

**Northrop Grumman Federal Credit Union  
and Subsidiary  
Audit of Consolidated  
Financial Statements  
For the Years Ended  
December 31, 2003 and 2002**

**McGladrey & Pullen**

Certified Public Accountants

McGladrey & Pullen, LLP is a member firm of RSM International –  
an affiliation of separate and independent legal entities.

## TABLE OF CONTENTS

INDEPENDENT AUDITOR'S REPORT.....	1
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION.....	2
CONSOLIDATED STATEMENTS OF INCOME.....	3
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME.....	4
CONSOLIDATED STATEMENTS OF MEMBERS' EQUITY.....	5
CONSOLIDATED STATEMENTS OF CASH FLOWS.....	6
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.....	7

# McGladrey & Pullen

Certified Public Accountants

## INDEPENDENT AUDITOR'S REPORT

Supervisory Committee  
Northrop Grumman Federal Credit Union and Subsidiary  
Gardena, California

We have audited the accompanying consolidated statements of financial condition of Northrop Grumman Federal Credit Union (a federally chartered credit union) and Subsidiary as of December 31, 2003 and 2002 and the related consolidated statements of income, comprehensive income, members' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Credit Union's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Northrop Grumman Federal Credit Union and Subsidiary as of December 31, 2003 and 2002 and the consolidated results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

*McGladrey & Pullen, LLP*

Los Angeles, California  
February 20, 2004

northr.la.fs.ann.03.no

**NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION  
DECEMBER 31, 2003 AND 2002**

**ASSETS**

	<b>2003</b>	<b>2002</b>
Cash and cash equivalents	\$ 22,376,852	\$ 56,095,934
Investments		
Available-for-sale	136,514,593	108,663,724
Other	23,975,904	4,073,314
Loans to members, net	271,912,927	217,172,093
Accrued interest receivable	1,535,464	1,747,522
Property and equipment	2,869,223	3,341,544
National Credit Union Share Insurance Fund deposit	3,528,450	2,971,057
Other assets	4,078,037	3,866,884
	<b>\$ 466,791,450</b>	<b>\$ 397,932,072</b>

**LIABILITIES AND MEMBERS' EQUITY**

Liabilities

Members' shares	\$ 382,094,552	\$ 342,518,997
Notes payable	30,000,000	0
Accrued expenses and other liabilities	3,526,602	3,024,008

Total liabilities	415,621,154	345,543,005
-------------------	-------------	-------------

Commitments and contingent liabilities

Members' Equity

Retained earnings	52,056,082	50,733,092
Accumulated other comprehensive income	(885,786)	1,655,975

Total members' equity	51,170,296	52,389,067
-----------------------	------------	------------

	<b>\$ 466,791,450</b>	<b>\$ 397,932,072</b>
--	-----------------------	-----------------------

**NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF INCOME  
FOR THE YEARS ENDED DECEMBER 31, 2003 AND 2002**

	<u>2003</u>	<u>2002</u>
<b>INTEREST INCOME</b>		
Interest on loans to members	\$ 15,742,762	\$ 16,980,212
Interest on investments and cash equivalents	5,562,713	6,031,642
	<u>21,305,475</u>	<u>23,011,854</u>
<b>INTEREST EXPENSE</b>		
Dividends on members' shares	4,860,691	7,128,519
Interest on notes payable	530,635	0
	<u>5,391,326</u>	<u>7,128,519</u>
<b>NET INTEREST INCOME</b>	15,914,149	15,883,335
<b>PROVISION FOR LOAN LOSSES</b>	<u>2,600,000</u>	<u>2,361,330</u>
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<u>13,314,149</u>	<u>13,522,005</u>
<b>NON-INTEREST INCOME</b>		
Fee income	1,261,552	987,481
Interchange income	581,705	801,476
Shared branching income	336,829	227,023
Gain on sale of available-for-sale investments	143,047	295,122
Gain on sale of loans	12,212	2,404,394
Other non-interest income	508,563	648,546
	<u>2,843,908</u>	<u>5,364,042</u>
	<u>16,158,057</u>	<u>18,886,047</u>
<b>GENERAL AND ADMINISTRATIVE EXPENSES</b>		
Salaries and benefits	7,694,024	7,330,122
Operations	5,897,006	6,664,430
Occupancy	1,244,037	1,191,091
	<u>14,835,067</u>	<u>15,185,643</u>
<b>NET INCOME</b>	<u>\$ 1,322,990</u>	<u>\$ 3,700,404</u>

**NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
FOR THE YEARS ENDED DECEMBER 31, 2003 AND 2002**

---

	<u>2003</u>	<u>2002</u>
<b>NET INCOME</b>	\$ 1,322,990	\$ 3,700,404
<b>OTHER COMPREHENSIVE INCOME</b>		
Unrealized holding (losses) gains on investments classified as available-for-sale	<u>(2,541,761)</u>	<u>547,078</u>
<b>COMPREHENSIVE INCOME</b>	<u>\$ (1,218,771)</u>	<u>\$ 4,247,482</u>

**NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF MEMBERS' EQUITY  
FOR THE YEARS ENDED DECEMBER 31, 2003 AND 2002**

	Retained Earnings			Accumulated Other Comprehensive Income
	Regular Reserve	Unappropriated	Total	
Balance, December 31, 2001, as restated (Note 11)	\$ 8,282,222	\$ 38,750,466	\$ 47,032,688	\$ 1,108,897
Net income		3,700,404	3,700,404	
Net change in unrealized gains (losses) on available-for-sale investments				547,078
Appropriations	(1,056,019)	1,056,019	0	
Balance, December 31, 2002	7,226,203	43,506,889	50,733,092	1,655,975
Net income		1,322,990	1,322,990	
Net change in unrealized gains (losses) on available-for-sale investments				(2,541,761)
Appropriations	(1,441,516)	1,441,516	0	
Balance, December 31, 2003	\$ 5,784,687	\$ 46,271,395	\$ 52,056,082	\$ (885,786)

The accompanying notes are an integral part of these statements.

**NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE YEARS ENDED DECEMBER 31, 2003 AND 2002**

	<u>2003</u>	<u>2002</u>
<b>OPERATING ACTIVITIES</b>		
Net income	\$ 1,322,990	\$ 3,700,404
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of net premium on investments	2,039,829	1,055,192
Provision for loan losses	2,600,000	2,361,330
Depreciation and amortization	1,002,202	1,022,375
Realized gain on sale of available-for-sale investments	(143,047)	(295,122)
Decrease in accrued interest receivable	212,058	185,693
Increase in other assets	(211,153)	(1,465,067)
Increase (decrease) in accrued expenses and other liabilities	502,594	(2,543,508)
Net cash provided by operating activities	<u>7,325,473</u>	<u>4,021,297</u>
<b>INVESTING ACTIVITIES</b>		
Purchases of available-for-sale investments	(136,770,093)	(74,469,594)
Proceeds from maturities and sales of available-for-sale investments	104,480,681	85,883,747
Net increase in other investments	(19,902,590)	(188,962)
Net increase in loans to members	(57,340,834)	(21,146,822)
(Increase) decrease in the National Credit Union Share Insurance Fund deposit	(557,393)	958
Purchases of property and equipment	(529,881)	(1,242,579)
Net cash used in investing activities	<u>(110,620,110)</u>	<u>(11,163,252)</u>
<b>FINANCING ACTIVITIES</b>		
Net increase in members' shares	39,575,555	31,558,372
Increase in notes payable	30,000,000	0
Net cash provided by financing activities	<u>69,575,555</u>	<u>31,558,372</u>
<b>(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>	<u>(33,719,082)</u>	<u>24,416,417</u>
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR</b>	<u>56,095,934</u>	<u>31,679,517</u>
<b>CASH AND CASH EQUIVALENTS AT END OF YEAR</b>	<u>\$ 22,376,852</u>	<u>\$ 56,095,934</u>
<b>SUPPLEMENTAL CASH FLOW INFORMATION:</b>		
Dividends paid on members' shares and interest paid on notes payable	\$ 5,507,010	\$ 7,344,000

**NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2003 AND 2002**

---

1. **SIGNIFICANT ACCOUNTING POLICIES**

**Organization:** Northrop Grumman Federal Credit Union (the Credit Union) is a cooperative association holding a corporate charter under the provisions of the Federal Credit Union Act.

