

Policy/Procedure: 1080 Internal Control	Approval Board of Directors 1/2/04, 6/28/06, 6/27/07, Charter Revision 1/31/07, 9/23/08
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INTERNAL CONTROL

Policy

It is the policy of the Association to maintain an internal audit function as a means of providing all levels of management with information to control the operations, to provide the Board of Directors with information necessary to discharge its responsibilities and to assist management in reaching a conclusion about the overall effectiveness of the system of internal control.

It is the policy of AgSouth Farm Credit to maintain a system of internal controls designed to provide reasonable assurance that:

- Transactions are executed in accordance with management’s general or specific authorization.
- Transactions are recorded as necessary to:
 1. Permit preparation of financial statements in conformity with generally accepted accounting principles and the requirements established by the Farm Credit Administration, and
 2. Maintain accountability for assets.
- Access to assets is permitted only in accordance with management’s authorization.
- The recorded accountability for assets is compared with existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

The concept of “reasonable assurance” for assets recognizes that the cost of internal controls should not exceed the benefits expected to be derived therefrom.

The Association will accomplish these functions through the Audit Committee, Internal Credit Reviewers, Internal Auditor and Appraisal Reviewer.

Responsibility For Maintenance And Compliance

The CEO of AgSouth Farm Credit (and/or his designee) has the ultimate responsibility for maintaining the system of internal controls and determining compliance therewith. In carrying out these responsibilities, the CEO shall determine that internal review procedures are designed and implemented to monitor compliance with:

- Loan and asset review policies and procedures
- Asset quality classification policies and procedures
- Credit Administration policies and procedures
- Appraisal Review policies and procedures
- Financial and operations policies and procedures

AUDIT COMMITTEE CHARTER

The Board of Directors (the “Board”) of AgSouth Farm Credit, ACA, (the “Association”) has created a committee of directors to be known as the Audit Committee (the “Committee”) with its goals and objectives, composition, term of office, and duties and responsibilities, as follows:

Policy/Procedure: 1080 Internal Control	Approval Board of Directors 1/2/04, 6/28/06, 6/27/07, Charter Revision 1/31/07, 9/23/08
--	---

Goals And Objectives

The primary goal of the Committee will be to assist the Board of Directors in fulfilling its fiduciary responsibilities relating to accounting and reporting practices of the Association. In addition, the Committee will:

- Oversee and appraise the quality of the audit effort of the Association’s internal audit function and those of its independent accountants.
- Maintain, by scheduling regular meetings, open lines of communications among the Board, its internal audit function and its independent accountant to exchange views and information as well as confirm their respective authority and responsibilities;
- Serve as an independent and objective party to review the financial information presented by management to shareholders, regulators, and the general public; and
- Determine the adequacy of the Association’s administrative, operating, and internal accounting controls and evaluate adherence thereto.

Composition

The Board shall appoint the membership of the Committee, which will be comprised of the Chairman and Vice Chairman of the Board of Directors and six other directors, each of whom will be independent of senior management and operating executives of the Association and free from any relationships which might in the opinion of the board be construed as a conflict of interest. The Committee shall elect a Chairman, who will serve a two-year term.

Term Of Membership

Appointments to the Committee shall be for two-year terms and members can be re-appointed.

Duties And Responsibilities

The Committee will hold at least four regular meetings per year with such additional meetings as the chairperson of the committee shall require in order to meet the following duties. Minutes of meetings held, including attendance, will be maintained for at least three (3) fiscal years.

The Audit Committee will either handle these duties in an Audit Committee meeting or during a regularly scheduled board meeting.

- Be knowledgeable in one of the financial areas (public and corporate finance, financial reporting and disclosure, or accounting procedures).
- Recommend to the full board the appointment of the independent accountant for the coming year including the approval of the engagement letter;
- Ensure that an audit is conducted in compliance with statutory requirements;
- Review and approve the audit plan of the independent accountants, internal credit reviewers, and internal auditor;
- Evaluate the effectiveness of both the internal and external audit effort through regular meetings with each respective group;
- Determine that no management restrictions are being placed upon either the internal or external auditors;

Policy/Procedure: 1080 Internal Control	Approval Board of Directors 1/2/04, 6/28/06, 6/27/07, Charter Revision 1/31/07, 9/23/08
--	---

