

**POLICE FEDERAL CREDIT UNION**  
**INDEPENDENT AUDITOR'S REPORT**  
**DECEMBER 31, 2007 AND 2006**



## INDEPENDENT AUDITOR'S REPORT

June 24, 2008

Supervisory Committee and Board of Directors  
Police Federal Credit Union  
Washington, D.C.

We have audited the accompanying statements of financial condition of Police Federal Credit Union as of December 31, 2007 and 2006, and the related statements of income and comprehensive income, changes in 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 U.S. generally accepted auditing standards. 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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Police Federal Credit Union as of December 31, 2007 and 2006, and the results of its operations and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

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**POLICE FEDERAL CREDIT UNION  
STATEMENTS OF FINANCIAL CONDITION  
AS OF DECEMBER 31, 2007 AND 2006**

ASSETS

	<u>2007</u>	<u>2006</u>
Cash and Cash Equivalents	\$ 7,978,631	\$ 13,421,406
Loans to Members		
Less: Allowance for Loan Losses of \$352,979 (2007) and \$181,302 (2006), and Net Deferred Loan Fees of \$(872) (2007) and \$456 (2006)	62,803,805	52,804,331
Investments	48,448,852	57,333,820
Accrued Income Receivable	592,446	541,347
Land	1,254,230	1,254,230
Building Construction in Process	-0-	5,861,529
Building Less: Accumulated Depreciation of \$69,460 (2007) and \$-0- (2006)	6,950,222	-0-
Furniture and Equipment		
Less: Accumulated Depreciation of \$431,053 (2007) and \$368,363 (2006)	1,566,122	60,414
Leasehold Improvements		
Less: Accumulated Depreciation of \$78,446 (2007) and \$78,446 (2006)	-0-	-0-
NCUSIF Deposit	1,117,793	1,071,200
Other Assets	<u>455,264</u>	<u>319,073</u>
<u>TOTAL ASSETS</u>	<u>\$ 131,167,365</u>	<u>\$ 132,667,350</u>

The accompanying notes are an integral  
part of these financial statements

**POLICE FEDERAL CREDIT UNION  
STATEMENTS OF FINANCIAL CONDITION  
DECEMBER 31, 2007 AND 2006  
(CONTINUED)**

LIABILITIES AND MEMBERS' EQUITY

	<u>2007</u>	<u>2006</u>
<u>Liabilities</u>		
Members' Share Accounts	\$ 115,047,576	\$ 117,283,529
Accrued Dividends	345,251	340,003
Accrued Expenses and Other Liabilities	<u>81,316</u>	<u>405,468</u>
<u>Total Liabilities</u>	<u>115,474,143</u>	<u>118,029,000</u>
<u>Members' Equity</u>		
Regular Reserve	3,707,139	3,051,321
Undivided Earnings	12,416,351	12,454,173
Accumulated Other Comprehensive Income	<u>(430,268)</u>	<u>(867,144)</u>
<u>Total Members' Equity</u>	<u>15,693,222</u>	<u>14,638,350</u>
<u>TOTAL LIABILITIES AND MEMBERS' EQUITY</u>	<u>\$ 131,167,365</u>	<u>\$ 132,667,350</u>

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part of these financial statements

**POLICE FEDERAL CREDIT UNION**  
**STATEMENTS OF INCOME AND COMPREHENSIVE INCOME**  
**FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006**

	<u>2007</u>	<u>2006</u>
<u>Interest Income</u>		
Interest and Fees on Loans	\$ 4,777,958	\$ 3,963,126
Interest on Investments	<u>3,070,927</u>	<u>3,075,668</u>
<u>Total Interest Income</u>	7,848,885	7,038,794
<u>Interest Expense</u>		
Interest on Members' Share Accounts	<u>4,304,652</u>	<u>3,641,695</u>
Net Interest Income	3,544,233	3,397,099
Provision for Loan Losses	<u>527,615</u>	<u>272,879</u>
Net Interest Income After Provision for Loan Losses	3,016,618	3,124,220
Other Operating Income	<u>705,791</u>	<u>420,031</u>
Net Operating Income Before Operating Expense	<u>3,722,409</u>	<u>3,544,251</u>
<u>Operating Expense</u>		
Employee Compensation and Benefits	1,613,995	825,257
Office Occupancy and Operations	625,582	382,262
Professional and Outside Services	301,946	261,541
General and Administrative	<u>549,790</u>	<u>391,051</u>
<u>Total Operating Expense</u>	<u>3,091,313</u>	<u>1,860,111</u>
Net Operating Income	631,096	1,684,140
<u>Non-Operating (Loss)</u>		
Other	-0-	5,000
(Loss) on Sale of Investments	<u>(13,100)</u>	<u>(360,754)</u>
<u>Net Income</u>	617,996	1,328,386
<u>Other Comprehensive Income</u>		
Reclassification Adjustment for (Losses) Included in Net Income	26,250	395,289
Unrealized Gain (Loss) on Available-for-Sale Securities: Unrealized Holding Gain (Loss) Arising During the Year	<u>410,626</u>	<u>(24,676)</u>
<u>Total Other Comprehensive Income</u>	<u>\$ 1,054,872</u>	<u>\$ 1,698,999</u>

