



**EXCHANGE**  
ARMY & AIR FORCE EXCHANGE SERVICE



# Annual Report 2011





## Our Mission

The Army & Air Force Exchange Service has a dual enduring mission to provide quality merchandise and services to its customers at competitively low prices and to generate earnings which provide a dividend to support Morale, Welfare and Recreation (MWR) programs.

## Our Vision

To be our customers' first choice.

## Contents

3	From the Top
4	Serving the Customer
5	Exchange Private Brand Products
6	Exchange by the Numbers
7	Social Media
8	Contingency Operations
9	Reaching out to our Valued Shoppers
10-11	Exchange Snapshots
12	Exchange Credit Program
13	Rebranding the Exchange
14	2011 Financials
59	Board of Directors

The Army & Air Force Exchange Service adds value everyday to our Soldiers, Airmen and their families. This guiding philosophy drives all of our business decisions and actions, and is mirrored in:

- Great prices. Our customers rely on us for ways to save on life's essentials.
- Great brands. Our customers like treating themselves and others to little luxuries at those great prices.
- Easy and convenient shopping tailored to their unique, on-the-go lifestyles.
- Being where our customers are—anywhere around the world.



*“Our associates are part of a long legacy of supporting our troops. Anywhere the troops go, our associates are there. Many of them have deployed and see first-hand the impact our actions have on service members around the world. All our associates play a critical role in the readiness of the greatest fighting force the world has ever known.”*

## SERVING THOSE WHO SERVE

**“There is no greater honor than to serve those who serve.”**

I am deeply honored to be named the first civilian Director/Chief Executive Officer in the history of the Army & Air Force Exchange Service, and would like to acknowledge all the Commanders who have taken the Exchange through its storied history.

As a military and retail veteran, my decision to join the Exchange team was based on a desire to serve again. My family, including my father, father-in-law, brother and brother-in-law, has a long history of military service. I spent nearly 20 years in the Army, and my commitment to the mission is as strong today as it was when I arrived at West Point in 1969.

After leaving active duty in the 1980s, I had hoped to find a way to leverage my private sector business experience for the benefit of military families. Joining the Exchange allows me to once again be of service to our military family and give back to a community with which I have always shared a special bond.

As with other major retailers, Internet shopping has become—and will continue to be—a primary focus for growth. We will expand our online presence so we can become more relevant to our customers’ lives, especially in times like these.

Some of my other future Strategic Priorities for the Exchange include:

- Developing and inspiring future leaders
- Increasing national brands
- Growing concessions
- Growing the Express stores
- Reducing SG&A (Selling General and Administrative) expenses

Our hard-working associates in the stores play a huge role in ensuring customers can find the products they want, whether in our stores or online. Collectively, they can become powerful advocates to guide customers to shop [myexchange.com](http://myexchange.com) to find great solutions to their shopping needs.

Speaking of our associates, the Exchange is full of people who have devoted their lives to the Soldiers, Airmen and families of our U.S. military. Like the troops, our associates move from location to location and make sacrifices to deliver the benefit wherever the military is called to serve. Whether it’s Afghanistan or Alaska, there’s an Exchange bringing the comforts of home that troops have come to expect.

Our dedicated associates selflessly go where the troops go to bring that “taste of home” to the people who are the very best our country has to offer.

**THOMAS C. SHULL**  
DIRECTOR/CEO

The Exchange, ranked 47<sup>th</sup> in the National Retail Federation’s Top 100 retailers in the U.S. based on dollar sales, is responsible for nearly 3,700 facilities worldwide in more than 30 countries, five U.S. territories and 50 states. The Exchange operates 180 main stores, more than 2,000 brand-name restaurants and also provides military communities with convenience stores, specialty shops and movie theaters on installations worldwide, including locations in Afghanistan.





*“The mainstay of the retail industry—customer service—continues to be just as important as ever. Our customers certainly are at the center of everything we do. We are not like other retailers in regards to how we interact with our shoppers. I think of it as family taking care of family versus just selling things to people.”*

## PROVIDING QUALITY GOODS AND SERVICES

**T**he Army & Air Force Exchange Service endured a challenging 2011, but emerged with sales increases both in our online and brick-and-mortar stores.

With revenues topping \$10.3 billion, the Department of Defense’s oldest and largest military reseller is poised for phenomenal growth during the next few years as we continue our 117-year-old mission of serving America’s warfighters and their families, while generating dividends for their Morale, Welfare and Recreation (MWR) programs.

We operated nearly 3,700 retail facilities, restaurants, convenience stores, movie theaters, car care centers, gas stations, personal services, and other facilities in 30 countries, five U.S. territories and all 50 states.

### **Dividends to the world’s best customers**

In 2011, we served “the best customers in the world” by going beyond simply products and services alone to provide a “total customer experience.”

Consider the following achievements:

- Achieved \$10.3 billion in sales, a 4 percent increase over 2010.
- Realized a 13 percent increase in online sales to nearly \$254 million for [shopmyexchange.com](http://shopmyexchange.com).
- Received more than 117,000 “likes” on Facebook with great promotions, special offers and popular contests.
- Earnings of \$277.8 million.
- Provided dividends of \$203.3 million to MWR programs and activities.
- Reduced our retail facilities in Iraq to match the withdrawal of troops, while ratcheting up operations in Afghanistan. No other American retailer follows the troops into dangerous war zones.
- Ensured our prices stayed competitive with those outside the gate and even lower in many cases through our price-matching policy.

### **Branding, capital improvements, product expansion**

- Continued our rebranding program to improve the customer experience at nearly 70 stores and other facilities.
- Right-sized and revitalized existing Exchanges based on the needs of military installations around the world.
- Expanded our array of mobile phones and accessories and Internet, cable and wireless plans through more than 70 in-store kiosks.
- Won “best” awards from the federal government for energy-saving initiatives.
- Told the Exchange value story to more than 75,000 National Guard members and Reservists, more than half of whom live nowhere near traditional brick-and-mortar Exchanges.

I am so proud of what the Exchange team does every day to ensure the best possible customer service to “the best customers in the world,” regardless of where they are located.

Our role is to provide quality goods and services to those warfighters who protect our cherished freedoms. I am so thankful that our 42,000 associates continue to give their all in carrying through with this mission.

**MIKE HOWARD**  
CHIEF OPERATING OFFICER





Sportswear separates focused on fashion basics; easy-to-wear styles for boys



Casual clothing with classic fit for the missy customer



Trend-setting fashion at value prices for juniors and young men



Outdoor-inspired men's casual clothing



Casual and career separates with a modern fit for the missy customer



Classic menswear



Casual fashion basics for men



Key basics at affordable prices for all members of the family



Fashion separates for girls



Affordable fashion trends for boys and girls aged newborn to four



Line of personal workout equipment including jump ropes, yoga mats and kettle bells



Quality line of snack items

To provide a true customer shopping experience, we're committed to providing high-quality, men's, women's and children's fashions to customers, while saving them up to 50 percent off national brands.

In 2011, sales from our wide range of traditional, contemporary, modern mix and basic apparel were more than \$85 million.

Shoppers found our exclusive clothing brands fashionable, quality-made and competitively priced.

### New exclusive label for electronics debuts

Our shoppers also enjoyed exclusive Exchange labels in nearly every other product category, all offering value pricing on high-quality merchandise.

In our PowerZone electronics departments, we debuted our Patronics brand of accessories. For substantially less, customers receive high-quality computer and video-game controllers, computer mice and pads, keyboards, batteries, speakers, headphones, cables, computer bags, blank CDs, and devices from GPS systems to cameras.

In fact, the Patronics brand offers an average savings of 20 to 25 percent off comparable national brands.

But our exclusive brands go far beyond clothes and gadgets. More than 700 of our competitively priced, quality Exchange Select products provide our valued shoppers with everything from health and beauty merchandise to household items like cleaners,



Line of electronics accessories



Everyday, value-driven line of quality products

detergents, toilet tissue and paper towels, diapers and baby wipes, oral rinses and smoking cessation gum.

What's more, customers save 20 percent to 50 percent less by filling their carts with Exchange Select products when compared to equivalent national brands.

### Wide range for all military exchanges

Annual revenues for Exchange Select products, which we have sold since 2000, have reached nearly \$40 million.

Find these wide range of products in all Navy, Marine and Coast Guard exchanges and Veterans Canteen Service locations.

Part of our 117-year-old mission is to provide quality products and services at competitive prices. Our entire line of exclusive label products helps us do just that—and save our customers money.

**\$10.3 BILLION** — Total sales generated by the Exchange's global operations.

**\$254 MILLION** — Record sales number of the Exchange's popular website, shopmyexchange.com in 2011.

**18 MILLION** — Number of products on shopmyexchange.com.

**\$203.3 MILLION** — Total dividends contributed by the Exchange from its revenues in 2011 to the Army's Morale, Welfare and Recreation programs and Air Force Services. Dividends also go to other branches of the armed services.

**\$563 MILLION** — Amount of Exchange dividends from MILITARY STAR<sup>®</sup> credit cards contributed to the Army's MWR programs and Air Force Services during the past 10 years.

**98 PERCENT** — Amount of the Exchange's budget that comes from its own revenue and other sources, not including tax money appropriated by Congress.

**UP TO 50 PERCENT** — What our shoppers save when buying the Exchange's exclusive brands of quality clothing for men, women and children, compared to national brands.

**42,000** — Number of Exchange associates serving troops and their families around the world.

**3,700** — Number of Exchange main stores and other retail facilities around the world.

**30** — Number of countries in which the Exchange has a footprint.

**118,000** — Number of "likes" on the Exchange's popular Facebook page.

**30 PERCENT** — Percentage of the Exchange's 42,000 associates who are military spouses.

**13 PERCENT** — Percentage of Exchange associates who are military veterans. About 3,000 veterans have been hired at the Exchange since 2010.

**35,000** — Number of loaves of bread baked by the Exchange bakery in a week at Yokota AB to meet emergency needs of military customers after the earthquake and tsunami struck Japan. The bakery cranks out 12,000 loaves on a normal week.

**38 AND 27** — Number of direct-operated Exchanges in Afghanistan and tactical field exchanges run by troops and supported by us.

**121 AND 610** — Numbers of Exchange associates and third-country and local nationals serving troops in Afghanistan and elsewhere for Operation Enduring Freedom.

**4,700** — Number of Exchange associates who have deployed voluntarily since 9/11—some more than once—to serve troops in Afghanistan, Iraq and elsewhere in the Middle East and Southwest Asia.

**10** — Contingency sites operated by the Exchange in Iraq to serve military advisers and remaining troops.

**1.8 MILLION** — Number of Exchange customers with low-interest MILITARY STAR<sup>®</sup> credit cards.

**4 MILLION** — Number of nutritious meals served by the Exchange to children in 90 Department of Defense schools throughout the world on a break-even basis.

**UP TO \$10** — Amount of the price adjustment we will provide on the spot during a price match challenge on identical merchandise from any local competitor.



Social media keeps us connected with our valued shoppers around the world. We stay in daily contact with thousands of our eligible customers on Facebook, Twitter, Pinterest, YouTube and the salutetoyourservice.com blog.

Our Facebook page, facebook.com/aafes.bx.px, establishes an online sense of community with shoppers in the comfort of their homes, provides customer service in real time, and tells our valued patrons about the Exchange benefit and value.

We're enjoying tremendous success on Facebook. Since launching our Facebook page in 2010:

- More than 118,000 of our valued customers have "liked" us—a 1,000 percent increase.
- Our average monthly users stand at 80,000, compared to 800 in 2010.
- Daily content "likes" have climbed to more than 38,000, compared to just 2,000 in 2010.

### Engaging customers

Our Facebook customers can print out online coupons and redeem them at their Exchanges for exclusive savings.



They also can participate in exciting contests for great prizes, such as the "Cutest Kiddo," which annually attracts more than 3,000 people who submit pictures of their children for chances to win great prizes.

Click on our Facebook page to find the most recent news

**Social media and online communities like Facebook allow our shoppers to play even more active roles in our business.**

stories, videos, photos from many valued shoppers, and details about events at military installations around the world.

Our Facebook fans join in discussions about how we can improve their military shopping experience.

### "Pinning" and "re-pinning"

Our newest venture into social media is Pinterest, a social networking site where members can share their favorite items by "pinning" them to a virtual pin board. At pinterest.com/myexchange, photos of items for sale on shopmyexchange.com are "pinned" to the following pages:

- Home Décor
- Fashion & Style
- Products We Love
- Other "boards"

Clicking on a photo of a shirt or dress that customers like, for example, will take shoppers directly to shopmyexchange.com, where they can buy the items. If they decide to re-pin the picture on their own Pinterest pages, then their friends now see the shirt or dress and can click to shopmyexchange.com to buy it for themselves.

The Exchange "likes" connecting with all of our valued shoppers in the store, online and in social media.



Like us.  
AAFES, Your Military BX/PX  
(Official Page)



Follow us.  
Exchange\_STYS



Blog w/ us.  
salutetoyourservice.com



Pin us.  
pinterest.com/myexchange



Watch us.  
AAFEsalutes

### Helping Our Customers Work, Play and CONNECT - Through Exchange Mobile Center!

The Exchange Mobile Center is the Exchange's one-stop shop for mobile sales, service and expert assistance necessary to make it all work.

Our Exchange Mobile Center kiosks in stores around the world and on shopmyexchange.com serve a quickly growing number of shoppers who are highly connected and tend to be early adopters and avid users of both mobile (Smartphones, tablets and laptops) and tethered (computers, TVs, gaming systems, etc.) devices.

During 2010 and 2011, our Advanced Telecommunications team introduced the Exchange Mobile Center concept, and expanded to 72 locations across the continental United States.

Shoppers now have ready access to the latest Smartphones and service plans at very competitive prices, with expert assistance



## EXCHANGE mobile center

Great Brands. Great Service. Military Discounts.

on mobile solutions. We also began similar initiatives for the Pacific and Europe regions.

But the most exciting aspect is the opportunity to help our customers enjoy fully the benefits of our increasingly connected world.

With most Exchange Mobile Centers located in or near our PowerZone electronics departments,

our shoppers can now get the best of two worlds in one location: the latest products and expert advice on devices, capabilities and service.

In addition, we introduced in our

PowerZones hundreds of new products, such as Internet-capable TVs, Blu-ray players, gaming systems, computers, tablets, iPods and other devices, many of which connect to the Internet.

As the mobile and electronics worlds continue to merge, customers look to the Exchange for the tools and resources to enjoy their increasingly connected lifestyles.

As the Defense Department's oldest and largest military retailer, the Army & Air Force Exchange Service faces unique challenges that don't confront our competitors in the private sector.

