# NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY

## CONSOLIDATED FINANCIAL STATEMENTS

## DECEMBER 31, 2008 AND 2007

Turner, Warren, Hwang & Conrad AC
Certified Public Accountants & Consultants

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# INDEPENDENT AUDITOR'S REPORT

Board of Directors
Northrop Grumman Federal Credit Union

We have audited the accompanying consolidated statement of financial condition of Northrop Grumman Federal Credit Union and subsidiary as of December 31, 2008, and the related consolidated statements of income, members' equity, and cash flows for the year 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 audit. The financial statements of Northrop Grumman Federal Credit Union as of December 31, 2007 were audited by other auditors whose report dated March 13, 2008 expressed an unqualified opinion.

We conducted our audit 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 that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Northrop Grumman Federal Credit Union and subsidiary as of December 31, 2008, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Turner, Warren, Hwang + Conrad

TURNER, WARREN, HWANG & CONRAD
ACCOUNTANCY CORPORATION

March 26, 2009

## NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

## DECEMBER 31, 2008 AND 2007

| | 2008 | 2007 |
|---|---|---|
| **ASSETS** | | |
| Cash and cash equivalents | $ 40,494,861 | $ 34,891,154 |
| Investments | | |
| Securities available-for-sale | 226,755,864 | 185,304,648 |
| Other | 12,334,047 | 9,941,112 |
| Loans to members | 389,257,711 | 357,220,530 |
| Accrued interest receivable | 2,255,181 | 2,297,983 |
| Property and equipment | 5,180,159 | 3,934,808 |
| NCUSIF deposit | 5,509,700 | 5,153,324 |
| Other assets | 2,143,360 | 2,642,515 |
| Total Assets | $ 683,930,883 | $ 601,386,074 |
| **LIABILITIES AND MEMBERS' EQUITY** | | |
| Liabilities | | |
| Members' share accounts | $ 552,646,544 | $ 508,731,796 |
| Borrowed funds | 46,200,000 | 15,400,000 |
| Accrued expenses and other liabilities | 5,003,361 | 5,785,187 |
| Total Liabilities | 603,849,905 | 529,916,983 |
| Members' equity | | |
| Regular reserve | 3,559,687 | 3,559,687 |
| Undivided earnings | 75,394,426 | 69,883,923 |
| Accumulated other comprehensive income (loss) | 1,126,865 | (1,974,519) |
| Total Members' Equity | 80,080,978 | 71,469,091 |
| Total Liabilities and Members' Equity | $ 683,930,883 | $ 601,386,074 |

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

# NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF INCOME

## YEARS ENDED DECEMBER 31, 2008 AND 2007

| | 2008 | 2007 |
|---|---|---|
| **INTEREST INCOME** | | |
| Loans to members | $ 22,034,029 | $ 20,914,439 |
| Investments and cash and cash equivalents | 11,191,287 | 11,089,802 |
| Total Interest Income | 33,225,316 | 32,004,241 |
| **INTEREST EXPENSE** | | |
| Members' share accounts | 14,876,525 | 15,357,741 |
| Borrowed funds | 1,202,099 | 758,618 |
| Total Interest Expense | 16,078,624 | 16,116,359 |
| **NET INTEREST INCOME** | 17,146,692 | 15,887,882 |
| **PROVISION FOR LOAN LOSSES** | 1,230,427 | 306,013 |
| **NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES** | 15,916,265 | 15,581,869 |
| **NON-INTEREST INCOME** | | |
| Fees and charges | 2,758,715 | 2,873,911 |
| Other income | 1,997,328 | 2,144,716 |
| Net realized gain on sale of securities available-for-sale | 446,895 | 36,382 |
| Total Non-Interest Income | 5,202,938 | 5,055,009 |
| **NON-INTEREST EXPENSE** | | |
| Compensation and benefits | 7,671,772 | 7,432,118 |
| Operations | 6,555,939 | 5,687,364 |
| Occupancy | 1,380,989 | 1,374,676 |
| Total Non-Interest Expense | 15,608,700 | 14,494,158 |
| **NET INCOME** | $ 5,510,503 | $ 6,142,720 |

