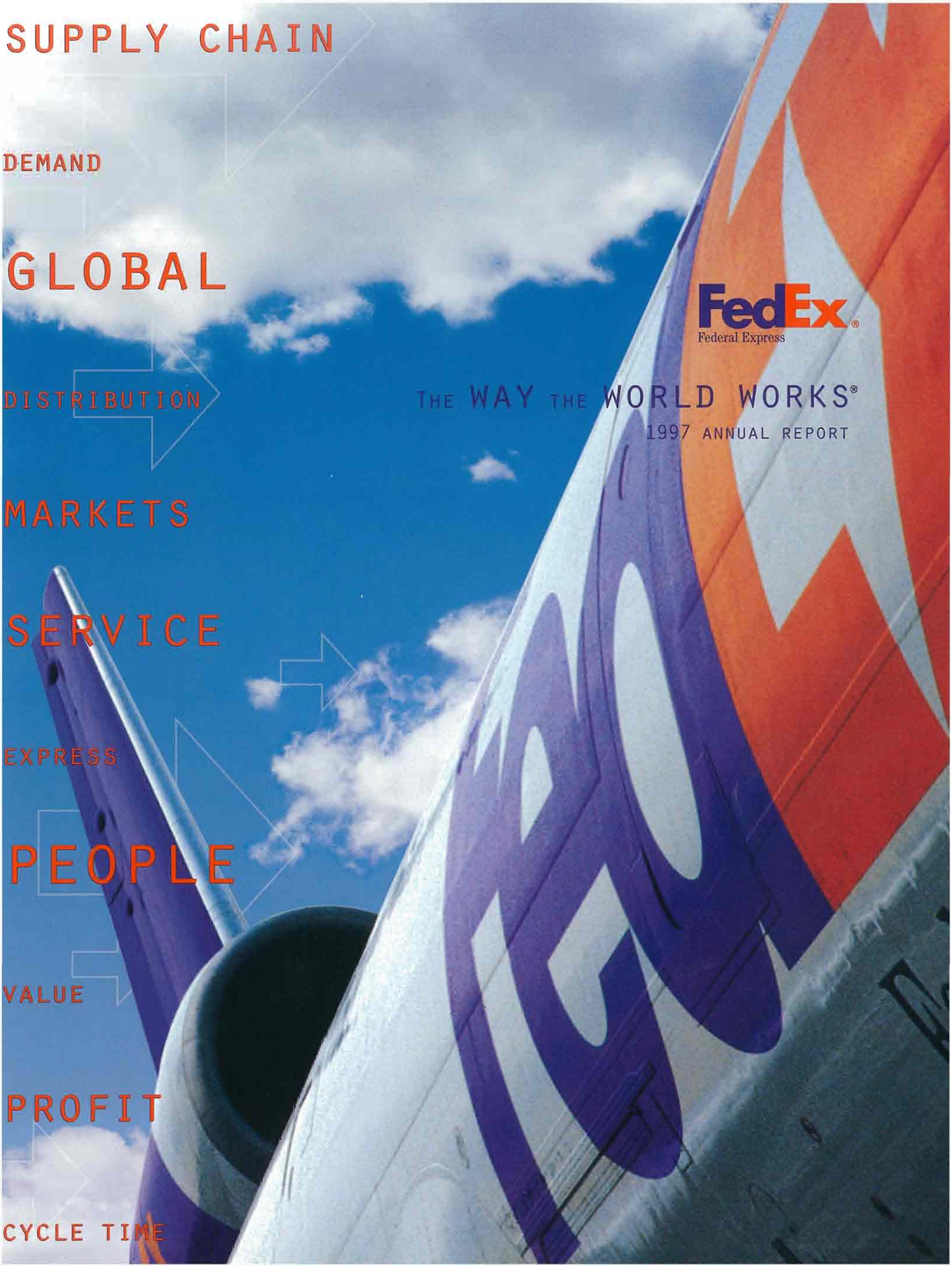

SUPPLY CHAIN

DEMAND

GLOBAL

DISTRIBUTION

MARKETS

SERVICE

EXPRESS

PEOPLE

VALUE

PROFIT

CYCLE TIME

FedEx®
Federal Express

# THE WAY THE WORLD WORKS®

1997 ANNUAL REPORT

AT FEDEX OUR ULTIMATE

COMPREHEND – AND BE A CATALYST


THE WAY THE WO

WE REMAIN UNIQUELY POSITION

AND PROFIT FROM THE MAJOR

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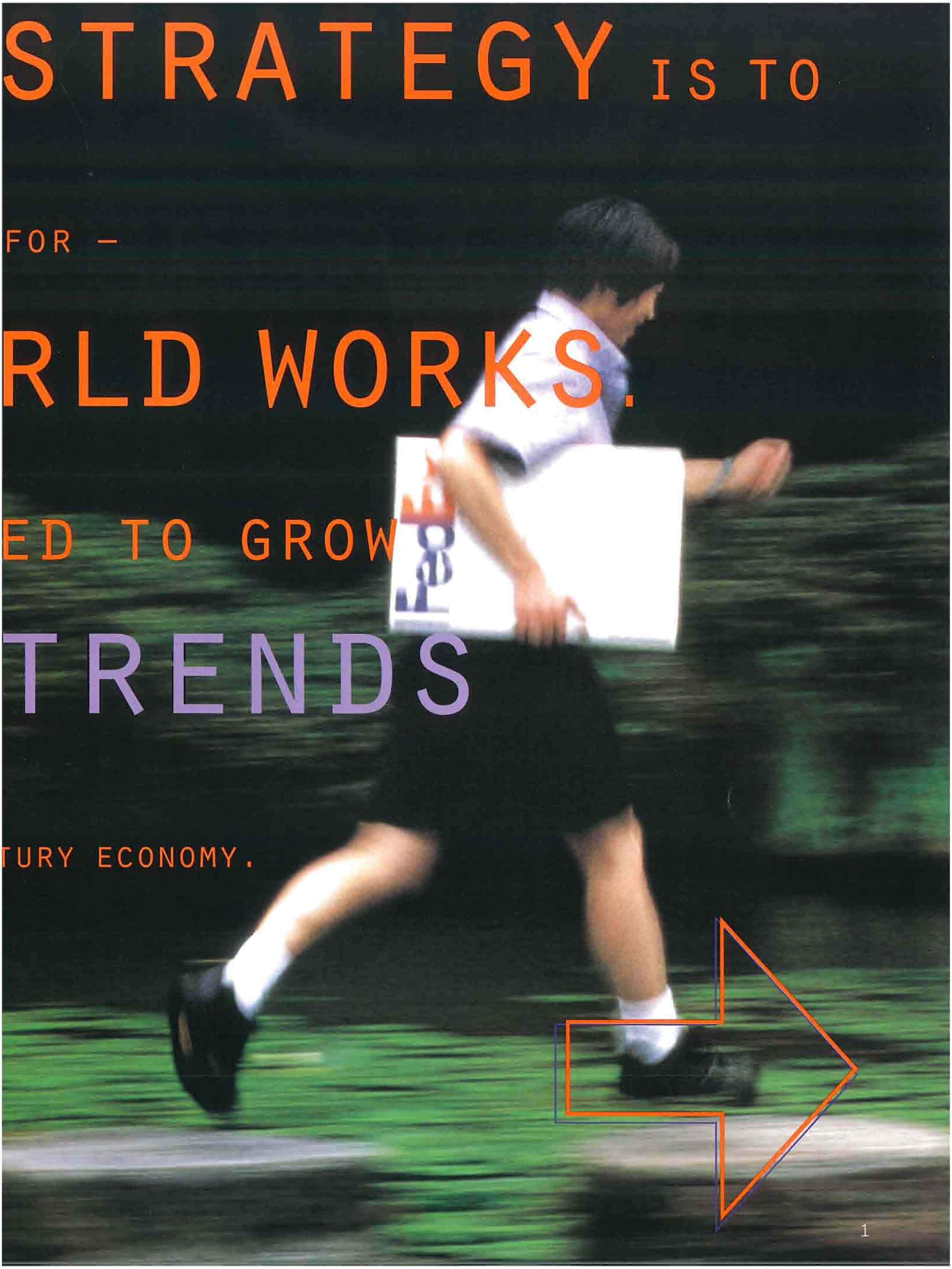
STRATEGY IS TO
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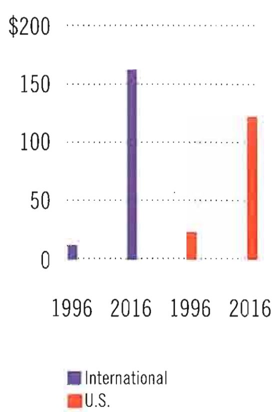
# TO OUR STOCKHOLDERS




**Global Express Market**
*(in billions)*

Source: FedEx

Our company's fiscal year 1997 performance reaffirms that FedEx has strategically positioned itself for ongoing leadership in a vital, high-growth, forward-looking industry—global express distribution.

