain percentage of employee contributions to the plan. Employer contributions to the Contribution Plan were \$154 in 2019, \$136 in 2018 and \$135 in 2017.

**NOTE 11 – RELATED PARTY TRANSACTIONS**

In the ordinary course of business, the Association enters into loan transactions with officers and directors of the Association, their immediate families and other organizations with which such persons may be associated. Such



loans are subject to special approval requirements contained in the FCA regulations and are made on the same terms, including interest rates, amortization schedules and collateral, as those prevailing at the time for comparable transactions with unrelated borrowers.

The Association has a policy that loans to directors and senior officers must be maintained at an Acceptable or Other Assets Especially Mentioned (OAEM) credit classification. If the loan falls below the OAEM credit classification, corrective action must be taken and the loan brought back to either Acceptable or OAEM within a year. If not, the director or senior officer must resign from the Board of Directors or employment.

Loan information to related parties for the years ended December 31 is shown below.

	2019	2018	2017
Beginning balance	\$ 24,102	\$ 12,279	\$ 11,311
New loans	14,507	15,215	6,413
Repayments	(14,182)	(15,873)	(5,445)
Reclassifications*	45	12,481	—
Ending balance	\$ 24,472	\$ 24,102	\$ 12,279

\* Represents loans that were once considered related party, but are no longer considered related party, or loans that were not related party that subsequently became related party loans.

In the opinion of management, none of the loans outstanding to officers and directors at December 31, 2019 involved more than a normal risk of collectibility.

The Association also has business relationships with certain other System entities. The Association paid \$914 in 2019, \$740 in 2018 and \$617 in 2017 to AgVantis for technology services and \$1 in 2019, \$12 in 2018 and \$9 in 2017 to CoBank for operational services. The Association paid \$68 in 2019, \$78 in 2018 and \$73 in 2017 to Foundations for human resource services.

## **NOTE 12 – REGULATORY ENFORCEMENT MATTERS**

There are no regulatory enforcement actions in effect for the Association.

## **NOTE 13 – COMMITMENTS AND CONTINGENCIES**

The Association has various commitments outstanding and contingent liabilities. With regard to contingent liabilities, there are no actions pending against the Association in which claims for monetary damages are asserted.

The Association may participate in financial instruments with off-balance sheet risk to satisfy the financing needs of its borrowers and to manage their exposure to interest-rate risk. These financial instruments include commitments to extend credit. The instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the consolidated financial statements. Commitments to extend credit are agreements to lend to a borrower as long as there is not a violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee by the borrower. At December 31, 2019, \$27.7 million of commitments to extend credit were outstanding.

Since many of these commitments are expected to expire without being drawn upon, the total commitments do not necessarily represent future cash requirements. However, these credit-related financial instruments have off-balance-sheet credit risk because their amounts are not reflected on the Consolidated Statement of Condition until funded or drawn upon. The credit risk associated with issuing commitments is substantially the same as that involved in extending loans to borrowers and management applies the same credit policies to these commitments. Upon fully funding a commitment, the credit risk amounts are equal to the contract amounts, assuming that borrowers fail completely to meet their obligations and the collateral or other security is of no value. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the borrower.

## **NOTE 14 – FAIR VALUE MEASUREMENTS**

Accounting guidance defines fair value as the exchange price that would be received for an asset or paid to transfer a liability in an orderly transaction between market participants in the principal or most advantageous market for the asset or liability. The fair value measurement is not an indication of liquidity. See Note 2 for additional information.

The Association has no assets or liabilities measured at fair value on a recurring basis for the periods presented.

Assets measured at fair value on a non-recurring basis at December 31 for each of the fair value hierarchy values are summarized as follows:

	Fair Value Measurement Using			Total Fair Value
	Level 1	Level 2	Level 3	
Assets:				
<b>2019</b>				
Loans	\$ —	\$ —	\$ 417	\$ 417
Other property owned	\$ —	\$ —	\$ —	\$ —
2018				
Loans	\$ —	\$ —	\$ 14	\$ 14
Other property owned	\$ —	\$ —	\$ —	\$ —
2017				
Loans	\$ —	\$ —	\$ 33	\$ 33
Other property owned	\$ —	\$ —	\$ 4	\$ 4

The Association has no liabilities measured at fair value on a non-recurring basis for any of the periods presented.

