AARP

Consolidated Financial Statements
December 31, 2004 and 2003
With Independent Auditors' Report Thereon

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December 31, 2004 and 2003

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KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report

The Board of Directors of AARP:

We have audited the accompanying consolidated statements of financial position of AARP as of December 31, 2004 and 2003, and the related consolidated statements of activities and cash flows for the years then ended. These consolidated financial statements are the responsibility of AARP management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control 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 AARP'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 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 AARP at December 31, 2004 and 2003, 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.

KPMG LLP

March 24, 2005

AARP
Consolidated Statements of Financial Position
December 31, 2004 and 2003
(in thousands)

	2004	2003
Current assets:		
Cash and cash equivalents	$ 333,579	$ 254,657
Investments committed to current operating reserves (Note 4)	3,262	30,109
Investments committed to current portion of deferred membership dues and postretirement health benefits (Note 4)	179,529	177,282
Investments committed to insurance premiums payable (Note 4)	355,084	345,774
Accounts receivable, net (Note 5)	41,138	28,578
Prepaid expenses and other current assets	31,559	16,286
Total current assets	944,151	852,686
Noncurrent assets:		
Investments committed to non-current operating reserves (Note 4)	228,366	186,119
Investments committed to noncurrent portion of deferred membership dues and postretirement health benefits (Note 4)	178,413	173,557
Deferred tax asset (Note 8)	1,837	1,454
Property and equipment, net (Note 6)	223,811	231,976
Prepaid pension asset (Note 10)	25,271	30,686
Other noncurrent assets	3,191	2,672
Total assets	$ 1,605,040	$ 1,479,150
Current liabilities:		
Accounts payable and accrued expenses	$ 101,969	$ 93,333
Insurance premiums payable (Note 3)	562,286	510,794
Current portion of deferred membership dues	177,407	175,638
Current portion of postretirement health benefits liability (Note 11)	2,122	1,644
Deferred revenue and other current liabilities	13,492	14,291
Total current liabilities	857,276	795,700
Noncurrent liabilities:		
Notes payable (Note 7)	232,342	248,988
Deferred membership dues, net of current portion	111,017	107,773
Postretirement health benefits liability, net of current portion (Note 11)	67,396	65,784
Other noncurrent liabilities	4,513	4,288
Total liabilities	1,272,544	1,222,533
Commitments and contingencies (Note 15)		
Net assets:		
Unrestricted:		
Undesignated	237,774	196,866
Board designated (Note 14)	91,760	58,738
Total unrestricted net assets	329,534	255,604
Temporarily restricted	2,962	1,013
Total net assets	332,496	256,617
Total liabilities and net assets	$ 1,605,040	$ 1,479,150

See accompanying notes to consolidated financial statements.

AARP
Consolidated Statement of Activities
Year Ended December 31, 2004
(in thousands)

	2004		
	Unrestricted	Temporarily Restricted	Total
Operating revenues:			
Membership dues	$ 223,767	$ -	$ 223,767
Royalties and service provider relationship management fees (Note 3)	350,053	-	350,053
Publications advertising	93,121	-	93,121
Federal and other grant revenues (Note 9)	82,713	-	82,713
Investment income (Note 4)	62,105	-	62,105
Program income	28,468	-	28,468
Contributions	32,230	2,326	34,556
Other operating income	2,856	-	2,856
Net assets released from restrictions	377	(377)	-
Total operating revenues	875,690	1,949	877,639
Operating expenses:			
Program services:			
Programs and field services	240,280	-	240,280
Publications	154,590	-	154,590
Member services	174,878	-	174,878
Legislation and research	61,299	-	61,299
Total program services	631,047	-	631,047
Supporting activities:			
Membership development	46,118	-	46,118
Management and general	122,683	-	122,683
Total supporting activities	168,801	-	168,801
Total operating expenses	799,848	-	799,848
Change in net assets from operations	75,842	1,949	77,791
Other income (expenses):			
Investment income from sinking fund (Note 7)	3,224	-	3,224
Income taxes (Note 8)	(5,136)	-	(5,136)
Change in net assets	73,930	1,949	75,879
Net assets, beginning of year	255,604	1,013	256,617
Net assets, end of year	$ 329,534	$ 2,962	$ 332,496

See accompanying notes to consolidated financial statements.