In 2011, we continued supporting 10 contingency sites in Iraq and two distribution hubs in northern and central Iraq, ensuring we got the right products to our customers at the right time. Concession services remained in full swing, while five Internet facilities, three barber shops, three Green Beans coffee shops and two pizza restaurants were added to round out a real taste of home for our troops and military advisors in Iraq.

We also expanded that experience in Afghanistan, where

thousands of additional troops were deployed in 2010 and 2011. The Exchange supports 70 retail facilities and 186 concessions, such as barber, beauty, alterations and gift shops.

Our nearly 50 restaurants include Pizza Hut, Burger King, Subway. This year, new facilities opened in Afghanistan that are staffed by more than 120 voluntarily deployed U.S. associates, backed up by 610 third-country and local nationals.

Our experience at serving troops in contingency locations during the past 117 years has taught us to remain agile and flexible, ready to shift our dynamic footprint as necessary to meet the changing needs of the American military on the ground.



## Connecting with spouses, veterans

Looking after spouses of our brave service members is just another example of how we fulfill the second half of our motto: "You save . . . we give back."

In October 2011, the Army & Air Force Exchange Service received accolades from Military Spouse magazine as a top Military Spouse Friendly Employer, earning number five on the publication's annual list.

The magazine ranking marks the fourth year the Exchange has appeared on the list.

Nearly 30 percent of our 42,000 associates around the world are military spouses and another 9 percent are family members of troops.

We've also been recognized by GI Jobs magazine and CivilianJobs.com for our hiring initiatives aimed not only at military spouses but also veterans.

### Transitioning after relocation

Through special initiatives, we help spouses make smooth transitions within military communities and deployment

locations, where they find meaningful employment with the Exchange. We also enable veterans to find gainful employment while getting back into civilian life. For instance, many military spouses and veterans work in our main stores and other retail facilities.

### Win-win situation

Still others work for our third-party vendors. For example, H&R Block, the Exchange's preferred provider of income tax services, hired and trained more than 670 military spouses last year to become tax pros in locations on U.S. military installations.

Our efforts result in a win-win situation that helps us retain valuable associates while allowing military spouses and veterans to build careers with the Exchange.



**EXCHANGE YOUR CAREER**  
OUR COMMITMENT TO HIRING VETERANS



At the Exchange, we don't wait for our shoppers to come to us. Throughout the year, our customer engagement initiatives reach out to these valued customers to tell them the Exchange value story on military installations, in surrounding communities, on social media, and wherever else they may be.

### Active duty troops

We serve 1.3 million active duty Soldiers and 600,000 Airmen, including National Guard and Reserve members who were called up on military installations around the world, including in Iraq and Afghanistan.

Our store managers collaborate with local Morale, Welfare and Recreation leaders for events to engage Soldiers and Airmen.

We also reach out to them through our "buddy lists" and Online Savings Club.

YouTube, Twitter and our blog, [salutetoyourserve.com](http://salutetoyourserve.com), also are integral to our outreach efforts. So is mobile marketing, in which shoppers can opt in to our program and get messages sent to their Smartphones. More than 36,000 customers participate in our mobile marketing outreach.

We also participate in programs aimed at smoothing the transition of active-duty troops back into civilian life, such as the Yellow Ribbon Reintegration Campaign.

### Families

We support military families at the quarterly Army Wives Field Training Exercise and Spouse Buzz Live events.

Our Patriot Family Connection website—[shopmyexchange.com/community](http://shopmyexchange.com/community)—features worldwide events and contests, military service links and resource guides.

We even provide coupons and other services for active duty troops who are relocating to new military installations around the world. Our coupons help them buy household supplies and food, while they set up their Internet, phone and cable TV services through our Get Connected! website.

### Military retirees

Military retirees who served 20 or more years in the armed



forces comprise nearly 20 percent of our 12.4 million authorized shoppers. In addition to our efforts with active-duty troops and families, we reach out to retirees through mailers, flyers and other publications, and make them feel special at such installation events as Still Serving and Military Retiree Appreciation Days.

We also work with organizations that represent retirees, even military retirement centers in the communities.

Our store managers and associates tailor events especially for retirees, such as product samplings and vendor demonstrations, health and nutrition clinics, line-dancing competitions, "over-50" fashion shows, travel seminars, and games like golf putting and shopping cart Bingo.

At many of our facilities, retiree advisory councils keep us in touch with this valuable demographic.

### National Guard and Reserves

In addition to active-duty National Guard and Reserve members, we make special efforts to reach those who are not on active duty but still eligible to shop with us. One out of every four customers on [shopmyexchange.com](http://shopmyexchange.com) is a National Guard member or Reservist, many of whom live nowhere near a traditional Exchange.

During the past two years, we have contacted unit commanders, appeared at conventions, and visited with more than 75,000 Guard and Reserve customers.

In 2011, we began offering a unique business-to-business (B2B) initiative to our sister federal agencies in which we sell our competitively priced products and services directly to them.

In addition, the agencies, just like our 12.4 million eligible shoppers, don't have to pay sales tax—and that's valuable savings to agency heads who face dwindling revenue, budget cuts and continued demands for services.

We aim to grow B2B annual sales from \$135 million this year to \$500 million by 2016—not an insurmountable task considering the lucrative \$10 billion market for B2B products and services.

By aligning with the Exchange, government agencies can use their government purchasing cards to buy products and services in any of our retail facilities and online at our website, [shopmyexchange.com](http://shopmyexchange.com).



They no longer need to go outside the gate and travel store to store to get the best prices. With the Exchange, they can find all they want—an immense range of merchandise—in one central location, online or in-store, featuring products such as:

- Office supplies
- Food and drinks for their conferences, seminars and other meetings
- Automotive supplies for their fleets of vehicles
- Cleaning supplies

We also offer 10 percent off purchases made with government purchase cards.

Also, about 65 percent of what the federal agencies spend with the Exchange is returned as dividends to Morale, Welfare and Recreation programs for troops and their families on military installations around the world.



## Worldwide store improvements

America's warfighters and their families deserve modern, state-of-the-art shopping destinations. Throughout 2011, we opened new, expanded or renovated shopping centers throughout the United States, from Charleston AFB, S.C., to Fairchild AFB in Washington State. New or renovated Express convenience stores welcomed shoppers at major installations in five states.

Throughout Europe, we built new retail facilities and renovated existing stores to meet customer needs and troop restationing initiatives. At Spangdahlem, Germany, for instance, we opened our first direct-run 3-D movie theater to the delight of military families and base commanders. (Our 3-D theater at Fort Bliss is operated by a third-party vendor.)

## Helping our biker troops to arrive alive!

The Exchange supports the military's mission to reduce motorcycle-related injuries and deaths among service members. We watch out for our customers' safety with protective helmets, gloves, eyewear and body armor in most main stores, select Expresses, Car Care Centers, Military Clothing stores, and on [shopmyexchange.com](http://shopmyexchange.com).



Customers who complete a locally required motorcycle safety course can get a one-time, 20 percent discount on any personal protective item in our stores or online at [shopmyexchange.com](http://shopmyexchange.com). All of our helmets, gloves, eyewear and body armor meet the highest safety standards, including all military, European and Pacific specifications and testing standards.

## Reducing our carbon footprint

Saving energy and reducing our carbon footprint at military installations is a top priority for the Exchange. Our award-winning sustainability experts hit a grand slam in November 2011 when they launched a successful energy project at an Express convenience store at Fort Hood, Texas.

From the moment the sophisticated environmentally friendly, high-tech equipment and controls were installed, the savings were immediate. Average monthly energy savings hit more than 45 percent, or \$17,000. We now are rolling the same program out to 265 Express convenience stores and other facilities around the continental United States—and expect to slash our energy costs by nearly \$2 million a year.



## Home delivery service expanded

In 2011, we rolled out nearly 160 Sears delivery/installation/assembly services in stores around the United States.

Now, customers who buy refrigerators, dishwashers, washing machines and dryers from the Exchange receive delivery dates at the times of purchase.

The products are delivered, hooked up, tested and demonstrated. For \$10 more, customers can get the old products hauled away.

## 'Dreaming' about sustainability

Customers recycled nearly 4,000 pounds of plastic and 2,200 pounds of aluminum in our 198 Dream Machines at military installations around the world. The machines, which we rolled out in 2011, are computerized kiosks that shoppers can use to recycle empty drink cans and plastic bottles into points they can redeem for merchandise, discounts or charitable donations.

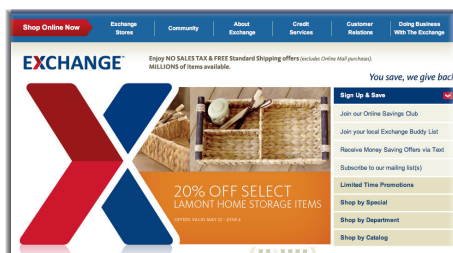
The kiosks, part of our corporate sustainability program, are a collaboration with PepsiCo and Waste Management Inc. The Dream Machine program, which includes 3,000 kiosks throughout the United States, aims to increase recycling and help the environment, with the overall objective of increasing the U.S. beverage container recycle rate to 50 percent by 2018.





## Enhancing the online shopping experience

We invited customers last year to shop online in a whole new way. In March 2011, the redesigned and enhanced shopmyexchange.com debuted with its fresh look and feel, ushering a new era of shopping that saw phenomenal sales and earnings growth.



Online sales for 2011 hit a record-breaking nearly \$254 million, a 13 percent increase over the previous year. Shopmyexchange.com serves as the entry way to the Exchange Online Store and Exchange Online Mall, where customers shop from among more than 18 million products from some of the country's best known brands.

The website is an ideal shopping venue for those authorized customers who live nowhere near a brick-and-mortar Exchange or, as in the cases of National Guard members and Reservists, aren't on military installations except for their weekend training or when called to active duty.

Customers began enjoying broader access to shopping, allowing us to serve them even better with eye-catching menus, express login, integrated social media, an interactive Exchange history timeline and a Reel Time Theaters section.

In 2011, the number of total visits rose to 25.3 million, an increase of 2.9 percent from 2010, while total unique visitors (those counted only once) rose 8.5 percent to 10.5 million in 2011.

In addition, shopmyexchange.com helped increase subscribers to the Online Savings Club to 272,433, up 29 percent from 2010. The savings club gives subscribers exclusive coupons and offers via email.

Between now and 2014, major upgrades to our technology will improve the online shopping experience even more and put shopmyexchange.com on par with the retail industry's leading websites. Customers will find many of the same products online that they can find in our traditional stores. They'll notice refined search and navigation capabilities faster browsing, enhanced product images, speedier order processing and tracking, and quicker checkout.

## Exchange adds to major diversity awards

The Exchange was one of 30 North Texas businesses and agencies recognized in 2011 by the Dallas-Fort Worth Minority Supplier Development Council for our work with minority-owned businesses. In 2011, we spent more than \$400 million with local minority-owned firms for products and services.

In addition, the New York-based Diversity Best Practices recognized our chief operating officer, Michael Howard, and Senior Diversity Director Tina Johnson for leading the Exchange's commitment to diversity and inclusion.

The Exchange's diversity and inclusion initiatives have won dozens of national, state and local awards during the past 20 years.



## Associates jump into action after tsunami

Despite the devastation of a 9.0-magnitude earthquake on March 11, 2011, and ensuing tsunami, Exchange associates on mainland Japan ensured uninterrupted service for customers.

As Exchange facilities faced intermittent power outages, closed roads and challenges of resupplying facilities, managers and associates quickly came up with plans to keep stores open and operating—after ensuring everybody was safe.

When the disaster first began, the main store at Misawa AB—about 150 miles from the earthquake and tsunami—lost power. Associates closed the store and moved flashlights, water, batteries and other emergency goods to the Express store so customers could get needed supplies.

Facing the possibility of bread shortages at base facilities, bakers produced nearly 35,000 loaves following the quake compared to 12,000 on a normal week. Bun production increased 7,500 a week to more than 21,000.



In 2011, our private fleet of 320 trucks and 1,380 trailers logged more than 20 million miles, delivering products to Exchange retail facilities around the world. Our distribution centers processed more than 45 million cases of merchandise with an average inventory of nearly \$373 million.



Nearly two million of our customers use our MILITARY STAR® credit cards to take advantage of significantly lower interest rates, great promotions and educational information about how to build good credit ratings.

We developed MILITARY STAR cards to respond to growing complaints from customers and base commanders of lenders preying on service members.

The number of MILITARY STAR accounts has grown by 31 percent since 2007—from 1.3 million users to 1.8 million as of January 2012.

**Low-cost method of purchasing**

Two types of cards afford Soldiers, Airmen, Sailors, Marines and members of the Coast Guard, National Guard and Reserves a low-cost method to buy products and pay for services, especially if they're at duty stations far from home. The cards also are a popular way of payment on our website, shopmyexchange.com.

The MILITARY STAR program educates

our valued customers on responsible use of credit through online communication and inserts into their monthly statements. The cards also reduce dependence on high-interest credit providers.

At 10.24 percent, the interest rate is far lower than typical rates charged by competing store cards. In fact, MILITARY STAR cardholders save about 50 percent in interest charges compared to competing retail credit cards.

**MWR dividends from the cards**

In addition, when customers use MILITARY STAR® cards to pay for products and services, they help decrease the amount of fees the Exchange pays to banks. In 2011, the Exchange avoided \$24.7 million in merchant fees, a savings which contributed to our bottom line and service members' dividends.

In addition, during the past 10 years, the credit program has contributed \$563 million in dividends—50 percent of its earnings—to the Army's Morale, Welfare and Recreation (MWR) programs and Air Force Services.

Now that's something to give credit where credit is due.



## Exchange Healthy Eating Great Food. Great Service. For all Tastes

The "family" is getting healthier, and Soldiers and Airmen are beginning to notice.

The Exchange's brand-name and signature-brand restaurants are continually adding healthier options to their menus as the tastes of more customers turn to less than traditional fare.

We want to be our customers' first shopping choice in our main stores and in our thousands of restaurants around the world, where we cater to their tastes and stay ahead of emerging trends.

During the past two years, demand for name-brand burgers has decreased from 45 percent to 35 percent of overall restaurant sales, compared to a restaurant industry average of 48 percent. At the same time, demand for sub sandwiches has risen from 16 percent to 22 percent of total sales, compared to an industry average of 14 percent.

During the past five years, the Exchange's portfolio has grown by just six burger restaurants, compared to 64 sandwich places. To meet these emerging trends, we opened in 2011:

- Fruits, a healthy salad and wrap option
- Arby's, which boosts a "market fresh" sandwich menu line-up
- UFood Grills, a healthy alternative menu the Exchange is testing at selected locations

Our brand-name partners and signature restaurants serve salads, low-fat sandwiches, fresh fruit and other healthy options.

At our request, Charley's Grilled Subs, which is based in Columbus, Ohio, is testing a multi-grain bun at its Exchange restaurants.

