



2019 MISSION REPORT



Exchange Is All In for Soldiers, Airmen and Military Communities

The Army & Air Force Exchange Service is a force multiplier for Soldiers, Airmen and military communities. As the Department of Defense's largest retailer, and 62nd largest in the U.S., the Exchange is honored to partner with the Army and Air Force to improve readiness, resiliency and quality of life for service members around the world.

The Exchange provides holistic community support through multiple lines of services including convenience stores, restaurants, e-commerce, department stores, movie theaters, malls and more to bring comforts of home to those serving around the world.

The Exchange self-funds its operations through customer revenues, except for 3% of its funding, which is paid from appropriated funds to predominantly ship goods to service members overseas, as required by law. 100% of Exchange earnings are returned to military communities as dividends for critical Quality-of-Life programs or reinvested to improve the customer experience.

In 2019, the Exchange recorded revenue of \$8.6 billion with \$369 million in dividend-eligible earnings. Earnings exceeded the organization's FY19 forecast, leading to \$217 million in dividends to support critical Quality-of-Life programs such as Child, Youth and School Services; Armed Forces Recreation Centers; and more. In the last 10 years, the Exchange has generated \$2.2 billion for Quality-of-Life programs.

Amid the challenges of an ever-changing retail climate during 2019, the Exchange evolved to protect the hard-earned benefit for Soldiers, Airmen, families, retirees and Veterans. The Exchange benefit—with safe, secure shopping—has never been more important to protecting the force.

Exchange successes in 2019 included:

- Providing unprecedented support at the tip of the spear, including reopening stores within days after rocket attacks at Camp Taji and Bagram Airfield.
- Welcoming home 4.1 million disabled Veterans and certain caregivers with in-store shopping privileges.
- Marching toward the goal of hiring 50,000 Veterans and military spouses by the end of 2020.
- Bringing a taste of home overseas by showing first-run movies like "Star Wars: The Rise of Skywalker" downrange and opening Wahlburgers' first military location.

The Exchange delivers Service-specific support and is fully nested with installation commands to ensure alignment with the Army and Air Force missions. To enhance military communities through this unique support, the Exchange piloted a campus-style dining program at the U.S. Air Force Academy at the end of fiscal 2019. With the Army, the team has been working on Digital Garrison, an app that will offer installation-specific information and shopping.

The Exchange is honored to serve our military communities and is committed to protecting the benefit for all who wear the uniform, past, present and future.

Army Strong! Air Force Strong! Exchange Strong!



Director/Chief Executive Officer



Board of Directors

Per Army Regulation 215-8/Air Force Instruction 24-211 (I), the Secretary of the Army and the Secretary of the Air Force have oversight responsibility of the Army & Air Force Exchange Service Board of Directors and exchange operations.



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Deputy Chief of Staff, Manpower,
Personnel & Services (HQ USAF/A1)



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Vice Chairman
Deputy Chief of Staff, G-4,
HQDA (DALO-ZA)



Mr.
Tom C. Shull, SES
Director/CEO, Army & Air
Force Exchange Service



LTG
Thomas A. Horlander
Military Deputy for Budget,
HQDA (ASA FM)



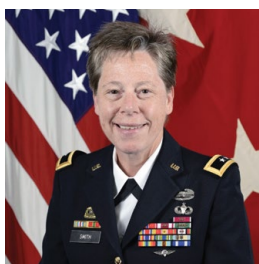
LTG
Jason T. Evans
Deputy Chief of Staff, G-9,
HQDA (DAIN-ZA)



CMSAF
Kaleth O. Wright
Chief Master Sergeant of
the Air Force (AF/CCC)



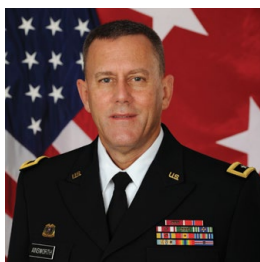
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MG
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Special Assistant, Assistant
Secretary of the Army
(Manpower & Reserve Affairs)
& Director, Quality of Life



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Executive Director, Air Force
Personnel Center (AFPC/CA)



Brig Gen
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Mobilization Assistant to the
Air Force Chief Of Staff



Mr.
Horace "H.L." Larry, SES
Director, Air Force Services (AF/A1S)

Military Community Support



Mission Support

- 811,000 military uniforms outfitted at cost in 2019
- More than 400 facilities in austere locations in the Middle East and Eastern Europe
- Mobile field Exchanges for military exercises and disaster support

Overseas Support

- 7 plants (bakeries and water)
- 9.9 million baked goods produced
- 4.2 million gallons of water bottled
- 2.6 million meals served in Department of Defense Education Activity schools



Retail

- 4,000 stores with operations in 32 countries, 50 states and 4 U.S. territories
- 121 main stores stocked with national brands
- 618 convenience stores (Express, gas stations, troop stores, specialty stores, Class Six)
- 165 Military Clothing stores
- Online shopping, including benefits for honorably discharged Veterans



Restaurants

- 1,700 restaurants with BE FIT options
- 56 restaurants opened in 2019
- 107 million meals served

Services

- 3,465 mall stores and kiosks, including wellness services like dentistry, optometry and cryotherapy
- 77 movie theaters showing first-run movies
- 180,000 internet subscribers



Veteran and Spouse Employment

- 85% of associates are connected to the military
- 45% of associates are Veterans, spouses or dependents
- 9,200 Veterans and 35,300 military spouses have joined the Exchange workforce since 2013
- 1,600 Wounded Warriors hired since 2010

Worldwide Logistics

- 3rd largest shipper in the defense transportation system
- 11 distribution centers
- 45.6 million cases shipped
- 12th largest private retail fleet
- 13.7 million miles driven

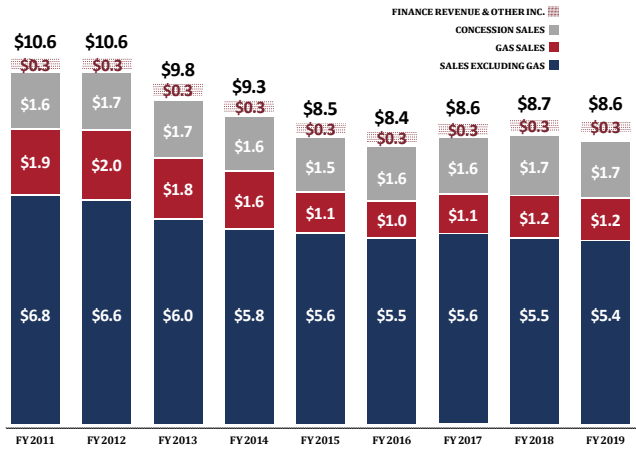


MILITARY STAR®

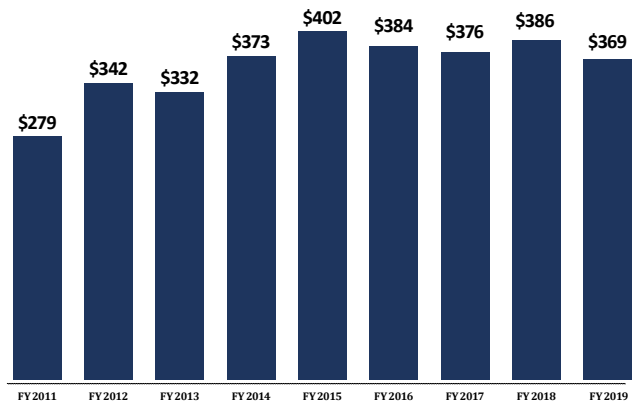
- Total benefit: \$468 million
- Total rewards earned: \$35 million
- Credit card fee avoidance: \$31 million

\$2.2B in support to Quality-of-Life programs in last 10 years

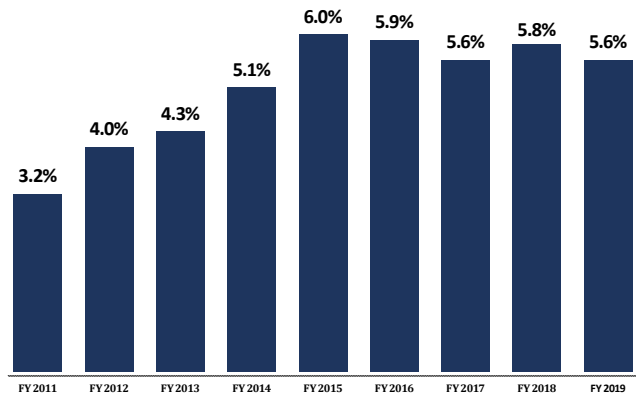
Financial Highlights



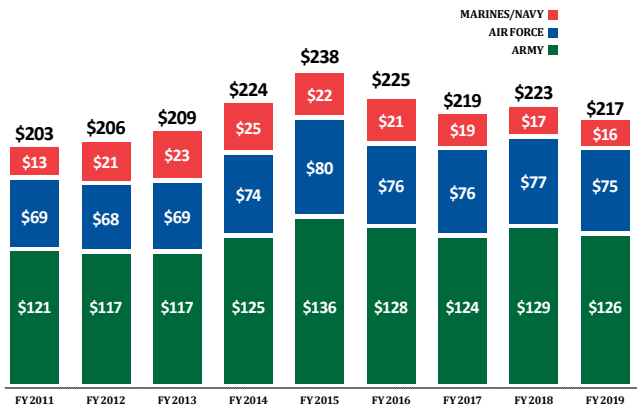
TOTAL REVENUE (\$ BILLIONS)



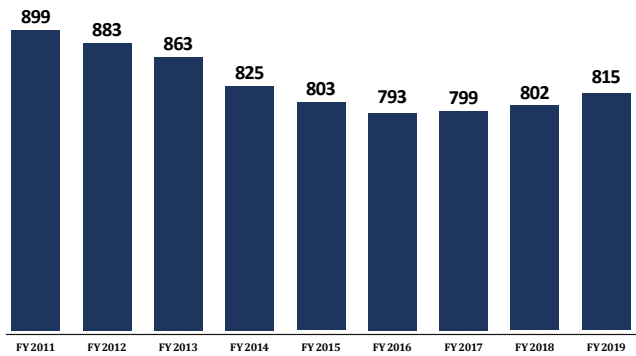
EARNINGS SUBJECT TO DIVIDENDS (\$ MILLIONS)



