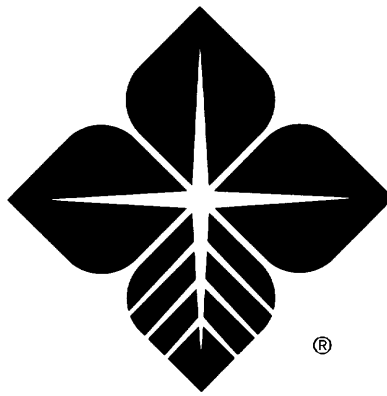


# **HERITAGE LAND BANK, ACA**

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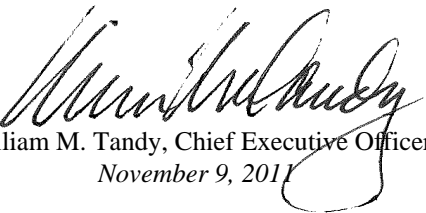
## **2011 Quarterly Report Third Quarter**

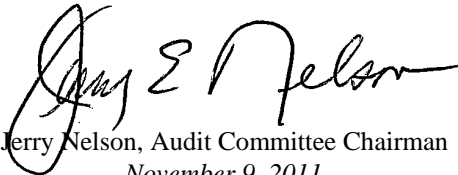



**For the Quarter Ended September 30, 2011**

**REPORT OF MANAGEMENT**

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.

  
William M. Tandy, Chief Executive Officer  
*November 9, 2011*

  
Jerry Nelson, Audit Committee Chairman  
*November 9, 2011*

  
Kenya Francis, Chief Financial Officer  
*November 9, 2011*

**HERITAGE LAND BANK, ACA**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
*(dollars by thousands, except as noted)*

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

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

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

**Significant Events:**

The Association underwent an examination by the Farm Credit Administration (FCA) in 2010. The examination cited serious management and credit weaknesses. As a result, the Association was placed under the special supervision of the Office of Examination of FCA. Under special supervision, the Association was required to undertake specific corrective actions. See details regarding the agreement in Note 9 to the consolidated financial statements, "Supervisory Agreement with the Farm Credit Administration," included in this quarterly report.

The Board immediately took action to improve the Association's management and operations by hiring a new Chief Executive Officer with experience in turning around financial institutions operating under special regulatory supervision. The Board has charged the new Chief Executive Officer with, among other things, keeping the Association in compliance with the Agreement and developing or improving controls to lower the Association's risk, particularly in its loan portfolio. Additionally, following the FCA's examination, the Board directed Management to hire a new Chief Credit Officer and a new Special Assets Manager to assist in maximizing the value of the Association's weaker assets and to aggressively and continually analyze any changes in the ability of borrowers to repay their loans, to conservatively reserve funds for potential losses, and to increase the Association's focus on loan servicing. The Board completed additional training to improve its supervisory effectiveness and is dedicated to improving its capacity and competence with additional training as opportunities arise. The Board and new Management are focused on establishing and keeping communication as a key priority in effectively overseeing the Association's business. The Board also has improved the structure of its oversight by chartering two new committees of the Board, one to oversee risk management and the other to address Association and Board governance. Finally, the Board has engaged a consultant to assist in revising and improving the Association's governance and internal controls to ensure the long-term financial health and soundness of Heritage Land Bank. It is the opinion of the Board and Management that material compliance with these requirements has been accomplished by the timeline outlined by FCA.

In 2010, the credit quality of the loan portfolio was steadily deteriorating. The deterioration led to losses in a number of large loans within the Association's loan portfolio and the addition of reserves to the allowance for loan losses. Consequently, these items significantly affected the Association's earnings in 2010 which resulted in a violation of the rolling 12-Month Return on Average Assets (ROA) covenant in the general financing agreement with the Farm Credit Bank of Texas (the Bank). The Bank has issued a limited waiver effective through January 31, 2012, related to not achieving this minimum standard subject to the Association meeting other designated conditions. All other conditions/covenants of the general financing agreement remain in full force and effect. It is Management's opinion that compliance with the limited waiver issued for 2011 will be maintained.

The Association continues its efforts to strengthen its financial position and manage the credit risk within its portfolio. High risk assets declined from \$34.0 million to \$22.2 million representing a decrease of \$11.8 million from December 31, 2010 to September 30, 2011. This decline was primarily due to the reduction in other property owned of \$6.5 million and nonaccrual loans of \$6.6 million, offset slightly by an increase in accrual loans that were 90 days past due or restructured of \$1.3 million. Net income was \$3.7 million for the nine months ending September 30, 2011 compared to the net loss of \$6.4 million for the same nine months in 2010.

