



Lone Star, ACA
2010 Annual Report
December 31, 2010



Part of the Farm Credit System

Letter from the CEO

Dear Stockholder:

Late in the fourth quarter of 2009 your association began to recognize deterioration in its credit quality. This deterioration was further accentuated by the economic tailspin in the national economy, and the effects were felt by many of your fellow stockholders. This negative impact was made even more severe as in addition to the slumping general economy, several industries in our agricultural economy were also specifically weakened — either through high input costs, low output prices or a combination of the two.

These combined effects accelerated rapidly during 2010. This deepening and widespread financial and economic crisis affected nearly every financial institution, and the full brunt of these events was strongly felt by Lone Star. While late 2009 was a signal of what was yet to come, 2010 was the year of the storm's full arrival.

You will see in the pages of this 2010 annual report the adverse impact these events had on Lone Star over the course of that full year. By the time 2010 had ended, your association had to increase allowance for loan losses and acquired property through provisions by approximately \$26 million, and its acceptable credit quality had declined to 79.9 percent. As a consequence, Lone Star is reporting a negative net income of \$1.157 million — the first negative earnings in its history. And because of this, Lone Star will be unable to provide our stockholders with any patronage for 2010.

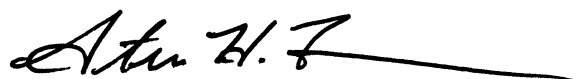
Despite all this, there is good news.

Because of strong collection efforts and a decline in loan volume, the capital of Lone Star increased from 13 percent to 15 percent. The board of directors believes it is prudent to preserve, protect and improve the association's capital position when experiencing uncertain times and adverse loan portfolio trends. It was the strong capital base of the association that has enabled us to weather the 2010 storm and has positioned us to emerge a better association.

Because we are well capitalized, Lone Star possesses the capacity, desire and ability to continue to fully serve the financial needs of our territory — whether that is a rural home, equipment financing, agricultural operating credit, rural land loans or other needs of our fellow stockholders.

Lone Star is a fundamentally sound institution. We are well capitalized, with an experienced and dedicated staff, and an experienced board of directors, and we serve a diverse and dynamic lending territory. Challenges remain for 2011, but we have successfully weathered the worst period in our long history, and the best is yet to come.

Sincerely,



Steve H. Fowlkes
Chief Executive Officer

Table of Contents

Report of Management	3
Report on Internal Control Over Financial Reporting	4
Report of Audit Committee	5
Five-Year Summary of Selected Consolidated Financial Data.....	6
Management’s Discussion and Analysis of Financial Condition and Results of Operations	8
Report of Independent Auditors.....	14
Consolidated Financial Statements.....	16
Notes to Consolidated Financial Statements	20
Disclosure Information and Index.....	40

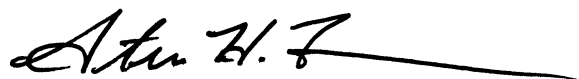
REPORT OF MANAGEMENT

The consolidated financial statements of Lone Star, ACA (association) are prepared by management, who is responsible for the statements' integrity and objectivity, including amounts that must necessarily be based on judgments and estimates. The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America appropriate in the circumstances. Other financial information included in the annual report is consistent with that in the consolidated financial statements.

To meet its responsibility for reliable financial information, management depends on the Farm Credit Bank of Texas' and the association's accounting and internal control systems, which have been designed to provide reasonable, but not absolute, assurance that assets are safeguarded and transactions are properly authorized and recorded. The systems have been designed to recognize that the cost of controls must be related to the benefits derived. The 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 this 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 his or her knowledge or belief.



Steve Fowlkes, Chief Executive Officer

March 3, 2011



Bruce Duncan, Chairman, Board of Directors

March 3, 2011



M'Lissa Kiel, Chief Financial Officer

March 3, 2011



Don Crawford, Audit Committee

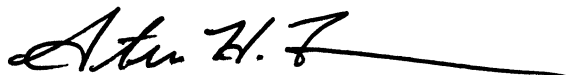
March 3, 2011

REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The association's chief executive officer and chief financial officer, or persons performing similar functions, are responsible for establishing and maintaining adequate internal control over financial reporting for the association's consolidated financial statements. For purposes of this report, "internal control over financial reporting" is defined as a process designed by, or under the supervision of, the association's principal executives and principal financial officers, or persons performing similar functions, and effected by its boards of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting information and the preparation of the consolidated financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America and includes those policies and procedures that: (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the association, (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial information in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures are being made only in accordance with authorizations of management and directors of the association and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the association's assets that could have a material effect on its consolidated financial statements.

The association's management has completed an assessment of the effectiveness of internal control over financial reporting as of December 31, 2010. In making the assessment, management used the framework in *Internal Control — Integrated Framework*, promulgated by the Committee of Sponsoring Organizations of the Treadway Commission, commonly referred to as the "COSO" criteria.

Based on the assessment performed, the association concluded that as of December 31, 2010, the internal control over financial reporting was effective based upon the COSO criteria. Additionally, based on this assessment, the association determined that there were no material weaknesses in the internal control over financial reporting as of December 31, 2010.



Steve Fowlkes, Chief Executive Officer

March 3, 2011



M'Lissa Kiel, Chief Financial Officer

March 3, 2011



Troy Bussmeir, Chief Credit Officer

March 3, 2011

REPORT OF AUDIT COMMITTEE

The Audit Committee (Committee) is composed of four members from the board of directors of Lone Star, ACA (association). Don Crawford, CPA, serves as the chairman of the Committee, and Bert Pruett, David Harris and Lonnie Hammonds are also members of the Audit Committee. In 2010, 14 Committee meetings were held. The Committee oversees the scope of Lone Star, ACA'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 approved responsibilities are described more fully in the Audit Committee Charter, which is available on request or on Lone Star, ACA's website. The Committee approved the appointment of PricewaterhouseCoopers LLP, independent auditors, to perform the outside audit for 2010.

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. The consolidated financial statements are prepared under the oversight of the Committee. PricewaterhouseCoopers LLP 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 for issuing a report thereon. The Committee's responsibilities include monitoring and overseeing the processes.

In this context, the Committee reviewed and discussed the audited consolidated financial statements for the year ended December 31, 2010 with management and PricewaterhouseCoopers LLP. The Committee also reviews with PricewaterhouseCoopers LLP the matters required to be discussed by Statement on Auditing Standards No. 114 (The Auditor's Communication With Those Charged With Governance) and both PricewaterhouseCoopers LLP and the association's internal auditors directly provide reports on significant matters to the Committee.

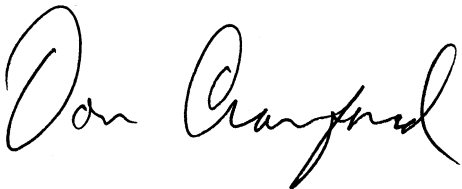
The Committee discussed with PricewaterhouseCoopers LLP its independence from the association. The Committee also reviewed the non-audit services provided by PricewaterhouseCoopers LLP and concluded that these services were not incompatible with maintaining the independent accountant's independence. The Committee has discussed with management and PricewaterhouseCoopers LLP such other matters and received such assurances from them as the Committee deemed appropriate.

Based on the foregoing review and discussions and relying thereon, the Committee recommended that the board of directors include the audited consolidated financial statements in the association's Annual Report to Stockholders for the year ended December 31, 2010.

Don Crawford, CPA
David Harris
Lonnie Hammonds
Bert Pruett

Audit Committee Members

March 3, 2011

A handwritten signature in black ink that reads "Don Crawford". The signature is written in a cursive, flowing style.

Don Crawford, CPA, Audit Committee Chairman

LONE STAR, ACA

FIVE-YEAR SUMMARY OF SELECTED CONSOLIDATED FINANCIAL DATA
(unaudited)
(dollars in thousands)

	2010	2009	2008	2007	2006
<u>Balance Sheet Data</u>					
<u>Assets</u>					
Investments	\$ 45,232	\$ -	\$ -	\$ -	\$ -
Loans	958,023	1,123,923	1,155,381	1,046,906	877,157
Less: allowance for loan losses	(19,068)	(7,386)	(917)	(1,012)	(705)
Net loans	938,955	1,116,537	1,154,464	1,045,894	876,452
Investment in and receivable from the bank	18,571	20,643	19,400	17,236	12,585
Other property owned, net	9,472	11,567	92	768	-
Other assets	12,001	15,205	16,748	18,584	14,898
Total assets	\$ 1,024,231	\$ 1,163,952	\$ 1,190,704	\$ 1,082,482	\$ 903,935
<u>Liabilities</u>					
Obligations with maturities of one year or less	\$ 3,294	\$ 5,843	\$ 10,972	\$ 10,236	\$ 12,229
Obligations with maturities greater than one year	852,113	987,426	1,019,556	930,369	766,936
Total liabilities	855,407	993,269	1,030,528	940,605	779,165
<u>Members' Equity</u>					
Capital stock and participation certificates	4,417	4,725	4,752	4,643	4,280
Additional paid-in capital	-	-	-	-	-
Allocated retained earnings	-	-	-	-	-
Unallocated retained earnings	164,672	165,951	155,237	136,800	120,490
Accumulated other comprehensive income (loss)	(265)	7	187	434	-
Total members' equity	168,824	170,683	160,176	141,877	124,770
Total liabilities and members' equity	\$ 1,024,231	\$ 1,163,952	\$ 1,190,704	\$ 1,082,482	\$ 903,935
<u>Statement of Income Data</u>					
Net interest income	\$ 28,295	\$ 32,320	\$ 30,575	\$ 27,412	\$ 22,135
Provision for loan losses	(21,871)	(14,856)	(1,342)	(900)	(344)
(Provision for loan losses) on acquired property or loss reversal	(3,837)	(442)	-	(41)	149
Income from the bank	5,214	4,790	3,736	3,412	2,459
Other noninterest income	2,258	2,618	3,422	2,310	1,975
Noninterest expense	(11,201)	(13,716)	(12,524)	(10,883)	(8,707)
Benefit from income taxes	(15)	-	-	-	11
Net income (loss)	\$ (1,157)	\$ 10,714	\$ 23,867	\$ 21,310	\$ 17,678
<u>Key Financial Ratios for the Year</u>					
Return on average assets	-0.1%	0.9%	2.1%	2.1%	2.3%
Return on average members' equity	-0.7%	6.3%	15.5%	15.8%	14.5%
Net interest income as a percentage of average earning assets	2.7%	2.7%	2.8%	2.8%	2.9%
Net charge-offs (recoveries) as a percentage of average loans	1.0%	0.7%	0.1%	0.1%	0.0%

LONE STAR, ACA

FIVE-YEAR SUMMARY OF SELECTED CONSOLIDATED FINANCIAL DATA
(unaudited)
(dollars in thousands)

	<u>2010</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>
<u>Key Financial Ratios at Year End</u>					
Members' equity as a percentage of total assets	16.5%	14.7%	13.5%	13.1%	13.8%
Debt as a percentage of members' equity	506.7%	581.9%	643.4%	663.0%	624.5%
Allowance for loan losses as a percentage of loans	2.0%	0.7%	0.1%	0.1%	0.1%
Permanent capital ratio	15.2%	13.4%	13.2%	13.0%	14.1%
Core surplus ratio	14.7%	13.0%	12.8%	12.6%	13.6%
Total surplus ratio	14.7%	13.0%	12.8%	12.6%	13.6%
<u>Net Income Distribution</u>					
Patronage refunds:					
Cash	\$ 122	\$ 5,430	\$ 5,000	\$ 7,000	\$ 7,000

**MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**
(dollars in thousands)

The following commentary explains management's assessment of the principal aspects of the consolidated financial condition and results of operations of Lone Star, ACA, including its wholly-owned subsidiaries, Lone Star, PCA and Lone Star, FLCA (association) for the years ended December 31, 2010, 2009 and 2008, and should be read in conjunction with the accompanying consolidated financial statements. The accompanying financial statements were prepared under the oversight of the association's Audit Committee.

Forward-Looking Information:

This annual information statement 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," "will" or other variations of these terms are intended to identify the 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-related, disease-related, 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
- actions taken by the Federal Reserve System in implementing monetary policy.

Significant Events:

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 increases in the allowance for loan losses, which were reflected in the financial results for 2010, and continued to work to remediate the material weakness in internal control over financial reporting which were cited in FCA's report. 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 had committed defaults under the agreement. The bank has granted limited waivers of these defaults provided that the association complies with all action outlined in its response to the FCA report.

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. The loans were transferred at market interest rates, had guarantee commitments in place, and the association receives an adequate servicing fee. 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. See Note 2 to the consolidated financial statements, "Summary of Significant Accounting Policies," included in this annual report, for further information.

In 2010 the association did not declare a patronage. In the future, as the association experiences improvement in credit quality and net earnings, the board of directors has committed to continue returning these earnings to members. This commitment to pay cash patronage is at the core of the association business model.

In December 2010, the association received a direct loan patronage of \$4,580 from the bank, representing 50 basis points on the average daily balance of the association's direct loan with the bank. During 2010, the association received \$572 in patronage payments from the bank, based on the association's stock investment in the bank. Also, the association received a capital markets patronage of \$62 from the bank, representing 65 basis points on the association's average balance of participations sold into the bank's patronage pool program.

In December 2009, the association received a direct loan patronage of \$4,124 from the bank, representing 40 basis points on the average daily balance of the association's direct loan with the bank. During 2009, the association received \$592 in patronage payments from the bank, based on the association's stock investment in the bank. Also, the association received a capital markets patronage of \$74 from the bank, representing 65 basis points on the year's average daily balance of participations sold into the bank's patronage pool program.

For over 93 years, the association has continued to provide its members with quality financial services. The board of directors and management remain committed to maintaining the financial integrity of the association while offering competitive loan products that meet the financial needs of agricultural producers.

Loan Portfolio:

The association makes and services loans to farmers, ranchers, rural homeowners and certain farm-related businesses. The association's loan volume consists of long-term farm mortgage loans, production and intermediate-term loans, and agribusiness loans. These loan products are available to eligible borrowers with competitive variable, fixed and adjustable interest rates. Loan maturities typically range from one to 30 years. Annual operating loans comprise the majority of production loans. The majority of the mortgage loans are comprised of loans with 20- to 30-year maturities. Loans serviced by the association offer several installment payment cycles, the timing of which usually coincides with the seasonal cash-flow capabilities of the borrower.

The composition of the association's loan portfolio (principal less funds held) of \$958,023, \$1,123,923 and \$1,155,381 as of December 31, 2010, 2009 and 2008, respectively, is described more fully in detailed tables as part of Note 4 to the consolidated financial statements, "Loans and Allowance for Loan Losses," included in this annual report.

