

THERE IS NO GREATER HONOR THAN SERVING SOLDIERS, AIRMEN AND THEIR FAMILIES



INTENSIFY NATIONAL BRANDS

GROW THE EXPRESS/ CONCESSIONS

OPTIMIZE SUPPLY CHAIN

INSPIRE FUTURE LEADERS

REDUCE EXPENSES

TRANSFORM ONLINE EXPERIENCE

FOCUS CAPEX



EXCHANGE
2013 Annual Report

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BOARD OF
DIRECTORS

60



DIRECTOR/CEO TOM SHULL



A meaningful legacy — a more promising future

What a year we've had. Only one year ago, we charted a course to transform the Exchange you know into the valued retailer our customers deserve. The strategic priorities we set in motion in **2013** are raising the value of the Exchange benefit for our customers, strengthening our financial stability and driving shareholder value. As we enter our **119th** year of serving military families, we are laser focused on providing a first-class shopping experience today and into the future.

Fulfilling our promise

Despite downturns in the economy, the budget sequestration, the Federal government shutdown, ramped up competition from online retailers, and troop reductions in Afghanistan and Europe, our **2013** earnings were **\$332 MILLION — \$20 MILLION** above our **2013** financial target.

From this, we were able to provide a healthy dividend of **\$116 MILLION** to Army Morale, Welfare & Recreation, and **\$69 MILLION** to Air Force Services—which both support military families. The remainder of the earnings will be used to build new stores, renovate Expresses, and buy new trucks to move products from the distribution centers to the stores. One hundred percent of the earnings serve Soldiers, Airmen and their families. We are fulfilling our promise.

Embracing a new Exchange

Through a season of transformation, our **38,000** Exchange associates worked to prove that a leaner organization could be responsive to customer needs. Last year's customer satisfaction score was the highest in our history. We scored high in areas such as "merchandise selection" and "product availability," which indicates that our strategic priorities are gaining traction with customers.

For example, our Intensify National Brand strategy is evident the moment you walk into an Exchange main store. In the past **21** months, we've opened **456** store-in-store concept

shops featuring highly recognizable brands set in attractive displays. This brand strategy is resonating with shoppers. Our online presence is becoming equally impressive as we remove barriers, and give distant customers direct access to browse our growing assortment of name-brand merchandise in a more organized fashion. By this summer, browsing shopmyexchange.com will be a more user-friendly experience with improved navigation, robust promotions, order status updates, plus greater assortment parity with physical Exchange stores.

Infrastructure integrity

Under the priority, Optimize the Supply Chain, we implemented numerous initiatives to reduce the cost of operations and increase efficiencies in our supply chain. For instance, we installed new warehouse management system software and new conveyor technology at our West Coast and Waco Distribution Centers. Together these systems, and the people behind them, helped the Exchange reduce supply chain costs by **\$24 MILLION**.

A shifting customer environment

The supply chain becomes profoundly important as we direct products to service members around the globe. We continue to support the troops during the drawdown in Afghanistan by operating Tactical Field Exchanges. We are still on the job, supporting Soldiers and Airmen wherever they serve, and as they return home.

We aren't just any retailer

The Exchange is a family of dedicated associates with an extraordinary legacy of serving the men and women in uniform. Today, we are a leaner, more responsive organization. Tomorrow, we will be here to provide the goods and services our customers need.

We are beginning a new journey to a culture of customer experience. Our commitment to Soldiers, Airmen and their families is what distinguishes the Exchange as a retailer.

Tom Shull

INTENSIFY NATIONAL BRANDS/REPOSITION THE MAIN STORE/ TRANSFORM ONLINE EXPERIENCE

In 2013, our merchandising strategy galvanized around two strategic priorities—“Intensify National Brands” and “Reposition the Main Store.”

In 2013, we opened 424 store-in-store concept shops featuring the top brands—and many more are planned throughout 2014. Executing the national brand strategy in our main stores resulted in \$447 million in sales for the national brands, 9 percent more than in 2012. Gross profit jumped 10 percent to \$116 million.

Shoppers tell us in our annual customer satisfaction survey that they notice better merchandise availability and selection.

Softlines

In 2013, total sales hit \$755 million as 251 concept shops, including 165 for the brand Michael Kors in women’s apparel, accessories and footwear premiered around the world. With Michael Kors, sales more than doubled from 2012 to \$30 million.

Other shops and initiatives put Columbia, Fossil, Lucky, Tommy Hilfiger, Ralph Lauren, Nautica, Nike, Nine West, The North Face & Spanx brands in prominent locations in our stores.

Our success with childrenswear continued throughout 2013. William Carter’s/OshKosh sales totaled \$11.4 million, a 6 percent increase over 2012. Gross profit from the sales of William Carter’s/OshKosh hit nearly \$4 million, a 1 percent increase.

14%

William Carter’s/OshKosh is the largest vendor in childrenswear, representing 14% of department sales.

national brands • 424 concept shops

\$447 M

IN SALES FOR
NATIONAL
BRANDS IN 2013



softlines

\$755 M

IN TOTAL SALES
IN 2013



softlines

\$30 M

IN TOTAL SALES FOR
MICHAEL KORS



Hardlines

The Exchange is intensifying the presence of Beats by Dre, Bose, Samsung and Martha Stewart, among others. Sales from these national brands were at \$201 million in 2013. Additionally, sales for Ashley Furniture grew from \$22 million in 2012 to \$30 million in 2013.

Consumables

2013 marked a year-long focus on Victoria's Secret, Bath & Body Works, bareMinerals, The Body Shop and nail bars. Concept shops sporting brand names rolled out to 160 stores, with continued focus on additional recognizable brands, such as Clinique, Elizabeth Arden, Estée Lauder, Lancôme and Shiseido. \$19 million in sales resulted from this initiative, a 239 percent increase over 2012 and 39 percent increase over goal. Resulting gross profit was \$3.8 million (up 267 percent) above 2012.

Transform Online Experience

In collaboration with our eCommerce team, we are building the same brand presence on our website, shopmyexchange.com. Achieving industry-standard parity between our brick-and-mortar stores and our website is imperative because more than 50 percent of Soldiers, Airmen and their families live at least 20 miles from a traditional Exchange.

50%

of customers live at least 20 miles from an Exchange.

Now, these shoppers are finding more of the national brands online that we sell in our traditional stores. We redesigned shopmyexchange.com in 2013 for easier navigation, and included more colorful graphics and expanded product information. From 2012 to 2013, our online to store assortment match rose from 5 percent to 16.1 percent after more than 20,000 items were added online.



\$16.8 M

IN TOTAL SALES FOR BEATS BY DRE



\$19 M

IN TOTAL SALES IN 2013



26,000

ONLINE & IN-STORE ITEM PARITY

GROW THE EXPRESS/ GROW CONCESSIONS

Our military shoppers have on-the-go lives and convenience is their primary driver.

Grow the Express

Whether visiting one of our gas stations or our nearly 400 Expresses, we seek to provide customers with a variety of products, healthier options and quick service. Our strategic priority “Grow the Express,” focuses on providing customers an expanded, one-stop shopping experience.

We installed 49 island coolers in Expresses around the world, packed with popular and healthy foods for customers to grab their favorite snack, pay and go.

We realigned our assortments to expand beverages, ready-to-eat foods and create larger Snack Avenues, one of the Expresses’ most popular stops. “Better for you” and other healthier options continued to grow in 2013 to align with installation commanders’ emphasis on readiness. Dollar Deals and Buy More Save More provide even more value to customers. Dollar Deals are just that, everyday items featured for \$1.

400

Express stores provide convenience to shoppers on the go.

Grow Concessions

In 2013, we operated more than 5,000 small and name-brand concessions worldwide. Through our strategic priority “Grow Concessions,” we opened more national brands in most prominent storefronts in our shopping malls.

5,000

Small & name-brand concessionaires worldwide.

In spite of the challenges we faced with reductions in troops, rising costs and a volatile economy, concession sales reached \$1.7 billion and net earnings hit \$193 million.

Current brands like GNC, Things Remembered and Starbucks expanded into more Exchange locations around the world, and H&R Block expanded its tax preparation services to Europe. We also installed nearly 170 Red Box movie-rental kiosks.

Local offerings also remained a strong part of our shopping malls, with more regional brands and “mom-and-pop” kiosks providing unique products.

