

## Management's Discussion and Analysis of Financial Condition and Results of Operations

### **Executive Summary**

Expeditors International of Washington, Inc. is engaged in the business of global logistics management, including international freight forwarding and consolidation, for both air and ocean freight. The Company acts as a customs broker in all domestic offices, and in many of its international offices. The Company also provides additional services for its customers including value-added distribution, purchase order management, vendor consolidation and other logistics solutions. The Company does not compete for overnight courier or small parcel business. The Company does not own or operate aircraft or steamships.

International trade is influenced by many factors, including economic and political conditions in the United States and abroad, currency exchange rates, and United States and foreign laws and policies relating to tariffs, trade restrictions, foreign investments, taxation, regional and global conflicts. Periodically, governments consider a variety of changes to current tariffs and trade restrictions. The Company cannot predict which, if any, of these proposals may be adopted, nor can the Company predict the effects the adoption of any such proposal will have on the Company's business. Doing business in foreign locations also subjects the Company to a variety of risks and considerations not normally encountered by domestic enterprises. In addition to being influenced by governmental policies concerning international trade, the Company's business may also be affected by political developments and changes in government personnel or policies in the nations in which it does business.

The Company derives its revenues from three principal sources: 1) airfreight, 2) ocean freight, and 3) customs brokerage and other services. These are the revenue categories presented in the financial statements.

The Company is managed along four geographic areas of responsibility: The Americas; Asia; Europe, Africa, Near/Middle East and Indian Subcontinent (EMAIR); and Australasia. Each area is divided into sub-regions which are composed of operating units with individual profit and loss responsibility. The Company's business involves shipments between operating units and typically touches more than one geographic area. The nature of the international logistics business necessitates a high degree of communication and cooperation among operating units. Because of this inter-relationship between operating units, it is very difficult to look at one geographic area and draw meaningful conclusions as to its contribution to the Company's overall success on a stand-alone basis.

The Company's operating units share revenue using the same arms-length pricing methodologies the Company uses when its offices transact business with independent agents. The Company's strategy closely links compensation with operating unit profitability. Individual success likely involves cooperation with other operating units.

As a non-asset based carrier, the Company does not own transportation assets. Rather, the Company generates the major portion of its air and ocean freight revenues by purchasing transportation services from direct (asset-based) carriers and reselling those services to its customers. The difference between the rate billed to customers (the sell rate), and the rate paid to the carrier (the buy rate) is termed "net revenue" or "yield." By consolidating shipments from multiple customers and concentrating its buying power, the Company is able to negotiate favorable buy rates from the direct carriers, while at the same time offering lower sell rates than customers would otherwise be able to negotiate themselves.

Customs brokerage and other services involves providing services at destination, such as helping customers clear shipments through customs by preparing required documentation, calculating and providing for payment of duties and other taxes on behalf of the customers as well as arranging for any required inspections by governmental agencies, and arranging for delivery. This is a complicated function requiring technical knowledge of customs rules and regulations in the multitude of countries in which the Company has offices.

The Company's ability to provide services to its customers is highly dependent on good working relationships with a variety of entities including airlines, ocean steamship lines, and governmental agencies. The significance of maintaining acceptable working relationships with governmental agencies and asset-based providers involved in global trade has gained increased importance as a result of ongoing concern over terrorism. As each carrier labors to comply with governmental regulations implementing security policies and procedures, inherent conflicts emerge which can and do affect global trade to some degree. A good reputation helps to develop practical working understandings that will effectively meet security requirements while minimizing potential international trade obstacles. The Company considers its current working relationships with these entities to be satisfactory. However, changes in space allotments available from carriers, governmental deregulation efforts, "modernization" of the regulations governing customs brokerage, and/or changes in governmental quota restrictions could affect the Company's business in unpredictable ways.

Historically, the Company's operating results have been subject to a seasonal trend when measured on a quarterly basis. The first quarter has traditionally been the weakest and the third and fourth quarters have traditionally been the strongest. This pattern is the result of, or is influenced by, numerous factors including climate, national holidays, consumer demand, economic conditions and a myriad of other similar and subtle forces. In addition, this historical quarterly trend has been influenced by the growth and diversification of the Company's international network and service offerings. The Company cannot accurately forecast many of these factors nor can the Company estimate accurately the relative influence of any particular factor and, as a result, there can be no assurance that historical patterns, if any, will continue in future periods.

A significant portion of the Company's revenues are derived from customers in retail industries whose shipping patterns are tied closely to consumer demand, and from customers in industries whose shipping patterns are dependent upon just-in-time production schedules. Therefore, the timing of the Company's revenues are, to a large degree, impacted by factors out of the Company's control, such as a sudden change in consumer demand for retail goods and/or manufacturing production delays. Additionally, many customers ship a significant portion of their goods at or near the end of a quarter, and therefore, the Company may not learn of a shortfall in revenues until late in a quarter. To the extent that a shortfall in revenues or earnings was not expected by securities analysts, any such shortfall from levels predicted by securities analysts could have an immediate and adverse effect on the trading price of the Company's stock.

