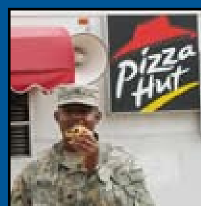
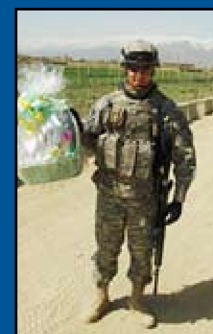
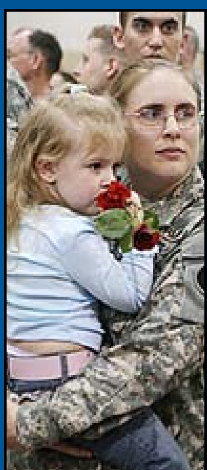
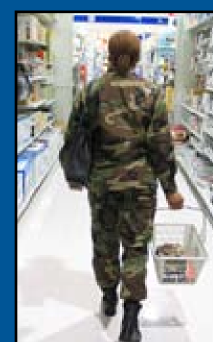
Army & Air Force Exchange Service

Annual Report 2008





AAFES
We go where you go!

The AAFES Story:

For 114 years,

'serving the best customers

in the world'

The AAFES Story

For 114 years, AAFES has provided Soldiers, Airmen, National Guard members, Reservists, Families and retirees throughout the world with exceptional services and brand-name goods at competitive prices.

The AAFES Story: Table of Contents

Commander's Column

The AAFES Story: strategic goals, right-sized inventories, profitable sales, supply-chain efficiency

We remain a financially stable, global multi-channel retailer serving 12.2 million active-duty, Reserve, National Guard, Family members and retirees in 30+ countries, five U.S. territories and 50 states.

AAFES Factoid

AAFES is a military command with a retail mission carried out by 43,000+ military and civilian associates and managers. A Board of Directors comprised of civilians and senior Army and Air Force military leaders oversees operations.

The AAFES Story

AAFES is clearly operating in challenging times in which the national economy's dramatic downturn devastated the retail landscape and resulted in decreased sales and sinking consumer confidence.

In this annual report, however, you'll read how our remarkable reputation, excellent credit rating, and deliberate actions by our 43,000+ forward-thinking associates buoyed AAFES during this economic storm. We accomplished these goals by:

- Increasing total sales to nearly $10 billion—about three percent higher than the previous year.
- Achieving earnings of $376 million.
- Providing dividends of $264.5 million to Morale, Welfare and Recreation programs for the troops.
- Delivering more than $150 million in supply-chain productivity.
- Expanding our award-winning Web site, www.aafes.com, to more than 18 million items.
- Managing a $1.2 billion, five-year program to build unique shopping destinations and address the Department of Defense's military transformation initiatives. From 2005 to 2008, we completed 50 projects valued at $442 million, and 10 projects at $173 million are now under construction.
- Improving customer and associate satisfaction scores by 200 and 400 basis points respectively.
- Receiving local and national accolades for our groundbreaking employee and supplier diversity, restaurant operations, and sales *(**See Pages** 11 and 13)*.
- Completing implementation of Oracle Retail, the sophisticated technology that provides us with industry-best allocation, forecasting, merchandising, pricing, purchasing, replenishment and inventory management practices.
- Introducing 36 new items under the 593-product Exchange Select exclusive brand to help budget-conscious shoppers save 20 to 50 percent on goods comparable in quality to national brands.
- Increasing the percentage of Energy-Star appliances to nearly 35 percent of our total stock of appliances and enacting other sustainability measures (***See Page*** 7).
- Creating an integrated business model—Operation Be Fit—to promote health and wellness solutions for customers and associates that will transform outcomes and reduce healthcare costs.
- Continuing to provide expeditionary and mission support capabilities to our troops at home and abroad.

As you can see, we remain a financially stable, global multi-channel retailer that serves 12.2 million active-duty, Reserve, National Guard, Family members, and retirees in 30-plus countries, five U.S. territories and 50 states. In 2008, we operated more than 3,100 facilities; 1,765 name-brand restaurants like Burger King, Starbucks, Subway and Taco Bell; and more than 5,100 concessions. We continue providing a "taste of home" to America's

See "Commander's Column," Page 14

The AAFES Story

2008: A year of many ‘firsts’

Historic collaborations give customers even greater selections for every room of their homes

The products are inspired by Martha’s favorite things, mixing the best of the past with innovative styling and modern sensibility.

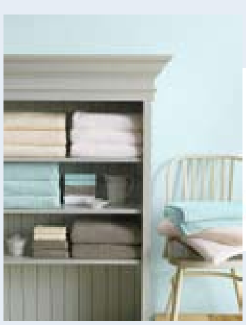
We give our valued shoppers plenty of reasons to make us their “first choice,” whether they walk through the doors of our worldwide brick-and-mortar exchanges or visit our award-winning Web site, www.aafes.com.

In 2008, AAFES, America’s 41st largest retailer, scored several “firsts” in product deals for Soldiers, Airmen, National Guard members, Reservists, Family members and military retirees, and they have carried over to this year, “The Year of the Customer.”

AAFES sales and marketing experts entered into a historic partnership with Martha Stewart, above, to offer her exclusive product lines throughout the world.

Bassett, Simply Perfect

In 2008, AAFES became the first retailer that furniture giant Bassett allowed to use its name for our private-label Simply Perfect as part of a global strategy to provide greater value on furniture, home décor, dinnerware and linens. Thanks to Vice President Ana Middleton’s Hardlines team, Simply Perfect sales hit nearly $29 million, 39 percent higher than in 2007.



MARTHA STEWART
MARTHA STEWART COLLECTION

In 2008, the Sales Directorate’s Hardlines team entered into historic partnerships to offer Macy’s selection of Martha Stewart products in 59 of our stores around the world. In just November and December, sales of Martha Stewart Collection bed and bath textiles, housewares, dinnerware, glassware, cookware, home décor and gifts hit $1.3 million.

“The products are inspired by Martha’s favorite things, mixing the best of the past with innovative styling and modern sensibility,” Ana says. “The products are the most authentic expressions of the Martha brand.”

Power in the PowerZones

Additionally, Ana’s team boosted the number of Apple-authorized dealers from 25 stores to 69, resulting in sales of $31 million, up from $16 million the previous year.

What’s more, 23 PowerZone electronics departments underwent strategic, “consumer friendly” redesigning and rebranding, as well as product repositioning to increase add-on sales. High-tech signs now entice shoppers to visit the “endless aisles” of electronic gadgetry on www.aafes.com. Collaborations with valued vendors Sony, Samsung, Panasonic, JVC and Hewlett-Packard on interactive, informative and solutions-based displays created “WOW factors” in the minds of customers.

The initiatives hiked sales by $3 million for the last three months of 2008.

Softlines’ major wins

Ana’s team also expanded our successful “electronic roadshows” to place name-brand electronics in smaller stores that don’t normally carry the breadth of assortments found in larger exchanges.

Meanwhile, our Softlines division, headed by Vice President Alicia Scott, scored major wins in 2008, including more than $23 million in revenue from the sale of Coach handbags and accessories and $16 million in sales of Under Armour athletic wear.

This year, Softlines rolled out nine more Coach Concept shops, which will grow sales for the exclusive brand to more than

See “Coach, Macy’s links,” Page 15

Going where they go

Associates leave safety of own homes to serve troops in hurricane recovery efforts

The AAFES Story

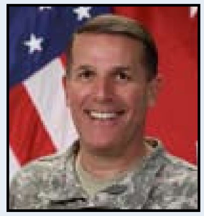
"We're here and ready to assist in the rebuilding process with a full assortment of generators, chain saws and lots and lots of bug spray. Whatever is needed, we're going to do everything we can to get the resources needed to complete the difficult task of getting this community back on its feet."

—Theresa Palu, store manager, Camp Mabry

Throughout our 114-year history, our associates have voluntarily left their Families and comforts of home to deploy around the world to serve America's Fighting Heroes. We take seriously our motto, "We Go Where You Go"—and that also means deploying into the face of forest fires and natural disasters.

In September 2008, Hurricane Ike, the third most destructive hurricane to ever make landfall in the United States, slammed into the Texas Gulf Coast, bringing Houston—the country's fifth largest city—to a standstill and destroying much of Galveston Island.

From one of our mobile field exchanges for at least two weeks, associates from our San Antonio exchanges served 7,000 National Guard members helping communities recover from Ike's wrath.



Authorized shoppers looking for emergency products file in and out of the AAFES mobile field exchange.

To grasp the enormity of the mission, consider AAFES Commander Maj. Gen. Keith Thurgood's column from the *Exchange Post*, the company's global internal print and online magazine:

When Hurricane Ike hit the Texas Gulf Coast, millions of people were evacuated to safer places further inland. A few days later, many of them, especially in Galveston, returned to their homes, only to find piles of rubble and memories.

To help the cities, towns and people recover and get back to normal, 7,500 National Guard members and other troops deployed to the Houston area. Associates from Texas exchanges jumped into action the day after the hurricane to set up and operate a 53-foot mobile field exchange at Ellington Field in Houston.

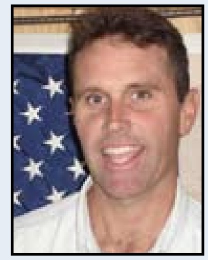
From Houston to Galveston

The trailer, stocked with merchandise from the Ellington exchange, opened to support local troops, members of the Air, Army and Texas National Guards, Marine and Navy Reserves, and the Coast Guard,

See "Hurricane Ike," Page 16

"All we want to do is make life a little more comfortable for those working to bring life back to normal for the residents here."

—John Burk, team leader



Dedicated associates from our Texas exchanges left the safety and comfort of their homes and families to staff serve troops helping with Hurricane Ike relief efforts.

The AAFES Story by the Numbers

3,100+ — Number of retail outlets at Army and Air Force installations across the world in 50 U.S. states, more than 30 countries and five U.S. territories.

