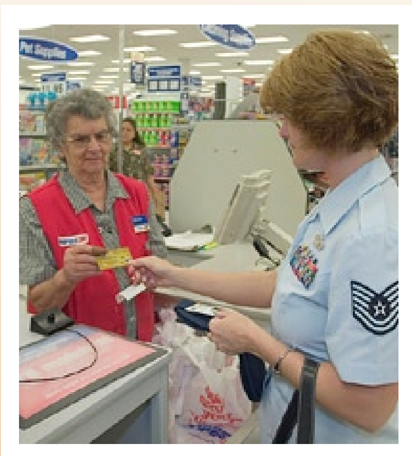
Army and Air Force Exchange Service

Annual Report 2007

'Serving the Best Customers in the World'



For more than 113 years, providing Soldiers, Airmen, National Guard members, Reservists, Families and retirees throughout the world with exceptional services and brand-name goods at competitive prices.

“In this annual report, you’ll learn how 43,658 associates are making a difference, driving results and fundamentally changing how AAFES does business to better serve our Soldiers, Airmen, National Guard and Reservists who gallantly lay their lives on the line.”

— Brig. Gen. Keith Thurgood

Commander’s Column

Exceeding expectations of “the best customers in the world”

Worldwide, we have the opportunity to connect with our customers almost 800,000 times each day. Each one of those encounters represents a moment of truth where we either exceed the expectations of “the best customers in the world” or we fall short.

Our customers expect excellence and increasingly demand consistent value and service.

In this annual report, you’ll learn how our 43,658 associates are making a difference, driving results and fundamentally changing how AAFES does business to better serve our Soldiers, Airmen, National Guard and Reservists who gallantly lay their lives on the line serving our nation.

Those customers also include Family members waiting for their heroes to return home, as well as retirees who have bravely served America in years past.

From Texas to the battlefields

In this publication, you’ll read about the scope of our mission, what differentiates us from our civilian competitors, and how our reach extends from Fort Hood, Texas, to Japan’s Misawa Air Base, to the battlefields of the Global War on Terror.

You will also learn about our lines of business and multi-channel retailing efforts, which include traditional brick and mortar, e-commerce and catalog sales.

2007 was an exciting year and a tipping point for AAFES. Our intense focus on performance delivered record results. For instance, AAFES:

- Continued to expand multicultural opportunities in hiring and with vendors. We plan to grow spending in 2008 with minority partners to $120 million.
- Increased earnings, subject to dividends, to $426 million, up 27 percent, including appropriated funding.
- Decreased worldwide retail markdowns by 14 percent.
- Decreased enterprise-wide inventory by $107.5 million.
- Provided many private-label brands to enhance our value to customers. ***(See Page 9)***
- Saved about $3 million, thanks to an energized sustainability team.
- Increased our Energy Star major appliances from 21 items to 37—or half of our present products.

- Improved associate and customer satisfaction scores by two points.
- Completed implementation of our $177 million Oracle enterprise resource system. ***(See Page 8)***
- Invested $355 million in capital programs at 57 installations, including 496 new or renovated retail, dining and services destinations. They include eight new shopping centers. We will invest $1.2 billion during the next few years in construction projects. ***(See Page 20)***
- Established a strategic planning team to help fill the innovation pipeline with new business opportunities.
- Defined our legislative and policy agenda to support future growth plans.
- Delivered about $140 million in supply chain productivity.

See “We Listen . . . ,” Page 16

"No matter where I was deployed, AAFES has been there, providing the comforts of home in the most uncomfortable locations. AAFES is the only retailer with people putting their lives on the line to support my troops in the combat zone."

—Capt. Samuel J. Jungman, U.S. Army

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2007 in Review

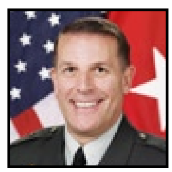
A great, but challenging, year

Here are major events and initiatives launched in 2007—and a peek at what will come this year and beyond:

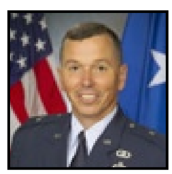
Change in Commanders. In August, Brig. Gen. Keith Thurgood became Commander, succeeding Maj. Gen. Bill Essex, who retired after a 34-year Air Force career. He served previously as Assistant Division Commander (Operation), 95th Division, U.S. Army Reserves, in Oklahoma City.

In 2006, General Thurgood, experienced in supply chain and logistics at PepsiCo, deployed to the Middle East, where he oversaw shipments of everything from tanks to ChapStick.

A month before General Thurgood joined AAFES, U.S. Air Force Brig. Gen. Fran Hendricks became Deputy Commanding General. A 27-year Air Force veteran, he came from the Defense Advanced Research Projects Agency in Washington, where he designed the "air base of the future."



Brig. Gen. Keith Thurgood



Brig. Gen. Fran Hendricks

Multi-channel retailing efforts. The internationally recognized All-Services Exchange Online Store—*www.aafes.com*—is more popular than ever before.

Continued, Page 17

Resilian: Getting and Keeping Troops 'Connected'

Soldiers and Airmen often live far away from Families and friends while serving their country, but new telecommunications products from AAFES will soon help close that gap.

Later this year, AAFES will launch a global wireless cellular product and early next year will offer a bundled TV, Internet and telephone product under the Resilian Communications brand name. The products are designed specifically to meet the needs of today's "on-the-go" military and Families.

"We're breaking new ground with Resilian," Vice President Craig Sewell

Continued, Page 18

AAFES and the 'Green Carpet'

Sustainability and the Carbon Footprint

AAFES rolled out the green carpet in 2007 and plans to keep it out to sustain the future by cutting operating costs and becoming more energy efficient.

"We will reduce our carbon footprint substantially," said Ann Scott, AAFES' corporate energy manager. "Our sustainability initiative will increase AAFES' recycling efforts to include everything from corrugated cardboard and aluminum cans to plastics and plastic hangers."

Emphasizing energy use will save AAFES more than $9 million over the next four years.

The savings have already started. In 2007, Scott identified errors in sewer charges and saved AAFES $200,000 a year. What's more, correcting errors in how AAFES was billed for energy at Air Force facilities saved about $3 million.

In 2008 and beyond, AAFES' annual sustainability goals are:

Continued, Page 18

Michael Howard

Chief Operating Officer

Rising to the challenges

We are justifiably proud of our achievements and performance in 2007. As we look forward to a successful 2008 and beyond, our continued success depends on our ability to demand more of ourselves.

We are committed to achieving even better results; improving the total store experience; earning more by losing less from theft, paperwork errors and other incidents; and using new technology to grow profitable sales.

We will continue focusing on delivering a shopping experience that surpasses expectations so that our patrons visit us again and again.

Facing tests

FY 2007 was successful due to the hard work and dedication of our associates. We focused on the basics: improving customer service, investing in our most important asset—our people—and improving processes.

FY 2008 proves to be equally as daunting, and will test AAFES. The uncertain economy, spiraling gas prices and our mission of serving the troops in the Middle East are our major challenges.

However, our associates are rising to the challenges, giving us a unique advantage and helping differentiate AAFES from our competitors.

We are providing our associates with the tools of "empowerment" and "pride of ownership." Our associates are shop owners, not shop keepers.

Driving out costs

We have the latest cutting-edge supply chain and the right people to improve merchandise procurement and distribution. Our entire supply chain is being refined continuously to drive out costs and improve accuracy and efficiency, allowing us to make better buying and stock decisions.

Our Business Intelligence experts are analyzing nearly every aspect of our business to create user-friendly reports that will provide timely information for better informed decisions.

Fiscal year 2007 set the framework to make 2008 and beyond a positive experience for our customers and a historical business success for this great company with a great mission to serve troops.

Whether at military installations like Dyess Air Force Base, Texas, above, or in the Middle East, below, AAFES stands ready to serve.

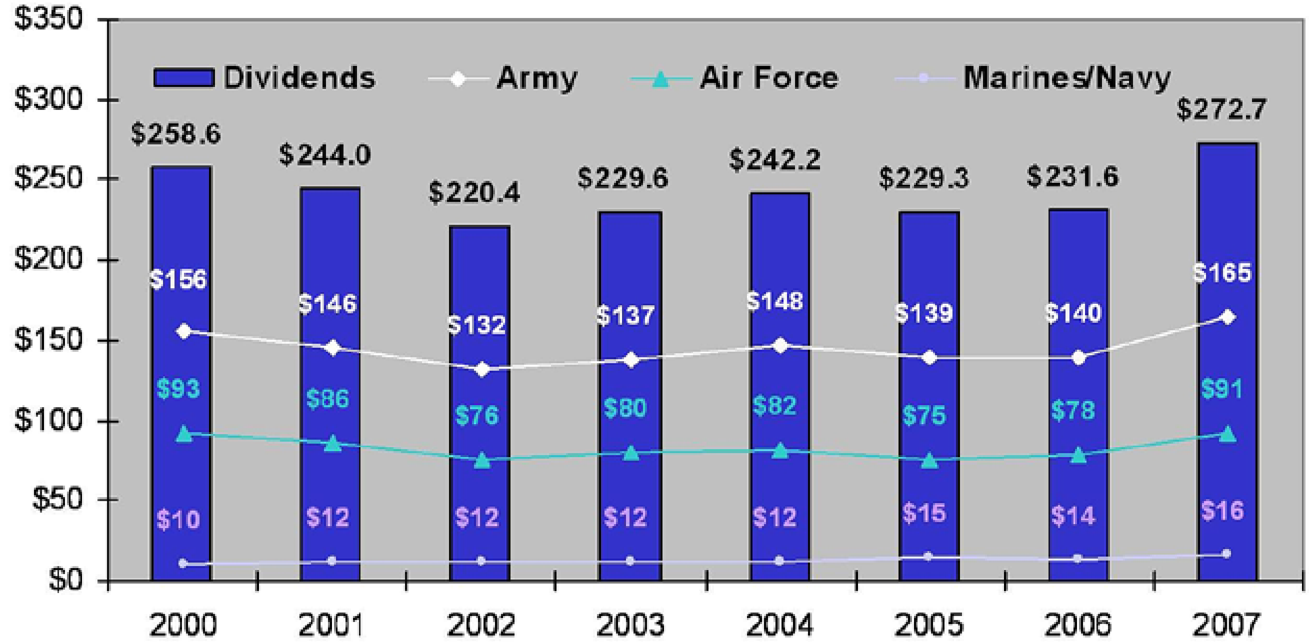
Other AAFES Events in 2007:

At Fort Sam Houston's Brooke Army Medical Center, AAFES serves troops recovering from injuries so these "wounded warriors" can concentrate on rehabilitation rather than worrying about getting haircuts and clean socks.