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**POLICE FEDERAL CREDIT UNION**  
**STATEMENTS OF CHANGES IN MEMBERS' EQUITY**  
**FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006**

	<u>Regular Reserve</u>	<u>Undivided Earnings</u>	<u>Accumulated Other Comprehensive Income</u>	<u>Total Members' Equity</u>
Balance as of December 31, 2005	\$ 3,051,321	\$ 11,125,787	\$ (1,237,757)	\$ 12,939,351
Net Income	-0-	1,328,386	-0-	1,328,386
Change in Unrealized Gain (Loss) on Available-for-Sale Securities	<u>-0-</u>	<u>-0-</u>	<u>370,613</u>	<u>370,613</u>
Balance as of December 31, 2006	3,051,321	12,454,173	(867,144)	14,638,350
Discretionary Transfer	655,818	(655,818)	-0-	-0-
Net Income	-0-	617,996	-0-	617,996
Change in Unrealized Gain (Loss) on Available-for-Sale Securities	<u>-0-</u>	<u>-0-</u>	<u>436,876</u>	<u>436,876</u>
Balance as of December 31, 2007	<u>\$ 3,707,139</u>	<u>\$ 12,416,351</u>	<u>\$ (430,268)</u>	<u>\$ 15,693,222</u>

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**POLICE FEDERAL CREDIT UNION**  
**STATEMENTS OF CASH FLOWS**  
**FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006**

<u>Cash Flows from Operating Activities</u>	<u>2007</u>	<u>2006</u>
Inflows:		
Interest Received on Loans	\$ 4,717,043	\$ 4,058,924
Investment Earnings Received	3,080,743	3,050,194
Fees and Charges and Other Receipts	<u>705,791</u>	<u>420,031</u>
	<u>8,503,577</u>	<u>7,529,149</u>
Outflows:		
Interest Paid on Members' Savings Accounts	4,299,404	3,425,855
Payments to Employees for Compensation and Benefits	1,550,737	819,866
Payments to Vendors and Suppliers	<u>1,866,331</u>	<u>913,247</u>
	<u>7,716,472</u>	<u>5,158,968</u>
Net Cash Provided by Operating Activities	<u>787,105</u>	<u>2,370,181</u>
<u>Cash Flows from Investing Activities</u>		
Inflows:		
Proceeds from Asset Sale	-0-	5,000
Proceeds from Other Investments	6,553,000	7,745,135
Proceeds from Available-for-Sale Maturity Securities	<u>13,893,313</u>	<u>32,209,896</u>
	<u>20,446,313</u>	<u>39,960,031</u>
Outflows:		
Loans Extended in Excess of Repayments	10,527,089	4,429,089
NCUSIF Deposit Payment	46,593	12,167
Purchases of Available-for-Sale Securities	5,335,352	23,125,000
Purchases of Other Investments	5,802,217	5,048,518
Purchases of Fixed Asset Additions	<u>2,728,989</u>	<u>4,694,550</u>
	<u>24,440,240</u>	<u>37,309,324</u>
Net Cash (Used in) Provided by Investing Activities	<u>(3,993,927)</u>	<u>2,650,707</u>
<u>Cash Flows from Financing Activities</u>		
Inflows:		
Net Increase in Members' Share Accounts	2,665,913	-0-
Net Increase in Time Deposits	<u>-0-</u>	<u>25,455,969</u>
	<u>2,665,913</u>	<u>25,455,969</u>
Outflows:		
Net Decrease in Members' Share Accounts	-0-	19,985,296
Net Decrease in Time Deposits	<u>4,901,866</u>	<u>-0-</u>
	<u>4,901,866</u>	<u>19,985,296</u>
Net Cash (Used in) Provided by Financing Activities	<u>(2,235,953)</u>	<u>5,470,673</u>
Net (Decrease) Increase in Cash and Cash Equivalents	(5,442,775)	10,491,561
Cash and Cash Equivalents - Beginning of Year	<u>13,421,406</u>	<u>2,929,845</u>
Cash and Cash Equivalents - End of Year	<u>\$ 7,978,631</u>	<u>\$ 13,421,406</u>