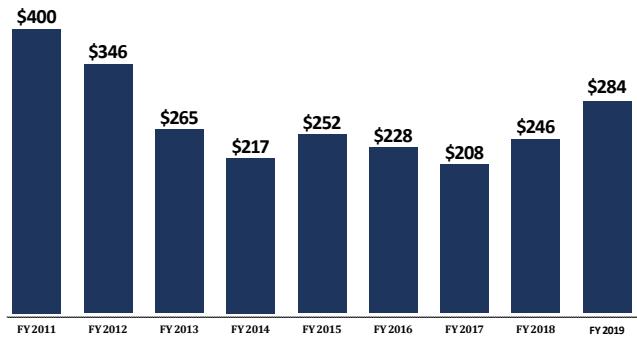
EARNINGS PERCENT OF SALES



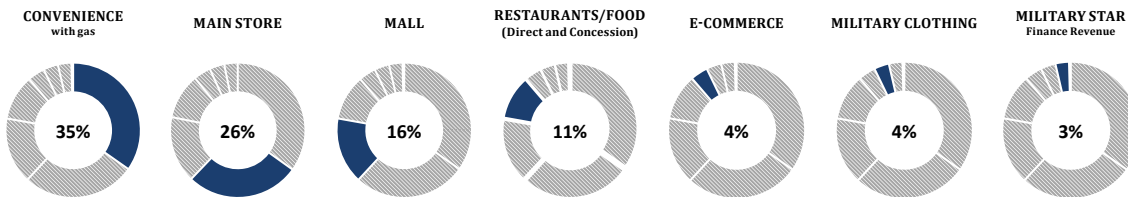
ARMY, AIR FORCE, MARINES/NAVY DIVIDENDS (\$ MILLIONS)



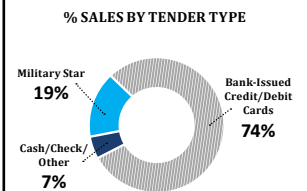
ACTIVE DUTY ARMY & AIR FORCE (THOUSANDS)



CAPITAL EXPENDITURES (\$ MILLIONS)



TOTAL 2019 REVENUE COMPOSITION



DoD Expanded Patronage— Welcoming Home 4.1 Million Veterans

It's been more than 65 years since Arnold Reichenthal, a World War II and Korean War Veteran, could shop his military exchange. That all changed Jan. 1, when he and 4.1 million Americans were welcomed back to the Exchange with in-store shopping privileges.

"I earned this," said the 92-year-old from Columbia, S.C. "We have the PX close by and I'm going to use it."

The tax-free shopping privilege expanded to all Veterans with service-connected disabilities; Purple Heart recipients; former POWs; and certain primary caregivers. This privilege was specified in the Purple Heart and Disabled Veterans Equal Access Act of 2018, included in the John S. McCain National Defense Authorization Act for fiscal 2019.

The extended privilege keeps Veterans connected to military communities. Before the expansion, only Veterans with 100% service-connected disabilities could shop in person. The growth in the customer base comes after 2017's online benefit expansion, which brought tax-free shopping at ShopMyExchange.com to 15 million honorably discharged Veterans.

The Exchange prepared throughout 2019 to welcome these new shoppers. Exchanges in areas with high populations of disabled Veterans increased inventory and quickly adjusted product quantities as needed.

The Exchange shared news of the expanded patronage through its online community Hub, with a special Americana-style truck wrap and at events, including the 120th Army-Navy Game, where Purple Heart recipients received a standing ovation after an on-field presentation.

The new patrons have access to commissaries and morale, welfare and recreation (MWR) retail facilities located on U.S. military installations.

"This whole town is active duty or retired military or Veterans," Reichenthal said. "I gravitate toward the guys on base. It's a magnetic attraction—it's the greatest thing in the world."



Exchange Director/CEO Tom Shull (left) honored Purple Heart recipients during the 120th Army-Navy Game, welcoming them home to in-store shopping. The Veterans received a standing ovation.



The Exchange spread the word about the new shopping benefit at Veterans events around the Nation in 2019.



The Fort Jackson Exchange celebrated World War II and Korean War Veteran Arnold Reichenthal, 92, in January. The disabled Veteran is among 4.1 million who earned in-store shopping privileges Jan. 1.

Disaster Support

Typhoon Lingling

In September, Typhoon Lingling severely damaged the Korea Distribution Center and destroyed \$1.3 million in food, mostly for Exchange restaurants and its school meal program.

The Exchange rerouted shipments to ensure children at Department of Defense Education Activity schools had nutritious lunches.

The Exchange's ability to respond to natural disasters is a major part of the organization's relevancy and resiliency to military communities.

BY THE NUMBERS

- 5,600 square feet of the Korea Distribution Center damaged by the typhoon
- 32,000 cases of food destroyed
- 26,000 Whoppers sent from Exchange's distribution center in Japan to keep Burger King restaurants in South Korea well-stocked

Hurricane Dorian

In the United States during the summer, the Exchange built inventory of emergency supplies, including water, batteries, flashlights and generators to ensure Soldiers and Airmen had necessities during natural disasters.

That readiness paid off in August and September when Hurricane Dorian struck the Caribbean and the Carolinas. Nearly 150,000 emergency supplies were shipped to stores, allowing most Exchanges and Expresses from Florida to Virginia to stay open for military communities.

BY THE NUMBERS

- 127,680 half-liter bottles of water
- 9,420 1-gallon bottles of water
- 3,908 packages of batteries
- 1,392 packages of flashlights
- 960 tarps
- 600 foam coolers
- 432 5-gallon gas cans
- 270 rolls of duct tape
- 145,058 total supplies shipped to Exchanges



Typhoon Lingling damaged the Exchange's distribution center at Camp Market in September.



Joint Base Charleston Exchange associates prepped sandbags ahead of Hurricane Dorian.



Joint Base Langley-Eustis received water and other emergency supplies to care for the community during Hurricane Dorian.

Tip of the Spear

The Exchange's "We Go Where You Go" motto shines at the tip of the spear, where associates put themselves in harm's way to deliver the benefit.

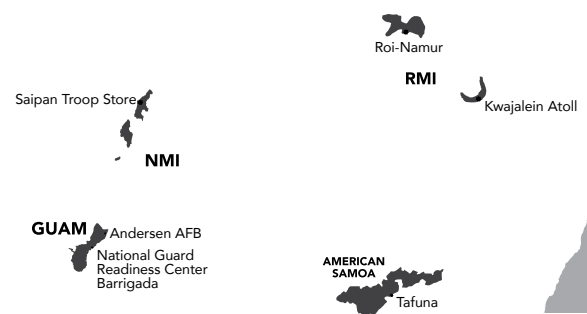
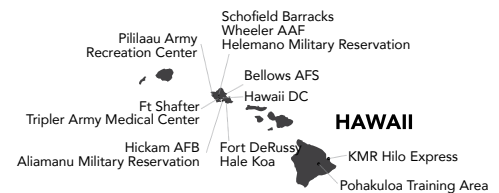
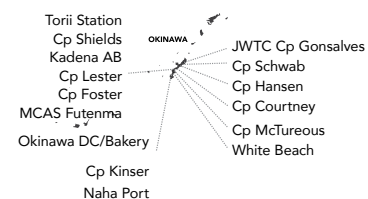
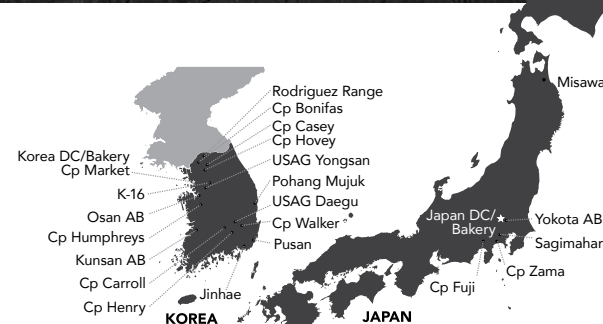
The Exchange at Iraq's Camp Taji reopened Oct. 31, three days after facing down a direct hit from a rocket. In December, the Exchange troop store at Bagram Air Base suffered an attack, but the associates stayed focused on their mission.