AARP
Consolidated Statement of Activities
Year Ended December 31, 2003
(in thousands)

	2003		
	Unrestricted	**Temporarily Restricted**	**Total**
Operating revenues:			
Membership dues	$ 210,790	$ -	$ 210,790
Royalties & service provider relationship management fees (Note 3)	299,192	-	299,192
Publications advertising	77,602	-	77,602
Federal & other grant revenues (Note 9)	68,872	-	68,872
Investment income (Note 4)	60,326	-	60,326
Program income	22,003	-	22,003
Contributions	26,293	310	26,603
Other operating income	4,236	-	4,236
Net assets released from restrictions	200	(200)	-
Total operating revenues	769,514	110	769,624
Operating expenses:			
Program services:			
Programs and field services	196,118	-	196,118
Publications	139,020	-	139,020
Member services	147,853	-	147,853
Legislation and research	58,781	-	58,781
Total program services	541,772	-	541,772
Supporting activities:			
Membership development	37,943	-	37,943
Management and general	109,690	-	109,690
Total supporting activities	147,633	-	147,633
Total operating expenses	689,405	-	689,405
Change in net assets from operations	80,109	110	80,219
Other income (expenses):			
Investment income from sinking fund (Note 7)	3,065	-	3,065
Income taxes (Note 8)	(4,300)	-	(4,300)
Change in net assets	78,874	110	78,984
Net assets, beginning of year	176,730	903	177,633
Net assets, end of year	$ 255,604	$ 1,013	$ 256,617

See accompanying notes to consolidated financial statements.

AARP
Consolidated Statements of Cash Flows
Years Ended December 31, 2004 and 2003
(in thousands)

	2004	2003
Cash flows from operating activities:		
Change in net assets	$ 75,879	$ 78,984
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	22,389	23,712
Reduction in uncollectible accounts	(426)	(808)
Net realized and unrealized gains on investments	(37,267)	(31,387)
Deferred income taxes	(383)	(261)
Amortization of premium on investments	1,563	836
Changes in operating assets and liabilities:		
(Increase) Decrease in accounts receivable	(12,134)	5,420
(Increase) Decrease in prepaid expenses and other current assets	(15,273)	9,709
Decrease (Increase) in prepaid pension asset	5,415	(62,339)
(Increase) Decrease in other noncurrent assets	(519)	1,402
Increase in accounts payable and accrued expenses	8,636	21,894
Increase in insurance premiums payable	51,492	58,541
Increase in deferred membership dues	5,013	4,671
(Decrease) Increase in deferred revenue and other current liabilities	(799)	13,408
Increase in postretirement health benefits liability	2,090	1,263
Increase in other noncurrent liabilities	225	1,927
Total adjustments	30,022	47,988
Net cash provided by operating activities	105,901	126,972
Cash flows from investing activities:		
Capital expenditures for property and equipment	(14,202)	(15,696)
Proceeds from sale and maturities of investments	1,157,415	1,364,465
Purchases of investments	(1,153,524)	(1,509,410)
Net cash used by investing activities	(10,311)	(160,641)
Cash flows from financing activities:		
Payment on commercial bank borrowings	(16,668)	-
Payment on bonds	(25,000)	-
Proceeds from borrowings	25,000	50,000
Net cash (used) provided by financing activities	(16,668)	50,000
Net increase in cash and cash equivalents	78,922	16,331
Cash and cash equivalents, beginning of year	254,657	238,326
Cash and cash equivalents, end of year	$ 333,579	$ 254,657
Supplemental disclosures:		
Cash paid for interest	$ 12,481	$ 13,151
Cash paid for income taxes	$ 8,294	$ 3,939

See accompanying notes to consolidated financial statements.

1. Description of Organizations and Activities

(a) AARP, Inc.

AARP, Inc. was organized in 1958 as a District of Columbia not-for-profit corporation for the purpose of promoting the interests of older persons. AARP, Inc. is qualified as a tax-exempt social welfare organization under Section 501(c)(4) of the Internal Revenue Code (IRC). The mission of AARP, Inc. is to meet the needs and promote the interests of persons 50 and older through education, advocacy and service programs designed to enhance the quality of life for all while promoting independence, dignity, and purpose of older persons. The programs and activities of AARP, Inc. and its affiliates include education, advocacy, research, social welfare activities, and charitable programs serving the needs of older persons.

AARP, Inc.'s programs, activities and operations are managed and supported primarily from its National Headquarters in Washington, D.C. AARP, Inc. and its affiliates also have local offices in 53 states and U.S. territories, a membership processing center located in Lakewood, California, and an advertising sales office in New York City.

(b) AARP Services, Inc.

AARP Services, Inc. (AARP Services) is a wholly owned taxable subsidiary of AARP, Inc., and was incorporated in Delaware in 1998. AARP, Inc. contracts with AARP Services to provide consulting and other services relating to the design, development, marketing and management of products and services available to AARP, Inc. members as part of their membership benefits, or offered as AARP-approved supplemental products and services which may be purchased by members from third parties for an additional cost. AARP Services receives fees from AARP, Inc. for specific services including new product development, marketing services, quality control services, and AARP Webplace design and maintenance. In addition, AARP Services receives a portion of the contractual payments generated from these membership benefit programs as a service provider relationship management fee.