Harmon Express at Fort Stewart



49

**ISLAND COOLERS
INSTALLED
WORLDWIDE**

Fort Leonard Wood Starbucks



\$1.7 B

**TOTAL
CONCESSION
SALES IN 2013**

FOCUS CAPEX

The Exchange faced a tighter budget in 2013, which led to our strategic priority, “Focus Capital Expenditure Funds on Projects with a High Return on Investment.” Overall, the Exchange reduced CAPEX by \$112 million over 2012.

Investing in our stores

We make it a priority to provide our customers with inviting shopping destinations while renovating and building stores with energy saving efficiencies. We want to keep earnings at an optimum level so we can return as much as possible back to our troops in the form of dividends to morale, welfare and recreation programs.

Consequently, our Real Estate Directorate continues to adapt store standards that focus on efficient design with a keen eye toward financial prudence, consolidation and right-sizing of buildings.

In 2013, we invested nearly \$190 million on facilities, opening new shopping centers at Fort Belvoir, Va., and Kirtland AFB, N.M.

We also completed image updates at:

- Fort Bragg, N.C.
- JB Anacostia-Bolling, D.C.
- JB Langley-Eustis, Va.
- Nellis AFB, Nev.

We also built nine new Expresses and fuel stations, including a new Express and mini-mall at Dal Molin (Vicenza), Italy. Other locations include:

- Redstone Arsenal, Ala.
- Fort Benning, Ga.

- JB Andrews, Md.
- Fort Wainwright, Alaska
- Edwards AFB, Calif.
- Fort Bliss, Texas
- JB San Antonio, Texas

We renovated dozens of other shopping centers, restaurants and other facilities to improve the customer’s shopping experience.

In addition, due to the success from a pilot project in 2012, our sustainability team is implementing energy-savings initiatives at an additional 84 Express convenience stores in the continental United States. We estimate that the Exchange will save nearly \$890,000 a year, representing nearly 11 million kilowatts of power based on the success of all the recently upgraded facilities.

Investing in distribution

In 2013, we continued to make vital changes to our merchandise distribution channels to reduce operating costs and gain efficiencies. Logistics CAPEX totaled \$2.5 million, and was used to replace and/or enhance distribution center technologies and end-of-life equipment requirements.

Investing in technology

In 2013, IT implemented quick wins, reducing our technology footprint, maximizing existing resources, and extending the useful life of equipment. We achieved a 31 percent reduction in enterprise storage, eliminated the purchase of a new mainframe, and extended desktop computer lifecycles to five years instead of four, resulting in a total CAPEX savings of \$36 million.

Redstone Arsenal Express



9

NEW EXPRESS STORES OPENED IN 2013

Fort Belvoir shopping center



\$190 M

INVESTED IN NEW/UPDATED STORES

REDUCE EXPENSES

Right-sizing expenses; reducing the cost to do business.

Throughout 2013, Exchange teams worked diligently to reduce and control expenses through the Reduce Selling, General and Administrative (SG&A) expenses strategic priority. The Exchange has well surpassed its goal to cut SG&A costs \$100 million by 2016. In FY 2012 and FY 2013 combined SG&A costs were \$293.3 million below plan.

SG&A Cost Reductions		
	2012	2013
PLAN	\$2,210M	\$2,068M
ACTUAL	\$2,067M	\$1,918M
VARIANCE	\$143.0M (7%)	\$150.3M (7%)

Troop reductions and the drawdown in Afghanistan make cost reductions a necessity. Each directorate looked for ways to improve processes while providing the best customer experience possible.

The majority of cost control has been through the reduction of Permanent Change of Station allotments, travel expenses and supplies. However, personnel costs have also been reduced by \$62.1 million, 5 percent below plan.

The Exchange offered Involuntary Early Retirement, continued a hiring freeze, and took steps, such as selectively filling vacancies, to right-size our staffing levels and manage costs.

The Exchange continues to look at its worldwide processes to determine where efficiencies can be improved. Outside of SG&A, we are reducing costs by conserving energy and improving our supply chain operations and capital expenditures.

As a result, the Exchange is able to provide a robust dividend to the Services to improve the lives of Soldiers, Airmen and families everywhere they serve.



Fort Bragg Exchange was recognized in 2013 for reducing expenses by \$600,000



LEED-certification helps Kirtland AFB Exchange reduce energy costs



New conveyor system improves supply chain at Waco DC, Texas

OPTIMIZE SUPPLY CHAIN/ IMPROVE ONLINE FULFILLMENT

In 2013, we achieved major strides in shipping what customers want, when they want it and at lower costs.

Updated wireless infrastructure and new scan, print and apply (SPA) and other technologies, improved inventory visibility, product flow and accuracy in order fulfillment. Efficiencies, using Industry-best practices, also shortened processing time and reduced not-in-stock conditions.

As a result:

- We shipped nearly a half-million packages from our Dan Daniel Distribution Center in Newport News, Va., the epicenter of our Internet fulfillment, where 18,000 items are stored for online ordering.
- We exceeded our ship-to-delivery goals in the continental United States to 3.1 days versus a seven-day goal.
- Our accuracy rate—99.8 percent.
- With productivity increasing and efficiencies improving daily at the distribution centers, customers will enjoy a vastly improved level of service because they will indeed get their packages quicker, regardless of whether they bought merchandise in our stores or online.

\$14.4 MILLION

Decrease in second-destination transportation spending versus 2012.

Almost halfway through the government 2013 fiscal year, the Army asked the Exchange to reduce our second-destination transportation target. Thanks to teams in our Logistics and Merchandising Directorates. We exceeded our target by \$200,000 and reduced actual spending by \$14.4 million versus 2012.

These efforts earned the prestigious National Innovative Logistics Service Award from the National Defense Transportation Association.

Waco Distribution Center, Texas



USMC Veteran receives driver of the year award • Garry Watts



Gruenstadt Distribution Center, Germany



INSPIRE FUTURE LEADERS

The foundation of the Exchange is our 38,000 associates, committed to making the lives of Soldiers, Airmen and families better.

In 2013, senior managers developed a strategic priority, “Inspire Future Leaders Who Are Passionate About Serving Soldiers, Airmen and their Families,” to find and develop leaders who will guide the Department of Defense’s oldest and largest military retailer well into the future.

To improve our ability to serve customers, we have four major programs:

- LEADERS, an elite, 18-month program that exposes “high-potential leaders” to innovative perspectives so they acquire relevant skills for current and future business challenges.
- Leadership Exchange, or LEX for short. This interactive learning management system allows associates to take training courses via online virtual classrooms, on-demand modules, and strategy-based curricula. Supervisors can manage their teams’ training progress.
- Merchandising Directorate Management Academy. Non-management hourly associates and entry-level managers learn skills to carry out their passion in leadership positions.
- The Retail Management Academy and Restaurant Operations Management Academy. Associates learn skills for entry-level retail and food management jobs in which they can serve Soldiers and Airmen with passion.

10%

Percentage of associates who are military veterans. In addition, since 2010, 524 “wounded warriors” have come to work for the Exchange.

We place a high priority on hiring qualified veterans to work at the Exchange. Veterans bring leadership skills, veterans bring first-hand knowledge of the customer, veterans make our team stronger.

A passion for serving • Travis AFB, Calif.



Retail Management Academy • Fort Wainwright, Alaska



Veteran hiring initiatives • Seymour Johnson AFB, N.C.



CONTINGENCY SUPPORT

2013 marked a milestone in the Exchange's mission to serve America's warfighters wherever they go: We concluded our 10-year footprint in Iraq and began reducing our services in Afghanistan.

In September, we closed our remaining stores in Iraq that were open to support State Department operations. We also continued drawing down services in Afghanistan as that conflict began winding down.

In 2013, we operated 48 retail facilities in Afghanistan, Iraq, the United Arab Emirates, Qatar, Kuwait, Bosnia, Kosovo, Romania and other countries to support ongoing military operations. We also operated two Exchange facilities in Jordan, about 20 miles from the border with Syria, serving more than 540 American troops and other allied troops a day.

Total contingency sales in the 14 countries reached nearly \$261 million, with slightly more than half coming from Afghanistan alone.

In 2013, our associates and 13 mobile field exchanges served thousands of military personnel in 14 military exercises throughout North & Central America, including humanitarian aid missions to Panama and El Salvador. The 53-foot mobile Exchanges provided comfort items in remote and austere environments, as well as places in the continental United States where troops were holding military exercises away from their installations.

\$261 MILLION

Total contingency sales in 2013.

As troops are deployed around the world to support military and humanitarian operations, we stand ready to support them, wherever they go.