As further discussed under liquidity and capital resources, total capital expenditures in 2007 are expected to exceed \$106 million.

In terms of the opportunities, challenges and risks that management focused on in 2006, the Company operates in 60 countries throughout the world in the competitive global logistics industry and Company activities are tied directly to the global economy. From the inception of the Company, management has believed that the elements required for a successful global service organization can only be assured through recruiting, training, and ultimately retaining superior personnel. The Company's greatest challenge is now and always has been perpetuating a consistent global culture which demands:

- Total dedication, first and foremost, to providing superior customer service;
- Aggressive marketing of all of the Company's service offerings;
- Ongoing development of key employees and management personnel via formal and informal means;
- Creation of unlimited advancement opportunities for employees dedicated to hard work, personal growth and continuous improvement;
- Individual commitment to the identification and mentoring of successors for every key position so that when inevitable change is required, a qualified and well-trained internal candidate is ready to step forward; and
- Continuous identification, design and implementation of system solutions, both technological and otherwise, to meet and exceed the needs of our customers while simultaneously delivering tools to make our employees more efficient and more effective.

The Company has reinforced these values with a compensation system that rewards employees for profitably managing the things they can control. There is no limit to how much a key manager can be compensated for success. The Company believes in a “real world” environment in every operating unit where individuals are not sheltered from the profit implications of their decisions. At the same time, the Company insists on continued focus on such things as accounts receivable collection, cash flow management and credit soundness in an attempt to insulate managers from the sort of catastrophic errors that might end a career.

Any failure to perpetuate this unique culture on a self-sustained basis throughout the Company, provides a greater threat to the Company’s continued success than any external force, which would be largely beyond our control. Consequently, management spends the majority of its time focused on creating an environment where employees can learn and develop while also building systems and taking preventative action to reduce exposure to negative events. The Company strongly believes that it is nearly impossible to predict events that, in the aggregate, could have a positive or a negative impact on future operations. As a result our focus is on building and maintaining a global culture of well-trained employees and managers that are prepared to identify and react to subtle changes as they develop and thereby help the Company adapt and thrive as major trends emerge.

### **Critical Accounting Estimates**

A summary of the Company’s significant accounting policies can be found in Note 1 to the consolidated financial statements in this Annual Report.

Management believes that the nature of the Company’s business is such that there are few, if any, complex challenges in accounting for operations.

While judgments and estimates are a necessary component of any system of accounting, the Company’s use of estimates is limited primarily to the following areas that in the aggregate are not a major component of the Company’s statement of earnings:

- accounts receivable valuation;
- the useful lives of long-term assets;
- the accrual of costs related to ancillary services the Company provides;
- establishment of adequate insurance liabilities for the portion of the freight related exposure which the Company has self-insured; and
- accrual of tax expense on an interim basis.

Management believes that the methods utilized in all of these areas are non-aggressive in approach and consistent in application. Management believes that there are limited, if any, alternative accounting principles or methods which could be applied to the Company’s transactions. While the use of estimates means that actual future results may be different from those contemplated by the estimates, the Company believes that alternative principles and methods used for making such estimates would not produce materially different results than those reported.

As described in Note 1 to the consolidated financial statements in this report, effective January 1, 2006, the Company adopted SFAS 123R. This accounting standard requires the recognition of compensation expense based on an estimate of the fair value of options granted to employees and directors under the Company’s stock option and employee stock purchase plans.

This expense is recorded ratably over the option vesting periods. The Company elected to utilize the modified retrospective method of adoption and has restated all prior periods to recognize the required stock compensation expense in accordance with the requirements of SFAS 123R.

Determining the appropriate option pricing model to use to estimate stock compensation expense requires judgment. Any option pricing model requires assumptions that are subjective and these assumptions also require judgment. Examples include assumptions about long-term stock price volatility, employee exercise patterns, pre-vesting option forfeitures, post-vesting option terminations, and the interest rates and dividend yields.

The Company has historically used the Black-Scholes model for estimating the fair value of stock options in providing pro forma fair value disclosures pursuant to SFAS No. 123, "Accounting for Stock-Based Compensation" (SFAS 123). After a review of alternatives, and considering the guidance outlined in Securities and Exchange Commission Staff Accounting Bulletin No. 107 (SAB 107), the Company has decided to continue to use this model for estimating the fair value of stock options granted subsequent to the adoption of SFAS 123R.

In reviewing the propriety of measurements and assumptions used historically to calculate compensation expense for disclosure purposes, management considered the guidance contained in SAB 107, even though all the Company's stock options had previously been granted under SFAS 123, as opposed to SFAS 123R, for which SAB 107 was expressly written. The Company began granting options under SFAS 123R in the second quarter of 2006. Refer to Note 5D in the consolidated financial statements for the assumptions used for grants issued during the years ended December 31, 2006, 2005 and 2004. The assumptions used by the Company for estimating the fair value of options granted under SFAS 123R were developed on a basis consistent with assumptions used for valuing previous grants.