After we invented modern express distribution in 1973, FedEx pioneered services and delivered innovations that helped our industry grow to nearly $35 billion by 1996. Looking ahead, the global express market is forecast to reach more than $250 billion in the next 20 years. With seven-fold industry growth projected over the next two decades, FedEx and you—the investors who share in our future—stand to benefit handsomely, provided we wisely manage and extend our leadership advantages.

## A FORMULA FOR THE FUTURE

Inside this year's annual report you'll discover ways FedEx is doing precisely that: working to sustain and enhance our leadership edge, in sync with trends and market forces that are transforming the global economy.

Our strategic actions and initiatives are summarized broadly by what we call the FedEx "V3" strategy—*Vision, Value, Virtual.*

VISION. To satisfy worldwide demand for fast, time-definite, reliable distribution, FedEx continues to build and refine a uniquely integrated, all-cargo express network. This network relies equally on transportation infrastructure, information technology and dedicated FedEx people for its seamless global operation.

Now, just 12 years after our first intercontinental FedEx aircraft lifted off from New York City bound for London, our "vision" network links markets that represent 90% of the world's gross domestic product with *next-business-day or two-business-day* pickup and delivery of documents, packages and freight.

As it stands, no competitor can begin to match the global service capability FedEx offers today's businesses. But rather than stop there, FedEx is aggressively pursuing additional market leverage, including new route configurations, additional air-route authorities and enhanced electronic links with customs organizations worldwide.

These are the essential building blocks that will allow FedEx to provide even faster and more reliable connections between major markets, while bringing the earth's farthest corners into the 48-hour service window for our customers.

VALUE. To serve the world's largest express market with a wide range of premium and deferred express delivery services at competitive rates, FedEx continues to expand and enhance its integrated air-ground transportation network within North America. Given trends showing that U.S. businesses are steadily reducing their investment in inventory, the demand for reliable, time-definite distribution options over both short- and long-haul distances is only expected to grow.

VIRTUAL. FedEx remains our industry's premier innovator in developing information technologies that help customers manage and grow their businesses, which in turn helps fuel our own growth.

Today, nearly 60% of all FedEx packages are generated by customers linked to us electronically. To remain successful, providing outstanding service while managing our costs, we'll continue using technology to move bytes—and boxes—with optimum speed, precision and efficiency.

And, as we have done consistently for years, FedEx will pursue these strategies of *Vision*, *Value* and *Virtual* within the context of our absolute commitment to improving service levels for our customers and providing rewarding employment for our employees.

## PROVEN BY PERFORMANCE

As I noted earlier, it is clear from our fiscal year 1997 financial results that our formula for leadership is correct. Notable achievements include:

- Worldwide revenues of $11.5 billion, a 12% increase over 1996
- Net income of $361 million, a year-over-year gain of more than 17%
- Earnings of $3.12 per share, a 16% improvement over last year
- International average daily express volume growth of nearly 18%
- U.S. domestic average daily express volume growth of 11%
- Total express shipment revenues 50% greater than those of our nearest competitor.

Despite their outstanding performance during the past fiscal year, FedEx employees at all levels of the organization remain diligently at work on operational and financial areas where we see any room for improvement—in our results, in our service, or in our competitive position.

FedEx continues, for example, to press for "open skies" treatment for all-cargo air transportation worldwide. As a case in point, we remain confident that U.S. government officials will soon persuade their Japanese counterparts to allow FedEx full and unfettered use of the route authorities we hold between Japan and markets throughout Asia, including China.

Meanwhile, employees in our newly formed Operations Support and Engineering division are aggressively pursuing new electronic connections with customs authorities around the world, links that will allow our customers' shipments to cross borders with fewer delays.

**It is clear from our fiscal year 1997 financial results that our formula for leadership is correct.**

## STRONG, DEFENSIBLE POSITION

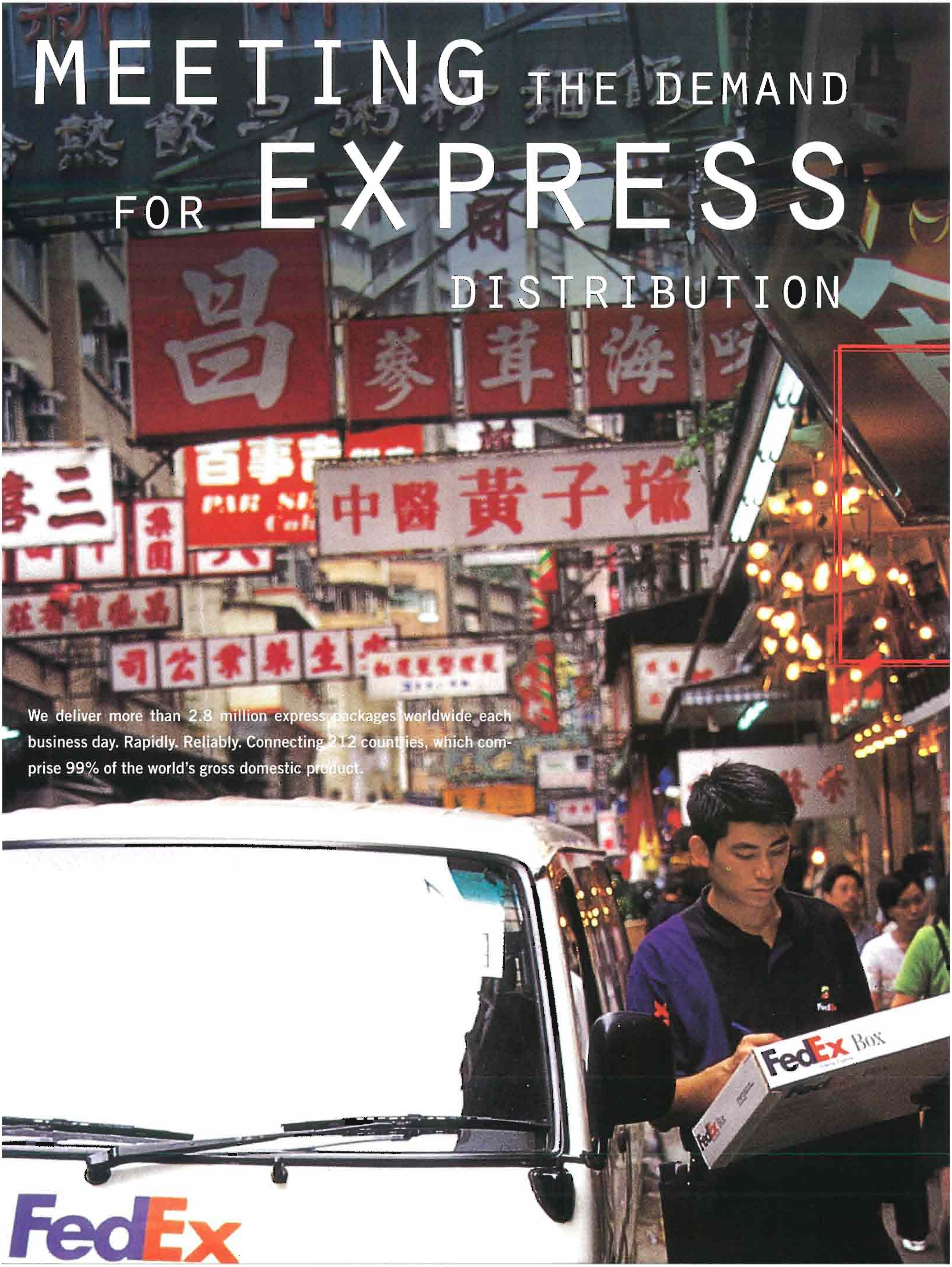
The core strengths of FedEx—brand recognition, global presence, customer base, asset base, customer service, technological expertise, regulatory rights, and the experience, skill and motivation of our people—place us in a strong and defensible competitive position in this high-growth industry. If you believe, as I do, in the trends shaping express distribution, and the commitment and ability of our employees to extend our leadership edge, you know as stockholders you're positioned to enjoy superior financial returns.

