



X EXCHANGE

LAWSON

ARMY



ARMY & AIR FORCE  
EXCHANGE SERVICE

# 2017 MISSION REPORT

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## From Director/CEO Tom Shull: A Year of Game Changers

In 2017, the Army & Air Force Exchange Service provided unrivaled support and changed the game for those we are privileged to serve: Soldiers, Airmen, military families, retirees—and now all honorably discharged Veterans.

The Exchange provided this support during another difficult year for the retail industry with thousands of store closures and multiple retailers filing for bankruptcy. In addition, several major eCommerce retailers continued to squeeze brick-and-mortar locations and drive up freight and shipping costs for other e-retailers.

Despite this difficult environment, the Exchange increased revenue by more than \$300 million to \$8.6 billion with \$376 million in dividend-eligible earnings.

From those earnings, the Exchange provided \$219 million in dividends to Quality-of-Life programs critical to Warfighters' readiness and resiliency, including combat uniforms, [school lunches](#) for military children overseas, Child Care Centers, Youth Programs, and [jobs for Veterans](#), military spouses and Wounded Warriors.

The Exchange invested \$208 million in total capital expenditures to improve the shopping experience for our customers. Roughly half of the total was related to upgrading our stores and restaurants as well as enhancements to our supply chain. The other half was spent on technology assets associated with improving operational efficiencies and ensuring we can meet the ever-changing shopping demands of our customers.

Exchange growth initiatives became game changers for service members past and present and their families. In 2017, the Exchange welcomed all honorably discharged Veterans home with a [lifelong online military exchange shopping benefit](#); expanded [acceptance of the MILITARY STAR card at commissaries](#) worldwide; and opened the [Exchange shopping center](#) at South Korea's Camp

Humphreys four months early to bring holiday shopping to troops and families serving far from home. These game changers made 2017 a banner year in the Exchange's nearly 123-year [history](#).

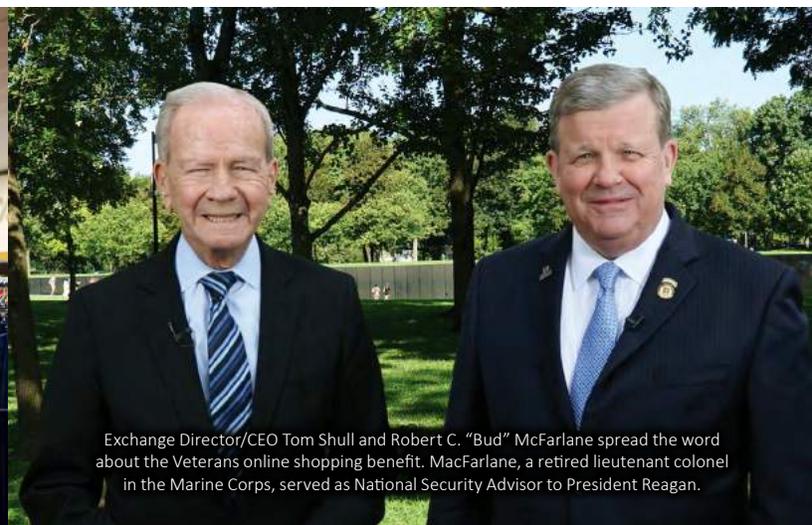
In addition, the Exchange kept operating costs as low as possible; gained valuable insights into our customers' product preferences; and strengthened our technologies to provide a safer, more secure and convenient shopping experience.

No other retailer puts Warfighters first, making austere locations feel more like home. In 2017—with three catastrophic hurricanes, unprecedented support in Eastern Europe and continued service in the Middle East, the Pacific and the tip of the spear—our team further upped the game.

The Exchange continued focusing on keeping service members ready and resilient with a holistic [BE FIT](#) approach to healthier living. In-store and online concept shops offered gear, athletic wear and shoes from various name brands in one easy-to-navigate spot. Express convenience stores and Exchange restaurants fueled fighting forces with better-for-you options.

In the coming year, associates will continue to stand at the forefront of delivering the level and breadth of merchandise and services that only the Exchange can provide. The Exchange will keep improving our game, ensuring the hard-earned benefit is preserved and protected for generations to come.

Army Strong! Air Force Strong! Exchange Strong!



Exchange Director/CEO Tom Shull and Robert C. "Bud" McFarlane spread the word about the Veterans online shopping benefit. McFarlane, a retired lieutenant colonel in the Marine Corps, served as National Security Advisor to President Reagan.

## WELCOMING HOME VETERANS

On [Veterans Day](#), the Army & Air Force Exchange Service, along with sister exchanges, gave our Nation's Veterans the homecoming they deserve. The Exchange made history as it launched a [lifelong online military exchange shopping benefit](#)—one of the biggest game changers in the organization's history.

With the launch, 18.5 million honorably discharged Veterans—no matter how long they served—can shop tax-free with military-exclusive savings for life at [ShopMyExchange.com](#).

Shopping with the exchanges online lets Veterans reconnect with their private and exclusive military community, enabling them to remain Soldiers, Airmen, Sailors, Marines and Coast Guard members for life—something other retailers can't offer. On ShopMyExchange.com, Veterans enjoy tax-free shopping, an average savings of 20 percent off Manufacturers' Suggested Retail Prices and a wide selection of name brands ranging from Apple to Under Armour.

At maturity, the Veterans program is expected to have added sales of about \$200 million, which will yield additional annual dividends of \$20 million in support of Quality-of-Life programs, such as Army Child Development Centers, Youth Programs, Fitness Centers and more.

Before the Veterans online shopping benefit, 90 percent of Veterans received no exchange shopping privileges because the benefit was limited to former service members with at least 20 years of service or those who were 100 percent disabled. In January 2017, the Department of Defense changed the policy, which marked the first expansion of military exchange benefits in nearly 30 years.

The Veterans online shopping benefit reinvigorated the Exchange's e-commerce business. Online sales surged 47 percent to \$143 million from Veterans Day 2017 through the end of the year, compared to the previous period in 2016.

More than 10,000 customers visited ShopMyExchange.com on Black Friday alone—an Exchange record. In fact, 2.4 online orders per second were placed between midnight and 1 a.m. on Black Friday.

December's e-commerce sales alone for the Exchange were up 55 percent.

### **Many teams, many players, working together**

Once the online shopping policy was approved, every business group across the Exchange began implementing programs and initiatives to continue improvement of the online shopping experience to truly honor our Nation's Veterans.



**18.5M**

HONORABLY DISCHARGED VETERANS RECONNECT  
WITH THEIR MILITARY COMMUNITY



The Exchange's Logistics Directorate transformed distribution centers in Virginia, Texas and California into online fulfillment locations with updated technology, space reallocation, additional work shifts and other improvements to handle expected e-Commerce growth. New robust warehouse management software enabled California's West Coast Distribution Center and Waco Distribution Center in Texas to track every item ordered on [ShopMyExchange.com](https://www.shopmyexchange.com), its location in the warehouses and movement throughout receiving, shipping and packing. Specially trained associates began picking, packing and shipping online orders the same day.

To provide the best possible customer experience, customers experienced faster order fulfillment when the Exchange began shipping from stores at 69 strategically located main exchanges.

The Information Technology Directorate continued enhancing the ShopMyExchange.com website to handle the expected high volume of new shoppers and be even more user-friendly from sign-on to payment. The website could then handle 30,000 users at once, compared to 5,000 before.

Because of work performed by the Merchandising Directorate and e-Commerce associates, customers easily find brand names in stock online.

The Customer Relationship Management team and other directorates acquired the data and developed processes that enabled Veterans to verify their military service and eligibility to shop online with the Exchange. The Exchange Credit Program staffed a 24/7 contact center with associates specifically trained to help Veterans.

### **Unprecedented publicity**

The Exchange relied on a robust social-media strategy to spread the word about the benefit.

[Actor Mark Wahlberg, "Lone Survivor" Navy SEAL Marcus Luttrell](#), actor Dwayne "The Rock" Johnson, [race-car great Richard Petty, New England Patriots tight end Rob Gronkowski](#) and other well-known personalities recorded shout-outs informing Veterans about the new benefit.

The video from Wahlberg and Luttrell on the Exchange's Facebook page was the most successful social media post in the Exchange's history, going viral and reaching 4.5 million people.

For the first time in its [history](#), the Exchange advertised on national television on [ESPN](#) during the 2017 Lockheed Martin Armed Forces Bowl, thanking Veterans for their service and informing them of their lifelong online exchange shopping benefit at ShopMyExchange.com.

The Nation's heroes now have a lifelong Exchange benefit for generations to come.

To all Veterans who served honorably, Welcome Back to Your Exchange! Welcome Home!



# 9.8M VIEWS

FROM 234 POSTS ON SOCIAL MEDIA WITH CELEBRITY SHOUTOUTS FROM JR MARTINEZ, MARK WAHLBERG, MARCUS LUTTRELL, DWAYNE "THE ROCK" JOHNSON AND GARTH BROOKS & TRISHA YEARWOOD



## EXCHANGE AND COMMISSARY GAME CHANGER

### Taking the MILITARY STAR card into all 237 commissaries

The MILITARY STAR® card remains a major game changer for the Exchange.

Military shoppers had long asked to use their MILITARY STAR cards at commissaries, and now, they can. To offer greater convenience and strengthen funding for critical military Quality-of-Life programs, military commissaries around the world began accepting the MILITARY STAR card, starting with the [Fort Lee commissary](#) on Oct. 5. By mid-November, the [Exchange Credit Program](#) completed the expansion into all 237 [commissaries](#).

The Exchange administers the MILITARY STAR credit program for all military exchange systems and Defense Commissary Agency (DeCA). In just four short months, acceptance of the MILITARY STAR card at the commissaries has already saved taxpayers more than \$860,000 in swipe fees associated with bank-issued credit cards. Additionally, the 1 percent the Exchange provides back to DeCA each month has resulted in a nearly \$510,000 revenue stream for the commissaries.

The expansion also is a win-win for commissary shoppers because they earn rewards points, allowing them to receive \$20 rewards cards faster and enjoy industry-leading fair and flexible credit terms.

Through the end of the 2017 fiscal year, 170,000 commissary shoppers used their MILITARY STAR cards to buy nearly \$51 million in groceries.

The military community benefits because of MILITARY STAR card earnings that support Quality-of-Life programs, including combat uniforms at cost, [school lunches](#) for Warfighters' children below cost, Child Development Centers, Youth Programs, Fitness Centers and other activities critical to readiness and resiliency.

The expansion further demonstrates the Exchange's commitment to increase the MILITARY STAR card's acceptance across the entire military community. The resulting increase in earnings from use of the MILITARY STAR card in the commissaries is expected to translate into as much as \$22 million annually in additional support for Quality-of-Life programs. During the past 10 years, MILITARY STAR earnings have provided \$727 million to these military programs.

The MILITARY STAR card demonstrates how the Army & Air Force Exchange Service, commissaries and other military exchange systems are meeting the needs of service members and their families, while saving them money with one of the retail industry's lowest APRs.



**ALL 237**  
COMMISSARIES NOW ACCEPT  
THE MILITARY STAR® CARD



## AFTERMATH OF HURRICANES

### Putting personal hardships aside to serve others

In less than 30 days, three major hurricanes pounded Texas, the southern United States and [Puerto Rico](#), but they did not impede the Exchange's capabilities to support military personnel during emergencies. This capability is a critical component of the organization's relevancy and mission.

During hurricanes Harvey, Irma and Maria, the Exchange was fully engaged, from its distribution centers to the stores, supporting service members, their families and first responders, even when associates were suffering hardships themselves.

While other retailers closed, the Exchange leveraged its collaborative partnership with the Coast Guard and installation commanders to send support by air, land and sea to those who needed help the most.