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

# Northrop Grumman Federal Credit Union and Subsidiary

## Consolidated Statements of Members' Equity

## Years Ended December 31, 2008 and 2007

| | Regular Reserve | Undivided Earnings | Accumulated Other Comprehensive Income (Loss) | Total |
|---|---|---|---|---|
| Balance, December 31, 2006 | $ 3,559,687 | $ 63,741,203 | $ (4,025,332) | $ 63,275,558 |
| Comprehensive income | | | | |
| Net income | - | 6,142,720 | - | 6,142,720 |
| Other comprehensive income | | | | |
| Net change in unrealized losses on securities available-for-sale | - | - | 2,087,195 | 2,087,195 |
| Less: reclassification adjustment for realized gain on investment included in net income | | | (36,382) | (36,382) |
| | | | | 2,050,813 |
| Total comprehensive income | - | - | - | 8,193,533 |
| Balance, December 31, 2007 | 3,559,687 | 69,883,923 | (1,974,519) | 71,469,091 |
| Comprehensive income | | | | |
| Net income | - | 5,510,503 | - | 5,510,503 |
| Other comprehensive income | | | | |
| Net change in unrealized losses on securities available-for-sale | - | - | 3,548,279 | 3,548,279 |
| Less: reclassification adjustment for realized gain on investment included in net income | | | (446,895) | (446,895) |
| | | | | 3,101,384 |
| Total comprehensive income | - | - | - | 8,611,887 |
| Balance, December 31, 2008 | $ 3,559,687 | $ 75,394,426 | $ 1,126,865 | $ 80,080,978 |

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

## NORTHROP GRUMMAN FEDERAL CREDIT UNION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF CASH FLOWS

## YEARS ENDED DECEMBER 31, 2008 AND 2007

| | 2008 | 2007 |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| Net income | $ 5,510,503 | $ 6,142,720 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,074,663 | 1,010,272 |
| Provision for loan losses | 1,230,427 | 306,013 |
| Net amortization of investments | 320,142 | 245,957 |
| Amortization of deferred loan origination costs, net | 202,440 | 218,842 |
| Gain on sale of securities available-for-sale | (446,895) | (36,382) |
| Net change in: | | |
| Accrued interest receivable | 42,802 | (126,064) |
| NCUSIF deposit | (356,376) | (803,820) |
| Other assets | 499,155 | (393,727) |
| Accrued expenses and other liabilities | (781,826) | (1,185,108) |
| Net cash provided by operating activities | 7,295,035 | 5,378,703 |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | |
| Purchases of securities available-for-sale | (171,136,224) | (62,351,605) |
| Proceeds from maturities and principal payments received on securities available-for-sale | 132,913,146 | 60,920,874 |
| Net (increase) decrease in other investments | (2,392,936) | 5,277,908 |
| Net increase in loans to members | (33,470,048) | (37,088,172) |
| Purchases of property and equipment | (2,320,014) | (1,699,415) |
| Net cash used in investing activities | (76,406,076) | (34,940,410) |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | |
| Net increase in members' share accounts | 43,914,748 | 36,312,419 |
| Net increase (decrease) on borrowed funds | 30,800,000 | (11,200,000) |
| Net cash provided by financing activities | 74,714,748 | 25,112,419 |
| **NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS** | 5,603,707 | (4,449,288) |
| **CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR** | 34,891,154 | 39,340,442 |
| **CASH AND CASH EQUIVALENTS AT END OF YEAR** | $ 40,494,861 | $ 34,891,154 |

**SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:**

| | | |
|---|---|---|
| Dividends paid on members’ share accounts | $ 15,067,942 | $ 15,883,128 |
| Interest paid on borrowed funds | 1,202,099 | 758,618 |

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

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Nature of Business:** 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. The credit union provides a variety of financial services to its members. Participation in the credit union is limited to those individuals who qualify for membership as defined in its charter and bylaws. The credit union's primary deposit products are share accounts, and its primary lending products are real estate, automobile and unsecured loans.

The credit union's wholly-owned subsidiary, Flight Plan Financial Services, Inc., provides insurance and investment services for members.

**Field of Membership and Sponsor:** Participation in the credit union is limited to those individuals who qualify for membership as defined in its charter and bylaws. The primary field of membership of the credit union is employees and former employees of Northrop Grumman Corporation.