Management believes that these assumptions are appropriate, based upon the requirements of SFAS 123, SFAS 123R, the guidance included in SAB 107 and the company's historical and currently expected future experience. Looking to future events, management has been strongly influenced by historical patterns which may not be valid predictors of future developments and any future deviation may be material.

The Company's expected volatility assumptions are based on the historical volatility of the Company's stock. The expected life assumption is primarily based on historical employee exercise patterns and employee post-vesting termination behavior. The risk-free interest rate for the expected term of the option is based on the corresponding yield curve in effect at the time of grant for U.S. Treasury bonds having the same term as the expected life of the option, i.e. a ten year bond rate is used for valuing an option with a ten year expected life. The expected dividend yield is based on the Company's historical experience. The forfeiture rate used to calculate compensation expense is primarily based on historical pre-vesting employee forfeiture patterns.

The use of different assumptions would result in different amounts of stock compensation expense. Keeping all other variables constant, the indicated change in each of the assumptions below increases or decreases the fair value of an option (and the resulting stock compensation expense), as follows:

Assumption	Change in assumption	Impact of fair value of options
Expected volatility	Higher	Higher
Expected life of option	Higher	Higher
Risk-free interest rate	Higher	Higher
Expected dividend yield	Higher	Lower

The fair value of an option is more significantly impacted by changes in the expected volatility and expected life assumptions. The pre-vesting forfeitures assumption is ultimately adjusted to the actual forfeiture rate. Therefore, changes in the forfeitures assumption would not impact the total amount of expense ultimately recognized over the vesting period. Different forfeitures assumptions would only impact the timing of expense recognition over the vesting period. Estimated forfeitures will be reassessed in subsequent periods and may change based on new facts and circumstances.

### Recent Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (FASB) ratified the Emerging Issues Task Force (EITF) Issue 06-3, "How Taxes Collected From Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement," (EITF 06-3). The scope of EITF 06-3 includes any tax assessed by a governmental authority that is both imposed on and concurrent with a specific revenue-producing transaction between a seller and

a customer, including but not limited to sales and value-added taxes. In EITF 06-3 a consensus was reached that entities may adopt a policy of presenting these taxes in the income statement on either a gross or net basis. If these taxes are significant, an entity should disclose its policy of presenting taxes and the amount of taxes if reflected on a gross basis in the income statement. EITF 06-3 is effective for interim and annual reporting periods beginning after December 15, 2006. The Company is required to and plans to adopt EITF 06-3 in the first quarter of 2007. The Company presents revenues net of sales and value-added taxes in its consolidated statement of earnings and does not anticipate changing its policy as a result of the adoption of EITF 06-3.

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109", (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in the Company's financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes" (SFAS 109). The interpretation establishes guidelines for recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is required to and plans to adopt the provisions of FIN 48 beginning in the first quarter of 2007. The Company does not expect the adoption of FIN 48 to have a material impact on the Company's consolidated financial condition or results of operations.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is required to and plans to adopt the provisions of SFAS 157 beginning in the first quarter of 2008. The Company is currently assessing the impact of the adoption of SFAS 157.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS 159). Under the provisions of SFAS 159, Companies may choose to account for eligible financial instruments, warranties and insurance contracts at fair value on a contract-by-contract basis. Changes in fair value will be recognized in earnings each reporting period. SFAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is required to and plans to adopt the provisions of SFAS 159 beginning in the first quarter of 2008. The Company is currently assessing the impact of the adoption of SFAS 159.

### **Results of Operations**

The following table shows the consolidated net revenues (revenues less transportation expenses) attributable to the Company's principal services and the Company's expenses for 2006, 2005, and 2004, expressed as percentages of net revenues. Management believes that net revenues are a better measure than total revenues of the relative importance of the Company's principal services since total revenues earned by the Company as a freight consolidator include the carriers' charges to the Company for carrying the shipment whereas revenues earned by the Company in its other capacities include only the commissions and fees actually earned by the Company.