The loan portfolio decrease between December 31, 2009 and December 31, 2010 of \$165,900 or 14.8 percent includes the conversion of \$59,626 Farmer Mac guarantee loans to AMBS investments during the first quarter of 2010. These AMBS investments are included in the association's Consolidated Balance Sheet as held-to-maturity investments at an amortized cost balance of \$45,232 million at December 31, 2010. The remaining \$106,274 decline in the loan portfolio is attributed to normal amortization of loan assets and collection of adverse loans, combined with decreased demand for real estate transactions during 2010 and tightened underwriting standards and practices. The association anticipates loan volume to remain relatively unchanged during 2011 as economic conditions remain uncertain.

Purchase and Sales of Loans:

The association has obtained loan guarantees in the form of standby commitments to purchase qualifying loans from the Federal Agricultural Mortgage Corporation through an arrangement with the bank. At December 31, 2010, 2009 and 2008, loans totaling \$1,517, \$61,672 and \$70,848, respectively, were guaranteed by these commitments. The decline in these commitments was primarily contributed to the conversion to Agricultural Mortgage-Backed Securities. See Note 3 to the consolidated financial statements, "Investments," included in this annual report, for further information. Fees paid for these guarantees totaled \$229, \$262 and \$302 in 2010, 2009 and 2008, respectively, and are reflected in "other noninterest expense."

During 2010, 2009 and 2008, the association participated in loans with other lenders. As of December 31, 2010, 2009 and 2008, these participations totaled \$53,359, \$46,610 and \$55,587, or 5.6 percent, 4.1 percent and 4.8 percent of loans, respectively. Included in these amounts are participations purchased from entities outside of the Farm Credit Texas District (district) of \$525, \$2,566 and \$4,555, or 0.1 percent, 0.2 percent and 0.4 percent of loans, respectively. The association has also sold participations of \$14,031, \$20,647 and \$37,674 as of December 31, 2010, 2009 and 2008, 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, net. The following table illustrates the association's components and trends of high-risk assets serviced for the prior three years as of December 31:

	2010		2009		2008	
	Amount	%	Amount	%	Amount	%
Nonaccrual	\$ 90,870	90.6%	\$ 52,971	82.1%	\$ 11,042	98.7%
90 days past due and still accruing interest	-	0.0%	-	0.0%	50	0.5%
Other property owned, net	9,472	9.4%	11,567	17.9%	92	0.8%
Total	<u>\$ 100,342</u>	<u>100.0%</u>	<u>\$ 64,538</u>	<u>100.0%</u>	<u>\$ 11,184</u>	<u>100.0%</u>

At December 31, 2010, 2009 and 2008, loans that were considered impaired were \$90,870, \$52,971 and \$11,042, representing 9.5 percent, 4.7 percent and 1.0 percent of loan volume, respectively. Impaired loans consist of all high-risk assets except other property owned, net.

The association experienced a \$37,899 increase in nonaccrual loan volume during 2010 for total outstanding nonaccrual volume of \$90,870 as of December 31, 2010. Of the \$90,870, dairy loans comprised \$48,341, general livestock (mostly cattle) comprised \$17,592 and timber tracts comprised \$8,818, with the remaining balance of nonaccrual volume being comprised by other various commodities.

The other property owned net balance of \$9,472 as of December 31, 2010 consisted primarily of three dairy facility loans which once belonged to a single borrower totaling \$4,777. The remaining balance of other property owned is comprised of various real estate tracks and ranch properties.

Except for the relationship between installment due date and seasonal cash-flow capabilities of the borrower, the association is not typically affected by seasonal characteristics. The factors affecting the operations of the association are the same factors that would affect any agricultural lender.

To help mitigate and diversify credit risk, the association has employed practices including but not limited to securitization of loans, obtaining credit guarantees, and engaging in loan participations.

Allowance for Loan Losses:

The following table provides relevant information regarding the allowance for loan losses as of, or for the year ended, December 31:

	2010	2009	2008
Allowance for loan losses	\$ 19,068	\$ 7,386	\$ 917
Provision for loan losses	21,871	14,856	1,342
Loans charged off	(10,635)	(8,428)	(1,446)
Recoveries	446	41	9
Allowance for loan losses to total loans	2.0%	0.7%	0.1%
Allowance for loan losses to nonaccrual loans	21.0%	13.9%	8.3%
Allowance for loan losses to impaired loans	21.0%	13.9%	8.3%
Net charge-offs to average loans	1.0%	0.7%	0.1%

The allowance for loan losses is maintained based upon estimates that consider the general financial strength of the agricultural economy, loan portfolio composition, management's process for classification of risk of the loans within the portfolio and the portfolio's prior loan loss experience. A reassessment by management of the risk within the portfolio, coupled with a general deterioration in economic conditions in our territory and within certain agricultural sectors, drove significant credit downgrades and corresponding increases in the allowance for loan losses, provision for loan losses and loan charge-offs during 2010. Of the \$10,636 charged off in 2010, \$6,059 related to cattle operations other than dairy, \$2,235 related to dairy operation and the balance related to sawmills, farm machinery and equipment, and various other loans. Based upon ongoing risk assessment and the allowance for loan losses procedures outlined above, the allowance for loan losses of \$19,068, \$7,386 and \$917 at December 31, 2010, 2009 and 2008, respectively, is considered adequate by management to compensate for expected losses in the loan portfolio at such dates.

Results of Operations:

The association's net income (loss) for the year ended December 31, 2010, was (\$1,157) as compared to \$10,714 for the year ended December 31, 2009, reflecting a decrease of \$11,871, or 110.8 percent. The decrease in net income during 2010 was largely due to downgrades in credit quality discussed under "Allowance for Loan Losses." The association's net income for the year ended December 31, 2008 was \$23,867. Net income decreased \$13,153 or 55.1 percent, in 2009 versus 2008.

Net interest income for 2010, 2009 and 2008 was \$28,295, \$32,320 and \$30,575, respectively, reflecting decreases of \$4,025, or 12.5 percent, for 2010 versus 2009 and \$1,745, or 5.7 percent, for 2009 versus 2008. Net interest income is the principal source of earnings for the association and is impacted by volume, yields on assets and cost of debt. The effects of changes in average volume and interest rates on net interest income over the past three years are presented in the following tables:

	2010		2009		2008	
	Average Balance	Interest	Average Balance	Interest	Average Balance	Interest
Loans	\$ 1,018,436	\$ 52,167	\$ 1,167,818	\$ 64,054	\$ 1,101,902	\$ 71,287
Investments	41,792	2,316	-	-	-	-
Total interest-earning assets	1,060,228	54,483	1,167,818	64,054	1,101,902	71,287
Interest-bearing liabilities	915,965	26,188	1,030,747	31,734	977,289	40,712
Impact of capital	\$ 144,263		\$ 137,071		\$ 124,613	
Net interest income		\$ 28,295		\$ 32,320		\$ 30,575

	Average Yield	Average Yield	Average Yield
Yield on loans	5.12%	5.48%	6.47%
Yield on investments	5.54%	0.00%	0.00%
Total yield on interest-earning assets	5.14%	5.48%	6.47%
Cost of interest-bearing liabilities	2.86%	3.08%	4.17%
Interest rate spread	2.28%	2.40%	2.30%

	2010 vs. 2009			2009 vs. 2008		
	Increase (decrease) due to			Increase (decrease) due to		
	Volume	Rate	Total	Volume	Rate	Total
Interest income - loans	\$ (8,193)	\$ (3,694)	\$ (11,887)	\$ 4,285	\$ (11,518)	\$ (7,233)
Interest income - investments	-	2,316	2,316	-	-	-
Total interest income	(8,193)	(1,378)	(9,571)	4,285	(11,518)	(7,233)
Interest expense	(3,534)	(2,012)	(5,546)	2,245	(11,223)	(8,978)
Net interest income	\$ (4,660)	\$ 635	\$ (4,025)	\$ 2,040	\$ (295)	\$ 1,745

Interest income for 2010 decreased by \$9,571, or 14.9 percent, as compared to 2009, primarily due to a decrease in average accruing loan volume. Interest expense for 2010 decreased by \$5,546, or 17.5 percent, compared to 2009 due to a decrease in average interest-bearing liabilities. The interest rate spread decreased by -13 basis points to 2.28 percent in 2010 from 2.41 percent in 2009, primarily because of a decline in average earning assets. In 2010, the association implemented authoritative accounting guidance that requires loan origination fees and costs to be capitalized and amortized over the life of the loans as an adjustment to yield. The resulting adjustment to loan yield for 2010 was a decrease of \$7. The interest rate spread increased by 10 basis points to 2.40 percent in 2009 from 2.30 percent in 2008, primarily because of a decline in borrowing rates.

Noninterest income for 2010 increased by \$65, or 0.9 percent, compared to 2009, due primarily to increases in patronage income received from the bank and a refund from excess reserves in the Farm Credit System Insurance Corporation (FCSIC or Insurance Fund), offset by decreases in loan fees. Patronage income from the bank increased \$424 and the association received a \$1,152 in refund distributions of excess reserves from prior years from the Insurance Fund. The distributions from the FCSIC included reserves it held in excess of its secure base amount in 2003 which had been previously allocated to its Allocated Insurance Reserves Accounts, and also included reserves in excess of its secure base amount in 2009 which were likewise allocated. The 2008 Farm Bill amended the Farm Credit Act and simplified the formula for payments from the Allocated Insurance Reserves Accounts to allow

more immediate distribution of excess Insurance Fund balances to System banks. The noninterest income increase was offset by a decrease in loan fees of \$1,408. The decrease of loan fees is a result of the decrease in new loan volume and the implementation of authoritative accounting guidance requiring the capitalization and amortization of loan origination fees and costs which were implemented during 2010 for loans closed in 2010, resulting in the capitalization of \$960 in origination fees, which will be amortized over the life of the loans as an adjustment to yield in net interest income. Noninterest income for 2009 increased by \$250, or 3.5 percent, compared to 2008, due primarily to a \$1,504 increase in patronage income received from the bank, offset by a \$755 decrease in loan fees.

Provisions for loan losses for 2010 increased by \$7,015, or 47.2 percent, compared to 2009. A reassessment by management of the risk within the portfolio, coupled with a general deterioration in economic conditions in our territory and within certain agricultural sectors, drove significant credit downgrades, and corresponding increases in provision for loan losses during 2010.

Operating expenses consist primarily of salaries, employee benefits and purchased services. Expenses for purchased services may include administrative services, marketing, information systems, accounting and loan processing, audit and credit review fees and legal fees, among others. Net operating expenses for 2010, 2009 and 2008 were \$15,040, \$14,158 and \$12,524, respectively, reflecting an increase of \$882 or 6.2 percent for 2010, and an increase of \$1,634 or 13 percent for 2009. The increase in operating expenses for 2010 was driven primarily by a \$507 increase in purchased services and a \$3,395 increase in acquired property provisions. The increase in operating expenses was partially offset by a \$1,299 decrease in salaries and employee benefits and a \$1,457 decrease in insurance fund premiums, resulting from a decrease in the premium rates from 20 basis points in 2009 to 5 basis points in 2010. Authoritative accounting guidance requiring the capitalization and amortization of loan origination fees and costs was implemented during 2010 for loans closed in 2010, resulting in the capitalization of \$863 in origination costs, which will be amortized over the life of the loans as an adjustment to yield in net interest income. The capitalized costs consisted of salaries and benefits totaling \$863 related to the origination of loans.

For the year ended December 31, 2010, the association's return on average assets was -.01 percent, as compared to 0.9 percent and 2.1 percent for the years ended December 31, 2009 and 2008, respectively. For the year ended December 31, 2010, the association's return on average members' equity was -0.7 percent, as compared to 6.3 percent and 15.5 percent for the years ended December 31, 2009 and 2008, respectively. The association experienced a decrease in return on average assets and return on average member's equity due to the decrease in net income as described previously.

Because the association depends on the bank for funding, any significant positive or negative factors affecting the operations of the bank would have a similar effect on the operations of the association.

Liquidity and Funding Sources:

The interest rate risk inherent in the association's loan portfolio is substantially mitigated through the funding relationship with the bank. The bank manages interest rate risk through its direct loan pricing and asset/liability management process.

The primary source of liquidity and funding for the association is a direct loan from the bank. The outstanding balance of \$850,096, \$984,984 and \$1,016,383 as of December 31, 2010, 2009 and 2008, respectively, is recorded as a liability on the association's balance sheet. The note carried a weighted average interest rate of 2.74 percent, 2.99 percent and 3.63 percent at December 31, 2010, 2009 and 2008, respectively. The indebtedness is collateralized by a pledge of substantially all of the association's assets to the bank and is governed by a financing agreement. The decrease in note payable to the bank and related accrued interest payable since December 31, 2009, is due to the association's decrease in average earning assets. The association's own funds, which represent the amount of the association's loan portfolio funded by the association's equity, were \$144,355, \$138,926 and \$138,789 at December 31, 2010, 2009 and 2008, respectively. The maximum amount the association may borrow from the bank as of December 31, 2010, was \$948,063 as defined by the general financing agreement.

The liquidity policy of the association is to manage cash balances to maximize debt reduction, and to increase accrual loan volume. This policy will continue to be pursued during 2011. As borrower payments are received, they are applied to the association's note payable to the bank.

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

Capital Resources:

The association's capital position remains strong, with total members' equity of \$168,824, \$170,683 and \$160,176 at December 31, 2010, 2009 and 2008, respectively. 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. In addition to the FCA's minimum requirement, the association's board of directors set an internal range of 14.0 to 15.0 percent for adjusted permanent capital as of the end of 2010. The permanent capital ratio measures available at-risk capital relative to risk-adjusted assets and off-balance-sheet contingencies. The ratio is an indicator of the institution's financial capacity to absorb potential losses beyond that provided in the allowance for loss accounts. The association's permanent capital ratio at December 31, 2010, 2009 and 2008 was 15.2 percent, 13.4 percent and 13.2 percent, respectively, exceeding both the FCA's minimum and the associations internal goal.

The core surplus ratio measures available core surplus capital relative to risk-adjusted assets and off-balance-sheet contingencies. The ratio is an indicator of the quality of capital that exists to maintain stable earnings and financial strength. The association's core surplus ratio at December 31, 2010, 2009 and 2008 was 14.7 percent, 13.0 percent and 12.8 percent, respectively, which is in compliance with the FCA's minimum ratio requirement of 3.5 percent. The total surplus ratio measures available surplus capital relative to risk-adjusted assets and off-balance-sheet contingencies. The ratio is an indicator of the reserves existing to protect borrowers' investments in the association. The association's total surplus ratio at December 31, 2010, 2009 and 2008 was 14.7 percent, 13.0 percent and 12.8 percent, respectively, which is in compliance with the FCA's minimum ratio requirement of 7.0 percent.

In 2010, 2009 and 2008, the association paid patronage distributions of \$122, \$5,430 and \$5,000, respectively. As a result of deterioration in the loan portfolio and the impact on 2010 financial results, the association does not anticipate paying patronage in 2011 based on 2010 earnings. The \$122 patronage distribution that was paid in 2010 was due to an erroneously omitted patronage payment in 2009. See Note 8 to the consolidated financial statements, "Members' Equity," included in this annual report, for further information.

