



ARMY & AIR FORCE
EXCHANGE SERVICE



2018 MISSION REPORT

SUPPORTING READINESS, RESILIENCY, RETENTION AND RECRUITMENT
WHILE BOLSTERING LETHALITY AT ALL TOUCHPOINTS

YEAR IN REVIEW

A Force Multiplier for Readiness, Resiliency, Recruitment and Retention

The Army & Air Force Exchange Service is the Department of Defense's largest retailer—ranked 61st among all U.S. retailers. We are not a private company. We are not a contractor. We are a DoD organization that improves military readiness, wherever service members and their families serve.



The Exchange exists to maximize the well-being of the military community. The Exchange funds its operations from customer revenues, except for 3% of its budget, which is paid from tax dollars to ship goods to service members overseas, as required by law. The resulting earnings are 100% returned to military communities as dividends to Quality-of-Life programs or reinvested in the Exchange's infrastructure. Simply put, the Exchange is a great deal for the Department of Defense, American taxpayers, and all who serve and have served.

During 2018, the Exchange took care of Soldiers, Airmen and military families by supporting their readiness, resiliency and quality of life. The Exchange's financial performance highlights the nearly 124-year-old benefit as a force multiplier, contributing to recruitment and retention of our Nation's Warfighters.

In 2018, the Exchange increased revenue by \$60 million to \$8.7 billion with \$386 million in dividend-eligible earnings. Earnings rose 8% from 2017, leading to \$223 million in dividends (vs. \$219 million in 2017) to support critical Quality-of-Life programs such as Army Child Development and fitness Centers, Air Force Outdoor Recreation and more.

For years, the retail climate has been challenging, but the Exchange remains all in to support Warfighters and families through an earned non-compensation benefit, which provides competitively priced, tax-free shopping.

The strategies the Exchange executed in 2018 have been instrumental in protecting and preserving this critical benefit for military communities around the world. For example:

- Veterans found a home at ShopMyExchange.com, helping boost online sales by nearly 18% over 2017.
- The BE FIT program is thriving, keeping Soldiers and Airmen fit to fight with better-for-you choices in Express convenience stores and restaurants, fitness gear in store and on ShopMyExchange.com and wellness services like optometry, dentistry and cryotherapy.
- The MILITARY STAR card continues to add value, generating \$471 million in direct benefits for military customers.

At the tip of the spear, the Exchange's passion for those who serve comes alive. No other retailer can do what we do—especially for Warfighters serving far from home. In 2018, the Exchange supported more than 155,000 troops in major military exercises and operations, bringing a lifeline to Eastern Europe, Southwest Asia, Africa and other austere locations.

The Exchange's singular mission to serve the military community worldwide—and return all earnings to the community—cannot be matched by any commercial player. 2018 was a fantastic year. Looking forward to what this team will continue to accomplish to support the readiness and resiliency of Soldiers, Airmen and military families for years to come.

Army Strong! Air Force Strong! Exchange Strong!

Tom Ansell
Director/Chief Executive Officer

BOARD OF DIRECTORS

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



LTG & Chairman
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Deputy Chief of Staff, G-4, HQDA



Lt Gen & Vice Chair
Brian T. Kelly
Deputy Chief of Staff, Manpower, Personnel & Services



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



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Assistant Chief of Staff for Installation Management (OACSIM)



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Military Deputy for Budget (HQDA ASA FM)



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CMSAF
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Chief Master Sergeant of the Air Force



MG
Steven W. Ainsworth
Commanding General 377th Theater Sustainment Command (AFRC-SLA-CG)



Maj Gen
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Deputy Assistant Secretary of the Air Force, Budget (SAF/FMB)



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



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



Brig Gen
John N. Tree
Mobilization Assistant to the Director for Logistics, Engineering & Security Cooperation (PACOM/J4)



Mr.
Horace Larry, SES
Director, Air Force Services

MILITARY COMMUNITY SUPPORT



Mission support

- Military uniforms at cost; interest-free payment plan
- More than 400 facilities in combat zones
- Mobile field Exchanges: military exercises/disaster support (hurricanes, typhoons, forest fires, etc.)
- Distribution centers/truck fleet
- School meal program: 2.5 million meals served annually overseas
- Bakeries, water/ice plants



Retail

- Department/Main stores: national brands
- Convenience stores: BE FIT focus
- Gas stations: 445 million gallons of gas
- E-commerce: all Veterans eligible to shop online
- Food courts: 1,700 restaurants all with BE FIT options



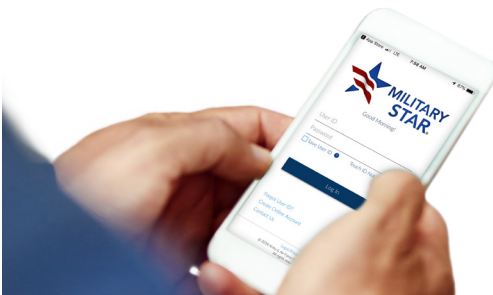
Services

- Mall operations/concessions
- Wellness services: dentistry, optometry, cryotherapy and ophthalmology
- Telecom/Internet/TV/AFN
- Theaters: premieres for troops in combat zones



Veteran and spouse employment

- More than 45% of associates are Veterans, spouses and dependents
- 85% of associates connected to military
- 1,400 Wounded Warriors hired