**Loan Portfolio:**

Total loans outstanding at September 30, 2011, including nonaccrual loans and sales contracts, were \$331.2 million compared to \$371.8 million at December 31, 2010, reflecting an decrease of 10.9 percent. Nonaccrual loans as a percentage of total loans outstanding were 5.6 percent at September 30, 2011, compared to 6.7 percent at December 31, 2010.

The credit quality of the portfolio declined slightly in the third quarter of 2011. Acceptable credit decreased from 85.5 percent at December 31, 2010 to 84.6 percent at September 30, 2011. Loans with potential weaknesses, classed special mention, increased from 5.2 percent at December 31, 2010 to 6.8 percent at September 30, 2011. Loans classed substandard decreased from 9.3 percent to 8.6 percent of the loan portfolio from December 31, 2010 to September 30, 2011, due to the upgrade of certain loans to accrual status. Despite the slight decline in credit quality, accrual loan volume has proportionately increased from 93.3 percent at December 31, 2010 to 94.4 percent at September 30, 2011 primarily due to the reduction in substandard credit.

The Association's allowance for loan losses was 2.8 percent and 2.7 percent of total loans outstanding as of September 30, 2011, and December 31, 2010, respectively.

The Association recorded \$230 thousand in recoveries and \$2.2 million in charge-offs for the quarter ending September 30, 2011, and \$101 thousand in recoveries and \$6.7 million in charge-offs for the same period in 2010.

### 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, 2011		December 31, 2010	
	Amount	%	Amount	%
Nonaccrual	\$ 18,447	83.1%	\$ 25,083	73.7%
90 days past due and still accruing interest	-	0.0%	55	0.2%
Formally restructured (accrual)	1,420	6.4%	88	0.2%
Other property owned, net	2,325	10.5%	8,813	25.9%
Total	\$ 22,192	100.0%	\$ 34,039	100.0%

### Investments:

During the first quarter of 2010, the Association exchanged \$6.9 million of mortgage loans for a Federal Agricultural Mortgage Corporation (Farmer Mac) guaranteed agricultural mortgage-backed security that previously were covered under a Long-Term Standby Commitment to Purchase Agreement with Farmer Mac. No gain or loss was recognized in the financial statements upon completion of the exchange transaction. The Association's intent is to hold the investment until maturity and therefore will carry it at amortized cost. 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:

	For the Three Months Ended September 30				For the Nine Months Ended September 30			
	2011	2010	\$ Change	% Change	2011	2010	\$ Change	% Change
Net Interest Income	\$ 2,568	\$ 2,761	\$ (194)	-7.0%	\$ 7,747	\$ 8,706	\$ (959)	-11.0%
Reversal of (Provision for)								
Loan Losses	275	(10,053)	10,328	-102.7%	(1,164)	(12,812)	11,648	-90.9%
Noninterest Income	517	722	(205)	-28.4%	1,797	2,709	(913)	-33.7%
Noninterest Expense	(1,692)	(1,697)	5	-0.3%	(4,716)	(4,973)	257	-5.2%
Net Income	\$ 1,668	\$ (8,266)	\$ 9,935	120.2%	\$ 3,664	\$ (6,369)	\$ 10,034	157.5%
Average Loan Volume	\$337,410	408,540	(71,130)	-17.4%	\$350,636	\$419,281	(68,645)	-16.4%
Average Direct Loan	285,581	352,973	(67,392)	-19.1%	300,814	359,887	(59,073)	-16.4%
Interest Rate Spread	2.47	2.28	0.19	8.3%	2.43	2.29	0.14	6.1%
Return on Average Assets*	1.92	(7.77)	9.69	124.7%	1.35	(1.95)	3.30	169.2%
Return on Average Equity	10.89	(46.66)	57.55	123.3%	8.15	(11.86)	20.01	168.7%

\*Annualized

The Association had net income of \$1.7 million and \$3.7 million for the three and nine months ended September 30, 2011, as compared to net losses of \$8.3 million and \$6.4 million for the same periods in 2010 reflecting an increase of 120.2 and 157.5 percent, respectively. The increase in net income, as shown in the table above, is due to several factors. One of these factors was the decrease in the provision for loan losses recorded for the three and nine months ended September 30, 2011, compared to the same periods in 2010. Net interest income was \$2.6 million and \$7.7 million for the three and nine months ended September 30, 2011, compared to \$2.8 million and \$8.7 million for the same period in 2010 reflecting a decrease of 7.0 and 11.0 percent, respectively. The decrease in the three months was related to a decrease in average loan volume of \$71.1 million, offset by an increase in the interest

rate spread of 19 bps. The decrease in the nine months was related to a decrease in average loan volume of \$68.6 million, offset by an increase in the interest rate spread of 14 bps. The decrease in loan volume is attributable to the slow demand for new loan financing, the collection of loans in default, and additional principal pay down on loans by borrowers. The increase in spread was a result of the reduced cost of funding from the Bank allowing the Association to offer borrowers funding at a reduced rate while improving the net spread on new and existing loans.

