

LONE STAR, ACA

2011 Quarterly Report Second Quarter



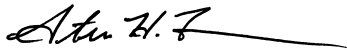
For the Quarter Ended June 30, 2011

REPORT OF MANAGEMENT

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

The board of directors has overall responsibility for the association's systems of internal control and financial reporting. The board consults regularly with management and reviews the results of the audits and examinations referred to previously.

The undersigned certify that we have reviewed this report, that it has been prepared in accordance with all applicable statutory or regulatory requirements, and that the information contained herein is true, accurate and complete to the best of his or her knowledge and belief.



Steve Fowlkes, Chief Executive Officer

August 8, 2011



Bruce Duncan, Chairman, Board of Directors

August 8, 2011



M'Lissa Kiel, Chief Financial Officer

August 8, 2011



Don Crawford, Chairman of the Audit Committee

August 8, 2011

LONE STAR, ACA MANAGEMENT'S DISCUSSION AND ANALYSIS

The following commentary reviews the financial performance of the Lone Star, Agricultural Credit Association (ACA), referred to as the association, for the quarter and six months ended June 30, 2011. These comments should be read in conjunction with the accompanying financial statements and the December 31, 2010 Annual Report to Stockholders.

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

The consolidated financial statements comprise the operations of the ACA and its wholly-owned subsidiaries. The consolidated financial statements were prepared under the oversight of the association's audit committee.

Significant Events:

As discussed in the 2010 annual report the association underwent an examination by the Farm Credit Administration (FCA) during the third quarter of 2009. The examination report, dated December 22, 2009, cited a severe management and internal control weakness in credit operations and credit administration. As a result of the examination the association identified and recorded additional credit downgrades and a corresponding increase in the allowance for loan losses, which were reflected in the financial results for December 31, 2009. Throughout 2010, the association continued to identify and record additional credit downgrades and corresponding increase in the allowance for loan losses, which were reflected in the financial results for 2010, and continued to work to remediate the material weaknesses in internal control over financial reporting which were cited in FCA's report. Management's review through the second quarter of 2011 revealed that there were no new material weaknesses. Additionally, existing internal controls were enhanced through training of management and staff, and the addition of key staff members. On May 1, 2010, Steve Fowlkes, interim CEO was named permanent CEO and Troy Bussmeir was named CCO. Steve Fowlkes previously served as CCO for the Farm Credit Bank of Texas, and Troy Bussmeir previously served as Relationship Manager for the Farm Credit Bank of Texas (bank). We believe we have fully remediated these internal control matters.

The association has a contractual lending relationship with the Farm Credit Bank of Texas from which the association borrows to fund the majority of its loan portfolio. The indebtedness is collateralized by a pledge of substantially all of the association's assets, and is governed by a general financing agreement (agreement) which contains certain loan covenants. The association received a "Notice of Default and Limited Waiver of Certain Requirements in the GFA" from the bank on January 21, 2010, March 5, 2010, April 28, 2010, September 2, 2010, January 31, 2011 and March 3, 2011. The current waiver expires February 29, 2012. The notices stated that the association was in default under the agreement. The bank has granted limited waivers of these defaults provided that the association complies with all of the actions outlined in its response to the December 2009 FCA report.

Loan Portfolio:

Total loans outstanding at June 30, 2011, including nonaccrual loans and sales contracts, were \$913,527,928 compared to \$958,022,921 at December 31, 2010, reflecting a decrease of 4.6 percent. Nonaccrual loans as a percentage of total loans outstanding were 11.0 percent at June 30, 2011, compared to 9.5 percent at December 31, 2010.

The association recorded \$33,580 in recoveries and \$1,185,396 in charge-offs for the quarter ending June 30, 2011, and \$115,710 in recoveries and \$5,353,048 in charge-offs for the quarter ending June 30, 2010. The association's allowance for loan losses was 2.1 percent and 1.7 percent of total loans outstanding as of June 30, 2011, and June 30, 2010 respectively.

Risk Exposure:

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

| | June 30, 2011 | | December 31, 2010 | |
|--|----------------|--------|-------------------|--------|
| | Amount | % | Amount | % |
| Nonaccrual | \$ 100,518,706 | 92.0% | \$ 90,870,374 | 90.6% |
| 90 days past due and still accruing interest | 155,285 | 0.1% | - | 0.0% |
| Formally restructured | - | 0.0% | - | 0.0% |
| Other property owned, net | 8,641,299 | 7.9% | 9,471,968 | 9.4% |
| Total | \$ 109,315,290 | 100.0% | \$ 100,342,342 | 100.0% |

The association experienced a \$9,648,332 increase in nonaccrual volume for the first six months of 2011. This increase is comprised by cattle and feed yard loans to two borrowers for \$7 million and turf grass loans of \$5 million. These accounts were previously recognized as substandard accrual loans however further deterioration in their financial performance or other circumstances has resulted in their migration to nonaccrual. The increase was offset by the moving of \$3 million in nonaccrual loans to other property owned.

Investments:

During the first quarter of 2010, the association exchanged \$59,626,146 of mortgage loans that previously were covered under a Long-Term Standby Commitment to Purchase Agreement with Federal Agricultural Mortgage Corporation (Farmer Mac) for a Farmer Mac guaranteed agricultural mortgage-backed security. No gain or loss was recognized in the financial statements upon completion of the exchange transaction. The association continues to service the loans included in this transaction. These investments in guaranteed securities are included in this report's Consolidated Balance Sheet as investments – held-to-maturity.

Results of Operations:

| | Quarter Ended June 30, | | Change | Six Months Ended June 30, | | Increase/ -Decrease |
|--|---------------------------|-------------------|---------------|------------------------------|-----------------------|------------------------|
| | 2011 | 2010 | | 2011 | 2010 | |
| INTEREST INCOME | | | | | | |
| Total interest income | \$ 12,150,067 | \$ 13,793,367 | -11.9% | \$ 24,680,020 | \$ 28,520,313 | -13.5% |
| Total interest expense | 5,364,116 | 6,574,687 | -18.4% | 11,085,220 | 13,554,130 | -18.2% |
| Net interest income | 6,785,951 | 7,218,680 | -6.0% | 13,594,800 | 14,966,183 | -9.2% |
| PROVISIONS FOR LOSSES | | | | | | |
| Provision for loan losses | 111,883 | 5,517,747 | -98.0% | 2,899,072 | 14,589,139 | -80.1% |
| Provision for acquired property losses | 2,001,009 | 582,872 | 243.3% | 2,487,001 | 2,199,510 | 13.1% |
| NET INCOME (LOSS) | \$ 2,643,974 | \$ 800,643 | 230.2% | \$ 3,915,996 | \$ (4,191,856) | 193.4% |

