

FINANCIAL STATEMENTS

Army and Air Force Exchange Service
Years Ended January 31, 2009 and February 2, 2008

Army and Air Force Exchange Service

Financial Statements

Years Ended January 31, 2009 and February 2, 2008

Contents

| | |
|---|---|
| Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of the Financial Statements Performed in Accordance With <i>Government Auditing Standards</i> | 1 |
| Report of Independent Auditors..... | 3 |
| Financial Statements | |
| Balance Sheets | 5 |
| Statements of Earnings | 6 |
| Statements of Changes in Net Assets..... | 7 |
| Statements of Cash Flows..... | 8 |
| Notes to Financial Statements..... | 9 |

Report on Internal Control Over Financial Reporting and on Compliance
and Other Matters Based on an Audit of Financial Statements
Performed in Accordance with *Government Auditing Standards*

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

We have audited the financial statements of Army and Air Force Exchange Service (AAFES) as of and for the year ended January 31, 2009, and have issued our report thereon dated May 1, 2009. We conducted our audit in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered AAFES' internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of AAFES' internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of AAFES' internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether AAFES' financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of management, Board of Directors, and the Departments of the Army and Air Force and is not intended to be and should not be used by anyone other than these specified parties.

Ernst + Young LLP

May 1, 2009

Report of Independent Auditors

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

We have audited the accompanying balance sheets of the Army and Air Force Exchange Service (AAFES or the Company) as of January 31, 2009 and February 2, 2008, and the related statements of earnings, changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of AAFES' internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of AAFES' internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Army and Air Force Exchange Service at January 31, 2009 and February 2, 2008, and the results of its operations and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated May 1, 2009 on our consideration of the Army and Air Force Exchange Service's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of

that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

As discussed in Notes 1 and 4 to the financial statements, on December 31, 2007, the Company adopted the recognition and disclosure provisions of Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Post-retirement Plans* (SFAS 158). Also, as discussed in Note 1, on January 31, 2009, the Company adopted the measurement date provisions of SFAS 158.

Ernst + Young LLP

May 1, 2009

Army and Air Force Exchange Service

Balance Sheets

(Dollars in thousands, unless otherwise noted)

| | January 31, 2009 | February 2, 2008 |
|--|---------------------|---------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 189,812 | \$ 167,751 |
| Trade and other accounts receivable, less allowance for uncollectible accounts (at January 31, 2009 – \$59,937, at February 2, 2008 – \$53,736) | 2,986,520 | 2,749,591 |
| Merchandise inventories | 1,569,440 | 1,519,085 |
| Short-term investments | 19,635 | 28,982 |
| Supplies and other current assets | 33,549 | 36,314 |
| Total current assets | 4,798,956 | 4,501,723 |
| Buildings and improvements | 2,571,525 | 2,415,525 |
| Fixtures and equipment | 1,208,297 | 982,148 |
| Construction-in-progress | 354,358 | 539,405 |
| | 4,134,180 | 3,937,078 |
| Accumulated depreciation | (2,046,402) | (1,945,060) |
| | 2,087,778 | 1,992,018 |
| Other assets | 1,711 | 4,321 |
| Prepaid pension assets | 394,274 | 1,515,681 |
| Long-term investments and supplemental plan assets | 258,855 | 357,015 |
| Total assets | \$ 7,541,574 | \$ 8,370,758 |
| Liabilities and net assets | | |
| Current liabilities: | | |
| Accounts payable | \$ 633,290 | \$ 765,031 |
| Notes payable to banks | 1,949,000 | 1,465,000 |
| Accrued salaries, separation pay and other employee benefits | 153,858 | 153,119 |
| Dividends payable | 59,081 | 70,204 |
| Other current liabilities | 232,385 | 240,019 |
| Total current liabilities | 3,027,614 | 2,693,373 |
| Accrued pension and other benefits | 1,111,263 | 775,898 |
| Other noncurrent liabilities | 56,747 | 56,460 |
| Total liabilities | 4,195,624 | 3,525,731 |
| Net assets: | | |
| Accumulated other comprehensive (loss) income: | | |
| Pension liability | (1,485,615) | 108,435 |
| Derivative instruments | (12,384) | 3,731 |
| Total accumulated other comprehensive (loss) income | (1,497,999) | 112,166 |
| Retained earnings | 4,843,949 | 4,732,861 |
| Total net assets | 3,345,950 | 4,845,027 |
| Total liabilities and net assets | \$ 7,541,574 | \$ 8,370,758 |

See accompanying notes.

Army and Air Force Exchange Service

Statements of Earnings

(Dollars in thousands, unless otherwise noted)

| | Years Ended | |
|---|-----------------------------|-----------------------------|
| | January 31, 2009 | February 2, 2008 |
| Net sales | \$ 8,421,671 | \$ 8,257,279 |
| Finance revenue | 213,107 | 242,820 |
| Concession income | 206,223 | 192,262 |
| Other operating income | 35,579 | 27,839 |
| Total revenue | 8,876,580 | 8,720,200 |
| Cost of sales and operating expenses: | | |
| Cost of goods sold | 6,514,148 | 6,424,307 |
| Selling, general and administrative: | | |
| Employee compensation and benefits | 1,094,038 | 1,096,238 |
| Depreciation and amortization | 246,821 | 216,018 |
| Other | 553,890 | 507,711 |
| Total selling, general and administrative | 1,894,749 | 1,819,967 |
| Interest expense | 45,955 | 49,906 |
| Bad debt (recoveries) expense | (28,067) | 12,505 |
| | 8,426,785 | 8,306,685 |
| Operating income | 449,795 | 413,515 |
| Other (expense) income | (73,505) | 28,268 |
| Net earnings | \$ 376,290 | \$ 441,783 |

See accompanying notes.