And you have our assurance that 130,000 FedEx employees are working around the clock, around the globe, to deliver world-class service and innovation for our customers and outstanding financial performance for our stockholders.

Frederick W. Smith
Chairman, President
and Chief Executive Officer

# MEETING THE DEMAND FOR EXPRESS DISTRIBUTION

We deliver more than 2.8 million express packages worldwide each business day. Rapidly. Reliably. Connecting 212 countries, which comprise 99% of the world's gross domestic product.




# DEMAND

**Sometimes challenges posed by the global economy seem to defy the laws of physics. Challenge: Businesses want to reduce their inventory and warehousing costs while still meeting customers' just-in-time supply demands, on an increasingly worldwide scale. Solution: express distribution.**

## SUPPLY CHAIN

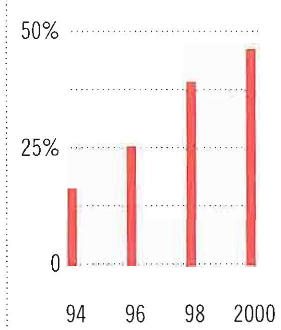
A factory fire temporarily shuts down a supplier to one of the world's major auto manufacturers. The part: a small valve, integral to the braking system of the automobiles being manufactured. The disruption sparks an immediate and all-out scramble for emergency sources of supply.

Why the uproar? Because for the automaker this isn't just any brake-valve supplier; for cost and quality reasons, it's the only one. And with the industry's just-in-time manufacturing honed to extremely close tolerances, extra inventory is perilously tight. Not weeks or even days tight. Try four *hours* tight.

Businesses competing in global markets. Time-critical manufacturing practices. Pressure to maintain absolute minimal inventories at both ends of the supply chain. Narrow, time-certain deadlines for moving high-value parts and products worldwide.

This is the marketplace the FedEx network was built to serve. We deliver more than 2.8 million express packages worldwide each business day. Rapidly. Reliably. Connecting 212 countries, which comprise 99% of the world's gross domestic product.

During fiscal year 1997, FedEx listened to its customers and continued to strategically expand its global network, meeting the demand for express distribution in a world where time—now, more than ever—is money.

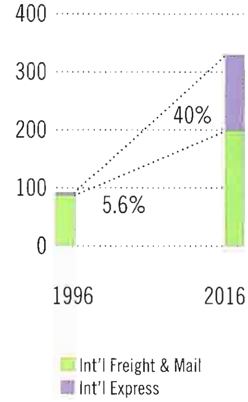



**Percent of Product Shipped Just In Time/Quick Response**

Source: Ohio State University Survey of Career Patterns in Logistics, 1996

# TRADE MARKETS

**The world isn't just getting smaller, it's getting busier — and in a hurry. As the rate of trade *among* nations continues to surpass the pace of economic growth *within* nations, international express shipping is expected to soar.**




**International Express Share of Total International Cargo Market**
*Revenue Ton Kilometers (billions)*

Source: Boeing World Air Cargo Forecast, 1997

Seven of the 10 fastest-growing economies are in Asia, and that region's share of exported manufactured goods has increased from 11% in 1970 to 28% in 1996. Going forward, this dramatic growth is expected to continue, emphasizing the importance of the FedEx AsiaOne® network as a strategic distribution resource for businesses.

Introduced in September 1995, FedEx AsiaOne revolutionized global distribution with a single, proprietary express network that offers late-in-the-day pickups and next-business-day deliveries among Asian markets, and between Asia and North America.

Superior FedEx® service capability in Asia, as in much of the world, stems from the vast collection of air-route authorities that FedEx controls, including access to many restricted markets. For example, FedEx is the only U.S.-based all-cargo carrier approved to fly its own aircraft into and out of China, the world's fastest-growing national economy. Similarly, FedEx is the only U.S.-based all-cargo carrier with the authority to fly between Tokyo and any other point in Asia.

In Asia, and throughout the world, FedEx puts this unmatched assemblage of air-route authorities to work for global shippers. For instance, we recently increased from two to four the number of FedEx flights serving China each week and expanded from 60 to 85 the number of Chinese cities we serve.

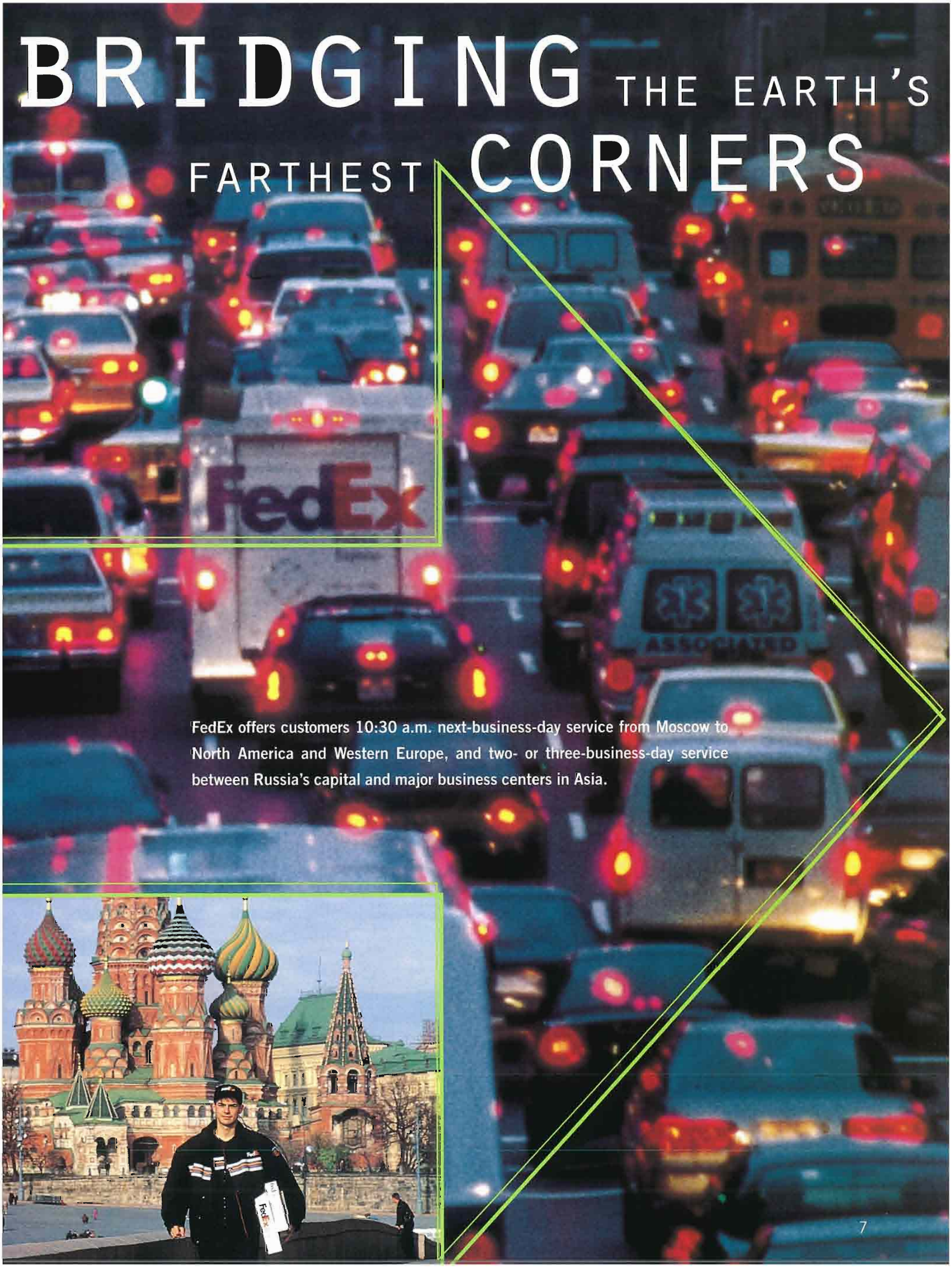
Elsewhere, FedEx launched international flight operations in Moscow during fiscal 1997, becoming the only U.S. express carrier to operate its own aircraft and customs warehousing for a market where exports are projected to grow 30% by the year 2000. This unique capability affords FedEx customers 10:30 a.m. next-business-day service from Moscow to North America and Western Europe, and two- or three-business-day service between Russia's capital and major business centers in Asia.