### Hurricane Harvey

[Hurricane Harvey](#) lashed the Texas coast Aug. 25, moving up the Gulf Coast and dropping historic amounts of rain.

Joint Base San Antonio-Lackland's food court associates helped the Air National Guard by quickly catering Popeyes meals to local shelters. The food court and Exchange theater stayed open after the base closed during the storm, supporting basic military trainees restricted to the installation because of the hurricane.

The Waco Distribution Center [stocked up on water](#) for relief efforts. The Camp Mabry Exchange in Austin provided bottled water to evacuees from Houston.

The Exchange opened a [mobile field exchange \(MFE\)](#) at Camp Swift in Bastrop, where 2,000 National Guard members acquired water, batteries, snacks, shampoo and other necessities. A second MFE opened days later in [Corpus Christi](#) for 100 National Guard members.

### Hurricane Irma

At the same time, the Exchange ramped up preparations at stores in Puerto Rico and Florida ahead of [Hurricane Irma](#). When civilian stores and restaurants in Irma's path closed or ran out of essentials, Exchange stores across Florida were typically the last to close and first to reopen.

The Logistics Directorate sent bottled water to Florida and Georgia. The Merchandising Directorate ensured stores were sufficiently stocked with emergency supplies. MFEs in Florida, Georgia, South Carolina and North Carolina stood ready to support troops during relief efforts. The Services, Food and Fuel Directorate provided fuel for military vehicles.

On Sept. 6, Irma knocked out electricity to more than 70 percent of Puerto Rico, and 500,000 residents were left without water. By midmorning the next day, [Fort Buchanan Exchange associates](#) opened restaurants and the Express, including gas pumps, to serve customers. Shoppers were happily surprised to find the Exchange's Starbucks serving coffee and snacks.

Many Exchange associates and their families lacked electricity or water at their homes but put their personal hardships aside to come to work to serve the community.

By Sept. 11—less than a week after Irma struck— Exchange stores were running as normal.



**50M**

GALLONS  
OF FUEL

**47,500**

BOTTLES  
OF WATER



## Hurricane Maria

Even before Hurricane Maria devastated Puerto Rico, the Exchange team began funneling emergency supplies to areas in the storm's path.

Just ahead of Maria's arrival Sept. 20, the Fort Buchanan Exchange opened 30 minutes early and sold nearly 12,000 bottles of water in 45 minutes. As Maria's intensity grew, more emergency supplies were staged throughout the Southeastern United States for immediate shipment to the island.

By Oct. 2, caring Exchange associates around the world donated more than 6,000 hours of vacation leave to co-workers in Puerto Rico, who struggled after the devastating storm. When Maria roared through in September, some associates' homes were destroyed. Others were still without running water or electricity in March 2018.

Yet, these associates still came to work each day, ready to serve the best customers in the world.

Just two days after the storm hit and with 90 percent of the island lacking power, 30 associates at Fort Buchanan began cleaning the Exchange to expedite opening. Other associates flew to the U.S. Virgin Islands to support relief efforts. Fort Buchanan associates arranged for safety inspections of the Express convenience store's damaged fuel pumps to get them running as soon as possible.

Even as Puerto Rico continued recovering from Irma and Maria, the Exchange still brought holiday spirit to the island.

In December, Fort Buchanan's Exchange received four containers of live Christmas trees, which associates distributed directly to customers. Thanks to work by the Logistics Directorate at Exchange HQ in Dallas, the Fort Buchanan store was the only facility on the island that offered live Christmas trees.

After the three hurricanes, troops and their families were excited to have their Exchanges open, signaling a return to normalcy and sense of calm.

Robert Jordan, an Exchange manager at MacDill AFB, Fla., summed up the Exchange's mission as he and his co-workers dealt with Hurricane Irma.

"We were the first to get here and the last to leave," he said. "That's our standard."



EXCHANGE



**4,000**

BAGS OF ICE DISTRIBUTED TO THOSE  
AFFECTED BY HURRICANES



# THE MIRACLE AT CAMP HUMPHREYS

## Game changer in South Korea

Three days before Thanksgiving in the Land of Morning Calm, the Exchange created holiday memories for U.S. troops and their families in South Korea by opening its [shopping center at Camp Humphreys](#)—four months ahead of schedule with the enthusiastic support of the installation command.

The Exchange responded to senior commanders' request to open four months early to support families in need. Many departments at the Exchange and associates from throughout the world collaborated to do something that they first thought was impossible, but they achieved success at opening before any other community organizations at Camp Humphreys.

As a result, the Exchange provided the community a great holiday present.

The [\\$64 million project](#) is a partnership among the Exchange, Republic of Korea, Army Corps of Engineers and Eighth Army, and includes \$9.9 million from the Exchange. The [project](#) features an Exchange with a Military Clothing store; [BE FIT](#) one-stop shop for athletic apparel and shoes; Chef Shop; and store-in-store concepts for Apple, Ashley furniture, Armani Exchange, Kate Spade, Michael Kors, Bose and other name brands. In the food court, American restaurants, such as Arby's, Auntie Anne's, Popeyes, Starbucks and other eateries, feature better-for-you options.

At 300,000 square feet, the shopping center is five times larger than the 14-year-old facility it replaced, making it the third largest Exchange in the world. The new building is part of the transformation at Camp Humphreys, where the population is expected to grow to nearly 45,000 troops and their families as U.S. forces relocate from other installations in South Korea. In 2017, 25,000 service members, families and Department of Defense civilians lived on the camp.

Hundreds of associates from around the world and the Human Resources; Logistics; Information Technology; Services, Food and Fuel; Loss Prevention; Real Estate; and Merchandising directorates at the Dallas headquarters helped open the shopping center before Thanksgiving. Bringing the magic of the holidays to Warfighters and their families, who are always facing an ever-changing climate at the tip of the spear, was an Exchange miracle.

Since the grand opening, shoppers have been more than satisfied. During the first three days, sales rose by 400 percent over the same period in 2016. From opening day until the end of FY 2017, sales reached nearly \$12 million for the main store—proof that service members and their families at Camp Humphreys appreciated the Exchange commitment of “We Go Where You Go!”



**45,000**  
TROOPS & THEIR FAMILIES MOVING  
TO CAMP HUMPHREYS



## BE FIT: BETTER-FOR-YOU GAME CHANGERS

### Food, equipment help troops stay ready, resilient

As partner in the Office of the Secretary of Defense's Healthy Army Community and Air Force Smart Fueling initiatives, the Exchange worked with installation commanders to expand its [BE FIT](#) program in 2017 to empower service members and families to live healthy lifestyles.

With BE FIT, the Exchange provides [fitness information, nutrition tips, equipment](#) and better-for-you food options. Warfighters and families need to stay ready and resilient.

For instance, [BE FIT food items](#) must contain fewer than 500 calories for entrées and 200 calories or fewer for snacks. BE FIT-approved products must contain less than 40 percent of calories from fat and 10 percent or less from saturated fat as well as be approved by the Exchange's registered dietitian.

In 2017, BE FIT resonated with Soldiers, Airmen and their families:

- » Sales for athletic footwear and apparel reached nearly \$98 million, compared to \$92 million the previous year.
- » Shoppers bought nearly \$19 million in digital fitness electronics, more than \$7 million in fitness equipment; \$10 million in hydration products; and \$22 million in Apple watches.
- » About 22 percent of all sales in retail food at Express convenience stores were BE FIT items.

Throughout the year, the Exchange:

- » Expanded its selection of restaurants offering healthier options, opening six Subways, three Boston Markets, two Smoothie Kings, three Qdoba Mexican Grills, and a Freshens, and Muscle Maker Grill. All 1,700 Exchange restaurants offer better-for-you choices.
- » Featured \$2 off entrée salads at participating restaurants every Wednesday.
- » Opened main store [BE FIT shops](#) at Forts Benning, Buchanan and Huachuca; Camp Humphreys; Joint Base San Antonio-Lackland; Joint Base Lewis-McChord; and Eglin AFB., bringing the total to 63 BE FIT shops worldwide. Nike, Adidas, Under Armour, Champion, New Balance and other name-brand athletic apparel, shoes and gear are featured.
- » Provided nearly 400 BE-FIT approved items, including fresh fruit; yogurt; grass-fed, nitrate-free beef sticks and jerky; gluten-free meat snacks, in more than 320 Express convenience stores. That's a 17 percent increase in the number of BE FIT items from 2016.
- » Stocked more than 100 Express reach-in coolers with wraps, salads, hummus and hard-boiled eggs.
- » Expanded better-for-you vending options.
- » Provided the best nutritional meals possible to military children in Department of Defense schools overseas by featuring menus comprised of all non-fried items.

To further help customers look after their health, the Exchange opened a durable medical equipment (DME) store at Nellis AFB in April and re-opened a DME store in September at Fort Bliss. The Exchange operates DME stores at Fort Belvoir and Holloman AFB. The Exchange also offered more than 200 durable medical items at [ShopMyExchange.com](#).



*In 2017, Sgt. Maj. Edward Bell and his wife, Lisa, became the Exchange's first spokespersons for BE FIT.*



# 400 BE FIT

APPROVED ITEMS, INCLUDING FRUIT, SALADS, YOGURT & BEEF JERKY



## WHAT TROOPS DESERVE

### Today's Exchanges are world-class shopping, dining destinations

The Exchange continued delivering world-class shopping and [dining](#) destinations, working with installation commanders to reaffirm the organization's commitment to Soldiers, Airmen and military families by providing the experiences they deserve.

In September, the Exchange opened the new \$7.6 million Burger King and Arby's dual restaurant to serve customers at Kadena AB, Japan. The Arby's is the second one in the Pacific Region's Okinawa Exchange.

In October, the Exchange broke ground on a [\\$54 million shopping center](#) at Joint Base San Antonio-Fort Sam Houston. The complex will replace the current facility, which was built in 1971 and remodeled in 2010.

The shopping center is a joint venture between the Exchange, the Air Force and Army Medical Command. The Exchange—not American taxpayers—is funding 94 percent of the project.

The 210,000-square-foot shopping center is expected to open in early 2020 and include an Exchange; mall with dental clinic and pharmacy; and food court with Starbucks, Sarku Japan, Freshens, Subway, Charleys, Boston Market, Qdoba and Arby's.

In 2017, the Exchange invested \$208 million in capital expenditures, which improved the shopping experience for customers. The total included nearly \$9.9 million for the Exchange's part of the new shopping center at Camp Humphreys, South Korea (see Page 14). Other significant projects included the additions of Starbucks coffee shops at Sheppard AFB and Scott AFB; food and services at the Joint Base-San Antonio-Lackland hospital; and a new troop store on the South Sea island of Saipan. Additionally, the Exchange updated multiple shopping centers, including Fort Buchanan, Puerto Rico, Fort Benning, Ga., and the Kaiserslautern Military Community Center (KMCC) at Ramstein AB, Germany.

Providing customers with name-brand food options remained a top focus. In 2017, the Exchange opened, relocated or converted 65 food facilities to name brands, including Panda Express, Qdoba, Auntie Anne's, Freshens, Einstein Bagels, Boston Market, Jimmy John's, among others.



**\$208M**

INVESTED IN CAPITAL EXPENDITURES, WHICH IMPROVED THE CUSTOMER EXPERIENCE



## ENHANCING THE EXCHANGE'S RELEVANCY

From Cameroon to Poland to South Korea, the Exchange's service at [the tip of the spear](#) in 2017 represented the very best of the Department of Defense's largest military retailer. Associates leaned forward to support American troops training with their counterparts to strengthen their posture of deterrence and defense, serving troops in more than 21 military exercises and missions around the world.

The Exchange steadfastly continues to support American troops and coalition forces in Afghanistan, Iraq, Kuwait, Jordan and elsewhere in Southwest Asia with 40 direct-operated Exchanges and [troop-run stores](#); brand-name restaurants; and concessions.