Army and Air Force Exchange Service

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

| | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Net Assets |
|--|------------------------------|--|---------------------|
| Balance at February 3, 2007 | \$ 4,563,824 | \$ (37,183) | \$ 4,526,641 |
| Net earnings | 441,783 | – | 441,783 |
| Net decrease in minimum pension liability | – | 14,341 | 14,341 |
| Net increase in fair value of derivative instruments | – | 2,586 | 2,586 |
| Comprehensive income | | | 458,710 |
| Adjustment resulting from adoption of FASB 158 | – | 132,422 | 132,422 |
| Dividends to the Central Welfare Funds, Departments of the Army, the Air Force, the Navy, and the Marine Corps | (272,746) | – | (272,746) |
| Balance at February 2, 2008 | 4,732,861 | 112,166 | 4,845,027 |
| Adjustment for measurement date change from adoption of FASB 158 | (703) | – | (703) |
| Adjusted balance at February 2, 2008 | 4,732,158 | 112,166 | 4,844,324 |
| Net earnings | 376,290 | – | 376,290 |
| Change in funded status of pension and other post-retirement benefit liabilities | – | (1,594,050) | (1,594,050) |
| Net decrease in fair value of derivative instruments | – | (16,115) | (16,115) |
| Comprehensive loss | | | (1,233,875) |
| Dividends to the Central Welfare Funds, Departments of the Army, the Air Force, the Navy, and the Marine Corps | (264,499) | – | (264,499) |
| Balance at January 31, 2009 | \$ 4,843,949 | \$ (1,497,999) | \$ 3,345,950 |

See accompanying notes.

Army and Air Force Exchange Service

Statements of Cash Flows

(Dollars in thousands, unless otherwise noted)

| | Years Ended | |
|---|-----------------------------|-----------------------------|
| | January 31, 2009 | February 2, 2008 |
| Operating activities | | |
| Net earnings | \$ 376,290 | \$ 441,783 |
| Adjustments to reconcile net earnings to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 269,201 | 214,709 |
| Loss on disposal of property and equipment | 1,077 | 7,618 |
| Loss (gain) on supplemental pension plan assets | 82,394 | (23,523) |
| Bad debt (income) expense | (28,067) | 12,505 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (208,862) | (285,893) |
| Merchandise inventories | (50,355) | 107,490 |
| Supplies and other current assets | 2,765 | 1,460 |
| Other assets | 2,610 | (2,242) |
| Prepaid pension assets | (73,399) | (74,999) |
| Supplemental plan assets | 24,066 | 31,338 |
| Accounts payable | (160,348) | 44,489 |
| Accrued salaries, separation pay and other employee benefits | (67,148) | 38,546 |
| Other current liabilities | (7,634) | 70,239 |
| Accrued pension and other benefits | (722) | (14,797) |
| Other noncurrent liabilities | 287 | 1,375 |
| Net cash provided by operating activities | 162,155 | 570,098 |
| Investing activities | | |
| Purchases of property and equipment | (378,431) | (373,813) |
| Proceeds from the sale of property and equipment | 12,392 | 18,367 |
| Purchases of investments | (28,037) | (20,548) |
| Proceeds from the disposition of investments | 29,084 | 46,888 |
| Net cash used in investing activities | (364,992) | (329,106) |
| Financing activities | | |
| Proceeds under line-of-credit agreements | 1,949,000 | 1,465,000 |
| Repayments under line-of-credit agreement | (1,465,000) | (1,437,000) |
| Change in cash overdraft | 16,520 | 21,373 |
| Payment of dividends | (275,622) | (248,918) |
| Net cash provided by (used in) financing activities | 224,898 | (199,545) |
| Net increase in cash and cash equivalents | 22,061 | 41,447 |
| Cash and cash equivalents at beginning of year | 167,751 | 126,304 |
| Cash and cash equivalents at end of year | \$ 189,812 | \$ 167,751 |

See accompanying notes.

Army and Air Force Exchange Service

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

January 31, 2009

1. Description of Business and Summary of Significant Accounting Policies

General

The Army and Air Force Exchange Service (AAFES or the Company) is a non-appropriated fund instrumentality (NAFI) of the United States (U.S.) and is organized as a joint major command of the U.S. Army and the U.S. Air Force. AAFES 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, primarily Iraq and Afghanistan in support of Operation Enduring Freedom and Operation Iraqi Freedom (OEF/OIF), substantially all of which are located on U.S. government installations. In addition to providing merchandise and services of necessity and convenience to authorized patrons at uniformly low prices, AAFES' mission is to generate reasonable earnings to supplement appropriated funds for the support of Army and Air Force morale, welfare, and recreation programs. AAFES maintains custody of and control over its non-appropriated funds. Funds that are not distributed as dividends are reinvested in AAFES' operations. AAFES is exempt from direct State taxation and from State regulatory laws, whose application would result in interference with the performance by AAFES of its assigned Federal functions. Such laws include licensing and price control statutes. AAFES summarizes its revenues on the basis of its customers' locations. Long-lived assets are comprised of property and equipment.

Net sales by geographic region are summarized below:

| | Years Ended | |
|--|---------------------|---------------------|
| | January 31, 2009 | February 2, 2008 |
| Continental U.S. | \$ 5,300,672 | \$ 5,233,824 |
| Pacific Rim, including Alaska and Hawaii | 1,140,998 | 1,087,125 |
| Germany | 825,906 | 843,009 |
| OEF/OIF | 839,392 | 786,891 |
| Other countries | 314,703 | 306,430 |
| Total net sales | <u>\$ 8,421,671</u> | <u>\$ 8,257,279</u> |

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in thousands, unless otherwise noted)

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

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

| | Years Ended | |
|--|---------------------|---------------------|
| | January 31, 2009 | February 2, 2008 |
| Continental U.S. | \$ 1,418,197 | \$ 1,353,616 |
| Pacific Rim, including Alaska and Hawaii | 364,696 | 287,214 |
| Europe, primarily Germany | 296,230 | 342,380 |
| OEF/OIF | 8,655 | 8,808 |
| Total long-lived assets | <u>\$ 2,087,778</u> | <u>\$ 1,992,018</u> |

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

In accordance with applicable Army and Air Force regulations, AAFES 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 AAFES and paid for from AAFES funds become the property of the U.S. Government; however, AAFES has the right to occupy and use the structures. The structures cannot be used for other than AAFES’ purposes without prior approval by the AAFES Commander and the Department of the U.S. Government concerned. As such, AAFES has included the cost of the structures on its balance sheet and amortizes 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 AAFES.

Management believes the value of transportation costs provided by the U.S. Government for AAFES materials shipped to and from overseas AAFES facilities totaled approximately \$145,064 and \$132,924 for fiscal years 2008 and 2007, respectively. In addition, AAFES received \$146,078 and \$130,754 in appropriations in relation to OEF/OIF transportation for fiscal years 2008 and 2007, 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)

In fiscal 2008, AAFES received \$98,742 in appropriations in relation to OEF/OIF. Of this amount, \$7,749 was recognized for inventory markdowns and shortages, \$26,035 for personnel cost and \$64,958 which includes \$59,496 for in-theater transportation and \$5,462 for other expenses. In fiscal 2007, AAFES received \$79,200 in appropriations related to OEF/OIF. Of this amount, \$13,642 was recognized for inventory markdowns and shortages, \$17,206 for personnel cost, \$3,605 for other expenses, and \$44,747 for in-theater transportation. Other support received during fiscal 2007 included \$12,751 in appropriations related to OEF/OIF for GFY 2003.

