# NORTHSTAR EDUCATION FINANCE, INC.
# AND SUBSIDIARIES
# CONSOLIDATED FINANCIAL STATEMENTS
# September 30, 2008 and 2007

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# INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
Northstar Education Finance, Inc.
St. Paul, Minnesota

We have audited the accompanying consolidated statements of financial position of Northstar Education Finance, Inc. and subsidiaries as of September 30, 2008 and 2007 and the related consolidated statements of activities and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

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 that our audits provide 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 Northstar Education Finance, Inc. and subsidiaries as of September 30, 2008 and 2007, and the changes in its net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*Baune Dosen & Co, LLP*

January 14, 2009
Minneapolis, Minnesota

**NORTHSTAR EDUCATION FINANCE, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF FINANCIAL POSITION**
**September 30, 2008 and 2007**
**(in thousands)**

| | 2008 | 2007 |
|---|---|---|
| **Assets** | | |
| Cash and cash equivalents (Note 2) | $ 5,119 | $ 3,155 |
| Loans, net (Note 2, 4, 5, and 6) | 6,272,341 | 5,710,438 |
| Interest receivable | 289,439 | 193,489 |
| Accounts receivable | 2,842 | - |
| Receivable from Great Lakes (Note 2) | 10,655 | 8,953 |
| Government receivable (Note 2) | 9,761 | 37,294 |
| Notes receivable (Note 6) | - | 22,018 |
| Restricted cash and cash equivalents (Note 3) | 249,651 | 298,611 |
| Investment securities (Note 2) | 6,596 | 5,850 |
| Amortizable assets, net (Note 2) | 15,309 | 16,393 |
| Other assets | 773 | 369 |
| Property and equipment, net | 415 | 524 |
| **Total assets** | $ 6,862,901 | $ 6,297,094 |
| **Liabilities and net assets** | | |
| Accounts payable and accrued liabilities | $ 42,472 | $ 65,799 |
| Government payable (Note 2) | 4,372 | - |
| Accrued salaries and benefits | 1,681 | 1,752 |
| Contract servicer payable | 470 | 443 |
| Income taxes payable | 600 | 305 |
| Government participation payable (Note 7) | 87,245 | - |
| Draw against bank lines of credit (Note 8) | 2,145,900 | 1,536,000 |
| Long-term debt (Note 9) | 4,525,714 | 4,666,564 |
| Total liabilities | 6,808,454 | 6,270,863 |
| **Net assets** | | |
| Net assets - unrestricted | 49,492 | 23,480 |
| Minority interest in subsidiary | 4,955 | 2,751 |
| Total net assets | 54,447 | 26,231 |
| **Total liabilities and net assets** | $ 6,862,901 | $ 6,297,094 |

See accompanying notes to consolidated financial statements.

**NORTHSTAR EDUCATION FINANCE, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF ACTIVITIES**
**For The Years Ended September 30, 2008 and 2007**
**(in thousands)**

| | 2008 | 2007 |
|---|---|---|
| **Income** | | |
| Loan interest income (Note 2) | $ 359,092 | $ 392,187 |
| | | |
| **Expenses** | | |
| Loan financing expenses (Note 12) | 306,106 | 352,244 |
| T.H.E. bonus expense | 5,130 | 12,824 |
| Provision for loan losses | 6,009 | 8,903 |
| Amortization | 1,842 | 1,714 |
| Salaries and benefits | 11,742 | 10,820 |
| Professional services | 1,412 | 1,241 |
| Promotion and marketing | 1,957 | 5,269 |
| Donations and grants | 631 | 801 |
| Other | 3,029 | 2,722 |
| Total expenses | 337,858 | 396,538 |
| | | |
| Change in net assets before other income | 21,234 | (4,351) |
| | | |
| **Other income** | | |
| Other revenue | 1,136 | 874 |
| Derivative market value adjustment (Note 15) | 2,241 | 1,148 |
| Interest income | 9,616 | 15,667 |
| Total other income | 12,993 | 17,689 |
| | | |
| Change in net assets before income tax provision and minority interest | 34,227 | 13,338 |
| | | |
| Provision for income taxes (Note 10) | (5,007) | (5,804) |
| Minority interest | (3,208) | (4,223) |
| | | |
| **Change in net assets** | 26,012 | 3,311 |
| | | |
| Net assets, beginning of period | 23,480 | 20,169 |
| | | |
| **Net assets, end of period** | $ 49,492 | $ 23,480 |

See accompanying notes to consolidated financial statements.

