

CONSOLIDATED FINANCIAL STATEMENTS

The Education Financing Foundation of California
Year Ended December 31, 2005
With Report of Independent Auditors

The Education Financing Foundation of California

Consolidated Financial Statements

Year Ended December 31, 2005

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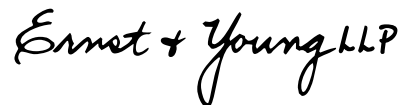
Report of Independent Auditors

The Board of Directors
The Education Financing Foundation of California

We have audited the accompanying consolidated statements of financial position of The Education Financing Foundation of California (TEFFC) as of December 31, 2005, and the related statements of activities and changes in net assets and cash flows for the year then ended. These financial statements are the responsibility of TEFFC's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. We were not engaged to perform an audit of internal control over financial reporting. Our audit included consideration of internal controls over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of TEFFC's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of TEFFC at December 31, 2005, and the results of its changes in net assets and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States.



April 25, 2006,
except for Note 3, as to which the date is
June 8, 2006

The Education Financing Foundation of California

Consolidated Statement of Financial Position

December 31, 2005

(In Thousands)

Assets

Cash and cash equivalents	\$ 138,214
Investments	217,925
Student loans receivable, net of allowance for loan losses of \$6,716	175,995
Student loans receivable held for sale	181,758
Other assets	9,078
Total assets	<u>\$ 722,970</u>

Liabilities

Accounts payable and accrued liabilities	\$ 12,278
Accrued interest payable	629
Student loans held for sale funding provided by Nelnet	181,758
Bonds and note payable	40,192
Asset-backed line of credit	113,000
Total liabilities	<u>347,857</u>

Net assets

Net assets restricted by trust indentures (Note 5)	22,940
Unrestricted net assets	352,173
Total net assets	<u>375,113</u>
Total liabilities and net assets	<u>\$ 722,970</u>

See accompanying notes.

The Education Financing Foundation of California

Consolidated Statement of Activities and Changes in Net Assets

Year Ended December 31, 2005

(In Thousands)

Revenues

Interest and investment income:

Student loan interest, including special allowance payments	\$ 124,014
Investments, including net realized and unrealized gains	23,326
Gain on loan and other assets sale	41,105
Total revenues	<u>188,445</u>

Expenses

Loss on extinguishment of debt	11,580
Interest	65,181
Loan servicing fees	7,966
Student loan program expenses	21,902
Scholarships and grants	2,406
Salaries and benefits	21,512
General and administrative	19,293
Total expenses	<u>149,840</u>

Increase in net assets	38,605
Net assets at beginning of year	<u>336,508</u>
Net assets at end of year	<u><u>\$ 375,113</u></u>

See accompanying notes.

The Education Financing Foundation of California

Consolidated Statement of Cash Flows

Year Ended December 31, 2005

(In Thousands)

Operating activities

Increase in net assets	\$ 38,605
Adjustments to reconcile increase in net assets to net cash used in operating activities:	
Amortization of deferred loan premiums, transfer fees, and financing costs	15,739
Provision for loan losses	1,336
Net realized and unrealized gains on investments	(6,071)
Net gain on sale of student loans and other assets	(41,105)
Loss on extinguishment of debt	11,580
Changes in operating assets and liabilities:	
Net increase in accrued interest and other receivables	(9,506)
Net increase in other assets	(420)
Net decrease in accounts payable and accrued liabilities	(13,951)
Net decrease in accrued interest payable	(3,019)
Other	(2,222)
Net cash used in operating activities	<u>(9,034)</u>

Investing activities

Purchases and originations of student loans	(548,939)
Proceeds from student loan repayments	546,311
Net proceeds from sale of student loans to third party	2,322,687
Net increase in deferred loan premiums and transfer fees	(7,707)
Proceeds from sale of other assets to third party	11,000
Net purchases of investments	(75,186)
Net cash provided by investing activities	<u>2,248,166</u>

Financing activities

Repayment of bonds and note payable	(2,142,637)
Net borrowings under asset-backed lines of credit	(181,000)
Net cash used in financing activities	<u>(2,323,637)</u>

Net decrease in cash and cash equivalents	(84,505)
Cash and cash equivalents at beginning of year	222,719
Cash and cash equivalents at end of year	<u>\$ 138,214</u>

See accompanying notes.

The Education Financing Foundation of California

Notes to Consolidated Financial Statements

December 31, 2005

1. Organization and Business

The Education Financing Foundation of California (TEFFC or the Foundation), formerly Chela Financial, Inc. (Chela Inc.), is the parent company of CEFI Corporation, and formerly Chela Education Financing Inc. (in either case, CEFI). TEFFC owns directly Chela Funding II, LLC (CFII) and indirectly Chela Funding I, LLC (CFI) (subsidiary of CEFI), two special-purpose financing subsidiaries. TEFFC and its subsidiaries are the surviving entities after a series of corporate restructurings that occurred in 2004 and early 2005, as described more fully below.

Prior to January 2005, Chela Financial Resources, Inc. (Resources) and its affiliates, Chela Financial USA, Inc. (Chela USA) and Chela Inc., were nonprofit public benefit corporations organized for the charitable purpose of assisting students in obtaining funds for educational purposes and for providing various education loan assistance programs and loan servicing. Chela Inc. was incorporated on April 23, 1979, and was organized under Internal Revenue Service (IRS) Code Section 150(d) as a corporation established and operated exclusively for the purpose of acquiring student loans originated under the Higher Education Act of 1965, as amended. Resources and Chela USA were each incorporated on May 11, 1994, and each commenced operations on January 1, 1995. All three entities were incorporated under the laws of the State of California.

