

AN ANALYSIS OF AAFES AND ITS RELEVANCE  
TO THE FUTURE OF THE ARMY  
AND AIR FORCE

A thesis presented to the Faculty of the U.S. Army  
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fulfillment of the requirements for the  
degree

MASTER OF MILITARY ART AND SCIENCE  
Strategist and Joint Planner

by

ROBERTO SALAS, MAJOR, USA  
M.S., Webster University, St. Louis, Missouri, 2007  
B.S., Georgia Institute of Technology, Atlanta, Georgia, 2000

AD BELLUM PACE PARATI

Fort Leavenworth, Kansas  
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Name of Candidate: MAJ Roberto Salas

Thesis Title: An Analysis of AAFES and Its Relevance to the Future of the Army and Air Force

Approved by:

\_\_\_\_\_, Thesis Committee Chair  
Mark A. Tolmachoff, M.M.A.S.

\_\_\_\_\_, Member  
Jonathan M. House, Ph.D.

\_\_\_\_\_, Member  
Bob A. King, M.S.

Accepted this 12th day of June 2009 by:

\_\_\_\_\_, Director, Graduate Degree Programs  
Robert F. Baumann, Ph.D.

The opinions and conclusions expressed herein are those of the student author and do not necessarily represent the views of the U.S. Army Command and General Staff College or any other governmental agency. (References to this study should include the foregoing statement.).

## ABSTRACT

AN ANALYSIS OF AAFES AND ITS RELEVANCE TO THE FUTURE OF THE ARMY AND AIR FORCE, by Major Roberto Salas, USA, 170 pages.

This study is a comprehensive analysis of the current posture and strategic efforts of the Army and Air Force Exchange Service (AAFES), and evaluates the strategic relevancy and strategic value of AAFES. Strategic relevancy is the distinctive ability to meet the full spectrum of customer requirements and needs. Strategic value is the worth of the service and goods provided relative to both quantifiable and unquantifiable variables in the context of the operating environment and global market place.

This report outlines the history, organization, charter, and operating parameters of the military exchange system. A detailed study of the administration, financial performance, and business operating environment forms the primary basis for analysis in determining the strategic relevancy and value of AAFES in the context of the competitive environment against commercial retail competitors. This study also includes an outline of the MWR activities and the Army and Air Force, and an analysis of the MWR dividend provided by AAFES operating revenue.

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## ACRONYMS

AAFES	Army and Air Force Exchange Service
ACSI	American Customer Satisfaction Index
AES	Army Exchange Service
AFI	Air Force Instruction
AFSVA	Air Force Services Agency
APF	Congressionally Appropriated Funds
APR	Annual Percentage Rate
AR	Army Regulation
ARCENT	U.S. Army Central Command
ASD(FM&P)	Assistant Secretary of Defense for Force Management and Personnel
ASI	Associate Satisfaction Index
BOD	Board of Directors
BRAC	Base Realignment and Closure
CGX	Coast Guard Exchange
CFI	Claes Fornell International
COGS	Costs of Goods Sold
CONUS	Continental United States
COO	Chief Operating Officer
DAROA	DuPont Analysis Return on Assets
DAROE	DuPont Analysis Return on Equity
DCS/IL	Deputy Chief of Staff / Installations and Logistics
DeCA	Defense Commissary Agency
DGDP	Directorate of Graduate Degree Programs

DoD	Department of Defense
DODI	Department of Defense Instruction
DOR	Direct Operating Results
DSCP	Defense Supply Center Philadelphia
EBIT	Earnings Before Interest and Taxes
EBITDA	Earnings Before Interest Depreciation Taxes Depreciation and Amortization
ECECS	Executive Control and Essential Command Supervision
ECP	Exchange Credit Program
EI	Extraordinary Income
ENCS	Exchange New Car Sales
FEMA	Federal Emergency Management Agency
FMWRC	Family and MWR Command
FOIA	Freedom of Information Act
FTME	Full-Time Military Equivalent
FY	Fiscal Year
G1	Personnel (Staff Section)
GNC	General Nutrition Center
IG	Inspector General
IMA	Installation Management Agency
IMCOM	Installation Management Command
K	Thousands
KBR	Kellogg Brown and Root
M	Millions
MAJCOM	Major Command (USAF)

MBO	Management by Objectives
MBS	Market Bases Survey
MCCS	Marine Corps Community Service
MCSS	Military Clothing and Sales Store
MCX	Marine Corps Exchange
MFE	Mobile Field Exchange
MOU	Memorandum of Understanding
MSI	Management Satisfaction Index
MWR	Morale, Welfare, and Recreation
NAF	Non-appropriated Funds
NAFCU	National Association of Federal Credit Unions
NAFI	Non-appropriated Fund Instrumentality
NEX	Navy Exchange
NQRC	National Quality Research Center
OCONUS	Outside the Continental United States
OMSC	Overseas Military Sales Corporation
OEF	Operation Enduring Freedom
OIF	Operation Iraqi Freedom
PACRIM	Pacific Rim
PDUSD(P&R)	Principle Deputy Under Secretary of Defense (Personnel and Readiness)
PX	Post Exchange
PX/BX	Post Exchange / Base Exchange
RFC	Reconstruction Finance Corporation
ROA	Return on Assets

ROE	Return on Equity
ROTC	Return on Total Capital
S&P	Standard and Poor's
SES	Senior Executive Service
SOFA	Status of Forces Agreement
SSA	Supply Support Activity
TFELO	Tactical Field Exchange Liaison Officer
U.S.	United States
USACFSC	U.S. Army Community and Family Support Center
USAF	United States Air Force
USAF/A1	Air Force Deputy Chief of Staff for Manpower & Personnel
USC	United States Code
USDA	United States Department of Agriculture
YMCA	Young Men's Christian Association

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## CHAPTER 1

### INTRODUCTION

Our military families also sacrifice for America. They endure sleepless nights and the daily struggle of providing for children while a loved one is serving far from home. We have a responsibility to provide for them.

— President George W. Bush<sup>1</sup>

The United States (U.S.) is currently in an era of persistent conflict and the Department of Defense (DoD) is simultaneously in the midst of a massive transformation initiative designed to modernize the force to meet the demands of the current and future operational environment. The Army and Air Force Exchange Service (AAFES) provides retail goods and services to the DoD, chiefly to the Army and Air Force. This service is provided both within the continental U.S. (CONUS) and outside the continental U.S. (OCONUS) on installations overseas. OCONUS service areas include forward deployed locations such as Hawaii, Alaska, Korea, Puerto Rico, and locations where the U.S. military is engaged in contingency operations encompassing the full spectrum of conflict from combat to humanitarian assistance. These non-tactical support functions provide critical capabilities and services to soldiers and their families.

#### The Research Question

What is the strategic relevancy and strategic value of AAFES? Strategic relevancy is the distinctive ability to meet the full spectrum of customer requirements and needs. Strategic value is the worth of the service and goods provided relative to both quantifiable and unquantifiable variables in the context of the operating environment and

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<sup>1</sup>President George W. Bush, State of the Union Address. Washington, DC, 28 January 2008.

global market place. To answer this, the following questions must first be answered: What is the history of this organization and under what precedence does it operate? What are the regulatory requirements and constraints governing this agency? How is this organization governed, managed and structured? What are the organizational mission, vision and strategic plan of this organization? What is the financial performance of this organization? How does this organization rate and compare against its competitors in the global market place? What are the needs of the customers, and are they being met? How do managers and stakeholders rate success for this organization? What are the benefits of this organization and are there any viable alternatives?

### Background and Significance

AAFES provides retail goods and services to a select population and provides operating funds to Morale, Welfare, and Recreation (MWR) programs. This study will attempt to place the services of AAFES in context within the global economy and analyze their strategic relevance and strategic value. Strategic relevancy refers to the distinctive ability to meet the full spectrum of customer requirements and needs, while strategic value is a measurement of the worth of the service and goods provided relative to cost, benefit, and alternative options.

### Assumptions

This study is based on the assumptions that AAFES and the MWR programs of the Army and Air Force provide capabilities and critical services that directly relate to the military readiness in matters of national defense. Other assumptions include an era of fiscal conservatism stemming from the current financial crisis which has fueled



competition and a diminished competitive advantage of AAFES resulting in an increase of competitive alternatives in the global marketplace. The most significant assumption is the willingness by the military services, the DoD, and congress to entertain debate, along with a willingness to respond and take actions deemed prudently viable pertaining to the funding, operations, and structure of the military exchange services.

### Definitions

Appropriated Funds (APF). Money appropriated by congress with a targeted application.

Army and Air Force Exchange Service (AAFES). Officially created on 6 June 1941 as the Army Exchange Service, AAFES traces its roots back to August 1895 when a regimental commander on frontier duty established the first organization to provide morale activities and personal demand items to soldiers. Designated as AAFES with the creation of the Air Force in 1948 as a separate service from the Army, AAFES is a joint Army and Air Force non-appropriated fund instrumentality (NAFI) charged with operating retail and service activities for the benefit of authorized patrons and provides revenue distributions to the MWR activities of the military services.

Army Exchange Service (AES). Predecessor to AAFES, created under the Morale Branch of the War Department on 6 June 1941 for the centralized management of all Post Exchanges. The name was changed to AAFES on 26 July 1948 with the establishment of the Air Force by the National Security Act of 1947.

Class Six. Package stores located on military installations that sell a wide array of spirits. The term Class Six refers to one of the ten military doctrinal classes of supply, Class Six representing non-military personal demand items

Consumables. Include beverage items, tobacco, food, snacks, fragrances, cleaning supplies, and health and beauty aids

CONUS. Continental United States (CONUS) is defined as the 48 contiguous United States and the District of Columbia.

Critical Capabilities. Vital functions and services which are essential to military operations.

Defense Commissary Agency (DeCA). A joint DoD non-appropriated fund instrumentality that administers grocery stores, called commissaries, on DoD installations.

Exchange Council. Until centralized control of the exchange service the Officer in Charge and two additional officers comprised the Exchange Council. The Exchange Council was responsible for all management functions of the Post Exchange including purchasing and auditing functions. These officers were selected by the installation commander and were held financially responsible for mismanagement or neglect. Currently the Exchange Council is an advisory council to the local AAFES activity comprised of representatives of military organizations, families, and other authorized patrons such as retirees.

Exchange Officer. A major or lieutenant colonel assigned to an Army Corps staff charged with regional management of exchange operations. This position and duty are no longer a component of the military exchange system.

Extraordinary Income. Income generated from non-core business activities.

Family Member. An individual whose relationship to the sponsor leads to entitlement, benefits, or access to the military exchange system. Family members include:

1. Dependent children 21 or over. Children, including adopted children, stepchildren, and wards, who are 21 years of age or older, unmarried, and dependent upon the sponsor for over half of their support and either incapable of self support because of a mental or physical handicap; or have not passed their 23rd birthday and are enrolled in a full-time course of study at an institution of higher education.

2. Dependent children under 21. Unmarried children under 21 years of age, including pre-adoptive children, adopted children, stepchildren, foster children, and wards dependent on the sponsor for over half of their support.

3. Lawful spouse. If separated, a dependent spouse retains privileges until a final divorce decree is issued.

4. Orphans. Surviving unmarried children of a deceased Uniformed Service Member or retired member of a Uniformed Service, who are either adopted or natural born and under the age of 21, or who are over 21 and incapable of self-support; or under 23 and enrolled in a full-time course of study. The surviving children must have been dependents under the Family member definitions at the time of the death of the parent or parents.

5. Parents. Father, mother, stepparent, parent by adoption, and parents-in-law, who depend on the sponsor for over half of their support. The surviving dependent parents of a member of the Armed Services who dies while on active duty are included.

6. Surviving Family Member. Children or parents of a sponsor who are dependent on the surviving spouse for over half their support.

7. **Surviving Spouse.** A widow or widower of a sponsor who has not remarried or who, if remarried, has reverted through divorce, annulment, or the demise of the spouse to an unmarried status.

8. **Unmarried Children.** Unmarried children, including pre-adoptive children, adopted children, stepchildren, foster children, and wards not having passed their 23rd birthday and enrolled in a full-time course of study at an institution of higher education and dependent on the sponsor for over half of their support.

9. **Unremarried Former Spouse.** An unremarried former spouse of a member or former member of the Uniformed Services, who (on the date of the final decree of divorce, dissolution, or annulment) had been married to the member or former member for a period of at least 20 years during which period the member or former member performed at least 20 years of service creditable for retired or retainer pay, or equivalent pay.

Hardlines. Include electronics, stationary, books, home accents and furnishings, appliances, hardware, sporting goods, and toys.

Imprest Fund Activity. A retail operation at remote contingency support location where AAFES is unable to or is not allowed to staff with civilian employees. AAFES provides goods and funds for operation by a uniformed service member.

Management by Objectives (MBO). A method of managing based on measurable and predetermined objectives.

Military Clothing and Sales Store (MCSS). A retail store operated by AAFES that sells official service uniforms, accessories, and other personal demand items.

Non-appropriated Fund Instrumentality (NAFI). A DoD sponsored organization that provides or assist the Military Service Secretaries in providing programs for DoD personnel and their dependents.

Non-appropriated Funds (NAF). Revenue generated through business operations of non-appropriated fund instrumentalities (NAFI).

OCONUS. Outside the Continental United States (CONUS) is defined as areas other than the 48 contiguous United States and the District of Columbia.

Post Trader. A civilian merchant who supplied the Army with non-military goods until 1866. Also referred to as the Sutler.

Shoppette. An AAFES operated convenience store with extended hours which may operate other activities such as a gas station, car wash, and a concession automotive repair facility.

Softlines. Include clothing items, footwear, jewelry and other accessories for men, women, and children.

Strategic Relevancy. The distinctive ability to meet the full spectrum of customer requirements and needs.

Strategic Value. The worth of the service and goods provided relative to both quantifiable and unquantifiable variables in the context of the global market place.

Sutler. A civilian merchant who supplied the Army with non-military goods until 1866. Also referred to as the Post Trader.

### Limitations

AAFES primarily supports the Army and Air Force but does provide limited support to the Navy, Marine Corps, and Coast Guard. This study will focus only on the

perspective of the Army as it assumes that the perspectives of all services towards retail activities will be similar. This study will exclude the Coast Guard Exchange activity from this analysis.

Some of the literature reviewed and analyzed for this study was either commissioned or published by AAFES. Additionally, much of the published literature pertaining to AAFES did not directly relate to the primary or secondary research questions. Despite the lack of published literature there is sufficient material to conduct a comprehensive analysis and there is no reason to doubt the credibility of the reports and studies published by AAFES.

Traditionally, the literature review chapter of a thesis would present information of what is and is not already known pertaining to the research question. The literature review chapter of this thesis will establish the historical context of the subject and present a current operational snapshot of AAFES. This will assist in establishing the framework for analysis as published materials relevant to the thesis topic are scarce. Published materials will be referenced throughout the thesis where relevant.

### Delimitations

The aim of this study is to analyze the current posture and strategic efforts of AAFES. Minimal effort will be dedicated to analyze operational or tactical efforts at the installation or individual store level. Additionally, international competition for AAFES obviously exists at its operational locations outside the U.S.; however, only market place competitors within the U.S. will be analyzed as a point of comparison against AAFES. Financial data of the military exchanges will include global operations, while market place competitors will include those only in the U.S. This is appropriate as military

exchanges are reimbursed for overhead costs associated with the transportation of goods overseas, and pricing strategies are centrally managed and based on average U.S. prices. An analysis of AAFES tactical military exchange operations and its international competitive environment would be impractical, and are outside the scope of this study.

In June 2008 the Vice Chief of Staff of the Army directed the Army Inspector General (IG) to conduct a joint Army and Air Force special investigation of AAFES. A redacted copy of the final report was obtained through a Freedom of Information Act (FOIA) request in April 2009, and relevant findings are included in this study. The objectives of the special IG investigation were to assess AAFES support to deployed military operations, assess patron satisfaction with the level of service and quality of goods, and assess AAFES corporate goals, plans, and major supporting strategies. This investigation fully complements the direct research conducted for this study, and significantly expands the scope of this report. The Army IG investigation lasted six months, from June through December 2008, and contacted over 2,300 patrons and AAFES employees while visiting 60 AAFES locations throughout the world at Army, Air Force, and Marine Corps installations. Inspected AAFES sites also included contingency areas of operations in Iraq, Afghanistan, Kuwait, and Qatar. The AAFES patrons contacted for this investigation included Army, Air Force, Navy, and Marine Corps service members, spouses, and retirees in individual and group interviews, to include round Table discussions. The IG inspection team consisted of five representatives from the Army IG office and two inspectors from the Air Force Inspection Agency. The inspection team also included a representative from the AAFES

IG Office, the Air Force Services Agency, and the Army's Installation Management Command as subject matter experts.

### Significance of the Study

In the past, AAFES was the only retail choice for soldiers and their families as most installations were located in remote CONUS and OCONUS areas. This is no longer the case as commercial development adjacent to military installations has added countless options for soldiers and their families. This competitive environment, coupled with global market forces, has placed the relevancy of AAFES in doubt. This study will arm AAFES stakeholders with knowledge to understand the administration, operation, and finances of AAFES.

Every AAFES Main Exchange store has a huge sign posted near the check-out area that cites the dollar amount of AAFES earnings distributed to the installation for the year. This sum is consistently above one million dollars at large installations and half a million dollars at smaller installations. Few are aware that these funds are distributed exclusively to the installation MWR activity which expends the funds as it wishes. This study will profile the MWR activities of the Army and Air Force and analyze the distribution of funds from AAFES to MWR programs.

Chapter 1 established the purpose and significance of this study, and identified the primary and secondary research questions. This chapter also discussed the significant assumptions and limitations of this study. The scope and delimitations were outlined in this chapter, and all relevant terms used in this study were defined. The next chapter will present the history of AAFES, its regulatory and operating parameters, and profile the MWR activities of the Army and Air Force.



## CHAPTER 2

### LITERATURE REVIEW

We go where you go!

— AAFES Motto

Chapter 1 introduced the research question and established its context and importance. The primary research question seeks to analyze the strategic relevancy and strategic value of AAFES. This chapter will present a history of AAFES to include a current operational and situational update and will outline the regulatory requirements that govern operations of the military exchange system, and AAFES specific operational requirements. This chapter relates to the research question by establishing the historical context of AAFES and providing a current operational snapshot in relation to the Army's current operational environment and its regulatory parameters. This chapter will also outline the Army and Air Force MWR activities and organizational structure in an effort to describe how AAFES revenues are distributed and applied towards MWR programs.

#### The History of AAFES

AAFES marks its inception year as 1895 and in anticipation of its one hundred year anniversary published *One Hundred Years of Service: A History of the Army and Air Force Exchange Service 1895 to 1995* in 1994. This book is the culmination of a five-year effort resulting in a 495 page comprehensive history of AAFES which served as the primary source for this section.

## Supplying An Army

The history of providing goods and services to military forces can be traced back to ancient Rome. The U.S. officially authorized civilian traders to supply soldiers with personal demand items during the Revolutionary War in 1776.<sup>2</sup> Civilian traders supplied General Washington's army with chewing tobacco, blankets, knives, and many other items in exchange for a sales commission. These civilian merchants were called sutlers and it was their entrepreneurial spirit that supplied non-military goods to the troops for the next hundred years.

The sutler became an integral part of the U.S. Army. He became a combination saloon keeper and general store operator. In 1835 regulations were put in place that centralized the authorization for sutlers to operate at a particular military post with the Secretary of War.<sup>3</sup> The Secretary of War would issue appointments to sutlers which authorized a four year charter to operate with a military rank equivalency of the most junior officer. These exclusive appointments created a monopoly, and sutlers became known for selling poor quality merchandise at exorbitantly high prices. These abuses reached intolerable amounts during the Civil War and Congress passed an act to abolish the sutler system in 1866. This act charged the Army with the procurement and sale of goods and service to both officers and enlisted men at cost with oversight of the Army

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<sup>2</sup>Colonel Carol A Habgood and Lieutenant Colonel Marcia Skaer, *One Hundred Years of Service: A History of the Army and Air Force Exchange Service, 1895-1995*, ed. Cynthia Reiber (Dallas, Texas Headquarters Army and Air Force Exchange Service, 1994), 1.

<sup>3</sup>Ibid., 2.

Inspector General (IG).<sup>4</sup> This act marked the birth of the modern system of the military commissary, which primarily sold unprepared foods and canned items.<sup>5</sup>

The influence of the sutlers in Congress and the War Department resulted in a second congressional act delaying the implementation of the ban on sutlers for eight months. However, four months after the original act was passed Congress approved a joint resolution that authorized sutlers in remote areas but prohibited competition with the new military commissaries. This noble effort by Congress was thwarted by the inability of commissaries to meet demand and within a year sutlers regained their niche market. Commissaries were unable to meet demand in part due to poor appropriations; however, the considerable demand of travelers heading west during the era of westward expansion played a considerable role as well. The lack of railroads in the western frontier severely limited the ability to supply the area, a problem that did not exist in the east. The sutlers, under the new name of post trader, continued to be a significant component of the western frontier supply system, but could only sell items that the commissaries did not stock. The post trader was able to expand his inventory during the winter months due to severe weather that strained the commissary supply chain.<sup>6</sup>

In 1870 the Secretary of War, William W. Belknap, made substantial changes to the operating authorities of the post trader which again led to rampant selling of inferior merchandise and over-inflated prices. Secretary Belknap ultimately submitted his

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<sup>4</sup>Ibid., 4.

<sup>5</sup>Peter D. Skirbunt, *The Illustrated History of American Military Commissaries*, (Fort Lee, Virginia: Defense Commissary Agency Office of Corporate Communications and Government Printing Office), 2008, 80.

<sup>6</sup>Ibid.

resignation to President Grant in 1876 immediately prior to a congressional impeachment vote on charges of corruption.<sup>7</sup> The inquiry into Secretary Belknap's corruption began after a dispute between the Secretary and Brevet Major General (Lieutenant Colonel) George Armstrong Custer, who at the time was in command of Fort Abraham Lincoln in the Dakota Territory, near Bismarck. Custer felt the Fort Lincoln post trader was severely overcharging for goods and ordered his men to purchase goods from the local economy in Bismarck. Despite Secretary Belknap's resignation he was impeached by Congress with irrefutable evidence for selling post trader positions to the highest bidder, rather than appointing capable and honest merchants. This led to the inclusion of a check and balance system for appointing post traders in the Army Appropriation Act of 1876. Under these provisions the Secretary of War was charged with appointing post traders only upon recommendation of an administrative council and the commanding general of each Army installation.<sup>8</sup>

### The Post Canteen

Colonel Henry A. Morrow was the commander of the 21st Infantry Regiment at Vancouver Barracks in the Pacific Northwest territory, presently Washington State, in 1880. Colonel Morrow was troubled by the lack of facilities for recreation and amusement at his installation. All soldiers of this era were forced to seek recreation and entertainment in adjacent towns and communities in saloons and establishments of ill repute. Colonel Morrow sought to establish a place where soldiers could pass their off

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<sup>7</sup>Habgood et al., 6.

<sup>8</sup>Skirbunt, 81.

duty time. This was in response to having witnessed countless soldiers depart the installation for recreation, particularly indulging in spirits, and return to Army barracks as disciplinary problems. Colonel Morrow's wife recalled his feelings and enthusiasm in a letter and quoted his words as

Gentlemen, something must be done for those soldiers. It is not right to let them go on as prey and victims of the saloons where they are soon made irresponsible through vile mixtures, and are then pushed into the street to become a scandal and a disgrace- debasing their manhood and their uniform. Something must be done, and we will begin tomorrow.<sup>9</sup>

Colonel Morrow set aside a room with magazines, newspapers, letter writing material, and games such as billiards and cards that became known as the Post Canteen. Food and beverages were also available at the new Post Canteen. The canteen became quite popular and the regiment saw a substantial reduction in disciplinary problems. Colonel Morrow established canteens at his next post and many other commanders established amusement rooms of their own throughout the west.<sup>10</sup>

The canteens served two purposes for soldiers. It was an off duty meeting place or social club for entertainment and amusement, and a facility or general store where soldiers could purchase food, drink, and other necessities at reasonably low prices. The canteens were managed by soldiers of the command, and operated on a self-supporting nonprofit basis which kept prices low, whereas the post trader facility was operated for private profit with little control over prices.<sup>11</sup>

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<sup>9</sup>Habgood et al., 9.

<sup>10</sup>Ibid., 9.

<sup>11</sup>Ibid., 11.

## The Birth of the Post Exchange

In 1888 the Secretary of War directed a study of canteens and post traders. This task was assigned to Major Theodore Schwan, the Assistant Adjutant General for the Army, and his report marked the birth of the modern military exchange system and family, morale, welfare, and recreation functions.<sup>12</sup> The Secretary of War approved Major Schwan's report and authorized the establishment of a canteen for every installation where no trader operated.<sup>13</sup> The Schwan report codified the mission and principles of the canteen. In addition to providing goods to soldiers at moderate prices, the canteen would provide an entertainment venue and gymnastic equipment.<sup>14</sup> The canteen would be a self-sustaining enterprise managed much like a business with a portion of proceeds being distributed among the different installation organizations for use as operating funds.

The establishment of canteens at all military installations quickly led to the downfall of the post trader. By 1892, Congress approved a request from the Army to abolish the post trader system in favor of the newly coined Post Exchange.<sup>15</sup> Although the new term for the post canteen would be Post Exchange (PX), the title would remain synonymous until World War II. On 25 July 1895, General Order Number 46 directed

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<sup>12</sup>Ibid., 11.

<sup>13</sup>This restriction was repealed eight months later authorizing a canteen at every military installation.

<sup>14</sup>Habgood et al., 12.

<sup>15</sup>Ibid., 17.

the establishment of a Post Exchange “wherever practical.”<sup>16</sup> Paragraph 9 of the General Order Number 46 outlined the features of the Post Exchange:

An exchange doing its full work should embrace the following sections: (a) A well-stocked general store in which goods are kept as are usually required at military posts, and as extensive in number and variety as conditions will justify; (b) A well-kept lunch counter supplied with as great a variety of viands as circumstances permit, such as tea, coffee, cocoa, nonalcoholic drinks, soup, fish, cooked and canned meats, sandwiches, pastries, etc.; (c) A canteen at which . . . beer and light wines by the drink, and tobaccos, may be sold; (d) Reading and recreation rooms, supplied with books, periodicals, and other reading matter, billiard and pool tables, bowling alley and facilities for other proper in-door games, as well as apparatus for out-door sports and exercises . . . a well-equipped gymnasium possessing also the requisite paraphernalia for out-door athletics.<sup>17</sup>

#### Independent Operations

The early history of AAFES is intertwined with the Army Quartermaster Corps whose combined mission was to provide the military with goods and services. The history of the Army Quartermaster Corps traces back to the Revolutionary War when the corps was charged with coordinating the acquisition and distribution of supplies for the Army.<sup>18</sup> Each Post Exchange operated independently until 1941. Each had its own policies, procedures, and practices in the execution of the exchange charter outlined in General Order Number 46. Independent operations created much disparity among Post Exchanges, particularly among morale programs.<sup>19</sup>

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<sup>16</sup>Ibid., 18.

<sup>17</sup>Ibid., 19.

<sup>18</sup>U.S. Army Quartermaster Corps, “Quartermaster History,” <http://www.qmmuseum.lee.army.mil/history/> (accessed 28 March 2009).

<sup>19</sup>Habgood et al., 19.

The commanding officer at each installation was responsible for the Post Exchange and the appointment of an Exchange Council to oversee and manage the day-to-day business operations. An officer was selected to serve as the Officer in Charge with the assistance of an enlisted man, and other assistants as needed. The Officer in Charge and two additional officers comprised the Exchange Council, who were collectively responsible for all management functions of the Post Exchange including purchasing and auditing functions.<sup>20</sup>

The War Department placed responsibility of the Post Exchange upon each commanding officer. It required a semi-annual report detailing operations and the financial condition of each Post Exchange. The Inspector General conducted an audit of each Post Exchange annually with special investigations when necessary. This was done in an effort to protect the Army's reputation.<sup>21</sup> In 1917, *A Manual for Post Exchanges* was published which provided the first set of comprehensive rules for operating PX's. Most notably, this manual included the opinion of the Judge Advocate General of the Army which placed financial responsibility upon the officers of the Exchange Council for neglect and mismanagement.

### World War I

The rapid expansion of the Army in 1917 for World War I overwhelmed the existing military exchange system. The lack of expeditionary capability resulted in the commander of the American Expeditionary Force, General John J. Pershing, to request

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<sup>20</sup>Ibid., 20.

<sup>21</sup>Ibid.



the assistance of civil welfare agencies. The Knights of Columbus, Salvation Army, the Young Men's Christian Association (YMCA), the American Red Cross, and the Jewish Welfare Board were among the organizations who answered the call.<sup>22</sup> Under the worst conditions these organizations established the infrastructure and capabilities needed to execute a monumental task. These efforts should not be forgotten.

President Harry S. Truman served as Regimental Canteen Officer during his World War I military service. While stationed at Camp Doniphan, Oklahoma, adjacent to Fort Sill, with the 35th Infantry Division for training prior to the movement to Europe, First Lieutenant Truman was assigned the duty to manage and operate a PX with no experience in merchandizing. He recruited Sergeant Edward Jacobson to assist him and began operations with two thousand dollars obtained from a two dollar per soldier capital investment. Within six months the canteen run by Lieutenant Truman and Sergeant Jacobson returned over \$10,000.00 dollars in dividends.<sup>23</sup> President Truman would later attribute management of the daily operations to Sergeant Jacobson, and assessed their collective efforts as being the most successful in the 35th Division.<sup>24</sup>

The Secretary of War sent a committee to Europe upon the cessation of hostilities in order to assess the morale conditions of the American Expeditionary Forces. The committee published its findings in 1919 and notably cited the need for the Army to assume full responsibility for supporting forces at war with morale activities and personal

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<sup>22</sup>Ibid., 21.