### Valuation Techniques

As more fully discussed in Note 2, accounting 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. Fair values of financial instruments represent the estimated amount to be received to sell an asset or paid to transfer or extinguish a liability in active markets among willing participants at the reporting date. Due to the uncertainty of expected cash flows resulting from financial instruments, the use of different assumptions and valuation methodologies could significantly affect the estimated fair value amounts. Accordingly, the estimated fair values may not be indicative of the amounts for which the financial instruments could be exchanged in a current or future market transaction. The following presents a brief summary of the valuation techniques used by the Association for assets and liabilities subject to fair value measurement.

### Loans

For impaired loans measured on a non-recurring basis, 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, a majority of these loans have fair value measurements that fall within Level 3 of the fair value 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. The fair value of these loans would fall under Level 2 of the hierarchy if the process only uses independent appraisals and other market-based information.

### Other Property Owned

Other property owned is generally classified as Level 3 of the fair value hierarchy. 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.

## NOTE 15 – QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

Quarterly results of operations for the years ended December 31, 2019, 2018 and 2017, follow.

	2019				
	First	Second	Third	Fourth	Total
Net interest income	\$ 1,680	\$ 1,721	\$ 1,594	\$ 1,529	\$ 6,524
(Credit loss reversal)/provision for credit losses	(167)	38	62	(143)	(210)
Noninterest expense, net	1,048	920	828	1,436	4,232
Net income	\$ 799	\$ 763	\$ 704	\$ 236	\$ 2,502

	2018				
	First	Second	Third	Fourth	Total
Net interest income	\$ 1,582	\$ 1,578	\$ 1,615	\$ 1,643	\$ 6,418
(Credit loss reversal)/Provision for credit losses	(119)	139	(88)	47	(21)
Noninterest expense, net	735	879	611	913	3,138
Net income	\$ 966	\$ 560	\$ 1,092	\$ 683	\$ 3,301

	2017				
	First	Second	Third	Fourth	Total
Net interest income	\$ 1,603	\$ 1,505	\$ 1,525	\$ 1,588	\$ 6,221
Provision for credit losses/(Credit loss reversal)	58	19	185	(164)	98
Noninterest expense, net	911	844	816	917	3,488
Net income	\$ 634	\$ 642	\$ 524	\$ 835	\$ 2,635

### **NOTE 16 – SUBSEQUENT EVENTS**

On March 3, 2020 and March 4, 2020, respectively, the boards of directors of Farm Credit of Western Oklahoma, ACA and Ag Preference, ACA approved a letter of intent to pursue a merger. The Associations will be completing due diligence over the next few months in order to develop definitive terms of the merger. The Associations anticipate a merger date of January 1, 2021 or as soon as practicable thereafter, subject to receiving all regulatory and shareholder approvals required. The Association does not expect there to be any material negative impact to its operations as a result of the merger.

The Association has evaluated subsequent events through March 24, 2020 which is the date the financial statements were issued, and no other material subsequent events were identified.

# DISCLOSURE INFORMATION REQUIRED BY FARM CREDIT ADMINISTRATION REGULATIONS

(Amounts in Whole Dollars)

## **DESCRIPTION OF BUSINESS**

The description of the territory served, persons eligible to borrow, types of lending activities engaged in and financial services offered, and related Farm Credit organizations required to be disclosed in this section is incorporated herein by reference from Note 1 to the financial statements, "Organization and Operations," included in this annual report to shareholders.

The description of significant developments that had or could have a material impact on earnings or interest rates to borrowers, acquisitions or dispositions of material assets, material changes in the manner of conducting the business, seasonal characteristics, and concentrations of assets, if any, required to be disclosed in this section, is incorporated herein by reference from "Management's Discussion and Analysis" (MD&A) included in this annual report to shareholders.