In addition, our complete nutrition education outreach involves our Operation Be Fit newspaper; smart codes that direct consumers to nutrition websites of name-brand partners; and nutrition information on tray liners and signs in our food courts.

The Exchange, however, reaches far beyond restaurants for its nutrition initiatives.

We serve more than 4 million meals a year to children in 90 Defense Department schools around the world.

Our bakeries in Germany, Korea and Japan produce whole-grain breads for the school feeding program, overseas Exchanges, the Defense Commissary Agency and other programs. Our water plants in Germany provide fluoridated Culligan water to families overseas.

Our vending machines follow the National Automatic Merchandising Association's Fit Pick program: less than 35 percent calories from fat, 10 percent calories from saturated fat and 35 percent total weight from sugar.

In our Express convenience stores, find salads with less than 300 calories, fruit cups and fresh fruits.





We continued rolling out the new Exchange brand in 2011 and 2012 at nearly 70 shopping centers and other facilities in the continental United States.

We rebranded Travis AFB, Calif.; Fort Bragg, N.C.; the U.S. Military Academy at West Point, N.Y.; Shaw AFB and 7th Special Forces in Eglin, Fla. Fort Bragg was the first Army post to receive the new branding elements, followed by the military academy.

The brand application continued with product packaging, business collateral, Military Clothing store graphics, restaurants, Express stores and other facilities. Branding involves much more than placing the new logo on everything from storefronts to shopping bags; it is a mindset. We want to create one brand, one voice and one consistent experience. The brand creates a timeless, tangible and emotional connection with our military shoppers.



### Fort Bragg

A new shopping experience was ushered into the community as the store became the first Army facility to unveil the Exchange's fresh new colors, textures and graphics. As with all newly renovated Exchanges, Fort Bragg features a store layout divided by Home, Life and Style merchandise categories.



### Travis AFB

Customers welcomed a much-anticipated renovated and rebranded Exchange May 4. The rebranding efforts provide a best-in-class shopping experience, and include lively colors and imagery, polished floors and a new layout that makes it easy for customers to navigate through the store.



### Shaw AFB

Service members and their families have a new 81,000 sq. ft. shopping center that offers everything from car rentals to hunting gear. The new Exchange provides a robust electronics section, a state-of-the-art food court, and a Military Clothing store. The complex also includes a new gas station, pharmacy and concession mall..

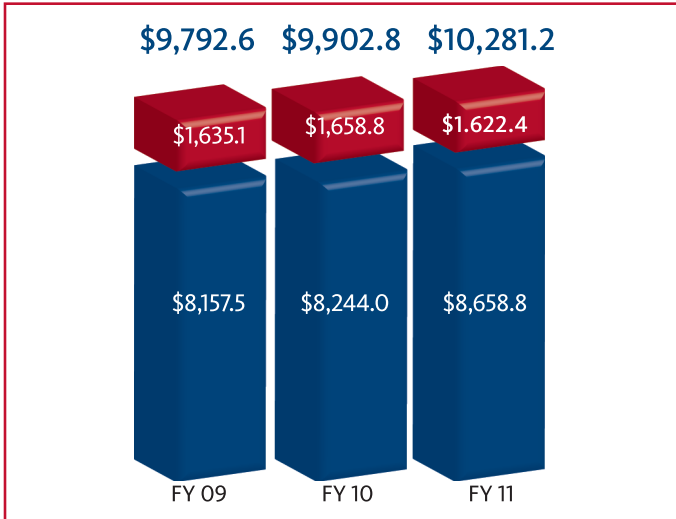


### Eglin AFB

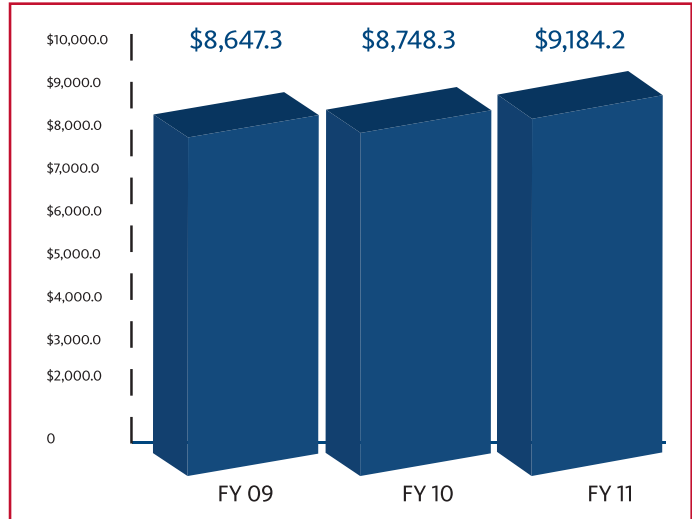
A ribbon cutting was held Dec. 15 at the 7th Special Forces new Exchange facilities near Eglin AFB, which include a Military Clothing store, Express/Gas, and Subway. Also, several services are available, including GNC, a barber shop and a laundry/dry cleaning/alterations shop.



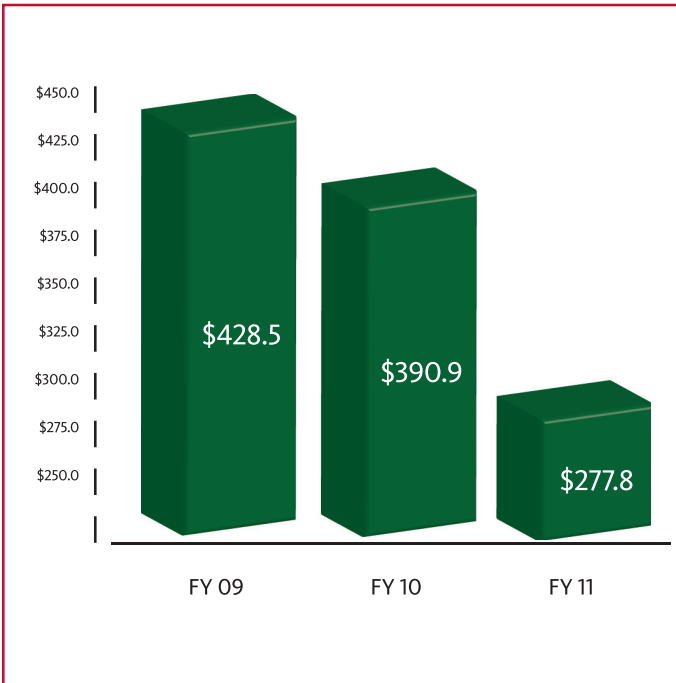
**Total Sales**



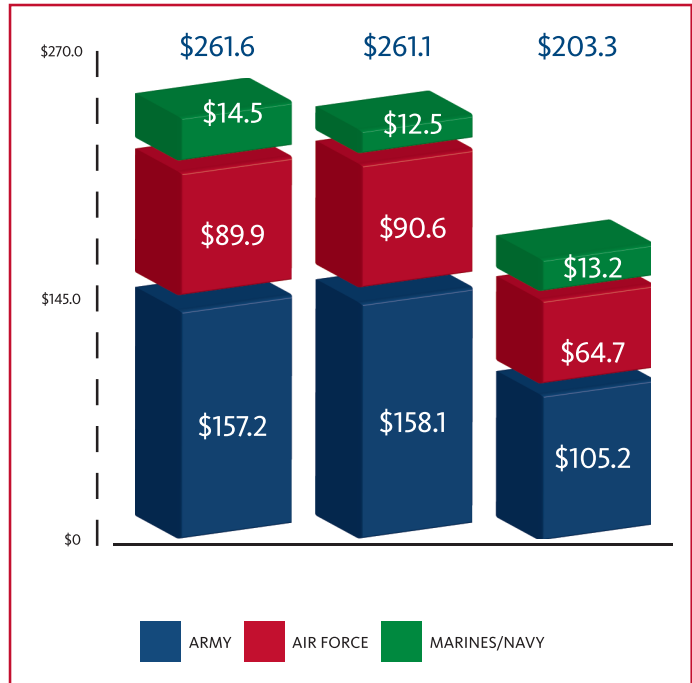
**Total Revenue**



**Total Earnings**



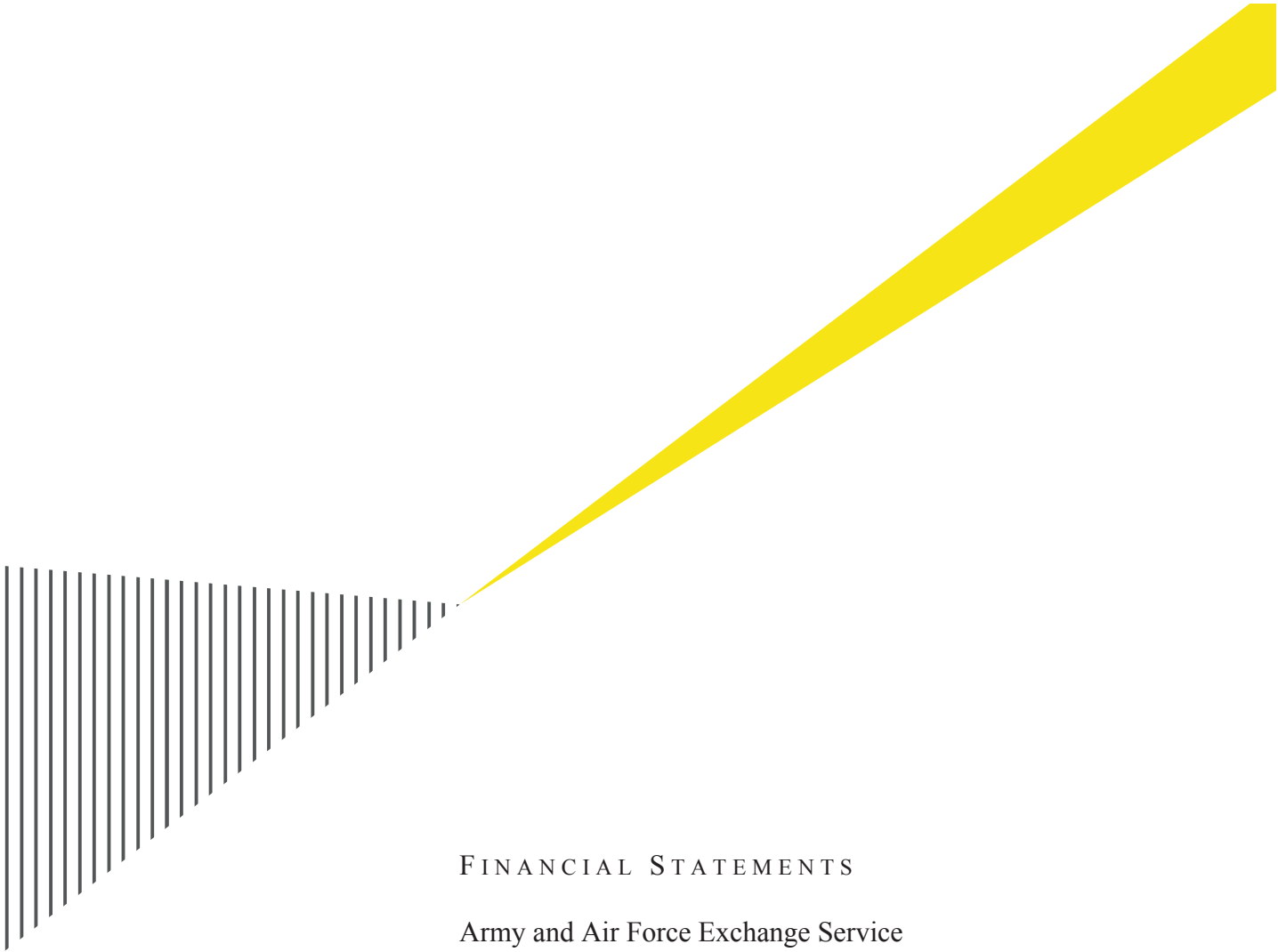
**Total Dividends**



**Total Dividends by branch**







FINANCIAL STATEMENTS

Army and Air Force Exchange Service  
Years Ended January 28, 2012 and January 29, 2011

Ernst & Young LLP



# Army and Air Force Exchange Service

## Financial Statements

Years Ended January 28, 2012 and January 29, 2011

### Contents

Report of Independent Auditors.....	1
Financial Statements	
Balance Sheets .....	2
Statements of Earnings .....	3
Statements of Changes in Net Assets.....	4
Statements of Cash Flows.....	5
Notes to Financial Statements.....	6



## Report of Independent Auditors

The Board of Directors  
Army and Air Force Exchange Service  
Departments of the Army and Air Force

We have audited the accompanying balance sheets of Army and Air Force Exchange Service (the Exchange or the Company) as of January 28, 2012 and January 29, 2011, and the related statements of earnings, changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Army and Air Force Exchange Service at January 28, 2012 and January 29, 2011, and the results of its operations and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

*Ernst & Young LLP*

June 18, 2012

## Army and Air Force Exchange Service

### Balance Sheets

*(Dollars in thousands, unless otherwise noted)*

	<b>January 28 2012</b>	<b>January 29 2011</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 112,075	\$ 100,778
Trade and other accounts receivable, less allowance for uncollectible accounts (at January 28, 2012 – \$43,324, at January 29, 2011 – \$42,561)	3,680,316	3,531,405
Merchandise inventories	1,412,036	1,520,344
Short-term investments	10,300	22,548
Supplies and other current assets	48,423	38,093
Total current assets	5,263,150	5,213,168
Buildings and improvements	3,186,269	3,102,074
Fixtures and equipment	1,405,738	1,404,923
Construction-in-progress	279,394	179,457
	4,871,401	4,686,454
Accumulated depreciation	(2,499,428)	(2,372,230)
	2,371,973	2,314,224
Other assets	2,590	603
Prepaid pension assets	–	402,563
Long-term investments and Supplemental Plan assets	35,093	23,864
Total assets	\$ 7,672,806	\$ 7,954,422
<b>Liabilities and net assets</b>		
Current liabilities:		
Accounts payable	\$ 550,936	\$ 621,424
Notes payable to banks	1,871,639	1,600,415
Accrued salaries, separation pay, and other employee benefits	119,368	119,562
Dividends payable	30,382	28,892
Other current liabilities	256,508	216,159
Total current liabilities	2,828,833	2,586,452
Notes payable to banks – long-term	575,725	730,364
Accrued pension and other benefits	762,881	568,489
Other noncurrent liabilities	65,012	59,117
Total liabilities	4,232,451	3,944,422
Net assets:		
Accumulated other comprehensive loss:		
Pension liability	(1,770,518)	(1,131,048)
Derivative instruments	(4,226)	461
Total accumulated other comprehensive loss	(1,774,744)	(1,130,587)
Retained earnings	5,215,099	5,140,587
Total net assets	3,440,355	4,010,000
Total liabilities and net assets	\$ 7,672,806	\$ 7,954,422

