

**Xerox Federal Credit Union
and Subsidiary
Audit of Consolidated
Financial Statements
For the Years Ended
December 31, 2006 and 2005**

McGladrey & Pullen

Certified Public Accountants

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INDEPENDENT AUDITOR'S REPORT

Supervisory Committee
Xerox Federal Credit Union
and Subsidiary
El Segundo, California

We have audited the accompanying consolidated statements of financial condition of Xerox Federal Credit Union (a federally chartered credit union) and Subsidiary as of December 31, 2006 and 2005 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.

The Credit Union has reported shares as members' equity in the accompanying consolidated statements of financial condition that, in our opinion, should be reported as liabilities in order to conform to accounting principles generally accepted in the United States of America. If these shares were properly reported, liabilities would increase and members' equity would decrease by \$532,835,408 and \$543,658,140, respectively, as of December 31, 2006 and 2005.

In our opinion, except for the effect of the accounting practice described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Xerox Federal Credit Union and Subsidiary as of December 31, 2006 and 2005 and the consolidated results of its operations and its 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
April 23, 2007

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**XEROX FEDERAL CREDIT UNION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
DECEMBER 31, 2006 AND 2005**

ASSETS

	2006	2005
Cash and cash equivalents	\$ 54,321,458	\$ 48,014,128
Investments		
Available-for-sale	52,396,328	59,523,714
Other	44,191,637	79,054,936
Loans, net	560,772,981	593,583,073
Accrued interest receivable	2,947,856	2,707,113
Property and equipment	6,502,659	6,521,511
National Credit Union Share Insurance Fund deposit	4,404,305	4,547,272
Other assets	7,410,788	4,807,957
	\$ 732,948,012	\$ 798,759,704

LIABILITIES AND MEMBERS' EQUITY

Liabilities

Notes payable	\$ 53,300,000	\$ 111,900,000
State of California Treasury deposits	57,000,000	57,000,000
Accrued expenses and other liabilities	5,737,639	5,111,968
	116,037,639	174,011,968

Commitments and contingent liabilities

Members' Equity

Members' shares	532,835,408	543,658,140
Retained earnings	85,388,966	82,976,387
Accumulated other comprehensive loss	(1,314,001)	(1,886,791)
	616,910,373	624,747,736
	\$ 732,948,012	\$ 798,759,704

**XEROX FEDERAL CREDIT UNION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005**

	<u>2006</u>	<u>2005</u>
INTEREST INCOME		
Interest on loans	\$ 34,237,364	\$ 32,603,319
Interest on investments and cash equivalents	6,175,381	5,634,098
	<u>40,412,745</u>	<u>38,237,417</u>
INTEREST EXPENSE		
Dividends on members' shares	14,115,742	10,858,696
Interest on notes payable and State of California Treasury deposits	5,818,111	4,529,992
	<u>19,933,853</u>	<u>15,388,688</u>
NET INTEREST INCOME	20,478,892	22,848,729
PROVISION FOR LOAN LOSSES	<u>2,024,825</u>	<u>2,719,793</u>
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	<u>18,454,067</u>	<u>20,128,936</u>
NON-INTEREST INCOME		
Service charges and other fees	5,068,127	4,602,486
Debit card interchange income	1,312,676	1,306,931
Rental income	864,741	762,824
Net gain (loss) on sale of loans	1,090	(805,448)
Realized loss on sale of available-for-sale investments	(82,619)	0
Other	209,843	784,293
	<u>7,373,858</u>	<u>6,651,086</u>
GENERAL AND ADMINISTRATIVE EXPENSES		
Salaries and benefits	12,090,793	12,111,781
Operations and occupancy	11,324,553	11,713,115
	<u>23,415,346</u>	<u>23,824,896</u>
NET INCOME	<u>\$ 2,412,579</u>	<u>\$ 2,955,126</u>

**XEROX FEDERAL CREDIT UNION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005**

	2006	2005
NET INCOME	\$ 2,412,579	\$ 2,955,126
OTHER COMPREHENSIVE INCOME		
Net change in unrealized gains (losses) on available-for-sale investments	397,519	(1,035,694)
Net change in fair value of interest rate swaps designated as cash flow hedges	92,652	517,777
Reclassification adjustment for realized loss on sale of available-for sale investment	82,619	0
COMPREHENSIVE INCOME	\$ 2,985,369	\$ 2,437,209