## **DESCRIPTION OF PROPERTY**

The following table sets forth certain information regarding the properties of the Association:

Location	Description	Form of Ownership
3120 North Main Altus, Oklahoma	Altus Administration and Altus Branch Office Building	Owned
3100 North Main Altus, Oklahoma	Office Building (Leased out)	Owned

## **LEGAL PROCEEDINGS AND ENFORCEMENT ACTIONS**

Information required to be disclosed in this section is incorporated herein by reference from Note 12 to the financial statements, "Regulatory Enforcement Matters," and Note 13 to the financial statements, "Commitments and Contingencies," included in this annual report to shareholders.

## **DESCRIPTION OF CAPITAL STRUCTURE**

Information required to be disclosed in this section is incorporated herein by reference from Note 7 to the financial statements, "Shareholders' Equity," included in this annual report to shareholders.

## **DESCRIPTION OF LIABILITIES**

The description of debt outstanding required to be disclosed in this section is incorporated herein by reference from Note 6 to the financial statements, "Note Payable to CoBank," included in this annual report to shareholders.

The description of advance conditional payments is incorporated herein by reference to Note 2 to the financial statements, "Summary of Significant Accounting Policies," included in this annual report to shareholders.

The description of contingent liabilities required to be disclosed in this section is incorporated herein by reference from Note 13 to the financial statements included in this annual report to shareholders.

## **SELECTED FINANCIAL DATA**

The selected financial data for the five years ended December 31, 2019, required to be disclosed in this section is incorporated herein by reference from the "Five-Year Summary of Selected Consolidated Financial Data," included in this annual report to shareholders.

## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

"Management's Discussion and Analysis," which appears within this annual report to shareholders and is required to be disclosed in this section, is incorporated herein by reference.

## **DIRECTORS AND SENIOR OFFICERS**

The following represents certain information regarding the directors and senior officers of the Association.

### **DIRECTORS**

Joe Kelly	Chairman of the Board, serving a three-year term which expires in 2020. Mr. Kelly's principal occupation has been farming since 1976. He has been an Association member for 37 years. He presently serves as President of the Humphreys Farmers Coop Board, whose principal business is cotton ginning, wheat merchandising, storage and selling fertilizer to area farmers. He also serves on the board of Great Plains Commodities, LLC. Mr. Kelly is a member of Altus Nazarene Church and Gideon International.
Lonnie Olson	Vice Chairman, serving a three-year term which expires in 2020. Mr. Olson serves as the Association's Audit Committee Chairman. He is a graduate of Oklahoma State University. Mr. Olson resides in Hobart, Oklahoma. He has worked for Edward Jones Investments as a Financial Advisor since 1997. He also has rental properties and a cattle operation. He is President of the Hobart Community Foundation, serves on the board of Kiowa County Economic Development and on the Kiowa County 529 Ambulance Board. He is President of a private corporation and a member of the Hobart Kiwanis Club. Mr. Olson is a member of the Hobart Church of Christ.
Donnie Bowles	Director, serving a three-year term which expires in 2022. Mr. Bowles' principal occupation has been farming since 1966. He farms wheat and has a cattle operation. He has been an Association member for 41 years. He served on the Board of Education at Big Pasture School District for 14 years. Mr. Bowles is a member of the Central Baptist Church.
Roger Fischer	Director, serving a three-year term which expires in 2021. Mr. Fischer has been farming since 1976. He is a 1975 graduate of Cameron University. Mr. Fischer has been an Association member for 37 years. He is a member of the board of directors of Oklahoma Cotton Council. Mr. Fischer is a member of the Peace Congregational Church.
John Huddleston	Director, serving a three-year term which expires in 2021. Mr. Huddleston's principal occupation has been farming since 1965. He is an auctioneer and real estate broker. Mr. Huddleston has been an Association member for 42 years. He is a member of the Masonic Lodge and the First Baptist Church.
Robert Williams	Director, serving a three-year term which expires in 2022. Mr. Williams' principal occupation is farming/ranching. He has been involved in farming since 1990. Mr. Williams has been an Association member for 24 years. He is a graduate of Oklahoma State University. He also serves on the Board of Regents for Western Oklahoma State College, the board of Baptist Medical and Dental Missions International, Harmon County Civic Trust and the Harmon County Water Corporation.
Brent York	Director, serving a three-year term which expires in 2020. Mr. York's principal occupation has been farming since 1980. He currently serves as County Commissioner for Greer County, District I. He has been an Association member for 33 years and has served on the AgPreference, ACA Board since 1999. He is retired from USDA, Natural Resources Conservation Service. Mr. York is on the board of trustees of South Western Oklahoma Development Authority. He is a member of the Church of Christ.
Jimmy Williams	Vice Chairman, served a three-year term which expired in 2019. Mr. Williams' principal occupation is farming/ranching. He is involved in a family wheat and stocker cattle operation. Mr. Williams has been farming since 1967 and has been an Association member since 1969. He is a Deacon at Hollis First Baptist Church.