Noninterest income was \$517 thousand and \$1.8 million for the three and nine months ended September 30, 2011, compared to \$722 thousand and \$2.7 million for the same periods in 2010 reflecting decreases of 28.4 percent and 33.7 percent, respectively. Noninterest income decreased for both periods due to a decrease in fee income because of the reduction in new loan financing. The decrease in noninterest income for both periods is also due to the decrease in the Association's accrual of patronage income from the Bank, which is based on a lower average loan volume in the capital markets pool held by the Bank and a lower average direct note payable. The decrease for the nine months in 2011 was also related to a refund received in 2010 of \$442 thousand from the Farm Credit System Insurance Corporation (FCSIC) based on excess reserves in the insurance fund.

Noninterest expense was \$1.7 million and \$4.7 million for the three and nine months ended September 30, 2011, compared to \$1.7 million and \$5.0 million for the same periods in 2010 reflecting decreases of 0.3 percent and 5.2 percent, respectively. The decrease in noninterest expense for the nine months in 2011 was primarily due to losses recorded in the 2010 related to other property owned.

The Association's return on average assets for the three and nine months ended September 30, 2011, was 1.92 percent and 1.35 percent as compared to -7.77 percent and -1.95 percent for the same periods in 2010. The Association's return on average equity for the three and nine months ended September 30, 2011, was 10.89 percent and 8.15 percent as compared to -46.66 percent and -11.86 percent for the same periods in 2010. The increase in both returns from 2010 is related to the increase in earnings due to the decrease in operating expenses as well as the decrease in the recognition of provision for loans losses in 2011.

**Liquidity and Funding Sources:**

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

	September 30, 2011	December 31, 2010
Note payable to the bank	\$ 278,763	\$ 328,507
Accrued interest on note payable	703	906
Total	<u>\$ 279,466</u>	<u>\$ 329,413</u>

**Capital Resources:**

The Association's capital position increased by \$3.5 million at September 30, 2011, compared to December 31, 2010. The Association's debt as a percentage of members' equity was 4.51:1 as of September 30, 2011, compared to 5.62:1 as of December 31, 2010.

Under regulations governing minimum permanent capital adequacy and other capitalization issues, the Association is required to maintain a minimum adjusted permanent capital of 7.0 percent of risk-adjusted assets as defined by the FCA. The Association's permanent capital ratio at September 30, 2011, was 15.9 percent, which is in compliance with the FCA's minimum permanent capital standard. The Association's core surplus ratio and total surplus ratio at September 30, 2011, were 15.2 and 15.2 percent, respectively, which is in compliance with the FCA's minimum surplus standard.

**Significant Recent Accounting Pronouncements:**

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

- A single statement must present the components of net income and total net income, the components of other comprehensive income and total other comprehensive income, and a total for comprehensive income.

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

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

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

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

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

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

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

In July 2010, the Financial Accounting Standards Board (FASB) issued guidance on “Disclosures about the Credit Quality of Financing Receivables and the Allowance for Loan Losses,” which is intended to provide additional information to assist financial statement users in assessing an entity’s credit risk exposures and evaluating the adequacy of the allowance for credit losses. Existing disclosures are amended to include additional disclosures of financing receivables on a disaggregated basis (by portfolio segment and class of financing receivable) including among others, a rollforward schedule of the allowance for credit losses from the beginning of the reporting period to the end of the period on a portfolio segment basis, with the ending balance further disaggregated on the basis of the method of impairment (individually or collectively evaluated). The guidance also calls for new disclosures including but not limited to credit quality indicators at the end of the reporting period by class of financing receivables, the aging of past due financing

receivables by class, the nature and extent of financing receivables modified as troubled debt restructurings by class and the effect on the allowance for credit losses. For public entities, the disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. The adoption of this Standard did not impact the Association's financial condition or results of operations, but did result in significant additional disclosures.