## NORTHSTAR EDUCATION FINANCE, INC. AND SUBSIDIARIES
## CONSOLIDATED STATEMENTS OF CASH FLOWS
### For the Years Ended September 30, 2008 and 2007
### (in thousands)

| | 2008 | 2007 |
|---|---|---|
| **Cash flows from operating activities** | | |
| Change in net assets | $ 26,012 | $ 3,311 |
| Adjustments to reconcile change in net assets to cash flows from operating activities: | | |
| Amortization | 1,842 | 1,714 |
| Depreciation | 227 | 187 |
| Issuance of stock options for services | 4 | 34 |
| Provision for loan losses | 6,009 | 8,903 |
| Loan premium expense | 2,021 | 9,269 |
| Investment impairment | 204 | - |
| (Increase) decrease in assets: | | |
| Interest receivable | (95,950) | (89,566) |
| Accounts receivable | (2,842) | - |
| Receivable from Great Lakes | (1,702) | 1,752 |
| Government receivable | 27,533 | 2,813 |
| Income taxes receivable | - | 120 |
| Other assets | (404) | (203) |
| Increase (decrease) in liabilities: | | |
| Accounts payable and accrued liabilities | (23,327) | 6,860 |
| Government payable | 4,372 | - |
| Accrued salaries and benefits | (71) | 336 |
| Contract servicer payable | 27 | 64 |
| Income taxes payable | 295 | 305 |
| Net cash flows from operating activities | (55,750) | (54,101) |
| **Cash flows from investing activities** | | |
| Net change in loans | (569,933) | (972,754) |
| Net change in restricted cash | 48,960 | (63,083) |
| Net change in notes receivable | 22,018 | (15,093) |
| Purchase of investment securities | (4,950) | (2,850) |
| Proceeds from sale of investments | 4,000 | - |
| Cash paid for amortizable assets | (758) | (4,015) |
| Purchases of property and equipment | (118) | (349) |
| Net cash flows from investing activities | (500,781) | (1,058,144) |
| **Cash flows from financing activities** | | |
| Proceeds from government participation payable | 87,245 | - |
| Net change in draw against bank lines of credit | 609,900 | 152,500 |
| Payments on long-term debt | (140,850) | 957,177 |
| Minority interest | 2,200 | 2,150 |
| Net cash flows from financing activities | 558,495 | 1,111,827 |
| **Net increase (decrease) in cash and cash equivalents** | 1,964 | (418) |
| **Cash and cash equivalents at beginning of year** | 3,155 | 3,573 |
| **Cash and cash equivalents at end of year** | $ 5,119 | $ 3,155 |

See accompanying notes to consolidated financial statements.

## NOTE 1 BUSINESS OPERATIONS

Northstar Education Finance, Inc. ("NEF" or the "Company") was organized and is operated exclusively for charitable and educational purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code of 1986, as amended. The Company is a Delaware non-stock, non-profit corporation, incorporated in January, 2000. The purposes for which NEF was formed are to foster, aid, encourage and assist the pursuit of higher education. NEF received a favorable determination from the Internal Revenue Service that it is an organization described in Section 501(c)(3) in March of 2003.

NEF accomplishes its mission and purpose by reducing the cost of higher education through the T.H.E. Loan Program, a trademarked suite of loan products. NEF formed Northstar Capital Markets Services, Inc., ("NCMS") a Delaware for-profit business corporation to administer the T.H.E. Loan Program and potentially provide services to third parties. NEF currently owns 56% of NCMS's issued and outstanding capital stock and nine members of NCMS's management collectively own 42%. The remaining 2% of outstanding stock is owned by a foundation.

All T.H.E Loan Program loans, related financial assets and associated liabilities are assets or liabilities of NEF, either directly or through one or more wholly-owned limited liability company subsidiaries (Northstar T.H.E. Funding, LLC [T.H.E.], Northstar T.H.E. Funding II, LLC [T.H.E. II], and Northstar T.H.E. Funding III, LLC [T.H.E. III]. Any potential claims against or liabilities of a subsidiary would be payable only out of the assets of that subsidiary. Operating assets and associated liabilities are assets or liabilities of NCMS. NCMS has entered into Administration Agreements with NEF and its limited liability company subsidiaries to provide general management services to originate, service and finance the T.H.E. Program Loans and to perform certain specific duties under the terms of certain contracts to which such entities are parties. The term of the administration agreements generally expire when no amounts remain unpaid under the indentures currently in place. The maturities of certain notes in the indentures exceed twenty years.

During 2006, NCMS created a subsidiary called Northstar SAL Funding, LLC (SAL). SAL entered into a financing arrangement with four graduate schools under the School as Lender program which is a specific program outlined under the Higher Education Act. Under this program, SAL provided a line of credit to the schools. The schools drew on this line of credit to make Federally Guaranteed Stafford loans to their students. Approximately sixty days after the loans are fully disbursed, T.H.E. purchased these loans from the schools for a premium. The schools were required to use these premiums for need-based aid programs after an allowance for administrative costs. This program was discontinued in May 2008 and SAL has no assets or liabilities at September 30, 2008.

