

LONE STAR, ACA

2010
Quarterly Report
Second Quarter



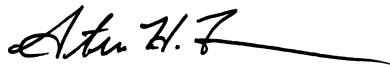
For the Quarter Ended June 30, 2010

REPORT OF MANAGEMENT

To meet its responsibility for reliable financial information, management depends on the Farm Credit Bank of Texas' and the Lone Star Ag Credit Association's accounting and internal control systems, which have been designed to provide reasonable, but not absolute, assurance that assets are safeguarded and transactions are properly authorized and recorded. The systems have been designed to recognize that the cost of controls must be related to the benefits derived. The 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 audit committee has oversight responsibility for the association's systems of internal control and financial reporting. The audit committee consults regularly with management and meets periodically with the independent auditors and the internal auditors to review the scope and results of their work. The independent auditors and the internal auditor have direct access to the audit committee.

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



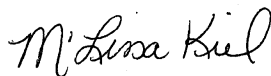
Steve Fowlkes, Chief Executive Officer

June 29, 2010



Bruce Duncan, Chairman, Board of Directors

June 29, 2010



M'Lissa Kiel, Chief Financial Officer

June 29, 2010



Don Crawford, Audit Committee

June 29, 2010

LONE STAR, ACA
MANAGEMENT'S DISCUSSION AND ANALYSIS
(dollars in thousands unless otherwise noted)

The following commentary reviews the financial performance of Lone Star, ACA (Agricultural Credit Association), referred to as the association, for the quarter and six months ended June 30, 2010. These comments should be read in conjunction with the accompanying financial statements and the December 31, 2009 Annual Report of the association.

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

The consolidated financial statements comprise the operations of the ACA and its wholly-owned subsidiaries, Lone Star Federal Land Credit Association (FLCA) and Lone Star Production Credit Association (PCA). The consolidated financial statements were prepared under the oversight of the association's audit committee.

Significant Events:

In 2009, an increase in adverse loans and increase in loan loss reserves resulted in a violation of the Return on Assets (ROA) and Adverse Assets/Risk Funds covenants of the General Financing Agreement ("GFA") between the association and the Farm Credit Bank of Texas ("bank"). 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, and April 28, 2010 stating that the association had committed non-monetary defaults under the agreement. The bank has granted limited waivers of these defaults provided that the association complies with all actions outlined in its response to the Farm Credit Administration (FCA) examination letter dated December 22, 2009.

As of June 30, 2010, the association was in default of certain non-monetary covenants of the April 28, 2010 waiver granted by the bank. As of this date the association has not received any notice from the bank regarding the default.

During the first quarter of 2010 Lone Star, ACA completed a conversion of Federal Agricultural Mortgage Corporation (Farmer Mac) guaranteed mortgage loans totaling \$59,626 for Agricultural Mortgage-Backed security (AMBS) investments. This transaction is not expected to have a material impact on the financial condition of Lone Star, ACA. See the Note – 2 Investments for more details.

Loan Portfolio:

Total association loans outstanding at June 30, 2010, including nonaccrual loans and sales contracts, were \$997,979 compared to \$1,123,923 at December 31, 2009, reflecting a decrease of 11.2 percent. The decrease of \$125,944 between December 31, 2009 and June 30, 2010, consists of \$59,626 conversion of Farmer Mac guarantee loans to Agricultural Mortgage-Backed Security (AMBS) investments during the first quarter of 2010. The additional decrease of \$66,318 is attributed to normal scheduled amortization of loan assets, combined with a continued decreased demand in real estate, recreational property, and large land tract purchases. Loan volume is expected to continue declining throughout the remainder of 2010 as borrowers continue to reduce debt, adverse loans are collected, and weak economic conditions hinder growth opportunities.