On June 30, 2004, Chela USA sold its non-federally guaranteed consumer education loan portfolio to Resources and subsequently merged with and into Chela Inc. (the Merger), with Chela Inc. being the surviving entity. Neither Chela Inc. nor Chela USA had any employees, and both operated for essentially the same purpose: to originate, buy, sell, and hold student and educational loans. The primary difference between the two affiliates was the source of funds used to finance the student loan portfolios. Primarily, Chela Inc. used tax-exempt bond funding, whereas Chela USA only used taxable bond funding and student loan asset-backed lines of credit.

The Education Financing Foundation of California

Notes to Consolidated Financial Statements (continued)

1. Organization and Business (continued)

The Merger involved two affiliated nonprofit public benefit corporations with a common sole corporate member, Chela Financial Resources. As a result of the Merger, there was no change in Chela Inc.'s use of its assets or its charitable purpose, and Resources remained as the sole member of Chela Inc., the surviving corporation. Immediately prior to the Merger, Chela Inc. and Chela USA shared all 11 members of their respective Boards of Directors. Subsequent to the Merger, all of these shared board members continued to serve on Boards of Directors of the surviving corporation, Chela Inc., and its sole member, Resources. Accordingly, the Merger of nonprofit entities was accounted for as a reorganization of entities under common control, and all of the assets and liabilities of Chela USA, except the non-federally guaranteed consumer education loans previously sold to Resources, were merged into Chela Inc. based on their historical book values.

2. Corporate Restructuring

On January 31, 2005, and on February 1, 2005, respectively, Chela Inc. and Resources underwent corporate restructurings involving the following three principal separate but related transactions:

- (i) The Internal Revenue Code (IRC) Section 150(d)(3) "conversion" of Chela Inc. This conversion involved the transfer of substantially all of Chela Inc.'s assets, including its rights and obligations under the bond indentures and an asset-backed line of credit, to CEFI, a newly created for-profit Delaware corporation, in exchange for CEFI's issuance of Senior Stock to Chela Inc., such that Chela Inc. (now TEFFC) would own all of the outstanding capital stock of CEFI;
- (ii) The merger of Resources with and into Chela Inc., with Chela Inc. as the surviving corporation in the merger; and
- (iii) The transfer of substantially all of Resources' assets, liabilities, business, and employees to CEFI.

In connection with the foregoing transactions, CEFI established two wholly owned single-purpose financing subsidiaries, CFI and CFII, and transferred certain of its assets and liabilities to each.

The Education Financing Foundation of California

Notes to Consolidated Financial Statements (continued)

2. Corporate Restructuring (continued)

The foregoing transactions are referred to herein as “the Restructuring” and constituted a purely internal restructuring of the Chela entities under common control. The Restructuring was intended to enable Chela Inc. and its affiliates to better carry out charitable purposes, provide enhanced benefits to charitable beneficiaries, and to operate in a more efficient and effective manner.

Further, the Restructuring was also motivated by the statutory restrictions imposed on entities subject to IRC Section 150(d). Under Chela Inc.’s Articles of Incorporation, as required pursuant to IRC Section 150(d), Chela Inc. was required to apply all of its net income (i.e., income after expenses, debt service, and related reserves) to the acquisition of additional student loans authorized under the Higher Education Act. In addition, Chela Inc. (prior to the Restructuring and absent the transfer of assets to its wholly owned subsidiary, CEFI) would have been required, upon dissolution, to return its net assets to the United States government.

Recognizing the problems inherent in these restrictions and the benefits from enabling IRC Section 150(d) corporations to utilize their assets more flexibly for the charitable purpose of benefiting and advancing education, Congress enacted IRC Section 150(d)(3). This section specifically authorizes IRC Section 150(d) corporations to elect to transfer all of their liabilities and pledged student loan assets to a wholly owned, for-profit subsidiary, subject to explicit statutory requirements and conditions. Chela Inc.’s transfer of assets to CEFI was done pursuant to the express and specific statutory authorization of IRC Section 150(d)(3). Chela Inc. (now TEFFC) remains an IRC Section 501(c)(3) exempt charitable organization with substantially the same charitable purposes and mission as it previously had (i.e., access to education for educationally or financially disadvantaged students).

The Education Financing Foundation of California

Notes to Consolidated Financial Statements (continued)

2. Corporate Restructuring (continued)

On October 25, 2005, CEFI sold the majority of its assets to Nelnet Corporation (Nelnet). This sale to Nelnet included substantially all of CEFI's FFELP student loan assets, totaling approximately \$2.2 billion, along with related origination, servicing operations, and intellectual property and trademarks. The gain on sale from this transaction totaled \$42.8 million in 2005. The sale of FFELP loans encompassed all loans except those loans that were more than 210 days delinquent. This sale did not include the private student loan portfolios that CEFI and its predecessors had purchased or originated. Concomitant with the sale of loan portfolios to Nelnet, the bonds that financed each asset pool were defeased with proceeds of the sales such that TEFFC and its subsidiaries had no further obligations to the bondholders whose bonds were shortly thereafter redeemed by the trustee for each bond issue. Loss on extinguishment of debt related to the write-off of deferred financing costs totaled \$11.6 million. One bond issue (Series 1998AB) and a portion of an asset-backed credit line were not defeased or repaid at this time.

In addition to the sale of the available FFELP portfolios (other than loans more than 210 days delinquent), CEFI contracted to sell to Nelnet future FFELP loan originations for those loans that were either partially disbursed or for which applications were in process but not yet disbursed at the time of initial sale. CEFI is due a premium from Nelnet when these loans are subsequently sold, as long as the first disbursement of such loans occurred on or before January 23, 2006. The contract also provided that those loans that collateralized the 1998AB bond financing would be sold to Nelnet at a future date once the principal amount of such collateral reduced to below \$22.0 million, at which stage the bonds would be redeemed by CFI. Furthermore, if any previously delinquent FFELP loans subsequently became current or up to 210 days delinquent, the agreement with Nelnet provided that these would be sold to Nelnet at par or without any premium.

