

AAFMAA

2001

123rd Annual Report



I am pleased to submit the 2001 Annual Report of the Army and Air Force Mutual Aid Association. You will like what you read. There were many challenges during the year, but the officers, management and staff stayed focused, met every challenge and delivered outstanding results.

Three factors guide us in everything we do. You've seen these three factors as part of AAFMAA's advertising tag line and on our stationery. They encapsulate what makes AAFMAA special. They are: Stability, Reputation, and Low Cost. Let me provide some perspective on each of these.

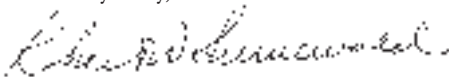
● **STABILITY.** AAFMAA has maintained sufficient and necessary reserves to support all insurance policy coverages for over 123 years. We have been around longer than the Brooklyn Bridge, the Statue of Liberty, the Eiffel Tower, the Kodak camera, the automobile, canned beer and Mother's Day. We have remained stable and steadfast through the Spanish-American War, Great Depression, both World Wars, Korean War, Vietnam War, Desert Storm, and countless conflicts. Wars come and go; we don't. AAFMAA was unaffected by the stock market crash of 1987 and, more recently, the dot com crash. Since implementing the crediting rate methodology, our crediting rate for Value-Added Whole Life policies has varied between 7.7% and 10.1%. We never have and never will reduce death benefits or fail to honor any other commitments. Every member can always count on AAFMAA — through thick or thin, tough times or easy times, war or peace.

● **REPUTATION.** As a member-owned, mutual insurance association, AAFMAA exists solely for the members and their families. Our reputation for attention to detail and responsiveness is well deserved. We maintain that reputation by having every member of the staff focus on members first. Our reputation is further enhanced by the way in which AAFMAA provides services for surviving widows and widowers of our deceased members. Our Survivor Assistance Services remain a hallmark of the Association and are part of every member's policy. Details of those services are included in the back cover of this report.

● **LOW COST.** We want every prospective and existing member to compare our low-cost premiums to every other insurance company. By demonstrating that AAFMAA is the best deal, soldiers and airmen will feel confident joining AAFMAA. The cost per policy has declined substantially since 1996 and was reduced an additional 18% from 2000 to 2001. Our low cost per policy and our high underwriting standards allow AAFMAA to provide insurance at unmatched premiums.

We're building on the past but focused on the future. On behalf of the entire Board of Directors, all serving without compensation, I thank you for the opportunity to serve this great Association and lead it to even greater achievements in the future.

Yours very truly,



Robert W. Sennewald
General, USA, Retired
Chairman of the Board



“My mother, my family and I are most grateful for the help and prompt assistance you have provided to us. We appreciated receiving your letter, the forms and the Army and Air Force Mutual settlement check on such a timely basis. They arrived at my mother's home while I was there earlier this week; thus I was able to help her with the forms and to ensure that she deposited the check.”

Sincerely yours,
Jeffrey R. Leighton, CPA

“It is comforting to know there are organizations like AAFMAA that not only recognize soldiers, but have their best interests in mind. Thanks again.”

*Wayne McPhillips
SFC, USAR
2001 Drill Sergeant of the Year*

**Message to the Army and Air Force
Mutual Aid Association**

April 1, 2002

Congratulations to the Army and Air Force Mutual Aid Association for its 123 years of dedicated service to our Nation’s Soldiers and Airmen. The Association’s legacy of support to Army families recognizes The Army’s dedication to its people – our Soldiers, civilians, retirees, veterans, and their families.

The magnificence of our moments as an Army have always been and will continue to be delivered by our people. Soldiers remain the centerpiece of our formations. We assure the Nation’s security by equipping and training them for victory, and caring for them in times of need. Organizations like the Army and Air Force Mutual Aid Association supplement that effort, offering life insurance and survivor services that augment our own and offer our families accessible choices in their own Well-Being.

On behalf of The Army, thank you for your important role and the services that you have made available over these many years, and best wishes for continued success. God bless you and your families, The Army, and our Nation.

Sincerely,



Eric K. Shinseki
General, United States Army

**Message to the Army and Air Force
Mutual Aid Association**

5 April 2002

The Army and Air Force Mutual Aid Association continues to provide outstanding services to the men and women of America's armed forces. We congratulate you on 123 years of excellence.

The tragic events of September 11th serve as a reminder of the tremendous cost associated with freedom. As it has throughout our nation's history, America's professional military force was called to defend our way of life. These warriors willingly place themselves in harms way to defend freedom-loving people everywhere. Regardless of where our forces travel, they have peace of mind knowing the Army and Air Force Mutual Aid Association stands beside them.

On behalf of the men and women of the United States Air Force, we salute your dedication and wish you continued success.



JOHN P. JUMPER
General, USAF

"I have been a member of AAFMAA since 1990, and my wife and I have been participating in the life insurance program with the last purchase in March 2002. I have found everyone at AAFMAA to be consistently professional, courteous and very responsive to all my questions and needs. Each is willing to provide assistance above and beyond what is normally expected."

*Michael Pavlisin
Col, USAFR, Retired*

Report of the President and Treasurer



"I commend everyone at AAFMAA on the excellent job you are doing in managing the Association's assets. I have recently transferred ALL my term life insurance requirements to AAFMAA. I also intend to recommend AAFMAA to other military peers who may have a need and/or interest in becoming members."

*Ralph D. Holweck
LTC, USA, Retired*

As General Sennewald illustrated, we are focused on doing our very best for AAFMAA members. The year 2001 has been challenging, but we set records in virtually every area. My report covers insurance in force, insurance policies, lives insured, membership, investments, financial results, and the crediting rate.