**XEROX FEDERAL CREDIT UNION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF MEMBERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005**

	Retained Earnings			Accumulated Other Comprehensive Income (Loss)
	Regular Reserve	Unappropriated	Total	
Balance, December 31, 2004	\$ 18,235,852	\$ 61,785,409	\$ 80,021,261	\$ (1,368,874)
Net income		2,955,126	2,955,126	
Net change in unrealized gains (losses) on available-for-sale investments				(1,035,694)
Net change in fair value of interest rate swaps designated as cash flow hedges				517,777
Balance, December 31, 2005	18,235,852	64,740,535	82,976,387	(1,886,791)
Net income		2,412,579	2,412,579	
Net change in unrealized gains (losses) on available-for-sale investments				397,519
Net change in fair value of interest rate swaps designated as cash flow hedges				92,652
Reclassification adjustment for realized loss on sale of available-for sale investment				82,619
Balance, December 31, 2006	\$ 18,235,852	\$ 67,153,114	\$ 85,388,966	\$ (1,314,001)

**XEROX FEDERAL CREDIT UNION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005**

	<u>2006</u>	<u>2005</u>
OPERATING ACTIVITIES		
Net income	\$ 2,412,579	\$ 2,955,126
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of net premium on investments	99,012	135,438
Provision for loan losses	2,024,825	2,719,793
Depreciation and amortization	1,436,187	1,276,765
Realized loss on sale of available-for-sale investments	82,619	0
Increase in accrued interest receivable	(240,743)	(198,978)
Increase in other assets	(2,602,831)	(1,690,008)
Increase in accrued expenses and other liabilities	718,323	1,273,587
Net cash provided by operating activities	<u>3,929,971</u>	<u>6,471,723</u>
INVESTING ACTIVITIES		
Proceeds from maturities of available-for-sale investments	5,661,435	7,224,380
Proceeds from sales of available-for-sale investments	1,764,458	0
Net decrease (increase) in other investments	34,863,299	(9,607,646)
Net decrease (increase) in loans	30,785,267	(44,034,503)
Decrease (increase) in the National Credit Union Share Insurance Fund deposit	142,967	(48,152)
Purchases of property and equipment	(1,417,335)	(2,100,527)
Net cash provided by (used in) investing activities	<u>71,800,091</u>	<u>(48,566,448)</u>
FINANCING ACTIVITIES		
Net (decrease) increase in notes payable	(58,600,000)	27,700,000
Net increase in State of California Treasury deposits	0	10,000,000
Net (decrease) increase in members' shares	(10,822,732)	6,532,861
Net cash (used in) provided by financing activities	<u>(69,422,732)</u>	<u>44,232,861</u>
INCREASE IN CASH AND CASH EQUIVALENTS	6,307,330	2,138,136
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	<u>48,014,128</u>	<u>45,875,992</u>
CASH AND CASH EQUIVALENTS AT END OF YEAR	<u>\$ 54,321,458</u>	<u>\$ 48,014,128</u>
SUPPLEMENTAL CASH FLOW INFORMATION		
Dividends paid on members' shares and interest paid on borrowed funds and State of California Treasury deposits	\$ 20,237,603	\$ 14,861,566

**XEROX FEDERAL CREDIT UNION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2006 AND 2005**

1. SIGNIFICANT ACCOUNTING POLICIES

Organization: Xerox 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 for the year ended December 31, 2005 include the accounts of the Credit Union and its wholly owned subsidiary, Credit Union Auto Finance, LLC (the Company). The subsidiary is primarily engaged in processing and underwriting of automobile secured loans. All material intercompany accounts and transactions have been eliminated in consolidation. The Credit Union sold a 50% interest in the Company in 2006 to another credit union. As the Credit Union is no longer a majority shareholder in the Company, the financial statements for the year ended December 31, 2006, are not consolidated.

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.

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.

Members' shares are classified as members' equity in the consolidated statements of financial condition. It is the Credit Union's position that members' shares represent an ownership interest and are properly classified as equity. Such classification is not in accordance with generally accepted accounting principles. Generally accepted accounting principles require members' shares be classified as liabilities. This change has no effect on the consolidated statements of income.