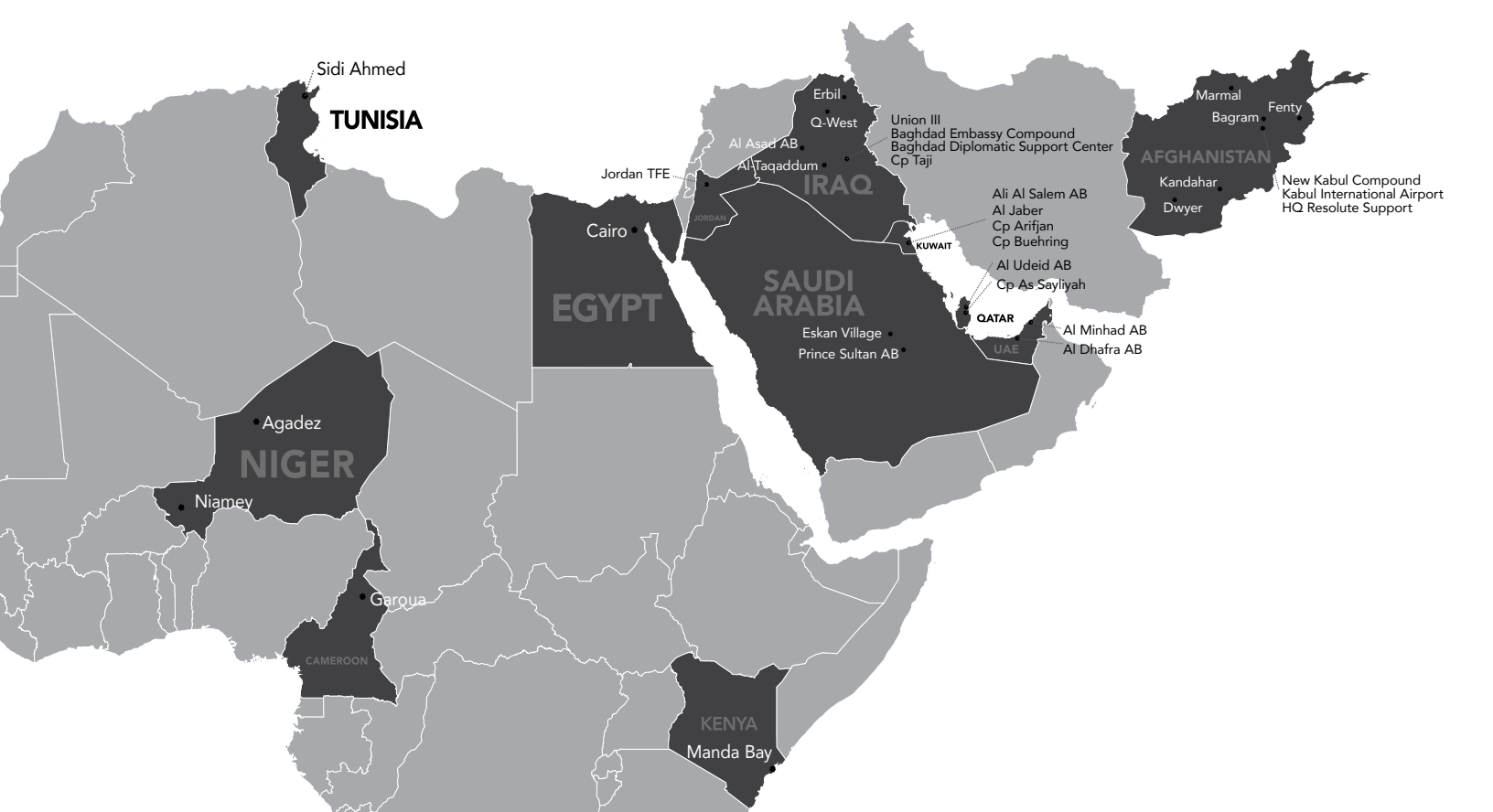
In December, the Exchange and longtime partner Walt Disney Studios premiered "Star Wars: The Rise of Skywalker" to more than 10,000 American troops throughout Southwest Asia at the same time as those back home saw the popular movie. Free screenings of first-run movies bring a taste of home and a chance for Warfighters to recover from stresses of deployment. Since 9/11, 4,800 Exchange associates have deployed to support our service members in hostile and austere locations.

"I know all too well how valuable it is for troop morale to enjoy a huge release like this, especially during the holidays," said Command Sgt. Maj. Barrett Taylor, 418th Contracting Support Brigade. "Thank you to Disney and the Exchange for personally bringing these movies to the troops."

TIP OF THE SPEAR BY THE NUMBERS

- 40,000 deployed troops at 64 locations in Southwest Asia and Middle East who watched 4 first-run movies
- 32 countries where the Exchange operates stores
- 27 major military exercises and operations served by the Exchange throughout Europe and the Pacific
- 12 troop-operated stores supported by the Exchange in Australia, Cyprus, Kenya, Tunisia, Niger, Poland, Cameroon and Turkey





Partnerships

Throughout 2019, the Exchange collaborated with sister military exchanges, the Defense Commissary Agency (DeCA), Army Installation Management Command (IMCOM), Air Force Services Agency, and other organizations to enhance military communities.

In June, the Exchange participated in a panel discussion regarding a campus-style dining program at the Association of Defense Communities' national summit in Washington. By January, the Exchange and the U.S. Air Force Academy began testing a campus-style dining program. Under the initiative, Cadets use their meal entitlements at select Exchange restaurants. This campus-dining model optimizes the meal entitlement program, appealing to younger generations of service members who expect more choices.

Other partnerships included:

- Implementing a joint buying alliance with the military exchanges and DeCA to maximize combined buying power.
- Meeting with representatives from sister exchanges and DeCA to share ideas on improving on-base shopping benefits.
- Staging the first-ever Military Exchange Electronics Expo, with the theme, "One Family, One Mission," which highlighted the long-existing collaborative spirit among the military exchanges.
- Developing and testing a transportation management system prototype with U.S. Transportation Command on behalf of the Department of Defense. "The ability to rapidly design, test, implement and now expand is a true testament of our prototype partners at the Exchange," said Andy Dawson, USTRANSCOM's TMS team.
- Leveraging Exchange customer hub data for 39 million authorized shoppers to provide authentication services for the Navy, Marine Corps and Coast Guard exchanges and in support of the Department of Defense American Forces Travel program.

The Exchange and Army Entertainment, an IMCOM Family and MWR program, collaborated to bring esports tournaments to installations as the Army draws on gaming to recruit Warfighters. The tournaments are recruitment tools for the Army.

"At its core, the National Guard is made up of citizen-Soldiers," said Sgt. Steve Johnson, Texas Army National Guard, Recruiting and Retention Command, who helped lead the first esports tournament at Camp Mabry in Austin. "It's important to the people in our communities to see that we are just like you, and you can come do this too."



Exchange Director/CEO Tom Shull (left) joined U.S. Air Force Academy Superintendent Lt. Gen. Jay Silveria and former Military Community and Family Policy Acting Deputy Assistant Secretary of Defense Chuck Milam to discuss plans to modernize food service on military installations.



Divisional merchandise managers from the military exchanges honored Nintendo as the Supplier of the Year at the 2019 Military Exchange Electronics Expo.



Soldiers and National Guard members competed at a Road to Twitchcon esports tournament at Camp Mabry.

2019: The Exchange Benefit in Action



1 The Exchange exemplified its “We Go Where You Go” motto with a new store at NATO headquarters in Bosnia. In 2019, the Exchange supported the tip of the spear in Europe and the Pacific with seven new stores, three rodeo trucks and 12 mobile field Exchanges. **2** The Exchange opened 17 quick-serve restaurants, including Hunt Brothers Pizza, J. Walken Chicken, Austin Blues BBQ and Chopz (pictured) in 2019. Sales for the Exchange’s quick-service restaurants were nearly \$19 million in 2019, up 37% from the previous year. **3** The Exchange brings cost-efficient methods of moving merchandise through its distribution centers via modern warehouse management technology. The JDA warehouse management system went live in August at the Dan Daniel Distribution Center. **4** Hiring heroes is a quality-of-life force multiplier—45% of the Exchange’s U.S. workforce is made up of Veterans, military spouses or dependents. For military families, an Exchange career means benefit retention, retirement opportunity and stability. The Exchange is committed to hiring 50,000 Veterans and military spouses by the end of 2020. **5** The Exchange and Army Installation Management Command brought the Military Long Drive to 12 installations, including Fort Benning. The partnership celebrated military communities’ physical activity, readiness and resiliency. **6** A partner of the 50th Anniversary Vietnam War



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Commemoration, the Exchange honored Veterans with pinning ceremonies, including at Kirtland AFB, during National Vietnam War Veterans Day. **7** The Exchange's nearly 125-year mission of providing a taste of home continued for Warfighters during a Veterans Day weekend barbecue in Kuwait with help from grill-maker Traeger. **8** The Exchange benefit brings modern shopping to military communities. Projects in 2019 included a new Express convenience store and mini mall at Fort Drum. **9** At a party attended by thousands at the Kaiserslautern Military Community Center, the Exchange introduced the new Wallburgers. The restaurant, founded by Mark, Donnie and Paul Wahlberg, is the famous brothers' first on a military installation. **10** The Exchange Credit Program's "Pay Your Way" program for budget-conscious MILITARY STAR® shoppers allows them to make larger purchases through monthly payments at reduced interest rates. **11** Month of the Military Child celebrations worldwide honored our Nation's youngest heroes. Hundreds of children received military brat patches, gift cards and tours of mobile field Exchanges like this one at Joint Base San Antonio-Lackland. **12** Thirty-five micro markets, including at Tinker Air Force Base, opened to serve Soldiers and Airmen around the clock. The unmanned stores offer on-the-go snacks, meals and sundries—including BE FIT options.

FINANCIAL STATEMENTS

Army and Air Force Exchange Service
Years Ended February 1, 2020 and February 2, 2019
With Report of Independent Auditors

Ernst & Young LLP



Army and Air Force Exchange Service

Financial Statements

Years Ended February 1, 2020 and February 2, 2019

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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, which comprise the balance sheets as of February 1, 2020 and February 2, 2019, and the related statements of earnings, comprehensive income, 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, 2020 and February 2, 2019, 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 22, 2020

Army and Air Force Exchange Service

Balance Sheets

(Dollars in Thousands, Unless Otherwise Noted)

	February 1, 2020	February 2, 2019
Assets		
Current assets:		
Cash and cash equivalents	\$ 97,169	\$ 99,762
Trade and other accounts receivable, less allowance for uncollectible accounts of \$29,667 and \$28,202 at February 1, 2020 and February 2, 2019, respectively	2,820,048	2,886,611
Merchandise inventories	1,386,214	1,309,052
Short-term investments	9,391	9,991
Supplies and other current assets	76,044	71,542
Total current assets	4,388,866	4,376,958
Property and equipment:		
Buildings and improvements	3,722,269	3,666,710
Fixtures and equipment	1,354,640	1,344,101
Construction-in-progress	266,535	176,380
	5,343,444	5,187,191
Accumulated depreciation	(3,491,155)	(3,331,352)
	1,852,289	1,855,839
Other assets	820	2,852
Overfunded retirement plans	924	2,012
Long-term investments and supplemental plan assets	22,222	19,910
Total assets	\$ 6,265,121	\$ 6,257,571
Liabilities and net assets		
Current liabilities:		
Accounts payable	\$ 420,393	\$ 414,763
Commercial paper and current maturities of long-term debt	419,887	482,555
Accrued salaries and other employee benefits	112,239	116,538
Dividends payable	29,932	48,860
Other current liabilities	153,119	130,610
Total current liabilities	1,135,570	1,193,326
Long-term debt	289,080	360,967
Accrued pension and other benefits	1,532,309	920,956
Other noncurrent liabilities	79,351	74,576
Total liabilities	3,036,310	2,549,825
Net assets:		
Accumulated other comprehensive loss:		
Pension and postretirement benefit liability	(2,290,921)	(1,730,094)
Derivative instruments	(25)	(228)
Total accumulated other comprehensive loss	(2,290,946)	(1,730,322)
Retained earnings	5,519,757	5,438,068
Total net assets	3,228,811	3,707,746
Total liabilities and net assets	\$ 6,265,121	\$ 6,257,571

See accompanying notes.