In February 2008, the assets and liabilities of the wholly-owned limited liability company T.H.E. were assumed by NEF and the subsidiary is no longer in operation.

## NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### *Cash and cash equivalents*

Cash and cash equivalents consist of checking accounts, cash management accounts, money market funds, and other operating accounts invested in short-term highly liquid investments with initial maturities of three months or less. Cash pledged as collateral for bank lines and long-term debt (see Note 8 and 9) is excluded from cash and cash equivalents and is presented in these financial statements as restricted cash and cash equivalents.

### *Loans and allowance for credit losses*

Investments in student loans, including premiums, are recorded at cost, net of premium amortization and the allowance for credit losses. Interest income is calculated by using the simple interest method on daily balances outstanding. Premiums are amortized using the interest method over the estimated principal life of the related loans. Consolidation loans have an estimated twenty-five year life and the remaining loans have an estimated ten year life. Premium amortization expense is offset against loan interest earnings when recording loan interest income.

In accordance with the indenture trust agreements, the allowance for credit losses is estimated and established by increasing restricted cash when private loans are disbursed and additional provisions based on the repayment status of student loans. Loans are charged against the allowance when the loans are 180 days delinquent and the indenture trustee may withdraw funds from the restricted cash accounts. Recovery of amounts charged off are credited to the allowance for credit losses. The allowance for credit losses is estimated and based on management's evaluation of the loan portfolio, including such factors as the volume and type of loans outstanding, past loan loss experience, and general economic conditions. Federal student loans are federally guaranteed ranging from 97% to 100% of the principal and interest balances. No provision for loan losses is deemed necessary for the federal loans and the allowance for credit losses is based entirely on private loans.

Management believes that the allowance for credit losses is adequate. While management used available information to recognize losses on loans, future additions to the allowance for loan losses may be necessary based on changes in economic conditions.

### *Loan premiums*

Loan premiums consist of origination and lender fees paid to the U.S. Department of Education (DOE) on federal loans originated by the Company, premiums paid in the acquisition of student loans and certain origination expenses incurred to originate student loans, as defined by Statement of Financial Accounting Standards (SFAS) No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.* The Company utilizes the interest method to amortize deferred costs as an adjustment to net interest income, taking into account actual loan prepayments.

***Receivable from Great Lakes***

Receivable from Great Lakes (a third party servicer) represents student loan principal and interest payments collected by Great Lakes that have not yet been remitted to the Company. No allowance was deemed necessary as of September 30, 2008 and 2007.

***Government receivable***

Government receivable represents subsidized student loan interest income and special allowance due from the DOE. No allowance was deemed necessary as of September 30, 2008 and 2007.

***Restricted cash and cash equivalents***

The Company's restricted cash is held by the trustee in various accounts subject to use restrictions, imposed by the indenture of trust. Restricted cash and cash equivalents consist of cash management accounts, money market funds, and other operating accounts invested in high quality short-term financial instruments. The amounts may exceed federally insured limits.

***Investment securities***

Investments are initially recorded at their acquisition cost, including brokerage and transaction fees if purchased, and at a fair value at the date of donation, if received as a contribution.

Investments are carried at fair market value. The net realized and unrealized gains (losses) on investments are reflected in the statement of activities in unrestricted revenue, unless donor stipulations temporarily or permanently restrict investment income.

Investments consist entirely of auction rate bonds. NCMS purchased $6.8 million of securities issued by NEF.

***Amortizable assets***

The Company's amortizable assets consist of financing costs and student loan servicing rights. The financing costs are amortized over the principal life of the corresponding debt. The servicing rights are amortized over fifteen years using the straight-line method.

***Government payable***

Government payable represents payments due to the DOE for excess interest earned on loans in excess of subsidized student loan interest and special allowances due from the DOE on federal loans.

### *Derivative accounting*

Derivative instruments that are used as part of the Company's interest rate risk management strategy include swaps and interest rate floor and cap contracts with indices that relate to the pricing of specific statement of financial position assets and liabilities. The Company follows Statement of Financial Accounting Standards ("SFAS") No. 133 which requires that derivative instruments, including certain derivative instruments embedded in other contracts, be recorded in the statement of financial position as either an asset or liability measured at its fair value. These amounts are currently presented in the statement of financial position caption "accounts payable and accrued liabilities." Under SFAS No. 133, not-for-profit entities such as the Company are not permitted to use cash flow hedge accounting, therefore all gains or losses are recorded in the statement of activities and reflected as a change in net assets in the period of change.

### *Income taxes*

The Company is a tax-exempt organization set up under the provisions of the Internal Revenue Code Section 501(c)(3). However, a provision for income taxes has been made in the accompanying financial statements for NCMS, its for-profit business subsidiary.