	2006		2005		2004	
	Amount	Percent of net revenues	Amount	Percent of net revenues	Amount	Percent of net revenues
<i>Net revenues:</i>						
<b>Airfreight</b>	<b>\$ 470,638</b>	<b>37%</b>	\$ 391,773	37%	\$ 348,949	39%
<b>Ocean freight and ocean services</b>	<b>322,580</b>	<b>25</b>	260,261	25	210,967	23
<b>Customs brokerage and other services</b>	<b>489,721</b>	<b>38</b>	407,575	38	346,321	38
<b>Net revenues</b>	<b>1,282,939</b>	<b>100</b>	1,059,609	100	906,237	100
<i>Overhead expenses:</i>						
<b>Salaries and related costs</b>	<b>701,824</b>	<b>55</b>	596,804	56	513,814	57
<b>Other</b>	<b>205,999</b>	<b>16</b>	191,752	18	180,999	20
<b>Total overhead expenses</b>	<b>907,823</b>	<b>71</b>	788,556	74	694,813	77
<b>Operating income</b>	<b>375,116</b>	<b>29</b>	271,053	26	211,424	23
<b>Other income, net</b>	<b>20,548</b>	<b>2</b>	15,644	1	8,535	1
<b>Earnings before income taxes and minority interest</b>	<b>395,664</b>	<b>31</b>	286,697	27	219,959	24
<b>Income tax expense</b>	<b>160,661</b>	<b>13</b>	89,365	8	84,971	9
<b>Net earnings before minority interest</b>	<b>235,003</b>	<b>18</b>	197,332	19	134,988	15
<b>Minority interest</b>	<b>91</b>	<b>—</b>	(6,896)	(1)	(5,039)	(1)
<b>Net earnings</b>	<b>\$ 235,094</b>	<b>18%</b>	\$ 190,436	18%	\$ 129,949	14%

### 2006 compared with 2005

Airfreight net revenues in 2006 increased 20% compared with 2005 primarily because of an increase in airfreight volumes. Global airfreight tonnages in 2006 increased 18% compared with 2005. Airfreight yields remained relatively constant at 21% for 2006 as compared to 2005. The Company's North American export airfreight net revenues increased 19% in 2006 compared to 2005, primarily the result of increased market share attributable to focused sales activity. Airfreight net revenues from Asia and from Europe increased 22% and 18%, respectively, for 2006 compared with 2005. These changes are the result of market pricing and tonnage increases of 19% from Asia and 16% from Europe. Management attributes these tonnage increases to effective sales efforts.

Ocean freight volumes, measured in terms of forty-foot container equivalents (FEUs), increased 20% over 2005 while ocean freight and ocean services net revenues increased 24% during the same period. Ocean freight yields increased 2% to 21% in 2006 as compared to 2005.

The Company continued its focus of offering competitive rates to customers at the retail level, while leveraging freight volumes to obtain favorable rates from carriers at the wholesale level. The Company's North American ocean freight net revenues increased 28% in 2006 compared to 2005. Ocean freight net revenues from Asia increased 24% and from Europe increased 12% for 2006 compared with 2005. The global increases in ocean freight net revenue are primarily a result of market share expansion.

Customs brokerage and other services net revenues increased 20% in 2006 as compared with 2005. Management believes this increase is attributable to increased market share as a result of the Company's reputation for providing high quality service and increased opportunities within the customs brokerage market. These opportunities arise as customers seek out customs brokers with sophisticated computerized capabilities. In addition, the Company's customs brokerage offerings have benefited from increased emphasis on regulatory compliance.

Salaries and related costs increased 18% in 2006 compared to 2005 as a result of (1) the Company's increased hiring of sales, operations, and administrative personnel in existing and new offices to accommodate increases in business activity and (2) increased compensation levels. As previously noted, the Company adopted SFAS 123R using the modified retrospective application method and has restated all periods presented to include compensation expense for all unvested stock options and share awards beginning with the first period restated. Accordingly, salaries and related costs for the years ended December 31, 2006 and 2005 have been increased to include compensation expense for the fair value of unvested stock options.

The decline in salaries and related costs as a percentage of net revenue for 2006 as compared with the same period for 2005, can be attributed to leveraging increased business volumes with improved productivity and increasing overall efficiency through technological advances. The effect of including stock-based compensation expense in salaries and related costs for 2006 and 2005 are as follows:

In thousands	Years ended December 31,	
	2006	2005
<b>Salaries and related costs</b>	<b>\$ 701,824</b>	\$ 596,804
<b>As a % of net revenue</b>	<b>54.7%</b>	56.3%
<b>Stock compensation expense</b>	<b>\$ 41,739</b>	\$ 33,457
<b>As a % of salaries and related costs</b>	<b>5.9%</b>	5.6%
<b>As a % of net revenue</b>	<b>3.3%</b>	3.2%

Historically, the relatively consistent relationship between salaries and net revenues is the result of a compensation philosophy that has been maintained since the inception of the Company: offer a modest base salary and the opportunity to share in a fixed and determinable percentage of the operating profit of the business unit controlled by each key employee. Using this compensation model, changes in individual compensation will occur in proportion to changes in Company profits. Management believes that the growth in revenues, net revenues and net earnings for 2006 are a result of the incentives inherent in the Company's compensation program.

Other overhead expenses increased 7% in 2006 as compared with 2005 as rent expense, communications expense, quality and training expenses, and other costs expanded to accommodate the Company's growing operations. Other overhead expenses as a percentage of net revenues decreased 2% in 2006 as compared with 2005. Management believes that this was significant as it reflects the successful achievement of ongoing cost containment objectives at the branch level.

Other income, net, increased 31% in 2006 as compared with 2005. Due to higher interest rates on higher average cash balances and short-term investments during 2006, interest income increased by \$7 million for the year ended December 31, 2006.