Mobile Field Exchange supports troops in South Dakota



Last associates to leave Iraq • US Embassy, Baghdad



Green Beans Coffee Kandahar, Afghanistan



2013 TIMELINE

FEBRUARY

Ground breaks for the new Hainerberg shopping center in Wiesbaden, Germany.



MARCH

Free alterations and modifications for wounded Soldiers available at all 79 Army Military Clothing stores around the world.

APRIL

Texas Diversity Council presents the Exchange with the Corporate Leadership Award 2013.

MAY

New "Account Services" system launches, improving customer service for credit accounts.

JUNE

The Southeast Distribution Center closes on June 30.

JULY

The Exchange celebrates 118 years of serving Soldiers, Airmen & their families.



AUGUST

U.S. Veterans Magazine names the Exchange to its 2013 Best of the Best list in the following categories:
 Veteran Friendly Companies
 Supplier Diversity Programs
 Government & Law Enforcement Agencies

Chain Store Age produces a list of the top 100 companies, based on net sales of the preceding fiscal year. The Exchange comes in at 43rd.

The Exchange redesigns its online shopping site, *shopmyexchange.com*, with a modern look and feel.

Speed Commerce, a leading internet sales company, is selected to redesign the Exchange's online shopping site, bringing it in line with industry standards and practices.

Exchange theaters begin first-run showings of Disney films in CONUS locations.



Latina Style Magazine names the Exchange one of the top 50 companies, ranked according to leadership roles occupied by, and opportunities for, Latinas.

SEPTEMBER

The final Exchange facilities in Iraq are closed.

OCTOBER

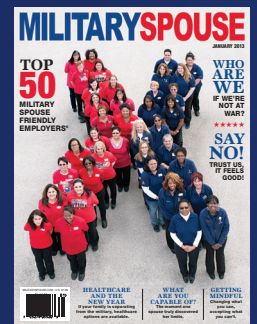
The Exchange remains open during the government shutdown, while other key operations closed, including the commissaries and dining facilities.

NOVEMBER

1st Denny's Fresh Express on a military installation opens at Nellis AFB in Las Vegas, Nev.

DECEMBER

Victory Media, publisher of Military Spouse magazine, names the Exchange the top military spouse employer for 2014.



Consumer Reports names the Exchange among the top 5 walk-in electronics stores.

JANUARY 2014

The Exchange celebrates the homecoming of our brave Soldiers and Airmen with a year-long campaign called "Homeward Bound."



RESTAURANT HIGHLIGHTS

2013 was a year of great expansion for the Exchange's food and fuel division, which opened 56 new brand-name restaurants around the world, including the:

- 132nd Subway
- 102nd Charley's
- 10th Arby's
- Denny's Fresh Express at Nellis AFB, Nev.; the first of the national restaurant chain's on a military installation
- The Exchange's first direct-operated Domino's Pizza at Kirtland AFB, N.M.
- The Exchange-operated Starbucks at Germany's Panzer Barracks, marking the fourth of the chain's unique coffee shops on an American military installation in Europe

Last year, sales at the Exchange's restaurants topped more than \$860 million, 9 percent of the Exchange's total sales. More than 108 million customers dined in Exchange facilities.

1,528

Restaurants the Exchange operates.

Forty-five of them are name-brand; eight are Exchange signature brands. The portfolio also includes 85 cafeterias in Department of Defense schools around the world where we serve 4 million meals annually, seven bakery & water plants, and 69 movie theaters.

We also expanded our health-menu options to align with the Department of Defense's Healthy Base Initiative. Many of our restaurants now display calorie counts on menu boards.

In our theaters, Exchange agreements with Disney, Sony and Paramount brought first-run movies to our military families at 19 installations in the continental United States. We also converted 64 theaters to digital format in 2013 and plan additional renovations this year, bringing first-run movies to even more service members and their families around the world.

Overall sales for our theater operations rose 16 percent to more than \$17 million.

Food court • Fort Belvoir, Va.



Denny's fresh express • Nellis AFB, Nev.



Starbucks grand opening • USAG Stuttgart, Germany



BY THE NUMBERS

100% OF EARNINGS SUPPORT SOLDIERS, AIRMEN & FAMILIES



\$8.3
BILLION
IN REVENUE



\$332
MILLION
IN EARNINGS



\$208
MILLION
IN DIVIDENDS



\$116.4 M Army
\$69.4 M Air Force
\$19.2 M Marine Corps
\$3.2 M Navy



4,345

ASSOCIATES DEPLOYED TO
COMBAT ZONES SINCE 9/11



4 M

SCHOOL LUNCHES SERVED EVERY YEAR



7 PLANTS

PROVIDING BAKED GOODS/BOTTLED
WATER TO MILITARY OVERSEAS



1.3 M

COMBAT UNIFORMS OUTFITTED



24%

ASSOCIATES WHO ARE MILITARY
SPOUSES & FAMILY MEMBERS



36%

EXCHANGE
Serving the best customers in the world

ASSOCIATES CONNECTED
TO THE MILITARY

524

WOUNDED WARRIORS
HIRED SINCE 2010

2,817

FACILITIES WORLDWIDE

50

STATES

33

COUNTRIES

FINANCIAL STATEMENTS

Army and Air Force Exchange Service
Years Ended February 1, 2014 and February 2, 2013
With Report of Independent Auditors

Ernst & Young LLP



Building a better
working world

Army and Air Force Exchange Service

Financial Statements

Years Ended February 1, 2014 and February 2, 2013

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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 financial statements of Army and Air Force Exchange Service (the Exchange or the Company), which comprise the balance sheets as of February 1, 2014 and February 2, 2013, and the related statements of earnings, comprehensive income (loss), changes in net assets, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in conformity with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement, whether due to fraud or error.

Auditor's Responsibility

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.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.



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 February 1, 2014 and February 2, 2013, 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

May 20, 2014

Army and Air Force Exchange Service

Balance Sheets

(Dollars in Thousands, Unless Otherwise Noted)

	February 1, 2014	February 2, 2013
Assets		
Current assets:		
Cash and cash equivalents	\$ 119,985	\$ 116,220
Trade and other accounts receivable, less allowance for uncollectible accounts (at February 1, 2014 – \$43,808, at February 2, 2013 – \$47,173)	3,540,440	3,678,674
Merchandise inventories	1,166,311	1,276,273
Short-term investments	21,997	32,263
Supplies and other current assets	48,741	49,161
Total current assets	4,897,474	5,152,591
Buildings and improvements	3,436,583	3,344,817
Fixtures and equipment	1,527,473	1,478,875
Construction-in-progress	145,796	229,697
	5,109,852	5,053,389
Accumulated depreciation	(2,856,602)	(2,689,825)
	2,253,250	2,363,564
Other assets	13,107	14,433
Long-term investments and Supplemental Plan assets	16,605	15,884
Total assets	\$ 7,180,436	\$ 7,546,472
Liabilities and net assets		
Current liabilities:		
Accounts payable	\$ 383,580	\$ 439,566
Commercial paper and current maturities of long-term debt	1,646,120	1,665,874
Accrued salaries and other employee benefits	116,886	140,564
Dividends payable	38,378	60,861
Other current liabilities	243,599	258,337
Total current liabilities	2,428,563	2,565,202
Long-term debt	265,731	620,851
Accrued pension and other benefits	999,247	1,313,572
Other noncurrent liabilities	67,501	70,643
Total liabilities	3,761,042	4,570,268
Net assets:		
Accumulated other comprehensive loss:		
Pension liability	(1,735,681)	(2,228,683)
Derivative instruments	234	7,541
Total accumulated other comprehensive loss	(1,735,447)	(2,221,142)
Retained earnings	5,154,841	5,197,346
Total net assets	3,419,394	2,976,204
Total liabilities and net assets	\$ 7,180,436	\$ 7,546,472

See accompanying notes.

Army and Air Force Exchange Service

Statements of Earnings (Dollars in Thousands, Unless Otherwise Noted)

	Year Ended	
	February 1, 2014	February 2, 2013
Net sales	\$ 7,782,792	\$ 8,605,746
Finance revenue	284,441	292,868
Concession income	208,027	212,682
Other operating income	32,709	42,941
Total revenue	8,307,969	9,154,237
Cost of sales and operating expenses:		
Cost of goods sold	5,985,378	6,646,290
Selling, general, and administrative:		
Employee compensation and benefits	1,283,887	1,328,216
Depreciation and amortization	334,117	327,509
Other	484,491	564,745
Total selling, general, and administrative expenses	2,102,495	2,220,470
Interest expense	33,661	49,583
Bad debt expense	29,627	40,831
Total expenses	8,151,161	8,957,174
Operating income	156,808	197,063
Other income	9,769	8,829
Net earnings	\$ 166,577	\$ 205,892

See accompanying notes.