Familiar products and warm smiles made home seem not so far away—and enhanced the Exchange's relevancy in the lives of Warfighters, regardless of the remoteness of their locations.

At Poland's [Bemowo Piskie Training Area](#) just 100 miles from the Russian border, Exchange associates opened a mobile field exchange (MFE) in March for nearly 1,000 Soldiers serving as part of NATO's enhanced Forward Presence. The MFE brought cold drinks, microwavable meals and supplies to U.S. Soldiers with Battle Group Poland, one of four combat-ready groups in Eastern Europe.

In July, the Exchange opened another MFE in [Cincu, Romania](#), for [Saber Guardian 17](#), a U.S. Army Europe-led, multinational exercise.

Throughout 2017, the Exchange opened and operated MFEs and troop stores in Australia, Bulgaria, Guam, Hungary, Japan, [Norway](#), Poland and South Korea, for American troops and coalition partners engaged in military exercises.

In addition to MFEs, the Exchange helped troops run their own stores in Cameroon, Cyprus, Kenya, Japan, Niger, Tunisia, Turkey and Ukraine. The Exchange provided Soldiers at the sites with initial funding and merchandise to get their retail operations open and running.

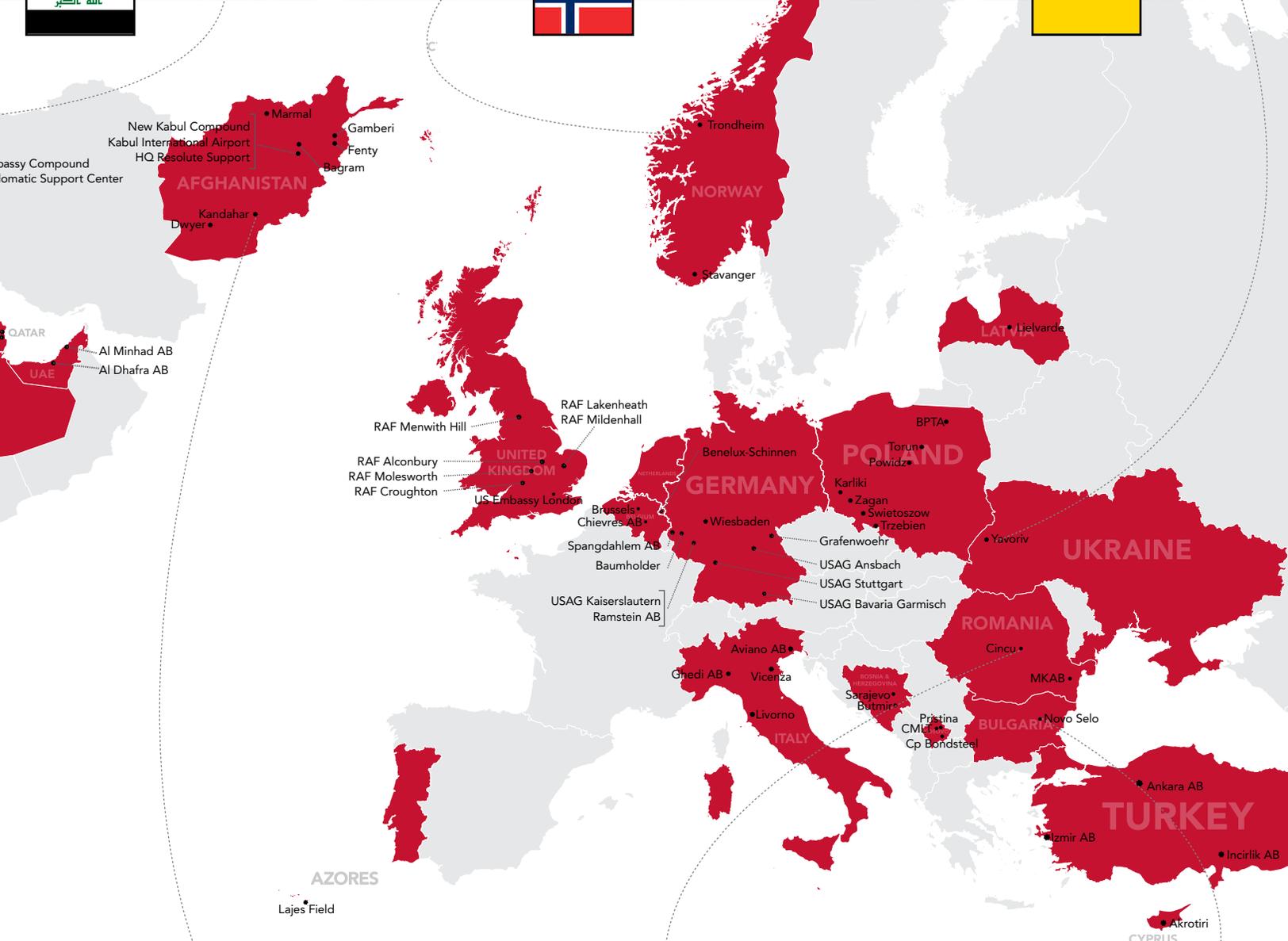


# 21

MILITARY EXERCISES THE  
EXCHANGE SERVED TROOPS







## THREE POWERFUL WORDS: FAMILY SERVING FAMILY

For the Exchange's 35,000 associates, Family Serving Family is more than a core value. It's a way of life.

More than 85 percent of Exchange associates are personally connected to the military, sharing a special bond with service members. They've served in the Armed Forces, or are the parent, spouse or extended family member of someone who is wearing or has worn our Nation's uniform.

For many associates, having close relatives who served in the military prompted them to join the Exchange and continue the tradition of service.

[Rhea Aguon](#), retail business manager in Kuwait/Jordan, lost her brother, Army SGT Eugene Aguon, on May 16, 2013, in Kabul, Afghanistan, while he was escorting a NATO convoy. On Sept. 8, Rhea, who has been deployed for 16 months from her native Guam, flew

a flag on board a C-17 transport aircraft from Kuwait to Afghanistan's Bagram AB and then on a CH-47 Chinook helicopter to Kabul to remember and honor her brother.

"Working for the Exchange, I understood what the words 'Family Serving Family' mean, but it was not until I lost my brother when I felt the true meaning and impact of what it was all about," Aguon said. "It makes me want to do more every day, whether helping fellow associates or taking care of customers, because we're all connected. We are Family Serving Family."

At the U.S. Air Force Academy, Logistics Assistant [Bonnie Bonnin](#) has sponsored more than 70 cadets since coming to the Exchange's Military Clothing store in 1982. The cadets eat, study and wash clothes at Bonnin's house when they visit. She makes herself available to cadets at the Military Clothing store for socializing, a shoulder to lean on or an ear to listen.

Holloman AFB Store Associate Elena Carter not only understands the meaning of Family Serving Family, but also knows the difference she makes to Airmen and their families. After seeing Carter's Exchange shirt at a doctor's office, a nurse told Carter she was sad because her husband was deploying to Iraq.

"I am not really sure how or why, but I started telling her how special she was and most of all blessed to be chosen to be a military wife," Carter said. "I am a military wife and understand the pain fellow wives and families have to endure."

Or, as in Kristopher Cubacub's case, military husbands: his wife is an Airman who was deployed to Qatar in 2017. On the home front, he is the services business manager at Offutt AFB.

Cubacub's father and grandfather served in the Army and Navy, respectively.

"When your wife or husband is in the military and you work for the Exchange—that's what Family Serving Family means," he said. "It is a great feeling knowing that I can give something back and help, because I know what it's like."



**85%**

EXCHANGE ASSOCIATES ARE  
CONNECTED TO THE MILITARY



## PROVIDING MEANINGFUL CAREERS FOR VETERANS, WOUNDED WARRIORS AND MILITARY SPOUSES

Supporting our Soldiers, Airmen & Families wherever they serve is a large part of the Exchange's relevancy in military life.

The Exchange stepped up efforts to hire more Veterans, Wounded Warriors and military spouses as yet another way to give back to the military communities it serves. The Exchange, Veterans, Wounded Warriors and military spouses fit well together because their values of loyalty, professionalism and commitment are exactly what Exchange managers seek when hiring. They understand the Exchange's customers because they, too, are Exchange customers.

To find candidates for open positions, Exchange managers attend job fairs, newcomers' programs and other installation events to promote opportunities for military spouses, Veterans and Wounded Warriors.

Last year, the Exchange hired 1,200 Veterans. For the fourth year in a row, [Military Times](#) named the Exchange as a top employer for Veterans.

To demonstrate the Exchange's commitment to hiring and promoting Veterans, the organization will continue to offer Veteran Retail Management Training program, which began in 2017. In the program, Veteran associates develop skills and knowledge to become Exchange retail managers.

As for [military spouses](#), with unemployment among them four times the national average, the Exchange placed a high priority in 2017 on hiring military spouses. Through a continuity program, eligible spouses can transfer from one job to another at the Exchange and keep their benefits.

In 2017, more than 4,000 military spouses joined the Exchange's ranks. In all, the Exchange employs more than 6,000 military spouses.

The Exchange's commitment to spouse employment has been recognized by [Military Spouse Magazine's](#) Top 10 Military Spouse Friendly Employers for 2018.

Since 2010, the Exchange has hired 1,100 Wounded Warriors. The Exchange participates in the Department of Defense's program, Operation Warfighter, which provides internships to Wounded Warriors as they recover from injuries.

Once hired, military spouses, Veterans, Wounded Warriors and all other associates participated in various forms of training from the HR Directorate. Investing in the workforce remained a top priority at the Exchange in 2017.

The HR Directorate provides a blended approach to training through onsite core business and leadership classroom training; virtual classroom facilitation; management academies for retail, restaurants and logistics; and online self-paced courses. These learning opportunities align training with corporate objectives, develop leadership capabilities at every level, and focus on essential skills and critical competencies.

In addition, HR provides Leadership Development Programs through its robust succession planning process that identifies and prepares high-potential associates for future senior leadership roles.

2017 continued with an emphasis on improving the Customer Experience (CX). Partnering with region leadership, enhancements were incorporated into the customer service training, The Exchange is You! The four foundations of customer focus; Greet, Suggest, Listen and Thank drive a unique shopping experience that is differentiated from the rest.



**1,200**

VETERANS JOINED  
THE EXCHANGE  
IN 2017

**4,000**

MILITARY SPOUSES  
JOINED THE  
EXCHANGE IN 2017





## FEBRUARY

Exchange managers and associates at all levels of the organization begin preparing to launch the [Veterans online shopping benefit](#).

At Fort Riley, the Exchange holds a Sending Love to Your Love social media event to reach thousands of service members in Korea, Afghanistan and Iraq.

## MARCH

At the "tip of the spear," the Exchange opens a [mobile field exchange \(MFE\)](#) at the Bemowo Piskie Training Area in Poland.

## APRIL

Kunsan AB's Exchange in South Korea supports 1,000 troops in the military exercise Max Thunder, the second largest flying exercise in Korea.

The Exchange opens a [store](#) in Zagan, Poland, to serve U.S. forces rotating into the region to train with the Polish Army.



[VetVerify.org](#), the website where Veterans go to verify their eligibility to shop online with the military exchanges, soft-launches.

## MAY

For the fourth straight year, the Exchange is named by [Military Times](#) as one of the best places for Veterans to work.

## JUNE

An MFE opens at Camp Manion in Al Taqaddum, Iraq.

## JULY

The Exchange celebrates its [122nd anniversary](#).

The Exchange is ranked by STORES magazine as the country's 56th largest operator of convenience stores.

The Exchange opens an MFE in Cincu, Romania, to support troops in Saber Guardian 17. Other MFEs are located at Hungary's Papa AB, Romania's MK Air Base and Bulgaria's Novo Selo Training Area.