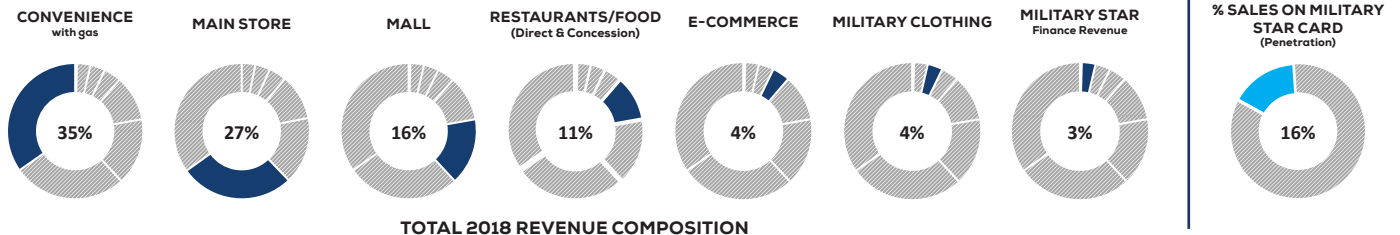
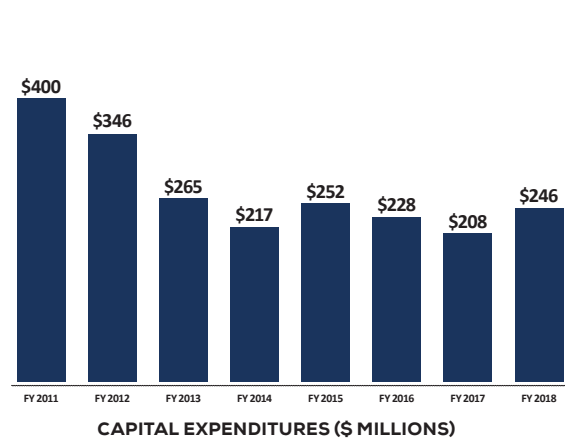
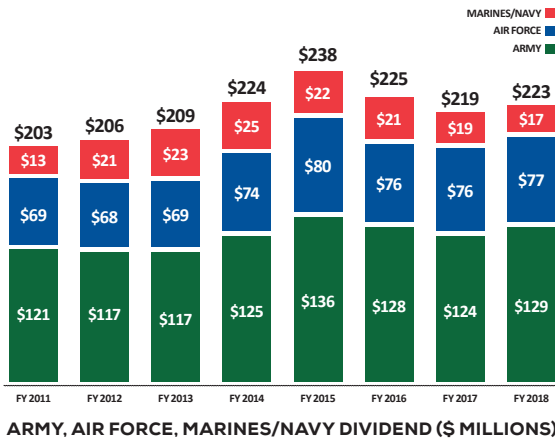
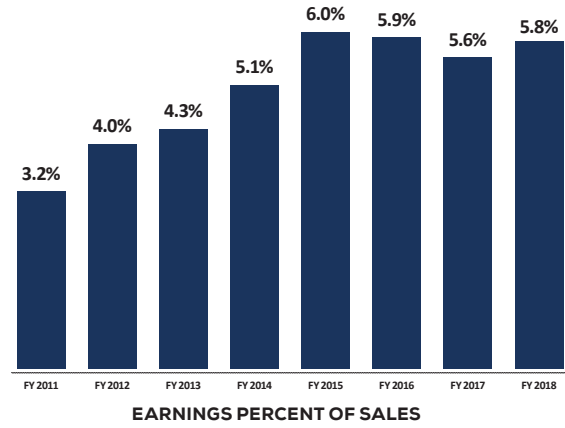
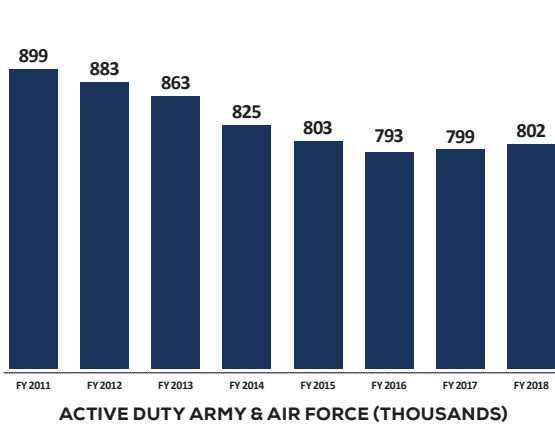
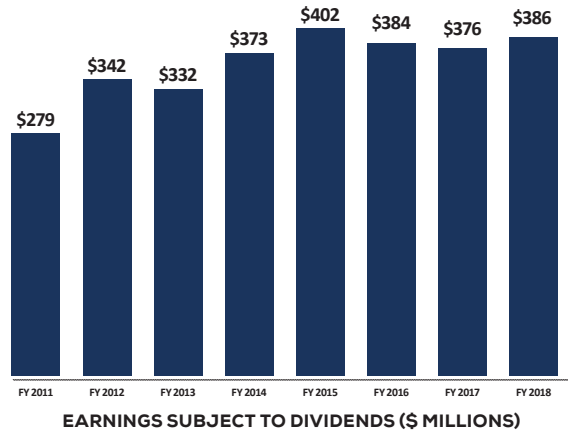
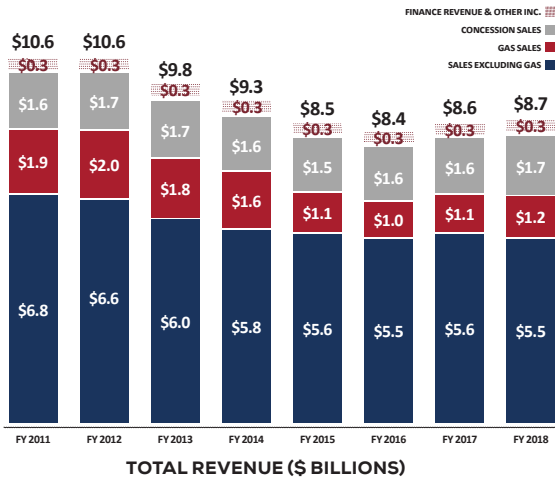
MILITARY STAR® credit card. Serving all military branches and Defense Commissary Agency customers.

- Affordable, low interest rate to help service members build credit responsibly, saving them \$348.1M annually
- No late, annual or over-limit fees, saving cardholders \$37.9M
- A generous rewards program that returned \$34.6M in rewards cards to shoppers
- A mobile app for 24/7 account management

\$2.3B in support to Quality-of-Life programs in last 10 years

FINANCIAL HIGHLIGHTS

Despite an 11% troop drawdown since 2011 and fierce online competition, the Exchange has improved, producing significant earnings for the military community.



MEETING TROOPS' NEEDS QUICKLY, WHEREVER THEY GO

When nearly 4,000 troops were sent to Texas and Arizona in 2018 for border support operations, the Exchange went with them.

The Exchange opened a 53-foot mobile field Exchange (MFE) to serve troops in Sunglow City—a tent city at Arizona's Davis-Monthan AFB.

The MFE was on site, fully stocked with shampoo, socks, pillows, flashlights, batteries, snacks, drinks, sandwiches and other supplies. The Exchange-on-wheels served a long line of Soldiers, Airmen, Marines and National Guard members.

On Nov. 14, the Exchange opened an MFE at Base Camp Donna in South Texas for border support operations. Installation commanders ordered the MFE four days before. The MFE closed Dec. 12, but not before logging more than 6,000 transactions for 500 troops.

"The process was extremely simple. I put in the request for the MFE on Monday, and by Thursday the store was up and running and serving the troops. We're very thankful to the Exchange team for their hard work to provide this taste of home for the troops."

— Col Julie Newlin, 355th Mission Support Group commander

"We were on meals ready to eat for the first 10 days.... The MFE means a little taste of home, a little bit of normalcy and routine."

— CPT Lauren Blanton, 19th Engineer Battalion



Army National Guard members shop the mobile field Exchange at Davis-Monthan AFB.



The Exchange can deploy mobile units within days of a request.

WHEN DISASTER STRIKES

Throughout 2018, the Exchange served troops helping communities and military installations recover from natural disasters including hurricanes, typhoons and an earthquake.

Just days after Hurricane Michael devastated Tyndall Air Force Base in October, only one retailer—the Exchange—was open within miles of the installation.

For six weeks, an Exchange on wheels served hundreds of service members rebuilding the installation after the storm.

The 53-foot mobile field Exchange stocked with emergency supplies, toiletries, drinks and food demonstrated the Exchange's capability to quickly deploy at command request.

After Tyndall took a direct hit from the storm, the heavily damaged main store and two Expresses closed, but the fully stocked MFE brought the Exchange mission to life.

Fuel, too, was available within days. The Exchange secured 55,000 gallons over six weeks. Even months later, the nearest town's gas stations still had no fuel—but the Exchange's supply stayed constant.

Six weeks after Michael's landfall—and in time for Thanksgiving—Tyndall's main Exchange reopened, an important step in the installation's recovery.

For TSgt Jody Brennan, who deployed from Scott Air Force Base to assist with rebuilding, the Exchange's reopening was an important milestone:

"For Airmen who are stationed here, the Exchange's opening brings a sense of returning back to normalcy."

— TSgt Jody Brennan

CONUS By The Numbers

- **300,000** emergency supplies sent to Exchanges after hurricanes Florence and Michael
- **43,000** supplies sent to Joint Base Elmendorf-Richardson after an earthquake in December
- **0%** financing offered by MILITARY STAR for customers in the Carolinas and Florida

Pacific Region By The Numbers

- **9** typhoons
- **2** hurricanes
- **30,000** bottles of water sent to Hawaii before Hurricane Lane
- **2,800** other emergency supplies sent to Hawaii



Customers lined up at the Kadena AB Exchange after Typhoon Trami ripped through Japan on Sept. 20.



Hurricane Michael devastated Tyndall Air Force Base.

TIP OF THE SPEAR

From Africa to El Salvador to Korea to Poland, the Exchange supported military exercises around the world involving more than 155,000 U.S. and allied troops.

Deployments to the tip of the spear bring potential danger.

