



*2008 Quarterly Report  
Third Quarter*

For the Quarter Ended September 30, 2008

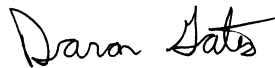
## REPORT OF MANAGEMENT

The consolidated financial statements of Lone Star, ACA (Association) are prepared by management, who are 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 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 this annual report 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 or belief.



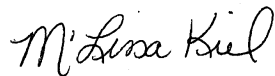
Daron Gates, Chief Executive Officer

October 31, 2008



Bruce Duncan, Chairman, Board of Directors

October 31, 2008



M'Lissa Kiel, Chief Financial Officer

October 31, 2008



Don Crawford, Audit Committee

October 31, 2008

**LONE STAR, ACA**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
(All numbers reported in thousands unless otherwise noted)

The following commentary reviews the financial performance of the Lone Star, ACA (Agricultural Credit Association), referred to as the Association, for the quarter and nine months ended September 30, 2008. These comments should be read in conjunction with the accompanying financial statements and the December 31, 2007 Annual Report of the Association.

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

**Significant Events:**

The Association is party to a Long Term Standby Purchase Commitment with the Farm Credit Bank of Texas which has been entered into with a corresponding Long Term Standby Purchase Commitment between the Bank and the Federal Agricultural Mortgage Corporation (Farmer Mac). The Association utilizes the relationship to manage certain credit risk as well as regulatory capital requirements and had commitments totaling \$73,975 as of September 30, 2008. During the month of September Farmer Mac disclosed impairments totaling approximately \$92 million relating to certain investments which placed Farmer Mac's ability to maintain regulatory compliance in jeopardy. Subsequently, Farmer Mac was able to issue \$65 million in new capital prior to month end in order to maintain compliance with all regulatory capital requirements.

**Loan Portfolio:**

Total loans outstanding at September 30, 2008, including nonaccrual loans and sales contracts, were \$1,130,712 compared to \$1,046,906 at December 31, 2007, reflecting an increase of 8.0 percent. Nonaccrual loans as a percentage of total loans outstanding were 0.3 percent at September 30, 2008, compared to 0.2 percent at December 31, 2007.

**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.

	September 30, 2008		December 31, 2007	
	Amount	%	Amount	%
Nonaccrual	\$ 3,828	90.2%	\$ 2,048	72.7%
90 days past due and still accruing interest	225	5.3%	-	0.0%
Other property owned, net	192	4.5%	768	27.3%
Total	\$ 4,245	100.0%	\$ 2,816	100.0%

**Results of Operations:**

The Association had net income of \$6,006 and \$18,286 for the three and nine months ended September 30, 2008, as compared to net income of \$4,813 and \$15,166 for the same periods in 2007 reflecting an increase of 24.8 and 20.6 percent, respectively. Net interest income was \$7,867 and \$22,684, respectively, for the three and nine months ended September 30, 2008, compared to \$7,025 and \$20,190 for the same periods in 2007. Interest income for the first nine months of 2008 decreased by \$2,693 or 4.8 percent from the same periods of 2007, primarily due to declines in yields on earning assets. Interest expense for the first nine months of 2008 decreased by \$5,187, or 14.4 percent, from the same periods of 2007 due to a decrease in interest rates. Average loan volume for the third quarter of 2008 was \$1,115,099, compared to \$1,009,624 in the third quarter of 2007. The average spread on the loan portfolio for the third quarter 2008 was 2.35 percent, compared to 2.15 percent in the third quarter of 2007.

The Association's noninterest income increased from \$3,260 as of September 30, 2007 to \$4,587 as of September 30, 2008. This increase is largely attributable to an increase in loan fees of \$1,327 for the nine months ending September 30, 2008 as compared to the same period in 2007.

The Association's improvement in net income was offset somewhat by an increase in expenses. Noninterest expenses increased \$1,029 for the nine months ending September 30, 2008 as compared to the same period in 2007. Most of the increase is attributable to increases in salary and employee benefits and purchased services. Salaries and employee benefits increased \$478 resulting from

the addition of staff members. Purchased services expenses increased \$100 as a result of increased loan volume related expenses including legal fees.