**Principles of Consolidation:** The accompanying consolidated financial statements include the accounts of the Northrop Grumman Federal Credit Union and Flight Plan Financial Services, Inc. All significant intercompany accounts and transactions have been eliminated.

**Use of Estimates:** The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities as of 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.

**Cash and Cash Equivalents:** For purposes of the statement of cash flows, cash and cash equivalents include cash on hand and in banks and all highly liquid debt instruments with original maturities of three months or less.

**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 recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of individual available-for-sale securities below their cost that are deemed to be other-than-temporary are reflected in earnings as realized losses. In determining whether other-than-temporary impairment exists, management considers many factors, including (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the credit union to retain its investments in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sale of securities are recorded on the trade date and the costs of securities sold are determined using the specific identification method.

Other investments are classified separately and are stated at cost.

**Loans to Members:** The credit union grants mortgage and consumer loans to members. A substantial portion of the loan portfolio is represented by automobile and mortgage loans to members. The ability of members to honor their contracts is dependent upon the real estate and general economic condition of the area.

**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

Loans that the credit union has the intent and ability to hold for the foreseeable future are stated at unpaid principal balances, less an allowance for loan losses and net deferred loan origination fees and costs. Interest on loans is recognized over the term of the loan and is calculated using the simple-interest method on principal amounts outstanding.

The accrual of interest on loans is discontinued at the time the loan is 90 days delinquent. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if management believes, after considering economic conditions, business conditions, and collection efforts, that collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans that are placed on nonaccrual or charged off is reversed against interest income. The interest on these loans is accounted for on the cash-basis until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Certain loan fees and direct loan origination costs are deferred, and the net fee or cost is recognized as an adjustment to interest income using the interest method over the contractual life of the loans, adjusted for estimated prepayments based on the credit union's historical prepayment experience.

**Allowance for Loan Losses:** The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

A loan is considered impaired when, based on current information and events, it is probable that a creditor will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reason for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the credit union does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a restructuring agreement.

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

**Other Real Estate Owned:** Assets acquired through, or in lieu of, loan foreclosure and included in other assets are held-for-sale and are initially recorded at fair value at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in operating expenses.

**Transfers of Financial Assets:** Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the credit union, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the credit union does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets.

**Property and Equipment:** Land is carried at cost. Furniture and equipment, data processing equipment, and leasehold improvements are carried at cost, less accumulated depreciation and amortization. The furniture and equipment and data processing equipment are depreciated 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.

**NCUSIF Deposit:** The deposit in the National Credit Union Share Insurance Fund (NCUSIF) is in accordance with the National Credit Union Administration (NCUA) regulations, which require the maintenance of a deposit by each insured credit union in an amount equal to 1% of its insured shares. The deposit would be refunded to the credit union if its insurance coverage is terminated, it converts insurance coverage to another source, or the operations of the fund are transferred from the NCUA Board. The fund is adjusted annually to reflect changes in the level of insured shares in the credit union.

**NCUSIF Insurance Premium:** A credit union is required to pay an annual premium equal to one-twelfth of 1% of its total insured shares unless the payments are waived or reduced by the NCUA Board. The NCUA Board waived the 2008 and 2007 insurance premiums. See Note 16 for 2009 NCUA insurance premium assessment information.

**Members' Share Accounts:** Members' share accounts are subordinated to all other liabilities of the credit union upon liquidation. Dividends on members' share accounts are based on available earnings at the end of a dividend period and are not guaranteed by the credit union. Dividend rates on members' share accounts are set by the board of directors, based on an evaluation of current and future market conditions.

**Members' Equity:** The credit union is required by regulation to maintain a statutory reserve. This reserve, which represents a regulatory restriction of retained earnings, is not available for the payment of dividends.

**Income Taxes:** The credit union is exempt from federal and California taxes on income. 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 2008 and 2007.