At Afghanistan's Bagram AB, a rocket struck the Warrior Exchange at 2:21 a.m. Aug. 21. Fortunately, the store was closed, and nobody was inside. The store reopened two days later.

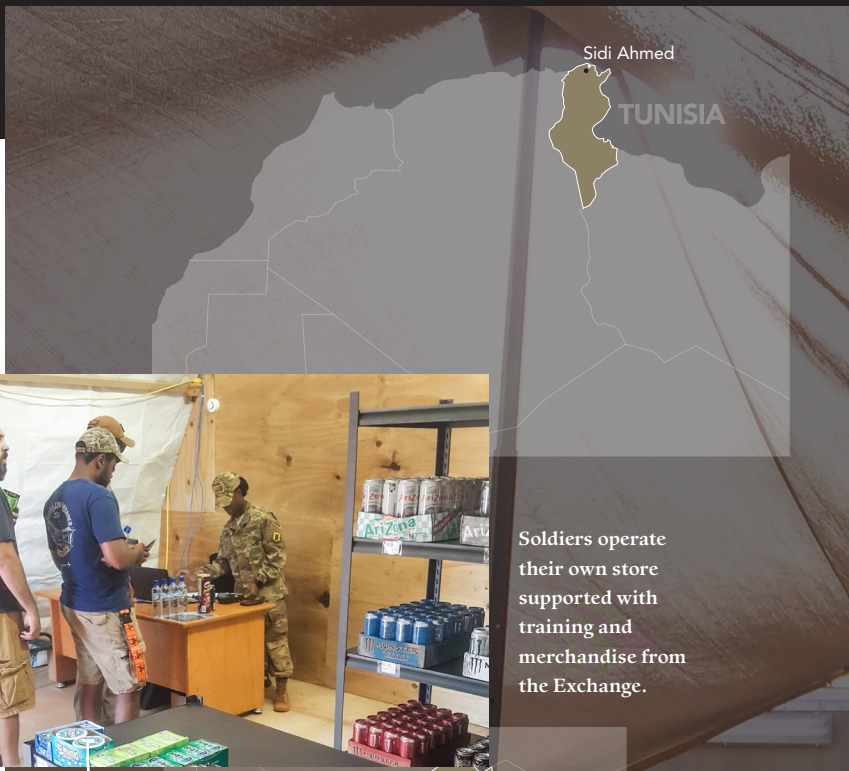
"They did a remarkable job in trying circumstances to ensure our Warfighters were served. They worked incredibly long hours to get the store open. They came together as a team and were true examples of the Exchange core value family serving family."

— Jason Rosenberg, Senior Vice President Exchange Europe/Southwest Asia Region

By The Numbers

- **33** countries where the Exchange operates
- **15+** major military exercises and operations throughout Europe and the Pacific
- **163,000** troops supported daily with an internet connection to family and home
- **86,000** troops supported in Europe, Africa & Southwest Asia
- **70,000** troops supported in the Pacific

We Go Where You Go



Soldiers operate their own store supported with training and merchandise from the Exchange.



The Exchange serves Marines at their store in Australia.



Marines get necessities from their own store supported by the Exchange.



Associates at RAF Fairford hold a sign with the Exchange's motto.



Exchange sends a specialized MFE truck providing Saphire "internet anywhere" service in a remote area of Poland.



Since 2003, the Exchange has served America's Warfighters in Iraq, including at Al-Taqaddum Air Base.



An American flag hangs in the Warrior Exchange at Bagram Air Base in Afghanistan after the building was hit by a rocket in August.



Exchange provides drinks, snacks and other necessities to troops in an undisclosed location.



An Exchange at Camp Dwyer stands ready to serve American Warfighters.

2018: THE EXCHANGE BENEFIT IN ACTION



1 More than \$65 million in earnings were reinvested in military communities worldwide, including \$6.4 million toward renovating the Wright-Patterson AFB Exchange. **2** Heroes were honored around the world, including at the Kaiserslautern Military Community, on National Vietnam War Veterans Day, reinforcing the commitment to Warfighters past, present and future. **3** Veterans make up 11.8% of the Exchange's workforce and 21.5% are military spouses such as Haley Noonan at Fort Bragg. In 2018, the Exchange reaffirmed its commitment to hiring 50,000 Veterans and spouses by 2020. **4** Truck wraps honored Vietnam Veterans like Pat Thompson, an Exchange mechanic at the Waco Distribution Center, with a rolling tribute to our Nation's heroes. In 2018, more than 58,000 Veterans used their new benefit on ShopMyExchange.com. Veterans saved nearly \$3 million in sales tax and accounted for roughly 10% of online sales. **5** At the Army-Navy Game, Director/CEO Tom Shull shares the Exchange mission with Army Chief of Staff GEN Mark Milley and actor Mark Wahlberg. **6** Cadets and Midshipmen gather near the mobile field Exchange at the Army-Navy Game. The Exchange's media blitz inside



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the stadium and TV advertising led to nearly 10,000 new shoppers registering on ShopMyExchange.com in the days after the game. **7** The Buy Online Pickup In Store option launched at more than 100 Exchanges, including at Keesler AFB. The program provides shoppers with a convenient fulfillment option. **8** Partnerships with sister agencies, including the commissary for Healthy Lifestyle Festivals, strengthened the military resale benefit throughout the year. **9** Sports nutrition shops rolled out at Exchange main stores to help Warfighters stay ready and resilient. **10** Military Clothing stores are the official source for government-certified authentic uniforms. The Exchange outfits 1.1 million Warfighters annually, including Airmen getting new OCPs at Aviano AB. **11** The MILITARY STAR card generated \$471 million in value, exclusive of finance revenue, for Warfighters and their families in 2018. **12** The Exchange takes a holistic approach to health and wellness through BE FIT. The program brings better-for-you choices to Expresses and restaurants; services including optometry, dentistry and cryotherapy; and the latest fitness products in store and at ShopMyExchange.com.

FINANCIAL STATEMENTS

Army and Air Force Exchange Service
Years Ended February 2, 2019 and February 3, 2018
With Report of Independent Auditors

Ernst & Young LLP



Army and Air Force Exchange Service

Financial Statements

Years Ended February 2, 2019 and February 3, 2018

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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 February 2, 2019 of and February 3, 2018, 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 2, 2019 and February 3, 2018, and the results of its operations and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Ernst + Young LLP

May 22, 2019

Army and Air Force Exchange Service

Balance Sheets

(Dollars in Thousands, Unless Otherwise Noted)

	February 2, 2019	February 3, 2018
Assets		
Current assets:		
Cash and cash equivalents	\$ 99,762	\$ 96,314
Trade and other accounts receivable, less allowance for uncollectible accounts of \$28,202 at February 2, 2019 and \$29,721 at February 3, 2018	2,886,611	2,948,746
Merchandise inventories	1,309,052	1,399,479
Short-term investments	9,991	10,891
Supplies and other current assets	71,542	62,399
Total current assets	4,376,958	4,517,829
Property and equipment:		
Buildings and improvements	3,666,710	3,617,450
Fixtures and equipment	1,344,101	1,228,446
Construction-in-progress	176,380	222,282
	5,187,191	5,068,178
Accumulated depreciation	(3,331,352)	(3,177,173)
	1,855,839	1,891,005
Other assets	2,852	2,264
Overfunded retirement plans	2,012	2,471
Long-term investments and supplemental plan assets	19,910	20,087
Total assets	\$ 6,257,571	\$ 6,433,656
Liabilities and net assets		
Current liabilities:		
Accounts payable	\$ 414,763	\$ 377,712
Commercial paper and current maturities of long-term debt	482,555	745,014
Accrued salaries and other employee benefits	116,538	111,304
Dividends payable	48,860	40,414
Other current liabilities	130,610	184,107
Total current liabilities	1,193,326	1,458,551
Long-term debt	360,967	442,522
Accrued pension and other benefits	920,956	1,068,389
Other noncurrent liabilities	74,576	80,614
Total liabilities	2,549,825	3,050,076
Net assets:		
Accumulated other comprehensive loss:		
Pension and postretirement benefit liability	(1,730,094)	(1,954,675)
Derivative instruments	(228)	1,271
Total accumulated other comprehensive loss	(1,730,322)	(1,953,404)
Retained earnings	5,438,068	5,336,984
Total net assets	3,707,746	3,383,580
Total liabilities and net assets	\$ 6,257,571	\$ 6,433,656

See accompanying notes.