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, other investments, members' shares, notes payable and State of California Treasury deposits 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

XEROX FEDERAL CREDIT UNION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2006 AND 2005

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.

Federal Home Loan Bank Stock: The Credit Union, as a member of the Federal Home Loan Bank (FHLB) system, is required to maintain an investment in capital stock of the FHLB in an amount equal to the greater of 1% of its outstanding mortgage loans or 5% of advances from the FHLB. No ready market exists for the FHLB stock, and it has no quoted market value.

Loans 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 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.

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 collectibility 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.

**XEROX FEDERAL CREDIT UNION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2006 AND 2005**

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 60 days delinquent. All interest accrued but not collected for loans that are placed on non-accrual status or subsequently charged off are 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.

Derivative Financial Instruments and Hedging Activities: The Credit Union records all derivatives at fair value in the consolidated statements of financial condition and designates derivative instruments as being used to hedge changes in fair value or changes in cash flows. If a derivative is designated as a cash flow hedge the changes in the fair value of the derivative are recorded initially in other comprehensive income to the extent the hedge is effective. Amounts recorded in other comprehensive income are subsequently reclassified into earnings during the same period in which the hedged item affects earnings. If a derivative is designated as a fair value hedge, then changes in the fair value of the derivative are recorded in earnings and are offset by changes in the fair value in the hedged item attributable to the hedged risk. Any portion of the changes in the fair value of derivatives designated as a hedge that is deemed ineffective is recorded in earnings.

Property and Equipment: Land is carried at cost. Building and building improvements, leasehold improvements, and furniture and equipment are carried at cost, less accumulated depreciation and amortization. Building and building improvements and furniture and 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.

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 2006 and 2005 insurance premiums.

Income Taxes: The Credit Union is exempt, by statute, from federal and state income taxes. The Credit Union's subsidiary is a limited liability company and as such is not subject to income tax. Income or loss from the Company is passed through to its members.

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 statements of financial condition.

Reclassifications: Certain account reclassifications have been made to the 2005 consolidated financial statements in order to conform to classifications used in the current year.

**XEROX FEDERAL CREDIT UNION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Recent Accounting Pronouncements: In March 2006, the Financial Accounting Standards Board issued SFAS No. 156, Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140. Among other matters, this Statement requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a service contract under certain situations. This Statement permits an entity to determine the method of measuring the servicing asset or liability by choosing either the amortization method or the fair value measurement method. The new standard is effective for fiscal years beginning after September 15, 2006. Management does not expect the adoption of this statement to have a material impact on its consolidated financial position or results of operations.

2. INVESTMENTS

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

<u>December 31, 2006</u>	<u>Amortized Cost</u>	<u>Unrealized Gains</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>
Federal agencies securities	\$ 42,793,686	\$ 0	\$ (1,103,414)	\$ 41,690,272
Mortgage-backed securities	10,988,935	55,750	(338,629)	10,706,056
	<u>\$ 53,782,621</u>	<u>\$ 55,750</u>	<u>\$ (1,442,043)</u>	<u>\$ 52,396,328</u>
<u>December 31, 2005</u>				
Federal agencies securities	\$ 42,811,055	\$ 0	\$ (1,444,797)	\$ 41,366,258
Mortgage-backed securities	18,579,089	84,956	(506,589)	18,157,456
	<u>\$ 61,390,144</u>	<u>\$ 84,956</u>	<u>\$ (1,951,386)</u>	<u>\$ 59,523,714</u>

Gross unrealized losses and fair value by length of time that the individual available-for-sale securities have been in a continuous unrealized loss position at December 31, 2006 and 2005 are as follows:

<u>December 31, 2006</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	\$ 41,690,272	\$ 0	\$ (1,103,414)	\$ (1,103,414)
Mortgage-backed securities	8,055,038	(11,322)	(327,307)	(338,629)
	<u>\$ 49,745,310</u>	<u>\$ (11,322)</u>	<u>\$ (1,430,721)</u>	<u>\$ (1,442,043)</u>
<u>December 31, 2005</u>				
Federal agencies securities	\$ 41,366,258	\$ (729,906)	\$ (714,891)	\$ (1,444,797)
Mortgage-backed securities	14,605,092	(209,425)	(297,164)	(506,589)
	<u>\$ 55,971,350</u>	<u>\$ (939,331)</u>	<u>\$ (1,012,055)</u>	<u>\$ (1,951,386)</u>