AAFES tactical field exchanges, like the one pictured above, are serving troops building schools, hospitals and wells in Trinidad, Tobago and Suriname. The exchanges also support mission training, exercise support and troop redeployment, and disaster response in the United States.

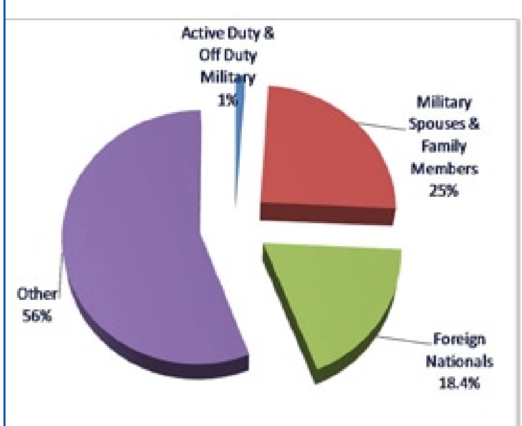
AAFES

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.

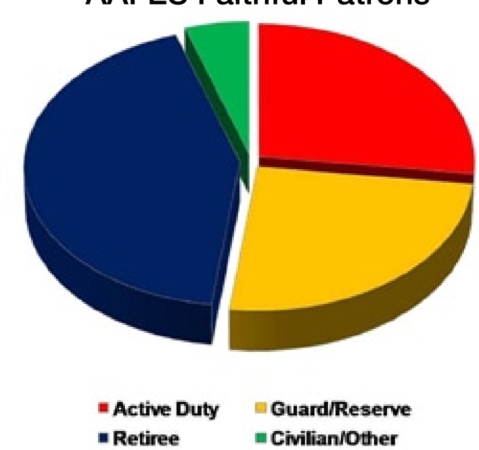
AAFES Associates



"Foreign nationals" include residents of Iraq, Afghanistan, Kuwait, Bosnia, Kosovo and other countries in which AAFES operates exchanges.

"Other" includes employees who were not in the Armed Forces or Family members of Soldiers and Airmen.

AAFES Faithful Patrons

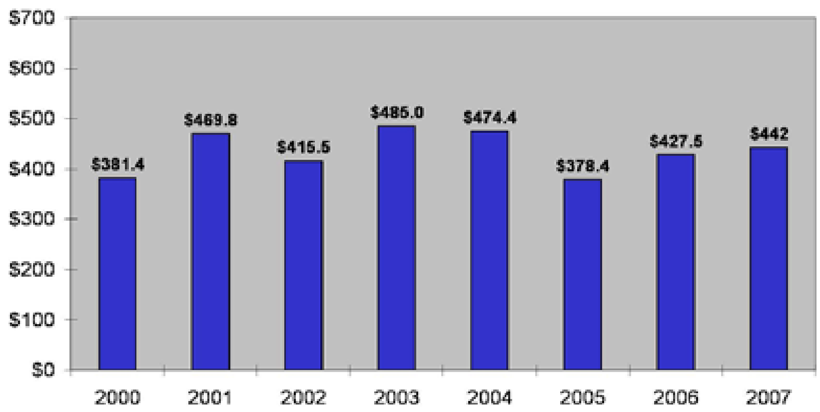


AAFES ranks . . .

- 38th on the list compiled by Stores.com of the top 200 retailers, one spot ahead of Nordstrom, the upscale department store chain.
- 58th in the *Internet Retailer* Top 500 Guide, thanks to *www.aafes.com*.
- 67th largest exporter in the United States, one of only three retailers in the top 100, according to the *Journal of Commerce.*

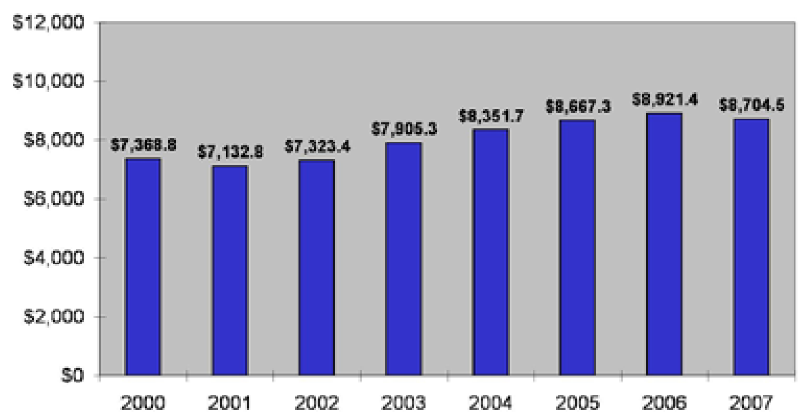
Snapshots

Earnings 2000-2007



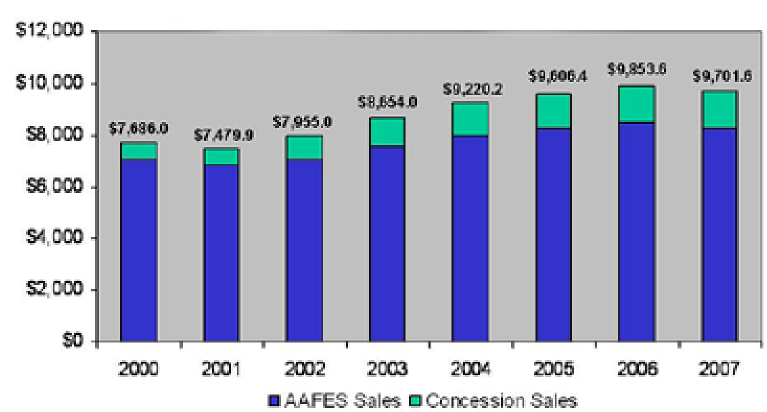
Note: Figures in millions.

Revenue 2000-2007



Note: Figures in millions.

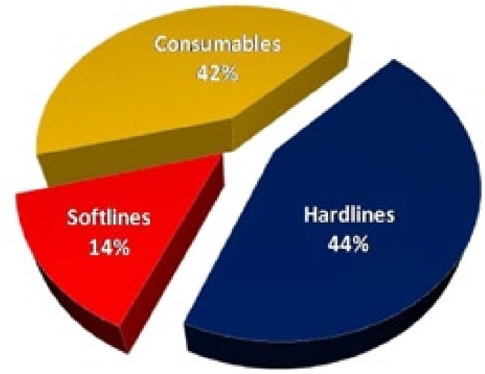
Total Retail Sales 2000-2007*



*Note: Figures in millions. * — Includes concession sales*

Charts compiled by Brooke Pester, AAFES financial analyst, and designed by Maj. Edwina Walton. For audited financials, see Page 22.

The Earnings Breakdown



"Hardlines" include electronics, such as computers, HD TVs, CDs, videos; stationary, books and magazines; housewares, furniture, linens, home accents and furnishings; pet supplies and food; appliances; hardware; outdoor living furniture and accessories; sporting goods and bicycles; toys.

"Softlines" are clothing, footwear, jewelry and other accessories for men, women and children.

"Consumables" are beverages, tobacco, food, snacks, fragrances, cleaning supplies, health and beauty aids.

- While 2007 was a challenging year for retailers, AAFES continued to demonstrate it is a strong and viable organization with strategic resilience and financial health to compete in the global marketplace.
- AAFES ended the year with earnings totalling $426 million, subject to dividends, a 27-percent increase from FY 2006, including appropriated funds.
- AAFES contributed $272.7 million in dividends, which support the Army, Air Force, Marine Corps and Navy service members and their Families. This return represents the highest dividend returned to the Services since 2000. These remarkable results are due to the outstanding efforts to improve supply chain efficiencies across the enterprise and, in part, attributable to Congressional supplemental funding for reimbursement of AAFES expenses in support of the Global War on Terror.
- AAFES earnings generate dividends for the military community while simultaneously funding its construction program to ensure its facilities provide a world-class shopping environment.

2008 and Beyond

"A foundation of basic retailing is ensuring we use technology to drive results and create sustainable business platforms." — Brig. Gen. Keith Thurgood

Oracle Retail signals bright financial future for AAFES

In February 2008, AAFES joined an elite group of major retailers by implementing the final phase of the $177 million Project Retek's Oracle Retail, the largest information technology project in the company's history.

For the past four years, more than 200 people on the "Project Retek" implementation team and from across AAFES, including three who returned from Iraq, have worked tirelessly and with unwavering dedication to make Oracle Retail work, said Susan Schweitzer, the project director.

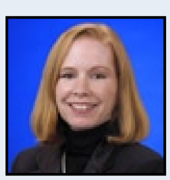
AAFES completed the technical implementation in 2007. In February 2008, the Oracle tool was turned over to the business division to put into operation in exchanges throughout the world during the next three to four years.

This sophisticated technology will help AAFES tap the retail industry's best merchandising, allocation, replenishment, forecasting, pricing and inventory management practices to ensure we get the right products to the troops and their Families in the right place, at the right time, at the right price, and in the right quantity.

'Riding a new wave'

"We're riding a new wave and using technology to gain efficiencies that are going to keep us competitive, better able to efficiently and accurately price our products, and remain our customers' first choice in 2008 and beyond," said Chief Operating Officer Michael Howard.