The Association recorded \$3 in recoveries and \$492 in charge-offs for the quarter ending September 30, 2008, and \$0 in recoveries and \$22 in charge-offs for the same period in 2007. The Association's allowance for loan losses was 0.1 percent and 0.1 percent of total loans outstanding as of September 30, 2008, and December 31, 2007, respectively.

The Association's return on average assets for the nine months ended September 30, 2008, was 2.17 and 2.03 percent for the same period in 2007. The Association's return on average equity for the nine months ended September 30, 2008, was 16.16 and 15.29 percent for the same period in 2007.

**Liquidity and Funding Sources:**

The primary source of liquidity and funding for the Association is a direct loan from the Bank. The interest rate risk inherent in the Association's loan portfolio is substantially mitigated through the funding and relationship with the Bank. The Bank manages interest rate risk through its direct loan pricing and asset/liability management process. The following schedule summarizes the Association's borrowings.

	September 30, 2008	December 31, 2007
Note payable to the Bank	\$ 1,000,417	\$ 926,206
Accrued interest on note payable	3,345	4,170
Total	<u>\$ 1,003,762</u>	<u>\$ 930,376</u>

The increase of \$73,386 for the nine months ended September 30, 2008 is attributable to the increase in the Association's loan volume. The note carried a weighted average interest rate of 4.1 percent as of September 30, 2008 compared to 5.4 percent as of December 31, 2007. 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 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 2008. As borrower 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, borrower stock. It is management's opinion that funds available to the Association are sufficient to fund its operations for the current year.

**Capital Resources:**

The Association's capital position increased by \$18,292 at September 30, 2008, compared to December 31, 2007. The Association's debt as a percentage of members' equity was 6.30:1 as of September 30, 2008, compared to 6.63:1 as of December 31, 2007.

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 September 30, 2008, was 13.1 percent, which is in compliance with the FCA's minimum permanent capital standard and meets the Association's goal of exceeding 12%. The Association's core surplus ratio and total surplus ratio at September 30, 2008, were 12.6 and 12.6 percent, respectively, which is in compliance with the FCA's minimum surplus standard and exceeds Association goals of, equal to or greater than, 5 percent and 10 percent, respectively.

**Forward Looking Statements:**

Throughout the Associations territory most areas have remained dry and are in need of additional moisture. Grain markets have continued to decrease the past quarter which is expected to have an effect on farmers who did not contract at higher prices seen early in 2008.

Cattle feeding operations are continuing to see losses on fed cattle but have begun to see some positive signs with the decrease in corn prices. It is expected that the next quarter many cattle feeders may see some opportunities to hedge new cattle placed in feed yards at a small profit with breakevens ranging from \$90-\$94 per hundredweight into March/April 2009.

Dairy operations have seen a decrease in milk prices the past quarter with continued pressure on prices expected to occur the last quarter of 2008 and into 2009. Feed prices have continued to decrease the third quarter of 2008 and are expected to decrease further throughout the end of the year however, higher hay prices will continue to pressure breakevens.

Real estate values throughout the Associations territory remain strong with the North Texas economy currently remaining generally positive compared to other areas across the nation. It is expected that the demand for real estate will slow down as many buyers take a wait and see approach through the end of the year.

**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, 2007 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](mailto:fcf@farmcreditbank.com). The District makes its annual and quarterly stockholder reports available on its web site at [www.farmcreditbank.com](http://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 [Adreana.Flores@LoneStarAgCredit.com](mailto:Adreana.Flores@LoneStarAgCredit.com).