The increase in net income is a result of the decrease in provision for loan losses, partially offset by the decrease in net interest income, due primarily to a decline in average volume outstanding for the same period, as reflected in the chart below.

| | Six Months Ended June 30, | | Increase/ -Decrease |
|--|------------------------------|------------------|------------------------|
| | 2011 | 2010 | |
| Average Loan Volume | \$ 941,133,822 | \$ 1,065,817,308 | -11.7% |
| Average Loan Portfolio Spread | 2.36 | 2.28 | 3.4% |
| ROA | 0.78% | -0.75% | 204.0% |
| ROE | 4.60% | -4.93% | 193.3% |
| Allowance for loan losses to total loans | 2.10% | 2.00% | 5.0% |

Liquidity and Funding Sources:

The association secures the majority of its lendable funds from the Farm Credit Bank of Texas (FCBT), referred to as the bank, which obtains its funds through the issuance of Systemwide obligations and with lendable equity. The following schedule summarizes the association's borrowings.

| | June 30, 2011 | December 31, 2010 |
|----------------------------------|-----------------------|-----------------------|
| Note payable to the bank | \$ 799,961,567 | \$ 850,095,961 |
| Accrued interest on note payable | 1,716,015 | 2,016,598 |
| Total | <u>\$ 801,677,582</u> | <u>\$ 852,112,559</u> |

The decrease in the note payable to the FCBT, of \$50,134,394 for the first half of 2011 is attributable to the decrease in the association's loan volume. The note payable to the FCBT carried a weighted average interest rate of 2.85 percent as of June 30, 2011, compared to 2.74 percent as of December 31, 2010. The indebtedness is collateralized by a pledge of substantially all of the association's assets to the FCBT and governed by a financing agreement.

The liquidity policy of the association is to manage cash balances to maximize debt reduction. This policy will continue to be pursued during 2011. As borrower's payments are received, they are applied to the association's direct note payable with the FCBT.

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

Capital Resources:

The association's capital position increased by \$3,602,452 at June 30, 2011, compared to December 31, 2010. The association's debt as a percentage of members' equity was 4.67:1 as of June 30, 2011, compared to 5.07:1 as of December 31, 2010.

Under regulations governing minimum permanent capital adequacy and other capitalization issues, the association is required to maintain a minimum adjusted permanent capital of 7.0 percent of risk-adjusted assets as defined by the FCA. The association's permanent capital ratio at June 30, 2011, was 16.2 percent, which is in compliance with the FCA's minimum permanent capital standard. The association's core surplus ratio and total surplus ratio at June 30, 2011, were 15.8 and 15.8 percent, respectively, which is in compliance with the FCA's minimum surplus standard.

Significant Recent Accounting Pronouncements:

In June 2011, the Financial Accounting Standards Board (FASB) issued guidance entitled, "Comprehensive Income – Presentation of Comprehensive Income." This guidance is intended to increase the prominence of other comprehensive income in financial statements. The current option that permits the presentation of other comprehensive income in the statement of changes in equity has been eliminated. The main provisions of the guidance provides that an entity that reports items of other comprehensive income has the option to present comprehensive income in either one or two consecutive financial statements:

- A single statement must present the components of net income and total net income, the components of other comprehensive income and total other comprehensive income, and a total for comprehensive income.
- In a two-statement approach, an entity must present the components of net income and total net income in the first statement. That statement must be immediately followed by a financial statement that presents the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income.

This guidance is to be applied retrospectively. For public entities, it is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The adoption of this guidance will not impact financial condition or results of operations, but will result in changes to the presentation of comprehensive income.

In May 2011, the FASB issued guidance entitled, "Fair Value Measurement – Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs." The amendments change the wording used to describe the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. The amendments include the following:

1. Application of the highest and best use and valuation premise is only relevant when measuring the fair value of nonfinancial assets (does not apply to financial assets and liabilities).
2. Aligning the fair value measurement of instruments classified within an entity's shareholders' equity with the guidance for liabilities. As a result, an entity should measure the fair value of its own equity instruments from the perspective of a market participant that holds the instruments as assets.
3. Clarifying that a reporting entity should disclose quantitative information about the unobservable inputs used in a fair value measurement that is categorized within Level 3 of the fair value hierarchy.
4. An exception to the requirement for measuring fair value when a reporting entity manages its financial instruments on the basis of its net exposure, rather than its gross exposure, to those risks.
5. Clarifying that the application of premiums and discounts in a fair value measurement is related to the unit of account for the asset or liability being measured at fair value. Premiums or discounts related to size as a characteristic of the entity's holding (that is, a blockage factor) instead of as a characteristic of the asset or liability (for example, a control premium), are not permitted. A fair value measurement that is not a Level 1 measurement may include premiums or discounts other than blockage factors when market participants would incorporate the premium or discount into the measurement at the level of the unit of account specified in other guidance.
6. Expansion of the disclosures about fair value measurements. The most significant change will require entities, for their recurring Level 3 fair value measurements, to disclose quantitative information about unobservable inputs used a description of the valuation processes used by the entity, and a qualitative discussion about the sensitivity of the measurements. New disclosures are required about the use of a nonfinancial asset measured or disclosed at fair value if its use differs from its highest and best use. In addition, entities must report the level in the fair value hierarchy of assets and liabilities not recorded at fair value but where fair value is disclosed.

The amendments are to be applied prospectively. The amendments are effective during interim and annual periods beginning after December 15, 2011. Early application is not permitted.

In January 2011, the FASB issued guidance entitled, "Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings." This guidance temporarily delayed the effective date of the disclosures about troubled debt restructurings required by the guidance previously issued on "Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses." The effective date of the new disclosures about troubled debt restructurings (TDR) coincides with the guidance for determining what constitutes a TDR as described below.

In April 2011, the FASB issued its guidance entitled, "A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring," which provides for clarification on whether a restructuring constitutes a TDR. In evaluating whether a restructuring is a TDR, a creditor must separately conclude that both of the following exists: (1) the restructuring constitutes a concession, and (2) the debtor is experiencing financial difficulties. For nonpublic entities, the guidance is effective for annual periods ending on or after December 15, 2012, including interim periods within those annual periods. The bank and associations are currently evaluating the impact of adoption of this Standard on the financial condition or results of operations. The adoption will result in additional disclosures.