"We can keep high-demand items stocked at greater levels, reduce our need for price markdowns, and boost our transportation savings," he said. "We also will enjoy a single, accurate and quickly accessible source of sales and inventory information that will help us make better buying and price management decisions."



"Delivery of a true end-to-end supply chain management will allow AAFES to realize a competitive advantage in an aggressive global market."

—Maggie Burgess, Senior VP, Sales Directorate

AAFES leaders estimate that because of Oracle Retail, earnings will increase by $84.6 million by 2012.

AAFES is in good company: Walgreens, Toys"R"Us, Office Depot, Nordstrom, Pier 1 Imports, Barnes & Noble, Borders, Radio Shack, and 15 of the top 16 food and drug retailers use the technology.

In fact, retailers running Oracle Retail are 32 percent more profitable than their peers. AAFES leaders estimate that because of Oracle Retail, earnings will increase by $84.6 million at the end of 2012 through:

- Increased sales;
- Improved profit margins;
- Reduced inventory investment;
- Lower costs.

'Fundamental change'

In early 2008, the Sales Directorate reorganized and created new responsibilities to manage Oracle Retail and see the technology through to success.

"Project Retek marked a fundamental change in corporate culture and in the way AAFES conducts day-to-day business," said Maggie Burgess, senior vice president over the Sales Directorate. "Delivery of a true end-to-end supply chain management will allow AAFES to realize a competitive advantage in an aggressive global market."

In 2005, the world's largest enterprise software company, Oracle Corp., acquired Retek Inc. At AAFES, "Project Retek" refers to integration of Oracle Retail software into the company's technology architecture, and included business processes, application designs, quality assurance testing and other components.

Our Imprint Across the World

AAFES' private label products saves customers 20 to 50 percent compared to comparative brand names. **In 2007, our private labels generated more than $120 million in revenue.**

Classic casual and career clothes for value-conscious adults—and their children, too.

Our R&R, De.Coded, Junction West, Luciano Dante, Passports, Wear It, New Recruit, Buzzcuts, Ponytails, Gumballs, PBX Basics and Pro brands are comparable to clothes at Macy's, Dillard's, Banana Republic, JC Penney, Kohl's, Lane Bryant, GAP, Abercrombie & Fitch and others.

Get your house, clothes, body squeaky clean with "Exchange Select" products.

Nearly 560 health, beauty and cleaning products, including diapers; bath tissue; trash and sandwich bags; charcoal, utensils, paper plates for picnics; cameras and film; creams and lotions; over-the-counter medicines for aches and allergies, coughs and colds, cuts and scraps; razors; soaps and detergents; paper towels; polish for your nails and furniture; and many others, all comparable to Aveeno, Coppertone, Claritin, Dial, Gillette, Huggies, Neutrogena, Oil of Olay and others.

Color, fashion, design and style!

Simply Perfect for the Home, the exclusive program that debuted in 2007, features home decor, dinnerware, flatware, glassware, furniture, beds, and linens. Simply Perfect for the Home by Bassett Furniture is AAFES' first venture in co-branding. Simply Perfect for Baby by Bassett will roll out in late 2008.

Quell the munchies with Patriot's Choice!

52 delectable items: Patriot's Choice gummy beans, bears, sharks and worms; rings, slices and twists; pretzels and all kinds of nuts and seeds; butterscotch, cherry, mint, orange, peach, sour and spice candy; drink mixes; pediatric drinks and Baby Choice's infant formulas.

EXCHANGE Select

"Savvy shoppers know these added savings don't come at the price of reliability."

—Bettye J. Golson,
AAFES General Manager, Tinker Air Force Base, Okla.

Offering a Lifestyle

Soldiers, Airmen and their Families don't want to leave the installation to find fun. New lifestyle centers will give them vibrant places to live, work, play and shop.

Imagine you're a Soldier or an Airman, strolling with your Family on the military installation, the quaint surroundings featuring well-known restaurants, movie theaters, boutique clothiers, gurgling fountains, comfy benches and lots of green space.

You can just feel a sense of community spirit, and your Family wouldn't mind coming back again and again, staying longer each time—and spending more money.

Joseph Giuffreda hopes that if AAFES builds it, they will come.

Shopping, entertainment, dining

In the fall of 2009, AAFES plans to open its nearly 490,000 square foot, $82 million "lifestyle center" at Fort Bliss in El Paso, Texas, providing a unique mix of shopping, entertainment, dining and relaxation venues, the first of its kind on any military installation in the world.

The lifestyle center is expected to create $488 million in earnings and boost the dividend to Morale, Welfare and Recreation programs for the troops from $155 million to $257 million.

Planning continues on lifestyle centers at Fort Sam Houston in San Antonio, Texas; Fort Carson in Colorado Springs, Colo.; Eglin Air Force Base in Fort Walton Beach, Fla.; and Fort Lewis in Tacoma, Wash. Fort Sam Houston's lifestyle center will be even bigger than the one at Fort Bliss because of a larger number of Soldiers and military retirees in the San Antonio area, said Giuffreda, who heads the projects for AAFES' Strategic Planning and Partnerships Directorate.

"We intend for these centers to bring onto the installations those contemporary evening entertainment and shopping choices that customers find off-post, and sometimes just outside the gate," he said. "We'll create not only a shopping center, but a destination location where Families will desire to come to spend extended periods of time.

"Think of days gone by when the town center was the hub of activity for a community, and you'll will begin to understand the concept of the modern lifestyle center."

21st century shopping

The massive project is part of nearly $795 million in AAFES construction this year in the United States to prepare for the Department of Defense's base closings and redeployment of hundreds of thousands of troops. Fort Bliss is among military installations expected to get the lion's share of redeployed Soldiers.

But, AAFES also is catching a tidal wave in the retail world. Industry experts say lifestyle centers in general represent shop-

Continued on next page

Catching a Retail Wave

Lifestyle centers are more like an enclosed mall turned inside out, like walking down Main Street.

continued from previous page

ping in the 21st century, especially for finicky shoppers bored with noisy, windowless indoor malls.

"AAFES had traditionally built its big-box retail stores right beside the big-box commissaries with a massive parking lot out in front," Giuffreda said. "But we've seen the trends in retailing and how the enclosed mall is seldom being built any more. Lifestyle centers are like a mall turned inside out, with everything that can remind you of growing up in a small town and walking down Main Street."

Joseph Giuffreda

Steady growth

During the past two years, the number of lifestyle centers has grown from just a few dozen based in warm climates to about 150 in 2008 throughout the United States, according to the International Council of Shopping Centers, an industry trade group.

Council spokeswoman Erin Hershkowitz said she expects the number of lifestyle centers to double over the next few years.

"The center becomes a place where Families can have an outing by shopping, catching a movie, taking in dinner, and then getting some ice cream cones afterward," she said. "It creates a lifestyle, hence the name."

What's more, sales at lifestyle centers average about $298 per square foot compared to $242 for traditional malls, while overall operating costs are lower, Hershkowitz said.

"Property owners get more bang for their bucks," she added.

Fort Bliss' lifestyle center will fan out over 57 acres and feature a traditional AAFES main store—more than 130,000 square feet bigger than the present 86,000 square foot facility—on one end and a new 111,000-square-foot commissary on the opposite end. More than 200,000 square feet of third-party retailers, including a 30,000-square-foot fitness center and six-screen movie theater, will comprise the middle.

AAFES leaders expect to break ground in July.

Enough brigades are being transferred to Fort Bliss that the lifestyle center will likely see more than 18,000 new customers and as many as 130,000 by 2012, according to the Fort Bliss Transformation Office.

"It becomes a place where Families can have an outing by shopping, catching a movie, taking in dinner, and then getting ice cream cones afterward. It creates a lifestyle, hence the name."

"This is absolutely the right time to move forward with this new concept and capture additional earnings and spectacular quality-of-life improvements," Giuffreda said.

What's more, AAFES is using the lifestyle centers to forge relationships with designers, architects, lodging providers and others to cement its profile as a market leader.

"The future belongs to those who collaborate in style," said AAFES Commander Brig. Gen. Keith Thurgood. "By building collaborative relationships, we can accomplish more together than we can by acting independently."

FORT BLISS, Texas—**An architect's rendering shows the first lifestyle center on a military installation anywhere in the world, a unique combination of retail shops, traditional AAFES PX, commissary, movie theater, comfy benches and shady trees.**

AAFES by the Numbers

3,100+ — Number of retail outlets at Army and Air Force installations across the world in **30** countries.

11.6 million — Number of active-duty troops, Reserves, National Guard members, retirees and their Families served by AAFES.

43,000+ — The number of AAFES civilian associates and managers around the world, including **10,918** spouses and children of Soldiers and Airmen.

85 and **197** — The number of AAFES exchanges and brand-name restaurants in Iraq, Afghanistan, and throughout the Middle East.

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

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

3,600+ — 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.

A Soldier at Camp Liberty, Iraq

$272.7 million — The dividend for 2007, a 17-percent increase from 2006.

$1.5 billion — Annual sales from the Military Star low-interest credit card AAFES manages for all Armed Forces exchanges.

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

30,000+ — Number of items offered on AAFES' Web site, *www.aafes.com*.

19.84% — The average savings a customer enjoys buying at AAFES compared to the competition, not counting the no sales tax benefit!

4.4 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 cost of new construction for AAFES shopping centers around the world.

1.5 million — The number of distinct items (SKUs) in AAFES stores.

AAFES continues to fulfill its 113-year-old mission of providing merchandise and services at competitively low prices to generate earnings to support the Morale, Welfare and Recreation programs for America's Troops.

Factoids

Five Years in Iraq

1 and 24 — The number of American associates and foreign nationals working for AAFES killed in the line of duty.

7 and 18 — Number of American associates and foreign nationals wounded in the line of duty.

3.3 million — Cans of Red Bull and Monster energy drinks sold in Army PXs and Air Force BXs since February 2006.