On May 13, 2005, the Department of Defense (DoD) announced the 2005 Base Realignment and Closure (BRAC) listing that will impact the existence of various military installations and personnel around the world. The goal of this global base realignment is to strategically position the military to accomplish future objectives. The list was formally approved by Congress and became law on November 9, 2005. Under this law, the DoD is required to complete these actions by September 15, 2011. As the realignments are still pending by the DoD, AAFES is unable to determine the impact on the Company's future operations. The net book value recorded for property at the BRAC locations was \$11,658 as of January 31, 2009, compared to \$13,808 as of February 2, 2008, and is being depreciated over the estimated remaining lives of the assets based on the expected dates of the closures.

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

Fiscal Year

AAFES' fiscal year-end is the Saturday nearest January 29. References to fiscal 2008 and fiscal 2007 herein are to the fiscal years ended January 31, 2009 and February 2, 2008, respectively.

Dividends

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

Pension assets include alternative investments in limited partnerships, real estate properties, private equity, timber, agriculture, and alternative debt, which do not have readily available market values. In these instances, management reviews and takes responsibility for assessing, concluding on, and recording the fair market values for alternative investments provided by the general partner, investment manager, or appraiser, as appropriate. Management believes estimated fair values have been reported in accordance with Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157), but may differ significantly from the values that would have been used had a ready market for these investments existed and such differences could be material.

Translation of Foreign Currencies

AAFES maintains foreign currencies only to the extent necessary to pay local current liabilities. Current liabilities are recorded daily and translated to U.S. dollars at “pegged” rates. Payments of current liabilities are recorded based on the “pegged” rate. At year-end, the current liabilities are translated from the pegged rates to the market rates. The majority of such resulting gain or loss is recorded as foreign currency gain or loss with the remainder to the expense or asset account that gave rise to the current liability. The Company recognized a net gain on foreign currency of approximately \$9,700 compared to a net loss of \$6,500 for the years ended January 31, 2009 and February 2, 2008, respectively. In addition, the noncurrent liability for local national separation pay has been adjusted to current rates.

Cash and Cash Equivalents

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

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

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

The Company's accounts receivable balance includes \$152,719 and \$138,026 of receivables from the Marine Exchange (MCX) for Marine MILITARY STAR[®] Card outstanding balances and related processing fees as of January 31, 2009 and February 2, 2008, respectively.

As of January 31, 2009 and February 2, 2008, approximately \$2,362,044 and \$2,193,026, respectively, of the accounts receivable balance represents amounts due to AAFES under its in-house credit program, the MILITARY STAR[®] Card. MILITARY STAR[®] Card extends credit to eligible AAFES customers for the purchase of retail goods at AAFES stores worldwide. Minimum payments are calculated over a 36-month term.

Finance revenue is calculated based upon the customer account balance outstanding during the period after consideration of the applicable grace period, typically 30 days following the billing date. The finance rate charged is a variable interest rate calculated at a variable amount above the U.S. Prime Rate reported in *The Wall Street Journal*. The average finance rate charged for fiscal 2008 and 2007 was 10.20% and 13.01%, respectively. Finance charges are recorded unless an account balance has been outstanding for more than 180 days. The recorded investment in customer receivables past due ninety days or more and still accruing interest is approximately \$87,282 and \$45,443 as of January 31, 2009, and February 2, 2008, respectively.

Accounts past due for 30 days or more are considered delinquent. Accounts delinquent for 180 days are submitted to Treasury Offset Program (TOPS) for collection. AAFES utilizes various means to collect past due accounts, as well as accounts written off, including some methods not available to other retail organizations. AAFES has agreements with other U.S. Government entities that allow AAFES 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.

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)

A provision for possible credit loss is recorded each month based on a percentage of total projected charge-offs that are considered uncollectible. AAFES 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 balances, and changes in credit policy. It is reasonably possible that the amounts AAFES 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.

Collections on delinquent balances that were submitted to U.S. Government entities for collection totaled approximately \$170,400 and \$99,118 in fiscal 2008 and 2007, respectively. In addition, increased collections resulted in net bad debt recoveries of \$28,067 in 2008 compared to bad debt expense of \$12,505 in 2007. The improved collections were a result of the Economic Stimulus Act of 2008 passed by Congress in early 2008 allowing the AAFES Collections Department to intercept approximately \$35,000 in disbursements made by the U.S. government. Given the uncertainty with regard to anticipating future stimulus payments by the U.S. Government, the allowance for bad debt as of January 31, 2009 was calculated based on the historical collection experience. Management will continue to refine its reserve policy as new customer information and trends develop.

Merchandise Inventories

AAFES inventories are valued at the lower of cost or market, as determined primarily by the retail inventory method of accounting, except for distribution center inventories, which are based on the first-in, first-out inventory method. Certain warehousing, distribution, and procurement expenses are included in the cost that can be inventoried. For the years ended January 31, 2009 and February 2, 2008, \$11,450 and \$13,742 of these expenses were capitalized in merchandise inventory.

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in thousands, unless otherwise noted)

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

Buildings and Improvements

Buildings and improvements primarily represent permanent structures constructed by AAFES and owned by the U.S. Government. These assets are recorded at cost with amortization 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 AAFES. Buildings are generally depreciated over 30 years and improvements are depreciated from 7 to 15 years. AAFES loses its rights to buildings and improvements in the event of base closures and accelerates amortization of its assets when such closures are probable, accordingly.

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>Asset Type</u> | <u>Depreciable Life</u> |
|-------------------|-------------------------|
| Motor vehicles | 5 to 10 years |
| Equipment | 2 to 10 years |
| Software | 3 to 7 years |

At January 31, 2009, property and equipment included approximately \$1,403,820 of fully depreciated assets that remain in use.

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)

Self-Insurance

AAFES acts as self-insurer for property, automobile, public liability, workers' compensation, comprehensive casualty losses, ocean marine, and other casualty losses. However, AAFES 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 AAFES' independent actuarial consultants using loss development factors to estimate ultimate loss. The Company has established self-insurance reserves of \$80,688 and \$78,465 as of January 31, 2009 and February 2, 2008, respectively. The reserves have been discounted based on a rate of 6.2% at both January 31, 2009 and February 2, 2008.