(c) AARP Foundation

The AARP Foundation (the Foundation) was organized in 1961 as a District of Columbia not-for-profit corporation. The goals of the Foundation are to lead positive social change, enhance the quality of life for all and deliver value to those 50 and older through information, education and service. The AARP Foundation, an AARP affiliated charity, is a qualified nonprofit organization under Section 501(c)(3) of the Internal Revenue Code and is therefore exempt from federal income taxes on its charitable operations. In addition, the Foundation is a public charity as defined in Section 509 (a)(1) of the Internal Revenue Code. The AARP Foundation receives funding principally from the federal government, AARP,

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foundations, corporations and individuals. The Foundation's Board of Directors is composed of seven members appointed by AARP Inc.'s Board of Directors.

The Foundation manages and reports the activities of another AARP, Inc. affiliate, AARP Institute (the Institute). The Institute qualifies as a tax-exempt organization under Section 501 (c) (3) of the IRC.

(d) Legal Counsel for the Elderly

Legal Counsel for the Elderly (LCE) was incorporated in the District of Columbia in 1980 for the purpose of providing free legal assistance and education to the elderly, primarily in the District of Columbia. LCE publishes manuals, conducts seminars on issues affecting the elderly, and operates legal services and long-term care ombudsman programs. LCE qualifies as a tax-exempt charitable organization under Section 501(c)(3) of the IRC. Funding for LCE is obtained primarily through contributions from AARP and grants. LCE's board of directors is comprised of seven members appointed by AARP, Inc.'s Chief Executive Officer.

(e) AARP Insurance Plan

The AARP Insurance Plan (the Plan) is a grantor trust established by an Agreement and Declaration of Trust for the purpose of making certain types of insurance available to AARP, Inc. members. Insurance premiums are collected directly from participants and are forwarded to third-party insurance carriers after agreed upon deductions from the Plan for expenses, royalties, and service fees. The Plan is administered by a board of trustees appointed by the Board of Directors of AARP, Inc.

(f) Other Affiliates

The AARP headquarters building located in Washington, D.C. and the related parking garage facilities are owned and operated by the following affiliates: AARP Properties LLC (Properties LLC), a wholly owned subsidiary of AARP, Inc.; AARP Financial Services Corp. (FSC), a wholly owned taxable subsidiary of AARP, Inc.; and AARP FSC LLC (FSC LLC), a wholly owned subsidiary of FSC.

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2. Summary of Significant Accounting Policies

(a) Basis of Presentation

These consolidated financial statements are prepared on the accrual basis of accounting and include the accounts of AARP Inc., AARP Services, Inc, AARP Foundation, AARP Institute, Legal Counsel for the Elderly, AARP Insurance Plan, AARP Properties LLC, AARP Financial Services Corp., and AARP FSC LLC (collectively, AARP).

All significant intercompany transactions have been eliminated in consolidation. The consolidated financial statements do not include the operations and accounts of over 2,500 local chapters of AARP that are organized and operated as separate entities. AARP neither controls nor derives beneficial economic interest from these organizations, as defined by accounting principles generally accepted in the United States.

AARP summarizes the costs of providing and managing its various programs and supporting activities on a functional basis in the accompanying consolidated statements of activities. Accordingly, certain operating costs are allocated among the program services and supporting activities that benefit from them based on specific identification or reasonable allocation methodologies.

(b) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect reported amounts and disclosures in the financial statements. Although actual results could differ from these estimates, management does not believe that such differences will be material.

(c) Cash Equivalents

Investments with original maturities of three months or less are reported as cash equivalents. As of December 31, 2004 and 2003, $209,700,000 and $167,038,000, respectively, is restricted for the payment of member insurance premiums.

(d) Accounts Receivable

AARP reserves for estimated uncollectible accounts based on the aging of outstanding accounts receivable and management's estimate of their net realizable values.

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(e) Investments

Investments in debt securities, institutional mutual funds, certain equity securities and derivative financial instruments are measured and reported at fair value. Classification of current and non-current investments in the accompanying consolidated statements of financial position is determined by management based on maturities of the investments and intentions for use of the funds. Changes in fair value are reported as investment income in the accompanying consolidated statements of activities.

(f) Property and Equipment

Property and equipment are stated at cost. Computer software is composed of external and certain qualifying internal costs related to software development. Management periodically evaluates whether events or circumstances have occurred indicating that the carrying amount of long-lived assets may not be recovered. If the sum of the undiscounted expected future cash flows is less than the carrying amount of an asset, AARP recognizes an impairment loss based on the amount by which the carrying amount of the asset exceeds the fair value of the asset. Depreciation and amortization are calculated using the straight-line method over the lesser of the estimated useful lives of the assets or the lease term. The lives used range from three to 30 years. Maintenance and repair costs are expensed as incurred.

(g) Membership Dues

Membership dues are deferred upon receipt and recognized as revenue ratably over the membership term of one, two or three years.