*See accompanying notes.*



## Army and Air Force Exchange Service

### Statements of Earnings (Dollars in thousands, unless otherwise noted)

	Year Ended	
	January 28 2012	January 29 2011
Net sales	\$ 8,658,849	\$ 8,244,004
Finance revenue	281,281	253,553
Concession income	207,891	213,763
Other operating income	36,277	36,935
Total revenue	<u>9,184,298</u>	<u>8,748,255</u>
Cost of sales and operating expenses:		
Cost of goods sold	6,742,032	6,308,863
Selling, general, and administrative:		
Employee compensation and benefits	1,161,675	1,151,106
Depreciation and amortization	321,848	316,647
Other	576,370	532,125
Total selling, general, and administrative expenses	<u>2,059,893</u>	<u>1,999,878</u>
Interest expense	51,505	50,843
Bad debt expense	60,170	9,608
Total expenses	<u>8,913,600</u>	<u>8,369,192</u>
Operating income	270,698	379,063
Other income	7,121	11,826
Net earnings	<u>\$ 277,819</u>	<u>\$ 390,889</u>

*See accompanying notes.*

## Army and Air Force Exchange Service

### Statements of Changes in Net Assets (Dollars in thousands, unless otherwise noted)

	<b>Retained Earnings</b>	<b>Accumulated Other Comprehensive Income (Loss)</b>	<b>Net Assets</b>
Balance at January 30, 2010	\$ 5,010,824	\$ (1,529,918)	\$ 3,480,906
Net earnings	390,889	-	390,889
Change in funded status of pension and other postretirement benefit liabilities	-	394,138	394,138
Net change in fair value of derivative instruments	-	5,193	5,193
Comprehensive income			790,220
Dividends to the Central Welfare Funds, Departments of the Army, the Air Force, the Navy, and the Marine Corps	(261,126)	-	(261,126)
Balance at January 29, 2011	5,140,587	(1,130,587)	4,010,000
Net earnings	<b>277,819</b>	-	<b>277,819</b>
Change in funded status of pension and other postretirement benefit liabilities	-	<b>(639,470)</b>	<b>(639,470)</b>
Net change in fair value of derivative instruments	-	<b>(4,687)</b>	<b>(4,687)</b>
Comprehensive loss			<b>(366,338)</b>
Dividends to the Central Welfare Funds, Departments of the Army, the Air Force, the Navy, and the Marine Corps	<b>(203,307)</b>	-	<b>(203,307)</b>
Balance at January 28, 2012	<b>\$ 5,215,099</b>	<b>\$ (1,774,744)</b>	<b>\$ 3,440,355</b>

*See accompanying notes.*



## Army and Air Force Exchange Service

### Statements of Cash Flows (Dollars in thousands, unless otherwise noted)

	Year Ended	
	January 28 2012	January 29 2011
<b>Operating activities</b>		
Net earnings	\$ 277,819	\$ 390,889
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	340,873	333,233
Loss on disposal of property and equipment	2,257	8,235
Gain on supplemental pension plan assets	(122)	(2,620)
Bad debt expense	60,170	9,608
Changes in operating assets and liabilities:		
Accounts receivable	(209,081)	(215,679)
Merchandise inventories	108,308	3,768
Supplies and other assets	(12,316)	3,674
Pension assets and liabilities	(23,777)	2,404
Long-term investments and supplemental plan assets	862	710
Accounts payable	(84,193)	(11,417)
Accrued salaries, separation pay, and other employee benefits	(457)	(35,076)
Other liabilities	26,597	22,240
Net cash provided by operating activities	<u>486,940</u>	<u>509,969</u>
<b>Investing activities</b>		
Purchases of property and equipment	(411,304)	(400,426)
Proceeds from the sale of property and equipment	10,425	3,548
Purchases of investments	(22,270)	(30,570)
Proceeds from the disposition of investments	22,548	28,570
Net cash used in investing activities	<u>(400,601)</u>	<u>(398,878)</u>
<b>Financing activities</b>		
Proceeds under line-of-credit agreements	1,717,000	1,596,000
Repayments under line-of-credit agreements	(1,596,000)	(1,455,000)
Repayments of long-term debt	(4,415)	(4,202)
Change in cash overdraft	10,190	10,972
Payment of dividends	(201,817)	(293,766)
Net cash used in financing activities	<u>(75,042)</u>	<u>(145,996)</u>
Net decrease in cash and cash equivalents	11,297	(34,905)
Cash and cash equivalents at beginning of year	100,778	135,683
Cash and cash equivalents at end of year	<u>\$ 112,075</u>	<u>\$ 100,778</u>

See accompanying notes.

# Army and Air Force Exchange Service

## Notes to Financial Statements (Dollars in thousands, unless otherwise noted)

January 28, 2012

### 1. Description of Business and Summary of Significant Accounting Policies

#### General

The Army and Air Force Exchange Service (the Exchange or the Company) is a non-appropriated fund instrumentality (NAFI) of the United States (U.S.) and is organized as a joint major command of the U.S. Army and the U.S. Air Force. The Exchange provides retail services to soldiers, airmen, and their families through a network of stores principally located in the U.S., Europe, the Pacific Rim, and the Middle East, substantially all of which are located on U.S. government installations. Middle East services operate primarily in Afghanistan in support of Operation Enduring Freedom (OEF), and, until recently, Iraq in support of Operation New Dawn (OND). In addition to providing merchandise and services of necessity and convenience to authorized patrons at uniformly low prices, the Exchange's mission is to generate reasonable earnings to supplement appropriated funds for the support of Army and Air Force morale, welfare, and recreation programs. The Exchange maintains custody of and control over its non-appropriated funds. Funds that are not distributed as dividends are reinvested in the Exchange's operations. The Exchange is exempt from direct state taxation and from state regulatory laws, whose application would result in interference with the performance by the Exchange of its assigned federal functions. Such laws include licensing and price control statutes. The Exchange summarizes its revenues on the basis of its customers' locations.

Net sales by geographic region are summarized below:

	Year Ended	
	January 28 2012	January 29 2011
Continental U.S.	\$ 5,754,855	\$ 5,303,101
Pacific Rim, including Alaska and Hawaii	1,218,728	1,197,400
Europe, primarily Germany	823,309	800,273
OEF/OND	584,703	683,216
Other countries	277,254	260,014
Total net sales	<u>\$ 8,658,849</u>	<u>\$ 8,244,004</u>



## Army and Air Force Exchange Service

### Notes to Financial Statements (continued)

*(Dollars in thousands, unless otherwise noted)*

#### 1. Description of Business and Summary of Significant Accounting Policies (continued)

Long-lived assets comprise property and equipment. Long-lived assets, net of accumulated depreciation and amortization, by geographic region are summarized below:

	Year Ended	
	January 28 2012	January 29 2011
Continental U.S.	\$ 1,755,994	\$ 1,670,979
Pacific Rim, including Alaska and Hawaii	328,070	369,427
Europe, primarily Germany	283,948	266,885
OEF/OND	3,960	6,933
Total long-lived assets	<u>\$ 2,371,973</u>	<u>\$ 2,314,224</u>

The Exchange utilizes accounting principles generally accepted in the United States applicable to “for profit” organizations, because of the nature of its commercial-type operations. The Exchange’s financial statements include the operations of all exchanges at U.S. Army and Air Force installations throughout the world.

#### Appropriated Funds

In accordance with applicable U.S. Army and Air Force regulations, the Exchange is not required to pay rent for the use of properties owned by the U.S. Government or utility costs associated with overseas exchanges. Permanent structures that are constructed by the Exchange and paid for from Exchange funds become the property of the U.S. Government; however, the Exchange has the right to occupy and use the structures. The structures cannot be used for other than the Exchange’s purposes without prior approval by the Exchange Commander and the relevant department of the U.S. Government. As such, the Exchange has included the cost of the structures on its balance sheet and depreciates the cost of the structures on a straight-line basis over their estimated useful lives. Services such as ocean transportation of merchandise to certain locations on U.S. chartered vessels, and performance of administrative and supervisory functions by military personnel, have been provided without charge to the Exchange.

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued)

*(Dollars in thousands, unless otherwise noted)*

#### **1. Description of Business and Summary of Significant Accounting Policies (continued)**

Management has estimated the value of transportation costs provided by the U.S. Government for Exchange materials shipped to and from overseas Exchange facilities to be approximately \$148,698 and \$143,540 for fiscal years 2011 and 2010, respectively. In addition, OEF/OND transportation costs of \$145,409 and \$140,319 were paid by the U.S. Government for fiscal years 2011 and 2010, respectively.

The Exchange receives reimbursements of certain incremental costs incurred by the Exchange in relation to OEF/OND from Department of the Army and Department of the Air Force appropriated funds. Appropriated funds (APF) reimbursements are recorded when an incremental cost that qualifies for reimbursement has been incurred and reimbursement by the Department of the Army or the Department of the Air Force is reasonably assured. Such APF reimbursements receivable are classified as trade and other accounts receivable in the balance sheets and are recorded as an offset to the related expenses (as described below) in the statement of earnings. In fiscal 2011, the Exchange recorded a total of \$93,362 in APF reimbursements. Of this amount, \$19,686 was recognized for inventory markdowns and shortages, \$21,760 was recognized for personnel costs, \$45,920 was recognized for in-theater transportation, and \$5,997 was recognized for other expenses. In fiscal 2010, the Exchange recorded a total of \$159,119 in APF reimbursements. Of this amount, \$6,125 was recognized for inventory markdowns and shortages, \$17,984 was recognized for personnel costs, \$41,185 was recognized for in-theater transportation, and \$93,824, primarily related to APF reimbursements of incremental costs incurred in years prior to 2010, was recognized for other expenses.

#### **Base Realignment**

On May 13, 2005, the Department of Defense (DoD) announced the 2005 Base Realignment and Closure (BRAC) listing that impacted the existence of various military installations and personnel around the world. The goal of this global base realignment was to strategically position the military to accomplish future objectives. The list was formally approved by Congress and became law on November 9, 2005. Under this law, the DoD was required to complete these actions by September 15, 2011. There have been no changes to the BRAC listings affecting the Exchange. Substantially all property at the BRAC locations was fully depreciated as of January 28, 2012.

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued)

*(Dollars in thousands, unless otherwise noted)*

#### **1. Description of Business and Summary of Significant Accounting Policies (continued)**

In the event of closure of certain military bases around the world or a reduction in military forces, a decrease in sales at Exchange stores and a related decrease in the use of MILITARY STAR<sup>®</sup> Card credit due to the reduction of the customer base would likely occur.

#### **Fiscal Year**

The Exchange's fiscal year-end is the Saturday nearest January 31. References to fiscal 2011 and fiscal 2010 herein are to the fiscal years ended January 28, 2012 and January 29, 2011, respectively.

#### **Dividends**

The Exchange is required, under various agreements, to distribute a portion of each year's net earnings in the form of dividend payments to the Central Welfare Funds, Departments of the Army, the Air Force, the Navy, and the Marine Corps.

#### **Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Pension assets include alternative investments in limited partnerships, real estate properties, private equity, timber, agriculture, and alternative debt, which do not have readily available market values. In these instances, management reviews and takes responsibility for assessing, concluding on, and recording the fair market values for alternative investments provided by the general partner, investment manager, or appraiser, as appropriate. Management believes estimated fair values have been reported in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 820, *Fair Value Measurements and Disclosures*, but may differ materially from the values that would have been used had a ready market for these investments existed.



## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) *(Dollars in thousands, unless otherwise noted)*

#### **1. Description of Business and Summary of Significant Accounting Policies (continued)**

##### **Translation of Foreign Currencies**

The Exchange maintains foreign currencies only to the extent necessary to pay local current liabilities. Current liabilities are recorded daily and translated to U.S. dollars at “pegged” rates. Payments of current liabilities are recorded based on the “pegged” rate. At year-end, the current liabilities are translated from the pegged rates to the end-of-period market rates. The majority of such resulting gain or loss is recorded as foreign currency gain or loss with the remainder to the expense or asset account that gave rise to the current liability. The Company recognized a net loss on foreign currency of approximately \$1,380 and \$16,577 for the years ended January 28, 2012 and January 29, 2011, respectively. In addition, the noncurrent liability for local national separation pay as of January 28, 2012 and January 29, 2011 has been adjusted to end-of-period market rates as of those respective dates.

##### **Cash and Cash Equivalents**

Cash equivalents represent cash on hand in stores, deposits in banks, and third-party credit card receivables. Cash and cash equivalents are carried at cost, which approximates fair value. All book overdraft balances have been reclassified to accounts payable.

##### **Investments in Debt Securities**

Investments in debt securities have original maturities of greater than 90 days. These investments are typically held to maturity and are classified as such because the Company has the intent and ability to hold them to maturity. Held-to-maturity securities are carried at amortized cost.

##### **Accounts Receivable, Finance Revenue, and Provisions for Credit Losses**

As of January 28, 2012 and January 29, 2011, approximately \$2,844,006 and \$2,760,138 respectively, of the accounts receivable balance represents amounts due to the Exchange under its in-house credit program, the MILITARY STAR<sup>®</sup> Card. The MILITARY STAR<sup>®</sup> Card program extends credit to eligible Exchange customers for the purchase of retail goods at Exchange stores worldwide.

Minimum payments are calculated based on 2.777% of the unpaid balance as of the customer’s last purchase. These payments are applied in accordance with the Credit CARD Act of 2009. Payments are recorded against outstanding receivable balance and debited to cash accounts.

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued)

*(Dollars in thousands, unless otherwise noted)*

#### **1. Description of Business and Summary of Significant Accounting Policies (continued)**

Customer accounts receivable are classified as current assets and include some amounts that are due after one year. Concentrations of credit risk, with respect to customer receivables, are limited due to the large number of customers comprising the Company's credit card base and their dispersion throughout the world. The Company believes the carrying value of existing customer receivables is the best estimate of fair value.

The Company's accounts receivable balance includes \$189,764 and \$182,624 of receivables from the Marine Exchange (MCX) for Marine MILITARY STAR<sup>®</sup> Card outstanding balances and related processing fees as of January 28, 2012 and January 29, 2011, respectively.