We also recently announced our purchase of three additional weekly frequencies from the U.S. to Argentina. These added frequencies will further position us to benefit from the rapid trade growth projected for many South American nations.

Besides linking new and fast-growing markets, FedEx consistently introduces innovative services with even more timely delivery commitments. An example is new FedEx International First℠, providing next-business-day or two-business-day delivery by 8 a.m. to the U.S. from 17 countries including Canada, France and Japan. The world also got just a little smaller as we began offering FedEx International Priority® second-business-day delivery by 10:30 a.m.—rather than noon—from the U.S. to more than a dozen of Europe's major commercial centers.

In the end, competition for international express cargo comes down to air routes and market access. The carrier with the most extensive and strategic collection of route authorities, and thus the ability to best serve more markets, is the one more shippers will turn to for solutions.

# BRIDGING THE EARTH'S FARTHEST CORNERS




FedEx offers customers 10:30 a.m. next-business-day service from Moscow to North America and Western Europe, and two- or three-business-day service between Russia's capital and major business centers in Asia.


# DISTRIBUTION SOLUTIONS

**Overseas businesses aren't the only ones seeking reliable, on-time delivery of products and materials. Increasingly, organizations inside the U.S. are demanding — and delivering — the same degree of service.**

The rush to express distribution—while a global trend—is also evident among businesses that do most of their shipping within the U.S.

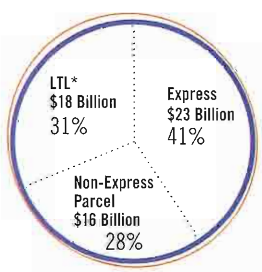
For many of the same reasons U.S. exporters value FedEx—time-definite delivery; real-time shipment-status tracking; service supported by a Money-Back Guarantee—U.S. businesses are shifting more of their domestic cargo to the express mode.

To further enhance its leadership position in the U.S., the world's largest express distribution market, FedEx introduced distance-based pricing for U.S. express services on July 1, 1997. Distance-based pricing allows FedEx to better balance the prices charged to customers with the costs of delivery, for both short- and long-haul shipments.

At the same time, we repositioned our list prices by eliminating a drop-off discount from our rates in favor of an on-call pick-up charge. Like our competitors, FedEx now shows the drop-off or regular stop rate as our base rate in the service guide so customers can see their actual transportation costs. This will help negate our competitors' ability to make unfavorable value comparisons between FedEx rates and their own.

These changes mark the next phase in a continued effort to better manage our yield—the revenue FedEx receives per package. Earlier, FedEx used sophisticated rate modeling—plus frank, fair-minded dialogue—to adjust prices for certain customers whose rates did not adequately reflect the cost of providing premium FedEx service.

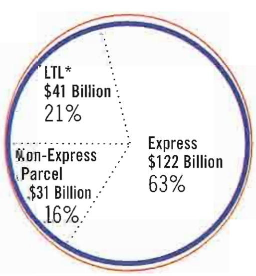
This better balancing of prices with the costs of servicing customers, plus our superiority in international express shipping, positions us as the carrier of choice for businesses intent on consolidating their time-critical shipping with a single carrier.




**The Move to Value**
**U.S. Domestic Market – 1996**

Source: The Colography Group, Inc.

*Less Than Truckload




**The Move to Value**
**U.S. Domestic Market – 2016**

Source: FedEx

*Less Than Truckload

# ONLINE

FedEx has a long history of equipping customers with innovative electronic technologies that make shipping easier and more productive.

Customers value the control, speed and convenience generated by these tools FedEx provides free of charge. Not surprisingly, conducting shipping transactions and delivering customer services electronically help FedEx conserve resources and reduce costs.

We estimate that building electronic connections with our customers, over time, has helped FedEx prevent the processing of an additional 2 billion pieces of paper per year, plus avoid the need to hire thousands of additional employees.

Customers who communicate electronically with FedEx now number more than 650,000, including 100,000 connected by FedEx PowerShip® automated shipping systems and more than 550,000 users of FedEx Ship® and FedEx interNetShip℠ software. Online customers now generate nearly 60% of the shipments handled by FedEx on a typical business day.

To extend our connectivity with customers, we recently added new service innovations to our award-winning FedEx Web site **(www.fedex.com)**. Lauded by many as a top Internet application, www.fedex.com has received numerous accolades, including one of ten "Business on the Internet" awards from the publisher of *Information Week*.

Now, for shipments within the U.S. and to many international locations, FedEx interNetShip lets customers go online to complete electronic airbills, print shipping labels, request courier pickups, even e-mail other parties about a shipment's status.

We've even added a handy Drop-Off Locator to our Web site, so customers can quickly pinpoint their nearest FedEx service location—even access an electronic map to the site—and in the process save FedEx the cost of dispatching a courier.

# CONNECTIVITY

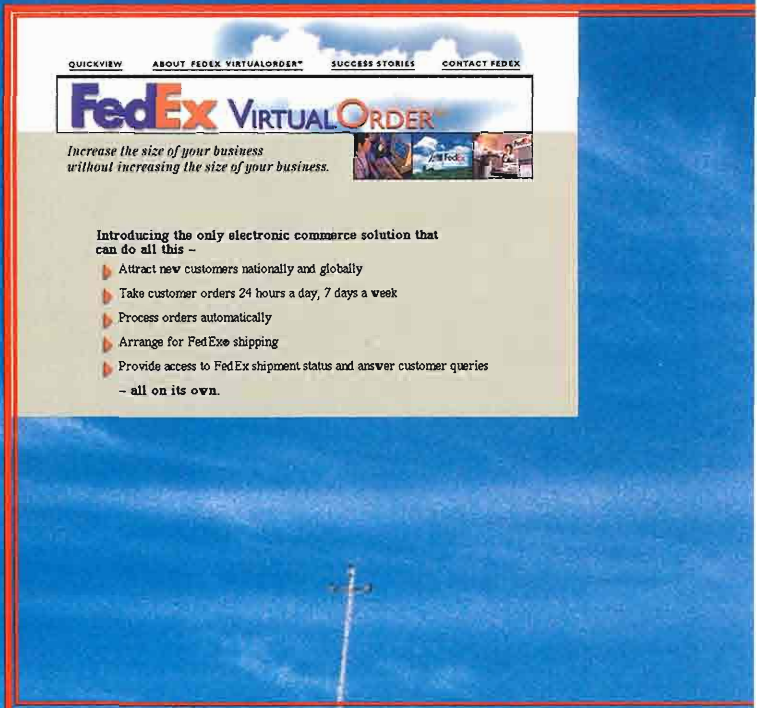
**By the end of 1997, forecasters project that over $1 billion worth of products and services will be sold online annually, and that number is expected to increase more than five times through the turn of the century. With all those "bytes" streaming through cyberspace, who will carry the "atoms" when it's time to deliver the goods?**