- Evaluate the adequacy of the Association’s administrative, operating, and accounting policies through active communications with operating management, internal audit, and the independent accountant;
- Evaluate the adequacy of the Association’s internal accounting control system by review of written reports from the internal and external auditors and monitor management’s response and actions to correct any noted deficiencies;
- Review quarterly accounting and financial reports;
- Review all regulatory reports submitted to the Association and monitor management’s response to them;
- Require periodic reports from management, the independent accountants, and internal audit function on any significant proposed regulatory, accounting, or reporting issue to assess the potential impact upon the Association’s financial reporting process;
- Review and approve all significant accounting changes;
- Review and approve the annual financial statements with operating management and the independent accountants;
- Identify and direct any special projects or investigations deemed necessary; and
- Prepare a report to the full Board summarizing the work performed by the Committee to fully discharge its duties during the year.
- As needed, contract with independent legal council and/or expert advisors to complete audits/reviews.
- Complete the performance evaluation of the Director of Internal Audit and Internal Credit Review staff on an annual basis and recommend salary adjustments.

Relationship of Internal Auditor to Audit Committee

The Audit Committee of the Board of Directors has the oversight responsibility for all audit functions in the Association. The internal audit function will report to the Audit Committee in writing on all internal reviews conducted in the Association and will appear before the committee at its meeting to report on findings.

Qualifications Of Internal Reviewers

The person or persons engaged to perform the internal audit and review procedures designed to monitor compliance with the system of internal controls shall:

- Have adequate technical training and proficiency to perform the tasks to which he/she is assigned;
- Maintain an appropriate degree of independence in mental attitude and objectivity; and
- Exercise due professional care in the performance of his/her assigned tasks.

Policy/Procedure: 1080 Internal Control	Approval Board of Directors 1/2/04, 6/28/06, 6/27/07, Charter Revision 1/31/07, 9/23/08
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Access And Confidentiality

The internal audit function is authorized to have access to all records that it requires to review responsibilities. It is expected that the auditor will exercise discretion in the review of records to assure the confidentiality of all matters that are noted.

Responsibility For Corrective Action

Senior management is responsible for seeing that corrective action on recommendations made or deficient conditions reported by the review is taken.

Independence

Independence is essential for effective operation of the auditing function. It is the policy of the association, therefore, that all auditing activities shall remain free of influence by any organizational elements. This shall include such matters as scope of audit programs, the frequency and timing of examinations, and the content of audit reports.

SCOPE OF INTERNAL AUDIT ACTIVITIES

Internal audit coverage will compass, as deemed appropriate by the internal audit function, reviews of any and all management operations and activities to apprise:

- The reliability and integrity of financial and operating information:
- Compliance with policies, plans, standards, laws, and regulations which could have significant impact upon operations;
- Measures taken to safeguard assets, including tests of existence and ownership as appropriate;
- Economy and efficiency in the use of resources;
- Effectiveness in the accomplishment of objectives and goals established for association operations and projects;
- The accuracy, timeliness, and effectiveness of all reporting systems and procedures.
- The scope of internal audit function will also include, but is not limited to such activities as:
 - ◊ Recommending improvements in controls, practices, and procedures in order to increase profitability and reduce exposure to loss;
 - ◊ Conducting special examinations at the request of management or the Board of Directors.

Where deemed appropriate, the internal audit function is specifically authorized to communicate directly in confidence to the CEO, the Audit Committee or the full Board of Directors. In accomplishing these activities, the auditor is authorized to have full, free and unrestricted access to all association functions, activities, operations, records, property and personnel.

Policy/Procedure: 1080 Internal Control	Approval Board of Directors 1/2/04, 6/28/06, 6/27/07, Charter Revision 1/31/07, 9/23/08
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Responsibilities And Relationships

The internal audit function will:

- Adhere to authoritative Standards of the Professional Practice of Internal Auditing published by the Institute of Internal Auditors. It is the desire of the Audit Committee that the internal audit function govern itself by the requirements of those standards and any revision and amendments.
- Report on the results of audits to appropriate management levels, independent accountants, and the Audit Committee, as appropriate.
- Coordinate activities with others in the Association and with those of the Association's independent accountant so as to best achieve its objectives and those of the Association.

Limitation Of Authority And Responsibility

In performing its duties, the internal audit function will have no direct authority over, nor responsibility for, any of the activities reviewed. The internal audit function will not prepare records, make management decision, or engage in any other activity which could be reasonably construed to compromise its independence. Therefore, internal audit review and appraisal do not in any way substitute for, nor relieve other persons in the organization of, the responsibilities assigned to them.

Procedure

LOAN AND ASSET REVIEW AND ASSET QUALITY CLASSIFICATION

Credit Administration

The AgFirst Credit, Appraisal and Review Standards will be the basis for rating performance on individual loan actions and the performance of the association overall. The CEO has established two committees to provide further internal controls: the Asset/Liability Management Committee and the Loan Committee.