### **SENIOR OFFICERS**

Cecil H. Sheperson	President and Chief Executive Officer since March 1989. Mr. Sheperson has been an employee of the Farm Credit System for the past 45 years with the last 40 years in senior management positions.
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Raylon Shumaker	Senior Vice President – Administration and Appraisal. Mr. Shumaker has been an employee of the Farm Credit System for 27 years and has only been in his present position since May 2019. Mr. Shumaker's past 5 years business experience includes real estate appraisal, collateral evaluation, and appraisal review. Mr. Shumaker also has a part time farming and ranching operation.
Jana Turner	Senior Vice President – Finance and Chief Financial Officer. Ms. Turner has been an employee of the Farm Credit System for 9 years. Ms. Turner has over 35 years of financial experience. She is a Certified Public Accountant and has served as the CFO for the past five years. Ms. Turner also serves on two nonprofit organization boards.
Diane Beach	Senior Vice President – Credit and Chief Credit Officer. Mrs. Beach has been an employee of the Farm Credit System for 25 years and has been in her current position since July 2019. She spent one year in credit support and the past 24 years in lending. Mrs. Beach is partners with her husband in their family farming/ranching operation. Mrs. Beach also currently serves on the Jackson County Excise Board and the board of the Elmer Rural Volunteer Fire Department.
John Kelln	Vice President – Agribusiness. Mr. Kelln has been an employee of the Farm Credit System for 34 years and has been in his present position for 16 years. His past 5 years of experience has been with senior management and agricultural lending. Mr. Kelln has a farming and ranching interest. He also serves as a board member of a hospital authority.
Randy Baden	Senior Vice President – Administration and Appraisal. Mr. Baden retired effective February 28, 2019. He had been an employee of the Farm Credit System for 33 years and was in his position for 21 years.
Ira Hopkins	Senior Vice President – Credit and Chief Credit Officer. Mr. Hopkins terminated his employment with the Association effective June 28, 2019. Mr. Hopkins was an employee of the Farm Credit System for 25 years and was the Chief Credit Officer for over 8 years.
Jack Stone	Senior Vice President – Correspondent Lending. Mr. Stone retired effective June 28, 2019. Mr. Stone had been an employee of the Farm Credit System for 28 years and was in his position for 16 years.

### **COMPENSATION OF DIRECTORS AND SENIOR OFFICERS**

Directors of the Association were compensated for services on a per diem basis at the rate of \$650 per day, and were reimbursed mileage at the rate of \$0.58 per mile while on official business.

Additional information for each director is provided below:

Name	Number of Days Served at		Compensation for			Total Compensation Paid During 2019
	Board Meetings	Other Official Activities	Board Meetings and Other Official Duties	Audit Committee	Compensation Committee	
Joe Kelly	10.0	7.0	\$ 11,050	\$ –	\$ –	\$ 11,050
Lonnie Olson	10.0	10.5	10,075	3,250	–	13,325
Donnie Bowles	9.0	9.0	11,050	–	650	11,700
Roger Fischer	10.0	17.0	14,300	3,250	–	17,550
John Huddleston	10.0	16.0	16,250	–	650	16,900
Robert Williams	5.0	5.0	5,850	650	–	6,500
Brent York	10.0	11.0	13,000	–	650	13,650
Jimmy Williams	5.0	5.0	4,550	1,950	–	6,500
Total Compensation			\$ 86,125	\$ 9,100	\$ 1,950	\$ 97,175

Directors and senior officers are reimbursed for travel, subsistence and other expenses related to Association business according to Association policy. A copy of this policy is available to shareholders upon request. Aggregate reimbursements to directors for travel, subsistence and other related expenses were \$57,623 in 2019, \$57,859 in 2018 and \$50,288 in 2017. There was no non-cash compensation paid to directors during 2019.