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part of these financial statements

**POLICE FEDERAL CREDIT UNION  
STATEMENTS OF CASH FLOWS  
FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006  
(CONTINUED)**

	<u>2007</u>	<u>2006</u>
<u>Reconciliation of Net Income to Net Cash</u>		
<u>Provided by Operating Activities</u>		
Net Income	\$ <u>617,996</u>	\$ <u>1,328,386</u>
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Provision for Loan Losses	527,615	272,879
Depreciation Expense	134,588	52,319
Loss on Sale of Investments	13,100	360,754
(Gain) on Sale of Assets	-0-	(5,000)
Decrease (Increase) in:		
Other Assets	(136,191)	(148,650)
Accrued Income	(51,099)	70,324
(Decrease) Increase in:		
Accrued Expenses and Other Liabilities	(324,152)	223,329
Dividends Payable	<u>5,248</u>	<u>215,840</u>
Total Adjustments	<u>169,109</u>	<u>1,041,795</u>
Net Cash Provided by Operating Activities	<u>\$ 787,105</u>	<u>\$ 2,370,181</u>

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**POLICE FEDERAL CREDIT UNION**  
**NOTES TO FINANCIAL STATEMENTS**  
**DECEMBER 31, 2007 AND 2006**

NATURE OF BUSINESS AND ORGANIZATION:

Police Federal Credit Union was organized as a federal credit union under provisions of the Federal Credit Union Act of 1935 for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes. The credit union's primary deposit products are prime share accounts, and its primary lending products are automobile, residential real estate, and other consumer loans.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The accompanying financial statements are presented in accordance with the accrual basis of accounting and U.S. generally accepted accounting principles.

Investments

Debt and equity securities are classified as available-for-sale (AFS) and reported at fair value, with the change in unrealized gains and losses reported as other comprehensive income in the statements of income and comprehensive income. Accumulated comprehensive income is recorded as a separate component of members' equity.

Premiums and discounts on investments are amortized or accreted using a method which approximates the interest method.

The cost of securities sold is recognized using the specific identification method. Gains and losses on sales of investment securities are stated separately in the statement of income and comprehensive income after arriving at operating income.

Declines in the fair value of individual available-for-sale securities below their costs that are other than temporary, result in write-downs of the individual securities to their fair value. Factors affecting the determination of whether an other-than temporary impairment has occurred include a downgrading of the security by a rating agency, a significant deterioration in the financial condition of the issuer, or that management would not have the intent and ability to hold a security for a period of time sufficient to allow for any anticipated recovery in fair value.

Other investments are carried at cost. The fair value of other investments, recorded at cost, is not estimated as fair values are not readily determinable.

### Fixed Assets and Depreciation

Credit union building, furniture and equipment is carried at original cost less accumulated depreciation. Depreciation is computed on a straight-line basis over the estimated useful lives of the various classes of assets. Depreciation expense for the years ended December 31, 2007 and 2006, was \$134,588 and \$52,319, respectively.

### Loans to Members and Allowance for Loan Losses

Loans are stated at the amount of unpaid principal, reduced by an allowance for loan losses. Interest on loans is recognized over the term of the loan and is calculated using the simple-interest method on principal amounts outstanding. The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes that the collectability of the principal is unlikely.

Interest income is accrued daily as earned based on the unpaid principal amount outstanding, except on loans that are in non-accrual status because of some doubt as to the future collectability of principal and interest. Generally, loans are placed in non-accrual status when they become 90 days past due, at which time previously accrued but uncollected interest is reversed. Interest is recorded to income on the cash basis until the loan is brought current.