Finance revenue is calculated based upon the customer account balance outstanding during the period after consideration of the applicable grace period, typically 30 days following the billing date. The finance rate charged is a variable interest rate calculated at a variable amount above the U.S. Prime Rate reported in *The Wall Street Journal*. The average finance rate charged for fiscal 2010 was 9.99%; however, effective September 1, 2010, the rate increased to 10.24%, which remained the rate for fiscal 2011. Beginning at 90 days past due, the delinquency rate of 18.24% applies. Finance charges are recorded unless an account balance has been outstanding for more than 150 days. The recorded investment in customer receivables past due 90 days or more and still accruing interest is approximately \$54,261 and \$45,169 as of January 28, 2012 and January 29, 2011, respectively. In fiscal 2010, the Company implemented new policies and procedures to comply with new federal credit card legislation. The legislation required the elimination of a minimum annual percentage rate (APR), which caused the Company to modify the variable rate formula. Additional provisions of the legislation included late payment warning, minimum payment warning, consideration of ability to repay, limits on raising interest rates and or fees on outstanding balances, and advance notice of rate increases or other significant changes.

Accounts past due for 30 days or more are considered delinquent. Accounts delinquent for 150 days are submitted to the Collection Department. The Exchange utilizes various means to collect past-due accounts, as well as accounts written off, including some methods not available to other retail organizations. The Exchange has agreements with other U.S. Government entities that allow the Exchange to garnish wages of service personnel, as well as claim the debtors' future payments from such U.S. Government entities, including U.S. Treasury income tax refunds. Personal contact, external collection agencies, and letters to service personnel superiors

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued)

*(Dollars in thousands, unless otherwise noted)*

#### **1. Description of Business and Summary of Significant Accounting Policies (continued)**

are also used to pursue delinquent accounts. The receivable related to accounts previously written off was \$301,863 and \$289,790 at January 28, 2012 and January 28, 2011, respectively. These accounts are at least 150 aged old and are generally outstanding for 1-5 years.

A provision for possible credit loss is recorded related to the Exchange's current credit card portfolio based on a percentage of total projected charge-offs that are considered uncollectible. Additionally, the Exchange records a net receivable related to accounts previously written off based upon estimated ultimate recoveries. The Exchange periodically evaluates the adequacy of the provision using such factors as prior account loss experience, changes in the volume of the account portfolio, changes in the estimates of anticipated recoveries on delinquent or written off balances, and changes in credit policy. These factors were considered in establishing the Exchange's allowance for doubtful accounts, and the net receivable related to accounts previously written off, as of January 28, 2012 and January 29, 2011. It is reasonably possible that the amounts the Exchange will ultimately recover on delinquent balances could differ materially in the near term from the amounts assumed in arriving at the allowance for doubtful accounts and net receivable related to accounts previously written off.

Collections on delinquent balances submitted to U.S. Government entities totaled approximately \$135,158 and \$127,136 in fiscal years 2011 and 2010, respectively. Bad debt expense of \$37,429 was recorded in 2011 compared to \$9,608 in fiscal 2010. The Exchange uses a portfolio approach pooled by year to record the net receivable related to accounts previously written off whereby finance income is no longer accrued and cash collections are applied to outstanding principal until 100% of the portfolio has been collected. Subsequent cash collections in excess of amounts previously written off are recorded as finance revenue. Finance revenue recognized in fiscal year 2011 related to accounts previously written off totaled approximately \$14,446 compared to approximately \$0 in fiscal year 2010.

Additionally, during the fiscal year ended January 28, 2012, the Exchange recorded a \$22,741 reduction in its net receivable related to accounts previously written off to cumulatively correct immaterial misstatements recorded in prior periods. This correction of prior periods resulted in \$22,741 of additional bad debt expense being recorded in the fiscal year ended January 28, 2012.



## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) (Dollars in thousands, unless otherwise noted)

#### 1. Description of Business and Summary of Significant Accounting Policies (continued)

The following table sets forth the age of the Exchange's current credit card receivables that have not yet been submitted to U.S. government entities for collection.

	<b>January 28, 2012</b>		<b>January 29, 2011</b>	
	<b>Amount</b>	<b>Percent of Receivables</b>	<b>Amount</b>	<b>Percent of Receivables</b>
	<i>(In Millions)</i>		<i>(In Millions)</i>	
Current	\$ 2,386	78.7%	\$ 2,358	80.1%
1-29 days past due	374	12.3	343	11.6
30-59 days past due	150	4.9	142	4.8
60-89 days past due	69	2.3	54	1.8
90+days past due	54	1.8	45	1.5
Period-end gross credit card receivables	<u>\$ 3,033</u>	<u>100.0%</u>	<u>\$ 2,942</u>	<u>100%</u>

The following table sets forth the provision for possible credit loss related to the Exchange's current credit card portfolio and does not include the net receivable related to accounts submitted to U.S. government entities for collection.

	<b>2011</b>	<b>2010</b>
	<i>(In Millions)</i>	
Allowance at beginning of period	\$ 31	\$ 28
Provision for bad debt	35	31
Write-offs (net of recoveries)	<u>(31)</u>	<u>(28)</u>
Allowance at end of period	<u>\$ 35</u>	<u>\$ 31</u>

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) (Dollars in thousands, unless otherwise noted)

#### 1. Description of Business and Summary of Significant Accounting Policies (continued)

The following table sets forth the credit card quality of the Exchange's current credit card portfolio.

	<b>January 28 2012</b>	<b>January 29 2011</b>
	<i>(In Millions)</i>	
Non-delinquent accounts (Current and 1-29 days past due):		
FICO score of 700 or above	\$ 661	\$ 599
FICO score of 600 to 699	1,492	1,438
FICO score below 600	607	665
Total non-delinquent accounts	<u>2,760</u>	<u>2,700</u>
Delinquent accounts (30+ days past due)	273	241
Period-end gross credit card receivables	<u>\$ 3,033</u>	<u>\$ 2,942</u>

#### Merchandise Inventories

The Exchange inventories are valued at the lower of cost or market, as determined primarily by the retail inventory method of accounting (RIM), except for distribution center inventories, which are based on the first-in, first-out inventory method. Certain warehousing and distribution expenses are included in the cost that can be inventoried. For the years ended January 28, 2012 and January 29, 2011, \$12,830 and \$10,359 of these expenses were allocated to merchandise inventory, respectively. For discussions of risk related to inventory in the OEF/OND regions, refer to Note 10.

Inherent in the RIM calculation are certain significant management judgments and estimates, including, among others, merchandise markons, markups, markdowns, and shrinkage, which significantly impact the ending inventory valuation at cost, as well as resulting gross margins. The methodologies utilized by the Exchange in the application of the RIM are consistent for all periods presented. Such methodologies include the development of the cost-to-retail ratios, the groupings of homogenous classes of merchandise, the development of shrinkage and obsolescence reserves, and the accounting for price changes.

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued)

*(Dollars in thousands, unless otherwise noted)*

#### **1. Description of Business and Summary of Significant Accounting Policies (continued)**

##### **Buildings and Improvements**

Buildings and improvements primarily represent permanent structures constructed by the Exchange and owned by the U.S. Government. These assets are recorded at cost with depreciation provided using the straight-line method over the estimated useful lives of the assets. The useful lives are governed, to a large extent, by the deployment of Army and Air Force personnel and, to some extent, by the requirements of the Departments of the Army and the Air Force with respect to space occupied by the Exchange. Buildings are generally depreciated over 30 years, and improvements are depreciated from 7 to 15 years. The Exchange loses its rights to buildings and improvements in the event of base closures and accelerates depreciation of its assets when such closures are probable.

In accordance with accounting standards governing the impairment or disposal of long-lived assets, the carrying value of long-lived assets, including property and equipment and definite-lived intangible assets, is evaluated whenever events or changes in circumstances indicate that a potential impairment has occurred relative to a given asset or assets. Factors that could result in an impairment review include, but are not limited to, a current-period cash flow loss combined with a history of cash flow losses or a projection that demonstrates continuing losses associated with the use of a long-lived asset, significant changes in the manner of use of the assets, or significant changes in business strategies. An impairment loss is recognized when the estimated undiscounted cash flows expected to result from the use of the asset plus net proceeds expected from disposition of the asset (if any) are less than the carrying value of the asset. When an impairment loss is recognized, the carrying amount of the asset is reduced to its estimated fair value as determined based on quoted market prices or through the use of other valuation techniques. The Company has not recorded any long-lived asset impairment charges during fiscal 2010 or 2011.



## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) *(Dollars in thousands, unless otherwise noted)*

#### **Fixtures and Equipment**

Fixtures and equipment are carried at cost with depreciation provided using the straight-line method over the estimated useful lives of the assets.

Depreciable lives used are as follows:

	<u>Depreciable Life</u>
Asset type:	
Motor vehicles	5 to 10 years
Equipment	2 to 15 years
Software	3 to 7 years

At January 28, 2012, property and equipment included approximately \$1,511,333 of fully depreciated assets that remain in use.

#### **Self-Insurance**

The Exchange acts as self-insurer for property, automobile, public liability, workers' compensation, comprehensive casualty losses, ocean marine, and other casualty losses. However, the Exchange has commercial property insurance covering the buildings, contents, and inventories at certain locations. The provision for certain self-insurance losses is based on calculations performed by the Exchange's independent actuarial consultants using loss development factors to estimate ultimate loss. The Company has established self-insurance reserves of \$71,262 and \$66,562 as of January 28, 2012 and January 29, 2011, respectively. Workers' compensation reserves have been discounted at a weighted-average rate of 4.02% for January 28, 2012. General liability reserves are discounted at a weighted-average rate of 2.23%. The reserves for both workers' compensation and property and liability were discounted based on a rate of 4.95% and 3.16%, respectively, for January 29, 2011.

#### **Separation Pay and Vacation Leave Accruals**

Separation pay and vacation leave for local national employees in foreign countries are accrued as earned based upon the labor laws of host countries and upon agreements between the U.S. and foreign governments. In order to estimate this liability, the Company and its actuaries make certain assumptions, including the amounts considered recoverable from foreign governments under existing agreement terms. Actual results may vary from these assumptions (see Note 7). Additionally, the liability for vacation leave earned by U.S. citizens is accrued as earned.

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) *(Dollars in thousands, unless otherwise noted)*

#### **1. Description of Business and Summary of Significant Accounting Policies (continued)**

##### **Advertising Costs**

Advertising costs are expensed in the period in which the advertising first occurs. The Exchange's cooperative advertising allowances are generally accounted for as a reduction in the purchase price of inventory.

Advertising expense was \$74,925 and \$64,861 for the years ended January 28, 2012 and January 29, 2011, respectively, and is included in selling, general, and administrative expenses.

##### **Revenue Recognition**

Revenue from retail sales is recognized at the time of sale. Revenue from sales made under a layaway program is recognized upon delivery of the merchandise to the customer. With respect to sales returns, a significant portion of the Company's products are consumables or perishables and are not subject to return by customers. Additionally, sales returns of products subject to the Company's return policy represent an insignificant portion of overall sales. Finance revenue includes finance charges and administrative fees on credit sales. Concession income includes fees charged to concessionaires based on a percentage of their sales and is recognized at the time of sale. Other operating income includes fees received from sources such as Western Union, delivery and ATM services, gift card breakage, and indirect retail income.

##### **Income Taxes**

The Exchange is a non-appropriated fund instrumentality of the U.S. and, as such, is not subject to the payment of income taxes.

##### **401(k)**

The Company has a 401(k) voluntary savings and investment plan open to regular full- and part-time employees who meet certain minimum requirements. The employees can make voluntary contributions to the plan not to exceed the lesser of 99% of eligible participant compensation or the applicable 401(k) maximum deferral contribution limit for the year.

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) (Dollars in thousands, unless otherwise noted)

#### 1. Description of Business and Summary of Significant Accounting Policies (continued)

##### Reclassifications

Certain reclassifications have been made to the accompanying fiscal 2010 financial statements to conform to the fiscal 2011 presentation.

##### Foreign Currency Hedging

As part of an overall risk management strategy, the Company uses foreign currency exchange contracts to hedge exposures to changes in foreign currency rates on the Company's payroll and foreign vendor obligations denominated in foreign currencies. These derivative instruments are accounted for in accordance with ASC 815, *Derivatives and Hedging*. ASC 815 requires that all derivative financial instruments be recognized in the financial statements and measured at fair value. Derivatives that are not hedges must be adjusted to fair value through earnings. If the derivative is a hedge, depending on the nature of the hedge, changes in the fair value of derivatives will either be offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings or recognized in net assets until the hedged item is recognized in earnings. Hedged items are reclassified from accumulated other comprehensive income (loss) and into earnings using the specific identification method. The Company's policy is that it does not speculate in hedging activities. The maximum length of time over which the Company is hedging its exposure to the variability of future cash flows for forecasted transactions is one year.

##### Fair Value Measurements

The Exchange records financial instruments at fair value in accordance with ASC 820. Under ASC 820, fair value is considered to be the exchange price in an orderly transaction between market participants to sell an asset or transfer a liability at the measurement date. The fair value definition under ASC 820 focuses on an exit price, which is the price that would be received to sell an asset or paid to transfer a liability versus an entry price, which would be the price paid to acquire an asset or received to assume a liability. See Note 3 for further information regarding fair value measurements.

Financial instruments that potentially subject the Exchange to concentrations of credit risk consist principally of investments held by the Supplemental Plan and derivative financial instruments. The Company uses high credit quality counterparties when executing derivative transactions.



## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) (Dollars in thousands, unless otherwise noted)

#### 1. Description of Business and Summary of Significant Accounting Policies (continued)

##### Recent Accounting Pronouncements

On May 12, 2011, the FASB ratified Accounting Standards Update (ASU) 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*. This ASU establishes a global standard for measuring amounts at fair value. This ASU will not have a material effect on the Company's financial position or results of operations, but will change the Company's disclosure policies for fair value. This ASU is effective for reporting periods beginning after December 15, 2011. The Company will adopt this ASU for the year ending February 2, 2013, and this ASU must be applied prospectively.

On June 16, 2011, the FASB ratified ASU 2011-05, *Presentation of Comprehensive Income*. This ASU eliminates the current option to report other comprehensive income and its components in the statement of changes in equity. Upon adoption, other comprehensive income must be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This ASU will not have a material effect on the Company's financial position or results of operations, but will change the Company's disclosure policies for other comprehensive income. This ASU is effective for fiscal years ending after December 15, 2011. This ASU must be applied retrospectively and early adoption is permitted. The Company will adopt this ASU for the year ended February 2, 2013.

##### Subsequent Events

The Exchange has evaluated subsequent events through June 18, 2012, the date at which the financial statements were available to be issued, and determined that no additional disclosures to those presented were necessary.

#### 2. Investments in Debt Securities

As of January 28, 2012, the Company held investments carried at \$8,300 and \$2,000 (which mature in March 2012 and April 2012, respectively), in support of non-German, Local National separation pay. Investments are classified as "held-to-maturity" in accordance with ASC 320-10, *Investments – Debt and Equity Securities*, and are classified on the accompanying balance sheets in short-term investments.