Insurance in Force. Our insurance in force grew from \$2.45 billion in 2000 to \$3.61 billion in 2001. This net increase of \$1.16 billion is the best result in Association history and over twice the growth of 2000. In fact, this one-year growth is greater than all the cumulative net insurance in force from our founding in 1879 through 1986. Competitive premium pricing, policy coverages up to \$500,000 and more aggressive marketing efforts contributed to this record growth.

Insurance Policies. Insurance policies, on a net basis, grew from 87,598 (including 341 Service Only policies) to 89,589, or 2.2%. More members are using AAFMAA to insure their entire family. The opportunity to insure spouses, children and grandchildren has contributed to the growth in the number of policies.

Lives Insured. While the membership grew by 1,283, spouses, children and grandchildren grew by 389. The growth in members and family members resulted in a total of 65,449 lives insured. This healthy expansion of 2.6% indicates that our competitive products address the needs of a broader market.

Membership. The number of Association members grew by 2% to an all-time high of 63,920. This indicates that our Association continues to evolve and become increasingly important to the soldiers and airmen of the Army and Air Force. During 2001, we achieved an objective sought since 1984 when members of the Air Force could first join the Association. The net membership growth reflects a balanced 50/50 split between Army and Air Force. We are truly one.

Investments. The \$3.61 billion insurance in force constitutes our liabilities. Our investments are the assets which enable us to meet those liabilities. Investments grew from \$662 million in 2000 to \$677 million in 2001. This \$15 million growth was achieved in a year when stock markets were not particularly kind. These assets, plus our future premium income and future investment earnings, will meet our \$3.61 billion of future liabilities. The \$677 million of investments is allocated as reflected in the Summary of Assets.

Financial Results. As mentioned above, the year 2001 included substantial market turbulence. In spite of that, our results for 2001 were very positive. Net Income totaled \$4.5 million. Recall that Net Income is the amount left after expenses,

death and other benefits paid, additions to members' policies, and term insurance premium rebates. In 2001 we paid \$20.6 million in death benefits, added \$22.2 million to member policies and insurance reserves and rebated \$380,000 to term policyholders. While setting records for insurance in force, policies, lives, and new members, General Administrative and Operating Expenses *declined* as a percentage of revenue from 8.8% to 7.6%. We actually *cut* these expenses by \$554,000 compared to 2000. This illustrates the care with which we treat your money. Continuing to control costs is imperative in achieving our goal of being the absolutely lowest cost provider of insurance.

Our Net Yield on Assets and Total Return for 2001 were each 6.1%. Considering the lower interest rates and the decline in equities markets during 2001, these returns validate our disciplined, consistent investment policies.

Consolidated Realty LLC, the Association's real estate equity investment arm, contributed to this outstanding financial result. The Net Rental Income for 2001 totaled \$2,547,104, an increase of 72% over 2000. Note that this result is *after depreciation*. The properties within Consolidated Realty, totaling 434,000 square feet of class A office space, had a 96% occupancy rate. Additional information on Consolidated Realty LLC is included later in this report.

Crediting Rate. Recall that the crediting rate is significantly influenced by the previous year's financial results and estimates of projected results. When setting the 2001 crediting rate (at the end of 2000) financial returns supported the crediting rate of 8.25% on Value-Added Whole Life policies for the year 2001. The crediting rate determines the amount of interest that is added to policy cash values each month. As cash values grow to sufficient levels, the insurance coverage grows. Recognizing that interest rates have declined, coupled with the stock market turbulence, (at the end of 2001) we determined that a crediting rate of 7.7% for 2002 would be a supportable and prudent crediting rate. Both the 8.25% crediting rate during 2001 and the 7.7% crediting rate for 2002 remain very competitive. As we repeatedly reinforce, crediting rates can vary from year to year, depending upon investment returns.

In summary, our Association had a record year. AAFMAA is larger, growing faster, and more financially sound than ever before. The officers of the Association and the management team have led the operations with efficiency, focus, and success. Most importantly, the staff of your Association has provided every member great service and great results. As President and Treasurer, I am honored to report to the membership on their successful efforts.

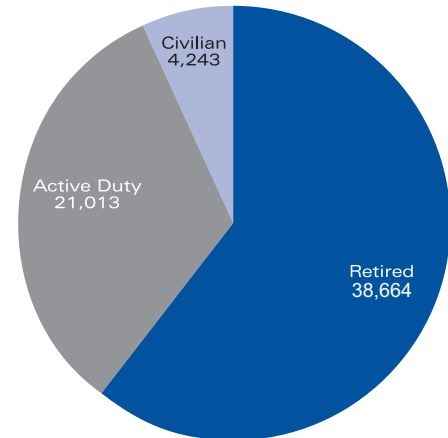
Walter R. Lincoln, CFP
President and Treasurer

AAFMAA Overview 2001

Comparative Highlights

	Year ended 31 December	
	2001	2000
Insurance in Force (\$ millions)	\$3,617.0	\$2,450.1
Total Reserves (\$ millions)	\$673.3	\$658.1
Number of members	63,920	62,637
Number of member deaths	826	772
Death benefits (\$ millions)	\$20.6	\$18.4
Net Yield on Assets	6.1%	6.6%
Total Portfolio Return	6.1%	10.6%
Expenses (% of gross revenue)	7.6%	8.8%

Member Profile



Surviving Spouses: 10,408

Statement of the Association Actuary A.C. Eddy, Inc., Norcross, GA

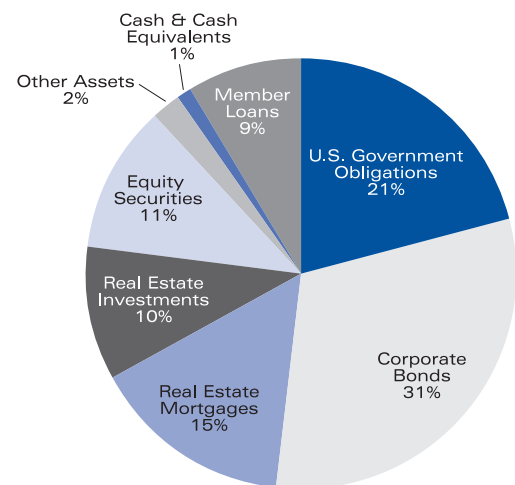
In my opinion the reserves of the Association are necessary and sufficient to provide for liabilities to its membership and will achieve the objective of distributing the Association's assets to members and/or their beneficiaries in an equitable manner.