Army and Air Force Exchange Service

Statements of Comprehensive Income (Loss)
(Dollars in Thousands, Unless Otherwise Noted)

	Year Ended	
	February 1, 2014	February 2, 2013
Net income	\$ 166,577	\$ 205,892
Other comprehensive income (loss)		
Unrealized gain (loss) on derivative instruments	(7,307)	11,767
Pension and postretirement benefits adjustments	493,002	(458,165)
Total other comprehensive income (loss)	<u>652,272</u>	<u>(240,506)</u>
Comprehensive income (loss)	<u>\$ 652,272</u>	<u>\$ (240,506)</u>

See accompanying notes.

Army and Air Force Exchange Service

Statements of Changes in Net Assets (Dollars in Thousands, Unless Otherwise Noted)

Years Ended February 1, 2014 and February 2, 2013

	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Net Assets
Balance at January 28, 2012	\$ 5,215,099	\$ (1,774,744)	\$ 3,440,355
Net earnings	205,892	–	205,892
Pension and postretirement benefits adjustments	–	(458,165)	(458,165)
Unrealized gain (loss) on derivative instruments	–	11,767	11,767
Dividends to the Central Welfare Funds, Departments of the Army, the Air Force, the Navy, and the Marine Corps	(223,645)	–	(223,645)
Balance at February 2, 2013	5,197,346	(2,221,142)	2,976,204
Net earnings	166,577	–	166,577
Pension and postretirement benefits adjustments	–	493,002	493,002
Unrealized gain (loss) on derivative instruments	–	(7,307)	(7,307)
Dividends to the Central Welfare Funds, Departments of the Army, the Air Force, the Navy, and the Marine Corps	(209,082)	–	(209,082)
Balance at February 1, 2014	\$ 5,154,841	\$ (1,735,447)	\$ 3,419,394

See accompanying notes.

Army and Air Force Exchange Service

Statements of Cash Flows (Dollars in Thousands, Unless Otherwise Noted)

	Year Ended	
	February 1, 2014	February 2, 2013
Operating activities		
Net earnings	\$ 166,577	\$ 205,892
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	368,998	350,839
Loss on disposal of property and equipment	3,534	2,490
Gain on supplemental pension plan assets	(1,172)	(1,310)
Bad debt expense	29,627	40,831
Changes in operating assets and liabilities:		
Accounts receivable	108,607	(39,189)
Merchandise inventories	109,962	135,763
Supplies and other assets	1,748	(12,582)
Pension assets and liabilities	165,698	90,096
Long-term investments and supplemental plan assets	450	249
Accounts payable	(71,446)	(103,241)
Change in cash overdraft	9,980	695
Accrued salaries and other employee benefits	(25,505)	32,295
Other liabilities	(4,902)	1,735
Net cash provided by operating activities	862,156	704,563
Investing activities		
Purchases of property and equipment	(265,379)	(377,073)
Proceeds from the sale of property and equipment	3,161	32,152
Purchases of investments	(21,997)	(23,992)
Proceeds from the disposition of investments	32,263	22,299
Net cash used in investing activities	(251,952)	(346,614)
Financing activities		
Net proceeds/(repayments) under line-of-credit agreements	(1,286,000)	(206,000)
Net proceeds/(repayments) under commercial paper agreements	1,066,000	-
Proceeds from long-term debt	-	200,000
Repayments of long-term debt	(154,874)	(154,639)
Payment of dividends	(231,565)	(193,165)
Net cash used in financing activities	(606,439)	(353,804)
Net (decrease) increase in cash and cash equivalents	3,765	4,145
Cash and cash equivalents at beginning of year	116,220	112,075
Cash and cash equivalents at end of year	\$ 119,985	\$ 116,220

See accompanying notes.

Army and Air Force Exchange Service

Notes to Financial Statements (Dollars in Thousands, Unless Otherwise Noted)

February 1, 2014

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 joint non-appropriated fund instrumentality (NAFI) of the United States (U.S.) organized under the Departments 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 operating in Afghanistan primarily provide support for Operation Enduring Freedom (OEF). In addition to providing merchandise and services of necessity and convenience to authorized patrons at competitively 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 nonappropriated 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.

Net sales by geographic region are summarized below:

	Year Ended	
	February 1, 2013	February 2, 2012
Continental U.S.	\$ 5,358,537	\$ 5,863,222
Pacific Rim, including Alaska and Hawaii	1,218,434	1,250,806
Europe, primarily Germany	661,402	776,011
Middle East, including OEF and U.S. Mission Iraq	293,036	452,512
Other countries	251,383	263,195
Total net sales	<u>\$ 7,782,792</u>	<u>\$ 8,605,746</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	
	February 1, 2014	February 2, 2013
Continental U.S.	\$ 1,729,567	\$ 1,754,031
Pacific Rim, including Alaska and Hawaii	267,881	310,620
Europe, primarily Germany	254,189	295,943
Middle East, including OEF and U.S. Mission Iraq	1,613	2,970
Total long-lived assets	<u>\$ 2,253,250</u>	<u>\$ 2,363,564</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 Director/Chief Executive Officer 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 \$128,563 and \$130,369 for fiscal years 2013 and 2012, respectively. In addition, OEF and U.S. Mission Iraq transportation costs of \$170,224 and \$162,954 were paid by the U.S. government for fiscal years 2013 and 2012, respectively.

The Exchange receives reimbursements of certain incremental costs incurred by the Exchange in relation to OEF from the Department of the Army appropriated funds. The Exchange receives reimbursements of certain incremental costs incurred by the Exchange in relation to the U.S. Mission Iraq from the Department of State appropriated funds, and from the Department of the Air Force, Office of Security Cooperation Iraq (OSC-I). 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, Department of State, or the Department of the Air Force is reasonably assured. Such APF reimbursement receivables are classified as trade and other accounts receivable in the accompanying balance sheets and are recorded as an offset to the related expenses (as described below) in the statement of earnings. In fiscal years 2013 and 2012, the Exchange recorded APF reimbursements of \$63,447 and \$27,422, respectively. These amounts include expenses related to inventory markdowns and shortages, personnel costs, in-theater transportation, and other expenses.

Base Realignment

Congress has not authorized a Base Realignment and Closure (BRAC) since 2005. 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[®] Card 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 2013 and fiscal 2012 herein are to the fiscal years ended February 1, 2014 and February 2, 2013, respectively.

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)

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. Key estimates made by Company management include the level of allowance needed for potentially uncollectible accounts receivable and discount rates used to discount the future obligations associated with pension plans and postretirement benefit plans.

In pension accounting, the most significant actuarial assumptions are the discount rate and the long-term rate of return on plan assets. In determining the long-term rate of return on plan assets, the Company considers the nature of the plans' investments, an expectation of the plans' investment strategies and the expected rate of return. 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.

Remeasurement of Foreign Currencies

The Exchange maintains foreign currencies only to the extent necessary to pay local current liabilities. Current liabilities are recorded daily and remeasured 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 remeasured 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

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 expense or asset account that gave rise to the current liability (e.g., payroll expense or inventory). The Company recognized a net gain on foreign currency of approximately \$5,883 and a net gain of approximately \$8,259 for the fiscal years ended February 1, 2014 and February 2, 2013, respectively, excluding the impact of the Company's foreign currency hedging contracts. In addition, the noncurrent liability for local national separation pay as of February 1, 2014 and February 2, 2013, has been remeasured 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. Book overdraft balances of \$9,979 and \$700 have been reclassified to accounts payable at February 1, 2014 and February 2, 2013, respectively.

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 February 1, 2014 and February 2, 2013, approximately \$2,645,913 and \$2,802,646 respectively, of the accounts receivable balance represents amounts due to the Exchange under its in-house credit program, the MILITARY STAR[®] Card. The MILITARY STAR[®] 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 due to the short-term nature of those receivables.

The Company's accounts receivable balance includes \$177,951 and \$190,949 of receivables from the Marine Exchange (MCX) for Marine MILITARY STAR[®] Card outstanding balances and related processing fees as of February 2, 2014 and 2013, 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 standard APR for fiscal years 2013 and 2012 was 10.24%. 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. Customer receivables past due 90 days or more and still accruing interest were approximately \$47,263 and \$52,096 as of February 1, 2014 and February 2, 2013, respectively.