**Principles of Consolidation:** The accompanying consolidated financial statements include the accounts of the Credit Union and its wholly owned subsidiary, Flight Plan Financial Services, Inc., a credit union service organization, which provides investment and insurance products for members. Material intercompany balances and transactions have been eliminated in consolidation.

**Use of Estimates in the Preparation of Financial Statements:** The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates. A material estimate that is particularly susceptible to significant change in the near term relates to the determination of the allowance for loan losses.

**Cash, Cash Equivalents and Cash Flows:** Cash and cash equivalents consist of cash on hand, demand deposits, and non-term share deposits in a corporate credit union. For purposes of reporting cash flows, loans to members, other investments, members' shares and notes payable are reported net.

**Investments:** Investments that the Credit Union has both the positive intent and ability to hold to maturity are classified as held-to-maturity and are carried at amortized cost. Investments that the Credit Union intends to hold for an indefinite period of time, but not necessarily to maturity, are classified as available-for-sale and are carried at fair value. Unrealized gains and losses on investments classified as available-for-sale have been accounted for as accumulated other comprehensive income. Gains and losses on the sale of available-for-sale securities are determined using the specific-identification method. Amortization of premiums and discounts are recognized in interest income over the period to maturity. Declines in the fair value of individual held-to-maturity and available-for-sale securities below their costs that are other than temporary result in write-downs of the individual securities to their fair value. Factors affecting the determination of whether an other-than-temporary impairment has occurred include a downgrading of the security by a rating agency, a significant deterioration in the financial condition of the issuer, or that management would not have the intent and ability to hold a security for a period of time sufficient to allow for any anticipated recovery in fair value. Other investments are classified separately and are stated at cost.

**Loans to Members and Allowance for Loan Losses:** Loans are stated at the amount of unpaid principal, reduced by an allowance for loan losses, and increased by deferred net loan origination costs. Interest on loans to members is recognized over the terms of the loans and is calculated using the simple interest method on principal amounts outstanding. Loan fees and certain direct loan origination costs are deferred, and the net fee or cost is recognized as an adjustment to interest income.

The Credit Union determines a loan to be delinquent when payments have not been made according to contractual terms, typically evidenced by non-payment of a monthly installment by the due date.

**NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2003 AND 2002**

---

Large groups of smaller-balance homogenous loans are collectively evaluated for impairment. Accordingly, the Credit Union does not separately identify individual consumer and residential loans for impairment disclosures.

The allowance for loan losses is increased by a provision for loan losses charged to expense and decreased by charge-offs (net of recoveries). Loans are charged against the allowance for loan losses when management believes that collectability of the principal is unlikely. The allowance is an amount management believes will be adequate to absorb estimated losses on existing loans. Management's periodic evaluation of the adequacy of the allowance is based on the Credit Union's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and current economic conditions. While management uses the best information available to make its evaluations, further adjustments to the allowance may be necessary if there are significant changes in economic conditions.

**Transfers and Servicing of Financial Assets:** The Credit Union accounts for transfers and servicing of financial assets in accordance with SFAS No. 140, Accounting for Transfers and Servicing Financial Assets and Extinguishment of Liabilities. SFAS No. 140 requires application of a financial component's approach that focuses on control. Under this approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. The statement also distinguishes transfers of financial assets that are sales from transfers of financial assets that are secured borrowings.