(h) Royalties and Service Provider Relationship Management Fees

Royalties and service provider relationship management fees are received from AARP-approved third-party providers of member benefit programs, in return for the rights to use AARP, Inc.'s intellectual property (including its brand name, logo, and member list) in marketing such programs. These royalties and fees are recognized as revenue when earned.

(i) Publications Advertising

AARP sells advertising space in its major publications, which are provided to members without additional charge as part of their membership benefits. Advertising revenue is recognized as earned, in the month of the issue date.

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(j) Federal and Other Grant Revenues

Federal and other grant revenues are recognized to the extent that qualifying expenditures under program agreements with federal agencies or other program providers are incurred. Amounts recorded as federal and other program grant receivables are for grant expenses incurred in advance of the receipt of funds. Funds received in advance of incurred grant expenses are reported as other current liabilities.

(k) Program Income

Certain AARP affiliates receive service fees from providers of and participants in member programs, for consulting, marketing and specific program services. These fees are recognized as earned.

(l) Contributions and Fundraising Expense

Contributions are recognized as revenue when received or pledged by the donor. Contributions received with restrictions for time or for use on a specific program are reported as temporarily restricted. Contributions whereby the principal amount may not be expended, but income earned from related investments is available for donor-specified or general operating purposes, are classified as permanently restricted.

When the time or program use restrictions are met, the temporarily restricted net assets are reclassified to unrestricted net assets and are reported as net assets released from restrictions in the accompanying statements of activities. For those restricted contributions where the contribution is received and the restriction is met during the same year, the contributions are reported as unrestricted.

Contributions revenue includes cash contributions received in support of both charitable and advocacy program activities, as well as in-kind contributed professional services. Contributed services were $15,673,000 and $12,046,000 for the years ended December 31, 2004 and 2003, respectively.

Fundraising expenses, which are reported as part of management and general expenses, were $14,225,000 and $13,785,000 for the years ended December 31, 2004 and 2003, respectively.

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(m) Volunteer Services

AARP and its members benefit from the efforts of many volunteers. These in-kind contributions by volunteers are not recorded as revenue in the consolidated financial statements, because they do not meet the requirements for recognition under accounting principles generally accepted in the United States of America. Travel and subsistence costs

incurred by these volunteers in carrying out their duties are reimbursed by AARP and are therefore included as an expense in the accompanying consolidated statements of activities.

(n) Income Taxes

AARP accounts for income taxes in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, *Accounting for Income Taxes*. AARP Inc.'s taxable subsidiaries, AARP Services and FSC, are subject to income taxes. AARP Inc. is also subject to income taxes in years when unrelated business income, primarily publication advertising, is in excess of deductible expenses.

(o) Financial Instruments

At December 31, 2004 and 2003, the carrying value of financial instruments such as cash equivalents, accounts receivable, and accounts payable approximated their fair value, based on the short-term maturities or floating interest rates of these instruments. The fair values of investments and notes payable are discussed in notes 4 and 7, respectively.

(p) Measure of Operating Results

AARP reports as operating all activities except for any required provision for federal and state income taxes and investment income earned on debt sinking funds.

(q) Advertising Expenses

AARP expenses advertising costs as incurred. These costs include brand awareness, member acquisition and retention, member program marketing, and advocacy advertising. For the years ended December 31, 2004 and 2003, advertising expense was $91,946,000 and $73,512,000 respectively.

(r) Reclassifications

Certain reclassifications have been made to 2003 reported amounts to conform to the 2004 presentation.

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3. Member Insurance Program

AARP makes certain types of insurance available to its members through a grantor trust called the AARP Insurance Plan (the Plan). Agreements between AARP, Inc., AARP Services, the Plan, United HealthCare Corporation (United) and the Metropolitan Life Insurance Company (MetLife) make Medicare supplement health insurance coverage and long-term care insurance coverage available to AARP members under the Plan. A separate agreement with The Hartford Fire Insurance Company (Hartford) provides for member services, payment processing, and accounting services to the Plan.

The Plan collects insurance premiums from participating members and is required to remit such payments to United and MetLife within a contractually specified period of time. The portion of premiums collected from insured members that are subsequently remitted to carriers are separately invested in short-term securities and recorded with an offsetting liability "Insurance Premiums Payable". For the years ended December 31, 2004 and 2003, AARP earned net investment income on these short term funds of $22,932,000 and $24,432,000, respectively, which is included in investment income in the accompanying consolidated statements of activities.

AARP retains a portion of the total premiums collected to pay the operating expenses of the Plan, as royalties for the use of its intellectual property, and as fees for service provider relationship management. These sources of compensation to AARP are reported as royalties and service provider relationship management fees in the consolidated statements of activities. For the years ended December 31, 2004 and 2003, AARP earned total royalties and service provider relationship management fees of $197,345,000 and $167,549,000, respectively, from the Plan.