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 are also used to pursue delinquent accounts. The outstanding receivable related to accounts previously written off (previously submitted to the Collections Department) was \$364,140 and \$341,453 at February 1, 2014 and February 2, 2013, respectively. These accounts are at least 150 days past due and are generally outstanding for 1 to 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.

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 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 February 1, 2014 and February 2, 2013. 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 accounts previously written off and submitted to U.S. government entities totaled approximately \$183,798 and \$158,997 in fiscal years 2013 and 2012, respectively. Bad debt expense of \$29,627 was recorded in 2013 and includes \$26,005 of bad debt expense related to the Exchange's current credit card portfolio and \$3,621 that is unrelated to the credit card portfolio. This is compared to \$40,831 in bad debt expense recorded in 2012 related to the Exchange's credit card portfolio. 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 2013 related to accounts previously written off totaled approximately \$15,898 compared to approximately \$15,711 in fiscal year 2012.

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.

	February 1, 2014		February 2, 2013	
	Amount	Percent of Receivables	Amount	Percent of Receivables
	<i>(In Millions)</i>		<i>(In Millions)</i>	
Current	\$ 2,253	79.8%	\$ 2,387	79.8%
1-29 days past due	319	11.3	346	11.6
30-59 days past due	131	4.6	139	4.6
60-89 days past due	74	2.6	69	2.3
90+ days past due	47	1.7	52	1.7
Period-end gross credit card receivables	\$ 2,824	100.0%	\$ 2,993	100.0%

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 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. Additionally, this table does not include the provision for bad debt for other trade accounts receivable that are unrelated to the Exchange's credit card portfolio.

	2013	2012
	<i>(In Millions)</i>	
Allowance at beginning of period	\$ 42	\$ 35
Provision for bad debt	26	37
Write-offs (net of recoveries)	(29)	(30)
Allowance at end of period	\$ 39	\$ 42

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

	February 1, 2014	February 2, 2013
	<i>(In Millions)</i>	
Nondelinquent accounts (Current and 1-29 days past due):		
FICO score of 700 or above	\$ 734	\$ 751
FICO score of 600 to 699	1,356	1,430
FICO score below 600	482	552
Total nondelinquent accounts	2,572	2,733
Delinquent accounts (30+ days past due)	252	260
Period-end gross credit card receivables	\$ 2,824	\$ 2,993

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)

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 of inventory. For the years ended February 1, 2014 and February 2, 2013, \$11,440 and \$12,846 of these expenses were included in merchandise inventory, respectively. For discussions of risk related to inventory in the Middle East, including OEF and U.S. Mission Iraq, 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.

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

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)

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 years 2013 or 2012.

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 10 years

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's self-insurance reserves were \$67,865 and \$72,548 as of February 1, 2014 and February 2, 2013, respectively. Workers' compensation reserves were discounted at a weighted-average rate of 4.11% and 3.67% as of February 1, 2014 and February 2, 2013, respectively. Property and liability reserves were discounted at a rate of 1.81% and 1.62% as of February 1, 2014 and February 2, 2013, respectively. General liability reserves were discounted at a weighted-average rate of 1.25% and 1.55% as of February 1, 2014 and February 2, 2013, respectively.

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)

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.

Advertising Costs

Advertising costs are expensed when the advertisement first occurs. Advertising expense was \$56,562 and \$68,504 for the years ended February 1, 2014 and February 2, 2013, respectively, and is included in selling, general, and administrative expenses. The Exchange's cooperative advertising allowances are generally accounted for as a reduction in the purchase price of inventory.

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 services, gift card breakage, and indirect retail income.

Income Taxes

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

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)

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. Effective fiscal 2013, new hire associates will be automatically enrolled in the 401(k) savings plan after a 30 day waiting period during which they may opt out. 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.

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, *Fair Value Measurements and Disclosures*. 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.

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)

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.

Recent Accounting Pronouncements

On February 5, 2013, the FASB issued ASU 2013-02, *Comprehensive Income (Topic 220): Reporting of Amounts Reclassified out of Accumulated Other Comprehensive Income*, to address the presentation of comprehensive income related to ASU 2011-05. This updated guidance requires companies to report significant amounts reclassified out of accumulated other comprehensive income, either on the face of the statement where net income is presented or in the notes. For other amounts not reclassified in their entirety to net income in the same reporting period, companies must provide cross-references in the notes to other disclosures that already provide information about those amounts. The guidance is effective prospectively for non-public companies for fiscal years beginning after December 15, 2013. The provisions of ASU 2013-02 are not expected to have a material impact on the Company's financial statements.

On February 7, 2013, the FASB issued ASU 2013-03: *Financial Instruments (Topic 825): Clarifying the Scope and Applicability of a Particular Disclosure to Nonpublic Entities*. This update clarifies that nonpublic companies are not required to disclose the fair value hierarchy level for financial instruments that are not measured at fair value on the statement of financial position but for which fair value is disclosed. The update was effective upon issuance in February 2013.

On February 28, 2013, the FASB issued ASU 2013-04, *Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date (a consensus of the FASB Emerging Issues Task Force)*, which amends ASC 405, *Liabilities*. The amendments require an entity to measure obligations resulting from certain joint and several liability arrangements where the total amount of the obligation is fixed as of the reporting date, as the sum of the amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors and any additional amount the reporting entity expects to pay on behalf of its co-obligors. This guidance is effective for non-public companies for fiscal years ending after 15 December 2014, and should be applied retrospectively. We do not expect the adoption to have a material impact on our financial statements.

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 December 2011, FASB issued Accounting Standards Update ASU 2011-11, *Disclosures about Offsetting Assets and Liabilities*, which was subsequently modified in January 2013 by ASU 2013-01, *Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*. ASU 2013-01 has requirements that are disclosure-only in nature. It requires disclosures about offsetting and related arrangements for certain financial instruments and derivative instruments, including gross and net information and evaluation of the effect of netting arrangements on the statements of financial position. The provisions of ASU 2013-01 did not have a material impact on the Company's financial statements.

Reclassifications

Certain reclassifications have been made to the accompanying 2012 financial statements and notes to conform to the 2013 presentation.

Subsequent Events

The Exchange has evaluated subsequent events through May 20, 2014, 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 February 1, 2014, the Company held an investment carried at \$12,000 (Freddie Mac Bond which matures March 21, 2014), 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. Additionally, as of February 1, 2014, the Company held a \$9,997 Freddie Mac Discount investment to support the liability for German Local National separation pay. The bond is due to mature on April 10, 2014, and is classified as short-term investments on the accompanying balance sheet.

3. Fair Value Measurements

Financial Accounting Standards Board ASC 820, *Fair Value Measurements and Disclosures*, established a framework for measuring fair value. The inputs used to measure fair value are prioritized based on a three-level hierarchy as follows:

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in Thousands, Unless Otherwise Noted)

3. Fair Value Measurements (continued)

Level 1 – Quoted prices in active markets for identical assets or liabilities. 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 occur with sufficient frequency and volume to provide ongoing pricing information.

Level 2 – Observable inputs other than quoted prices in Level 1. 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 – Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. 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. The Company's benefit plan Level 3 assets and liabilities are measured at fair value on a recurring basis.

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.

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 February 1, 2014, and February 2, 2013:

	Fair Value as of February 1, 2014			
	Total	Level 1	Level 2	Level 3
Assets:				
Collective investment funds ⁽¹⁾	\$ 16,589	\$ —	\$ 16,589	\$ —
Due from broker	12	12	—	—
Short-term investments	21,997	21,997	—	—
Foreign currency derivatives ⁽²⁾	234	—	234	—
Total assets	\$ 38,832	\$ 22,009	\$ 16,823	\$ —
	Fair Value as of February 2, 2013			
	Total	Level 1	Level 2	Level 3
Assets:				
Cash and cash equivalents	\$ 1	\$ 1	\$ —	\$ —
Collective investment funds ⁽¹⁾	15,830	—	15,830	—
Due from broker	24	24	—	—
Short-term investments	32,263	32,263	—	—
Foreign currency derivatives ⁽²⁾	7,541	—	7,541	—
Total assets	\$ 55,659	\$ 32,288	\$ 23,371	\$ —

⁽¹⁾ Holdings consist of a Blackrock equity fund (approximately 40% in fiscal 2013 and 2012), 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 2013 and 2012), 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.

⁽²⁾ Derivatives are included on the balance sheet in 2013 and 2012 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 \$16,601 and \$15,854 at February 1, 2014 and February 2, 2013, 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 \$1,172 and \$1,310 in fiscal 2013 and 2012, 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.)