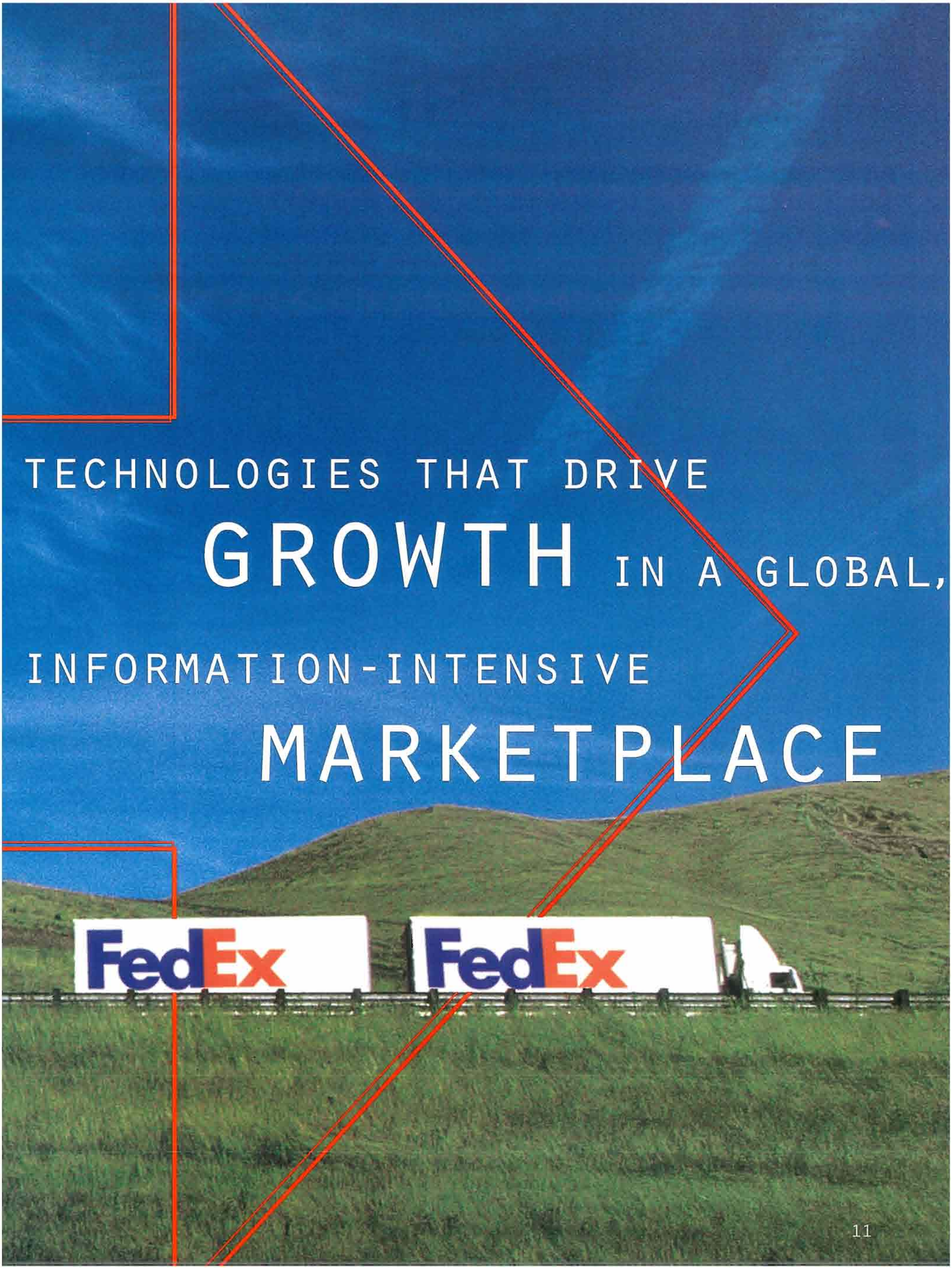
# COMMERCE

While FedEx automated shipping tools are primarily designed to help customers manage their existing shipping volume more efficiently, FedEx is keenly interested in helping customers use technology to build their businesses and, in turn, generate more business for us. With that in mind, FedEx recently unveiled yet another technology first for our industry: FedEx VirtualOrder℠.

FedEx VirtualOrder equips small and medium-size businesses with the hardware and online *publishing tools to quickly and easily — within* a matter of days — establish an electronic product catalog and begin processing orders from their own World Wide Web site.

By helping our customers connect with their customers 24 hours a day, seven days a week, FedEx VirtualOrder — though still in its early stages — is putting FedEx and its customers at the "storefront" of electronic commerce.




TECHNOLOGIES THAT DRIVE
GROWTH IN A GLOBAL,
INFORMATION-INTENSIVE
MARKETPLACE
FedEx
FedEx

# COST

**Even in a global economy, there's no getting around the fundamentals. *Profit equals revenue minus cost.* With customers concentrating intently on that formula, today's businesses must be focused as well.**

FedEx continues to enhance its profit potential by using technology and aggressive management to improve our operations. By leveraging our technology capabilities, our network's economies of scale and the extensive skills of our people, we will strive to be the highest-quality, lowest-cost service provider.

We're confident, for example, that our freshly named—and newly focused—Strategic Sourcing & Supply group will generate millions of dollars in savings by conducting thorough analyses of what products and services we purchase from what suppliers, at what price. Initial results have been impressive, including savings on FedEx packaging and contract trucking for our longer-haul U.S.-domestic shipments.

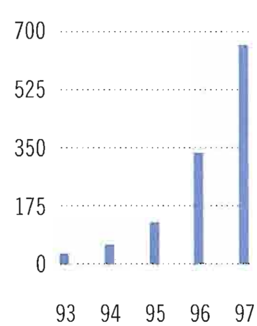
The introduction of the MD10, a modified version of the existing DC10, into our fleet is another way we're managing our resources efficiently. The MD10 program secures future airlift capacity at a lower unit cost and allows us to modify and introduce the aircraft into our fleet based upon volume demands. This aircraft will have totally new avionics and state-of-the-art systems which will extend the useful life of the aircraft and make them compatible with the MD11s already in our fleet.

# PRODUCTIVITY

We've also added state-of-our-industry dimensional-weight pricing equipment at several of our U.S. sorting hubs. Rather than spot check oversize packages by hand to see if a package's excessive size merits recalculation to a higher rate, these systems can calculate "DIM" weight automatically on each package, allowing FedEx to recoup millions in revenue that otherwise would be lost.

In another technology innovation, we recently unveiled an enhanced model of our SuperTracker®, that seemingly magical wand FedEx couriers use for scanning bar-coded labels to capture vital shipment routing and tracking data.

Instead of physically swiping the scanner across each bar code, the new SuperTracker lets couriers "point and shoot," much like a TV remote control. This technology is enabling couriers to exit their stations and begin delivery routes earlier. Leveraged across the entire FedEx network, that means tremendous gains in productivity and customer service.




**Customers Linked Electronically to FedEx**
*(in thousands)*

# USING TECHNOLOGY AND BEST PRACTICES TO BETTER MANAGE OUR OPERATIONS


Instead of physically swiping the scanner across each bar code, the new SuperTracker lets couriers "point and shoot," much like a TV remote control. This technology is enabling couriers to exit their stations and begin delivery routes earlier.

# FEDEX EMPLOYEES DELIVER OUR BRAND

FedEx couriers and customer service agents do more than move packages and delight our customers. More persuasively than any ad campaign or marketing promotion, they deliver our FedEx brand to the marketplace.

## SERVICE

**Employees extend their maximum effort for customers when they feel respected and rewarded by their employer. Never has tapping human commitment and energy been more essential than in today's competitive, service-driven economy.**

## PEOPLE


FedEx couriers and customer service agents do more than move packages and delight our customers. More persuasively than any ad campaign or marketing promotion, they deliver our FedEx brand to the marketplace.

To outfit them properly for this key role, FedEx recently completed a comprehensive redesign of their uniforms. Consistent with our People-Service-Profit philosophy, our first step was to gather employee input and insights. We conducted 30 focus groups in 15 cities worldwide, to ensure that the updated uniforms met employees' needs for comfort, style and safety.

The outcome is a dynamic new uniform collection that offers 80% better reflectivity for safety, while displaying the leadership image of FedEx. By combining uniform styles for two employee groups into one, the program also promises to save FedEx more than $5 million over the first five years, and more than $1 million annually each year thereafter.

FedEx also launched Safety-Above-All during fiscal 1997, a companywide safety initiative aimed at reducing personal and vehicle incidents by 15%. As with most everything we do, FedEx will measure the results carefully and critically. And we've put teeth in the program by tying safety improvements directly to senior management compensation.