Sony and the Exchange partner to show "[Spider-Man: Homecoming](#)" to deployed U.S. troops and coalition forces in Romania, Bulgaria and Poland.



## AUGUST

Associates from Camp Humphreys operate an MFE for U.S. troops and their South Korean counterparts in the [Ulchi Freedom Guardian](#) military exercises.

Associates at Houston's Ellington Field serve National Guard members helping the city recover from Hurricane Harvey. MFEs open at Camp Swift and in Corpus Christi to serve Texas National Guard members.



## SEPTEMBER

On Sept. 6, Exchanges in Puerto Rico, Florida, Georgia, South Carolina and North Carolina report only minor damage from Hurricane Irma and resume normal operations by Sept. 14. By Sept. 19, associates at Puerto Rico's Fort Buchanan and Camp Santiago were readying for Hurricane Maria.





An MFE opens in Torun, Poland, for U.S. troops engaged in military exercises with local troops.

## OCTOBER

The [Fort Lee commissary](#) becomes the first military grocery store to accept the MILITARY STAR card. All 237 commissaries came online by Nov. 10.

## NOVEMBER

On Veterans Day, 18.5 million honorably discharged Veterans become eligible to shop [online with the military exchanges](#).

On Nov. 20, the Exchange opens a 300,000-square-foot shopping complex at South Korea's Camp Humphreys for thousands of troops and their families expected to move from other parts of the country to the installation.



## DECEMBER

For the first time in its history, the Exchange [advertised on national television](#) on ESPN during the 2017 Lockheed Martin Armed Forces Bowl, thanking Veterans for their service and reminding them of their lifelong online exchange shopping benefit at ShopMyExchange.com.

The Exchange and The Walt Disney Studios bring a holiday treat to troops serving in Afghanistan, Iraq, Kuwait, Jordan and the United Arab Emirates: first-run screenings of "Star Wars: The Last Jedi."



The Exchange is named a 2018 Top 10 Military Friendly Employer and Military Spouse Friendly Employer by the publisher of G.I. Jobs and Military Spouse magazines.

Consumer Reports readers rank ShopMyExchange.com as the second best place to buy electronics, up from eighth in 2016. The Exchange's brick-and-mortar stores jumped nine spots ahead of last year to finish second among competitors. Both rankings are the highest the Exchange has achieved.



## JANUARY

The Exchange is selected Retailer of the Year by New Age Electronics, a leading distributor of consumer electronics and gaming products and services.

Retail Leader magazine names Exchange Director/CEO Tom Shull one of 18 retailer leaders to watch in 2018, heralding him as a "servant to those who serve(d)."



Seeking to expand better-for-you dining options, the Exchange opens a Muscle Maker Grill at Fort Benning.





**LTG & Chairman**  
**Andre F. Piggee**  
 Deputy Chief of Staff, G-4, HQDA



**Lt Gen & Vice Chair**  
**Gina M. Grosso**  
 Deputy Chief of Staff, Manpower, Personnel & Services



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



**LTG**  
**Kenneth R. Dahl**  
 Commanding General, Installation Management Command (IMCOM)



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



**SMA**  
**Daniel A. Dailey**  
 Sergeant Major of the Army



**CMSAF**  
**Kaleth O. Wright**  
 Chief Master Sergeant of the Air Force



**MG**  
**James "Boe" V. Young Jr.**  
 Commanding General (Troop Program Unit), 75th Training Command



**Maj Gen**  
**John M. Pletcher**  
 Deputy Assistant Secretary of the Air Force, Budget (SAF/FMB)



**Ms.**  
**Kimberly K. Toney SES**  
 Executive Director, Air Force Personnel Center (AFPC/CA)



**Mr.**  
**Donald G. Salo SES**  
 Deputy Assistant Secretary of the Army (Military Personnel/Quality of Life)



**Brig Gen**  
**John N. Tree**  
 Mobilization Assistant to the Commander, Oklahoma City Air Logistics Complex

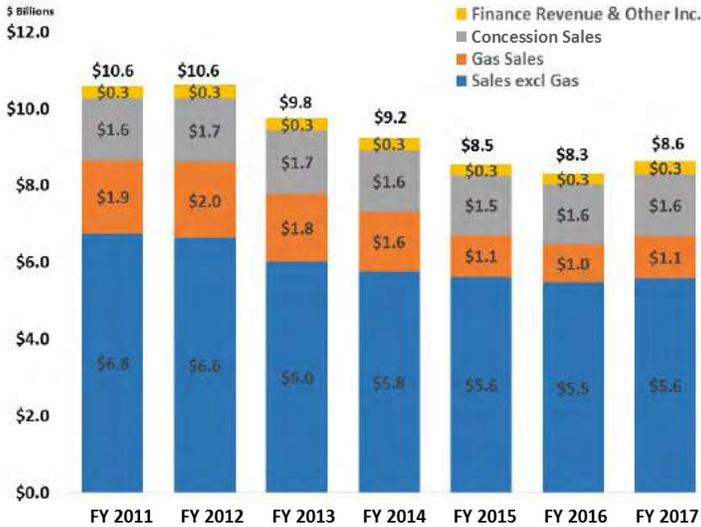


**Mr.**  
**Horace Larry SES**  
 Deputy Director, Air Force Services

# THE EXCHANGE BENEFIT – 2011 TO 2017

The Army & Air Force Exchange Service transitioned to its first civilian Director/CEO in 2012. Since then, the Exchange has transformed, producing significant earnings for the military community despite a marked decline in its customer base of 11% active-duty troop strength.

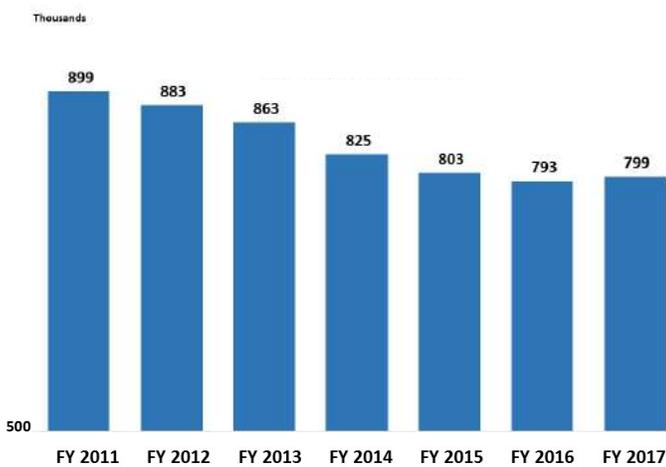
TOTAL REVENUE



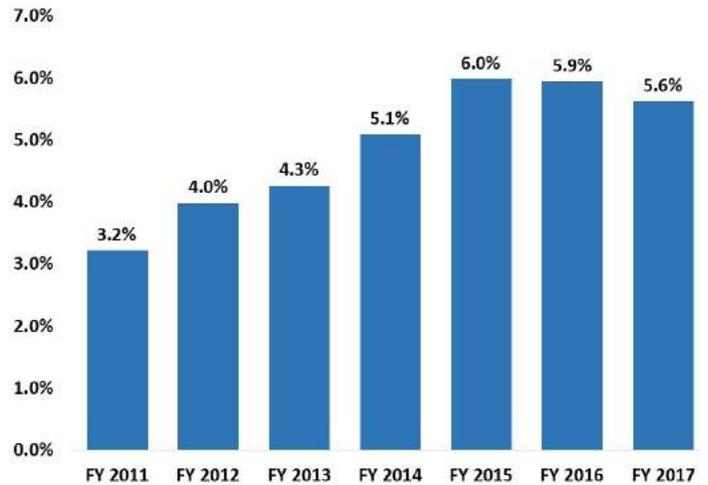
EARNINGS SUBJECT TO DIVIDENDS



ACTIVE DUTY ARMY & AIR FORCE



EARNINGS PERCENT



FINANCIAL STATEMENTS

Army and Air Force Exchange Service  
Years Ended February 3, 2018 and January 28, 2017  
With Report of Independent Auditors

Ernst & Young LLP



Building a better  
working world

Army and Air Force Exchange Service

Financial Statements

Years Ended February 3, 2018 and January 28, 2017

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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 3, 2018 and January 28, 2017, 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 3, 2018 and January 28, 2017, 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 24, 2018

## Army and Air Force Exchange Service

### Balance Sheets

*(Dollars in Thousands, Unless Otherwise Noted)*

	<b>February 3, 2018</b>	<b>January 28, 2017</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 96,314	\$ 61,554
Trade and other accounts receivable, less allowance for uncollectible accounts of \$29,721 at February 3, 2018 and \$32,245 at January 28, 2017	2,948,746	3,058,184
Merchandise inventories	1,399,479	1,288,450
Short-term investments	10,891	9,937
Supplies and other current assets	62,399	41,193
Total current assets	4,517,829	4,459,318
Property and equipment:		
Buildings and improvements	3,617,450	3,606,910
Fixtures and equipment	1,228,446	1,214,605
Construction-in-progress	222,282	218,411
	5,068,178	5,039,926
Accumulated depreciation	(3,177,173)	(3,072,285)
	1,891,005	1,967,641
Other assets	2,264	5,437
Overfunded retirement plans	2,471	-
Long-term investments and supplemental plan assets	20,087	18,614
Total assets	\$ 6,433,656	\$ 6,451,010
<b>Liabilities and net assets</b>		
Current liabilities:		
Accounts payable	\$ 377,712	\$ 406,183
Commercial paper and current maturities of long-term debt	745,014	999,553
Accrued salaries and other employee benefits	111,304	111,330
Dividends payable	40,414	38,116
Other current liabilities	184,107	184,514
Total current liabilities	1,458,551	1,739,696
Long-term debt	442,522	298,761
Accrued pension and other benefits	1,068,389	1,086,849
Other noncurrent liabilities	80,614	77,314
Total liabilities	3,050,076	3,202,620
Net assets:		
Accumulated other comprehensive loss:		
Pension and postretirement benefit liability	(1,954,675)	(2,012,149)
Derivative instruments	1,271	437
Total accumulated other comprehensive loss	(1,953,404)	(2,011,712)
Retained earnings	5,336,984	5,260,102
Total net assets	3,383,580	3,248,390
Total liabilities and net assets	\$ 6,433,656	\$ 6,451,010

*See accompanying notes.*

## Army and Air Force Exchange Service

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

	<b>Year Ended</b>	
	<b>February 3, 2018</b>	<b>January 28, 2017</b>
Net sales	\$ 6,691,735	\$ 6,462,469
Finance revenue	273,012	256,829
Concession income	214,405	202,179
Other operating income	31,691	31,019
Total revenue	7,210,843	6,952,496
Cost of sales and operating expenses:		
Cost of goods sold	5,038,481	4,791,553
Selling, general, and administrative expenses:		
Employee compensation and benefits	1,082,382	1,073,974
Depreciation and amortization	251,753	261,270
Other	512,855	505,237
Total selling, general, and administrative expenses	1,846,990	1,840,481
Interest expense	13,097	11,354
Bad debt expense	21,760	24,221
Total expenses	6,920,328	6,667,609
Operating income	290,515	284,887
Other income	9,342	7,558
Net earnings	\$ 299,857	\$ 292,445

*See accompanying notes.*

Army and Air Force Exchange Service

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

	Year Ended	
	February 3, 2018	January 28, 2017
Net earnings	\$ 299,857	\$ 292,445
Other comprehensive income:		
Reclassification of unrealized gains on derivative instruments to earnings	834	1,584
Pension and postretirement benefits adjustments:		
Unrealized gains arising during the period	(52,740)	298,394
Amortization of net loss	110,214	101,041
Other comprehensive income	58,308	401,019
Comprehensive income	\$ 358,165	\$ 693,464