Army and Air Force Exchange Service

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

	Year Ended	
	February 1, 2020	February 2, 2019
Net sales	\$ 6,575,724	\$ 6,699,955
Finance revenue	281,597	280,130
Concession income	232,394	228,749
Other operating income	32,631	35,942
Total revenue	7,122,346	7,244,776
Cost of sales and operating expenses:		
Cost of goods sold	4,920,659	5,040,666
Selling, general, and administrative:		
Employee compensation and benefits	1,148,406	1,144,578
Depreciation and amortization	254,044	248,829
Other	548,654	538,831
Total selling, general, and administrative expenses	1,951,104	1,932,238
Interest expense	11,708	16,741
Bad debt expense	19,755	20,893
Total expenses	6,903,226	7,010,538
Operating income	219,120	234,238
Other income	10,149	7,331
Non-service pension and postretirement income	69,737	82,566
Net earnings	\$ 299,006	\$ 324,135

See accompanying notes.

Army and Air Force Exchange Service

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

	Year Ended	
	February 1, 2020	February 2, 2019
	<hr/>	<hr/>
Net earnings	\$ 299,006	\$ 324,135
Other comprehensive income:		
Reclassification of unrealized gain (loss) on derivative instruments to earnings	203	(1,499)
Pension and postretirement benefits adjustments:		
Unrealized (loss) gain arising during the period	(648,846)	112,193
Amortization of net loss	88,019	112,388
Other comprehensive (loss) income	<hr/> (560,624)	<hr/> 223,082
Comprehensive (loss) income	<hr/> \$ (261,618) <hr/>	<hr/> \$ 547,217 <hr/>

See accompanying notes.

Army and Air Force Exchange Service

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

	Retained Earnings	Accumulated Other Comprehensive Loss	Net Assets
Balance at February 3, 2018	\$ 5,336,984	\$ (1,953,404)	\$ 3,383,580
Net earnings	324,135	–	324,135
Pension and postretirement benefits adjustments	–	224,581	224,581
Reclassification of unrealized gain on derivative instruments to earnings	–	(1,499)	(1,499)
Dividends to the Central Welfare Funds, Departments of the Army, the Air Force, the Navy and the Marine Corps	(223,051)	–	(223,051)
Balance at February 2, 2019	5,438,068	(1,730,322)	3,707,746
Net earnings	299,006	–	299,006
Pension and postretirement benefits adjustments	–	(560,827)	(560,827)
Reclassification of unrealized loss on derivative instruments to earnings	–	203	203
Dividends to the Central Welfare Funds, Departments of the Army, the Air Force, the Navy and the Marine Corps	(217,317)	–	(217,317)
Balance at February 1, 2020	\$ 5,519,757	\$ (2,290,946)	\$ 3,228,811

See accompanying notes.

Army and Air Force Exchange Service

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

	Year Ended	
	February 1, 2020	February 2, 2019
Operating activities		
Net earnings	\$ 299,006	\$ 324,135
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	281,989	279,063
(Gain) loss on disposal of property and equipment	(73)	163
Loss on supplemental pension plan assets	2,803	312
Bad debt expense	19,755	20,893
Change in operating assets and liabilities:		
Accounts receivable	46,808	41,242
Merchandise inventories	(77,162)	90,427
Supplies and other assets	(1,382)	(9,272)
Pension assets and liabilities	49,961	78,845
Long-term investments and supplemental plan assets	(2,803)	(312)
Accounts payable	5,783	35,915
Change in cash overdraft	-	12
Accrued salaries and other employee benefits	(4,248)	4,859
Other liabilities	27,848	(61,230)
Net cash provided by operating activities	648,285	805,052
Investing activities		
Purchases of property and equipment	(283,503)	(245,743)
Proceeds from the sale of property and equipment	5,137	1,683
Purchases of investments	(11,912)	(59)
Proceeds from the disposition of investments	10,200	1,136
Net cash used in investing activities	(280,078)	(242,983)
Financing activities		
Payments under line-of-credit agreements	(65,000)	(225,000)
Proceeds (payments) under commercial paper agreement	37,000	(362,775)
Proceeds from long-term debt	-	250,000
Repayment of long-term debt	(106,555)	(6,240)
Payment of dividends	(236,245)	(214,606)
Net cash used in financing activities	(370,800)	(558,621)
Net (decrease) increase in cash and cash equivalents	(2,593)	3,448
Cash and cash equivalents at beginning of year	99,762	96,314
Cash and cash equivalents at end of year	\$ 97,169	\$ 99,762

See accompanying notes.

Army and Air Force Exchange Service

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

February 1, 2020

1. Description of Business and Summary of Significant Accounting Policies

General

The Army and Air Force Exchange Service (the Exchange) 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 (including e-commerce) to soldiers, airmen, and their families through a network of stores located on U.S. government installations in the U.S., Europe, the Pacific Rim, and the Middle East. Middle East services operating in Afghanistan and Iraq primarily provide support for Operation Freedom Sentinel (OFS) and Operation Inherent Resolve (OIR). 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 non-appropriated funds. Funds that are not distributed as dividends are reinvested in the Exchange's operations. The Exchange is exempt from direct state taxation and from state regulatory laws. Such laws include licensing and price control statutes.

The Exchange utilizes accounting principles generally accepted in the United States (U.S. GAAP) applicable to "for profit" organizations because of the nature of its commercial-type operations. The Exchange's financial statements include the operations of all exchange activities worldwide.

Fiscal Year

The Exchange's fiscal year-end is the Saturday nearest January 31. References to fiscal year 2019 and fiscal year 2018 herein are to the fiscal years ended February 1, 2020 and February 2, 2019, 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)

Net sales by geographic region are summarized below:

	Year Ended	
	February 1, 2020	February 2, 2019
Continental U.S., including Alaska	\$ 4,498,560	\$ 4,550,663
Pacific Rim	932,052	945,314
Europe, primarily Germany	655,730	670,162
Middle East, including Afghanistan and Iraq	218,401	214,387
Other countries	270,981	319,429
Total net sales	<u>\$ 6,575,724</u>	<u>\$ 6,699,955</u>

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

	Year Ended	
	February 1, 2020	February 2, 2019
Continental U.S., including Alaska	\$ 1,480,577	\$ 1,551,666
Europe, primarily Germany	197,180	210,425
Pacific Rim	153,439	83,693
Middle East, including Afghanistan and Iraq	956	1,050
Other	20,137	9,005
Total long-lived assets, net	<u>\$ 1,852,289</u>	<u>\$ 1,855,839</u>

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. 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

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)

included the cost of the structures on its balance sheets 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.

Management has estimated the value of transportation costs paid by the U.S. government for Exchange materials shipped to and from overseas Exchange facilities (excluding Middle East) to be approximately \$90,956 and \$90,844 for fiscal years 2019 and 2018, respectively. In addition, Middle East transportation costs of \$40,281 and \$36,067 were paid by the U.S. government for fiscal years 2019 and 2018, respectively.

The Exchange receives reimbursements from the U.S. government of certain incremental costs incurred by the Exchange in relation to support provided to contingency operations. Appropriated fund (APF) reimbursements are recorded when an incremental cost that qualifies for reimbursement has been incurred and reimbursement by responsible agency is probable. Such APF reimbursement receivables are classified as trade and other accounts receivable on the accompanying balance sheets and are recorded as an offset to the related expenses (as described below) on the statement of earnings. In fiscal years 2019 and 2018, the Exchange recorded APF reimbursements of \$26,580 and \$23,104, respectively. These amounts include expenses related to inventory markdowns and shortages, personnel costs, in-theater transportation, and other expenses.

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 U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the accompanying financial statements and accompanying notes. Key estimates made by Exchange management include the level of allowance needed for potentially uncollectible accounts receivable and discount rates, long-term rate of return on assets, health care trend assumptions, and mortality assumptions used to determine obligations associated with pension plans and postretirement benefit plans.

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 pension accounting, the most significant actuarial assumptions are the discount rate, the long-term rate of return on plan assets, health care trend assumptions, and mortality rates. In determining the long-term rate of return on plan assets, the Exchange considers the nature of the plans' investments, an expectation of the plans' investment strategies, and the expected rate of return. Pension assets include investments in limited partnerships; real estate properties; and private equity, timber, agriculture, and 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 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 Measurement*, but may differ materially from the values that would have been used had a ready market for these investments existed. See Note 6 for further information about benefit plans.

Cash and Cash Equivalents

Cash equivalents represent cash on hand in stores, deposits in banks, and third-party credit card receivables, which generally are collected within a week of fiscal year-end. Cash and cash equivalents are carried at cost, which approximates fair value.

Accounts Receivable, Finance Revenue, and Provisions for Credit Losses

As of February 1, 2020 and February 2, 2019, \$2,321,625 and \$2,363,471, respectively, of the Exchange's accounts receivable balance represents amounts due from cardholders 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 and services at Exchange activities worldwide.

Minimum payments are calculated based on 2.777% of the unpaid balance as of the customer's last purchase date. These payments are applied in accordance with the Credit CARD Act of 2009.