In July 2010, the Financial Accounting Standards Board (FASB) issued guidance on "Disclosures about the Credit Quality of Financing Receivables and the Allowance for Loan Losses," which is intended to provide additional information to assist financial statement users in assessing an entity's credit risk exposures and evaluating the adequacy of the allowance for credit losses. Existing disclosures are amended to include additional disclosures of financing receivables on a disaggregated basis (by portfolio segment and class of financing receivable) including among others, a rollforward schedule of the allowance for credit losses from the beginning of the reporting period to the end of the period on a portfolio segment basis, with the ending balance further disaggregated on the basis of the method of impairment (individually or collectively evaluated). The guidance also calls for new disclosures including but not limited to credit quality indicators at the end of the reporting period by class of financing receivables, the aging of past due financing receivables by class, the nature and extent of financing receivables modified as troubled debt restructurings by class and the effect on the allowance for credit losses. For public entities, the disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. The adoption of this Standard did not impact the association's financial condition or results of operations, but did result in significant additional disclosures. For nonpublic entities, the disclosures are effective for annual reporting periods ending on or after December 15, 2011. The adoption of this Standard will not have an impact on the association's financial condition or results of operations, but will result in additional disclosures for annual reporting periods ending after December 15, 2011.

In January 2010, the FASB issued guidance on "Fair Value Measurements and Disclosures," which is to improve disclosures about fair value measurement by increasing transparency in financial reporting. The changes will provide a greater level of disaggregated information and more robust disclosures of valuation techniques and inputs to fair value measurement. The new disclosures and

clarification of existing disclosures were effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances and settlements in the rollforward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The adoption of this Standard did not impact the association's financial condition or results of operations but did result in additional disclosures.

Relationship with the Farm Credit Bank of Texas:

The association's financial condition may be impacted by factors that affect the bank. The financial condition and results of operations of the bank may materially affect the stockholder's investment in the association. The Management's Discussion and Analysis and Notes to Financial Statements contained in the December 31, 2010 Annual Report of Lone Star, ACA more fully describe the association's relationship with the bank.

The Texas Farm Credit District's (district) annual and quarterly stockholder reports are available free of charge, upon request. These reports can be obtained by writing to Farm Credit Bank of Texas, The Ag Agency, P.O. Box 202590, Austin, Texas 78720, or by calling (512) 483-9204. Copies of the district's quarterly and annual stockholder reports also can be requested by e-mail at fcf@farmcreditbank.com. The district makes its annual and quarterly stockholder reports available on its website at www.farmcreditbank.com.

The association's quarterly stockholder reports are also available free of charge, upon request. These reports can be obtained by writing to Lone Star, ACA, 1612 Summit Avenue, Fort Worth, TX, 76102 or calling (817)332-6565. Copies of the association's quarterly stockholder reports can also be requested by e-mailing Lydia.Laske@lonestaragcredit.com.

LONE STAR, ACA

CONSOLIDATED BALANCE SHEET

| | June 30, 2011 (unaudited) | December 31, 2010 |
|---|--|------------------------------|
| <u>ASSETS</u> | | |
| Cash | \$ 92,939 | \$ 66,243 |
| Investments | 43,103,950 | 45,231,568 |
| Loans | 913,527,793 | 958,022,787 |
| Less: allowance for loan losses | 18,887,835 | 19,067,611 |
| Net loans | 894,639,958 | 938,955,176 |
| Accrued interest receivable | 8,240,063 | 7,748,626 |
| Investment in and receivable from the bank: | | |
| Capital stock | 18,570,550 | 18,570,550 |
| Other | 1,380,014 | 1,856,461 |
| Other property owned, net | 8,641,299 | 9,471,968 |
| Premises and equipment | 1,378,300 | 1,532,386 |
| Other assets | 1,393,122 | 797,994 |
| Total assets | \$ 977,440,196 | \$ 1,024,230,972 |
| <u>LIABILITIES</u> | | |
| Note payable to the bank | \$ 799,961,567 | \$ 850,095,961 |
| Accrued interest payable | 1,716,015 | 2,016,598 |
| Drafts outstanding | 141,855 | 23,786 |
| Other liabilities | 3,194,040 | 3,270,360 |
| Total liabilities | 805,013,477 | 855,406,705 |
| <u>MEMBERS' EQUITY</u> | | |
| Capital stock and participation certificates | 4,236,555 | 4,417,400 |
| Unallocated retained earnings | 168,588,260 | 164,672,264 |
| Accumulated other comprehensive income (loss) | (398,096) | (265,397) |
| Total members' equity | 172,426,719 | 168,824,267 |
| Total liabilities and members' equity | \$ 977,440,196 | \$ 1,024,230,972 |

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

LONE STAR, ACA

CONSOLIDATED STATEMENT OF INCOME

(unaudited)

| | Quarter Ended | | Six Months Ended | |
|---|---------------|---------------|------------------|----------------|
| | June 30, | | June 30, | |
| | 2011 | 2010 | 2011 | 2010 |
| <u>INTEREST INCOME</u> | | | | |
| Loans | \$ 11,551,451 | \$ 12,976,610 | \$ 23,472,065 | \$ 27,685,169 |
| Investments | 598,616 | 816,757 | 1,207,960 | 835,153 |
| Total interest income | 12,150,067 | 13,793,367 | 24,680,025 | 28,520,322 |
| <u>INTEREST EXPENSE</u> | | | | |
| Note payable to the bank | 5,364,112 | 6,574,678 | 11,085,220 | 13,554,130 |
| Advance conditional payments | 4 | 9 | 5 | 9 |
| Total interest expense | 5,364,116 | 6,574,687 | 11,085,225 | 13,554,139 |
| Net interest income | 6,785,951 | 7,218,680 | 13,594,800 | 14,966,183 |
| <u>PROVISION FOR LOAN LOSSES</u> | | | | |
| | 111,883 | 5,517,747 | 2,899,072 | 14,589,139 |
| Net interest income after provision for loan losses | 6,674,068 | 1,700,933 | 10,695,728 | 377,044 |
| <u>NONINTEREST INCOME</u> | | | | |
| Income from the bank: | | | | |
| Patronage income | 421,626 | 494,312 | 857,573 | 1,006,000 |
| Loan fees | 128,892 | 851,971 | 279,232 | 1,086,972 |
| Financially related services income | 13,832 | 11,201 | 21,902 | 54,104 |
| Gain (loss) on other property owned, net | 151,446 | (15,986) | 229,720 | 4,661 |
| Gain (loss) on sale of premises and equipment, net | 400 | 100 | 400 | 100 |
| Other noninterest income | 464 | 1,152,019 | 63,905 | 1,191,779 |
| Total noninterest income | 716,660 | 2,493,617 | 1,452,732 | 3,343,616 |
| <u>NONINTEREST EXPENSES</u> | | | | |
| Salaries and employee benefits | 1,616,093 | 1,498,119 | 3,298,142 | 2,793,821 |
| Directors' expense | 118,455 | 138,091 | 205,439 | 213,718 |
| Purchased services | 168,606 | 371,777 | 452,227 | 843,484 |
| Travel | 124,845 | 112,907 | 235,067 | 206,941 |
| Occupancy and equipment | 162,895 | 189,601 | 337,575 | 389,377 |
| Communications | 40,560 | 46,076 | 85,882 | 93,900 |
| Advertising | 39,302 | 51,841 | 70,946 | 118,177 |
| Public and member relations | 122,692 | 117,531 | 240,829 | 229,878 |
| Supervisory and exam expense | 108,278 | 89,212 | 216,557 | 178,424 |
| Insurance Fund premiums | 141,571 | 14,861 | 284,397 | 258,756 |
| Other noninterest expense | 2,099,622 | 763,891 | 2,798,807 | 2,586,040 |
| Total noninterest expenses | 4,742,919 | 3,393,907 | 8,225,868 | 7,912,516 |
| Income before income taxes | 2,647,809 | 800,643 | 3,922,592 | (4,191,856) |
| Provision for (benefit from) income taxes | 3,835 | - | 6,596 | - |
| Net income | \$ 2,643,974 | \$ 800,643 | \$ 3,915,996 | \$ (4,191,856) |