*Arthur Crooks Eddy, FSA
President*

2001 Assets

Summary of Assets

Securities	Amortized Value	Market Value
U.S. Government Obligations	\$142,612,969	\$159,950,723
Corporate Bonds	211,630,187	214,794,344
Real Estate Mortgages	103,234,652	103,234,652
Real Estate Investments	68,469,952	82,432,000
Equity Securities	75,737,108*	75,737,108
Cash and Cash Equivalents	7,571,120	7,571,120
Accrued Investment Income	7,990,405	7,990,405
Total Securities	617,246,393	651,710,352
Member Loans	58,823,482	58,823,482
Property & Equipment		
Net of Accumulated Depreciation	887,174	887,174
Total Assets	\$676,957,049	\$711,421,008



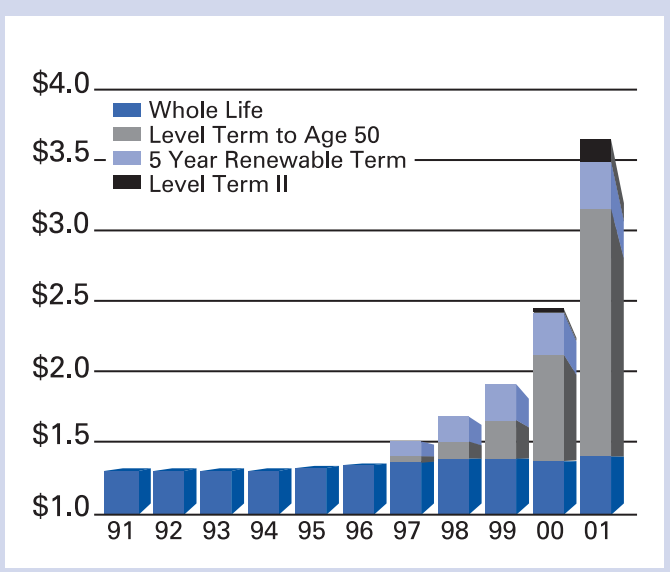
Total Assets: \$677 Million

*Equity Securities are valued at market.

Insurance in Force Statement

(includes family coverages)

Insurance in force, beginning of year	\$2,450,142,874
New insurance sold in 2001 . \$1,266,794,898	
Death benefit growth29,887,801
Death benefits incurred	(20,637,709)
Other terminations	(109,154,532)
Insurance in force, end of year	\$3,617,033,332

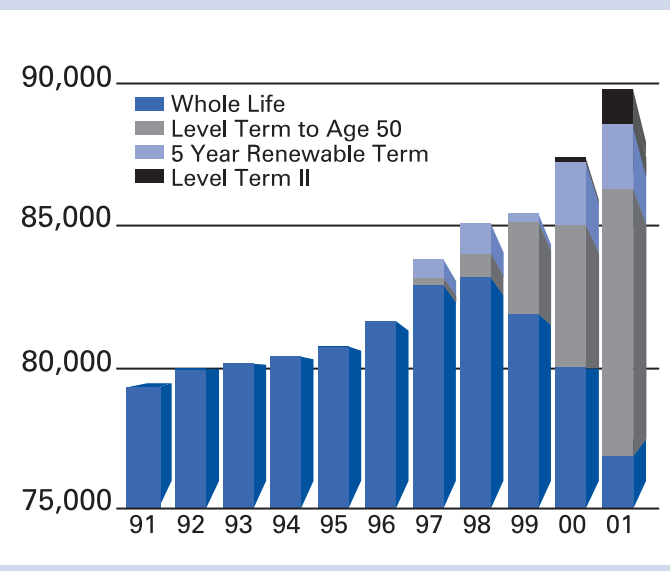


Insurance Policy Statement

(includes family coverages)

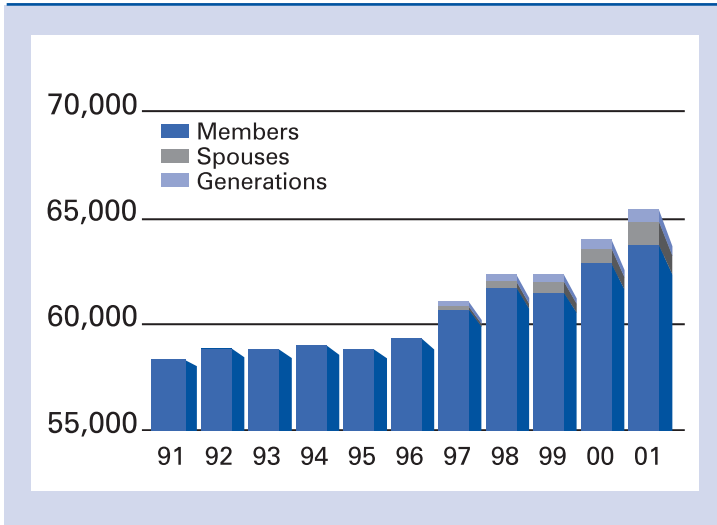
Insurance policies in force, beginning of year*	87,598
New policies issued	6,057
Policies matured by death	(1,150)
Other policy net terminations	(2,916)
Insurance policies in force, end of year	89,589

*Consists of 87,257 insurance policies and 341 Service Only (SO) policies, each of which carries a \$1,000 Accidental Death and Dismemberment policy. The SO policies were not included in the report for 2000.