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

**Relationship with the Farm Credit Bank of Texas:**

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

The Texas Farm Credit District's (district) annual and quarterly stockholder reports are available free of charge, upon request. These reports can be obtained by writing to Farm Credit Bank of Texas, The Ag Agency, P.O. Box 202590, Austin, Texas 78720, or by calling (512) 483-9204. Copies of the district's quarterly and annual stockholder reports also can be requested by e-mail at [fcf@farmcreditbank.com](mailto:fcf@farmcreditbank.com). The district makes its annual and quarterly stockholder reports available on its website 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 Heritage Land Bank, ACA, 4608 Kinsey Drive, Tyler, TX 75703 or calling (903) 534-4975. The Association also makes its annual report and quarterly reports available on its web site at [www.heritagelandbank.com](http://www.heritagelandbank.com).

**HERITAGE LAND BANK, ACA**  
**CONSOLIDATED BALANCE SHEET**  
*(dollars in thousands)*

	<b>September 30, 2011 (unaudited)</b>	<b>December 31, 2010</b>
<b><u>ASSETS</u></b>		
Cash	\$ 603	\$ 586
Investments – Held-to-Maturity	4,584	5,288
Loans	331,225	371,795
Less: allowance for loan losses	9,111	9,876
Net loans	322,114	361,919
Accrued interest receivable	2,506	2,277
Investment in and receivable from the bank:		
Capital stock	7,174	7,174
Other	1,306	805
Other property owned, net	2,325	8,813
Premises and equipment	1,946	2,001
Other assets	357	609
Total assets	\$ 342,916	\$ 389,472
<b><u>LIABILITIES</u></b>		
Note payable to the bank	\$ 278,763	\$ 328,507
Accrued interest payable	703	906
Drafts outstanding	21	15
Other liabilities	1,164	1,254
Total liabilities	280,651	330,681
<b><u>MEMBERS' EQUITY</u></b>		
Capital stock and participation certificates	2,206	2,362
Allocated retained earnings	6,359	6,365
Unallocated retained earnings	53,406	49,742
Accumulated other comprehensive income	293	322
Total members' equity	62,264	58,791
Total liabilities and members' equity	\$ 342,916	\$ 389,472

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

HERITAGE LAND BANK, ACA

CONSOLIDATED STATEMENT OF INCOME

(dollars in thousands)

(unaudited)

	Quarter Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
<b><u>INTEREST INCOME</u></b>				
Loans	\$ 4,746	\$ 5,610	\$ 14,651	\$ 17,453
Investments	58	91	190	203
Total interest income	<u>4,804</u>	<u>5,701</u>	<u>14,841</u>	<u>17,656</u>
<b><u>INTEREST EXPENSE</u></b>				
Note payable to the bank	<u>2,236</u>	<u>2,940</u>	<u>7,094</u>	<u>8,949</u>
Net interest income	<u>2,568</u>	<u>2,761</u>	<u>7,747</u>	<u>8,706</u>
<b><u>PROVISION FOR LOAN LOSSES</u></b>				
(Reversal of) Provision for loan losses	<u>(275)</u>	<u>10,053</u>	<u>1,164</u>	<u>12,812</u>
Net interest income after provision for loan losses	<u>2,843</u>	<u>(7,292)</u>	<u>6,583</u>	<u>(4,106)</u>
<b><u>NONINTEREST INCOME</u></b>				
Patronage income from the Bank	426	542	1,487	1,652
Patronage income from other Farm Credit institutions	53	-	116	82
Loan fees	31	171	144	487
Financially related services income	1	3	5	7
Other noninterest income	6	7	45	480
Total noninterest income	<u>517</u>	<u>722</u>	<u>1,797</u>	<u>2,709</u>
<b><u>NONINTEREST EXPENSES</u></b>				
Salaries and employee benefits	749	835	2,396	2,467
Directors' expense	41	72	182	180
Purchased services	132	162	324	341
Travel	66	61	148	153
Occupancy and equipment	67	65	200	203
Communications	17	17	55	55
Advertising	29	24	76	50
Public and member relations	60	62	133	175
Supervisory and exam expense	49	41	147	124
Insurance Fund premiums	45	47	143	141
Loss on other property owned, net	404	291	771	953
Other noninterest expense	34	20	141	131
Total noninterest expenses	<u>1,692</u>	<u>1,697</u>	<u>4,716</u>	<u>4,973</u>
Net income	<u>\$ 1,668</u>	<u>\$ (8,266)</u>	<u>\$ 3,664</u>	<u>\$ (6,369)</u>