Deferred taxes are recorded to reflect the tax consequences on future years of differences between the tax bases of assets and liabilities and the financial reporting amounts at each year end of NCMS. These amounts are presented in the statement of financial position caption "other assets."

Management has elected to defer the application of FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, in accordance with FASB Staff Position FIN 48-3. The Company will continue to follow SFAS No. 5, *Accounting for Contingencies*, until it adopts FIN 48.

### *Principles of consolidation*

The consolidated financial statements include the accounts of NEF and its subsidiaries (T.H.E., T.H.E. II, T.H.E. III, NCMS and SAL). All significant intercompany transactions have been eliminated in consolidation.

### *Loan interest income*

The Company's portfolio of student loans originated under the Federal Family Education Loan Program (FFELP) has a variety of interest rate characteristics. The Company earns interest at the greater of the borrower's rate or a floating rate determined by reference to the average of the 90-day financial commercial paper, plus a fixed spread which is dependent upon when the loan was originated. If the floating rate exceeds the borrower rate, the Department of Education makes a payment directly to the Company based upon the special allowance payment ("SAP") formula established under the Higher Education Act. If the floating rate is less than the rate the borrower is obligated to pay, the Company earns interest at the borrower rate on all loans with first disbursements prior to April 1, 2006. For loans with first disbursements on or after April 1, 2006, the Company must remit back to the Department of Education on a quarterly basis any borrower interest in excess of the SAP formula. The borrowers' interest rates are either fixed to term or are reset annually on July 1 of each year depending on loan type. The private student loans have variable interest rates that reset quarterly.

***Loan interest expense***

The Company generally finances its student loan portfolio with floating rate debt tied to commercial paper rates or LIBOR.

***Stock options***

In accordance with FASB Statement 123(R), stock options for NCMS are recorded under the fair value method and compensation cost is recognized for stock-based employee compensation.

***Advertising***

The Company expenses promotion and marketing costs as they are incurred.

***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 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.

***Reclassifications***

Certain reclassifications were made to prior year amounts to conform to current year classifications.

***Disclosures about fair value of financial instruments***

SFAS No. 107, "Disclosures about Fair Value of Financial Instruments," requires that the Company disclose estimated fair values for its financial instruments.

The following methods and assumptions are used by the Company in estimating the fair value of its financial instruments.

> ***Cash and cash equivalents:*** The carrying amount of cash and cash equivalents is a reasonable estimate of fair value.
>
> ***Loans:*** The estimate of fair value of loans pledged to warehouse financings are based on portfolio valuation rates calculated by warehouse provider. Loans pledged to asset backed bonds are based on values derived by third party calculations of net present value of future cash flows. All other loans are shown at par value.
>
> ***Interest receivable*****:** Interest receivable is based on the loans listed above.
>
> ***Receivables:*** The carrying amount approximates fair value due to the short maturity of these receivable amounts.

***Restricted cash and cash equivalents:*** The carrying amount of restricted cash and cash equivalents is a reasonable estimate of fair value.

***Notes receivable:*** The carrying amount of notes receivable is a reasonable estimate of fair value based on their short-term maturity and frequency of interest rate re-pricing structured in the financing arrangement.

***Investment securities:*** The carrying amount of investment securities is recorded at fair value.

***Accounts payable and accrued liabilities:*** The carrying amount approximates fair value due to the short maturity of these instruments.

***Government payable:*** The carrying amount approximates fair value due to the short maturity of this asset and/or liability.

***Draw against bank lines of credit:*** The carrying amount approximates fair value due to the short-term maturity and frequency of interest rate repricing structured in the financing arrangement.

***Long-term debt:*** The carrying amount approximates fair value due to the frequency of interest rate repricing structured in the financing arrangement.

***Derivative financial instruments:*** The fair value of derivative financial instruments are determined through quoted market prices representing the amount at which the instruments can be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

***Limitations:*** Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instruments. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no public market exists for a significant portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect estimates. In addition, the tax ramifications related to the realization of the unrealized gains or losses can have a significant effect on fair value estimates and have not been considered in the estimates.

## NOTE 3 RESTRICTED CASH AND CASH EQUIVALENTS

The components of restricted cash and cash equivalents in the statement of financial position at September 30, 2008 and 2007 are as follows (in thousands):

| | 2008 | 2007 |
|---|---|---|
| Accounts pledged to financings | $ 216,628 | $ 246,649 |
| Accounts pledged for liquidity and default reserves | 33,023 | 51,962 |
| Total | $ 249,651 | $ 298,611 |

## NOTE 4 LOANS

The components of loans in the statement of financial position at September 30, 2008 and 2007 are as follows (in thousands):

| | 2008 | 2007 |
|---|---|---|
| Federal guaranteed student loans | $ 5,500,525 | $ 4,979,460 |
| Private student loans | 657,321 | 655,805 |
| Unamortized loan premium | 135,863 | 120,217 |
| Loans and refunds in process | (2,793) | (28,406) |
| Total | 6,290,916 | 5,727,076 |
| Allowance for credit losses | (18,575) | (16,638) |
| Net loans | $ 6,272,341 | $ 5,710,438 |

As of September 30, 2008, the Company has committed to fund student loans totaling approximately $91 million.