The Company pays income taxes in the United States and other jurisdictions, as well as other taxes which are typically included in costs of operations. The Company's consolidated effective income tax rate in 2006 of 40.6% increased when compared with the 31.2% rate in 2005. The lower tax rate in 2005 is primarily the result of the Company adopting a plan under Internal Revenue Code (IRC) 965, which was added by the American Jobs Creation Act. In accordance with IRC 965, the Company recorded a one-time tax benefit of \$22 million in the fourth quarter of 2005. In order to qualify for this credit, the Company adopted a plan which required qualified capital expenditures of approximately \$105 million. The Company completed the required capital expenditures during 2006. Additionally, income tax expense in 2005 has been restated to include the tax benefit related to stock-based compensation expense recorded as a result of applying the requirements of SFAS 123R under the modified retrospective method. Although a tax benefit related to stock-based compensation expense is recorded for non-qualified stock options at the time the related compensation expense is recognized, the tax benefit received for disqualifying dispositions of incentive stock

options cannot be anticipated. The higher consolidated effective income tax rate for 2006 as compared to 2005 is partially the result of a smaller tax benefit received for disqualifying dispositions of incentive stock options during 2006 than was realized 2005.

#### 2005 compared with 2004

Airfreight net revenues in 2005 increased 12% compared with 2004 primarily because of an increase in airfreight volumes. Global airfreight tonnages in 2005 increased 9% compared with 2004. The 1% decrease in airfreight yields in 2005 was primarily a result of air carrier fuel surcharges which the Company typically passes on without a profit element. The Company's North American export airfreight net revenues increased 13% in 2005 compared to 2004, primarily the result of increased market share attributable to focused sales activity. Airfreight net revenues from Asia and from Europe increased 15% and 8%, respectively, for 2005 compared with 2004. These increases are the result of market price increases, partially offset by yield declines of less than 1%, and increased tonnage of 13% from Asia and 2% from Europe, primarily as a result of increased sales success.

Ocean freight volumes, measured in terms of forty-foot container equivalents (FEUs), increased 18% over 2004 while ocean freight and ocean services net revenues increased 23% during the same period. The increase in net revenue can be attributed to cyclical market conditions and trade lane imbalances.

The Company continued its focus of offering competitive rates to customers at the retail level, while leveraging freight volumes to obtain favorable rates from carriers at the wholesale level. The Company's North American ocean freight net revenues increased 22% in 2005 compared to 2004. Ocean freight net revenues from Asia increased 31% and from Europe decreased 1% for 2005 compared with 2004. The increase in North American and Asian ocean freight net revenue are primarily a result of greater market share. The decrease experienced in Europe is primarily due to decreased export volumes which can be attributable to the relative value of European currencies throughout the year.

Customs brokerage and other services net revenues increased 18% in 2005 as compared with 2004. This is a result of the Company's reputation for providing high quality service and increased opportunities within the customs brokerage market. These opportunities arise as customers seek out customs brokers with sophisticated computerized capabilities. In addition, the Company's customs brokerage offerings have benefited from increased emphasis on regulatory compliance.

Salaries and related costs increased 16% in 2005 compared to 2004 as a result of (1) the Company's increased hiring of sales, operations, and administrative personnel in existing and new offices to accommodate increases in business activity and (2) increased compensation levels. As previously noted, the Company adopted SFAS 123R using the modified retrospective application method and has restated all periods presented to include compensation expense for all unvested stock options and share awards beginning with the first period restated. Accordingly, salaries and related costs for the years ended December 31, 2005 and 2004 have been increased to include compensation expense for the fair value of unvested stock options.

The decline in salaries and related costs as a percentage of net revenue for 2005 as compared with the same period for 2004, can be attributed to leveraging increased business volumes with improved productivity and increasing overall efficiency through technological advances. The effect of including stock-based compensation expense in salaries and related costs for 2005 and 2004 are as follows:

In thousands	Years ended December 31,	
	2005	2004
<b>Salaries and related costs</b>	\$ 596,804	\$ 513,814
<b>As a % of net revenue</b>	56.3%	56.7%
<b>Stock compensation expense</b>	\$ 33,457	\$ 29,621
<b>As a % of salaries and related costs</b>	5.6%	5.8%
<b>As a % of net revenue</b>	3.2%	3.3%

Historically, the relatively consistent relationship between salaries and net revenues is the result of a compensation philosophy that has been maintained since the inception of the Company: offer a modest base salary and the opportunity to share in a fixed and determinable percentage of the operating profit of the business unit controlled by each key employee. Using this compensation model, changes in individual compensation will occur in proportion to changes in Company profits. Management believes that the growth in revenues, net revenues and net earnings for 2005 are a result of the incentives inherent in the Company's compensation program.

Other overhead expenses increased 6% in 2005 as compared with 2004 as rent expense, communications expense, quality and training expenses, and other costs expanded to accommodate the Company's growing operations. Other overhead expenses as a percentage of net revenues decreased 2% in 2005 as compared with 2004. Management believes that this was significant as it reflects the successful achievement of ongoing cost containment objectives at the branch level.