10.6 million — Burger King Whoppers and Pizza Hut pizzas sold at exchange service concessions since the invasion.

417 million — Military Exchange Global prepaid phone card minutes used by troops since 2004 to call home from Iraq.

$737 million — Retail sales in 2007 for AAFES facilities in all war zones, up 13.8 percent from 2006.

Our Associates Go the Extra Mile

Ann Scott

Corporate Energy Program Manager
HQ AAFES, Dallas

Last year, Ann discovered AAFES was paying at least $1.5 million too much to keep on the lights.

Scott charted utility costs by every building, and found the exchanges were being charged much higher Department of Defense agency rates rather than special rates for organizations like AAFES.

The annual savings ranged as high as $288,000 for MacDill Air Force Base near Tampa, Fla.

Alan Scheer

Graduate Gemologist
Fort Gillem, Ga.

Shoppers who buy "fine jewelry" in any AAFES exchange can rest assured that Alan Scheer has put everything under the microscope, literally.

Every year, under a high-powered microscope, he scrutinizes 24,000 "fine jewelry" items to ensure that clarity, cut, carat weight and color meet or exceed AAFES specifications. Fine jewelry accounts for more than $100 million in revenue for AAFES.

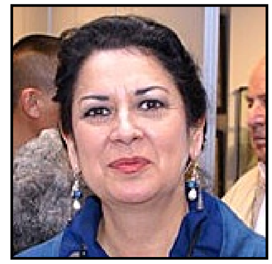
Scheer is part of AAFES' Quality Assurance team, which includes inspectors with more than 80 years' experience who pore over everything from adult Army jackets and kids' pajamas to crock pots and Christmas lights.

Factoid—*www.aafes.com*

Check out the AAFES Web site, *www.aafes.com*, for speedy access to the All-Services Exchange Online Store and more than 30,000 products from AAFES and 75+ vendors.

Erika Pfauntsch

General Manager, BX
Kadena Air Base, Okinawa, Japan



A 28-year AAFES veteran and one of the top managers, Erika views the store through customers' eyes, engaging shoppers daily. She focuses on training, mentoring and coaching associates, who then enjoy the ability to solve any problems customers may have.

"I encourage one-stop answers. I also encourage shared success, and the notion that every associate is an indispensable member of the AAFES team."

Higinio Ortiz

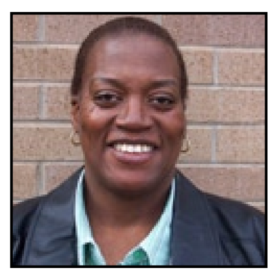
Motor Vehicle Operator
Fort Bliss
El Paso, Texas

In 2007, Higinio was inducted into the National Private Truck Council's Hall of Fame after logging more than 4 million accident-free miles during his 49-year AAFES career. He is one of only 12 truckers nationwide to reach that nearly impossible milestone of so many safe miles.

He also was named the 2007 Driver of the Year for AAFES. He logs 100,000 miles a year delivering merchandise throughout the Southwest, engaging in his love affair with the wide open spaces.

Floris Jenkins

End-User Computer Technician
Cannon AFB, N.M.



The mother of four children deployed to Qatar for 13 months and another five months in Kuwait, lending her technical expertise to the troops.

The 24-year AAFES veteran deployed the first time because she wanted to give something back to her country; the second time, because her son signed up to deploy but couldn't go because of medical reasons.

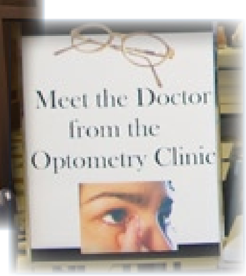
Since 1990, nearly 1,800 current Associates have deployed overseas at least once.

What Else Does AAFES Do?

- Provides a $280 million economic impact to Dallas/Fort Worth, with nearly 2,600 employees at its headquarters.
- Operates overseas bakeries and water bottling activities that make Wonder and Country Heart breads and Culligan Water products for commissaries, troop dining facilities, military hospitals, and Morale, Welfare and Recreation clubs.
- Furnishes calling cards and phones for troops to call loved ones back home.
- Provides packing, shipping and florist services; optometry care and optical centers; gas stations; barber shops, hair and nail salons; spas; dry cleaners; new car sales; Internet cafes; military clothing stores; and movie theaters.
- Manages the All-Services private label credit card, the Military Star C0ard.

GIESSEN, Germany—**A sign at the Giessen Distribution Center near Frankfurt best illustrates the AAFES motto, "We Go Where You Go."**

So Much More than Just a PX/BX



We listen to our customers

Continued from Page 2

- Gained approval from the Board of Directors for our first-ever public-private venture at Fort Bliss, Texas. ***(See Page 10)***

Winning the future

And more good news: this is the beginning of "Winning the Future" by "thinking BIG and acting small." The future is very bright. We are building on the legacy of the past and continuing to execute our strategies with a focus on operational excellence and customer service.

I am confident of what lies ahead. I am confident in our team's ability to deliver world-class productivity, service and opportunities.

We anticipate growing sales and driving more customers to our stores by focusing on our seven priorities for 2008 and our long-term strategies.

Irreversible momentum

We expect to build on the "irreversible momentum" we created in the past year. We are listening to our customers and updating our store designs to better meet their needs and exceed their expectations.

We are committed to enhancing the in-store and online experience by clearly telling our value story, improving our assortment and quality of goods and services, and providing world-class customer service that educates and engages our patrons.

QATAR **— AAFES brings a 'taste of home' to Soldiers fighting the Global War on Terror.**

"To the extent that we deliver on our commitments, our fighting force is more effective and our Families, retirees and other customers get an excellent return on their investment in the AAFES team."

We also recognize that collaborating with our trading partners, community leaders and other agencies makes us better managers and leaders, and we fully expect to extend these efforts beyond the historical boundaries in 2008.

All this is possible because of our dedicated associates who make a difference in our business everyday. We recognize their significant contributions and are investing twice as much in our people and team as we did last year.

At AAFES, we recognize that how we execute our mission is a critical factor in being recognized as an important mission partner and "combat multiplier."

'Strong and viable'

To the extent that we deliver on our commitments, our fighting force is more effective, and our Families, retirees and other customers get an excellent return on their investment in the AAFES team.

AAFES is a strong and innovative organization with strategic resilience and financial health to compete globally. In this report you will read about how we expect to perform at the "top of the class" by creating value and being recognized as an industry leader.

The future is indeed bright!

Brig. Gen. Keith Thurgood assumed command of AAFES in August 2007. He served previously as Assistant Division Commander (Operations), 95th Division, U.S. Army Reserves, Oklahoma City. He was deployed to the Middle East in 2006 as commander of 143rd Transportation Command and deputy commander for Theater Support. When not on active duty, he directs strategy and innovation at PepsiCo, Inc.

Equal to Purple Heart

A Special Award for a Special Hero

FORT HOOD, Texas—Bety Desil didn't know whether she'd make it out alive in 2007 after mortars struck Iraq's Camp Cuervo.

As the mortars exploded just outside the PX where Bety worked, the AAFES associate felt dozens of pieces of shrapnel piercing deep into her foot. In searing pain, she tumbled to the floor, bleeding profusely and fearing for her life.

The clock read 5:20 on the blistering hot afternoon, July 27, her 30th birthday. She had been looking forward to leaving the next day for the United States as her deployment concluded.

In October, Bety returned to work to Fort Hood, where she works as a forewoman for Einstein Bagels. On March 14, Bety, recovered from her injuries, received the federal government's Defense of Freedom Award—the civilian equivalent of the Purple Heart. She is the fourth AAFES associate presented with the medal in the organization's 113-year history, all for service in Iraq.

"Thanks for everything you've done as a civilian in a combat zone to support our Soldiers," said AAFES Commander Brig. Gen. Keith Thurgood, as he presented the award to Bety. "You are leaving a legacy at AAFES, and you are an AAFES hero."

Despite her injuries, Bety said she would return to Iraq again.

"The Soldiers really need us," she said.

Creating a Compelling Reason for Shopping AAFES First

Continued from Page 4

AAFES direct marketing experts increased awareness of the site, in addition to sending out thousands of catalogs to customers throughout the world. In February 2008 alone, more than 870,000 new visitors and at least 370,000 repeat customers logged 5 million page views on *www.aafes.com*.

"Our robust Web site enables customers to purchase goods from just about anywhere in the world," said Richard Sheff, senior vice president for marketing. "This is rapidly becoming a greater portion of the business, now that National Guard members and Reserve troops who live far from military installations continue to discover the benefits of shopping at AAFES.

The entire Coach line is expected to produce more than $37 million in sales in 2008.

"One of AAFES' most significant growth opportunities lies on the Internet."

By going to the Web site, shoppers gain access to more than 30,000 products, and hundreds of thousands of other items from vendor partners.

"Physical space is not a limitation in the virtual world," said Dan King, director of Catalog & E-Commerce.

Best brands, prices

For the Sales Directorate, meanwhile, 2007 was a "turnaround year" as AAFES right-sized inventories by more than $199 million and increased inventory turns by 8 percent.

AAFES started its second year as one of the world's only two authorized partners for Apple computers. Sales of Apple products in 52 AAFES exchanges hit $16 million in fiscal year 2007-2008.

Despite tight worldwide supplies, AAFES provided Wii video consoles and iPods to troops in Iraq and Afghanistan through special allotments from manufacturers.

AAFES also re-energized the "Best Brands-Best Prices-Guaranteed" strategy by offering more than 60 apparel brands with double-digit percentages off manufacturer's suggested retail prices. Simultaneously, AAFES established four "concept shops" devoted to popular Coach women's purses and accessories, with five more coming this year. Shoppers received 25 percent off the manufacturer's suggested retail price.

What's more, the Cross Acceptance Exchange Gift Card

"Our robust Web site enables customers to purchase goods from just about anywhere in the world . . . One of AAFES' most significant growth opportunities lies on the Internet."