12.2 million — Number of active-duty troops, Reserves, National Guard members, retirees and Family members served by AAFES.

43,000+ — The number of AAFES associates around the world, including nearly 11,000 spouses and children of Soldiers and Airmen.

90 and **224** — The number of AAFES exchanges and restaurants in Iraq, Afghanistan and throughout the Middle East.

72— Number of AAFES phone centers in the Middle East and the Balkans for troops to call home.

2,065 — Number of restaurants operated by AAFES throughout the world.

430+ — Number of AAFES associates deployed to the Middle East and other places throughout the world.

4,500+ — Number of AAFES associates who have deployed since the start of the war on terror.

$2.4 billion+ — Estimated total dividends contributed by AAFES to military Morale, Welfare and Recreation programs during the past 10 years.

Honoring our fighting heroes with a cookout at Camp Stryker, Iraq

Service members in Afghanistan

$264.5 million — The dividend for 2008.

20,926 and **$1.6 million** — Number and amount of phone cards bought in 2008 for the "Help our Troops Call Home" program.

2,700 and **$6.4 billion** — The number of "vendor partners," many with household names, and their annual sales with AAFES.

18 million — Number of items offered on AAFES' Web site, www.aafes.com.

20 percent — The average savings a customer receives at AAFES compared to the competition, not counting the no sales tax benefit!

4 million — The number of meals served to children each year by AAFES at 90 Department of Defense schools in nine countries on a break-even basis.

$1.2 billion — The total investment of new construction for AAFES shopping centers over the past five years around the world.

500+ — Number of items in the "Click to Brick" program, where shoppers who prefer the ease and comfort of Internet shopping can have their products delivered to nearby exchanges in the U.S. for pickup, thus saving shipping costs.

AAFES to 12.2 million shoppers: 'We have value for you!'

'The best customers in the world' is the reason we exist

The AAFES Story

In these perilous economic times when shoppers are looking to stretch their dollars and customers are coming back to the exchanges, we are seizing the opportunity to say, "Welcome! We have value for you!"

We have christened 2009 as the "Year of the Customer" as our associates focus on providing the best service and best deals possible.

Many of them already are like Pam Thompson, one of our jewelry buyers. Customers compliment her continuously for how she cares for them, including a woman who told us that thanks to Pam's service, she purchased an expensive and beautiful ring from AAFES and hasn't taken it off since. Pam went above and beyond to ensure the ring got to the customer and was exactly what she wanted—that is the foundation of the "Year of the Customer."

A different customer

When we think about these customers, Mat Dromey, our chief marketing officer, says that we face a very different shopper today than several years ago. Today, the typical customer is no longer the 20-year, career-oriented military member whose use of our services was a daily part of military life. Our challenge is to educate today's customers about who we are, what we do and how important AAFES is to their installations.

We already are reaching out to them. In a marketing tabloid aimed at the critical demographic, 18- to 24-year-old male Soldiers and Airmen, Mat's team promoted our low prices and no-tax value on our wide selection of electronics, such as Wii video-game systems.

In 2009, through our "Rediscover the Value of AAFES" program, we will boost our visibility across all demographic segments in the military community to communicate our value. For instance, our customers are "shareholders" who invest in AAFES by buying our products and services. In turn, AAFES sends 60 percent of its profits as "dividends" to the troops for Morale, Welfare and Recreation programs.

We also differentiate ourselves from the pack by being the world's only retailer to serve our Warriors fighting the Global War on Terror.

Outstanding work, smiles

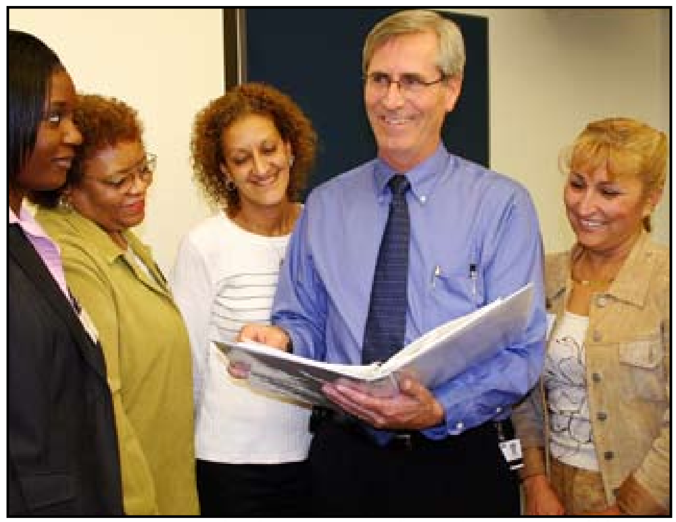
Late last year, I returned from Kuwait, Afghanistan and Qatar, where our volunteer associates, with smiles on their faces, provided products and services that vastly improved the quality of life for our fighting heroes. Truly, I couldn't be more proud of them.

A global organization

Being a global organization with a unique mission to "go where you go," AAFES is positioned to live up to those words, whether the troops are fighting our enemies in the Middle East, forest fires in the United States or building medical clinics in Peru.

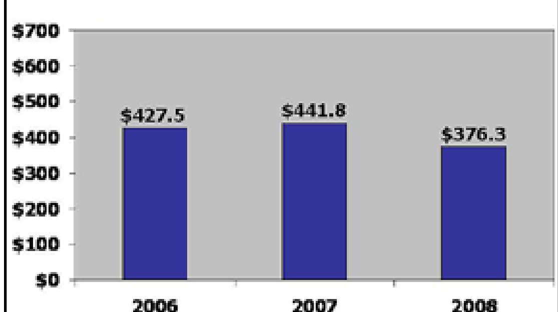
"The best customers in the world" is the reason we exist. With determination and hard work from our 43,000+ associates, our customers will continue to view AAFES as their "first choice" for exceptional service, low prices and great merchandise.

Today, the typical customer is no longer the 20-year, career-oriented military member whose use of our services was a daily part of military life.



Chief Operating Officer

Earnings, 2006-2008



All audited figures in millions.

The AAFES Story

Hunter Cole and John Englehart are directing the most expensive tech project in AAFES' 114-year history.

For every dollar we save in this integrated network of suppliers, buyers, distribution centers and stores, our "dividends" climb proportionately for Morale, Welfare and Recreation programs for America's fighting heroes and their Families—one of the major reasons we're here.

A $22 million warehouse management system is giving AAFES logistics experts access to the industry's best practices at our distribution centers around the world.

Leveraging Technology

Investing millions to get the right products to the right people at the right places

Although we've served America's fighting heroes for 114 years, our forward-looking managers and associates keenly anticipate future challenges and create solutions so we continue getting the right products to the right places at the right times.

We have invested millions of dollars in sophisticated technologies to streamline our sales, logistics and procurement divisions so we can slash operating costs, enhance productivity and get any kinks out of our supply chains.

For every dollar we save in this integrated network of suppliers, buyers, distribution centers and stores, our "dividends" climb proportionately for Morale, Welfare and Recreation programs for America's fighting heroes and their Families—one of the major reasons we're here in the first place.

Costliest project to date

In February 2008, we completed the costliest technology project—the $177 million Oracle Retail system to gain the retail industry's best allocation, forecasting, merchandising, pricing, purchasing, replenishment and inventory management practices. This technology could boost AAFES earnings by $84.6 million by 2012 through increased sales, improved profit margins, reduced inventories and lower operating costs.

Toys "R" Us, Walgreens, Office Depot, Nordstrom, Pier 1 Imports, Barnes & Noble, Borders, Radio Shack, Wal-Mart, and 15 of the top 16 food and drug retailers also use Oracle Retail.

Under guidance from Vice President Hunter Cole and Strategic Business Architect John Englehart, "retail master trainers" in 2008 began training all sales associates on how to use the technology.

As a result, we enhanced our ability to establish data-driven pricing strategies and manage promotions and clearance pricing programs more efficiently. During the next two years, we will improve replenishment processes so that our Sales Directorate can create critical seasonal and fashion allocation plans targeted for the right stores with the right inventory levels of top-selling products and sizes.

A warehouse 'symphony'

But Oracle Retail is just one piece of the tech strategy that will help us serve our valued customers well into the future. A $22 million warehouse management system, which is scheduled for 2009 at our Waco (Texas) Distribution Center, gives logistics experts access to their industry's best practices.

Once the system from RedPrairie of Waukesha, Wisc., hits the rest of AAFES' distribution centers around the world by mid-2011, we will gain greater inventory control over nearly 5 million square feet of warehouse space and save more than $13 million a year, said George Carpenter, the project's director.

"We can see it, ship it, process it and put it away in the most efficient way possible," he says. "We're in control over what's coming in the door and what are we going to do with it."

Like a conductor leading a symphony, RedPrairie's technology orchestrates all movement of goods and people throughout the distribution centers by essentially thinking of the best placement and routes for everyone and everything. The system tracks our tractor-trailer trucks from the moment they arrive to the time they leave.

See "Leveraging," next page

Sustainability

We have environmental change 'in the bag'

The AAFES Story

Sustainability—forms of progress that meet the needs of the present without compromising the ability of future generations to meet their needs.

- World Commission on Environment and Development

Cleaning up the environment begins at home, and "home" for us are the military communities where our valued customers live, serve and shop.

As we seek to make the "homes" we share better places to live, we incorporated sustainability as one of five AAFES corporate strategies for winning the future and reducing our carbon footprint.

With 3,100+ facilities around the world, our impact on the environment cannot be overstated.

Our Energy Management Team, headed by Ann Scott, has launched many initiatives during the past two years to reduce energy, water, waste and fossil fuels, while we construct earth-friendly buildings and buy and sell environmentally-friendly goods and services that our customers desire.

For example, in June 2008, we introduced throughout the world reusable bags made of non-woven polypropylene mesh and capable of carrying up to 35 pounds. In 2008, shoppers bought more than 83,000 bags.