Risk Exposure:

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

	June 30, 2010		December 31, 2009	
	Amount	%	Amount	%
Nonaccrual	\$ 98,969	92.0%	\$ 52,971	82.1%
90 days past due and still accruing interest	849	0.8%	-	0.0%
Formally restructured	-	0.0%	-	0.0%
Other property owned, net	7,710	7.2%	11,567	17.9%
Total	\$ 107,528	100.0%	\$ 64,538	100.0%

During the second quarter of 2010 the association's high-risk asset portfolio continued to increase as compared to year-end 2009. This increase is primarily attributed to increases in nonaccrual loans from \$52,971 to \$98,969 in December 2009 and June 30, 2010, respectively. Nonaccrual loans as a percentage of total loans outstanding were 9.9 percent at June 30, 2010, compared to 4.7 percent at December 31, 2009. The association's credit quality continued to weaken during the second quarter of 2010 due primarily to the downgrade of certain dairy loans to an adverse classification. Dairy loans have been downgraded because of unusually high operating losses caused by low prices for milk in 2009 and through the second quarter of 2010. The decrease in Other Property Owned is attributed to the sale of acquired property and the revaluation of existing acquired property. The volatility in the national economy continues to impact borrower's credit quality grading as well as influence the demand for loans in both agricultural and nonagricultural sectors of the financial industry. The association will closely monitor its financial performance and adjust operations to ensure profitability and long-term sustainability for the betterment of its stockholders.

Investments:

During the first quarter of 2010 Lone Star, ACA was approved as a Farmer Mac I seller. As a result, the association converted \$59,626 of mortgage loans covered under a Long-Term Standby Commitment to Purchase Agreement with Farmer Mac for guaranteed agricultural mortgage-backed securities. No gain or loss was recognized in the financial statements upon completion of the exchange transaction. The association continues to service the loans included in this transaction. These investments in guaranteed securities are included in this report's Consolidated Balance Sheet as investments – held-to-maturity

Results of Operations:

	Quarter Ended		Increase/ (Decrease)	Six Months Ended		Increase/ (Decrease)
	June 30,	2009		June 30,	2009	
	2010	2009		2010	2009	
INTEREST INCOME						
Total interest income	\$ 13,794	\$ 16,445	-16.1%	\$ 28,520	\$ 32,872	-13.2%
Total interest expense	6,575	8,131	-19.1%	13,554	16,372	-17.2%
Net interest income	7,219	8,314	-13.2%	14,966	16,500	-9.3%
PROVISION FOR LOSSES						
Provision (negative prov) for loan losses	5,518	996	454.0%	14,589	1,438	914.5%
Provision for acquired property losses	583	17	3329.4%	2,200	17	12841.2%
NET INCOME (LOSS)	\$ 801	\$ 5,373	-85.1%	\$ (4,192)	\$ 11,295	-137.1%

The decrease in net income is a result of the decrease in net interest income, due primarily to a decline in average volume outstanding and an increase in association provision for loan losses as the result of loan downgrades in credit quality and reduced collateral valuations for loans and other property owned.

	Six Months Ended		Increase/ (Decrease)
	June 30,	2009	
	2010	2009	
Average Loan Volume	\$ 1,019,980	\$ 1,185,666	-14.0%
Average Loan Portfolio Spread	2.5%	2.5%	2.8%
ROA	-0.8%	1.9%	-140.9%
ROE	-4.9%	13.6%	-136.0%

Liquidity and Funding Sources:

The association secures the majority of its lendable funds from the bank, which obtains its funds through the issuance of Systemwide obligations and with lendable equity. The following schedule summarizes the Association's borrowings.

	<u>June 30,</u> <u>2010</u>	<u>December 31,</u> <u>2009</u>
Note payable to the Bank	\$ 909,397	\$ 984,984
Accrued interest on note payable	2,153	2,440
Total	<u>\$ 911,550</u>	<u>\$ 987,424</u>

The decrease, in the note payable to FCBT, of \$75,874 for the six months ended June 30, 2010, is attributable to the decrease in the association's loan volume. The note payable to the bank carried a weighted average interest rate of 2.81 as of June 30, 2010, compared to 2.99 as of December 31, 2009. The indebtedness is collateralized by a pledge of substantially all of the association's assets to the bank and governed by a financing agreement.