**Accrued Interest on Loans:** Accrual of interest on loans is discontinued when management believes that, after considering economics, business conditions, and collection efforts, the borrower's financial condition is such that collection of interest is doubtful. The Credit Union's policy is to stop accruing interest when the loan becomes 90 days delinquent. All interest accrued but not collected for loans that are placed on non-accrual status or subsequently charged off is reversed against interest income. Income is subsequently recognized on the cash basis until, in management's judgment, the borrower's ability to make periodic interest and principal payments is back to normal and future payments are reasonably assured, in which case the loan is returned to accrual status.

**Property and Equipment:** Property and equipment are carried at cost, less accumulated depreciation and amortization. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets. The cost of leasehold improvements is amortized using the straight-line method over the terms of the related leases.

**National Credit Union Share Insurance Fund Deposit:** The deposit in the National Credit Union Share Insurance Fund (NCUSIF) is in accordance with NCUA regulations, which require the maintenance of a deposit by each federally insured Credit Union in an amount equal to 1% of its insured members' shares. The deposit would be refunded to the Credit Union if its insurance coverage is terminated, if it converts its insurance coverage to another source, or if management of the fund is transferred from the NCUA Board.

**NCUSIF Insurance Premium:** The Credit Union is required to pay an annual insurance premium equal to one-twelfth of one percent of total insured shares, unless the payment is waived or reduced by the NCUA Board. The NCUA Board waived the 2003 and 2002 insurance premiums.

**NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2003 AND 2002**

---

**Members' Shares:** Members' shares are the savings deposit accounts of the owners of the Credit Union. Share ownership entitles the members to vote in the annual elections of the Board of Directors and on other corporate matters. Irrespective of the amount of shares owned, no member has more than one vote. Members' shares are subordinated to all other liabilities of the Credit Union upon liquidation. Dividends on members' shares are based on available earnings at the end of a dividend period and are not guaranteed by the Credit Union. Dividend rates are set by the Credit Union's Board of Directors.

**Income Taxes:** The Credit Union is exempt, by statute, from federal and state income taxes. The Credit Union's wholly owned subsidiary, Flight Plan Financial Services, is subject to federal and state income taxes.

**Comprehensive Income:** Accounting principles generally require that recognized revenue, expenses, gains, and losses be included in net income. Certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the members' equity section of the statement(s) of financial condition. For 2003 and 2002, other comprehensive income includes no reclassification adjustments.

**Reclassifications:** Certain account reclassifications have been made to the 2002 consolidated financial statements in order to conform to classifications used in the current year.

**2. INVESTMENTS**

Investments classified as available-for-sale consist of the following:

<u>December 31, 2003</u>	<u>Amortized Cost</u>	<u>Unrealized Gains</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>
Federal agencies securities	\$ 36,973,127	\$ 199,192	\$ (228,787)	\$ 36,943,532
Mortgage-backed securities	100,427,252	472,937	(1,329,128)	99,571,061
	<u>\$ 137,400,379</u>	<u>\$ 672,129</u>	<u>\$ (1,557,915)</u>	<u>\$ 136,514,593</u>
<u>December 31, 2002</u>				
Federal agencies securities	\$ 40,173,316	\$ 593,349	\$ 0	\$ 40,766,665
Mortgage-backed securities	66,834,433	1,073,039	(10,413)	67,897,059
	<u>\$ 107,007,749</u>	<u>\$ 1,666,388</u>	<u>\$ (10,413)</u>	<u>\$ 108,663,724</u>

**NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2003 AND 2002**

Gross unrealized losses and fair value by length of time that the individual securities have been in a continuous unrealized loss position at December 31, 2003 are as follows:

<u>Available-for-sale</u>	<u>Fair Value</u>	<u>Continuous unrealized losses existing for:</u>		<u>Total Unrealized Losses</u>
		<u>Less than 12 months</u>	<u>More than 12 months</u>	
Federal agencies securities	\$ 16,780,395	\$ (228,787)	\$ 0	\$ (228,787)
Mortgage-backed securities	58,288,207	(1,328,656)	(472)	(1,329,128)
	<u>\$ 75,068,602</u>	<u>\$ (1,557,443)</u>	<u>\$ (472)</u>	<u>\$ (1,557,915)</u>

There are a total of 39 investments with unrealized losses as of December 31, 2003. The unrealized losses associated with these investments are considered temporary as the Credit Union has both the intent and ability to hold these investments for a period of time sufficient to allow for any anticipated recovery in fair value.