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

HERITAGE LAND BANK, 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, 2009	\$ 2,573	\$ 6,498	\$ 61,032	\$ 423	\$ 70,525
Comprehensive income					
Net income	-	-	(6,369)	-	(6,369)
Change in postretirement benefit plans	-	-	-	26	26
Total comprehensive income	-	-	(6,369)	26	(6,343)
Capital stock/participation certificates issued	156	-	-	-	156
Capital stock/participation certificates and allocated retained earnings retired	(290)	(86)	-	-	(376)
<b>Balance at September 30, 2010</b>	<b>\$ 2,439</b>	<b>\$ 6,412</b>	<b>\$ 54,663</b>	<b>\$ 449</b>	<b>\$ 63,962</b>
Balance at December 31, 2010	\$ 2,362	\$ 6,365	\$ 49,742	\$ 322	\$ 58,791
Comprehensive income					
Net income	-	-	3,664	-	3,664
Change in postretirement benefit plans	-	-	-	(29)	(29)
Total comprehensive income	-	-	3,664	(29)	3,636
Capital stock/participation certificates issued	127	-	-	-	127
Capital stock/participation certificates and allocated retained earnings retired	(283)	(6)	-	-	(289)
<b>Balance at September 30, 2011</b>	<b>\$ 2,206</b>	<b>\$ 6,359</b>	<b>\$ 53,406</b>	<b>\$ 293</b>	<b>\$ 62,264</b>

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

**HERITAGE LAND BANK, ACA**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
*(dollars by thousands, except as noted)*  
*(unaudited)*

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

The Heritage Land Bank, 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 Dallas, Tarrant, Collin, Hunt, Rockwall, Smith, Henderson, Rusk, Cherokee, Anderson, Nacogdoches, Panola, Sabine, Angelina, San Augustine, and Shelby in the state of Texas. The Association is a lending institution of the Farm Credit System (the System), which was established by Acts of Congress to meet the needs of American agriculture.

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

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

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

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

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

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

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

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

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

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

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

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

The consolidated financial statements comprise the operations of the ACA and its wholly-owned subsidiaries. The preparation of these consolidated financial statements requires the use of management’s estimates. The results for the quarter ended September 30, 2011, are not necessarily indicative of the results to be expected for the year ended December 31, 2011. Certain amounts in the prior period’s financial statements have been reclassified to conform to current financial statement presentation.

## NOTE 2 — INVESTMENTS:

### *Held-to-Maturity*

Effective February 1, 2010, \$6.9 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:

	<b>September 30, 2011</b>				
	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>	<b>Weighted Average Yield</b>
Agricultural mortgage-backed securities	\$ 4,584	\$ 62	\$ -	\$ 4,646	5.16 %

	<b>December 31, 2010</b>				
	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>	<b>Weighted Average Yield</b>
Agricultural mortgage-backed securities	\$ 5,288	\$ 44	\$ -	\$ 5,332	5.23 %

Substantially all the investment securities mature within one year to five years.

## NOTE 3 — LOANS AND ALLOWANCE FOR LOAN LOSSES:

A summary of loans follows:

<u>Loan Type</u>	<u>September 30, 2011 Amount</u>	<u>December 31, 2010 Amount</u>
Production agriculture:		
Real estate mortgage	\$ 280,956	\$ 305,314
Production and intermediate term	21,376	33,785
Agribusiness:		
Loans to cooperatives	76	740
Processing and marketing	14,089	15,666
Communication	1,230	1,441
Rural residential real estate	13,498	14,849
Total	<u>\$ 331,225</u>	<u>\$ 371,795</u>

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

	Other Farm Credit Institutions		Non-Farm Credit Institutions		Total	
	Participations	Participations	Participations	Participations	Participations	Participations
	Purchased	Sold	Purchased	Sold	Purchased	Sold
Real estate mortgage	\$ 14,782	\$ 120,052	\$ -	\$ -	\$ 14,782	\$ 120,052
Production and intermediate term	1,152	3,793	912	-	2,064	3,793
Agribusiness	6,389	30,522	-	-	6,389	30,522
Communication	1,230	-	-	-	1,230	-
Energy	-	-	-	-	-	-
Water and waste disposal	-	-	-	-	-	-
Rural residential real estate	-	-	-	-	-	-
International	-	-	-	-	-	-
Lease receivables	-	-	-	-	-	-
Total	<u>\$ 23,553</u>	<u>\$ 154,367</u>	<u>\$ 912</u>	<u>\$ -</u>	<u>\$ 24,465</u>	<u>\$ 154,367</u>