Aside from the purchase of loans and other assets as discussed above, there were a number of other contractual arrangements entered into between CEFI and Nelnet. These included the contracting of Nelnet to provide future servicing or oversight of third-party servicers for those loans retained by CEFI. Nelnet assumed from CEFI a variety of contracts with third parties in connection with the acquired business activities, including any rights to purchase loans under forward purchase contracts. CEFI contracted to provide certain management and administrative services to Nelnet during a transition period to end no later than June 30, 2006.

The Education Financing Foundation of California

Notes to Consolidated Financial Statements (continued)

2. Corporate Restructuring (continued)

For a period of 36 months from the initial purchase date of October 25, 2005, Nelnet may require CEFI to repurchase any of the purchased loans under a variety of specified circumstances. Generally, these circumstances relate to events or actions prior to the date Nelnet purchased the loans. Any such repurchases are to be at a comparable premium to the purchase price Nelnet had originally paid plus any incidental costs to fully compensate Nelnet. CEFI has established an indemnification reserve of \$0.8 million at December 31, 2005, against potential repurchases of this nature. Repurchases through April 25, 2006 have been negligible.

CEFI had in the past provided all management and other personnel to perform administrative, marketing, management, financial, and accounting services for its affiliates. After the sale of assets to Nelnet, these activities have continued to be performed by CEFI for TEFFC, though on a curtailed and diminishing basis. This reduction in scope resulted from the sale of the marketing, origination, and servicing activities and the significant reduction in loan portfolios and associated financings.

Prior to the sale of assets to Nelnet, TEFFC's primary sources of revenue were interest on student loans and investment income. Chela Inc. and Chela USA each issued student loan revenue bonds and asset-backed lines of credit to fund student loan acquisition programs, including those loans originated by Resources. These financings were repaid primarily from funds derived from principal repayments, borrower interest and fee payments, special allowance payments, government interest payments, guarantee payments on defaulted loans, proceeds from sales of student loans, proceeds from bonds or notes issued to refund such bonds, and investment income.

3. Subsequent Events

The long-term goals of TEFFC are to fulfill its mission to provide financial aid to students through grants and other means unconnected with lending activities. Subsequent to the signature of the Asset Purchase Agreement with Nelnet on September 27, 2005, the short-term business goals of CEFI turned from its prior marketing, loan origination, servicing, and financing activities to the completion of asset sales and the wind-down of the remaining business activities of CEFI, CFI, and CFII. The remaining activities of CEFI, other than those already sold to Nelnet, were scheduled to be mainly wound down in late 2005 and the first half of 2006. Some residual ownership of delinquent and charged-off loans are expected to reside with TEFFC into the second half of 2006 and beyond in order for TEFFC to fully realize fair market values from its residual assets.

The Education Financing Foundation of California

Notes to Consolidated Financial Statements (continued)

3. Subsequent Events (continued)

On June 8, 2006, TEFFC consummated a sale of the remaining \$93.0 million consumer education loan (CEL loan) portfolio at above carrying value.

As part of the wind-down, payments in respect of retention and severance arrangements were accrued and paid to employees at termination. Some employees of CEFI were hired by Nelnet in conjunction with the asset purchases, and some were retained by CEFI on a temporary basis to perform transitional tasks for Nelnet with their compensation costs reimbursed by Nelnet. The remaining employees of CEFI were retained to perform the wind-down tasks, with most terminations scheduled during the later part of 2005 and first half of 2006. It is expected that three CEFI employees will transition to TEFFC.

Retention and severance bonuses totaled \$5.0 million in 2005. At December 31, 2005, the retention and severance bonus liability was \$1.3 million. Through March 15, 2006, \$0.7 million of this liability had been paid.

4. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States that require management to make estimates and assumptions that affect reported amounts. These estimates are based on information available as of the date of the consolidated financial statements. Therefore, actual results could differ from those estimates.

Under the provisions of the American Institute of Certified Public Accountants (AICPA) *Audit and Accounting Guide for Not-for-Profit Organizations* and related standards, net assets and revenues, expenses, gains and losses are classified based on the existence or absence of donor-imposed restrictions. At December 31, 2005, there were no donor-imposed restrictions. Therefore, according to AICPA standards, net assets of TEFFC were unrestricted. However, a portion of net assets is restricted by the trust indentures.

The Education Financing Foundation of California

Notes to Consolidated Financial Statements (continued)

4. Summary of Significant Accounting Policies (continued)

Basis of Presentation (continued)

The consolidated financial statements include the accounts of TEFFC and its subsidiaries, CEFI, CFI, and CFII, as well as the accounts of the trusts for the outstanding student loan revenue bonds, notes, the asset-backed line of credit, and the general operating accounts for each of the consolidated entities. All significant intercompany accounts and transactions have been eliminated. References to TEFFC in these notes to consolidated financial statements refer to or include TEFFC and its subsidiaries.

Fund Accounting

The accounts of TEFFC and its subsidiaries, CEFI, CFI, and CFII, included in these consolidated financial statements are maintained in accordance with the principles of fund accounting as required by the trust indentures. This is a system under which resources are classified for accounting purposes into funds established for specific purposes. The individual subsidiaries' funds are maintained based on the source of the funding.

Cash and Cash Equivalents

Cash and cash equivalents consist of demand deposits in banks, money market funds, and other short-term investments with original maturities of 90 days or less. Certain cash and cash equivalents are held in trust with Union Bank of California, National Association (the Trustee) under trust indentures, and access to those funds is subject to certain limitations (see Note 5, Trust Indenture Restrictions).

Investments

On April 5, 2005, the Board of Directors of the Foundation delegated authority to the Investment Committee of the Board to develop the Foundation's investment policy and objectives, and to allocate and direct the investment of Foundation funds. The Investment Committee reports to the Board of Directors on a quarterly basis. At December 31, 2005, the Foundation had investments in the following categories, totaling \$215.3 million: fixed income and bond funds, diversified inflation hedge fund, domestic equity funds, and international equity funds. The diversified inflation hedge fund includes a wide variety of

The Education Financing Foundation of California

Notes to Consolidated Financial Statements (continued)

4. Summary of Significant Accounting Policies (continued)

Investments (continued)

investments, such as domestic and international equities, fixed income securities, commodities futures, and real estate investments. Additionally, the CalEdge student loan and bond program had guaranteed investment contracts totaling \$2.6 million at December 31, 2005.