## NOTE 5 ALLOWANCE FOR CREDIT LOSSES

Analysis of the change in the allowance for credit losses on private loans for the year ended September 30, 2008 and 2007 follows (in thousands):

| | 2008 | 2007 |
|---|---|---|
| Beginning balance | $ 16,638 | $ 12,756 |
| Provision for loan losses | 6,004 | 8,903 |
| Charge-offs | (5,062) | (5,461) |
| Recoveries | 995 | 440 |
| Net charge-offs | (4,067) | (5,021) |
| Ending balance | $ 18,575 | $ 16,638 |

At September 30, 2008 loans totaling approximately $30 million were 91 days or more delinquent. Of the total delinquent loans over 91 days approximately $26 million were federal guaranteed student loans and approximately $4 million were private student loans.

## NOTE 6 NOTES RECEIVABLE

SAL issued lines of credit to four medical schools with interest rates at LIBOR plus .35%. These lines granted a maximum credit of $55 million. Amounts outstanding were due on demand and were secured by pledged assets covered under a loan and security agreement. The Company cancelled the lines effective May 2008. The Company had amounts outstanding of approximately $22 million at September 30, 2007.

## NOTE 7 GOVERNMENT PARTICIPATION PROGRAM

During 2008, the DOE has purchased participation interests in pools of Federal loans owned by the Company. Amounts funded under this program must be either refinanced by the Company or sold to the DOE prior to its expiration date on September 30, 2009. The DOE charges interest at a rate of commercial paper plus .50% (commercial paper rate was 2.75% on September 30, 2008) on the principal amount outstanding. The Company has amounts outstanding of approximately $87 million at September 30, 2008. In December 2008, the DOE approved a renewal of the Participation Program for funding student loans for the 2009-2010 school year.

## NOTE 8 DRAW AGAINST BANK LINES OF CREDIT

The Company has four lines of credit with interest at varying rates (interest rates were 3.1% to 3.3% at September 30, 2008) depending on funding sources. These lines grant maximum credit of approximately $2.15 billion. Amounts outstanding are due on demand, and are secured by student loans. The Company had amounts outstanding of $2.15 billion and $1.54 billion at September 30, 2008 and 2007. In connection with the line of credit agreement, the Company is required, among other things, to maintain certain covenants and ratios. Due to the disruption in the credit markets, the bank-assigned valuation of the student loans collateralizing these lines of credit have declined below the levels the Company is required to maintain. Certain lenders have the right to request additional collateral and have done so. At September 30, 2008 the Company has not fully complied with these requests. The lines of credit are non-recourse and the lenders' remedies are generally limited to foreclosing on the loans. The lenders have not exercised their right to foreclose on the student loan collateral but some of the lenders have not waived their right to do so. The Company is in discussions with the lenders and does not anticipate that the lenders will foreclose.

## NOTE 9 LONG-TERM DEBT

The Company periodically issues taxable student loan asset-backed notes to finance the acquisition of student loans. All notes are primarily secured by the student loans receivable, related accrued interest, and other property and funds held in trust. The notes are variable rate notes with interest rates reset periodically.

The Company issues Floating Rates Notes (FRNs) which are issued at a fixed spread to 3 month LIBOR and at a fixed maturity with targeted amortization schedules. The interest rates on these notes reset quarterly. The Company also issues Senior and Subordinate Auction Rate Securities. The interest rates on these securities are usually reset every 28 days based upon auction procedures. These securities have a forty year maturity with prepayment at the option of the Company. The securities are issued out of two master trusts, one trust contains only federal guaranteed student loans and the other contains only private student loans.

The table below summarizes outstanding notes payable at September 30, 2008 and 2007 by issue (in thousands):

| Auction Rate Student Loan Asset-Backed Notes | Final Maturity | 2008 Carrying Amount | 2007 Carrying Amount | Interest Rate |
|---|---|---|---|---|
| Series 2000-B | 11/1/2040 | $ 9,500 | $ 9,500 | 4.04% |
| Series 2002 | 4/1/2042 | 233,500 | 233,500 | 3.16-3.56% |
| Series 2002-B | 4/1/2042 | 37,000 | 37,000 | 4.57% |
| Series 2004-B | 12/1/2044 | 30,000 | 30,000 | 3.75% |