The allowance for loan losses is maintained at a level considered adequate to provide for probable loan losses on the entire portfolio based on the following methodology. Management utilizes collective loan impairment to evaluate the collectability of impaired loans within various pools of loans with similar credit and collateral risk based on the credit union's prior loan loss experience applied to those risk pools. Because of the uncertainties inherent in the estimation process, and changes in observable data, management's estimate of credit losses inherent in the loan portfolio and the related allowance may change in the near term.

### Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles 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 revenues and expenses during the reporting period. Actual results could differ from those estimates.

### Loan Origination Fees and Costs

Consumer loan origination costs are not deemed material to defer to future periods and are expensed as incurred. The credit union does not charge fees to originate non-real estate related loans.

Prepaid deferred loan income (points) is amortized to interest income on loans over the life of the loan using a method that approximates the interest method.

#### Regular Reserve

The credit union is required by regulation to maintain a statutory reserve. This reserve, which represents an appropriation of undivided earnings, may be restricted and not available for the payment of dividends and operating expenses, should the credit union's net worth or risk based net worth ratios fall below statutory minimums. The Board of Directors is permitted to make discretionary transfers to and from this reserve, provided the credit union's net worth ratio equals or exceeds statutory minimums.

#### Dividends on Members' Savings Accounts

It is the policy of the Board of Directors to declare dividends payable monthly on the first day of the following month on all share types. Dividend rates are set by the Board of Directors, based on an evaluation of current and future market conditions.

#### Disclosures About the Fair Value of Financial Instruments

Statement of Financial Accounting Standards (SFAS) 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, for which it is practicable to estimate that value. 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 cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. SFAS 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 Police Federal 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 that value:

Cash and Short-Term Investments: For cash equivalents and short-term investments, the carrying amount is a reasonable estimate of fair value.

Investment Securities: Fair value is based on quoted market price, if available. If a quoted market price is not available fair value is estimated using quoted market prices for similar securities. The approximate fair value and carrying value of the credit union's investment securities is \$48,448,852 and \$57,333,820 at December 31, 2007 and 2006, respectively.

Loans to Members: Credit card and most variable-rate loans with yearly rate adjustments have carrying amounts that approximate fair value. The fair value of the remaining loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. The approximate fair value and carrying value of loans to members at December 31, 2007, was \$63,685,129 and \$63,803,805, respectively. The approximate fair value and carrying value of loans to members at December 31, 2006, was \$52,620,059 and \$52,804,331, respectively.

Other Instruments: The fair value of the deposit with the NCUSIF is the amount payable to the credit union upon liquidation of the fund or withdrawal from the fund by the credit union. The NCUA maintains the fund at or near 1.3 percent of insurable obligations. The approximate fair value and carrying value at December 31, 2007, was \$1,453,131 and \$1,117,793, respectively. The approximate fair value and carrying value at December 31, 2006, was \$1,392,560 and \$1,071,200, respectively.

Members' Share Accounts: The fair value of share drafts, share accounts, and money market deposits is the amount payable on demand at the reporting date. 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 maturities. The approximate fair value and the carrying value at December 31, 2007, were \$115,233,260 and \$115,047,576, respectively. The approximate fair value and the carrying value at December 31, 2006, were \$117,216,668 and \$117,283,529, respectively.

#### Statement of Cash Flows

The credit union considers all demand cash balances and highly liquid debt instruments purchased with an initial maturity of three months or less to be cash equivalents for purposes of the statement of cash flows.

Interest earning cash equivalent balances totaled \$6,921,911 and \$11,232,022 at December 31, 2007 and 2006, respectively.

#### NOTE 2 - INCOME TAXES

The credit union is currently exempt from the payment of federal, state, and local income tax.

NOTE 3 - INVESTMENTS

The weighted average maturities of the investments in the credit union's portfolio as of December 31, 2007 and 2006, are as follows:

	<u>2007</u>	<u>2006</u>
U.S. Government and Federal Agency Securities	10.3 Years	8.7 Years
Mortgage-Backed Securities	6.9 Years	20.8 Years
Certificates of Deposit	15 Months	5.7 Months
CUSO Investments – Stock	Long-Term	Long-Term
Corporate Credit Union Capital Account	3 Years	3 Years

The composition of investments is shown below:

	<u>2007</u>	<u>2006</u>
U.S. Government and Federal Agency Securities	\$ 19,930,033	\$ 25,486,279
Mortgage-Backed Securities	<u>21,105,142</u>	<u>23,683,081</u>
Total Debt Securities	41,035,175	49,169,360
Certificates of Deposit	6,439,000	7,246,000
CUSO Investments - Stock	9,507	6,270
Corporate Credit Union Capital Account	<u>965,170</u>	<u>912,190</u>
<u>Total Investments</u>	<u>\$ 48,448,852</u>	<u>\$ 57,333,820</u>

Available-for-sale securities consist of the following:

<u>December 31, 2007</u>				
	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
U.S. Government and Federal Agency Securities	\$ 19,986,745	\$ 28,228	\$ 84,940	\$ 19,930,033
Mortgage-Backed Securities	<u>21,478,698</u>	<u>5,226</u>	<u>378,782</u>	<u>21,105,142</u>
<u>Total Debt Securities</u>	<u>\$ 41,465,443</u>	<u>\$ 33,454</u>	<u>\$ 463,722</u>	<u>\$ 41,035,175</u>

<u>December 31, 2006</u>				
	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
U.S. Government and Federal Agency Securities	\$ 25,803,353	\$ -0-	\$ 317,074	\$ 25,486,279
Mortgage-Backed Securities	<u>24,233,151</u>	<u>11,468</u>	<u>561,538</u>	<u>23,683,081</u>
<u>Total Debt Securities</u>	<u>\$ 50,036,504</u>	<u>\$ 11,468</u>	<u>\$ 878,612</u>	<u>\$ 49,169,360</u>

Expected maturities of mortgage-backed securities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

The following is a summary of maturities for debt securities as of December 31, 2007 and 2006:

Amounts Maturing in:	<u>2007</u>		<u>2006</u>	
	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Amortized Cost</u>	<u>Fair Value</u>
One Year or Less	\$ -0-	\$ -0-	\$ -0-	\$ -0-
After One Year through Five Years	1,494,368	1,487,055	7,998,438	7,937,820
Over Five Years	18,492,377	18,442,978	17,804,915	17,548,459
Mortgage-Backed Securities	<u>21,478,698</u>	<u>21,105,142</u>	<u>24,233,151</u>	<u>23,683,081</u>
	<u>\$ 41,465,443</u>	<u>\$ 41,035,175</u>	<u>\$ 50,036,504</u>	<u>\$ 49,169,360</u>

For the year ended December 31, 2007, the credit union sold securities with a book value of \$4,043,736 at a loss of \$13,100. Gross proceeds from sales totaled \$4,030,636.

For the year ended December 31, 2006, the credit union sold securities with a book value of \$17,972,890 at a loss of \$360,754. Gross proceeds from sales totaled \$17,612,136.

Debt securities temporarily impaired as of December 31, 2007 and 2006, consist of the following:

	<u>December 31, 2007</u>					
	<u>Less Than 12 Months</u>		<u>12 Months or Longer</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>
U.S. Government and Federal Agency Securities	\$ 3,972,440	\$ 27,560	\$ 5,437,179	\$ 57,380	\$ 9,409,619	\$ 84,940
Mortgage-Backed Securities	<u>3,100,637</u>	<u>33,809</u>	<u>15,946,585</u>	<u>344,973</u>	<u>19,047,222</u>	<u>378,782</u>
Total Temporarily Impaired Securities	<u>\$ 7,073,077</u>	<u>\$ 61,369</u>	<u>\$ 21,383,764</u>	<u>\$ 402,353</u>	<u>\$ 28,456,841</u>	<u>\$ 463,722</u>

	December 31, 2006					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. Government and Federal Agency Securities	\$ 11,922,320	\$ 71,980	\$ 13,563,959	\$ 245,094	\$ 25,486,279	\$ 317,074
Mortgage-Backed Securities	11,491,418	55,265	9,046,711	506,273	20,538,129	561,538
Total Temporarily Impaired Securities	\$ 23,413,738	\$ 127,245	\$ 22,610,670	\$ 751,367	\$ 46,024,408	\$ 878,612

U.S. Government Federal Agency Securities - The unrealized losses on the credit union's investments in U.S. Government Federal Agency obligations were caused by interest rate variations. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investments. Because the credit union has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the credit union does not consider these investments to be other-than-temporarily impaired at December 31, 2007 and 2006.