The liquidity policy of the association is to manage cash balances to maximize debt reduction. This policy will continue to be pursued during 2010. As borrower's payments are received they are applied to the association's note payable with 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 current year.

Capital Resources:

The association's capital position decreased by \$4,383 to \$166,300 at June 30, 2010, compared to \$170,683 at December 31, 2009. The association's debt as a percentage of members' equity was 5.50:1 as of June 30, 2010, compared to 5.82:1 as of December 31, 2009.

Under regulations governing minimum permanent capital adequacy and other capitalization issues, the association is required to maintain a minimum adjusted permanent capital of seven percent of risk-adjusted assets as defined by the FCA. The association's permanent capital ratio at June 30, 2010, was 14.3 percent, which is in compliance with the FCA's minimum permanent capital standard and meets the association's goal of a fourteen to fifteen percent range. The association's core surplus ratio and total surplus ratio at June 30, 2010, were 13.9 and 13.9 percent, respectively, which is in compliance with the FCA's minimum surplus standard and exceeds the association's goal of, equal to or greater than five percent and ten percent, respectively.

Significant Recent Accounting Pronouncements:

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 January 1, 2010. This statement must be applied to transfers occurring on or after the effective date. Additionally, 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 in accordance with the applicable consolidation guidance. If the evaluation results in consolidation, the reporting entity should apply the transition guidance provided in the pronouncement that requires consolidation. The association reviewed its loan participation agreements to ensure that participations would meet the requirements for sales treatment and not be required to be consolidated. The association reviewed its loan participation agreements to ensure that participations would meet the requirements for sales treatment and there are no special-purpose entities that would require consolidation.

Relationship with the Farm Credit Bank of Texas:

The association's financial condition may be impacted by factors that affect the bank. The financial condition and results of operations of the bank may materially affect the stockholder's investment in the association. The Management's Discussion and Analysis and Notes to Financial Statements contained in the December 31, 2009 Annual Report of Lone Star, ACA more fully describe the association's relationship with the bank.

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, or by calling (512) 483-9260. Copies of the District's quarterly and annual stockholder reports also can be requested by e-mail at fcf@farmcreditbank.com. The District makes its annual and quarterly stockholder reports available on its web site at www.farmcreditbank.com.

The association's quarterly stockholder reports are also available free of charge, upon request. These reports can be obtained by writing to Lone Star ACA, 1612 Summit Ave Suite 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 Kimberly.Thomas@LoneStarAgCredit.com.

LONE STAR, ACA

CONSOLIDATED BALANCE SHEET
(dollars in thousands)

	June 30, 2010 (unaudited)	December 31, 2009
<u>ASSETS</u>		
Cash	\$ 47	\$ 47
Investments	56,473	-
Loans	997,979	1,123,923
Less: allowance for loan losses	(16,737)	(7,386)
Net loans	981,242	1,116,537
Accrued interest receivable	9,745	10,501
Investment in and receivable from the Bank:		
Capital stock	20,643	20,643
Other	2,239	2,612
Other property owned, net	7,710	11,567
Premises and equipment	1,540	1,674
Other assets	1,341	371
Total assets	\$ 1,080,980	\$ 1,163,952
<u>LIABILITIES</u>		
Note payable to the Bank	\$ 909,397	\$ 984,984
Advance conditional payments	201	14
Accrued interest payable	2,153	2,440
Drafts outstanding	99	132
Other liabilities	2,829	5,699
Total liabilities	914,679	993,269
<u>MEMBERS' EQUITY</u>		
Capital stock and participation certificates	4,580	4,725
Unallocated retained earnings	161,759	165,951
Accumulated other comprehensive income (loss)	(39)	7
Total members' equity	166,300	170,683
Total liabilities and members' equity	\$ 1,080,979	\$ 1,163,952

LONE STAR, ACA

CONSOLIDATED STATEMENT OF INCOME

(dollars in thousands)

(unaudited)