Concentrations of credit risk, with respect to customer accounts receivables, are limited due to the large number of customers comprising the Exchange's credit card base and their dispersion throughout the world. The Exchange believes the carrying amount of existing customer receivables approximated its fair value due to the short-term nature of those receivables.

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's trade and accounts receivable balance also includes \$145,550 and \$148,725 of receivables from the Marine Exchange (MCX) for Marine MILITARY STAR[®] Card outstanding balances and related processing fees as of February 1, 2020 and February 2, 2019, 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 annual percentage rate (APR) for retail purchases was 11.74% and 12.49% as of February 1, 2020 and February 2, 2019, respectively. Beginning at 90 days past due, the delinquency rate of 19.74% applies. Finance revenue is recorded unless an account balance has been outstanding for an extended period of time, generally 150 days. Customer receivables past due 90 days or more and still accruing interest were approximately \$33,925 and \$41,977 as of February 1, 2020 and February 2, 2019, respectively.

Accounts past due for 30 days or more are considered delinquent. Accounts delinquent for 150 days are placed on non-accrual status whereby finance income is no longer accrued and submitted to the Exchange's collection department. The Exchange utilizes various means to collect past-due accounts, as well as non-accrual status accounts, including some methods not available to other commercial credit card financial institutions. 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 receivables related to accounts previously charged off (previously submitted to the collection department) were \$225,327 and \$238,637 at February 1, 2020 and February 2, 2019, respectively. These accounts are at least 150 days past due and are generally outstanding for one to five years.

The Exchange's credit card portfolio consists of smaller-balance, homogeneous loans. Due to the homogeneous nature of the credit card portfolios, a provision for 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.

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, 2020 and February 2, 2019. 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. Bad debt expense of \$19,755 recorded in fiscal year 2019 is primarily related to the Exchange's current credit card portfolio. This is compared to \$20,893 in bad debt expense recorded in fiscal year 2018.

With respect to accounts previously written off, the Exchange records and evaluates collectibility of a net receivable using a portfolio approach pooled by year based on estimated probable recoveries. Finance income and cash collections are applied to outstanding balances until 100% of the net receivables from each portfolio year has been collected. Subsequent cash collections in excess of amounts previously charged off are recorded as finance revenue upon collection. Collections on accounts previously written off and submitted to U.S. government entities totaled approximately \$149,017 and \$154,590 in fiscal years 2019 and 2018, respectively. Finance revenue recognized in fiscal year 2019 related to non-accrual accounts totaled approximately \$14,522 compared to approximately \$12,579 in fiscal year 2018.

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

	February 1, 2020		February 2, 2019	
	Amount	Percentage of Receivables	Amount	Percentage of Receivables
	<i>(In Millions)</i>		<i>(In Millions)</i>	
Current	\$ 2,099	85.2%	\$ 2,120	84.5%
1–29 days past due	199	8.1	200	8.0
30–59 days past due	83	3.3	88	3.5
60–89 days past due	50	2.0	59	2.3
90+ days past due	33	1.4	42	1.7
Period-end gross credit card receivables	\$ 2,464	100.0%	\$ 2,509	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. In addition, 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.

	2019	2018
	<i>(In Millions)</i>	
Allowance at beginning of period	\$ 26	\$ 26
Provision for bad debt	20	21
Net write-offs	(21)	(21)
Allowance at end of period	\$ 25	\$ 26

The following table sets forth the credit scores of the Exchange's credit card portfolio that have not yet been submitted to U.S. government entities for collection as reported by FICO.

	February 1, 2020	February 2, 2019
	<i>(In Millions)</i>	
Nondelinquent accounts (current and 1–29 days past due):		
FICO score of 700 or above	\$ 787	\$ 783
FICO score of 600 to 699	1,082	1,078
FICO score below 600	429	459
Total nondelinquent accounts	2,298	2,320
Delinquent accounts (30+ days past due)	166	189
Period-end gross credit card receivables	\$ 2,464	\$ 2,509

Merchandise Inventories

The Exchange's inventories are valued at the lower of cost or net realizable value, as determined by the retail inventory method of accounting (RIM). Certain warehousing and distribution expense costs are included in the cost of inventory, which amounted to \$17,244 and \$15,201 at February 1, 2020 and February 2, 2019, 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)

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 calculation 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 and paid for by the Exchange and owned by the U.S. government. These assets are recorded by the Exchange 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 over periods 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. As part of the Exchange's mission, "We Go Where You Go," there are facilities built to serve the military community regardless of its ability to generate a profit. With all construction projects, these service (Quality of Life) projects must go through the Board and Finance Committee for review and approval prior to construction. Projected returns of less than 7% internal rate of return are considered service projects and are identified during the asset impairment review process (discussed below). Although these facilities are segregated from the fixed asset portfolio, the Exchange closely monitors operations to ensure the highest level of efficiencies can be maintained while maximizing profits.

The carrying value of long-lived assets, including property and equipment, is evaluated annually or whenever events or changes in circumstances indicate that a potential impairment has occurred relative to a given asset or assets. Factors that could result in an impairment review include, but are not limited to, a current period cash flow loss combined with a history of cash flow losses or a projection that demonstrates continuing losses associated with the use of a long-lived asset, significant changes in the manner of use of the assets, or significant changes in business strategies. An impairment loss is recognized when the estimated undiscounted cash flows expected to result from the use of the asset plus net proceeds expected from disposition of the asset (if any) are less

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)

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. The Exchange has not recorded any long-lived asset impairment charges during fiscal years 2019 or 2018.

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

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 Exchange's self-insurance reserves were \$87,522 and \$77,319 as of February 1, 2020 and February 2, 2019, respectively.

Reserves were discounted at a weighted average rate:

	<u>February 1, 2020</u>	<u>February 2, 2019</u>
Workers' compensation	2.87%	4.03%
Property liability	1.90	3.29
Public liability	1.81	3.38
General liability	1.84	3.34

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 Exchange 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. 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 \$46,515 and \$44,900 for the years ended February 1, 2020 and February 2, 2019, 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

The Exchange adopted ASC 606, *Revenue from Contracts with Customers*, on February 3, 2019, using the modified retrospective approach. Prior period amounts were not adjusted and continue to be reported in accordance with ASC 605, *Revenue Recognition*. The adoption of ASC 606 did not materially impact the financial position or the results of operations for the year ended February 1, 2020.

The Exchange recognizes revenue when control of the merchandise is transferred to customers in an amount that reflects the consideration received in exchange for such merchandise. For sales at the retail locations, control is transferred at the point at which the customer receives and pays for the merchandise at the register. For e-commerce sales, control is transferred when merchandise is tendered to a third-party carrier for delivery to the customer. Cash is typically received on the day of or, in the case of credit or debit card transactions, within several days of the related 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.

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)

Prior to fiscal year 2019, the Exchange recognized revenue when the merchandise was sold and transferred to customers at the time of sale. For e-commerce sales, revenue was recognized when merchandise was tendered to a third-party carrier for delivery to the customer. Concession income included fees charged to concessionaries based on a percentage of their sales and was recognized when earned.

Income Taxes

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

401(k) Plan

The Exchange has a 401(k) voluntary savings and investment plan open to regular full- and part-time employees who meet certain minimum requirements. New hire associates are 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 Exchange uses foreign currency exchange contracts to hedge exposures to changes in foreign currency rates on the Exchange's payroll and foreign vendor obligations denominated in foreign currencies. These derivative instruments are recognized in the accompanying 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 Exchange's policy is that it does not speculate in hedging activities. The maximum length of time over which the Exchange is hedging its exposure to the variability of future cash flows for forecasted transactions is one year.

Army and Air Force Exchange Service

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

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

Benefit Plans

Liabilities and expenses related to the Exchange's benefit plans are determined based on a number of actuarial assumptions, which are reviewed and determined on an annual basis. These assumptions include discount rates, health care cost trend rates, compensation increase rate, benefits earned, mortality rates, number of participants, certain demographics, and other factors. Actual results that differ from assumptions are accumulated and amortized to expense over future periods and, therefore generally affect recognized expense in future periods. The projected benefit obligation is recognized on the balance sheets. Actuarial gains and losses are recognized as components of accumulated other comprehensive loss in net assets until amortized as a component of net periodic benefit cost.

The Exchange adopted Accounting Standards Update (ASU) 2017-07, *Compensation – Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*, which changes the presentation of net periodic benefit cost on the statement of earnings as of February 1, 2020, and applied the guidance retrospectively for the income statement classification of the components of net periodic benefit cost. On the statements of earnings, the service cost component of net periodic benefit cost is included in selling, general, and administrative expenses and the other components of net periodic benefit cost are included in non-service pension and postretirement income. The retrospective application of the new accounting guidance decreased operating income for the year ended February 1, 2020 and February 2, 2019, by \$69,737 and \$82,566, respectively, and had no impact on net earnings.

Fair Value Measurements

The Exchange records financial instruments at fair value in accordance with ASC 820. Under ASC 820, fair value is considered to be the exchange price in an orderly transaction between market participants to sell an asset or transfer a liability at the measurement date. The fair value definition under ASC 820 focuses on an exit price, which is the price that would be received to sell an asset or paid to transfer a liability versus an entry price, which would be the price paid to acquire an asset or received to assume a liability. See Note 2 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 a noncontributory supplement deferred compensation plan (Supplemental Plan) and derivative financial instruments. The Exchange uses high-credit quality counterparties when executing derivative transactions.

Recent Accounting Pronouncements

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. ASC 2016-02 requires all leases that have a term of over 12 months to be recognized on the balance sheet with the liability for lease payments and the corresponding right-of-use asset initially measured at the present value of amounts expected to be paid over the term. Recognition of the costs of these leases on the income statement will be dependent upon their classification as either an operating or a financing lease. Costs of an operating lease will continue to be recognized as a single operating expense on a straight-line basis over the lease term. Costs for a financing lease will be disaggregated and recognized as both an operating expense (for the amortization of the right-of-use asset) and interest expense (for interest on the lease liability). For nonpublic companies, ASU 2016-02 is effective for reporting periods after December 15, 2020. The Exchange is currently evaluating the effects of this ASU on its financial statements.