**XEROX FEDERAL CREDIT UNION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2006 AND 2005**

There are a total of 8 and 16 investments with unrealized losses as of December 31, 2006 and 2005, respectively. 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	
	2006	2005
Share certificates in a corporate credit union	\$ 34,590,064	\$ 62,865,831
Certificates of deposit in banks, savings institutions and other credit unions	200,000	5,200,000
Federal Home Loan Bank stock	3,661,300	5,858,700
Member capital account in a corporate credit union	3,240,273	2,630,405
Permanent capital account in a corporate credit union	2,500,000	2,500,000
	\$ 44,191,637	\$ 79,054,936

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.

Securities with a par value of \$26,159,201 have been pledged as collateral to secure Federal Home Loan Bank advances as more fully disclosed in Note 7.

Securities with a par value of \$28,148,972 have been pledged as collateral to secure State of California Treasury Deposits as disclosed in Note 8.

At December 31, 2006 and 2005, there were approximately \$84,255,000 and \$101,255,000, respectively, in credit union and bank deposits with individual balances in excess of the insured limit.

**XEROX FEDERAL CREDIT UNION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2006 AND 2005**

Investments by maturity as of December 31, 2006 are summarized as follows:

	Available-for-sale		Other
	Amortized Cost	Fair Value	
No contractual maturity	\$ 0	\$ 0	\$ 9,401,573
Less than 1 year maturity	4,250,000	4,216,069	5,210,000
1 – 5 years maturity	38,543,686	37,474,203	23,218,280
5 – 10 years maturity	0	0	6,361,784
Mortgage-backed securities	10,988,935	10,706,056	0
	\$ 53,782,621	\$ 52,396,328	\$ 44,191,637

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. FHLB stock and member and permanent capital accounts have been classified with no contractual maturity.

3. LOANS

Loans consist of the following:

	December 31	
	2006	2005
Mortgage loans:		
Fixed rate	\$ 187,229,056	\$ 232,047,635
Hybrid	22,239,388	21,172,585
Home equity line of credit, variable rate	99,327,911	56,329,270
Participation loans purchased	14,861,741	16,221,345
	323,658,096	325,770,835
Vehicle loans	195,836,988	222,747,994
Other consumer loans, primarily unsecured	40,139,446	42,024,424
	559,634,530	590,543,253
Deferred net loan origination costs	3,671,136	5,688,160
Allowance for loan losses	(2,532,685)	(2,648,340)
	\$ 560,772,981	\$ 593,583,073

The participation loans purchased consist of pools of residential mortgage loans. The lead lender is responsible for the administration of these loans, including the collection of payments, record keeping, and collection procedures, if necessary. The Credit Union holds a fractional security interest in the underlying collateral.

**XEROX FEDERAL CREDIT UNION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2006 AND 2005**

Mortgage loans totaling \$262,061,760 have been pledged as collateral to secure amounts borrowed from the Federal Home Loan Bank as disclosed in Note 7.

Vehicle loans totaling \$195,836,988 have been pledged as collateral to secure amounts borrowed from a corporate credit union as disclosed in Note 7.

Mortgage loans totaling \$50,241,461 have been pledged as collateral to secure State of California Treasury deposits as disclosed in Note 8.

The Credit Union offers non-traditional mortgage loans to its members. These loans include hybrid mortgages and consist of loans that are fixed for an initial period of three, five, seven years or ten years. After this period, the mortgages are converted to variable rate using the fully indexed rate, which can result in significant payment shock to the borrower. Non-traditional mortgage loans may have significantly different credit risk characteristics than traditional fixed and variable rate mortgages. However, the Credit Union believes it has established prudent underwriting standards as well as adequate risk management functions to monitor these additional risks.

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

	Years Ended December 31	
	2006	2005
Balance, beginning of year	\$ 2,648,340	\$ 2,307,957
Provision for loan losses	2,024,825	2,719,793
Recoveries	344,771	258,901
Loans charged off	(2,485,251)	(2,638,311)
Balance, end of year	\$ 2,532,685	\$ 2,648,340

Outstanding mortgage loan commitments at December 31, 2006 and 2005 total approximately \$6,290,000 and \$7,556,000, respectively.