Other investments consist of the following:

	<u>December 31</u>	
	<u>2003</u>	<u>2002</u>
Certificates of deposit in a corporate credit union	\$ 21,000,000	\$ 0
NCUA Central Liquidity Fund	0	1,125,475
Certificates of deposit in banks and savings institutions	99,279	312,700
Member capital account in a corporate credit union	1,876,625	1,635,139
Permanent capital account in a corporate credit union	1,000,000	1,000,000
	<u>\$ 23,975,904</u>	<u>\$ 4,073,314</u>

Certificates are generally non-negotiable and non-transferable, and may incur substantial penalties for withdrawal prior to maturity.

Permanent capital accounts are uninsured equity capital accounts and are redeemable only if called by the corporate credit union. Member capital accounts are uninsured equity capital accounts that may be redeemed with a three-year notice. The fair value of other investments approximates book value.

Gross realized gains and losses on sales of investments available-for-sale were \$184,016 and \$40,969, respectively, in 2003 and \$320,088 and \$24,966, respectively, in 2002.

At December 31, 2003 and 2002, there were approximately \$40,981,000 and \$51,856,000, respectively, in credit union and bank deposits with individual balances in excess of the insured limit and maturity dates ranging from no contractual maturity to July 2007.

**NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2003 AND 2002**

Investments by maturity as of December 31, 2003 are summarized as follows:

	<b>Available-for-sale</b>		
	<b>Amortized Cost</b>	<b>Fair Value</b>	<b>Other</b>
No contractual maturity	\$ 0	\$ 0	\$ 2,876,625
Less than 1 year maturity	0	0	2,099,279
1 – 5 years maturity	16,501,847	16,457,827	19,000,000
5 – 10 years maturity	17,246,449	17,228,315	0
Over 10 years maturity	3,224,831	3,257,390	0
Mortgage-backed securities	100,427,252	99,571,061	0
	<b>\$ 137,400,379</b>	<b>\$ 136,514,593</b>	<b>\$ 23,975,904</b>

Expected maturities of mortgage-backed securities may differ from contractual maturities because borrowers may have the right to call or prepay the obligations and are, therefore, classified separately with no specific maturity date. Member and permanent capital accounts have been classified with no contractual maturity.

**3. LOANS TO MEMBERS**

Loans to members consist of the following:

	<b>December 31</b>	
	<b>2003</b>	<b>2002</b>
Mortgage loans:		
Fixed rate	\$ 126,171,769	\$ 62,437,027
Variable rate	5,678,821	6,925,808
Home equity line of credit, variable rate	37,153,012	34,701,687
	169,003,602	104,064,522
Vehicle loans	88,378,404	97,347,394
Consumer loans, primarily unsecured	17,214,677	18,941,122
	274,596,683	220,353,038
Deferred net loan origination costs	113,097	55,776
Allowance for loan losses	(2,796,853)	(3,236,721)
	<b>\$ 271,912,927</b>	<b>\$ 217,172,093</b>

**NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2003 AND 2002**

---

On December 31, 2002, the credit union sold its unsecured credit card portfolio. The balance of credit card loans at the date of sale was \$14,025,771. Total cash proceeds from the sale were \$15,634,780. The transaction resulted in a net gain to the credit union of \$2,355,102, net of selling costs and including a portion to be received in the future dependent on the performance of the portfolio. Under the terms of the agreement, the credit union is prohibited from offering credit cards to the membership for six years from the date of sale. The credit union also entered into an agreement to service the portfolio from the time of purchase through May 31, 2003. The loans were sold without recourse.