Federal Agency Mortgage-Backed Securities - The unrealized losses on the investment in federal agency mortgage-backed securities were caused by interest rate variations. The contractual cash flows of these investments are guaranteed by an agency of the U.S. government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of the credit union's investment. Because the decline in market value is attributable to changes in interest rates and not credit quality and because the credit union has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the credit union does not consider these investments to be other-than-temporarily impaired at December 31, 2007 and 2006.

As of December 31, 2007 and 2006, the credit union had 67 and 76 positions, respectively, that were temporarily impaired.

NOTE 4 - NCUSIF DEPOSIT

In order to provide for the capitalization of the National Credit Union Share Insurance Fund (NCUSIF), the National Credit Union Administration requires each federally insured credit union to maintain with the NCUSIF a deposit in an amount equaling one percent of its insured share accounts. The deposit amount is adjusted semi-annually based upon the changes in the credit union's insured share accounts. The deposit would be refunded to the credit union if its insurance coverage is terminated, it converts to insurance coverage from another source, or the operations of the fund are transferred from the NCUA Board.

A credit union is required to pay an annual insurance premium equal to one-twelfth of one percent of its total insured shares, unless the payment is waived or reduced by the NCUA Board. The NCUA Board waived the 2007 and 2006 insurance premium.

NOTE 5 - LOANS TO MEMBERS AND ALLOWANCE FOR LOAN LOSSES

The composition of loans to members is as follows:

	<u>2007</u>	<u>2006</u>
Automobile/Vehicle	\$ 20,931,308	\$ 21,786,266
Mortgage/Home Equity	20,574,882	12,788,545
Unsecured and Other	20,230,315	17,146,655
Credit Card	42,836	47,299
Share Secured	<u>1,378,315</u>	<u>1,216,412</u>
Total Loans before Allowance and Deferred Loan Fees	63,157,656	52,985,177
Less: Allowance for Loan Losses	(352,979)	(181,302)
Net Deferred Loan Fees	(872)	456
Total Net Loans to Members	<u>\$ 62,803,805</u>	<u>\$ 52,804,331</u>

Loans on which the accrual of interest has been discontinued or reduced amounted to \$451,861 and \$69,750 at December 31, 2007 and 2006, respectively. If interest on those loans had been accrued, such income would have approximated \$21,656 and \$3,069 at December 31, 2007 and 2006, respectively.

An analysis of the allowance for loan losses is as follows:

	<u>2007</u>	<u>2006</u>
Balance - Beginning of Year	\$ 181,302	\$ 100,000
Provision for Loan Losses Expense	527,615	272,879
Recoveries Credited to Allowance	60,278	105,681
Loans Charged Against Allowance	<u>(416,216)</u>	<u>(297,258)</u>
Balance - End of Year	<u>\$ 352,979</u>	<u>\$ 181,302</u>

NOTE 6 - MEMBERS' SHARE ACCOUNTS

A summary of members' share accounts as of December 31, 2007 and 2006, is as follows:

	<u>2007</u>	<u>2006</u>
Regular Share Savings and Club Accounts	\$ 32,654,781	\$ 43,328,101
Money Market Accounts	29,154,481	15,457,951
Share Certificates	50,776,010	55,677,876
Share Draft - Checking	<u>2,462,304</u>	<u>2,819,601</u>
Total Members' Savings Accounts	<u>\$ 115,047,576</u>	<u>\$ 117,283,529</u>

A summary of share accounts by maturity as of December 31, 2007 and 2006, is as follows:

	<u>2007</u>	<u>2006</u>
No Maturity	\$ 64,271,566	\$ 61,605,653
Less Than One Year	34,999,242	31,687,016
One to Three Years	13,540,929	18,346,718
Greater Than Three Years	<u>2,235,839</u>	<u>5,644,142</u>
	<u>\$ 115,047,576</u>	<u>\$ 117,283,529</u>

Uninsured members' share account balances in excess of NCUA deposit insurance limits totaled \$5,761,706 and \$6,085,190 at December 31, 2007 and 2006, respectively.

Members' share accounts are subordinate to all other liabilities of the credit union upon liquidation.

**NOTE 7 - COMMITMENTS AND CONTINGENT LIABILITIES**

In the normal course of business, there are outstanding various commitments and contingent liabilities, such as commitments to extend credit and investment purchase commitments, which are not reflected in the accompanying financial statements. Management does not anticipate losses as a result of any of these transactions.