Army and Air Force Exchange Service

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

	Year Ended	
	February 2, 2019	February 3, 2018
Net sales	\$ 6,699,955	\$ 6,691,735
Finance revenue	280,130	273,012
Concession income	228,749	214,405
Other operating income	35,942	31,691
Total revenue	7,244,776	7,210,843
Cost of sales and operating expenses:		
Cost of goods sold	5,040,666	5,038,481
Selling, general, and administrative:		
Employee compensation and benefits	1,062,012	1,082,382
Depreciation and amortization	248,829	251,753
Other	538,831	512,855
Total selling, general, and administrative expenses	1,849,672	1,846,990
Interest expense	16,741	13,097
Bad debt expense	20,893	21,760
Total expenses	6,927,972	6,920,328
Operating income	316,804	290,515
Other income	7,331	9,342
Net earnings	\$ 324,135	\$ 299,857

See accompanying notes.

Army and Air Force Exchange Service

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

	Year Ended	
	February 2, 2019	February 3, 2018
	<hr/>	<hr/>
Net earnings	\$ 324,135	\$ 299,857
Other comprehensive income:		
Reclassification of unrealized (losses) gains on derivative instruments to earnings	(1,499)	834
Pension and postretirement benefits adjustments:		
Unrealized gains (losses) arising during the period	112,193	(52,740)
Amortization of net loss	112,388	110,214
Other comprehensive income	<hr/> 223,082	<hr/> 58,308
Comprehensive income	<hr/> \$ 547,217	<hr/> \$ 358,165

See accompanying notes.

Army and Air Force Exchange Service

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

	Retained Earnings	Accumulated Other Comprehensive Loss	Net Assets
Balance at 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 gain 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
Net earnings	324,135	–	324,135
Pension and postretirement benefits adjustments	–	224,581	224,581
Reclassification of unrealized loss on derivative instruments to earnings	–	(1,499)	(1,499)
Dividends to the Central Welfare Funds, Departments of the Army, the Air Force, the Navy and the Marine Corps	(223,051)	–	(223,051)
Balance at February 2, 2019	\$ 5,438,068	\$ (1,730,322)	\$ 3,707,746

See accompanying notes.

Army and Air Force Exchange Service

Statements of Cash Flows

(Dollars in Thousands, Unless Otherwise Noted)

	Year Ended	
	February 2, 2019	February 3, 2018
Operating activities		
Net earnings	\$ 324,135	\$ 299,857
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	279,063	281,146
Loss (gain) on disposal of property and equipment	163	(460)
Loss (gain) on supplemental pension plan assets	312	(1,854)
Bad debt expense	20,893	21,760
Change in operating assets and liabilities:		
Accounts receivable	41,242	87,678
Merchandise inventories	90,427	(111,029)
Supplies and other assets	(9,272)	(18,033)
Pension assets and liabilities	78,845	40,407
Long-term investments and supplemental plan assets	(312)	1,870
Accounts payable	35,915	(25,997)
Change in cash overdraft	12	(1,848)
Accrued salaries and other employee benefits	4,859	182
Other liabilities	(61,230)	(972)
Net cash provided by operating activities	805,052	572,707
Investing activities		
Purchases of property and equipment	(245,743)	(208,171)
Proceeds from the sale of property and equipment	1,683	4,121
Purchases of investments	(59)	(14,302)
Proceeds from the disposition of investments	1,136	11,860
Net cash used in investing activities	(242,983)	(206,492)
Financing activities		
Proceeds (payments) under line-of-credit agreements	(225,000)	50,000
Proceeds (payments) under commercial paper agreement	(362,775)	95,160
Proceeds from long-term debt	250,000	-
Repayment of long-term debt	(6,240)	(255,939)
Payment of dividends	(214,606)	(220,676)
Net cash used in financing activities	(558,621)	(331,455)
Net increase in cash and cash equivalents	3,448	34,760
Cash and cash equivalents at beginning of year	96,314	61,554
Cash and cash equivalents at end of year	\$ 99,762	\$ 96,314

See accompanying notes.

Army and Air Force Exchange Service

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

February 2, 2019

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) 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 2018 and fiscal year 2017 herein are to the fiscal years ended February 2, 2019 and February 3, 2018, respectively.

Army and Air Force Exchange Service

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

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

Net sales by geographic region are summarized below:

	Year Ended	
	February 2, 2019	February 3, 2018
Continental U.S., including Alaska and Hawaii	\$ 4,550,663	\$ 4,566,479
Pacific Rim	945,314	937,865
Europe, primarily Germany	670,162	679,503
Middle East, including Afghanistan and Iraq	214,387	198,586
Other countries	319,429	309,302
Total net sales	<u>\$ 6,699,955</u>	<u>\$ 6,691,735</u>

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

	Year Ended	
	February 2, 2019	February 3, 2018
Continental U.S., including Alaska and Hawaii	\$ 1,551,666	\$ 1,520,863
Pacific Rim	210,425	223,924
Europe, primarily Germany	83,693	145,099
Middle East, including Afghanistan and Iraq	1,050	1,119
Other	9,005	—
Total long-lived assets, net	<u>\$ 1,855,839</u>	<u>\$ 1,891,005</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)

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 (excluding Middle East) to be approximately \$90,844 and \$111,281 for fiscal years 2018 and 2017, respectively. In addition, Middle East transportation costs of \$36,067 and \$47,516 were paid by the U.S. government for fiscal years 2018 and 2017, respectively.

The Exchange receives reimbursements from the U.S. government of certain incremental costs incurred by the Exchange in relation to support provided to contingency operations. Appropriated fund (APF) reimbursements are recorded when an incremental cost that qualifies for reimbursement has been incurred and reimbursement by responsible agency is probable. Such APF reimbursement receivables are classified as trade and other accounts receivable 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 2018 and 2017, the Exchange recorded APF reimbursements of \$23,104 and \$20,855, 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 Exchange management include the level of allowance needed for potentially uncollectible accounts receivable and discount rates, long-term rate of return on assets, health care trend assumptions, and mortality assumptions used to determine obligations associated with pension plans and postretirement benefit plans.

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 are purchased with a maturity 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 2, 2019 and February 3, 2018, approximately \$2,363,471 and \$2,368,030, respectively, of the Exchange's accounts receivable balance represents amounts due from cardholders under its in-house credit program, the MILITARY STAR[®] Card. The MILITARY STAR[®] Card program extends credit to eligible Exchange customers for the purchase of retail goods and services at Exchange activities worldwide.

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

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

The Exchange's trade and accounts receivable balance also includes \$148,725 and \$148,766 of receivables from the Marine Exchange (MCX) for Marine MILITARY STAR[®] Card outstanding balances and related processing fees as of February 2, 2019 and February 3, 2018, 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 12.49% and 11.49% as of February 2, 2019 and February 3, 2018 respectively. Beginning at 90 days past due, the delinquency rate of 20.49% 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 \$41,977 and \$39,448 as of February 2, 2019 and February 3, 2018 respectively.