In the ordinary course of business, the Credit Union makes loans to its directors and officers at the same terms as those prevailing at the time of origination for comparable transactions with other members. Loans to directors and officers at December 31, 2003 and 2002 total \$2,065,205 and \$1,247,383, respectively.

The following is an analysis of the allowance for loan losses:

	<b>Years Ended December 31</b>	
	<b>2003</b>	<b>2002</b>
Balance, beginning of year, as restated (Note 11)	\$ 3,236,721	\$ 2,530,208
Provision for loan losses	2,600,000	2,361,330
Recoveries	240,559	181,345
Loans charged off	(3,280,427)	(1,836,162)
Balance, end of year	\$ 2,796,853	\$ 3,236,721

Outstanding mortgage loan commitments at December 31, 2003 and 2002 total approximately \$648,000 and \$2,410,000, respectively.

Available credit on home equity and unsecured lines of credit is summarized as follows:

	<b>December 31</b>	
	<b>2003</b>	<b>2002</b>
Home equity	\$ 41,496,000	\$ 27,964,000
Other consumer	50,426,000	50,181,000
	\$ 91,922,000	\$ 78,145,000

Commitments for home equity and unsecured lines of credit may expire without being drawn upon. Therefore, the total commitment amount does not necessarily represent future cash requirements of the Credit Union. These commitments are not reflected in the consolidated financial statements.

Mortgage loans serviced for Fannie Mae are not included in the accompanying consolidated statements of financial condition. The unpaid principal balances of these loans at December 31, 2003 and 2002 are \$5,468,468 and \$6,243,000, respectively.

**NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2003 AND 2002**

---

4. **PROPERTY AND EQUIPMENT**

Property and equipment are summarized as follows:

	<b>December 31</b>	
	<b>2003</b>	<b>2002</b>
Data processing equipment	\$ 5,554,208	\$ 5,348,096
Facility improvement	2,920,450	2,830,014
Furniture and equipment	3,414,606	3,453,270
	11,889,264	11,631,380
Accumulated depreciation and amortization	(9,020,041)	(8,289,836)
	\$ 2,869,223	\$ 3,341,544

The Credit Union leases five offices. The operating leases contain renewal options and provisions requiring the Credit Union to pay property taxes and operating expenses over base period amounts. All rental payments are dependent only upon the lapse of time. Minimum rental payments under operating leases with initial or remaining terms of one year or more at December 31, 2003 are as follows:

<b><u>Years ending December 31</u></b>	
2004	\$ 818,000
2005	831,000
2006	763,000
2007	791,000
2008	793,000
Subsequent years	517,000
	\$ 4,513,000

Rental expense for the years ended December 31, 2003 and 2002 for all facilities leased under operating leases totaled \$834,000 and \$778,000, respectively.

**NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2003 AND 2002**

**5. MEMBERS' SHARES**

Members' shares are summarized as follows:

	December 31	
	2003	2002
Regular shares	\$ 139,031,712	\$ 113,243,364
Share draft accounts	55,289,660	44,433,276
Money market accounts	111,261,656	103,152,507
Non-term individual retirement accounts	7,685,723	6,028,099
Certificates (including IRA certificates)	68,468,813	75,189,079
	381,737,564	342,046,325
Dividends payable	356,988	472,672
	\$ 382,094,552	\$ 342,518,997

Shares by maturity as of December 31, 2003 are summarized as follows:

No contractual maturity	\$ 313,268,751
0 – 1 year maturity	56,626,835
1 – 2 years maturity	6,193,155
2 – 3 years maturity	1,890,788
3 – 4 years maturity	1,562,525
4 – 5 years maturity	2,195,510
	381,737,564

Regular shares, share draft accounts, money market accounts, and individual retirement account shares have no contractual maturity. Certificate accounts have maturities of five years or less.

Members' shares are insured up to \$100,000 through the National Credit Union Share Insurance Fund.

The aggregate amount of time deposits in denominations of \$100,000 or more at December 31, 2003 is approximately \$13,024,000.