Other income, net, increased 83% in 2005 as compared with 2004. Due to higher interest rates on higher average cash balances and short-term investments during 2005, interest income increased by \$6 million for the year ended December 31, 2005.

The Company pays income taxes in the United States and other jurisdictions, as well as other taxes which are typically included in costs of operations. The Company's consolidated effective income tax rate in 2005 of 31.2% decreased when compared with the 38.6% rate in 2004. The lower tax rate in 2005 is primarily the result of the Company adopting a plan under Internal Revenue Code (IRC) 965, which was added by the American Jobs Creation Act. In accordance with IRC 965, the Company recorded a one-time tax benefit of \$22 million in the fourth quarter of 2005. In order to qualify for this credit, the Company adopted a plan which requires qualified capital expenditures of approximately \$105 million over the next two to three years.

### **Currency and Other Risk Factors**

International air/ocean freight forwarding and customs brokerage are intensively competitive and are expected to remain so for the foreseeable future. There are a large number of entities competing in the international logistics industry; however, the Company's primary competition is confined to a relatively small number of companies within this group. While there is currently a marked trend within the industry toward consolidation into large firms with multinational offices and agency networks, regional and local broker/forwarders remain a competitive force.

Historically, the primary competitive factors in the international logistics industry have been price and quality of service, including reliability, responsiveness, expertise, convenience, and scope of operations. The Company emphasizes quality customer service and believes that its prices are competitive with those of others in the industry. Customers have exhibited a trend towards more sophisticated and efficient procedures for the management of the logistics supply chain by embracing strategies such as just-in-time inventory management. The Company believes that this trend has resulted in customers using fewer service providers with greater technological capacity and consistent global coverage. Accordingly, sophisticated computerized customer service capabilities and a stable worldwide network have become significant factors in attracting and retaining customers.

Developing these systems and a worldwide network has added a considerable indirect cost to the services provided to customers. Smaller and middle-tier competitors, in general, do not have the resources available to develop customized systems and a worldwide network. As a result, there is a significant amount of consolidation currently taking place in the industry. Management expects that this trend toward consolidation will continue for the short- to medium-term.

The nature of the Company's worldwide operations necessitates the Company dealing with a multitude of currencies other than the U.S. dollar. This results in the Company being exposed to the inherent risks of the international currency markets and governmental interference. Some of the countries where the Company maintains offices and/or agency relationships have strict currency control regulations which influence the Company's ability to hedge foreign currency exposure. The Company tries to compensate for these exposures by accelerating international currency settlements among its offices or agents. The Company enters into foreign currency hedging transactions only in limited locations where there are regulatory or commercial limitations on the Company's ability to move money freely around the world or the short-term financial outlook in any country is such that hedging is

the most time-sensitive way to avoid short-term exchange losses. Any such hedging activity during 2006, 2005 and 2004 was insignificant. Net foreign currency losses realized in 2006 were \$321. Net foreign currency gains realized in 2005 and 2004 were \$862 and \$86, respectively. The Company had no foreign currency derivatives outstanding at December 31, 2006 and 2005.

### Sources of Growth

During 2006, the Company opened 2 full-service offices (\*) and 6 satellite offices (+), as follows:

ASIA	EUROPE	NORTH AMERICA	MIDDLE EAST
Shantou, PRC+ Xi'an, PRC•	Graz, Austria+	Reynosa, Mexico• Querétaro, Mexico+ Omaha, Nebraska+ Calexico, California+	Islamabad, Pakistan+

Xi'an, People's Republic of China (PRC) converted from a satellite office to a full-service office during 2006.

*Acquisitions* – Historically, growth through aggressive acquisition has proven to be a challenge for many of the Company's competitors and typically involves the purchase of significant "goodwill," the value of which can be realized in large measure only by retaining the customers and profit margins of the acquired business. As a result, the Company has pursued a strategy emphasizing organic growth supplemented by certain strategic acquisitions, where future economic benefit significantly exceeds the "goodwill" recorded in the transaction.

*Internal Growth* – Management believes that a comparison of "same store" growth is critical in the evaluation of the quality and extent of the Company's internally generated growth. This "same store" analysis isolates the financial contributions from offices that have been included in the Company's operating results for at least one full year. The table below presents "same store" comparisons on a year-over-year basis for the years ended December 31, 2006, 2005 and 2004.

Same store comparisons for the years ended December 31,

	2006	2005	2004
<b>Net revenues</b>	<b>21%</b>	16%	20%
<b>Operating income</b>	<b>38%</b>	28%	31%

### Liquidity and Capital Resources

The Company's principal source of liquidity is cash generated from operating activities. Net cash provided by operating activities for the year ended December 31, 2006 was \$333 million, as compared with \$267 million for 2005. This \$66 million increase is principally due to increased net earnings. The increase in taxes payable, net of prepaid taxes, is the result of higher tax liabilities on higher earnings and lower relative amounts of estimated tax payments.