Information on the President and Chief Executive Officer (CEO), senior officers and other highly compensated individuals is provided below. Certain amounts in prior years have been restated to conform to the current year's presentation.

President and CEO	Year	Salary	Incentive Compensation	Perquisites	Other	Total
Cecil H. Sheperson	2019	\$ 233,767	\$ –	\$ 18,290	\$ 333,551	\$ 585,608
Cecil H. Sheperson	2018	\$ 227,501	\$ 32,310	\$ 13,937	\$ 2,180	\$ 275,928
Cecil H. Sheperson	2017	\$ 223,752	\$ 11,982	\$ 14,418	\$ 43,925	\$ 294,077

Aggregate Number of Senior Officers/Highly Compensated Individuals (excluding CEO)	Year	Salary	Incentive Compensation	Perquisites	Other	Total
5	2019	\$ 567,866	\$ –	\$ 24,400	\$ 960,224	\$ 1,552,490
5	2018	\$ 586,664	\$ 99,099	\$ 17,094	\$ 27,646	\$ 730,503
5	2017	\$ 570,244	\$ 35,420	\$ 17,332	\$ 273,526	\$ 896,522

Disclosure of information on the total compensation paid during the last fiscal year to any senior officer, or to any other officer included in the aggregate, is available upon request.

Perquisites/other represents allowance for use of Association automobiles and life insurance premiums. Other includes employer match on defined contribution plan available to all employees, any changes in the value of pension benefits, including the two senior officer retirees in 2019 and a Christmas bonus. The change in value of the pension benefits is defined as the vested portion of the present value of the accumulated benefit obligation from December 31 of the prior year, disclosed in Note 10 of the Financial Statements. No tax reimbursements are made to senior officers/highly compensated individuals.

We believe the design and governance of our compensation program is consistent with the highest standards of risk management and provides total compensation that promotes our mission to ensure a safe, sound, and dependable source of credit and related services for agriculture and rural America. Our compensation philosophy aims to provide a competitive total rewards package that will enable us to attract and retain highly qualified officers with the requisite expertise and skills while achieving desired business results aligned with the best interest of our shareholders. The design of our senior officer compensation program supports our risk management goals and includes (1) a balanced mix of base and variable pay, (2) a balanced use of performance measures that are risk-adjusted where appropriate, (3) a pay-for-performance process that allocates individual awards based on both results and how those results were achieved, and (4) a long-term portion of variable pay to encourage retention and alignment with shareholder interests.

Senior officers are compensated with a mix of direct cash and long-term compensation as well as retirement plans generally available to all employees. Our Board of Directors determines the appropriate balance of short-term and long-term compensation while keeping in the mind their responsibilities to our shareholders. Base salary and short-term incentive are intended to be competitive with annual compensation for comparable position at peer organizations.

Senior officer base salaries reflect the officer's experience and level of responsibility. Base salaries are subject to review and approval by the Compensation Committee of our Board of Directors and are subject to adjustment based on changes in responsibilities or competitive market conditions.

In addition to base salary, the President, senior officers and all employees can earn additional compensation under an administrative incentive plan which is tied to the Association's overall business performance and the individual's rating. It is based on a fiscal year and is designed to motivate employees to exceed financial and credit quality performance targets approved by the Compensation Committee and Board of Directors. These targets include return on assets, credit quality, loan volume, and other key ratios. Short-term incentives are shown in the year paid during the first quarter.

The President participates in a long-term agreement. This agreement is based on fiscal year targets established by the Board of Directors. Targets include loan volume, core earnings, credit administration and credit quality. The compensation is included in the Salary column and is earned and paid in the same year.

The CEO and certain Senior Officers participate in the Ninth Farm Credit District Pension Plan (Pension Plan), which is a qualified defined benefit plan. Additionally, substantially all employees participate in the 401(k) Plan, which has

an employer matching contribution. Information on pension benefits attributable to the CEO, senior officers and other highly compensated individuals follows.