Members and Lives Statement

(includes family coverages)



Members, beginning of year	.62,637
Gains	.4,466
Losses	.(3,183)
Members, end of year	.63,920
Spouses and Generations, beginning of year	.1,140
Gains	.433
Losses	.(44)
Spouses and Generations, end of year	.1,529
Total Lives	.65,449



REMINDER: In order to maintain status and services as a grandfathered member, grandfathered members must continuously satisfy two requirements: (1) continue in good standing as an AAFMAA member from and after 30 June 2000; and (2) continue in good standing at least one life insurance policy which was issued on or before 30 June 2000, which includes a charge for services, either embedded or additional. Free Service Only and Insurance Only members were excluded from being grandfathered. Any grandfathered member who terminates all life insurance policies issued prior to 1 July 2000 forfeits his or her grandfathered status. Every member's policy still includes Survivor Assistance Services to the member's family. To maintain current grandfathered services, no action is necessary so long as the two requirements are satisfied.

AAFMAA Mission

To be the premier provider of insurance and survivor services to the Army and Air Force communities.

"There IS an organization that really cares about its' members. DFAS recently made a terrible mistake in deducting my allotment. Instead of deducting \$169 they deducted \$1,696 leaving almost nothing. I called AAFMAA and explained what had happened. Though the mistake was not theirs, AAFMAA immediately wired the monies due directly to my bank account. Thanks to all the AAFMAA staff for their assistance."

Edgar A. Robertson
TSgt, USAF

VERKOUTEREN, AUERBACH & OLSON, L.L.P.

Certified Public Accountants

**850 SLIGO AVENUE, SUITE 400
SILVER SPRING, MARYLAND 20910-4703**

(301) 588-5572

FAX (301) 588-5262

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
Army and Air Force Mutual Aid Association
Arlington, Virginia

We have audited the accompanying statutory basis statements of assets, liabilities and reserves of Army and Air Force Mutual Aid Association as of December 31, 2001, and the related statutory basis statements of income and reserves and cash flows for the year then ended. These financial statements are the responsibility of the Association's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described more fully in Note 1 to the financial statements, the Association prepared these financial statements using accounting practices prescribed or permitted by the National Association of Insurance Commissioners, which practices differ from generally accepted accounting principles (GAAP). The effects on the financial statements of the variances between the statutory basis of accounting and GAAP, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present, and are not intended to present, in conformity with GAAP, the financial position of Army and Air Force Mutual Aid Association as of December 31, 2001, or the results of its operations or its cash flows for the year then ended.

In our opinion, the statutory basis financial statements referred to above do present fairly, in all material respects, the financial position of Army and Air Force Mutual Aid Association as of December 31, 2001, and the results of its operations and its cash flows for the year then ended, on the basis of accounting described in Note 1.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information (Summary of Assets - 31 December 2001) is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.



VERKOUTEREN, AUERBACH & OLSON, L.L.P.
SILVER SPRING, MARYLAND

March 15, 2002

Statement of Assets, Liabilities and Reserves

Statutory Basis
31 December 2001

Assets

Bonds

U.S. Government Obligations	\$142,612,969
Corporate Bonds	<u>211,630,187</u>

Total Bonds\$ 354,243,156

Real Estate Mortgages 103,234,652

Real Estate Investments 68,469,952

Equity Securities 75,737,108

Member Loans, net of allowance 58,823,482

Cash and Cash Equivalents 7,571,120

Accrued Investment Income 7,990,405

Property and Equipment, at cost

(less accumulated depreciation of \$1,044,328) 887,174

Total Assets\$ 676,957,049

Liabilities and Reserves

Liabilities

Death Benefits Payable	\$ 1,333,262
Accounts Payable	509,233
Deferred Revenue	1,572,325
Accrued Post-Retirement Benefits	<u>201,020</u>

Total Liabilities\$ 3,615,840

Reserves

Insurance and Other	\$567,621,574
Interest Maintenance	25,169,666
Asset Valuation	29,262,414
General Contingency	<u>51,287,555</u>

Total Reserves 673,341,209

Total Liabilities and Reserves\$ 676,957,049

See Auditor's Report and Accompanying Notes to the statutory basis Financial Statements

Statement of Income and Reserves

Statutory Basis

For the year ended 31 December 2001

Income

Premiums	\$ 15,411,258	
Dues	176,863	
Consideration for Supplemental Contracts	30,520	
Net investment income	39,930,541	
Amortization of interest maintenance reserve	<u>1,106,822</u>	\$ 56,656,004

Benefits and Expenses

Death benefits	\$ 20,637,709	
Surrender benefits	3,950,904	
Services benefits	2,437,108	
Premium refunds, term insurance	379,511	
Annuity payments	48,409	
Insurance expense		
Increase in aggregate reserves for life policies	9,947,817	
Increase in reserves for annuities	5,100	
Increase in other reserves	67,759	
General administrative and operating expenses	<u>4,326,314</u>	<u>(41,800,631)</u>

Net Income Before Excess Interest Credits

and Investment Transactions		14,855,373
Excess interest credited to members' policies		<u>(12,260,947)</u>

Net Income After Excess Interest Crediting

Net realized gain on investments (excluding interest maintenance reserve gains)		<u>1,911,416</u>
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Net Income

		<u>\$ 4,505,842</u>
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Reserve Transactions