Just as FedEx strives for 100% service quality on each shipment, Safety-Above-All represents our commitment to pursue a 100% injury- and accident-free work environment. Because, after all, at FedEx, people have always been our first order of business.

# MESSAGE

## FROM THE CHIEF FINANCIAL OFFICER

The numbers speak for themselves.

The investments we've made to position FedEx for leadership were borne out by another year of robust performance in fiscal year 1997 — our fifth consecutive year of improved earnings. Among the year's other important achievements:

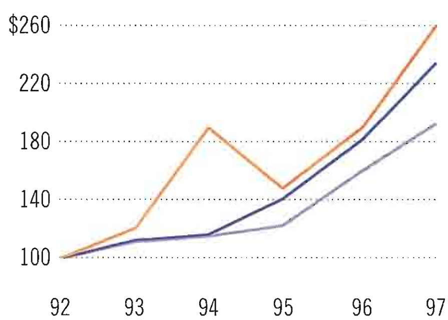
- Worldwide revenues of $11.5 billion
- Continued remarkable growth in our international express package volume and revenue
- Solid expansion in the U.S. domestic market
- Record net income of $361 million, or a year-over-year increase of 16% in earnings per share.

All of this was accomplished, even as FedEx invested almost $2 billion in the infrastructure and technologies required to sustain our edge well into the next century.

The decision to split our FedEx stock during fiscal 1997 reflects the confidence we, as FedEx managers, have in the accuracy of our corporate vision, and in the dynamic growth of the global marketplace in which we operate, compete and lead.

Alan B. Graf, Jr.

Alan B. Graf, Jr.
Executive Vice President
and Chief Financial Officer

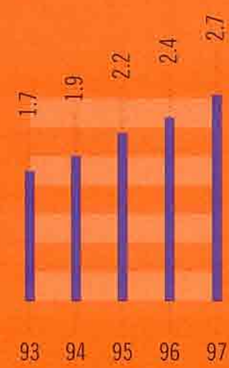



**Stock Performance**
- FedEx (FDX) Common Stock
- S&P 500 Composite Index
- S&P Transportation Index

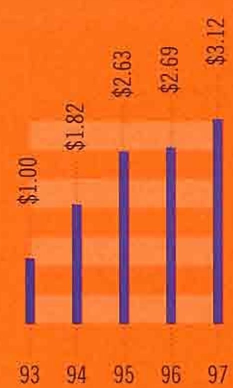
The Stock Performance graph shows changes over the past five fiscal years in the value of $100 invested on May 31, 1992.

## 1993-1997 HIGHLIGHTS

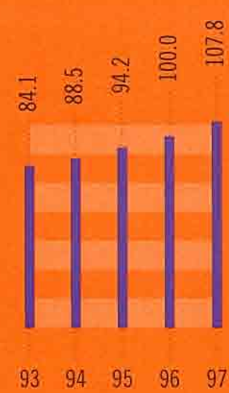

**Revenues**
*(in billions)*



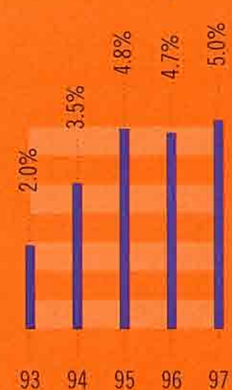

**Average Daily Express Packages** *(in millions)*



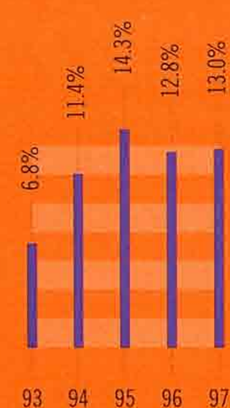

**Earnings per Share**
*(in dollars)*




**Average Number of Employees** *(in thousands)*
Based on a standard full-time workweek




**Return on Assets**
*(percent)*




**Return on Equity**
*(percent)*

(1) EPS, ROA and ROE results exclude a 1993 after-tax charge of $55.9 million ($.51 per share) for the cumulative effect of a change in an accounting principle. ROA and ROE are calculated using the average of the year's beginning and ending assets or equity.

## Financial Highlights

Years ended May 31 — In thousands, except earnings per share and Other Operating Data

| | 1997 | 1996 | Percent Change |
|---|---|---|---|
| **OPERATING RESULTS** | | | |
| Revenues | $11,519,750 | $10,273,619 | +12 |
| Operating income | 699,042 | 623,824 | +12 |
| Income before income taxes | 628,221 | 539,959 | +16 |
| Net income | 361,227 | 307,777 | +17 |
| Earnings per share | $ 3.12 | $ 2.69 | +16 |
| Average shares outstanding | 115,641 | 114,276 | + 1 |
| **FINANCIAL POSITION** | | | |
| Property and equipment, net | $ 4,622,080 | $ 4,116,601 | +12 |
| Total assets | 7,625,486 | 6,698,971 | +14 |
| Long-term debt | 1,397,954 | 1,325,277 | + 5 |
| Common stockholders' investment | 2,962,514 | 2,576,139 | +15 |
| **OTHER OPERATING DATA** | | | |
| Express package: | | | |
| Average daily package volume | 2,715,894 | 2,437,662 | +11 |
| Average pounds per package | 7.2 | 6.4 | +13 |
| Average revenue per pound | $ 2.11 | $ 2.31 | − 9 |
| Average revenue per package | $ 15.11 | $ 14.87 | + 2 |
| Airfreight: | | | |
| Average daily pounds | 2,542,226 | 2,144,225 | +19 |
| Average revenue per pound | $ .94 | $ 1.01 | − 7 |
| Operating weekdays | 254 | 256 | |
| Aircraft fleet | 584 | 557 | |
| Vehicle fleet | 38,500 | 36,900 | |
| Average number of employees (based on a standard full-time workweek) | 107,827 | 99,999 | |

## RESULTS OF OPERATIONS

Year-over-year improvements in consolidated results for the past three years reflect the expansion of the Company's express delivery services and the stabilization of U.S. domestic express revenue per package (yield). In 1997, international results improved primarily due to continued strong growth of express volumes and increased airfreight revenues, despite declining airfreight revenue per pound (yield). Intense domestic competition and the rising cost of providing express services restrained U.S. domestic results in 1997. Consolidated net income for 1997 was $361 million ($3.12 per share) compared with $308 million ($2.69 per share) and $298 million ($2.63 per share) for 1996 and 1995, respectively.

### Revenues

The following table shows a comparison of revenues for the years ended May 31:

In millions

| | | | | Percent Change | |
|---|---|---|---|---|---|
| | **1997** | 1996 | 1995 | 1997/ 1996 | 1996/ 1995 |
| U.S. domestic express | **$ 8,073** | $ 7,284 | $6,700 | +11 | + 9 |
| International Priority (IP) | **2,351** | 1,997 | 1,680 | +18 | +19 |
| International Express Freight (IXF) and Airport-to-Airport (ATA) | **605** | 554 | 580 | + 9 | – 5 |
| FedEx Air Charter | **72** | 92 | 115 | –22 | –20 |
| Logistics services | **99** | 94 | 106 | + 5 | –11 |
| Other* | **320** | 253 | 211 | +27 | +20 |
| | **$11,520** | $10,274 | $9,392 | +12 | + 9 |

*Includes the sale of engine noise reduction kits.

The following table shows a comparison of selected express and airfreight (IXF/ATA) statistics for the years ended May 31:

In thousands, except dollar amounts

| | | | | Percent Change | |
|---|---|---|---|---|---|
| | **1997** | 1996 | 1995 | 1997/ 1996 | 1996/ 1995 |
| U.S. domestic express: | | | | | |
| Average daily packages | **2,490** | 2,246 | 2,084 | +11 | + 8 |
| Revenue per package | **$12.77** | $12.67 | $12.61 | + 1 | — |
| IP: | | | | | |
| Average daily packages | **226** | 192 | 164 | +18 | +17 |
| Revenue per package | **$40.91** | $40.58 | $40.28 | + 1 | + 1 |
| IXF/ATA: | | | | | |
| Average daily pounds | **2,542** | 2,144 | 2,153 | +19 | — |
| Revenue per pound | **$ .94** | $ 1.01 | $ 1.06 | – 7 | – 5 |

In 1997, U.S. domestic yield improved on a year-over-year basis (including the effect of a temporary 2% fuel surcharge discussed below). Excluding the surcharge, yields remained stable due to the effects of continuing yield-management actions which include systematic review and revision of customer pricing, an increase in the list price for FedEx Standard Overnight® service in April 1996 and improved average weight per package. The yield improvement was restrained by strong growth in the Company's lower-yielding products and a reduction in the price for FedEx 2Day® service.