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) *(Dollars in thousands, unless otherwise noted)*

#### **2. Investments in Debt Securities (continued)**

As of January 29, 2011, the Company held a €15,000 (approximately \$20,548) German government security to support the liability for German Local National separation pay, which was classified as and included in short-term investments on the accompanying balance sheet. In December 2011, this bond matured and a new bond, valued at €15,000 (approximately \$20,270), was purchased. The new bond is due to mature on March 13, 2013, is valued at \$19,737 as of January 28, 2012, and is classified as long-term investments and supplemental plan assets on the accompanying balance sheet.

#### **3. Fair Value Measurements**

As prescribed by ASC 820, the fair value of financial assets and liabilities is based on the following fair value hierarchy, which prioritizes the inputs to valuation techniques used to measure fair value into three levels:

**Level 1** – The Exchange uses the unadjusted quoted prices in active markets for identical assets or liabilities to which the Exchange has access. An active market for the asset or liability is one in which transactions for the asset or liability occurs with sufficient frequency and volume to provide ongoing pricing information.

**Level 2** – The Exchange determines the value of the investment holdings by evaluating its pro rata share of investments where it does not own the underlying securities but rather a proportional share of the fund, such as mutual fund and common collective trusts. Significant inputs, other than quoted market prices included in Level 1 that are observable, impact either directly or indirectly, the asset or liability. Level 2 inputs include, but are not limited to, quoted prices for similar assets or liabilities in an active market, quoted prices for identical or similar assets or liabilities in markets that are not active, and inputs other than quoted market prices that are observable for the asset or liability, such as interest rate curves and yield curves observable at commonly quoted intervals, volatilities, credit risk, and default rates.

**Level 3** – Inputs are unobservable for the assets or liabilities. The Exchange invests only with managers that provide financial statements that are independently audited at least once a year. The statements are accompanied by a report from the auditing firm, which discloses the accounting basis as well as an opinion regarding the reliability of the financial statements. In addition to the audited statements, the fund managers have provided the type of investments as well as the methods used to value and appraise all investments in the fund's portfolio.

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued)

*(Dollars in thousands, unless otherwise noted)*

#### 3. Fair Value Measurements (continued)

The following table sets forth by level, within the fair value hierarchy, the Company's assets and liabilities that are measured at fair value as of January 28, 2012 and January 29, 2011:

	Fair Value as of January 28, 2012			
	Total	Level 1	Level 2	Level 3
Assets:				
Cash and cash equivalents	\$ 38	\$ 38	\$ -	\$ -
Collective investment funds <sup>(1)</sup>	14,974	-	14,974	-
Due from broker	27	27	-	-
<b>Total assets</b>	<b>\$ 15,039</b>	<b>\$ 65</b>	<b>\$ 14,974</b>	<b>\$ -</b>

Liabilities:				
Foreign currency derivative liabilities <sup>(2)</sup>	\$ 4,226	\$ -	\$ 4,226	\$ -
<b>Total liabilities</b>	<b>\$ 4,226</b>	<b>\$ -</b>	<b>\$ 4,226</b>	<b>\$ -</b>

	Fair Value as of January 29, 2011			
	Total	Level 1	Level 2	Level 3
Assets:				
Cash and cash equivalents	\$ 18	\$ 18	\$ -	\$ -
Collective investment funds <sup>(1)</sup>	15,339	-	15,339	-
Foreign currency derivatives <sup>(2)</sup>	461	-	461	-
<b>Total assets</b>	<b>\$ 15,818</b>	<b>\$ 18</b>	<b>\$ 15,800</b>	<b>\$ -</b>

<sup>(1)</sup> Holdings consist of a Blackrock equity fund (approximately 40% in fiscal 2011 and 97% in fiscal 2010), which is passive in nature and employs a strategy to closely follow the S&P 500 index, and a Blackrock U.S. Debt Index fund (approximately 60% in fiscal 2011 and 3% in fiscal 2010), which employs a strategy that seeks to match the performance of the Barclays Capital Aggregate Bond Index by investing in a diversified sample of the bonds that make up the index.

<sup>(2)</sup> Derivatives are included on the balance sheet in 2011 and 2010 in accounts payable and accrued salaries, separation pay, and other employee benefits.



## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) (Dollars in thousands, unless otherwise noted)

#### 3. Fair Value Measurements (continued)

The Company holds investments related to the Supplemental Plan totaling \$15,039 and \$15,357 at January 28, 2012 and January 29, 2011, respectively, which are included in long-term investments and Supplemental Plan assets on the balance sheet. Supplemental Plan assets are classified as trading securities since gains and losses from these investments are intended to offset the cost of the Supplemental Plan. Net income on trading securities was \$122 and \$2,620 in fiscal 2011 and 2010, respectively. The cost of securities sold is determined primarily on a specific identification method. (Refer to Note 7 for further discussion of the Supplemental Plan, and refer to Note 5 for further discussion of the Company's derivative positions.)

Cash and cash equivalents, accounts payable, and accrued liabilities are reflected in the balance sheet at cost, which approximates fair value due to the short-term nature of these instruments. Trade and other accounts receivable are reflected in the balance sheet at cost less a provision for credit losses, which approximates market value due either to the short-term nature of the instruments or the variable market rate of interest that is charged on outstanding credit card balances. The fair value of the Company's debt is disclosed in Note 4.

The allocation of Supplemental Plan assets at January 28, 2012 and January 29, 2011, by asset category, is as follows:

	<u>2011</u>	<u>2010</u>
Domestic equity securities	41%	97%
Investment-grade fixed income	59	3
Total	<u>100%</u>	<u>100%</u>

#### 4. Indebtedness

##### Syndicated Lines of Credit

In June 2011, the 12-bank syndicate led by Wells Fargo/Wachovia and 15-bank syndicate led by JP Morgan Chase were terminated. As of January 28, 2012, the Exchange has an unsecured, revolving line of credit that is facilitated by a 16-bank syndicate led by JP Morgan Chase aggregating to \$1,500,000. This agreement expires in June 2015. There was \$120,000 outstanding under this line of credit at January 28, 2012.

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) *(Dollars in thousands, unless otherwise noted)*

#### **4. Indebtedness (continued)**

##### **Uncommitted Lines of Credit**

As of January 28, 2012, the Exchange maintains three uncommitted lines of credit aggregating to approximately \$1,925,000, one with JP Morgan Chase, one with Bank of America, and the other with Installation Management Command G-9 (IMCOM G-9), a separate NAFI. Borrowings under these lines of credit were \$1,597,000 at January 28, 2012, compared to \$1,346,000 at January 29, 2011. While both of these lines are open ended, the outstanding balances under these lines as of January 28, 2012, have various maturity dates, with the latest being May 2012. Accordingly, the Company classifies outstanding amounts on these lines of credit as current obligations.

Borrowings under all lines of credit both committed and uncommitted bear interest rates ranging from 0.37% to 1.45%. The average interest rate under these lines of credit was 1.07% for the year ended January 28, 2012.

##### **Senior Notes**

In December 2011, the Exchange completed a private placement debt offering of \$200,000 in senior notes. A delayed funding option was utilized allowing the Exchange to receive funding of the senior notes in February 2012.

In October 2009, the Exchange completed a private placement debt offering of \$90,000 in senior notes (the 2024 senior notes), which comprise a 15-year amortizing principal. As of January 28, 2012, these senior notes have a total remaining obligation of \$80,364.

In June 2009, the Exchange completed a \$650,000 offering of debt in a private placement. This offering provided the Exchange with \$650,000 in fixed-rate, committed senior notes (the Series A, B, and C senior notes), which were issued in three tranches.

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) (Dollars in thousands, unless otherwise noted)

#### 4. Indebtedness (continued)

Debt obligations as of January 28, 2012 and January 29, 2011, consisted of the following:

	<b>2011</b>	<b>2010</b>
Outstanding debt principal balances:		
Wachovia revolving line of credit, terminated June 2011	\$ —	\$ 250,000
JP Morgan Chase revolving line of credit, terminated June 2011	—	—
JP Morgan Chase revolving line of credit, expiring 2015	<b>120,000</b>	—
JP Morgan Chase uncommitted line of credit	<b>947,000</b>	996,000
IMCOM G-9 uncommitted line of credit	<b>425,000</b>	350,000
Bank of America uncommitted line of credit	<b>225,000</b>	—
5.24% Series A senior notes due 2012	<b>150,000</b>	150,000
5.47% Series B senior notes due 2013	<b>150,000</b>	150,000
5.74% Series C senior notes due 2014	<b>350,000</b>	350,000
4.95% senior notes due 2024	<b>80,364</b>	84,779
Total debt obligations	<b>2,447,364</b>	2,330,779
Current maturities	<b>(1,871,639)</b>	(1,600,415)
Total long-term debt obligations	<b>\$ 575,725</b>	\$ 730,364

Based on the short-term nature of the Company's line of credit borrowings, the Exchange believes that the carrying values of amounts outstanding under the line of credit agreements approximate fair value given the term of the debt and floating interest rates. The estimated aggregate fair value for the senior notes (A–C) is \$687,481 as of January 28, 2012, and the estimated fair value of the 2024 senior notes is \$86,036. Fair value is calculated using a discounted cash flow analysis with estimated interest rates offered for notes with similar terms and maturities.

Cash paid for interest for fiscal years 2011 and 2010 was approximately \$56,218 and \$50,843, respectively. The Exchange has complied with all financial and non-financial covenants per loan agreements as of January 28, 2012.

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) *(Dollars in thousands, unless otherwise noted)*

#### 4. Indebtedness (continued)

Principal maturities of debt obligations as of January 28, 2012, are as follows (in thousands):

2012	\$ 1,871,639
2013	154,874
2014	355,120
2015	5,380
2016	5,652
Thereafter	54,699
	<u>\$ 2,447,364</u>

The Company has historically regularly extended or replaced its line of credit facilities with similar short term borrowings and on similar terms and conditions. The Company believes it has the ability and intent to renew its existing facilities coming due in 2012 or replace such facilities on substantially the same or better terms and conditions.

#### 5. Derivative Financial Instruments

Forward and option collar foreign exchange contracts are used primarily to hedge the risk of the Company's euro-denominated payroll and foreign vendor obligations against adverse changes in foreign currency exchange rates. Under the foreign exchange contracts, the Company agrees to pay an amount equal to a specified exchange rate multiplied by a Euro notional principal amount, and to receive in return an amount equal to a specified monthly pegged exchange rate multiplied by the same euro notional principal amount. No other cash payments are made under the contracts, and the contracts cannot be terminated. Under the option collar contracts (effectively the simultaneous purchase of a put and call option for the same notional amount and maturity, with the put being the floor strike rate and the call being the ceiling strike rate) the user maintains full protection against adverse movements, but gains due to favorable exchange rate moves are limited to the strike price of the sold option.

The Company has designated the forward and option collar foreign exchange contracts as cash flow hedges of its exposure to changes in its functional currency-equivalent cash flows on the associated payroll and foreign vendor obligations. Accordingly, the changes in the fair value of the Company's forward and option collar foreign exchange contracts are recorded in the Company's balance sheet as an asset or liability and in net assets (as a component of accumulated other comprehensive loss). As the notional amounts and terms of each forward and



## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) (Dollars in thousands, unless otherwise noted)

#### 5. Derivative Financial Instruments (continued)

option collar foreign exchange contract match those of its liability counterpart at maturity, any ineffectiveness is immaterial in the foreign exchange contracts.

Upon expiration of the hedge contracts, the amount of the hedged item that affects earnings is reclassified from accumulated other comprehensive loss.

As of January 28, 2012, the Company had various foreign exchange contracts (forwards and option collars) outstanding related to approximately \$128,668 (€95,000) of its forecasted payroll and inventory purchase liabilities. As of January 28, 2012, the notional value of the outstanding forward contracts (€15,000) was \$20,370 with a corresponding loss of \$657. The notional value of outstanding option collar contracts (€80,000) was \$108,298, with a corresponding loss of \$3,569. The net loss of \$4,226 is included in accrued salaries, separation pay, and other benefits and accounts payable on the accompanying balance sheet and is included as a component of accumulated other comprehensive loss. The balance of \$4,226 in accumulated other comprehensive loss is expected to be reclassified into earnings within the next 12 months. In addition, the Company has recognized approximately \$593 in gains on foreign currency hedge transactions during fiscal 2011, compared to \$13,661 in losses during fiscal 2010.

Unrealized gains and losses on foreign exchange hedges that are included in accumulated other comprehensive loss are recognized into earnings as the related payroll expenses are paid or the related inventory is purchased.

Derivatives designated as hedging instruments	Derivative Assets (Liabilities)		
	Balance Sheet Location	Fair Value	
		January 28 2012	January 29 2011
Foreign currency exchange contracts	Accounts payable	\$ (3,170)	\$ 346
	Accrued salaries, separation pay, and other employee benefits	(1,056)	115
<b>Total derivatives designated as hedging instruments</b>		<b>\$ (4,226)</b>	<b>\$ 461</b>

Reclassifications from accumulated other comprehensive loss are recognized in selling, general, and administrative other expense in the statement of earnings.

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) (Dollars in thousands, unless otherwise noted)

#### 6. Lease and Rental Obligations

The Company's operating lease and rental commitments primarily include real estate and information technology leases. The Company recorded rent expense of \$22,564 and \$21,944 for the fiscal years ended January 28, 2012 and January 29, 2011, respectively. The following is a schedule, by year, of the future minimum rental payments required under all leases as of January 28, 2012:

2012	\$ 9,011
2013	6,253
2014	1,489
2015	1,197
2016	400
Thereafter	360
	<u>\$ 18,710</u>

#### 7. Benefit Plans

The Exchange has a defined benefit pension plan, the Retirement Annuity Plan (the Basic Plan), covering regular full-time civilian employees of the Company who are citizens or residents of the U.S. In addition, a noncontributory supplemental deferred compensation plan (the Supplemental Plan) provides for selected benefits to employees in the Executive Management Program. The Exchange's policy is to annually fund actuarially determined postretirement expense unless the respective plan is fully funded or unless an asset-liability model has shown the respective plan will likely become fully funded even in the absence of future contributions. The benefits are based on years of service and the employees' highest three-year average compensation. Assets of the plans consist primarily of marketable debt and equity securities.

In addition to the Exchange's pension plan, certain medical and dental (health care) and life insurance benefits are also provided to retired employees through the Postretirement Medical/Dental and Life Insurance (Postretirement) plans for employees of the Exchange. All regular full-time U.S. civilian employees who are paid on the U.S. dollar payroll may become eligible for these benefits if they satisfy eligibility requirements during their working lives. The Exchange's policy is to annually fund actuarially determined Postretirement expense unless the respective plan is fully funded or unless an asset-liability model has shown the respective plan will likely become fully funded, even in the absence of future contributions.