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. This guidance will require Companies to recognize an allowance for credit losses on available-for-sale debt securities rather than the current approach of recording a reduction to the carrying value of the asset. The ASU is effective for fiscal years beginning after December 15, 2022. Early adoption is permitted for annual periods beginning after December 15, 2018, and interim periods therein. The Exchange is currently evaluating the effects of this ASU on its financial statements.

In August 2018, the FASB issued ASU 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement*. This ASU eliminates, modifies and adds disclosure requirements for fair value measurements. The amendments in this ASU are effective for fiscal years beginning after December 15, 2019, with early adoption permitted. The Exchange is currently evaluating the effects of this ASU on its 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 August 2018, the FASB issued ASU 2018-14, *Compensation – Retirement Benefits – Defined Benefit Plans – General (Subtopic 715-20): Disclosure Framework – Changes to the Disclosure Requirements for Defined Benefit Plans*, which amends the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. The amendments in this update removed disclosures that no longer are considered cost beneficial, clarify the specific requirements of disclosures, and add disclosure requirements identified as relevant. The amendment is effective in fiscal years ending after December 15, 2021. Early adoption is permitted. The Exchange is currently evaluating the effects of this ASU on its financial statements.

2. Fair Value Measurements

ASC 820 establishes a framework for measuring fair value. The inputs used to measure fair value are prioritized based on a three-level hierarchy as follows:

- 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 holding 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.

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in Thousands, Unless Otherwise Noted)

2. Fair Value Measurements (continued)

- 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 financial 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 financial 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 Exchange'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 on the accompanying balance sheets at cost, which approximates fair market value due to the short-term nature of these instruments. Trade and other accounts receivable are reflected on the accompanying balance sheet at cost less a provision for credit losses, which approximates fair 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 Exchange's debt is disclosed in Note 3.

The Exchange holds investments related to the Supplemental Plan totaling \$22,007 and \$19,711 at February 1, 2020 and February 2, 2019, respectively, which are included in long-term investments and Supplemental Plan assets on the accompanying balance sheets. 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. Earnings on trading securities were \$2,803 and \$312 in fiscal years 2019 and 2018, respectively. The cost of securities sold is determined primarily on a specific identification method. (Refer to Note 6 for further discussion of the Supplemental Plan, and refer to Note 4 for further discussion of the Exchange's derivative positions.)

3. Indebtedness

Committed Lines of Credit

The Exchange maintains two committed lines of credit aggregating to \$2,000,000. The first is an unsecured revolving line of credit that is facilitated by a ten-bank syndicate led by Wells Fargo Bank, N.A. aggregating to \$1,500,000 that was entered into on June 15, 2018, and expires on June 15, 2023. As of February 1, 2020, there is a zero balance outstanding and there were no borrowings under this line of credit during fiscal year 2019.

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in Thousands, Unless Otherwise Noted)

3. Indebtedness (continued)

In addition, the Exchange has a committed line of credit for \$500,000 with Installation Management Command G-9 (IMCOM G-9). This agreement was renewed on December 4, 2019, for a five-year term. Borrowings under the IMCOM G-9 line of credit had interest rates ranging from 1.70% to 2.50% during fiscal year 2019 and 1.45% to 2.00% during fiscal year 2018. Renewal reviews will take place 24 months prior to expiration in order to have the renewal of future agreements in place prior to the one year expiration time frame. During fiscal year 2019, daily borrowings were generally due within 30 to 260 days. As of February 1, 2020, there was \$10,000 outstanding under the IMCOM G-9 line of credit, with all such borrowings currently scheduled to become due within fiscal year 2020. Historically, the Exchange has regularly replaced its line of credit facilities with similar borrowings with extended terms. The Exchange believes it has the ability and intent to refinance its outstanding borrowings coming due in fiscal year 2020 under the current agreement or replace such facilities on substantially the same or better terms and conditions. Accordingly, these outstanding borrowings have been classified as noncurrent at February 1, 2020, as they are not expected to require the use of current working capital during fiscal year 2020.

Commercial Paper

In June 2013, the Exchange implemented a Commercial Paper (CP) program. As of February 1, 2020 and February 2, 2019, the outstanding commercial paper obligations, inclusive of original issue discount, were \$413,000 and \$376,000, respectively. The CP program is an open-ended agreement; however, outstanding balances as of February 1, 2020, have maturity dates that range from 1 to 270 days and as such were classified as current. Borrowings under the commercial paper program had interest rates ranging from 1.56% to 4.08% during fiscal year 2019, and 1.37% to 2.50% during fiscal year 2018.

Senior Notes

In October 2009, the Exchange completed a private placement debt offering of \$90,000 of 4.95% senior notes due in 2024 (the senior notes), which comprise a 15-year amortizing principal. As of February 1, 2020, the senior notes have a total remaining outstanding obligation of \$35,967.

Army and Air Force Exchange Service

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

3. Indebtedness (continued)

Term Loans

The Exchange had a term loan agreement with Branch Banking & Trust in an aggregate amount of \$100,000 that matured and was paid on March 31, 2019, and bore interest at London Interbank Offered Rate (LIBOR) plus 0.625%. A syndicated term loan of \$250,000 was entered into as part of the Wells Fargo syndication agreement on June 15, 2018. This term loan agreement matures June 15, 2021, and bears an interest rate of LIBOR plus 0.75%.

The average interest rate for all indebtedness, including lines of credit (both committed and uncommitted), commercial paper, senior notes and term loans was 2.02% for the year ended February 1, 2020.

Debt obligations consisted of the following:

	February 1, 2020	February 2, 2019
Outstanding debt principal balances:		
IMCOM G-9 committed line of credit	\$ 10,000	\$ 75,000
Senior notes	35,967	42,522
Term Loan – Branch Banking & Trust	–	100,000
Term Loan – Wells Fargo	250,000	250,000
Commercial Paper – Wells Fargo	159,000	50,000
Commercial Paper – Fifth Third Bank	100,000	–
Commercial Paper – Citibank	154,000	326,000
Total debt obligations	708,967	843,522
Current maturities	(419,887)	(482,555)
Total long-term debt obligations	\$ 289,080	\$ 360,967

The Exchange believes that the carrying values of amounts outstanding under its line of credit, commercial paper, and term loan agreements approximate fair value given the term of the debt and floating interest rates. As of February 1, 2020, the estimated fair value for the 2024 senior notes is \$37,433. Fair value is calculated using a discounted cash flow analysis (Level 2), with estimated interest rates offered for notes with similar terms and maturities.

Army and Air Force Exchange Service

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

3. Indebtedness (continued)

Cash paid for interest for fiscal years 2019 and 2018, was approximately \$15,366 and \$21,420, respectively. The Exchange has complied with all financial and nonfinancial covenants per loan agreements as of February 1, 2020, and expects to comply through the period ending January 30, 2021.

Principal maturities of debt obligations as of February 1, 2020, are as follows:

2020	\$ 419,887
2021	257,236
2022	7,602
2023	7,987
2024	16,255
	<u>\$ 708,967</u>

4. Derivative Financial Instruments

Forward and option collar foreign exchange contracts are used primarily to hedge the risk of the Exchange's Euro-denominated payroll and foreign vendor obligations against adverse changes in foreign currency exchange rates. Under the foreign exchange contracts, the Exchange 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 Exchange 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 Exchange's forward and option collar foreign exchange contracts are recorded on the Exchange's balance sheets as an asset or liability and in net assets (as a component of accumulated other comprehensive loss). As the notional amounts and terms of each forward and option collar foreign exchange contract match those of its liability counterpart at maturity, any ineffectiveness is immaterial in the foreign exchange contracts.

Army and Air Force Exchange Service

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

4. Derivative Financial Instruments (continued)

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, 2020, the Exchange had various foreign exchange contracts (option collars) outstanding related to approximately \$79,068 (€67,000) of its forecasted payroll and inventory purchase liabilities. The notional value of outstanding option collar contracts was \$79,068 (€67,000). The loss of \$6 for accrued salaries, separation pay and other benefits and \$19 for accounts payable totaling a net loss of \$25 on the accompanying balance sheet is included as a component of accumulated other comprehensive loss. The balance of \$25 in accumulated other comprehensive loss is expected to be reclassified into earnings within the next 12 months. The effects of outstanding derivatives are revalued periodically. The Exchange has recognized approximately \$328 in gain on foreign currency hedge transactions settled during fiscal year 2019, compared to \$1,451 in loss during fiscal year 2018.

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 sold through. As of February 1, 2020 and February 2, 2019, total derivatives designated as hedging instruments were \$25 and \$228, respectively.

5. Lease and Rental Obligations

The Exchange's operating lease and rental commitments primarily include real estate and information technology leases. The Exchange recorded rent expense of \$2,578 and \$1,956 for the fiscal years ended February 1, 2020 and February 2, 2019, respectively. The following is a schedule, by fiscal year, of the future minimum rental payments required under all leases as of February 1, 2020:

2020	\$	2,363
2021		2,356
2022		2,255
2023		1,138
2024		760
Thereafter		2,949
	\$	<u>11,821</u>

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in Thousands, Unless Otherwise Noted)

6. 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 Exchange who are citizens or residents of the U.S. In addition, 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 benefit plans discussed above, 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 Exchange contributes each year. As of February 1, 2020, the Exchange recorded a liability of approximately \$13,363, which represents an estimated liability of \$29,208 less trust assets of \$42,571. As of February 2, 2019, the Exchange recorded a liability of approximately \$9,360, which represents an estimated liability of \$28,657 less trust assets of \$38,017.

In addition, the Exchange 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)

6. Benefit Plans (continued)

The Exchange measures the cost of its pension plans and other postretirement benefit plans in accordance with ASC 715, *Compensation – Retirement Benefits*. As the Exchange’s fiscal year-end does not coincide with a month-end, the Exchange has elected to measure plan assets and benefit obligations using the month-end that is closest to the Exchange’s fiscal year-end. The assets of the Supplemental Plan are not effectively restricted from being used by the Exchange for other purposes. Therefore, these assets 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 fiscal years 2019 and 2018. Amounts are stated in millions.