*See accompanying notes.*

## Army and Air Force Exchange Service

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

Years Ended February 3, 2018 and January 28, 2017

	<b>Retained Earnings</b>	<b>Accumulated Other Comprehensive Loss</b>	<b>Net Assets</b>
Balance at February 1, 2016	\$ 5,192,672	\$ (2,412,731)	\$ 2,779,941
Net earnings	292,445	–	292,445
Pension and postretirement benefits adjustments	–	399,435	399,435
Reclassification of unrealized gains on derivative instruments to earnings	–	1,584	1,584
Dividends to the Central Welfare Funds, Departments of the Army, the Air Force, the Navy and the Marine Corps	(225,015)	–	(225,015)
Balance at January 28, 2017	5,260,102	(2,011,712)	3,248,390
Net earnings	299,857	–	299,857
Pension and postretirement benefits adjustments	–	57,474	57,474
Reclassification of unrealized gains on derivative instruments to earnings	–	834	834
Dividends to the Central Welfare Funds, Departments of the Army, the Air Force, the Navy and the Marine Corps	(222,975)	–	(222,975)
Balance at February 3, 2018	\$ 5,336,984	\$ (1,953,404)	\$ 3,383,580

*See accompanying notes.*

## Army and Air Force Exchange Service

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

	<b>Year Ended</b>	
	<b>February 3, 2018</b>	<b>January 28, 2017</b>
<b>Operating activities</b>		
Net earnings	\$ 299,857	\$ 292,445
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	281,146	291,359
(Gain) loss on disposal of property and equipment	(460)	1,696
(Gain) loss on supplemental pension plan assets	(1,854)	1,412
Bad debt expense	21,760	24,221
Changes in operating assets and liabilities:		
Accounts receivable	87,678	94,159
Merchandise inventories	(111,029)	27,515
Supplies and other current assets	(18,033)	7,161
Pension assets and liabilities	40,407	(160,179)
Long-term investments and supplemental plan assets	1,870	(2,339)
Accounts payable	(25,997)	18,909
Change in cash overdraft	(1,848)	476
Accrued salaries and other employee benefits	182	(2,091)
Other liabilities	(972)	(24,701)
Net cash provided by operating activities	572,707	570,043
<b>Investing activities</b>		
Purchases of property and equipment	(208,171)	(228,085)
Proceeds from the sale of property and equipment	4,121	7,753
Purchases of investments	(14,302)	(58)
Proceeds from the disposition of investments	11,860	3,040
Net cash used in investing activities	(206,492)	(217,350)
<b>Financing activities</b>		
Proceeds (repayments) under line-of-credit agreements	50,000	(50,000)
Net proceeds (repayments) under commercial paper agreements	95,160	(83,385)
Repayments of long-term debt	(255,939)	(5,652)
Payment of dividends	(220,676)	(236,632)
Net cash used in financing activities	(331,455)	(375,669)
Net increase (decrease) in cash and cash equivalents	34,760	(22,976)
Cash and cash equivalents at beginning of year	61,554	84,530
Cash and cash equivalents at end of year	\$ 96,314	\$ 61,554

*See accompanying notes.*

# Army and Air Force Exchange Service

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

February 3, 2018

### **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 to soldiers, airmen, and their families through a network of stores principally located in the U.S., Europe, the Pacific Rim, and the Middle East, substantially all of which are located on U.S. government installations. Middle East services operating in Afghanistan and Iraq primarily provide support for Operation Freedom Sentinel (OFS), Operation Resource Support (ORS), 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 2017 and fiscal year 2016 herein are to the fiscal years ended February 3, 2018 and January 28, 2017, 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:

	<b>Year Ended</b>	
	<b>February 3, 2018</b>	<b>January 28, 2017</b>
	<hr/>	
Continental U.S., including Alaska and Hawaii	<b>\$ 4,566,479</b>	\$ 4,648,354
Pacific Rim	<b>937,865</b>	711,433
Europe, primarily Germany	<b>679,503</b>	680,948
Middle East, including Afghanistan and Iraq	<b>198,586</b>	174,905
Other countries	<b>309,302</b>	246,829
Total net sales	<b><u>\$ 6,691,735</u></b>	<b><u>\$ 6,462,469</u></b>

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

	<b>As of</b>	
	<b>February 3, 2018</b>	<b>January 28, 2017</b>
	<hr/>	
Continental U.S., including Alaska and Hawaii	<b>\$ 1,520,863</b>	\$ 1,593,618
Pacific Rim	<b>223,924</b>	227,626
Europe, primarily Germany	<b>145,099</b>	145,332
Middle East, including Afghanistan and Iraq	<b>1,119</b>	1,065
Total long-lived assets, net	<b><u>\$ 1,891,005</u></b>	<b><u>\$ 1,967,641</u></b>

## 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)**

##### **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 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 provided by the U.S. government for Exchange materials shipped to and from overseas Exchange facilities to be approximately \$111,281 and \$101,522 for fiscal years 2017 and 2016, respectively. In addition, Middle East transportation costs of \$47,516 and \$26,131 were paid by the U.S. government for fiscal years 2017 and 2016, 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 reasonably assured. Such APF reimbursement receivables are classified as trade and other accounts receivable in the accompanying balance sheets and are recorded as an offset to the related expenses (as described below) in the statement of earnings. In fiscal years 2017 and 2016, the Exchange recorded APF reimbursements of \$20,855 and \$18,358, 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.

## 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)**

##### **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 Company management include the level of allowance needed for potentially uncollectible accounts receivable and actuarial assumptions used to determine obligations associated with pension plans and postretirement benefit plans.

In pension accounting, the most significant actuarial assumptions are the discount rate, the long-term rate of return on plan assets, healthcare 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; 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 Measurements and Disclosures*, 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. Cash and cash equivalents are carried at cost, which approximates fair value.

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

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

## 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)

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

As of February 3, 2018 and January 28, 2017, approximately \$2,368,030 and \$2,412,248, respectively, of the Exchange's accounts receivable balance represents amounts due from cardholders under its in-house credit program, the MILITARY STAR<sup>®</sup> Card. The MILITARY STAR<sup>®</sup> Card program extends credit to eligible Exchange customers for the purchase of retail goods 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.

The Exchange's trade and accounts receivable balance also includes \$148,766 and \$152,944 of receivables from the Marine Exchange (MCX) for Marine MILITARY STAR<sup>®</sup> Card outstanding balances and related processing fees as of February 3, 2018 and January 28, 2017, respectively.

Finance revenue is calculated based upon the customer account balance outstanding during the period after consideration of the applicable grace period, typically 30 days following the billing date. The finance rate charged is a variable interest rate calculated at a variable amount above the U.S. Prime Rate reported in *The Wall Street Journal*. The standard APR for retail purchases was 11.49% as of fiscal year end 2017. Beginning at 90 days past due, the delinquency rate of 19.49% 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 \$39,448 and \$55,539 as of February 3, 2018 and January 28, 2017, 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)

Accounts past due for 30 days or more are considered delinquent. Accounts delinquent for 150 days are placed on nonaccrual 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 nonaccrual 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 \$272,154 and \$302,258 at February 3, 2018 and January 28, 2017, 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. Additionally, with respect to nonaccrual status accounts, the Exchange records and evaluates collectability of a net receivable using a portfolio approach pooled by year based on estimated probable recoveries

The Exchange periodically evaluates the adequacy of the provision using such factors as prior account loss experience, changes in the volume of the account portfolio, changes in the estimates of anticipated recoveries on delinquent or written off balances, and changes in credit policy. These factors were considered in establishing the Exchange's allowance for doubtful accounts, and the net receivable related to accounts previously charged off, as of February 3, 2018 and January 28, 2017. 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 nonaccrual status accounts. Collections on accounts previously charged off and submitted to U.S. government entities totaled approximately \$177,072 and \$165,492 in fiscal years 2017 and 2016, respectively. Bad debt expense of \$21,760 recorded in fiscal year 2017 is primarily related to the Exchange's current credit card portfolio. This is compared to \$24,221 in bad debt expense recorded in fiscal year 2016. The Exchange uses a portfolio approach pooled by year to record the net receivable related to nonaccrual status accounts, whereby finance income is no longer accrued and cash collections are applied to outstanding balances until 100% of the net receivables from each portfolio year 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)**

been collected. Subsequent cash collections in excess of amounts previously written off are recorded as finance revenue upon collection. Finance revenue recognized in fiscal year 2017 related to nonaccrual accounts totaled approximately \$22,563, compared to approximately \$14,063 in fiscal year 2016.

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 3, 2018		January 28, 2017	
	Amount	Percentage of Receivables	Amount	Percentage of Receivables
	<i>(In Millions)</i>			
Current	\$ 2,118	84.3%	\$ 2,070	80.7%
1–29 days past due	207	8.2	265	10.3
30–59 days past due	86	3.4	111	4.3
60–89 days past due	62	2.5	63	2.5
90+ days past due	40	1.6	56	2.2
Period-end gross credit card receivables	<u>\$ 2,513</u>	<u>100.0%</u>	<u>\$ 2,565</u>	<u>100.0%</u>

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

	2017		2016	
	<i>(In Millions)</i>			
Allowance at beginning of period	\$ 29	\$	34	
Provision for bad debt	22		24	
Write-offs (net of recoveries)	(25)		(29)	
Allowance at end of period	<u>\$ 26</u>	<u>\$</u>	<u>29</u>	

## Army and Air Force Exchange Service

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

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

The following table sets forth the credit 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 3, 2018	January 28, 2017
	<i>(In Millions)</i>	
Nondelinquent accounts (Current and 1–29 days past due):		
FICO score of 700 or above	\$ 764	\$ 722
FICO score of 600 to 699	1,077	1,224
FICO score below 600	484	389
Total nondelinquent accounts	2,325	2,335
Delinquent accounts (30+ days past due)	188	230
Period-end gross credit card receivables	<u>\$ 2,513</u>	<u>\$ 2,565</u>

#### Merchandise Inventories

The Exchange's inventories are valued at the lower of cost or market, 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 \$17,551 and \$10,715 at February 3, 2018 and January 28, 2017, respectively.

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.

## Army and Air Force Exchange Service

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

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

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

Buildings and improvements primarily represent permanent structures constructed 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 than the carrying value of the asset. When an impairment loss is recognized, the carrying amount of the asset is reduced to its estimated fair value as determined based on quoted market prices or through the use of other valuation techniques. The Exchange has not recorded any long-lived asset impairment charges during fiscal years 2017 or 2016.

## 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)

##### 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

##### Base Realignment

Congress has not authorized a Base Realignment and Closure (BRAC) since 2005. In the event of closure of certain military bases around the world or a reduction in military forces, a decrease in sales at Exchange stores and a related decrease in the use of MILITARY STAR<sup>®</sup> Card due to the reduction of the customer base would likely occur.

##### 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 \$78,072 and \$80,167 as of February 3, 2018 and January 28, 2017, respectively. Workers' compensation reserves were discounted at a weighted-average rate of 3.67% and 3.85% as of February 3, 2018 and January 28, 2017, respectively. Property and liability reserves were discounted at a weighted-average rate of 2.97% and 2.28% as of February 3, 2018 and January 28, 2017, respectively. General liability reserves were discounted at a weighted-average rate of 2.90% and 2.31% as of February 3, 2018 and January 28, 2017, respectively.

## Army and Air Force Exchange Service

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

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

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

Separation pay and vacation leave for local national employees in foreign countries are accrued as earned based upon the labor laws of host countries and upon agreements between the U.S. and foreign governments. In order to estimate this liability, the 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 \$44,598 and \$45,103 for the years ended February 3, 2018 and January 28, 2017, respectively, and is included in selling, general, and administrative expenses. The Exchange's cooperative advertising allowances are generally accounted for as a reduction in the purchase price of inventory.