The allocation of Supplemental Plan assets at February 1, 2014 and February 2, 2013, by asset category, is as follows:

	<u>2013</u>	<u>2012</u>
Domestic equity securities	47%	41%
Investment-grade fixed income	53	59
Total	<u>100%</u>	<u>100%</u>

4. Indebtedness

Committed Lines of Credit

The Exchange maintains two committed lines of credit aggregating to \$2,020,000. The first is an unsecured revolving line of credit that is facilitated by a 16 bank syndicate led by JP Morgan Chase aggregating to \$1,520,000, expiring June 2015. In addition, the Exchange has a committed line of credit for \$500,000 with Installation Management Command G-9 (IMCOM G-9). This agreement expires in May 2014; however, the Company is in the process of renewing the agreement for a 5-year term. During fiscal 2013, daily borrowings were generally due within 30 to 260 days. As of February 1, 2014, there is \$0 and \$225,000 outstanding under the JP Morgan Chase Syndication and IMCOM G-9 line of credit, respectively. There were no borrowings under the JP Morgan Chase syndication in 2013; during fiscal 2013, borrowings under the IMCOM G-9 line of credit had interest rates ranging from 0.40% to 0.85%.

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 February 1, 2014, the Exchange maintains a JP Morgan Chase \$1,200,000 open-ended line of credit. Borrowings under this line of credit were \$0 as of February 1, 2014, compared to \$1,086,000 as of February 2, 2013. During fiscal 2013, borrowings under this line of credit had interest rates ranging from 0.65% to 1.0%.

Commercial Paper

In June 2013, the Exchange implemented a Commercial Paper (CP) program. The four dealers are JPMorgan, Wells Fargo, Bank of America and Williams Capital. As of February 1, 2014, the outstanding commercial paper obligations, inclusive of original issue discount, are \$1,066,000. This is an open-ended agreement; however, outstanding balances as of February 1, 2014 have maturity dates that range from 1 to 265 days. During fiscal 2013, borrowings under the commercial paper program had interest rates ranging from 0.07% to 0.33%.

Senior Notes

In December 2011, the Exchange completed a private placement debt offering of \$200,000 in senior notes due 2017. 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 February 1, 2014, these senior notes have a total remaining obligation of \$70,851.

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. The Series A and Series B senior notes matured in June 2012 and June 2013, respectively. The Series C senior notes will mature on June 17, 2014, respectively.

Army and Air Force Exchange Service

Notes to Financial Statements (continued) (Dollars in Thousands, Unless Otherwise Noted)

4. Indebtedness (continued)

The average interest rate for all indebtedness including lines of credit (both committed and uncommitted), commercial paper and senior notes was 1.8% for the year ended February 1, 2014.

Debt obligations as of February 2, 2014 and 2013, consisted of the following:

	2013	2012
Outstanding debt principal balances:		
JP Morgan revolving line of credit	\$ —	\$ —
JP Morgan Chase uncommitted line of credit	—	1,086,000
IMCOM G-9 committed line of credit	225,000	425,000
5.47% Series B senior notes due 2013, matured	—	150,000
5.74% Series C senior notes due 2014	350,000	350,000
2.50% senior notes due 2017	200,000	200,000
4.95% senior notes due 2024	70,851	75,725
Commercial Paper – JP Morgan	270,000	—
Commercial Paper – Wells Fargo	268,000	—
Commercial Paper – Bank of America	263,000	—
Commercial Paper – Williams Capital	265,000	—
Total debt obligations	1,911,851	2,286,725
Current maturities	(1,646,120)	(1,665,874)
Total long-term debt obligations	\$ 265,731	\$ 620,851

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. As of February 1, 2014, the estimated fair value for the Series C senior notes, 2017 senior notes, and 2024 senior notes are \$358,330, \$200,089, and \$77,877, respectively. 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 2013 and 2012 was approximately \$38,130 and \$54,188, respectively. The Exchange has complied with all financial and nonfinancial covenants per loan agreements as of February 1, 2014.

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 February 1, 2014, are as follows (in thousands):

2014	\$ 1,646,120
2015	5,380
2016	5,652
2017	205,938
2018	6,239
Thereafter	42,522
	<u>\$ 1,911,851</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 2014 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 call option and sale of a put 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

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in Thousands, Unless Otherwise Noted)

5. Derivative Financial Instruments (continued)

accumulated other comprehensive loss). As the notional amounts and terms of each forward and 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 February 1, 2014, the Company had various foreign exchange contracts (forwards and option collars) outstanding related to approximately \$128,887(€98,500) of its forecasted payroll and inventory purchase liabilities. As of February 1, 2014, the notional value of the outstanding forward contracts was \$24,135 (€17,900) with a corresponding gain of \$12. The notional value of outstanding option collar contracts was \$104,752 (€80,600) with a corresponding gain of \$221. The net gain of \$234 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 \$234 in accumulated other comprehensive loss is expected to be reclassified into earnings within the next 12 months. In addition, the Company has recognized approximately \$2,128 in gains on foreign currency hedge transactions settled during fiscal 2013, compared to \$5,585 in losses during fiscal 2012.

Army and Air Force Exchange Service

Notes to Financial Statements (continued) (Dollars in Thousands, Unless Otherwise Noted)

5. Derivative Financial Instruments (continued)

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		
	Balance Sheet Location	Fair Value	
		February 1, 2014	February 2, 2013
Foreign currency exchange contracts	Accounts payable	\$ 175	\$ 5,656
	Accrued salaries, separation pay, and other employee benefits	59	1,885
Total derivatives designated as hedging instruments		\$ 234	\$ 7,541

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

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 \$6,419 and \$13,545 for the fiscal years ended February 1, 2014 and February 2, 2013, respectively. The following is a schedule, by year, of the future minimum rental payments required under all leases as of February 1, 2014:

2014	\$ 462
2015	265
2016	208
2017	122
2018	122
Thereafter	3,490
	\$ 4,669

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in Thousands, Unless Otherwise Noted)

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.

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 February 1, 2014, the Company recorded a liability of approximately \$32,613, which represents an estimated liability of \$41,764 less trust assets of \$9,151. At February 2, 2013, the Company recorded a liability of \$35,589, which represents an estimated liability of \$42,957 less trust assets of \$7,368.

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).

Army and Air Force Exchange Service

Notes to Financial Statements (continued) (Dollars in Thousands, Unless Otherwise Noted)

7. Benefit Plans (continued)

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, *Investments-Debt and Equity Securities*.

The following table provides a reconciliation of the changes in the plans' benefit obligations and fair value of assets for the years ended February 1, 2014 and February 2, 2013. Amounts are stated in millions.

	Pension Benefits				Other Benefits			
	The Basic Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2013	2012	2013	2012	2013	2012	2013	2012
Change in projected benefit obligations (PBO)								
PBO at prior measurement date	\$ 4,249	\$ 3,608	\$ 18	\$ 14	\$ 2,208	\$ 2,009	\$ 84	\$ 94
Service cost	99	87	1	1	27	26	3	3
Interest cost	194	199	1	1	99	104	3	4
Plan participants' contributions	4	4	–	–	–	–	–	–
Change in assumptions	–	–	–	–	–	–	2	5
Actuarial loss (gain)	(135)	655	(5)	3	(73)	169	(1)	(2)
Curtailment	–	–	–	–	–	–	–	1
Foreign exchange impact	–	–	–	–	–	–	–	(1)
Benefits paid	(221)	(286)	–	(1)	(100)	(93)	(5)	(3)
Administrative expenses paid	(16)	(18)	–	–	(6)	(7)	–	–
Other	–	–	–	–	–	–	(4)	(17)
PBO at current measurement date	<u>\$ 4,174</u>	<u>\$ 4,249</u>	<u>\$ 15</u>	<u>\$ 18</u>	<u>\$ 2,155</u>	<u>\$ 2,208</u>	<u>\$ 82</u>	<u>\$ 84</u>
Change in plan assets								
Fair value of assets at prior measurement date	\$ 3,716	\$ 3,544	\$ –	\$ –	\$ 1,448	\$ 1,331	\$ 38	\$ 33
Actual return on assets	320	472	–	–	165	175	2	4
Employer contributions	–	–	–	–	54	42	3	3
Plan participants' contributions	4	4	–	–	–	–	–	–
Benefits paid	(221)	(286)	–	–	(100)	(93)	(2)	(2)
Administrative expenses paid/foreign exchange impact	(16)	(18)	–	–	(6)	(7)	2	–
Fair value of assets at current measurement date	<u>\$ 3,803</u>	<u>\$ 3,716</u>	<u>\$ –</u>	<u>\$ –</u>	<u>\$ 1,561</u>	<u>\$ 1,448</u>	<u>\$ 43</u>	<u>\$ 38</u>
Funded status at fiscal year-end	<u>\$ (371)</u>	<u>\$ (533)</u>	<u>\$ (15)</u>	<u>\$ (18)</u>	<u>\$ (594)</u>	<u>\$ (760)</u>	<u>\$ (39)</u>	<u>\$ (46)</u>

Army and Air Force Exchange Service

Notes to Financial Statements (continued) (Dollars in Thousands, Unless Otherwise Noted)

7. Benefit Plans (continued)

Supplemental assets do not qualify as plan assets.