To help our customers throughout the world slash their utility bills, we sold both online and in our stores 63 different Energy Star products, including washing machines, refrigerators, DVD players and other items.

See "Sustainability," next page

Shoppers bought more than 83,000 of our earth-friendly bags in 2008.

Leveraging technology: becoming the best retailer we can be

Continued from previous page

We also will gain access to the top procurement processes through "Operation Blowtorch," which kicked off in March 2008. Once completed by more than 100 procurement and IT specialists, Blowtorch will transform nearly every aspect of AAFES business, even the plastic bags in all of our stores. Oracle once again enters the picture, this time with its E-Business Suite, which Virgil DeArmond, our director of corporate procurement, says will adeptly address problems and give customers greater control and visibility over tracking their items.

At AAFES, we believe that leveraging technology drives results, creates sustainable business platforms and allows the company to be the best retailer it can be. *Retailing Today's* "2008 Annual Top 150 Annual Industry Report" wrote this about our efforts:

"AAFES has been around a long time, but the past few years have seen the organization digest a massive amount of change en route to becoming a more modern and efficient retailer. The changes are largely enabled by investments in technology. However, the organization's philosophy about how to manage its business also has evolved in a way that puts it on an equal footing with best-in-class retailers against whom it competes. As investments were made in merchandising systems that centralized product assortment decisions, it freed up store managers who are now better able to manage their stores."

We couldn't have said it better.

AAFES Factoid

In 2008, thanks to Dallas technology giant Texas Instruments, the film industry and AAFES, more than 200 troops at Camp Arifjan in Kuwait became the world's first group to screen Will Smith's summer blockbuster movie, "Hancock," in a digital cinema projector format.

The high-tech projector provided the Soldiers and Airmen with the highest quality image free of the normal wear that takes place with normal projectors.

AAFES' philosophy "about how to manage its business has evolved in a way that puts it on an equal footing with best-in-class retailers against whom it competes."

—Retailing Today

The AAFES Story

Sustainability: a major key to winning the future

Continued from previous page

'Sustainability' is not a corporate buzzword—it's a responsibility. —Ann Scott, AAFES corporate energy program manager

In 2008, nearly 35 percent of our appliances were Energy-Star rated—and we're aiming for 50 percent this year.

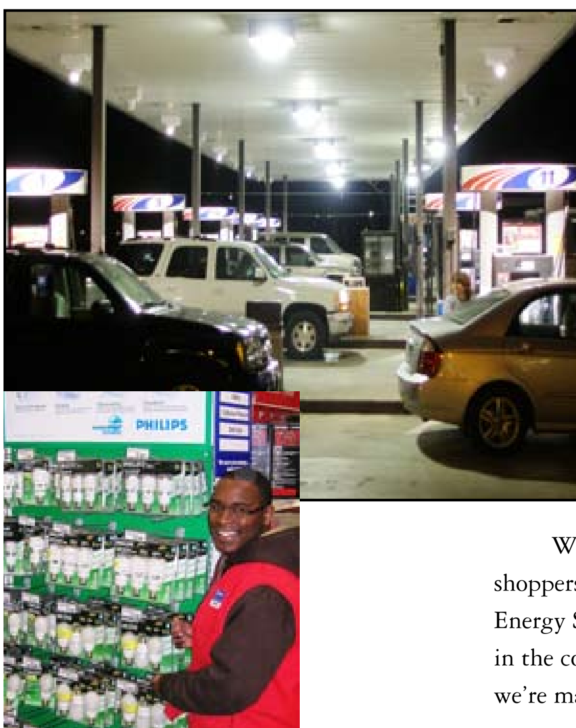
Sales of energy-efficient CFL light bulbs in our exchanges shot up by 290 percent in 2008, compared to the previous year.

Worldwide marketing tabloids promote sustainable products, such as bamboo coffee filters and rugs made from recycled plastic bottles. We spread the sustainability ethic through board games like "EarthOpoly," where players are the Earth's stewards.

Sustainability at the gas pumps

When customers fill up their vehicles at our gas stations, energy-efficient light-emitting diodes (LEDs) illuminate the pumps. Those small solid-state lamps are 75 percent more energy efficient and will provide paybacks in about five years.

At Fort Polk, La., for instance, just changing to LEDs in the canopies over the gas pumps reduced the annual kilowatt hours from nearly 39,000 to 5,000 saving nearly $4,100. At Fort Hood, Texas, wattage dropped by 77 percent after "intelligent lighting systems" were installed.



Motorists are filling up at our many gas stations illuminated by energy-efficient canopy lights, while CFL light bulbs are hot sellers in our stores throughout the world.

What's more, thirsty or hungry shoppers can slip coins into nearly 2,100 Energy Star-compliant vending machines in the continental United States—and we're making more of our 17,107 machines energy-efficient.

When our customers dine in more than 2,000 of our brand-name restaurants, they probably won't realize that their delicious meals are made with energy-efficient equipment. In 2008, we teamed up with brand partners Burger King, Subway and Taco Bell to install on-demand heating and air-conditioning systems; digital signs; heat reduction and holding equipment; more than 200 Energy Star reach-in refrigerators, dishwashers, steamers, fryers and ice machines; and walk-in coolers.

The expected savings from the restaurant initiatives will only add to our bottom line and enable us to devote hundreds of thousands of dollars more in dividends to Morale, Welfare and Recreation programs for service members. For example, flexible batch broilers in all of our Burger King restaurants are expected to yield more than $924,000 in savings by the end of 2010.

Shoppers will even notice the "green wave" washing over our award-winning Web site, www.aafes.com, which we call "the largest BX/PX in the world." In 2008, MilitaryRecycling.com, through the AAFES site, began paying shoppers for recycling electronics, cell phones and computers.

And that's something that excites our merchandise manager at the time, Don Walker: "They just log on and get rewarded for their stuff."

Earth-friendly buildings

But we're not stopping with our products and restaurant equipment. Our new "lifestyle centers" and other new facilities will be energy-efficient and built according to the latest earth-friendly standards.

Ann's team also uses a Web-based program they designed to track and compare utility costs in all AAFES buildings, which helped us reduce utility costs by $5.9 million in 2008, compared with 2007.

Our sustainability initiatives aren't to be taken lightly. At AAFES, like Ann says, 'sustainability' is not a corporate buzzword, it's a corporate responsibility that we take very seriously so we can win the future.

Changing our thinking, not our oil

Something no bigger than two coffee cans slashes a truck's oil changes from six to one a year

The AAFES Story

Our own Rose Marie Brady knows every inch and what's under the hoods of nearly 400 trucks that traverse America's highways delivering our products to exchanges. As chief of Fleet Operations, her quest in 2008 to keep the trucks running as smoothly as Swiss watches and cut maintenance costs hit the jackpot—and it took something no bigger than two coffee cans.

Starting in April 2008, Rose Marie's team in the Logistics Directorate installed sophisticated oil purification systems on 294 of our nearly 400 trucks, and discovered the devices dropped the number of required oil changes from six a year per truck to only one. Now, mechanics change the oil in the 18-wheelers after 150,000 miles, rather than 15,000.

Two-year payback

Although the systems cost $176,000 to install, we expect to save 17,640 gallons of oil a year—70 gallons per truck—and $882,000 in oil and maintenance costs over two years, which will recoup our investment. Eventually, Rose Marie's mechanics will install the devices on new trucks we buy to replace old ones.

Oil Purification Systems of Shelton, Conn., developed the on-board refining technology to meet a growing demand among trucking, busing, construction, mining and other companies with large fleets to cut costs and create more environmentally-friendly operations. OPS-1 removes solid and liquid contaminants from engine oil, which allows users to reduce oil consumption dramatically, cut maintenance costs by 80 percent and extend equipment life, says Mark Genereaux, a company vice president.

The company has installed more than 6,000 refining units since 2002. Most OPS clients pay for their investments within six months. North America's largest independent fuel delivery carrier now runs its trucks 120,000 miles between oil changes and slashed its maintenance costs by 60 percent, or $480 a truck each year.

More bio-diesel fuel

To Rose Marie, in this age of cost cutting, installing the systems on AAFES' trucks was a no-brainer. "Like Oil Purification Systems says, when it comes to vehicle maintenance, we are changing our thinking, not our oil," she says.

"The system has proven to save money, which is critical in these economic times. However, the effect on our environment would be the most visible accomplishment."

She and other AAFES logistics experts also are using 15 percent more earth-friendly bio-diesel fuel in 2008 than in the previous year; installing auxiliary power units on trucks so drivers can operate TVs, coffee makers and other devices while their rigs are off; and using inflation devices that maintain proper tire pressure at all times.

Within two years, the majority of our 400 trucks will roll down America's highways for 150,000 miles between oil changes.

"We expect to save 17,640 gallons of oil a year—70 gallons per truck—and $882,000 in oil and maintenance costs over two years."
—Rose Marie Brady, chief, fleet operations

AAFES' new environmentally friendly tractor-trailer truck

The AAFES Story's Factoids

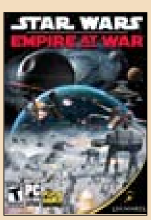
'Venerable' company provides savings, music, gift certificates, phone cards, brand-name electronics, low-interest credit cards to America's Fighting Heroes and Families

• **Helping Soldiers, Airmen, National Guard members, Reservists, Family members and military retirees stretch their bucks.** An exhaustive Market Basket Survey by an independent research firm of more than 300 products, including shampoo, diapers and makeup, shows that AAFES does indeed save authorized shoppers more than 20 percent. The complete results are available at www.aafes.com/docs/valuestory.htm.

• **Providing music to the ears of troops.** Recognizing that good music is integral to morale, we teamed up with 14 recording artists, including Grammy Award winners/nominees and multi-platinum sellers, to deliver a special gift to troops during the 2008 holiday season—a free CD produced exclusively for troops with tunes by Trace Adkins, Five for Fighting, Josh Groban, Isaac Hayes, Alan Jackson Jude, Roy Orbison, Joe Perry, Three Doors Down and others.