For the years ended December 31, 2004 and 2003, the Plan processed $5.0 billion and $4.5 billion, respectively, of premium payments from member participants.

As of December 31, 2004 and 2003, insurance premiums payable is comprised of the following:

(In thousands)	2004	2003
Premiums payable to the insurance underwriters	$ 408,699	$ 373,069
Payments received in advance	142,701	126,389
Partial and unprocessed payments	10,886	11,336
Total insurance premiums payable	$ 562,286	$ 510,794

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4. Investments

Reported investment values are based on or derived from quoted prices as reported to AARP by its investment custodial bank or PIMCO. The institutional mutual funds are comprised of fixed income securities and are managed by PIMCO. AARP's investments by type of security and by management intention are as follows at December 31, 2004 and 2003:

(In thousands)	Investments at Fair Value as of December 31, 2004	2003
U.S. government and agency obligations	$ 55,091	$ 70,699
Mortgage-backed securities	130,292	117,066
Fixed income securities	103,037	162,186
Equities securities	303,668	185,393
Institutional mutual funds:		
U.S. government portfolio	159,029	148,581
Mortgage portfolio	101,686	74,600
Municipal portolio	7,580	2,798
Corporate portfolio	15,059	27,015
International portfolio	35,203	11,749
Short term fund	4,090	67,367
Asset backed fund	5,818	6,550
Real return fund	26,026	27,403
Private emerging markets bond fund	11,181	15,507
Book value wrapper contract	(13,106)	(4,073)
Total investments	$ 944,654	$ 912,841
Investments committed to:		
Current operating reserves	$ 3,262	$ 30,109
Non-current operating reserves	228,366	186,119
Insurance premiums payable	355,084	345,774
Current portion of deferred membership dues and postretirement health benefits	179,529	177,282
Non-current portion of deferred membership dues and postretirement health benefits	178,413	173,557
Total investments	$ 944,654	$ 912,841

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The synthetic Book Value Wrapper Contract (BV Wrapper) with AIG Financial Products Corporation and AEGON Institutional Markets was entered into to provide a higher degree of predictability for overall investment returns and to reduce the short-term impact of significant fluctuations in the financial markets.

The BV Wrapper has two components – a portfolio of investment securities and a third-party book value "put" feature. The agreement establishes, on a quarterly basis, a specific guaranteed return based on the nature of the underlying portfolio, historical gains and losses of the portfolio, and certain other factors. AARP retains legal title to the underlying investment portfolio and controls investment related risks by setting investment guidelines.

As of December 31, 2004 and 2003, the market value of the investment portfolio underlying the BV Wrapper was $262,251,000 and $243,208,000, respectively, and the value of the BV Wrapper as a whole was $249,145,000 and $239,135,000, respectively. The market value of the investment portfolio as determined by AARP's investment managers, and the market value of the BV Wrapper as determined by AIG and AEGON, have been netted to determine the reported value of the total position. The associated net loss amounted to ($9,033,000) and ($20,406,000) for the years ended December 31, 2004 and 2003 respectively, and is included as a component of investment income in the accompanying statements of activities.

Investment income, excluding the return on the Board-approved sinking fund (see note 7), for the year ended December 31 was comprised of:

(In thousands)	2004	2003
Interest and dividend income	$ 27,183	$ 31,776
Net gain	34,922	28,550
Investment income	$ 62,105	$ 60,326

(Continued)

5. Accounts Receivable

Accounts receivable as of December 31 are as follows:

(In thousands)	2004	2003
Royalties & service provider relationship management fees	$ 16,842	$ 16,683
Program fees	3,900	259
Publication advertising	8,412	4,843
Interest and dividends	2,579	3,149
Federal and other program grants	5,130	1,785
Other	4,496	2,506
Gross accounts receivable	41,359	29,225
Allowance for doubtful accounts	(221)	(647)
Accounts receivable, net	$ 41,138	$ 28,578

6. Property and Equipment

Property and equipment as of December 31 are as follows:

(In thousands)	2004	2003
Land	$ 41,942	$ 41,942
Buildings and improvements	166,126	165,411
Furniture and equipment	74,457	68,747
Computer software	29,223	26,452
Leasehold improvements	5,679	5,526
Less: Accumulated depreciation	(93,616)	(76,102)
Property and equipment, net	$ 223,811	$ 231,976

7. Notes Payable

On May 1, 2001, AARP issued unsecured fixed rate debentures and unsecured variable rate notes in the amounts of $125,000,000 and $75,000,000 respectively, for permanent financing of the AARP Headquarters Building. On December 1, 2004 AARP made debt repayments of $25,000,000 on the unsecured variable notes.