Insurance and Other Reserves, Beginning of Year

Increase in reserves for life policies	\$ 9,947,817	
Increase in reserves for annuities	5,100	
Increase in other reserves	67,759	
Excess interest credited	<u>12,260,947</u>	
Net change in reserves for the year		<u>22,281,623</u>

Insurance and Other Reserves, End of Year

		<u>\$ 567,621,574</u>
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General Contingency Reserve, Beginning of Year

Net Income	\$ 4,505,842	
Change in unrealized appreciation of equity securities	(10,835,848)	
Change in asset valuation reserve	<u>431,308</u>	
Net change in reserves for the year		<u>(5,898,698)</u>

General Contingency Reserve, End of Year

		<u>\$ 51,287,555</u>
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See Auditor's Report and Accompanying Notes to the statutory basis Financial Statements

Statement of Cash Flows

Statutory Basis
For the year ended 31 December 2001

Cash Flows from Operating Activities

Net income		\$ 4,505,842
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of interest maintenance reserve	\$ (1,106,822)	
Equity earnings in subsidiaries	(3,546,722)	
Realized gains from investments	(430,513)	
Amortization/accretion of bond discounts/premiums	(5,843,804)	
Depreciation	120,770	
Bad debt expense	372,874	(10,434,217)
Changes in operating assets and liabilities:		
Increase in accrued investment income	\$ (360,878)	
Decrease in related party receivable	94,035	
Increase in death benefits payable	249,487	
Decrease in accounts payable	(150,099)	
Decrease in deferred revenue	(401,530)	
Decrease in accrued post-retirement benefits	(50,817)	
Net increase in life, annuities and other reserves	22,281,623	21,661,821
Net Cash Provided by Operating Activities		15,733,446

Cash Flows from Investing Activities

Member Loans Issued	\$ (29,836,972)
Member Loan Repayments	23,800,911
Securities Purchased	(44,581,736)
Securities Sold/Redeemed	28,311,148
Capital Contributions to Subsidiaries	(1,684,649)
Distribution from Subsidiaries	754,877
Property and Equipment Purchased	(57,898)

Net Cash Used in Investing Activities (23,294,319)

Decrease in Cash and Cash Equivalents (7,560,873)

Cash and Cash Equivalents at Beginning of Year 15,131,993

Cash and Cash Equivalents at End of Year \$ 7,571,120

See Auditor's Report and Accompanying Notes to the statutory basis Financial Statements

“AAFMAA’s \$5,000 Career Assistance Loan was my first introduction. I can honestly look anyone in the eye and tell them to call AAFMAA for their life insurance and know they will never go wrong. There’s not another military provider that works harder for their member’s best interest than AAFMAA.”

*Christopher S. Cutler
CPT, USA*

1. Significant Accounting Policies

The major accounting policies followed by the Association in the preparation of the financial statements are summarized herein. The accompanying financial statements have been prepared in conformity with statutory accounting practices. Although Army and Air Force Mutual Aid Association is not regulated by a state insurance department, these financial statements were prepared in conformity with accounting practices used by insurance companies for regulatory reporting purposes. Such accounting practices, referred to as prescribed or permitted practices, are a comprehensive basis of accounting other than generally accepted accounting principles. Because a major objective of state regulatory authorities is to protect the interests of policyholders, statutory accounting practices are oriented toward demonstrating the solvency of insurance companies and their ability to pay policyholder claims when those claims come due. Generally accepted accounting principles (GAAP) focus on a company’s operating performance from period to period on a going-concern basis. Management of the Association believes statutory accounting practices more conservatively measure the Association’s financial position and results of operations. The more significant categories of differences between statutory accounting practices and GAAP are summarized below:

- Valuation of investments in bonds
- Accounting for the costs of acquiring new business
- Calculation of certain reserves for policy contract benefits
- Designation of certain assets as “non-admitted” under statutory accounting practices
- Accounting for investment in subsidiaries
- Recording of an asset valuation reserve (AVR) and an interest maintenance reserve (IMR).

Cash and Cash Equivalents

Cash includes currency on hand and demand deposits with banks or other financial institutions. Cash equivalents are short-term highly liquid investments with original maturities of three months or less.

Investments

Investments are reported according to prescribed valuation procedures. Investments in bonds are reported at amortized value. Equity mutual funds are reported at fair market value. Real estate mortgage, member and Career Assistance Program (CAP) loans are reported at unpaid principal balances, or cost. The carrying values of mortgage

and CAP loans are periodically evaluated and adjusted for any perceived impairment in value.

Interest on bonds is recorded as investment income when earned and adjusted for any amortization of premium or accretion of discount. Dividends are recorded as income when earned. Interest income from mortgage and CAP loans is recorded when earned, except on loans in foreclosure or where collection is uncertain. There are currently six mortgage loans on three properties in default. There is one acquisition and one development loan on each property. The loans in default are 10.8% of the total mortgage loans outstanding. The terms of the default agreement allow the borrower a grace period. To prevent foreclosure, the borrower must pay principal, interest, accumulated interest, late fees and legal expenses before 15 April 2002. Each loan is fully collateralized by land parcels. The fair market value of the collateral is estimated to approximate the amount of the mortgages. CAP loans of approximately \$354,000 were written off during the year. This number represents about 1½% of total CAP loans outstanding as of year end.

Realized gains and losses on sales of investment securities are included in the Statement of Income and Reserves, except as noted in the Interest Maintenance Reserve section below. Unrealized gains and losses are included in the Contingency Reserves in the Statement of Assets, Liabilities and Reserves.

The summary of assets shows the amortized value and market value of each category of securities held by the Association. The mortgages held by the Association are private placements for which quoted market values are not available. For such securities, as well as member loans, cost is used as the market value.