##### **Revenue Recognition**

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

##### **Income Taxes**

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

## Army and Air Force Exchange Service

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

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

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

The Exchange has a 401(k) voluntary savings and investment plan open to regular full- and part-time employees who meet certain minimum requirements. Effective in fiscal 2013, 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 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.

##### **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.

## 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)

##### Fair Value Measurements

The Exchange records financial instruments at fair value in accordance with ASC 820, *Fair Value Measurements and Disclosures*. Under ASC 820, fair value is considered to be the exchange price in an orderly transaction between market participants to sell an asset or transfer a liability at the measurement date. The fair value definition under ASC 820 focuses on an exit price, which is the price that would be received to sell an asset or paid to transfer a liability versus an entry price, which would be the price paid to acquire an asset or received to assume a liability. See Note 2 for further information regarding fair value measurements.

Financial instruments that potentially subject the Exchange to concentrations of credit risk consist principally of investments held by 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 May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers, issued as a new Topic, ASC 606. ASC 606 is a comprehensive new revenue recognition model that requires an entity to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. For non-public companies, ASC 606 is effective for reporting periods after December 15, 2018. The Exchange is currently assessing the impact of the adoption of ASC 606 and has not determined the effect of the standard on the Exchange's ongoing financial reporting.

In March 2016, the FASB issued ASU No. 2016-04, *Recognition of Breakage for Certain Prepaid Stored-Value Products* (ASU 2016-04). ASU 2016-04 requires that breakage on prepaid stored-value product liabilities (for example, prepaid gift cards) be accounted for consistent with the breakage guidance in ASC 606. For non-public companies, ASU 2016-04 is effective for annual reporting periods beginning after December 15, 2018. This standard is to be applied either using a modified retrospective approach or retrospectively to each period presented. The Exchange is currently assessing the impact of the adoption of ASU 2016-04 and has not determined the effect of the standard on the Exchange's ongoing financial reporting.

## 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 2016, the FASB issued ASU No. 2016-15, *Classification of Certain Cash Receipts and Cash Payments* (ASU 2016-15). ASU 2016-15 is intended to reduce the diversity in practice around how certain transactions are classified within the statement of cash flows. For non-public companies, ASU 2016-15 is effective for annual reporting periods beginning after December 15, 2018. The Exchange is currently assessing the impact of the adoption of ASU 2016-15 and has not determined the effect of the standard on the Exchange's statement of cash flows.

In November 2016, the FASB issued ASU No. 2016-18, *Restricted Cash* (ASU 2016-18). ASU 2016-18 is intended to reduce the diversity in practice around how restricted cash is classified within the statement of cash flows. For non-public entities, ASU 2016-18 is effective for annual reporting periods beginning after December 15, 2018. The ASU will be adopted using a retrospective transition approach. The Exchange is currently assessing the impact of the adoption of ASU 2016-18 and has not determined the effect of the standard on the Exchange's statement of cash flows.

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)* (ASC 2016-02). 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 non-public companies, ASU 2016-02 is effective for reporting periods after December 15, 2019. The Exchange is currently assessing the impact of the adoption of ASU 2016-02 and has not determined the effect of the standard on the Exchange's ongoing financial reporting.

## Army and Air Force Exchange Service

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

#### **2. Fair Value Measurements**

ASC 820 established 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 holdings by evaluating its pro rata share of investments where it does not own the underlying securities but rather a proportional share of the fund, such as mutual fund and common collective trusts. Significant inputs, other than quoted market prices included in Level 1 that are observable, impact either directly or indirectly, the asset or liability. Level 2 inputs include, but are not limited to, quoted prices for similar assets or liabilities in an active market, quoted prices for identical or similar assets or liabilities in markets that are not active, and inputs other than quoted market prices that are observable for the asset or liability, such as interest rate curves and yield curves observable at commonly quoted intervals, volatilities, credit risk, and default rates.

Level 3 – Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Inputs are unobservable for the assets or liabilities. The Exchange invests only with managers that provide financial statements that are independently audited at least once a year. The 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.

## Army and Air Force Exchange Service

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

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

Cash and cash equivalents, accounts payable, and accrued liabilities are reflected in 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 in 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 following table sets forth by level within the fair value hierarchy, the Exchange's assets and liabilities, except for pension and postretirement assets and debt which are disclosed later, that are measured at fair value as of February 3, 2018 and January 28, 2017:

	<b>Fair Value as of February 3, 2018</b>			
	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
Assets:				
Short-term investments	<b>\$ 10,891</b>	<b>\$ 10,891</b>	<b>\$ -</b>	<b>\$ -</b>
Assets at fair value	<b>10,891</b>	<b>\$ 10,891</b>	<b>\$ -</b>	<b>\$ -</b>
Investments measured at net asset value:				
Collective investment funds <sup>(1)</sup>	<b>19,895</b>			
Total assets	<b>\$ 30,786</b>			
Liabilities:				
Foreign currency derivatives <sup>(2)</sup>	<b>\$ (1,271)</b>	<b>\$ (1,271)</b>	<b>\$ -</b>	<b>\$ -</b>
Total liabilities	<b>\$ (1,271)</b>	<b>\$ (1,271)</b>	<b>\$ -</b>	<b>\$ -</b>

## Army and Air Force Exchange Service

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

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

	Fair Value as of February 28, 2017			
	Total	Level 1	Level 2	Level 3
Assets:				
Due from broker	\$ 9	\$ 9	\$ –	\$ –
Short-term investments	9,937	9,937	–	–
Assets at fair value	9,946	\$ 9,946	\$ –	\$ –
Investments measured at net asset value:				
Collective investment funds <sup>(1)</sup>	18,518			
Total assets	\$ 28,464			
Liabilities:				
Foreign currency derivatives <sup>(2)</sup>	\$ 437	\$ 437	\$ –	\$ –
Total liabilities	\$ 437	\$ 437	\$ –	\$ –

<sup>(1)</sup> Holdings consist of a BlackRock equity fund (approximately 42% of the total in fiscal year 2017 and 50% in fiscal year 2016), which is passive in nature and employs a strategy to closely follow the S&P 500 index, and a BlackRock U.S. Debt Index fund (approximately 58% of the total in fiscal year 2017 and 50% in fiscal year 2016), which employs a strategy that seeks to match the performance of the Barclays Capital Aggregate Bond Index by investing in a diversified sample of the bonds that make up the index.

<sup>(2)</sup> Derivatives are included on the accompanying balance sheets in 2017 and 2016 in accounts payable and accrued salaries and other employee benefits.

The Exchange holds investments related to the Supplemental Plan totaling \$19,895 and \$18,518 at February 3, 2018 and January 28, 2017, 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 \$1,854 and \$1,412 in fiscal years 2017 and 2016, 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.)

## Army and Air Force Exchange Service

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

#### **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 13-bank syndicate led by Wells Fargo Bank, N.A. aggregating to \$1,500,000 that was entered into on June 24, 2014, and expires on June 24, 2019. As of February 3, 2018, there is a zero balance outstanding and there were no borrowings under this line of credit during 2017.

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 March 2, 2016, for a five-year term. Borrowings under the IMCOM G-9 line of credit had interest rates ranging from 0.73% to 1.20% during fiscal year 2017 and 0.50% to 0.85% during fiscal year 2016. 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 timeframe. During fiscal year 2017, daily borrowings were generally due within 30 to 260 days. As of February 3, 2018, there was \$300,000 outstanding under the IMCOM G-9 line of credit, with all such borrowings currently scheduled to become due within fiscal year 2018. 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 2018 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 3, 2018, as they are not expected to require the use of current working capital during fiscal year 2018.

##### **Commercial Paper**

In June 2013, the Exchange implemented a Commercial Paper (CP) program. Currently, the four dealers are BTMU, Wells Fargo, Williams Capital and SunTrust Bank. As of February 3, 2018 and January 28, 2017, the outstanding commercial paper obligations, inclusive of original issue discount, were \$738,776 and \$643,615, respectively. The CP program is an open-ended agreement; however, outstanding balances as of February 3, 2018, have maturity dates that range from 1 to 265 days. Borrowings under the commercial paper program had interest rates ranging from 0.63% to 1.48% during fiscal year 2017, and 0.33% to 0.69% during fiscal year 2016.

## Army and Air Force Exchange Service

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

### 3. Indebtedness (continued)

#### Senior Notes

In December 2011, the Exchange completed a private placement debt offering of \$200,000 in senior notes due and paid on February 28, 2017. In October 2009, the Exchange completed a private placement debt offering of \$90,000 in senior notes (the 2024 senior notes), which comprise a 15-year amortization of principal. As of February 3, 2018, these senior notes have a total remaining outstanding obligation of \$48,760.

#### Term Loans

The Exchange has a term loan agreement with Branch Banking & Trust in an aggregate amount of \$100,000 as of February 3, 2018. This term loan agreement matures March 31, 2019, and bears interest at LIBOR plus 0.625%. The Exchange's term loan with Fifth Third Bank was repaid in December 2017.

The average interest rate for all indebtedness, including lines of credit (both committed and uncommitted), commercial paper, senior notes and term loans, was 1.53% for the year ended February 3, 2018.

Debt obligations as of February 3, 2018 and January 28, 2017 consisted of the following:

	2017	2016
Outstanding debt principal balances:		
IMCOM G-9 committed line of credit	\$ 300,000	\$ 250,000
2.50% senior notes due 2017	—	200,000
4.95% senior notes due 2024	48,760	54,699
Term Loan – Branch Banking & Trust	100,000	100,000
Term Loan – Fifth Third Bank	—	50,000
Commercial Paper – Wells Fargo	161,776	153,615
Commercial Paper – Bank of Tokyo Mitsubishi	390,000	231,000
Commercial Paper – Williams Capital	60,000	106,000
Commercial Paper – SunTrust Bank	127,000	153,000
Total debt obligations	1,187,536	1,298,314
Current maturities	(745,014)	(999,553)
Total long-term debt obligations	\$ 442,522	\$ 298,761

## Army and Air Force Exchange Service

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

#### 3. Indebtedness (continued)

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 3, 2018, the estimated fair value for the 2024 senior note is \$52,046. Fair value is calculated using a discounted cash flow analysis, with estimated interest rates offered for notes with similar terms and maturities.

Cash paid for interest for fiscal years 2017 and 2016 was approximately \$16,730 and \$11,354, respectively. The Exchange has complied with all financial and nonfinancial covenants per loan agreements as of February 3, 2018, and expects to comply through the period ending February 2, 2019.

Principal maturities of debt obligations as of February 3, 2018 are as follows:

2018	\$ 745,014
2019	106,555
2020	6,887
2021	7,236
2022	307,602
Thereafter	14,242
	<u>\$ 1,187,536</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.

## Army and Air Force Exchange Service

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

#### **4. Derivative Financial Instruments (continued)**

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 in 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.

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 3, 2018, the Exchange had various foreign exchange contracts (option collars) outstanding related to approximately \$86,045 (€75,500) of its forecasted payroll and inventory purchase liabilities. The notional value of outstanding option collar contracts was \$86,045 (€75,500). The net gain of \$1,271 is included in accrued salaries, separation pay and other benefits and accounts payable on the accompanying balance sheet and is included as a component of accumulated other comprehensive loss. The balance of \$1,271 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 \$3,368 in gains on foreign currency hedge transactions settled during fiscal year 2017, compared to \$155 in losses during fiscal year 2016.