During 2005, TEFFC investments consisted of guaranteed investment contracts, U.S. government debt, U.S. government agency debt, corporate debt, fixed income securities, commodity futures, real estate investments, and domestic and international equity securities. Dividend income is recorded on ex-dividend dates. Interest income from investments is recorded on an accrual basis. Investments are stated at fair value, with unrealized gains and losses reported as increases or decreases in net assets in TEFFC's statements of activities and changes in net assets. Certain investments for which there are no active market quotes are initially valued at cost. Subsequently, these investments are adjusted to reflect changes in valuation as indicated by periodic statements from fund managers.

Student Loans Receivable and Student Loans Receivable Held for Sale

Student loans held for investment are classified as portfolio loans and are carried at the principal amount outstanding net of unamortized premiums or discounts, deferred loan fees and costs and acquisition fair value adjustments, if any. Student loan receivables that CEFI has committed to sell are classified as loans held for sale. Loans held for sale are carried at the lower of the carrying amount or fair value applied on an aggregate basis. Fair value is measured based on purchase commitments, bids received from potential purchasers, quoted prices for the same or similar loans, or prices of recent sales.

As a result of the Nelnet Asset Purchase Agreement, FFELP loans originated are classified as held for sale upon origination based upon management's intent to sell all of these loans to Nelnet. Loans originated for the portfolio and subsequently transferred to held for sale, based on management's decision to sell, are transferred at the lower of cost or fair value. Write-downs of the loans' carrying value attributable to credit quality are charged to the allowance for loan losses while write-downs attributable to interest rates are charged to noninterest income.

The Education Financing Foundation of California

Notes to Consolidated Financial Statements (continued)

4. Summary of Significant Accounting Policies (continued)

Student Loan Income

Interest income on student loans includes borrower interest, government interest, and special allowance payments. Interest income is recognized based upon the interest rate and principal amount outstanding in accordance with the terms of the applicable loan agreement until the outstanding balance is paid or charged off.

Loan premiums, discounts, transfer fees, and certain incremental direct origination costs are deferred and amortized into interest income over the estimated lives of the student loans using a method that approximates the effective yield method. Amortization of deferred loan premium, transfer fees, and origination costs for the year ended December 31, 2005, totaled \$14.8 million.

Allowance for Loan Losses

TEFFC maintains an allowance for loan losses to provide for probable net losses on the uninsured portion of its federally guaranteed FFELP student loans and on both privately guaranteed and uninsured consumer education loans (CEL loans). The allowance is maintained at a level to provide for probable losses, net of estimated recoveries, inherent in the portfolio as of the reporting date. The allowance is established through a provision charged to student loan program expenses as well as through guarantee fees associated with certain CEL loan programs.

In assessing the appropriate level of the allowance for loan losses, TEFFC adheres to an internal review process with an established methodology to evaluate its loans for impairment. The evaluation of the allowance for loan losses is inherently subjective and combines both objective and subjective elements. The allowance reflects statistically derived loss probabilities associated with current portfolio attributes, based on empirical loan performance data, combined with management's judgment of the impact of macroeconomic and other external factors on loan losses. Current portfolio attributes considered include but are not limited to the size and credit condition of the loan portfolio, exhibited borrower behavior, loan age, historical loss experience, and levels and trends of certain loan delinquencies.

The Education Financing Foundation of California

Notes to Consolidated Financial Statements (continued)

4. Summary of Significant Accounting Policies (continued)

Allowance for Loan Losses (continued)

In evaluating the adequacy of the allowance for federally guaranteed FFELP loans, TEFFC also considers the incidence of student loan claims rejected for payment by guarantors and the amount of FFELP loans subject to risk-sharing.

Substantially all of TEFFC's FFELP loans were sold to a third party, Nelnet, in October 2005. A small number of FFELP loans, \$60.9 million, representing less than 3% of FFELP loans outstanding prior to the Nelnet asset sale, were excluded from the sale as they consisted of loans more than 210 days delinquent or because they are financed under a bond that is not currently redeemable. The delinquent loans will eventually flow through the defaulted loan process or become eligible for sale without premium to the same acquiring entity, Nelnet, as they become current or up to 210 days delinquent. The loans under the unredeemed bond (1998AB bond indenture with \$26.3 million outstanding at December 31, 2005) are expected to become eligible for sale to Nelnet when the bond is redeemed, which is anticipated in mid-2006. Accordingly, the allowance process for these few remaining FFELP loans has been refined due to the small amount of loans involved and the uniformity of risk profiles. CEL loans were not included in the asset sale. Therefore, the CEL allowance process and the CEL reserve model design remain unchanged.

Interest Expense and Financing Costs

Interest expense is based upon contractual interest rates adjusted for the amortization of deferred financing costs. Financing costs incurred when establishing financing arrangements are capitalized and amortized over the term of the financing arrangement as a component of interest expense. TEFFC's total amortization of deferred financing costs for the year ended December 31, 2005, was \$0.9 million.

Student Loan Program Expenses

Student loan program expenses include all other third-party costs directly attributable to the management of trust assets and liabilities. Major program expenses are origination fees paid to the United States Department of Education (DOE), bond broker/dealer fees, trustee fees, professional service provider fees, excess loan yield, and arbitrage rebate expenses.

The Education Financing Foundation of California

Notes to Consolidated Financial Statements (continued)

4. Summary of Significant Accounting Policies (continued)

Income Taxes

TEFFC's predecessors, Resources and Chela, Inc., have each been previously notified by both the IRS and the State of California, respectively, that they qualify for exemption from income tax (except for income tax on any unrelated business income) under IRS Code Section 501(c)(3) and California Revenue and Taxation Code Section 23701(d).