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

LONE STAR, AGRICULTURAL CREDIT ASSOCIATION

CONSOLIDATED STATEMENT OF CHANGES IN MEMBERS' EQUITY

(unaudited)

| | Capital Stock/ Participation Certificates | Additional Paid-in-Capital | Retained Earnings | | Accumulated Other Comprehensive Income (Loss) | Total Members' Equity |
|---|---|-------------------------------|--------------------|------------------------------|--|------------------------------|
| | | | Allocated | Unallocated | | |
| Balance at December 31, 2009 | \$ 4,726,260 | \$ - | \$ - | \$ 165,950,671 | \$ 7,376 | \$ 170,684,307 |
| Comprehensive income | | | | | | |
| Net income | - | - | - | (4,191,858) | - | (4,191,858) |
| Change in postretirement benefit plans | - | - | - | - | (46,400) | (46,400) |
| Total comprehensive income | - | - | - | (4,191,858) | (46,400) | (4,238,258) |
| Capital stock/participation certificates and allocated retained earnings issued | 173,865 | - | - | - | - | 173,865 |
| Capital stock/participation certificates and allocated retained earnings retired | (319,475) | - | - | - | - | (319,475) |
| Patronage refunds: | | | | | | |
| Cash | - | - | - | - | - | - |
| Balance at June 30, 2010 | <u>\$ 4,580,650</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 161,758,813</u> | <u>\$ (39,024)</u> | <u>\$ 166,300,439</u> |
| | | | | | | |
| Balance at December 31, 2010 | \$ 4,417,400 | \$ - | \$ - | \$ 164,672,264 | \$ (265,397) | \$ 168,824,267 |
| Comprehensive income | | | | | | |
| Net income | - | - | - | 3,915,996 | - | 3,915,996 |
| Change in postretirement benefit plans | - | - | - | - | (132,699) | (132,699) |
| Total comprehensive income | - | - | - | 3,915,996 | (132,699) | 3,783,297 |
| Capital stock/participation certificates and allocated retained earnings issued | 369,330 | - | - | - | - | 369,330 |
| Capital stock/participation certificates and allocated retained earnings retired | (550,175) | - | - | - | - | (550,175) |
| Balance at June 30, 2011 | <u>\$ 4,236,555</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 168,588,260</u> | <u>\$ (398,096)</u> | <u>\$ 172,426,719</u> |

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

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

NOTE 1 — ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES:

The Lone Star, ACA (Agricultural Credit Association), referred to as the association, is a member-owned cooperative that provides credit and credit-related services to or for the benefit of eligible borrowers/stockholders for qualified agricultural purposes. The association serves the counties of Hood, Johnson, Somervell, Tarrant, Denton, Wise, Dallas, Bowie, Camp, Cass, Morris, Titus, Delta, Lamar, Red River, Cooke, Fannin, Grayson, Eastland, Erath, Palo Pinto, Parker, Shackelford, Stephens, Throckmorton, Young, Borden, Fisher, Kent, Mitchell, Nolan, Scurry and Taylor in the state of Texas. The association is a lending institution of the Farm Credit System (the System), which was established by Acts of Congress to meet the needs of American agriculture.

The significant accounting policies followed and the financial condition and results of operations of the association as of and for the year ended December 31, 2010 are contained in the 2010 Annual Report to Stockholders. These unaudited second quarter 2011 financial statements should be read in conjunction with the 2010 Annual Report to Stockholders.

In June 2011, the Financial Accounting Standards Board (FASB) issued guidance entitled, “Comprehensive Income – Presentation of Comprehensive Income.” This guidance is intended to increase the prominence of other comprehensive income in financial statements. The current option that permits the presentation of other comprehensive income in the statement of changes in equity has been eliminated. The main provisions of the guidance provides that an entity that reports items of other comprehensive income has the option to present comprehensive income in either one or two consecutive financial statements:

- A single statement must present the components of net income and total net income, the components of other comprehensive income and total other comprehensive income, and a total for comprehensive income.
- In a two-statement approach, an entity must present the components of net income and total net income in the first statement. That statement must be immediately followed by a financial statement that presents the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income.

This guidance is to be applied retrospectively. For public entities, it is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The adoption of this guidance will not impact financial condition or results of operations, but will result in changes to the presentation of comprehensive income.

In May 2011, the FASB issued guidance entitled, “Fair Value Measurement – Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs.” The amendments change the wording used to describe the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. The amendments include the following:

1. Application of the highest and best use and valuation premise is only relevant when measuring the fair value of nonfinancial assets (does not apply to financial assets and liabilities).
2. Aligning the fair value measurement of instruments classified within an entity’s shareholders’ equity with the guidance for liabilities. As a result, an entity should measure the fair value of its own equity instruments from the perspective of a market participant that holds the instruments as assets.
3. Clarifying that a reporting entity should disclose quantitative information about the unobservable inputs used in a fair value measurement that is categorized within Level 3 of the fair value hierarchy.
4. An exception to the requirement for measuring fair value when a reporting entity manages its financial instruments on the basis of its net exposure, rather than its gross exposure, to those risks.
5. Clarifying that the application of premiums and discounts in a fair value measurement is related to the unit of account for the asset or liability being measured at fair value. Premiums or discounts related to size as a characteristic of the entity’s holding (that is, a blockage factor) instead of as a characteristic of the asset or liability (for example, a control premium), are not permitted. A fair value measurement that is not a Level 1 measurement may include premiums or discounts other than blockage factors when market participants would incorporate the premium or discount into the measurement at the level of the unit of account specified in other guidance.
6. Expansion of the disclosures about fair value measurements. The most significant change will require entities, for their recurring Level 3 fair value measurements, to disclose quantitative information about unobservable inputs used a

description of the valuation processes used by the entity, and a qualitative discussion about the sensitivity of the measurements. New disclosures are required about the use of a nonfinancial asset measured or disclosed at fair value if its use differs from its highest and best use. In addition, entities must report the level in the fair value hierarchy of assets and liabilities not recorded at fair value but where fair value is disclosed.