Four internal reviews will be completed every twelve months on approximately quarterly intervals. The sample will include at least 10% of all actions in each branch office and at least 10% of all actions from each of the following categories in Special Assets and the accrual branches: (1) new and refinancing loan actions, (2) treatments (interest rate conversions, reamortizations, deferrals, extension, subordinations, assumptions, releases, changes of maturities etc.), and (3) loans with delinquencies exceeding 30 days. Loans will be selectively chosen for review to include the most significant actions, in terms of risk, occurring during the review period. Large, adversely classified accounts with activity during the period will be chosen first with progression toward smaller accounts of better quality to fill the balance of the sample.

Special Assets Management

The sample for the Special Asset Management center will be included in the total sample. The nonaccrual review will include no less than 10% of the portfolio by number. This selection will be given to accounts with larger net balances and accounts not included in recent, previous reviews. The intent will be to review all significant nonaccrual accounts on a revolving basis. Accounts will also be selected from each of the following categories but the relevance of accounts will be the overriding criteria for selection: (1) resolved accounts, (2) unresolved accounts and (3) accounts in litigation (bankruptcy or foreclosure),

The acquired property sample will be stratified to include the following if available: acquisitions during the review period, (2) sales during the review period and accounts in inventory more than 3 months. The selection process will be biased toward larger accounts that have not been included in other recent reviews.

Policy/Procedure: 1080 Internal Control	Approval Board of Directors 1/2/04, 6/28/06, 6/27/07, Charter Revision 1/31/07, 9/23/08
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Credit Classification Testing

Credit classification will be tested on each account included in the credit administration review. Emphasis will be placed on the accuracy and timeliness of classification assignments.

Specific reserves will be tested in the same manner as credit classifications.

Other Areas

In addition to the credit review the following areas will be tested for propriety and compliance with regulations: perfection of liens on collateral, consumer lending regulations, disclosure of effective interest rates on loan not subject to truth in lending, collateral insurance, and borrowers’ rights (proper notice of adverse action, distressed borrowers’ right to restructure, and previous owners’ right to first refusal on acquired property). The review will include a minimum of 3 accounts, if available, in each compliance area from each office.

Reporting

The CEO of the Association will be provided a detailed report of findings following each review. An Executive Summary Report will be mailed to each member of the association Audit Committee. On request, the Audit Committee will be provided a copy of the detailed report

Response

Upon completion of the quarterly AICR review, the Chief Operating Officer will prepare a response to be presented to the Audit Committee along with the credit review results. Senior Management or the Audit committee may request additional responses at their discretion. The level of response may vary from the minimum required by this procedure up to a detailed report as to what steps have been taken to prevent repeat of the deficiency.

Follow-Up

It will be the responsibility of the reviewer to determine if deficient areas have been addressed by senior management and report this to the Audit Committee during the next review.

APPRAISAL REVIEW

The Association will rely on the procedure for Appraisal Reviews as defined in the AgFirst District Credit Manual. Two types of reviews will be used:

1. Technical - Technical appraisal reviews are conducted in accordance with USPAP Standards Rule 3-1-(f) “for the purpose of forming an opinion as to whether the analysis, opinions and conclusion in the report are appropriate and reasonable.” The AgFirst Farm Credit Bank Appraisal Reviewer or a third party reviewer will conduct technical reviews. The Association has chosen to have a semi-annual Review. The deminimis level for Technical Reviews will be \$250,000. Grading will be according to National Review Standards.
2. Administrative Reviews will be conducted by the Chief Appraiser, or his designee, and may include either appraisals or collateral valuations below the deminimis of \$250,000. The purpose is to determine if collateral evaluations conform to the Association’s policies and procedures and provides adequate information to support the credit decision. Administrative Reviews will be conducted at least quarterly and will include a sample of at least 10%. Most will be office reviews but may include field review if deemed appropriate.

Management has the responsibility to ensure that the sample of appraisals reviewed provides feedback as to the performance of its appraisal function. With each appraisal reviewed, the appraisal reviewer should evaluate the

Policy/Procedure: 1080 Internal Control	Approval Board of Directors 1/2/04, 6/28/06, 6/27/07, Charter Revision 1/31/07, 9/23/08
--	---

compliance with recognized techniques and the reliability of the appraised value. Management has the ability to control both the sample size, focus, and the grading system.

Appraisal Grading

The grading system will be A, B or C for both Technical and Administrative reviews. Appraisals graded C are unsatisfactory, seriously inaccurate, misleading or do not comply with the institution’s policies, law, or federal regulation. These inadequacies may or may not lead to an inaccurate appraised value. All others are considered satisfactory.