<sup>23</sup>U.S. History Interactive, "Harry Truman Page," <http://www.geocities.com/beberius/bio/Truman/HSTchap3.html> (accessed 28 March 2009).

<sup>24</sup>Harry S. Truman Library & Museum, "Outtakes from Decision: The Conflicts of Harry S. Truman," <http://www.trumanlibrary.org/hstpape/screengems.htm> (accessed 28 March 2009).

demand items.<sup>25</sup> The post-war drawdown coupled with the redeployment of U.S. forces from abroad did not result in any material change to the Post Exchange service.

## World War II

As the Army mobilized for war in 1940, it paid much attention to moral programs and the Post Exchange system which had changed little since 1895. The Army assigned the G-1 staff, responsible for personnel administration, the monumental task of solving the PX problems for the Army. This task fell upon Lieutenant Colonel J. Edwin Grose for his experience as a Post Exchange officer in charge, and presumably because no one else wanted the job.<sup>26</sup> Post Exchanges were designed to service a local installation. Many installations had numerous Post Exchanges which operated independently of each other serving a particular unit or division. Fort McClellan, Alabama, for example had ten Post exchanges in 1940.<sup>27</sup> Post Exchanges in 1940 were not designed to mobilize with their parent organizations and did not have the means to sustain their stocks while deployed. Colonel Grose envisioned the centralization of the Post Exchange with a national headquarters, where the Army would assume responsibility of operating an extensive chain store system.<sup>28</sup>

A PX review committee of five prominent retail executives was formed and published its findings and recommendations in April 1941. This report was significant in that it was a comprehensive business review of the existing PX operations and found that

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<sup>25</sup>Habgood et al., 21.

<sup>26</sup>Ibid., 22.

<sup>27</sup>Ibid., 20.

<sup>28</sup>Ibid., 22.

decentralized management and operations were not maximizing potential efficiencies or benefits to soldiers. The committee report validated the need for centralized management of the PX with emphasis on consolidating efficiencies, distribution of funds for expansion, and the professional management and administration of the PX by civilian personnel with executive direction performed by officers of the Army. An integral part of the decentralized Post Exchange operations was the issuance of shares. Each unit member of the servicing PX owned one share. Profits were distributed to the organization according to the number of service members who participated in the exchange.<sup>29</sup> The historical account of the exchange service does not make clear whether participation was voluntary, however, each participant could be assessed a charge should expenses exceed operating income. The committee found that this system of shares and dividend distribution negatively influenced PX operations for the desire for dividends, which further fueled the call for centralized administration of the Post Exchange.<sup>30</sup>

### The Army Exchange Service

The Chief of Staff of the Army, General George C. Marshall, endorsed the Post Exchange review committee's findings and on 6 June 1941, the Army Exchange Service (AES) was created under the Morale Branch of the War Department. The AES staff initially comprised six people: Lieutenant Colonel Grose as officer in charge, an executive officer, and four civilians each responsible for a line of operation that included

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<sup>29</sup>Ibid., 20.

<sup>30</sup>Ibid., 23.

personnel, operations, purchasing, and auditing.<sup>31</sup> At this point installation commanders still had virtually autonomous control over exchanges. The AES was responsible for broad policy guidance issued by the Department of the Army. As the AES grew in the years to come, it provided auditing services, standardized accounting and operation policies, training, and human resource support. The AES also provided standardized purchasing and procurement services.

In 1941 the Army was organized into nine corps and four departments that included Hawaii, the Panama Canal, the Philippines, and Puerto Rico. Alaska was included in the Ninth Corps' area of responsibility.<sup>32</sup> Each of these organizations was required to appoint an exchange staff to administer and manage exchange operations. A lieutenant colonel or major was the Exchange Officer and his staff was filled by lieutenants or captains who primarily served as auditors. This is notable as the auditors were junior in rank to the Exchange Officer whose operations they were auditing.

In 1941 the first AES headquarters was located in Washington D.C., with the deputy chief and operating divisions located in New York. In 1943 most of the AES headquarters functions moved to New York where it maintained its worldwide headquarters until 1966 when it relocated to its current location in Dallas, Texas. In 1942 the AES was organized under the Army Chief, Administrative Services, until October 1943, when it was moved under the authority of the Director of Personnel.<sup>33</sup>

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<sup>31</sup>Ibid., 24.

<sup>32</sup>Ibid., 25.

<sup>33</sup>Ibid., 29.

Funds to finance the establishment of new PX's were obtained through loans from the Defense Supplies Corporation at an interest rate of 2 percent.<sup>34</sup> The official history of AAFES boasts that exchanges were not financed by congressionally appropriated funds (APF); however, this is not entirely accurate. The Defense Supplies Corporation was a subsidiary of the Reconstruction Finance Corporation (RFC) which was a government agency created in 1932. The RFC was created to provide financial aid and loans in an effort to assist the private sector in the war effort and to promote economic stimulus.<sup>35</sup> The RFC used APF for initial operations and continued to receive some APF support throughout its existence. The RFC issued both grants and low interest loans in an effort to facilitate economic stimulus. The RFC was intended to be nonpartisan; however, by 1948 the agency had become politicized and congressional investigations revealed widespread corruption. The RFC was reorganized in 1952 but dismantled under the Eisenhower administration in 1957.

### Centralized Management and Control

An effort to centralize the management and control of the PX began after World War II. Overseas Post Exchange operations were already centralized, and much efficiency was obtained through centralization. In December 1945 the AES began to test a centralization system that grouped various exchanges into regions, consolidating many book-keeping and administrative functions from each exchange branch. This initiative was followed by two studies known respectively as Fry and Wood.

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<sup>34</sup>Ibid., 26.

<sup>35</sup>Encyclopedia Britannica, 'Reconstruction Finance Corporation,' <http://www.britannica.com/EBchecked/topic/493753/Reconstruction-Finance-Corporation> (accessed 28 March 2009).

The first study, commissioned by the Secretary of War in 1946 at a cost of \$320,000, paid for by the AES, was conducted by a Chicago based firm of consulting management engineers, George Fry and Associates, Inc. The Fry study recommended that the AES be separated from the Army's Special Services Division within the War Department and that it be held responsible for centrally managing all phases of the business with only administrative relationships to Army commanders. The Fry study also asserted that the AES, as a self-supporting agency, should be sustained within the limits of its own income. The Fry report recommended that centralization of the AES take place as soon as practically possible.

A second study was directed by the Chief of Staff of the Army and conducted by the AES Policy Committee to identify the types of merchandise and services necessary to meet Army needs, and to identify military policy issues as they pertained to the AES. The committee included many high ranking Army officials and was chaired by Brigadier General J.W. Wood. The Wood Committee conducted a comprehensive survey of exchange operations with visits to 40 installations within the continental United States and 31 installations overseas. The Wood report was published in 1947 and its findings upheld the recommendations of the Fry Report.<sup>36</sup> Both the Wood and Fry reports included the overwhelming support from Army commanders, adding further credibility and urgency to the question of centralization.

Exchange facilities were faced with a surplus of large stocks after World War II and the subsequent reduction in military forces. Prices at Exchange facilities rose sharply as a result of post-war inflation, which increased the costs of goods sold. Unfortunately,

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<sup>36</sup>Habgood et al., 32.

customers blamed higher prices on the centralization of the Exchange without fully understanding the efficiencies through economies gained by centralization.<sup>37</sup>

Centralization of exchange operations allowed the AES to pool proceeds for distribution to the Army for MWR purposes. The Army then would uniformly distribute funds to installations based upon troop population. Prior to centralization, installations with less profitable exchange facilities would not be able to generate sufficient funds for MWR programs. Army officials also identified the need to provide retail services to Soldiers everywhere. Lieutenant General Brehon B. Somervell, Commanding General of Army Services of Supply, described the AES responsibility as “Exchange service to every soldier, every day, wherever he may be.”<sup>38</sup>

#### The Army and Air Force Exchange Service

The AES served both Army and Army Air Force installations. The National Security Act of 1947 established the Air Force which chose to continue participation with the AES. The AES was redesignated the Army and Air Force Exchange Service (AAFES) on 26 July 1948. In May of 1949, the Secretary of Defense approved a request from the Secretaries of the Army and Air Force to designate AAFES as a joint agency of the Departments of the Army and Air Force.

All AAFES headquarters operations moved to New York City after World War II. The AAFES headquarters occupied two locations, each in the heart of Manhattan until 1966 when it relocated to its present location in Dallas, Texas. AAFES did not complete

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<sup>37</sup>Ibid., 34.

<sup>38</sup>Ibid., 29.

the world-wide centralization process until 1972. The title of Chief, AAFES, was changed to Commander, AAFES, during the same year. For the first time in its history the Commander of AAFES was responsible for the total operation, management and performance of the exchanges world-wide.<sup>39</sup> Under the new organizational structure the AAFES Commander was responsible to the AAFES Board of Directors who in turn are responsible to the Secretaries of the Army and Air Force.<sup>40</sup>

### AAFES Today

Today AAFES operates over 3,000 facilities worldwide in more than 30 countries, five U.S. territories and 49 states. A full list of authorized AAFES activities is detailed in Appendix B of this study AAFES employs more than 43,000 associates, of which approximately 25 percent are military family members and 1.1 percent are military members who work during their off duty hours.

AAFES is structured and managed to operate as a business with the ultimate goal of providing goods and services to its customers, and providing funds to Army and Air Force MWR programs. A not-for-profit organization is a business-like entity with primary objectives other than returning profits to their owners.<sup>41</sup> Their goal is to provide goods or services in support of their specific agenda and proceeds are generally reinvested in the organization. AAFES closely resembles a not-for-profit agency;

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<sup>39</sup>Ibid., 47.

<sup>40</sup>*Army Regulation 15-110 and Air Force Instruction 34-203 Board of Directors, Army and Air Force Exchange Service (AAFES), "Direction and Control,"* (Washington, DC: U.S. Government Printing Office, 2005).

<sup>41</sup>Louis E. Boone and David L. Kurtz, *Contemporary Business* (Fort Worth: The Dryden Press, 1999), 8.



however, its aim is to produce operating capital to fund internal strategic objectives and for distribution to supplement MWR activities. AAFES has no authority over MWR operations, or how the AAFES dividend distribution to service MWR programs is used. Subsequently AAFES more closely resembles a for-profit entity as it distributes earnings to an organization to over which it has no influence.

### Corporate Organizational Structure and Governance

The AAFES Chief Executive Officer position is titled Commander in keeping with the military traditions. The Commander and Deputy Commander positions are assigned to a major general and brigadier general appointed by either the Army or the Air Force. These are two-year alternating positions between the Army and Air Force and the intent is that both services are represented in the command team.

The AAFES Chief Operating Officer (COO) is a permanent civilian Senior Executive Service (SES) position. The COO is responsible for worldwide operations and directly supervises all regional managers, and all support staff including marketing, sales and logistics. The COO works closely with the Deputy Commander who supervises the AAFES Support Group which includes information technology, human resources, loss prevention, and equal opportunity directorates. SES personnel are senior executive public servants who serve in the key positions below the top Presidential appointees.<sup>42</sup> DoD SES positions are general officer equivalent positions without command authority. The COO of AAFES is an SES with the equivalent rank of a brigadier general.

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<sup>42</sup>U.S. Officer of Personnel Management, "About the Senior Executive Service," [http://www.opm.gov/ses/about\\_ses/history.asp](http://www.opm.gov/ses/about_ses/history.asp) (accessed 29 March 2009).

AAFES is governed by a Board of Directors (BOD) comprised of members of the Army and Air Force. The organization and responsibilities of the AAFES BOD is outlined in a joint Army and Air Force Regulation Board titled *Directors, Army and Air Force Exchange Service (AAFES)*, Army Regulation (AR) 15-110 / Air Force Instruction (AFI) 34-203(I). There are eighteen positions on the AAFES BOD:

1. Deputy Chief of Staff/Installations & Logistics (DCS/IL), U.S. Air Force (USAF).
2. Deputy Chief of Staff, G-4, U.S. Army.
3. Deputy Assistant Secretary of the Army (Human Resources).
4. Deputy Assistant Secretary of the Air Force (Force Management and Personnel).
5. Deputy Assistant Secretary of the Army for Budget.
6. Deputy Assistant Secretary of the Air Force for Budget.
7. Chairman, Army and Air Force Exchange Service, Europe-Region Council.
8. Commander, AAFES.
9. Pacific Rim (PACRIM) member (Deputy Commander, U.S. Army Pacific or Vice Commander, Pacific Air Forces).
10. Assistant Deputy Chief of Staff, G-1, U.S. Army.
11. Director of Services, USAF.
12. A general officer representing the Reserve Component.
13. Commander, U.S. Army Community and Family Support Center (USACFSC).

14. Director of Budget Operations and Personnel, Deputy Assistant Secretary of the Air Force (Budget).

15. Sergeant Major of the Army.

16. Chief Master Sergeant of the Air Force.

17. Army member-at-large for a 1-year appointment renewable up to 3 years.

18. Air Force member-at-large for a 1-year appointment renewable up to 3 years.

Member-at-large appointments will include minority or female members, if not already represented. The PACRIM member will be from the same Service as the chairman of the board, and the chairman, AAFES Europe Council will be from the opposite Service. The AAFES BOD also has a number of standing committees, including the executive, finance, pay and compensation, and audit committees. The exact composition, duties, and responsibilities of each committee are outlined in AR 15-110/AFI 34-203(I), which indicates a strong effort to have equal Army and Air Force representation on each of the boards.

#### Regulatory Charter, Authority and Operating Parameters

It is important to understand the authority under which AAFES exists and the operating parameters under which it operates. This section will outline these authorities and parameters and will contribute to the comprehensive analysis.

## Title 10 United States Code – Armed Forces

The authority for the military services to operate a military exchange service is granted under Title 10 of the United States Code (USC).<sup>43</sup> The secretary of defense is directed to operate a world-wide system of exchange stores intended to enhance the quality of life of members of the uniformed services, and other authorized patrons. The exchange system is also intended to support military readiness, recruitments and retention.<sup>44</sup> According to the DoD, the military exchange system is considered an integral part of non-pay compensation for military personnel.<sup>45</sup>

Title 10 USC does not specify how the exchange service is to be operated other than for the procurement of alcoholic beverages. Military exchanges are required by law to procure alcoholic beverages through the most competitive source from within the state, or states, where the military installation is located.<sup>46</sup> In comparison Title 10 USC establishes many operating parameters for the Defense Commissary Agency (DeCA) and MWR activities. Specifically, DeCA is required to sell at reduced prices with a specified markup surcharge for capital improvements and expenditures.<sup>47</sup> DeCA is a joint DoD Non-appropriated Fund Instrumentality that administers grocery stores, called commissaries, on DoD installations worldwide. Both DeCA and the military exchanges

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<sup>43</sup>*Title 10 U.S. Code - Armed Forces*, “Chapter 147 Commissaries and Exchanges and Other Morale, Welfare, and Recreation Activities,” (Washington DC: U.S. Government Printing Office, 2007).

<sup>44</sup>*Ibid.*, “Section 2481.”

<sup>45</sup>*Department of Defense Instruction Number 1330.09*, (Washington, DC: U.S. Government Printing Office, 2005).

<sup>46</sup>*Title 10 U.S. Code - Armed Forces*, “Section 2495.”

<sup>47</sup>*Ibid.*, “Section 2481.”

receive congressionally appropriated funds to subsidize overhead and administration costs under specified guidelines.<sup>48</sup>

### Non-appropriated Fund Instrumentalities

AAFES is characterized as a Non-appropriated Fund Instrumentality (NAFI). A NAFI is a DoD sponsored organization that provides or assist the Military Service Secretaries in providing programs for DoD personnel and their dependents. NAFIs are governed by Department of Defense Instruction (DODI) 1015.15 and are primarily established to provide military morale, welfare, and recreation (MWR) programs, armed services exchange services, and other support activities as deemed necessary by the Military Service Secretaries.<sup>49</sup> NAFIs are considered DoD organizations and are instrumentalities of the U.S. Government. They are not incorporated under the law of any State. They are granted the same immunities and privileges as the U.S. Government in the absence of other federal laws.

NAFI programs and facilities are operated, maintained, and funded as an integral part of the military personnel and readiness program. NAFI programs can be funded by both congressionally appropriated funds (APF) and non-appropriated funds (NAF). NAF resources include funds generated by NAFI operations, private sources, or commercial borrowing. Use, procurement, and management of APF and NAF funds are governed by many laws and regulations. NAFs are designated for the collective benefit of authorized patrons, units, organizations, installations, or NAFIs themselves. Organizational

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<sup>48</sup>Ibid., “Section 2484.”

<sup>49</sup>*Department of Defense Instruction Number 1015.15*, (Washington, DC: U.S. Government Printing Office, 2007).

commands are prohibited from having proprietary interest in NAFs or other NAFI assets. NAFI resources are required to be administered in an economical, businesslike manner. DODI 1015.15 requires the NAFI to be dissolved when its intended purpose ceases to exist.

All NAFIs are classified into one of six program groups to ensure uniformity in their establishment and management across the DoD. These groups are as follows: Group I - Military MWR Programs; Group II - Armed Service Exchange Programs; Group III - Civilian MWR Programs; Group IV – Lodging Programs; Group V – Supplemental Mission Fund Activities; and Group VI – Special Purpose Central Funds. Group VI activities are operated by the DoD and military service headquarters and include specific administrative services or functions such as NAF employee life and health insurance.

NAFI activities within each Program Group are further classified into one of three funding categories. These funding categories are the basis of APF and NAF funding authorizations. These funding categories are:

Category A – Mission Sustaining Activities. Category A activities have virtually no capacity for generating NAF revenues and are supported almost entirely with APFs. The use of NAFs is limited to specific instances where APF support is prohibited by law or when NAF support is essential for the operation. Some examples are physical fitness facilities, libraries, and unit level sports.

Category B – Basic Community Support Activities. Category B activities are financed with a combination of NAF and APF resources. Category B NAF activities are substantially supported with APFs due to their limited revenue-generating abilities.

These activities must satisfy the basic physiological and psychological needs of Military Service members and families. Some examples are automotive skills development, youth activities, child development programs, arts and crafts skill development, lodging, and outdoor recreation programs.

Category C – Revenue-Generating Activities. Category C activities have the highest capability to generate NAF revenues and generally receive only indirect APF support. Military MWR and Armed Service Exchange Category C activities at designated remote and isolated locations are authorized funding in a manner consistent with under Category B funding. Some examples are golf courses, clubs (officer's, enlisted, and consolidated), bowling centers, and boating activities.

#### Army Regulation 215-8 / Air Force Instruction 34-211(I)

The Army and Air Force operate a joint exchange system, while the Navy and Marine Corps operate separate individual exchange operations. The Department of Defense has published numerous instructions pertaining to the Armed Services Exchange. Many of these have been codified by the Army and Air Force into a single Army and Air Force joint publication outlining in totality the operations of the AAFES. This document titled *Army and Air Force Exchange Service Operations* is applicable to each service as an Army Regulation (AR) 215-8 and Air Force Instruction (AFI) 34-211(I). The latest edition of this publication was on 30 July 2008 and it consolidated eight separate Army Regulations and Air Force Instructions into a single publication. Table 1 is provided in an effort to summarize the relevant components of AR 215-8/AFI 34-211(I).

Table 1. Summary of AAFES Regulatory Parameters

Topic (Reference)	Regulatory Operating Requirement/ Parameter
Legal Status (1-9 – 1-11)	AAFES is a Joint Program II NAFL, category C revenue generating program. It is immune from state laws and taxation, with the exception of gasoline.
Gasoline Prices (1-11, b)	AAFES is required by Section 104, Title 4, United States Code to collect state taxes on gasoline and fuel sales not for official business.
APF and Logistical Support (2-3, f)	The Army and Air Force are required to provide the following on a non-reimbursable basis: port handling and transportation for movement of AAFES merchandise, supplies, and equipment from CONUS ports to overseas ports and return, and between overseas ports.
Contingency / Wartime Operational Support (2-3, g)	The Army and Air Force are required to provide the following on a non-reimbursable basis: all support services in include transportation, facilities, operational personnel, security, medical, and finance support for all exchange operations in contingency and wartime operations or emergencies.
Host Nation Agreements (2-3, h, 1)	The Army and Air Force are required to ensure that exchange merchandise and services are included in agreements with host nations for reduced freights rates, customs clearances, and tax exemptions.
Garrison and Installation Requirements (2-4, a; 2-4, b)	Army and Air Force garrison and installation commanders are required to provide AAFES activities with adequate, suitable building/facilities, and applicable services on a non-reimbursable basis. Remote and isolated locations are authorized APF support in the same manner as a category B MWR program.
OCONUS AAFES Employee Support (4-2)	AAFES employees recruited from the United States for service overseas are entitled to government housing. They are also given access to medical care and DoD schools in the same manner as an APF DoD employee.
Military Clothing Sales Stores (5-7)	Military Clothing Sales Stores (MCSS) are APF activities managed by AAFES. Each military service will reimburse AAFES for all costs associated with the construction, facility improvement, operation, and management of an MCSS.
School Food Service (5-8)	AAFES operates the DoD School Meal Program on a nonprofit basis. Operating costs are subsidized by United States department of Agriculture (USDA) funds, student meal prices, and the DoD Education Activity.
Donations (5-18)	AAFES is authorized to donate unmarketable and unsalable assets to nonprofit charities, but is prohibited from performing any service, such as transportation, in connection with the donation. AAFES is authorized to donate gift certificates or gift cards to MWR programs and to transfer no-value inventory to MWR or other government entity at no charge. AAFES is prohibited from making contributions or donations to any charity or other organization in the form of services (such as financial, procurement, or contracting). Collection jars or other displays for donations are not permitted at AAFES facilities.
Retail Stock Assortment (7-1)	The AAFES Commander prescribes the AAFES master stock assortment for each retail department. The CONUS retail stock restriction applies to all AAFES location and only the Principle Deputy Under Secretary of defense (Personnel and Readiness) (PDUSD(P&R)) can make changes to the restrictions.
CONUS Retail Stock Restrictions (Appendix E)	<p>AAFES is prohibited from selling-</p> <ul style="list-style-type: none"> <li>a. Televisions with a cost to the exchange of more than \$3,500.</li> <li>b. Diamond settings with individual stones that exceed one carat.</li> <li>c. Jewelry other than diamond jewelry with per unit (piece) cost to the exchange in excess of the cost price of 2 ounces of gold.</li> <li>d. Finished furniture with per unit (piece) cost to the exchange in excess of</li> </ul>



	<p>\$900.</p> <p>(1) CONUS exchanges may not undertake new capital construction or renovation of an exchange facility of any kind for the purpose, in whole or in part, of providing additional space in which to sell finished furniture.</p> <p>(2) At any location at which AAFES proposes to sell finished furniture, the AAFES GM or garrison/installation commander will consult in advance with local furniture merchants and ascertain in writing whether there are any objections to the introduction of furniture at the exchange facility.</p> <p>(3) Any objections, along with a list of locations where exchanges propose to sell finished furniture, will be forwarded to the Office of the PDUSD(P&amp;R) within 60 days in advance of sales, so OPDUSD(P&amp;R) can notify the Congressional Committees on Armed Services in advance.</p> <p>(4) The OPDUSA(P&amp;R) must approve the offering of finished furniture at new locations and will notify Congress of such approval prior to offering finished furniture at new locations.</p> <p><i>e.</i> Decorative housewares and furnishings with per unit (piece) cost to the exchange in excess of \$500.</p> <p><i>f.</i> Small appliances with per unit (piece) cost to the exchange in excess of \$150, except that there is no cost limitation on floor polishers, food processors, fans, coffee makers, humidifiers, dehumidifiers, air purifiers, microwave ovens, rotisseries, roasters, broilers, and vacuum cleaners.</p> <p><i>g.</i> Recreational boats with per unit (piece) cost to the exchange in excess of \$750.</p> <p><i>h.</i> Sports, recreational, garden, and manual arts equipment and supplies, photographic supplies and film with per unit (piece) cost to the exchange in excess of \$500. There is no cost limitation on aquatic equipment; bicycles; cameras and projectors; camera and projector accessories; fishing equipment; golf club sets; guns and gun accessories; physical fitness exercise equipment; power tools; outdoor power equipment, including lawn mowers, edgers, and snow blowers; ski equipment; surfboards; and tents.</p>
Retail Pricing and Markups (7-2)	The AAFES commander is responsible for and has authority to establish generally uniform prices and standard markups that support AAFES' mission and service objectives. AAFES internal operating procedures relating to pricing strategies are considered proprietary to AAFES and are not disseminated outside of AAFES channels.
Vending Sales of Tobacco and Alcohol (7-5)	AAFES is not permitted to sale state tax exempt tobacco products through vending machines CONUS, Alaska or Hawaii. State exempt beer may be sold through vending machines if approved by the local installation/garrison commander.
Required Surveys (7-14)	AAFES is required to conduct a customer satisfaction index (CSI) in order to compare individual exchange facilities and AAFES against the exchange services of the Navy and Marine Corps. AAFES is also required to conduct an annual, standardized market-based price survey to measure customer savings by comparing the costs of like products in the commercial industry in the United States.
Concessionaires (14-2, d)	Concessionaires and other independent contractors are not exempt from taxation and are required to collect state taxes.
Unauthorized AAFES Activities (Appendix F)	AAFES will not: <ul style="list-style-type: none"> <li>a. Sell or solicit the sale of real estate, either as a retail item or a service.</li> <li>b. Sell used media of any type, including but not limited to books, magazines, videos, recorded music, or computer software unless specifically authorized by the AAFES commander. This does not apply to previously-rented videos which may be sold by AAFES or its concessionaires when clearly identified as such.</li> </ul>

	<ul style="list-style-type: none"> <li>c. Operate pawnshops, adults-only entertainment centers, or child care centers.</li> <li>d. Sell, lease, or display new cars on installations except overseas.</li> <li>e. Sell or lease space in AAFES facilities. AAFES in-store bank, automated teller machine, and concession and franchise agreements are not leases as contemplated by this prohibition.</li> <li>f. Provide services that require the customer to sign a separate contract with a service provider, except as approved by the AAFES commander.</li> <li>g. Provide paid or free babysitting services, nonsports or nontherapeutic massage, legal services, financial planning services, or funeral/mortuary services.</li> <li>h. Sell or solicit the sale of stocks, bonds, mutual funds, or other investment instruments.</li> <li>i. Sell live animals, including fish, birds, or reptiles unless specifically authorized by the AAFES commander.</li> <li>j. Offer any form of permanent tattooing or body piercing (other than ear piercing consistent with standard industry retail practices) unless approved in advance by the AAFES commander.</li> <li>k. Use vendor-owned equipment except as authorized by the AAFES commander.</li> <li>l. Use service or equipment items that contain product promotional advertisement, except where the product name is an integral part of the display. (Examples: packaged cereal and dessert displays, Table condiments, gasoline pumps, and gasoline pylons.)</li> <li>m. Authorize credit sales.</li> <li>n. Stock or sell drug abuse paraphernalia.</li> <li>o. Sell or rent media of any type if it contains sexually explicit material.</li> <li>p. Operate gambling devices in CONUS.</li> </ul>
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*Source:* Department of the Army and Department of the Air Force AR 215-8/AFI 34-211(I), Army and Air Force Exchange Service Operations (Washington, DC: Government Printing Office, 2008).

### Military Exchange Use of Congressionally Appropriated Funds

The availability of APF for use by the military exchange system is extensive. A comprehensive list of the expenses authorized APF versus NAF revenue is outlined in Appendix B of AR 215-9/AFI 31-211(I). In summary, APFs may be used in lieu of NAFs for the following:

1. Port handling and transportation for movement of AAFES merchandise, supplies, and equipment from CONUS ports to overseas ports and return, and between overseas ports.

2. Facility construction related to the establishment, activation, or expansion of a military installation or relocation of facilities for the convenience of the Government. In the case of installation expansion, a major increase in authorized and assigned personnel strength over a short period of time is necessary before APF construction can be programmed. Such expansion must be the result of a mission change or influx of new units or systems.

3. Replacement of facilities denied by country-to-country agreements.

4. Restoration of facilities and improvements destroyed by acts of God, fire, or terrorism.

5. Antiterrorism and force protection measures required by the DoD.

6. The correction of deficiencies in life safety, force protection, and compliance with the Americans with Disabilities Act.

7. Base Realignment and Closure (BRAC) costs. These include relocation costs of NAF employees, unemployment and severance payments, and facility construction.

8. Military and civilian personnel assigned to perform essential command supervision (ECECS) functions.

9. Utilities for facilities primarily used for AAFES.

#### Authorized Patrons

Authorized patrons of AAFES facilities and services are classified into two categories, unlimited and limited exchange privileges. The primary difference between unlimited and limited privileges refers to the ability to purchase tax-free alcohol and tobacco products. The primary population of authorized patrons includes active, reserve, and retired military service members and their dependents. There are many other

populations authorized to patronize military exchange systems, a full list is listed in Appendix A.

### AAFES Profits: Where does the money go?

AAFES earnings are distributed to each service's MWR program in accordance with agreements between each of the military services and AAFES. Three sources contribute separately to the AAFES dividend distribution to the MWR activities of each military service. These include regular earnings and two special dividends calculated from the direct operating results (DOR) of alcoholic beverages and telephone activities.<sup>50</sup>

#### Regular Earnings Dividend

Regular earnings are the total net earnings less alcohol and telephone proceeds. AAFES retains 50 percent of regular earnings and the remaining 50 percent is made available for distribution. Earnings from the all services mail order catalogue are included in the regular earning dividend and are distributed based on the patronage ratio of customers affiliated with AAFES, the Navy Exchange (NEX), Marine Corps Exchange (MCX), or the Coast Guard Exchange (CGX).