The amendments are to be applied prospectively. The amendments are effective during interim and annual periods beginning after December 15, 2011. Early application is not permitted.

In January 2011, the FASB issued guidance entitled, “Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings.” This guidance temporarily delayed the effective date of the disclosures about troubled debt restructurings required by the guidance previously issued on “Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses.” The effective date of the new disclosures about troubled debt restructurings (TDR) coincides with the guidance for determining what constitutes a TDR as described below.

In April 2011, the FASB issued its guidance entitled, “A Creditor’s Determination of Whether a Restructuring is a Troubled Debt Restructuring,” which provides for clarification on whether a restructuring constitutes a TDR. In evaluating whether a restructuring is a TDR, a creditor must separately conclude that both of the following exists: (1) the restructuring constitutes a concession, and (2) the debtor is experiencing financial difficulties. For nonpublic entities, the guidance is effective for annual periods ending on or after December 15, 2012, including interim periods within those annual periods. The bank and associations are currently evaluating the impact of adoption of this Standard on the financial condition or results of operations. The adoption will result in additional disclosures.

In July 2010, the FASB issued guidance on “Disclosures about the Credit Quality of Financing Receivables and the Allowance for Loan Losses,” which is intended to provide additional information to assist financial statement users in assessing an entity’s credit risk exposures and evaluating the adequacy of the allowance for credit losses. Existing disclosures are amended to include additional disclosures of financing receivables on a disaggregated basis (by portfolio segment and class of financing receivable) including among others, a rollforward schedule of the allowance for credit losses from the beginning of the reporting period to the end of the period on a portfolio segment basis, with the ending balance further disaggregated on the basis of the method of impairment (individually or collectively evaluated). The guidance also calls for new disclosures including but not limited to credit quality indicators at the end of the reporting period by class of financing receivables, the aging of past due financing receivables by class, the nature and extent of financing receivables modified as troubled debt restructurings by class and the effect on the allowance for credit losses. For public entities, the disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. The adoption of this Standard did not impact the association’s financial condition or results of operations, but did result in additional disclosures. For nonpublic entities, the disclosures are effective for annual reporting periods ending on or after December 15, 2011. The adoption of this Standard will not have an impact on the association’s financial condition or results of operations, but will result in additional disclosures for annual reporting periods ending after December 15, 2011.

In January 2010, the FASB issued guidance on “Fair Value Measurements and Disclosures,” which is to improve disclosures about fair value measurement by increasing transparency in financial reporting. The changes will provide a greater level of disaggregated information and more robust disclosures of valuation techniques and inputs to fair value measurement. The new disclosures and clarification of existing disclosures were effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances and settlements in the rollforward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The adoption of this Standard did not impact the association’s financial condition and results of operations but did result in additional disclosures.

The accompanying consolidated financial statements contain all adjustments necessary for a fair presentation of the interim financial condition and results of operations and conform with generally accepted accounting principles, except for the inclusion of a statement of cash flows. Generally accepted accounting principles require a business enterprise that provides a set of financial statements reporting both financial position and results of operations to also provide a statement of cash flows for each period for which results of operations are provided. In regulations issued by FCA, associations have the option to exclude statements of cash flows in interim financial statements. Therefore, the association has elected not to include a statement of cash flows in these consolidated financial statements.

The consolidated financial statements comprise the operations of the ACA and its wholly-owned subsidiaries. The preparation of these consolidated financial statements requires the use of management’s estimates. The results for the quarter ended June 30, 2011,

are not necessarily indicative of the results to be expected for the year ended December 31, 2011. Certain amounts in the prior period's financial statements have been reclassified to conform to current financial statement presentation.

NOTE 2 — INVESTMENTS:

Mission-Related and Other Investments Held-to-Maturity

A summary of the amortized cost and fair value of mission-related and other investment securities held-to-maturity is as follows:

| <u>June 30, 2011</u> | Gross | | Gross | | Weighted |
|----------------------------|----------------------|-------------------|-------------------|----------------------|----------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value | |
| Mortgage-backed securities | 43,103,950 | 775,555 | - | 43,879,505 | 5.48 |
| Asset-backed securities | - | - | - | - | - |
| Total | <u>\$ 43,103,950</u> | <u>\$ 775,555</u> | <u>\$ -</u> | <u>\$ 43,879,505</u> | 5.48 % |

| <u>December 31, 2010</u> | Gross | | Gross | | Weighted Average |
|----------------------------|----------------------|-------------------|-------------------|----------------------|------------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value | |
| Mortgage-backed securities | 45,231,568 | 284,022 | - | 45,515,590 | 5.42 |
| Asset-backed securities | - | - | - | - | - |
| Total | <u>\$ 45,231,568</u> | <u>\$ 284,022</u> | <u>\$ -</u> | <u>\$ 45,515,590</u> | 5.42 % |

During the first quarter of 2010, \$59,626 million of agricultural mortgage loans previously covered under a Long-Term Standby Commitment to Purchase agreement with the Federal Agricultural Mortgage Corporation (Farmer Mac) were securitized. No gain or loss was recognized in the financial statements upon completion of the securitization. Terms of the agreement call for a guarantee fee of 20-50 basis points to be paid to Farmer Mac, and for the association to receive a 30-basis-point fee for servicing the underlying loans.

The following is a summary of Farmer Mac agricultural mortgage-backed securities:

| | <u>June 30, 2011</u> | | | | |
|---|----------------------|------------------------|-------------------------|--------------|------------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Weighted Average Yield |
| Agricultural mortgage-backed securities | \$43,103,950 | \$775,555 | \$ - | \$43,879,505 | 5.48 % |

| | <u>December 31, 2010</u> | | | | |
|---|--------------------------|------------------------|-------------------------|---------------|------------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Weighted Average Yield |
| Agricultural mortgage-backed securities | \$ 45,231,568 | \$ 284,022 | \$ - | \$ 45,515,590 | 5.42 % |

The association evaluates investment securities for other-than-temporary impairment on a quarterly basis. Impairment is considered to be other than temporary if an entity (i) intends to sell the security, (ii) is more likely than not to be required to sell the security before recovering its cost, or (iii) does not expect to recover the security's entire amortized cost basis (even if the entity does not intend to sell).

