

**Northrop Grumman Federal Credit Union
and Subsidiary
Audit of Consolidated Financial
Statements
For the Years Ended
December 31, 2005 and 2004**

McGladrey & Pullen

Certified Public Accountants

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INDEPENDENT AUDITOR'S REPORT

Supervisory Committee
Northrop Grumman Federal Credit Union
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, 2005 and 2004 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 audits 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, 2005 and 2004 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.

(M&P Signature)

Los Angeles, California
February 17, 2006

northr.la.fs.ann.05.nh.03-07.doc

NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
DECEMBER 31, 2005 AND 2004

ASSETS

| | 2005 | 2004 |
|--|----------------|----------------|
| Cash and cash equivalents | \$ 38,205,205 | \$ 28,727,838 |
| Investments | | |
| Available-for-sale | 174,960,819 | 198,562,568 |
| Other | 17,328,509 | 22,162,313 |
| Loans to members, net | 296,319,240 | 262,332,766 |
| Accrued interest receivable | 2,032,951 | 1,726,987 |
| Property and equipment | 2,410,197 | 2,610,894 |
| National Credit Union Share Insurance Fund deposit | 3,918,651 | 3,735,018 |
| Other assets | 2,475,377 | 3,133,158 |
| | \$ 537,650,949 | \$ 522,991,542 |

LIABILITIES AND MEMBERS' EQUITY

Liabilities

| | | |
|--|----------------|----------------|
| Members' shares | \$ 438,009,489 | \$ 405,479,064 |
| Notes payable | 39,800,000 | 60,000,000 |
| Accrued expenses and other liabilities | 4,377,339 | 3,432,638 |
| | 482,186,828 | 468,911,702 |

Commitments and contingent liabilities

Members' Equity

| | | |
|--------------------------------------|----------------|----------------|
| Retained earnings | 60,894,906 | 56,054,498 |
| Accumulated other comprehensive loss | (5,430,785) | (1,974,658) |
| | 55,464,121 | 54,079,840 |
| | \$ 537,650,949 | \$ 522,991,542 |

**NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004**

| | <u>2005</u> | <u>2004</u> |
|---|---------------------|---------------------|
| INTEREST INCOME | | |
| Interest on loans to members | \$ 15,914,695 | \$ 15,197,528 |
| Interest on investments and cash equivalents | <u>8,701,246</u> | <u>7,371,284</u> |
| | <u>24,615,941</u> | <u>22,568,812</u> |
| INTEREST EXPENSE | | |
| Dividends on members' shares | 6,867,801 | 4,415,972 |
| Interest on notes payable | <u>1,502,771</u> | <u>1,272,508</u> |
| | <u>8,370,572</u> | <u>5,688,480</u> |
| NET INTEREST INCOME | 16,245,369 | 16,880,332 |
| PROVISION FOR LOAN LOSSES | <u>518,321</u> | <u>1,900,000</u> |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | <u>15,727,048</u> | <u>14,980,332</u> |
| NON-INTEREST INCOME | | |
| Fee income | 1,869,380 | 1,483,129 |
| Interchange income | 630,993 | 542,492 |
| Shared branching income | 350,488 | 358,910 |
| Net realized (loss) gain on sales of available-for-sale investments | (232,923) | 248,117 |
| Other | <u>925,261</u> | <u>740,926</u> |
| | <u>3,543,199</u> | <u>3,373,574</u> |
| | <u>19,270,247</u> | <u>18,353,906</u> |
| GENERAL AND ADMINISTRATIVE EXPENSES | | |
| Salaries and benefits | 7,202,833 | 7,189,278 |
| Operations | 5,976,094 | 5,912,032 |
| Occupancy | <u>1,250,912</u> | <u>1,254,180</u> |
| | <u>14,429,839</u> | <u>14,355,490</u> |
| NET INCOME | <u>\$ 4,840,408</u> | <u>\$ 3,998,416</u> |

The accompanying notes are an integral part of these statements.

NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004

| | 2005 | 2004 |
|---|--------------|--------------|
| NET INCOME | \$ 4,840,408 | \$ 3,998,416 |
| OTHER COMPREHENSIVE INCOME | | |
| Reclassification adjustment for realized (losses) gains on investments included in net income | 69,323 | 158,053 |
| Unrealized holding losses on investments classified as available-for-sale | (3,525,450) | (1,246,925) |
| Net change in unrealized losses on investments classified as available-for-sale | (3,456,127) | 1,088,872 |
| COMPREHENSIVE INCOME | \$ 1,384,281 | \$ 2,909,544 |

NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF MEMBERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004

| | Retained Earnings | | | Accumulated Other Comprehensive Loss |
|--|---------------------|----------------------|----------------------|---|
| | Regular Reserve | Unappropriated | Total | |
| Balance, December 31, 2003 | \$ 5,784,687 | \$ 46,271,395 | \$ 52,056,082 | \$ (885,786) |
| Net income | | 3,998,416 | 3,998,416 | |
| Net change in unrealized gains (losses) on available-for-sale investments, net of reclassification adjustment | | | | (1,088,872) |
| Appropriations | (2,225,000) | 2,225,000 | 0 | |
| Balance, December 31, 2004 | 3,559,687 | 52,494,811 | 56,054,498 | (1,974,658) |
| Net income | | 4,840,408 | 4,840,408 | |
| Net change in unrealized gains (losses) on available-for-sale investments, net of reclassification adjustment | | | | (3,456,127) |
| Balance, December 31, 2005 | <u>\$ 3,559,687</u> | <u>\$ 57,335,219</u> | <u>\$ 60,894,906</u> | <u>\$ (5,430,785)</u> |

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, 2005 AND 2004**

| | <u>2005</u> | <u>2004</u> |
|---|----------------------|----------------------|
| OPERATING ACTIVITIES | | |
| Net income | \$ 4,840,408 | \$ 3,998,416 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Amortization of net premium on investments | 664,893 | 847,184 |
| Provision for loan losses | 518,321 | 1,900,000 |
| Depreciation and amortization | 1,241,627 | 1,030,792 |
| Net realized losses (gains) on sales of available-for-sale investments | 232,923 | (248,117) |
| Increase in accrued interest receivable | (305,964) | (191,523) |
| Decrease in other assets | 657,781 | 944,879 |
| Increase (decrease) in accrued expenses and other liabilities | 944,701 | (93,964) |
| Net cash provided by operating activities | <u>8,794,690</u> | <u>8,187,667</u> |
| INVESTING ACTIVITIES | | |
| Purchases of available-for-sale investments | (52,402,295) | (207,589,870) |
| Proceeds from maturities of available-for-sale investments | 34,980,170 | 41,992,687 |
| Proceeds from sales of available-for-sale investments | 36,669,931 | 101,861,269 |
| Net decrease in other investments | 4,833,804 | 1,813,591 |
| Net (increase) decrease in loans to members | (34,504,795) | 7,680,161 |
| Increase in the National Credit Union Share Insurance Fund deposit | (183,633) | (206,568) |
| Purchases of property and equipment | (1,040,930) | (772,463) |
| Net cash used in investing activities | <u>(11,647,748)</u> | <u>(55,221,193)</u> |
| FINANCING ACTIVITIES | | |
| Net increase in members' shares | 32,530,425 | 23,384,512 |
| Net (decrease) increase in notes payable | (20,200,000) | 30,000,000 |
| Net cash provided by financing activities | <u>12,330,425</u> | <u>53,384,512</u> |
| INCREASE IN CASH AND CASH EQUIVALENTS | <u>9,477,367</u> | <u>6,350,986</u> |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR | <u>28,727,838</u> | <u>22,376,852</u> |
| CASH AND CASH EQUIVALENTS AT END OF YEAR | <u>\$ 38,205,205</u> | <u>\$ 28,727,838</u> |
| SUPPLEMENTAL CASH FLOW INFORMATION | | |
| Dividends paid on members' shares and interest paid on notes payable | \$ 8,007,268 | \$ 5,645,334 |

NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2005 AND 2004

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., 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 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 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 deferred net loan origination fees. 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, 2005 AND 2004

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 and facility improvements are carried at cost, less accumulated depreciation and amortization. Property and equipment are depreciated using the straight-line method over the estimated useful lives of the assets. The cost of facility 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 National Credit Union Administration (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 2005 and 2004 insurance premiums.

NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2005 AND 2004

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, however, is subject to federal and state income taxes. Operations of the CUSO resulted in immaterial income taxes for the years ended 2005 and 2004.