Separation Pay and Vacation Leave Accruals

Separation pay and vacation leave for local national employees in foreign countries are accrued as earned based upon the labor laws of host countries and upon agreements between the U.S. and foreign governments. In order to estimate this liability, the Company and its actuaries make certain assumptions. 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 in the period in which the advertising first occurs. AAFES cooperative advertising allowances are generally accounted for as a reduction in the purchase price of inventory.

Advertising expense was \$75,908 and \$70,029 for the years ended January 31, 2009 and February 2, 2008, respectively, and is included in selling, general, and administrative expense.

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. Finance revenue includes finance charges and late fees on credit sales. Concession income includes fees charged to concessionaires based on a percentage of their sales and is recognized at the time of sale.

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in thousands, unless otherwise noted)

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

Income Taxes

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

401(k)

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

Reclassifications

Certain reclassifications have been made to the accompanying fiscal 2007 financial statements to conform to the fiscal 2008 presentation.

Foreign Currency Hedging

As part of an overall risk management strategy, the Company uses foreign currency exchange contracts to hedge exposures to changes in foreign currency rates on AAFES payroll and foreign vendor obligations denominated in foreign currencies. These derivative instruments are accounted for in accordance with Statement of Financial Accounting Standards No. 133, *Accounting for Derivatives and Hedging Activities*, as amended (SFAS 133). SFAS 133 requires that all derivative financial instruments be recognized in the financial statements and measured at fair value. Derivatives that are not hedges must be adjusted to fair value through earnings. If the derivative is a hedge, depending on the nature of the hedge, changes in the fair value of derivatives will either be offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings or recognized in net assets until the hedged item is recognized in earnings. Hedged items are reclassified from accumulated other comprehensive income (loss) and into earnings using the specific identification method. The Company's policy is that it does not speculate in hedging activities. The maximum length of time over which the Company is hedging its exposure to the variability of future cash flows for forecasted transactions is one year.

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

AAFES adopted Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157), on February 3, 2008. SFAS 157 defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosure requirements about fair value measurements. Under SFAS 157, 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 SFAS 157 focuses on an exit price, which is the price that would be received by AAFES 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. Although SFAS 157 does not require additional fair value measurements, it applies to other accounting pronouncements that require or permit fair value measurements. In February 2008, the Financial Accounting Standards Board (FASB) issued FSP No. 157-2, which delayed the effective date of SFAS No. 157 for one year for nonfinancial assets and liabilities.

Financial instruments that potentially subject AAFES to concentration of credit risk consist principally of investments held by the supplemental plan and derivative financial instruments. The Company used high credit quality counterparties to transact derivative transactions.

The Company determined the fair value of financial assets and liabilities based on the fair value hierarchy prescribed by SFAS 157, which prioritizes the inputs to valuation techniques used to measure fair value into three levels. See Note 3 to the financial statements for further information regarding the Company's derivative positions.

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements*. See Note 3 for further discussion regarding the adoption of SFAS 157 in fiscal 2008.

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106 and 132(R)* (SFAS 158). This standard requires recognition of the funded status of a benefit plan in the statement of financial position. The standard also requires recognition in other

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)

comprehensive income (loss) of certain gains and losses that arise during the period but are deferred under pension accounting rules, as well as modifies the timing of reporting and adds certain disclosures. On December 31, 2007, the Company adopted the recognition provisions of SFAS 158.

The effect of adopting SFAS 158 on the Company's balance sheet has been included in the accompanying financial statements. SFAS 158 did not have an effect on the Company's statements of earnings at February 2, 2008 or February 3, 2007. See Note 4 for further discussion of the effect of adopting the recognition and disclosure elements of SFAS 158 on the Company's financial statements.

Also, as required under SFAS 158, the Company adopted the measurement-date requirements of SFAS 158 effective January 31, 2009. Under the measurement-date requirements, an employer is required to measure defined benefit plan assets and obligations as of the date of the employer's fiscal year-end. Prior to adoption of the measurement-date requirements, the Company measured the plan assets and obligations as of December 31 of each year. See Note 4 for discussion of the impact of adoption of the measurement date provisions of SFAS 158 on the Company's financial statements as of January 31, 2009.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an amendment of SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities* (SFAS 161). SFAS 161 expands the disclosure requirements of SFAS 133 to require entities to make qualitative disclosures regarding objectives and strategies for using derivatives, quantitative disclosures regarding fair value amounts of and gains and losses on derivative instruments, and disclosures regarding credit-risk-related contingent features in derivative instruments. SFAS 161 is effective for fiscal years beginning after November 15, 2008, and the Company adopted this standard as of February 1, 2009. The Company does not expect this statement to have a material impact on the financial statements.

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in thousands, unless otherwise noted)

2. Financial Instruments

Investments and Supplemental Plan Assets

On January 31, 2009, the Company held an investment carried at \$8,300 which approximates fair value. This investment will mature in June, 2010 in support of non-German, Local National separation pay. This investment is classified as “held-to-maturity” in accordance with FAS 115, *Investments: Debt and Equity*, and is classified on the balance sheet in “Long-term investments and supplemental plan assets.”

As of February 2, 2008, the Company held a €15,000 (approximately \$22,059) German government security to support the liability for German Local National separation pay, which was included in short-term investments. In September 2008 this bond matured and a new bond, valued at €15,000 (approximately \$22,388), was purchased. The new bond is due to mature on September 11, 2009, and is classified as a short-term investment at January 31, 2009. As of January 31, 2009, this new bond was valued at \$19,737, which approximates fair value, and was classified as held-to-maturity.

The Company also holds investments related to the Supplemental Plan totaling \$250,478 and \$357,015 at January 31, 2009 and February 2, 2008, respectively. Supplemental Plan assets are classified as trading securities since gains and losses from these investments are intended to offset the cost of the Supplemental Plan. Net losses on trading securities were \$91,857 in fiscal 2008 compared to gains of \$23,523 recorded in fiscal 2007. The cost of securities sold is determined primarily on a specific identification method.