The Company's business is subject to seasonal fluctuations. Cash flow fluctuates as a result of this seasonality. Historically, the first quarter shows an excess of customer collections over customer billings. This results in positive cash flow. The increased activity associated with peak season (typically commencing late second or early third quarter) causes an excess of customer billings over customer collections. This cyclical growth in customer receivables consumes available cash.

As a customs broker, the Company makes significant 5-10 business day cash advances for certain of its customers' obligations such as the payment of duties to the Customs and Border Protection of the Department of Homeland Security. These advances are made as an accommodation for a select group of credit-worthy customers. Cash advances are a "pass through" and are not recorded as a component of revenue and expense. The billings of such

advances to customers are accounted for as a direct increase in accounts receivable to the customer and a corresponding increase in accounts payable to governmental customs authorities. As a result of these “pass through” billings, the conventional Days Sales Outstanding or DSO calculation does not directly measure collection efficiency.

Cash used in investing activities for the year ended December 31, 2006 was \$143 million, as compared with \$91 million during the same period of 2005. The largest use of cash in investing activities is cash paid for capital expenditures. As a non-asset based provider of integrated logistics services, the Company does not own any physical means of transportation (i.e., airplanes, ships, trucks, etc.). However, the Company does have need, on occasion, to purchase buildings to house staff and to facilitate the staging of customers’ freight. The Company routinely invests in technology, office furniture and equipment and leasehold improvements. For the year ended December 31, 2006, the Company made capital expenditures of \$141 million as compared with \$91 million for the same period in 2005. Capital expenditures in 2006 included \$67 million for the acquisition of real estate and office/warehouse facilities in Miami, Florida. In addition, the Company had real estate development expenditures of \$22 million related to projects in Seattle, Washington and Houston, Texas. Other capital expenditures in 2006 and 2005 related primarily to investments in technology, office furniture and equipment and leasehold improvements. The Company currently expects to spend approximately \$43 million for normal capital expenditures in 2007. In addition to property and equipment, normal capital expenditures include leasehold improvements, warehouse equipment, computer hardware and furniture and fixtures. Total capital expenditures in 2007 are currently estimated to be \$106 million. This includes normal capital expenditures as noted above, plus additional real estate acquisitions and development. The Company expects to finance capital expenditures in 2007 with cash.

Cash used in financing activities for the year ended December 31, 2006 was \$160 million as compared with \$107 million for the same period in 2005. The Company uses the proceeds from stock option exercises to repurchase the Company’s stock on the open market. In 2006, the Company continued its policy of repurchasing stock to prevent growth in issued and outstanding shares as a result of stock option exercises. The increase in cash used in financing activities for the year ended December 31, 2006 compared with the same period in 2005 is primarily the result of this policy. During 2006 and 2005 the net use of cash in financing activities included the payment of dividends of \$.22 per share and \$.15 per share, respectively.

At December 31, 2006, working capital was \$633 million, including cash and short-term investments of \$512 million. The Company had no long-term debt at December 31, 2006.

The Company maintains international and domestic unsecured bank lines of credit. At December 31, 2006, the United States facility totaled \$50 million and the international bank lines of credit, excluding the U.K. bank facility, totaled \$18 million. In addition, the Company maintains a bank facility with its U.K. bank for \$14 million which is available for short-term borrowings and issuances of standby letters of credit. At December 31, 2006, the Company had no amounts outstanding on these lines of credit, but was contingently liable for \$63 million from standby letters of credit and guarantees related to these lines of credit and other obligations. The guarantees relate to obligations of the Company’s foreign subsidiaries for credit extended in the ordinary course of business by direct carriers, primarily airlines, and for duty and tax deferrals available from governmental entities responsible for customs and value-added-tax (VAT) taxation. The total underlying amounts due and payable for transportation and governmental excises are properly recorded as obligations in the books of the respective foreign subsidiaries, and there would be no need to record additional expense in the unlikely event the parent company were to be required to perform.

At December 31, 2006, the Company's contractual obligations and other commitments are as follows:

In thousands	Total	Payments Due by Period			
		Less than 1 year	1 - 3 years	3 - 5 years	After 5 years
<i>Contractual Obligations:</i>					
<b>Operating leases</b>	\$ 86,075	\$ 37,133	\$ 38,585	\$ 7,939	\$ 2,418
<b>Unconditional purchase obligations</b>	293,019	293,019	—	—	—
<b>Construction obligations</b>	7,781	6,890	697	194	—
<b>Total contractual cash obligations</b>	<b>\$ 386,875</b>	<b>\$ 337,042</b>	<b>\$ 39,282</b>	<b>\$ 8,133</b>	<b>\$ 2,418</b>

The Company enters into short-term agreements with asset-based providers reserving space on a guaranteed basis. The pricing of these obligations varies to some degree with market conditions. The Company only enters into agreements that management believes the Company can fulfill with relative ease. Historically, the Company has not paid for guaranteed space that it has not used. Management believes, in line with historical experience, committed purchase obligations outstanding as of December 31, 2006, will be fulfilled during 2007 in the Company's ordinary course of business.