**6. CONCENTRATIONS OF CREDIT RISK**

Participation in the Credit Union is limited to those individuals who qualify for membership. The field of membership is defined in the Credit Union's bylaws. A large percentage of the Credit Union's members are employees or former employees of Northrop Grumman Corporation. Further, a significant concentration of members resides in Southern California. Although the Credit Union has a diversified loan portfolio, borrowers' ability to repay loans may be affected by the economic climate of either the aerospace industry or the overall geographic region in which borrowers reside.

**NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2003 AND 2002**

---

**7. NOTES PAYABLE**

Pursuant to the terms of a Master Loan and Security Agreement, Western Corporate Federal Credit Union (WesCorp) has advanced a total of \$30 million to the Credit Union. The terms of the agreement call for the pledging of all consumer loans, but primarily vehicle loans, to secure the outstanding balances. The advances have interest rates ranging from 1.35% to 3.35% and have maturity dates as follows:

	<b>Balance</b>
Less than 1 year maturity	\$ 5,000,000
1 – 2 years maturity	10,000,000
2 – 3 years maturity	5,000,000
3 – 4 years maturity	5,000,000
4 – 5 years maturity	5,000,000
	\$ 30,000,000

**8. COMMITMENTS AND CONTINGENT LIABILITIES**

The Credit Union has demand loan agreements with several corporate credit unions, in addition to the agreement noted above. The terms of these agreements call for the pledging of all assets not already pledged as collateral under other borrowing agreements as security for any and all obligations taken by the credit union. These agreements provide for a combined credit limit of \$10,000,000 with interest charged at a rate determined by the lenders on a periodic basis. At December 31, 2003 and 2002, there were no borrowings under these agreements. The agreements are reviewed for continuation by the lenders and the Credit Union annually.

The Credit Union is a party to various legal actions normally associated with collections of loans and other business activities of financial institutions, the aggregate effect of which, in management's opinion, would not have a material adverse effect on the financial condition or results of operations of the Credit Union.

The Credit Union has no outstanding commitments to sell loans or investments at December 31, 2003.

**9. EMPLOYEE BENEFITS**

The Credit Union staff are participants in the pension plan of Northrop Grumman Corporation. Since the Credit Union staff are only fractional participants in the plan, it is not practicable to disclose actuarial benefit data. The Credit Union funds the plan through Northrop Grumman Corporation.

**NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2003 AND 2002**

---

**10. MEMBERS' EQUITY**

The Credit Union is subject to various regulatory capital requirements administered by the NCUA. Failure to meet minimum capital requirements can initiate certain mandatory – and possibly additional discretionary – actions by regulators that, if undertaken, could have a direct material effect on the Credit Union's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Credit Union must meet specific capital guidelines that involve quantitative measures of the Credit Union's assets, liabilities, and certain off-balance-sheet items as calculated under generally accepted accounting principles. The Credit Union's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Credit Union to maintain minimum amounts and ratios (set forth in the table below) of net worth to total assets. Further, credit unions over \$10,000,000 in assets are also required to calculate a Risk-Based Net Worth (RBNW) requirement which establishes whether or not the Credit Union will be considered "complex" under the regulatory framework. The Credit Union's RBNW requirements as of December 31, 2003 and 2002 were 6.5% and 5.4%, respectively. The minimum requirement to be considered "complex" under the regulatory framework is 6%. Management believes, as of December 31, 2003 and 2002, that the Credit Union meets all capital adequacy requirements to which it is subject.

As of December 31, 2003, the most recent call reporting period, and 2002, the NCUA categorized the Credit Union as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well capitalized," the Credit Union must maintain a minimum net worth ratio of 7% of assets. There are no conditions or events since that notification that management believes have changed the institution's category.