If the association intends to sell the security or it is more likely than not that it would be required to sell the security, the impairment loss equals the full difference between amortized cost and fair value of the security. When the association does not intend to sell securities in an unrealized loss position, other-than-temporary impairment is considered using various factors, including the length of time and the extent to which the fair value is less than cost, adverse conditions specifically related to the industry, geographic area and the condition of the underlying collateral, payment structure of the security, ratings by rating agencies, the creditworthiness of bond insurers and volatility of the fair value changes. The association uses estimated cash flows over the remaining lives of the underlying collateral to assess whether credit losses exist. In estimating cash flows, it considers factors such as expectations of relevant market and economic data, including underlying loan level data for mortgage-backed and asset-backed securities and credit enhancements.

NOTE 3 — LOANS AND ALLOWANCE FOR LOAN LOSSES:

A summary of loans follows:

| Loan Type | June 30, 2011 Amount | December 31, 2010 Amount |
|-------------------------------------|----------------------------|--------------------------------|
| Production agriculture: | | |
| Real estate mortgage | \$ 726,341,914 | \$ 760,724,047 |
| Production and intermediate term | 121,341,982 | 139,139,347 |
| Agribusiness: | | |
| Loans to cooperatives | 1,679,610 | 2,988,302 |
| Processing and marketing | 33,486,161 | 30,430,889 |
| Farm-related business | 3,700,717 | 4,509,956 |
| Communication | 5,654,149 | 1,699,955 |
| Energy | 4,802,276 | 753,480 |
| Rural residential real estate | 16,578,240 | 17,776,944 |
| Total | \$ 913,585,048 | \$ 958,022,920 |

The association purchases or sells participation interests with other parties in order to diversify risk, manage loan volume and comply with Farm Credit Administration regulations. The following table presents information regarding the balances of participations purchased and sold at June 30, 2011:

| | Other Farm Credit Institutions | | Non-Farm Credit Institutions | | Total | |
|---------------------------------------|--------------------------------|------------------------|------------------------------|------------------------|-----------------------------|------------------------|
| | Participations Purchased | Participations Sold | Participations Purchased | Participations Sold | Participations Purchased | Participations Sold |
| | Real estate mortgage | \$ 15,888,552 | \$ 4,546,358 | \$ 502,756 | \$ 9,376,979 | \$ 16,391,308 |
| Production and intermediate term | 15,247,496 | - | - | 212,346 | 15,247,496 | 212,346 |
| Agribusiness Loans to Co-ops | 1,679,610 | - | - | - | 1,679,610 | - |
| Agribusiness Processing and Marketing | 24,244,804 | 2,524,629 | - | - | 24,244,804 | 2,524,629 |
| Communication | 5,654,149 | - | - | - | 5,654,149 | - |
| Energy | 4,802,276 | - | - | - | 4,802,276 | - |
| Total | \$ 67,516,887 | \$ 7,070,987 | \$ 502,756 | \$ 9,589,325 | \$ 68,019,643 | \$ 16,660,312 |

The allowance for loan losses is maintained at a level considered adequate by management to provide for estimated losses inherent in the loan portfolio. The allowance is based on a periodic evaluation of the loan portfolio by management in which numerous factors are considered, including economic conditions, loan portfolio composition and prior loan loss experience. An analysis of the allowance for loan losses follows:

| | June 30, 2011 | December 31, 2010 |
|---------------------------------|--------------------------|----------------------|
| Balance at beginning of quarter | \$ 19,927,767 | \$ 18,838,691 |
| Provision for loan losses | 111,883 | 5,010,599 |
| Charge-offs | (1,185,396) | (4,988,578) |
| Recoveries | 33,580 | 206,900 |
| Balance at end of quarter | <u>\$ 18,887,835</u> | <u>\$ 19,067,611</u> |

The following table presents information concerning impaired loans:

| | June 30, 2011 | June 30, 2010 |
|---|--------------------------|----------------------|
| Impaired loans with related allowance | \$ 27,589,610 | \$ 27,113,115 |
| Impaired loans with no related allowance | 73,084,381 | 72,702,821 |
| Total impaired loans | <u>\$ 100,673,991</u> | <u>\$ 99,815,936</u> |
| Allowance on impaired loans | \$ 12,628,767 | \$ 12,172,121 |
| Average impaired loans | \$ 93,770,681 | \$ 84,642,052 |
| Interest income on impaired loans for the quarter | \$ 193,075 | \$ 343,328 |

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

| | June 30, 2011 | December 31, 2010 |
|---|--------------------------|----------------------|
| Nonaccrual loans: | | |
| Real estate mortgage | \$ 55,141,947 | \$ 49,122,714 |
| Production and intermediate term | 35,688,881 | 32,030,878 |
| Agribusiness Farm-related business | 1,184,178 | 1,491,924.00 |
| Agribusiness Processing and Marketing | 8,201,973 | 7,800,597 |
| Rural residential real estate | 301,726 | 424,261 |
| Total nonaccrual loans | <u>100,518,706</u> | <u>90,870,374</u> |
| Accruing loans 90 days or more past due: | | |
| Real estate mortgage | 64,643 | - |
| Production and intermediate term | 90,641 | - |
| Total accruing loans 90 days or more | <u>155,285</u> | <u>-</u> |
| Total nonperforming loans | 100,673,991 | 90,870,374 |
| Other property owned | 8,641,299 | 9,471,968 |
| Total nonperforming assets | <u>\$ 109,315,290</u> | <u>\$100,342,342</u> |

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

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

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

| | June 30, 2011 | December 31, 2010 |
|----------------------------------|--------------------------|----------------------|
| Real estate mortgage | | |
| Acceptable | 85.27% | 85.53% |
| OAEM | 3.03% | 2.75% |
| Substandard/doubtful | 11.70% | 11.72% |
| | 100.00% | 100.00% |
| Production and intermediate term | | |
| Acceptable | 49.46% | 50.44% |
| OAEM | 9.96% | 10.09% |
| Substandard/doubtful | 40.58% | 39.46% |
| | 100.00% | 100.00% |
| Loans to cooperatives | | |
| Acceptable | 100.00% | 100.00% |
| OAEM | 0.00% | 0.00% |
| Substandard/doubtful | 0.00% | 0.00% |
| | 100.00% | 0.00% |
| Processing and marketing | | |
| Acceptable | 70.50% | 66.03% |
| OAEM | 5.00% | 8.34% |
| Substandard/doubtful | 24.49% | 25.63% |
| | 100.00% | 100.00% |
| Farm-related business | | |
| Acceptable | 60.14% | 62.72% |
| OAEM | 3.48% | 0.00% |
| Substandard/doubtful | 36.39% | 37.28% |
| | 100.00% | 100.00% |
| Energy and water/waste disposal | | |
| Acceptable | 100.00% | 100.00% |
| OAEM | 0.00% | 0.00% |
| Substandard/doubtful | 0.00% | 0.00% |
| | 100.00% | 0.00% |
| Communication | | |
| Acceptable | 100.00% | 100.00% |
| OAEM | 0.00% | 0.00% |
| Substandard/doubtful | 0.00% | 0.00% |
| | 100.00% | 0.00% |
| Rural residential real estate | | |
| Acceptable | 88.19% | 89.65% |
| OAEM | 2.25% | 6.42% |
| Substandard/doubtful | 9.56% | 3.93% |
| | 100.00% | 0.00% |
| Total Loans | | |
| Acceptable | 80.12% | 79.87% |
| OAEM | 3.97% | 4.03% |
| Substandard/doubtful | 15.91% | 16.10% |
| | 100.00% | 100.00% |