Relationship with the Bank:

The association's statutory obligation to borrow only from the bank is discussed in Note 7 to the consolidated financial statements, "Note Payable to the Bank," included in this annual report.

The bank's ability to access capital of the association is discussed in Note 2 to the consolidated financial statements, "Summary of Significant Accounting Policies," included in this annual report, within the section "Capital Stock Investment in the Bank."

The bank's role in mitigating the association's exposure to interest rate risk is described in the section "Liquidity and Funding Sources" of Management's Discussion and Analysis and in Note 7 to the consolidated financial statements, "Note Payable to the Bank," included in this annual report.

The bank provides computer systems to support the critical operations of all district associations. In addition, each association has operating systems and facility-based systems that are not supported by the bank. As disclosed in Note 11 to the consolidated financial statements, "Related Party Transactions," included in this annual report, the bank provides many services that the association can utilize, such as administrative, marketing, information systems and accounting services. Additionally, the bank allocates district expenses to the associations, such as the Farm Credit System Insurance Corporation insurance premiums.

Summary:

Over the past 93 years your association's board of directors and management, as well as the board of directors and management of the bank, have been committed to offering eligible borrowers a reliable source of financing at a competitive price.

Report of Independent Auditors

To the Board of Directors and Members of
Lone Star, ACA:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of changes in members' equity, and of cash flows present fairly, in all material respects, the financial position of Lone Star, ACA and subsidiaries (Association) at December 31, 2010, 2009 and 2008, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Association's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements 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 financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.



March 3, 2011

LONE STAR, ACA

CONSOLIDATED BALANCE SHEET
(dollars in thousands)

	December 31,		
	2010	2009	2008
<u>Assets</u>			
Cash	\$ 66	\$ 47	\$ 380
Investments	45,232	-	-
Loans	958,023	1,123,923	1,155,381
Less: allowance for loan losses	(19,068)	(7,386)	(917)
Net loans	938,955	1,116,537	1,154,464
Accrued interest receivable	7,749	10,501	12,491
Investment in and receivable from the bank:			
Capital stock	18,571	20,643	19,400
Other	1,856	2,612	1,927
Other property owned, net	9,472	11,567	92
Premises and equipment	1,532	1,674	1,684
Other assets	798	371	266
Total assets	\$ 1,024,231	\$ 1,163,952	\$ 1,190,704
<u>Liabilities</u>			
Note payable to the bank	\$ 850,096	\$ 984,984	\$ 1,016,383
Advance conditional payments	-	14	220
Accrued interest payable	2,017	2,440	3,173
Drafts outstanding	24	132	197
Dividends payable	-	-	5,430
Other liabilities	3,270	5,699	5,125
Total liabilities	855,407	993,269	1,030,528
<u>Members' Equity</u>			
Capital stock and participation certificates	4,417	4,725	4,752
Unallocated retained earnings	164,672	165,951	155,237
Accumulated other comprehensive income (loss)	(265)	7	187
Total members' equity	168,824	170,683	160,176
Total liabilities and members' equity	\$ 1,024,231	\$ 1,163,952	\$ 1,190,704

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

LONE STAR, ACA

CONSOLIDATED STATEMENT OF INCOME
(dollars in thousands)

	Year Ended December 31,		
	2010	2009	2008
<u>Interest Income</u>			
Loans	\$ 52,161	\$ 64,054	\$ 71,287
Investments	2,316	-	-
Other	6	-	-
Total interest income	<u>54,483</u>	<u>64,054</u>	<u>71,287</u>
<u>Interest Expense</u>			
Note payable to the bank	26,188	31,734	40,710
Advance conditional payments	-	-	2
Total interest expense	<u>26,188</u>	<u>31,734</u>	<u>40,712</u>
Net interest income	<u>28,295</u>	<u>32,320</u>	<u>30,575</u>
<u>Provision for Loan Losses</u>			
Net interest income after provision for losses	<u>21,871</u>	<u>14,856</u>	<u>1,342</u>
<u>Noninterest Income</u>			
Income from the bank:			
Patronage income	5,214	4,790	3,736
Loan fees	980	2,388	3,143
Refunds from Farm Credit System			
Insurance Corporation	1,151	-	-
Financially related services income	86	153	94
Gain on other property owned, net	-	-	131
Gain on sale of premises and equipment, net	1	17	-
Other noninterest income	41	60	54
Total noninterest income	<u>7,473</u>	<u>7,408</u>	<u>7,158</u>
<u>Noninterest Expenses</u>			
Salaries and employee benefits	5,334	6,633	6,590
Directors' expense	332	324	316
Purchased services	1,518	1,011	836
Travel	466	456	455
Occupancy and equipment	820	761	696
Communications	195	188	189
Advertising	311	360	430
Public and member relations	419	517	379
Supervisory and exam expense	395	343	315
Insurance Fund premiums	655	2,112	1,699
Provisions for acquired property losses	3,837	442	-
Net loss on other property owned	235	442	-
Other noninterest expense	522	569	619
Total noninterest expenses	<u>15,039</u>	<u>14,158</u>	<u>12,524</u>
Income before income taxes	<u>(1,142)</u>	<u>10,714</u>	<u>23,867</u>
Provision for income taxes	15	-	-
Net (loss) income	<u>\$ (1,157)</u>	<u>\$ 10,714</u>	<u>\$ 23,867</u>

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

LONE STAR, ACA

CONSOLIDATED STATEMENT OF CHANGES IN MEMBERS' EQUITY

(dollars in thousands)

	Capital Stock/ Participation Certificates	Retained Earnings Unallocated	Accumulated Other Comprehensive Income (Loss)	Total Members' Equity
Balance at December 31, 2007	\$ 4,643	\$ 136,800	\$ 434	\$ 141,877
Comprehensive income				
Net income	-	23,867	-	23,867
Change in postretirement benefit plans	-	-	(247)	(247)
Total comprehensive income	-	23,867	(247)	23,620
Capital stock/participation certificates issued	816	-	-	816
Capital stock/participation certificates and allocated retained earnings retired	(707)	-	-	(707)
Patronage refunds:				
Cash	-	(5,430)	-	(5,430)
Balance at December 31, 2008	4,752	155,237	187	160,176
Comprehensive income				
Net income	-	10,714	-	10,714
Change in postretirement benefit plans	-	-	(180)	(180)
Total comprehensive income	-	10,714	(180)	10,534
Capital stock/participation certificates issued	588	-	-	588
Capital stock/participation certificates and allocated retained earnings retired	(615)	-	-	(615)
Balance at December 31, 2009	4,725	165,951	7	170,683
Comprehensive income				
Net income	-	(1,157)	-	(1,157)
Change in postretirement benefit plans	-	-	(272)	(272)
Total comprehensive income	-	(1,157)	(272)	(1,429)
Capital stock/participation certificates issued	398	-	-	398
Capital stock/participation certificates and allocated retained earnings retired	(706)	-	-	(706)
Patronage refunds:				
Cash	-	(122)	-	(122)
Balance at December 31, 2010	\$ 4,417	\$ 164,672	\$ (265)	\$ 168,824

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

LONE STAR, ACA

CONSOLIDATED STATEMENT OF CASH FLOWS
(dollars in thousands)

	Year Ended December 31,		
	2010	2009	2008
Cash flows from operating activities:			
Net income	\$ (1,157)	\$ 10,714	\$ 23,867
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	21,871	14,856	1,342
Provision for acquired property	3,837	442	(387)
Loss (gain) on other property owned, net	235	442	(141)
Depreciation	283	399	335
Loss (gain) on sale of premises and equipment, net	1	(17)	-
Decrease in accrued interest receivable	2,752	1,990	330
Decrease (increase) in other receivables from the bank	756	(685)	1,855
(Increase) decrease in other assets	(427)	(105)	2
Decrease in accrued interest payable	(423)	(733)	(997)
(Decrease) increase in other liabilities	(2,701)	394	440
Net cash provided by operating activities	<u>25,027</u>	<u>27,697</u>	<u>26,646</u>
Cash flows from investing activities:			
Decrease (increase) in loans, net	106,139	8,318	(109,921)
Cash recoveries of loans previously charged off	447	41	9
Purchase of investment in bank	2,072	(1,243)	(2,164)
Purchases of premises and equipment	(274)	(411)	(438)
Proceeds from sales of premises and equipment	132	39	-
Proceeds from sales of other property owned	1,916	2,353	1,204
Net cash provided by (used in) investing activities	<u>110,432</u>	<u>9,097</u>	<u>(111,310)</u>

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

LONE STAR, ACA

CONSOLIDATED STATEMENT OF CASH FLOWS
(dollars in thousands)

	Year Ended December 31,		
	2010	2009	2008
Cash flows from financing activities:			
Net (repayment of) draws on note payable to the bank	(134,888)	(31,399)	90,177
Decrease in drafts outstanding	(108)	(65)	(161)
Decrease in advance conditional payments	(14)	(206)	(213)
Issuance of capital stock and participation certificates	398	588	816
Retirement of capital stock and participation certificates	(706)	(615)	(707)
Patronage distributions paid	(122)	(5,430)	(5,000)
Net cash (used in) provided by financing activities	(135,440)	(37,127)	84,912
Net increase (decrease) in cash	19	(333)	248
Cash at the beginning of the year	47	380	132
Cash at the end of the year	\$ 66	\$ 47	\$ 380

Supplemental schedule of noncash investing and financing activities:

Loans exchanged for agricultural mortgage-backed securities	\$ 59,626	\$ -	\$ -
Loans transferred to other property owned	4,380	14,712	-
Loans charged off	10,635	8,428	1,446
Financed sales of other property owned	901	-	-
Patronage distributions declared	-	-	5,430

Supplemental cash information:

Cash paid during the year for:			
Interest	\$ 26,611	\$ 32,467	\$ 41,709

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

LONE STAR, ACA
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(dollars in thousands)

NOTE 1 — ORGANIZATION AND OPERATIONS:

- A. Organization: Lone Star, ACA, including its wholly-owned subsidiaries, Lone Star, PCA and Lone Star, FLCA (collectively called 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 in 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 (System), a nationwide system of cooperatively owned banks and associations that 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 (Act). The most recent significant amendment to the Act was the Agricultural Credit Act of 1987 (1987 Act). At December 31, 2010, the System consisted of four Farm Credit Banks and their affiliated associations, one Agricultural Credit Bank and its affiliated associations, the Federal Farm Credit Banks Funding Corporation (Funding Corporation) and various service and other organizations.

The Farm Credit Bank of Texas (bank) and its related associations are collectively referred to as the “district.” The bank provides funding to all associations within the district and is responsible for supervising certain activities of the district associations. At December 31, 2010, the district consisted of the bank, one FLCA and 16 ACA parent companies, which have two wholly-owned subsidiaries, an FLCA and a PCA, operating in or servicing the states of Alabama, Louisiana, Mississippi, New Mexico and Texas. ACA parent companies provide financing and related services through their FLCA and PCA subsidiaries. The FLCA makes secured long-term agricultural real estate and rural home mortgage loans. 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 associations to ensure their compliance with the Farm Credit Act, FCA regulations and safe and sound banking practices.

The Act established the Farm Credit System Insurance Corporation (FCSIC) 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, (2) to ensure the retirement of protected borrower capital at par or stated value and (3) for other specified purposes. The Insurance Fund is also available for the discretionary uses by the FCSIC of providing assistance to certain troubled System institutions and to cover the operating expenses of the FCSIC. 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 percent of the aggregate insured obligations (adjusted to reflect the reduced risk on loans or investments guaranteed by federal or state governments) or other such 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 FCSIC is required to reduce premiums as necessary to maintain the Insurance Fund at the 2 percent 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.

FCA regulations require borrower information to be held in strict confidence by Farm Credit institutions, their directors, officers and employees. Directors and employees of the Farm Credit institutions are prohibited, except under specified circumstances, from disclosing nonpublic personal information about members.

- B. Operations: The Act sets forth the types of authorized lending activity, persons eligible to borrow and financial services that 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, rural residents and farm-related businesses. The association makes and services short- and intermediate-term loans for agricultural production or operating purposes, and secured long-term real estate mortgage loans, with funding from the bank.

The association provides a service facilitating the origination of residential loans that are funded by other lenders as well as acting as an intermediary in offering credit life insurance.

The association's financial condition may be affected by factors that affect the bank. The financial condition and results of operations of the bank may materially affect stockholders' investments in the association. Upon request, stockholders of the association will be provided with the Farm Credit Bank of Texas and District Associations' Annual Report to Stockholders, which includes the combined financial statements of the bank and all of the district associations. The district's annual report discusses the material aspects of the financial condition, changes in financial condition and results of operations for the bank and the district. In addition, the district's annual report identifies favorable and unfavorable trends, significant events, uncertainties and the impact of activities of the Insurance Fund.

The lending and financial services offered by the bank are described in Note 1, "Organization and Operations," of the district's annual report to stockholders.

NOTE 2 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

The accounting and reporting policies of the association conform to accounting principles generally accepted in the United States of America (GAAP) and prevailing practices within the banking industry. The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Significant estimates are discussed in these footnotes, as applicable. Actual results could differ from those estimates. Certain amounts in prior years' consolidated financial statements have been reclassified to conform to current financial statement presentation. The consolidated financial statements include the accounts of Lone Star, PCA and Lone Star, FLCA. All significant intercompany transactions have been eliminated in consolidation.

A. Recently Issued or Adopted Accounting Pronouncements: In July 2010, the Financial Accounting Standards Board (FASB) issued guidance on "Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit 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, 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 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 should not have an impact on the association's financial condition or results of operations, but will result in additional disclosures.

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 had no impact on the association's financial condition and results of operations but resulted in additional disclosures.

In June 2009, the FASB issued guidance on "Accounting for Transfers of Financial Assets," which amends previous guidance by improving the relevance, representational faithfulness and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets.

This guidance was effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. Earlier application was prohibited. This statement must be applied to transfers occurring on or after the effective date. Additionally, on and after the effective date, the concept of a qualifying special purpose entity is no longer relevant for accounting purposes. Therefore, formerly qualifying special-purpose entities (as defined under previous accounting standards) should be evaluated for consolidation by reporting entities on and after the effective date, in accordance with the applicable consolidation guidance. If the evaluation on the effective date results in consolidation, the reporting entity should apply the transition guidance provided in the pronouncement that requires consolidation. System institutions reviewed their loan participation agreements to ensure that participations would meet the requirements for sales treatment and not be required to be

consolidated. The impact of adoption on January 1, 2010, was immaterial to the association's financial condition and results of operations.

In June 2009, the FASB also issued guidance to improve financial reporting for those enterprises involved with variable interest entities, which amends previous guidance by requiring an enterprise to perform an analysis to determine whether the enterprise's variable interest or interests give it a controlling financial interest in a variable interest entity. Additionally, an enterprise is required to assess whether it has an implicit financial responsibility to ensure that a variable interest entity operates as designed when determining whether it has the power to direct the activities of the variable interest entity that most significantly impact the entity's economic performance.