The air cargo transportation excise tax expired on December 31, 1995, was reenacted by Congress effective August 27, 1996, and expired again on December 31, 1996. The excise tax was reenacted by Congress effective March 7, 1997, and is scheduled to expire again on September 30, 1997. This expiration relieved the Company of its obligation to pay the tax for approximately five months in both 1997 and 1996. The expiration of the tax contributed approximately $50 million to U.S. domestic revenues and 1% to U.S. domestic yields in both 1997 and 1996. Legislation to reenact the tax for a ten-year period as of October 1, 1997, is currently pending in Congress.

Over the past three years, the Company's IP service experienced year-over-year growth in average daily volumes ranging from 17% to 23% and revenues from 18% to 25%. This strong growth is attributable to the Company's unique and expanding network which provides customers with reduced transit times, later drop-off opportunities and daily service on a global basis. Over the same period, yields remained relatively constant.

In 1996 and 1997, the Company's international non-express airfreight revenues were a significant factor in determining overall profitability. The Company uses ATA airfreight service (a lower-priced, space-available service) to fill space on international flights not used by express services such as IP or IXF. In 1996, excess capacity in the global airfreight market and slowing growth in world demand resulted in lower non-express airfreight pounds, prices and revenues than in 1995. In 1997, airfreight revenues increased, due to the Company's expansion in international markets, despite continued excess market capacity and downward pressure on yields.

The increases in other revenue in 1997 and 1996 were primarily attributable to increased sales of engine noise reduction kits.

### Operating Expenses

Volume growth and expansion of the Company's operations resulted in a trend of rising operating expenses. Presented below are year-over-year percentage changes in operating expenses:

| | Percent Change | |
|---|---|---|
| | 1997/ 1996 | 1996/ 1995 |
| Salaries and employee benefits | +10 | + 4 |
| Rentals and landing fees | +12 | +17 |
| Depreciation and amortization | + 8 | +10 |
| Fuel | +19 | +15 |
| Maintenance and repairs | +17 | +14 |
| Other | +14 | +16 |
| Total operating expenses | +12 | +10 |

Salaries and employee benefits expense rose primarily due to higher employment levels associated with volume growth. In 1997, increased provisions under the Company's performance-based, incentive compensation plans also contributed to the increase in salaries and employee benefits expense. In 1996, decreased provisions under these plans offset a large portion of the increase in salaries and employee benefits expense.

Rentals and landing fees increased primarily due to the leasing of additional aircraft. As of May 31, 1997, the Company had 78 wide-bodied aircraft under operating lease compared with 74 as of May 31, 1996, and 58 as of May 31, 1995. Management expects year-over-year increases in lease expense to continue as the Company enters into additional aircraft rental agreements during 1998 and thereafter.

Fuel expense increased in 1997 and 1996 due to increases in average jet fuel price per gallon (12% and 7%, respectively) and gallons consumed (8% and 9%, respectively). The increases in average price per gallon of jet fuel were due to higher jet fuel prices and a 4.3 cents per gallon excise tax on aviation fuel, used domestically, which became effective October 1, 1995.

In order to mitigate the impact of the recent increases in jet fuel prices, the Company implemented temporary fuel surcharges on airfreight shipments, effective December 1, 1996, for shipments out of Europe and selected Asian countries. Additionally, the Company implemented fuel surcharges, effective December 15, 1996, for airfreight shipments originating in the U.S., Latin America and the remaining parts of Asia, except those to the People's Republic of China and Hong Kong. These surcharges were discontinued effective April 15 or June 1, 1997, depending on the origin country. The Company also implemented a temporary 2% fuel surcharge, effective February 3, 1997, on U.S. domestic shipments except FedEx SameDay® service and including Puerto Rico. This surcharge also applied to all U.S. export IP shipments, except those to the People's Republic of China and Hong Kong. The Company plans to lift this surcharge on August 1, 1997.

In the past three years, the Company's aircraft fleet has increased, resulting in a corresponding rise in maintenance expense. The rise in maintenance and repairs expense for 1997 was primarily due to higher engine maintenance on MD11 and A310 aircraft. In 1996, the Company incurred significant spare parts expense outfitting the newly-opened Subic Bay facility and earlier than expected DC10 engine maintenance expense.

The Company expects a predictable pattern of aircraft maintenance and repairs expense. However, unanticipated maintenance events will occasionally disrupt this pattern, resulting in periodic fluctuations in maintenance and repairs expense. Given the Company's increasing fleet size, aging fleet and variety of aircraft types, management believes that maintenance and repairs expense will continue a trend of year-over-year increases for the foreseeable future.

Increases in other operating expenses for 1997 and 1996 were primarily due to expenses related to volume growth, including the transportation of packages by third parties and, for 1996, the cost of temporary manpower. The cost of sales of engine noise reduction kits also increased in 1997 and 1996. A significant portion of the 1996 increase in other operating expenses was due to consulting fees related to ongoing projects designed to optimize the value of goods and services purchased and the use of internal resources.

### Operating Income

The Company's operating income increased 12% and 6% in 1997 and 1996, respectively.

U.S. domestic operating income rose 3% and 16% in 1997 and 1996, respectively. In 1997, domestic income included a $15 million pre-tax benefit from the settlement of a Tennessee personal property tax matter and an incremental contribution from the sales of engine noise reduction kits of $24 million. Increases in cost per package (1.4%) exceeded increases in revenue per package (0.8%). Conversely, in 1996, operating income improved primarily due to increases in revenue per package (0.5%) exceeding increases in cost per package (0.3%) and due to increases in average daily volume (8%). In addition, in 1996, sales of engine noise reduction kits contributed an incremental $15 million to U.S. domestic operating income, while severe winter storms in the eastern United States lowered U.S. domestic operating income by approximately $30 million. U.S. domestic operating margins were 6.7%, 7.3% and 6.8% in 1997, 1996 and 1995, respectively.

International operating income increased $59 million in 1997 compared with a $44 million decrease in 1996. The increase in operating income in 1997 was attributable to strong growth in the Company's IP volumes and airfreight pounds, partially offset by lower airfreight yields. In addition to the factors impacting express and airfreight revenue discussed above, in 1996, the costs of establishing the Company's intra-Asian network and declines in charter revenue contributed to the decline in international operating income. International operating margins were 4.4%, 2.9% and 4.9% in 1997, 1996 and 1995, respectively.

For additional information on the Company's U.S. domestic and international operations, see Note 10 of Notes to Consolidated Financial Statements.

### Other Income and Expense and Income Taxes

Net interest expense decreased 5% for 1997, primarily due to lower effective interest rates. For 1996, net interest expense decreased 17% due to lower debt levels and a higher level of capitalized interest than in 1995. Interest is capitalized during eligible projects, the most significant of which is the modification of certain Airbus A310 aircraft from passenger to freighter configuration. The level of capitalized interest in 1997 was comparable to that of 1996.

Other, net for 1997 included a $17.1 million gain from an insurance settlement for a DC10 aircraft destroyed by fire in September 1996. Other, net for 1996 included a distribution of $7.8 million from the bankruptcy estate of a firm engaged by the Company in 1990 to remit payments of employee payroll taxes to the appropriate authorities. Other, net for 1996 also included gains on sales of B727 aircraft.

The Company's effective tax rate was 42.5% in 1997 and 43.0% in 1996 and 1995. In each year, the effective tax rate was greater than the statutory U.S. federal tax rate primarily because of state income taxes and the impact of foreign operations. For 1998, management expects the effective tax rate to remain at a level similar to the 1997 rate. The actual rate, however, is dependent on a number of factors, including the amount and source of operating income.