This made the second "CD for the Troops" from Grammy-nominated, platinum-selling singer/songwriter John Ondrasik of Five for Fighting. In 2007, the first CD reached more than 500,000 service members, with 400,000 downloads off www.aafes.com alone.

• **Gifts from the Homefront.** In the five years since we launched "Gifts from the Homefront," people from throughout the country have contributed more than $2 million toward gift cards and certificates to lift the morale of troops. Active-duty Soldiers, Airmen, Sailors, Marines National Guard members and Reservists around the world have redeemed 67,245 gift cards and certificates for Military Exchange Global prepaid phone cards; snacks and drinks; DVDs; and other products.



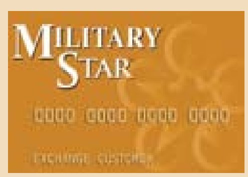
To send gift cards of up to $500 under Gifts from the Homefront, visit www.aafes.com or call (800) 527-2345.

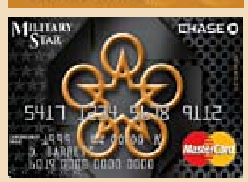
• **Major accolades.** AAFES received major kudos from *Retailing Today's* "2008 Annual Top 150 Annual Industry Report," which picked the organization as one of 12 "most venerable" companies whose "influence on retailing cannot be overstated." The others included Wal-Mart, Target, Sears, JC Penney and Kohl's.

• **Helping troops reach out and touch.** AAFES is keeping deployed troops connected with loved ones back home with the Military Exchange Global Prepaid Phone Cards. With rates as low as 15 cents a minute, the phone cards provide the best value for troops calling from the Middle East to the United States. Since 2004, when the Help our Troops Call Home program began, nearly 175,000 individual orders for about 344,000 phone cards valued at nearly $8 million have been purchased. The phone cards enable troops to call from any of the 60+ phone centers in Iraq, Afghanistan or Kuwait.

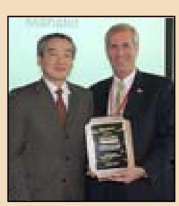
Any American can send a Military Exchange phone card to deployed troops or their Families, through our "Help Our Troops Call Home" program. To do so, visit www.aafes.com or call (800) 527-2345.

• **Two more big reasons to shop AAFES.** Our new MILITARY STAR Rewards MasterCard began in 2008 rewarding shoppers for everyday purchases on *and* off military installations. They also can get three-cent discounts off a gallon of gas when they use the cards to pay at AAFES stations. The regular MILITARY STAR private-label card generated nearly $2 billion in revenue for AAFES and the other military exchanges. The new card, besides creating loyal customers, also provided us with a supplementary source of income of about $437,000 in 2008.





• **Sony partnership thrives.** In recognition of AAFES exceeding $100 million in purchases from Sony, the company's leaders in Tokyo presented a plaque to AAFES Chief Operating Officer Michael Howard to commemorate the 50-year relationship. Our PowerZones throughout the world feature many products from Sony and other dealers.



The AAFES story: a 'taste of home'

With Whoppers to Frappacino Mochas, troops can get away from war and return home . . . if only in their minds

Soldiers, Airmen, National Guard members and Reservists around the world turned to the organization's 2,000-plus restaurants to enjoy special "tastes of home" in the forms of Whoppers, sub sandwiches, bagels, pizza, fried chicken, and boatloads of Frappacino Mochas.

From Baghdad's battlefields to North Dakota's frozen tundra to the lush island of Okinawa, customers bought nearly $825 million worth of food and drinks in 2008 at our nearly 1,100 brand-name and 538 signature-brand restaurants—a 9 percent increase from the previous year.

We also operated 131 movie theaters, six plants in Europe that made baked goods and bottled water, and 92 lunch programs at Department of Defense schools.

Opening new restaurants

To meet customer demand during 2008, we opened 86 eateries—Burger King, Charley's Grilled Subs, Pizza Hut, Popeye's, Manchu Wok, Baskin Robbins, Captain D's, Einstein Bagels, Starbucks, among others, and our own Anthony's Pizza, Main Street Expresso and Robin Hood—around the planet, from one of the world's largest coral atolls in the South Pacific to Camp Taji in Iraq.

Our restaurant support in 2008 to troops fighting the Global War on Terror throughout the Middle East grew to 232 locations, up from 197 in the previous year—sometimes not far from where bullets were flying.

At AAFES, we take very seriously our mission of providing troops unique tastes of home, because as long as it takes them to eat a burger or pizza, they can return home, if only in their minds. Like Roy Robertson, vice president over our food service division, puts it, "We make sure the Whoppers in Baghdad taste the same as the Whoppers in their hometowns."

But we also give them plenty of other opportunities to unwind. In an exclusive deal with AAFES, GameStop, the world's largest video-game retailer, opened 22 stores, which are expected to generate at least $3.6 million in earnings annually. More GameStops are on the way for 2009.

Patrick McGhee, our general manager at Fort Lewis, expects big things out of the relationship, even at the Pizza Hut and Blimpie's restaurants next door to the dynamic store.

"I visited the location several times today and at one time the check-out line was 20-plus Soldiers," he says.

That's news we like to hear.

AAFES Factoid

If a customer calls, we'll deliver.

Now, troops can get pizzas from Pizza Hut, Domino's and Papa John's delivered right to their doorsteps, thanks to a new pizza delivery program that started at nine military installations in the United States.

Just in 2008, the program drove additional earnings of $1.4 million. In 2009, 13 more delivery programs are planned.

The AAFES Story

Our Top 10 Name-Brand Restaurants

1. Burger King—210
2. Subway—133
3. Charley's Grilled Subs—93
4. Baskin Robbins—93
5. Taco Bell—69
6. Green Bean Coffee, Popeyes—64 each
7. Pizza Hut—51
8. Cinnabon—41
9. Starbucks—33
10. Manchu Wok—23

"We make sure the Whoppers in Baghdad taste the same as the Whoppers in their hometowns."

—Roy Robertson, vice president, Restaurant, Hospitality and Theater Division

In 2008, AAFES racked up even more awards for its restaurants.

The Schofield Barracks' Popeyes in Hawaii won the International Gold Plate award from Popeyes Chicken & Biscuits. AAFES received the Operator of the Year award and Camp Casey in Korea received the "Bronze Plate."

Schofield Barracks also was recognized for logging $2 million in sales, while Camp Casey and Kadena AB on Okinawa hit $1.5 million each in sales.

The AAFES Story

Serving Soldiers in Harm's Way

New Air Assault PX reaches troops in isolated, dangerous mountains of Afghanistan

Army choppers begin flying AAFES "air assault PXs" to Soldiers isolated in the rugged Afghan mountains in the background.

DEEP IN THE AFGHAN MOUNTAINS—Soldiers at a remote combat outpost in eastern Afghanistan got the products they needed in late 2008 thanks to a new mobile exchange airlifted by helicopter into the volatile mountainous region teeming with enemy insurgents.

AAFES' new Air Assault PX program focused on serving troops at Combat Outpost Malekshay, about three miles from the Pakistani border at what arguably is the Global War on Terror's ground zero.

"The guys at these locations are put in some of the most extreme conditions," said Robert Van Oss, a retired service member who is the only AAFES associate at the mobile exchange. "We know there is a need out here, and we're trying to find the best way to fill it with as much as possible and as often as possible."

The Soldiers survive without the amenities of larger military installations, such as showers and normal AAFES facilities. But from our 5-by-8-foot metal container no bigger than a typical laundry room, they buy deodorant, toothpaste, shampoo, shaving products, snacks, drinks and tobacco.

"Out here, there isn't much that reminds us of home. With AAFES, it's indeed been like a little slice of home."

"When I first heard they were going to fly a PX out here, I thought they were lying. Who's going fly all the way out here with a PX?" said Spec. Benjamin Nelson, one of Charlie's members. "Out here, there isn't much that reminds us of home. With AAFES, it's indeed been like a little slice of home."

The troops are encouraged by the program, which AAFES leaders in Afghanistan may expand this year to other remote locations.

"Getting a chance to look at these magazines helps me keep up-to-date on what's going on back home and makes me feel closer to the States," said Sgt. Ronald Rucker Jr.

We Reach Out to National Guard, Reservists, too

The brave citizen-warriors of the National Guard and Army and Air Force Reserves represent a unique customer base for AAFES.

In fact, members of the National Guard and Reserves make up about 25 percent—or nearly 3 million—of the 12.2 million armed forces members, their Families, and retirees who are eligible to shop at our exchanges throughout the world and on our Web site, www.aafes.com. One of them is our commander, Maj. Gen. Keith Thurgood, an active-duty member of the U.S. Army Reserves.

Reaching these potential shoppers is critical because more than half of the National Guard members and Reservists live nowhere near traditional exchanges and never set foot on military installations other than during their training weekends or when called to active duty.

Furthermore, a majority of National Guard members and Reservists are unaware that they can still shop at AAFES when they are not on active duty.

In 2008, we let them know their exchange benefits were just waiting for them through mailings to millions of Reservists and Guard members and then "parking lot sales" outside exchanges and commissaries.

In November, our Marketing's Strategic Corporate Communications group created the Salute to Your Service blog, www.salutetoyourservice.com, a robust online community where shoppers and our managers engage in conversations for instantaneous and actionable feedback.

We're also on Twitter and YouTube.

Our National Guard and Reserves fight terror in Iraq and Afghanistan, as well as battle raging forest fires and aid in disaster recovery projects in the United States—and sometimes they're taken for granted.

This unending devotion on the part of the National Guard members and Reservists to serving America is why we're unleashing the power of AAFES to support them and their Families like never before.

As in the words of General Thurgood, "They, like all our patrons, deserve our very best effort."