**LONE STAR, ACA**

**CONSOLIDATED BALANCE SHEET**  
(dollars in thousands)

	<b>(unaudited)</b> <b>September 30,</b> <b>2008</b>	<b>December 31,</b> <b>2007</b>
<b><u>ASSETS</u></b>		
Cash	\$ 35	\$ 132
Loans	1,130,712	1,046,906
Less: allowance for loan losses	<u>865</u>	<u>1,012</u>
Net loans	1,129,847	1,045,894
Accrued interest receivable	16,414	12,821
Investment in and receivable from the Bank:		
Capital stock	17,236	17,236
Other	2,754	3,782
Other property owned, net	192	768
Premises and equipment	1,665	1,581
Other assets	<u>371</u>	<u>268</u>
Total assets	<u><u>\$ 1,168,514</u></u>	<u><u>\$ 1,082,482</u></u>
 <b><u>LIABILITIES</u></b>		
Note payable to the Bank	\$ 1,000,417	\$ 926,206
Advance conditional payments	215	433
Accrued interest payable	3,345	4,170
Drafts outstanding	979	358
Patronage distributions payable	19	5,000
Other liabilities	<u>3,370</u>	<u>4,438</u>
Total liabilities	<u><u>1,008,345</u></u>	<u><u>940,605</u></u>
 <b><u>MEMBERS' EQUITY</u></b>		
Capital stock and participation certificates	4,756	4,643
Unallocated retained earnings	155,086	136,800
Accumulated other comprehensive income (loss)	<u>327</u>	<u>434</u>
Total members' equity	<u>160,169</u>	<u>141,877</u>
Total liabilities and members' equity	<u><u>\$ 1,168,514</u></u>	<u><u>\$ 1,082,482</u></u>

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

**LONE STAR, ACA**  
**CONSOLIDATED STATEMENT OF INCOME**  
(dollars in thousands)  
(unaudited)

	Quarter Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
<b><u>INTEREST INCOME</u></b>				
Loans	\$ 17,790	\$ 19,650	\$ 53,532	\$ 56,225
Total interest income	<u>17,790</u>	<u>19,650</u>	<u>53,532</u>	<u>56,225</u>
<b><u>INTEREST EXPENSE</u></b>				
Note payable to the Bank	9,923	12,624	30,847	36,026
Advance conditional payments	-	1	1	9
Total interest expense	<u>9,923</u>	<u>12,625</u>	<u>30,848</u>	<u>36,035</u>
Net interest income	<u>7,867</u>	<u>7,025</u>	<u>22,684</u>	<u>20,190</u>
<b><u>PROVISION FOR LOSSES</u></b>				
Provision (negative provision) for loan losses	578	589	617	861
Provision for acquired property losses	-	-	-	41
Net interest income after provision for loan losses	<u>7,289</u>	<u>6,436</u>	<u>22,067</u>	<u>19,288</u>
<b><u>NONINTEREST INCOME</u></b>				
Patronage income from the Bank	544	514	1,639	1,500
Loan fees	778	301	2,672	1,345
Financially related services income	30	38	78	149
Gain (loss) on other property owned, net	149	6	142	(2)
Gain (loss) on sale of premises and equipment, net	(11)	11	2	209
Other noninterest income	-	-	54	59
Total noninterest income	<u>1,490</u>	<u>870</u>	<u>4,587</u>	<u>3,260</u>
<b><u>NONINTEREST EXPENSES</u></b>				
Salaries and employee benefits	1,356	1,199	4,010	3,532
Directors' expense	26	79	200	252
Purchased services	243	182	665	565
Travel	136	86	327	241
Occupancy and equipment	175	149	473	428
Communications	50	42	142	123
Advertising	85	81	288	274
Public and member relations	62	54	280	222
Supervisory and exam expense	82	75	233	203
FCSIC insurance expense	358	375	1,157	1,097
Other noninterest expense	200	128	593	402
Total noninterest expenses	<u>2,773</u>	<u>2,450</u>	<u>8,368</u>	<u>7,339</u>
Income before income taxes	<u>6,006</u>	<u>4,856</u>	<u>18,286</u>	<u>15,209</u>
Provision for (benefit from) income taxes	-	43	-	43
Net income	<u>\$ 6,006</u>	<u>\$ 4,813</u>	<u>\$ 18,286</u>	<u>\$ 15,166</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)

(unaudited)