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 consolidated statements of financial condition.

Reclassifications: Certain account reclassifications have been made to the 2004 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, 2005</u> | <u>Amortized Cost</u> | <u>Unrealized Gains</u> | <u>Unrealized Losses</u> | <u>Fair Value</u> |
|-----------------------------|---------------------------|-----------------------------|------------------------------|-----------------------|
| Federal agencies securities | \$ 43,727,287 | \$ 0 | \$ (894,035) | \$ 42,833,252 |
| Mortgage-backed securities | 136,664,317 | 2,574 | (4,539,324) | 132,127,567 |
| | <u>\$ 180,391,604</u> | <u>\$ 2,574</u> | <u>\$ (5,433,359)</u> | <u>\$ 174,960,819</u> |
| | | | | |
| <u>December 31, 2004</u> | | | | |
| Federal agencies securities | \$ 61,408,986 | \$ 18,309 | \$ (564,453) | \$ 60,862,842 |
| Mortgage-backed securities | 139,128,240 | 109,476 | (1,537,990) | 137,699,726 |
| | <u>\$ 200,537,226</u> | <u>\$ 127,785</u> | <u>\$ (2,102,443)</u> | <u>\$ 198,562,568</u> |

Securities totaling \$21,745,757 held in safekeeping at the corporate credit union are pledged as collateral for borrowings advanced under the line of credit agreement as more fully described in Note 7.

NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2005 AND 2004

Gross unrealized losses and fair value by length of time that individual available-for-sale securities have been in a continuous unrealized loss position at December 31, 2005 and 2004 are as follows:

| | <u>December 31, 2005</u> | Continuous Unrealized Losses Existing For: | | Total Unrealized Losses |
|-----------------------------|--------------------------|---|--------------------------------|------------------------------------|
| | | Fair Value | Less Than 12 Months | |
| Federal agencies securities | \$ 42,833,252 | \$ (515,087) | \$ (378,948) | \$ (894,035) |
| Mortgage-backed securities | 131,520,418 | (3,030,170) | (1,509,154) | (4,539,324) |
| | <u>\$ 174,353,670</u> | <u>\$ (3,545,257)</u> | <u>\$ (1,888,102)</u> | <u>\$ (5,433,359)</u> |
| | | | | |
| | <u>December 31, 2004</u> | | | |
| Federal agencies securities | \$ 58,354,671 | \$ (389,688) | \$ (174,765) | \$ (564,453) |
| Mortgage-backed securities | 113,881,134 | (1,287,870) | (250,120) | (1,537,990) |
| | <u>\$ 172,235,805</u> | <u>\$ (1,677,558)</u> | <u>\$ (424,885)</u> | <u>\$ (2,102,443)</u> |

There are a total of 98 and 83 investments, respectively, with unrealized losses as of December 31, 2005 and 2004. The unrealized losses associated with these investments are considered temporary as the Credit Union has the 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:

| | December 31 | |
|---|----------------------|----------------------|
| | 2005 | 2004 |
| Certificates in a corporate credit union | \$ 14,500,000 | \$ 19,000,000 |
| Member capital account in a corporate credit union | 1,828,509 | 2,162,313 |
| Permanent capital account in a corporate credit union | 1,000,000 | 1,000,000 |
| | <u>\$ 17,328,509</u> | <u>\$ 22,162,313</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.

For the years ended December 31, 2005 and 2004, gross realized gains and losses on sales of available-for-sale investments were \$68,028 and (\$300,951), and \$595,867 and (\$347,750), respectively.

NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2005 AND 2004

At December 31, 2005 and 2004, there were approximately \$48,428,000 and \$38,435,000, 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 January 2008.