In the normal course of business operations, the credit union will have funds on deposit in various correspondent financial institutions in excess of federal deposit insurance ceilings. The credit union does not anticipate any loss as a result of this activity.

**NOTE 8 - FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK**

The credit union is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the statement of financial condition. The contract or notional amounts of these instruments reflects the extent of involvement the credit union has in this particular class of financial instruments.

The credit union's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual or notional amount of these instruments. The credit union uses the same credit policies in making these commitments and

conditional obligations as it does for on-balance-sheet instruments. Unless noted otherwise, the credit union does not require collateral or other security to support financial instruments with credit risk.

Unextended credit card and other lines of credit approximate \$1,085,018 and \$296,291 at December 31, 2007 and 2006, respectively.

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. Some commitments generally have fixed expiration dates or other termination clauses. Since many of the commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The credit union evaluates each member's creditworthiness on a case-by-case basis. The amount of collateral deemed necessary by the credit union on extension of credit is based on management's credit evaluation of the member.

NOTE 9 - SIGNIFICANT GROUP CONCENTRATIONS OF CREDIT RISK

A significant portion of the credit union's business activity is with members located within the local Washington, D.C. metropolitan area and is dependent largely on the employment trends of the D.C. Police Department.

NOTE 10 - RELATED PARTY TRANSACTIONS

Loans to credit union officials and their families were made with interest rates, terms, and collateral requirements the same as those required of other members.

NOTE 11 - RETIREMENT PLAN

The credit union participates in a non-contributory defined contribution retirement plan covering all full-time employees who meet age and length of service requirements. The credit union's policy is to fund pension costs as incurred. The total pension expense for the years ended December 31, 2007 and 2006, was \$28,408 and \$14,874, respectively.

NOTE 12 - SHORT-TERM BORROWINGS

The credit union has a \$4,000,000 line-of-credit with Mid-Atlantic Corporate Federal Credit Union. This line-of-credit is utilized on a short-term basis as the credit union needs funds to clear daily transaction activity. As of December 31, 2007 and 2006, there were no outstanding loan balances.

NOTE 13 - CONTRIBUTIONS OF SERVICES AND USE OF FACILITIES

Police Federal Credit Union receives some services and use of facilities from its sponsoring agency at several of its branch office locations free of cost. Utilization of these services and facilities is not recognized as revenue. The credit union views this relationship with the sponsor organization as a reciprocal transfer; that

is, in return for the use of services and facilities, the sponsoring employer receives the fringe benefit of on-site financial services for its employees who elect to join the credit union.

Statement of Financial Accounting Standards No. 116 (SFAS No. 116), *Accounting for Contributions Received and Contributions Made*, requires that contributions received in voluntary, nonreciprocal transfers be recognized as revenue. As the credit union views this arrangement as a reciprocal transfer, and not a contribution as defined by SFAS No. 116, the credit union believes that the cost-free use of these services and facilities is not required to be reported as revenue.

NOTE 14 - REGULATORY CAPITAL REQUIREMENTS

The credit union is subject to various regulatory capital requirements administered by the National Credit Union Administration (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 U.S. generally accepted accounting principles. The credit union's capital amounts and net worth classification are also subject to qualitative judgments by the regulators and other components, risk weightings, and other factors.

Quantitative measures established by regulations to ensure capital adequacy require the credit union to maintain minimum amounts and ratios (set forth in the following table) of net worth (as defined) to total 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, 2007, was 7.88 percent. The minimum ratio to be considered complex under the regulatory framework is 6.0 percent. Because 7.88 percent is greater than 6.0 percent, the credit union is considered complex under the risk-based net worth requirement. Further, in performing its calculation of net worth, the credit union used the quarter end balance option as permitted by regulation.

As of December 31, 2007, the most recent Call reporting period, 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 7.88 percent of assets. There are no conditions or events since that notification date that management believes have changed the institution's category. Management believes, as of December 31, 2007, that the credit union meets all capital adequacy requirements to which it is subject.

The credit union's actual capital amounts and ratios as of December 31, 2007, are presented in the table below:

	<u>Actual</u>		<u>To be Adequately Capitalized Under the Prompt Corrective Action Provisions</u>		<u>To be Well Capitalized Under the Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
Net Worth	\$ 16,123,490	12.29%	N/A	N/A	N/A	N/A
Risk-Based Net Worth	N/A	N/A	N/A	N/A	\$ 10,335,988	7.88%