	Quarter Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
<u>INTEREST INCOME</u>				
Loans	\$ 12,977	\$ 16,445	\$ 27,685	\$ 32,872
Investments	817	-	835	-
Total interest income	<u>13,794</u>	<u>16,445</u>	<u>28,520</u>	<u>32,872</u>
<u>INTEREST EXPENSE</u>				
Note payable to the Bank	<u>6,575</u>	<u>8,131</u>	<u>13,554</u>	<u>16,372</u>
Total interest expense	<u>6,575</u>	<u>8,131</u>	<u>13,554</u>	<u>16,372</u>
Net interest income	<u>7,219</u>	<u>8,314</u>	<u>14,966</u>	<u>16,500</u>
<u>PROVISION FOR LOSSES</u>				
Provision (negative provision) for loan losses	5,518	996	14,589	1,438
Provision for acquired property losses	<u>583</u>	<u>17</u>	<u>2,200</u>	<u>17</u>
Net interest income (loss) after provision for loan losses	<u>1,118</u>	<u>7,301</u>	<u>(1,823)</u>	<u>15,045</u>
<u>NONINTEREST INCOME</u>				
Income from the bank:				
Patronage income	494	542	1,006	1,082
Loan fees	851	737	1,087	1,649
Financially related services income	11	35	54	69
Gain (loss) on other property owned, net	(16)	(1)	5	(17)
Gain (loss) on sale of premises and equipment, net	-	9	-	17
Other noninterest income	<u>1,152</u>	<u>-</u>	<u>1,192</u>	<u>59</u>
Total noninterest income	<u>2,492</u>	<u>1,322</u>	<u>3,344</u>	<u>2,859</u>
<u>NONINTEREST EXPENSES</u>				
Salaries and employee benefits	1,498	1,630	2,794	3,349
Directors' expense	138	86	214	173
Purchased services	372	229	843	463
Travel	113	118	207	212
Occupancy and equipment	190	185	389	349
Communications	46	45	94	92
Advertising	52	50	118	147
Public and member relations	118	126	230	281
Supervisory and exam expense	89	82	178	165
Insurance Fund premiums	15	502	259	992
Other noninterest expense	<u>178</u>	<u>197</u>	<u>387</u>	<u>386</u>
Total noninterest expenses	<u>2,809</u>	<u>3,250</u>	<u>5,713</u>	<u>6,609</u>
Income before income taxes	<u>801</u>	<u>5,373</u>	<u>(4,192)</u>	<u>11,295</u>
Net income (loss)	<u>\$ 801</u>	<u>\$ 5,373</u>	<u>\$ (4,192)</u>	<u>\$ 11,295</u>

LONE STAR, ACA

CONSOLIDATED STATEMENT OF CHANGES IN MEMBERS' EQUITY

(unaudited)

	<u>Capital Stock/ Participation Certificates</u>	<u>Retained Earnings Unallocated</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Total Members' Equity</u>
Balance at December 31, 2008	\$ 4,752	\$ 155,237	\$ 187	\$ 160,176
Net income	-	11,295	-	11,295
Amortization of costs included in periodic retirement benefit costs	-	-	(50)	(50)
Total comprehensive income	4,752	166,532	137	171,421
Capital stock/participation certificates				
Issued	327	-	-	327
Retired	(269)	-	-	(269)
Other	1	(1)	1	1
Balance at June 30, 2009	<u>\$ 4,811</u>	<u>\$ 166,531</u>	<u>\$ 138</u>	<u>\$ 171,480</u>
Balance at December 31, 2009	\$ 4,726	\$ 165,951	\$ 7	\$ 170,684
Comprehensive income				
Net income	-	(4,192)	-	(4,192)
Amortization of costs included in periodic retirement benefit costs	-	-	(46)	(46)
Total comprehensive income	4,726	161,759	(39)	166,446
Capital stock/participation certificates				
Issued	171	-	-	171
Retired	(317)	-	-	(317)
Patronage refunds:				
Cash	-	-	-	-
Other	-	-	-	-
Balance at June 30, 2010	<u>\$ 4,580</u>	<u>\$ 161,759</u>	<u>\$ (39)</u>	<u>\$ 166,300</u>