This guidance was effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. Earlier application was prohibited. System institutions reviewed transactions that are included in the scope of this guidance and determined that the impact of adoption on January 1, 2010, was immaterial to the association's financial condition and results of operations.

- B. Cash and Cash Equivalents: Cash and cash equivalents, as included in the statement of cash flows, represent cash on hand and on deposit at local banks.
- C. Investment Securities: The association's investments include mortgage-backed securities issued by Farmer Mac for which the association has the intent and ability to hold to maturity and which are consequently classified as held-to-maturity. Held-to-maturity investments are carried at cost, adjusted for the amortization of premiums and accretion of discounts. Changes in the fair value of these investments are not recorded unless the investment is deemed to be other-than-temporarily impaired. Impairment is considered to be other-than-temporary if the present value of cash flows expected to be collected from the debt security is less than the amortized cost basis of the security (any such shortfall is referred to as a credit loss). If an entity intends to sell an impaired debt security or is more likely than not to be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the impairment is other-than-temporary and should be recognized currently in earnings in an amount equal to the entire difference between fair value and amortized cost. If a credit loss exists, but an entity does not intend to sell the impaired debt security and is not more likely than not to be required to sell before recovery, the impairment is other-than-temporary and should be separated into (i) the estimated amount relating to credit loss, and (ii) the amount relating to all other factors. Only the estimated credit loss amount is recognized currently in earnings.

The association may also hold additional investments in accordance with mission-related investment and other investment programs approved by the Farm Credit Administration. These programs allow the association to make investments that further the System's mission to serve rural America. Mission-related investments for which the association has the intent and ability to hold to maturity are classified as held-to-maturity and carried at cost, adjusted for the amortization of premiums and accretion of discounts.

- D. 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 for agricultural production or operating purposes have maturities of 10 years or less.

Loans are carried at their principal amount outstanding adjusted for charge-offs and deferred loan fees or costs. Authoritative accounting guidance requires loan origination fees and direct loan origination costs, if material, to be capitalized and the net fee or cost to be amortized over the life of the related loan as an adjustment to yield. Prior to 2010, this guidance was not implemented due to its immaterial effect on the association's financial position or results of operation for any year presented. The guidance was implemented in 2010 for loans closed in 2010, resulting in the capitalization of \$960 in origination fees and \$863 in origination costs, primarily salaries and benefits related to the origination of loans. The net adjustment to yield on loans for 2010 was a decrease of \$7.

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 instrument 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 as a result of past-due status, is collected or otherwise discharged in full.

Loans are generally placed in nonaccrual status when principal or interest is delinquent for 90 days (unless adequately secured and in the process of collection) or circumstances indicate that collection of principal and/or interest is in doubt. When a loan is placed in nonaccrual status, accrued interest deemed uncollectible is either reversed (if accrued in the current year) or charged against the allowance for loan losses (if accrued in prior years).

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.

Payments received on nonaccrual loans are generally applied to the recorded investment in the loan asset. If collection of the recorded investment in the loan is fully expected and the loan does not have a remaining unrecovered prior charge-off associated with it, the interest portion of payments is recognized as current interest income. Nonaccrual loans may be returned to accrual status when principal and interest are current, prior charge-offs have been recovered, the ability of the borrower to fulfill the contractual repayment terms is fully expected, and the loan is not classified as "doubtful" or "loss." If previously unrecognized interest income exists upon transfer of a nonaccrual loan to accrual status, interest income will be recognized as cash payments are received.

Loans are charged off at the time they are determined to be uncollectible.

The bank and related associations use a two-dimensional loan rating model based on an 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. 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 (OAEM) and grows significantly as a loan moves to a substandard (viable) level. A substandard (nonviable) 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 the institution's 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 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, collateral value, portfolio quality, current production conditions and economic conditions, and prior loan loss experience. It is based on estimates, appraisals and evaluations of loans which, by their nature, contain elements of uncertainty and imprecision. The possibility exists that changes in the economy and its impact on borrower repayment capacity will cause these estimates, appraisals and evaluations to change.

- E. Capital Stock Investment in the Bank: The association's investment in the bank is in the form of Class A voting capital stock and allocated retained earnings. This investment is adjusted periodically based on the association's proportional utilization of the bank compared to other district associations. The bank requires a minimum stock investment of 2 percent of the association's average borrowing from the bank. This investment is carried at cost plus allocated equities in the accompanying consolidated balance sheet.

If needed to meet regulatory capital adequacy requirements, the board of directors of the bank may increase the percentage of stock held by an association from 2 percent of the average outstanding balance of borrowings from the bank to a maximum of 5 percent of the average outstanding balance of borrowings from the bank.

- F. Other Property Owned, Net: Other property owned, net, consisting of real and personal property acquired through a collection action, is recorded at fair value less estimated selling costs upon acquisition. Revised estimates to the fair value less cost to sell 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 gains (losses) on other property owned, net.

- G. Premises and Equipment: Premises and equipment are carried at cost less accumulated depreciation. Land is carried at cost. Depreciation expense is calculated using the straight-line method over the estimated useful lives of 40 years for buildings and improvements; three to 10 years for furniture, equipment and certain leasehold improvements; and three to four years for automobiles. Computer software and hardware are amortized over three years. Gains and losses on dispositions are reflected in current operations. Maintenance and repairs are charged to operating expense, and improvements are capitalized.
- H. Advance Conditional Payments: The association is authorized under the Act to accept advance payments from borrowers. To the extent that the borrower's access to such funds is restricted, the advance conditional payments are netted against the borrower's related loan balance. Amounts in excess of the related loan balance and amounts to which the borrower has unrestricted access are presented as liabilities in the accompanying consolidated balance sheet. Advance conditional payments are not insured. Interest is generally paid by the association on such accounts at rates established by the board of directors.
- I. Employee Benefit Plans: Employees of the association participate in either the district defined benefit retirement plan (DB Plan) or the defined contribution plan (DC Plan). Also, the association sponsors a nonqualified defined contribution 401(k) plan. All eligible employees may participate in the Farm Credit Benefits Alliance 401(k) Plan. The DB Plan is closed to new participants. Participants generally include employees hired prior to January 1, 1996. The DB Plan is noncontributory and provides benefits based on salary and years of service. The "projected unit credit" actuarial method is used for financial reporting and funding purposes for the DB Plan.

Participants in the DC Plan generally include employees who elected to transfer from the DB Plan prior to January 1, 1996, and employees hired on or after January 1, 1996. Participants in the DC Plan direct the placement of their employers' contributions, 5.0 percent of eligible pay for the year ended December 31, 2010, made on their behalf into various investment alternatives.

The structure of the district's DB Plan is characterized as multi-employer, since neither the assets, liabilities nor costs of the plan are segregated or separately accounted for by the associations. No portion of any surplus assets is available to the associations, nor are the associations required to pay for plan liabilities upon withdrawal from the plans. As a result, the associations recognize as pension cost the required contribution to the plans for the year. Contributions due and unpaid are recognized as a liability. The association recognized pension costs for the DC Plan of \$156, \$170 and \$139 for the years ended December 31, 2010, 2009 and 2008, respectively. For the DB Plan, the association recognized pension costs of \$756, \$1,069 and \$402 for the years ended December 31, 2010, 2009 and 2008, respectively.

The association also participates in the Farm Credit Benefits Alliance 401(k) Plan, which requires the associations to match 100 percent of employee contributions up to 3.0 percent of eligible earnings and to match 50 percent of employee contributions for the next 2.0 percent of employee contributions, up to a maximum employer contribution of 4.0 percent of eligible earnings. Association 401(k) plan costs are expensed as incurred. The association's contributions to the 401(k) plan were \$152,541, \$163,185 and \$137,559 for the years ended December 31, 2010, 2009 and 2008, respectively.

In addition to pension benefits, the association provides certain health care and life insurance benefits to qualifying retired employees (other postretirement benefits). These benefits are not characterized as multi-employer and, consequently, the liability for these benefits is included in other liabilities. No association employees hired on or after January 1, 2004, will be eligible for these health care and life insurance benefits upon retirement.

- J. Income Taxes: The ACA holding company conducts its business activities through two wholly-owned subsidiaries. Long-term mortgage lending activities are operated through the wholly-owned FLCA subsidiary which is exempt from federal and state income tax. Short- and intermediate-term lending activities are operated through the 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 tax. The association is eligible 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 refunds. Deferred taxes are provided on the association's taxable income on the basis of a proportionate share of the tax effect of temporary differences not allocated in patronage form. 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, that they will not be realized. The consideration of valuation allowances involves various estimates and assumptions as to future taxable earnings, including the effects of our expected patronage program, which reduces taxable earnings.
- K. Patronage Refunds From the Farm Credit Bank of Texas: The association records patronage refunds from the bank on an accrual basis.

- L. Fair Value Measurement: The FASB 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 asset and liabilities include debt and equity securities and derivative contracts that are traded in an active exchange market, as well as certain U.S. Treasury, other U.S. Government and agency mortgage-backed debt securities that are highly liquid and are actively traded in over-the-counter markets. Also included in Level 1 are assets held in trust funds, which relate to deferred compensation and our supplemental retirement plan. The trust funds include investments that are actively traded and have quoted net asset values that are observable in the marketplace. Pension plan assets that are invested in equity securities, including mutual funds and fixed-income securities that are actively traded, are also included in Level 1.

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. This category generally includes certain U.S. Government and agency mortgage-backed debt securities, corporate debt securities, and derivative contracts. Pension plan assets that are derived from observable inputs, including corporate bonds and mortgage-backed securities, are reported in Level 2.

Level 3 — Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities are considered Level 3. These unobservable inputs reflect the reporting entity's own assumptions about assumptions that market participants would use in pricing the asset or liability. Level 3 assets and liabilities include financial instruments whose value is 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. This category generally includes certain private equity investments, retained residual interests in securitizations, asset-backed securities, highly structured or long-term derivative contracts, certain loans and other property owned. Pension plan assets such as certain mortgage-backed securities that are supported by little or no market data in determining the fair value, are included in Level 3.

The fair value disclosures are presented in Note 12, "Fair Value Measurements."

NOTE 3 — INVESTMENTS:

Held-to-Maturity Mission-Related and Other Investments:

The association may hold mission-related and other investments. The Farm Credit Administration approves mission-related programs and other mission-related investments. The following is a summary of mission-related and other investments that are held to maturity:

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:

	December 31, 2010				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Weighted Average Yield
Agricultural mortgage-backed securities	\$ 45,232	\$ 284	\$ -	\$ 45,516	5.42 %

	December 31, 2009				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Weighted Average Yield
Agricultural mortgage-backed securities	\$ -	\$ -	\$ -	\$ -	- %

	December 31, 2008				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Weighted Average Yield
Agricultural mortgage-backed securities	\$ -	\$ -	\$ -	\$ -	- %

NOTE 4 — LOANS AND ALLOWANCE FOR LOAN LOSSES:

A summary of loans as of December 31 follows:

Loan Type	2010		2009		2008	
	Amount	%	Amount	%	Amount	%
Real estate mortgage	\$ 760,684	79.4%	\$ 886,866	78.9%	\$ 887,469	76.8%
Production and intermediate term	139,139	14.5%	186,990	16.6%	201,851	17.5%
Agribusiness:						
Loans to cooperatives	2,988	0.3%	-	0.0%	-	0.0%
Processing and marketing	30,431	3.2%	19,819	1.8%	32,992	2.9%
Farm-related business	4,510	0.5%	7,322	0.6%	8,807	0.7%
Communication	1,700	0.2%	1,779	0.2%	4,313	0.4%
Energy	753	0.1%	1,955	0.2%	2,127	0.2%
Rural residential real estate	17,777	1.9%	19,192	1.7%	17,822	1.5%
Lease receivables	41	0.0%	-	0.0%	-	0.0%
Total	\$ 958,023	100.0%	\$ 1,123,923	100.0%	\$ 1,155,381	100.0%

Loan Volume by Office:

Branch	2010	2009	2008
Stephenville	27.0%	27.0%	28.2%
Sherman	19.3%	18.2%	14.8%
Denton	11.2%	12.1%	12.0%
Cleburne	10.4%	11.8%	11.1%
Paris	7.2%	7.9%	8.4%
Abilene	6.2%	6.1%	7.1%
New Boston	6.5%	5.8%	6.2%
Fort Worth	5.8%	4.4%	5.3%
Sweetwater	3.2%	3.1%	3.1%
Mt. Pleasant	2.0%	2.4%	2.9%
Weatherford	1.4%	1.2%	0.9%
Total	100.0%	100.0%	100.0%

The association's concentration of credit risk in various agricultural commodities is shown in the following table. While the amounts represent the association's maximum potential credit risk as it relates to recorded loan principal, a substantial portion of the association's lending activities is collateralized, and the association's exposure to credit loss associated with lending activities is reduced accordingly. An estimate of the association's credit risk exposure is considered in the determination of the allowance for loan losses.

Operation/Commodity	2010		2009		2008	
	Amount	%	Amount	%	Amount	%
Livestock, except dairy and poultry	\$ 646,620	67.5%	\$ 762,578	67.9%	\$ 764,148	66.1%
Dairy farms	91,985	9.6%	100,321	8.9%	109,209	9.5%
General farms, primarily crops	52,162	5.4%	51,111	4.5%	46,043	4.0%
Field crops except cash grains	41,464	4.3%	54,692	4.9%	53,872	4.6%
Timber	27,130	2.8%	33,510	3.0%	36,644	3.2%
Rural home loans	17,186	1.8%	18,065	1.6%	17,789	1.5%
Wholesale trade - nondurable goods	16,586	1.7%	15,871	1.4%	11,360	1.0%
Food and kindred products	16,488	1.7%	12,765	1.1%	17,731	1.5%
Animal specialties	13,977	1.5%	19,100	1.7%	24,165	2.1%
Cash grains	9,378	1.0%	13,606	1.3%	24,983	2.2%
Poultry and eggs	6,438	0.7%	-	0.0%	-	0.0%
Farm and garden machinery equipment	1,115	0.1%	8,166	0.7%	-	0.0%
Other	17,494	1.8%	34,138	3.0%	49,437	4.3%
Total	\$ 958,023	100.0%	\$ 1,123,923	100.0%	\$ 1,155,381	100.0%

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, crops and livestock, as well as receivables. Long-term real estate loans are secured by the first liens on the underlying real property. Federal regulations state that long-term real estate loans are not to exceed 85 percent (or 97 percent if guaranteed 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 the loan-to-value ratios in excess of the regulatory maximum.

The association has obtained loan guarantees in the form of standby commitments to purchase qualifying loans from the Federal Agricultural Mortgage Corporation through an arrangement with the bank. At December 31, 2010, 2009 and 2008, loans totaling \$1,517, \$61,672 and \$70,848, respectively, were guaranteed by these commitments. Fees paid for these guarantees totaled \$229, \$262 and \$302 in 2010, 2009 and 2008, respectively, and are reflected in "other noninterest expense."