The following table provides an age analysis of past due loans (including accrued interest) as of June 30, 2011:

| | 30-89 Days Past Due | 90 Days or More Past Due | Total Past Due | Not Past Due or Less Than 30 Days Past Due | Total Loans | Recorded Investment >90 Days and Accruing |
|----------------------------------|---------------------------|--------------------------------|----------------------|--|----------------|---|
| Real estate mortgage | \$ 4,720,186 | \$ 31,600,682 | \$ 36,320,869 | \$ 690,021,045 | \$ 726,341,914 | \$ 64,643 |
| Production and intermediate term | 1,660,348 | 15,794,124 | 17,454,472 | 103,887,510 | 121,341,982 | 90,641 |
| Loans to cooperatives | - | - | - | 1,679,610 | 1,679,610 | - |
| Processing and marketing | - | 7,575,997 | 7,575,997 | 25,910,164 | 33,486,161 | - |
| Farm-related business | 128,674 | - | 128,674 | 3,572,043 | 3,700,717 | - |
| Communication | - | - | - | 5,654,149 | 5,654,149 | - |
| Energy and water/waste disposal | - | - | - | 4,802,276 | 4,802,276 | - |
| Rural residential real estate | 1,130,459 | - | 1,130,459 | 15,447,781 | 16,578,240 | - |
| Total | \$ 7,639,667 | \$ 54,970,803 | \$ 62,610,470 | \$ 850,974,577 | \$ 913,585,048 | \$ 155,285 |

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

Additional impaired loan information is as follows:

| | At June 30, 2011 | | | For the Three Months Ended June 30, 2011 | | For the Six Months Ended June 30, 2011 | |
|---|------------------------|---|----------------------|---|----------------------------------|---|----------------------------------|
| | Recorded Investment | Unpaid Principal Balance ^a | Related Allowance | Average Impaired Loans | Interest Income Recognized | Average Impaired Loans | Interest Income Recognized |
| Impaired loans with a related allowance for credit losses: | | | | | | | |
| Real estate mortgage | \$ 12,066,511 | \$ 11,606,431 | \$ 1,472,914 | \$ 11,548,374 | \$ 80,448 | \$ 12,931,480 | \$ 181,050 |
| Production and intermediate term | \$ 11,748,867 | \$ 16,247,656 | \$ 9,580,086 | \$ 16,545,227 | \$ 463 | \$ 18,065,134 | \$ 32,320 |
| Processing and marketing | \$ 2,362,338 | \$ 2,461,887 | \$ 1,314,083 | \$ 2,361,912 | \$ - | \$ 2,361,482 | \$ - |
| Farm-related business | \$ 1,184,178 | \$ 1,472,466 | \$ 237,650 | \$ 1,187,956 | \$ 22,255 | \$ 1,194,442 | \$ 37,231 |
| Rural residential real estate | \$ 227,716 | \$ 282,502 | \$ 24,034 | \$ 229,860 | \$ - | \$ 254,914 | \$ - |
| Total | \$ 27,589,610 | \$ 32,070,942 | \$ 12,628,767 | \$ 31,873,329 | \$ 103,166 | \$ 34,807,452 | \$ 250,602 |
| Impaired loans with no related allowance for credit losses: | | | | | | | |
| Real estate mortgage | \$ 43,140,080 | \$ 44,926,934 | \$ - | \$ 44,028,970 | \$ 43,479 | \$ 43,652,281 | \$ 260,774 |
| Production and intermediate term | \$ 24,030,656 | \$ 30,527,402 | \$ - | \$ 19,508,175 | \$ 43,121 | \$ 18,185,553 | \$ 101,172 |
| Processing and marketing | \$ 5,839,635 | \$ 9,251,064 | \$ - | \$ 5,873,942 | \$ 381 | \$ 5,545,127 | \$ 381 |
| Farm-related business | \$ - | \$ 95,682 | \$ - | \$ - | \$ 2,928 | \$ - | \$ 4,376 |
| Rural residential real estate | \$ 74,010 | \$ 97,999 | \$ - | \$ 74,963 | \$ - | \$ 75,908 | \$ - |
| Total | \$ 73,084,381 | \$ 84,899,081 | \$ - | \$ 69,486,050 | \$ 89,909 | \$ 67,458,869 | \$ 366,703 |
| Total impaired loans: | | | | | | | |
| Real estate mortgage | \$ 55,206,591 | \$ 56,533,366 | \$ 1,472,914 | \$ 55,577,344 | \$ 123,927 | \$ 56,583,761 | \$ 441,825 |
| Production and intermediate term | \$ 35,779,523 | \$ 46,775,058 | \$ 9,580,086 | \$ 36,053,402 | \$ 43,584 | \$ 36,250,687 | \$ 133,492 |
| Processing and marketing | \$ 8,201,973 | \$ 11,712,951 | \$ 1,314,083 | \$ 8,235,854 | \$ 381 | \$ 7,906,609 | \$ 381 |
| Farm-related business | \$ 1,184,178 | \$ 1,568,147 | \$ 237,650 | \$ 1,187,956 | \$ 25,183 | \$ 1,194,442 | \$ 41,607 |
| Rural residential real estate | \$ 301,726 | \$ 380,501 | \$ 24,034 | \$ 304,823 | \$ - | \$ 330,822 | \$ - |
| Total | \$ 100,673,991 | \$ 116,970,023 | \$ 12,628,767 | \$ 101,359,379 | \$ 193,075 | \$ 102,266,321 | \$ 617,305 |

The "Average Impaired" column is the Weighted Average Month-End Recorded Investment.