As of December 31, 2019				
President and CEO	Plan	Years of Credited Service	Present Value of Accumulated Benefits	Payments Made During the Reporting Period
Cecil H. Shepersen	Pension Plan	46	\$ –	\$ 150,281

  

Aggregate Number of Senior Officers/ Highly Compensated Individuals	Plan	Average Years of Credited Service	Present Value of Accumulated Benefits	Payments Made During the Reporting Period
1	Pension Plan	27	\$ 708,000	\$ –

In general, the Pension Plan is a qualified plan and provides participants with a 50% joint-and-survivor annuity benefit at normal retirement that is equal to 1.50% of average monthly compensation during the 60 consecutive months in which an individual receives his highest compensation (High 60) multiplied by his years of benefit service, plus 0.25% of the amount by which the High 60 exceeds covered compensation multiplied by years of benefit service. The benefit is actuarially adjusted if the individual chooses a different form of distribution than a 50% joint-and-survivor annuity, such as a lump sum distribution. The pension valuation was determined using a blended approach assuming half of the benefits would be paid as a lump sum and half as an annuity at the participants earliest unreduced retirement age. The Pension Plan pays benefits up to the applicable limits under the Internal Revenue Code.

### **TRANSACTIONS WITH SENIOR OFFICERS AND DIRECTORS**

The Association's policies on loans to and transactions with its officers and directors, required to be disclosed in this section are incorporated herein by reference from Note 11 to the financial statements, "Related Party Transactions," included in this annual report to shareholders.

### **INVOLVEMENT OF SENIOR OFFICERS AND DIRECTORS IN CERTAIN LEGAL PROCEEDINGS**

There were no matters which came to the attention of management or the Board of Directors regarding involvement of senior officers or current directors in specified legal proceedings which are required to be disclosed in this section.

### **BORROWER PRIVACY STATEMENT**

Since 1972, Farm Credit Administration (FCA) regulations have forbidden the directors and employees of Farm Credit institutions from disclosing personal borrower information to others without borrower consent. The Association does not sell or trade customers' personal information to marketing companies or information brokers. Additional information regarding FCA rules governing the disclosure of customer information can be obtained by contacting the Association.

### **RELATIONSHIP WITH COBANK, ACB (COBANK)**

The Association is materially affected by CoBank's financial condition and results of operations.

The Association's statutory obligation to borrow from CoBank is discussed in Note 6. Financial assistance agreements between the Association and CoBank are discussed in Note 7. Association requirement to invest in CoBank and CoBank's ability to access capital of the Association is discussed in Note 4 to the financial statements, "Investment in CoBank," included in this annual report to shareholders. CoBank's role in mitigating the Association's exposure to interest rate risk is discussed in the MD&A section – Liquidity.

CoBank is required to distribute its Annual Report to shareholders of the Association if the bank experiences a significant event that has a material effect on the Association as defined by FCA regulations.

### **RELATIONSHIP WITH INDEPENDENT AUDITORS**

There were no changes in independent auditors since the prior annual report to shareholders and there were no material disagreements with our independent auditors on any matter of accounting principles or financial statement disclosure during this period.



## **FINANCIAL STATEMENTS**

The financial statements, together with the report thereon of PricewaterhouseCoopers LLP dated March 24, 2020, and the Report of Management, appearing as part of this annual report to shareholders, are incorporated herein by reference.

## **COBANK ANNUAL AND QUARTERLY REPORTS TO SHAREHOLDERS**

The shareholders' investment in the Association is materially affected by the financial condition and results of operations of CoBank. Consequently, the Association's annual and quarterly reports should be read in conjunction with CoBank's 2018 Annual and Quarterly Reports to Shareholders. Quarterly reports are available approximately 40 days after the calendar quarter end and annual reports are available approximately 75 days after the calendar year end. A copy of these reports may be obtained free upon request from the Association. The Association is located at 3120 North Main, Altus, Oklahoma 73521-1305, or may be contacted by calling (580) 482-3030 or (800) 727-3276. The reports may also be obtained free of charge by visiting CoBank's website at [www.cobank.com](http://www.cobank.com).