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

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

NOTE 1 — ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES:

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

Effective January 1, 2010, the bank and related associations adopted Financial Accounting Standards Board (FASB) guidance on “Fair Value Measurements and Disclosures,” which is to improve disclosures about fair value measurements by increasing transparency in financial reporting. The guidance will provide for a greater level of disaggregated information and more robust disclosures of valuation techniques and inputs to fair value measurements. The adoption of this guidance 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 is 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 is 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. The association does not have any variable interest or controlling interest in a variable entity, thus there is no impact of adoption of the guidance.

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 is 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 is prohibited. The association does not have any variable interest or controlling interest in a variable entity, thus there is no impact of adoption of the guidance.

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

The consolidated financial statements comprise the operations of the ACA and its wholly-owned subsidiaries. The preparation of these consolidated financial statements requires the use of management's estimates. The results for the quarter and the six months ended June 30, 2010, are not necessarily indicative of the results to be expected for the year ended December 31, 2010.

NOTE 2 — INVESTMENTS:

Mission-related and Other Investments Held-to-Maturity

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

<u>June 30, 2010</u>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Weighted Average Yield
Commercial paper, bankers' acceptances, certificates of deposit and other securities	\$ -	\$ -	\$ -	\$ -	-
U.S. Treasury securities	-	-	-	-	-
U.S. agency securities	-	-	-	-	-
Mortgage-backed securities	56,473	2,493	-	58,966	5.55
Asset-backed securities	-	-	-	-	-
Total	\$ 56,473	2,493	\$ -	\$ 58,966	- %

<u>December 31, 2009</u>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Weighted Average Yield
Commercial paper, bankers' acceptances, certificates of deposit and other securities	\$ -	\$ -	\$ -	\$ -	-
U.S. Treasury securities	-	-	-	-	-
U.S. agency securities	-	-	-	-	-
Mortgage-backed securities	-	-	-	-	-
Asset-backed securities	-	-	-	-	-
Total	\$ -	\$ -	\$ -	\$ -	- %

The contractual agreement on the held-to-maturity securities is greater than 10 years.

NOTE 3 — ALLOWANCE FOR LOAN LOSSES:

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

	For the six months ended		For the year ended	
	June 30, 2010	June 30, 2009	December 31, 2009	
Beginning Balance	\$ 7,386	\$ 917	\$ 917	
Provision for loan losses	14,589	1,438	14,856	
Charge-offs	(5,353)	(835)	(8,428)	
Recoveries	115	7	41	
Ending Balance	\$ 16,737	\$ 1,527	\$ 7,386	

A reassessment by management at December 31, 2009 of the risk within the portfolio together with general economic conditions has resulted in an increase in the allowance for loan losses. For further description of this change please refer to information contained in the December 31, 2009 Annual Report of Lone Star, ACA. The increase in the allowance for loan losses for the six months ended June 30, 2010, is a result of loan credit quality downgrades as well as decreases in collateral valuations supporting the various loans. The association also recognized a charge off of \$5 million on a large cattle loan in the first quarter of 2010.

The following table presents information concerning impaired loans:

	June 30, 2010	June 30, 2009
Impaired loans with related allowance	\$ 27,113	\$ 10,962
Impaired loans with no related allowance	72,703	8,244
Total impaired loans	<u>\$ 99,816</u>	<u>\$ 19,206</u>
Allowance on impaired loans	\$ 12,172	\$ 183
Average impaired loans	\$ 84,642	\$ 17,363
Interest income on impaired loans for the quarter	\$ 10	\$ 29

The association's loan portfolio has experienced credit quality weaknesses resulting in an increase in impaired loans.