| Auction Rate Student Loan Asset-Backed Notes | Final Maturity | 2008 Carrying Amount | 2007 Carrying Amount | | Interest Rate |
|---|---|---|---|---|---|
| Series 2004-2B | 2/28/2044 | 25,500 | 25,500 | | 4.09% |
| Series 2005-1B | 10/30/2045 | 20,000 | 20,000 | | 2.56% |
| Series 2007-1A | 1/29/2046 | 410,150 | 410,150 | | 3.62-4.70% |
| Series 2007-1B | 1/28/2047 | 32,200 | 32,200 | | 4.50% |
| Total Auction Rate Securities | | 797,850 | 797,850 | | |

| Floating Rate Notes Loan Asset-Backed Notes | Final Maturity | 2008 Carrying Amount | 2007 Carrying Amount | | Interest Rate |
|---|---|---|---|---|---|
| Series 2004-1A-1 | 1/28/2011 | - | 19,000 | | 5.41% |
| Series 2004-1A-2 | 1/28/2014 | 166,000 | 225,000 | | 2.92% |
| Series 2004-1A-3 | 4/28/2017 | 200,000 | 200,000 | | 2.97% |
| Series 2004-1A-4 | 4/29/2019 | 225,000 | 225,000 | | 2.99% |
| Series 2004-2A-1 | 4/28/2016 | 295,000 | 295,000 | | 2.92% |
| Series 2004-2A-2 | 1/30/2017 | 150,000 | 150,000 | | 2.94% |
| Series 2004-2A-3 | 7/30/2018 | 280,000 | 280,000 | | 2.97% |
| Series 2004-2A-4 | 7/28/2021 | 249,500 | 249,500 | | 3.03% |
| Series 2005-1A-1 | 10/28/2026 | 193,100 | 193,100 | | 2.90% |
| Series 2005-1A-2 | 7/28/2027 | 118,300 | 118,300 | | 2.93% |
| Series 2005-1A-3 | 10/30/2030 | 227,900 | 227,900 | | 2.97% |
| Series 2005-1A-4 | 4/28/2032 | 210,700 | 210,700 | | 3.03% |
| Series 2006-A1 | 11/30/2020 | 36,827 | 99,677 | | 2.85% |
| Series 2006-A2 | 11/28/2023 | 111,290 | 111,290 | | 3.00% |
| Series 2006-A3 | 5/28/2026 | 112,931 | 112,931 | | 3.02% |
| Series 2006-A4 | 8/28/2035 | 208,056 | 208,056 | | 3.16% |
| Series 2006-B1 | 11/28/2035 | 65,260 | 65,260 | | 3.36% |
| Series 2007-1A-1 | 4/28/2030 | 193,000 | 193,000 | | 2.90% |
| Series 2007-1A-2 | 1/29/2046 | 200,000 | 200,000 | | 2.82% |
| Series 2007-1A-3 | 1/29/2046 | 235,000 | 235,000 | | 2.86% |
| Total Floating Rate Notes | | 3,477,864 | 3,618,714 | | |

| Fixed Rate Notes Loan Asset-Backed Notes | Final Maturity | 2008 Carrying Amount | 2007 Carrying Amount | | Interest Rate |
|---|---|---|---|---|---|
| Series 2005-1A-5 | 10/30/2045 | 250,000 | 250,000 | * | 4.74% |
| Total Long-term Debt | | $ 4,525,714 | $ 4,666,564 | | |

*This note involves a fixed rate derivative product as discussed in Note 15.

The following is a schedule of anticipated long-term debt principal reductions as of September 30, 2008 (in thousands):

| | |
|---|---|
| 2009 | $ 124,325 |
| 2010 | 162,495 |
| 2011 | 200,095 |
| 2012 | 208,844 |
| 2013 | 212,761 |
| Remainder | 3,617,194 |
| Total | $ 4,525,714 |

## NOTE 10 INCOME TAXES

### *Provision for income taxes*

The components of income tax provision consists of the following (in thousands):

| | 2008 | 2007 |
|---|---|---|
| Current: | | |
| Federal | $ 4,052 | $ 4,529 |
| State | 1,305 | 1,450 |
| | 5,357 | 5,979 |
| Deferred: | | |
| Federal | (280) | (140) |
| State | (70) | (35) |
| | (350) | (175) |
| Total | $ 5,007 | $ 5,804 |

The income tax provision is based on the pre-tax income of NCMS which is $12,255 thousand and $14,143 thousand as of September 30, 2008 and 2007, respectively.

### *Deferred income taxes*

As of September 30, 2008 and 2007, deferred tax assets consist of the following (in thousands):

| | 2008 | 2007 |
|---|---|---|
| Assets: | | |
| Investments | $ 25 | $ - |
| Accrued liabilities | 310 | 75 |
| Depreciation and amortization | 215 | 125 |
| Net deferred tax assets | $ 550 | $ 200 |

The net deferred tax assets are recorded in the statement of financial position caption "other assets."