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

**Recent Accounting Pronouncements**: In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 provides a framework for measuring fair value when such measurements are utilized for accounting purposes. The framework focuses on an exit price in the principal (or, alternatively, the most advantageous) market determined in

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

an orderly transaction between willing market participants. SFAS 157 establishes a three-tiered fair value hierarchy with the highest tier (Level 1) representing quoted prices for identical assets or liabilities in an active market and the lowest tier (Level 3) representing estimated values based on unobservable inputs. Under SFAS 157, related disclosures are segregated for assets and liabilities measured at fair value based on the level used within the hierarchy to determine their fair values.

The credit union has adopted SFAS 157 for financial assets at January 1, 2008 and is deferring application as allowed for nonfinancial assets until January 1, 2009. The financial impact, if any, upon full adoption has not yet been determined. On February 12, 2008, FASB issued FASB Staff Position (FSP) 157-2, to delay the effective date of SFAS 157 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115,* (SFAS 159). SFAS 159 permits fair value accounting to be irrevocably elected for certain financial assets and liabilities on an individual contract basis at the time of acquisition or at a remeasurement event date. Upon adoption of SFAS 159, fair value accounting may also be elected for existing financial assets and liabilities. For those instruments for which fair value accounting is elected, changes in fair value will be recognized in earnings and fees and costs associated with origination or acquisition will be recognized as incurred rather than deferred. SFAS 159 is effective January 1, 2008, with early adoption permitted as of January 1, 2007. The credit union has elected not to adopt SFAS 159 at this time.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141R, *Business Combinations*, (SFAS 141R). SFAS 141R requires that the acquisition method of accounting be used for all business combinations including mutual entities such as credit unions that previously used the pooling-of-interests method of accounting. This statement applies to prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008, with early adoption prohibited. The credit union is currently evaluating the future impact of SFAS 141R on its financial position, results of operations and cash flows.

## NOTE 2 – INVESTMENTS

The amortized cost and fair value of securities available-for-sale are as follows:

| 2008 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Federal agency securities | $ 8,048,523 | $ 38,309 | $ - | $ 8,086,832 |
| Mortgage-backed securities | 217,580,476 | 3,268,491 | (2,179,935) | 218,669,032 |
| | $ 225,628,999 | $ 3,306,800 | $ (2,179,935) | $ 226,755,864 |

| 2007 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Federal agency securities | $ 52,323,993 | $ 198,847 | $ (47,183) | $ 52,475,657 |
| Mortgage-backed securities | 134,955,174 | 127,318 | (2,253,501) | 132,828,991 |
| | $ 187,279,167 | $ 326,165 | $ (2,300,684) | $ 185,304,648 |

## NOTE 2 – INVESTMENTS (CONTINUED)

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, 2008 are as follows:

| Description | Fair Value | Continuous Unrealized Losses Existing for: Less Than 12 Months | 12 Months Or Longer | Total |
|---|---|---|---|---|
| Mortgage-backed securities | $ 57,994,779 | $ (634,701) | $ (1,545,234) | $ (2,179,935) |
| | $ 57,994,779 | $ (634,701) | $ (1,545,234) | $ (2,179,935) |

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the credit union to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

There are a total of 12 investments that have been in a continuous unrealized loss position for less than 12 months and 34 investments that have been in a continuous unrealized loss position for 12 months or longer as of December 31, 2008. 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.

The amortized cost and fair value of investments by contractual maturity at December 31, 2008 are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

A summary of securities by maturity at December 31, 2008 is as follows:

| Maturity | Securities Available-for-Sale: Amortized Cost | Fair Value | Other |
|---|---|---|---|
| No maturity | $ | $ | $ 3,834,047 |
| Less than one year | | | 8,500,000 |
| One to five years | 6,548,523 | 6,582,939 | - |
| Five to ten years | 1,500,000 | 1,503,893 | - |
| | 8,048,523 | 8,086,832 | 12,334,047 |
| Mortgage-backed securities | 217,580,476 | 218,669,032 | - |
| | $ 225,628,999 | $ 226,755,864 | $ 12,334,047 |

Other investments consisted of the following:

| | 2008 | 2007 |
|---|---|---|
| Certificates of deposit | $ 8,500,000 | $ 6,500,000 |
| Member capital shares in a corporate credit union | 2,834,047 | 2,441,112 |
| Permanent capital shares in a corporate credit union | 1,000,000 | 1,000,000 |
| | $ 12,334,047 | $ 9,941,112 |

## NOTE 2 – INVESTMENTS (CONTINUED)

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

Permanent capital accounts are uninsured equity 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.