Accounts past due for 30 days or more are considered delinquent. Accounts delinquent for 150 days are placed on non-accrual status whereby finance income is no longer accrued and submitted to the Exchange's collection department. The Exchange utilizes various means to collect past-due accounts, as well as non-accrual status accounts, including some methods not available to other commercial credit card financial institutions. The Exchange has agreements with other

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)

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 \$238,637 and \$272,154 at February 2, 2019 and February 3, 2018, 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 accounts previously written off, 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 written off, as of February 2, 2019 and February 3, 2018. It is reasonably possible that the amounts the Exchange will ultimately recover on delinquent balances could differ materially in the near term from the amounts assumed in arriving at the allowance for doubtful accounts and net receivable related to accounts previously written off. Collections on accounts previously written off and submitted to U.S. government entities totaled approximately \$154,590 and \$177,072 in fiscal years 2018 and 2017, respectively. Bad debt expense of \$20,893 recorded in fiscal year 2018 is primarily related to the Exchange's current credit card portfolio. This is compared to \$21,760 in bad debt expense recorded in fiscal year 2017. The Exchange uses a portfolio approach pooled by year to record the net receivable related to non-accrual 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 been collected. Subsequent cash collections in excess of amounts previously charged off are recorded as finance revenue upon collection. Finance revenue recognized in fiscal year 2018 related to non-accrual accounts totaled approximately \$12,579 compared to approximately \$22,563 in fiscal year 2017.

Army and Air Force Exchange Service

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

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

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

	February 2, 2019		February 3, 2018	
	Amount	Percentage of Receivables	Amount	Percentage of Receivables
	<i>(In Millions)</i>		<i>(In Millions)</i>	
Current	\$ 2,120	84.5%	\$ 2,118	84.3%
1–29 days past due	200	8.0	207	8.2
30–59 days past due	88	3.5	86	3.4
60–89 days past due	59	2.3	62	2.5
90+ days past due	42	1.7	40	1.6
Period-end gross credit card receivables	<u>\$ 2,509</u>	<u>100.0%</u>	<u>\$ 2,513</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.

	2018	2017
	<i>(In Millions)</i>	
Allowance at beginning of period	\$ 26	\$ 29
Provision for bad debt	21	22
Write-offs (net of recoveries)	(21)	(25)
Allowance at end of period	<u>\$ 26</u>	<u>\$ 26</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 2, 2019	February 3, 2018
	<i>(In Millions)</i>	
Nondelinquent accounts (current and 1–29 days past due):		
FICO score of 700 or above	\$ 783	\$ 764
FICO score of 600 to 699	1,078	1,077
FICO score below 600	459	484
Total nondelinquent accounts	2,320	2,325
Delinquent accounts (30+ days past due)	189	188
Period-end gross credit card receivables	\$ 2,509	\$ 2,513

Merchandise Inventories

The Exchange's inventories are valued at the lower of cost or net realizable value, as determined by the retail inventory method of accounting (RIM). Certain warehousing and distribution expense costs are included in the cost of inventory, which amounted to \$15,201 and \$17,551 at February 2, 2019 and February 3, 2018, 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 2018 or 2017.

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[®] 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 \$77,319 and \$78,072 as of February 2, 2019 and February 3, 2018, respectively. Workers' compensation reserves were discounted at a weighted average rate of 4.03% and 3.67% as of February 2, 2019 and February 3, 2018, respectively. Property liability reserves were discounted at a weighted average of 3.29% and 2.84% as of February 2, 2019 and February 3, 2018, respectively. Public liability reserves were discounted at a weighted average rate of 3.38% and 2.97% as of February 2, 2019 and February 3, 2018, respectively. General liability reserves were discounted at a weighted average rate of 3.34% and 2.90% as of February 2, 2019 and February 3, 2018, 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 \$44,900 and \$44,598 for the years ended February 2, 2019 and February 3, 2018, 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. Revenue from Ecommerce sales is recognized upon shipment 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. 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 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 Accounting Standards Update (ASU) 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 service 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 nonpublic companies, ASC 606 is effective for reporting periods after December 15, 2018. We do not expect the adoption of ASC 606 to have a significant effect on the Exchange's financial statements.

In March 2016, the FASB issued ASU 2016-04, *Recognition of Breakage for Certain Prepaid Stored-Value Products*. 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 nonpublic 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. We do not expect the adoption of ASU 2016-04 to have a significant effect on the Exchange's financial statements.

Army and Air Force Exchange Service

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

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

In August 2016, the FASB issued ASU 2016-15, *Classification of Certain Cash Receipts and Cash Payments*. ASU 2016-15 is intended to reduce the diversity in practice around how certain transactions are classified within the statement of cash flows. For nonpublic companies, ASU 2016-15 is effective for annual reporting periods beginning after December 15, 2018. We do not expect the adoption of ASU 2016-15 to have a significant effect on the Exchange's financial statements.

In November 2016, the FASB issued ASU 2016-18, *Restricted Cash*. ASU 2016-18 is intended to reduce the diversity in practice around how restricted cash is classified within the statement of cash flows. For nonpublic 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. We do not expect the adoption of ASU 2016-18 to have a significant effect on the Exchange's financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. ASC 2016-02 requires all leases that have a term of over 12 months to be recognized on the balance sheet with the liability for lease payments and the corresponding right-of-use asset initially measured at the present value of amounts expected to be paid over the term. Recognition of the costs of these leases on the income statement will be dependent upon their classification as either an operating or a financing lease. Costs of an operating lease will continue to be recognized as a single operating expense on a straight-line basis over the lease term. Costs for a financing lease will be disaggregated and recognized as both an operating expense (for the amortization of the right-of-use asset) and interest expense (for interest on the lease liability). For nonpublic companies, ASU 2016-02 is effective for reporting periods after December 15, 2019. We do not expect the adoption of ASU 2016-02 to have a significant effect on the Exchange's financial statements.

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments – Credit Losses (ASC Topic 326): Measurement of Credit Losses on Financial Instruments*. This guidance will require Companies to recognize an allowance for credit losses on available-for-sale debt securities rather than the current approach of recording a reduction to the carrying value of the asset. The ASU is effective for fiscal years beginning after December 15, 2020 and interim periods therein. Early adoption is permitted for annual periods beginning after December 15, 2018 and interim periods therein. The Company is currently evaluating the effects of this ASU on its financial statements.

Army and Air Force Exchange Service

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

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

In August 2018, the FASB issued ASU 2018-13, *Fair Value Measurement (ASC Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement*. This ASU eliminates, modifies and adds disclosure requirements for fair value measurements. The amendments in this ASU are effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2019, with early adoption permitted. The Company is currently evaluating the effects of this ASU on its financial statements.

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

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

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in Thousands, Unless Otherwise Noted)

2. Fair Value Measurements (continued)

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.

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.

Army and Air Force Exchange Service

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

2. Fair Value Measurements (continued)

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 2, 2019 and February 3, 2018:

	Fair Value as of February 2, 2019			
	Total	Level 1	Level 2	Level 3
Assets:				
Collective investment funds ⁽¹⁾	\$ —	\$ —	\$ —	\$ —
Due from broker	—	—	—	—
Short-term investments	9,991	9,991	—	—
Assets at fair value	9,991	\$ 9,991	\$ —	\$ —
Investments measured at net asset value:				
Collective investment funds ⁽¹⁾	19,711			
Total assets	\$ 29,702			
Liabilities:				
Foreign currency derivatives	\$ 228	\$ 228	\$ —	\$ —
Total liabilities	\$ 228	\$ 228	\$ —	\$ —
Fair Value as of February 3, 2018				
	Total	Level 1	Level 2	Level 3
Assets:				
Collective investment funds ⁽¹⁾	\$ —	\$ —	\$ —	\$ —
Due from broker	—	—	—	—
Short-term investments	10,891	10,891	—	—
Assets at fair value	10,891	\$ 10,891	\$ —	\$ —
Investments measured at net asset value:				
Collective investment funds ⁽¹⁾	19,895			
Total assets	\$ 30,786			
Liabilities:				
Foreign currency derivatives	\$ (1,271)	\$ (1,271)	\$ —	\$ —
Total liabilities	\$ (1,271)	\$ (1,271)	\$ —	\$ —

⁽¹⁾Holdings consist of a Black Rock equity fund (approximately 40% of the total in fiscal year 2018 and 42% in fiscal year 2017), which is passive in nature and employs a strategy to closely follow the S&P 500 index, and a BlackRock U.S. Debt Index fund (approximately 60% of the total in fiscal year 2018 and 58% in fiscal year 2017), 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.