***Reconciliation of tax rates***

| | 2008 | 2007 |
|---|---|---|
| U.S. Federal statutory rate | 35.0% | 35.0% |
| State taxes, net of federal benefit | 6.4 | 6.4 |
| Other | (0.5) | (0.4) |
| Effective tax rate | 40.9% | 41.0% |

**NOTE 11 SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION**

| | 2008 | 2007 |
|---|---|---|
| Cash paid for interest (in thousands) | $ 272,689 | $ 304,185 |
| Cash paid for income taxes (in thousands) | 5,062 | 5,619 |

**NOTE 12 LOAN FINANCING EXPENSES**

| Loan financing expenses consist of the following (in thousands) | 2008 | 2007 |
|---|---|---|
| Interest expense | $ 254,996 | $ 311,677 |
| Program and commitment fees | 51,110 | 40,567 |
| | $ 306,106 | $ 352,244 |

**NOTE 13 EMPLOYEE BENEFITS**

NCMS has a 401(k) defined contribution plan for employees who have attained age 19 and completed three months of service. Plan benefits are 100% vested at the completion of three years of service. Prior to the completion of three years of service, vesting is graduated. Employees may contribute up to the maximum percentage allowable not to exceed the limits of Code Sections 401(k), 404 and 415. NCMS matches employee contributions on a discretionary basis. In addition, NCMS can also contribute additional amounts to all participants on a discretionary basis, which is not limited to Company profitability. NCMS's total contributions were $767 thousand for the year ended September 30, 2008 and $639 thousand for the year ended September 30, 2007.

**NOTE 14 CONCENTRATION OF CREDIT RISK**

The Company receives program fees from their primary contract loan services. These amounts are generally unsecured.

The Company originates and holds student loans from students throughout the United States. The Company grants credit for private loans which are generally unsecured. The government subsidized loans are substantially guaranteed. The Company's ability to collect loans and interest from students may be affected by general economic fluctuations.

Due to recent economic conditions, the Company may have difficulty obtaining financing to fund student loans.

## NOTE 15 DERIVATIVE FINANCIAL INSTRUMENTS

### *Risk Management Strategy*

The Company maintains an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize the economic effect of interest rate volatility. These derivative instruments are usually put in place to protect holders of the Company's debt instruments (See Note 9) against specific stress case scenarios assumed by the rating agencies as they model different cash flow scenarios.

By using derivative instruments, the Company is exposed to credit and market risk. However, management considers the credit risk to be minimal. In addition, the Company further minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties that are reviewed periodically. The Company also requires all derivative contracts be governed by the International Swaps and Derivative Association Master Agreement.

### *LIBOR Derivative Product Agreement*

During 2006 the Company entered into a LIBOR derivative product agreement with two counterparties. Under this agreement the counterparties pay to the Company on a monthly basis one month LIBOR and the Company pays the fixed amount at an annualized rate of 4.61%. Only the net of these two amounts will be exchanged between the companies on a notional amount of $500 million. This agreement terminated April 25, 2007. This agreement was in place to support the Company’s Student Loan Asset Backed Note Series 2005-1 issuance.

### *Fixed Rate to Floating Rate Derivative Product Agreement*

During 2006 the Company entered into a fixed to floating rate derivative product agreement with two counterparties which commenced on April 25, 2007. Under this agreement the counterparties pay to the Company on a quarterly basis the fixed amount at an annualized rate of 4.74% and the Company pays the daily average of the 90 day financial commercial paper rate for the quarter, plus 17.9 basis points. Only the net of these two amounts will be exchanged between the companies on a notional amount of $250 million. This agreement terminates October 27, 2008 or earlier in accordance with the early termination terms of the agreement. This agreement is in place to support the Company’s Student Loan Asset Backed Note Series 2005-1 issuance (see Note 9).

### *Currency Swap Agreements*

The Company may enter into one or more currency swap agreements if any of its reset rate notes are reset to a currency other than US dollars. No currency swap agreements are in place at this time.

### *Summary of derivative financial statement impact*

The following table summarizes the notional value of all derivative instruments at September 30, 2008 and 2007, and their impact on earnings for the year then ended (in thousands).

| | 2008 | 2007 |
|---|---|---|
| ***Notional Values*** | | |
| Fixed for variable swap | $ 250,000 | $ 500,000 |
| ***Earnings summary*** | | |
| Total earnings impact | $ 2,241 | $ 1,148 |