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

	September 30, 2011	December 31, 2010
<b>Nonaccrual loans:</b>		
Real estate mortgage	\$ 15,698	\$ 21,729
Production and intermediate term	1,893	3,312
Agribusiness	599	-
Rural residential real estate	265	42
Total nonaccrual loans	<u>18,455</u>	<u>25,083</u>
<b>Accruing restructured loans:</b>		
Real estate mortgage	278	-
Production and intermediate term	507	88
Rural residential real estate	38	-
Total accruing restructured loans	<u>823</u>	<u>88</u>
<b>Accruing loans 90 days or more past due:</b>		
Production and intermediate term	383	55
Real estate mortgage	845	-
Total accruing loans 90 days or more	<u>1,228</u>	<u>55</u>
Total nonperforming loans	<u>20,506</u>	<u>25,226</u>
Other property owned	<u>2,325</u>	<u>8,813</u>
Total nonperforming assets	<u>\$ 22,831</u>	<u>\$ 34,039</u>

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

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

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

	<b>September 30, 2011</b>	December 31, 2010
Real estate mortgage		
Acceptable	86.6 %	87.7 %
OAEM	5.4	3.1
Substandard/doubtful	8.0	9.2
	<u>100.0</u>	<u>100.0</u>
Production and intermediate term		
Acceptable	86.6	84.4
OAEM	1.5	4.4
Substandard/doubtful	12.0	11.2
	<u>100.1</u>	<u>100.0</u>
Agribusiness		
Acceptable	29.3	35.9
OAEM	50.0	51.0
Substandard/doubtful	20.7	13.1
	<u>100.0</u>	<u>100.0</u>
Communication		
Acceptable	100.0	100.0
OAEM	-	-
Substandard/doubtful	-	-
	<u>100.0</u>	<u>100.0</u>
Rural residential real estate		
Acceptable	96.5	96.6
OAEM	0.5	0.6
Substandard/doubtful	3.0	2.7
	<u>100.0</u>	<u>99.9</u>
Total Loans		
Acceptable	84.6	85.5
OAEM	6.8	5.2
Substandard/doubtful	8.6	9.3
	<u>100.0 %</u>	<u>100.0 %</u>

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

	30-89 Days Past Due	90 Days or More Past Due	Total Past Due	Not Past Due or Less Than 30 Days Past Due	Total Loans	Recorded Investment >90 Days and Accruing
Real estate mortgage	\$ 1,745	\$ 9,300	\$ 11,045	\$ 272,098	\$ 283,143	\$ -
Production and intermediate term	162	978	1,140	20,451	21,591	-
Loans to cooperatives	-	-	-	76	76	-
Processing and marketing	-	-	-	14,122	14,122	-
Communication	-	-	-	1,242	1,242	-
Rural residential real estate	299	-	299	13,241	13,540	-
Total	<u>\$ 2,206</u>	<u>\$ 10,278</u>	<u>\$ 12,484</u>	<u>\$ 321,230</u>	<u>\$ 333,714</u>	<u>\$ -</u>

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

Additional impaired loan information is as follows:

	At September 30, 2011			For the Three Months Ended September 30, 2011		For the Nine Months Ended September 30, 2011	
	Recorded Investment	Unpaid Principal Balance <sup>a</sup>	Related Allowance	Average Impaired Loans	Interest Income Recognized	Average Impaired Loans	Interest Income Recognized
	Impaired loans with a related allowance for credit losses:						
Real estate mortgage	\$ 11,782	\$ 12,242	\$ 2,596	\$ 11,908	\$ 3	\$ 11,852	\$ 52
Production and intermediate term	2,169	2,270	913	2,203	92	2,185	122
Processing and marketing	207	213	136	212	-	211	-
Rural residential real estate	243	257	120	243	-	243	-
Total	\$ 14,401	\$ 14,982	\$ 3,765	\$ 14,566	\$ 95	\$ 14,491	\$ 174
Impaired loans with no related allowance for credit losses:							
Real estate mortgage	\$ 5,039	\$ 7,148	\$ -	\$ 5,747	\$ 3	\$ 5,888	\$ 26
Production and intermediate term	614	1,865	-	751	8	795	75
Processing and marketing	392	6,002	-	404	-	403	-
Rural residential real estate	60	60	-	44	1	56	2
Total	\$ 6,105	\$ 15,075	\$ -	\$ 6,946	\$ 12	\$ 7,142	\$ 103
Total impaired loans:							
Real estate mortgage	\$ 16,821	\$ 19,390	\$ 2,596	\$ 17,655	\$ 6	\$ 17,740	\$ 78
Production and intermediate term	2,783	4,135	913	2,954	100	2,980	197
Processing and marketing	599	6,215	136	616	-	614	-
Rural residential real estate	303	317	120	287	1	299	2
Total	\$ 20,506	\$ 30,057	\$ 3,765	\$ 21,512	\$ 107	\$ 21,633	\$ 277