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in Thousands, Unless Otherwise Noted)

2. Fair Value Measurements (continued)

The Exchange holds investments related to the Supplemental Plan totaling \$19,711 and \$19,895 at February 2, 2019 and February 3, 2018, 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 \$312 and \$1,854 in fiscal years 2018 and 2017, respectively. The cost of securities sold is determined primarily on a specific identification method. (Refer to Note 6 for further discussion of the Supplemental Plan, and refer to Note 4 for further discussion of the Exchange's derivative positions.)

3. Indebtedness

Committed Lines of Credit

The Exchange maintains two committed lines of credit aggregating to \$1,500,000. The first is an unsecured revolving line of credit that is facilitated by a 10-bank syndicate led by Wells Fargo Bank, N.A. aggregating to \$1,000,000 that was entered into on June 15, 2018, and expires on June 15, 2021. As of February 2, 2019, there is a zero balance outstanding and there were no borrowings under this line of credit during fiscal year 2018.

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 1.45% to 2.00% during fiscal year 2018 and 0.73% to 1.20% during fiscal year 2017. 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 2018, daily borrowings were generally due within 30 to 260 days. As of February 2, 2019, there was \$75,000 outstanding under the IMCOM G-9 line of credit, with all such borrowings currently scheduled to become due within fiscal year 2019. 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 2019 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 2, 2019, as they are not expected to require the use of current working capital during fiscal year 2019.

Army and Air Force Exchange Service

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

3. Indebtedness (continued)

Commercial Paper

In June 2013, the Exchange implemented a Commercial Paper (CP) program. The six dealers used during FY 2018 were Mitsubishi UFG, Wells Fargo, Williams Capital, SunTrust Bank, Citibank, and PNC. As of February 2, 2019 and February 3, 2018, the outstanding commercial paper obligations, inclusive of original issue discount, were \$376,000 and \$738,776, respectively. The CP program is an open-ended agreement; however, outstanding balances as of February 2, 2019, have maturity dates that range from 1 to 265 days. Borrowings under the commercial paper program had interest rates ranging from 1.37% to 2.50% during fiscal year 2018, and 0.63% to 1.48% during fiscal year 2017.

Senior Notes

In October 2009, the Exchange completed a private placement debt offering of \$90,000 in senior notes (the 2024 senior notes), which comprise a 15-year amortizing principal. As of February 2, 2019, the 2024 senior notes have a total remaining outstanding obligation of \$42,522.

Term Loans

The Exchange has a term loan agreement with Branch Banking & Trust in an aggregate amount of \$100,000 as of February 2, 2019. This term loan agreement matures and was paid on March 31, 2019, and bore interest at LIBOR plus 0.625%. A syndicated term loan of \$250,000 was entered into as part of the Wells Fargo syndication agreement on June 15, 2018. This term loan agreement matures June 15, 2021, and bears an interest rate of LIBOR plus 0.75%.

The average interest rate for all indebtedness, including lines of credit (both committed and uncommitted), commercial paper, senior notes and term loans was 2.86% for the year ended February 2, 2019.

Army and Air Force Exchange Service

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

3. Indebtedness (continued)

Debt obligations as of February 2, 2018 and February 3, 2017, consisted of the following:

	2018	2017
Outstanding debt principal balances:		
IMCOM G-9 committed line of credit	\$ 75,000	\$ 300,000
4.95% senior notes due 2024	42,522	48,760
Term Loan – Branch Banking & Trust	100,000	100,000
Term Loan – Wells Fargo	250,000	–
Commercial Paper – Wells Fargo	50,000	161,776
Commercial Paper – Mitsubishi UFG	–	390,000
Commercial Paper – Williams Capital	–	60,000
Commercial Paper – SunTrust Bank	–	127,000
Commercial Paper – Citibank	326,000	–
Total debt obligations	843,522	1,187,536
Current maturities	(482,555)	(745,014)
Total long-term debt obligations	<u>\$ 360,967</u>	<u>\$ 442,522</u>

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 2, 2019, the estimated fair value for the 2024 senior notes is \$45,068. Fair value is calculated using a discounted cash flow analysis (Level 2), with estimated interest rates offered for notes with similar terms and maturities.

Cash paid for interest for fiscal years 2018 and 2017, was approximately \$21,420 and \$16,730, respectively. The Exchange has complied with all financial and nonfinancial covenants per loan agreements as of February 2, 2019, and expects to comply through the period ending February 1, 2020.

Army and Air Force Exchange Service

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

3. Indebtedness (continued)

Principal maturities of debt obligations as of February 2, 2019, are as follows:

2019	\$	482,555
2020		6,887
2021		332,236
2022		7,602
2023		7,987
Thereafter		6,255
	\$	<u>843,522</u>

4. Derivative Financial Instruments

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

The Exchange has designated the forward and option collar foreign exchange contracts as cash flow hedges of its exposure to changes in its functional currency-equivalent cash flows on the associated payroll and foreign vendor obligations. Accordingly, the changes in the fair value of the Exchange's forward and option collar foreign exchange contracts are recorded 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.

Army and Air Force Exchange Service

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

4. Derivative Financial Instruments (continued)

As of February 2, 2019, the Exchange had various foreign exchange contracts (option collars) outstanding related to approximately \$72,915 (€64,500) of its forecasted payroll and inventory purchase liabilities. The notional value of outstanding option collar contracts was \$72,915 (€64,500). The net loss of \$228 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 \$228 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 \$1,451 in loss on foreign currency hedge transactions settled during fiscal year 2018, compared to \$3,368 in gains during fiscal year 2017.

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.

Balance Sheet Location	Derivative Instruments	
	Fair Value	
	February 2, 2019	February 3, 2018
Derivatives designated as hedging instruments		
Foreign currency exchange contracts	Accounts payable	\$ 57
	Accrued salaries, separation pay, and other employee benefits	\$ (953)
		171
Total derivatives designated as hedging instruments		\$ 228
		\$ (1,271)

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

Army and Air Force Exchange Service

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

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 \$1,956 and \$4,229 for the fiscal years ended February 2, 2019 and February 3, 2018, respectively. The following is a schedule, by fiscal year, of the future minimum rental payments required under all leases as of February 2, 2019:

2019	\$	1,184
2020		128
2021		122
2022		122
2023		122
Thereafter		2,882
	\$	<u>4,560</u>

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.

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

The Exchange also provides certain life insurance and other disability benefits for active employees. Benefits are paid from a Voluntary Employee Beneficiary Association (VEBA) trust maintained by the Exchange and to which the Exchange contributes each year. As of February 2, 2019, the Exchange recorded a liability of approximately \$9,360, which represents an estimated liability of \$28,657 less trust assets of \$38,017. 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.

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*. As the Exchange's fiscal year-end does not coincide with a month-end, the Exchange has elected to measure plan assets and benefit obligations using the month-end that is closest to the Exchange's fiscal year-end. The assets of the Supplemental Plan are not effectively restricted from being used by the Exchange for other purposes. Therefore, these assets do not qualify as plan assets as defined in ASC 715 and, as a result, are accounted for in accordance with ASC 320, *Investments – Debt and Equity Securities*.