—Richard Sheff,
Senior VP, Marketing Directorate

Program was rolled out in November 2007, allowing customers to redeem cards at three military exchange services. The new worldwide Third-Party Prepaid Gift Card Program brought in more than $23 million in sales during 2007.0

Planning for the future

In 2007, the new Planning, Allocation and Replenishment division was developed to implement industry-best practices in merchandise planning, forecasting and inventory management.

And, a strategic planning team is creating ways that AAFES can develop new business opportunities so that Soldiers, Airmen, National Guard members, Reservists, their Families and retirees can have even more reasons to shop their favorite exchange.

"Our buyers, planners, and restaurant and service experts will continue to concentrate on increasing sales and margins, cutting costs from the supply chain, and being first to market," Senior Sales Vice President Maggie Burgess said. "We will continue to find ways to differentiate AAFES from other retailers. Whether with new name-brand restaurants, services, unique merchandise, or creating solutions for our customers, we will create a compelling offer for our customers to shop AAFES first."

*TWIN CITIES AFB—***Airmen enjoy singing and playing the Rock Band video game, an example of how AAFES seeks to keep the most popular products right at the fingertips of customers, whether they're in Minnesota or the Middle East.**

AAFES' Green Carpet

Energy Star products give AAFES customers great breaks on their utility bills.

Continued from Page 4

- Reducing energy consumption by 3 percent a year;
- Reducing waste;
- Cutting consumption of petroleum products 10 percent by 2015;
- Increasing amount of reuseable shopping bags;
- Increasing recycled office paper by 15 percent.

Savings at the store level, too

Families also looking to stretch their energy dollars need look no further than their nearest PX, BX or at *www.aafes.com.* In 2007, AAFES became one of Energy Star's newest partners, and now helps shoppers buy energy-efficient refrigerators, washers and dryers, DVD players, and other products.

Thanks to the U.S. Environmental Protection Agency's Energy Star, Americans last year saved the energy required to power 15 million homes, saving $7 billion on their energy bills, and reduced air pollution equivalent to taking 14 million cars off the road.

In addition, AAFES formed a real-estate energy management team and joined the U.S. Green Building Council in 2007 to reduce energy consumption through employee training and construction of four shopping centers that are Leadership in Energy and Environment Design (LEED) certified.

The shopping centers at Fort Polk, La.; Randolph Air Force Base, Texas; Fort Belvoir, Va.; and Fort Bliss, Texas, will set new standards in energy efficiency.

Factoid

In 2007, AAFES recycled:

- **1.3 tons of cardboard;**
- **351 tons of metal;**
- **10 tons of office paper;**
- **100,487 pallets on which products are stored in warehouses.**

What's more, of the 1.2 millions of gallons of gas used last year, about 180,000 of them were biofuel.

"It pays to be green," said Senior Vice President Dan Metsala. "Rising utility costs affect our expenses and operations, but also the dividend we provide to support the Morale, Welfare and Recreation programs for the troops. By focusing our attention on reducing our energy footprint, we hope to make military installations, and the world as a whole, a better place to live, work and shop."

"It pays to be green."

— Dan Metsala,

Senior VP, Real Estate Directorate

Furthermore, AAFES seeks to make thousands of its 21,000 vending machines Energy Star compliant by late 2008 and is partnering with restaurants to create "pollution solutions," such as energy-efficient cooking, refrigeration and heating methods.

Energy-efficient lighting over gasoline pumps have yielded savings of up to 60 percent in electricity.

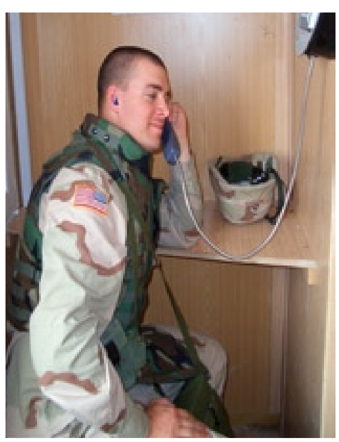
Resilian meets evolving telecom needs

Continued from Page 4

said. "We're going well beyond off-the-shelf offerings to create customized products to provide them with the same telecom experiences available in every major U.S. city, whether they're based in the United States or overseas.

The new products will be available exclusively from AAFES, and complement the existing array of telecom services, such as pay phones, calling cards, Internet cafes and WiFi that the company has provided around the world for 20 years.

During the planning stages, Resilian focus groups of current and potential customers identified what they wanted most: global portability, convenience, competitive pricing, and bundled TV, Internet and telephone offerings comparable to what's available in the United States.



Telecom products designed to meet the needs of today's on-the-go military are coming soon from AAFES.

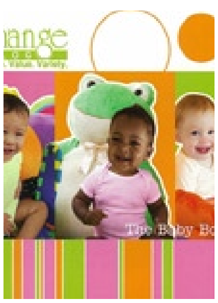
The Resilian initiative is part of an overall corporate strategy that includes creating profitable new businesses.

AAFES is positioned to accelerate profitable growth by developing and bringing innovative businesses to market as quickly as possible, said Commander Brig. Gen. Keith Thurgood.

"We've been in the telecom business for nearly 20 years and our major products have served our customers well, but their needs continue to evolve," he said. "Resilian is expected to significantly improve AAFES' financial performance and help improve dramatically the quality of life of Soldiers, Airmen and their Families."

Among Our Many Awards and Accolades

For the second straight year, DiversityBusiness.com recognized AAFES as **one of America's Top Government Organizations for multicultural business opportunities.** *Hispanic Trends* magazine recognized AAFES as **one of the Top 50 Corporations for Supplier Diversity.** The Dallas Regional Minority Business Development Agency recognized 16 AAFES buyers and contracting officers for **purchasing $1 million or more in goods and services from minority and women-owned businesses.**



Three AAFES catalogs from 2007—*The Baby Book, Home Decor Summer* and *Outdoor Living*—were named **finalists in the 23rd Annual Multichannel Merchant Awards competition.** Finalists were chosen from a highly competitive field of nearly 200 entries from throughout the world. The catalogs were published by the AAFES Direct Marketing Team. Meanwhile, the AAFES Web site, *www.aafes.com*, was named finalist for **Best International Web site**. *Internet Retailer* also named the site the 58th largest out of 500 Web sites, based on volume.

AAFES received **the 2007 Goody Products "Sales Achievement Award"** for attaining and surpassing $5 million retail sales for the first time in the history of the program. Goody is one of the country's largest providers of styling tools and hair accessories for women.

In 2007, *Playthings*, a major industry trade journal, recognized AAFES for **having the largest sales growth among major toy businesses—a 21 percent explosion to $290 million.** AAFES sells toys at more than 150 exchanges around the world and on *www.aafes.com*.

Charley's Grilled Subs

Multi-Unit Partner of the Year

Subway eat fresh.

Franchisee of the Year
Multi-Unit Operator of Year

Popeyes Chicken & Biscuits

International Silver Plate Awards to Misawa AB, Japan; Lakenheath AB, United Kingdom

Pizza Hut

Taco Bell Express

A&W

Global Developer of the Year, Operator of the Year, awarded by these restaurants' parent company

Manchu Wok

Church's Chicken

Developers of the Year

AAFES named as **one of the country's top 10 Military Spouse Friendly Employers** by *Military Spouse* magazine.

Twenty-five percent of AAFES' 43,658 associates are military Family members.

AAFES is the largest employer of military Family members in the U.S. Department of Defense.

Building for the Present and the Future

AAFES' $1.2 billion during the next few years in construction provides unique shopping environments, addresses base closings and troop redeployments.

In 2007, AAFES completed nearly $355 million in capital improvements at 57 military installations throughout the world to provide shoppers with 496 new or renovated retail, dining and services destinations.

The projects included eight new shopping centers, such as the ones at Los Angeles Consolidated, Peterson AFB in Colorado, Grafenwoehr and Panzer Barracks in Germany, Georgia's Fort Benning, and Hawaii's Schofield Barracks.

The construction also included retail, food and bookstore outlets; mini-malls, shoppettes and gas stations; automobile repair facilities and car washes; and launderettes.

FORT BENNING, Ga.—**Soldiers and Family members enjoy holiday shopping at AAFES' new shopping center.**

'Undeniable benefit'

"AAFES earnings generate dividends for the Morale, Welfare and Recreation of our troops, while simultaneously funding capital reinvestment to ensure our facilities provide a shopping environment that is an undeniable benefit to the military community," said AAFES Commander Brig. Gen. Keith Thurgood. "The reinvestment in 2007 directly impacts thousands of troops, their Families and retirees, who will enjoy an enhanced in-store experience for years to come."

LOS ANGELES, Calif.—**Cars fill the parking lot of the new AAFES shopping center serving the Los Angeles AFB and surrounding military installations.**

AAFES' current building program includes construction requirements resulting from the U.S. Department of Defense's base closing and troop redeployment programs. The outcome of the department's initiatives is expected to be 13 major expansions of AAFES facilities that will affect more than 65,000 troops.

GRAFENWOEHR, Germany— **An airy, well-lit center court greets Soldiers and their Families.**

In total, AAFES plans to spend $1.2 billion during the next few years for 6.3 million total square feet of new space, from El Paso, Texas, to Stuttgart, Germany, to the Island of Okinawa. For instance, Fort Bliss near El Paso is expected to gain a lion's share of the redeployed troops, so AAFES plans to start construction on a $82 million Lifestyle Center. ***(See Page 10)***

SCOFIELD BARRACKS, Hawaii— **The new AAFES shopping center blends into the Hawaiian landscape.**

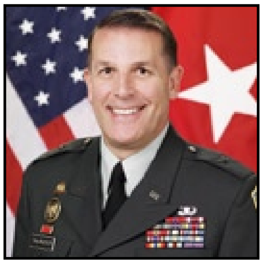
Hickam to Hainerberg

Other major projects in the United States include Fort Benning, Ga.; Fort Sam Houston and Fort Hood, Texas; Fort Belvoir, Va.; Fort Riley, Kan.; Little Rock Air Force Base, Ark.; Fort Campbell, Ky.; Fort Meade, Md.; and Shaw Air Force Base, S.C.