	At December 31, 2010			For the Year Ended December 31, 2010	
	Recorded Investment	Unpaid Principal Balance <sup>a</sup>	Related Allowance	Average Impaired Loans	Interest Income Recognized
	Impaired loans with a related allowance for credit losses:				
Real estate mortgage	\$ 18,661	\$ 20,234	\$ 4,265	\$ 14,636	\$ -
Production and intermediate term	2,196	2,226	1,765	1,517	-
Rural residential real estate	40	40	3	37	-
Total	\$ 20,897	\$ 22,500	\$ 6,033	\$ 16,190	\$ -
Impaired loans with no related allowance for credit losses:					
Real estate mortgage	\$ 3,068	\$ 3,203	\$ -	\$ 7,547	\$ 69
Production and intermediate term	1,259	1,989	-	2,028	10
Processing and marketing	-	5,748	-	3,613	-
Rural residential real estate	2	4	-	2	2
Total	\$ 4,329	\$ 10,944	\$ -	\$ 13,190	\$ 81
Total impaired loans:					
Real estate mortgage	\$ 21,729	\$ 23,437	\$ 4,265	\$ 22,183	\$ 69
Production and intermediate term	3,455	4,215	1,765	3,545	10
Processing and marketing	-	5,748	-	3,613	-
Rural residential real estate	42	44	3	39	2
Total	\$ 25,226	\$ 33,444	\$ 6,033	\$ 29,380	\$ 81

<sup>a</sup> Unpaid principal balance represents the recorded principal balance of the loan.

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

	Real Estate Mortgage	Production and Intermediate Term	Agribusiness	Communications	Rural Residential Real Estate	Total
<b>Allowance for Credit Losses:</b>						
Balance at						
December 31, 2010	\$ 7,430	\$ 2,100	\$ 172	\$ 15	\$ 159	\$ 9,876
Charge-offs	(1,366)	(774)	(16)	-	(3)	(2,159)
Recoveries	-	80	150	-	-	230
Provision for loan losses	988	75	50	4	47	1,164
Balance at						
September 30, 2011	\$ 7,052	\$ 1,481	\$ 356	\$ 19	\$ 203	\$ 9,111
Ending Balance:						
individually evaluated for impairment	\$ 2,483	\$ 906	\$ 136	\$ -	\$ 120	\$ 3,645
Ending Balance:						
collectively evaluated for impairment	\$ 4,569	\$ 575	\$ 220	\$ 19	\$ 83	\$ 5,466
Ending Balance: loans acquired with deteriorated credit quality	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
<b>Recorded Investments in Loans Outstanding:</b>						
Ending Balance at						
September 30, 2011	\$ 283,224	\$ 21,420	\$ 14,198	\$ 1,242	\$ 13,540	\$ 333,623
Ending Balance for loans individually evaluated for impairment	\$ 10,431	\$ 2,177	\$ 207	\$ -	\$ 243	\$ 13,058
Ending Balance for loans collectively evaluated for impairment	\$ 272,793	\$ 19,243	\$ 13,990	\$ 1,242	\$ 13,297	\$ 320,565
Ending Balance for loans acquired with deteriorated credit quality	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -

**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:

Heritage Land Bank, ACA and its subsidiary are subject to federal and certain other income taxes. The associations are eligible to operate as cooperatives that qualify for tax treatment under Subchapter T of the Internal Revenue code. Under specified conditions, the associations can exclude from taxable income amounts distributed as qualified patronage refunds in the form of cash, stock or allocated surplus. Provisions for income taxes are made only on those earnings that will not be distributed as qualified patronage refunds. During the nine months ended September 30, 2011, the Association did not participate in a patronage program.

Deferred taxes are recorded at the tax effect of all temporary differences based on the assumption that such temporary differences are retained by the institution and will therefore impact future tax payments. A valuation allowance is provided against deferred tax assets to the extent that it is more likely than not (more than 50 percent probability), based on management's estimate, that they will not be realized. For the nine months ended September 30, 2011, and 2010 net income for tax purposes the Association carries a deferred tax asset of \$6.3 million and \$2.4 million respectively, with a full valuation allowance recorded against the asset each year. The subsidiary, Heritage Land Bank, FLCA, is exempt from federal and other income taxes as provided in the Farm Credit Act of 1971.

## NOTE 6 — FAIR VALUE MEASUREMENTS:

FASB guidance defines fair value as the exchange price that would be received for an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability. See Note 2 to the 2010 Annual Report to Stockholders for a more complete description.