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued)

*(Dollars in thousands, unless otherwise noted)*

#### **7. Benefit Plans (continued)**

The Exchange also provides certain life insurance and other disability benefits for active employees. Benefits are paid from a Voluntary Employee Beneficiary Association (VEBA) trust maintained by the Exchange and to which the Company contributes each year. As of January 28, 2012, the Company recorded a liability of approximately \$17,767, which represents an estimated liability of \$38,481 less trust assets of \$20,714. At January 29, 2011, the Company recorded a liability of \$22,895, which represents an estimated liability of \$43,368 less trust assets of \$20,473.

In addition, the Company provides a noncontributory defined benefit pension plan to its employees in the United Kingdom (UK Plan). With the UK Plan, the Exchange also provides postemployment benefits (e.g., separation pay) through its Local National benefit plans to employees in Germany, Japan, Okinawa, Azores, Italy, and Turkey (collectively, referred to as Foreign Plans).

The Exchange measures the cost of its pension plans and other benefit plans in accordance with ASC 715, *Compensation – Retirement Benefits*. In addition, assets of the Supplemental Plan do not qualify as plan assets as defined in ASC 715 and, as a result, are accounted for in accordance with ASC 320.

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) (Dollars in thousands, unless otherwise noted)

#### 7. Benefit Plans (continued)

The following tables provide a reconciliation of the changes in the plans' benefit obligations and fair value of assets for the years ended January 28, 2012 and January 29, 2011. Amounts are stated in millions.

	Pension Benefits				Other Benefits			
	The Basic Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2011	2010	2011	2010	2011	2010	2011	2010
<b>Change in projected benefit obligations (PBO)</b>								
PBO at prior measurement date	\$ 3,186	\$ 3,119	\$ 9	\$ 7	\$ 1,837	\$ 1,798	\$ 110	\$ 108
Service cost	74	72	1	1	24	22	5	4
Interest cost	188	185	-	-	108	102	4	4
Plan participants' contributions	4	4	-	-	-	-	-	-
Change in assumptions	-	-	-	-	-	-	(22)	-
Actuarial loss (gain)	391	34	4	1	134	6	1	(4)
Foreign exchange impact	-	-	-	-	-	-	-	1
Benefits paid	(217)	(210)	-	-	(87)	(84)	(4)	(3)
Administrative expenses paid	(18)	(18)	-	-	(7)	(7)	-	-
PBO at current measurement date	<u>\$ 3,608</u>	<u>\$ 3,186</u>	<u>\$ 14</u>	<u>\$ 9</u>	<u>\$ 2,009</u>	<u>\$ 1,837</u>	<u>\$ 94</u>	<u>\$ 110</u>
<b>Change in plan assets</b>								
Fair value of assets at prior measurement date	\$ 3,589	\$ 3,241	\$ -	\$ -	\$ 1,324	\$ 1,174	\$ 30	\$ 27
Actual return on assets	186	572	-	-	55	220	2	3
Employer contributions	-	-	-	-	46	21	3	2
Plan participants' contributions	4	4	-	-	-	-	-	-
Benefits paid	(217)	(210)	-	-	(87)	(84)	(2)	(2)
Administrative expenses paid/foreign exchange impact	(18)	(18)	-	-	(7)	(7)	-	-
Fair value of assets at current measurement date	<u>\$ 3,544</u>	<u>\$ 3,589</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,331</u>	<u>\$ 1,324</u>	<u>\$ 33</u>	<u>\$ 30</u>
Funded status at fiscal year-end	<u>\$ (64)</u>	<u>\$ 403</u>	<u>\$ (14)</u>	<u>\$ (9)</u>	<u>\$ (678)</u>	<u>\$ (513)</u>	<u>\$ (61)</u>	<u>\$ (80)</u>

<sup>(1)</sup> Supplemental assets do not qualify as plan assets.



## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) (Dollars in thousands, unless otherwise noted)

#### 7. Benefit Plans (continued)

The following table reflects amounts recognized in the balance sheets as of January 28, 2012 and January 29, 2011. Amounts are stated in millions.

	Pension Benefits				Other Benefits			
	The Basic Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2011	2010	2011	2010	2011	2010	2011	2010
<b>Amounts recognized in the balance sheets</b>								
Prepaid pension asset	\$ -	\$ 403	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Other current liabilities	-	-	1	-	63	43	8	8
Accrued pension and other benefits liability	64	-	13	9	615	470	53	72
Accumulated other comprehensive loss	(925)	(426)	(11)	(9)	(813)	(675)	(21)	(21)

A summary of the components of net periodic benefit cost (income) for the benefit plans is as follows for the years ended January 28, 2012 and January 29, 2011. Amounts are stated in millions.

	Pension Benefits				Other Benefits			
	The Basic Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2011	2010	2011	2010	2011	2010	2011	2010
<b>Net periodic cost</b>								
Service cost	\$ 74	\$ 72	\$ 1	\$ 1	\$ 23	\$ 22	\$ 5	\$ 4
Interest cost	188	185	-	-	108	102	4	4
Expected return on assets	(295)	(299)	-	-	(107)	(109)	(2)	(2)
Prior service cost amortization	-	-	-	-	(4)	(4)	-	-
Net loss amortization	1	-	2	2	52	48	1	2
Net periodic benefit (income) cost	\$ (32)	\$ (42)	\$ 3	\$ 3	\$ 72	\$ 59	\$ 8	\$ 8

Information for benefit plans with an accumulated benefit obligation in excess of plan assets is as follows. Amounts are stated in millions.

	Pension Benefits		Other Benefits		Pension Benefits	
	Supplemental Plan		Postretirement		Foreign Plans	
	2011	2010	2011	2010	2011	2010
Projected benefit obligation	\$ 14	\$ 9	\$ 2,009	\$ 1,837	\$ 94	\$ 110
Accumulated benefit obligation	9	9	2,009	1,837	79	92
Fair value of plan assets	-	-	1,331	1,324	33	30

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) (Dollars in thousands, unless otherwise noted)

#### 7. Benefit Plans (continued)

Amounts included in accumulated other comprehensive income for all plans at January 28, 2012, consist of net actuarial losses of \$1,765,907 and a net prior service credit of \$4,346. Amortization of these amounts expected to be recognized in fiscal year 2012 is \$123,968 for net actuarial losses and \$4,346 for prior service credit.

#### Actuarial Assumptions

Actuarial weighted-average assumptions used in determining plan liabilities are as follows:

	Pension Benefits		Pension Benefits		Other Benefits	
	The Basic Plan		Supplemental Plan		Postretirement	
	2011	2010	2011	2010	2011	2010
Assumptions used to determine expense:						
Discount rate	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%
Long-term rate of return on assets	8.25%	8.25%	—	—	8.75%	8.75%
Compensation increase rate	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%
Assumptions used at disclosure:						
Discount rate	5.26%	6.00%	5.26%	6.00%	5.45%	6.00%
Compensation increase rate	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%
			Other Benefits		Other Benefits	
			UK Plan		Local National Plan	
			2011	2010	2011	2010
Assumptions used to determine expense:						
Discount rate			5.70%	5.70%	3.57%	3.26%
Long-term rate of return on assets			6.90%	6.90%	—	—
Compensation increase rate			4.50%	4.50%	2.51%	2.58%
Assumptions used at disclosure:						
Discount rate			4.80%	5.70%	3.13%	3.04%
Compensation increase rate			4.20%	4.50%	2.51%	2.52%

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) (Dollars in thousands, unless otherwise noted)

#### 7. Benefit Plans (continued)

Actuarial assumptions are based on management's best estimates and judgment. The Exchange reassesses its benefit plan assumptions on a regular basis. The expected rate of return for the pension plans represents the average rate of return to be earned on the plan assets over the period that the benefits included in the benefit obligation are to be paid. In developing the expected rate of return, the Exchange considers the impact of long-term compound annualized returns on the plan assets.

#### Pension Plan Assets

The Exchange's investment objectives for the benefit plans are designed to generate asset returns that will enable the plans to meet their future benefit obligations. The precise amount for which these obligations will be settled depends on future events, including interest rates, salary increases, and the life expectancy of the plans' members. The obligations are estimated using actuarial assumptions, based on the current economic environment.

The benefit plans seek to achieve total returns sufficient to meet expected future obligations, as well as returns greater than their policy benchmark reflecting the target weights of the asset classes used in their targeted strategic asset allocation. The plans' targeted strategic allocation to each asset class was determined through an asset-liability modeling study.

The following table sets forth the target allocations of plan assets:

	Pension Benefits		Other Benefits		Other Benefits	
	The Basic Plan		Postretirement Plan		UK Plan	
	2011	2010	2011	2010	2011	2010
Domestic equity securities	17%	17%	22%	22%	26%	26%
International equity securities	12	12	16	16	35	35
Emerging market equity securities	5	5	5	5	4	4
Investment-grade fixed income	21	21	12	12	35	35
High-yield fixed income	10	10	10	10	—	—
Treasury inflation protected securities (TIPS)	5	5	5	5	—	—
Real estate – private	8	8	8	8	—	—
Real estate – public	2	2	2	2	—	—
Private equity	10	10	10	10	—	—
Commodities	5	5	5	5	—	—
Alternative debt	5	5	5	5	—	—
Total	100%	100%	100%	100%	100%	100%

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) (Dollars in thousands, unless otherwise noted)

#### 7. Benefit Plans (continued)

The Exchange's benefit plan actual asset allocations at January 28, 2012 and January 29, 2011, by asset class category are as follows:

	Pension Benefits		Other Benefits		Other Benefits	
	The Basic Plan		Postretirement Plan		UK Plan	
	2011	2010	2011	2010	2011	2010
Domestic equity securities	<b>20%</b>	22%	<b>24%</b>	26%	<b>26%</b>	26%
International equity securities	<b>11</b>	13	<b>16</b>	18	<b>35</b>	36
Emerging market equity securities	<b>4</b>	5	<b>5</b>	6	<b>4</b>	4
Investment-grade fixed income	<b>22</b>	20	<b>12</b>	13	<b>35</b>	34
High-yield fixed income	<b>10</b>	5	<b>10</b>	5	–	–
TIPS	<b>5</b>	8	<b>5</b>	5	–	–
Real estate – private	<b>8</b>	8	<b>8</b>	8	–	–
Real estate – public	<b>2</b>	2	<b>2</b>	2	–	–
Private equity	<b>9</b>	7	<b>9</b>	7	–	–
Commodities	<b>5</b>	5	<b>5</b>	6	–	–
Alternative debt	<b>4</b>	5	<b>4</b>	4	–	–
Total	<b>100%</b>	100%	<b>100%</b>	100%	<b>100%</b>	100%

Equity securities are diversified across various industries and comprise common and preferred stocks of U.S. and international companies and equity positions in privately held companies controlled through limited partnerships. Common and preferred stocks are based on market quotations and are classified as Level 1 in the fair value hierarchy. The estimated fair values of the investments in the collective investment funds represent the underlying net asset values of the shares or units of such funds as determined by the issuer. Limited partnerships are valued at the plans' proportionate share of the estimated fair value of the underlying net assets as determined by the general partners. The limited partnerships are valued based on purchase price when recently acquired; valuation models such as discounted cash flows or market multiples; financial measures, such as free cash flow or earnings before interest, taxes, depreciation, and amortization (EBITDA); or market comparisons for similar assets and are classified as Level 3 investments. Foreign obligations are foreign equities traded on U.S. exchanges as American Depository Receipts (ADRs), are valued based on market quotations, and are classified as Level 1 investments.



## Army and Air Force Exchange Service

### Notes to Financial Statements (continued)

*(Dollars in thousands, unless otherwise noted)*

#### **7. Benefit Plans (continued)**

Debt securities comprise corporate bonds, government securities, and asset-backed or collective investment funds and limited partnerships with underlying debt securities. U.S. Government obligations are valued at the closing price reported on the active market on which the individual securities U.S. Government obligations are valued at the closing price reported on the active market on which the individual securities are traded. U.S. government agency securities are usually traded in active markets; however, they may not trade with sufficient frequency to rely on a single price of the same security. As such, broker quotes may be used based on similar assets in active markets. U.S. government obligations are valued as Level 1 investments. Corporate bonds are usually traded in active markets; however, they may not trade with sufficient frequency to rely on a single price of the same security. As such, broker quotes may be used based on similar assets in active markets. Asset-backed securities are publicly traded securities with coupon payments based on the performance of the underlying assets and are usually traded in active markets; however, they may not trade with sufficient frequency to rely on a single price of the same security. As such, broker quotes may be used based on similar assets in active markets. Corporate bonds and asset-backed securities are classified as Level 2 investments. Registered investment companies are valued based on the net asset value held at year-end and are classified as Level 2 investments.

Real estate and commodities comprise investments whose underlying value is based on real estate or commodities. Publicly traded securities are equity shares in Real Estate Investment Trusts (REITs) and valued based on market quotations. Collective investment funds with underlying investments in exchange-traded positions are classified as Level 2 investments. Collective investment funds and limited partnerships with underlying investments in real estate are classified as Level 3 investments. The estimated fair value of the underlying real estate is based on the selling price of the property, income the property is expected to generate, and the market values of any commodities currently on the land.

Other investments consist primarily of investment contracts and are valued at the quoted price as determined by the issuer. Contracts are classified as Level 2 investments.