Army and Air Force Exchange Service

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

**4. Derivative Financial Instruments (continued)**

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

Derivatives designated as hedging instruments	Derivative Instruments		
	Balance Sheet Location	Fair Value	
		February 3, 2018	January 28, 2017
Foreign currency exchange contracts	Accounts payable	\$ (953)	\$ (328)
	Accrued salaries, separation pay, and other employee benefits	(318)	(109)
Total derivatives designated as hedging instruments		\$ (1,271)	\$ (437)

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

**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 \$4,229 and \$4,461 for the fiscal years ended February 3, 2018 and January 28, 2017, respectively. The following is a schedule, by fiscal year, of the future minimum rental payments required under all leases as of February 3, 2018:

2018	\$ 541
2019	219
2020	128
2021	121
2022	121
Thereafter	3,003
	\$ 4,133

## 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, a noncontributory supplemental deferred compensation plan (the Supplemental Plan) provides for selected benefits to employees in the Executive Management Program. The Exchange's policy is to annually fund actuarially determined postretirement expense unless the respective plan is fully funded or unless an asset-liability model has shown the respective plan will likely become fully funded even in the absence of future contributions. The benefits are based on years of service and the employees' highest three-year average compensation. Assets of the plans consist primarily of marketable debt and equity securities.

In addition to the Exchange's 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 3, 2018, the Exchange recorded a liability of approximately \$2,773, which represents an estimated liability of \$29,476 less trust assets of \$26,703. As of January 28, 2017, the Exchange recorded a liability of approximately \$21,813, which represents an estimated liability of \$31,502 less trust assets of \$9,689.

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).

The Exchange measures the cost of its pension plans and other postretirement benefit plans in accordance with ASC 715, *Compensation – Retirement Benefits*. 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*.

## Army and Air Force Exchange Service

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

#### 6. Benefit Plans (continued)

The following table provides a reconciliation of the changes in the plans' benefit obligations and fair value of assets for fiscal years 2017 and 2016. Amounts are stated in millions.

	Pension Benefits				Other Benefits			
	Basic Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2017	2016	2017	2016	2017	2016	2017	2016
<b>Change in projected benefit obligations (PBO)</b>								
PBO at prior measurement date	\$ 4,524	\$ 4,429	\$ 22	\$ 19	\$ 2,383	\$ 2,423	\$ 73	\$ 70
Service cost	93	89	1	1	25	23	2	2
Interest cost	196	205	1	1	105	111	2	2
Plan participants' contributions	4	3	–	–	–	–	–	–
Actuarial loss (gain)	243	71	–	2	160	(68)	1	10
Foreign exchange impact	–	–	–	–	–	–	8	(5)
Benefits paid	(273)	(253)	(1)	(1)	(99)	(98)	(2)	(3)
Administrative expenses paid	(21)	(20)	–	–	(8)	(8)	–	–
Other	–	–	–	–	–	–	(3)	(3)
PBO at current measurement date	<u>\$ 4,766</u>	<u>\$ 4,524</u>	<u>\$ 23</u>	<u>\$ 22</u>	<u>\$ 2,566</u>	<u>\$ 2,383</u>	<u>\$ 81</u>	<u>\$ 73</u>
<b>Change in plan assets</b>								
Fair value of assets at prior measurement date	\$ 4,184	\$ 3,699	\$ –	\$ –	\$ 1,665	\$ 1,512	\$ 44	\$ 42
Actual return on assets	547	505	–	–	232	218	5	7
Employer contributions	–	250	–	–	38	41	7	2
Plan participants' contributions	4	3	–	–	–	–	–	–
Benefits paid	(273)	(253)	–	–	(99)	(98)	(2)	(2)
Administrative expenses paid/foreign exchange impact	(21)	(20)	–	–	(8)	(8)	6	(5)
Fair value of assets at current measurement date	<u>\$ 4,441</u>	<u>\$ 4,184</u>	<u>\$ –</u>	<u>\$ –</u>	<u>\$ 1,828</u>	<u>\$ 1,665</u>	<u>\$ 60</u>	<u>\$ 44</u>
Funded status at fiscal year end	<u>\$ (325)</u>	<u>\$ (340)</u>	<u>\$ (23)</u>	<u>\$ (22)</u>	<u>\$ (738)</u>	<u>\$ (718)</u>	<u>\$ (21)</u>	<u>\$ (29)</u>

Army and Air Force Exchange Service

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

**6. Benefit Plans (continued)**

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

The following table reflects amounts recognized in the balance sheets for fiscal years 2017 and 2016. Amounts are stated in millions.

	Pension Benefits				Other Benefits			
	Basic Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2017	2016	2017	2016	2017	2016	2017	2016
<b>Amounts recognized in the balance sheets</b>								
Other current liabilities	\$ -	\$ -	\$ 1	\$ 1	\$ 52	\$ 35	\$ 2	\$ 2
Accrued pension and other benefits liability	325	340	23	22	686	683	20	27
Accumulated other comprehensive loss	\$ (1,192)	\$ (1,250)	\$ (6)	\$ (7)	\$ (740)	\$ (736)	\$ (16)	\$ (18)

A summary of the components of net periodic benefit cost (income) for the benefit plans is as follows for fiscal years 2017 and 2016. Amounts are stated in millions.

	Pension Benefits				Other Benefits			
	Basic Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2017	2016	2017	2016	2017	2016	2017	2016
<b>Net periodic cost</b>								
Service cost	\$ 93	\$ 89	\$ 1	\$ 1	\$ 25	\$ 23	\$ 2	\$ 2
Interest cost	196	204	1	1	105	111	2	2
Expected return on assets	(314)	(299)	-	-	(119)	(117)	(3)	(3)
Prior service cost amortization	-	-	-	-	-	-	-	-
Other adjustments	-	-	-	-	-	-	1	(1)
Net loss amortization	64	60	-	-	45	45	1	1
Net periodic benefit cost	\$ 39	\$ 54	\$ 2	\$ 2	\$ 56	\$ 62	\$ 3	\$ 1

## Army and Air Force Exchange Service

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

#### 6. Benefit Plans (continued)

Information for benefit plans with an accumulated benefit obligation in excess of plan assets is as follows for fiscal years 2017 and 2016. Amounts are stated in millions.

	Pension Benefits				Other Benefits			
	Basic Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2017	2016	2017	2016	2017	2016	2017	2016
Projected benefit obligation	\$ 4,766	\$ 4,524	\$ 23	\$ 22	\$ 2,566	\$ 2,383	\$ 81	\$ 73
Accumulated benefit obligation	4,470	4,255	8	8	2,566	2,383	75	66
Fair value of plan assets	\$ 4,441	\$ 4,184	\$ –	\$ –	\$ 1,828	\$ 1,665	\$ 60	\$ 44

Amounts included in accumulated other comprehensive loss for all plans at February 3, 2018 consist of net actuarial loss of \$1,954,675. Amortization of this amount expected to be recognized in fiscal year 2018 is \$132,274.

#### Actuarial Assumptions

Actuarial weighted-average assumptions used in determining plan obligations and the related expense are as follows:

	Pension Benefits		Pension Benefits		Other Benefits	
	Basic Plan		Supplemental Plan		Postretirement	
	2017	2016	2017	2016	2017	2016
Assumptions used to determine expense:						
Discount rate	4.48%	4.83%	4.48%	4.83%	4.54%	4.94%
Long-term rate of return on assets	7.61	7.75	–	–	7.83	7.95
Compensation increase rate	4.04	4.03	9.34	8.92	–	–
Assumptions used at disclosure:						
Discount rate	3.96	4.48	3.96	4.48	3.98	4.54
Compensation increase rate	4.04	3.91	9.54	9.28	–	–

## Army and Air Force Exchange Service

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

#### 6. Benefit Plans (continued)

##### Assumed Health Care Cost Trend Rates at Fiscal Year End

	<b>2017</b>			<b>2016</b>
Health care cost trend rate assumed for next year	<b>6.00%</b>			6.50%
Rate to which the cost trend rate is assumed to decline (ultimate trend rate)	<b>4.50%</b>			4.50%
Year that the rate reaches the ultimate trend rate	<b>2025</b>			2025
	<b>Other Benefits</b>		<b>Other Benefits</b>	
	<b>UK Plan</b>		<b>Local National Plans</b>	
	<b>2017</b>	<b>2016</b>	<b>2017</b>	<b>2016</b>
Assumptions used to determine expense:				
Discount rate	<b>2.70%</b>	3.60%	<b>1.22%</b>	1.10%
Long-term rate of return on assets	<b>6.50</b>	6.50	–	–
Compensation increase rate	<b>2.90</b>	2.40	<b>2.42</b>	2.37
Assumptions used at disclosure:				
Discount rate	<b>2.50</b>	2.70	<b>0.88</b>	1.20
Compensation increase rate	<b>2.70</b>	2.90	<b>2.42</b>	2.37

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.

## Army and Air Force Exchange Service

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

#### 6. Benefit Plans (continued)

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

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

	Pension Benefits		Other Benefits Postretirement		Other Benefits	
	Basic Plan		Plan		UK Plan	
	2017	2016	2017	2016	2017	2016
Domestic equity securities	<b>14%</b>	12%	<b>15%</b>	13%	<b>26%</b>	26%
International equity securities	<b>10</b>	11	<b>10</b>	11	<b>35</b>	35
Emerging market equity securities	<b>3</b>	3	<b>4</b>	4	<b>4</b>	4
Low-Vol Global Equity	<b>9</b>	9	<b>10</b>	10	–	–
Investment-grade fixed income	<b>25</b>	16	<b>25</b>	12	<b>35</b>	35
High-yield fixed income	<b>4</b>	10	–	10	–	–
Treasury inflation protected securities (TIPS)	<b>3</b>	5	<b>3</b>	5	–	–
Real estate – private	<b>4</b>	5	<b>4</b>	5	–	–
Real estate – public	<b>1</b>	2	<b>1</b>	2	–	–
Private equity	<b>9</b>	9	<b>10</b>	10	–	–
Commodities	<b>3</b>	5	<b>3</b>	5	–	–
Alternative debt	<b>5</b>	5	<b>5</b>	5	–	–
MLPs	<b>5</b>	5	<b>5</b>	5	–	–
Timber/Farmland	<b>5</b>	3	<b>5</b>	3	–	–
<b>Total</b>	<b>100%</b>	100%	<b>100%</b>	100%	<b>100%</b>	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 3, 2018 and January 28, 2017, by asset class category, are as follows:

	Pension Benefits		Other Benefits Postretirement		Other Benefits UK Plan	
	The Basic Plan		Plan		UK Plan	
	2017	2016	2017	2016	2017	2016
Domestic equity securities	<b>13%</b>	13%	<b>15%</b>	15%	<b>20%</b>	20%
International equity securities	<b>11</b>	10	<b>12</b>	12	<b>40</b>	40
Emerging market equity securities	<b>4</b>	3	<b>4</b>	5	<b>6</b>	6
Low-Vol Global Equity	<b>9</b>	9	<b>10</b>	11	—	—
Investment-grade fixed income	<b>16</b>	16	<b>12</b>	13	<b>34</b>	34
High-yield fixed income	<b>10</b>	10	<b>10</b>	10	—	—
TIPS	<b>5</b>	5	<b>5</b>	5	—	—
Real estate – private	<b>7</b>	8	<b>6</b>	6	—	—
Real estate – public	<b>2</b>	2	<b>2</b>	2	—	—
Private equity	<b>8</b>	10	<b>8</b>	10	—	—
Commodities	<b>5</b>	4	<b>5</b>	1	—	—
Alternative debt	<b>2</b>	3	<b>3</b>	3	—	—
MLPs	<b>5</b>	4	<b>5</b>	4	—	—
Timber/Farmland	<b>3</b>	3	<b>3</b>	3	—	—
<b>Total</b>	<b>100%</b>	100%	<b>100%</b>	100%	<b>100%</b>	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.

## Army and Air Force Exchange Service

### Notes to Financial Statements (continued)

*(Dollars in Thousands, Unless Otherwise Noted)*

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

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 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

## Army and Air Force Exchange Service

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

#### 6. Benefit Plans (continued)

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.