Diversity

This competitive business strategy is woven into our overall plans to win the future

The AAFES Story

At AAFES, our strength lies with a workforce of more than 43,000 associates that is comprised of 60 percent people of color and 64 percent women. Forty-three percent of our managers are people of color.

This incredibly diverse workforce serves an equally diverse customer base of 12.2 million military members, their Families and retirees. To meet these customers' needs, AAFES must understand and reflect the same diversity within its organization.

Major recognition

In 2008, we received the following recognitions:

- **Continued Excellence in Diversity,** from *Latina Style 50* magazine.
- **One of the country's top 50 retailers,** awarded by *Professional Woman's* magazine.
- **America's Top Government Agency for Diverse Business Opportunities,** from DiversityBusiness.com, a leading business-to-business Web site, for the third straight year.
- **Best Practices,** U.S. Office of Government Ethics.
- **Million Dollar Roundtable Award,** from the Dallas Regional Minority Business Development Agency for the third year in a row.
- **Federal Employer of the Year,** from the Texas Governor's Committee on People with Disabilities.

Fostering unique, diverse strengths

A generation ago, some experts described workforce diversity as the right thing to do or a corporate responsibility. Today, diversity is recognized as a competitive business strategy and incorporated into our overall strategy as a key to winning the future.

Workforce diversity also means creating a professional environment where the unique and diverse strengths of associates and suppliers are valued, leveraged, recognized and rewarded. Companies with strong diversity programs outperform those that don't; and a mix of ethnic backgrounds, thought, age and life experiences add value to the organization through innovation and creativity.

Under the leadership of Diversity Director Jeanne McDonald and others, we are paving the way with forward-thinking strategies.

Sharing culture, networking

For instance, associate resource groups provide opportunities for workers to share cultures, give back to communities, network with senior managers, attend career-building workshops and assist in guiding product selection and advertising.

In addition, we increased our spending with diverse business owners last year by more than $59 million.

In our five-year Strategic Plan, linking diversity to organizational goals, leadership, workforce, customers and suppliers will ensure we build a business sustainable over the next century.

"Valuing diversity means creating a culture where every individual can achieve and contribute to the success of AAFES," says AAFES Commander Maj. Gen. Keith Thurgood. "As we seek to understand each other, we grow associates and show we value them. As we seek to better understand our customers, we grow the business in new and improved ways."

"As we seek to better understand our customers, we grow the business in new and improved ways."

—AAFES Commander Maj. Gen. Keith Thurgood

AAFES received national accolades in 2008 for workplace diversity initiatives.

A diverse group of AAFES associates serve an equally diverse group of customers around the world.

Commander's Column

We're spreading the news of our unique 'value story,' *the AAFES story*

Continued from Page 3

Fighting Heroes in Iraq, Afghanistan and the rest of the Middle East, where more than 400 associates were deployed voluntarily in 2008.

Bakeries and barbers, gas and glasses

We also fix and sell cars and the gas that goes in them; cut and style hair; issue low-interest credit cards; operate overseas bakeries making 6 million loaves of bread and factories making 6 million gallons of bottled water; provide dry cleaning, packing, shipping, florist, and optometry and optical services; run Internet cafes; furnish pre-paid phone cards so troops in Afghanistan and Iraq can call loved ones back home; and dish up 4 million nutritious meals annually to children in 92 Department of Defense schools in nine countries.

AAFES We go where you go!

The AAFES Story

Our valued customers enjoy the latest fashions, including a wide selection of exclusive-brand quality clothing. They also find the most up-to-date electronics in our "PowerZones," a virtual Nirvana for the gadget-minded.

Furthermore, thousands of our customers log onto www.aafes.com and browse 100-plus name-brand retailers and 18 million items. In February 2008, 870,000 new visitors came to the site, and 370,000-plus repeat customers logged 5 million page views.

Additionally, we are interacting with customers in online chat rooms, on a blog and even Twitter.

I'm proud that these products and services are giving our shoppers what they want. In fact, an independent "market basket" survey confirms that AAFES is a one-stop solution offering overall savings of more than 20 percent compared to the competition.

Spreading the 'value story'

We are spreading the news of this value story as we finish the Patriot Family Deployment Passbook, a comprehensive coupon book packed with unique savings at AAFES retail, food and services locations.

To focus on serving shoppers into the future, we refined our strategic goals in 2008 to build on past successes and take actions at the local level—the stores. These Strategic Goals will guide us through 2009 and beyond:

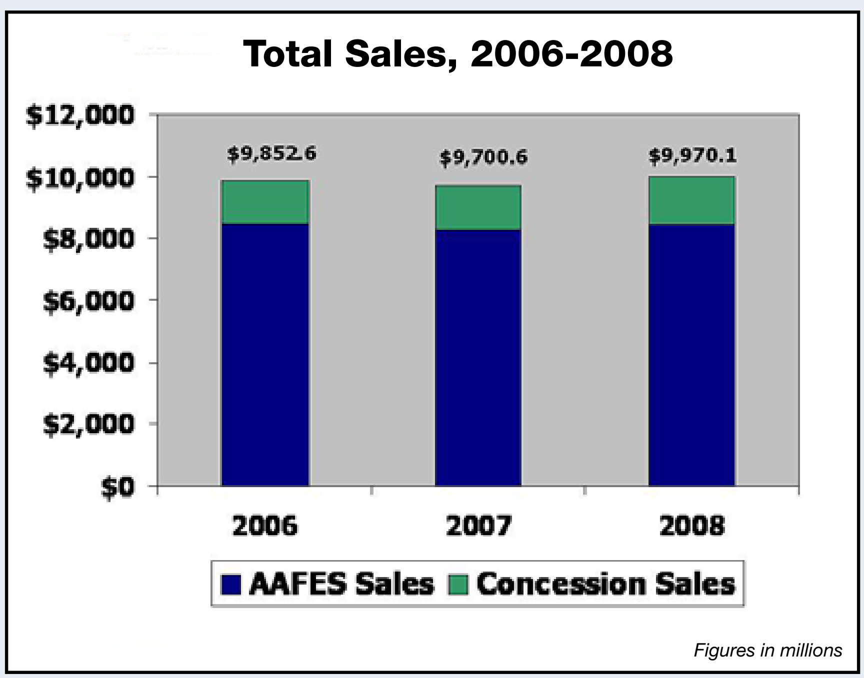
- Developing a lifelong emotional connection with customers;
- Building a culture of loyalty, ownership, sustainability and continuous improvement;
- Providing expeditionary and mission capabilities to "go where you go," like our motto says;
- Collaborating with our federal and commercial partners;
- Communicating the benefit, value and capabilities of AAFES.

"Winning the future" is not accomplished in one giant leap, but through measured steps along a path where teamwork, excellent customer service, innovation and results are rewarded.

In my congressional testimony this year, I said "winning the future" is not accomplished in one giant leap, but through measured steps along a path where teamwork, excellent customer service, innovation and results are rewarded.

AAFES will remain a viable force in the lives of our customers and military communities for many years to come and wherever our fighting heroes serve.

Maj. Gen. Keith Thurgood, Commander



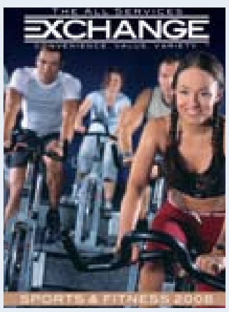
Coach, Macy's links, to boost sales, product lines

Continued from Page 2

$37 million. Representing another AAFES "first," ladies' apparel will be driven by two mutually-exclusive brands from Macy's—STYLE&CO and INC—for missy to women's sizes. We expect sales to hit $8 million on these products.

Expanding exclusive labels

Already, AAFES stores are updating our highly profitable exclusive brands of men's, women's and children's clothing that convey the overall "personalities" of our target customers. Our family of exclusive-label apparel will grow this year with Drift Away ladies' sleepwear, and we certainly will capture the young men's business, with cutting-edge denim lines like Mavi, X-Ray, Kentucky Jean Co. and MEK, with sales projected to grow to $1 million annually.



One of our many 2008 catalogs.

Coffee, computers and construction

For coffee lovers, our Consumables division launched our exclusive "Premium Java" in 381 exchanges, and sales have already climbed by 45 percent. John Engroff, vice president for consumables, says a loyalty program, seasonal flavor profiles and combo promotions will build an "emotional connection" with customers.

To keep track of all the sales and our supply chain, we're leveraging the retail and distribution industries' latest technology. In February 2008, we implemented the $177 million Oracle Retail technology, which provides the best merchandising, allocation, replenishment, forecasting, pricing and inventory management practices.

At our worldwide distribution centers, we are rolling out a $22 million warehouse management system that will get products into customers' hands faster than ever. *To read more, see Pages 6-7.*

In 2008, meanwhile, we completed nearly $202 million in new and refurbished shoppettes, restaurants and shopping centers at 118 installations.

From Alaska to Germany

We also set up operations on the South Pacific's Kwajalein to serve troops at a missile test site.

This year, we'll open new or expanded shopping centers at Okinawa's Kadena AB, Germany's Ramstein AB, Minot AFB, N.D., and Eielson AFB and Fort Wainwright, Alaska. Customers at Japan's Misawa AB will get a new shoppette and Popeyes restaurant, while a new shoppette and AAFES gas station are coming to Yokota AB.

We view these developments as opportunities to accomplish a dual mission 114 years in the making—providing quality goods and services at competitively low prices and generating earnings to support Morale, Welfare and Recreation programs for the troops.

Like AAFES Commander Maj. Gen. Keith Thurgood says, "We will take proactive action at the lowest levels of the organization—the stores—to win the future by establishing lifelong emotional connections with the best customers in the world, one person at a time."

A display of Coach purses at Fort Sam Houston, Texas.

Our family of exclusive-label products brought in millions in revenue in 2008. For instance, sales of 593 Exchange Select products topped $41 million, up 2.4 percent from the previous year. Exchange Select offers a full and competitive line of health & beauty, household cleaning, laundry, office, picnic and camera products.