Additionally, in March 2006, TEFFC was notified by the IRS that an examination was performed of Chela Financial Resources, Inc. for the 2002 tax year, and that the organization continued to qualify for exemption from Federal income tax, and the respective form 990 return was accepted as filed. TEFFC, formerly Chela Inc. maintains its IRS Code Section 501(c)(3) organization status.

As a newly created for-profit Delaware corporation, CEFI uses the liability method to account for income taxes. Under this method, deferred income tax assets and liabilities are based on the differences between the financial statement and tax bases of assets and liabilities that will result in taxable or deductible amounts in the future based on enacted tax laws and rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

Allowance for Excess Loan Yield and Investment Arbitrage Rebates

The IRC, as amended, requires that TEFFC subsidiaries calculate and remit amounts deemed by the IRC to be excess yields earned on (a) non-purpose investments (arbitrage rebates) and (b) FFELP student loan investments (excess loan yield) acquired with proceeds of tax-exempt bond or note financings. Both calculations are based on the excess of investment yield over the related bond or note cost of funds. Arbitrage rebate, if any, is paid at each five-year anniversary of the underlying bond's issuance date and at bond maturity. Excess loan yield liability, if any, is paid at final maturity of the underlying bond. TEFFC accrues a liability for these amounts and recognizes income or expense related to changes in these liabilities based on third-party calculations as of the balance sheet date.

As discussed in Note 2, on October 25, 2005, TEFFC defeased all of its tax-exempt bond financings and fully satisfied its bond obligations along with its excess loan yield liabilities concurrent with the sale of student loan receivables to Nelnet. Thus, at December 31, 2005, TEFFC had no excess loan yield liabilities outstanding.

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Notes to Consolidated Financial Statements (continued)

4. Summary of Significant Accounting Policies (continued)

Derivative Instruments

The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and its amendments, SFAS No. 137, No. 138, and No. 149, which require that all derivative instruments be recorded on the balance sheet as either assets or liabilities measured at fair value. Derivatives that are not designated as hedges under SFAS No. 133, as amended, must be adjusted to fair value through income. If a derivative is a hedge, depending on the nature of the hedge, changes in the fair value of the derivative are either offset against the change in fair value of the assets or liabilities through earnings or are recognized as a change in net assets in the period of change. For a derivative designated as a hedge, the ineffective portion of its change in fair value will be immediately recognized in earnings.

TEFFC has not designated any derivatives as hedges under SFAS No. 133. Thus, changes in derivative instrument fair values are reported as a component of interest expense.

Derivative instruments were used in the past to moderate earnings exposure to changes in absolute interest rate levels and interest rate spreads between indices. With the sale of substantially all of its loan portfolio assets, all but one derivative instrument had expired or been cancelled by December 31, 2005.

At no time did TEFFC enter into derivative contracts for the purpose of speculation. Derivatives with positive fair values are reported as a component of other assets. Derivatives with negative fair values are reported as a component of accounts payable and accrued liabilities.

The Education Financing Foundation of California

Notes to Consolidated Financial Statements (continued)

5. Trust Indenture Restrictions

Under the provisions of the AICPA *Audit and Accounting Guide for Not-for-Profit Organizations* and related standards, net assets, revenues, expenses, gains, and losses are reported based on the existence or absence of donor-imposed restrictions. At December 31, 2005, the net assets of TEFFC are not subject to any donor-imposed restrictions and are reported as “Unrestricted Net Assets.” The only limits on unrestricted net assets are those resulting from TEFFC’s trust indentures, the purposes specified in its articles of incorporation or bylaws, and limits resulting from other contractual agreements. TEFFC’s trust indentures under which bonds and notes are issued or the asset-backed credit line restrict the transfer of trust funds to the general operating account until the ratio of trust asset collateral to bond liability or indebtedness meets or exceeds specified distribution thresholds.

Asset collateral held in trusts in excess of bond and notes liability or indebtedness, but not available for distribution due to asset collateral ratio threshold restrictions, was approximately \$22.9 million at December 31, 2005.

6. Investments

TEFFC’s investments at December 31, 2005, held by the trustees, agents of the trustees, and other financial institutions were as follows (in thousands):

Guaranteed investment contracts (CalEdge Program)	\$ 2,615
Fixed income and bond funds	52,338
Diversified inflation hedge fund	27,637
Domestic equity funds	92,730
International equity funds	42,605
Total investments	<u>\$ 217,925</u>

The guaranteed investment contracts held by TEFFC at December 31, 2005, mature in 2010, 2028, and 2031 and include provisions requiring the issuer to provide collateralization in the form of U.S. government obligations. The guaranteed investment contracts held by TEFFC were issued by GE Capital Corporation.

The Education Financing Foundation of California

Notes to Consolidated Financial Statements (continued)

6. Investments (continued)

Investment income for the year ended December 31, 2005, is as follows (in thousands):

Interest and dividends	\$ 17,247
Realized and unrealized gains	<u>6,079</u>
Total investment income, net	<u>\$ 23,326</u>

7. Student Loans Receivable

At December 31, 2005, student loans receivable consisted of the following (in thousands):

FFELP student loans receivable	\$ 60,532
Consumer education loans receivable	108,921
Accrued interest and other receivables	12,613
Deferred loan premiums, transfer fees, and origination costs, net of accumulated amortization	<u>645</u>
	182,711
Allowance for loan losses	<u>(6,716)</u>
Student loans receivable, net	<u>\$ 175,995</u>

FFELP Program

FFELP student loans receivable is comprised of federally guaranteed student loans with DOE-specified interest rate formulas and repayment terms. TEFFC's FFELP student loans receivable consists of loans originated under the provisions of the FFELP. The FFELP programs are the Federal Stafford Loan (Stafford) Program, the Federal Supplemental Loans for Students (SLS) Program, the Federal Parent Loan for Undergraduate Students (PLUS) Program, and the Federal Consolidation Loan Program. These loan programs are generally available to eligible students and parents of students who were enrolled in post-secondary education institutions.