Asset Quality:

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Acceptable	79.9%	83.6%	97.0%
Special mention	4.0%	6.3%	0.8%
Substandard	16.1%	10.1%	2.2%
Doubtful	0.0%	0.0%	0.0%
Loss	0.0%	0.0%	0.0%
Total	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

Impaired loans are loans for which it is probable that not all principal and interest will be collected according to the contractual terms. The following presents information relating to impaired loans as of December 31:

	<u>2010</u>		<u>2009</u>		<u>2008</u>	
	Amount	%	Amount	%	Amount	%
Nonaccrual loans						
Current as to principal and interest	\$ 32,385	35.6%	\$ 8,099	15.3%	\$ 5,912	53.3%
Past due	58,485	64.4%	44,872	84.7%	5,130	46.2%
Total nonaccrual loans	<u>90,870</u>	<u>100.0%</u>	<u>52,971</u>	<u>100.0%</u>	<u>11,042</u>	<u>99.5%</u>
Accrual loans						
90 days or more past due	-	0.0%	-	0.0%	50	0.5%
Total impaired accrual loans	<u>-</u>	<u>0.0%</u>	<u>-</u>	<u>0.0%</u>	<u>50</u>	<u>0.5%</u>
Total impaired loans	<u>\$ 90,870</u>	<u>100.0%</u>	<u>\$ 52,971</u>	<u>100.0%</u>	<u>\$ 11,092</u>	<u>100.0%</u>

A reassessment by management of the risk within the portfolio during 2010, coupled with continued deterioration in economic conditions and within the dairy industry drove significant credit downgrades, and corresponding increases in allowance for loan losses, provisions for loan losses and loan charge-offs during 2010. There were no material commitments to loan additional funds to debtors whose loans were classified as impaired at December 31, 2010.

Interest income is recognized and cash payments are applied on nonaccrual impaired loans as described in Note 2, "Summary of Significant Accounting Policies." The following table presents interest income recognized on impaired loans.

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Interest income recognized on nonaccrual loans	\$ 464	\$ 2,056	\$ 12
Interest income recognized on impaired accrual loans	14	-	1
Interest income recognized on impaired loans	<u>\$ 478</u>	<u>\$ 2,056</u>	<u>\$ 13</u>

A summary of the allowance for loan losses as of December 31 follows:

	Year Ended December 31,		
	2010	2009	2008
Balance at beginning of year	\$ 7,386	\$ 917	\$ 1,012
Charge-offs:			
Production agriculture:			
Real estate mortgage	(692)	(488)	-
Production and intermediate term	(8,320)	(3,508)	(1,219)
Agribusiness			
Processing and marketing	-	(2,564)	-
Farm-related business	(1,623)	(1,868)	(227)
Total charge-offs	<u>\$ (10,635)</u>	<u>\$ (8,428)</u>	<u>\$ (1,446)</u>
Recoveries:			
Production agriculture:			
Production and intermediate term	445	32	3
Agribusiness			
Farm-related business	1	9	6
Total recoveries	<u>\$ 446</u>	<u>\$ 41</u>	<u>\$ 9</u>
Net charge-offs	(10,189)	(8,387)	(1,437)
Provision for loan losses	21,871	14,856	1,342
Balance at end of year	<u><u>\$ 19,068</u></u>	<u><u>\$ 7,386</u></u>	<u><u>\$ 917</u></u>
Ratio of net charge-offs during the period to average loans outstanding during the period	-1.0%	-0.7%	-0.1%

The following table presents information concerning impaired loans as of December 31:

	2010	2009	2008
Impaired loans with related allowance	\$ 30,215	\$ 25,930	\$ 1,378
Impaired loans with no related allowance	60,655	27,041	9,714
Total impaired loans	<u>\$ 90,870</u>	<u>\$ 52,971</u>	<u>\$ 11,092</u>
Allowance on impaired loans	<u>\$ 16,595</u>	<u>\$ 6,138</u>	<u>\$ 94</u>
Average impaired loans	<u>\$ 76,791</u>	<u>\$ 11,817</u>	<u>\$ 2,769</u>

Interest income on nonaccrual and accruing restructured loans that would have been recognized under the original terms of the loans at December 31:

	2010	2009	2008
Interest income which would have been recognized under the original terms	\$ 6,320	\$ 4,653	\$ 378
Less: interest income recognized	(478)	(2,056)	(13)
Foregone interest income	<u>\$ 5,842</u>	<u>\$ 2,597</u>	<u>\$ 365</u>

NOTE 5 — PREMISES AND EQUIPMENT:

Premises and equipment consisted of the following at December 31:

	2010	2009	2008
Land and improvements	\$ 208	\$ 298	\$ 208
Building and improvements	1,633	1,543	1,542
Furniture and equipment	437	443	454
Computer equipment and software	393	359	321
Automobiles	818	705	619
Construction in progress	-	-	67
	<u>3,489</u>	<u>3,348</u>	<u>3,211</u>
Accumulated depreciation	(1,957)	(1,674)	(1,527)
Total	<u>\$ 1,532</u>	<u>\$ 1,674</u>	<u>\$ 1,684</u>

The association leases office space in Mount Pleasant, Sherman, Gainesville, Abilene, Van Alstyne, Bonham, Fort Worth and Weatherford. Lease expense was \$375, \$416 and \$296 for 2010, 2009 and 2008, respectively. Minimum annual lease payments for the next five years are as follows:

	Operating
2011	\$ 352
2012	172
2013	81
2014	71
2015	71
Thereafter	203
Total	<u>\$ 950</u>

NOTE 6 – OTHER PROPERTY OWNED, NET:

Net gain (loss) on other property owned, net consists of the following for the years ended December 31:

	2010	2009	2008
Gain (loss) on sale, net	\$ 228	\$ 7	\$ 131
Carrying value adjustments	-	-	-
Operating income (expense), net	(463)	(449)	-
Net gain (loss) on other property owned	<u>\$ (235)</u>	<u>\$ (442)</u>	<u>\$ 131</u>

NOTE 7 — NOTE PAYABLE TO THE BANK:

The interest rate risk inherent in the association's loan portfolio is substantially mitigated through the funding relationship with the bank. The bank manages interest rate risk through its direct loan pricing and asset/liability management process. The association's indebtedness to the bank represents borrowings by the association 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. The interest rate on the direct loan is based upon the bank's cost of funding the loans the association has outstanding to its borrowers.

The total amount and the weighted average interest rate of the association's direct loan from the bank at December 31, 2010, 2009 and 2008, were \$850,096 at 2.7 percent, \$984,984 at 3.0 percent and \$1,016,383 at 3.6 percent, respectively.

Under the Act, the association is obligated to borrow only from the bank unless the bank approves borrowing from other funding sources. The bank and FCA regulations have 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, 2010, 2009 and 2008, the association's note payable was within the specified limitations. The maximum amount the association may borrow from the bank as of December 31, 2010, was \$948,063, as defined by the general financing agreement.

In addition to borrowing limits, the financing agreement establishes certain covenants including limits on leases, investments, other debt, and dividend and patronage distributions; minimum standards for return on assets and for liquidity; and provisions for conducting business, maintaining records, reporting financial information, and establishing policies and procedures. Remedies

specified in the financing agreement associated with the covenants include additional reporting requirements, development of action plans, increases in interest rates on indebtedness, reduction of lending limits or repayment of indebtedness. As of and for the years ended December 31, 2010, 2009 and 2008, the association was not subject to remedies associated with the covenants in the financing agreement.

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 had committed defaults under the agreement. The bank has granted limited waivers of these defaults provided that the association complies with all action outlined in its response to the FCA report of examination.

NOTE 8 — MEMBERS’ EQUITY:

A description of the association’s capitalization requirements, protection mechanisms, regulatory capitalization requirements and restrictions, and equities are provided below.

Protection of certain borrower equity is provided under the Act that requires the association, when retiring protected borrower equity, to retire such equity at par or stated value regardless of its book value. Protected borrower equity includes capital stock, participation certificates and allocated equities that were outstanding as of January 6, 1988, or were issued or allocated prior to October 6, 1988. If an association is unable to retire protected borrower equity at par value or stated value, amounts required to retire this equity would be obtained from the Insurance Fund.

In accordance with the Act and the association’s capitalization bylaws, each borrower is required to invest in the association as a condition of borrowing. The investment in Class B capital stock (for farm loans), or participation certificates (for rural home loans) is equal to 2 percent of the loan amount, up to a maximum amount of \$1,000. The borrower acquires ownership of the capital stock or participation certificates at the time the loan is made, usually by adding the aggregate par value of the capital stock or participation certificates to the principal amount of the related loan obligation. The capital stock or participation certificates are subject to a first lien by the association. 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 capital stock or participation certificates.

If needed to meet regulatory capital adequacy requirements, the board of directors of the association may increase the percentage of stock requirement for each borrower up to a maximum of 10 percent of the loan amount.

Each owner of Class B capital stock is entitled to a single vote, while participation certificates provide no voting rights to their owners.

Within two years of repayment of a loan, the association capital bylaws require the conversion of any borrower’s outstanding Class B to Class A stock. Class A stock has no voting rights except in a case where a new issuance of preferred stock has been submitted to stockholders affected by the preference. Redemption of Class A shares is made solely at the discretion of the association’s board of directors. At December 31, 2010, 2009 and 2008, the association had \$0, \$0 and \$6, respectively, of Class A stock.

All borrower stock is at-risk. As such, losses that result in impairment of capital stock or participation certificates shall be borne on a pro rata basis by all holders of Class A capital stock, Class B capital stock and participation certificates. In the event of liquidation of the association, capital stock and participation certificates would be utilized as necessary to satisfy any remaining obligations in excess of the amounts realized on the sale or liquidation of assets. Any excess of the amounts realized on the sale or liquidation of assets over the association’s obligations to external parties and to the bank would be distributed to the association’s stockholders.

Dividends and patronage distributions may be paid on the capital stock and participation certificates of the association, as the board of directors may determine by resolution subject to capitalization requirements as defined by the FCA. Amounts not distributed are retained as unallocated retained earnings. The following dividends and patronage distributions were declared and paid in 2009, 2008 and 2007, respectively:

<u>Date Declared</u>	<u>Date Paid</u>	<u>Patronage</u>
December 2008	August 2010	\$122
December 2008	March 2009	\$5,430
December 2007	March 2008	\$5,000

The association did not declare a patronage distribution for 2009 or 2010. The \$122 patronage distribution that was paid in 2010 was due to an erroneously omitted patronage payment in 2009.

The FCA's capital adequacy regulations require the association to achieve permanent capital and total surplus of at least 7.0 percent and core surplus of at least 3.5 percent of risk-adjusted assets and off-balance-sheet commitments. Failure to meet the ratio requirements can initiate certain mandatory and possibly additional discretionary actions by the FCA that, if undertaken, could have a direct material effect on the association's financial statements. The association is prohibited from reducing permanent capital by retiring stock or making certain other distributions to stockholders unless prescribed capital standards are met. The association's permanent capital ratio, core surplus ratio and total surplus ratio at December 31, 2010, were 14.7 percent, 13.0 percent and 12.8 percent, respectively.

The association Capital Adequacy Plan directs association management to manage the capital position in a manner which:

- Permits the association to operate profitably over the long term;
- Provides reasonable protection against risks inherent in association operations;
- Meets all regulatory requirements;
- Recognizes the cost to stockholders related to investing capital in the association; and
- Is an integral part of the association's business plan.

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

At December 31, the association had the following shares of Class A capital stock, Class B capital stock and participation certificates outstanding at a par value of \$5 per share:

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Class A stock	-	-	1,226
Class B stock	833,270	891,608	902,875
Participation certificates	50,210	53,644	46,494
Total	<u>883,480</u>	<u>945,252</u>	<u>950,595</u>

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

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Nonpension post-retirement benefits	\$ 7	\$ 187	\$ 434
Unrealized gains (losses) on investments available for sale	(272)	(180)	(247)
Total	<u>\$ (265)</u>	<u>\$ 7</u>	<u>\$ 187</u>

NOTE 9 — INCOME TAXES:

The association's provision for (benefit from) income taxes follows for the years ended December 31, 2010, 2009 and 2008.

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 for the years ended December 31:

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Federal tax at statutory rate	\$ (388)	\$ 3,643	\$ 8,353
Effect of nontaxable FLCA subsidiary	(7,639)	(7,818)	(8,806)
Change in valuation allowance	6,600	4,574	136
Other	1,442	(399)	317
Provision for (benefit from) income taxes	<u>\$ 15</u>	<u>\$ -</u>	<u>\$ -</u>

Deferred tax assets and liabilities in accordance with accounting guidance, “Accounting for Income Taxes,” are comprised of the following at December 31:

	<u>2010</u>	<u>2009</u>	<u>2008</u>
<u>Deferred Tax Assets</u>			
Allowance for loan losses	\$ 4,906	\$ 1,762	\$ 83
Loss carryforwards	6,680	3,230	335
Other	6	-	-
Gross deferred tax assets	<u>11,592</u>	<u>4,992</u>	<u>418</u>
Deferred tax asset valuation allowance	<u>(11,592)</u>	<u>(4,992)</u>	<u>(418)</u>
<u>Deferred Tax Liabilities</u>			
Investment in bank stock redemption	-	-	-
Other	<u>(15)</u>	<u>-</u>	<u>-</u>
Gross deferred tax liabilities	<u>(15)</u>	<u>-</u>	<u>-</u>
Net deferred tax asset (liability)	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

The calculation of tax assets and liabilities involves various management estimates and assumptions as to the future taxable earnings including the following at December 31, 2010: Nonpatronage income is expected to be less than 5 percent of total taxable income (before patronage), and patronage income retained is expected to be disbursed. The expected future tax rates are based upon enacted tax laws.

The association recorded valuation allowances of \$11,592, \$4,992 and \$418 during 2010, 2009 and 2008, respectively. The association will continue to evaluate the realizability of the deferred tax assets and adjust the valuation allowance accordingly.

NOTE 10 — EMPLOYEE BENEFIT PLANS:

Employee Retirement Plans: Employees of the association participate in either the defined benefit retirement plan (DB Plan) or the defined contributions plan (DC Plan) and are eligible to participate in the Farm Credit Benefits Alliance 401(k) Plan. Also, the association sponsors a nonqualified defined contribution 401(k) plan. These plans are described more fully in section I of Note 2, “Summary of Significant Accounting Policies.”

Other Postretirement Benefits: In addition to pension benefits, the association provides certain health care and life insurance benefits to qualifying retired employees (other postretirement benefits). These benefits are not characterized as multi-employer and, consequently, the liability for these benefits is included in other liabilities.

In September 2006, the FASB issued guidance, which required the recognition of the overfunded or underfunded status of pension and other postretirement benefit plans on the balance sheet. The balance sheet recognition provisions of this guidance were adopted at December 31, 2007. The guidance also required that employers measure the benefit obligation and plan assets as of the fiscal year end for fiscal years ending after December 15, 2008. In fiscal 2007 and earlier, the System used a September 30 measurement date for pension and other postretirement benefit plans. The guidance provided two approaches for an employer to transition to a fiscal year-end measurement date. The System has applied the second approach, which allows for the use of the measurements determined for the prior year end.