The AAFES Story

AAFES responds to Ike's havoc, devastation

Continued from Page 3

"Our most important mission is to support troops in contingency locations, to bring that 'taste of home' when they absolutely need it the most."

—Capt. Kristin Burt, AAFES contingency planning officer

who picked up drinks and grabbed snacks after long days of recovery operations. Authorized shoppers also traveled up to 30 miles to pick up basic necessities, such as ice, at the mobile exchange.

A few days later, the associates moved the exchange-on-wheels 40 miles to Galveston's airport. As homeowners returned, AAFES' mobile field exchange took on a special importance for military retirees rebuilding their lives: it offered generators, chain saws and bug spray.

Making life a little comfortable

Team leader John Burk, sales and merchandise manager at Lackland AFB, summed up their task quite beautifully: "All we want to do is make life a little more comfortable for those working to bring life back to normal for the residents here. By volunteering to support the troops, it's our way of giving back to them for all the hard work they're doing.

"They appreciate that we're here when they didn't expect us. Even though we're only doing our job, it's very rewarding and worthwhile to be here supporting the troops."

AAFES associates from San Antonio and Waco staffed a 53-foot mobile exchange, above, to serve troops helping residents recover from Hurricane Ike's wrath.

I'm also proud of folks like Roger Lindsey, our acting facility manager at the Ellington Field exchange. Despite his house suffering extensive damage from Ike, Roger still reported to work to serve our customers and ensure his associates were safe.

Roger unloaded trucks, stocked, cleaned, priced and worked the customer carry-outs from the early-morning hours to well into the evening. He moved merchandise from the Ellington BX to the mobile field operation, and used his personal cell phone to round up a power generator from our Atlanta warehouse.

This manager who worked nearly around the clock at the BX then returned home through debris-filled streets to make whatever repairs he could to his house. Roger is the real example of enduring an unbelievably horrendous personal tragedy, but stepping up for our customers.

Isn't that why AAFES is here? These from-the-heart feelings and actions make me proud to tell people I am the AAFES commander.

When troops need us, we're there with our mobile exchanges and sacrificing our personal lives, and not just for hurricane relief efforts.

Pride in dedication, commitment

In fact, such assistance is so important to the AAFES mission that we have contingency planners here at our Dallas headquarters.

"Our most important mission is to support troops in contingency locations, to bring that 'taste of home' when they absolutely need it the most," said Capt. Kristin Burt, an AAFES contingency planning officer. "Troops can rely on AAFES to be on the ground with what they need and want during a deployment or a domestic emergency."

There are no words to adequately describe the AAFES team's dedication and commitment to excellence in this endeavor. The military and civilian leaders who formed AAFES more than a century ago would be proud of how we are still living up to our mission, whether in the Global War on Terror or a hurricane's aftermath.

I am proud of the work our teams have done to bring the full spectrum of AAFES' mission support capabilities to bear at home and abroad.

You can count on us!

Mobile exchanges: helping us 'go where you go'

Our mobile exchanges certainly help us live up to the motto, "We Go Where You Go"—and there was no better example of that in 2008 than in northern California's forests and the isolated mountains of Peru.

When 600 California National Guard members deployed this past fall to battle raging fires, associates from Travis AFB and Beale AFB came as far as 240 miles from their own homes to set up three mobile exchanges.

Throughout their stay, they never knew when the menacing fire would pour over the ridge and force them to flee. To Associate Debi Monaghan, the air quality was so poor that "the sun appeared red."

"The fire fighters and National Guard are working hard to stop the fires that have devastated California for more than a month, so our associates don't mind working the long hours necessary to support them," she said.

Many associates share that same attitude regardless of where they're deployed, even in the remote, mountainous Ayacucho region of Peru, where 950 troops spent three months building medical clinics, schoolhouses and a water well.

They found an AAFES mobile exchange staffed by two of our Honduras Exchange associates and fully stocked with snacks, drinks, baby wipes, deodorant and toothpaste.

"Let me tell you, I didn't expect AAFES to be here in Peru to support a small task force for a such short period of time," said Capt. Aurelio Perez, from Fort Buchanan, Puerto Rico. "But to have AAFES here, carrying items that I forgot to bring, need more of, or just plain want to have, has made this bare bones camp feel a bit like home."

That's exactly why our associates deploy to the ends of the earth to serve America's Fighting Heroes—to give them tastes of home, whether they're fighting the Global War on Terror in the Middle East or serving impoverished residents in the mountains of Peru.

AAFES We go where you go!

Tired firefighters file into an AAFES mobile exchange in northern California, while an Airman looks for snacks at another mobile exchange in the Peruvian mountains.

Personal shoppers

We care for our wounded fighters while they recover

To wounded troops at Brooke Army Medical Center in San Antonio and Germany's Landstuhl Regional Medical Center, they can concentrate on rehabilitation rather than worrying about getting clean socks.

Associates at Fort Sam Houston, where Brooke is located, and Landstuhl serve as their "personal shoppers," ensuring they get from our stores the clothes, personal hygiene items and other products they need.

"AAFES says, 'We Go Where You Go,' and I'm adding to it, 'We are here for you,'" says Mark Shutte, one of our personal shoppers at Ramstein AB in Germany.

Soldiers at Walter Reed Medical Center and Brooke also get free uniform modifications for their injuries under a program the U.S. Army began through AAFES. Changes include Velcro closures, sleeve zippers, and footwear designed for prosthetics.

Our support also continues into civilian life. We attend the Department of Defense's Hiring Heroes career fairs to recruit them for jobs.

These vital programs for our wounded warriors show that our support to combat troops is central to our call, whether they're fighting in battle or recovering from their injuries.

A vendor donated a pool table to Fort Sam Houston for Soldiers recovering from injuries in the Global War on Terror.

The AAFES Story

Freedom Crossing

'Lifestyle centers' to become shopping destinations with small-town, Main Street flair

What an apropos name for this never-before-seen shopping destination for Soldiers: Freedom Crossing.

As heat from summer's blast furnace scorches Fort Bliss, Texas, and surrounding El Paso in 2010, Soldiers and their families can cool their heels and lunch inside the installation's nationally known restaurants, then watch first-run movies on one of 10 movie screens in a top-rung theater.

Maybe they'll browse in a well-known shoe store or sporting-goods outlet, and then check out the hottest movies and games at a major video retailer.

The Fort Bliss 'lifestyle center' will be the first of its kind on any military installation in the world.

This spring, three years of planning came to fruition when we broke ground on a nearly 500,000-square-foot, $97 million unique mix of shopping, entertainment, dining and relaxation venues that no military complex has ever seen.

The "lifestyle center" is expected to open in October 2010 to an excited throng of shoppers numbering in the thousands.

And what an apropos name for this never-seen-before shopping destination that serves our Fighting Heroes: Freedom Crossing.

Quaint surroundings, comfy benches

Freedom Crossing will resemble a small town's Main Street, with quaint surroundings accented by fountains, comfy benches and lots of green space over 52 acres—a destination where military families stay as long as they like and spend more money rather than going outside the gates to our competitors.

A traditional AAFES main store, nearly 79,000 square feet bigger than the present facility, and a 111,000-square-foot commissary will sandwich 172,000 square feet of third-party retailers.

Freedom Crossing is expected to create $488 million in earnings for AAFES.

Preliminary planning continues on similar centers at Fort Sam Houston, Texas, and Fort Lewis, Wash., where we plan to start construction in mid-2011. Smaller installations will continue to see traditional AAFES exchanges.

Major paradigm shift

Freedom Crossing represents a major paradigm shift for us, because we historically have built big-box retail stores beside the Defense Commissary Agency's big-box grocery stores. But under the guidance of Joseph Giuffreda, a vice president in our Strategic Planning & Partnerships Directorate, AAFES is opening the vast military market to outside retailers.

Under the Defense Department's troop redeployment program, Fort Bliss—a 1.12-million-acre spread bigger than Rhode Island—will morph into the country's fourth largest Army installation by 2013, with more than 90,000 Soldiers by 2012.

Add family members to the mix, and 136,000 total customers represent an ideal market for retailers.

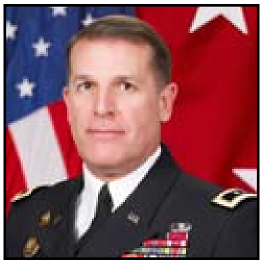
Stable economic pool

"This development will be the social gathering spot for Soldiers and their Families where they feel a sense of belonging," says Todd Rosen, vice president with Denver's ServiceStar Development Co., the center's developer. "Even with the economic challenges the retail industry is facing, those retailers who are open to new locations understand the possibility of a new sales channel never before open to them—and military personnel who would give them a stable economic pool of customers in a world with uncertain paychecks."

Will Soldiers, their Families and retirees who live off-base return to Fort Bliss for leisure and shopping? To ensure they do, we have designed an environment far superior to any retail setting in the El Paso area.

What's more, they will pay no sales tax at AAFES' direct operations and the commissary at Freedom Crossing—and know that about 60 percent of the profits will be reinvested as dividends into Morale, Welfare and Recreation programs for the troops.