The Association has two different types of real estate mortgage loans: those with a fixed interest rate, and those with a variable interest rate. The fixed interest rate loans have the same characteristics as conventional single-family mortgage loans, except that certain loans also require the borrower to pay a fixed amount of additional interest at prepayment or maturity of the loan. The variable interest rate loans have the borrower’s obligation to pay both minimum fixed interest and contingent interest. The contingent interest is either a stated amount within the terms of the loan or a stated percentage of one or more of (i) the net cash flow from the property, (ii) excess net refinancing proceeds from the property, (iii) net appreciation on the disposition of the property, (iv) gross proceeds from the sale of the property above a threshold amount, and/or (v) initial principal.

The Association has one wholly owned subsidiary, a Limited Liability Company (LLC). The LLC holds real estate properties with a total estimated market value of \$82,432,000. The investment in this wholly owned LLC is accounted for using the equity method.

Property and Depreciation

Property and equipment are capitalized as purchased and depreciated on a straight-line basis over their useful life, ranging from three to fifty years. Under statutory accounting practices, the depreciated cost of furniture, equipment and applications software are considered to be “non-admitted assets,” i.e. assets accorded no values because they do not conform to the laws and regulations of the various states. Since the Association is not regulated by any state due to its special exempt status, management has chosen not to reflect these categories of property and equipment as non-admitted assets. The Association holds \$279,239 of net assets categorized in Property and Equipment on the statement of Assets, Liabilities and Reserves, which would otherwise be reported as non-admitted.

Use of Estimates

The process of preparing financial statements requires the use of estimates and assumptions regarding certain types of assets, liabilities, revenues and expenses. Such estimates primarily relate to unsettled transactions and events as of the date of the financial statements. Accordingly, upon settlement, actual results may differ from estimated amounts.

Actuarial Reserves

Actuarial reserves for all plans are equal to the sum of the individual benefit plan accumulation values but not less than the minimum cash value for each policy. The Association holds certain additional reserves at 31 December 2001 such that the sum of accumulation values and these additional reserves are equal to or greater than minimum reserves for such policies as prescribed by the National Association of Insurance Commissioners (NAIC) for regulated insurers.

Excess interest credits, as reflected in the statement of income and reserves, equal the amount credited to cash value accounts in excess of statutory minimums.

Interest Maintenance Reserve/Asset Valuation Reserve

An interest maintenance reserve (IMR) is maintained based upon a formula prescribed by the NAIC for the purpose of capturing the realized gains and losses resulting from changes in the overall level of interest rates. These realized gains and losses are then amortized into income over the approximate remaining life of the investments sold. An asset valuation reserve (AVR) is maintained

based upon a formula prescribed by the NAIC for the purpose of providing for default and equity risks related to the Association’s invested assets.

Concentration of Credit Risk

The Association has a concentration of credit risk in that a majority of its Real Estate Mortgages is held for properties or construction in the Washington, DC metropolitan area. Likewise, the Real Estate Investments consist of real estate located in the Northern Virginia area.

Income Taxes

The Association is a tax-exempt, non-profit association as described in section 501(c)(23) of the Internal Revenue Code.

2. Nature of Business

The Association, a 123-year-old non-profit service organization with over 63,000 members, is dedicated to providing low-cost life insurance and to aiding its members and the families of deceased members in a prompt, simple and substantial manner. Members consist of active, reserve and retired officers, warrant officers and non-commissioned officers and soldiers and airmen of the United States Army and United States Air Force, as well as cadets serving at the US Military Academy and at the US Air Force Academy, and cadets with ROTC scholarships and contracts. The spouses, children and grandchildren of members may also be insured by the Association however, spouses, children, and grandchildren are NOT members unless qualified as such in their own right. The Association provides interest-sensitive whole life and term life insurance protection.

3. Related-Party Transactions

Armed Forces Services Corporation (AFSC) is a for-profit, Virginia non-stock corporation created 1 July 2000. This organization resulted from the spin-off of the services department of the Association. As part of the Association, this department provided the various services to the Association’s members, i.e., financial awareness and income protection counseling, assistance in applying for entitlement benefits, and storage of documents.

For all Association members who were such before 1 July 2000, and maintain their grandfathered status, these services will always continue. In order to maintain status and services as a grandfathered member, grandfathered members must continuously satisfy two requirements: (1) continue in good standing as an AAFMAA member from and after 30 June 2000; and (2) continue in good standing at least one life insurance policy which was issued on or before 30 June 2000, which includes a charge for services, either embedded or additional. Free Service Only and Insurance Only members were excluded from being grandfathered. Any grandfathered member who terminates all life insurance policies issued before 1 July 2000 forfeits his or her grand-

“Thanks for your assistance on the phone. I will definitely spread the word. AAFMAA’s insurance policy is better and less expensive than both my SGLI and Armed Forces Benefit Association policies.”

*Kevin L. Curry
CW2, USA*

fathered status. Every member's policy still includes Survivor Assistance Services to the member's family. To maintain current grand-fathered services, no action is necessary so long as the two requirements are satisfied.

The Association signed a ten-year contract with AFSC to provide these continuing services. For the year ended 31 December 2001, the Association incurred servicing expenses of \$2,437,108.

In 2000, the Association guaranteed two loans for AFSC, a six-year term loan for long-term start-up expenses of \$1,700,000, and a one-year line of credit for \$500,000 to provide working capital funds. AFSC signed a promissory note to AAFMAA for the amount of both the guaranteed loans. Under the guarantee agreement, AFSC agrees to pay AAFMAA a fee for the guarantee in the amount of 7% of the amount borrowed. AFSC did not borrow on the line of credit and it expired during 2001. AFSC borrowed \$1,000 on the long-term loan in June 2001. AFSC's loan with the lender contained a clause that stipulated that advances on this loan were available only until 30 June 2001. Therefore, AFSC is no longer able to draw additional funds under this loan. As of 31 December 2001, the outstanding balance on the loan remains at \$1,000. This long-term loan matures in February 2007. Therefore, AAFMAA is liable as a guarantor for the outstanding amount of \$1,000 as of 31 December 2001, until such time as AFSC has repaid the loan. Correspondingly, AFSC has paid AAFMAA its 7% guarantee fee monthly since the borrowing occurred.