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in thousands, unless otherwise noted)

**7. Benefit Plans (continued)**

The following table sets forth by level, within the fair value hierarchy, the Company's plan assets and liabilities that are measured at fair value as of January 28, 2012:

	<b>Benefit Plans</b>			
	<b>Total</b>	<b>Level 1 Quoted Prices in Active Markets</b>	<b>Level 2 Significant Observable Inputs</b>	<b>Level 3 Significant Unobservable Inputs</b>
<b>Assets</b>				
Temporary investments <sup>(a)</sup>	\$ 4,286	\$ 4,286	\$ —	\$ —
Equity securities:				
Common and preferred stock <sup>(b)</sup>	848,612	848,612	—	—
Collective investment funds <sup>(c)</sup>	893,796	—	893,796	—
Limited partnerships <sup>(d)</sup>	428,425	—	—	428,425
Foreign obligations <sup>(e)</sup>	87,163	87,163	—	—
Debt securities:				
U.S. government obligations <sup>(f)</sup>	344,246	344,246	—	—
Corporate bonds <sup>(g)</sup>	457,286	—	457,286	—
Asset-backed securities <sup>(i)</sup>	44,033	—	44,033	—
Collective investment funds <sup>(h)</sup>	797,613	—	797,613	—
Limited partnerships <sup>(d)</sup>	209,383	—	—	209,383
Registered investment companies	14,206	—	14,206	—
Real estate and commodities:				
Common and preferred stock <sup>(b)</sup>	117,663	117,663	—	—
Collective investment funds <sup>(i)</sup>	555,085	—	83,513	471,572
Limited partnerships <sup>(d)</sup>	104,971	—	—	104,971
Due to/from broker for sale of securities – net	(10,943)	(10,943)	—	—
Other investments	12,495	—	12,495	—
<b>Total investments</b>	<b>\$ 4,908,320</b>	<b>\$ 1,391,027</b>	<b>\$ 2,302,942</b>	<b>\$ 1,214,351</b>

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in thousands, unless otherwise noted)

7. Benefit Plans (continued)

The following table sets forth by level, within the fair value hierarchy, the Company's plan assets and liabilities that are measured at fair value as of January 29, 2011:

	Benefit Plans			
	Total	Level 1 Quoted Prices in Active Markets	Level 2 Significant Observable Inputs	Level 3 Significant Unobservable Inputs
<b>Assets</b>				
Temporary investments <sup>(a)</sup>	\$ 15,741	\$ 15,741	\$ —	\$ —
Equity securities:				
Common and preferred stock <sup>(b)</sup>	1,089,898	1,089,898	—	—
Collective investment funds <sup>(c)</sup>	764,786	—	764,786	—
Limited partnerships <sup>(d)</sup>	336,565	—	—	336,565
Foreign obligations <sup>(e)</sup>	107,729	107,729	—	—
Debt securities:				
U.S. government obligations <sup>(f)</sup>	421,888	421,888	—	—
Corporate bonds <sup>(g)</sup>	382,122	—	382,122	—
Asset-backed securities <sup>(i)</sup>	30,713	—	30,713	—
Collective investment funds <sup>(h)</sup>	600,189	—	600,189	—
Limited partnerships <sup>(d)</sup>	214,772	—	—	214,772
Registered investment companies	69,238	—	69,238	—
Real estate and commodities:				
Common and preferred stock <sup>(b)</sup>	106,543	106,543	—	—
Collective investment funds <sup>(i)</sup>	563,357	—	136,448	426,909
Limited partnerships <sup>(d)</sup>	101,733	—	—	101,733
Due to/from broker for sale of securities – net	116,587	116,587	—	—
Other investments	14,751	—	14,677	74
Total investments	<u>\$ 4,936,612</u>	<u>\$ 1,858,386</u>	<u>\$ 1,998,173</u>	<u>\$ 1,080,053</u>

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued)

*(Dollars in thousands, unless otherwise noted)*

#### 7. Benefit Plans (continued)

- (a) Primarily consist of cash held in foreign currencies.
- (b) Holdings are diversified as a percentage of total equity with the following breakout and approximate allocation percentages: Domestic Markets (50%); Developed International Markets (35%); International Emerging Markets (15%). Domestic Markets are diversified by Large Cap Value (40%), Large Cap Growth (40%), and Small Cap (20%).
- (c) Holdings consist of Blackrock index funds, which are passive in nature and employ a strategy of investing in securities that provide beta (market) exposure to a specific index including the S&P 500 and MSCI EAFE. The collective investment funds consist of domestic (approximately 70%) and International (approximately 30%) investments that have a required notice of three days for any sales or liquidation. The fund's management may impose restrictions on cash redemptions in the fund outside the normal course of business. Distributions may be made in cash or in kind or partly in cash or partly in kind at the sole discretion of the fund's trustee. There are no restrictions on withdrawals.
- (d) Includes limited partnerships that invest primarily in U.S. buyout opportunities as well as opportunistic debt of a range of privately held companies. The fund does not have to redeem its limited partnership investment at its net asset value. Instead, the fund receives distributions as the underlying assets of the fund are liquidated. It is estimated that the underlying assets of these funds will be gradually liquidated over the next 1 to 10 years.
- (e) Holdings include International (approximately 25%) and Emerging Markets (approximately 75%) securities in the form of American Depository Receipts which represent underlying securities, traded on non-U.S. exchanges.
- (f) Fixed-income treasury securities backed by the full faith and credit of the U.S. government. There are no significant foreign currency risks within this segment.
- (g) Includes approximately 65% and 40% of investments in corporate high-yield debt with S&P rating of B- and below as of January 28, 2012 and January 29, 2011, respectively. The remaining investments are in investment-grade corporate bonds.
- (h) The State Street Bank and Trust Company Short Term Investment Fund employs a strategy to provide safety of principal, daily liquidity, and a competitive yield by investing in high-quality money market instruments. Issuances and redemptions are made on each business day. The fund's management may impose restrictions on cash redemptions in the fund outside the normal course of business. Distributions may be made in cash or in kind or partly in cash or partly in kind at the discretion of the funds' trustee.
- (i) Investments include both commodities and real estate, which provide diversified returns relative to stocks and bonds. The underlying commodity investments are actively traded futures, which have full pricing transparency and daily liquidity and are reported as Level 2 investments. Real estate holdings include direct real estate investments in properties that are valued by appraisal and reported as Level 3. The investments are diversified by core (approximately 70%) and value-added or opportunistic (approximately 5%) investments. Commodity investments include farmland and timber, which represent approximately 25% of the allocation. There is quarterly redemption available for the real estate investments with a 60-day notice.
- (j) Holdings consist primarily of publicly traded fixed-income securities whose payments are based on the performance of an underlying asset. The underlying assets are approximately allocated as follows: collateralized mortgage obligations (55%), credit card receivables, (25%) and other assets (20%) including student loans.



## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) (Dollars in thousands, unless otherwise noted)

#### 7. Benefit Plans (continued)

The Plan previously classified asset-backed securities and corporate bonds as using Level 1 inputs. The Plan has determined that the pricing methods for certain of these investments use significant other observable inputs. Accordingly, such investments held by the plan in prior periods have been reclassified to Level 2 to correct the prior-year presentation. The reclassification had no impact on the fair value of investments in any of the periods presented.

#### Level 3 Gains and Losses

The tables below set forth a summary of changes in the fair value of the Plan Level 3 assets for the years ended January 28, 2012 and January 29, 2011:

	<b>Year Ended January 28, 2012</b>		
	<b>Equity Securities</b>	<b>Debt Securities</b>	<b>Real Estate/ Commodities</b>
Balance, beginning of year	\$ 336,565	\$ 214,772	\$ 528,715
Realized gains	13,464	6,092	16,047
Unrealized gains relating to instruments still held at the reporting date	46,298	5,567	41,072
Net purchases, sales, issuances, and settlements	32,098	(17,047)	(9,292)
Balance, end of year	\$ 428,425	\$ 209,383	\$ 576,542

	<b>Year Ended January 29, 2011</b>		
	<b>Equity Securities</b>	<b>Debt Securities</b>	<b>Real Estate/ Commodities</b>
Balance, beginning of year	\$ 254,953	\$ 198,672	\$ 496,275
Realized gains	3,931	6,215	18,860
Unrealized gains relating to instruments still held at the reporting date	30,261	20,179	29,635
Net purchases, sales, issuances, and settlements	47,420	(10,294)	(16,055)
Balance, end of year	\$ 336,565	\$ 214,772	\$ 528,715

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) (Dollars in thousands, unless otherwise noted)

#### 7. Benefit Plans (continued)

##### Employer Contributions

The Exchange expects to contribute approximately \$62,242 to the other Postretirement benefit plans in fiscal 2012.

##### Estimated Future Benefit Payments

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

Fiscal Years	Basic Plan	Supplemental Plan	Postretirement	Foreign Plans
2012	\$ 221,773	\$ 509	\$ 101,843	\$ 9,049
2013	225,591	514	108,487	7,204
2014	230,431	523	114,618	7,371
2015	235,977	543	120,175	6,863
2016	241,222	561	124,971	7,031
2017–2021	1,267,078	2,971	685,506	33,135

##### Assumed Health Care Cost Trend Rates at the End of January:

	2011	2010
Health care cost trend rate assumed for next year	<b>7.00%</b>	8.00%
Rate to which the cost trend rate is assumed to decline (ultimate trend rate)	<b>4.50%</b>	4.50%
Year that the rate reaches the ultimate trend rate	<b>2016</b>	2016

#### 8. Dividends

The Exchange is required, under various agreements, to distribute a portion of each year's net earnings before bonuses in the form of dividend payments to the Central Welfare Funds, Departments of the Army, the Air Force, the Navy, and the Marine Corps.

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued) *(Dollars in thousands, unless otherwise noted)*

#### **8. Dividends (continued)**

If dividends were paid on the pension income and realized and unrealized gains and losses recorded in accordance with ASC 715 and ASC 320, the Exchange would be paying dividends to the Central Welfare Funds, Departments of the Army, the Air Force, the Navy, and the Marine Corps on noncash amounts, which would impact cash reserves used in the normal operation of the business. Accordingly, under the current dividend policy, these items are excluded from net earnings subject to dividends. Any other exclusion used in the calculation of net earnings subject to dividends must be approved by the Board of Directors.

The Exchange's policy is to annually fund actuarially determined Postretirement expense unless the plan is fully funded or unless an asset-liability model has shown the plan will likely become fully funded, even in the absence of future contributions. Therefore, each year, pension expense generally reduces the net earnings subject to dividends to the extent cash contributions have actually been made.

#### **9. Commitments and Contingencies**

The Company is a defendant in various lawsuits and claims. In the opinion of management, the amounts, if any, which might ultimately be paid in connection with settlement of the litigation would not have a material effect on the financial condition, results of operations, or cash flows of the Company.

#### **10. Operation Enduring Freedom/Operation New Dawn (OEF/OND)**

The Company's presence in Iraq, Qatar, Afghanistan, and Kuwait was supported by 101 stores as of January 28, 2012. Approximately \$584,703 (6.8%) and \$683,216 (8.3%) of the Company's net revenues in the fiscal years 2011 and 2010, respectively, were derived from sales to U.S. troops stationed in OEF/OND regions. The Company's OEF/OND inventory balance was \$57,697 at January 28, 2012, and \$53,374 at January 29, 2011. The decrease in revenue for fiscal years 2011 and 2010 was primarily due to U.S. troop withdrawal from Iraq completed December 31, 2011. All U.S. combat forces were mandated to withdraw from Iraqi territory by December 31, 2011, under the terms of a bilateral agreement signed in 2008 by President George Bush and implemented by President Barrack Obama in 2010. The drawdown in OND troop levels initiated a closure of military bases and leaves limited Exchange operations in Iraq to support the Department of State's ongoing mission. Iraq net revenues decreased to \$134,298 in fiscal 2011, from \$291,727 in fiscal 2010. Iraq inventory balance decreased to \$3,498 at the end of fiscal 2011, from \$19,563

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued)

*(Dollars in thousands, unless otherwise noted)*

#### **10. Operation Enduring Freedom/Operation New Dawn (OEF/OND) (continued)**

at the end of fiscal 2010. Current conditions in Afghanistan continue to be uncertain. Any continued or significant disruption or retreat from the locale directed by the United States military could have an adverse impact on the results of operations. As a result, it is difficult to estimate the potential inventory that may be forfeited if the United States must quickly exit the country. Any related loss on inventory could adversely affect the Company's results of operations unless such losses are eligible for appropriations that are reasonably assured of collection.



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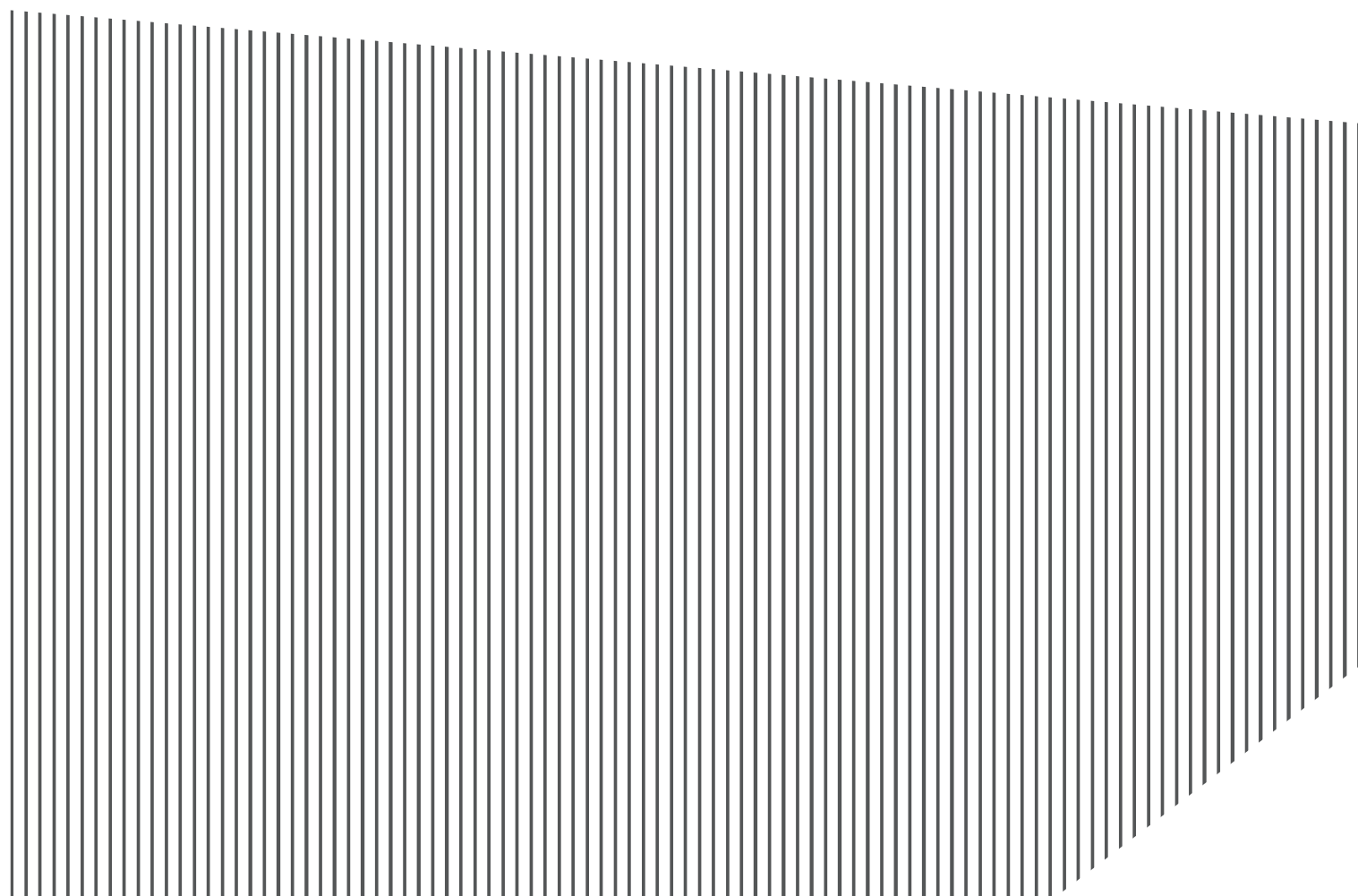
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