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The fixed rate debentures carry an interest rate of 7.5% and mature on May 1, 2031. Interest is payable semi-annually on May 1 and November 1 of each year. The variable rate notes also mature on May 1, 2031, and carry an interest rate which is revalued each week to establish the accurate market rate for their respective note rating. Interest on the variable rate notes is payable monthly in arrears. As of December 31, 2004 and 2003, the variable rate notes had an interest rate of 2.32% and 1.17%, respectively.

Based on the borrowing rates currently available to AARP for fixed rate bonds with similar terms and average maturities, the fair value of the $125,000,000 fixed rate debentures is approximately $155,342,000 and $149,833,000 as of December 31, 2004 and 2003, respectively.

In 2001, three interest rate swap agreements (Swaps), each covering $25,000,000 of the variable rate notes, were executed to manage the variability of the interest expense associated with the floating rate debt. Under the Swap agreements, AARP pays fixed annual rates of 5.40%, 5.42%, and 3.61%, and receives an amount based on the notional amount of each Swap at an interest rate equal to the current U.S. Dollar London Interbank Offered Rate (LIBOR). The terms of the swaps provide for net receipt or payment on the first of each month. The Swaps are reported at their fair value on the accompanying consolidated statements of financial position, and changes in the fair value are recorded as a component of interest expense in the accompanying statements of activities. The net interest accrual, which is the difference between the monthly fixed payment on the Swap and the variable receipt from the Swap counter-party, is recorded as interest expense together with the interest expense on the fixed rate debt in the accompanying statements of activities. The Swap agreement with the fixed rate of 3.61% matured on December 1, 2003. As of December 31, 2004 and 2003, the Swaps are valued at a loss of $1,373,000 and $2,378,000, respectively.

In 2001, the AARP board of directors authorized the creation and funding of a Sinking Fund for the purpose of repayment of outstanding notes and bonds payable. The designated minimum funding is $3,600,000 per year, to be transferred on or about January 1 of each year. The balance in the Sinking Fund as of December 31, 2004 and 2003 was $34,490,000 and $27,801,000, respectively, and the Sinking Fund assets are included in investments in the accompanying consolidated statements of financial position. The net investment income for the Sinking Fund investments for the years ended December 31, 2004 and 2003 was $3,224,000 and $3,065,000, respectively.

On September 25, 2003, AARP obtained an unsecured $50,000,000 loan from a commercial bank, maturing September 30, 2006. The loan bears a variable rate of interest at 30 day LIBOR plus 18 basis points and is payable in monthly payments of accrued interest only, beginning November 1, 2004. During 2004, AARP made total repayments on the loan of $16.7 million.

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On October 21, 2004, the Foundation issued 30 year District of Columbia Variable Rate Revenue Bonds Series 2004 in the amount of $25,000,000, due October 1, 2034, to finance the purchase of two condominium units located within the AARP Headquarters building at 601 E Street NW, Washington, DC. The bonds bear interest at a variable rate determined by the Remarketing Agent, based upon market conditions of reselling the bonds in a secondary market sale. Accrued interest is payable monthly. The Foundation may elect at anytime to convert to a fixed interest rate.

The Foundation has obtained a letter of credit to secure repayment of the bond financing of its office space. The letter of credit constitutes an irrevocable obligation to pay the bond trustee up to an amount equal to the sum of the principal amount of the Series 2004 Bonds outstanding, plus an amount equal to interest for 35 days on the principal amount of each Bond outstanding.

Total interest expense incurred for the years ended December 31, 2004 and 2003 was $11,400,000 and $10,977,000, respectively.

8. Income Taxes

The significant components of the provision for income taxes are as follows for the years ended December 31, 2004 and 2003, respectively:

The significant components of income tax expense as of December 31, 2004 and 2003 are as follows:

(In thousands)	2004	2003
Current:		
Federal income tax	$ 4,069	$ 3,421
State income tax	1,451	1,140
Current income tax expense	5,520	4,561
Deferred:		
Federal income tax	(288)	(187)
State income tax	(96)	(74)
Deferred income tax benefit	(384)	(261)
Total income tax expense	$ 5,136	$ 4,300

(Continued)

The significant components of the deferred tax asset at December 31, 2004 and 2003 were as follows:

(In thousands)	2004	2003
Deferred income tax assets:		
Employee benefits	$ 749	$ 501
Accrued start-up expenses	1,151	590
Depreciation	26	5
Deferred revenue	6	678
Total deferred income tax assets	1,932	1,774
Deferred income tax liability:		
Pension expense	$ (75)	$ (301)
Property tax expense	(20)	(19)
Net deferred income tax asset	$ 1,837	$ 1,454

9. Federal and Other Grants

AARP administers grants received from federal agencies and private organizations. The two largest grant programs are described below:

- **Senior Community Service Employment Program** (SCSEP) provides subsidized assignments and job training for persons 55 and older whose income is at or below 125% of the federal poverty level. The SCSEP project is primarily funded by the U.S. Department of Labor. The current commitment expires in June 2005.