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in thousands, unless otherwise noted)

2. Financial Instruments (continued)

The allocation of Supplemental Plan assets at January 31, 2009 and February 2, 2008, by asset category, is as follows:

| | 2008 | 2007 |
|---|-------------|-------------|
| Domestic Equity securities | 25% | 31% |
| International Equity securities | 9 | 10 |
| Emerging Market Equity securities | 5 | 5 |
| Investment Grade fixed income | 21 | 21 |
| High Yield fixed income | 6 | 5 |
| Treasury Inflation Protected securities | 10 | 9 |
| Real Estate—private | 7 | 5 |
| Real Estate—public | 1 | 2 |
| Private equity | 5 | 2 |
| Commodities | 7 | 6 |
| Alternative debt | 4 | 4 |
| Total | 100% | 100% |

Lines of Credit

At January 31, 2009, AAFES had the following unsecured line of credit agreements:

- The Wachovia Bank N.A. (Wachovia) line-of-credit is a multiyear revolving credit agreement with a group of banks led by Wachovia aggregating \$750,000 that expires in December 2011. There was \$700,000 outstanding under this line of credit at January 31, 2009.
- The JPMorgan Chase (Chase) line-of-credit agreement is a 364-day revolving credit line with a group of banks led by Chase aggregating \$265,000 that expires in November 2009. At January 31, 2009, \$265,000 was outstanding on this line-of-credit. Subsequent to year-end, the line of credit was increased to \$445,000.
- AAFES also has additional lines of credit (which are subject to approval) with various banks aggregating approximately \$1,300,000 at January 31, 2009. Borrowings under these additional lines of credit aggregated \$984,000 at January 31, 2009. In February 2009, this line of credit was reduced to \$900,000. Outstanding balances under all line-of-credit agreements have various maturity dates, with the latest being July 2009.

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in thousands, unless otherwise noted)

2. Financial Instruments (continued)

Borrowings under all lines of credit bear interest rates ranging from 0.78% to 6.11%. The average interest rate under these lines of credit was 2.71% for the year ended January 31, 2009. Based on the short-term nature of these borrowings, AAFES believes that the carrying values of amounts outstanding under the line-of-credit agreements approximate fair value given the term of the debt and floating interest rates.

Cash paid for interest for fiscal years 2008 and 2007 was approximately \$49,322 and \$70,453 respectively. AAFES has complied with all debt covenants per loan agreements. AAFES is not subject to any financial covenants.

Subsequent to year-end, AAFES established a Memorandum of Agreement (MOA) with Army Family and Morale, Welfare and Recreation Command (FMWRC), a separate NAFI. This MOA allows for inter-NAFI borrowing and was finalized in March 2009. The agreement is an uncommitted line of credit that allows for borrowings at a negotiated interest rate which shall approximate the Company's short term variable interest rates. The MOA has no termination date. As of April 22, 2009, AAFES borrowed \$200,000 through this MOA.

Derivative Financial Instruments

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

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

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in thousands, unless otherwise noted)

2. Financial Instruments (continued)

accumulated other comprehensive income (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 income (loss).

As of January 31, 2009, the Company had various foreign exchange contracts (forwards and option collars) outstanding related to approximately \$101,939 (€67,000) of its forecasted payroll and inventory purchase liabilities. As of January 31, 2009, the notional value of the outstanding forward contracts (€13,000) was \$19,322 with a corresponding unrecognized loss of \$2,848. The notional value of outstanding option collar contracts (€54,000) was \$82,617, with a corresponding unrecognized loss of \$9,536. The net unrecognized loss of \$12,384 is included in other current assets on the accompanying balance sheet and is included as a component of accumulated other comprehensive income (loss). In addition, the Company has recognized approximately \$2,307 in losses on foreign currency hedge transactions during fiscal 2008. Unrealized gains and losses on foreign exchange hedges are recognized into earnings as the related payroll expenses are paid or the related inventory is purchased.

On January 30, 2009, AAFES entered into an interest rate swap with a total notional amount of \$100,000. The impact on AAFES financial statements as of January 31, 2009, is insignificant.

3. Fair Value Measurements

On February 3, 2008, the Company adopted SFAS No. 157, *Fair Value Measurements*. The adoption of SFAS No. 157 is currently limited to financial instruments and to nonfinancial derivatives as, in February 2008, the Financial Accounting Standards Board (FASB) issued FSP No. 157-2, which delayed the effective date of SFAS No. 157 for one year for nonfinancial assets and liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis. The adoption of SFAS No. 157 had no impact on the Company's financial position or results of operations.

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in thousands, unless otherwise noted)

3. Fair Value Measurements

As prescribed by SFAS No. 157, the fair value of financial assets and liabilities was based on the following fair value hierarchy, as prescribed by SFAS No. 157, which prioritizes the inputs to valuation techniques used to measure fair value into three levels:

Level 1 inputs—unadjusted quoted prices in active markets for identical assets or liabilities to which the Company 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 inputs—significant inputs other than quoted market prices included in Level 1 that are observable, either directly or indirectly, for the asset or liability. Level 2 inputs include, but are not limited to, quoted prices for similar assets or liabilities in an active market, quoted prices for identical or similar assets or liabilities in markets that are not active and inputs other than quoted market prices that are observable for the asset or liability, such as interest rate curves and yield curves observable at commonly quoted intervals, volatilities, credit risk and default rates.

Level 3 inputs—unobservable inputs for the asset or liability.

The following table sets forth by level, within the fair value hierarchy, the AAFES Supplemental Plan's assets at fair value as of January 31, 2009:

| | Assets at Fair Value as of January 31, 2009 | | | |
|---|--|----------------|----------------|--------------|
| | Level 1 | Level 2 | Level 3 | Total |
| Assets (1): | | | | |
| Publicly held securities | \$ 3,712 | \$ 173,869 | \$ — | \$ 177,581 |
| Real estate and commodities | — | 3,704 | 43,098 | 46,802 |
| Private debt | — | — | 14,374 | 14,374 |
| Private equity | — | — | 11,721 | 11,721 |
| Total assets | \$ 3,712 | \$ 177,573 | \$ 69,193 | \$ 250,478 |
| Liabilities (2): | | | | |
| Foreign currency derivative liabilities | \$ — | \$ 12,384 | \$ — | \$ 12,384 |

(1) Included in Long-term investments and Supplemental Plan assets.

(2) Included in Accounts Payable and Accrued salaries, separation pay, and other employee benefits.

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in thousands, unless otherwise noted)

3. Fair Value Measurements (continued)

The Company does not invest directly in publicly traded securities. All Level 2 Publicly Held Securities consist of holdings in funds of Level 1 quality assets that are managed by outside investment firms.

Publicly Held Securities: Cash instruments valued at face value. Investments in funds comprised entirely of actively traded securities valued at the total of all closing prices from active markets on which the securities are traded.

Real Estate and Commodities: Valued at the estimated fair value of the underlying assets. The estimated fair value is based on the selling price of the property, income the property is expected to generate, and the market values of any commodities currently on the land.