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

	December 31	
	2006	2005
Unsecured lines of credit	\$ 66,594,000	\$ 77,575,000
Home equity	56,024,000	54,616,000
	\$ 122,618,000	\$ 132,191,000

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 financial statements.

XEROX FEDERAL CREDIT UNION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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4. LOAN SERVICING

Mortgage loans serviced for others are not included in the accompanying consolidated statements of financial condition. The unpaid principal balances of these loans at December 31, 2006 and 2005 are summarized as follows:

	December 31	
	2006	2005
Mortgage loan portfolios serviced for:		
Other investors	\$ 28,915,953	\$ 31,126,542
Freddie Mac	12,495,598	14,690,693
	\$ 41,411,551	\$ 45,817,235
 Automobile loan portfolios serviced for others:		
3.5% limited subordination	\$ 24,443,282	\$ 35,768,060
4.25% limited subordination	4,189,699	6,954,443
No recourse	13,294,349	26,584,356
	41,927,330	69,306,859
	\$ 83,338,881	\$ 115,124,094

Automobile loans with limited subordination consist of pools of loans sold to a corporate credit union with limited recourse. The Credit Union has retained a limited subordination percentage in the amounts shown above. Net loan losses in each pool will be charged first to the subordination amount held by the Credit Union. Net losses exceeding this amount will be shared equally between the Credit Union and the corporate credit union.

5. PROPERTY AND EQUIPMENT

Property and equipment are summarized as follows:

	December 31	
	2006	2005
Land	\$ 323,886	\$ 323,886
Building and improvements	4,654,759	4,654,759
Leasehold improvements	1,483,238	1,455,317
Furniture and equipment	14,034,695	13,110,992
	20,496,578	19,544,954
Accumulated depreciation and amortization	(13,993,919)	(13,023,443)
	\$ 6,502,659	\$ 6,521,511

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The Credit Union leases 14 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, 2006 are as follows:

<u>Years Ending December 31</u>		
2007	\$	304,000
2008		177,000
2009		36,000
Subsequent years		0
	\$	517,000

Rental expense for the years ended December 31, 2006 and 2005 for all facilities leased under operating leases totaled \$440,865 and \$444,610, respectively.

6. OTHER ASSETS

Included in other assets are variable universal life insurance policies totaling approximately \$6,629,000, and \$4,119,000, respectively, as of December 31, 2006 and 2005. The Credit Union is the owner and beneficiary of these policies. The policies provide for investments in various unit investment trusts administered by Lincoln Financial and Pacific Life. These underlying investments incurred a gain in value of approximately \$88,000 and \$42,000, respectively, for the years ended December 31, 2006 and 2005, and this amount is included in other non-interest income.

7. NOTES PAYABLE

The Credit Union utilizes a demand loan agreement with the Federal Home Loan Bank (FHLB). The terms of the agreement call for pledging certain investments held in safekeeping by the FHLB and a portion of the Credit Union's mortgage loan portfolio. The agreement provides for a maximum borrowing capacity of \$183,237,000. As of December 31, 2006 and 2005, the advances total \$53,300,000 and \$111,900,000, respectively.

As of December 31, 2006, the outstanding balances by maturity dates are as follows:

	Balance	Weighted Cost
0 – 1 year maturity	\$ 1,000,000	4.9%
2 – 3 years maturity	15,000,000	3.6%
3 – 4 years maturity	25,000,000	4.2%
4 – 5 years maturity	2,300,000	5.1%
Over 5 years maturity	10,000,000	4.4%
	\$ 53,300,000	4.1%

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The Credit Union also utilizes a secured borrowing agreement with a corporate credit union. This agreement calls for the pledging of vehicle loans as security for any and all obligations taken by the Credit Union under this agreement. The agreement provides for a credit limit of \$85 million with interest charged at a rate determined by the lender on a periodic basis. At December 31, 2006 and 2005, there were no outstanding balances under this agreement. The agreement is reviewed for continuation by the lender and the Credit Union annually.