## NOTE 16 ESTIMATED FAIR VALUES

The Company has estimated fair values of financial instruments as follows (in thousands):

| | Carrying Amount | Fair Value | Change in Fair Value from Carrying Amount |
|---|---|---|---|
| **Earning assets** | | | |
| Cash and cash equivalents | $ 5,119 | $ 5,119 | $ - |
| Loans, net | 6,272,341 | 6,214,996 | (57,345) |
| Interest receivable | 289,439 | 282,336 | (7,103) |
| Receivable from Great Lakes | 10,655 | 10,655 | - |
| Government receivable | 9,761 | 9,761 | - |
| Notes receivable | - | - | - |
| Restricted cash and cash equivalents | 249,651 | 249,651 | - |
| Investment securities | 6,596 | 6,596 | - |
| **Non-interest and interest-bearing liabilities** | | | |
| Accounts payable and accrued liabilities | 42,473 | 42,473 | - |
| Accrued salaries and benefits | 1,681 | 1,681 | - |
| Contract servicer payable | 470 | 470 | - |
| Draw against bank line of credit | 2,145,900 | 2,145,900 | - |
| Long-term debt | 4,525,714 | 4,525,714 | - |

## NOTE 17 COMMITMENTS AND CONTINGENCIES

### *Operating leases*

The Company leases two facilities for its operations. The first facility is under a non-cancelable operating lease that expires December 31, 2012. The second facility is under a non-cancelable operating lease that expires September 30, 2009.

Future minimum operating lease payments as of September 30, 2008 are (in thousands):

| | |
|---|---|
| 2009 | $ 509 |
| 2010 | 458 |
| 2011 | 480 |
| 2012 | 492 |
| 2013 | 124 |
| Total | $ 2,063 |

***Donations and grants***

NEF has committed to provide donations and grants to various organizations totaling $349 thousand through September 30, 2009. Since funds won't be transferred to these organizations without making certain benchmarks agreed upon in advance, no liability has been recorded since these are not unconditional promises to give.

***Litigation***

The Company is a defendant in three similar putative nationwide class action cases which allege that the Company's suspension of the "bonus" benefit of its student loans in February 2008 was unlawful. This bonus benefit, in brief, had the effect of reducing qualified borrowers' interest expense and, thus, lowering borrowers' loan payments. The Company suspended the bonus because of adverse financial market conditions and maintains that the suspension was lawful in all respects and consistent with the terms and conditions of the student loan programs in which the plaintiffs participate.

The first action, filed July 14, 2008 in the Central District of California, is styled *Jennifer So v. Northstar Education Finance, Inc.*, Case No. CV08-04580 R (FFM). Plaintiff, on behalf of a putative nationwide class of student loan borrowers, alleges that the Company's decision to suspend the bonus was a breach of the student loan contracts. Plaintiff also seeks declaratory and injunctive relief. Plaintiff lists "DOES 1 through 10" as additional defendants but has not yet disclosed their identities.

The second action, filed August 5, 2008 in the District of Minnesota, is styled *John M. Guidos and John J. Guidos v. Northstar Education Finance, Inc. d/b/a Total Higher Education*, Case No. 0:08-cv-4837 (DWF/JJK). As in the *So* action, plaintiffs, on behalf of a putative nationwide class of student loan borrowers, allege that the Company's suspension of the bonus was a breach of the student loan contracts and also seek injunctive relief (though not declaratory relief). Plaintiffs further allege that the bonus suspension violated the Minnesota Uniform Deceptive Trade Practices Act and the Minnesota Prevention of Consumer Fraud Act.

The third action, filed September 10, 2008 in the Eastern District of Michigan, is styled *Jeffrey Pintar v. Northstar Education Finance, d/b/a Total Higher Education,* Case No. 2:08-cv-13895-JF-DAS. The *Pintar* action is similar to the *So* action, in that plaintiff, on behalf of a putative nationwide class of student loan borrowers, alleges that the Company's suspension of the bonus was a breach of the student loan contracts and also seeks injunctive and declaratory relief.

On November 20, 2008, the Judicial Panel on Multidistrict Litigation ("JPML") heard argument on motions brought by the *Guidos* and *Pintar* plaintiffs to transfer these three similar actions to one federal court in order to coordinate pretrial proceedings. The Company joined in these motions to transfer and further argued that the actions should be transferred to the District of Minnesota. The JPML has not yet ruled on these motions. Other than the JPML motions, and the Company having filed answers to each complaint, no significant pretrial activity in these actions has yet occurred. The Company is vigorously defending this litigation and is unable to predict the likely outcome and whether such outcome may have a material adverse effect on the Company's results of operations or financial condition. Accordingly, no provision for a loss contingency has been accrued at September 30, 2008.

## NOTE 18 CHANGE IN ACCOUNTING ESTIMATE

As a result of management's analysis of compliance with SFAS No. 91, the Company changed certain assumptions and estimates for calculating loan premium amortization when applying the interest method which decreased the current year premium expense and increased net assets by approximately $9 million.

## NOTE 19 SUBSEQUENT EVENT

On October 1, 2008, NEF obtained a line of credit from NCMS totaling $7 million.