## NOTE 3 – LOANS TO MEMBERS

The composition of loans to members is as follows:

| | 2008 | 2007 |
|---|---|---|
| Mortgage loans: | | |
| Fixed rate | $ 155,056,116 | $ 141,557,096 |
| Hybrid | 21,135,240 | 15,509,566 |
| Variable rate | 1,196,408 | 1,247,396 |
| Home equity line of credit, variable rate | 52,097,113 | 50,829,616 |
| Home equity line of credit, fixed rate | 47,146,108 | 30,144,620 |
| | 276,630,985 | 239,288,294 |
| Vehicle loans | 91,714,076 | 97,529,852 |
| Other consumer loans, primarily unsecured | 22,260,838 | 21,067,630 |
| | 390,605,899 | 357,885,776 |
| Net deferred loan origination costs | 191,812 | 332,255 |
| Allowance for loan losses | (1,540,000) | (997,501) |
| | $ 389,257,711 | $ 357,220,530 |

A summary of the changes in the allowance for loan losses is as follows:

| | 2008 | 2007 |
|---|---|---|
| Balance, beginning of year | $ 997,501 | $ 1,215,000 |
| Provision charged to operations | 1,230,427 | 306,013 |
| Loans charged off | (1,034,438) | (768,132) |
| Recoveries | 346,510 | 244,620 |
| Balance, end of year | $ 1,540,000 | $ 997,501 |

Loans to officials totaled $1,800,162 and $1,317,461 at December 31, 2008 and 2007, respectively.

## NOTE 4 – PROPERTY AND EQUIPMENT

The composition of property and equipment is summarized as follows:

| | 2008 | 2007 |
|---|---|---|
| Land | $ 872,994 | $ 872,994 |
| Data processing equipment | 6,309,231 | 5,899,484 |
| Leasehold improvements | 2,870,960 | 3,060,881 |
| Furniture and equipment | 2,796,808 | 2,688,578 |
| | 12,849,993 | 12,521,937 |
| Accumulated depreciation and amortization | (9,853,435) | (9,183,623) |
| Construction in progress | 2,183,601 | 596,494 |
| | $ 5,180,159 | $ 3,934,808 |

## NOTE 4 – PROPERTY AND EQUIPMENT (CONTINUED)

Depreciation and amortization expense was $1,074,663 and $1,010,272 for the years ended December 31, 2008 and 2007, respectively.

## NOTE 5 – MEMBERS' SHARE ACCOUNTS

A summary of members' share accounts by type is as follows:

| | 2008 | 2007 |
|---|---|---|
| Regular shares | $ 113,372,791 | $ 111,996,189 |
| Share drafts | 64,886,840 | 65,691,442 |
| Money Market | 128,178,568 | 111,722,891 |
| Share certificates | 191,242,943 | 173,184,630 |
| Individual Retirement Account | 54,965,402 | 46,136,644 |
| | $ 552,646,544 | $ 508,731,796 |

Dividend rates are set by the board of directors and dividends are charged to operations. The aggregate amounts of members' share accounts over $100,000 were $101,137,820 and $75,199,000 at December 31, 2008 and 2007, respectively.

A summary of members' share accounts by maturity at December 31, 2008 is as follows:

| | |
|---|---|
| No contractual maturity | $ 311,096,491 |
| Within one year | 214,309,806 |
| One to three years | 13,244,876 |
| Three to five years | 13,995,371 |
| | $ 552,646,544 |

## NOTE 6 – BORROWINGS

The credit union is borrower under a Master Loan and Security Agreement (Master Agreement) with a corporate credit union. Fixed rate loan advances currently outstanding under the Master Agreement bear interest at rates from 3.15% to 4.73% and are collateralized by all consumer loans plus three specified investment securities held in safekeeping at the corporate credit union. A Demand Loan and Security agreement under the master loan agreement provides for a credit limit of $85 million with interest rates determined at the time of the advance. As of December 31, 2008 and 2007, fixed rate loans under the agreement total $46,200,000 and $15,400,000, respectively.