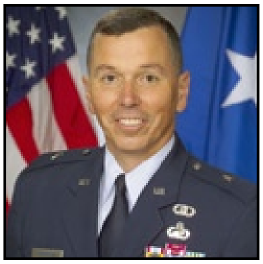
In Europe, 35,000 troops are being redeployed around the world, so construction projects will center on Kaiserslautern, Grafenwoehr, the European Command Center in Stuttgart, Hainerberg/Wiesbaden, and Spangdahlem/Bitburg, where the majority of the remaining Soldiers and Airmen will remain.

In the Pacific, 14,000 troops will be restationed, which means AAFES is spending $185 million on facilities at Kadena AB on Okinawa, Osan AB and Camp Humphries in South Korea, Andersen AFB in Guam, and Hickam AFB at Pearl Harbor.

AAFES Leadership



Brig. Gen. Keith Thurgood,
Commander



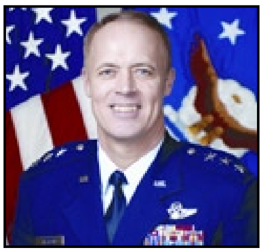
Brig. Gen. Fran Hendricks,
Deputy Commander

Michael Howard,
Chief Operating Officer

Chief Master Sgt.
Bryan Eaton
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. Ann E. Dunwoody, USA, Senior Member
Deputy Chief of Staff, G-4, U.S. Army

SMA Kenneth O. Preston
Sergeant Major of the Army

CMSAF Rodney McKinley
Chief Master Sergeant of the Air Force

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

Maj. Gen. Edgar E. Stanton III, USA
Director of Army Budget

Maj. Gen. G. Michael Hostage III, USAF
Vice Commander, Pacific Air Forces

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

Maj. Gen. George R. Harris, USAR
Assistant Military Deputy to Assistant Secretary Army (Acquisition, Logistics and Technology)

Maj. Gen. John A. MacDonald, USA
Commander, U.S. Army Family and MWR Command

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

Ronald A. Winter, SES
Principal Deputy Assistant Secretary of the Air Force (Manpower & Reserve Affairs)
Deputy Assistant Secretary of the Air Force (Force Management Integration)

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

Arthur J. Myers, SES
Director, Air Force Services (AF/A1S)

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

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

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

Gregg Cox
Executive Secretary

As of June 2008, the position of Army Member At Large was vacant.

IRAQ—**AAFES provides a break from the traditional mess halls by operating 197 name-brand restaurants in the Middle East.**

Financial Statements

Army and Air Force Exchange Service
Years Ended February 2, 2008 and February 3, 2007

FORT HOOD, Texas — AAFES Associates were out in force one sunny day this past April to help more than 80,000 people welcome home hundreds of thousands of troops who were coming home from Iraq. From its earnings at the Fort Hood PX, AAFES gave more than $4 million in dividends to the Morale, Welfare and Recreation programs for Soldiers at the Central Texas installation, one of the largest in the world.

Army and Air Force Exchange Service

Financial Statements

Years Ended February 2, 2008 and February 3, 2007

Contents

The FY 2007 dividend to MWR programs represents an increase of approximately 17 percent over FY 2006. "This proves that even during tough economic times, the exchange benefit can thrive and remain a relevant quality of life enhancement for its shareholders—the authorized military shoppers who make the BX or PX their first choice."

"With a mission to provide quality goods and services at competitively low prices and generate earnings to support MWR programs, the dual benefit of AAFES provides military Families goes far beyond the clothes, electronics or consumables available at the exchange."

—Brig. Gen. Keith Thurgood, AAFES Commander
quoted in the Offutt AFB *Air Pulse*, June 12, 2008

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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 February 2, 2008, and have issued our report thereon dated May 5, 2008. 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.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

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. We consider the deficiency described in the accompanying schedule of findings and responses to be a significant deficiency in internal control over financial reporting.

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 the 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 the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that none of the significant deficiencies described above is a material weakness.

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* and which are described in the accompanying schedule of findings and responses.

AAFES' response to the findings identified in our audit is described in the accompanying schedule of findings and responses. We did not audit AAFES' response and accordingly, we express no opinion on it.

This report is intended solely for the information and use of management of the Board of Directors, management, 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 5, 2008

Army and Air Force Exchange Service
Schedule of Findings and Responses for the Year Ended February 2, 2008

Financial Statement Findings

AAFES' financial statement close process did not detect that certain investments related to the Company's Supplemental Deferred Compensation Plan were not recorded at fair market value as of February 2, 2008, in accordance with Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (SFAS 115). Rather, an audit adjustment was identified by Ernst & Young LLP.

Company Response
As a result of the finding, we have properly reflected the adjustment in our 2007 audited financial statements. Additionally, as a result of the adoption of the measurement date provision of SFAS 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, at fiscal year-end 2008, this will not continue to be an issue.

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Report of Independent Auditors

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

We have audited the accompanying balance sheets of the Army and Air Force Exchange Service (AAFES) as of February 2, 2008 and February 3, 2007, 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 February 2, 2008 and February 3, 2007, 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 5, 2008 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 Note 1 to the financial statements, on December 31, 2007, the Company adopted the provisions of Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*.

Ernst + Young LLP

May 5, 2008

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Army and Air Force Exchange Service

Balance Sheets

(Dollars in thousands, unless otherwise noted)

	February 2, 2008	February 3, 2007
Assets		
Current assets:		
Cash and cash equivalents	$ 167,751	$ 126,304
Trade and other accounts receivable, less allowance for uncollectible accounts (at February 2, 2008 – $53,736; at February 3, 2007 – $56,654)	2,749,591	2,476,203
Merchandise inventories	1,519,085	1,626,575
Short-term investments	28,982	47,757
Supplies and other current assets	36,314	37,774
Total current assets	4,501,723	4,314,613
Property and equipment:		
Buildings and improvements	2,415,525	2,215,677
Fixtures and equipment	982,148	996,607
Construction in progress	539,405	487,498
	3,937,078	3,699,782
Accumulated depreciation	(1,945,060)	(1,840,883)
	1,992,018	1,858,899
Other assets	4,321	2,079
Prepaid pension assets	1,515,681	903,845
Long-term investments and Supplemental Plan assets	357,015	372,395
Total assets	$ 8,370,758	$ 7,451,831
Liabilities and net assets		
Current liabilities:		
Accounts payable	$ 765,031	$ 701,755
Notes payable to banks	1,465,000	1,437,000
Accrued salaries, separation pay, and other employee benefits	153,119	114,573
Dividends payable	70,204	46,376
Other current liabilities	240,019	169,780
Total current liabilities	2,693,373	2,469,484
Accrued pension and other benefits	775,898	400,620
Other noncurrent liabilities	56,460	55,086
Total liabilities	3,525,731	2,925,190
Net assets:		
Accumulated other comprehensive income (loss)		
Pension liability	108,435	(38,328)
Derivative instruments	3,731	1,145
Accumulated other comprehensive income (loss)	112,166	(37,183)
Retained earnings	4,732,861	4,563,824
Total net assets	4,845,027	4,526,641
Total liabilities and net assets	$ 8,370,758	$ 7,451,831

See accompanying notes.

0801-0908182

Army and Air Force Exchange Service

Statements of Earnings

(Dollars in thousands, unless otherwise noted)

	Years Ended February 2, 2008	Years Ended February 3, 2007
Net sales	**$ 8,257,279**	$ 8,474,145
Finance revenue	**242,820**	225,242
Concession income	**192,262**	192,413
Other operating income	**12,122**	29,648
Total revenue	**8,704,483**	8,921,448
Cost of sales and operating expenses:		
Cost of goods sold	**6,424,307**	6,671,722
Selling, general, and administrative:		
Employee compensation and benefits	**1,096,238**	1,093,962
Depreciation and amortization	**216,018**	195,400
Other	**507,711**	518,406
Total selling, general, and administrative	**1,819,967**	1,807,768
Interest expense	**49,906**	59,011
Bad debt expense	**12,505**	16,940
	8,306,685	8,555,441
Operating income	**397,798**	366,007
Other income	**43,985**	61,474
Net earnings	**$ 441,783**	$ 427,481

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 January 28, 2006	$ 4,367,975	$ (43,131)	$ 4,324,844
Net earnings	427,481	–	427,481
Net decrease in minimum pension liability	–	3,812	3,812
Net increase in fair value of derivative instruments	–	2,136	2,136
Comprehensive earnings			433,429
Dividends to the Central Welfare Funds, Departments of the Army, the Air Force, the Navy, and the Marine Corps	(231,632)	–	(231,632)
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 earnings			**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**

See accompanying notes.