The Education Financing Foundation of California

Notes to Consolidated Financial Statements (continued)

7. Student Loans Receivable (continued)

FFELP Program (continued)

FFELP loans obligate the borrower to pay interest at a stated fixed rate or a variable rate that has a maximum rate. Variable borrower interest rates reset annually on July 1, at levels dependent on loan type, status, loan origination date, and prevailing interest rates. TEFFC earns interest at the greater of the borrower's rate or a DOE-specified Special Allowance Payment (SAP) rate. If the SAP rate exceeds the borrower rate, the DOE makes a payment directly to TEFFC equal to the excess of the SAP rate over the borrower rate. The SAP rate varies by product type, status, loan disbursement date, and funding source. The SAP rate formula floats with a reference index rate (91-day Treasury bill, 3-month commercial paper, or 52-week Treasury bill) plus a spread of between 1.74 and 3.50 percentage points. Loans funded with tax-exempt debt originally issued prior to October 1, 1993, or direct refinancings or refundings thereof, are subject to a 9.5% minimum SAP rate.

FFELP student loans held by TEFFC at December 31, 2005, bore borrower interest rates that primarily ranged from 2.0% to 9.5%. Stafford, SLS, and PLUS loans have repayment periods ranging from 5 to 10 years. Federal consolidation loans have repayment periods ranging from 10 to 30 years.

FFELP loans held by TEFFC have been guaranteed by eligible guarantors against the borrower's default, death, disability, or bankruptcy. FFELP loans originated prior to October 1, 1993, are guaranteed at 100%, while FFELP loans originated on or after October 1, 1993, are guaranteed at 98% or 100%. All FFELP loans are reinsured by the DOE under the Higher Education Act of 1965, as amended, provided applicable program requirements have been met by the originating lender with respect to such loans.

In the event of a FFELP student loan default, TEFFC files a claim with the guarantor of the loan. TEFFC will receive the unpaid principal balance and accrued interest on the loan less risk sharing, if applicable, provided the loan has been properly originated and serviced.

Third parties who have sold FFELP loans to TEFFC warranted that the student loans were originated in accordance with program requirements and were valid obligations of the borrowers. In the event that student loans do not conform to the terms of the purchase agreement between TEFFC and the third-party seller, the loans may be returned to the third-party seller for reimbursement of principal and accrued interest. During the year ended December 31, 2005, no material loan amounts were returned to third-party sellers.

The Education Financing Foundation of California

Notes to Consolidated Financial Statements (continued)

7. Student Loans Receivable (continued)

FFELP Program (continued)

At December 31, 2005, TEFFC had no outstanding loan purchase obligations under forward purchase agreements or contingent loan purchase obligations from prior purchase agreements. All such agreements were assumed by Nelnet as part of the sale of FFELP student loan receivables in October 2005.

Student Loan Receivable Held for Sale

As part of the agreements entered into with Nelnet, TEFFC committed to sell to Nelnet loans that were partially disbursed or loans to be disbursed under applications that were in process (Pipeline Loans). For those loans to be first disbursed within the 90 days following the October 25, 2005 initial loan sale to Nelnet, a premium would be paid on the full disbursement amount regardless of the timing of subsequent disbursements. Under the terms of a Participation Loan Sale Agreement, Nelnet contracted to fund these Pipeline Loans until sold to Nelnet several months after final disbursement. At December 31, 2005, the principal balance of such funded participation loans totaled \$181.8 million. Both an asset and corresponding liability is recorded for these participation loans.

Under the Participation Loan Sale Agreement, it is forecast that \$280.0 million in student loan receivables with \$9.4 million of premium will be sold to Nelnet. As of April 1, 2006, \$161.9 million of participation loans had been sold, and \$5.2 million in premiums had been recognized.

CEL Program

TEFFC's CEL portfolio consists of loans originated or purchased under various programs. Loans under The Education Resources Institute, Inc. (TERI) program are guaranteed by TERI, a private loan guarantor. Loans receivable under the TERI program at December 31, 2005 approximated \$16.8 million. Under certain other loan programs, TEFFC receives guarantee fees that are included in the allowance for loan losses. Guarantee fees are used to offset losses associated specifically with these loan programs.

The remaining CEL portfolio was sold on June 8, 2006 as mentioned in Note 3.

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Notes to Consolidated Financial Statements (continued)

7. Student Loans Receivable (continued)

Combined FFELP and CEL Programs

At December 31, 2005, TEFFC maintained third-party servicing agreements with four corporations to act as agents for the FFELP and or CEL programs to perform loan servicing, billing, accounting, reporting, and loan administrative duties. Under the terms of the servicing agreements, the servicers are held liable for losses resulting from their own negligent loan servicing. At December 31, 2005, 100% of TEFFC's loans were serviced by third-party servicers.

8. Allowance for Loan Losses

The table below summarizes the changes in the allowance for loan loss reserve for the year ended December 31, 2005 (in thousands):

Balance at the beginning of the year	\$ 6,428
Provision for possible losses	1,336
Charges to allowance	(2,511)
Recoveries and other	1,463
Balance at end of the year	<u>\$ 6,716</u>

9. Bonds and Note Payable

The following table summarizes TEFFC's bond and note payable as of December 31, 2005 (in thousands):

<u>Series or Note</u>	<u>Interest Rate</u>	<u>Maturity Date</u>	<u>Principal</u>
1998AB	Variable	2010, 2016	\$ 26,297
Note payable (CEFA)	5.55%	2028	13,895
Total			<u>\$ 40,192</u>

The CEFA note payable is in connection with a tax-exempt financing and is payable is at a fixed rate of 5.55%.

The 1998AB bond is a taxable adjustable rate obligation which floats at LIBOR for Class 1998A, and Auction Rate for Class 1998B.