AAFES Leadership



Maj. Gen. Keith Thurgood, Commander

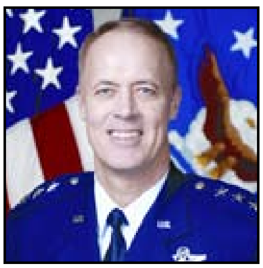
Brig. Gen. Fran Hendricks, Deputy Commander

Michael Howard, Chief Operating Officer

Chief Master Sgt. Jeffry Helm Assistant to the Commander

Col. Thomas Baker, Chief of Staff

Board of Directors



Lt. Gen. Richard Y. Newton III, USAF, Chairman
Deputy Chief of Staff, Manpower & Personnel, U.S. Air Force (AF/A1)

Lt. Gen. Mitchell H. Stevenson, USA, Senior Member
Deputy Chief of Staff, G-4, U.S. Army

SMA Kenneth O. Preston, USA, Sergeant Major of the Army

CMSAF Rodney McKinley, USAF, Chief Master Sergeant of the Air Force

Lt. Gen. Gary D. Speer, USA, Deputy Commanding General/Chief of Staff, U.S. Army Europe and Seventh Army

Lt. Gen. Joseph F. Peterson, USA, DCG/CS, U.S. Army Forces Command

Lt. Gen. Edgar E. Stanton III, USA, Military Deputy for Budget

Maj. Gen. Gilmary M. Hostage III, USAF
Vice Commander, Pacific Air Forces

Maj. Gen. Robert B. Newman Jr., USAF
Adjuctant General of Virginia

Maj. Gen. Larry Spencer, USAF, Deputy Assistant Secretary of the Air Force (Budget)

Maj. Gen. Keith Thurgood, USA, Commander, Army and Air Force Exchange Service

Lynn S. Heirakuji, SES, Deputy Assistant Secretary of the Army (Personnel Oversight)

Barbara J. Barger, SES, Deputy Assistant Secretary of the Air Force (Force Management Integration)

Kathleen I. Ferguson, SES, Deputy Assistant Secretary of the Air Force (Installations)

Charles E. Milam, SES, Deputy Director, Air Force Services (HQ USAF/A1S)

Karl Schneider, SES, Assistant Deputy Chief of Staff, G-1

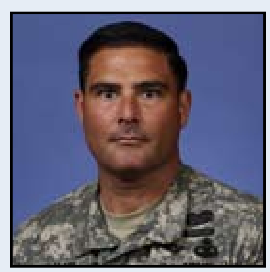
Brig. Gen. David E. Price, USAF, Director of Budget Ops, HQ USAF

Gregg Cox, Executive Secretary, AAFES

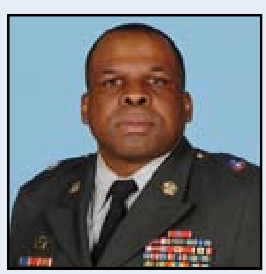
A position representing the U.S. Army Family and MWR Command was vacant.

Regional Commanders

Col. Steve Kimball, Pacific Region



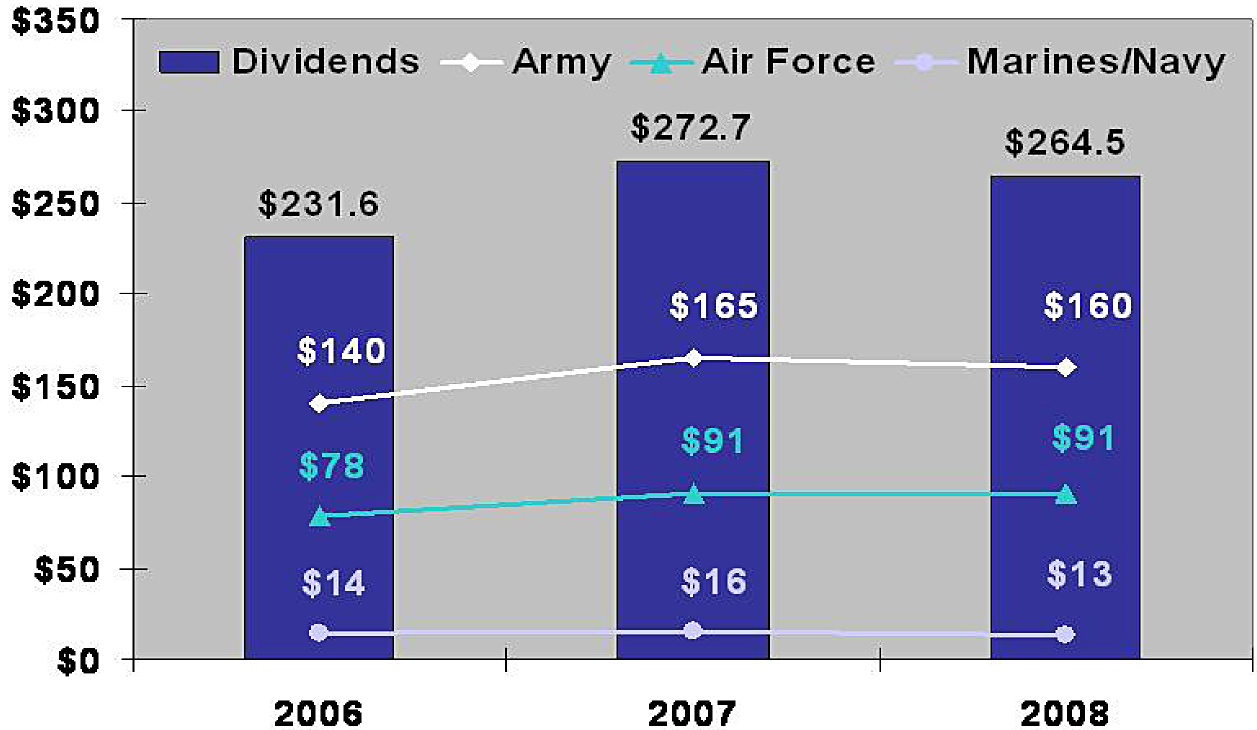
Col. Chuck Salvo, Europe Region



Sgt. Maj. James Pigford, Assistant to the Commander

Sgt. Maj. Douglas Dunn, Assistant to the Commander

AAFES Dividends to Morale, Welfare and Recreation Programs for the Armed Services



Note: Amount of dividends is based on earnings and troop strength for each Service Branch. All amounts in millions.

Financial charts by Veronica Nelson, AAFES financial analyst

FINANCIAL STATEMENTS

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

Ernst & Young LLP

Army and Air Force Exchange Service

Financial Statements

Years Ended January 31, 2009 and February 2, 2008

Contents

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

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

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

Internal Control Over Financial Reporting

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

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

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

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

Compliance and Other Matters

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

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

Ernst & Young LLP

May 1, 2009

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Report of Independent Auditors

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

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

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

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

In accordance with *Government Auditing Standards*, we have also issued our report dated May 1, 2009 on our consideration of the Army and Air Force Exchange Service's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

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

Ernst & Young LLP

May 1, 2009

Army and Air Force Exchange Service

Balance Sheets

(Dollars in thousands, unless otherwise noted)

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

See accompanying notes.

Army and Air Force Exchange Service

Statements of Earnings

(Dollars in thousands, unless otherwise noted)

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

See accompanying notes.

Army and Air Force Exchange Service

Statements of Changes in Net Assets

(Dollars in thousands, unless otherwise noted)

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

See accompanying notes.

Army and Air Force Exchange Service

Statements of Cash Flows

(Dollars in thousands, unless otherwise noted)

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

See accompanying notes.

(Dollars in thousands, unless otherwise noted)

1. Description of Business and Summary of Significant Accounting Policies

General

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

Net sales by geographic region are summarized below:

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

(Dollars in thousands, unless otherwise noted)

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

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

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

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

In accordance with applicable Army and Air Force regulations, AAFES is not required to pay rent for the use of properties owned by the U.S. Government or utility costs associated with overseas exchanges. Permanent structures that are constructed by AAFES and paid for from AAFES funds become the property of the U.S. Government; however, AAFES has the right to occupy and use the structures. The structures cannot be used for other than AAFES' purposes without prior approval by the AAFES Commander and the Department of the U.S. Government concerned. As such, AAFES has included the cost of the structures on its balance sheet and amortizes the cost of the structures on a straight-line basis over their estimated useful lives. Services such as ocean transportation of merchandise to certain locations on U.S. chartered vessels and performance of administrative and supervisory functions by military personnel have been provided without charge to AAFES.

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

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

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

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

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

Fiscal Year

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

Dividends

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

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

Use of Estimates

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

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

Translation of Foreign Currencies

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

Cash and Cash Equivalents

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

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

Accounts Receivable

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

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

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

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

Accounts past due for 30 days or more are considered delinquent. Accounts delinquent for 180 days are submitted to Treasury Offset Program (TOPS) for collection. AAFES utilizes various means to collect past due accounts, as well as accounts written off, including some methods not available to other retail organizations. AAFES has agreements with other U.S. Government entities that allow AAFES to garnish wages of service personnel, as well as claim the debtors' future payments from such U.S. Government entities, including U.S. Treasury income tax refunds. Personal contact, external collection agencies, and letters to service personnel superiors are also used to pursue delinquent accounts.

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

A provision for possible credit loss is recorded each month based on a percentage of total projected charge-offs that are considered uncollectible. AAFES periodically evaluates the adequacy of the provision using such factors as prior account loss experience, changes in the volume of the account portfolio, changes in the estimates of anticipated recoveries on delinquent balances, and changes in credit policy. It is reasonably possible that the amounts AAFES will ultimately recover on delinquent balances could differ materially in the near term from the amounts assumed in arriving at the allowance for doubtful accounts.

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

Merchandise Inventories

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

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

Buildings and Improvements

Buildings and improvements primarily represent permanent structures constructed by AAFES and owned by the U.S. Government. These assets are recorded at cost with amortization provided using the straight-line method over the estimated useful lives of the assets. The useful lives are governed, to a large extent, by the deployment of Army and Air Force personnel and, to some extent, by the requirements of the Departments of the Army and the Air Force with respect to space occupied by AAFES. Buildings are generally depreciated over 30 years and improvements are depreciated from 7 to 15 years. AAFES loses its rights to buildings and improvements in the event of base closures and accelerates amortization of its assets when such closures are probable, accordingly.

Fixtures and Equipment

Fixtures and equipment are carried at cost with depreciation provided using the straight-line method over the estimated useful lives of the assets.