Army and Air Force Exchange Service

Statements of Cash Flows

(Dollars in thousands, unless otherwise noted)

	Years Ended February 2, 2008	February 3, 2007
Operating activities		
Net earnings	**$ 441,783**	$ 427,481
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	**214,709**	219,341
Loss on disposal of property and equipment	**7,618**	5,933
Gain on Supplemental Pension Plan assets	**(23,523)**	(52,649)
Bad debt expense	**12,505**	16,939
Changes in operating assets and liabilities:		
Accounts receivable	**(285,893)**	(140,672)
Merchandise inventories	**107,490**	49,747
Supplies and other current assets	**1,460**	(2,635)
Other assets	**(2,242)**	9,729
Prepaid pension assets	**(74,999)**	(64,299)
Supplemental Plan assets	**31,338**	25,475
Accounts payable	**44,489**	(49,180)
Accrued salaries, separation pay, and other employee benefits	**38,546**	(11,604)
Other current liabilities	**70,239**	(3,699)
Accrued pension and other benefits	**(14,797)**	2,628
Other noncurrent liabilities	**1,375**	484
Net cash provided by operating activities	**570,098**	433,019
Investing activities		
Purchases of property and equipment	**(373,813)**	(473,355)
Proceeds from the sale of property and equipment	**18,367**	–
Purchases of investments	**(20,548)**	(819)
Proceeds from sale of Supplemental Plan assets	**46,888**	–
Net cash used in investing activities	**(329,106)**	(474,174)
Financing activities		
Proceeds under line-of-credit agreements	**1,465,000**	1,437,000
Repayments under line-of-credit agreement	**(1,437,000)**	(1,185,500)
Change in cash overdraft	**21,373**	6,474
Payment of dividends	**(248,918)**	(213,223)
Net cash (used in) provided by financing activities	**(199,545)**	44,751
Net increase in cash and cash equivalents	**41,447**	3,596
Cash and cash equivalents at beginning of year	**126,304**	122,708
Cash and cash equivalents at end of year	**$ 167,751**	$ 126,304

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 of 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 immune 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	
	February 2, 2008	**February 3, 2007**
Continental U.S.	**$ 5,233,824**	$ 5,442,501
Pacific Rim, including Alaska and Hawaii	**1,087,125**	1,139,309
Germany	**843,009**	884,961
OEF/OIF	**786,891**	691,689
Other countries	**306,430**	315,685
Total net sales	**$ 8,257,279**	$ 8,474,145

(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	
	February 2, 2008	**February 3, 2007**
Continental U.S.	**$ 1,353,616**	$ 1,343,200
Pacific Rim, including Alaska and Hawaii	**287,214**	222,788
europe, primarily Germany	**342,380**	285,149
OEF/OIF	**8,808**	7,762
Total long-lived assets	**$ 1,992,018**	$ 1,858,899

AAFES utilizes those 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.

The value of transportation costs provided by the U.S. Government for AAFES materials shipped to and from overseas AAFES facilities totaled approximately $132,924 and $129,912 for fiscal years 2007 and 2006, respectively. In addition, AAFES received $130,754 and $120,984 in appropriations in relation to OEF/OIF transportation for fiscal years 2007 and 2006, respectively.

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

In fiscal 2007, AAFES received $79,200 in appropriations in relation 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 in relation to OEF/OIF for GFY 2003. In fiscal 2006, AAFES received $78,007 in appropriations in relation to OEF/OIF for GFY 2006. Of this amount, $25,130 was recognized for inventory markdowns and shortages, $16,326 for personnel cost, $4,226 for other expenses, and $32,325 for in-theater transportation. The OEF appropriations or reimbursements are recorded primarily as a reduction of inventory markdowns and shortages as well as selling, general, and administrative expenses in the accompanying financial statements.

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. Property at the BRAC locations was $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[SM] 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 2007 and fiscal 2006 herein are to the fiscal years ended February 2, 2008 and February 3, 2007, respectively.

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

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.

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 the good faith estimates of fair market values for alternative investments as provided by the general partner, investment manager, or appraiser, as appropriate. The estimated fair values 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. In addition, the noncurrent liability for local national separation pay has been adjusted to current rates.

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

Cash and Cash Equivalents and Short-Term Investments

Cash equivalents represent cash on hand in stores, deposits in banks, and third-party credit card receivables. Investments with maturities less than 12 months at year-end are classified as short-term investments. Cash and cash equivalents and short-term investments are carried at cost, which approximates fair value. All book overdraft balances have been reclassified to accounts payable.

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 Company believes that the carrying value of existing customer receivables is the best estimate of fair value.

The Company's accounts receivable balance includes $138,026 of receivables from the Marine Exchange (MCX) for Marine MILITARY STAR[SM] Card outstanding balances and related processing fees.

Approximately $2,193,026 of the accounts receivable balance represents amounts due to AAFES under its in-house credit program, the MILITARY STAR[SM] Card. MILITARY STAR[SM] 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 both fiscal 2007 and 2006 was 13.01% and 13.01% respectively. Finance charges are recorded unless an account balance has been outstanding for more than 180 days.

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

Accounts past due for 30 days or more are considered delinquent. Accounts delinquent for 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.

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 $88,384 and $82,085 in fiscal 2007 and 2006, respectively.

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.

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

Property and Equipment

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 February 2, 2008, property and equipment included approximately $1,396,300 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 $78,465 and $77,385 as of February 2, 2008 and February 3, 2007, respectively. The reserves have been discounted based on a rate of 6.2% at both February 2, 2008 and February 3, 2007.

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 $70,029 and $72,996 for the years ended February 2, 2008 and February 3, 2007, 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 nonappropriated 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 balance sheet reclassifications have been made to the accompanying fiscal 2006 financial statements to conform to the fiscal 2007 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 earnings 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)

Recent Accounting Pronouncements

In September 2006, the FASB issued Statement of Financial Accounting Standards 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 comprehensive earnings 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 and disclosure 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. The Company will adopt the measurement date provisions of SFAS 158 as of January 31, 2009. See Note 4 for further discussion of the effect of adopting SFAS 158 on the Company's financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157). This standard defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The Company will adopt SFAS 157 on February 3, 2008, as required. The adoption of SFAS 157 is not expected to have a material impact on the Company's financial condition, results of operations, or liquidity.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 permits companies to measure many financial instruments and certain other items at fair value at specified election dates. SFAS 159 will be effective beginning February 3, 2008. The Company is currently assessing the impact of SFAS 159 on its financial statements.

2. Investments and Supplemental Plan Assets

On February 2, 2008, the Company held a short-term investment carried at $7,025 which approximates fair value. This investment will mature in April 2008, 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*.

On February 3, 2007, the Company held long-term investments totaling $43,425. Of this total, $36,400 in U.S. Government securities was held for payment of workers' compensation claims in accordance with the Longshore and Harbor Workers' Compensation Act. Upon maturity in 2007, these securities were not renewed. Instead, the Company covered this obligation through use of a Surety Bond policy.

As of February 3, 2007, the Company held a €9,000 (approximately $11,842) German government security to support the liability for the German Local National separation pay, which was included in long-term investments. In August 2007, this bond matured and a new bond, valued at €15,000 (approximately $20,548), was purchased. The new bond is due to mature on September 12, 2008, and is classified as a short-term investment at February 2, 2008. As of February 2, 2008, this new bond was valued at $22,059, which approximates fair value, and was classified as held-to-maturity.

The Company also holds investments related to the Supplemental Plan totaling $357,015 and $364,830 at February 2, 2008 and February 3, 2007, 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. Total gains on trading securities were $23,523 and $52,649 in fiscal 2007 and fiscal 2006, respectively. The cost of securities sold is determined primarily on a specific identification method.

(Dollars in thousands, unless otherwise noted)

2. Investments and Supplemental Plan Assets (continued)

The allocation of Supplemental Plan assets at December 31, 2007 and 2006 (measurement date), by asset category, is as follows:

	2007	2006
Domestic Equity securities	**31%**	42%
International Equity securities	**10**	16
Emerging Market Equity securities	**5**	3
Investment Grade Fixed Income	**21**	19
High Yield Fixed Income	**5**	4
Treasury Inflation Protected Securities	**9**	5
Real Estate–Private	**5**	5
Real Estate–Public	**2**	2
Private Equity	**2**	2
Commodities	**6**	2
Alternative Debt	**4**	0
Total	**100%**	100%

3. Financial Instruments

Lines of Credit

At February 2, 2008, AAFES had an unsecured line-of-credit agreement with a group of banks aggregating $750,000. This is a multiyear revolving credit agreement expiring in December 2012. There was $150,000 outstanding under this line of credit at February 2, 2008. Also at February 2, 2008, AAFES had additional lines of credit with various banks (which are subject to bank approval) aggregating approximately $1,725,000. Borrowings under these lines of credit aggregated $1,315,000 at February 2, 2008. Borrowings under all lines of credit bear interest rates ranging from 3.30% to 5.61%. The average interest rate under these lines of credit was 5.17% for the year ended February 2, 2008.

3. Financial Instruments (continued)

At February 3, 2007, AAFES had an unsecured line-of-credit agreement with a group of banks aggregating $750,000. This is a multi-year revolving credit agreement expiring in December 2011. There was $250,000 outstanding under this line of credit at February 3, 2007. Also at February 3, 2007, AAFES had additional available lines of credit with various banks (which are subject to bank approval) aggregating approximately $1,685,000. Borrowings under these lines of credit aggregated $1,187,000 at February 3, 2007. Borrowings under all lines of credit bear interest rates ranging from 5.35% to 5.48%. The average interest rate under these lines of credit was 5.19% for the year ended February 3, 2007. Based on the short-term nature of these borrowings, AAFES believes that the carrying values of amounts outstanding under the line-of-credit agreements are the best estimate of fair value. Cash paid for interest for fiscal years 2007 and 2006 was approximately $70,453 and $60,905, respectively.

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 accumulated other comprehensive earnings (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.

3. Financial Instruments (continued)

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

As of February 2, 2008, the Company had various foreign exchange contracts (forwards and option collars) outstanding related to approximately \$179,227 (€124 million) of its forecasted payroll and inventory purchase liabilities. As of February 2, 2008, the notional value of the outstanding forward contracts (€84 million) was \$122,427 with a corresponding unrecognized gain of \$3,731. The notional value of outstanding option collar contracts (€40 million) was \$56,800, with a corresponding unrecognized gain of \$2,504. The total unrecognized gain of \$3,731 is included in other current assets on the accompanying balance sheet and is included as a component of accumulated other comprehensive earnings. In addition, the Company has recognized approximately \$10,400 in gains on foreign currency hedge transactions during fiscal 2007.

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 Postretirement Medical/Dental (PRM) and Life Insurance (Other Postretirement) 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 postretirement 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 Postretirement 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 an Equity Securities* (SFAS 115).

AAFES uses a December 31 measurement date for its plans.