Under this alternative, pension and postretirement benefit income measured for the three-month period October 1, 2007, to December 31, 2007, (determined using the September 2007 measurement date) was recorded as an adjustment to beginning 2008 retained earnings. As a result, the association decreased retained earnings \$316, net of taxes and increased the pension and other postretirement benefit liabilities by \$316.

The following table reflects the benefit obligation, cost and actuarial assumptions for the association’s other postretirement benefits:

Retiree Welfare Benefit Plans

Disclosure Information Related to Retirement Benefits	2010	2009	2008
Change in Accumulated Postretirement Benefit Obligation			
Accumulated postretirement benefit obligation, beginning of year	\$ 1,823	\$ 1,637	\$ 1,451
Service cost	60	55	60
Interest cost	109	102	116
Plan participants' contributions	21	25	31
Plan amendments	-	-	-
Special termination benefits	-	-	-
Actuarial loss (gain)	180	81	69
Benefits paid	(76)	(77)	(90)
Accumulated postretirement benefit obligation, end of year	\$ 2,117	\$ 1,823	\$ 1,637
Change in Plan Assets			
Plan assets at fair value, beginning of year	\$ -	\$ -	\$ -
Actual return on plan assets	-	-	-
Company contributions	55	52	59
Plan participants' contributions	21	25	31
Benefits paid	(76)	(77)	(90)
Plan assets at fair value, end of year	\$ -	\$ -	\$ -
Funded status of the plan	\$ (2,117)	\$ (1,823)	\$ (1,637)
Amounts Recognized in Statement of Financial Position			
Assets	\$ -	\$ -	\$ -
Current Liabilities	(64)	(1,823)	(1,637)
Noncurrent Liabilities	(2,053)	-	-
Total	\$ (2,117)	\$ (1,823)	\$ (1,637)
Amounts Recognized in Accumulated Other Comprehensive Income			
Net actuarial loss	\$ 938	\$ 808	\$ 770
Prior service cost	(673)	(815)	(957)
Total	265	(7)	(187)
Weighted-Average Assumptions Used to Determine Obligations at Year-end			
Measurement date	12/31/2010	12/31/2009	12/31/2008
Discount rate	5.70%	6.05%	6.30%
Health care cost trend rate assumed for next year (pre-/post-65) - medical	7.5%/6.5%	8.0%/7.0%	8.5%/6.25%
Health care cost trend rate assumed for next year - Rx	10.00%	10.50%	12.00%
Ultimate health care cost trend rate	5.00%	5.00%	5.00%
Year that the rate reaches the ultimate trend rate	2017	2017	2015

Total Cost	2010	2009	2008
Service cost	\$ 63	\$ 55	\$ 48
Interest cost	119	102	93
Expected return on plan assets	-	-	-
Amortization of:			
Unrecognized net transition obligation (asset)	-	-	-
Unrecognized prior service cost	(140)	(142)	(143)
Unrecognized net loss (gain)	63	43	1
Net postretirement benefit cost	<u>105</u>	<u>58</u>	<u>(1)</u>

Other Changes in Plan Assets and Projected Benefit Obligation Recognized in Other Comprehensive Income

Net actuarial loss (gain)	\$ 180	\$ 81
Amortization of net actuarial loss (gain)	(49)	(43)
Amortization of prior service cost	141	142
Total recognized in other comprehensive income	<u>\$ 272</u>	<u>\$ 180</u>

AOCI Amounts Expected to be Amortized into Expense in 2011

Unrecognized net transition obligation (asset)	\$ -	\$ -	\$ -
Unrecognized prior service cost	(140)	(142)	(142)
Unrecognized net loss (gain)	63	49	43
Total	<u>\$ (77)</u>	<u>\$ (93)</u>	<u>\$ (99)</u>

Weighted-Average Assumptions Used to Determine Benefit Cost

Measurement date	12/31/2009	12/31/2008	9/30/2007
Discount rate	6.05%	6.05%	6.50%
Health care cost trend rate assumed for next year (pre-/post-65) - medical	8.0%/7.0%	8.0%/7.0%	9.0%/6.75%
Health care cost trend rate assumed for next year - Rx	10.50%	10.50%	13.00%
Ultimate health care cost trend rate	5.00%	5.00%	4.75%
Year that the rate reaches the ultimate trend rate	2017	2017	2016

Expected Future Cash Flows

Expected Benefit Payments (net of employee contributions)

Fiscal 2011	\$ 64
Fiscal 2012	69
Fiscal 2013	77
Fiscal 2014	90
Fiscal 2015	97
Fiscal 2016–2020	644

Expected Contributions

Fiscal 2011	\$ 64
-------------	-------

NOTE 11 — RELATED PARTY TRANSACTIONS:

Directors of the association, except for any director-elected directors, are required to be borrowers/stockholders of the association. Also, in the ordinary course of business, the association may enter into loan origination or servicing transactions with its officers, relatives of officers and directors or with organizations with which such persons are associated. Such loans are subject to special approval requirements contained in FCA regulations and are made on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated borrowers.

Total loans to such persons for the association amounted to \$17,596, \$18,866 and \$18,177 at December 31, 2010, 2009 and 2008, respectively. During 2010, \$12,615 of new loans were made, and repayments totaled \$12,945. In the opinion of management, no such loans outstanding at December 31, 2010, 2009 and 2008 involved more than a normal risk of collectibility.

Expenses included in purchased services may include purchased services such as administrative services, marketing, information systems, accounting services and allocations of expenses incurred by the bank and passed through to the associations, such as FCSIC expenses. The bank charges the individual associations directly for these services based on each association's proportionate usage. These expenses totaled \$495, \$545 and \$516 in 2010, 2009 and 2008, respectively.

The association received patronage payments from the bank totaling \$5,214, \$4,790 and \$3,736 during 2010, 2009 and 2008, respectively.

NOTE 12 — 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. See Note 2, "Summary of Significant Accounting Policies," for additional information.

Assets and liabilities measured at fair value on a recurring basis at December 31, 2010, and December 31, 2009, for each of the fair value hierarchy values are summarized below:

December 31, 2010	Fair Value Measurement Using		
	Level 1	Level 2	Level 3
Assets held in non-qualified benefit trusts	<u>51</u>	<u>-</u>	<u>-</u>
Total assets	<u>51</u>	<u>-</u>	<u>-</u>
December 31, 2009	Fair Value Measurement Using		
	Level 1	Level 2	Level 3
Assets held in non-qualified benefit trusts	<u>35</u>	<u>-</u>	<u>-</u>
Total assets	<u>35</u>	<u>-</u>	<u>-</u>

Assets and liabilities measured at fair value on a non-recurring basis at December 31, 2010 for each of the fair value hierarchy values are summarized below:

December 31, 2010	Fair Value Measurement Using		
	Level 1	Level 2	Level 3
Assets:			
Loans	\$ -	\$ -	\$ 74,759
Other property owned	-	-	9,472
December 31, 2009	Fair Value Measurement Using		
	Level 1	Level 2	Level 3
Assets:			
Loans	\$ -	\$ -	\$ 43,466
Other property owned	-	-	11,567

Valuation Techniques

As more fully discussed in Note 2, "Summary of Significant Accounting Policies," 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. The following represent a brief summary of the valuation techniques used by the bank and associations for assets and liabilities:

Investment Securities

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

Loans

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

Other Property Owned

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

NOTE 13 — COMMITMENTS AND CONTINGENCIES:

In addition to those commitments and contingencies discussed in Note 2, "Summary of Significant Accounting Policies," the association is involved in various legal proceedings in the ordinary 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.

In the ordinary course of business the association originates and purchases loan participations with other lenders. These participations present both credit and counterparty risk. As of December 31, 2010, the association had loan participations in the amount of \$53,359 including participations purchased outside the district of \$525 and participations sold of \$14,031.

The association may participate in financial instruments with off-balance-sheet risk to satisfy the financing needs of its borrowers in the form of commitments to extend credit and commercial letters of credit. These financial instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the 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.

The association also participates in standby letters of credit to satisfy the financing needs of its borrowers. These letters of credit are irrevocable agreements to guarantee payments of specified financing obligations. Standby letters of credit are recorded, at fair value, on the balance sheet by the association. At December 31, 2010, the association had \$2,855 of standby letters of credit.

NOTE 14 — DISCLOSURE ABOUT THE FAIR VALUE OF FINANCIAL INSTRUMENTS:

The following table presents the carrying amounts and estimated fair values of the association's financial instruments at December 31, 2010, 2009 and 2008. Quoted market prices are generally not available for certain System financial instruments, as described below. Accordingly, fair values are based on judgments regarding anticipated cash flows, future expected loss experience, discount rates, current economic conditions, risk characteristics of various financial instruments and other factors. These estimates involve uncertainties and matters of judgment, and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

The estimated fair values of the association's financial instruments as of December 31 follow:

	2010		2009		2008	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets						
Cash	\$ 66	\$ 66	\$ 47	\$ 47	\$ 380	\$ 380
Loans, net	938,955	927,479	1,116,537	1,113,816	1,154,464	1,196,067
Investments	45,232	45,516	-	-	-	-
Financial liabilities						
Note payable to the bank	850,096	839,706	984,984	982,584	1,016,383	1,053,010

A description of the methods and assumptions used to estimate the fair value of each class of the association's financial instruments for which it is practicable to estimate that value follows:

A. Cash:

The carrying value of cash is a reasonable estimate of fair value.

B. Investment Securities:

Includes held-to-maturity investments. See Note 12, "Fair Value Measurements," for the valuation technique used to determine the fair value of investments.

C. Loans:

Because no active market exists for association's loans, fair value is estimated by discounting the expected future cash flows using the association's current interest rates at which similar loans would be made to borrowers with similar credit risk. Since the discount rates are based on the association's loan rates as well as on management estimates, management has no basis to determine whether the fair values presented would be indicative of the value negotiated in an actual sale.

For purposes of determining fair value of accruing loans, the loan portfolio is segregated into pools of loans with homogeneous characteristics. Expected future cash flows and discount rates reflecting appropriate credit risk are determined separately for each individual pool.

Fair value of loans in nonaccrual status that are current as to principal and interest is estimated as described above, with appropriately higher discount rates to reflect the uncertainty of continued cash flows. For noncurrent nonaccrual loans, it is assumed that collection will result only from the disposition of the underlying collateral. Fair value of these loans is estimated to equal the aggregate net realizable value of the underlying collateral, discounted at an interest rate that appropriately reflects the uncertainty of the expected future cash flows over the average disposal period. Where the net realizable value of the collateral exceeds the legal obligation for a particular loan, the legal obligation is generally used in place of net realizable value.

The carrying value of accrued interest approximates its fair value.

D. Investment in the bank:

Estimating the fair value of the association's investment in the bank is not practicable because the stock is not traded. As described in Note 2, "Summary of Significant Accounting Policies," the investment is a requirement of borrowing from the bank and is carried at cost plus allocated equities in the accompanying consolidated balance sheet. The association owns 8.1 percent of the issued common stock of the bank as of December 31, 2010. As of that date, the bank's assets totaled \$14.1 billion and members' equity totaled \$1.2 billion. The bank's earnings were \$168.5 million during 2010.

E. Assets held in non-qualified benefits trusts:

These assets relate to deferred compensation and supplemental retirement plans. As discussed in Note 12, "Fair Value Measurements," the fair value of these assets is quoted net asset values.

F. Note payable to the bank:

The note payable to the bank is not regularly traded; thus, quoted market prices are not available. Fair value of this instrument is discounted based on the association's and bank's loan rates as well as on management estimates. For the purposes of this estimate it is assumed that the cash flow on the note is equal to the principal payments on the association's loan receivables plus accrued interest on the note payable. This assumption implies that earnings on the association's interest margin are used to fund operating expenses and capital expenditures. Management has no basis to determine whether the fair values would be indicative of the value negotiated in an actual sale.

G. Commitments to extend credit:

The association does not normally assess fees on its commitments to extend credit; hence, there is no fair value to be assigned to these commitments until they are funded.

NOTE 15 – QUARTERLY FINANCIAL INFORMATION (UNAUDITED):

Quarterly results of operations for the years ended December 31 follow:

	2010				
	First	Second	Third	Fourth	Total
Net interest income	\$ 7,747	\$ 7,219	\$ 6,728	\$ 6,600	\$ 28,294
(Provision for) reversal of loan losses	(9,071)	(5,519)	(2,271)	(5,010)	(21,871)
Noninterest income (expense), net	(3,668)	(900)	(2,722)	(290)	(7,580)
Net income	<u>\$ (4,992)</u>	<u>\$ 800</u>	<u>\$ 1,735</u>	<u>\$ 1,300</u>	<u>\$ (1,157)</u>
	2009				
	First	Second	Third	Fourth	Total
Net interest income	\$ 8,186	\$ 8,314	\$ 8,153	\$ 7,667	\$ 32,320
(Provision for) reversal of loan losses	(442)	(996)	(7,542)	(5,876)	(14,856)
Noninterest income (expense), net	(1,822)	(1,945)	(2,332)	(651)	(6,750)
Net income	<u>\$ 5,922</u>	<u>\$ 5,373</u>	<u>\$ (1,721)</u>	<u>\$ 1,140</u>	<u>\$ 10,714</u>
	2008				
	First	Second	Third	Fourth	Total
Net interest income	\$ 7,272	\$ 7,545	\$ 7,866	\$ 7,891	\$ 30,575
(Provision for) reversal of loan losses	(257)	218	(577)	(725)	(1,342)
Noninterest income (expense), net	(1,070)	(1,429)	(1,283)	(1,584)	(5,366)
Net income	<u>\$ 5,945</u>	<u>\$ 6,334</u>	<u>\$ 6,006</u>	<u>\$ 5,582</u>	<u>\$ 23,867</u>

NOTE 16 — SUBSEQUENT EVENTS:

The association has evaluated subsequent events through March 3, 2011, which is the date the financial statements were available to be issued. Other than as noted below, there are no events to report.

DISCLOSURE INFORMATION AND INDEX

Disclosures Required by Farm Credit Administration Regulations

DESCRIPTION OF BUSINESS

The description of the territory served, the persons eligible to borrow, the types of lending activities engaged in and the 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 consolidated financial statements, "Organization and Operations," included in this annual report.

The descriptions of significant developments that had or could have a material impact on earnings, interest rates to borrowers, patronage, or dividends and acquisitions or dispositions of material assets, changes in patronage policies or practices, if any, required to be disclosed in this section are incorporated herein by reference from "Management's Discussion and Analysis of Financial Condition and Results of Operations," included in this annual report.