Investments by maturity as of December 31, 2005 are summarized as follows:

| | <u>Available-for-sale</u> | | <u>Other</u> |
|----------------------------|---------------------------|-----------------------|----------------------|
| | <u>Amortized Cost</u> | <u>Fair Value</u> | |
| No contractual maturity | \$ 0 | \$ 0 | \$ 2,828,509 |
| Less than 1 year maturity | 0 | 0 | 5,500,000 |
| 1 – 5 years maturity | 35,643,151 | 34,836,133 | 9,000,000 |
| 5 – 10 years maturity | 8,084,136 | 7,997,119 | 0 |
| Mortgage-backed securities | 136,664,317 | 132,127,567 | 0 |
| | <u>\$ 180,391,604</u> | <u>\$ 174,960,819</u> | <u>\$ 17,328,509</u> |

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:

| | <u>December 31</u> | |
|---|-----------------------|-----------------------|
| | <u>2005</u> | <u>2004</u> |
| Mortgage loans: | | |
| Fixed rate | \$ 123,897,501 | \$ 109,896,116 |
| Hybrid | 3,732,223 | 2,464,058 |
| Variable rate | 3,883,507 | 5,818,838 |
| Home equity line of credit, variable rate | 57,629,526 | 47,705,614 |
| | <u>189,142,757</u> | <u>165,884,626</u> |
| Vehicle loans | 90,464,783 | 83,231,474 |
| Consumer loans, primarily unsecured | 18,682,524 | 15,779,485 |
| | <u>298,290,064</u> | <u>264,895,585</u> |
| Deferred net loan origination fees | (50,824) | (15,980) |
| Allowance for loan losses | (1,920,000) | (2,546,839) |
| | <u>\$ 296,319,240</u> | <u>\$ 262,332,766</u> |

NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2005 AND 2004

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

| | Years Ended December 31 | |
|----------------------------|-------------------------|--------------|
| | 2005 | 2004 |
| Balance, beginning of year | \$ 2,546,839 | \$ 2,796,853 |
| Provision for loan losses | 518,321 | 1,900,000 |
| Recoveries | 311,219 | 218,230 |
| Loans charged off | (1,456,379) | (2,368,244) |
| Balance, end of year | \$ 1,920,000 | \$ 2,546,839 |

Outstanding mortgage loan commitments at December 31, 2005 and 2004 total approximately \$393,000 and \$408,000, respectively.

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

| | December 31 | |
|----------------|----------------|----------------|
| | 2005 | 2004 |
| Home equity | \$ 59,533,000 | \$ 51,446,000 |
| Other consumer | 77,879,000 | 49,323,000 |
| | \$ 137,412,000 | \$ 100,769,000 |

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.

4. **LOAN SERVICING**

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, 2005 and 2004 are \$16,032,464 and \$18,371,045, respectively.

NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2005 AND 2004

5. **PROPERTY AND EQUIPMENT**

Property and equipment are summarized as follows:

| | December 31 | |
|---|--------------|--------------|
| | 2005 | 2004 |
| Data processing equipment | \$ 5,173,459 | \$ 5,999,312 |
| Furniture and equipment | 3,369,492 | 3,657,842 |
| Facility improvements | 2,902,701 | 2,957,115 |
| | 11,445,652 | 12,614,269 |
| Accumulated depreciation and amortization | (9,035,455) | (10,003,375) |
| | \$ 2,410,197 | \$ 2,610,894 |

The Credit Union leases four 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, 2005 are as follows:

| <u>Years Ending December 31</u> | |
|---------------------------------|--------------|
| 2006 | \$ 763,000 |
| 2007 | 791,000 |
| 2008 | 793,000 |
| 2009 | 318,000 |
| 2010 | 81,000 |
| Subsequent years | 118,000 |
| | \$ 2,864,000 |

Rental expense for the years ended December 31, 2005 and 2004 for all facilities leased under operating leases totaled \$927,000 and \$920,000, respectively.

NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2005 AND 2004

6. **MEMBERS' SHARES**

Members' shares are summarized as follows:

| | December 31 | |
|---|----------------|----------------|
| | 2005 | 2004 |
| Regular shares | \$ 147,025,806 | \$ 152,056,276 |
| Share draft accounts | 67,970,779 | 63,932,902 |
| Money market accounts | 107,457,123 | 111,396,655 |
| Non-term individual retirement accounts | 5,518,272 | 6,354,475 |
| Certificates (including IRA certificates) | 109,274,071 | 71,338,622 |
| | 437,246,051 | 405,078,930 |
| Dividends payable | 763,438 | 400,134 |
| | \$ 438,009,489 | \$ 405,479,064 |

Shares by maturity as of December 31, 2005 are summarized as follows:

| | |
|-------------------------|----------------|
| No contractual maturity | \$ 327,971,980 |
| 0 – 1 year maturity | 90,455,291 |
| 1 – 2 years maturity | 8,200,072 |
| 2 – 3 years maturity | 4,847,475 |
| 3 – 4 years maturity | 2,410,926 |
| 4 – 5 years maturity | 3,360,307 |
| | \$ 437,246,051 |

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 certificates in denominations of \$100,000 or more at December 31, 2005 and 2004 is approximately \$28,430,000 and \$15,478,000, respectively.