NOTE 4 — CAPITAL:

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

NOTE 5 — INCOME TAXES:

Lone Star, ACA and its subsidiary are subject to federal and certain other income taxes. The associations are eligible to operate as cooperatives that qualify for tax treatment under Subchapter T of the Internal Revenue code. Under specified conditions, the associations can exclude from taxable income amounts distributed as qualified patronage refunds in the form of cash, stock or allocated surplus. Provisions for income taxes are made only on those earnings that will not be distributed as qualified patronage refunds. No provision for income taxes was recorded as of June 30, 2010.

Deferred taxes are recorded at the tax effect of all temporary differences based on the assumption that such temporary differences are retained by the institution and will therefore impact future tax payments. A valuation allowance is provided against deferred tax assets to the extent that it is more likely than not (over 50 percent probability), based on management's estimate, that they will not be realized. For the six months ended June 30, 2010, and 2009 the association carries a deferred tax asset of \$9,883 and \$622 respectively with full valuation allowance recorded against the asset each year.

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

NOTE 6 — FAIR VALUE MEASUREMENTS:

Authoritative guidance defines fair value as the exchange price that would be received for an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability. See Note 11 to the 2009 Annual Report to Stockholders for a more complete description.

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

	Fair Value Measurement Using		
	Level 1	Level 2	Level 3
<u>June 30, 2010</u>			
Assets held in non-qualified benefit trusts	\$ 44	-	-
Total assets	\$ 44	-	-
<u>December 31, 2009</u>			
Assets held in non-qualified benefit trusts	\$ 35	-	-
Total assets	\$ 35	-	-

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

	Fair Value Measurement Using		
	Level 1	Level 2	Level 3
<u>June 30, 2010</u>			
Assets:			
Loans *	\$ -	\$ -	\$ 145,337
Other property owned	-	-	7,710
<u>December 31, 2009</u>			
Assets:			
Loans *	\$ -	\$ -	\$ 43,466
Other property owned	-	-	11,567

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

Valuation Techniques

As more fully discussed in Note 11 to the 2009 Annual Report to Stockholders, authoritative guidance establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The following represent a brief summary of the valuation techniques used for the associations' assets and liabilities. For a more complete description, see Notes to the 2009 Annual Report.

Investment Securities

Where quoted prices are available in an active market, available-for-sale securities are classified as Level 1. If quoted prices are not available in an active market, the fair value of securities is estimated using quoted prices for similar securities received from pricing services, pricing models that utilize observable inputs or discounted cash flows. Generally, these securities are classified as Level 2. This would include certain mortgage-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-backed securities and certain mortgage-backed securities.

Assets Held in Non-Qualified Benefits Trusts

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

Loans

For certain loans evaluated for impairment under authoritative guidance, the fair value is based upon the underlying collateral since the loans were collateral dependent loans for which real estate is the collateral. The fair value measurement process uses

independent appraisals and other market-based information, but in many cases it also requires significant input based on management's knowledge of and judgment about current market conditions, specific issues relating to the collateral and other matters. As a result, these fair value measurements fall within Level 3 of the hierarchy. When the value of the real estate, less estimated costs to sell, is less than the principal balance of the loan, a specific reserve is established.

Other Property Owned

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

NOTE 7 — EMPLOYEE BENEFIT PLANS:

The following table summarizes the components of net periodic benefit costs for the six months ended June 30, 2010:

	Other Benefits	
	2010	2009
Service cost	\$ 30	\$ 28
Interest cost	54	51
Amortization of prior service costs	(71)	(71)
Amortizations of net (gain) loss	24	22
Net periodic benefit cost	\$ 37	\$ 30

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.

The association previously disclosed in its financial statements for the year ended December 31, 2009, that it expected to contribute \$59 to its defined pension plan in 2010. As of June 30, 2010, \$38 of contributions have been made. The association presently anticipates contributing an additional \$21 to fund its defined pension plan in 2010 for a total \$59.

NOTE 8 — Commitments and Contingent Liabilities:

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 against the association 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 June 30, 2010, the association had loan participations in the amount of \$43,066 including participations purchased outside the district of \$546 and participations sold of \$14,196.

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 June 30, 2010, the association had \$676 of standby letters of credit.