The Credit Union's actual capital amounts and ratios are presented in the following table:

	<u>December 31, 2003</u>		<u>December 31, 2002</u>	
	<u>Amount</u>	<u>Ratio/Requirement</u>	<u>Amount</u>	<u>Ratio/Requirement</u>
➤ Amount needed to be classified as "adequately capitalized"	\$ 30,341,444	6.5%	\$ 23,875,924	6.0%
➤ Amount needed to be classified as "well capitalized"	\$ 32,675,402	7.0%	\$ 27,855,245	7.0%
➤ Actual net worth	\$ 52,056,082	11.2%	\$ 50,733,092	12.7%

Because the RBNW requirement is less than the net worth ratio, the Credit Union retains its original category. Further, in performing its calculation of total assets, the Credit Union used the quarter-end balance option, as permitted by regulation.

**NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2003 AND 2002**

---

**11. BUSINESS COMBINATION**

On May 31, 2003, the Credit Union merged with Ross-Loos Federal Credit Union. The merger was accounted for as a pooling of interests and accordingly, all prior year financial statements have been restated to include Ross-Loos Federal Credit Union. The unaudited results of operations and applicable account balances of the separate entity for periods prior to the combination are as follows:

	<u>May 31, 2003</u>	<u>December 31, 2002</u>
Total assets	\$ 1,600,587	\$ 1,599,196
Loans outstanding	391,327	534,324
Allowance for loan losses	(30,539)	(30,489)
Members' shares	1,303,211	1,241,997
Retained earnings	288,605	349,328
Net loss – five months ended May 31, 2003 and year ended December 31, 2002	(60,723)	(47,680)

**12. FAIR VALUE OF FINANCIAL INSTRUMENTS**

The estimated fair value amounts have been determined by the Credit Union using available market information and appropriate valuation methodologies. However, considerable judgment is necessarily required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Credit Union could realize in a market exchange. The use of different assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

The following methods and assumptions were used to estimate fair value of each class of financial instruments for which it is practicable to estimate fair value:

Investments

Estimated fair values for investments are obtained from quoted market prices where available. Where quoted market prices are not available, estimated fair values are based on quoted market prices of comparable instruments.

Loans to Members

The estimated fair value for all fixed rate loans is determined by discounting the estimated cash flows using the current rate at which similar loans would be made to borrowers with similar credit ratings and maturities.

The estimated fair value for variable rate loans is the carrying amount. Credit card loans are considered, for estimation of fair value purposes, variable rate loans since interest rates may be changed by the Credit Union.

**NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2003 AND 2002**

---

The impact of delinquent loans on the estimation of the fair values described above is not considered to have a material effect and, accordingly, delinquent loans have been disregarded in the valuation methodologies employed.

Members' Shares

The estimated fair value of demand deposit accounts (regular share, share draft, money market and IRA share accounts) is the carrying amount. The fair value of fixed-maturity certificates is estimated by discounting the estimated cash flows using the current rate at which similar certificates would be issued.

Notes Payable

The fair value of borrowed funds is estimated by discounting the estimated cash flows using the current rate at which similar borrowings could be obtained.

Other On-Balance-Sheet Financial Instruments

Other on-balance-sheet financial instruments include cash and cash equivalents, accrued interest receivable, and dividends payable. The carrying value of each of these financial instruments is a reasonable estimation of fair value.

Off-Balance-Sheet Financial Instruments

The fair values for the Credit Union's off-balance sheet commitments are estimated based on fees charged to others to enter into similar agreements taking into account the remaining terms of the agreements and credit standing of the members. The estimated fair value of these commitments is not significant.

The estimated fair value of the Credit Union's financial instruments are summarized as follows:

	December 31, 2003		December 31, 2002	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets:				
Cash and cash equivalents	\$ 22,377,000	\$ 22,377,000	\$ 56,096,000	\$ 56,096,000
Investments available-for-sale	136,515,000	136,515,000	108,664,000	108,664,000
Other investments	23,976,000	23,976,000	4,073,000	4,073,000
Loans to members, net	271,913,000	269,431,000	217,172,000	218,089,000
Accrued interest receivable	1,535,000	1,535,000	1,748,000	1,748,000
Financial Liabilities:				
Members' shares	382,095,000	382,727,000	342,519,000	343,854,000
Notes payable	30,000,000	30,322,000	0	0