#### Alcohol Beverage Dividend (Class Six)

Alcoholic beverages are predominantly sold at the installation Class Six store. The Class Six are package stores located on military installations that sell a wide array of spirits. The term Class Six refers to one of the ten military doctrinal classes of supply, Class Six representing non-military personal demand items. These earnings are reduced

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<sup>50</sup>Army and Air Force Exchange Service, "Dividend Fact Paper," (Washington, DC: U.S. Government Printing Office, 2006).

by a contribution to the AAFES Capital Program which has historically averaged 2.24 percent.<sup>51</sup> The DOR, minus the AAFES Capital Program contribution, is paid directly to the local installation MWR activity.

#### Telephone Dividend

The telephone dividend includes DOR from long distance telephone banks, payphones, telephone services in single-soldier barracks, and calling cards. AAFES retains 10 percent of this income for its capital program and another 10 percent is distributed directly to the local installation MWR activity. The remaining 80 percent of income generated is distributed to each military service MWR governing agency based on the percentage of service alignment at the installation where the income was generated.

#### Local MWR Dividend Distribution

Each service has a unique method of computing local MWR distributions from AAFES regular earnings. The Air Force uses a sliding scale based on local monthly revenue which is shown in Table 2. Remaining funds are retained by AAFES for centralized dividend distribution.

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<sup>51</sup>Ibid.

Table 2. Air Force MWR Dividend

4%	of the first \$250K in Regular Earnings
3%	of the next \$250K in Regular Earnings
2%	of the next \$500K in Regular Earnings
1%	of the next \$250K in Regular Earnings
0.50%	of the next \$1M in Regular Earnings
0.10%	of all Regular Earnings over \$3M

*Source:* Army and Air Force Exchange Service, “Dividend Fact Paper,” (Washington, DC: U.S. Government Printing Office, 2006).

The Army dividend is much simpler than the Air Force. All Class Six and telephone proceeds are retained locally by the installation MWR program, as is 0.4 percent of regular AAFES earnings. Army Reserve and National Guard installations receive dividends in the same manner as active installations. The remaining funds are retained by AAFES for centralized dividend distribution.

AAFES operates a limited number of facilities at remote and OCONUS Navy and Marine Corps installations. This is a mutually beneficial activity as the Navy and Marine Corps are able to rely on AAFES’ superior logistics capabilities, while AAFES is able to retain a portion of earnings from these profitable activities. The dividend distribution formula for these locations was not made available for this study.

#### Contingency Operations and Isolated Site Dividend Distribution

Each service has a unique method of distributing funds to MWR activities at contingency locations and isolated sites. Isolated Air Force units are those which reside outside of a 15-mile radius from an installation receiving AAFES dividends. The Air Force Services Agency funds the MWR program of isolated Air Force units from their centralized account based on their full-time military equivalent (FMTE) strength.

Distributions are as follows: \$3 per month per FTME for the first 100 FTME, \$2 per month for the next 100 FTME, and \$1 per month per FTME over 200 FTME.

Dividend distributions to Army MWR activities at contingency locations and isolated locations are vary depending on location and assigned troop strength. Units at remote and isolated locations in CONUS can requests MWR funds from their nearest installation. The installation distributes funds based on a per capita amount that is approved by the MWR Board of Directors, currently \$2 per capita per month. This \$2 per capita per month applies to OCONUS locations except Army units stationed in Kuwait, Qatar, and Saudi Arabia. These locations receive their dividends based on per capita strength reports submitted quarterly by the Army Theater Commander, U.S. Army Central Command (ARCENT) to the Installation Management Agency (IMA). IMA is a component of the Installation Management Command (IMCOM). These locations receive \$2 per capita per month plus approximately \$3 more from AAFES dividends earned at Camp Doha in Kuwait and Eskan Village in Saudi Arabia.<sup>52</sup>

#### AAFES Centralized Core Dividend and Retained Earnings

AAFES retained earnings include 50 percent of regular earnings plus 10 percent of earnings generated from telephone activities and an average of 2.24% of alcoholic beverage income. These funds are applied to the AAFES Capital Program which is used to fund discretionary construction projects and other corporate priorities.

The remaining funds are made available for distribution to the MWR activities of the Army and Air Force as a centralized core dividend. This amount is determined by the

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<sup>52</sup>Ibid.

military personnel end strength ratio of each service. The 2008 core dividend was 61.02 percent for the Army, and 38.98 percent for the Air Force based on personnel end strength of 552,017 and 337,547 respectively.<sup>53</sup> Each service’s MWR activity prioritizes and distributes these funds based on individually established priorities and goals.

The Army and Air Force Morale Welfare and Recreation Program

The Army and Air Force each has a unique MWR program which services military service members and their dependents. A summary of revenue generating MWR activities by category is listed in Table 3.

Table 3. MWR Revenue Generating Categories

Category A <u>Mission Essential</u>	Category B <u>Community Support</u>	Category C <u>Business Activities</u>
Fitness Programs	Child & Youth Programs	Conference Centers And Clubs
Intramural Sports	Varsity Sports	Golf Courses
Library Programs	Bowling (12 Lanes Or Less)	Bowling (13 Lanes Or More)
Recreation Center/Rooms	Recreation Pools	Retail Activities
Parks	Outdoor Recreation	Restaurants and Snack Bars
Community Centers	Arts & Crafts	Clubs
MWR Command And Control Functions	Marinas Without Resale Or Private Boat Berthing	Marinas With Resale Or Private Boat Berthing

Source: Department of Defense Instruction 1015.10, Programs for Military Morale, Welfare, and Recreation (MWR) (Washington, DC: Government Printing Office, 2007).

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<sup>53</sup>U.S. Army Family and Morale, Welfare and Recreation Command. *Distribution of the AAFES Dividends to the Services*, Memorandum 21 December 2007.



## Army Family and MWR Command

The Army MWR program is operated under the Family and MWR Command (FMWRC) headquartered at the Pentagon in Arlington, Virginia. FMWRC is a component of the Army Installation Management Command (IMCOM) which reports directly to the Army Chief of Staff and is commanded by an Army lieutenant general. FMWRC is commanded by an Army major general who is dual-hatted as the IMCOM Deputy Commanding General. The IMCOM organizational chart is depicted in Figure 1.

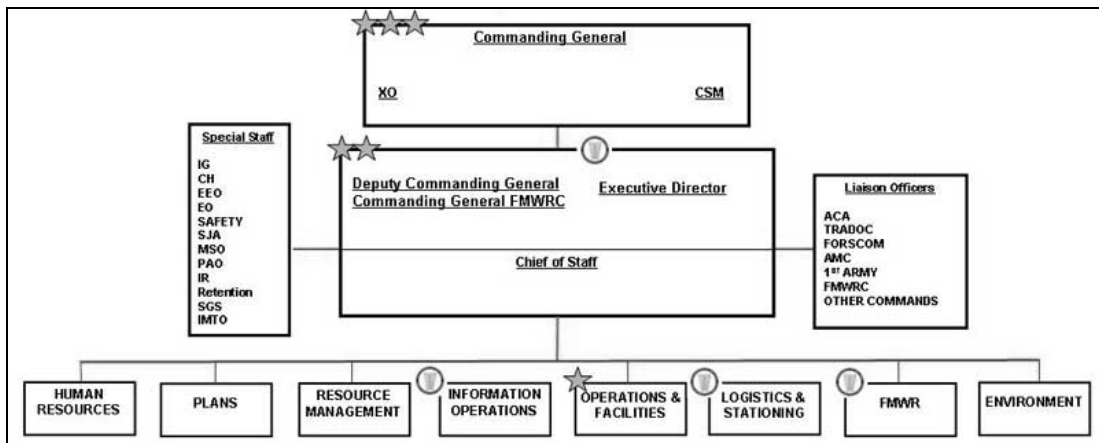


Figure 1. U.S. Army IMCOM Organizational Chart

Source: U.S. Army Installation Management Command, "Organizational Chart," <http://www.imcom.army.mil/hq/organization/> (accessed 10 October 2008).

The day to day operations of the Army's FMWRC is directed by a Senior Executive Service (SES) civilian who oversees each of the IMCOM's seven regions as depicted in Figure 2. FMWRC and each of the IMCOM regions provide staff supervision, policy guidance interpretation, program evaluation, and technical assistance to each installation FMWR directorate. Installation FMWR Directorates are a component



FMWR Support Division is responsible for financial management, internal controls, contracts and all marketing for FMWR. The Child and Youth Services Division operates all family child care and development centers and youth sports programs. The FMWR Support Division and Child and Youth Services Divisions are both Category A activities. The Business Division is funded as a Category B activity and is financed by a combination of NAF and APF resources due to their limited revenue generating abilities. The ratio between NAF and APF funding will vary according to the installation and command priorities.

The FMWR Business Division and Recreation Services Division oversees a variety of recreational functions and activities. These include fitness centers, golf courses, bowling centers, arts and crafts centers and other outdoor recreation activities such as horse stables, parks and picnic areas, and sport firing ranges. These activities are funded as Category B or C activities, with the exception of adult fitness centers. Adult fitness centers are funded as a Category A activity as a component of the health and welfare of service members.

The Army Community Services (ACS) Division of FMWR is a Category A activity which provides programs and services that contribute to the readiness and well-being of the military community. These services include transition, relocation and employment assistance, financial education and assistance, family advocacy and prevention programs and assistance, and soldier and family deployment readiness services. These are invaluable services and capabilities to the military community which directly contribute to the welfare and readiness of soldiers.

## The Air Force MWR Program

Air Force MWR programs are overseen by the Air Force Services Agency (AFSVA). The AFSVA is commanded by a Colonel who reports to the Air Force Deputy Chief of Staff for Manpower & Personnel (USAF/A1), an SES major general equivalent. The AFSVA, through the Air Force Major Commands, provides policy interpretation and technical assistance to installation MWR programs in a similar manner as the Army FMWRC. This relationship is depicted in Figure 3. Local installation MWR directorates are integrated components of the Air Force Wing Force Support Squadron.<sup>54</sup>

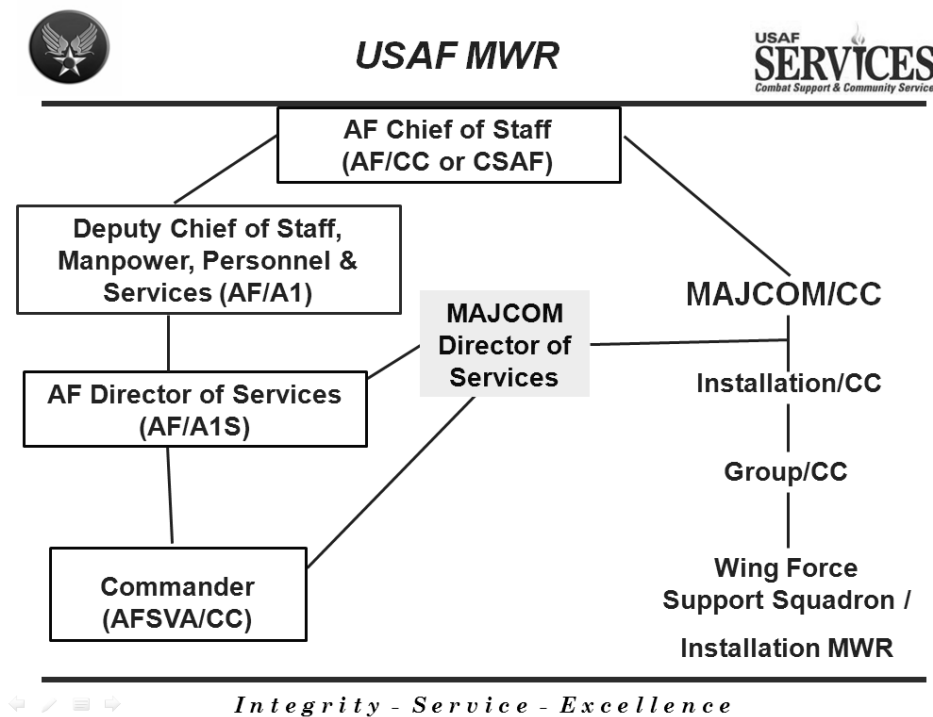


Figure 3. U.S. Air Force MWR Hierarchy

Source: Air Force Services Agency Commander's Action Group e-mail, "U.S. Air Force MWR&S Program," 31 March 2009.

<sup>54</sup>Air Force Services Agency Commander's Action Group e-mail, "U.S. Air Force MWR&S Program," 31 March 2009.

Air Force MWR programs provide the identical services as the Army MWR program and operate under identical parameters and NAFI program groups and categories. This installation MWR program hierarchy is presented in Figure 4, where MWR activities are shaded in grey.

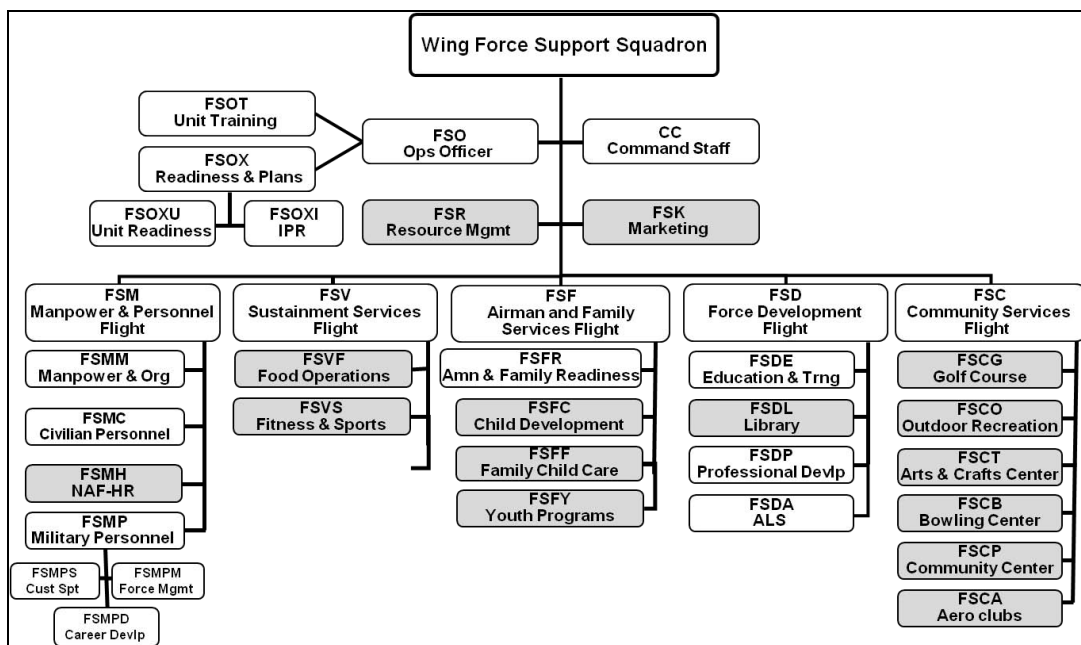


Figure 4. U.S. Air Force Wing Force Support Squadron Organizational Chart  
 Source: Air Force Services Agency Commander's Action Group e-mail, "U.S. Air Force MWR&S Program," 31 March 2009.

Chapter 2 answered three of the secondary research questions. It presented a history of AAFES to include a current operational situational update, and outlined the regulatory requirements that govern operations of the military exchange system, to include the specific operational requirements of AAFES. This chapter also outlined the Army and Air Force MWR activities, and described how AAFES revenues are distributed

and applied towards MWR programs. The next chapter will outline the research methodology used to conduct analysis to answer the primary and secondary research questions.

## CHAPTER 3

### RESEARCH METHODOLOGY

It is extremely difficult to measure the importance of what AAFES does every day.

— AAFES Commander<sup>55</sup>

Chapter two presented a history of AAFES with a current operational update. It is important to understand the history of AAFES and how it is entrenched in the lives of service members and in the culture of the Army and Air Force. This chapter will identify the analysis necessary to formulate conclusions pertaining to the primary research question. The primary research question seeks to analyze the strategic relevancy and strategic value of AAFES. The research methodology used in this analysis will comprise three main parts: an operational analysis, a financial analysis, and a business environment analysis. These three analyses will collectively contribute to the formulation of a strengths, weakness, opportunities and threats (SWOT) analysis of AAFES in order to assess and identify components of the internal and external operating environment.

#### Operational Analysis Methodology

The operational analysis of AAFES will analyze its business lines of operations and compare them against its peers and commercial competitors. AAFES does not have any true peer competitors; however, the military exchanges of the Marine Corps, Navy, and Coast Guard are peer parallel organizations. The NEX, MCX, and CGX all operate under an identical congressional charter and DoD direction as AAFES but have entirely

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<sup>55</sup>General Keith L. Thurgood, Commander, AAFES (testimony before the Military Personnel Subcommittee of the Committee on Armed Services United States House of Representatives, 17 April 2008).

autonomous management and operational oversight. This analysis will also include a comparison against industry competitors as reported by professional industry analysis. This analysis will be framed in a CONUS only perspective as analyzing international competitors is not within the scope of this study.

### Financial Analysis Methodology

Typical financial reporting analysis models are of limited value when analyzing the financial data of AAFES and other military exchange operations. AAFES and its peer parallel organizations, the NEX and MCX, have many significant comparative advantages over their retail contemporaries which invalidate many financial analysis methods. These advantages include virtually cost free land acquisitions, immunity from local, state, and federal taxation, guaranteed markets, and APF funding and subsidizing. APF funding and subsidizing of military exchange operations are both direct and indirect and include such things as utilities, construction costs, and its ability to self insure. These monumental advantages do not allow for standard financial analysis.

However irrelevant standard financial reporting analysis models may be, they can provide a base line for analysis. An attempt to explain special factors affecting any calculation will be made in order to facilitate a comprehensive analysis. Financial comparisons between AAFES, the NEX, MCX, and commercial competitors from the retail industry will provide valuable insight into the overall financial performance of AAFES. The financial analysis will ultimately answer two secondary research questions by assessing the financial performance of AAFES, and indicating how it compares against its competitors in the global market place. It is important to understand that all military exchanges have developed partnerships in order to both pool their collective



buying power and achieve certain targeted efficiencies. This partnership is expected to have the least overall benefit for AAFES as the NEX has 30 percent, and the MCX has 12 percent the amount of annual net income in dollars as compared to AAFES.<sup>56</sup>

In addition to analyzing the financial data of AAFES against its peers, they will be compared to those of the average retail industry. The average retail industry data is a compilation of 9,390 retail sector firms in the U.S. An analysis of financial ratios will provide valuable insight into the viability, stability and profitability of each military exchange service. Each military exchange operation has vastly different market share and financial performance; therefore, comparative ratio analysis will be used. Comparative ratio analysis will quantify strengths and weaknesses and assist in evaluating financial performance on comparatively equal terms.

The first method used for financial analysis will be to present financial statement data in proportion to sales and revenue, expenses, and income. The activity ratio analysis will follow, which will assist in assessing the efficiency of each organization. Activity ratios describe the relationship between operations, sales and other income generating activities, and the assets needed to sustain operations. Activity ratios serve as the primary means to evaluate management. The higher the ratio, the more efficient the firm's operations are.<sup>57</sup>

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<sup>56</sup>2008 Net Income (in thousands): AAFES (8,704,483); NEX 30% (2,667,647); MCX 12% (1,023,082). CGX financial data not reviewed.

<sup>57</sup>Gerald I. White, Ashwinpaul C. Sondhi, and Dov Fried, "The Analysis and Use of Financial Statements," (Hoboken, NJ: John Wiley & Sons, 2003), 120.

## Activity Analysis Methodology

1. Sales Activity Ratios: Sales activity ratios can be used to measure profitability through the relationship between the firm's costs and sales.<sup>58</sup>

2. Return on Investment Ratios: The return on investment ratios measure the relationship between profits and the investments required to generate them.<sup>59</sup> The return on investment ratios are an indicator of how profitable operations are.

3. Operating Efficiency Ratios: Operating efficiencies ratios are a critical analysis of numerous components of an organizations finances and activities. They measure the organizations' use of assets, capital, and productivity in relation to sales, account receivable, and accounts payables.

4. DuPont Analysis: The DuPont Analysis is a method of evaluating a company's earnings by calculating two distinct earnings ratios and comparing them against each other.<sup>60</sup> The first component is the Return on Assets (ROA) calculated as:  $(\text{Net Income} \times \text{Sales}) / (\text{Asset Turnover Ratio})$ . The second is Return on Equity (ROE) calculated as:  $(\text{Profit Margin}) (\text{Asset Turnover}) (\text{Equity Multiplier})$ , where the Equity Multiplier is calculated as  $(\text{Assets}/\text{Equity})$ . ROE represents the profitability of invested capital, while ROA represents profitability as a function of assets.<sup>61</sup> Revenue calculations do not consider extraordinary income (EI). The DuPont analysis can assist in identifying

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<sup>58</sup>Ibid., 133.

<sup>59</sup>Ibid., 134.

<sup>60</sup>Money Soft, "Beyond Traditional Ratio Analysis," [www.moneysoft.com/pdf/DuPont-analysis.pdf](http://www.moneysoft.com/pdf/DuPont-analysis.pdf) (accessed 5 March 2009).

<sup>61</sup>Harvard Business Online, "Sustainable Growth Rate and DuPont Ratio Analysis," [http://harvardbusinessonline.hbsp.harvard.edu/b02/en/academic/edu\\_tk\\_fin\\_sus\\_grow.jhtml](http://harvardbusinessonline.hbsp.harvard.edu/b02/en/academic/edu_tk_fin_sus_grow.jhtml) (accessed 4 April 2009).

whether the changes in ROE are being driven by sales margins, asset management, or financial leverage.<sup>62</sup> A high ROE is beneficial; however, it can be misleading as the equity multiplier or leverage ratio may high as a result of high debt.

### Financial Risk Analysis Methodology

1. Liquidity Analysis: Internal liquidity ratios describe the relationship between sales and the assets needed to sustain those operating activities.<sup>63</sup>

2. Leverage Analysis: Leverage refers to the proportion of financing and instruments of debt used by an organization to finance operations.<sup>64</sup> The amount and type of leverage can be a measure of solvency and an organizations' ability to meet future obligations. The unique ability of military exchanges to finance operations through APF adds complexity to calculating accurate and relevant financial leverage analysis.

### Business Environment Analysis Methodology

The business environment analysis will seek to analyze select components of the internal and external business environment of AAFES. These components will include core ideology and vision, the corporate management structure, and a market and global economic analysis. The business environment analysis will ultimately answer two secondary research questions by analyzing how managers and stakeholders rate success of AAFES, and whether or not the needs of the customers are being met.

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<sup>62</sup>Money Soft, "Beyond Traditional Ratio Analysis."

<sup>63</sup>Fried et al., 119.

<sup>64</sup>Forbes Digital, "Investopedia – Leverage," <http://www.investopedia.com/terms/l/leverage.asp> (accessed 5 April 2009).

Chapter 3 outlined the methodology for analysis to be used to formulate conclusions pertaining to the primary research question. This methodology will be applied in the next chapter and will be used to draw conclusions pertaining to the primary and secondary research questions.

## CHAPTER 4

### FINDINGS AND ANALYSIS

We need to pay attention to the entirety of our people and their families and the programs which support them in order to make sure that they are well-positioned for the future.

— Admiral Michael Mullen, Chairman of the Joint Chiefs of Staff<sup>65</sup>

Chapter 3 identified the methodology of analysis necessary to formulate conclusions pertaining to the primary research question. The primary research question seeks to analyze the strategic relevancy and strategic value of AAFES. This chapter will present the findings of the research methodology outlined in the previous chapter. This chapter will comprise three main parts: an operational analysis, a financial analysis, and a business environment analysis. The purpose of this chapter is to outline the global operations, financial posture, and the operating environment of AAFES in relation to its peers and commercial competitors. This chapter will conclude with a summation of the internal strengths and weaknesses, and the external opportunities and threats of AAFES outlined in a SWOT analysis.

#### Business Lines of Operation

Authorized military exchange activities are outlined in enclosure 3 of DODI 1330.21 and are detailed in Appendix B of this study. For the purposes of this study AAFES global operations will be classified into four categories: retail operations, installation convenience activities, special activities, and contingency support activities.

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<sup>65</sup>Admiral Michael Mullen, 17th Chairman of the Joint Chiefs of Staff (2008-2009 Pew Memorial Lecture, Grove City College, PA, 2 February 2009).

Each of these categories has multiple sub-activities which encompass all of AAFES' operations.

### Retail Operations

AAFES retail operations include the Main Exchange store, concessionaires, military clothing and sales stores (MCSS), catalog sales, and ecommerce activities. The Main Exchange store is typically referred to as the Post Exchange (PX) on Army installations or Base Exchange (BX) on Air Force installations. The Main Exchange store is the central retail location which sells hardlines, softlines, and consumables. Hardlines include electronics, stationary, books, home accents and furnishings, appliances, hardware, sporting goods, and toys. Softlines are clothing items, footwear, jewelry and other accessories for men, women, and children. Consumables are beverage items, tobacco, food, snacks, fragrances, cleaning supplies, and health and beauty aids. The competitors to the PX/BX include all commercial retail outlets.

Each PX/BX is located in a large facility with a mall area with small shops and kiosks. These facilities are leased to a wide array of concessioners. Typical AAFES concessionaires include an optometry office, General Nutrition Center (GNC), dry cleaning and alterations, and other specialty shops such as military memorabilia and custom embroidery. The type of concessions can vary greatly by location and are a function of the local market demand. Some PX/BX locations have cell phone providers, internet cafe's, or retail stores such as GameStop.<sup>66</sup> Each PX/BX also has a hair salon

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<sup>66</sup>US Fed News Service Including US State News, "AAFES Opens Gamestop," November 3, 2008, <http://www.proquest.com> (accessed 31 March 2009).

and barber shop. While the hair salon is a concession activity the barber shop is an AAFES operated facility.

Concession activities provide goods or services which AAFES is either unable or unwilling to provide. AAFES charges these concessions considerable fees to operate on military installations. AAFES negotiates these fees individually and data were not made available for this study; however, an unscientific survey of AAFES concessions indicates that these fees can range from an average of 20 percent of sales, to as high as 40 percent. Many concession activities are negotiated by sealed bid, presumably always going to the highest bidder. Concessions sales are not afforded the same immunity from taxation as are AAFES run facilities.<sup>67</sup> They are however entitled to the same APF support as AAFES.<sup>68</sup>

Every installation above a predetermined population has a MCSS which sells official uniform items and accessories to service members. AAFES also sells unofficial commercial personal demand items such as backpacks, watches, books, and other commercial items. The MCSS is operated by AAFES on behalf of the military services which are required to reimburse AAFES for all costs associated with the construction, facility improvement, operation, and management of the MCSS facility with APF.<sup>69</sup> Each military service has memorandum of understandings (MOU) with AAFES and regulations governing the operations of MCSSs; however, they all generally have the

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<sup>67</sup>*Army Regulation 215-8 and Air Force Instruction 34-211(I) Army and Air Force Exchange Service Operations*, "Taxes," (Washington, DC: U.S. Government Printing Office, 2008).

<sup>68</sup>Ibid., "Stock Assortment, sales, Pricing, Advertising, and Promotions."

<sup>69</sup>*Army Regulation 215-8 and Air Force Instruction 34-211(I) Army and Air Force Exchange Service Operations*, "Exchange Operations," (Washington, DC: U.S. Government Printing Office, 2008).

same provisions governing MCSS operations and APF reimbursement. AAFES is responsible for calculating the amount of APF reimbursement attributed to official uniform items and accessories. This calculation is based solely of the on the percentage of sales of official and unofficial items, where AAFES absorbs the share of costs associated with unofficial items. Official uniform items are procured by the Defense Supply Center Philadelphia (DSCP). The DCSP-distributed-items to AAFES and current policy provides a standard discount on the merchandise provided to AAFES in order to account for shortages, damages, and defects. The costs associated with the construction and upgrade of MCSS facilities are funded entirely by APF.<sup>70</sup>

AAFES operates an extensive catalog sales and ecommerce activity. Authorized AAFES patrons are able to purchase a wide array of products from all product lines, with the exception of perishable food items, to include uniform items. The online and catalog activities are joint endeavors between all military exchange services. AAFES is responsible for the bulk of the administration and operation of these activities. The terms of sale are identical as PX/BX locations in that they are for qualified customers only and free from state and local taxes. AAFES ecommerce and catalog activities are very competitive against similar competing companies, and include an auction site and ship to store feature. The most significant aspect of the ecommerce and catalog advantages is the shipping fees which are free on all orders over \$49, and \$4.95 on orders under \$49. The AAFES shipping policy also includes free shipping on all orders that contain at least one MCSS item, and orders to deployed locations such as Iraq and Afghanistan.

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<sup>70</sup>AAFES, *EOP Procedures 40-4 Military Clothing and Sales Stores (MCSS)*,” (Washington, DC: U.S. Government Printing Office, 2002).



Shipping fees of oversized items are very competitive as well; these range from \$25 to \$200 which is comparable to other competing ecommerce retailers.<sup>71</sup>

AAFES also facilitates concessionaire type transactions through its ecommerce site through their Online Mall. The AAFES Online Mall is an ecommerce portal through the main web site which connects AAFES patrons with over 70 retailers. These transactions are not afforded the same immunity from sales tax, but the Online Mall does facilitate connecting AAFES patrons with special offers and discounts from other retail outlets. The AAFES revenue model for this activity was not available for this study.