The Credit Union also utilizes demand loan agreements with several corporate credit unions. The terms of these agreements call for the pledging of all assets, except for those assets already pledged as collateral under other agreements, as security for any and all obligations taken by the Credit Union under these agreements. The agreements provide for a total credit limit of \$35.3 million with interest charged at rates determined by the lenders on a periodic basis. December 31, 2006 and 2005, there were no outstanding balances under these agreements. The agreements are reviewed for continuation by the lenders and the Credit Union annually.

8. STATE OF CALIFORNIA TREASURY DEPOSITS

The Credit Union has entered into an agreement with the Treasurer of the State of California whereby the State will deposit funds with the Credit Union. Interest on these deposits will be paid at the end of each calendar quarter and at maturity. The terms of the agreement call for pledging certain investments held in safekeeping at the Federal Reserve Bank and a portion of the Credit Union's mortgage loan portfolio. While not guaranteed, it is management's understanding that the State of California intends to continue rolling over these time deposits as they mature. As of December 31, 2006 and 2005, the deposits total \$57,000,000.

The deposit amounts and terms as of December 31, 2006 are as follows:

<u>Maturity Date</u>	<u>Balance</u>	<u>Interest Rate</u>
January 18, 2007	\$ 10,000,000	5.4%
February 16, 2007	20,000,000	5.2%
March 2, 2007	20,000,000	5.1%
March 16, 2007	7,000,000	5.0%
	<u>\$ 57,000,000</u>	<u>5.2%</u>

9. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGING ACTIVITIES

The Credit Union has entered into derivative financial instruments in the form of interest rate swap agreements. These transactions involve both credit and market risk. The Credit Union has exposure to credit-related losses in the event of nonperformance by the agreements' counterparties. The Credit Union does not expect any counterparties to fail their obligations.

The Credit Union enters into these derivative financial instruments in order to hedge the exposure that variability in interest rates may have on net interest income, especially in a rising interest rate environment. These agreements allow the Credit Union to lock in interest payments at a fixed rate.

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Interest rate swap agreements derive their value from the underlying interest rates. The fair value of the interest rate swap agreements are determined based on the present value of the estimated future net cash flows using implied rates in the applicable yield curve as of the valuation date. Due to changes in the yield curve, the fair value of the interest rate swap agreements fluctuates.

The interest rate swap agreements have been designated as cash flow hedges. Originally, these agreements were hedging the change in benchmark interest rates on specifically identified variable rate obligations. In July 2004, these hedges were de-designated and new cash flow hedges were designated. The amounts in other comprehensive income related to the original hedges will be amortized into the income statement over the remaining original hedge period.

The interest rate swap agreements are now cash flow hedges that are hedging the variability in the change in the entire interest rate associated with the Credit Union's Jumbo Money Market accounts.

The information pertaining to the outstanding interest rate swap agreements is as follows:

	December 31	
	2006	2005
Notional amount	\$ 20,000,000	\$ 35,000,000
Weighted average pay rate	3.8%	4.1%
Weighted average receive rate	3 month T-Bill	3 month T-Bill
Weighted average maturity in years	0.56	2.85
Unrealized gain – included in the consolidated statements of financial condition	\$ 124,585	\$ 114,469

No interest rate swap agreements were terminated prior to maturity in 2006 other than one swap with a notional amount of \$5 million, which was terminated in August 2006 for a resulting net gain to the Credit Union of \$108,802. Changes in the fair value of interest rate swaps designated as cash flow hedges are reported in other comprehensive income to the extent the hedge is deemed effective. These amounts are subsequently reclassified into interest expense as a yield adjustment in the same period in which the related interest on the hedged item affects earnings. Any over-performance of the interest rate swap agreement is recognized immediately in interest expense. For the year ended December 31, 2006, there was \$82,536 in ineffectiveness recognized in interest expense. As of December 31, 2006, approximately \$72,000 in net cash payments related to the interest rate swap agreements are expected to be reclassified into interest expense as a yield adjustment during the year ended December 31, 2007.

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10. **MEMBERS' SHARES**

Members' shares are summarized as follows:

	December 31	
	2006	2005
Regular shares	\$ 65,049,588	\$ 70,502,838
Share draft accounts	77,864,933	75,782,545
Money market accounts	140,698,768	163,817,056
Certificates	240,335,567	225,565,129
Individual retirement accounts	8,841,629	7,949,818
	532,790,485	543,617,386
Dividends payable	44,923	40,754
	\$ 532,835,408	\$ 543,658,140

Shares by maturity as of December 31, 2006 are summarized as follows:

No contractual maturity	\$ 292,454,918
0 – 1 year maturity	172,422,153
1 – 2 years maturity	44,967,381
2 – 3 years maturity	17,503,056
3 – 4 years maturity	4,857,542
4 – 5 years maturity	582,289
Over 5 years maturity	3,146
	532,790,485

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.