Private Debt: Alternative debt instruments targeted for conversion to equity positions in the issuing company that are valued at estimated fair market value based on purchase price when recently acquired; valuation models, such as discounted cash flows or market multiples; financial measures, such as free cash flows or earnings before interest, taxes, depreciation, and amortization (EBITDA); or market comparisons for similar assets.

Private Equity: Estimated fair value of the underlying assets based on purchase price when recently acquired; valuation models, such as discounted cash flows or market multiples; financial measures, such as free cash flows or EBITDA; or market comparisons for similar assets.

Foreign Currency Derivative Liabilities: The fair values of derivative liabilities traded in the over-the-counter market are determined using quantitative models that require the use of multiple inputs including interest rates, foreign exchange rates, prices and indices to generate pricing and volatility factors. The predominance of market inputs are actively quoted and can be validated through external sources, including brokers, market transactions and third-party pricing services.

Army and Air Force Exchange Service

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

3. Fair Value Measurements (continued)

Level 3 Gains and Losses

The table below sets forth a summary of changes in the fair value of the Plan's Level 3 assets for the year ended January 31, 2009:

| | Year Ended January 31, 2009 | | |
|---|------------------------------------|-------------------------|-------------------------------------|
| | Private Equity | Private Debt | Real Estate/ Commodities |
| Balance, beginning of year | \$ 8,230 | \$ 14,212 | \$ 49,968 |
| Realized gains (losses) | 194 | – | 93 |
| Unrealized gains (losses) relating to instruments still held at the reporting date | (765) | (3,838) | (2,189) |
| Net purchases, sales, issuances and settlements | 4,062 | 4,000 | (4,774) |
| Balance, end of year | \$ 11,721 | \$ 14,374 | \$ 43,098 |

4. Benefit Plans

AAFES has a defined benefit pension plan, the Retirement Annuity Plan (the Plan), covering regular full-time civilian employees of the Company who are citizens or residents of the U.S. In addition, a noncontributory supplemental deferred compensation plan (the Supplemental Plan) provides for selected benefits to employees in the Executive Management Program. AAFES' policy is to fund pension costs accrued unless fully funded or unless an asset-liability model has shown the 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 AAFES' pension plan, certain medical and dental (health care) and life insurance benefits are also provided to retired employees through the Post-retirement Medical/Dental (PRM) and Life Insurance (Other Post-retirement) plans for employees of AAFES. 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. AAFES' policy is to fund post-retirement costs accrued unless fully funded or unless an asset-liability model has shown the plan will likely become fully funded even in the absence of future contributions.

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in thousands, unless otherwise noted)

4. Benefit Plans (continued)

In addition, the Company provides a noncontributory defined benefit pension plan to its employees in the United Kingdom (UK Plan). AAFES also provides post-employment benefits through its Local National benefit plans to employees in Germany, Japan, Okinawa, Azores, Italy, and Turkey.

Accounting principles generally accepted in the U.S. require AAFES to measure the cost of the Plan and the Supplemental Plan in accordance with Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* (SFAS 87), and Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Post-retirement Benefits Other than Pensions* (SFAS 106) as amended by SFAS 158. In addition, assets of the Supplemental Plan do not qualify as plan assets as defined in SFAS 87 and, as a result, are accounted for in accordance with Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (SFAS 115).

On December 31, 2007, the Company adopted the recognition and disclosure provisions of SFAS 158. SFAS 158 required the Company to recognize the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligations) of its pension plans in the balance sheet as of February 2, 2008, with a corresponding adjustment to accumulated other comprehensive income (loss). The adjustment to accumulated other comprehensive income (loss) at adoption primarily represents the net unrecognized actuarial losses and unrecognized prior service costs which were previously netted against the funded status of the plans in the Company's balance sheets pursuant to the provisions of SFAS 87. These amounts will be subsequently recognized as net periodic pension cost pursuant to the Company's historical accounting policy of amortizing such amounts. Further, actuarial gains and losses that arise in subsequent periods and are not recognized as net periodic pension cost in the same periods will be recognized as a component of other comprehensive income (loss). Those amounts will be subsequently recognized as a component of net periodic pension cost on the same basis as the amounts recognized in accumulated other comprehensive income (loss) at adoption of SFAS 158.

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in thousands, unless otherwise noted)

4. Benefit Plans (continued)

The incremental effects of adopting the provisions of SFAS 158 on the Company's balance sheet are presented in the following table (in millions). The adoption of SFAS 158 had no effect on the Company's statement of earnings for fiscal 2007, or for any prior period presented, and it will not affect the Company's operating results in future periods.

| | Before Application of Statement 158 | Adjustments | After Application of Statement 158 |
|--|--|--------------------|---|
| Intangible assets (pension) | \$ 1,445 | \$ (1,445) | \$ — |
| Prepaid pension assets | 977,398 | 538,283 | 1,515,681 |
| Accrued pension and other benefits liability | 401,546 | 404,416 | 805,962 |
| Accumulated other comprehensive (loss) income | (23,986) | 132,422 | 108,436 |

In fiscal 2008, in accordance with SFAS 158, the Company changed the measurement date of its defined benefit and other post-retirement benefit plans from December 31 to the Company's fiscal year-end date, January 31, 2009. The adoption of the measurement-date requirements of SFAS 158 resulted in a net increase to the projected benefit obligation of \$32,000 and a net decrease to retained earnings of \$703.

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in thousands, unless otherwise noted)

4. Benefit Plans (continued)

The following tables provide a reconciliation of the changes in the benefit plans' benefit obligations and fair value of assets for the years ended January 31, 2009 and December 31, 2007. Amounts are stated in millions.

| | Pension Benefits | | | | Other Benefits | | | |
|--|------------------|-----------------|-------------------|---------------|-----------------|-----------------|---------------|---------------|
| | The Plan | | Supplemental Plan | | Post-retirement | | Foreign Plans | |
| | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 |
| Change in projected benefit obligations (PBO) | | | | | | | | |
| PBO at prior measurement date | \$ 2,572 | \$ 2,628 | \$ 355 | \$ 367 | \$ 1,559 | \$ 1,589 | \$ 100 | \$ 93 |
| Service cost | 68 | 58 | 3 | 4 | 21 | 21 | 4 | 3 |
| Interest cost | 167 | 155 | 24 | 22 | 97 | 93 | 4 | 4 |
| Plan participants' contributions | 4 | 4 | - | - | - | - | - | - |
| Change in measurement date | 20 | - | 2 | - | 10 | - | - | - |
| Actuarial gain | (184) | (93) | (4) | (13) | (34) | (75) | (9) | (2) |
| Foreign exchange impact | - | - | - | - | - | - | (8) | 6 |
| Benefits paid | (184) | (161) | (28) | (25) | (75) | (69) | (5) | (4) |
| Administrative expenses paid | (21) | (19) | - | - | - | - | - | - |
| PBO at current measurement date | \$ 2,442 | \$ 2,572 | \$ 352 | \$ 355 | \$ 1,578 | \$ 1,559 | \$ 86 | \$ 100 |