#### Installation Convenience Activities

AAFES operates a number of revenue generating activities in addition to their retail operations. These activities include fast food restaurants, convenience stores, gas stations, car washes, movie theater operations, furniture stores, and vending machines. The fast food restaurant activities of AAFES include over 1,765 stand-alone facilities throughout the installation and food court establishments in the PX/BX, and other government buildings.<sup>72</sup> AAFES operates fast food facilities under its own trademark, in addition to national franchises such as Burger King, Taco Bell and Starbucks. AAFES operates national franchises no different from any other franchisee, and pays the same fees and royalties. Some national franchises located on military installations are operated by a concessionaire that pays an operating fee to AAFES in addition of the franchise fees and royalties.

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<sup>71</sup>AAFES, "Shipping Policy," [https://thor.aafes.com/ics/info/DynamicInfo.asp?ID=Shipping Policy&mscssid=2Fs2e3V1MKsH2KAC00LHrFGeQ8XeVCKQ](https://thor.aafes.com/ics/info/DynamicInfo.asp?ID=ShippingPolicy&mscssid=2Fs2e3V1MKsH2KAC00LHrFGeQ8XeVCKQ) (accessed 27 March 2009).

<sup>72</sup>Thurgood, (testimony before the Military Personnel Subcommittee of the Committee on Armed Services United States House of Representatives, 12 March 2009).

AAFES operates a number of convenience stores on military installation. These are sometimes called book stores or Mini-PX/BXs, and are placed in buildings or areas with a large concentration of authorized patrons. Two types of AAFES convenience stores central to every AAFES location are the Shoppette and Class Six. The Shoppette is a convenience store with extended hours which may operate other activities such as a gas station, car wash, and a concession automotive repair facility. The Class Six are package stores located on military installations that sell a wide array of spirits. The term Class Six refers to one of the ten military doctrinal classes of supply, Class Six representing non-military personal demand items. Installations will only have one Class Six store; however, larger installations may have multiple Shoppettes as a function of customer density and demand. Small installations may combine the Shoppette and Class Six activities in order to provide service and maintain efficiencies.

AAFES operates a motion picture service, named Reel Time, on installations serviced by AAFES. A few installations have separate concessionaire operated commercial movie theaters equivalent to movie theaters across the U.S. Most installations do not have the population to warrant such an investment and as such an APF theater is used for this activity. In these cases AAFES uses the APF facility at no cost but is responsible for movie projection equipment, concession stand, and general cleanliness during use. These APF facilities have other official uses and their use by AAFES is considered a morale support activity.

The admission prices at AAFES Reel Time facilities range from a minimum of \$1 to a maximum of \$4 for CONUS locations and \$4 to \$4.50 at OCONUS locations. The

average theater admission price in the US was \$7.18 in 2008.<sup>73</sup> This represents a 44 percent savings at CONUS locations and 37 percent at OCONUS facilities as compared to the US national average. CONUS concession stand prices are based on local market surveys and OCONUS prices are based on the average of CONUS based prices. In response to an inquiry for this study, AAFES has indicated that popcorn, candy and beverages are priced at 20 percent below the average of commercial survey price and rounded to the nearest quarter, and must reflect a minimum of 10 percent savings over the lowest priced local theater.

AAFES run car wash, vending machine, and other supplemental revenue generating activities are designed to satisfy customer needs and enhance revenue generation. Vending machines are typically operated by a vendor which pays a royalty fee to AAFES. Pricing strategies for these activities is based on the local market surveys and tend to be equally priced with the public sector.

AAFES also administers the fuel ratio card program in Germany. The aptly named Esso card is accepted at both AAFES and Esso gas stations. This program was put in place in 2008 in response to requests from the German government in an effort to stem fraud and abuse of fuel sales exempt from German sales and duty taxes.<sup>74</sup> This program appears to be an administrative burden on AAFES and provides no economic benefit to AAFES activities; nonetheless, it is a host nation requirement that warrants mandatory compliance.

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<sup>73</sup>National Association of Theater Owners, "NATO Statistics," <http://www.natoonline.org/statisticstickets.htm> (accessed 3 April 2009).

<sup>74</sup>Installation Management Command Europe Region, "Fuel Ration Cards in Germany," <http://www.imcom-europe.army.mil/sites/news/fuelcard.asp> (accessed 4 April 2009).

## Special Activities

AAFES special activities include both revenue generating and non-revenue generating activities. The sole non-revenue generating activity for AAFES is the OCONUS DoD School Meal Program (SMP). AAFES operates the SMP for kindergarten through twelfth grade students on Army and Air Force installations in nine countries overseas. The AAFES SMP provides 24,000 meals each day for a total of more than 4.4 million meals each school year at over 92 schools throughout Europe and the Pacific.<sup>75</sup> The intent of this program is to provide typical U.S. menus that are approved by the U.S. Department of Agriculture (USDA) to military dependents serving overseas.

Other special revenue generating AAFES activities include the Exchange Credit Program (ECP). This program was approved by Congress in 1992 and is governed by DODI 1330.21. The ECP is a joint Army, Air Force, Navy, Marine Corps, and Coast Guard exchange activity which is administered by AAFES. The ECP is marketed as the Military Star Card and has three components. The Military Star Master Card is a Chase Bank rewards charge card which can be used wherever Master Card is accepted. The Military Star Card is a charge card that is accepted only at military exchange locations, and on the all services exchange ecommerce site. The Take It Home Today charge card program is designed for large furniture and appliance purchases and is only honored by AAFES and NEX stores.

The ECP is administered in accordance with established business practices, to include the maintenance of a Standard and Poor's (S&P) rating. The S&P is an

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<sup>75</sup>AAFES, "AAFES School Meal Program," <http://odin.aafes.com/nutrition/08/index.html> (accessed 4 April 2009).

independent provider of financial market analysis, among them credit ratings. The current AAFES S&P rating is AA/Stable/A-1+.<sup>76</sup> The AA rating differs from the highest rating only to a small degree and signifies that the capacity for AAFES to meet its financial commitment is very strong. The stable rating refers to the potential for the rating to change, with stable referring to a rating change as being not likely. The third portion of the rating refers to AAFES' capacity to meet short-term obligations. A-1 is rated in the highest category by the S&P, and the plus sign (+) indicated the capacity is extremely strong.<sup>77</sup>

The ECP S&P rating indicates that the program is being administered properly and the revenue generating potential for AAFES is high. This is in part facilitated by the ability of the ECP program to contact commanders of service members with delinquent accounts, and their ability to garnish wages. This program is also benefited by military exchange authorized patrons being public servants who have fixed incomes and are relatively immune to private sector economic factors.

The ECP benefit to military exchange customers is significant as fees and benefits are unmatched by any other charge card program. The ECP offers competitive interest rates as outlined in Table 4 which details card features in comparison to three commercial competitors. The ECP offers a zero to six percent annual percentage rate (APR) for deployed service members, and debt forgiveness for service members killed in action. Another benefit available to service members through the ECP is the Military Clothing

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<sup>76</sup>Standard & Poor's, "S&P Ratings Corporate," [http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/ratings\\_corp/2,1,3,0,0,0,0,0,0,0,3,0,0,0,0,0.html](http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/ratings_corp/2,1,3,0,0,0,0,0,0,0,3,0,0,0,0,0.html) (accessed 4 April 2009).

<sup>77</sup>Standard & Poor's, "Products & Services," *About Credit Ratings*, 1 December 2008, [http://www2.standardandpoors.com/spf/pdf/fixedincome/Ratings\\_Definitions.pdf](http://www2.standardandpoors.com/spf/pdf/fixedincome/Ratings_Definitions.pdf) (accessed April 1, 2009).

Plan, formerly called the Uniform and Clothing Deferred Payment Plan. This program allows service members to purchase official uniform items at zero percent interest at MCSS facilities.

Table 4. ECP Credit Card Comparison

Issuer	MILITARY STAR <sup>1</sup>		Kmart / Sears Credit Card <sup>3</sup>		Target <sup>4</sup>		Wal-Mart <sup>5</sup>
Card Metric	Store Card	Master Card	Store Card	Master Card	Store Card	Visa Card	Store Card / Discover Card
Interest Rate	Prime + 4.99% (Min 9.99%)	9.99% 10.24% 13.24%	20.40%	Data Available Only To Applicants	24.24%	11.24% 14.24% 17.24% 20.24%	9.87% 15.87% 18.87% 19.87%
Delinquency Interest Rate	13.24%		Prime + 22.15%		27.24%	Prime + 23.99%	24.99%
Late Fees	0.5% of the amount past due, not to exceed \$25	\$20	\$15-\$39		\$15-\$39		\$15-35

Source: <sup>1</sup>AAFES, “Summary Of Military StarSM Credit Program Terms,” <https://thor.aafes.com/ics/credit/terms.asp?mcsid=2Fs2e3V1MKsH2KAC00LHrFGGeQ8XeVCKQ> (accessed 4 April 2009).

<sup>2</sup>Sears, “Compare Cards,” [http://www.citibank.com/us/cards/srs/credit\\_options.jsp](http://www.citibank.com/us/cards/srs/credit_options.jsp) (accessed 4 April 2009).

<sup>3</sup>Target, “Target REDCards,” [https://redcard.target.com/redcard/content/rcw\\_rates\\_fees](https://redcard.target.com/redcard/content/rcw_rates_fees) (accessed 4 April 2009).

<sup>4</sup>Wal-Mart, “The Key Credit Terms,” <https://www.onlinecreditcenter2.com/consumereApply/Internet/walmart/en/pdf/TermsConditions.pdf> (accessed 4 April 2009).

The Military Star Master Card offered by Chase Bank was launched in May 2008 and has been the subject of some controversy.<sup>78</sup> The National Association of Federal Credit Unions (NAFCU) argues that the Military Star Master Card violates DoD policy

<sup>78</sup>Chris Ward, “AAFES News Online,” April 2008. <http://www.aafes.com/pa/news/08news/08-024.htm> (accessed 4 April 2009).

restricting DoD components of NAFIs from engaging in retail banking activities.

AAFES argues that this program is an extension of existing services and thus does not violate any policies. The NAFCU also argues that the revenue model for this activity is dependent on service members accruing debts that they may not be able to afford.<sup>79</sup>

Another AAFES special revenue generating activity is the Exchange New Car Sales (ENCS) program. This program is available to both military service members and civilian stationed at OCONUS locations for over 30 days, and facilitates the sale of U.S. manufactured vehicles and motorcycles with favored military pricing and rebates. The ENCS is operated by and administered by the Overseas Military Sales Corporation (OMSC), an AAFES concessionaire. OMSC contracts directly with American automobile manufacturers to sell their vehicles at OCONUS locations.<sup>80</sup>

The AAFES revenue model for the ENCS program has not been disclosed in any documentation and was not made available for this study. The OMSC utilizes independent sales representatives whose compensation rates vary but are generally in excess of \$1,000 per vehicle sold. Despite the generous compensation for the independent sales contractors, OMSC and AAFES assert that the price of these vehicles is generally lower than U.S. based dealerships that have a high overhead and markup.

The ENCS provides a number of valuable benefits to customers which are as follows:

1. **Lowest Price Guarantee.** OMSC will pay the difference of a bona fide offer with a lower price from a franchised dealer in the Continental U.S. or Puerto Rico for the

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<sup>79</sup>US Fed News Service Including US State News, "NAFCU, DoD Reps Meet on AAFES Card," 9 June 2009, <http://www.proquest.com> (accessed 31 March 2009).

<sup>80</sup>Overseas Military Sales Corporation. "Important Customer Information, "Exchange New Car Sales," <http://www.encs.com/customer-info.aspx> (accessed 4 April 2009).

same vehicle, delivery date and location. This guarantee is available for up to 14 days after delivery.

2. Money Back Guarantee. The vehicle will be delivered exactly as specified on your order acceptance, or a full refund will be issued.

3. Guaranteed Delivery Date. OMSC guarantees that the vehicle will be delivered at the exact location and time promised.

4. Exclusive Military Rebates. OMSC asserts that it offers exclusive rebates, discounts, and benefits not available anywhere else.

5. One Pre-Negotiated Low Price. Prices on every car are pre-negotiated between AAFES and the manufacturers, so that there will never be a need to haggle.

6. Special Orders. Customers can custom order a vehicle direct from the factory, and have it delivered overseas or in the U.S.

7. Worldwide Delivery. Customers are able to take delivery almost anywhere in the U.S. and at most overseas duty stations.

8. 100 Percent Price Protection. The customer will pay the exact contracted price and is not subject to manufacturer price increases, or reductions in the rebate amount.

9. Cancellation Without Penalty. If official government travel or special duty affects the delivery of a new car, the customer has the right to cancel the order and receive a full refund.

10. Choice of Financing Sources. Independent sales consultants will advise customers on a wide range of financing sources, but customers are able to secure financing through any other means. If for any reason a customer is unable to secure financing within 10 days of his or her order OMSC will issue a refund on the deposit.



A relatively new special activity for AAFES is the Mobile Field Exchange (MFE). The MFE is designed to bring the AAFES benefit to locations without a permanent AAFES presence. AAFES currently has nine MFE's available for deployment. This program is chiefly designed to serve reserve component members of the military service. In 2008 AAFES MFE trailers visited nine locations across the U.S. to include the city of Hilo in the state of Hawaii.<sup>81</sup> The MFE's have also been deployed to serve military disaster relief workers. In 2008 MFE trailers were deployed to California to support National Guard members fighting wild fires<sup>82</sup> and Texas in the aftermath of Hurricane Ike.<sup>83</sup>

#### Contingency Operation Support

Support to contingency operations is the AAFES trademark and is codified in the AAFES motto *We Go Where You Go*. Contingency operation support includes AAFES presence at all places where the U.S. military is deployed in both permanent and temporary locations. The intent of AAFES operations in contingency locations is to supply military service members with personal demand items which support troop morale, at average U.S. based prices. As of September 2008, AAFES support to contingency operations spanned seven countries, to include Iraq and Afghanistan, with 87

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<sup>81</sup>*Warrior – Citizen*, "AAFES Benefits Go On The Road," 1 July 2008, 30.

<sup>82</sup>*Transport Topics*, "Fleet Briefs," September 22, 2008, <http://www.proquest.com> (accessed 31 March 2009).

<sup>83</sup>*US Fed News Service, Including US State News*, "AAFES Supports Troops Bringing Relief To Hurricane Ike Victims," September 18, 2008. <http://proquest.com> (accessed March 31, 2009).

retail facilities, 216 food outlets, and 661 concessions.<sup>84</sup> AAFES contingency activities operate out of a variety of permanent structures, pre-fabricated buildings, trailers, tents, and at times on pallets in the sand.<sup>85</sup>

AAFES contingency activities receive significant support from the military services and receive substantial APF support. Contingency retail goods are shipped from AAFES warehouses in the U.S., with APF funding the costs of transportation. AAFES does procure some items locally; however, this is based on availability and demand. All costs associated with the operations and management of contingency support activities, with the exception of the wholesale costs of goods sold is funded by APF.

AAFES cargo is prioritized with other military cargo for shipment to contingency locations. While conducting research for this study one Army logistics officer expressed frustration over having military cargo bumped by AAFES goods during the onset of military operations in Afghanistan. Other Army officers recalled providing convoy security for AAFES goods and dedicating military construction capacity for AAFES at the expense of other military operations. Army logistical units regularly support AAFES and other contractor activities. This support includes receiving, inventorying, and storing which is done down to the brigade Supply Support Activity (SSA).<sup>86</sup> Military commanders and staffs presumably balance operational requirements against the requirements to support AAFES contingency operations, and thus allocate resources and manpower appropriately without degradation to the success of military operations.

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<sup>84</sup>Department of the Army Office of the Inspector General (DAIG), *Final Report on the Joint Inspection of the Army and Air Force Exchange Service (June – December 2008)*, 17 February 2009, 2-1.

<sup>85</sup>*Warrior – Citizen*, “AAFES Benefits Go On The Road,” 30.

<sup>86</sup>Lee Elder, “Keeping Em’ Rolling,” *Soldiers*, (Alexandria, Virginia, November 2006) 30.

The 2009 Army IG special investigation observations found strategic planning efforts of AAFES to be lacking with regard to contingency operations. Army leadership frequently failed to share critical planning information that would allow AAFES to forecast support for changes in troop density and the resulting surges in demand for AAFES services.<sup>87</sup> This highlights a major communication failure between the military services and AAFES, and the resulting degradation of service to deployed service members. AAFES patrons may fault AAFES for its inability to respond to changes in demand; however, Army leadership is primarily at fault for failing to include AAFES in its planning process as an element of operational design. The Tactical Field Exchange Liaison Officer (TFELO) is a uniformed liaison charged with coordinating AAFES operations with military commands. Synchronization gaps can be directly attributed to the failed efforts of this individual. AAFES managers are partially responsible for failed integration and synchronization efforts, as they should have a routine relationship with their assigned TFELO and should proactively seek information.

AAFES patrons have compared the contingency retail operations of AAFES with those of contractors, specifically Kellogg Brown and Root (KBR), which never ran out of food items in contracted dining facilities. This correlation is unfair to AAFES, as transportation of food items receive higher priority than retail goods. AAFES inventory takes an average of 55 days and 46 days to travel to Afghanistan and Iraq, respectively.<sup>88</sup> In comparison, routine military cargo is estimated to arrive in Kuwait within 25 days, and it takes another five to eight days to arrive by ground convoy to Iraq. Routine military

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<sup>87</sup>DAIG, 2-4.

<sup>88</sup>Ibid., 2-2.

cargo arrived in Afghanistan in about 35 days by ground convoy through Pakistan.<sup>89</sup>

Deployed service members report receiving items ordered online or sent in the mail by family members within 15 days; however this correlation is also unfair as the military mail system received significantly higher priority than routine cargo.

In addition to being a function of failed communication between the military services and AAFES, inventory shortages in contingency areas can be directly attributed to the AAFES corporate goal to reduce inventory within OEF and OIF by \$25 million.<sup>90</sup> Measures of performance for retail operations include inventory carrying costs and inventory turnover. The goal to reduce inventory is a suitable measure of performance; however, it has little effectiveness as the difficulty of synchronizing the supply chain with demand is exacerbated by the nature and operating environment of contingency operations. In response to inventory shortages and long inventory transit times, AAFES has created a supply chain management position for operations in Afghanistan and Iraq.<sup>91</sup>

At locations where AAFES is unable to staff with civilian employees an Imprest Fund activity may be established. In an Imprest Fund activity AAFES provides retail goods and operating capital for operation and management by a uniformed service member. This activity is operated out of a container that can be transported by rotary wing air assault or ground to remote locations.<sup>92</sup> As of September 2008, AAFES

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<sup>89</sup>Army Transportation Corps Officer, personal communication with the author, 28 April 2009.

<sup>90</sup>DAIG, 2-3.

<sup>91</sup>Ibid., 2-2.

<sup>92</sup>Army and Air Force Exchange Service, "Serving Troops Downrange," <http://www.aafes.com/downrange/home.htm> (accessed 4 April 2009).

supported 41 Imprest activities in contingency areas.<sup>93</sup> The 2009 Army IG report found the coordination between AAFES and military organizations to be lacking, to the detriment of service members in remote contingency locations. Imprest Fund activities were found to be difficult to implement and currently operating activities were not uniformly managed. A recently deployed military commander indicated that Imprest Fund activities needed to be approved by the AAFES headquarters in Dallas, Texas, significantly adding to the difficulty in establishing such activities. Although the 2009 Army IG investigation observed no improprieties within the operation of Imprest activities not one Imprest activity visited operated in accordance with established standards.<sup>94</sup>

The Marine Corps is the only military service to have a dedicated military occupational specialty (MOS) to support its exchange activity.<sup>95</sup> This population of 12 officers and 155 enlisted marines provide an immediate expeditionary capability to the MCX. The Navy has a purchasing & supply career field which is responsible for the operations and management of expeditionary NEX type functions called Ship's Stores. The Ship's Stores are Navy retail facilities aboard Navy ships and other Navy remote locations. These facilities also operate a number of quality of life services and proceeds are distributed to MWR programs. All military services exchange activities rely on the AAFES logistical network to provide and transport goods overseas. This partnership

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<sup>93</sup>DAIG, 2-1.

<sup>94</sup>Ibid., 2-6.

<sup>95</sup>United States Marine Corps Training and Education Command, "MOS Road Maps," <https://www.intranet.tecom.usmc.mil/hq/divisions/g3/Pages/MOS%20Roadmaps.aspx> (accessed 4 April 2009).

capitalizes on the maturity and excellence of the AAFES logistical network to the benefit of the Navy and Marine Corps.

The preceding section is not an all inclusive analysis of all of AAFES global activities. AAFES engages in many other activities; however, those presented here comprise the bulk of AAFES activities that are sufficiently significant to warrant analysis within the scope of this study. AAFES operates over 3,100 facilities and provides the military exchange benefits in more than 30 countries, five U.S. territories, and 49 states. The customer base is 11.6 million active duty, Reserve, National Guard, and retired military members and their families.<sup>96</sup>

### Financial Analysis

The difficulty of conducting a financial analysis of government organizations stems from the subjective value of the product or service being provided. This difficulty is exacerbated by the hybrid nature of the organization, structure, and financing of these organizations. Financial ratio analysis between AAFES, the NEX, MCX, and data from the average U.S. retail industry will provide valuable insight into the overall financial performance of the military exchanges. The four ratio categories used include sales, expenses and income ratios, activity analysis ratios, and financial risk ratios. These categories are not independent factors, but rather are interrelated as each affects the other which together facilitates comprehensive analysis.<sup>97</sup> Ratio analysis eliminates the influence of size differences across these organizations; however lack of published

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<sup>96</sup>Thurgood, (Statement Before the Military Personnel Subcommittee of the Committee on Armed Services United States House of Representatives, 12 March 2009).

<sup>97</sup>Gerald I. White, Ashwinpaul C. Sondhi, and Dov Fried, “The Analysis and Use of Financial Statements,” (Hoboken, NJ: John Wiley & Sons, 2003), 110.

benchmarks or goals in relation to many of these ratios result in the somewhat subjective analysis of this study. Differences in accounting methods and estimates can have an effect on the analysis. Every attempt to establish uniform methods for analysis will be done in order to accurately represent the organizations in this study.

All financial data presented are from the published financial statement of the military exchanges, with the calendar year ending on the Saturday nearest to 29 January the following year indicated; for example, fiscal year 2007 ended on 2 February 2009. In order to facilitate uniform analysis the statement period for all calculations is 365 days. All dollar amounts are presented in thousands, unless otherwise noted. The financial statements of AAFES, the NEX, and MCX conform to *Government Audit Standards* as issued by the Comptroller General of the U.S. Despite this adherence to standards they differ greatly in depth and clarity and result in the need to carefully extrapolate data in order to facilitate analysis. For the NEX, revenue and expenses generated from the Ship's Store Program were not included in NEX financial statements as there is insufficient data to accurately reflect all financial activities of this operation. The Ship's Store Program operates exclusively in an expeditionary manner and unaccounted direct and indirect APF support of this activity does not permit appropriate analysis in a number of areas.

Industry data were obtained from the marketing research firm BizMiner.<sup>98</sup> BizMiner conducts targeted industry research and publishes data on more than 16,000 lines of business in national and local markets across the U.S. The industry data

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<sup>98</sup>BizMiner, "BizMiner Data and Methodology," <http://www.bizminer.com/methodology.asp> (accessed 5 April 2009).

presented is the average of 9,390 U.S. based organizations of the retail sector.<sup>99</sup>

Extrapolated financial data from all sources are presented in Appendix C.

The methodology and findings of this financial analysis were validated by professionals specializing in accounting and financial analysis. These findings were also shared with representatives from AAFES, the MCX, and NEX for comment. The MCX was the only exchange service to object to the findings in this financial analysis; however, it did not make representatives available to dispute the data or methodology used despite numerous requests from the author. One significant objection was the classification of extraordinary income (EI). For the purposes of this study EI is defined as revenue generated from non-core business activities. The financial statements of the MCX reflect a dividend received from AAFES operations in support of Marine Corps installations and is designated as EI in this study. Some of the MCX financial data may be materially affected by the combined Marine MWR and MCX activity under the Marine Corps Community Service (MCCS) activity. All data analyzed has been presented and correlated in a uniform manner. In spite of the lack of disclosures from the MCCS or MCX the author remains confident in the findings presented.

#### Annual Average Sales, Revenue, Expenses, and Income

Presenting financial statement data in proportion to sales revenue will facilitate comparison by placing the data on relatively equal terms.

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<sup>99</sup>BizMiner, "Industry Financial Profile." Sector: Retail [96-300]. (Camp Hill, PA, December 2008).



## Sales Percentage Ratios

Table 5. Sales and Revenue Percentage Ratios

	AAFES <sup>1</sup>		NEX <sup>2</sup>		MCX <sup>3</sup>		INDUSTRY <sup>4</sup>	
	'06	'07	'06	'07	'06	'07	'06	'07
<b>Net Sales &amp; Revenue</b>	8,921,448	8,704,483	2,548,592	2,601,021	997,133	1,054,165	88,454,865	85,087,444
<b>COGS &amp; Op Exp</b>	74.78%	73.80%	74.62%	74.51%	63.48%	64.22%	68.68%	68.57%
<b>Gross Profit</b>	25.22%	26.20%	25.38%	25.49%	36.52%	35.78%	31.32%	31.43%

Source: <sup>1</sup>AAFES, Annual Report 2007 (Washington, DC: Government Printing Office, 2008).

<sup>2</sup>Naval Supply Systems Command and the Navy Exchange Command, 2007 Annual Report (Washington, DC: Government Printing Office, 2008).

<sup>3</sup>Marine Corps Community Services, Fiscal Year 2007 Annual Report (Washington, DC: Government Printing Office, 2008).

<sup>4</sup>BizMiner, "Industry Financial Profile." Sector: Retail [96-300]. (Camp Hill, PA, December 2008).

These data show that AAFES and the NEX have higher than average costs of goods sold (COGS) and operating expenses and have the lowest gross profit margin. The MCX has notably lower COGS and operating expenses and the highest gross profit margin, with both above the industry average.

The Gross Profit Margin captures the relationship between costs and sales:  $(\text{Gross Profit}) / (\text{Sales \& Revenue})$ . This ratio is an indicator of profitability prior to the allocation of overhead. It can be an indicator of efficiencies and the effectiveness of pricing strategies. It was calculated by dividing Net Sales and Revenue into Gross Profit minus both COGS and operating expensed. These data indicate that AAFES and the NEX are slightly below average, while the MCX is slightly above average. This is noteworthy, as one might infer that military exchanges would naturally have a high gross profit margin due to the numerous competitive advantages authorized, such as immunities

from taxation, tariffs, and direct and indirect APF authorizations. Industry competitors may have a higher gross profit margin as their higher market share permits them to obtain goods under more favorable terms. AAFES and the NEX could also have significantly higher operating expenses, which would indicate operational inefficiencies.

Operating Expenses Percentage Ratios

Table 6. Expense to Sales and Revenue Ratios

	AAFES <sup>1</sup>		NEX <sup>2</sup>		MCX <sup>3</sup>		INDUSTRY <sup>4</sup>	
	'06	'07	'06	'07	'06	'07	'06	'07
<b>Salary, Wages, Comp</b>	12.26%	12.59%	23.42%	23.53%	16.11%	15.22%	12.84%	12.29%
<b>Other Op Expenses</b>	6.00%	8.46%	-	0.35%	19.57%	18.32%	12.99%	12.84%
<b>Interest Expense</b>	0.66%	0.57%	-	-	-	-	0.94%	1.03%
<b>Lease Expense</b>	-	-	-	-	-	-	2.08%	2.23%
<b>Income Tax</b>	-	-	-	-	-	-	1.55%	1.79%

Source: <sup>1</sup>AAFES, Annual Report 2007 (Washington, DC: Government Printing Office, 2008).

<sup>2</sup>Naval Supply Systems Command and the Navy Exchange Command, 2007 Annual Report (Washington, DC: Government Printing Office, 2008).

<sup>3</sup>Marine Corps Community Services, Fiscal Year 2007 Annual Report (Washington, DC: Government Printing Office, 2008).

<sup>4</sup>BizMiner, "Industry Financial Profile." Sector: Retail [96-300]. (Camp Hill, PA, December 2008).

The AAFES expense to sales ratios are comparable to the industry averages. The ratio is slightly above the industry average ratio for the MCX, but the NEX is significantly higher. However, this is slightly negated by the significantly lower other operating expense ratio. AAFES interest expense is well below the industry average, and the lease and tax expense ratios are shown to illustrate the advantage military exchanges have over industry competitors.

## Income Percentage Ratios

Table 7. Income to Sales and Revenue Ratios

	AAFES <sup>1</sup>		NEX <sup>2</sup>		MCX <sup>3</sup>		INDUSTRY <sup>4</sup>	
	'06	'07	'06	'07	'06	'07	'06	'07
<b>Net Income</b>	4.79%	5.08%	2.14%	1.85%	2.30%	3.51%	3.00%	3.48%
<b>Pre-Tax Net Income</b>	-	-	-	-	-	-	4.55%	5.27%
<b>EBITDA</b>	7.64%	8.13%	-	-	-	-	7.78%	7.75%
<b>EBIT</b>	5.45%	5.65%	2.14%	1.85%	2.30%	3.51%	5.49%	6.30%

Source: <sup>1</sup>AAFES, Annual Report 2007 (Washington, DC: Government Printing Office, 2008).

<sup>2</sup>Naval Supply Systems Command and the Navy Exchange Command, 2007 Annual Report (Washington, DC: Government Printing Office, 2008).

<sup>3</sup>Marine Corps Community Services, Fiscal Year 2007 Annual Report (Washington, DC: Government Printing Office, 2008).