The National Credit Union Share Insurance Fund insures members' shares up to \$100,000, and certain individual retirement and Keogh accounts up to \$250,000.

The aggregate amount of certificates in denominations of \$100,000 or more at December 31, 2006 and 2005 is approximately \$86,127,000 and \$81,459,000, respectively.

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11. 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 employed by Xerox Corporation. Further, a significant concentration of members resides in similar geographic regions in California, New York, and other states. Although the Credit Union has a diversified loan portfolio, borrowers' ability to repay loans may be affected by the economic climate of the overall geographic regions in which the borrowers reside.

12. 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, 2006.

13. EMPLOYEE BENEFITS

The Credit Union employees are participants in numerous benefit and pension plans of Xerox Corporation (the company). All expenses related to payroll and benefits are paid by the company and reimbursed by the Credit Union to the company in the following month. Since the Credit Union employees are only fractional participants in these plans, it is not practical to disclose benefit data.

The Credit Union has entered into deferred compensation agreements with members of the executive management team that provides benefits payable to these employees if they remain employed by the Credit Union until the age specified in the individual contracts. If these employees become fully disabled as defined in the agreement, accrued benefits are immediately payable. The benefits are subject to forfeiture if employment is terminated for cause as defined in the agreement. The estimated liability under the agreements is being accrued over the remaining years until the eligible employees attain the ages specified in the individual contracts. As of December 31, 2006 and 2005, the total accrued liability is approximately \$719,000 and \$496,000, respectively.

14. 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.

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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, 2006 and 2005 were 6.4% and 6.0%, respectively. The minimum requirement to be considered “complex” under the regulatory framework is 6%. Management believes, as of December 31, 2006 and 2005, that the Credit Union meets all capital adequacy requirements to which it is subject.

As of December 31, 2006, the most recent call reporting period, and 2005, 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, 2006</u>		<u>December 31, 2005</u>	
	<u>Amount</u>	<u>Ratio/Requirement</u>	<u>Amount</u>	<u>Ratio/Requirement</u>
➤ Amount needed to be classified as “adequately capitalized”	\$ 46,908,673	6.4%	\$ 47,925,582	6.0%
➤ Amount needed to be classified as “well capitalized”	\$ 51,306,361	7.0%	\$ 55,913,179	7.0%
➤ Actual net worth	\$ 85,388,966	11.7%	\$ 82,976,387	10.4%

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.

15. 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, 2006 and 2005 are \$6,597,283 and \$3,179,245, respectively. Deposits from related parties at December 31, 2006 and 2005 amounted to \$1,127,097 and \$1,053,808, respectively.

16. 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.

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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

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.

Notes Payable and State of California Treasury deposits

The fair value of fixed-maturity notes payable and State of California Treasury deposits is estimated by discounting the estimated cash flows using the current rate at which similar funds could be borrowed.

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.

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 fair value of the Credit Union's interest rate swaps is estimated by discounting the cash flows for fixed rate payments and variable rate receipts. The resulting difference of these estimates is the estimated fair value.

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

	December 31, 2006		December 31, 2005	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets:				
Cash and cash equivalents	\$ 54,321,000	\$ 54,321,000	\$ 48,014,000	\$ 48,014,000
Investments available-for-sale	52,396,000	52,396,000	59,524,000	59,524,000
Other investments	44,192,000	44,192,000	79,055,000	79,055,000
Loans, net	560,773,000	551,545,000	593,583,000	587,721,000
Accrued interest receivable	2,948,000	2,948,000	2,707,000	2,707,000
Financial Liabilities:				
Members' shares	532,835,000	531,748,000	543,658,000	541,602,000
Notes payable	53,300,000	52,671,000	111,900,000	110,979,000
State of California Treasury deposits	57,000,000	57,136,000	57,000,000	57,054,000
Interest rate swaps	125,000	125,000	114,000	114,000