- **Tax Counseling for the Elderly** (Tax-Aide) provides volunteer assistance for federal income tax preparation to low and moderate income persons, with special attention to those 60 and older throughout the country. In the 2004 and 2003 tax seasons, approximately 1,890,000 and 1,900,000 older persons were assisted. The Tax-Aide project is primarily funded by the Internal Revenue Service. The current commitment expires in September 2005.

Included in grant revenues from sponsoring agencies are reimbursements for enrollees, facility costs, office expenses, and other allowable costs.

The continuation of all grant programs for fiscal year 2005 and beyond is subject to commitment of funds by sponsoring agencies.

10. Defined Benefit Pension Plan

Eligible employees of AARP and its affiliates participate in a noncontributory defined benefit pension plan called the AARP Employees' Pension Plan (the Plan). The Plan covers all employees meeting eligibility service requirements. Plan assets, investment income and administrative expenses generally are allocated to the participating affiliates in proportion to the related projected benefit obligation. AARP's funding policy is to contribute an amount equal to or greater than the minimum funding requirements of the Employee Retirement Income Security Act of 1974, as actuarially determined, calculated on a level percentage of payroll costs basis, but not greater than the maximum tax deductible limit. Plan assets are invested in equity and fixed income securities managed by outside fund managers.

In 2004, employer contributions to the Plan were $5,000,000. In 2003, employer contributions to the Plan were $67,078,000. AARP is not required to make a contribution to the Plan in 2005. However, supplemental contributions may be made that are not estimable at this time.

The net periodic pension expense for the years ended December 31, 2004 and 2003, was $10,431,000 and $6,388,000, respectively.

(Continued)

The plan's measurement date is September 30. The following sets forth the funded status of the Plan and prepaid pension asset shown in the accompanying consolidated statements of financial position at December 31:

(In thousands)	2004	2003
Change in benefit obligation:		
Benefit obligation at beginning of year	$ (226,839)	$ (188,907)
Service cost	(11,862)	(9,458)
Interest cost	(13,322)	(12,118)
Actuarial loss	(14,210)	(22,507)
Benefits paid	5,767	6,151
Benefit obligation at end of year	$ (260,466)	$ (226,839)
Change in plan assets:		
Fair value at beginning of year	$ 212,820	$ 129,003
Actual return on plan assets	17,517	12,216
Contribution to the plan	5,000	67,078
Actuarial gain	3,143	10,674
Benefits paid	(5,767)	(6,151)
Fair value at end of year	$ 232,713	$ 212,820
Funded status	$ (27,753)	$ (14,019)
Unrecognized net actuarial loss	52,430	43,322
Unrecognized prior service cost	594	1,383
Prepaid pension asset	$ 25,271	$ 30,686

The assumptions used to determine the benefit obligation in the actuarial valuations at the September 30, 2004 and 2003 measurement dates are as follows:

	2004	2003
Discount rate	5.80%	5.95%
Expected long-term rate of return	8.50%	8.50%
Future salary increases	4.00%	4.00%

(Continued)

The assumptions used to determine net periodic benefit cost in the actuarial valuations at the September 30, 2004 and 2003 measurement dates are as follows:

	2004	2003
Discount rate	5.95%	6.50%
Expected long-term rate of return	8.50%	8.50%
Future salary increases	4.00%	4.00%

As of December 31, 2004 and 2003, the weighted-average asset allocation for the Plan is as follows:

	2004	2003
Asset Categories:		
Equity securities	70%	67%
Debt securities	29%	32%
Cash equivalents	1%	1%
	100%	100%

The targeted allocation of the investment assets in the Plan is for equities to comprise 65% of the investment portfolio and debt securities to comprise the remaining 35%. These targets are not intended to serve as a rigid constraint on the investment allocation. The following chart sets out the minimum and maximum positions for the various asset classes in the Plan:

Asset Class:	Minimum	Target	Maximum
Equity securities	35%	65%	70%
Debt securities	30%	35%	65%
Cash equivalents	0%	0%	15%

The following benefit payments, which reflect expected future service, are expected to be paid:

2005	$ 6,695,000
2006	7,262,000
2007	7,760,000
2008	8,323,000
2009	9,109,000
Years 2010-2014	59,804,000

(Continued)

11. Postretirement Health Benefits

All employees of AARP and its affiliates may become eligible for continuing health care benefits after retirement if they meet minimum age and service requirements and are covered by an AARP employee health insurance plan at the date of retirement. Healthcare benefits are provided through the AARP Employees' Welfare Plan (the Welfare Plan).

The net postretirement health benefits expense for the Welfare Plan for the years ended December 31, 2004 and 2003 was $4,040,000 and $3,092,000, respectively.