<sup>4</sup>BizMiner, "Industry Financial Profile." Sector: Retail [96-300]. (Camp Hill, PA, December 2008).

The net income to sales and revenue ratio indicates above average net income for AAFES, with the NEX being less than half of AAFES. The MCX is close to the average industry, but remains significantly below AAFES. The gross profit margin of AAFES and the NEX are on par, however, the disparity of the net income to sales ratio indicates that the NEX has significantly higher expenses. The pre-tax net income and income tax ratios are presented to further illustrate the business advantages afforded to military exchanges by their non-tax status. Both the Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) and Earnings Before Interest and Taxes (EBIT) ratio calculations include extraordinary items for the military exchanges. The EBITDA margin is a measure of profitability independent of the organizations financing, tax, and accounting considerations:  $(EBITDA) / (Sales \& Revenue)$ , where EBITDA includes extraordinary income (EI). The data indicates that AAFES is within range of the

industry average. Interest, depreciation, and amortization data are not available for the NEX and MCX. The EBIT margin measures profitability, but also deducts depreciation and amortization:  $(EBIT) / (\text{Sales \& Revenue})$ , where EBIT includes EI. The data puts AAFES in line with the industry average; however, the NEX and MCX are well below the average as a result of not disclosing any depreciation or amortization expenses, invalidating this measure for the NEX and MCX.

### Activity Analysis Ratios

The activity ratio analysis will assist in assessing the efficiency of the organization by depicting the relationship between operations, sales and other income generating activities, and the assets needed to sustain operations. The higher the ratio, the more efficient the firm's operations are.<sup>100</sup> Activity ratios serve as the primary means to evaluate management.

### Return on Investment Ratios

The return on investment ratios measure the relationship between profits and the investments required to generate them.<sup>101</sup> The return on investment ratios are an indicator of how profitable operations are.

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<sup>100</sup>Fried et al., 120.

<sup>101</sup>Ibid., 134.

Table 8. Return on Investment Ratios

	AAFES <sup>1</sup>		NEX <sup>2</sup>		MCX <sup>3</sup>		INDUSTRY <sup>4</sup>	
	'06	'07	'06	'07	'06	'07	'06	'07
<b>Return on Assets</b>	6.15%	6.22%	4.09%	3.61%	2.57%	4.14%	11.82%	13.05%
<b>Return on Equity</b>	9.37%	9.33%	10.62%	5.99%	4.40%	6.81%	14.26%	20.07%
<b>Return on Total Capital</b>	6.92%	6.62%	6.17%	3.95%	2.85%	4.03%	15.35%	17.88%

Source: <sup>1</sup>AAFES, Annual Report 2007 (Washington, DC: Government Printing Office, 2008).

<sup>2</sup>Naval Supply Systems Command and the Navy Exchange Command, 2007 Annual Report (Washington, DC: Government Printing Office, 2008).

<sup>3</sup>Marine Corps Community Services, Fiscal Year 2007 Annual Report (Washington, DC: Government Printing Office, 2008).

<sup>4</sup>BizMiner, "Industry Financial Profile." Sector: Retail [96-300]. (Camp Hill, PA, December 2008).

Return on Assets (ROA) compares income against total assets:  $(EBIT) / (\text{Average Total Assets})$ . The ROA can be used to measure the efficiency in which assets are used to generate profits without regard to financial structure by removing the influence of interest and income taxes. The data puts all military exchanges operations well below average. This is partially the result of lower asset turnover, to be subsequently calculated. The Return on Equity (ROE) ratio indicates the return on the book value of the stockholders' investment:  $(\text{Net Income}) / (\text{Stockholder Equity})$ . The measure may not be a valid measure of performance as military exchanges do not have a requirement to accurately account for stockholder equity.

The Return on Total Capital (ROTC) measures the sum of all external debt and equity against earnings:  $(EBIT) / (\text{Total Debt} + \text{Stockholders Equity})$ . This ratio measures the total return the company generates. The data indicates relatively consistent performance among the military exchanges; however, it is well below the industry average. This ratio may not be a valid measure of performance due to APF funding of

operations and the inability to accurately account for stockholders equity, or total NAFI retained earnings.

### Operating Efficiency Ratios

Operating efficiency ratios are an intense look at numerous components of an organization's activities. They measure the organization's use of assets, capital, and productivity in relation to sales, accounts receivable, and accounts payables.

Table 9. Operating Efficiency Ratios

	AAFES <sup>1</sup>		NEX <sup>2</sup>		MCX <sup>3</sup>		INDUSTRY <sup>4</sup>	
	'06	'07	'06	'07	'06	'07	'06	'07
<b>Asset (Inventory) Turnover</b>	5.39	5.25	5.50	5.60	8.02	8.53	7.46	7.18
<b>Days Inventory</b>	67.75	69.52	66.41	65.15	45.50	42.78	48.93	50.87
<b>Working Capital Turnover</b>	4.59	4.57	3.19	2.22	9.72	12.71	14.34	23.78
<b>Account Rec Turnover</b>	3.60	3.17	-	-	6.25	4.98	32.75	37.03
<b>Avg Collection Period (days)</b>	101.31	115.30	0.00	0.00	58.38	73.25	11.14	9.86
<b>Accts Payable Period (days)</b>	38.39	43.47	46.57	52.42	35.04	34.24	34.80	53.44
<b>Days of Cash</b>	5.17	7.03	13.36	21.35	39.07	40.04	12.84	12.38
<b>Productivity (Sales) in \$</b>	197.07	192.03	161.98	165.12	138.69	147.53	-	-

Source: <sup>1</sup>AAFES, Annual Report 2007 (Washington, DC: Government Printing Office, 2008).

<sup>2</sup>Naval Supply Systems Command and the Navy Exchange Command, 2007 Annual Report (Washington, DC: Government Printing Office, 2008).

<sup>3</sup>Marine Corps Community Services, Fiscal Year 2007 Annual Report (Washington, DC: Government Printing Office, 2008).

<sup>4</sup>BizMiner, "Industry Financial Profile." Sector: Retail [96-300]. (Camp Hill, PA, December 2008).

Inventory or Asset Turnover indicates the number of times the inventory was sold during the year: (Sales) / (Average Inventory), where average inventory are calculated by averaging balance sheet inventories. A higher ratio indicates that inventory is sold rather than languishing in processing or waiting to be sold. Conversely, a high ratio could

indicate that inventory shelves are too low and that there is risk of losing potential customers by not being able to meet their needs on a timely basis. Days of Inventory indicated the number of days inventory is held until sold:  $(365) / (\text{Inventory Turnover})$ . This ratio is a representation of the inventory turnover ratio in days. Inventory Turnover and Days of Inventory is consistent across within each military exchange. AAFES and the NEX have a low Inventory Turnover and high Days Inventory, above the industry standard, but not at an alarming rate. The MCX has a significantly higher Asset Turnover and lower Days Inventory than the industry average, despite having lower sales activity ratios. This typically contributes to higher profitability for the MCX; however, the effect is negated by higher expense ratios.

The Working Capital Turnover indicates how well the working capital, Current Assets – Current Liabilities, is used to generate sales:  $(\text{Sales}) / (\text{Working Capital})$ . All military exchanges have a significantly low Working Capital Turnover ratio. This is a result of lower Net Working Capital due to low cash and cash equivalents due to monthly MWR dividend disbursements.

The Accounts Receivable Turnover is a measure of the number of times that accounts cycled during the period:  $(\text{Sales \& Revenue}) / (\text{Accounts Receivable})$ . The data indicates that AAFES and the MCX have low accounts receivables in relation to sales; however, the nature of the military exchange does not warrant the accumulation of receivables. The NEX did not list any accounts receivables data in its financial statement. The Average Collection Period measures the length of time, in days, an organization waits to collect accounts receivable:  $(\text{Accounts Receivable}) / (\text{Sales \& Revenue} / \text{Statement Period})$ . Both AAFES and the NEX have very long collection

periods, well above the industry standard. This is offset by the low accumulation of receivable as noted by Accounts Receivable Turnover. Additionally, the long collection periods may be a function of unique accounting practices, where the ECP balances are included as accounts receivables. Commercial retail activities may underwrite these receivables differently, and presumably a significant number of the market-based competitors do not extend in house credit.

The Account Payable Period is a measure of the time it takes for the organization to pay its suppliers:  $(\text{Accounts Payable}) / (\text{Credit Purchases} / \text{Statement Period})$ . COCG is used as an approximation of credit purchases. The data indicates a consistent trend among AAFES and the MCX, with the MCX having a slightly shorter accounts payable period. The NEX did increase its Account Payable Period in direct correlation to the industry increase. A higher Accounts Payable Period may be desirable as an organization is able to retain cash longer while having the benefit of receiving goods or services. In the retail industry, however, early payment of invoices is routinely rewarded with discounts, thus reducing cost of sales and increases gross margins.

The Days Cash ratio represents the number of days of cash on hand at present sales levels:  $(\text{Cash}) / (\text{Sales \& Revenue} / \text{Statement Period})$ . The erratic data may be a reflection of the unique nature of military exchange operations and the continuous dividend distributions to MWR. Productivity measures sales per employee:  $(\text{Sales}) / (\text{Number of Employees})$ , where sales figures do not include finance, concession, or other EI. The data are consistent, but there is almost a 25 percent disparity between AAFES and the MCX. This measure of performance would be a negative indicator for the MCX; however, it is possible that a number of employees reported included MCSS APF



employees, and may warrant further study. The industry data was not available for analysis.

### DuPont Ratio Analysis

The DuPont Ratio Analysis is a method of evaluating a company's earnings by calculating two distinct earnings ratios and comparing them against each other.<sup>102</sup> The DuPont Ratio Analysis uses two distinct methods to calculate return on assets and return on equity, referred to as DAROA and DAROE respectively for the purposes of this study. The DAROA calculation is:  $(\text{Net Income} \times \text{Sales \& Revenue}) / (\text{Asset Turnover Ratio})$ . The DAROE calculation is:  $(\text{Profit Margin}) (\text{Asset Turnover Ratio}) (\text{Equity Multiplier})$ , where the Equity Multiplier is calculated as  $(\text{Assets}/\text{Equity})$ . ROE represents the profitability of invested capital, while ROA represents profitability as a function of assets.<sup>103</sup> Revenue calculations do not consider EI.

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<sup>102</sup>Money Soft, "Beyond Traditional Ratio Analysis," [www.moneysoft.com/pdf/DuPont-analysis.pdf](http://www.moneysoft.com/pdf/DuPont-analysis.pdf) (accessed 5 March 2009).

<sup>103</sup>Harvard Business Online, "Sustainable Growth Rate and DuPont Ratio Analysis," [http://harvardbusinessonline.hbsp.harvard.edu/b02/en/academic/edu\\_tk\\_fin\\_sus\\_grow.jhtml](http://harvardbusinessonline.hbsp.harvard.edu/b02/en/academic/edu_tk_fin_sus_grow.jhtml) (accessed 4 April 2009).

Table 10. DuPont Ratio Analysis

	AAFES <sup>1</sup>		NEX <sup>2</sup>		MCX <sup>3</sup>		INDUSTRY <sup>4</sup>	
	'06	'07	'06	'07	'06	'07	'06	'07
ROS (Net Income/ Sales)	0.05	0.05	0.02	0.02	0.03	0.04	0.03	0.03
x Asset Turnover Ratio	5.39	5.25	5.50	5.60	8.02	8.53	7.46	7.18
= Return on Assets (DAROA)	<b>0.27</b>	<b>0.28</b>	<b>0.12</b>	<b>0.11</b>	<b>0.20</b>	<b>0.33</b>	<b>0.22</b>	<b>0.25</b>
Profit Margin (Profit/Sales)	0.25	0.26	0.25	0.25	0.37	0.36	0.31	0.31
x Asset Turnover Ratio	5.39	5.25	5.50	5.60	8.02	8.53	7.46	7.18
x EqMul (Assets/Equity)	1.63	1.77	2.21	1.91	1.57	1.78	2.17	2.82
= Return on Equity (DAROE)	<b>2.22</b>	<b>2.43</b>	<b>3.08</b>	<b>2.72</b>	<b>4.60</b>	<b>5.44</b>	<b>5.08</b>	<b>6.37</b>

Source: <sup>1</sup>AAFES, Annual Report 2007 (Washington, DC: Government Printing Office, 2008).

<sup>2</sup>Naval Supply Systems Command and the Navy Exchange Command, 2007 Annual Report (Washington, DC: Government Printing Office, 2008).

<sup>3</sup>Marine Corps Community Services, Fiscal Year 2007 Annual Report (Washington, DC: Government Printing Office, 2008).

<sup>4</sup>BizMiner, "Industry Financial Profile." Sector: Retail [96-300]. (Camp Hill, PA, December 2008).

The DuPont analysis can assist in identifying whether the changes in DAROE are being driven by sales margins, asset management, or financial leverage.<sup>104</sup> A high DAROE is beneficial; however, it can be misleading as the equity multiplier may be high as a result of a high leverage (debt). The DuPont analysis may be an unreliable measure of performance in comparison with industry averages due to the unique nature of military exchanges. The data indicates a reliance on equity; however, it is not attributable to higher than average leverage or debt. The DAROA for AAFES is higher than the NEX, which indicates their investments are high in relation to sales. The DAROA and DAROE are consistent for AAFES and the NEX, however the MCX has a higher annual increase which may be the result of the combined financing of the MWR activity and exchange operations, but may warrant further study.

<sup>104</sup>Money Soft, "Beyond Traditional Ratio Analysis."

## Financial Risk Analysis Ratios

### Liquidity Analysis Ratios

Internal liquidity ratios are activity or operating ratios which describe the relationship between sales and the assets needed to sustain those operating activities.<sup>105</sup>

Table 11. Liquidity Analysis

	AAFES <sup>1</sup>		NEX <sup>2</sup>		MCX <sup>3</sup>		INDUSTRY <sup>4</sup>	
	'06	'07	'06	'07	'06	'07	'06	'07
<b>Current Ratio</b>	1.75	1.67	3.06	3.68	1.33	1.20	1.47	1.23
<b>Quick Ratio</b>	1.09	1.11	1.91	2.58	0.95	0.89	0.58	0.45
<b>Cash Ratio</b>	0.07	0.07	0.25	0.37	0.38	0.31	0.24	0.19
<b>Cash Flow From Ops</b>	0.91	0.85	1.75	1.60	1.28	1.00	2.13	1.76

*Source:* <sup>1</sup>AAFES, Annual Report 2007 (Washington, DC: Government Printing Office, 2008).

<sup>2</sup>Naval Supply Systems Command and the Navy Exchange Command, 2007 Annual Report (Washington, DC: Government Printing Office, 2008).

<sup>3</sup>Marine Corps Community Services, Fiscal Year 2007 Annual Report (Washington, DC: Government Printing Office, 2008).

<sup>4</sup>BizMiner, "Industry Financial Profile." Sector: Retail [96-300]. (Camp Hill, PA, December 2008).

The Current Ratio measures the organizations ability to pay short-term liabilities from short term assets:  $(\text{Current Assets}) / (\text{Current Liabilities})$ . A small ratio could be an indicator of potential inabilities to meet financial obligations. A high ratio could indicate an inefficient use of assets. The Current Ratio is within industry standard for AAFES and the MCX, but very high for the NEX. The higher Current Ratio for the NEX is not a negative indicator with respect o liquidity since it is a result of high cash reserves and small amounts of debt.

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<sup>105</sup>Fried et al., 119.

The Quick Ratio, also known as the Acid Test, measures the organizations' ability to pay off its short-term obligations from current assets, excluding inventories:  $(\text{Current Assets} - \text{Inventories}) / (\text{Current Liabilities})$ . Only liquid assets are taken into account and it is therefore a more stringent measure than the current ratio. A similar correlation exists between the Current Ratio and Quick Ratio, attributable to differences in inventories in relation to other assets. As a measure of performance, the quick ratio of the military exchanges is comparable.

The Cash Ratio measures the ability of an organization to meet current obligations from cash or near cash reserves:  $(\text{Cash} + \text{Cash Equivalents}) / (\text{Current Liabilities})$ . This is the most stringent liquidity test as only cash on hand is measured against liabilities. The NEX and MCX are within industry standards; however, AAFES has a significantly lower Cash Ratio. This may be as a result of continuous cash distributions to MWR and lower cash reserves.

The Cash Flow From Operations Ratio provides a better indicator of a company's ability to pay its short-term liabilities with the cash it produces from operations:  $(\text{Cash Flow From Operations}) / (\text{Current Liabilities})$ , where Cash Flow From Operations is from all operation's sources. The data indicates that AAFES and the NEX are within industry standards and have a strong ability to satisfy liabilities with cash flow. The MCX has a lower Cash Flow From Operations Ratio as it has significantly lower operating cash flow in relation to its liabilities.

## Leverage Analysis Ratios

Leverage refers to the proportion of debt used by an organization to finance its operations.<sup>106</sup> The amount and type of leverage can be a measure of solvency and an organizations' ability to meet future obligations. The unique ability of military exchanges to finance operations through APF adds complexity to calculating accurate and relevant financial leverage ratios. It was expected that the financial leverage ratios would be significantly lower than industry averages; however this did not hold true.

Table 12. Leverage Analysis

Leverage Analysis	AAFES <sup>1</sup>		NEX <sup>2</sup>		MCX <sup>3</sup>		INDUSTRY <sup>4</sup>	
	'06	'07	'06	'07	'06	'07	'06	'07
<b>Leverage</b>	1.63	1.77	2.21	1.91	1.57	1.78	2.17	2.82
<b>Debt to Asset Ratio</b>	0.08	0.17	0.33	0.28	0.02	0.08	0.32	0.44
<b>Debt to Total Capital Ratio</b>	0.39	0.43	0.55	0.48	0.36	0.44	0.54	0.65
<b>Debt to Equity Ratio</b>	0.09	0.20	0.49	0.39	0.02	0.09	0.48	0.79

Source: <sup>1</sup>AAFES, Annual Report 2007 (Washington, DC: Government Printing Office, 2008).

<sup>2</sup>Naval Supply Systems Command and the Navy Exchange Command, 2007 Annual Report (Washington, DC: Government Printing Office, 2008).

<sup>3</sup>Marine Corps Community Services, Fiscal Year 2007 Annual Report (Washington, DC: Government Printing Office, 2008).

<sup>4</sup>BizMiner, "Industry Financial Profile." Sector: Retail [96-300]. (Camp Hill, PA, December 2008).

Leverage is calculated as (Total Assets / Total Equity) and accounts for all the organizations' liabilities in relation to assets. The Debt to Asset ratio is a complete measure of the organizations' solvency: (Total Liabilities) / (Total Assets). The debt to asset ratio is a measure of the extent to which the organization is financed with debt. It

<sup>106</sup>Forbes Digital, "Investopedia – Leverage," <http://www.investopedia.com/terms/l/leverage.asp> (accessed 5 April 2009).

was expected that leverage analysis ratios would be much lower than the industry standard as a result of the numerous advantages afforded to military exchanges.

The Debt to Total Capital ratio measures the proportion of debt to capital:  $(\text{Total Debt}) / (\text{Total Capital} = \text{total debt} + \text{stockholders' equity})$ . The Debt to Equity ratio measure is a simplified version of the debt to total capital measurement:  $(\text{Total Debt}) / (\text{Total Equity})$ . Both ratios were significantly lower than the industry standard, indicating a strong position in relation to leverage among military exchanges.

## Business Environment Analysis

### Corporate Management and Structure

#### Administration and Human Resources

AAFES is governed by a joint Army and Air Force BOD. Members of the BOD, along with the AAFES commander, are responsible to the Chiefs of Staff of the Army and Air Force. AAFES is a stand-alone NAFI with no direct ties to either the Army or Air Force MWR programs. The exchanges of both Navy and Marine Corps are organized under the same headquarters that oversees their MWR program. NEX managers report directly to the installation commander, with secondary responsibilities to district managers, then NEX headquarters. The Marine Corps has completely merged the exchange and MWR activities under a single headquarters. At Marine installations the exchange manager reports to the MCCS director, who in turn works for the installation commander. There is a secondary relationship to the MCX headquarters that balances retail management and operations with the needs and desires of the local commander. On Army and Air Force installations the manager reports to an area manager, with another three layers of management until reaching the AAFES Commander.

The NEX and MCX are able to structure themselves with much less managerial oversight than AAFES due to their smaller size. AAFES is a significantly larger organization, and performs many functions that support the exchange operations of the other services. There have been many technological and software advances in retail operation administration and management. These advantages have simplified many of the retail managerial duties. Store managers' main duties include policy enforcement,

verifying facility standards, and addressing organizational behavior issues. Pricing, marketing, and automated merchandize ordering and recording are centrally managed and executed by the exchange headquarters.

Although a comprehensive human resource analysis is not within the scope of this study, much evidence was uncovered during the course of this study indicating that AAFES is very competitive as an employer against its retail competitors. The salary, wages, and compensation expense to sales ratio for AAFES is average against industry standards, and they do offer competitive compensation and benefits to their full time associates. Career employees also receive a generous retirement package, which include comprehensive medical care.<sup>107</sup>

In order to assess employee satisfaction AAFES has contracted with the Claes Fornell International (CFI) Group to conduct satisfaction surveys which separately target both employees and managers. The Associate Satisfaction Index (ASI) and the Management Satisfaction Index (MSI) have been administered annually since 1998 and 1999 respectively.<sup>108</sup> The CFI Group founder, Dr. Claes Fornell is a Professor at the University of Michigan's Ross School of Business and the Director of the National Quality Research Center (NQRC) where he developed the ASI and MSI.<sup>109</sup> The ASI and MSI facilitate uniform measurement of employee satisfaction, and is one measure of performance used by AAFES against internal goals. A two point increase in the ASI was

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<sup>107</sup>AAFES, "Benefits," <http://odin.aafes.com/employment/BenefitsHomepage.html> (accessed 6 April 2009).

<sup>108</sup>AAFES, "CSI, ASI, and MSI Survey Fact Paper," (Washington, DC: U.S. Government Printing Office, 2008).

<sup>109</sup>CFI Group, "About Us" <http://www.cfigroup.com/about/> (accessed 9 April 2009).



among the AAFES 2008 corporate goals. ASI data provided by AAFES for this study is represented in Figure 5. These data illustrates some disparity between CONUS and overseas based employees, which may warrant further study.

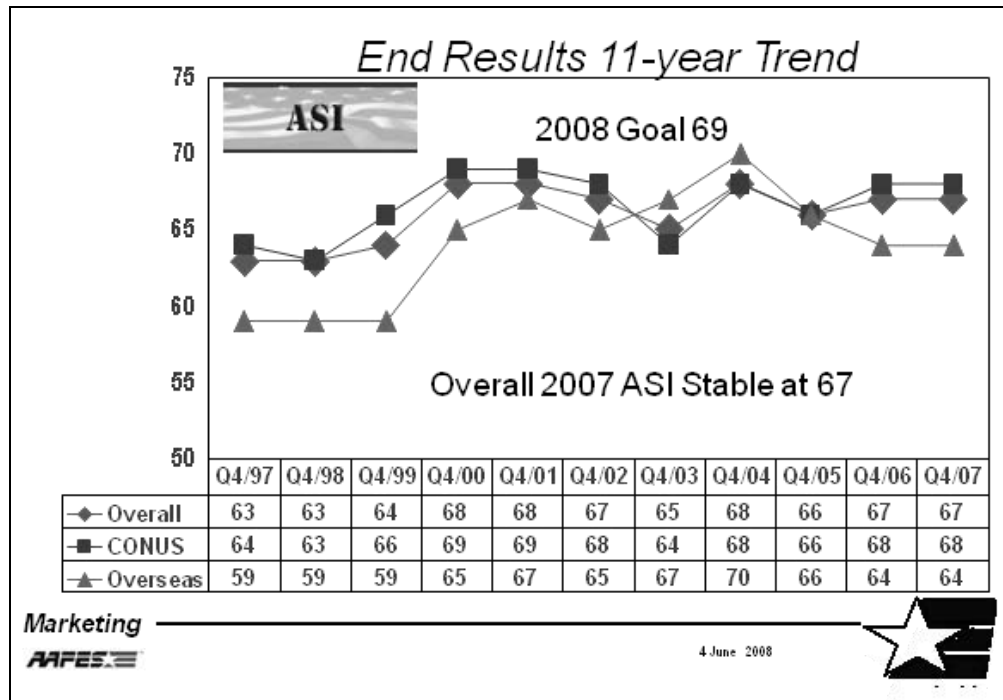


Figure 5. AAFES Associate Satisfaction Index (ASI)  
Source: AAFES, “CSI, ASI, and MSI Survey Fact Paper,” (Washington, DC: U.S. Government Printing Office, 2008).

AAFES employees surveyed in the 2009 Army IG investigation expressed a decline in the overall AAFES employment experience. The observations included concerns about promotion potential and training. Employees also expressed dissatisfaction with the yearend bonus calculations, where non-managers were paid \$100, while managers were paid six percent of their salary. Non-managers felt that this formula

was not sufficiently representative of their value to the organization.<sup>110</sup> Results of the MSI provided by AAFES for this study included the fourth quarter results for years 2005 through 2007, and are presented in Figure 6. The three year trend shows an MSI score increase from 65 to 69, and indicates consistent scores between CONUS and overseas based managers.<sup>111</sup>

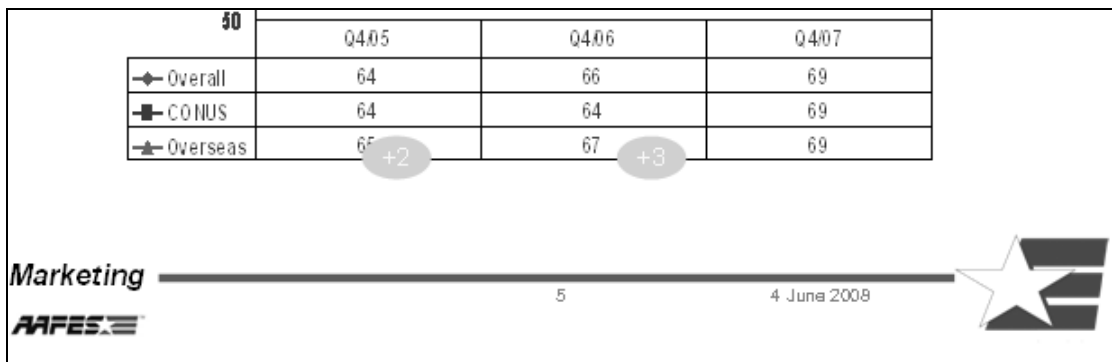


Figure 6. AAFES Management Satisfaction Index (MSI)  
Source: AAFES, “CSI, ASI, and MSI Survey Fact Paper,” (Washington, DC: U.S. Government Printing Office, 2008).

The most critical component to AAFES’ operations is the contingency support operations where civilian employees of AAFES work in hazardous duty under in austere conditions. AAFES is never short of volunteers to serve overseas, although motivation is aided by generous compensatory incentives. Thus far over 4,000 employees have volunteered to serve in the contingency support areas.<sup>112</sup> The 2009 AAFES IG report

<sup>110</sup>DAIG, 2-17.

<sup>111</sup>AAFES, “CSI, ASI, and MSI Survey Fact Paper,” (Washington, DC: U.S. Government Printing Office, 2008).

<sup>112</sup>Mona Moore, “The most rewarding thing you’ll do.” *Tribune Business News*, November 28, 2008.

special investigation did observe significant failures in the management of contingency support activities. The investigation cited a lack of structured transition for managers as having a negative effect on the continuity of management and integration with military leadership at contingency locations. Additionally, managers in deployed areas were more often than not assigned to positions one or two levels above their previous grade and often lacked the necessary skills and expertise.<sup>113</sup> In response to an inquiry for this study, AAFES indicated that there were no standard education or progression tracks for managers or non managers who aspire to ascend to a managerial position.<sup>114</sup>

### Core Ideology and Vision

Codifying a desired ideology and vision help guide organizations towards a common purpose. These are usually expressed as mission and vision and are accompanied by goals. These goals will direct planning and efforts across all systems and functions towards the accomplishment of the stated mission while adhering to the vision and values of the organization.

### Mission

Chapter 147 of Title 10 USC outlines the charter of all military exchange services, “The Secretary of Defense shall operate . . . a world-wide system of commissary stores and a separate world-wide system of exchange stores. The stores of each system may sell, at reduced prices, food and other merchandise.”<sup>115</sup> The DoD mission for the military exchange

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<sup>113</sup>DAIG, 2-4.

<sup>114</sup>AAFES Q&A e-mail response from the AAFES Public Affairs Office, November 25, 2008.

<sup>115</sup>*Title 10 U.S. Code - Armed Forces*, “Chapter 147 Commissaries and Exchanges and Other Morale, Welfare, and Recreation Activities.”

is outlined in DODI 1330.09 as “the dual mission of providing authorized patrons with articles of merchandise and services and of generating NAF earnings as a source of funding for DoD military MWR programs.”<sup>116</sup> The AAFES mission statement mirrored the AAFES mission statement until 2008. In 2008 AAFES changes its mission as follows.

It is the dual enduring mission of AAFES to provide quality merchandise and services to its customers at competitively low prices and to generate earnings which provide a dividend to support morale, welfare and recreation (MWR) programs.<sup>117</sup>

The NEX mission is similar to the AAFES mission, “To provide customers quality goods and services at a savings and to contribute to quality of life programs.”<sup>118</sup> The MCX or MCCS do not have specified mission statements. The AAFES vision is “to be our customers’ first choice.”<sup>119</sup> The NEX and MCX or MCCS do not have published organizational visions.