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 2018 and 2017. Amounts are stated in millions.

	Pension Benefits				Other Benefits			
	The Basic Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2018	2017	2018	2017	2018	2017	2018	2017
Change in projected benefit obligations (PBO)								
PBO at prior measurement date	\$ 4,766	\$ 4,524	\$ 23	\$ 22	\$ 2,566	\$ 2,383	\$ 81	\$ 73
Service cost	102	93	1	1	25	25	2	2
Interest cost	186	196	1	1	88	105	2	2
Plan participants' contributions	4	4	—	—	—	—	—	—
Actuarial loss (gain)	(187)	243	(5)	—	(409)	160	(3)	1
Foreign exchange impact	—	—	—	—	—	—	(5)	8
Benefits paid	(275)	(273)	(1)	(1)	(98)	(99)	(2)	(2)
Administrative expenses paid	(21)	(21)	—	—	(8)	(8)	1	—
Other	—	—	—	—	—	—	—	(3)
PBO at current measurement date	4,575	4,766	19	23	2,164	2,566	76	81
Change in plan assets								
Fair value of assets at prior measurement date	4,441	4,184	—	—	1,828	1,665	60	44
Actual return on assets	—	547	—	—	(17)	232	—	5
Employer contributions	—	—	—	—	15	38	1	7
Plan participants' contributions	4	4	—	—	—	—	—	—
Benefits paid	(275)	(273)	—	—	(98)	(99)	(2)	(2)
Administrative expenses paid/ foreign exchange impact	(21)	(21)	—	—	(8)	(8)	(5)	6
Fair value of assets at current measurement date	4,149	4,441	—	—	1,720	1,828	54	60
Funded status at fiscal year end	\$ (426)	\$ (325)	\$ (19)	\$ (23)	\$ (444)	\$ (738)	\$ (22)	\$ (21)

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

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

The following table reflects amounts recognized in the balance sheets as of fiscal years 2018 and 2017. Amounts are stated in millions.

	Pension Benefits				Other Benefits			
	The Basic Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2018	2017	2018	2017	2018	2017	2018	2017
Amounts recognized in the balance sheets								
Other current liabilities	\$ -	\$ -	\$ -	\$ 1	\$ -	\$ 52	\$ 3	\$ 2
Accrued pension and other benefits liability	426	325	19	23	444	738	22	20
Accumulated other comprehensive loss	(1,259)	(1,192)	(1)	(6)	(455)	(740)	(15)	(16)

A summary of the components of net periodic benefit cost (income) for the benefit plans is as follows for fiscal years 2018 and 2017. Amounts are stated in millions.

	Pension Benefits				Other Benefits			
	The Basic Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2018	2017	2018	2017	2018	2017	2018	2017
Net periodic cost								
Service cost	\$ 102	\$ 93	\$ 1	\$ 1	\$ 25	\$ 25	\$ 2	\$ 2
Interest cost	186	196	1	1	88	105	2	2
Expected return on assets	(337)	(314)	-	-	(131)	(119)	(3)	(3)
Other adjustments	-	-	-	-	-	-	-	1
Net loss amortization	83	64	-	-	28	45	1	1
Net periodic benefit cost	\$ 34	\$ 39	\$ 2	\$ 2	\$ 10	\$ 56	\$ 2	\$ 3

Information for benefit plans with an accumulated benefit obligation in excess of plan assets is as follows for fiscal years 2018 and 2017. Amounts are stated in millions.

	Pension Benefits				Other Benefits			
	The Basic Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2018	2017	2018	2017	2018	2017	2018	2017
Projected benefit obligation	\$ 4,575	\$ 4,766	\$ 19	\$ 23	\$ 2,164	\$ 2,566	\$ 76	\$ 81
Accumulated benefit obligation	4,312	4,470	8	8	2,164	2,566	68	75
Fair value of plan assets	4,149	4,441	-	-	1,719	1,828	54	60

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

Amounts included in accumulated other comprehensive loss for all plans at February 2, 2019, consist of net actuarial loss of \$1,730,094. Amortization of this amount expected to be recognized in fiscal year 2019 is \$85,940.

Actuarial Assumptions

Actuarial weighted average assumptions used in determining plan obligations and the related expense are as follows for fiscal years 2018 and 2017:

	Pension Benefits		Pension Benefits		Other Benefits	
	Basic Plan		Supplemental Plan		Postretirement	
	2018	2017	2018	2017	2018	2017
Assumptions used to determine expense and liabilities:						
Discount rate	3.96%	4.48%	3.96%	4.48%	3.98%	4.54%
Long-term rate of return on assets	8.08	7.61	-	-	8.24	7.83
Compensation increase rate	4.19	4.04	9.41	9.34	-	-
Assumptions used at disclosure:						
Discount rate	4.36	3.96	4.36	3.96	4.37	3.98
Compensation increase rate	4.19	4.04	9.60	9.54	-	-

Assumed Health Care Cost Trend Rates at Fiscal Year End

	2018	2017
Health care cost trend rate assumed for next year	6.25%	6.00%
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	2025	2025

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

	Other Benefits		Other Benefits	
	UK Plan		Local National Plan	
	2018	2017	2018	2017
Assumptions used to determine expense:				
Discount rate	2.50%	2.70%	0.86%	1.22%
Long-term rate of return on assets	6.20	6.50	—	—
Compensation increase rate	2.70	2.90	2.38	2.42
Assumptions used at disclosure:				
Discount rate	2.50	2.50	0.75	0.88
Compensation increase rate	2.80	2.70	2.38	2.42

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

Pension Plan Assets

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

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

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

The following table sets forth the target allocations of plan assets for the fiscal years 2018 and 2017:

	Pension Benefits		Other Benefits		Other Benefits	
	The Basic Plan		Postretirement Plan		UK Plan	
	2018	2017	2018	2017	2018	2017
Domestic equity securities	14%	14%	15%	15%	26%	26%
International equity securities	10	10	10	10	35	35
Emerging market equity securities	3	3	4	4	4	4
Low-vol global equity	9	9	10	10	—	—
Investment-grade fixed income	25	25	25	25	35	35
High-yield fixed income	4	4	—	—	—	—
Treasury inflation protected securities (TIPS)	3	3	3	3	—	—
Real estate – private	4	4	4	4	—	—
Real estate – public	1	1	1	1	—	—
Private equity	9	9	10	10	—	—
Commodities	3	3	3	3	—	—
Alternative debt	5	5	5	5	—	—
MLPs	5	5	5	5	—	—
Timber/Farmland	5	5	5	5	—	—
Total	100%	100%	100%	100%	100%	100%

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

The Exchange's benefit plan actual asset allocations at February 2, 2019 and February 3, 2018, by asset class category are as follows:

	Pension Benefits		Other Benefits		Other Benefits	
			Postretirement			
	The Basic Plan		Plan		UK Plan	
	2018	2017	2018	2017	2018	2017
Domestic equity securities	14%	13%	15%	15%	20%	20%
International equity securities	10	11	11	12	38	40
Emerging market equity securities	3	4	4	4	7	6
Low-vol global equity	9	9	10	10	—	—
Investment-grade fixed income	26	16	27	12	35	34
High-yield fixed income	4	10	—	10	—	—
TIPS	3	5	3	5	—	—
Real estate – private	5	7	4	6	—	—
Real estate – public	1	2	1	2	—	—
Private equity	10	8	10	8	—	—
Commodities	3	5	3	5	—	—
Alternate debt	4	2	4	3	—	—
MLPs	5	5	5	5	—	—
Timber/Farmland	3	3	3	3	—	—
Total	100%	100%	100%	100%	100%	100%