Personal Property Appraisals/Valuations By Loan Officers

The Chief Appraiser or his designee will conduct administrative Reviews of these evaluations at least annually.

Loan Officers will maintain an Appraisal Log on all Personal Property Appraisals/Valuation completed. This log should be kept current and submitted to Chief Appraiser or his designee upon request in order to conduct the Administrative Review. Grading system will be Satisfactory/Unsatisfactory.

Reporting

3. Technical Reviews - The CEO of the Association will be provided a written report of the findings which addresses the scope of the review, the areas of significant concern and weaknesses, and an overall summary. The Summary Report will be provided to the Association CEO and Audit Committee. The Chief Appraiser will receive a report which provides detailed comments on each appraisal reviewed.
4. Administrative Reviews - The Chief Appraiser, or his designee, will complete a review sheet on each appraisal received, complete a brief review summary, and maintain in a file. The Summary Report will be provided to the Audit Committee. Unless significant problems are found, no further reporting is required. The review details are available to senior management upon request.
5. Personal Property Reviews - The Chief Appraiser, or his designee, will complete a review sheet on each personal property appraisal reviewed, complete a brief review summary, and maintain in a file. The Summary Report will be provided to the association CEO and Audit Committee. Unless significant problems are found, no further reporting is required. The review details are available to senior management upon request.

Response

Upon completion of the annual Technical Review, The Chief Appraiser will prepare a response to be presented to the Audit Committee along with the appraisal review results. Senior Management or the Audit Committee may request additional responses at their discretion. The level of response may vary from the minimum required by this procedure up to a detailed report as to what steps have been taken to prevent repeat of the deficiency.

Follow-Up

It will be the responsibility of the reviewer to determine if deficient areas have been addressed by senior management and report this to the Audit Committee.

FINANCIAL AND OPERATIONS

The Internal Auditor for AgSouth Farm Credit, ACA will conduct fiscal and operations (F&O) audits of finance and operations based on an annual audit plan approved by the Audit Committee. The F&O audit program will focus on achieving the following objectives:

- a) Evaluate the adequacy and effectiveness of the Association’s internal controls;

Policy/Procedure: 1080 Internal Control	Approval Board of Directors 1/2/04, 6/28/06, 6/27/07, Charter Revision 1/31/07, 9/23/08
--	---

- b) Determine the degree of compliance with policies and procedures, applicable regulations, and contracts;
- c) Determine the reliability and integrity of financial and operational information; and
- d) Assess the adequacy, effectiveness and efficiency of the Association’s operating policies and procedures.

An evaluation of internal controls is conducted to provide reasonable assurance that:

1. Transactions are executed in accordance with management’s authorization.
2. Transactions are recorded as necessary to permit preparation of financial statements in accordance with Generally Accepted Accounting Principals and maintain accountability for assets.
3. Access to assets is permitted only in accordance with management’s authorizations.
4. The recorded accountability for assets is compared with existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

Schedule

Reviews will be conducted on a rotating basis between office locations. The rotation schedule will be completed by the auditor and the Chief Financial Officer during the internal review planning phase. Senior Management can elect to have specific office locations audited if deemed necessary.

Scope

A risk assessment will be completed on each audit component, which will assist in identifying allocation of resources, guiding the frequency of audits, and will be a factor in determining appropriate audit coverage.

A system of Transaction and Compliance Testing will be utilized with review results documented on work papers. Additional work papers will be added as needed to ensure thorough and complete audits.

Compliance testing will be conducted to ensure compliance with policies and procedures established by management, and if not, a reasonable basis for any differences is well documented.

Transaction testing will be conducted to ensure the system of internal controls is adequate and functioning properly, and that operations are carried out in accordance with prescribed policy and procedures. This is to ensure that transactions are properly classified, authorized, and posted accurately and timely.

Reporting

All deficiencies and/or weaknesses noted by the auditor will be summarized and sent to the Audit Committee. The CEO will be provided a detailed report. On request, the Audit Committee will be provided a copy of the detailed report.

Response

Upon completion of the review and receipt of the report, the Chief Financial Officer will prepare a response to be presented to the Audit Committee. Senior management or the Audit Committee may request additional responses at their discretion. The level of response may vary from the minimum required by this procedure up to a detailed report as to what steps have been taken to prevent repeat of the deficiency.

Follow-Up

It will be the responsibility of the auditor to determine if deficient areas have been addressed by senior management and report this to the Audit Committee.