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7. **NOTES PAYABLE**

The Credit Union utilizes a Master Loan and Security Agreement with a corporate credit union. The terms of the agreement call for the pledging of all vehicle loans plus investment securities held in safekeeping at the corporate credit union as more fully described in Note 2, to secure the outstanding balances. The agreement provides for a credit limit of \$85 million with interest rates determined at the time of the advance. As of December 31, 2005 and 2004, borrowings under this agreement total \$39,800,000 and \$60,000,000, respectively. At December 31, 2005, advances have interest rates ranging from 2.7% to 4.5% and maturity dates as follows:

| | |
|---------------------------|----------------------|
| Less than 1 year maturity | \$ 13,200,000 |
| 1 – 2 years maturity | 11,200,000 |
| 2 – 3 years maturity | 9,200,000 |
| 2 – 3 years maturity | <u>6,200,000</u> |
| | <u>\$ 39,800,000</u> |

In addition to the agreement described above, the Credit Union utilizes demand loan agreements with two corporate credit unions. 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. The agreements provide for a combined credit limit of \$10 million with interest charged at a rate determined by the lenders on a periodic basis. At December 31, 2005 and 2004, there were no borrowings under these agreements. The agreements are reviewed for continuation by the lenders and the Credit Union annually.

8. **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.

9. **COMMITMENTS AND CONTINGENT LIABILITIES**

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, 2005.

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10. **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.

11. **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, 2005 and 2004 were 6.7% and 7.6%, respectively. The minimum requirement to be considered "complex" under the regulatory framework is 6%. Management believes, as of December 31, 2005 and 2004, that the Credit Union meets all capital adequacy requirements to which it is subject.

As of December 31, 2005, the most recent call reporting period, and 2004, 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, 2005</u> | | <u>December 31, 2004</u> | |
|--|--------------------------|--------------------------|--------------------------|--------------------------|
| | <u>Amount</u> | <u>Ratio/Requirement</u> | <u>Amount</u> | <u>Ratio/Requirement</u> |
| ➤ Amount needed to be classified as "adequately capitalized" | \$ 36,022,614 | 6.7% | \$ 39,747,357 | 7.6% |
| ➤ Amount needed to be classified as "well capitalized" | \$ 37,635,566 | 7.0% | \$ 39,747,357 | 7.6% |
| ➤ Actual net worth | \$ 60,894,906 | 11.3% | \$ 56,054,498 | 10.7% |

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.

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12. RELATED PARTY TRANSACTIONS

In the normal course of business, the Credit Union extends credit to directors, supervisory committee members, and executive officers. The aggregate loans to related parties at December 31, 2005 and 2004 are \$2,260,563 and \$1,888,023, respectively. Deposits from related parties at December 31, 2005 and 2004 amounted to \$4,094,086 and \$3,909,578, respectively.

13. 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.

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.

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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 is summarized as follows:

| | December 31, 2005 | | December 31, 2004 | |
|--------------------------------|--------------------|---------------|--------------------|---------------|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Financial Assets: | | | | |
| Cash and cash equivalents | \$ 38,205,000 | \$ 38,205,000 | \$ 28,728,000 | \$ 28,728,000 |
| Investments available-for-sale | 174,961,000 | 174,961,000 | 198,563,000 | 198,563,000 |
| Other investments | 17,329,000 | 17,329,000 | 22,162,000 | 22,162,000 |
| Loans to members, net | 296,319,000 | 292,763,000 | 262,333,000 | 260,571,000 |
| Accrued interest receivable | 2,033,000 | 2,033,000 | 1,727,000 | 1,727,000 |
| Financial Liabilities: | | | | |
| Members' shares | 438,009,000 | 437,630,000 | 405,479,000 | 405,192,000 |
| Notes payable | 39,800,000 | 39,443,000 | 60,000,000 | 60,670,000 |