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

Equity securities are diversified across various industries and comprise common and preferred stocks of U.S. and international companies and equity positions in privately held companies controlled through limited partnerships. Common and preferred stocks are based on market quotations and are classified as Level 1 in the fair value hierarchy. The fair values of the investments in the collective investment funds represent the net asset values of the shares or units of such funds as determined by the issuer. Limited partnerships are valued based on net asset value as determined by the general partners and represent the plans' proportionate share of the estimated

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

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

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

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

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

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

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

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

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

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:

	Benefit Plans			
	Total	Level 1	Level 2	Level 3
Assets				
Temporary investments ^(a)	\$ (11)	\$ (11)	\$ —	\$ —
Equity securities:				
Common and preferred stock ^(b)	841,653	841,653	—	—
Foreign obligations ^(c)	22,863	22,863	—	—
Debt securities:				
Common and preferred stock ^(b)	1,765	1,765	—	—
Corporate bonds ^(d)	635,985	—	635,985	—
U.S. government obligations ^(e)	329,898	329,898	—	—
Asset-backed securities ^(f)	1,263	—	1,263	—
Real estate and commodities:				
Common and preferred stock ^(b)	408,759	408,759	—	—
Other investments	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 ^(g)	1,634,221			
Debt securities ^(h)	858,308			
Real estate and commodities ⁽ⁱ⁾	853,203			
Short-term investment funds ⁽ⁱ⁾	81,414			
Limited partnerships:				
Equity securities ^(k)	431,211			
Debt securities ^(k)	162,679			
Real estate and commodities ^(k)	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 ^(l)	8,998			
Total assets	<u><u>\$ 6,328,111</u></u>			

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

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

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

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.

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

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.

(d) 2018: Includes 80% and 20% of investments in corporate high-yield debt with S&P rating of B- and below as of February 2, 2019. The remaining investments are in investment-grade corporate bonds.

2017: Includes 59% and 60% of investments in corporate high-yield debt with S&P rating of B- and below as of February 3, 2019. The remaining investments are in investment-grade corporate bonds.

(e) Includes fixed-income treasury securities backed by the full faith and credit of the U.S. government. There are no significant foreign currency risks within this segment.

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

(g) 2018: 73% of holdings consist of BlackRock index funds, which are passive in nature and employ a strategy of investing in securities that provide beta (market) exposure to a specific index, including the S&P 500 and MSCI EAFE. The remaining 27% consists of international, small cap, and low volatility investments in the form of mutual funds. The collective investment funds consist of Domestic (60%) and International (40%). Investments have a required notice of three days for any sales or liquidation. The fund's management may impose restrictions on cash redemptions in the

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

fund outside the normal course of business. Distributions may be made in cash or in kind or partly in cash or partly in kind at the sole discretion of the fund's trustee. There are no restrictions on withdrawals.

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.

- ^(h) 2018: 94% of the holdings consist of two core fixed income index funds, which both employ a strategy that seeks to match the performance of the Barclays Long Credit Index, and a Loomis Sayles high yield fund (6%), which employs a strategy that seeks to match the performance of the CS High Yield Index. Issuances and redemptions are made on each business day. Distributions may be made in cash or in kind or partly in cash or partly in kind at the sole discretion of the fund's trustee. The BlackRock funds have a required notice of three days for any sales or liquidation.

2017: 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⁾ 2018: Investments include both commodities and real estate, which provide diversified returns relative to stocks and bonds. The underlying commodity investments are actively traded futures, which have full pricing transparency and daily liquidity and are reported at net asset value. Real estate holdings include direct real estate investments in properties that are valued by appraisal and reported as Level 3. The investments are diversified by core 38% and value-added or opportunistic 12% investments. Commodity investments include farmland and timber, which represent 50% of the allocation. There is quarterly redemption available for the real estate investments with a 60-day notice.

Army and Air Force Exchange Service

Notes to Financial Statements (continued)

(Dollars in Thousands, Unless Otherwise Noted)

6. Benefit Plans (continued)

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.

- (i) The State Street Bank and Trust Company Short Term Investment Fund employs a strategy to provide safety of principal, daily liquidity, and a competitive yield by investing in high-quality money market instruments. Issuances and redemptions are made on each business day. The fund's management may impose restrictions on cash redemptions in the fund outside the normal course of business. Distributions may be made in cash or in kind or partly in cash or partly in kind at the discretion of the fund's trustee.
- (k) Includes limited partnerships that invest primarily in U.S. 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.

Employer Contributions

The Exchange does not expect to contribute to the other postretirement benefit plans in fiscal year 2019.

Army and Air Force Exchange Service

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

6. Benefit Plans (continued)

Estimated Future Benefit Payments

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

Fiscal Years	Basic Plan	Supplemental Plan	Postretirement	Foreign Plans
2019	\$ 256,272	\$ 456	\$ 109,050	\$ 4,508
2020	260,488	461	113,145	3,486
2021	264,500	467	116,714	3,833
2022	268,000	473	119,819	3,855
2023	271,524	480	123,010	4,020
2024–2028	1,396,095	2,766	638,288	19,840

7. Dividends

The Exchange is required, under various agreements, to distribute a portion of each year's net earnings before performance bonuses in the form of dividend payments to the Central Welfare Funds, Departments of the Army, the Air Force, the Navy, and the Marine Corps. If earnings exceed the financial plan, the Exchange will retain the first 15% of the excess earnings and the remainder will be distributed in the form of dividend payments.

Under the current dividend policy, noncash pension and employee benefit plan expenses are excluded from net earnings subject to dividends. Any other exclusion, such as employee bonuses, used in the calculation of net earnings subject to dividends must be approved by the Board of Directors.

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

Army and Air Force Exchange Service

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

8. Commitments and Contingencies

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

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

The Exchange's presence in Iraq, Qatar, Afghanistan, and Kuwait was supported by 49 stores as of February 2, 2019, and 46 stores as of February 3, 2018. Approximately \$212,425 (3.0%) and \$197,667 (3.0%) of the Exchange's net revenues in the fiscal years 2018 and 2017, respectively, were derived from sales to U.S. troops stationed in the Middle East, including Operation Freedom's Sentinel (OFS) and Operation Inherent Resolve (OIR). The increase in revenue for fiscal year 2018 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 \$39,503 at February 2, 2019, and \$27,551 at February 3, 2018. It is difficult to estimate the potential inventory that may be forfeited if the United States must quickly exit a country. Any related loss on inventory would adversely affect the Exchange's results; however, such losses are eligible for reimbursement appropriations that are reasonably assured of collection.

10. Subsequent Events

The Exchange has evaluated subsequent events through May 22, 2019, the date at which the financial statements were available to be issued.

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2018 BY THE NUMBERS



\$8.7B

FY 2018 REVENUE

\$386M

FY 2018 EARNINGS

\$223M

FY 2018 DIVIDENDS

85%

ASSOCIATES CONNECTED
TO MILITARY

1,400

WOUNDED WARRIORS
HIRED SINCE 2010

4,768

ASSOCIATES DEPLOYED TO
COMBAT ZONES SINCE 9/11

1,358

VETERANS HIRED

11,799

VETERANS/SPOUSES
EMPLOYED

7 PLANTS

PROVIDING BAKED GOODS/
WATER OVERSEAS

2.5M

SCHOOL LUNCHES SERVED
AT OR BELOW COST

9.9M

BAKERY ITEM PRODUCED
OVERSEAS

1.1M

COMBAT UNIFORMS
OUTFITTED AT COST

107.5M

MEALS SERVED AT
EXCHANGE RESTAURANTS

8.1M

HAIRCUTS PROVIDED

4.2M

GALLONS OF BOTTLED
WATER OVERSEAS