### Strategic Planning Effort and Goals

For the first time in the history of the AAFES, a five-year strategic plan was published in 2008. The AAFES strategic campaign plan includes goals and supporting strategies with performance measures as metrics for assessing progress. These goals address customers, organizational culture, mission, and business and marketing strategies and are presented in Table 13. This marks an initiative to embrace standard business practices and management by objectives (MBO) systems. MBO is a method of managing based on measurable and predetermined objectives. The MBO cycle has four steps:

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<sup>116</sup>*Department of Defense Instruction Number 1330.09, 2.*

<sup>117</sup>AAFES, *Annual Report 2007* (U.S. Government Printing Office, Washington DC, 2008).

<sup>118</sup>Navy Supply Systems Command and the Navy Exchange Service Command, *2007 Annual Report* (U.S. Government Printing Office, Washington DC, 2008).

<sup>119</sup>AAFES, *2013 Strategic Plan* (U.S. Government Printing Office, Washington DC, 2008).

setting objectives, developing action plans, periodic review, and performance appraisal.<sup>120</sup> AAFES currently appears to be between step-2 and step-3 of the MBO cycle.

Table 13. AAFES 2009 Strategic Goals

<p>1. Develop a life-long emotional connection without customers.</p> <ul style="list-style-type: none"> <li>a. Increase CSI by 2 points (specifically merchandise selection).</li> <li>b. Increase attachment rate by 10%.</li> <li>c. Increase sales by 2% (excluding gas).</li> <li>d. Promote AAFES.COM.</li> </ul>
<p>2. Build a culture of loyalty, ownership, sustainability and continuous improvement.</p> <ul style="list-style-type: none"> <li>a. Increase ASI by 2 points.</li> <li>b. Succession planning / develop future leaders.</li> <li>c. Achieve AAFES corporate energy sustainment goals for 2009.</li> <li>d. Increase gross margin return on investment by 2%</li> </ul>
<p>3. Provide expeditionary and mission support capabilities... to “go where you go.”</p> <ul style="list-style-type: none"> <li>a. Improve the speed and execution of the MFE’s and TFW’s.</li> <li>b. Increase deployed CSI score by 2 points.</li> </ul>
<p>4. Be the premier collaborative partner with federal and commercial entities.</p> <ul style="list-style-type: none"> <li>a. Increase military outreach programs / AAFES.COM on the move.</li> </ul>
<p>5. Communicate the benefit, value and capabilities of AAFES.</p> <ul style="list-style-type: none"> <li>a. Implement / Communicate the Value Story 2009.</li> <li>b. Increase earnings without appropriated funds by 3%.</li> </ul>

Source: AAFES, *2013 Strategic Plan* (Washington, DC: Government Printing Office, 2008).

<sup>120</sup>Robert Kreitner, *Management*, 5th ed. (Boston, MA: Houghton Mifflin Company, 1992).

The 2009 Army IG investigation noted that employees expressed dissatisfaction with the method by which the AAFES corporate goals were communicated, and how individual goals were established. The AAFES corporate goals were distributed to each employee in the form of a card, an example of which can be seen in Figure 7. Many employees were unaware how their daily tasks were nested with AAFES corporate goals. Some employees were given a goals card with their individual goals already filled in. Others received their goals card with no explanation, or were not given any instruction or assistance on the development of personal goals. A few managers did help develop individual goals, but many employees were given a card immediately prior to a visit from AAFES higher management.<sup>121</sup>

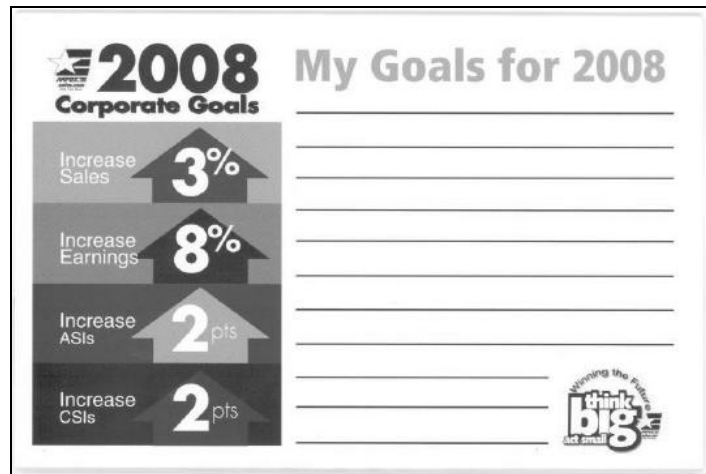


Figure 7. 2008 Corporate Goal Card

Source: Department of the Army Office of the Inspector General (DAIG), *Final Report on the Joint Inspection of the Army and Air Force Exchange Service (June – December 2008)*, 17 February 2009.

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<sup>121</sup>DAIG, 2-17.

## MWR Dividend Analysis

Depicting MWR dividend distribution as a function of Sales & Revenue and Net income will provide valuable measures for analysis. The Dividend to Sales & Revenue ratio will calculate MWR dividends as a function of all income generating activities.

This ratio is calculated: (Dividend) / (Sales & Revenues), where total revenue includes income from all sources, including EI. All data used in this calculation are presented in

Table 14.

Table 14. Dividend to Sales & Revenue Ratio

	AAFES <sup>1</sup>			NEX <sup>2</sup>			MCX <sup>3</sup>		
	'05	'06	'07	'05	'06	'07	'05	'06	'07
<b>Sales &amp; Revenue</b>	8,921,400	8,921,448	8,704,483	2,312,164	2,429,728	2,476,818	879,597	901,516	958,967
<b>Other Income</b>	61,500	61,474	43,985	35,605	35,123	35,257	89,374	95,617	95,198
<b>Other Income</b>				4,025	83,741	88,946	16,229	15,273	15,617
<b>Other Income</b>				90,139	4,401	6,031	188	214	936
<b>Other Income</b>				4,273					
<b>Total Revenue</b>	<b>8,982,900</b>	<b>8,982,922</b>	<b>8,748,468</b>	<b>2,446,206</b>	<b>2,552,993</b>	<b>2,607,052</b>	<b>985,388</b>	<b>1,012,620</b>	<b>1,070,718</b>
<b>MWR Dividend</b>	229,300	231,600	272,700	47,507	39,966	33,938	24,941	31,761	35,047
<b>Dividend / Sales &amp; Revenue</b>	<b>2.5%</b>	<b>2.5%</b>	<b>3.1%</b>	<b>1.9%</b>	<b>1.6%</b>	<b>1.3%</b>	<b>2.5%</b>	<b>3.1%</b>	<b>3.3%</b>
<b>Ship's Stores Program</b>									
	<b>Sales &amp; Revenue</b>	87,866	84,171	66,626					
	<b>MWR Dividend</b>	8,213	10,327	9,435					
	<b>Dividend / Sales &amp; Revenue</b>	<b>9.3%</b>	<b>12.3%</b>	<b>14.2%</b>					

Source: <sup>1</sup>AAFES Annual Report 2006 (Washington, DC: Government Printing Office, 2007). AAFES, Annual Report 2007 (Washington, DC: Government Printing Office, 2008).

<sup>2</sup>Naval Supply Systems Command and the Navy Exchange Command, 2006 Annual Report (Washington, DC: Government Printing Office, 2007). Naval Supply Systems Command and the Navy Exchange Command, 2007 Annual Report (Washington, DC: Government Printing Office, 2008).

<sup>3</sup>Marine Corps Community Services, Fiscal Year 2006 Annual Report (Washington, DC: Government Printing Office, 2007). Marine Corps Community Services, Fiscal Year 2007 Annual Report (Washington, DC: Government Printing Office, 2008).

An alternative method to evaluate dividend distribution is to calculate the Dividend to Net Income: (Dividend) / (Net Income). This ratio accounts for all expenses and the data used in this calculation is presented in Table 15.

Table 15. Dividend to Net Income Ratio

	AAFES			NEX			MCX		
	'05	'06	'07	'05	'06	'07	'05	'06	'07
<b>Other Income</b>	61,500	61,474	43,985	35,605	35,123	35,257	89,374	95,617	95,198
<b>Other Income</b>		61,474	43,985	4,025	83,741	88,946	16,041	15,273	15,617
<b>Other Income</b>				90,139	4,401	6,031	188	214	936
<b>Other Income</b>				4,273					
<b>Total Revenue (All Sources)</b>	<b>8,982,900</b>	<b>9,044,396</b>	<b>8,792,453</b>	<b>2,446,206</b>	<b>2,552,993</b>	<b>2,607,052</b>	<b>985,200</b>	<b>1,012,620</b>	<b>1,070,718</b>
<b>COCG</b>	1,807,800	6,671,722	6,424,307	1,813,459	1,901,732	1,938,029	619,812	632,931	677,026
<b>Comp, Benefits</b>		1,093,692	1,096,238	567,091	596,786	612,007	159,293	160,622	160,440
<b>Depr &amp; Amort</b>		195,400	216,018						
<b>Int, Other Exp</b>		59,011	49,906						
<b>Other Exp</b>	76,000	16,940	12,505			9,000	192,751	195,099	193,108
<b>Other Exp</b>	6,671,600	518,406	507,711				1,338	992	3,092
<b>Total Debt</b>	<b>8,555,400</b>	<b>8,555,171</b>	<b>8,306,685</b>	<b>2,380,550</b>	<b>2,498,518</b>	<b>2,559,036</b>	<b>973,194</b>	<b>989,644</b>	<b>1,033,666</b>
<b>Net Income</b>	<b>427,500</b>	<b>489,225</b>	<b>485,768</b>	<b>65,656</b>	<b>54,475</b>	<b>48,016</b>	<b>12,006</b>	<b>22,976</b>	<b>37,052</b>
<b>MWR Dividend</b>	228,300	231,600	272,700	47,507	39,966	33,938	24,941	31,761	35,047
<b>Dividend / Net Income</b>	<b>53.4%</b>	<b>47.3%</b>	<b>56.1%</b>	<b>72.3%</b>	<b>73.4%</b>	<b>70.7%</b>	<b>207.7%</b>	<b>138.2%</b>	<b>94.6%</b>

Ship's Stores Program			
<b>Total Revenue</b>	87,866	84,171	66,626
<b>COGS/OPS</b>	<b>77,028</b>	<b>71,450</b>	<b>55,351</b>
<b>Net Income</b>	<b>10,838</b>	<b>12,721</b>	<b>11,275</b>
<b>MWR Dividend Paid</b>	<b>8,216</b>	<b>10,327</b>	<b>9,435</b>
<b>Dividend / Net Income</b>	<b>75.8%</b>	<b>81.2%</b>	<b>83.7%</b>

Source: <sup>1</sup>AAFES Annual Report 2006 (Washington, DC: Government Printing Office, 2007).

AAFES, Annual Report 2007 (Washington, DC: Government Printing Office, 2008)

<sup>2</sup>Naval Supply Systems Command and the Navy Exchange Command, 2006 Annual Report (Washington, DC: Government Printing Office, 2007). Naval Supply Systems Command and the Navy Exchange Command, 2007 Annual Report (Washington, DC: Government Printing Office, 2008).

<sup>3</sup>Marine Corps Community Services, Fiscal Year 2006 Annual Report (Washington, DC: Government Printing Office, 2007). Marine Corps Community Services, Fiscal Year 2007 Annual Report (Washington, DC: Government Printing Office, 2008).



A summary of the Dividend/Sales & Revenue and Dividend/ Net Income Ratios is presented in Table 16. These calculations illustrate consistent MWR contributions as a function of total revenue across all three exchanges. The Dividend to Sales & Revenue ratio indicates that the MCX contributes the most to MWR in relation to revenue, while the NEX contributes the least. The Ships Store Program has a notably high dividend contribution ratio, as function of low overhead, and presumably as a result of high APF support.

The Dividend to Net Income indicates that AAFES consistently contributes about half of its net earnings to MWR, while the NEX contributes almost one-third. The combined financial statements of the Marine Corps' MWR and exchange activities may not facilitate accurate representation of the Dividend to Net Income Ratio. The significantly higher MCX Dividend to Net Income Ratio can only be possible with considerable transfer of APF, or over reporting of MWR dividends, and may thus warrant further study. This most significant finding indicated by these calculations is that AAFES has the highest reduction to the MWR dividend from revenues, as represented by having the lowest difference between the two ratios calculated.

Table 16. MWR Dividend Analysis Ratio Summary

	AAFES			NEX			MCX		
	'05	'06	'07	'05	'06	'07	'05	'06	'07
<b>Dividend / Revenue</b>	2.5%	2.5%	3.1%	1.9%	1.6%	1.3%	2.5%	3.1%	3.3%
<b>Dividend / Net Income</b>	53.4%	47.3%	56.1%	72.3%	73.4%	70.7%	207.7%	138.2%	94.6%
	<b>Ship's Stores Program</b>								
		<b>Dividend / Revenue</b>	9.3%	12.3%	14.2%				
		<b>Dividend / Net Income</b>	75.8%	81.2%	83.7%				

Source: Table 14 and Table 15.

The current formula used to calculate the installation MWR distribution outlined in Chapter 2 provided significant disparity between the Army and Air Force. The Army and Air Force each calculate local MWR dividends differently, with remaining funds pooled and made available for service distribution based on the ratio of total service personnel end strength. Table 17 illustrates a notional example of AAFES revenue distribution. Under the current formula for distributing funds to local MWR programs, Air Force installations would be underfunded by 46.7 percent as compared to an Army installation with identical revenue. The 2008 core dividend was 61.02 percent for the Army and 38.98 percent for the Air Force based on personnel end strength of 552,017 and 337,547 respectively.<sup>122</sup> The resulting effect is that Air Force installation AAFES revenue is transferred to the Army as a result of the pooling of revenue.

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<sup>122</sup>U.S. Army Family and Morale, Welfare and Recreation Command. *Distribution of the AAFES Dividends to the Services*, Memorandum 21 December 2007.

Table 17. Notional MWR Dividend Distribution

(in thousands)	AAFES Retained (Capital Program)	Available for Local MWR Distribution	Available for Service MWR Dividend
<b>Regular Earnings</b> <sup>1</sup>			
7,000	3,500	3,500	-
<b>Alcohol Earnings</b> <sup>2</sup>			
75	1.8	73.2	-
<b>Telephone Earnings</b> <sup>3</sup>			
50	5	5	40
<b>Army</b> <sup>4</sup>	<b>Regular</b>	<b>140</b>	<b>3,360</b>
	<b>Alcohol</b>	<b>73.2</b>	<b>-</b>
	<b>Telephone</b>	<b>5</b>	<b>40</b>
	<b>Total Army</b>	<b>218.2</b>	<b>3,400</b>
<b>Air Force</b> <sup>5</sup>			
4% first 250		10	
3% next 250		7.5	
2% next 500		10	
1% next 250		2.5	
.5% next 1,000		5	
.1% all over 3,000		3	
	<b>Regular</b>	<b>38</b>	<b>3,462</b>
	<b>Alcohol</b>	<b>73.2</b>	<b>-</b>
	<b>Telephone</b>	<b>5</b>	<b>40</b>
	<b>Total Air Force</b>	<b>116.2</b>	<b>3,502</b>
<b>Total Service Installation Difference</b>		<b>102 or 46.7 %</b>	
<b>Total Available for MWR Service Dividend</b> <sup>6</sup>		<b>Army Model:</b>	<b>Air Force Model:</b>
		<b>3,400</b>	<b>3,502</b>
<b>Army Share</b>	<b>61.02%</b>	<b>2,074.68</b>	<b>2,136.92</b>
<b>Air Force Share</b>	<b>38.98%</b>	<b>1,325.32</b>	<b>1,365.08</b>

Source: Notional Data, Formula per AAFES Dividend Fact Sheet.

<sup>1</sup>AAFES Retains 50% of the Regular Earnings.

<sup>2</sup>2.24% Historical Average Retained by AAFES for Capital Program.

<sup>3</sup>10% Retained by AAFES, 10% Distributed to Local MWR, 80% MWR Dividend.

<sup>4</sup>0.4% of Regular Earnings, Alcohol Earning minus 2.24% AAFES Retained Earnings, and 10% of Telephone Earnings.

<sup>5</sup>Air Force Local MWR Distribution per Table 2.

<sup>6</sup>Army and Air Force Exchange Service, "Dividend Fact Paper," (Washington, DC: U.S. Government Printing Office, 2006).

### Economy of Scale (Consolidation) Analysis

Numerous studies have analyzed the feasibility of consolidating all military exchange services into a single activity. A 1990 study conducted by the Assistant Secretary of Defense for Force Management and Personnel (ASD(FM&P)) recommended full consolidation. A second study was conducted in 1991 by the Logistics Management Institute under contract by the DoD, and the third in 2003 under similar auspices. These

all recommended consolidation and the establishment of a DoD exchange oversight board with regulatory power to implement the integration.<sup>123</sup> Multiple subsequent studies have been conducted since, most concurring with previous studies and recommending consolidation.

The Army and Air Force generally agree with consolidation, with the Navy and Marine Corps being vehemently opposed. There is no doubt that efficiencies will be maximized, redundant capabilities reduced or eliminated, and economies of scale achieved. The reasons for the Navy and Marine Corps opposition vary; however, the general arguments include lack of confidence in the financial analysis of the studies, inability of a consolidated exchange to remain attuned to the organizational culture, and the inability of a consolidated exchange to respond to individual service needs.

From a financial analysis perspective consolidation is not in the interest of the Navy or Marine Corps as they contribute significantly more to their MWR programs in terms of percentage of net income. The financial analysis findings of this study indicate that this is not as a result of more efficient operations or higher sales. The ability of the NEX and MCX to contribute more to MWR programs in relation to AAFES is a result of increased reliance on APF to subsidize exchange operations and significantly less investment in capital expenditures in real property.

#### The Effect of Appropriated Funds on the Financial Statements

Contingency revenue and APF funding has a material effect on the financial statements of AAFES and the other military exchanges. Income generated from

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<sup>123</sup>Sonny Oh, Robert Crosslin, and Trevor Neve, *Toward a More Efficient Military Exchange System*, (Bethesda, MD: Logistics Management Institute, 1991).

contingency operation sales has only the COGS applied as an expense, while all other costs associated with overhead are funded by APF. The financial statements of the military exchanges do not overtly publish the amount of APF reimbursed for contingency operations or other APF support as authorized by regulations and law.

AAFES received \$79.2 million and \$78 million in APF reimbursement, in 2006 and 2008 respectively, for costs associated with contingency operations support of Operation Enduring Freedom (OEF) and Operation Iraqi Freedom (OIF). The AAFES Annual Report is not clear on how this income is accounted for and recognized on the financial statement. The only reference to how APF is recognized is a single sentence in the notes to financial statements which states “appropriations or reimbursements are recorded primarily as a reduction of inventory markdown and shortages as well as selling general, and administrative expenses in the accompanying financial statements.”<sup>124</sup>

The ultimate effect of APF reimbursement for contingency operations is a material misrepresentation of the financial success of military exchange operations. Revenue generated from contingency operations is reflected as earnings; however, the costs associated are not as they are reimbursed by APF, resulting in a significant increase in stated earnings, with no associated costs. OEF and OIF net sales were \$786.9 million and \$691.7 million for years 2006 and 2007 respectively. This revenue represents 9.6 percent of the 2006 and 8.2 percent of the 2007 reported total net sales of AAFES; as such, the overrepresentation of profitability is expected to be no less than these percentages.

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<sup>124</sup>AAFES, *Annual Report 2007*, 11.

In an attempt to illustrate the operating profitability of AAFES contingency operations in support OEF and OIF a theoretical income statement is shown in Table 18. The sales figures and detailed APF reimbursements are detailed in the accompanying notes to the financial statements in the 2008 AAFES annual report. The COGS for OEF and OIF net sales were estimated by multiplying the OEF and OIF net sales by the COCG and Operating Expense ratio calculated from the financial statements as 74.78 percent and 73.80 percent for 2006 and 2007 respectively. ECECS, interest, and depreciation and amortization expenses were estimated in an attempt to fully estimate overhead costs. The estimated ECECS costs were estimated by charging a two percent cost to sales. Two percent was determined as an appropriate ECECS charge as it is identical to the OEF and OIF personnel cost to sales ratio. The interest expense charge was estimated by calculating the ratio of actual interest expense to both sales and concession income in the financial statements. The interest expense to sales and concession income calculated was .68 percent and .59 percent for 2006 and 2007 respectively. The amortization and depreciation expense was estimated as two percent of sales. These data illustrated in Table 18 indicate that AAFES operations in support of OEF and OIF have generated earnings of over an estimated \$82 million in 2006 and \$71 million in 2007 without APF reimbursement. This illustration does not fully account for all contingency operations costs, particularly construction, which could remain an appropriate APF charge.

Table 18. OEF and OIF Income Statement Without APF

OPERATING YEAR	2006	2007
Net Sales in OEF,OIF	786,891	691,689
Estimated COGS	(588,437)	(510,466)
<b>Gross Revenue</b>	<b>198,454</b>	<b>181,223</b>
Personnel Costs	(17,206)	(16,326)
Inventory Markdowns and Shortages	(13,642)	(25,130)
Other Expenses	(3,605)	(4,226)
In Theater Transportation	(44,747)	(32,325)
Estimated ECECS Charge	(15,738)	(13,834)
<b>Net Operating Expenses</b>	<b>(94,938)</b>	<b>(91,841)</b>
<b>EBITDA</b>	<b>103,516</b>	<b>89,382</b>
Estimated Interest Expense	(5,351)	(4,081)
Depreciation and Amortization	(15,738)	(13,834)
<b>Net Income Before Taxes</b>	<b>82,427</b>	<b>71,467</b>
<b>50% MWR Dividend</b>	<b>41,213.5</b>	<b>35,733.5</b>
Tax Expense	0	0
<b>Theoretical Net Income</b>	<b>41,213.5</b>	<b>35,733.5</b>

Source: AAFES, Annual Report 2007 (Washington, DC: Government Printing Office, 2008).

Attempts to quantify the amount of APF allocated to individual exchange activities were unsuccessful. Direct and indirect allocations of APF, accounting standards, financial reporting standards, and poor oversight all contribute to the difficulties in calculating APF support to exchange activities.

## Market and Global Economics

### Industry Profile

The economic turmoil affecting the U.S. and the world has had a significant impact on the retail industry. Retail and food services sales in the U.S. have steadily declined since the beginning of 2008. Figure 8 graphically depicts the average change in

sales for the U.S. retail and food service industry from 1998 through April 2009.<sup>125</sup>

Although AAFES has had relatively steady increases in total revenue, as depicted in Figure 10, the percent change in total revenue has steadily declined since 2004, as presented in Figure 9. Figure 8 represents data ending in December through the year 2008, while Figures 9 and 10 represent data ending in February through the year 2008.

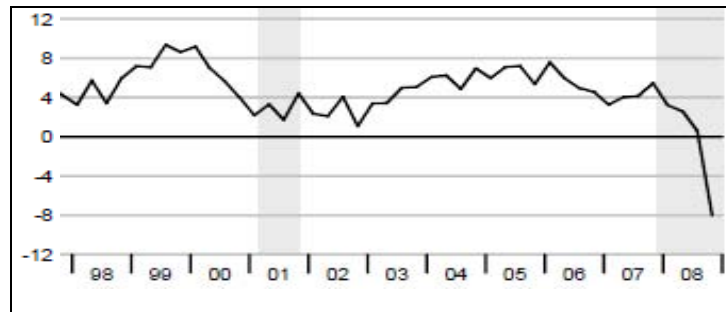


Figure 8. Percent Change in U.S. Retail and Food Service Sales, 1998 - 2008  
*Source:* Research Division of the Federal Reserve Bank of St. Louis. *National Economic Trends*, March 2009 . <http://research.stlouisfed.org/publications/net/20090401/netpub.pdf> (Accessed 9 April 2009).

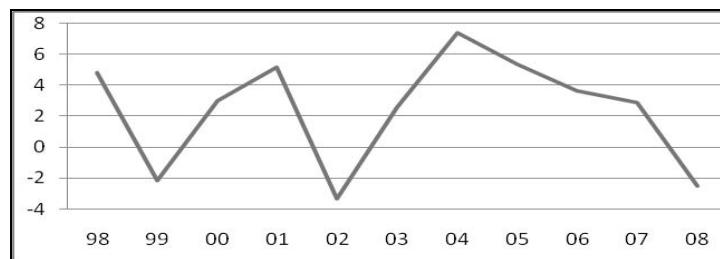


Figure 9. Percent Change of AAFES Total Revenues, 1998 - 2008  
*Source:* AAFES, Annual Report 2007 (Washington, DC: Government Printing Office, 2008). AAFES, Annual Report 2006 (Washington, DC: Government Printing Office, 2007). AAFES, Annual Report 2001 (Washington, DC: Government Printing Office, 2002).

<sup>125</sup>Research Division of the Federal Reserve Bank of St. Louis. *National Economic Trends*, March 2009 . <http://research.stlouisfed.org/publications/net/20090401/netpub.pdf> (Accessed 9 April 2009).



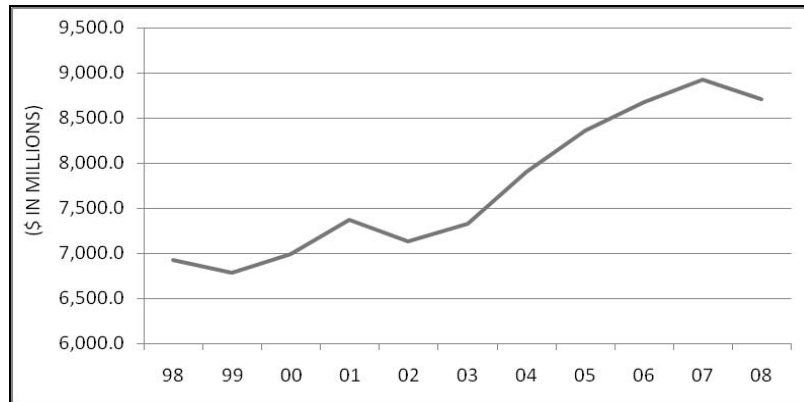


Figure 10. AAFES Total Revenue, 1998 - 2008

*Source:* AAFES, Annual Report 2007 (Washington, DC: Government Printing Office, 2008). AAFES, Annual Report 2006 (Washington, DC: Government Printing Office, 2007). AAFES, Annual Report 2001 (Washington, DC: Government Printing Office, 2002).

Figure 10 illustrates a decline in AAFES sales in 2007, which mirrors the economic decline in retail sales nationwide. Despite the economic downturn AAFES has experienced increased sales during 2008.<sup>126</sup> As weak sales continue to affect the retail industry, AAFES officers were quoted as stating that AAFES has experienced “a significant increase in activity in categories such as home goods, furniture and electronics” through June 2008.<sup>127</sup> The reduction in AAFES revenue from 2007 to 2008 is a result of a significant change in revenues and APF reimbursement for OCONUS and contingency operations. The ability of AAFES to weather the current economic downturn is due to the unique nature of its market base. As previously stated, the primary customer base of AAFES, military service members, are public servants who have fixed income and are relatively immune to private sector economic factors.

<sup>126</sup>Karen Jowers, “Commissary, Exchange Officials See Higher Sales.” *Air Force Times*, November 3, 2008, 20.

<sup>127</sup>Mike Troy, “The Ups and Downs of the AAFES Economy,” *Retailing Today*, 9 June 2008, 2.

## Customer Satisfaction

In addition to the ASI and MSI, AAFES participates in the American Customer Satisfaction Index (ACSI) also operated by the University of Michigan. AAFES has participated in the ACSI since 1996 and is the only NAFI activity to be compared against marketplace competitors in the Department and Discount Store category. Other NAFIs are included in the *Other* category within the ACSI.<sup>128</sup> The ACSI operates in a similar manner as the ASI and MSI, and facilitates benchmarking against other organizations in the same industry, and is an additional measure of performance used to evaluate AAFES. Ten years of SCSi scores for the Department and Discount Store category are listed in Table 19. The ACSI score for AAFES dropped four points in 2006, but has risen by three points to 73 in 2008. The Department and Discount Store category ACSI average for 2008 was 74.<sup>129</sup>

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<sup>128</sup>AAFES, "CSI, ASI, and MSI Survey Fact Paper," (Washington, DC: U.S. Government Printing Office, 2008).

<sup>129</sup>Source: The American Customer Satisfaction Index. ACSI Scores & Commentary. Scores by Company. <http://www.theacsi.org> (accessed 9 April 2009).

Table 19. Annual ACSI Department and Discount Store Category Scores

Store \ Year	'98	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08
<b>Nordstrom</b>	79	76	76	76	-	-	-	-	-	80	80
<b>Kohl's</b>	-	-	-	-	84	79	79	80	80	79	80
<b>J.C. Penney</b>	75	75	74	75	74	77	76	78	78	77	78
<b>Target</b>	-	-	-	-	-	-	75	78	77	77	77
<b>Dollar General</b>	-	-	-	-	-	-	-	-	-	78	75
<b>Dillard's</b>	71	68	72	75	75	75	77	76	75	76	75
<b>All Others</b>	71	73	70	75	73	78	76	77	74	75	74
<b>Macy's.</b>	-	-	-	-	-	-	-	74	71	75	74
<b>Category Average</b>	<b>73</b>	<b>72</b>	<b>72</b>	<b>75</b>	<b>74</b>	<b>76</b>	<b>74</b>	<b>75</b>	<b>74</b>	<b>73</b>	<b>74</b>
<b>AAFES</b>	<b>68</b>	<b>70</b>	<b>70</b>	<b>74</b>	<b>73</b>	<b>71</b>	<b>72</b>	<b>74</b>	<b>70</b>	<b>72</b>	<b>73</b>
<b>Sears</b>	-	-	-	-	-	-	-	-	-	72	72
<b>Wal-Mart</b>	75	72	73	75	74	75	73	72	72	68	70

Source: The American Customer Satisfaction Index. ASCI Scores & Commentary. Scores by Company. <http://www.theacsi.org> (accessed 9 April 2009).