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 3, 2018:

	<b>Benefit Plans</b>			
	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
<b>Assets</b>				
Temporary investments <sup>(a)</sup>	\$ (11)	\$ (11)	–	\$ –
Equity securities:				
Common and preferred stock <sup>(b)</sup>	841,653	841,653	–	–
Foreign obligations <sup>(c)</sup>	22,863	22,863	–	–
Debt securities:				
Common and preferred stock <sup>(b)</sup>	1,765	1,765	–	–
Corporate bonds <sup>(d)</sup>	635,985	–	635,985	–
U.S. government obligations <sup>(e)</sup>	329,898	329,898	–	–
Asset-backed securities <sup>(f)</sup>	1,263	–	1,263	–
Real estate and commodities:				
Common and preferred stock <sup>(b)</sup>	408,759	408,759	–	–
Other investments <sup>(m)</sup>	5,885	–	5,885	–
Total investments at fair value	<u>2,248,060</u>	<u>\$ 1,604,927</u>	<u>\$ 643,133</u>	<u>\$ –</u>
Investments measured at net asset value:				
Collective investment funds:				
Equity securities <sup>(g)</sup>	1,634,221			
Debt securities <sup>(h)</sup>	858,308			
Real estate and commodities <sup>(i)</sup>	853,203			
Short term investment funds <sup>(i)</sup>	81,414			
Limited partnerships:				
Equity securities <sup>(k)</sup>	431,211			
Debt securities <sup>(k)</sup>	162,679			
Real estate and commodities <sup>(k)</sup>	50,017			
Total investments measured at net asset value	<u>4,071,053</u>			
Plan assets not measured at fair value or net asset value <sup>(l)</sup>	8,998			
Total assets	<u>\$ 6,328,111</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 January 28, 2017:

	Benefit Plans			
	Total	Level 1	Level 2	Level 3
<b>Assets</b>				
Temporary investments <sup>(a)</sup>	\$ 3,601	\$ 3,601	\$ –	\$ –
Equity securities:				
Common and preferred stock <sup>(b)</sup>	782,096	782,096	–	–
Foreign obligations <sup>(c)</sup>	18,163	18,163	–	–
Debt securities:				
Corporate bonds <sup>(d)</sup>	610,088	–	610,088	–
U.S. government obligations <sup>(e)</sup>	309,199	309,199	–	–
Asset-backed securities <sup>(f)</sup>	1,581	–	1,581	–
Real estate and commodities:				
Common and preferred stock <sup>(b)</sup>	343,454	343,454	–	–
Other investments <sup>(m)</sup>	6,656	–	6,656	–
Total investments at fair value	2,074,838	\$ 1,456,513	\$ 618,325	\$ –
Investments measured at net asset value:				
Collective investment funds:				
Equity securities <sup>(g)</sup>	1,571,329			
Debt securities <sup>(h)</sup>	777,259			
Real estate and commodities <sup>(i)</sup>	710,936			
Short term investment funds <sup>(i)</sup>	96,768			
Limited partnerships:				
Equity securities <sup>(k)</sup>	438,165			
Debt securities <sup>(k)</sup>	168,473			
Real estate and commodities <sup>(k)</sup>	51,615			
Total investments measured at net asset value	3,814,545			
Plan assets not measured at fair value or net asset value <sup>(l)</sup>	4,030			
Total assets	\$ 5,893,413			

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

(b) 2017: Holdings are diversified as a percentage of total equity as follows: Domestic Markets (59%) and Developed International Markets (41%). Domestic Markets are diversified by Large Cap (24%), Small Cap (10%), Public Real Estate – REITS (16%), Low volatility investments (10%), and MLPs (41%). There are no significant concentrations of holdings by the Exchange.

## Army and Air Force Exchange Service

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

#### 6. Benefit Plans (continued)

2016: Holdings are diversified as a percentage of total equity as follows: Domestic Markets (46%) and Developed International Markets (54%). Domestic Markets are diversified by Large Cap (55%), Small Cap (19%), and Public Real Estate – REITS (27%). There are no significant concentrations of holdings by the Exchange.

- (c) 2017: Holdings include International 52% and Domestic 48% securities in the form of American Depository Receipts which represent underlying securities, traded on non-U.S. exchanges.

2016: Holdings include International 70% and Domestic 30% securities in the form of American Depository Receipts which represent underlying securities, traded on non-U.S. exchanges.

- (d) 2017: Includes 59% and 60% of investments in corporate high-yield debt with S&P rating of B- and below as of February 3, 2018 and January 28, 2017, respectively. 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) 2017: 76% 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 24% consists of international, small cap, and low volatility investments in the form of mutual funds. The collective investment funds consist of Domestic (56%) and International (44%). 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.

2016: 74% 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 26% consists of international, small cap, and low volatility investments in the form of mutual funds. The collective investment funds consist of Domestic (46%) and International (54%). 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.

## Army and Air Force Exchange Service

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

#### 6. Benefit Plans (continued)

- (h) For both periods presented, 75% 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 (25%), 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) 2017: 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 45% and value-added or opportunistic 7% investments. Commodity investments include farmland and timber, which represent 48% of the allocation. There is quarterly redemption available for the real estate investments with a 60-day notice.
- 2016: 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 64% and value-added or opportunistic 11% investments. Commodity investments include farmland and timber, which represent 25% of the allocation. There is quarterly redemption available for the real estate investments with a 60-day notice.
- (j) 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. buyout opportunities, as well as opportunistic debt of a range of privately held companies. The fund does not have to redeem its limited partnership investment at its net asset value. Instead, the fund receives distributions as the underlying assets of the fund are liquidated.
- (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.

Army and Air Force Exchange Service

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

**6. Benefit Plans (continued)**

**Employer Contributions**

The Exchange expects to contribute approximately \$52,324 to the other postretirement benefit plans in fiscal 2018.

**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 Plan	Foreign Plans
2019	\$ 251,927	\$ 446	\$ 119,847	\$ 5,165
2020	254,910	452	124,927	4,637
2021	258,217	457	129,011	4,395
2022	261,685	463	132,277	4,406
2023	264,802	470	135,131	4,727
2024–2028	1,366,443	2,564	707,183	23,583

**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 annual financial plan (AFP), the Exchange will retain the first 15% of the excess earnings and the remainder will be distributed in the form of dividend payments.

## Army and Air Force Exchange Service

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

#### **7. Dividends (continued)**

Under the current dividend policy, non-cash 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.

#### **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 46 stores as of February 3, 2018, and 44 stores as of January 28, 2017. Approximately \$198,667 (3.0%) and \$174,038 (2.7%) of the Exchange's net revenues in fiscal years 2017 and 2016, respectively, were derived from sales to U.S. troops stationed in the Middle East, including Operation Freedom's Sentinel (OFS), Operations Resources Support (ORS), and Operation Inherent Resolve (OIR). The increase in revenue for fiscal year 2017 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 \$27,551 at February 3, 2018 and \$20,469 at January 28, 2017. 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.

Army and Air Force Exchange Service

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

**10. Subsequent Events**

The Exchange has evaluated subsequent events through May 24, 2018, the date at which the financial statements were available to be issued, and determined that no additional disclosures to those presented were necessary.

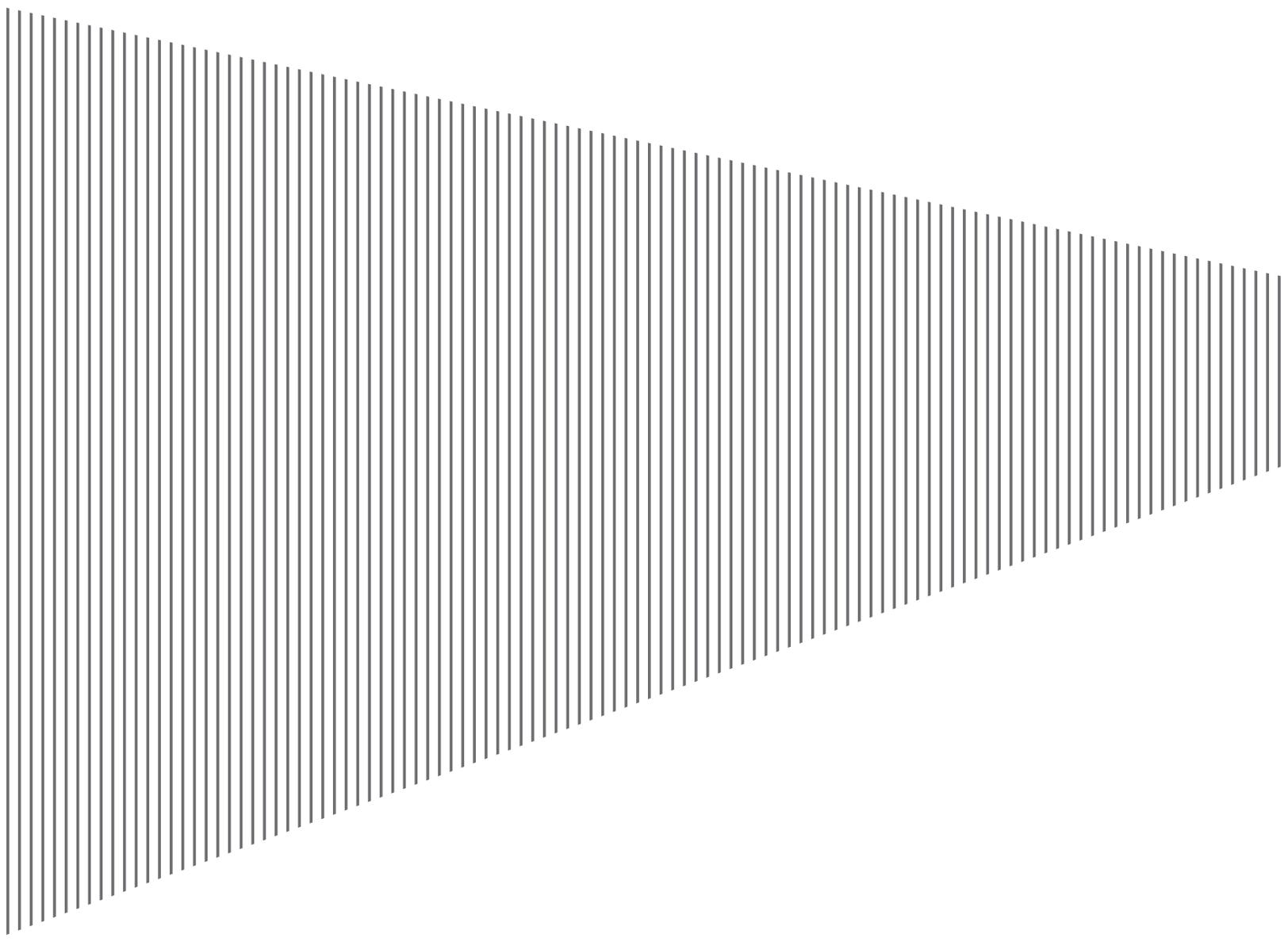
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# EXCHANGE MISSION

Since 1895, the Army & Air Force Exchange Service's enduring mission has been to make the lives of Soldiers and Airmen better through the goods and services we offer. The Exchange goes where Soldiers, Airmen and their families go to improve their quality of life through retail goods and services.



**EXCHANGE**



**\$8.6B**

FY 2017 REVENUE

**\$376M**

FY 2017 EARNINGS

**\$219M**

FY 2017 DIVIDENDS

**85%**

ASSOCIATES CONNECTED  
TO MILITARY

**1,100**

WOUNDED WARRIORS  
HIRED SINCE 2010

**4,600**

ASSOCIATES DEPLOYED TO  
COMBAT ZONES SINCE 9/11

**1.1M**

COMBAT UNIFORMS  
OUTFITTED AT COST

**7 PLANTS**

PROVIDING BAKED GOODS/  
WATER OVERSEAS

**2.6M**

SCHOOL LUNCHES  
SERVED BELOW COST



ARMY & AIR FORCE  
EXCHANGE SERVICE