| | Pension Benefits | | | | Other Benefits | | | |
|--|------------------|-----------------|-------------------|---------------|-----------------|-----------------|---------------|--------------|
| | The Plan | | Supplemental Plan | | Post-retirement | | Foreign Plans | |
| | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 |
| Change in plan assets | | | | | | | | |
| Fair value of assets at prior measurement date | \$ 4,087 | \$ 3,887 | \$ 373 | \$ 365 | \$ 1,161 | \$ 1,056 | \$ 36 | \$ 33 |
| Actual return on assets | (1,051) | 376 | (92) | 35 | (362) | 88 | (8) | 2 |
| Employer contributions | - | - | - | - | 63 | 86 | 2 | 5 |
| Plan participants' contributions | 4 | 4 | - | - | - | - | - | - |
| Benefits paid | (183) | (161) | (29) | (25) | (75) | (69) | (2) | (4) |
| Administrative expenses paid/foreign exchange impact | (21) | (19) | (2) | (2) | - | - | (8) | - |
| Fair value of assets at current measurement date | \$ 2,836 | \$ 4,087 | \$ 250 | \$ 373 | \$ 787 | \$ 1,161 | \$ 20 | \$ 36 |

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in thousands, unless otherwise noted)

4. Benefit Plans (continued)

The following tables reflect a reconciliation of funded status and amounts recognized in the balance sheets as of January 31, 2009 and February 2, 2008. Amounts are stated in millions.

| | Pension Benefits | | | | Other Benefits | | | |
|--|------------------|-----------------|-------------------|-----------------|-----------------|-----------------|----------------|----------------|
| | The Plan | | Supplemental Plan | | Post-retirement | | Foreign Plans | |
| | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 |
| Reconciliation of funded status | | | | | | | | |
| Funded status at current measurement date | \$ 394 | \$ 1,516 | \$ (352) | \$ (355) | \$ (791) | \$ (397) | \$ (66) | \$ (64) |
| Contribution after measurement date and on or before fiscal year-end | - | - | - | 4 | - | 6 | - | - |
| Funded status at fiscal year-end | <u>\$ 394</u> | <u>\$ 1,516</u> | <u>\$ (352)</u> | <u>\$ (351)</u> | <u>\$ (791)</u> | <u>\$ (391)</u> | <u>\$ (66)</u> | <u>\$ (64)</u> |
| Amounts recognized in the balance sheets | | | | | | | | |
| Prepaid pension asset | \$ 394 | \$ 1,516 | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - |
| Other current liabilities | - | - | 27 | 24 | 66 | - | 6 | (2) |
| Accrued pension and other benefits liability | - | - | 325 | 327 | 725 | 391 | 60 | 45 |
| Accumulated other comprehensive (loss) income | <u>\$ (662)</u> | <u>\$ 538</u> | <u>\$ (13)</u> | <u>\$ (18)</u> | <u>\$ (791)</u> | <u>\$ (391)</u> | <u>\$ (19)</u> | <u>\$ (3)</u> |

A summary of the components of net periodic benefit cost for the benefit plans is as follows for the years ended January 31, 2009 and February 2, 2008:

| | Pension Benefits | | | | Other Benefits | | | |
|------------------------------------|------------------|----------------|-------------------|--------------|-----------------|--------------|---------------|-------------|
| | The Plan | | Supplemental Plan | | Post-retirement | | Foreign Plans | |
| | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 |
| Net periodic cost | | | | | | | | |
| Service cost | \$ 68 | \$ 58 | \$ 3 | \$ 4 | \$ 21 | \$ 21 | \$ 4 | \$ 4 |
| Interest cost | 167 | 155 | 24 | 22 | 97 | 93 | 4 | 4 |
| Expected return on assets | (308) | (288) | - | - | (91) | (85) | (2) | (2) |
| Prior service cost amortization | - | - | - | - | (4) | (4) | - | - |
| Net loss amortization | - | - | 1 | - | 29 | 41 | 1 | 1 |
| Net periodic benefit (income) cost | <u>\$ (73)</u> | <u>\$ (75)</u> | <u>\$ 28</u> | <u>\$ 26</u> | <u>\$ 52</u> | <u>\$ 66</u> | <u>\$ 7</u> | <u>\$ 7</u> |

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in thousands, unless otherwise noted)

4. Benefit Plans (continued)

Information for benefit plans with an accumulated benefit obligation in excess of plan assets (dollars in millions):

| | Pension Benefits | | Other Benefits | | Pension Benefits | |
|--------------------------------|-------------------|--------|-----------------|----------|------------------|--------|
| | Supplemental Plan | | Post-retirement | | Foreign Plans | |
| | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 |
| Projected benefit obligation | \$ 352 | \$ 355 | \$ 1,578 | \$ 1,559 | \$ 86 | \$ 100 |
| Accumulated benefit obligation | 350 | 355 | 1,578 | 1,559 | 72 | 84 |
| Fair value of plan assets | – | – | 787 | 1,161 | 20 | 36 |

Amounts included in accumulated other comprehensive income (loss) for all plans at January 31, 2009, consist of net actuarial losses of \$1,463,437 and a net prior service credit of \$16,601. Amortization of these amounts expected to be recognized in fiscal year 2009 is \$33,853 for net actuarial losses and \$4,732 for prior service cost.