AAFES published data pertaining to the ACSI differs slightly from the data presented in Figure 11. AAFES published yearly fourth quarter scores, and distinguished between the CONUS and overseas results.<sup>130</sup>

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<sup>130</sup> AAFES, "CSI, ASI, and MSI Survey Fact Paper," (Washington, DC: U.S. Government Printing Office, 2008).

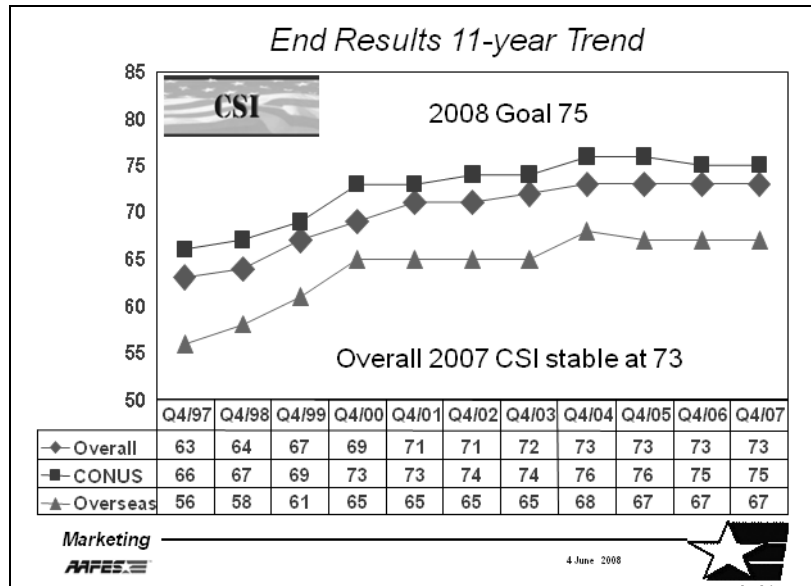


Figure 11. AAFES Reported Customer Satisfaction Index (CSI)  
 Source: AAFES, “CSI, ASI, and MSI Survey Fact Paper,” (Washington, DC: U.S. Government Printing Office, 2008).

The 2009 Army IG investigation observed a number of significant deficiencies in the implementation of the ASCI that may skew or even entirely invalidate the results. The ACSI survey was conducted only at main exchange stores, and did not include locations without a main store. Additionally, the survey sample could also be manipulated as managers were allowed to select the patrons who completed the survey.<sup>131</sup> Another noteworthy observation of the 2009 Army IG investigation is the lowest satisfaction among patrons at small, remote, and OCONUS locations. This is significant as a key role of AAFES is to serve this market. The perception among patrons is that AAFES was more focused on profitable locations, and patrons would choose to travel

<sup>131</sup>DAIG, 2-15.

long distances to shop at other market competitors. Many of these remote sites are not included in the ACSI as they do not have a main exchange store.<sup>132</sup>

The perceptions of customers observed in the 2009 Army IG investigation consistently indicated a certainty that AAFES was more of a convenience than a first choice. Patrons who resided off military installations felt no desire to travel to an AAFES facility during their off duty time. Additionally, a number of military commanders perceived that AAFES was too focused on revenue and was “losing the balance between service and profit... and placed greater emphasis on business analysis results than quality of life considerations.”<sup>133</sup>

AAFES patrons at small, remote, OCONUS, and contingency locations expressed the greatest need for AAFES during the 2009 Army IG investigation; however, these patrons had the lowest satisfaction. Specifically, OCONUS patrons felt they were an AAFES “captive audience” and perceived significant “price gouging” as prices they noted higher prices in their current location than at previous CONUS assignments.<sup>134</sup> This is a significant observation as AAFES is reimbursed for the transportation of OCONUS goods with APF for the specific reason of providing U.S. standard goods and U.S. standards process in an effort to provide a U.S. standard of livings to patrons residing OCONUS.

AAFES support to contingency operations has not met the expectations of customers as 2009 marks the eighth year of operations in Afghanistan, and the sixth year

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<sup>132</sup>Ibid., 2-12.

<sup>133</sup>Ibid., 2-14.

<sup>134</sup>Ibid., ES2.

of operations in Iraq. The 2009 Army IG investigation noted a perception among patrons in contingency areas that AAFES was more concerned with profitability than fulfilling the needs of patrons. AAFES had been unable to maintain sufficient inventories to meet demand. This appears to partly the result of a management decision to reduce OEF and OIF inventories by \$25 million.<sup>135</sup> A lack of appropriate training and procedural standards for rotating management and staff was found to result in a degradation of service at contingency locations. Many managers were also assigned to positions above their experience and skill level and a lack of training and procedures for the integration of managers has inhibited coordination and communication between AAFES and commands.<sup>136</sup> The difficulty to implement Imprest Fund activities has also had a negative effect on the ability of AAFES to support patrons in contingency areas. A lack of information, uniform management and oversight were noted by the 2007 Army IG investigation.<sup>137</sup>

The strategic planning and integration efforts with Army organizational headquarters is severely lacking. As noted by the 2009 Army IG investigation, a significant lack of coordination has hindered AAFES' ability to respond to changes in troop density and specific installation needs to the detriment of the responsiveness and overall quality of service to meet the needs of patrons.<sup>138</sup> Similar concerns were raised in

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<sup>135</sup>Ibid., 2-3.

<sup>136</sup>Ibid., 2-4.

<sup>137</sup>Ibid., 2-6.

<sup>138</sup>Ibid., 2-23.

regards to reserve component installations and mobilization locations.<sup>139</sup> As the reserve component mobilizations have increased exponentially in response to OEF, OIF and homeland security requirements, much of the AAFES support at reserve component locations has remained the same.

Most patrons expressed high satisfaction with the operation and management of AAFES MCSS activities, but expressed dissatisfaction with the availability and quality of uniform stock. These deficiencies were often blamed on AAFES; however, AAFES felt that DSCP was responsible for addressing these issues.<sup>140</sup> AAFES' sustainability efforts have satisfied many customer requests to make a more positive contribution to the environment. AAFES' efforts to eliminate energy waste and to embrace more efficient building practices in new construction are notable.<sup>141</sup> AAFES has also installed efficient LED lights in gas stations, placed motion-activated lights in low traffic areas, and is mandating a minimum of 20 percent Energy-Star rating in all equipment and appliances. AAFES is also executing an aggressive recycling program and is making efforts to transition to more environmentally friendly goods and services.<sup>142</sup>

### Marketing Overview

All of AAFES' marketing efforts are centrally managed at its headquarters in Dallas, Texas. The bulk of AAFES marketing consists of sale flyers and mailings to lure

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<sup>139</sup>Ibid., 2-12.

<sup>140</sup>Ibid., 2-14.

<sup>141</sup>Katherine Field, "Best Buy and AAFES Detail Green Building Plans," *Chain Store Age*, September 2008, 17.

<sup>142</sup>US Fed News Service Including US State News, "Six Ways AAFES Tackles Environment Sustainability," 1 October 2008.

customers to an AAFES facility. The sales to advertising ratio is an indication of how each dollar spent on advertising correlates to sales. It is calculated: (Sales) / (Advertising Costs). The sales to advertising ratio of AAFES is higher than the industry average, indicating that AAFES generates more sales with each dollar spent on advertising. AAFES has a higher than industry average; however, industry sales are over ten times that of AAFES with less than twice the increase in advertising expenses.

Table 20. Sales to Advertising Ratio

	AAFES <sup>1</sup>		INDUSTRY <sup>2</sup>	
	07'	08'	07'	08'
<b>Net Sales</b>	8,475,145	8,257,279	88,454,865	85,087,444
<b>Concession Income</b>	225,242	242,820	-	-
<b>Total</b>	8,700,387	8,500,099	88,454,865	85,087,444
<b>Advertising Expense</b>	72,966	70,029	1,158,759	1,217,581
<b>Sales / Advertising</b>	<b>Thus Every \$1 spent on Advertising = \$ in Sales</b>			
	<b>\$119.24</b>	<b>\$121.38</b>	<b>\$76.34</b>	<b>\$69.88</b>

Source: <sup>1</sup>AAFES, Annual Report 2007 (Washington, DC: Government Printing Office, 2008).

<sup>2</sup>BizMiner, "Industry Financial Profile." Sector: Retail [96-300]. (Camp Hill, PA, December 2008).

AAFES facilities have the advantage of being centrally located on every installation and having a captive customer base that appreciates many of the conveniences of having AAFES facilities near where they work, play, and reside. The biggest challenge for AAFES is to lure authorized customers who reside off the installation to patronize AAFES facilities. The 2009 Army IG investigation observed that most CONUS patrons who resided off the installation would not shop at AAFES



during off duty hours.<sup>143</sup> Patrons who reside off post also felt little appreciation for the MWR dividend as they did not benefit from MWR activities or use MWR supplemented facilities.<sup>144</sup> Capital improvements designed to enhance the shopping experience are one way AAFES is attempting to improve market share.

### Pricing Strategies

While conducting research for this report many AAFES patrons, including active service members and family members, expressed significant displeasure with AAFES prices for goods. Many felt that AAFES did not have competitive prices, despite the tax savings, and that they were overpaying for products as earnings went to MWR and AAFES. The 2009 Army IG investigation also observed that the most important consideration for patrons was low prices.<sup>145</sup> The 2009 Army IG report observed that most patrons shop at AAFES for convenience rather than as a first choice. The IG report also observed that many customers felt that the sales tax savings was the only AAFES benefit, rather than a significant price savings.<sup>146</sup> An Army lieutenant colonel stationed at Fort Leavenworth, Kansas, expressed a similar view when attempting to purchase a high-end television in late 2008. This officer made a noteworthy effort to compare prices on comparable televisions and found that a market based competitor significantly undercut AAFES price on comparable items.<sup>147</sup>

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<sup>143</sup>DAIG, 2-9.

<sup>144</sup>Ibid., 2-11.

<sup>145</sup>Ibid.

<sup>146</sup>Ibid., 2-9.

<sup>147</sup>Anonymous Army Officer, personal communication with the author, 14 April 2009.

The military exchanges are required by the DoD to conduct annual market based surveys (MBS). The goal of the MBS is to compare the price of exchange items against the pre-tax price of identical items in nine markets across CONUS and Hawaii. These surveys are conducted by an independent research firm under contract with each exchange service. The results of the survey form a major component of the AAFES marketing strategy, as its goal is to achieve a 20 percent average saving between AAFES.<sup>148</sup>

The latest MBS was conducted in October 2008 and calculated an average 20.38 percent savings at AAFES as compared to marketplace competitors. A select list of the findings is shown in Table 21, where the percentage shown represents the average pre-tax price savings of items surveyed at both retailer and department.<sup>149</sup> The parameters of the MBS survey include only regular priced or identical items sold at military exchanges. Sale prices, discounts, and comparable or substitute identical items are not included in the survey.<sup>150</sup>

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<sup>148</sup>AAFES Q&A e-mail response from the AAFES Public Affairs Office, 25 November 2008.

<sup>149</sup>AAFES, "The AAFES Value Story," <http://www.aafes.com/docs/valuestory.htm> (accessed 4 April 2009).

<sup>150</sup>Retail Data LLC, "Military Check Instructions" collection methodology provided by Client Service Manger of the organization contracted with the military exchanges to conduct the MBS survey.

Table 21. AAFES 2008 Market Based Survey Select Results

<b>Saving</b>	<b>Retailer</b>	<b>Saving</b>	<b>Department</b>
25.79%	7-Eleven	29.81%	Automotive
43.39%	Ace Hardware...	13.56%	Books
26.06%	Advance Auto...	35.09%	Boys
10.60%	Best Buy	6.57%	Cameras
20.32%	Books A Million	22.34%	Computers & Peripherals
12.76%	Borders	20.11%	Cosmetics
14.82%	Cabella's	13.97%	Electronics
10.40%	Circuit City	21.58%	Fashion Jewelry
24.62%	CVS	19.93%	Furniture - Juvenile
27.69%	Dillard's	21.71%	Giftware
21.93%	Foot Locker	28.74%	Girls
20.33%	Hallmark	20.10%	Greeting Cards
9.45%	Home Depot	20.10%	Handbags/Hosiery
21.85%	JCPenney	12.58%	Hardware
18.73%	KB Toys	20.93%	Health & Beauty
15.20%	Kmart	23.72%	Household
21.77%	Lowe's	16.13%	Housewares
24.39%	Macys	16.68%	Infants
31.04%	Nebraska Furniture Mart	23.11%	Intimate Apparel
19.46%	Office Depot	25.41%	Ladies
13.68%	Office Max	56.29%	Luggage
27.09%	O'Reilly Auto Parts	8.59%	Magazines
30.99%	Pep Boys	23.44%	Major Appliances
16.56%	Publix	27.01%	Mens
2.51%	Quick Trip	10.49%	Retail Food
4.56%	Radio Shack	21.42%	Shoes
26.53%	Sears	9.18%	Small Appliances
21.22%	Sports Authority	27.75%	Sporting Goods
10.43%	Staples	31.43%	Stationery
8.45%	Target	22.64%	Sunglasses
24.50%	Walgreens	17.03%	Toys
6.02%	Wal-Mart	16.41%	Watches

*Source:* AAFES, “The AAFES Value Story,” <http://www.aafes.com/docs/valuestory.htm> (accessed April 4, 2009).

AAFES’ pricing strategy is propriety information and was not made available for this study. There was only one reference to pricing guidance found in all of the regulations, policies, and laws pertaining to AAFES and the military exchange system reviewed for this study. “AAFES will support pricing of smoking cessation products

below the local competitive price.”<sup>151</sup> AAFES does place responsibility on the consumer and has a price match guarantee. The policy allows cashiers to immediately respond to customers’ verbal attestation of a lower price that is less than ten dollars. Customers will need to bring a competitor advertisement to receive the lower price.<sup>152</sup> The price match guarantee on high-end electronics is somewhat negated by manufactures who specify retail prices for certain goods and distribute different models to retailers. Electronic manufactures are able to distribute different models to retailers in an effort to avoid exact comparisons across different retailers, despite identical characteristics and features. The 2009 Army IG investigation summarized most patrons’ perception as “AAFES is my benefit and I should not have to match prices because AAFES should be the best price.”<sup>153</sup>

One contentious subject is that of fuel prices. AAFES is required by law to charge tax on fuels in accordance with section 105, Title 5 of the United States Code (USC). AAFES managers conduct local price surveys to set the price, and customers who decide to pay with one of the ECP cards receive a three cent per gallon discount. OCONUS gas sales are immune from taxation, a privilege granted by Congress. The OCONUS price is set based on the monthly Department of Energy U.S. national average of price of gasoline with a predetermined facility overhead charge.<sup>154</sup>

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<sup>151</sup>*Army Regulation 215-8 and Air Force Instruction 34-211(I) Army and Air Force Exchange Service Operations*, “Exchange Operations,” (Washington, DC: U.S. Government Printing Office, 2008), 24.

<sup>152</sup>AAFES, “AAFES News Online,” <http://www.aafes.com/pa/news/07news/07-013.htm> (accessed 4 April 2009).

<sup>153</sup>DAIG, 2-10.

<sup>154</sup>Ethan E. Rocke, “Deployed Marines Feel the Sting of Stateside Gas Price Hikes,” *Leatherneck*, July 2006, 47.

Thus far, every analysis of AAFES pricing indicates that AAFES has consistently lower prices than its market competitors. In addition to the MBS results which show a significant average price savings, AAFES has the lowest gross profit margin as compared to the MCX, NEX and industry standards. One exception is contingency support operations. According to AAFES pricing at contingency locations is based on average CONUS prices. AAFES is able to do this since all transportation fees and overhead costs are paid for with APF as authorized by law. The 2009 Army IG investigation reported that patrons in contingency locations noted higher process than at other CONUS locations.<sup>155</sup> Additionally, the 2009 Army IG Investigation noted that AAFES retail support to contingency operations had notably higher profit margins as opposed to CONUS and Europe. AAFES operations in remote areas of the Pacific also had a significantly higher profit margin than CONUS and Europe.<sup>156</sup>

### SWOT Analysis

A SWOT analysis is an assessment of significant internal strengths and weaknesses and external opportunities and threats.<sup>157</sup> This analysis will conclude the presentation of findings, and will group important findings identified into an organized framework.

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<sup>155</sup>DAIG, 2-1

<sup>156</sup>Ibid., 2-3.

<sup>157</sup>Louis E. Boone, and David L. Kurtz, *Contemporary Business* (Fort Worth: The Dryden Press, 1999), 234.

## Strengths

The immunities from taxation, protections from competition, and APF direct and indirect funding provide AAFES with an unparalleled competitive advantage over its competitors. By regulation AAFES is afforded the right of first refusal to operate all activities listed in Appendix B of this study. This provides AAFES with guaranteed revenue generating opportunities without competition within the boundaries of each military installation.

The Exchange Cooperative Efforts Board (ECEB) is a collaborative forum among all the military exchange activities charged with coordinating and implementing cooperative efforts. These efforts are aimed at achieving efficiencies in the areas including logistics, procurements, and information technologies ultimately aimed at saving money and improving the overall benefit to patrons.<sup>158</sup>

The logistics framework of AAFES is a critical component of AAFES operations and its ability to remain competitive in the global market place. The logistical framework of AAFES also serves as a critical component of the operations of the other military exchanges. The investment and continual improvement to technologies enhance the operational capabilities of AAFES and greatly assist in the centralized management and control of its worldwide operations. Inventory management, distribution, and purchasing automated systems greatly enhance its ability to remain competitive.

Although a number of negative financial measures of performance were noted, the overall financial performance of AAFES is strong. AAFES has been able to weather the

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<sup>158</sup>Thurgood, (testimony before the Military Personnel Subcommittee of the Committee on Armed Services United States House of Representatives, 17 April 2008).

economic downturn and has consistently provided a source of revenue to MWR activities.

### Weaknesses

The chief internal weakness identified in this study is a decline in the overall AAFES employment experience. The observations included concerns about promotion potential and training. Other internal weaknesses include significant failures among the management and execution of contingency support operations, which directly relate to the strategic relevancy and value of AAFES.

The 2009 Army IG investigation noted a consensus among AAFES managers interviewed that centralization of all purchasing activities by AAFES headquarters has limited the ability of local managers to respond to the local needs of patrons. Managers understood the benefits of centralized purchasing and stock assortment decisions, but the absence of a means by which to provide input into the process did not allow managers to respond to local needs.<sup>159</sup>

### Opportunities

The principal external opportunity for AAFES is a function of BRAC initiatives. As military locations are closed the density of troops will consolidated at fewer locations. AAFES will have the potential to increase profitability as the operating costs for each exchange facility remain relatively the same while serving more customers. Another opportunity available to AAFES is its ability to increase its market share. It will be difficult to target retired service members, and members of the reserve component, and

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<sup>159</sup>DAIG, 2-19.

authorized patrons who reside off post; however, aggressive marketing, competitive pricing strategies, and the ecommerce activity are all ways in which AAFES can reach these patrons.

### Threats

AAFES appears to be failing to fully exploit its comparative advantages over its commercial competitors. The overall confidence among customers that AAFES provides competitive prices is critically low. This poor confidence in the value of AAFES prices has direct correlation to patron loyalty and overall satisfaction. The resulting affect represents a critical weakness of AAFES' operational environment, which will result on lower sales as patrons will choose to shop where they perceive the highest value for goods, services, and the overall shopping experience. Figure 12 illustrates the relationship between value, satisfaction, and loyalty.<sup>160</sup> AAFES' inability to create a high level of perceived value, satisfaction and loyalty among patrons significantly inhibits the revenue potential. The resulting effect is a diminished benefit among patrons, reduced revenue for MWR, and the overall degradation of service to military service members and their families.

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<sup>160</sup>CFI Group, "The Role of Value, Satisfaction and Loyalty," [http://www.cfigroup.com/about/ca\\_m.asp](http://www.cfigroup.com/about/ca_m.asp) (accessed 24 April 2009).



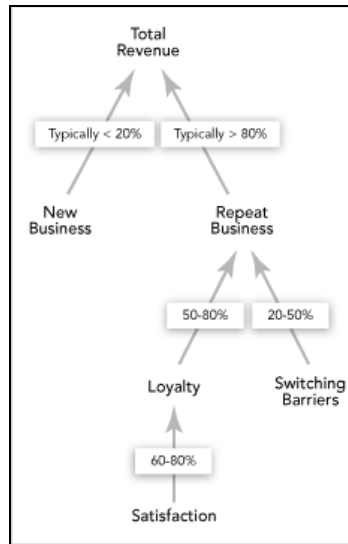


Figure 12. The Relationship Between Value, Satisfaction, and Loyalty  
 Source: CFI Group, “Customer Asset Management,” <http://www.cfigroup.com/about/cam.asp> (accessed 24 April 2009).

Chapter 4 presented the findings of the research methodology outlined in the previous chapter. The global operations, financial posture, and the operating environment of AAFES were outlined in relation to its parallel peers and commercial competitors. The next chapter will present the conclusions of the findings outlined in this chapter, to include recommendations for action and further study.

## CHAPTER 5

### CONCLUSIONS AND RECOMMENDATIONS

Chapter 4 presented the findings of the research methodology in terms of AAFES' global operations, financial posture, and the operating environment in relation to its parallel peers and commercial competitors. The primary research question seeks to analyze the strategic relevancy and strategic value of AAFES. This chapter will present the conclusions of the findings, to include recommendations for action and further study.

#### Recommendations

##### Recommendations for Further Study

The amount of direct and indirect APF funding of military exchange activities is worthy of further study. Chapter 4 illustrated the profitability of contingency support activities without APF funding. Capturing the total amount of worldwide direct and indirect APF funding may significantly change the financial performance assessment of military exchange activities. A comprehensive study may illustrate that fully funding MWR activities with APF may be the most beneficial course of action, and may warrant significant change to the military exchange operational charter.

During the course of conducting research for this study a significant concern for the evolving culture of Army MWR activities was noted. The Army FMWRC requires notably high returns as measures of performance for MWR revenue generating activities. These performance measures may be inhibiting the potential of MWR activities to serve military service members and appear to be over emphasizing profitability over the value

of service provided. These observations warrant a comprehensive analysis of the Army MWR activity.

A 1975 USAF Air Command and Staff College research study analyzed the viability of AAFES managing the commissary activities, which today are operated by DeCA.<sup>161</sup> Since 1975 a number of other studies have been published, all of which have recommended against AAFES assuming any responsibility over the commissary system. This study concurs with this recommendation on the grounds that AAFES, in its current form, is a profit based organization and any such realignment will erode the benefit provided by commissary activities to service members. The charter and organizational management of DeCA closely resemble a non-profit organization. Additionally, DeCA arguably provides the best value to its customers of all the DoD NAFI activities. This study acknowledges that the operating environment has significantly changed since 1975. Should the charter and organizational philosophy of AAFES change sufficiently to place value, price and service above profitability the potential for efficiencies from consolidating AAFES and DeCA exists without any degradation of benefits is worthy of further study.

The military exchanges are charged with providing a non pay benefit to patrons and generating funds for MWR activities. Further study is recommended in order to determine the feasibility of achieving the goals of the military exchange system through alternate means. The vast majority of military installations have sufficient regional commercial retail activities to provide a viable alternative to the military exchange.

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<sup>161</sup>Roy G. Kennington, "AAFES as the Commissary Manager" (Air Command and Staff College student research study, 1975).

Agreements could be established with commercial retailers to provide discounts to authorized patrons of military exchanges as an alternative to the military exchange. These agreements could include donating a percentage of sales of authorized patrons to the installation MWR activity.

AAFES currently under prices Wal-Mart by only six percent according to the 2008 MBS commissioned by AAFES. Military exchange patrons could be allowed tax free purchases and a six percent discount at Wal-Mart. Wal-Mart could in turn contribute one or two percent of the purchase to the local installation MWR program. This would essentially satisfy the goals of the military exchange system and significantly reduce the direct and indirect APF costs of operating a military exchange. Local MWR contributions could be significantly increased as it is presumed that the average military family spends significantly more at local commercial retail establishments than at their local military exchange facility. Minimum or maximum purchases and other controls would be required in order to abate fraud; however, admittedly the most difficult hurdle to such a proposal will be the immunity from local taxes since sales tax is a significant source of revenue for states and municipalities.

## Conclusions and Recommendations for Action

### Retail Operations

Concession activities are entitled to the same APF support as AAFES; however, they are not afforded the same immunity from taxation as AAFES operated facilities. This is a major fault of existing laws and regulation as AAFES patrons are not being afforded the best value for goods or services. Concession activities are more than simply a convenience provided to customers to enhance their AAFES experience. In 1941 an

exchange advisory committee was established by the Chief of Staff of the Army, General George C. Marshall, consisting of five prominent retail executives. Within their findings they attested that “soldiers do not receive as great a value for their money as they should” with regard to concession purchases.<sup>162</sup> Concessions operate facilities that AAFES is either unable or unwilling to provide, and as such are acting as an agent of AAFES and should be afforded the same operating parameters as AAFES in order to provide the best value to customers.

The method used to calculate the APF reimbursement to AAFES for the operation of the MCSS activity is based solely on sales and not actual costs. Under the current agreement AAFES is reimbursed with APF for all costs associated with the operation of MCSS activities based on the percentage of sales of official DSCP items. The percentage of sales of unofficial DSCP items is absorbed by AAFES. The overhead cost attributable to DSCP items may be minimal as compared to other commercial items; therefore, the charges to APF may be excessive. The opposite could hold true and AAFES could be absorbing more operational overhead costs than warranted. APF overhead and management reimbursement should be calculated using activity based cost accounting, where costs are directly attributable to DSCP items. Allocating costs based on the percentage of sales may not accurately reflect actual costs incurred and may result in a significant miscalculation of APF reimbursement.

The net profits from the sale of unofficial items could not be determined with the data available for this study; however, it is presumed that AAFES would not operate activities that do not provide a minimal economic return, and as such the net revenue

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<sup>162</sup>Habgood et al., 23.

from the sale of unofficial items at MCSS facilities may be sufficient to cover all MCSS operating costs. If MCSS revenues are sufficient to fund all operational costs of MCSS locations, APF funds earmarked for MCSS activities could be distributed directly to MWR activities. A second alternative would be for MWR activities to operate MCSS activities as a Category A or B MWR activity. Under the current agreement, AAFES retains about 50 percent of net revenue. With the MCSS operating as an MWR activity, MWR would retain 100 percent of the net revenues generated.

The costs associated with the construction and upgrade of MCSS facilities are funded entirely by APF. This is a significant overcharge to APF as a significant amount of the square footage of the facility is dedicated to unofficial items. Many MCSS facilities include a concession operated alteration shop, the costs of which are attributed to APF as well. Calculating APF reimbursement of construction costs for MCSS facilities should be reduced proportionally by the square footage attributed to unofficial items.

Most AAFES patrons expressed dissatisfaction with the availability and quality of uniform stock at MCSS facilities. AAFES blames these deficiencies on DSCP who is responsible for the procurement and quality control of all official uniform items. AAFES has a responsibility to the military services and the DSCP for whom it operates the MCSS retail activity and is reimbursed for all associated operating costs. However, AAFES has a second responsibility which to the military service members whom AAFES serves. These responsibilities include the duty to forecast demand of DSCP items in order to adequately meet the needs of its patrons. Additionally, AAFES should facilitate communication between patrons and the DSCP on issues relating to satisfaction and

quality. AAFES is the face of DSCP and will bear all the consequences of negative perceptions among patrons; as such, it is in AAFES' interest to ensure that the products it sells are of the highest quality and are satisfactory to its patrons.

#### Garrison and Installation Convenience Activities

The AAFES revenue from vending activities is negligible. This unique characteristic warrants special treatment of royalties and thus should be treated similarly to the Alcoholic Beverage dividend where 100 percent of DOR is distributed to the service MWR program. Vending activities have minimal overhead cost which can be attributed to AAFES, however AAFES benefits from 50 percent of those earning. Currently AAFES vending royalties are part of AAFES regular earning which is subject to the local regular (core) dividend 50 percent AAFES capital fund and 50 percent MWR dividend split. This activity could also be transferred to MWR for operation management as a Category C activity.

#### Special Activities

The arguments made by the NAFCU regarding the ECP are valid. The NAFCU holds that the Military Star Master Card violates DoD policy restricting DoD components of NAFIs from engaging in retail banking activities, and that the revenue model of the ECP is dependent on service members accruing debts that they may not be able to afford. Since the Military Star Master Card is offered by a commercial bank, the revenue model for this activity is predominately based on interest charges and the accumulation of debt. This study finds that the Military Star Master Card is not an extension of existing services as argued by AAFES. The fact that AAFES may not allow customers to have both the

Military Star and the Military Star Master Card does not substantiate the claim that one is an extension of the other, even though one card includes all the benefits of the Military Star Card. Since the original Military Star Card and the Military Star Master Card are separate and underwritten by separate institutions they are therefore separate offers of credit and separate revenue generating activities.

The AAFES ENCS represents a significant benefit for service members and should be expanded to include CONUS authorized patrons. With the worldwide realignment for U.S. military forces, the military presence overseas will be significantly reduced. Extending this benefit to authorized patrons worldwide would enhance the benefits of the military exchange system, while also enhancing revenue generation.

The effort of AAFES to serve customers with MFE's is notable. The revenue model for the MFE program may have a smaller economic return; however, the benefit it provides is invaluable. The MFE deploys the exchange benefit to active, retired and reserve component service members, their families, and other authorized patrons who do not reside within the immediate area of a military exchange facility. DeCA has initiated a similar program aimed at projecting their services beyond traditional boundaries. This represented a unique opportunity for further partnership and coordination between AAFES and DeCA.