The property, credit enhancement and intangible benefits provided by AAFMAA to AFSC were carefully valued to assure AAFMAA members and the Internal Revenue Service that no "private inurement" was given by non-profit AAFMAA to for-profit AFSC and to assure the AFSC Board that it was being asked to pay a fair price for the benefits it received. PriceWaterhouseCoopers provided a third party valuation of the intangible benefits ("going concern" value) to assure that intangible benefits were neither under-valued nor over-valued. The valuation amount of \$644,800, owed by AFSC to the Association, is not reflected in the Statement of Assets, Liabilities and Reserves. It will be reflected in the financial statements at such time when payment is received. The valuation amount incurred interest at a rate based upon AAFMAA's total return from the previous year (9.2% through 30 June 2001 and 10.6% from 1 July 2001 through 31 December 2001). Accumulated interest amounted to \$65,444 as of 31 December 2001. The total amount owed to AAFMAA by AFSC is \$710,244 as of 31 December 2001.

4. Employee Benefits

Retirement Plan

The Association has a 401(k) and profit-sharing plan that covers all employees who meet certain minimum eligibility requirements. The Association may contribute as a matching contribution up to 5% of

employee elective deferrals. In addition, it may contribute an amount equal to 3% of compensation. The total retirement plan expense for the year ended 31 December 2001 was \$234,470, which includes \$119,976 of employees' elective deferrals.

Other

As a cost containment measure effective March 2001, the Association terminated the Short Term Disability coverage to employees.

5. Post-Retirement Benefits

The Association previously sponsored a post-retirement health care plan and a post-retirement life insurance plan for its retirees. The post-retirement health care plan is contributory, with retiree contributions of 60%, and has been eliminated except for retirees already covered by the plan. In another cost containment measure effective March 2001, the Association terminated post-retirement dental care coverage except for retirees already covered by the plan. As a result of this termination, current full-time employees received compensation as a one-time pay-out of post-retirement dental benefits totaling \$43,260. The life insurance plan was non-contributory, and has also been eliminated except for retirees already covered by the plan. The post-retirement expense for the year ended 31 December 2001 was approximately \$27,700.

6. Reinsurance

Reinsurance is provided for catastrophes defined as an accident, including war risk, arising out of one event or occurrence resulting in the death of three or more insureds. This agreement is subject to a deductible of \$750,000, with a maximum reimbursement of \$500,000 per insured and \$10,000,000 per loss occurrence, \$30,000,000 annual in aggregate. Such reimbursement does not discharge the primary liability of the Association as direct insurer of the risks insured. The Association evaluates the financial strength of potential reinsurers and continually monitors the financial condition of the reinsurer. For the year ended 31 December 2001, the Association incurred premiums of \$44,727 for reinsurance.

7. Commitments

The Association has committed \$2,417,750 to the Armed Forces Services Corporation for the performance of services to our members for 2002. Since 31 December 2001, the Association has committed to fund approximately \$19,870,000 for commercial real estate loans and \$6,015,000 for the purchase of corporate bonds.

8. Land Lease

In December 1998, the Association entered into a 30-year lease with the Department of the Army to lease the land upon which the Association's building rests. The annual lease payment is \$11,700, with an evaluation of the fair market rental value to be performed every five years.

"My first policy with AAFMAA goes back to 1947 and have added two more since then. They have done exceptionally well and are excellent examples of the "Principal of Compounding". As a near octogenarian, I am pleased to know you folks are standing by ready to lend a helping hand when the time comes."

*Carl K. Russell
LTC, USA, Retired*

Consolidated Realty LLC is wholly owned by AAFMAA and serves as AAFMAA's real estate equity investment arm. Consolidated Realty helps diversify AAFMAA's investment portfolio and strives to generate a rate of return equal to or exceeding the historical rate of return on real estate equity, adjusted for inflation. This is accomplished by offering exceptional value to tenants through a focus on providing class A office space and superior services. Consolidated Realty expands its holdings by either constructing buildings on its own land or by purchasing existing properties, whichever offers the more attractive option.

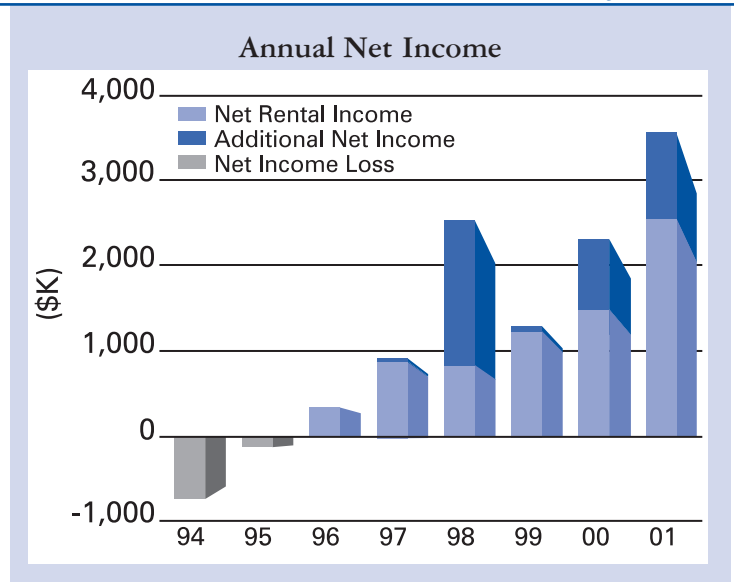
Consolidated Realty was formed in 1994 to eliminate losses and introduce efficiencies among real estate investment properties owned by AAFMAA. Two factors continue to be responsible for improved performance: (1) greater attention by management, and (2) additional capital contributions.