Actuarial Assumptions

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

| | Pension Benefits | | Pension Benefits | | Other Benefits | |
|--|------------------|-------|---------------------|-------|-----------------|-------|
| | The Plan | | Supplemental Plan | | Post-retirement | |
| | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 |
| Assumptions used to determine expense: | | | | | | |
| Discount rate | 6.50% | 6.15% | 6.50% | 6.15% | 6.50% | 6.15% |
| Long-term rate of return on assets | 8.25% | 8.25% | –% | – | 8.75% | 8.75% |
| Compensation increase rate | 5.50% | 4.00% | 5.50% | 4.00% | 5.50% | 4.00% |
| Assumptions used at disclosure: | | | | | | |
| Discount rate | 6.75% | 6.50% | 6.75% | 6.50% | 6.75% | 6.50% |
| Compensation increase rate | 5.50% | 5.19% | 5.50% | 5.19% | 5.50% | 5.19% |
| | | | | | | |
| | Other Benefits | | Other Benefits | | | |
| | UK Plan | | Local National Plan | | | |
| | 2008 | 2007 | 2008 | 2007 | | |
| Assumptions used to determine expense: | | | | | | |
| Discount rate | 5.80% | 5.10% | 3.68% | 3.50% | | |
| Long-term rate of return on assets | 6.90% | 6.80% | – | – | | |
| Compensation increase rate | 4.80% | 4.50% | 2.71% | 2.80% | | |
| Assumptions used at disclosure: | | | | | | |
| Discount rate | 7.00% | 5.80% | 3.71% | 3.68% | | |
| Compensation increase rate | 4.50% | 4.80% | 2.57% | 2.65% | | |

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in thousands, unless otherwise noted)

4. Benefit Plans (continued)

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

Pension Plan Assets

AAFES' pension plans asset allocations at January 31, 2009 and December 31, 2007, by asset class category are as follows:

| | Pension Benefits | | Other Benefits | | Other Benefits | |
|-----------------------------------|------------------|------|----------------------|------|----------------|------|
| | The Plan | | Post-retirement Plan | | UK Plan | |
| | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 |
| Domestic Equity securities | 25% | 31% | 26% | 31% | 26% | 25% |
| International Equity securities | 9 | 10 | 16 | 10 | 35 | 34 |
| Emerging Market Equity securities | 5 | 5 | 5 | 5 | 4 | 4 |
| Investment Grade fixed income | 23 | 22 | 19 | 20 | 35 | 37 |
| High Yield fixed income | 5 | 5 | 6 | 5 | – | – |
| TIPS | 10 | 9 | 5 | 9 | – | – |
| Real Estate–private | 6 | 5 | 7 | 5 | – | – |
| Real Estate–public | 2 | 2 | 1 | 2 | – | – |
| Private equity | 6 | 3 | 6 | 3 | – | – |
| Commodities | 6 | 5 | 6 | 6 | – | – |
| Alternative debt | 3 | 3 | 3 | 4 | – | – |
| Total | 100% | 100% | 100% | 100% | 100% | 100% |

AAFES' investment objectives for the pension 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)

4. Benefit Plans (continued)

The pension 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.

Employer Contributions

AAFES expects to contribute approximately \$27,208 to The Supplemental Plan and \$65,549 to the other post-retirement benefit plans in fiscal 2009.

Estimated Future Benefit Payments

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid (dollars in millions):

| Fiscal Years | Pension The Plan | Pension Supplemental Plan | Other Post- retirement | Foreign Plans |
|--------------|---------------------|---------------------------------|---------------------------|---------------|
| 2009 | \$ 174 | \$ 27 | \$ 82 | \$ 8 |
| 2010 | 176 | 27 | 90 | 7 |
| 2011 | 179 | 27 | 97 | 7 |
| 2012 | 182 | 28 | 103 | 7 |
| 2013–2018 | 1,187 | 170 | 703 | 40 |

Assumed Health Care Cost Trend Rates at December 31:

| | 2008 | 2007 |
|--|-------|-------|
| Health care cost trend rate assumed for next year | 9.00% | 9.00% |
| Rate to which the cost trend rate is assumed to decline (ultimate trend rate) | 4.50% | 4.50% |
| Year that the rate reaches the ultimate trend rate | 2014 | 2013 |

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in thousands, unless otherwise noted)

5. Dividends

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

If dividends were paid on the pension income and realized and unrealized gains and losses recorded in accordance with SFAS 87 and SFAS 115, AAFES would be paying dividends to the Central Welfare Funds, Departments of the Army, the Air Force, the Navy, and the Marine Corps, on noncash income, which would reduce cash reserves used in the normal operation of the business. Accordingly, under the current dividend policy, these items are excluded from net earnings subject to dividends. Any other exclusions used in the calculation of net earnings subject to dividends must be approved by the Board.

AAFES' policy is to fund post-retirement costs accrued unless 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, pension expense generally reduces the net earnings subject to dividends.

6. Commitments and Contingencies

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

7. Operation Enduring Freedom/Operation Iraqi Freedom (OEF/OIF)

On March 19, 2003, the United States declared war against Iraq. As a result, the Company increased its presence in Iraq, Qatar, Afghanistan and Kuwait from 12 stores as of February 1, 2003, to 85 stores as of January 31, 2009. The inventory balance in OEF/OIF has decreased from \$180,417 at February 2, 2008, to \$151,130 at January 31, 2009. Current conditions in Iraq are uncertain. As a result, it is difficult to estimate the potential inventory that may be forfeited if the United States must quickly exit Iraq. Any related loss on inventory could adversely affect the results of operations. Approximately \$839,392 (10.0%) and \$786,891 (9.5%) of the Company's net revenues in the fiscal years ended January 31, 2009 and February 2, 2008, respectively, were

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in thousands, unless otherwise noted)

7. Operation Enduring Freedom/Operation Iraqi Freedom (OEF/OIF) (continued)

derived from sales to U.S. troops stationed in OEF/OIF regions. Any significant disruption or retreat from the locale directed by the United States military could have an adverse impact on the results of operations.

As a result of the lack of depository banks in the region, cash sales are deposited with United States Military Finance offices in the Middle East and are then reimbursed to the Company within 90 days. Receivables from Military Finance offices were \$9,457 and \$3,410 as of January 31, 2009 and February 2, 2008, respectively.

8. Post Allowance for Overseas Personnel

On March 21, 2008, AAFES received a letter from Department of Defense confirming that U.S. citizens hired overseas in DOD NAFI positions from December 2001 to the present are eligible for a post allowance in accordance with DOD 1401.1-M, *Personnel Policy Manual for Non-appropriated Fund Instrumentalities*, and DOD 1400-.25-M, *DOD Civilian Personnel Manual*. Subchapter 1250 of DOD 1400.25-M states that employees who are U.S. citizens are eligible for post allowance unless they are part-time, intermittent, or family member summer/winter hire employees.

AAFES and certain other NAFIs did not previously pay this particular post allowance under the good faith interpretation that the post allowance was intended only for U.S. employees transferred to an overseas post. At February 2, 2008, AAFES recorded a charge for its best estimate of its obligation of \$33,572. During fiscal 2008, the DOD issued final guidance on payments of the obligation. Individuals have 6 years to file a claim. The Company paid \$27,290 in fiscal 2008 in accordance with DOD guidelines. At January 31, 2009, the Company has a remaining obligation of \$6,282 included in current liabilities and is based on its best estimate of claims remaining to be paid.