	Pension Benefits				Other Benefits			
	The Basic Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2019	2018	2019	2018	2019	2018	2019	2018
Change in projected benefit obligations (PBO)								
PBO at prior measurement date	\$ 4,575	\$ 4,766	\$ 19	\$ 23	\$ 2,164	\$ 2,566	\$ 76	\$ 81
Service cost	97	102	1	1	24	25	2	2
Interest cost	196	186	1	1	92	88	1	2
Plan participants’ contributions	4	4	–	–	–	–	–	–
Actuarial loss (gain)	705	(187)	6	(5)	358	(409)	6	(3)
Foreign exchange impact	–	–	–	–	–	–	(1)	(5)
Benefits paid	(298)	(275)	(1)	(1)	(97)	(98)	(3)	(2)
Administrative expenses paid	(18)	(21)	–	–	(8)	(8)	1	1
PBO at current measurement date	5,261	4,575	26	19	2,533	2,164	82	76
Change in plan assets								
Fair value of assets at prior measurement date	4,149	4,441	–	–	1,720	1,828	54	60
Actual return on assets	618	–	–	–	248	(17)	7	–
Employer contributions	–	–	–	–	–	15	2	1
Plan participants’ contributions	4	4	–	–	–	–	–	–
Benefits paid	(298)	(275)	–	–	(97)	(98)	(3)	(2)
Administrative expenses paid/ foreign exchange impact	(18)	(21)	–	–	(8)	(8)	–	(5)
Fair value of assets at current measurement date	4,455	4,149	–	–	1,863	1,720	60	54
Funded status at fiscal year end	\$ (806)	\$ (426)	\$ (26)	\$ (19)	\$ (670)	\$ (444)	\$ (22)	\$ (22)

Supplemental Plan assets do not qualify as plan assets as discussed above.

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

The following table reflects amounts recognized in the balance sheets as of fiscal years 2019 and 2018. Amounts are stated in millions.

	Pension Benefits				Other Benefits			
	The Basic Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2019	2018	2019	2018	2019	2018	2019	2018
Amounts recognized in the balance sheets								
Other current liabilities	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 2	\$ 3
Net accrued pension and other benefits liability	806	426	26	19	670	444	21	22
Accumulated other comprehensive loss	(1,596)	(1,259)	(6)	(1)	(671)	(455)	(17)	(15)

A summary of the components of net periodic benefit cost (income) for the benefit plans is as follows for fiscal years 2020 and 2019. Amounts are stated in millions.

	Pension Benefits				Other Benefits			
	The Basic Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2019	2018	2019	2018	2019	2018	2019	2018
Net periodic cost								
Service cost	\$ 96	\$ 102	\$ 1	\$ 1	\$ 24	\$ 25	\$ 2	\$ 2
Interest cost	196	186	1	1	92	88	1	2
Expected return on assets	(320)	(337)	-	-	(125)	(131)	(3)	(3)
Other adjustments	-	-	-	-	-	-	-	-
Net loss amortization	70	83	-	-	18	28	1	1
Net periodic benefit cost	\$ 42	\$ 34	\$ 2	\$ 2	\$ 9	\$ 10	\$ 1	\$ 2

Information for benefit plans with an accumulated benefit obligation in excess of plan assets is as follows for fiscal years 2020 and 2019. Amounts are stated in millions.

	Pension Benefits				Other Benefits			
	The Basic Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2019	2018	2019	2018	2019	2018	2019	2018
Projected benefit obligation	\$ 5,261	\$ 4,575	\$ 26	\$ 19	\$ 2,533	\$ 2,164	\$ 81	\$ 76
Accumulated benefit obligation	4,911	4,312	9	8	2,533	2,164	74	68
Fair value of plan assets	4,455	4,149	-	-	1,863	1,719	60	54

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

Amounts included in accumulated other comprehensive loss for all plans at February 1, 2020, consist of net actuarial loss of \$2,290,921. Amortization of this amount expected to be recognized in fiscal year 2020 is \$172,653.

Actuarial Assumptions

Actuarial weighted average assumptions used in determining plan obligations and the related expense are as follows for fiscal years 2019 and 2018:

	Pension Benefits				Other Benefits	
	The Basic Plan		Supplemental Plan		Postretirement	
	2019	2018	2019	2018	2019	2018
Assumptions used to determine expense and liabilities:						
Discount rate	4.36%	3.96%	4.36%	3.96%	4.37%	3.98%
Long-term rate of return on assets	7.69	8.08	–	–	7.79	8.24
Compensation increase rate	4.31	4.19	9.50	9.41	–	–
Assumptions used at disclosure:						
Discount rate	3.16	4.36	3.16	4.36	3.19	4.37
Compensation increase rate	4.31	4.19	9.73	9.60	–	–

Assumed Health Care Cost Trend Rates at Fiscal Year-End

	2019	2018
Health care cost trend rate assumed for next year	6.00%	6.25%
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	2026	2025

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

	Other Benefits		Other Benefits	
	UK Plan		Local National Plan	
	2019	2018	2019	2018
Assumptions used to determine expense:				
Discount rate	2.50%	2.50%	0.79%	0.86%
Long-term rate of return on assets	6.20	6.20	–	–
Compensation increase rate	2.80	2.70	2.37	2.38
Assumptions used at disclosure:				
Discount rate	1.60	2.50	0.79	0.75
Compensation increase rate	2.50	2.80	2.37	2.38

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 plan assets 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)

6. Benefit Plans (continued)

The following table sets forth the target allocations of plan assets for the fiscal years 2019 and 2018:

	Pension Benefits		Other Benefits			
			Postretirement			
	The Basic Plan		Plan		UK Plan	
	2019	2018	2019	2018	2019	2018
Domestic equity securities	14%	14%	15%	15%	–%	26%
International equity securities	10	10	10	10	20	35
Emerging market equity securities	3	3	4	4	–	4
Low-volatility global equity	9	9	10	10	–	–
Investment-grade fixed income	25	25	25	25	80	35
High-yield fixed income	4	4	–	–	–	–
Treasury inflation protected securities (TIPS)	3	3	3	3	–	–
Real estate – private	4	4	4	4	–	–
Real estate – public	1	1	1	1	–	–
Private equity	9	9	10	10	–	–
Commodities	3	3	3	3	–	–
Alternative debt	5	5	5	5	–	–
MLPs	5	5	5	5	–	–
Timber/Farmland	5	5	5	5	–	–
Total	100%	100%	100%	100%	100%	100%

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

The Exchange's benefit plan actual asset allocations at February 1, 2020 and February 2, 2019, by asset class category are as follows:

	Pension Benefits		Other Benefits			
			Postretirement			
	The Basic Plan		Plan		UK Plan	
	2019	2018	2019	2018	2019	2018
Domestic equity securities	14%	14%	15%	15%	–%	20%
International equity securities	10	10	10	11	19	38
Emerging market equity securities	3	3	4	4	–	7
Low-volatility global equity	9	9	10	10	–	–
Investment-grade fixed income	25	26	26	27	81	35
High-yield fixed income	4	4	–	–	–	–
TIPS	3	3	3	3	–	–
Real estate – private	4	5	4	4	–	–
Real estate – public	1	1	1	1	–	–
Private equity	10	10	10	10	–	–
Commodities	4	3	3	3	–	–
Alternate debt	4	4	5	4	–	–
MLPs	5	5	5	5	–	–
Timber/Farmland	4	3	4	3	–	–
Total	100%	100%	100%	100%	100%	100%

The Exchange uses the fair value hierarchy discussed in Note 2 to measure the fair value of assets held by pension and postretirement benefit plans.

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 fair values of the investments in the collective investment funds represent the net asset values of the shares or units of such funds as determined by the issuer. Limited partnerships are valued based on net asset value as determined by the general partners and represent the plans' proportionate share of the estimated

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in Thousands, Unless Otherwise Noted)

6. Benefit Plans (continued)

fair value of the underlying net assets limited partnership. The limited partnerships are valued based on purchase price when recently acquired; valuation models such as discounted cash flows or market multiples; financial measures, such as free cash flow or earnings before interest, taxes, depreciation and amortization (EBITDA); or market comparisons for similar assets and are classified as Level 3 investments. Foreign obligations are foreign equities traded on U.S. exchanges as American Depository Receipts (ADRs), are valued based on market quotations, and are classified as Level 1 investments.

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 are traded. U.S. government obligations are classified as Level 1 investments. 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 with these assets classified as Level 2. 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.

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) or Master Limited Partnerships (MLPs) and are valued based on market quotations. Collective investment funds with underlying investments in exchange-traded positions are classified as Level 2 investments. The net asset value of collective investment funds and limited partnerships with underlying investments in real estate are 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. Such contracts are classified as Level 2 investments.