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, 2008 and 2007, there were no borrowings under these agreements. The agreements are reviewed for continuation by the lenders and the credit union annually.

## NOTE 7 – LEASE COMMITMENTS

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, 2008 are as follows:

| Years Ending December 31, | | |
|---|---|---|
| 2009 | $ | 593,116 |
| 2010 | | 1,080,012 |
| 2011 | | 1,065,076 |
| 2012 | | 1,046,423 |
| 2013 | | 1,041,913 |
| Thereafter | | 6,104,178 |
| | $ | 10,930,718 |

Rent expense was $1,082,464 and $1,095,380 for the years ended December 31, 2008 and 2007, respectively.

## NOTE 8 – OFF-BALANCE-SHEET ACTIVITIES

The credit union is a party to conditional commitments to lend funds in the normal course of business to meet the financing needs of its members. These commitments represent financial instruments to extend credit which include lines of credit and home equity lines that involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the financial statements.

The credit union's exposure to credit loss is represented by the contractual notional amount of these instruments. The credit union uses the same credit policies in making commitments as it does for loans recorded in the financial statements.

| | | 2008 | | 2007 |
|---|---|---|---|---|
| Home equity lines of credit | $ | 94,790,324 | $ | 80,185,920 |
| Lines of credit | | 71,003,495 | | 73,979,919 |
| Courtesy pay program | | 9,935,785 | | 9,924,156 |
| Loans approved but not funded | | 838,500 | | - |
| Total commitments to extend credit | $ | 176,568,104 | $ | 164,089,995 |

Commitments to extend credit are agreements to lend to a member as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The credit union evaluates each member's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the credit union upon extension of credit is based on management's credit evaluation of the member. Collateral held generally consists of certificates of deposit, share accounts, automobiles and real estate.

Unfunded commitments under revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing members. These lines-of-credit are uncollateralized and usually do not contain a specified maturity date and may not be drawn upon to the total extent to which the credit union is committed.

## NOTE 9 – LEGAL CONTINGENCIES

The credit union is a party to various legal actions normally associated with financial institutions, the aggregate effect of which, in management's and legal counsel's opinion, would not be material to the financial condition of the credit union.

## NOTE 10 – CONCENTRATION OF CREDIT RISK

At December 31, 2008 the credit union had cash and certificates of deposit at various financial institutions which exceeded federally insured limits. The aggregate uninsured amount was $43,496,194.

## NOTE 11 – RELATED PARTY TRANSACTIONS

Loans to credit union officials and deposits held by credit union officials were treated the same with regard to rates, terms and requirements as loans and deposits of other members with similar circumstances.

## NOTE 12 – EMPLOYEE BENEFIT PLANS

The credit union employees are participants in the pension plan of Northrop Grumman Corporation. Since the credit union employees 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. The total pension plan expense for the years ended December 31, 2008 and 2007 was $205,017 and $189,444, respectively.

## NOTE 13 – FAIR VALUE OF FINANCIAL INSTRUMENTS

Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments*, requires disclosure of fair value information about financial instruments, whether or not recognized in the statement of financial condition. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. Statement No. 107 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the credit union.

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

**Cash and Cash Equivalents:** The carrying amount is a reasonable estimate of fair value.

**Investments:** Fair values of securities are usually based on quoted market prices. If quoted market prices were not available, fair value was estimated using quoted market prices of similar securities.

**Loans to Members:** Fair value is estimated by discounting the future cash flows using the current average rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

**Borrowed Funds:** The fair value of short term borrowed funds is the carrying amount. The fair value of long-term borrowed funds is estimated by discounting the future cash flows using the rates offered for borrowings of similar remaining maturities.

## NOTE 13 – FAIR VALUE OF FINANCIAL INSTRUMENTS (CONTINUED)

**Members' Share Accounts:** The fair value of regular shares and share draft accounts is the carrying amount. The fair value of fixed-maturity certificates of deposit is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities.

**Off-Balance-Sheet Financial Instruments:** The fair value of off-balance-sheet commitments is estimated based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the members. The estimated value of these commitments is not significant.