The Education Financing Foundation of California

Notes to Consolidated Financial Statements (continued)

9. Bonds and Note Payable (continued)

The 1998AB bond is collateralized by and payable from the trust established under the indenture pursuant to which they were issued. TEFFC maintains certain accounts under the control of the Trustee that are held as collateral. Assets held in these accounts consist of cash and cash equivalents, investments, and student loans receivable in the accompanying consolidated statements of financial position.

The 1998AB bond is subject to optional, mandatory, and extraordinary redemption under various circumstances as described in the trust indenture. At the option of TEFFC, the bond may be redeemed, in full, prior to maturity when the amount of loan collateral outstanding equals 10% or less of the initial aggregate amount of the bond which was \$220.0 million. The associated swap agreement will terminate upon the final payment of the bond obligation.

Bond and note maturities are as follows at December 31, 2005 (in thousands):

2010	\$ 13,097
2016	13,200
2028	13,895
Total	<u>\$ 40,192</u>

10. Asset-Backed Lines of Credit

As of December 31, 2005, TEFFC had a \$175 million student loan asset-backed commercial paper line of credit, made available through Citicorp North America, Inc. (CNAI), as agent, maturing April 6, 2006. This line of credit was available for the financing of FFELP or CEL with a maximum limit for CEL of \$120 million. The facility, which issues commercial paper under a multi-issuer conduit, had liquidity backstop lines totaling \$175 million provided by Citibank N.A. At December 31, 2005, \$113 million of borrowings were outstanding under this facility.

Effective February 15, 2006, this line limit was reduced from \$175 million to \$125 million. This facility was then renewed effective April 4, 2006 to April 3, 2007, with a \$100 million line limit, unrestricted as to availability for either FFELP or CEL financings.

Interest rates on borrowings are at spreads over the prevailing commercial paper rate for Prime-1 rated commercial paper. There is a liquidity fee paid on this facility, independent of the level of utilization, as well as commercial paper dealer fees. This facility contains

The Education Financing Foundation of California

Notes to Consolidated Financial Statements (continued)

10. Asset-Backed Lines of Credit (continued)

various financial covenants, including minimum collateral ratio requirements. TEFFC was in compliance with these financial covenants at December 31, 2005.

11. Derivative Instruments

At December 31, 2005, TEFFC was party to the following derivative contracts.

Derivative product:	Treasury/LIBOR index swap
Payment formula:	TEFFC pays prevailing 91-day Treasury bill rate + 66 basis points TEFFC receives prevailing 1-month LIBOR
Notional value:	\$30.41 million
Amortization:	Indexed to 1998A financing trust outstanding loan portfolio
Fair value:	\$10 thousand payable
Maturity:	April 26, 2010

12. Employee Benefits

CEFI sponsors a 401(k) plan to which eligible employees may voluntarily contribute a percentage of their compensation. CEFI's Board of Directors determines the amount contributed by CEFI annually. CEFI's 401(k) plan expense was \$0.1 million for the year ended December 31, 2005.

CEFI also has a profit sharing benefit plan that covers employees who have provided at least five hundred and one hours of service each year. CEFI's contribution is determined annually by the CEFI Board of Directors and is based upon each employee's annual compensation. CEFI's total profit sharing benefit plan expense was \$0.3 million for the year ended December 31, 2005.

CEFI also has a nonqualified deferred compensation plan (the DCP) established to provide specified benefits to a select group of management. Contribution, vesting, and benefit provisions are as outlined in the plans. In May 2005, CEFI funded the DCP plan using corporate-owned life insurance carried by Sun Life Assurance Company of Canada (U.S.) owned by a Rabbi Trust through Wilmington Trust Bank. At December 31, 2005, the cash surrender value of this life insurance policy was \$1.5 million. The deferred compensation liability was \$1.6 million, and the deferred compensation expense for 2005 was \$0.2 million.

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Notes to Consolidated Financial Statements (continued)

12. Employee Benefits (continued)

The following table sets forth the DCP status, along with amounts recognized in TEFFC's consolidated statements of financial position for the year ended December 31, 2005:

Reconciliation of DCP cost:	
Accrued DCP cost at beginning of year	\$ (1,166,020)
Net periodic DCP credit	(220,344)
Plans' participant contributions	(950,957)
Benefits paid	<u>783,509</u>
Accrued DCP cost at end of year	\$ (1,553,812)
Cash surrender value of insurance policy	<u>1,496,840</u>
Unfunded status	<u>\$ 56,972</u>

13. Income Taxes

As a result of the Restructuring discussed in Note 2, CEFI, a newly created for-profit Delaware corporation, paid both federal and state income taxes totaling \$1.5 million in 2005. Because CEFI incurred a taxable net loss in 2005, there is no current income tax expense and the \$1.5 million is expected to be refunded in 2006 upon filing of the 2005 corporate income tax returns.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of CEFI's deferred tax liabilities and assets at December 31, 2005, are as follows:

Deferred tax assets:	
Accrued liabilities	\$ 886,109
Deferred installment sale loss	5,896,672
Tax loss carryforwards	1,255,593
Other	<u>141,340</u>
Net deferred tax assets	8,179,714
Valuation allowance	<u>(8,179,714)</u>
Net deferred taxes	<u>\$ -</u>

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Notes to Consolidated Financial Statements (continued)

13. Income Taxes (continued)

CEFI has provided a full valuation allowance on the net deferred tax assets due to uncertainties regarding the realization of deferred tax assets based on CEFI's lack of earnings history and nominal projected future earnings. The valuation allowance increased by \$8,179,714 during 2005.

CEFI, on a stand alone reporting basis apart from the Company, incurred a deferred tax expense of \$18.6 million relating to the realization of certain deferred tax assets upon the Nelnet loan sale. The deferred tax assets were created in the intracompany restructuring. Accordingly, the \$18.6 million expense was eliminated upon consolidation of the Company. No future tax liability exists with respect to the realization of these deferred tax assets.