Management's attention is focused on maintaining high occupancy rates. As of December 2001, Consolidated Realty's occupancy rate of 96% was well above the market occupancy rate of 73%. High occupancy rates increase net rental income and also provide for consistent cash flow, improving overall performance.

Consolidated Realty's most recent project was the construction of an office building at 1775 Wiehle Avenue in Reston, VA. This project required capital contributions beginning in June 2000. The project began to generate rental income in June 2001, and is 100% leased. All leases commenced by August 2001.

The chart at right depicts the growth in net income since Consolidated Realty's formation in 1994. Included in this chart are net rental income, or loss, and additional income earned from property sales, interest income, and reimbursements for tenant improvements.

The photos are a representative sample of the 6 buildings owned by Consolidated Realty.



1450 Newbrook Drive – Completed in August 1999



14155 Newbrook Drive – Completed in November 2000



1775 Wiehle Avenue – Completed in June 2001

“As an AAFMAA member, and as Director of Administration for Piper Marbury Rudnick and Wolfe, one of Consolidated Realty's prime tenants, I'm impressed by the quality of personnel representing Consolidated. With 20 years of experience dealing with numerous landlords, I rate Consolidated as one of the best.”

*Robert F. Carr
COL, USA, Retired*

“Graduating from West Point in 1939, I signed up for my first insurance policy from AAFMAA. I can only say they have always displayed the highest integrity and willingness to help. Now that I’m retired, the comfort in knowing they will be there for my family with their Survivor Assistance Services is truly gratifying. They have earned my trust and deserve our enthusiastic support. I strongly recommend that every eligible military person join their ranks.”

*George E. Pickett
LTG, USA, Retired*

In 1876 Lieutenant Colonel George Armstrong Custer (former brevet Major General) led his ill-fated expedition against the Cheyenne and Sioux in Dakota Territory. The ensuing massacre of the 7th Cavalry at the Battle of Little Big Horn starkly emphasized the desperate circumstances of bereaved Army families of that era.

When a death occurred on the frontier, the family was usually in need, and the Army’s method of resolving those needs was a literal “passing of the hat” to raise money to transport dependents “back East” to the care of relatives and friends. In the case of the 7th Cavalry, the old system collapsed. There were no survivors; there was no hat to pass-and no one to pass it to! Thence came the impetus to establish an in-house benefit society. As a result, on 13 January 1879, the Army Mutual Aid Association was created and adopted its Constitution. Those documents were prepared by a Committee chaired by Lieutenant Colonel Roger Jones, Assistant Inspector General of the Army. They expressed the purpose of the Association as “to aid the families of the deceased members in a prompt, simple and substantial manner”. The first Certificate of Membership and Insurance was issued to the first President of the Association, the same Lieutenant Colonel Roger Jones on 3 February 1879.

Since then, its active supporters and officers have included Generals Philip H. Sheridan, Abner N. Doubleday, John J. Pershing, George C. Marshall, Dwight D. Eisenhower, Henry H. (Hap) Arnold, Carl A. (Tooe) Spaatz, Omar N. Bradley, Maxwell D. Taylor, Lyman L. Lemnitzer, George H. Decker, Harold K. Johnson, William C. Westmoreland, Creighton W. Abrams, Fred C. Weyand, Bernard W. Rogers, Edward C. Meyer, John A. Wickham, Jr., Walter T. “Dutch” Kerwin, Michael S. Davison, H. Norman Schwarzkopf, Ronald R. Fogleman, and Michael E. Ryan.

In 1984, the Association’s members voted to make Air Force officers eligible to join. In 1987, the name was officially changed to the Army and Air Force Mutual Aid Association (AAFMAA). In 1995, the Association’s members voted to expand membership to include noncommissioned officers and raise the age limit for admitting new members from 60 to 66 years. In 2000, the Association’s members voted to include all enlisted ranks of the Army and Air Force within the eligible categories of membership. Also, in 2000, a corporation comprised of former AAFMAA employees was created and member services were contracted out to the Armed Forces Services Corporation (AFSC), based upon approval at the Annual Meeting.

For more than 123 years, the Association has offered its members permanent life insurance at a minimum cost and has provided immediate cash to the bereaved families of its members. It has withstood the losses of various military campaigns and weathered the financial crises of those years. Today the Association is even more sound and secure and also offers term life insurance. Spouses, children, and grandchildren of members are also eligible to purchase these life insurance plans.

Each member’s policy includes Survivor Assistance Services to assist with expeditious payment, claims initiation, claims representation and lifetime generic benefit notification for the bereaved spouses and children of its’ members.

With no paid agents, AAFMAA relies on its members for support and assistance in bringing the benefits of membership to the attention of those eligible for membership.

Every eligible U.S. Army and Air Force Officer, Warrant Officer, Noncommissioned Officer and soldier and airman should become a member of AAFMAA. Every member is urged to inform their families of the assistance the Association provides at the time of death, and recommend membership to others eligible for membership.

Army and Air Force Mutual Aid Association

102 Sheridan Avenue • Fort Myer, VA 22211-1110

Toll Free: 1-866-4AAFMAA (422-3622) • Local: 703-522-3060 • FAX: 703-522-1336

E-mail: info@aafmaa.com • Web Site: www.aafmaa.com

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Night depository at Fort Myer