In thousands	Total amounts committed	Amount of Commitment Expiration Per Period			
		Less than 1 year	1 - 3 years	3 - 5 years	After 5 years
<i>Other Commitments:</i>					
<b>International lines of credit</b>	\$ 19,516	\$ 19,516	\$ —	\$ —	\$ —
<b>Standby letters of credit</b>	62,608	58,712	3,397	415	84
<b>Total commitments</b>	<b>\$ 82,124</b>	<b>\$ 78,228</b>	<b>\$ 3,397</b>	<b>\$ 415</b>	<b>\$ 84</b>

The Company has a Non-Discretionary Stock Repurchase Plan to repurchase shares from the proceeds of stock option exercises. As of December 31, 2006, the Company had repurchased and retired 15,407,473 shares of common stock at an average price of \$13.24 per share over the period from 1994 through 2006. During 2006, 1,105,773 shares were repurchased at an average price of \$44.20 per share.

The Company has a Discretionary Stock Repurchase Plan under which Management is allowed to repurchase such shares as may be necessary to reduce the issued and outstanding stock to 200,000,000 shares of common stock. As of December 31, 2006, the Company had repurchased and retired 9,752,196 shares of common stock at an average price of \$26.43 per share over the period from 2001 through 2006. During 2006, 2,825,042 shares were repurchased at an average price of \$44.92. These discretionary repurchases were made to keep the number of issued and outstanding shares from growing as a result of stock option exercises.

Management believes that the Company's current cash position, bank financing arrangements, and operating cash flows will be sufficient to meet its capital and liquidity requirements for the foreseeable future, including meeting any contingent liabilities related to standby letters of credit and other obligations.

In some cases, the Company's ability to repatriate funds from foreign operations may be subject to foreign exchange controls. At December 31, 2006, cash and cash equivalent balances of \$345 million were held by the Company's non-United States subsidiaries, of which \$46 million was held in banks in the United States.

**Impact of Inflation**

To date, the Company's business has not been adversely affected by inflation. Direct carrier rate increases could occur over the short- to medium-term period. Due to the high degree of competition in the market place, these rate increases can lead to an erosion in the Company's margins. As the Company is not required to purchase or maintain extensive property and equipment and has not otherwise incurred substantial interest rate-sensitive indebtedness, the Company currently has limited direct exposure to increased costs resulting from increases in interest rates.

**Off-Balance Sheet Arrangements**

As of December 31, 2006, the Company did not have any material off-balance-sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

*Quantitative And Qualitative Disclosures About Market Risk*

The Company is exposed to market risks in the ordinary course of its business. These risks are primarily related to foreign exchange risk and changes in short-term interest rates. The potential impact of the Company's exposure to these risks is presented below:

**Foreign Exchange Risk**

The Company conducts business in many different countries and currencies. The Company's business often results in revenue billings issued in a country and currency which differs from that where the expenses related to the service are incurred. In the ordinary course of business, the Company creates numerous intercompany transactions. This brings a market risk to the Company's earnings.

Foreign exchange rate sensitivity analysis can be quantified by estimating the impact on the Company's earnings as a result of hypothetical changes in the value of the U.S. dollar, the Company's reporting currency, relative to the other currencies in which the Company transacts business. All other things being equal, an average 10% weakening of the U.S. dollar, throughout the year ended December 31, 2006, would have had the effect of raising operating income approximately \$22 million. An average 10% strengthening of the U.S. dollar, for the same period, would have the effect of reducing operating income approximately \$18 million. This analysis does not take into account changes in shipping patterns based upon this hypothetical currency fluctuation. For example, a weakening in the U.S. dollar would be expected to increase exports from the United States and depress imports into the United States over some relevant period of time, but the exact effect of this change cannot be quantified without making speculative assumptions.

As of December 31, 2006, the Company had approximately \$2 million of net unsettled intercompany transactions. The Company currently does not use derivative financial instruments to manage foreign currency risk and only enters into foreign currency hedging transactions in limited locations where regulatory or commercial limitations restrict the Company's ability to move money freely. Any such hedging activity throughout the year ended December 31, 2006, was insignificant. The Company had no foreign currency derivatives outstanding at December 31, 2006 and 2005. The Company instead follows a policy of accelerating international currency settlements to manage foreign exchange risk relative to intercompany billings. The majority of intercompany billings are resolved within 30 days and intercompany billings arising in the normal course of business are fully settled within 90 days.

**Interest Rate Risk**

At December 31, 2006, the Company had cash and cash equivalents and short-term investments of \$512 million, of which \$1 million was invested at various short-term market interest rates. There were no short-term borrowings at December 31, 2006. A hypothetical change in the interest rate of 10% would not have a significant impact on the Company's earnings.

In management's opinion, there has been no material change in the Company's market risk exposure between 2005 and 2006.