The following table reflects amounts recognized in the balance sheets as of February 1, 2014 and February 2, 2013. Amounts are stated in millions.

	Pension Benefits				Other Benefits			
	The Basic Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2013	2012	2013	2012	2013	2012	2013	2012
Amounts recognized in the balance sheets								
Other current liabilities	\$ -	\$ -	\$ -	\$ -	\$ 38	\$ 62	\$ 3	\$ 7
Accrued pension and other benefits liability	371	533	15	18	556	698	36	39
Accumulated other comprehensive loss	(1,028)	(1,314)	(7)	(13)	(681)	(880)	(19)	(21)

A summary of the components of net periodic benefit cost (income) for the benefit plans is as follows for the years ended February 1, 2014 and February 2, 2013. Amounts are stated in millions.

	Pension Benefits				Other Benefits			
	The Basic Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2013	2012	2013	2012	2013	2012	2013	2012
Net periodic cost								
Service cost	\$ 99	\$ 87	\$ 1	\$ 1	\$ 27	\$ 26	\$ 3	\$ 3
Interest cost	194	199	1	-	99	104	3	4
Expected return on assets	(274)	(286)	-	-	(109)	(108)	(2)	(2)
Prior service cost								
amortization	-	-	-	-	-	(4)	-	-
Other Adjustments	-	-	-	-	-	-	(3)	-
Net loss amortization	112	73	1	2	62	48	1	1
Net periodic (income) cost benefit	\$ 131	\$ 73	\$ 3	\$ 3	\$ 79	\$ 66	\$ 2	\$ 6

Army and Air Force Exchange Service

Notes to Financial Statements (continued) (Dollars in Thousands, Unless Otherwise Noted)

7. Benefit Plans (continued)

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			
	The Basic Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2013	2012	2013	2012	2013	2012	2013	2012
Projected benefit obligation	\$ 4,174	\$ 4,249	\$ 15	\$ 18	\$ 2,155	\$ 2,208	\$ 82	\$ 84
Accumulated benefit obligation	3,913	3,972	8	9	2,155	2,208	69	71
Fair value of plan assets	3,803	3,716	-	-	1,561	1,448	43	38

Amounts included in accumulated other comprehensive income for all plans at February 1, 2014, consist of net actuarial losses of \$1,735,798. Amortization of this amount expected to be recognized in fiscal year 2014 is \$123,024.

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	
	2013	2012	2013	2012	2013	2012
Assumptions used to determine expense:						
Discount rate	4.62%	5.26%	4.62%	5.26%	4.68%	5.45%
Long-term rate of return on assets	8.25	8.25	-	-	8.75	8.75
Compensation increase rate	4.30	5.50	9.00	5.50	-	5.50
Assumptions used at disclosure:						
Discount rate	5.01	4.62	5.01	4.62	5.10	4.68
Compensation increase rate	4.30	5.50	9.00	5.50	-	5.50

Army and Air Force Exchange Service

Notes to Financial Statements (continued) (Dollars in Thousands, Unless Otherwise Noted)

7. Benefit Plans (continued)

	Other Benefits		Other Benefits	
	UK Plan		Local National Plan	
	2013	2012	2013	2012
Assumptions used to determine expense:				
Discount rate	4.50%	4.80%	2.36%	2.81%
Long-term rate of return on assets	6.00	6.50	–	–
Compensation increase rate	3.20	4.20	2.33	2.24
Assumptions used at disclosure:				
Discount rate	4.30	4.50	2.14	2.22
Compensation increase rate	3.20	3.20	2.33	2.24

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.

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 the target allocations of plan assets:

	Pension Benefits		Other Benefits Postretirement		Other Benefits	
	The Basic Plan		Plan		UK Plan	
	2013	2012	2013	2012	2013	2012
Domestic equity securities	12%	17%	13%	22%	26%	26%
International equity securities	11	12	11	16	35	35
Emerging market equity securities	3	5	4	5	4	4
Investment-grade fixed income	16	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	5	8	5	8	—	—
Real estate – public	2	2	2	2	—	—
Private equity	9	10	10	10	—	—
Commodities	5	5	5	5	—	—
Alternative debt	5	5	5	5	—	—
Low Vol Global Equity	9	—	10	—	—	—
MLP's	5	—	5	—	—	—
Timber/Farmland	3	—	3	—	—	—
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 February 1, 2014 and February 2, 2013, by asset class category are as follows:

	<u>Pension Benefits</u>		<u>Other Benefits</u>		<u>Other Benefits</u>	
	<u>The Basic Plan</u>		<u>Postretirement Plan</u>		<u>UK Plan</u>	
	<u>2013</u>	<u>2012</u>	<u>2013</u>	<u>2012</u>	<u>2013</u>	<u>2012</u>
Domestic equity securities	19%	18%	24%	23%	26%	26%
International equity securities	14	12	19	18	35	35
Emerging market equity securities	5	5	4	4	4	4
Investment-grade fixed income	16	20	11	11	35	35
High-yield fixed income	10	10	10	10	—	—
TIPS	4	5	5	5	—	—
Real estate – private	9	9	8	8	—	—
Real estate – public	3	3	2	2	—	—
Private equity	9	9	10	10	—	—
Commodities	8	5	4	5	—	—
Alternative debt	3	4	3	4	—	—
Total	100%	100%	100%	100%	100%	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

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in Thousands, Unless Otherwise Noted)

7. Benefit Plans (continued)

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.

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 are 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 fair value hierarchy discussed in Note 3 is not only applicable to assets and liabilities that are included in the Company's consolidated balance sheets but is also applied to certain other assets that indirectly impact the consolidated financial statements. The Company uses the fair value hierarchy to measure the fair value of assets held by pension and postretirement benefit plans. The following table sets forth by level, within the fair value hierarchy, the Company's benefit plan assets and liabilities that are measured at fair value as of February 1, 2014:

	Benefit Plans			
	Total	Level 1 Quoted Prices in Active Markets	Level 2 Significant Observable Inputs	Level 3 Significant Unobservable Inputs
Assets				
Temporary investments ^(a)	\$ 14,005	\$ 14,005	\$ –	\$ –
Equity securities:				
Common and preferred stock ^(b)	881,738	881,738	–	–
Collective investment funds ^(c)	1,279,626	–	1,279,626	–
Limited partnerships ^(d)	466,487	–	–	466,487
Foreign obligations ^(e)	29,926	29,926	–	–
Debt securities:				
Common and preferred stock ^(b)	486	486	–	–
Corporate bonds ^(g)	537,770	–	537,770	–
U.S. government obligations ^(f)	255,634	255,634	–	–
Asset-backed securities ⁽ⁱ⁾	5,354	–	5,354	–
Collective investment funds ^(h)	763,432	–	763,432	–
Limited partnerships ^(d)	173,324	–	–	173,324
Registered investment companies	38,500	–	38,500	–
Real estate and commodities:				
Common and preferred stock ^(b)	127,943	127,943	–	–
Collective investment funds ⁽ⁱ⁾	733,388	–	197,435	535,953
Limited partnerships ^(d)	82,404	–	–	82,404
Due to/from broker for sale of securities – net	5,853	5,853	–	–
Other investments	11,000	–	11,000	–
Total investments	\$ 5,406,870	\$ 1,315,585	\$ 2,833,117	\$ 1,258,168

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 benefit plan assets and liabilities that are measured at fair value as of February 2, 2013:

	Benefit Plans			
	Total	Level 1 Quoted Prices in Active Markets	Level 2 Significant Observable Inputs	Level 3 Significant Unobservable Inputs
Assets				
Temporary investments ^(a)	\$ 5,353	\$ 5,353	\$ –	\$ –
Equity securities:				
Common and preferred stock ^(b)	838,390	838,390	–	–
Collective investment funds ^(c)	1,162,107	–	1,162,107	–
Limited partnerships ^(d)	443,434	–	–	443,434
Foreign obligations ^(e)	27,100	27,100	–	–
Debt securities:				
U.S. government obligations ^(f)	317,139	317,139	–	–
Corporate bonds ^(g)	505,328	–	505,328	–
Asset-backed securities ^(j)	49,761	–	49,761	–
Collective investment funds ^(h)	814,220	–	814,220	–
Limited partnerships ^(d)	185,038	–	–	185,038
Registered investment companies	21,608	–	21,608	–
Real estate and commodities:				
Common and preferred stock ^(b)	131,498	131,498	–	–
Collective investment funds ⁽ⁱ⁾	586,028	–	84,005	502,023
Limited partnerships ^(d)	90,692	–	–	90,692
Due to/from broker for sale of securities – net	13,032	13,032	–	–
Other investments	11,243	–	11,243	–
Total investments	\$ 5,201,971	\$ 1,332,512	\$ 2,648,272	\$ 1,221,187

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 allocation percentages: Domestic Markets (51%); Developed International Markets (38%); International Emerging Markets (11%). Domestic Markets are diversified by Large Cap Value (41%), Large Cap Growth (40%), and Small Cap (16%).
- (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 72% and International 28% 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 82% and Domestic 18% 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 61% and 15% of investments in corporate high-yield debt with S&P rating of B- and below as of February 2, 2014 and 2013, 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 65% and value-added or opportunistic 9% investments. Commodity investments include farmland and timber, which represent 26% 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 allocated as follows: collateralized mortgage obligations 38%, credit card receivables 0%, and other assets 62%, 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 February 1, 2014 and February 2, 2013:

	Year Ended February 1, 2014		
	Equity Securities	Debt Securities	Real Estate/ Commodities
Balance, beginning of year	\$ 443,434	\$ 185,038	\$ 592,716
Realized gains	23,539	20,106	25,313
Unrealized gains relating to instruments still held at the reporting date	36,207	9,536	40,916
Purchases	36,814	14,816	–
Sales	(73,507)	(56,172)	(40,588)
Balance, end of year	\$ 466,487	\$ 173,324	\$ 618,357

	Year Ended February 2, 2013		
	Equity Securities	Debt Securities	Real Estate/ Commodities
Balance, beginning of year	\$ 428,425	\$ 209,383	\$ 576,542
Realized gains	19,376	23,972	16,467
Unrealized gains relating to instruments still held at the reporting date	11,173	7,831	35,684
Purchases	47,208	16,200	1,119
Sales	(62,748)	(72,348)	(37,097)
Balance, end of year	\$ 443,434	\$ 185,038	\$ 592,715

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 \$38,428 to the other Postretirement benefit plans in fiscal 2014.

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
2014	\$ 233,538	\$ 445	\$ 102,368	\$ 5,433
2015	239,985	458	108,371	6,492
2016	246,687	472	114,530	4,556
2017	252,731	481	120,473	4,580
2018	258,410	489	125,670	4,418
2019–2023	1,367,407	2,644	681,556	22,003

Assumed Health Care Cost Trend Rates at the End of January

	2013	2012
Health care cost trend rate assumed for next year	7.00%	7.00%
Rate to which the cost trend rate is assumed to decline (ultimate trend rate)	4.50%	4.50%
Year that the rate reaches the ultimate trend rate	2019	2017

Army and Air Force Exchange Service

Notes to Financial Statements (continued) *(Dollars in Thousands, Unless Otherwise Noted)*

8. Dividends

The Exchange is required, under various agreements, to distribute a portion of each year's net earnings before performance 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.

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. Middle East, Including Operation Enduring Freedom and U.S. Mission Iraq

The Company's presence in Iraq, Qatar, Afghanistan, and Kuwait was supported by 52 and 92 stores as of February 1, 2014, and February 2, 2013. Approximately \$293,036 (3.8%) and \$452,512 (5.3%) of the Company's net revenues in the fiscal years 2013 and 2012, respectively, were derived from sales to U.S. troops stationed in the Middle East, including OEF and U.S. Mission Iraq. The decrease in revenue for fiscal years 2013 and 2012 was primarily due to U.S. troop withdrawal from Iraq. The drawdown in troop levels initiated a closure of military bases

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in Thousands, Unless Otherwise Noted)

10. Middle East, Including Operation Enduring Freedom and U.S. Mission Iraq (continued)

and leaves limited Exchange operations. 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. The Company's OEF physical inventory balance, at cost, was \$23,253 at February 1, 2014. At February 1, 2014, the Exchange held no inventory in Iraq. The Company's OEF and U.S. Mission Iraq physical inventory balance, at cost, was \$68,366 at February 2, 2013. It is difficult to estimate the potential inventory that may be forfeited if the United States must quickly exit a 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".

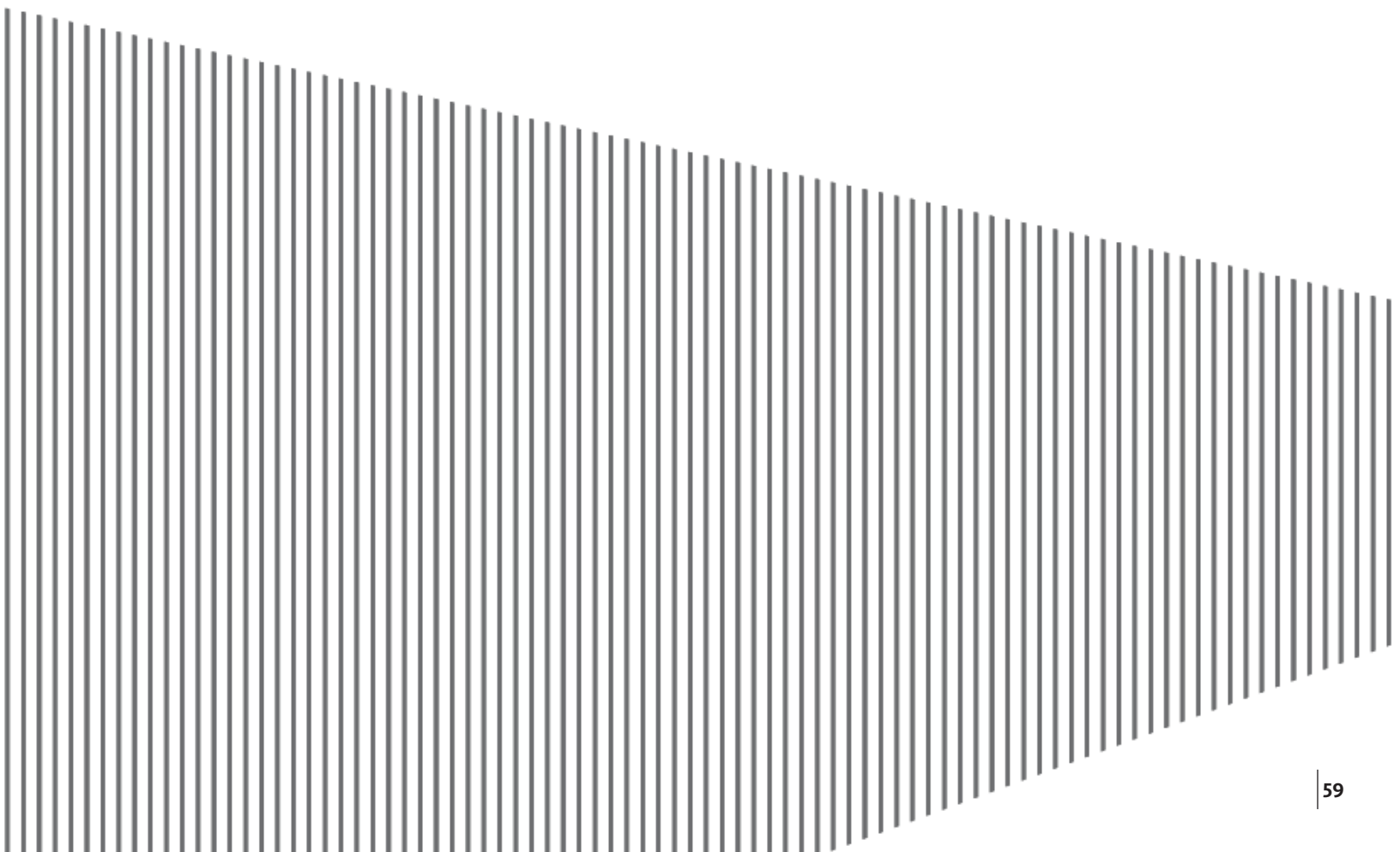
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