Depreciable lives used are as follows:

Asset Type	Depreciable Life
Motor vehicles	5 to 10 years
Equipment	2 to 10 years
Software	3 to 7 years

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

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

Self-Insurance

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

Separation Pay and Vacation Leave Accruals

Separation pay and vacation leave for local national employees in foreign countries are accrued as earned based upon the labor laws of host countries and upon agreements between the U.S. and foreign governments. In order to estimate this liability, the Company and its actuaries make certain assumptions. Actual results may vary from these assumptions. Additionally, the liability for vacation leave earned by U.S. citizens is accrued as earned.

Advertising Costs

Advertising costs are expensed in the period in which the advertising first occurs. AAFES cooperative advertising allowances are generally accounted for as a reduction in the purchase price of inventory.

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

Revenue Recognition

Revenue from retail sales is recognized at the time of sale. Revenue from sales made under a layaway program is recognized upon delivery of the merchandise to the customer. Finance revenue includes finance charges and late fees on credit sales. Concession income includes fees charged to concessionaires based on a percentage of their sales and is recognized at the time of sale.

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

Income Taxes

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

401(k)

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

Reclassifications

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

Foreign Currency Hedging

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

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

Fair Value Measurements

AAFES adopted Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157), on February 3, 2008. SFAS 157 defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosure requirements about fair value measurements. Under SFAS 157, fair value is considered to be the exchange price in an orderly transaction between market participants to sell an asset or transfer a liability at the measurement date. The fair value definition under SFAS 157 focuses on an exit price, which is the price that would be received by AAFES to sell an asset or paid to transfer a liability versus an entry price, which would be the price paid to acquire an asset or received to assume a liability. Although SFAS 157 does not require additional fair value measurements, it applies to other accounting pronouncements that require or permit fair value measurements. In February 2008, the Financial Accounting Standards Board (FASB) issued FSP No. 157-2, which delayed the effective date of SFAS No. 157 for one year for nonfinancial assets and liabilities.

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

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

Recent Accounting Pronouncements

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

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

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

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

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

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

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

2. Financial Instruments

Investments and Supplemental Plan Assets

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

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

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

(Dollars in thousands, unless otherwise noted)

2. Financial Instruments (continued)

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

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

Lines of Credit

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

- The Wachovia Bank N.A. (Wachovia) line-of-credit is a multiyear revolving credit agreement with a group of banks led by Wachovia aggregating $750,000 that expires in December 2011. There was $700,000 outstanding under this line of credit at January 31, 2009.

- The JPMorgan Chase (Chase) line-of-credit agreement is a 364-day revolving credit line with a group of banks led by Chase aggregating $265,000 that expires in November 2009. At January 31, 2009, $265,000 was outstanding on this line-of-credit. Subsequent to year-end, the line of credit was increased to $445,000.

- AAFES also has additional lines of credit (which are subject to approval) with various banks aggregating approximately $1,300,000 at January 31, 2009. Borrowings under these additional lines of credit aggregated $984,000 at January 31, 2009. In February 2009, this line of credit was reduced to $900,000. Outstanding balances under all line-of-credit agreements have various maturity dates, with the latest being July 2009.

2. Financial Instruments (continued)

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

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

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

Derivative Financial Instruments

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

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

2. Financial Instruments (continued)

accumulated other comprehensive income (loss). As the notional amounts and terms of each forward and option collar foreign exchange contract match those of its liability counterpart at maturity, any ineffectiveness is immaterial in the foreign exchange contracts.

Upon expiration of the hedge contracts, the amount of the hedged item that affects earnings is reclassified from accumulated other comprehensive income (loss).

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

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

3. Fair Value Measurements

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

(Dollars in thousands, unless otherwise noted)

3. Fair Value Measurements

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

Level 1 inputs—unadjusted quoted prices in active markets for identical assets or liabilities to which the Company has access. An active market for the asset or liability is one in which transactions for the asset or liability occur with sufficient frequency and volume to provide ongoing pricing information.

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

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

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

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

(1) Included in Long-term investments and Supplemental Plan assets.
(2) Included in Accounts Payable and Accrued salaries, separation pay, and other employee benefits.

3. Fair Value Measurements (continued)

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

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

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

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

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

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

(Dollars in thousands, unless otherwise noted)

3. Fair Value Measurements (continued)

Level 3 Gains and Losses

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

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

4. Benefit Plans

AAFES has a defined benefit pension plan, the Retirement Annuity Plan (the Plan), covering regular full-time civilian employees of the Company who are citizens or residents of the U.S. In addition, a noncontributory supplemental deferred compensation plan (the Supplemental Plan) provides for selected benefits to employees in the Executive Management Program. AAFES' policy is to fund pension costs accrued unless fully funded or unless an asset-liability model has shown the Plan will likely become fully funded even in the absence of future contributions. The benefits are based on years of service and the employees' highest three-year average compensation. Assets of the plans consist primarily of marketable debt and equity securities.

In addition to AAFES' pension plan, certain medical and dental (health care) and life insurance benefits are also provided to retired employees through the Post-retirement Medical/Dental (PRM) and Life Insurance (Other Post-retirement) plans for employees of AAFES. All regular full-time U.S. civilian employees who are paid on the U.S. dollar payroll may become eligible for these benefits if they satisfy eligibility requirements during their working lives. AAFES' policy is to fund post-retirement costs accrued unless fully funded or unless an asset-liability model has shown the plan will likely become fully funded even in the absence of future contributions.

4. Benefit Plans (continued)

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

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

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

4. Benefit Plans (continued)

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

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

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

4. Benefit Plans (continued)

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

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

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

4. Benefit Plans (continued)

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

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

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

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

4. Benefit Plans (continued)

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

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

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

Actuarial Assumptions

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

	Pension Benefits The Plan		Pension Benefits Supplemental Plan		Other Benefits Post-retirement	
	2008	**2007**	**2008**	**2007**	**2008**	**2007**
Assumptions used to determine expense:						
Discount rate	**6.50%**	6.15%	**6.50%**	6.15%	**6.50%**	6.15%
Long-term rate of return on assets	**8.25%**	8.25%	**–%**	–	**8.75%**	8.75%
Compensation increase rate	**5.50%**	4.00%	**5.50%**	4.00%	**5.50%**	4.00%
Assumptions used at disclosure:						
Discount rate	**6.75%**	6.50%	**6.75%**	6.50%	**6.75%**	6.50%
Compensation increase rate	**5.50%**	5.19%	**5.50%**	5.19%	**5.50%**	5.19%

	Other Benefits UK Plan		Other Benefits Local National Plan	
	2008	**2007**	**2008**	**2007**
Assumptions used to determine expense:				
Discount rate	**5.80%**	5.10%	**3.68%**	3.50%
Long-term rate of return on assets	**6.90%**	6.80%	**–**	–
Compensation increase rate	**4.80%**	4.50%	**2.71%**	2.80%
Assumptions used at disclosure:				
Discount rate	**7.00%**	5.80%	**3.71%**	3.68%
Compensation increase rate	**4.50%**	4.80%	**2.57%**	2.65%

(Dollars in thousands, unless otherwise noted)

4. Benefit Plans (continued)

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

Pension Plan Assets

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

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

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

4. Benefit Plans (continued)

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

Employer Contributions

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

Estimated Future Benefit Payments

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

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

Assumed Health Care Cost Trend Rates at December 31:

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

5. Dividends

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

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

AAFES' policy is to fund post-retirement costs accrued unless fully funded, or unless an asset-liability model has shown the Plan will likely become fully funded even in the absence of future contributions. Therefore, pension expense generally reduces the net earnings subject to dividends.

6. Commitments and Contingencies

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

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

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

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

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

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

8. Post Allowance for Overseas Personnel

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

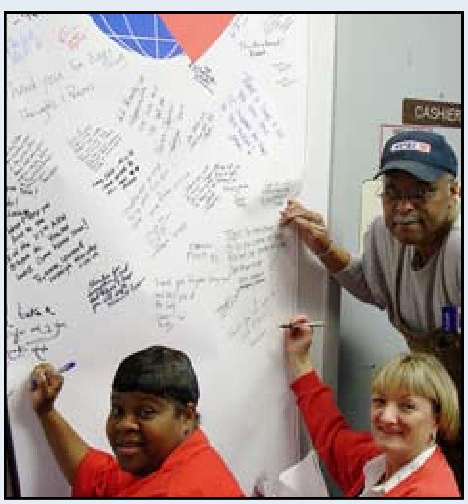
AAFES and certain other NAFIs did not previously pay this particular post allowance under the good faith interpretation that the post allowance was intended only for U.S. employees transferred to an overseas post. At February 2, 2008, AAFES recorded a charge for its best estimate of its obligation of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

The AAFES Story in Pictures

Our Yokota AB main store in Japan won the Best Exchange Store in the Pacific from customers polled by *Stars and Stripes* newspaper, the sixth time in seven years associates were honored with the award. The BX got high marks for its furniture store, food court, shoppette, gift shop, and long-distance service.

The past seven AAFES Drivers of the Year for the continental United States gather at the Dan Daniel Distribution Center in Newport News, Va., with Logistics Senior Vice President Dale Bryan, left, and AAFES Commander Maj. Gen. Keith Thurgood. Roger Brown, third from left, was named the 2008 Driver of the Year in the United States after driving more than 2 million accident-free miles.

Troops file into a new temporary AAFES exchange at Camp Bastion in Afghanistan.



Associates at Maxwell AFB, Ala., sign a banner for troops and civilians serving in Afghanistan.

Soldiers give a thumbs-up during the opening of a GameStop at Fort Hood, Texas. AAFES and the country's largest video-game dealer are opening stores around the world for the troops' enjoyment.

A crowd of shoppers get ready for good deals at the grand opening of the AAFES exchange at Minot AFB, N.D.

Associates from AAFES-Europe serve troops during military exercises in the country of Georgia in 2008—another example of "We Go Where You Go."

Cashier Colline Arnold bids farewell to the final customer at our Hanau main store in Germany, which closed after 63 years in response to the drawdown of troops in Europe. An AAFES store at Wurzburg, Germany, also closed.

Army and Air Force Exchange Service

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