NOTE 4 — CAPITAL:

The association's board of directors has established a Capital Adequacy Plan (Plan) that includes the capital targets that are necessary to achieve the institution's capital adequacy goals as well as the minimum permanent capital standards. The Plan monitors projected dividends, equity retirements and other actions that may decrease the association's permanent capital. In addition to factors that must be considered in meeting the minimum standards, the board of directors also monitors the following factors: capability of management; quality of operating policies, procedures, and internal controls; quality and quantity of earnings; asset quality and the adequacy of the allowance for losses to absorb potential loss within the loan and lease portfolios; sufficiency of liquid funds; needs of an institution's customer base; and any other risk-oriented activities, such as funding and interest rate risk, potential obligations

under joint and several liability, contingent and off-balance-sheet liabilities or other conditions warranting additional capital. At least quarterly, management reviews the association's goals and objectives with the board.

NOTE 5 — INCOME TAXES:

Lone Star, ACA and its subsidiary are subject to federal and certain other income taxes. The associations are eligible to operate as cooperatives that qualify for tax treatment under Subchapter T of the Internal Revenue code. Under specified conditions, the associations can exclude from taxable income amounts distributed as qualified patronage refunds in the form of cash, stock or allocated surplus. Provisions for income taxes are made only on those earnings that will not be distributed as qualified patronage refunds. During the six months ended June 30, 2011, the association did not participate in a patronage program. Deferred taxes are recorded at the tax effect of all temporary differences based on the assumption that such temporary differences are retained by the institution and will therefore impact future tax payments. A valuation allowance is provided against deferred tax assets to the extent that it is more likely than not (more than 50 percent probability), based on management's estimate, that they will not be realized. For the six months ended June 30, 2011, and 2010 net income for tax purposes the association carries a deferred tax asset of \$13,040,785 and \$8,481,998 respectively with full valuation allowance recorded against the asset each year.

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

NOTE 6 — FAIR VALUE MEASUREMENTS:

FASB guidance defines fair value as the exchange price that would be received for an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability. See Note 12 to the 2010 Annual Report to Stockholders for a more complete description.

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

| <u>June 30, 2011</u> | <u>Fair Value Measurement Using</u> | | | <u>Total Fair Value</u> |
|--|-------------------------------------|---------------------|----------------|-------------------------|
| | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> | |
| Assets: | | | | |
| Assets held in nonqualified benefit trusts | <u>28,120</u> | <u>-</u> | <u>-</u> | <u>28,120</u> |
| Total assets | <u>28,120</u> | <u>-</u> | <u>-</u> | <u>28,120</u> |
| Liabilities: | | | | |
| Standby letters of credit | <u>-</u> | <u>3,729,440</u> | <u>-</u> | <u>3,729,440</u> |
| Total liabilities | <u>\$ -</u> | <u>\$ 3,729,440</u> | <u>\$ -</u> | <u>\$ 3,729,440</u> |
| | | | | |
| <u>December 31, 2010</u> | <u>Fair Value Measurement Using</u> | | | <u>Total Fair Value</u> |
| | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> | |
| Assets: | | | | |
| Assets held in nonqualified benefit trusts | <u>51,280</u> | <u>-</u> | <u>-</u> | <u>51,280</u> |
| Total assets | <u>51,280</u> | <u>-</u> | <u>-</u> | <u>51,280</u> |
| Liabilities: | | | | |
| Standby letters of credit | <u>-</u> | <u>3,429,454</u> | <u>-</u> | <u>3,429,454</u> |
| Total liabilities | <u>\$ -</u> | <u>\$ 3,429,454</u> | <u>\$ -</u> | <u>\$ 3,429,454</u> |

* Accounting guidance requires that the fair value measurement for investments be broken out by the different types of investments held.

The table below presents significant transfers in and out of Level 1 during the six months ended June 30, 2011 for all assets measured at fair value on a recurring basis:

| | Total Fair Value Measurement | |
|--------------------------|--------------------------------|---|
| | Level 1 Assets | |
| | Investments Available for Sale | Assets Held in Nonqualified Benefits Trusts |
| Transfers into Level 1 | \$ - | \$ - |
| Transfers out of Level 1 | - | (24,661) |

The transfer out of Level 1 Non-qualified benefit trust was the result of a former employee withdrawing eligible funds.

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

| <u>June 30, 2011</u> | Fair Value Measurement Using | | | Total Fair Value |
|--------------------------|------------------------------|---------|---------------|------------------|
| | Level 1 | Level 2 | Level 3 | |
| Assets: | | | | |
| Loans * | \$ - | \$ - | \$ 64,893,468 | \$ 64,893,468 |
| Other property owned | - | - | 8,641,299 | 8,641,299 |
| | | | | |
| <u>December 31, 2010</u> | Fair Value Measurement Using | | | Total Fair Value |
| | Level 1 | Level 2 | Level 3 | |
| Assets: | | | | |
| Loans * | \$ - | \$ - | \$ 74,759,366 | \$ 74,759,366 |
| Other property owned | - | - | 9,471,968 | 9,471,968 |

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

Valuation Techniques

As more fully discussed in Note 12 to the 2010 Annual Report to Stockholders, authoritative guidance establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The following represent a brief summary of the valuation techniques used for the associations' assets and liabilities. For a more complete description, see Notes to the 2010 Annual Report to Stockholders.

Investment Securities

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

Assets Held in Nonqualified Benefits Trusts

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

Loans

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

Other Property Owned

Other property owned is generally classified as Level 3. The fair value is based upon the collateral value, which is generally determined using appraisals or other indications based on comparable sales of similar properties. Costs to sell represent transaction costs and are not included as a component of the asset's fair value.

NOTE 7 — EMPLOYEE BENEFIT PLANS:

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

| | Other Benefits | |
|-------------------------------------|------------------|------------------|
| | 2011 | 2010 |
| Service cost | \$ 31,714 | \$ 30,188 |
| Interest cost | 59,564 | 54,358 |
| Amortization of prior service costs | (69,842) | (70,820) |
| Amortizations of net (gain) loss | 31,278 | 24,420 |
| Net periodic benefit cost | <u>\$ 52,714</u> | <u>\$ 38,146</u> |

The association previously disclosed in its financial statements for the year ended December 31, 2010, that it expected to contribute \$105,427 to its defined pension plan in 2011. As of June 30, 2011, \$52,713 of contributions have been made. The association presently anticipates contributing an additional \$52,714 to fund its defined pension plan in 2011 for a total of \$105,427.

NOTE 8 — COMMITMENTS AND CONTINGENT LIABILITIES:

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

NOTE 9 — SUBSEQUENT EVENTS:

The association has evaluated subsequent events through August 8, 2011, which is the date the financial statements were issued.