DESCRIPTION OF PROPERTY

Lone Star, ACA (association) serves its 33-county territory through its main administrative and lending office at 1612 Summit Avenue, Suite 300, Fort Worth, Texas 76102. Additionally, there are 10 branch lending offices and three contact points located throughout the territory. The association owns the office buildings in Paris, New Boston, Denton, Cleburne, Stephenville and Sweetwater, free of debt. The association leases office space in Sherman, Mount Pleasant, Gainesville, Abilene, Weatherford, Van Alstyne, Bonham and Fort Worth.

LEGAL PROCEEDINGS

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

DESCRIPTION OF CAPITAL STRUCTURE

The information required to be disclosed in this section is incorporated herein by reference from Note 8 to the consolidated financial statements, "Members' Equity," included in this annual report.

DESCRIPTION OF LIABILITIES

The description of contingent liabilities required to be disclosed in this section is incorporated herein by reference from Notes 2 and 13 to the consolidated financial statements, "Summary of Significant Accounting Policies" and "Commitments and Contingencies," respectively, included in this annual report.

RELATIONSHIP WITH THE FARM CREDIT BANK OF TEXAS

The association's financial condition may be impacted by factors that affect the bank, as discussed in Note 1 to the consolidated financial statements, "Organization and Operations," included in this annual report. The financial condition and results of operations of the Bank may materially affect the stockholders' investment in the association.

The Tenth Farm Credit District's (district) annual and quarterly stockholder reports are available free of charge, upon request. These reports can be obtained by writing to Farm Credit Bank of Texas, The Ag Agency, P.O. Box 202590, Austin, Texas 78720-2590 or calling (512) 483-9204. Copies of the district's annual and quarterly stockholder reports can also be requested by e-mailing fcdb@farmcreditbank.com. The district's annual and quarterly stockholder reports are also available on its website at www.farmcreditbank.com.

The association's quarterly stockholder reports are also available free of charge, upon request. These reports will be available approximately 40 days after quarter end and can be obtained by writing to Lone Star ACA, 1612 Summit Ave. Ste. 300, 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. The association's annual stockholder report is available on its website at www.lonestaragcredit.com 75 days after the fiscal year end. Copies of the Association's annual stockholder report can also be requested 90 days after the fiscal year end.

SELECTED FINANCIAL DATA

The selected financial data for the five years ended December 31, 2010, required to be disclosed, is incorporated herein by reference to the “Five-Year Summary of Selected Consolidated Financial Data” included in this annual report to stockholders.

MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

“Management’s Discussion and Analysis,” which precedes the consolidated financial statements in this annual report, is incorporated herein by reference.

BOARD OF DIRECTORS

CORPORATE GOVERNANCE

The board of directors at Lone Star, ACA is comprised of 12 director positions. Ten directors are elected by the voting membership. Each represents one of five geographic regions that comprise Lone Star, ACA’s lending territory. Two directors are appointed by the other members of the board and cannot be customers, stockholders, employees or agents of any Farm Credit institution. One of these appointed outside directors brings specific financial, accounting and audit expertise to the board and chairs the board’s Audit Committee. The other appointed outside director position is used to bring outside perspective and other areas of expertise to enhance board oversight capabilities.

AUDIT COMMITTEE

This Committee is made up of four board members including at least one appointed outside director. All members of the Committee are expected to have practical knowledge of finance and accounting, be able to read and have a working understanding of the financial statements, or develop that understanding within a reasonable period of time after being appointed to the Committee. The outside director appointed to this Committee has significant financial and audit expertise and chairs this Committee. Don Crawford serves in this position. The board of directors has determined that Mr. Crawford has the qualifications and experience necessary to serve as an Audit Committee “financial expert” as defined by FCA regulation, and has been designated as such. Other current Audit Committee members are David Harris, Lonnie Hammonds and Bert Pruett.

The Audit Committee members are appointed by the board. All members of the Audit Committee are independent of management for Lone Star, ACA or any system entity. The Audit Committee has unrestricted access to representatives of the internal audit firm, independent public accountants, internal credit review firms and financial management.

The Committee assists the board in fulfilling its oversight responsibility related to accounting policies, internal controls, financial reporting practices and regulatory requirements. This Committee has a charter detailing its purpose and key objectives, authority, composition, meeting requirements and responsibilities. The charter among other things gives the Committee the authority to hire and compensate the internal and external auditors and credit reviewers, approve all audit and permitted non-audit services, review the audited financial statements and all public financial disclosures, meet privately with internal and external auditors and credit reviewers and review any complaints regarding accounting irregularities and fraud. The charter is posted on Lone Star, ACA’s website at www.lonestaragcredit.com.

COMPENSATION COMMITTEE

The Compensation Committee consists of three board members selected by the board of directors. Neither the CEO nor management can have any involvement in the selection of Committee members, nor can they participate in any deliberations of the Committee on matters relating to their own compensation. The Committee is presently chaired by the board of directors’ vice chairman, Tom Johnson. Mr. Johnson also currently serves as vice chairman of the Texas District Benefits Administration Committee and is a member of the AgFirst/FCBT Joint Plan Sponsor Committee. Other current Compensation Committee members are David Stubblefield and Larry Stewart.

The Committee is responsible for reviewing and recommending for full board approval, the performance standards of the CEO and the evaluation of the CEO’s performance against those standards. It also recommends to the board all actions necessary to administer the CEO’s compensation plan. The board has delegated to the CEO the responsibility to administer the base salaries of senior officers and all other staff of Lone Star, ACA, within board approved guidelines. However, the CEO must review the base salary administration with the Compensation Committee and the Committee recommends for board approval the overall compensation program for senior officers. The Committee is also responsible for director compensation and for oversight of Lone Star, ACA’s employee’s salary and benefits plans and all board policies applicable to those plans.

DIRECTORS AND SENIOR OFFICERS

The association's member-elected and director-elected board of directors and senior officers are as follows:

NAME	POSITION	DATE ELECTED/ EMPLOYE	TERM EXPIRES
Bruce Duncan	Chairman	1986	2013
Tom Johnson	Vice Chairman	2000	2013
Richard Gaona	Director	2000	2012
Bobby Mathiews	Director	2006	2012
Don Crawford	Director-Elected Director	2002	2011
Wallace E. Kraft II	Director	1993	2011
Lonnie Hammonds	Director	2002	2011
Bert Pruett	Director	1984	2011
David Harris	Director	2001	2013
Larry Stewart	Director	1984	2013
David Stubblefield	Director	1994	2012
Troy Moncrief	Director-Elected Director	2007	2010
Steve Fowlkes	Chief Executive Officer	2010	-
Troy Bussmeir	Chief Credit Officer	2010	-
M'Lissa Kiel	Chief Financial Officer	1997	-
Jim Bob Reynolds	SVP-Commercial Credit	2010	-
Ronald J. Carlock	Sr Regional President	1979	-
Thomas Keith	Regional President	1982	-
James Welch	Regional President	1997	-
Matthew James	Regional President and Branch Manager	1998	-
James Bearden	SVP Policy and Compliance	1997	-
Jeff Royal	Chief Appraisal Officer	1999	-

A brief statement of the business and employment background of each director and senior officer is provided for informational purposes.

Bruce Duncan, 67, currently serves as chairman of the board of Lone Star and is from Avery, Texas. He is a building contractor working under the business name of Bruce Duncan Construction Company. He has been in the construction business since the 1960s. He is presently running a cow/calf operation and since 1970 has farmed and ranched in the Red River County area. Mr. Duncan graduated from Clarksville High School and attended the University of Texas at Arlington. Mr. Duncan served on the school board of Avery Independent School District for 18 years. He has also formerly served on the Red River County Water Board and was vice president of the Chamber of Commerce. He is a member of the Church of Christ. He was elected to the board in 1986.

Tom Johnson, 59, currently serves as vice chairman of the board of Lone Star and as chairman of the Compensation Committee. Mr. Johnson also serves as vice chairman of the Texas District Benefits Administration Committee and is a member of the AgFirst/FCBT Joint Plan Sponsor Committee. Mr. Johnson owns more than 1,600 acres on the Colorado River in San Saba County where he maintains a Black Angus cow/calf operation. Mr. Johnson has been active in the communications industry for more than 25 years and is currently the president and chief executive officer of First American Communications Enterprises, Inc. Mr. Johnson serves as a director of First United Bank and its Trust Committee in Durant, Oklahoma and is a financial board member of Victory Life Church. He is also active in several other charitable organizations. Mr. Johnson was elected to serve on the association's board in April 2001.

Richard Gaona, 52, farms cotton, wheat, hay and cattle in Fisher County. Mr. Gaona serves as board chairman of the Fisher County Appraisal Board. Mr. Gaona is a supporter of the Fisher County Junior Livestock Show and Sale; he has served in the past as a board member of the Roby Independent School District. Mr. Gaona is currently on the steering committee for Rolling Plains Cotton Growers representing the Longworth Co-op Gin. Mr. Gaona was elected to serve on the association's board in 2000.

Bobby Mathiews, 63, was elected to the board in 2006. Mr. Mathiews is a graduate of Tarleton State University. He is a small independent oil company operator and stock farmer in Throckmorton County. Mr. Mathiews has served as mayor of Woodson for the past 19 years. He also serves on the board of the Brazos Telephone Co-op, is a former school board member and a former

member of the Throckmorton County Livestock Show board where he served as superintendent and director. He also serves on the Throckmorton County Tax Appraisal Board. Mr. Mathiews attends First Christian Church in Woodson.

Don Crawford, 63, serves a board as a director-elected director. Mr. Crawford was elected to serve on the board in 2002 and currently serves as chairman of the Audit Committee. He is a director of Titan Bank, N.A. of Mineral Wells, Texas. Mr. Crawford lives in Mineral Wells and is a certified public accountant (CPA) with Crawford, Carter and Thompson of Mineral Wells. He is also a partner in Crawford Ranch of Strawn, Texas, a commercial beef cattle operation. He is chairman of the Finance Committee for Our Lady of Lourdes Catholic Church.

Wallace E. Kraft II, 66, lives in Lamar County. Dr. Kraft was elected to the board in 1993 and he currently serves as the association representative on the District Farm Credit Council. Dr. Kraft is a general veterinary practitioner in Paris, Texas, and owns Animal Health Center. He also operates a 350-acre ranch. He holds a bachelor of science and doctorate of veterinary medicine degree from Kansas State University. He is a member of the American Veterinary Medical Association, past president of the Texas Veterinary Medical Association, past president of the Lamar County Farm Bureau, current chairman of the Lamar County Board of Health, president of Marvin Jennings Clardy Water System and is a member of the Rotary Club, Lamar County Junior Livestock Association and Lamar County Chamber of Commerce. Dr. Kraft also serves on the church council of the First Methodist Church of Paris and is chairman of the Board of Trustees.

Lonnie Hammonds, 70, was elected to the board in 2002 currently serves on the association Audit Committee. Mr. Hammonds has been involved in agriculture all of his life. He is presently the owner and operator of a cow-calf operation in Erath and Hamilton counties. He is a graduate of the University of Texas at Arlington. He has 20 years of experience in the banking industry. Mr. Hammonds is a member of the First United Methodist Church.

Bert Pruett, 58, was elected to the board in 1984 and currently serves on the Audit Committee. Mr. Pruett lives near Slidell in northwest Denton County. He is a self-employed farmer who maintains an operation of cattle, wheat, milo and hay. He is president of Denton/Wise County Farmers' Union, which provides services to the agricultural sector. Currently, he is the chairman of deacons at the First Baptist Church in Slidell. He also serves as treasurer on the Greenwood-Slidell V.F.D.

David Harris, 51, lives in Johnson County and owns property in Somervell County. Mr. Harris was elected to the board in 2001 and currently serves on the Audit Committee. Mr. Harris a graduate of Southern Methodist University and is the president of Bob Harris Oil Company. Mr. Harris also manages Harris Farms and he serves on the Breed Improvement Committee for Santa Gertrudis Breeders International. In the past, Mr. Harris served on the board of directors for the Federal Land Bank Association of Cleburne. He is a member of St. Mark's United Methodist Church.

Larry Stewart, 61, lives between Granbury and Lipan in Hood County. Mr. Stewart was elected to the board in 1984 and currently serves on the Compensation Committee. Mr. Stewart's primary operation is beef cattle. Mr. Stewart also serves as a director on the F.N.B. Granbury Bank Board. Mr. Stewart is an active member of the Acton United Methodist Church.

David Stubblefield, 59, is a farmer-stockman in the Colorado City area of Mitchell County. He was elected to the board in 1994 and currently serves on the Compensation Committee. Mr. Stubblefield is on the board of the Producers Co-op Gin and he serves as state director of Texas Farm Bureau District 6. Mr. Stubblefield is also president of the Lone Wolf Groundwater Conservation District. He is president of the board of Affiliated Food Stores in Abilene and he is also a member of Rolling Plains Cotton Growers Board. Mr. Stubblefield serves on the Extension Program Planning Executive Committee. He is past president of Mitchell County Livestock Show Association. Mr. Stubblefield operates the Gas 'n' Grub convenience store featuring a deli, catering and Western Union services.

Troy Moncrief served on the board as a director-elected director through January 2011. Mr. Moncrief's term expired, and as of January 2011 he is no longer serving as a director.

Steve Fowlkes, 57, became interim CEO of Lone Star in February 2010. In May of 2010 the board named Mr. Fowlkes permanent CEO. Mr. Fowlkes had served as the senior vice president/chief credit officer of the Farm Credit Bank of Texas in Austin, Texas, for the preceding six and a half years. Mr. Fowlkes began his career as a credit examiner with the Farm Credit Administration. He was assistant manager of the Federal Land Bank Association of Cleburne prior to joining the Federal Land Bank (FLB) of Texas in 1979 as a management analyst. Subsequently, he held the positions of associate vice president of internal review for the FLB of Texas, vice president of review for the Farm Credit Banks of Texas, and vice president, special assets, for the Farm Credit Bank of Texas. In 1998, Fowlkes was promoted to senior vice president of bank administration with responsibility for human resources, building operations and the bank's in-house marketing agency. He also was vice chairman of the bank's executive committee. From January to March 2003, he served as interim chief executive officer of the bank. Fowlkes, who is a native of Fort Worth, earned his bachelor's and master's degrees in agricultural economics from Texas A&M University.

Troy Bussmeir, 38, became the chief credit officer for Lone Star in May, 2010. Mr. Bussmeir had served as a relationship manager at the Farm Credit Bank of Texas in Austin, for the previous five years, and as a capital markets analyst for one year prior to that. Mr. Bussmeir began his banking career with Farm Credit of South Florida, as a credit analyst trainee. Three years later, he left South Florida as a senior loan officer and special assets manager, to work at AgFirst Farm Credit Bank in Columbia, South Carolina, as a commercial credit analyst in their capital markets group. Mr. Bussmeir is a native of Seattle, Washington and earned his bachelor's degree in finance and accounting from Palm Beach Atlantic University in West Palm Beach, Florida.

M'Lissa Kiel, 47, joined the Farm Credit Bank of Texas in 1986 and served in various accounting and financial capacities before assuming the role of chief financial officer of Lone Star in December 1997.