On December 8, 2003, the U.S. enacted into law the *Medicare Prescription Drug, Improvement and Modernization Act of 2003* (the Act). The Act established prescription drug benefits under Medicare, known as "Medicare Part D," and a federal subsidy to sponsors of retiree health care benefit plans that provided a benefit that is at least the actuarial equivalent to Medicare Part D. On March 19, 2004, the FASB issued FASB Staff Position No. 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003* (FSP 106-2). The FSP provides guidance on the accounting for the effects of the Act for employers that sponsor postretirement health care plans that provide drug benefits. In 2006 the Office of Management and Budget (OMB) denied the Nonappropriated Fund Health Benefits Program the Medicare Part D employer (cash) subsidy. As such, AAFES management has not reflected the effect of the Act on the PRM plan's accumulated postretirement benefit obligation and the net periodic benefit costs in fiscal years 2007 and 2006.

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. The adjustment to accumulated other comprehensive income at adoption

4. Benefit Plans (continued)

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. 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 at adoption of SFAS 158.

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 income (loss)	(23,986)	132,422	108,436

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 December 31, 2007 and 2006. Amounts are stated in millions.

	Pension Benefits				Other Benefits			
	The Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2007	2006	2007	2006	2007	2006	2007	2006
Change in projected benefit obligations (PBO)								
PBO at prior measurement date	**$ 2,628**	$ 2,652	**$ 367**	$ 371	**$ 1,589**	$ 1,518	**$ 93**	$ 105
Service cost	**58**	61	**4**	4	**21**	24	**3**	4
Interest cost	**155**	151	**22**	21	**93**	91	**4**	3
Plan participants' contributions	**4**	4	**–**	–	**–**	–	**–**	–
Amendments	**–**	–	**–**	–	**–**	(31)	**–**	–
Actuarial (gain) loss	**(93)**	(74)	**(13)**	(5)	**(75)**	49	**(2)**	(14)
Foreign exchange impact	**–**	–	**–**	–	**–**	–	**6**	(2)
Benefits paid	**(161)**	(154)	**(25)**	(24)	**(69)**	(62)	**(4)**	(3)
Administrative expenses paid	**(19)**	(12)	**–**	–	**–**	–	**–**	–
PBO at current measurement date	**$ 2,572**	$ 2,628	**$ 355**	$ 367	**$ 1,559**	$ 1,589	**$ 100**	$ 93

	Pension Benefits				Other Benefits			
	The Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2007	2006	2007	2006	2007	2006	2007	2006
Change in plan assets								
Fair value of assets at prior measurement date	**$ 3,887**	$ 3,518	**$ –**	$ –	**$ 1,056**	$ 903	**$ 33**	$ 30
Actual return on assets	**376**	531	**–**	–	**88**	142	**2**	2
Employer contributions	**–**	–	**25**	24	**86**	73	**5**	4
Plan participants' contributions	**4**	4	**–**	–	**–**	–		
Benefits paid	**(161)**	(154)	**(25)**	(24)	**(69)**	(62)	**(4)**	(3)
Administrative expenses paid	**(19)**	(12)	**–**	–	**–**	–		
Fair value of assets at current measurement date	**$ 4,087**	$ 3,887	**$ –**	$ –	**$ 1,161**	$ 1,056	**$ 36**	$ 33

4. Benefit Plans (continued)

The following tables reflect a reconciliation of funded status and amounts recognized in the balance sheets as of February 2, 2008 and February 3, 2007. Amounts are stated in millions.

	Pension Benefits				Other Benefits			
	The Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2007	2006	2007	2006	2007	2006	2007	2006
Reconciliation of funded status								
Funded status at current measurement date	**$ 1,516**	$ 1,259	**$ (355)**	$ (367)	**$ (397)**	$ (533)	**$ (64)**	$ (60)
Contribution after measurement date and on or before fiscal year-end	**–**	–	**4**	4	**6**	26	**–**	–
Funded status at fiscal year-end	**$ 1,516**	$ 1,259	**$ (351)**	$ (363)	**$ (391)**	$ (507)	**$ (64)**	$ (60)
Amounts recognized in the balance sheets								
Prepaid pension asset	**$ 1,516**	$ 904	**$ –**	$ –	**$ –**	$ –	**$ –**	$ –
Other current liabilities	**–**	–	**24**	22	**–**	–	**6**	2
Accrued pension and other benefits liability	**–**	–	**327**	341	**391**	–	**58**	40
Accumulated other comprehensive income (loss)	**$ 538**	$ –	**$ (18)**	$ (31)	**$ (391)**	$ –	**$ (21)**	$ (3)

A summary of the components of net periodic benefit cost for the benefit plans is as follows for the years ended December 31, 2007 and 2006 (in millions).

	Pension Benefits				Other Benefits			
	The Plan		Supplemental Plan		Postretirement		Foreign Plans	
	2007	2006	2007	2006	2007	2006	2007	2006
Net periodic cost								
Service cost	**$ 58**	$ 61	**$ 4**	$ 4	**$ 21**	$ 24	**$ 4**	$ 4
Interest cost	**155**	151	**22**	21	**93**	91	**4**	3
Expected return on assets	**(288)**	(277)	**–**	–	**(85)**	(79)	**(2)**	(2)
Transition obligation (asset) amortization	**–**	–	**–**	–	**–**	6	**–**	–
Prior service cost amortization	**–**	–	**–**	–	**(4)**	(4)	**–**	–
Net loss (gain) amortization	**–**	–	**–**	–	**41**	55	**1**	2
Net periodic benefit cost (income)	**$ (75)**	$ (65)	**$ 26**	$ 25	**$ 66**	$ 93	**$ 7**	$ 7

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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 Postretirement		Pension Benefits Foreign Plans	
	2007	**2006**	**2007**	**2006**	**2007**	**2006**
Projected benefit obligation	**$ 355**	$ 367	**$ 1,559**	$ 1,589	**$ 100**	$ 93
Accumulated benefit obligation	**355**	367	**1,559**	1,589	**84**	77
Fair value of plan assets	**–**		**1,161**	1,056	**36**	33

Amounts included in accumulated other comprehensive income at December 31, 2007, consist of net actuarial gains of $87 million and a net prior service credit of $21 million. Amortization of these amounts expected to be recognized in fiscal year 2008 is $33 million for net actuarial losses and $4 million 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 Postretirement	
	2007	**2006**	**2007**	**2006**	**2007**	**2006**
Assumptions used to determine expense:						
Discount rate	**6.15%**	5.75%	**6.15%**	5.75%	**6.15%**	5.75%
Long-term rate of return on assets	**8.25%**	8.25%		–	**8.75%**	8.75%
Compensation increase rate	**4.00%**	4.00%	**4.00%**	4.00%	**4.00%**	4.00%
Assumptions used at disclosure:						
Discount rate	**6.50%**	6.15%	**6.50%**	6.15%	**6.50%**	6.15%
Compensation increase rate	**5.19%**	4.00%	**5.19%**	4.00%	**5.19%**	4.00%

	Other Benefits UK Plan		Other Benefits Local National Plan	
	2007	**2006**	**2007**	**2006**
Assumptions used to determine expense:				
Discount rate	**5.10%**	4.75%	**3.50%**	3.19%
Long-term rate of return on assets	**6.80%**	6.60%	**N/A**	N/A
Compensation increase rate	**4.50%**	4.20%	**2.80%**	2.67%
Assumptions used at disclosure:				
Discount rate	**5.80%**	5.10%	**3.68%**	3.50%
Compensation increase rate	**4.80%**	4.50%	**2.65%**	2.05%

(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 December 31, 2007 and 2006, by asset class category are as follows:

	Pension Benefits The Plan		Other Benefits Postretirement Plan		Other Benefits UK Plan	
	2007	2006	2007	2006	2007	2006
Domestic Equity securities	**31%**	31%	**31%**	40%	**25%**	39%
International Equity securities	**10**	15	**10**	17	**34**	27
Emerging Market Equity securities	**5**	5	**5**	5	**4**	–
Investment Grade Fixed Income	**22**	24	**20**	17	**37**	34
High Yield Fixed Income	**5**	4	**5**	5	**–**	–
TIPS	**9**	9	**9**	5	**–**	–
Real Estate–Private	**5**	4	**5**	1	**–**	–
Real Estate–Public	**2**	3	**2**	5	**–**	–
Private Equity	**3**	3	**3**	3	**–**	–
Commodities	**5**	2	**6**	2	**–**	–
Alternative Debt	**3**	0	**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 $24.4 million to The Supplemental Plan and $55.8 million to the other postretirement benefit plans in fiscal 2008. The expected contributions to the pension plans during fiscal 2008 are estimated to reflect fiscal amounts necessary to satisfy minimum funding requirements.

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 Postretirement	Foreign Plans
2008	$ 159	$ 24	$ 77	$ 7
2009	165	25	84	8
2010	171	26	91	7
2011	178	27	98	7
2012	185	27	103	7
2013–2017	1,013	142	576	35

Assumed Health Care Cost Trend Rates at December 31

	December 31 2007	December 31 2006
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	**2013**	2012

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 postretirement 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.

In fiscal year 2006, supplemental dividends of $265 were declared on $531 of Supplemental Plan pension income. In fiscal year 2007, supplemental dividends of $195 were declared on $390 of Supplemental Plan pension income.

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 60 stores as of February 2, 2008. The inventory balance in OEF/OIF has increased from $172,614 at February 3, 2007, to $180,417 at February 2, 2008. 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 $786,891 (9.5%) and $691,689 (8.2%) of the Company's net revenues in the fiscal years ended February 2, 2008 and February 3, 2007, respectively, were 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 $3,410 and $6,736 as of February 2, 2008 and February 3, 2007, 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. The DOD stated that it will provide guidance for notifying employees to file claims and for calculating the retroactive post allowances; this guidance has not been received by AAFES. As of February 2, 2008, AAFES has recorded a charge for its best estimate of its obligation, which is $33 million which is included in current liabilities. It is possible that AAFES' recorded estimate of its obligation may change in the near term pending further guidance provided by the DOD.

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