	Capital Stock/ Participation Certificates	Retained Earnings		Accumulated Other Comprehensive Income (Loss)	Total Members' Equity
		Allocated	Unallocated		
Balance at December 31, 2006	\$ 4,280	\$ -	\$ 120,490	\$ -	\$ 124,770
Net income	-	-	15,166	-	15,166
Capital stock/participation certificates issued	746	-	-	-	746
Capital stock/participation certificates and allocated retained earnings retired	(438)	-	-	-	(438)
<b>Balance at September 30, 2007</b>	<b>\$ 4,588</b>	<b>\$ -</b>	<b>\$ 135,656</b>	<b>\$ -</b>	<b>\$ 140,244</b>
Balance at December 31, 2007	\$ 4,643	\$ -	\$ 136,800	\$ 434	\$ 141,877
Comprehensive income					
Net income	-	-	18,286	-	18,286
Other comprehensive income					
Prior service credits (costs)	-	-	-	(107)	(107)
Other comprehensive income	-	-	-	(107)	(107)
Comprehensive income	-	-	18,286	(107)	18,179
Effects of accounting change regarding measurement date of postretirement benefits plans pursuant to FASB Statement No. 158					
Service and interest costs for October 1- December 31, net of tax	-	-	(107)	-	(107)
Amortization of prior service credits for October 1-December 31, net of tax	-	-	107	-	107
Capital stock/participation certificates issued	673	-	-	-	673
Capital stock/participation certificates and allocated retained earnings retired	(560)	-	-	-	(560)
<b>Balance at September 30, 2008</b>	<b>\$ 4,756</b>	<b>\$ -</b>	<b>\$ 155,086</b>	<b>\$ 327</b>	<b>\$ 160,169</b>

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

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

**NOTE 1 — ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES:**

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

The 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 nine months ended September 30, 2008, are not necessarily indicative of the results to be expected for the year ended December 31, 2008. Certain amounts in the prior period's financial statements have been reclassified to conform to current financial statement presentation.

**NOTE 2 — 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:

	<b>September 30, 2008</b>	September 30, 2007
Balance at beginning of quarter	\$ 777	\$ 989
Provision for loan losses	577	588
Charge-offs	(492)	(22)
Recoveries	3	-
Balance at end of quarter	<u>\$ 865</u>	<u>\$ 1,555</u>

The following table presents information concerning impaired loans:

	<b>September 30, 2008</b>	September 30, 2007
Impaired loans with related allowance	\$ 175	\$ 1,456
Impaired loans with no related allowance	3,879	1,115
Total impaired loans	<u>\$ 4,054</u>	<u>\$ 2,571</u>
Allowance on impaired loans	\$ 62	\$ 558
Average impaired loans	\$ 3,481	\$ 2,409
Interest income on impaired loans for the quarter	\$ 25	\$ 33

### **NOTE 3 — CAPITAL:**

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

### **NOTE 4 — INCOME TAXES:**

Lone Star, ACA and its subsidiary are subject to federal and certain other income taxes. The Associations are eligible to operate as cooperatives that qualify for tax treatment under Subchapter T of the Internal Revenue code. Under specified conditions, the Associations can exclude from taxable income amounts distributed as qualified patronage refunds in the form of cash, stock or allocated surplus. Provisions for income taxes are made only on those earnings that will not be distributed as qualified patronage refunds. During 2008, the Association is participating in a patronage program. Deferred taxes are recorded at the tax effect of all temporary differences based on the assumption that such temporary differences are retained by the institution and will therefore impact future tax payments. A valuation allowance is provided against deferred tax assets to the extent that it is more likely than not (over 50 percent probability), based on management's estimate, that they will not be realized.

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

In June 2006, the Financial Accounting Standards Board (FASB) released Interpretation No. 48, "Accounting for Uncertainty in Income Taxes." This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes." This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Interest and penalties recognized are classified in the financial statements as a component of income taxes. This interpretation is effective for fiscal years beginning after December 15, 2006. The impact of applying the interpretation is not expected to have a material impact on the association's financial condition or results of operations.

Effective January 1, 2007, the Association adopted FIN 48: *Accounting for Uncertainty in Income Taxes*. Adoption of the accounting interpretation resulted in no material adjustments to the Association's financial statements at that time and no material impact is anticipated due to this accounting interpretation in future periods. Management believes the tax position taken by the Association will be sustained upon examination, including resolution of any related appeals or litigation processes, based upon the technical merits of the positions. In its evaluation process, management has presumed that the tax positions will be examined by the appropriate taxing authority that thus has full knowledge of all relevant information.