Jim Bob Reynolds, 46, currently serves as senior vice president of commercial credit. Jim Bob began his Farm Credit career with Lone Star, ACA on September 1, 2010. Prior to joining Lone Star, ACA Jim Bob worked for First State Bank in Dalhart, Texas for the preceding 11 years, serving as SVP of commercial lending. His career in banking began in the early 1990s at Interstate Bank in Perryton, Texas, serving in various capacities from loan officer to SVP. Jim Bob is a native of Dalhart, Texas where he grew up on his family's farming/cattle operation. He earned his BS in ag economics from Texas Tech University and his MBA from UTSA. Jim Bob is a member of St Andrew Catholic Church in Ft. Worth.

Ronald J. Carlock, 53, is a graduate of Texas A&M University. He began his career with the Federal Land Bank Association of Denton in 1979. Mr. Carlock served as president of the association prior to the merger forming Lone Star on December 31, 1997. Mr. Carlock currently serves as a senior regional president for the association.

Thomas Keith, 51, was named regional president in January 2007. Prior to his promotion, Mr. Keith served as credit office president of the Stephenville office. Mr. Keith, a graduate of Tarleton State University, began his Farm Credit career as a loan officer trainee at Farm Credit Bank of Texas in June 1982.

James Welch, 37, began his Farm Credit career in 1997 with North Texas PCA. From May 2002 through January 2006, Mr. Welch was a credit office president for Lone Star in Paris. Mr. Welch transferred to AgriLand Farm Credit in February 2006 as a joint branch manager of the Paris and Clarksville offices. Mr. Welch returned to Lone Star in December 2006 in his current capacity as a regional president.

Matthew James, 35, was named regional president of the Stephenville region in July of 2010. Prior to his promotion, Mr. James served as branch president of the Stephenville office. Mr. James graduated from Tarleton State University with a bachelor of science degree in agriculture and a minor in business. He began his Farm Credit career as an intern with Lone Star Federal Land Bank in Stephenville in spring of 1998 and accepted a full-time position in August of 1998.

James Bearden, 56, has been employed by Lone Star since 1997. He has served the Farm Credit System since 1980 in several capacities. Mr. Bearden is a native of Hillsboro, Texas, and a graduate of Texas A&M University. Mr. Bearden currently serves as senior vice president of policy and compliance.

Jeff Royal, 48, began his career with Farm Credit as a staff appraiser for Farm Credit Bank of Texas in 1998. Mr. Royal assumed the duties of appraisal operations for Lone Star in 1999 and currently serves as the chief appraisal officer for the association. He is a graduate of Texas A&M University, earning a bachelor's degree in agricultural economics and a master's degree in land economics and real estate.

COMPENSATION OF DIRECTORS

Directors were compensated for their service to the association in the form of an honorarium at the rate of \$600 per day for director meetings and special meetings, except for the board chairman who receives \$700 per day. Directors also receive an annual retention fee of \$600 per month. Committee meetings that are held in conjunction with another meeting are paid at the rate of \$150 per meeting. Directors are paid honorarium for conference calls less than an hour at the rate of \$100 per hour, and for calls in excess of an hour they are compensated \$200 per hour. Directors were reimbursed for certain expenses incurred while representing the association in an official capacity. Mileage for attending official meetings during 2010 was paid at the IRS-approved rate of 50 cents per mile. A copy of the travel policy is available to stockholders of the association upon request.

Director	Number of Days Served Associated With		Total Compensation in 2010
	Board Meetings	Other Official Activities	
Bruce Duncan	14	10	\$ 21,600
Tom Johnson	14	13	23,300
Richard Gaona	14	7	19,800
Bobby Mathiews	14	9	21,000
Don Crawford	12	9	19,800
Wallace E Kraft II	14	11	21,700
Lonnie Hammonds	14	12	22,800
Bert Pruett	13	5	18,000
David Harris	12	3	16,200
Larry Stewart	14	6	19,200
David Stubblefield	14	4	18,000
Troy Moncrief	13	6	18,600
			\$ 240,000

The aggregate compensation paid to directors in 2010, 2009 and 2008 was \$257,500, \$239,100 and \$242,500, respectively. Additional detail regarding director compensation paid for Committee service (which is included in the table above) is as follows:

Director	Committee			Total
	Audit Committee	Compensation Committee	Credit Review Committee	
Don Crawford	\$ 3,850	\$ -	\$ -	\$ 3,850
Lonnie Hammonds	4,300	-	900	5,200
David Harris	3,700	-	-	3,700
Tom Johnson	-	400	-	400
Bert Pruett	3,850	-	-	3,850
Larry Stewart	-	200	-	200
David Stubblefield	-	300	-	300
	\$ 15,700	\$ 900	\$ 900	\$ 17,500

The aggregate amount of reimbursement for travel, subsistence and other related expenses paid to directors and on their behalf was \$75, \$85 and \$73 in 2010, 2009 and 2008, respectively.

COMPENSATION OF SENIOR OFFICERS

Compensation Discussion and Analysis – Senior Officers

Overview

The objective of the association’s salary administration program is to attract, develop, retain and motivate staff that are knowledgeable and efficient in their ability to support the association in the execution of its strategic objectives and delivery of association results that maximize the value received by its membership. The Association’s board of directors, through its Compensation Committee, establishes salary and incentive programs utilizing the services of the Human Resources Compensation Team at the Farm Credit Bank of Texas to compile “Compensation Market Data” annually that is used by the board and management in establishing salary and incentive levels. Data sources used include the Federal Reserve Bank of Dallas 11th District survey, Texas Community Bank survey (Independent Bankers Association of Texas), Watson Wyatt Financial Institution surveys, Mercer Financial Services Commercial Lending survey and CompData surveys. The Compensation Market Data reveals salary and incentive levels for similar sized institutions operating in our geographic area.

Chief Executive Officer (CEO) Compensation Table and Policy

Name of Individual	Year	Salary	Bonus	Deferred/ Perquisite	Other	Total
Steve Fowlkes	2010	\$ 233,340	\$ -	\$ 3,016	\$ 58,424	\$ 294,780
Daron Gates	2010	18,570	-	2,300	-	20,870
Daron Gates	2009	225,000	-	7,259	103,492	335,751
Daron Gates	2008	216,000	138,000	5,722	-	359,722

Daron Gates resigned effective January 27, 2010.

Deferred/Perquisite includes taxable mileage related to personal use of association vehicles. 2010 Other consists of temporary housing and subsidies and relocation cost reimbursement.

2009 Other consists of a severance payment of \$65,000, annual leave paid in the amount of \$27,331 and contributions to non-qualified benefit trusts of \$11,161.

The CEO’s salary is set by the board using the Compensation Market Data as a guideline to arrive at a fair and competitive salary. The CEO did not receive a bonus in 2010.

The association offers a nonqualified supplemental 401(k) plan to all employees who qualify. Through the plan the association may offer restored employer contributions, discretionary contributions or an eligible employee may make elective deferrals. In 2010, the association did not make any restored employer contributions or discretionary contribution to the CEO.

The CEO participates in the DB Pension Plan as described in paragraph I in Note 2. For 2010, the associated costs for the CEO were borne by a different institution. Starting in 2011, the association will be responsible for assuming any additional earned years of service cost.

Compensation of Other Senior Officers

The following table summarizes the compensation paid to the five highest paid officers of the association during 2010, 2009 and 2008. Amounts reflected in the table are presented in the year the compensation was earned.

Name of Group	Year	Salary	Bonus	Deferred/ Perquisite	Other	Total
Aggregate No. of 5 Highest Paid Officers in Year (excludes CEO)						
(5)	2010	\$ 641,608	\$ -	\$ 26,297	\$ 60,051	\$ 727,956
(5)	2009	622,300	-	37,126	6,000	665,426
(5)	2008	543,693	193,632	34,302	-	771,627

Deferred/Perquisite includes taxable mileage related to personal use of association vehicles.

2010 Other consists of relocation costs.

2009 Other consists of contributions to nonqualified benefit trusts.

Senior officer salaries are set by the CEO working in conjunction with the Compensation Committee and utilizing Compensation Market Data. No members of senior management received a bonus in 2010.

The association offers a nonqualified supplemental 401(k) plan to all employees who qualify. Through the plan the association may offer restored employer contributions, discretionary contributions or an eligible employee may make elective deferrals. In 2010, the association did not make any restored employer contributions or discretionary contribution to any senior officer, and no senior officer elected to defer any of his/her salary or incentive.

Disclosure of information on the total compensation paid and the arrangements of the compensation plans during the last fiscal year to any senior officer or to any other officer included in the aggregate is available and will be disclosed to shareholders of the institution upon request.

Total compensation paid to the five most highly paid officers of the association, including bonuses, was \$727,306, \$659,426 and \$771,627 in 2010, 2009 and 2008, respectively. Bonuses paid to such officers for 2010, 2009 and 2008 were \$0, \$0 and \$193,632, respectively.

Personal mileage on association automobiles is reported as taxable income to employees. Employees who use their personal automobile for business purposes were reimbursed during 2010 at the IRS-approved rate of 50 cents per mile.

Neither the CEO nor any other senior officer received noncash compensation exceeding \$5,000 in 2010.

Senior officers, including the CEO, are reimbursed for reasonable travel, subsistence and other related expenses while conducting association business. A copy of the association's travel policy is available to shareholders upon request.

TRANSACTIONS WITH DIRECTORS AND SENIOR OFFICERS

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 consolidated financial statements, "Related Party Transactions," included in this annual report.

DIRECTORS' AND SENIOR OFFICERS' INVOLVEMENT IN CERTAIN LEGAL PROCEEDINGS

There are no legal proceedings involving directors or senior officers of the association.

RELATIONSHIP WITH INDEPENDENT AUDITOR

Fees and expenses incurred by Lone Star, ACA for audit services rendered by its independent auditors, PricewaterhouseCoopers LLP, for the years ended December 31, 2010, 2009 and 2007 were \$55, \$45 and \$37, respectively. These fees and expenses were incurred for the annual financial statement audit.

FINANCIAL STATEMENTS

The financial statements, together with the report thereon of PricewaterhouseCoopers LLP dated March 3, 2011, and the report of management in this annual report to stockholders, are incorporated herein by reference.

CREDIT AND SERVICES TO YOUNG, BEGINNING AND SMALL FARMERS AND RANCHERS, AND PRODUCERS OR HARVESTERS OF AQUATIC PRODUCTS

Lone Star, ACA is obligated to establish programs that respond to the credit and related service needs of Young, Beginning and Small (YBS) farmers and ranchers. It is the association’s responsibility to fulfill its public policy role by extending credit and related services to this important sector of our customer base. YBS farmers and ranchers face continuing challenges in agriculture, including access to capital and credit needs, limited financial resources for land and equipment, urbanization demands and increasing competition from larger and highly capitalized operations.

The board of directors and management are committed to providing programs that facilitate meeting the needs of this group of customers. These programs also address other issues, including the aging of agricultural landowners and customers, the need to transfer assets to another generation of potential landowners and a recognition that many young, beginning and small operators will need to supplement their farm income by seeking off-farm employment. Additionally, demographic trends indicate that agricultural landowners make decisions regarding land or agricultural endeavors based on lifestyle choices, recreational utility or as an alternative investment in a major financial asset.

Definitions for YBS Farmers and Ranchers

Young Farmer or Rancher- a farmer, rancher or producer/harvester of aquatic products who was age 35 or younger as of the date when the loan was originally made.

Beginning Farmer or Rancher- a farmer, rancher or producer/harvester of aquatic products who had ten years or less of experience at farming or ranching as of the date the loan was originally made.

Small Farmer or Rancher- a farmer, rancher or producer/harvester of aquatic products who normally generated less than \$250,000 in annual gross sales of agricultural or aquatic products at the date the loan was originally made. An individual loan to a small borrower will be reported in one of four loan size categories: \$0-\$50,000; \$50,001-\$100,000; \$100,001-\$250,000; and \$250,001 and greater.

In order to address the specific needs of these customers, and to be responsive to the credit needs of young, beginning and small farmers, the association utilizes all existing loan programs to the maximum benefit of young, beginning and small farmers. The association has also developed specific loan programs to meet the credit needs of this group. A New Generation Loan Program has been established to provide reduced interest rates to qualifying young, beginning and small farmers.

The United States Department of Agriculture’s NASS Census of Agriculture-2007 Census provides data regarding the actual market for YBS farmers and ranchers. This census data indicated 4.2 percent of farm operators are “young,” 34.4 percent of operators are “beginning” and 97.7 percent of farm units are categorized as “small.”

The board has established quantitative targets in the business plan to measure and evaluate progress toward serving young, beginning and small customers. These volume-based targets included credit to young farmers at 12 percent, credit to beginning farmers at 35 percent and credit to small farmers at 40 percent. While existing credit to all targeted groups was slightly below expectations in 2010, the board considered the goals to be aggressive and challenging to the association.

The association’s YBS loans, as a percentage of total loans outstanding on December 31, 2010, 2009 and 2008, respectively, are reflected in the table below:

	2010		2009		2008	
	<u>% loans</u>	<u>% volume</u>	<u>% loans</u>	<u>% volume</u>	<u>% loans</u>	<u>% volume</u>
Young	19.80	12.33	19.93	11.46	20.44	11.99
Beginning	54.06	51.99	53.21	53.18	53.73	53.09
Small	77.17	64.36	76.09	63.16	75.99	60.55

The association's YBS loans, as a percentage of all loans closed each year, are reflected in the table below for the past three years:

	2010		2009		2008	
	<u>% loans</u>	<u>% volume</u>	<u>% loans</u>	<u>% volume</u>	<u>% loans</u>	<u>% volume</u>
Young	16.20	11.81	19.19	10.50	22.30	11.90
Beginning	36.64	23.76	45.35	40.84	50.42	41.14
Small	65.11	36.87	69.62	43.06	74.07	40.30

The association coordinates its young, beginning and small farmer loan program activities with other lenders. This includes the purchase and sale of loan participations, loan guarantees and joint lending. Related services including appraisal, credit life insurance, life and disability products and leasing programs are available to assist YBS borrowers in their credit and related service needs.

Important components of the association's YBS efforts include the emphasis placed on outreach programs. The association has held a long-standing belief that an investment in agricultural students and youth activities is important to the long-term success of the cooperative.

The association offers a scholarship program for area seniors and four scholarships are awarded in the lending area. The association also sponsors youth activities in the local area and at the state level through support of 4-H and FFA activities.

A YBS advisory board was formed to generate ideas and methods on how Lone Star, ACA, can better serve the YBS demographic in our area. The advisory board minutes will be reported to the board of directors.

Association loan officers contribute to YBS objectives by providing input and participation in credit training sessions at several area universities.

In summary, the association fulfills its mission of providing agricultural credit, and meeting the specific credit and related service needs of young, beginning and small farmers, ranchers and producers/harvesters of aquatic products through specific lending programs, quantitative performance measures and broad-based objectives.

This page intentionally left blank.

This page intentionally left blank.

This page intentionally left blank.