The estimated fair values of the credit union's financial instruments are as follows:

| | 2008 | | 2007 | |
|---|---|---|---|---|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Financial assets: | | | | |
| Cash and cash equivalents | $ 40,495,000 | $ 40,495,000 | $ 34,891,000 | $ 34,891,000 |
| Loans to members | 389,258,000 | 395,335,000 | 357,221,000 | 356,357,000 |
| Investments | 239,090,000 | 239,201,000 | 195,246,000 | 195,246,000 |
| Financial liabilities: | | | | |
| Members' share accounts | 552,647,000 | 553,995,000 | 510,092,000 | 510,771,000 |
| Borrowed funds | 46,200,000 | 46,352,000 | 15,400,000 | 15,437,000 |

## NOTE 14 – FAIR VALUE MEASUREMENTS

Fair values of assets and liabilities measured on a recurring basis at December 31, 2008 are as follows:

| | | Fair value measurements at reporting date using | | |
|---|---|---|---|---|
| Description | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Available-for-sale securities | $ 226,755,864 | $ 15,695,230 | $ 211,060,634 | $ - |

## NOTE 15 – REGULATORY CAPITAL

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 regulations and the regulatory framework for prompt corrective action, the credit union must meet specific capital regulations 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 net worth classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

## NOTE 15 – REGULATORY CAPITAL (CONTINUED)

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 (as defined) to assets (as defined). Credit unions are also required to calculate a risk-based net worth (RBNW) requirement that establishes whether the credit union will be considered "complex" under the regulatory framework. The credit union's RBNW ratio as of December 31, 2008 and 2007 was 8.54% and 7.1%, respectively. The minimum ratio to be considered complex under the regulatory framework is 6%. Management believes, as of December 31, 2008, that the credit union meets all capital adequacy requirements to which it is subject.

As of December 31, 2008, the most recent call reporting period, 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 and meet any applicable RBNW requirement. There are no conditions or events since that notification that management believes have changed the credit union's category.

| | Actual | | To Be Adequately Capitalized Under Prompt Corrective Action Provisions | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|
| December 31, 2008 | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Net worth | $ 78,954,113 | 11.54% | $ 41,035,853 | 6% | $ 47,857,162 | 7% |
| RBNW requirement | 58,407,697 | 8.54% | N/A | N/A | N/A | N/A |
| | | | | | | |
| December 31, 2007 | | | | | | |
| Net worth | $ 73,443,610 | 12.2% | $ 36,083,164 | 6% | $ 42,097,025 | 7% |
| RBNW requirement | 42,698,411 | 7.1% | N/A | N/A | N/A | N/A |

Because the RBNW requirement is less than the net worth ratio, the credit union retains its original category.

## NOTE 16 – SUBSEQUENT EVENTS

Corporate credit unions provide investment and liquidity services to consumer-owned natural person credit unions. From late January 2009 to March 20, 2009, the NCUA Board has approved a series of actions under its Corporate Stabilization Program designed to enhance and support a corporate credit union system facing unprecedented strains on liquidity and capital due to extraordinary market disruptions and the current economic climate.

The NCUA Board has approved the following: guarantee of uninsured shares at all corporate credit unions through February 2009; establishment of a voluntary guarantee program for uninsured shares of all corporate credit unions through December 31, 2010; issuance of a $1 billion capital note to U.S. Central Corporate Federal Credit Union (U.S. Central); at March 20, 2009, the placing into conservatorship of two corporate credit unions (U.S. Central and WesCorp); issuance of an Advance Notice of Public Rulemaking (ANPR) on restructuring the corporate credit union system; and declaration of a premium assessment to restore the National Credit Union Share Insurance Fund (NCUSIF) equity ratio to 1.30%, which will be collected in 2009.

The expense of the actions will be passed on proportionately to all federally-insured credit unions through a 69% impairment recognition of credit unions' existing 1% NCUSIF deposits on insured shares and an additional assessment of a 0.30% premium, sufficient to return the NCUSIF's equity ratio to 1.30% or total impairment and premium assessments of 0.99%. The estimated cost of the current NCUA's program and assessments to the credit union in 2009 is approximately $5.5 million. It is probable that the credit union's investment in capital shares of WesCorp in the amount of $3.8 million is impaired, requiring a write down in 2009.