The MFE activity and revenue model could be expanded by establishing agreements with municipalities and with the Department of Homeland Security, specifically the Federal Emergency Management Agency (FEMA). The MFE could easily provide service in disaster areas to all relief workers and victims. Expanding the list of authorized patrons in disaster areas would necessitate legislative action; however,



this should not pose a significant hurdle as AAFES would satisfy a critical requirement that is not otherwise being filled. The American Red Cross is postured to provide only limited service such as meals, coffee, and other comfort items. With the appropriate amount of strategic planning and synchronization, AAFES alone would be able to consistently supply personal demand items with a consistent logistical sustainment network.

### Contingency Operation Support

The strategic planning and integration efforts between AAFES and Army operational headquarters require significant improvement. Within the limits of operational security requirements, AAFES management should be integrated into the planning process in order to facilitate synchronization of AAFES support to better respond to changes in troop density and the resulting surges in demand for AAFES services. This coordination should be no different than installation logistics civilian support personnel who play an integral role in the mobilization, deployment, and redeployment of military forces. Patrons may fault AAFES entirely for failing to synchronize demand with the availability of supplies and services; however, some of the blame should be attributed to the military leadership and poor performance of the Tactical Field Exchange Liaison Officer (TFELO). The corporate goal to reduce inventories in OEF and OIF by \$25 million is not a valid measure of performance, and should be immediately removed as a corporate goal.

The Army Logistics Corps should be charged with overall integrating, synchronizing, and planning retail contingency support operations as a core competency in parallel with traditional military supply management. In order to further facilitate

communication and coordination between AAFES and military organizational headquarters, training should be developed for all military officers and noncommissioned officers that teach the contingency support capabilities of AAFES and the role of TFELO. This training should be included in the professional education of senior noncommissioned officers and field grade officers, including the Army's School for Command Preparation and its Air Force equivalent. This would ultimately improve contingency support operations by educating the target customer on not only the capabilities of AAFES, but on the responsibilities of supported military organizations.

The implementation, training for, and oversight of Imprest Fund activities require immediate improvement. The negative observations noted by the 2009 Army IG investigation represent a critical failure by AAFES to serve troops in remote and austere locations. Authority to implement an Imprest activity should reside with the local AAFES manager within the contingency area, and training programs should be established to communicate already established standards.

Retail support to contingency operations is a critical capability that provides functions and services that are essential to military operations and troop morale. Currently established laws, policies and procedures under which AAFES operates have permitted AAFES to evolve into an organization that does not represent a strategic value to the military services or the U.S. government. Although limited transportation and associated support within each contingency area will always be required, the theoretical OEF and OIF income statement illustrated in Chapter 4 indicates that contingency operations have a strong potential for profitability without APF funding. The net effect of eliminating APF support to contingency support activities would result in reduced

MWR distributions; however, this could be negated by a policy to distribute 100 percent of contingency areas earnings to MWR. Under the current operating parameters, AAFES assumes virtually zero overhead costs, but retains roughly half of the net earnings for its capital improvement fund.

The theoretical OEF and OIF income statement illustrated in Chapter 4 illustrates a very strong revenue model. An estimated net income of \$35.7 million and \$41.2 million was calculated, after a 50 percent income dividend distribution to MWR, for years 2007 and 2006 respectively. This revenue model justifies the elimination of APF funding and makes retail support to contingency operations a potential candidate for outsourcing. Outsourcing this activity would require stringent price controls and oversight, but could result in a significant increase in overall quality and breadth of services provided as the provider of retail services would make every effort to satisfy customers and increase revenue. This study does not recommend outsourcing of retail support to contingency operations. The revenue generated from this activity should be retained for the benefit of service members and not redistributed to the private sector.

#### Measures of Performance (Financial)

The significant disparities in financial reporting among the military exchanges added difficulty to financial analysis. The DoD and the ECEB should implement uniform financial reporting standards that will require uniform depth and clarity in financial reporting which will facilitate analysis. Military exchanges should also be required to disclose all direct APF funding, and an estimate of indirect APF funding.

From an AAFES patron's perspective, a number of negative financial performance measures were noted. AAFES has a higher than average cost of goods sold

(COGS) and operating expenses, with a low gross profit margin. This is noteworthy, as one might infer that military exchanges would naturally have a high gross profit margin due to the numerous competitive advantages authorized, such as immunities from taxation, tariffs, and direct and indirect APF authorizations.

#### Measures of Performance (Human Resources)

Despite indications that AAFES provides above average employee compensation, benefits, and recognition, the decline in the overall AAFES employment experience is of concern. Employee dissatisfaction can result in reduced performance, diminished customer service, and ultimately reduced customer satisfaction. The issues identified pertaining to promotion potential, and training deserve immediate attention, particularly deficiencies noted in relation to the management of contingency support activities. AAFES should develop education and training plans for employees and managers. A structured training and integration program for contingency area employees and managers is also required in order to improve contingency support activities. The disparity in the CSI of CONUS and overseas based employees may warrant further study in order to identify the root causes and effects of the disparity while operating under identical administrative parameters. The lost MSI also warrants a thorough analysis as managers are responsible for the implementation of organizational policies, vision, and goals and have a significant impact on the climate and culture of the organization.

#### Measures of Performance (MWR Revenue Generation)

AAFES consistently contributes about half of its net earnings to MWR, whereas the NEX contributes three-quarters, and the MCX averages well over 100 percent of net

earnings. Although AAFES may appear to contribute less to MWR, it contributes the highest in relation to total sales and revenue. This indicates the MCX and NEX both have higher overhead costs which reduce net revenue available for distribution to MWR.

The formula used to calculate installation MWR dividends as shown in Table 17 indicated that Air Force installation MWR activities are under-funded by 46.7 percent as compared to Army installations. Formulas used to calculate installation MWR dividends should be identical across all services. The remaining funds should also be distributed to the Service MWR agency where it was generated, and not distributed based on the ratio of service personnel end strength. Army or Air Force installation generated revenue should serve that service, as opposed to being transferred to another military service.

#### Consolidation of the Military Exchange System

Consolidation of the military exchange system would reduce overhead costs and would contribute to efficiencies which would increase the dividend to sales and revenue ratio of the MCX and NEX. Notwithstanding potential efficiencies this study does not recommend consolidation of the military exchange services at this time. The current organization, operating parameters, and corporate goals would not benefit the Marine Corps or Navy MWR programs sufficiently to warrant consolidation. This recommendation is primarily based the negative trends in customer satisfaction, perceptions, and the decentralized corporate management of AAFES which appears to be unable to establish the necessary relationships and loyalties with patrons.

## Transformation of the Military Exchange System and DoD NAFI Entities

This study recommends a transformation of the current military exchange system and other DoD NAFI entities. The first transformation initiative recommended is an organizational merger of AAFES and MWR Category C activities. The proposed new organization would be directly responsible for all revenue generating activities on military installations. Under this recommended construct, AAFES would receive no APF support, as MWR Category A and B activities would be fully funded with APF, relieving AAFES from the requirement to provide a revenue dividend to MWR. With only the requirement to fund internal capital improvement objectives AAFES would be able to commit to a philosophy of lowered prices while absorbing the increased overheads as a result of the elimination of APF. This proposed organization would be able to satisfy the requirements of the Marine Corps and Navy, justifying the consolidation of all military exchange activities into a DoD joint NAFI, the Armed Forces Exchange Service, responsible to the DoD and Service secretaries.

Eliminating APF support of AAFES would significantly modify its revenue model and force AAFES to achieve significant efficiencies in order to remain competitive against the commercial competitors. The theoretical OEF and OIF income statement calculated in Chapter 4 illustrates a strong potential for retail contingency support operations to remain profitable without APF. The income statement and balance sheet of the military exchanges would improve significantly as they would be relieved of the requirement to share profits with MWR. Annual markets surveys, oversight from installation leadership, and continued pressures from customers would be necessary to ensure that pricing remains no less than twenty percent below market survey prices.

Additionally, installation AAFES general managers would be responsible to the installations' senior mission commanders, with an indirect relationship to the AAFES headquarters, in order to ensure responsiveness to local needs and to fully integrate AAFES into the command team.

#### The Availability of APF to Military Exchange Activities

The ratio of military exchange generated MWR dividends to total MWR assets is disproportionate to the amount of APF allocated to the military exchange activities. The 2006 Army FMWRC annual report cites the AAFES dividend of \$108 million dollars as five percent of the total MWR operating budget. A 1919 Army report states "morale is as important as ammunition and is just as legitimate a charge against the public treasure." This study recommends stringent restrictions be placed on APF allocations to military exchange activities, while increasing APF support to MWR activities. The military exchanges would be relieved from contributing dividends to new programs, and could transition to a commitment to reduce prices as a result of the lowered overhead requirements.

#### Organization Management and Strategic Planning

The MWR activities of the military services are the chief stakeholder in AAFES. Under the current operating parameters MWR has no authority over AAFES; whereas patrons are represented in a number of ways that include the military chain of command, and local exchange councils. The MWR directors of the Army and Air Force should be members of the AAFES BoD as half of AAFES' charter is to serve the interest of MWR and as such they should be represented in the oversight and administrative control of

AAFES. MWR should be consulted regarding significant decisions to expend AAFES capital funds that could otherwise be distributed to MWR for purposes with greater impact to the military community.

AAFES has operated a successful and competitive retail and service business while consistently providing a source of revenue to MWR activities. The strategic goals and metrics outlined in the AAFES 2013 strategic plan are excellent measures of performance for a for profit organization. However, these goals and metrics are poor measures of effectiveness in achieving patron satisfaction, loyalty, and remaining competitive in the competitive global environment. An important factor in patron satisfaction and loyalty is pricing. Instead, AAFES has chosen to highlight contributions to MWR and retail support to contingency operations as its hallmark.

The only commitment AAFES has made in relation to pricing is the price match guarantee. This is a potential option for some CONUS patrons; however, patrons in remote and contingency areas have no alternatives. The direct operating profit of AAFES retail operations was 11.7 in contingency areas and 8.4 percent in the Pacific. In contrast the direct operating profits in CONUS and Europe were 6.9 percent and 5.29 percent respectively. This is a significant observation as the underlying intent of the military exchange system is to provide uniform prices to authorized patrons worldwide. This disparity illustrates a significant failure by AAFES and supports the argument that AAFES is taking advantage of those who have fewer retail alternatives.

#### Title 10 USC and the Charter of the Military Exchange System

Notwithstanding the changes in law and regulations required to enact many of the recommendation of this study, the authority and charter of the military exchange system



is in need of significant modification. Title 10 USC does not specify how the exchange service is to be operated other than for the procurement of alcoholic beverages.<sup>163</sup> In comparison Title 10 USC enacts many operating parameters for the DeCA and MWR activities. Specifically, DeCA is required to sell at reduced prices<sup>164</sup> with a specified markup surcharge for capital improvements and expenditures.<sup>165</sup> Military exchange activities should be much more than a convenience. Exchange prices and services should provide a distinct value and quality advantage over commercial competitors. Patrons should not be responsible for researching price and quality criteria, particularly in remote and contingency locations. The military exchange system is a non-compensatory benefit for military service members and as such the military exchange services should be responsible for acting in the best interest of its patrons.

### Summary and Conclusions

AAFES is a competitive retailer in the global marketplace, and is strategically relevant as a part of the U.S. military. Its ability to weather the current economic downturn is strong; however, a significant number of strategic and operations deficiencies threaten the potential to accomplish its strategic objectives.

Direct and indirect APF support in other CONUS and OCONUS locations negatively impact ability to accurately assess the financial performance of AAFES. The benefits of having AAFES support in contingency and remote locations are many and its

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<sup>163</sup>*Title 10 U.S. Code - Armed Forces*, “Section 2495.” Requires the procurement of alcoholic beverages be done through the most competitive source from within the state(s) that the military installation is located.

<sup>164</sup>*Ibid.*, Section 2481.

<sup>165</sup>*Ibid.*, Section 2484.

value is incalculable; however, the level of APF provided to AAFES is excessive. This study outlined a number of significant operational and strategic deficiencies in the management, oversight, and execution of AAFES' operations. Of these deficiencies the most significant are contingency support operations and the pricing strategies. Ultimately each patron is responsible for deciding where and how he spends his money.

AAFES should act in the best interest of its customers, particularly in remote and contingency areas where patrons have very limited options; however, this study illustrated that AAFES may not be providing the best value for its customers to the full extent of its abilities. The origins of AAFES were to serve Soldiers in remote areas. It is possible the military exchange system has outlived its intended goals as commercial development has kept pace with most military locations in terms of value, service and convenience. AAFES is unhindered in its ability to respond to the needs of stakeholders and customers and has the potential to address each of the deficiencies and recommendations noted in this study.

## APPENDIX A

### Authorized Patrons of Military Exchanges

Category	Status
1. Active or Retired Members of the Active or Reserve Component of the Armed Forces	<p>a. All members of the Army, Air Force, Navy, Marines, Coast Guard, commissioned officers of the National Oceanic and Atmosphere Administration (NOAA), and its predecessors, and commissioned officers of the Public Health Service.</p> <p>b. Former members of the Lighthouse Services and personnel of the Emergency Officers' Retired List of the Army, Navy, Air Force, and Marine Corps, and members or former members of Reserve Components who, but for age, would be eligible for retired pay.</p> <p>c. Enlisted personnel transferred to the Fleet Reserve of the Navy and Fleet Marine Corps Reserve after 16 or more years of active military service. (These personnel are equivalent to Army and Air Force retired enlisted personnel.)</p>
2. Congressional Medal of Honor recipients	All
3. Honorably Discharged Veterans	<p>When</p> <p>(a) Classified by the Veterans' Administration as being 100 percent disabled;</p> <p>(b) Hospitalized where exchange facilities are available.</p>
4. Military Members of Foreign Nations	<p>(a) Active duty officers and enlisted personnel of foreign nations when on duty with the U.S. Military Services under competent orders issued by the U.S. Army, Navy, Air Force, or Marine Corps. (Purchase of uniforms will be limited by the provisions of AR 12-15 and AFI 16-105(I).)</p> <p>(b) Excluded are active duty military personnel of foreign nations, retired, or on leave in the U.S., or when attending U.S. schools, but not under orders issued by the U.S. Army, Navy, Air Force, or Marine Corps.</p> <p>(c) Overseas, when determined by the Region Director IMCOM/MAJCOM that the granting of such privileges is in the best interest of the U.S. and such persons are connected with, or their activities are related to, the performance of functions of the U.S. military establishment.</p>
5. National Guard not in Federal Service	When called or ordered to duty in response to a Federally-declared disaster or national emergency, during the period of such duty, on the same basis as active duty members of the Armed Forces.
6. Red Cross Personnel	U.S. citizens assigned to duty outside the U.S. and Puerto Rico with an activity of the military Service. Uniform items are not authorized.
7. Civilian DoD Employees	When stationed outside the U.S., except when assigned to U.S. territories and possessions. Uniform items are not authorized.
8. Employees of Firms	When employed outside the U.S., except when assigned to U.S.

Under Contract to the DoD	territories and possessions. Uniform items are not authorized.
9. Wage Marine Personnel and Retired Wage Marine Personnel, Including Noncommissioned Ships' Officers and Crew Members of the NOAA	All
10. Authorized Family Members of Personnel in Paragraphs 1–9, above.	See definitions for description of "Family member."
11. Contract Surgeons	During the period of their contract with The Surgeon General.
12. Official DoD Activities	For activity purchase and use only (not for individual purchases or use). All purchases authorized for Government-wide purchase card use. All purchases authorized by 10 USC 2492. All other purchases based on sole source justification.
13. Non-DoD Federal Departments/Agencies	(a) For Federal department/agency purchases and use only (not for individual purchases or use). (b) When it is determined by the local commander that the desired supplies or services cannot be conveniently obtained elsewhere and the supplies or services can be furnished without unduly impairing the service to exchange patrons. (c) All purchases authorized by 10 USC 2492.
14. Dependents of Members of the Armed Forces, Commissioned Officers of the Public Health Service, and Commissioned Officers of the NOAA, Separated for Dependent Abuse	A dependent or former dependent entitled to transition compensation under 10 USC 1059, if not eligible under another provision of law, while receiving payments for transition compensation.
15. United Service Organizations (USO)	(a) USO personnel stationed outside the U.S. (b) USO clubs and agencies may purchase supplies for use in club snack bars, which support active duty military members and their families. (c) Overseas, garrison/installation commanders may extend privileges to USO area executives (directors, assistant directors) who are U.S. citizens on invitational travel orders, when it is in the capacity of the exchange and does not impair the exchange military mission. (d) Uniform items are not authorized.
16. Agents	Persons authorized in writing by the garrison/installation commander to shop for an authorized patron or official organization or activity entitled to unlimited exchange privileges. Agents are not authorized to shop for themselves.
17. Delayed Entry Program Participants	Authorized to use exchange facilities during interim period before entering active duty.
18. Armed Services Young Men's Christian Association of the	In overseas areas, garrison/installation commanders may extend privileges to ASYMCA branch or unit directors and assistant directors for their personal and Family needs and for use in

USA, Inc. (ASYMCA)	ASYMCA programs that support active duty military members and their Families, when it is in the capability of AAFES and does not impair the military mission. Uniform items are not authorized.
19. United Seaman's Service (USS)	Support to USS personnel for personal and Family needs and for supplies and services necessary to accomplish the USS mission when economic conditions or isolated locations are such that support is not available from local civilian sources, cannot be imported from other sources, or is available from local civilian sources or by importation only at prohibitive cost. The local commander may authorize access when available without detriment to DoD mission accomplishment.

*Source:* Department of Defense Instruction 1330.21, Armed Services Exchange (Washington, DC: Government Printing Office, 2005).

## APPENDIX B

### Authorized Revenue Generating Activities of Military Exchanges

All military exchanges operate under the same charter and authorities which are outlined in federal law and codified in Department of Defense Instructions (DODI). Enclosure 3 of DODI 1130.21 details revenue generating activities that military exchanges are authorized to operate. These include:

1. General Activities:

- a) Retail stores.
- b) Mail order, catalog, and ecommerce services.
- c) Automobile garages and service stations.
- d) Name brand fast food outlets (restaurants, cafeterias, and snack bars),

including nationally recognized franchises.

- e) Packaged beverage stores.
- f) Barber and beauty shops.
- g) Flower shops.
- h) Laundries, dry cleaning, and pressing.
- i) Tailor shops.
- j) Watch repair shops.
- k) Radio, television, computer, and electronic repair shops.
- l) Shoe repair shops.
- m) Photographic studios.
- n) Vending machines.
- o) Taxicab and bus services.

- p) Personal services.
- q) Newsstands.
- r) Pay telephone stations, telephone calling centers, and personal telecommunication services.
- s) Military Clothing Sales Operations.
- t) School Lunch Programs.
- u) Exchange Credit Programs.
- v) Tax Preparation Services.
- w) Exchange Marts.
- x) The Secretaries of the Military Departments may prescribe in their regulations a selection of food and beverages, including malt beverages, wines, and other alcoholic beverages. Food items shall supplement the primary full-line grocery service provided by the commissary system.

2. Activities which may be authorized by the secretary of each military department:

- a) Membership clubs (open messes), restaurants, cafeterias, and snack bars.
- b) Lodging, including Permanent Change of Station (PCS), guest houses and hostess houses.
- c) Amusement machines.
- d) Recreational, social, and family support activities.
- e) Pet Shops

3. The DoD has placed the responsibility for managing the list of stockage or sale items with the secretaries of each service. They are responsible for determining what items are to be stocked and sold and for complying with any regional restrictions.

4. Authorized activities with special restrictions include:

a) Fresh Meat and Produce Departments. Service secretaries may authorize the sale of fresh meat, fresh poultry, fresh seafood, fresh fruit, and produce when no commissary store is available on the installation or when fresh meat and produce is not available within a reasonable distance at a reasonable price, or in satisfactory quality and quantity. Other necessary grocery items may be sold without limitation in the number of items or container size.

b) Mini-Storage Facilities. Proposals for individual activities must be submitted 60 days in advance to the DoD for Congressional notification prior to approval.

c) Medical and Dental Services including Pharmacies. Proposals for medical services at specific locations must be submitted 60 days in advance to the DoD for Congressional notification. The DoD must approve the offering of new medical and dental services and shall notify Congress of such approval. Congressional notification and DoD approval must be obtained before exchanges initiate construction or contract action, including entering into any license agreement with private practitioners.

d) Firearms and ammunition are authorized exchange sale items. Firearms shall be sold in compliance with Federal laws and regulations. Overseas activities shall conform to all applicable Status of Forces Agreements (SOFA) requirements, as well as any requirements imposed by bilateral agreements between the United States and the host nation.



e) Name-Brand Fast-Food Operations. When establishing name-brand commercial fast-food operations, concession operations are preferred for military bases in the United States, and exchange direct-run operations are the preferred method for bases overseas. Both economic and non-economic factors shall be evaluated to decide on the method of operation that best meets the exchange mission for each location. In addition, the following factors shall be considered in the aggregate: financial risk, customer service, employment opportunities, management control, operational risk, and investment opportunities. Primary consideration shall be given to the overall quality of life and welfare of the active duty community.

f) Only Armed Services exchanges are permitted to sell, publicize, or display new or factory certified cars or motorcycles on overseas DoD installations. Exchanges may sell automobiles and motorcycles only to authorized patrons who are stationed or are assigned overseas for 30 consecutive days or more.

g) Alternative Fuels Armed Services exchanges may sell alternative fuels to the general public in compliance with 42 US. 6374, 42 USC 7586, and Executive Order 13149.

h) Cable Television Services. Armed Services exchanges may provide cable television services in compliance with 47 USC 548.

APPENDIX C

Extrapolated Income Statement and Balance Sheet Data

Table 22. Income Statement and Balance Sheet Data

	AAFES		NEX		MCX		INDUSTRY	
NUMBER OF EMPLOYEES	43,000	43,000	15,000	15,000	6,500	6,500	-	-
OPERATING YEAR	2006	2007	2006	2007	2006	2007	2006	2007
<b>INCOME STATEMENT</b>								
Sales Income	8,474,145	8,257,279	2,429,728	2,476,818	901,516	958,967	88,454,865	85,087,444
Concession Income	192,413	192,262	35,123	35,257	31,491	30,669	0	0
Finance / Other Revenue	225,242	242,820	0	0	1,450	1,116	0	0
Other Operating Income	29,648	12,122	83,741	88,946	29,218	33,446	0	0
Other Operating Income	0	0	0	0	33,458	29,967	0	0
Net Sales and Revenue	8,921,448	8,704,483	2,548,592	2,601,021	997,133	1,054,165	88,454,865	85,087,444
COGS & Operating Expenses	(6,671,722)	(6,424,307)	(1,901,732)	(1,938,029)	(632,931)	(677,026)	(60,750,801)	(58,344,460)
Gross Revenue or Income	2,249,726	2,280,176	646,860	662,992	364,202	377,139	27,704,064	26,742,984
Less: Operating Expenses:								
Emp Compensation & Benefits	(1,093,962)	(1,096,238)	(596,786)	(612,007)	(160,622)	(160,440)	(11,357,605)	(10,458,933)
Depreciation/Amortization Expense	(195,400)	(216,018)	0	0	0	0	(2,025,616)	(1,233,768)
Lease Expense	0	0	0	0	0	0	(1,839,861)	(1,900,828)
Bad Debt Expense	(16,940)	(12,505)	0	0	0	0	0	0
Other Expenses	(518,406)	(507,711)	0	(9,000)	(195,099)	(193,108)	(7,624,810)	(7,787,432)
Net Operating Expenses	(1,824,708)	(1,832,472)	(596,786)	(621,007)	(355,721)	(353,548)	(22,847,892)	(21,380,961)
Income From Core Operations	425,018	447,704	50,074	41,985	8,481	23,591	4,856,172	5,362,023
Extraordinary Income	61,474	43,985	4,401	6,031	14,495	13,461	0	0
Net Operating Income (EBIT)	486,492	491,689	54,475	48,016	22,976	37,052	4,856,172	5,362,023
Interest Expense	(59,011)	(49,906)	0	0	0	0	(831,476)	(876,401)
Net Income Before Taxes	427,481	441,783	54,475	48,016	22,976	37,052	4,024,696	4,485,622
Tax Expense	0	0	0	0	0	0	(1,368,397)	(1,523,065)
Net Income	427,481	441,783	54,475	48,016	22,976	37,052	2,656,299	2,962,557
EBITDA	681,892	707,707	54,475	48,016	22,976	37,052	6,881,788	6,595,791
<b>BALANCE SHEET</b>								
<b>Current Assets:</b>								
Cash	126,304	167,751	93,254	152,165	106,731	115,643	3,111,168	2,886,494
Marketable Securities	47,757	28,982	0	0	0	0	0	0
Accounts Receivable	2,476,203	2,749,591	0	0	159,492	211,557	2,700,901	2,297,856
Inventories	1,626,575	1,519,085	426,600	457,553	106,885	117,896	11,690,057	12,026,223
Supplies & Other Current Assets	37,774	36,314	612,396	919,075	4,212	6,071	1,666,614	1,595,826
Total Current Assets	4,314,613	4,501,723	1,132,250	1,528,793	377,320	451,167	19,168,740	18,806,399
<b>Gross Fixed Assets:</b>								
Land & Buildings (Fixed Assets)	2,215,677	2,415,525	0	0	739,025	768,083	12,350,566	13,817,149
Machinery and Equipment	996,607	982,148	0	0	0	0	8,985,203	9,064,690
Other	487,498	539,405	0	0	0	0	0	0
Total Gross Fixed Assets	3,699,782	3,937,078	0	0	739,025	768,083	21,335,769	22,881,839
Less: Accumulated Depreciation	1,840,883	1,945,060	0	0	380,271	373,255	0	0
Net Fixed Assets	1,858,899	1,992,018	0	0	358,754	394,828	21,335,769	22,881,839
Other Assets	2,079	4,321	0	0	82,463	123,446	0	0
Other Assets	903,845	1,515,681	0	0	0	0	0	0
Other Assets	372,395	357,015	0	0	0	0	0	0
Total Other Assets	1,278,319	1,877,017	0	0	82,463	123,446	0	0
Total Assets	7,451,831	8,370,758	1,132,250	1,528,793	818,537	969,441	40,504,509	41,688,238
<b>Current Liabilities:</b>								
Accounts Payable	701,755	765,031	242,618	278,315	60,754	63,503	5,792,145	8,541,920
Notes Payable	1,437,000	1,465,000	0	0	0	0	1,855,107	2,096,918

Accruals	114,573	153,119	0	0	0	0	0	0
Dividends Payable	46,376	70,204	0	0	0	0	0	0
Other Current Liabilities	169,780	240,019	127,566	136,832	223,814	312,232	5,354,696	4,589,872
<b>Total Current Liabilities</b>	<b>2,469,484</b>	<b>2,693,373</b>	<b>370,184</b>	<b>415,147</b>	<b>284,568</b>	<b>375,735</b>	<b>13,001,948</b>	<b>15,228,710</b>
Other Liabilities								
Accrued Pension & Other Benefits	400,620	775,898						
Other Noncurrent Liabilities	55,086	56,460	248,898	312,047	0	37,845	8,870,487	11,701,888
Pension Liability	(38,328)	108,435						
Other	1,145	3,731			12,358	11,799		
<b>Total Other Liabilities</b>	<b>418,523</b>	<b>944,524</b>	<b>248,898</b>	<b>312,047</b>	<b>12,358</b>	<b>49,644</b>	<b>8,870,487</b>	<b>11,701,888</b>
<b>Total Liabilities</b>	<b>2,888,007</b>	<b>3,637,897</b>	<b>619,082</b>	<b>727,194</b>	<b>296,926</b>	<b>425,379</b>	<b>21,872,435</b>	<b>26,930,598</b>
Stockholders' Equity								
Retained Earnings	4,563,824	4,732,861	513,168	801,599	521,611	544,062	18,632,074	14,757,640
<b>Total Stockholders' Equity</b>	<b>4,563,824</b>	<b>4,732,861</b>	<b>513,168</b>	<b>801,599</b>	<b>521,611</b>	<b>544,062</b>	<b>18,632,074</b>	<b>14,757,640</b>
<b>Total Liabs. &amp; Stockholders' Equity</b>	<b>7,451,831</b>	<b>8,370,758</b>	<b>1,132,250</b>	<b>1,528,793</b>	<b>818,537</b>	<b>969,441</b>	<b>40,504,509</b>	<b>41,688,238</b>
<i>Balance Sheet Reconciliation</i>	<i>\$0</i>	<i>\$0</i>	<i>\$0</i>	<i>\$0</i>	<i>\$0</i>	<i>\$0</i>	<i>\$0</i>	<i>\$0</i>
Average Inventory		1,572,830		442,077		112,391		11,858,140
Average Total Assets		7,911,295		1,330,522		893,989		41,096,374

Source: <sup>1</sup>AAFES Annual Report 2006 (Washington, DC: Government Printing Office, 2007). AAFES, Annual Report 2007 (Washington, DC: Government Printing Office, 2008).

<sup>2</sup>Naval Supply Systems Command and the Navy Exchange Command, 2006 Annual Report (Washington, DC: Government Printing Office, 2007). Naval Supply Systems Command and the Navy Exchange Command, 2007 Annual Report (Washington, DC: Government Printing Office, 2008).

<sup>3</sup>Marine Corps Community Services, Fiscal Year 2006 Annual Report (Washington, DC: Government Printing Office, 2007). Marine Corps Community Services, Fiscal Year 2007 Annual Report (Washington, DC: Government Printing Office, 2008).

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USACGSC  
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