As of December 31, 2005, CEFI had federal net operating loss carryforwards of approximately \$3.1 million. The net operating loss carryforwards will expire beginning in 2025, if not utilized.

Utilization of net operating losses may be subject to a substantial annual limitation due to the "change of ownership" provisions of the Internal Revenue Code of 1986. The annual limitation may result in the expiration of net operating losses before utilization.

CEFI's provision for income taxes differs from the expected tax benefit amount computed by applying the statutory federal income tax rate of 34% to loss before income taxes primarily due to the increase in the valuation allowance.

14. Fair Value of Financial Instruments

SFAS No. 107, *Disclosures About Fair Value of Financial Instruments*, requires an estimation of fair values of TEFFC's financial instruments. The following is a summary of the assumptions and methods used to estimate those values.

Cash and Equivalents

Fair value approximates carrying value based on the liquidity and short-term nature of the instruments.

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Notes to Consolidated Financial Statements (continued)

14. Fair Value of Financial Instruments (continued)

Investments

Fair value for investments with short-term remaining maturities (less than three months) is approximately carrying value. The fair value of variable rate guaranteed investment contracts approximates carrying value as the underlying interest rate of these investments over the anticipated holding period approximates current market rates. The fair value of the fixed rate investment contracts is estimated using discounted cash flow analyses, using then-prevailing market interest rates. The carrying value for the remaining investments, principally debt and equity securities, approximates fair value, as taken from market prices reported in brokerage and investment manager account statements.

Student Loans Receivable and Student Loans Receivable Held for Sale

The fair value of student loans receivable, with the exception of certain fixed rate loans, is deemed to be their carrying value. The fair value for fixed rate loans is estimated using discounted cash flow analyses, using then-prevailing market interest rates.

Bonds and Notes Payable, Asset-Backed Lines of Credit

The fair value approximates the carrying value as bonds, notes, and asset-backed lines of credit obligation interest rates are principally variable rates that regularly adjust to levels consistent with prevailing market interest rates. For fixed rate bonds and notes, the fair value is estimated using discounted cash flow analyses using then-prevailing market interest rates.

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Notes to Consolidated Financial Statements (continued)

14. Fair Value of Financial Instruments (continued)

Derivative Instruments

The fair value of interest rate derivatives approximates the carrying value. When available, independent fair value estimates are reported. When not available, fair value estimates are derived using discounted cash flow analyses, using then-prevailing market interest rates.

The following table summarizes the fair value of TEFFC's financial instruments as of December 31, 2005 (in thousands):

	Carrying Value	Fair Value
Assets		
Cash and equivalents	\$ 138,214	\$ 138,214
Investments	217,925	\$218,032
Student loan receivables*	163,382	175,038
Student loan receivables held for sale	181,758	188,828
Liabilities		
Bonds and note payable	40,192	40,610
Asset-backed lines of credit	113,000	113,000
Student loans held for sale funding provided by Nelnet	181,758	181,758
Derivative instruments	10	10

* The carrying value for student loans receivable includes net unamortized purchase premiums and origination costs, and allowance for loan losses, but excludes accrued interest receivable.

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Notes to Consolidated Financial Statements (continued)

15. Commitments, Contingencies, and Concentrations of Risk

Premises and Equipment Lease Commitments

The following is a schedule of future minimum rental payments required under operating leases, including TEFFC's office facilities and equipment that have remaining noncancelable terms in excess of one year at December 31, 2005:

2006	\$ 695,920
2007	697,449
2008	699,590
2009	276,835
2010	59,943
Total	<u>\$ 2,429,737</u>

The above future minimum rental payments under lease obligations includes the lease on the CEFI office premises in San Francisco equivalent to \$596,830 per annum in each of the years 2006 through 2008 and \$174,075 for part of 2009 though the expiration of the lease on April 16, 2009. From April 17, 2007 onward, this lease may be terminated at any time by CEFI upon payment of a termination fee. CEFI plans to exercise this termination option for a portion of the premises and to relinquish the remainder of the space back to the owner on two separate occasions (June 15, 2006, and September 30, 2006, respectively) during 2006, partially with and partially without a termination fee. The portion of the premises to be retained until April 17, 2007 has been subleased to a third party for a one-year period through March 31, 2007.

Taking the above lease terminations into account, the future minimum rental payment schedule excluding sublease rental income and termination fees is as follows:

2006	\$ 611,072
2007	255,314
2008	102,760
2009	102,760
2010	59,943
Total	<u>\$ 1,131,849</u>

The Education Financing Foundation of California

Notes to Consolidated Financial Statements (continued)

15. Commitments, Contingencies, and Concentrations of Risk (continued)

Premises and Equipment Lease Commitments (continued)

The total sublease income in 2006 and 2007 specified in the sublease agreement is \$270,439 and \$90,146, respectively, for a total of \$360,585 through expiration on April 17, 2007. In addition, for the first half of 2006, CEFI is being reimbursed by Nelnet in the amount of \$6,630 per month for space it occupies at CEFI's offices.

The termination fees with respect to the CEFI premises expected to be paid in 2006 total approximately \$72,000.

Total rental expense for the year ended December 31, 2005, was \$0.8 million.

16. Contingencies and Concentrations of Risk

From time to time, TEFFC may be involved as a party to certain legal proceedings and other claims arising in the normal course of its business. While litigation and claims resolution are subject to many uncertainties and cannot be predicted with assurance, it is management's opinion that any resulting losses would not have a material effect on TEFFC's financial statements.

TEFFC is subject to significant regulations and administrative rules imposed by various regulatory bodies. These rules and regulations are subject to legislative changes and departmental interpretation that may change over time. It is possible that future legislative changes or interpretations of administrative rules and regulations may result in changes to TEFFC's financial position.

TEFFC's credit risk is inherent principally in its student loans receivable. Adverse economic conditions either regionally or nationwide may result in an increase in student loan borrower defaults.