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

<u>September 30, 2011</u>	<u>Fair Value Measurement Using</u>			<u>Total Fair Value</u>
	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	
Assets:				
Loans *	\$ -	\$ -	\$ 9,282	\$ 9,282
Other property owned	-	-	2,325	2,325
<u>December 31, 2010</u>	<u>Fair Value Measurement Using</u>			<u>Total Fair Value</u>
	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	
Assets:				
Loans *	\$ -	\$ -	\$ 14,864	\$ 14,864
Other property owned	-	-	8,813	8,813

### Valuation Techniques

As more fully discussed in Note 2 to the 2010 Annual Report to Stockholders, authoritative guidance establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The following represent a brief summary of the valuation techniques used for the Associations' assets and liabilities. For a more complete description, see Notes to the 2010 Annual Report to Stockholders.

#### *Loans*

For loans evaluated for impairment under FASB guidance, the fair value is based upon the underlying collateral since the loans were collateral-dependent loans. 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. 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 Association previously disclosed in its financial statements for the year ended December 31, 2010, that it expected to contribute \$41 thousand to its postretirement benefit plan in 2011. As of September 30, 2011, \$25 thousand of contributions has been made. The Association presently anticipates contributing an additional \$8 thousand to fund its postretirement benefit plan in 2011 for a total of \$33 thousand. The unfunded accumulated benefit obligation related to this plan at September 30, 2011 is \$836 thousand.

**NOTE 8 — COMMITMENTS AND CONTINGENT LIABILITIES:**

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

**NOTE 9 — SUPERVISORY AGREEMENT WITH THE FARM CREDIT ADMINISTRATION**

The Association underwent an examination by the Farm Credit Administration (FCA) in 2010. The examination cited serious management and credit weaknesses, particularly in risk identification. As a result, the Association was placed under the special supervision of the Office of Examination of FCA. In December 2010, the Board of directors entered into a supervisory agreement with FCA after its Office of Examination deemed the Association's response to the findings of an independent Board governance study to be inadequate.

As required by the supervisory agreement, the Board and Management are to take specific actions to strengthen several areas of Association operations and governance. The Agreement requires the Board to receive additional training designed to improve its supervisory capacity. The Board is also required to hire a qualified consultant to help the Association improve its system of controls, train board members and management and assist in compliance with the Agreement. The Agreement also requires improvements to the board nominating process so as to improve the Board's representation of the shareholder base and to ensure ongoing identification and development of quality board candidates. The Agreement also requires the Board to hire a new Chief Executive Officer and to submit a plan which addresses compliance with the Association's general financing agreement with the Farm Credit Bank of Texas. The Agreement further outlines a system of monthly and quarterly reporting that keeps the FCA informed of the Association's financial, lending and operating activities.

The Board acted quickly to improve the Association's management and operations by hiring a new Chief Executive Officer with experience in turning around financial institutions operating under special regulatory supervision. The Board has charged the new Chief Executive Officer with, among other things, keeping the Association in compliance with the Agreement and developing or improving controls to lower the Association's risk, particularly in its loan portfolio. Additionally, since the FCA's examination, the Board has directed Management to hire a new Chief Credit Officer and a new Special Assets Manager to assist in maximizing the value of the Association's weaker assets. The Board has further directed Senior Management to aggressively and continually analyze any changes in the ability of borrowers to repay their loans, to conservatively reserve funds for potential losses, and to increase the Association's focus on loan servicing. The Board completed additional training to improve its supervisory effectiveness and is dedicated to improving its capacity and competence with additional training as opportunities arise. The Board and new Management are focused on establishing and keeping communication as a key priority in effectively overseeing the Association's business. The Board also has improved the structure of its oversight by chartering two new committees of the Board, one to oversee risk management and the other to address Association and Board governance. Finally, the Board has engaged a consultant to assist in revising and improving the Association's governance and internal controls to ensure the long-term financial health and soundness of Heritage Land Bank.

The Board believes the Association is in substantial compliance with the Agreement and is committed to the establishment of a new culture of accountability and professionalism. It believes the actions taken to strengthen operating practices and governing standards will result in a stronger and healthier Association which will better meet the financing needs of its stockholders. The Board will continue to update its stockholders as to its compliance with the Supervisory Agreement on a quarterly basis until such time that FCA determines this Agreement is no longer in effect.

**NOTE 10 — SUBSEQUENT EVENTS:**

The Association has evaluated subsequent events through November 9, 2011, which is the date the financial statements were available to be issued. No subsequent events were noted to report.