The actuarial benefit obligation and the accrued liability for post-retirement health benefits at December 31 were as follows:

(In thousands)	2004	2003
Actuarial present value of benefit obligation	$ 55,563	$ 58,822
Accrued postretirement health benefits	$ 69,518	$67,428

As of December 31, 2004 and 2003, the weighted-average discount rate used in the actuarial valuation is as follows:

	2004	2003
End of year benefit obligation	5.80%	5.95%
Net periodic benefit cost	5.95%	6.50%

For measurement purposes, the health care cost trend rate is 9.0 percent for 2004 (the rate is assumed to decrease gradually to 5.5 percent through 2008 and remain level thereafter).

Actual postretirement health care costs paid by the Welfare Plan were approximately $2,143,000 and $2,033,000 in 2004 and 2003, respectively. Retiree health benefits are paid as covered expenses are incurred. Based upon the actuarial analysis set out above, AARP has committed investments of $69,518,000 and $67,428,000 at December 31, 2004 and 2003, respectively, for postretirement health benefit liabilities. This obligation is based upon AARP's current policy, and such amounts have not been contributed to the Welfare Plan, and therefore the related investment income has remained available for the general operations of AARP.

(Continued)

On December 8, 2003, the President signed into law the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act). The Act introduces a prescription drug benefit under Medicare (Medicare Part D) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to

Medicare Part D. FASB Statement 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (FAS 106), requires presently enacted changes in relevant laws to be considered in current period measurements of postretirement benefit costs and the APBO.

AARP adopted FASB 106-2, *Accounting and Disclosure Requirement Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*, which supersedes FASB 106-1, retroactive to the beginning of 2004. Management believes that the prescription drug benefit under the Welfare Plan is actuarially equivalent to Medicare Part D. In addition, management believes that the subsidy will reduce AARP's obligation related to the underlying postretirement prescription drug coverage on which the subsidy is based. The expected subsidy reduced the accumulated postretirement benefit obligation at January 1, 2004 by $9.3 million. In addition, the aggregate effect on service costs, interest cost and amortization of gains and losses results in a $1.8 million reduction in the annual net postretirement health benefits expense in 2004.

12. Employee Health Care Benefits

AARP operates under a "pay as you go" model for employee health benefits, with obligations being funded out of general corporate assets. For the years ended December 31, 2004 and 2003, expenses for the AARP Welfare Plan for current health care benefits were $12,926,000 and $10,694,000, respectively. For the years ended December 31, 2004 and 2003, AARP had a liability related to these benefits of $4,159,000 and $4,060,000, respectively, which is included in accounts payable and accrued liabilities on the statement of financial position.

13. Defined Contribution Plan

Effective January 1, 1998, AARP and certain affiliates participate in a single-employer defined contribution plan through the AARP Employees' 401(k) Plan (the 401(k) Plan). There are no age or service requirements to participate in the 401(k) Plan.

AARP provides an employer contribution to the 401(k) Plan, which matches 100% of employee contributions up to 3% of employee compensation, and 50% of employee contributions for the next 2% of employee compensation, up to the maximum limit allowed by law. For the years ended December 31, 2004 and 2003, AARP employer contributions to this plan totaled approximately $4,342,000 and $3,984,000, respectively.

(Continued)

14. Board Designated Unrestricted Net Assets

Board designated net assets at December 31, 2004 and 2003 are available to fund the following:

(In thousands)	2004	2003
Debt retirement sinking fund	$ 34,490	$ 27,801
Investment earnings reserve	41,745	18,294
Foundation quasi endowment	11,027	10,000
LCE quasi endowment	2,296	-
Other board designations	2,202	2,643
Board designated net assets	$ 91,760	$ 58,738

15. Commitments and Contingencies

(a) Lease commitments

AARP leases offices, information centers, and warehouse facilities in 90 locations in the U.S. and its territories under operating leases with various lease terms. Total rent expense incurred under operating leases was $14,111,000 and $15,236,000 in 2004 and 2003, respectively.

Future minimum lease payments, exclusive of additional operating costs, at December 31, 2004 are:

(In thousands)	
2005	$ 13,493
2006	12,245
2007	10,588
2008	9,416
2009	5,695
2010 and thereafter	10,817
	$ 62,254

(b) Contingencies

In the normal course of business, AARP is involved in various claims and lawsuits. Management believes that at December 31, 2004 any liability that results from resolving these claims for damages will not materially impact AARP's financial position or changes in its net assets.

16. Subsequent Event

On January 3, 2005, AARP purchased condominium office units at a total cost of $32,638,000. In connection with the transaction, AARP obtained an unsecured loan of $15,000,000 with a commercial bank. As of December 31, 2004, AARP made a deposit payment toward the condominium purchase in the amount of $3,500,000 which is included in prepaid expenses and other current assets on the Statement of Financial Position. Two single member LLCs were created in 2004 to hold the real property assets.