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

The following table sets forth by level within the fair value hierarchy, the Exchange's benefit plan assets and liabilities that are measured at fair value as of February 1, 2020:

	Benefit Plans			
	Total	Level 1	Level 2	Level 3
Assets				
Temporary investments ^(a)	\$ 45,690	\$ 45,690	\$ —	\$ —
Equity securities:				
Common and preferred stock ^(b)	820,247	820,247	—	—
Foreign obligations ^(c)	14,691	14,691	—	—
Debt securities:				
Common and preferred stock ^(b)	2,018	2,018	—	—
Corporate bonds ^(d)	620,122	—	620,122	—
U.S. government obligations ^(e)	209,075	209,075	—	—
Asset-backed securities ^(f)	552	—	552	—
Real estate and commodities:				
Common and preferred stock ^(b)	181,686	181,686	—	—
Other investments	5,372	—	5,372	—
Total investments at fair value	<u>1,899,453</u>	<u>\$ 1,273,407</u>	<u>\$ 626,046</u>	<u>\$ —</u>
Investments measured at net asset value:				
Collective investment funds:				
Equity securities ^(g)	1,639,120			
Debt securities ^(h)	1,104,406			
Real estate and commodities ⁽ⁱ⁾	485,930			
Short-term investment funds ⁽ⁱ⁾	43,974			
Limited partnerships:				
Equity securities ^(k)	628,792			
Debt securities ^(k)	262,387			
Real estate and commodities ^(k)	289,354			
Total investments measured at net asset value	<u>4,453,963</u>			
Plan assets not measured at fair value or net asset value ^(l)	33,802			
Total assets	<u><u>\$ 6,387,218</u></u>			

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

The following table sets forth by level within the fair value hierarchy, the Exchange's benefit plan assets and liabilities that are measured at fair value as of February 2, 2019:

	Benefit Plans			
	Total	Level 1	Level 2	Level 3
Assets				
Temporary investments ^(a)	\$ 9,012	\$ 9,012	\$ —	\$ —
Equity securities:				
Common and preferred stock ^(b)	792,684	792,684	—	—
Foreign obligations ^(c)	18,174	18,174	—	—
Debt securities:				
Common and preferred stock ^(b)	1,624	1,624	—	—
Corporate bonds ^(d)	563,933	—	563,933	—
U.S. government obligations ^(e)	194,295	194,295	—	—
Asset-backed securities ^(f)	1,012	—	1,012	—
Real estate and commodities:				
Common and preferred stock ^(b)	361,707	361,707	—	—
Other investments	5,937	—	5,937	—
Total investments at fair value	<u>1,948,378</u>	<u>\$ 1,377,496</u>	<u>\$ 570,882</u>	<u>\$ —</u>
Investments measured at net asset value:				
Collective investment funds:				
Equity securities ^(g)	1,592,672			
Debt securities ^(h)	996,469			
Real estate and commodities ⁽ⁱ⁾	523,032			
Short-term investment funds ⁽ⁱ⁾	55,595			
Limited partnerships:				
Equity securities ^(k)	479,575			
Debt securities ^(k)	221,469			
Real estate and commodities ^(k)	86,734			
Total investments measured at net asset value	<u>3,955,546</u>			
Plan assets not measured at fair value or net asset value ^(l)	18,264			
Total assets	<u><u>\$ 5,922,188</u></u>			

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

(a) Primarily consist of cash held in foreign currencies.

(b) 2019: Holdings are diversified as a percentage of total equity as follows: Domestic Markets (53%) and Developed International Markets (47%). Domestic Markets are diversified by Large Cap (34%), Small Cap (11%), Public Real Estate – REITS (20%), Low volatility investments (17%), and MLPs (18%). There are no significant concentrations of holdings by the Exchange.

2018: Holdings are diversified as a percentage of total equity as follows: Domestic Markets (60%) and Developed International Markets (40%). Domestic Markets are diversified by Large Cap (25%), Small Cap (8%), Public Real Estate – REITS (14%), Low volatility investments (12%), and MLPs (41%). There are no significant concentrations of holdings by the Exchange.

(c) 2019: Holdings include International 75% and Domestic 25% securities in the form of American Depository Receipts which represent underlying securities, traded on non-U.S. exchanges.

2018: Holdings include International 53% and Domestic 47% securities in the form of American Depository Receipts which represent underlying securities, traded on non-U.S. exchanges.

(d) 2019: Includes 81% and 19% of investments in corporate high-yield debt with S&P rating of B- and below as of February 2, 2019. The remaining investments are in investment-grade corporate bonds.

2018: Includes 80% and 20% of investments in corporate high-yield debt with S&P rating of B- and below as of February 3, 2019. The remaining investments are in investment-grade corporate bonds.

(e) Includes 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.

(f) Holdings consist primarily of publicly traded fixed-income securities whose payments are based on the performance of an underlying asset.

(g) 2019: 73% of 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 remaining 27% consists of international, small cap, and low volatility investments in the form of mutual funds. The collective investment funds consist of Domestic (60%) and International (40%). Investments have a required notice of three days for any sales or liquidation. The fund's management may impose restrictions on cash redemptions in the

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

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.

2018: 73% of 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 remaining 27% consists of international, small cap, and low volatility investments in the form of mutual funds. The collective investment funds consist of Domestic (60%) and International (40%). Investments 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.

- (h) 2019: 95% of the holdings consist of two core fixed income index funds, which both employ a strategy that seeks to match the performance of the Barclays Long Credit Index, and a Loomis Sayles high yield fund (5%), which employs a strategy that seeks to match the performance of the CS High Yield Index. Issuances and redemptions are made on each business day. 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. The BlackRock funds have a required notice of three days for any sales or liquidation.

2018: 94% of the holdings consist of two core fixed income index funds, which both employ a strategy that seeks to match the performance of the Barclays Long Credit Index, and a Loomis Sayles high yield fund (6%), which employs a strategy that seeks to match the performance of the CS High Yield Index. Issuances and redemptions are made on each business day. 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.. The BlackRock funds have a required notice of three days for any sales or liquidation.

- (i) 2019: 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 at net asset value. 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 31% and value-added or opportunistic 10% investments. Commodity investments include farmland and timber, which represent 59% of the allocation. There is quarterly redemption available for the real estate investments with a 60-day notice.

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

2018: 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 at net asset value. 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 38% and value-added or opportunistic 12% investments. Commodity investments include farmland and timber, which represent 50% of the allocation. There is quarterly redemption available for the real estate investments with a 60-day notice.

- (i) 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 fund's trustee.
- (k) Includes limited partnerships that invest primarily in U.S. buy-out 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.
- (l) Holdings consist of net amounts due to or from brokers for the sale of securities as of the balance sheet date.
- (m) Includes two immediate participation guarantee contracts at contract value.

Employer Contributions

The Exchange does not expect to contribute to the other postretirement benefit plans in fiscal year 2020.

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

Estimated Future Benefit Payments

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

Fiscal Years	Basic Plan	Supplemental Plan	Postretirement	Foreign Plans
2020	\$ 258,370	\$ 465	\$ 114,945	\$ 4,306
2021	262,607	471	118,480	3,892
2022	266,200	477	121,550	3,944
2023	269,609	483	124,763	3,998
2024	272,708	490	127,076	3,918
2025–2030	1,394,124	2,941	648,328	20,106

7. 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 earnings exceed the financial plan, the Exchange will retain the first 15% of the excess earnings and the remainder will be distributed in the form of dividend payments.

Under the current dividend policy, noncash pension and employee benefit plan expenses are excluded from net earnings subject to dividends. Any other exclusion, such as employee bonuses, 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.

Army and Air Force Exchange Service

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

8. Commitments and Contingencies

The Exchange 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 Exchange.

9. Middle East, Including U.S. Missions in Afghanistan and Iraq

The Exchange's presence in Iraq, Qatar, Afghanistan, and Kuwait was supported by 50 stores as of February 1, 2020, and 49 stores as of February 2, 2019. Approximately \$217,137 (3.0%) and \$212,425 (3.0%) of the Exchange's net revenues in the fiscal years 2019 and 2018, respectively, were derived from sales to U.S. troops stationed in the Middle East, including OFS and OIR. The increase in revenue for fiscal year 2019 was primarily due to an increased level of U.S. troops being redeployed in those areas. The Exchange's inventory balance in this region, at cost, was \$32,243 and \$39,503 at February 1, 2020 and February 2, 2019, respectively. 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 would adversely affect the Exchange's results; however, such losses are eligible for reimbursement appropriations that are reasonably assured of collection.

10. Subsequent Events

The Exchange has evaluated subsequent events through May 22, 2020, the date at which the accompanying financial statements were available to be issued.

In March 2020, the World Health Organization declared the novel strain of coronavirus (COVID-19) a global pandemic and recommended containment and mitigation measures worldwide. In response to this coronavirus outbreak, the governments of many countries, states, cities and other geographic regions in which the Exchange operates have taken preventative or protective actions, such as imposing restrictions on travel and business operations and advising or requiring individuals to limit or forego their time outside of their homes. Local military commands, while not required to adhere to state and local directives, have largely followed the same mitigations efforts to slow the spread of the virus.

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in Thousands, Unless Otherwise Noted)

10. Subsequent Events (continued)

The Exchange has been declared mission essential by local military commands, resulting in only a minimal number of temporary closures and reduced hours at select stores worldwide. While social distancing and shelter-in-place directives have impacted foot traffic in physical shopping locations, the effect has not been consistent across all lines of business and in all geographical regions in which we operate. At this time we cannot reasonably estimate the short- and long-term impact the COVID-19 pandemic will have on the Exchange's ability to generate earnings and free cash flow; however, we have proactively and aggressively taken steps to reduce costs to ensure the continued strength and financial position of the Exchange. These efforts include, but are not limited to, delays of capital expenditures, reduction of non-essential operating expenses, and aggressive inventory management efforts.

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2019 BY THE NUMBERS

\$8.6B

REVENUE

\$369M

EARNINGS

\$217M

DIVIDENDS

85%

ASSOCIATES
CONNECTED TO
THE MILITARY

44,579

VETERANS/
SPOUSES HIRED
SINCE 2013

4,800

ASSOCIATES DEPLOYED
TO COMBAT ZONES
SINCE 9/11

1,606

WOUNDED
WARRIORS HIRED
SINCE 2010

811,000

COMBAT UNIFORMS
OUTFITTED AT COST

7 PLANTS

PROVIDING BAKED
GOODS & WATER
OVERSEAS

9.9M

BAKERY ITEMS
PRODUCED
OVERSEAS

4.2M

GALLONS OF
WATER BOTTLED

1,700

RESTAURANTS WITH
BE FIT OPTIONS

107M

MEALS SERVED
AT EXCHANGE
RESTAURANTS

2.6M

SCHOOL LUNCHES
SERVED AT OR BELOW
COST

8M

HAIRCUTS
PROVIDED

438M

GALLONS OF FUEL
DISPENSED

11

DISTRIBUTION
CENTERS

45.6M

CASES
SHIPPED

13.7M

FLEET MILES
DRIVEN