### Outlook

Management is committed to achieving long-term earnings growth by positioning the Company's resources to address customers' expectations and to capitalize on emerging markets for express distribution services. This frequently involves a significant front-end investment in assets, technology and personnel that may reduce near-term profitability. The level of investment in 1998 is anticipated to be greater than that in 1997.

As discussed above, a key factor in the stabilization of the Company's U.S. domestic yield was the customer pricing review program. In 1998, management will continue this program with the intent of pursuing price increases on low-yielding accounts and discontinuing unprofitable accounts. In addition, on July 1, 1997, the Company introduced distance-based pricing for all U.S. domestic services. As a result of yield-management actions and the introduction of distance-based pricing, management believes U.S. domestic yields will remain stable or increase slightly, while package volumes will grow at a considerably lower rate in 1998 than in the past several years. The goal of these actions is to ensure an appropriate balance between revenues generated and the cost of providing express services. Actual results, however, may vary depending primarily on the impact of competitive pricing changes, including distance-based pricing, customer responses to yield-management initiatives and changing customer demand patterns.

To reduce the cost of providing express services, management will continue to invest in technologies that improve the efficiency of package pick-up, sorting, tracking and delivery and further integrate the Company's air and ground transportation system. The Company will also strive to increase the number of transactions initiated through customer automation tools and will continue projects designed to enhance productivity and strengthen the Company's infrastructure. Assuming effective implementation, these investments are expected to reduce transportation cost per package.

Long-term plans for the Company's international operations include continued expansion of the international network to the emerging centers of economic growth, particularly China, the Pacific Basin and Latin America. Management expects this expansion to allow for continued growth of the Company's international express services. However, with the additional capacity, more reliance is placed on lower-yielding IXF/ATA to fill the available space until express volumes grow into the increased capacity.

Management expects IP average daily volume to continue its strong growth in 1998 and IP yields to remain relatively constant. With respect to airfreight, management believes that excess market capacity will continue its downward pressure on yields in 1998. Actual results for IP or airfreight, however, will depend on international economic conditions, actions by the Company's competitors and regulatory conditions for international aviation rights.

## FINANCIAL CONDITION

### Liquidity

Cash and cash equivalents totaled $122 million at May 31, 1997, an increase of $29 million during 1997 compared with decreases of $264 million in 1996 and $35 million in 1995. Cash provided from operations during 1997 was $1.0 billion compared with $947 million and $1.0 billion in 1996 and 1995, respectively. The Company currently has available a $1.0 billion revolving bank credit facility (of which $799 million was available as of May 31, 1997) that is generally used to finance temporary operating cash requirements and to provide support for the issuance of commercial paper. The reduction in the amount available under the credit facility was solely attributable to support for the issuance of commercial paper during the year. Management believes that cash flow from operations, its commercial paper program and the revolving bank credit facility will adequately meet its working capital needs for the foreseeable future.

### Capital Resources

The Company's operations are capital intensive, characterized by significant investments in aircraft, vehicles, computer and telecommunication equipment, package handling facilities and sort equipment. The amount and timing of capital additions are dependent on various factors including volume growth, new or enhanced services, geographical expansion of services, competition, availability of satisfactory financing and actions of regulatory authorities.

Capital expenditures for 1997 totaled $1.5 billion and included ten Airbus A310 aircraft, two MD11 aircraft (which were subsequently sold and leased back, one in 1997 and one in 1998), customer automation and computer equipment and vehicles and ground support equipment. In comparison, prior year expenditures totaled $1.4 billion and included seven Airbus A310 aircraft (one of which, along with two purchased in 1995, was subsequently sold and leased back), two MD11 aircraft (which were subsequently sold and leased back, one in 1996 and one in 1997), five B727-200 aircraft, 35 Cessna 208 aircraft, deposits on future Airbus A300 aircraft, vehicles and ground support equipment, customer automation and computer equipment, and package handling facilities and sort equipment. For information on the Company's purchase commitments, see Note 12 of Notes to Consolidated Financial Statements.

Additional investing activities in 1996 included the purchase of an all-cargo route authority between the U.S. and China.

The Company has historically financed its capital investments through the use of lease, debt and equity financing in addition to the use of internally generated cash from operations. Generally, management's practice in recent years with respect to funding new wide-bodied aircraft acquisitions has been to finance such aircraft through long-term lease transactions that qualify as off-balance sheet operating leases under applicable accounting rules. Management has determined that these operating leases have provided economic benefits favorable to ownership with respect to market values, liquidity and after-tax cash flows. In the future, other forms of secured financing may be pursued to finance the Company's aircraft acquisitions based on what management determines will best meet the Company's needs. The Company has been successful in obtaining investment capital, both domestic and international, for long-term leases on acceptable terms although the marketplace for such capital can become restricted depending on a variety of economic factors beyond the control of the Company. See Note 3 of Notes to Consolidated Financial Statements for additional information concerning the Company's debt and credit facilities.

In June 1996, October 1996 and May 1997, approximately $190 million, $186 million and $556 million, respectively, of pass through certificates were issued under shelf registrations filed with the Securities and Exchange Commission to finance or refinance the debt portion of leveraged leases related to nine Airbus A300 and six MD11 aircraft. The pass through certificates are not direct obligations of, or guaranteed by, the Company, but amounts payable by the Company under the leveraged leases are sufficient to pay the principal of and interest on the certificates.

Management believes that the capital resources available to the Company provide flexibility to access the most efficient markets for financing its capital acquisitions, including aircraft, and are adequate for the Company's future capital needs.

### Deferred Tax Assets

At May 31, 1997, the Company had a net cumulative deferred tax liability of $10 million consisting of $495 million of deferred tax assets and $505 million of deferred tax liabilities. The reversals of deferred tax liabilities in future periods will offset similar amounts of deferred tax assets.

Statements in this "Management's Discussion and Analysis of Results of Operations and Financial Condition" or made by management of the Company which contain more than historical information may be considered forward-looking statements (as such term is defined in the Private Securities Litigation Reform Act of 1995) which are subject to risks and uncertainties. Actual results may differ materially from those expressed in the forward-looking statements because of important factors identified in this section.

## Consolidated Statements of Income

Years ended May 31 In thousands, except Earnings Per Share

| | 1997 | 1996 | 1995 |
|---|---|---|---|
| **REVENUES** | **$11,519,750** | $10,273,619 | $9,392,073 |
| **Operating Expenses:** | | | |
| Salaries and employee benefits (Notes 8 and 9) | **5,095,462** | 4,619,990 | 4,425,202 |
| Rentals and landing fees (Note 4) | **1,070,658** | 959,055 | 818,599 |
| Depreciation and amortization | **777,374** | 719,609 | 652,287 |
| Fuel | **690,412** | 578,614 | 502,417 |
| Maintenance and repairs | **724,416** | 617,657 | 544,170 |
| Other | **2,462,386** | 2,154,870 | 1,858,254 |
| | **10,820,708** | 9,649,795 | 8,800,929 |
| **OPERATING INCOME** | **699,042** | 623,824 | 591,144 |
| **Other Income (Expense):** | | | |
| Interest, net (Note 1) | **(90,634)** | (95,599) | (114,687) |
| Other, net (Note 14) | **19,813** | 11,734 | 45,627 |
| | **(70,821)** | (83,865) | (69,060) |
| **Income before Income Taxes** | **628,221** | 539,959 | 522,084 |
| **Provision for Income Taxes** (Note 7) | **266,994** | 232,182 | 224,496 |
| **NET INCOME** | **$ 361,227** | $ 307,777 | $ 297,588 |
| **EARNINGS PER SHARE** (Note 6) | **$ 3.12** | $ 2.69 | $ 2.63 |
| **AVERAGE SHARES OUTSTANDING** (Note 6) | **115,641** | 114,276 | 112,987 |

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

## Consolidated Balance Sheets

May 31 In thousands

| ASSETS | 1997 | 1996 |
|---|---|---|
| **Current Assets:** | | |
| Cash and cash equivalents | $ 122,023 | $ 93,419 |
| Receivables, less allowance for doubtful accounts of $36,175 and $30,809 | 1,512,939 | 1,271,599 |
| Spare parts, supplies and fuel | 313,337 | 222,110 |
| Deferred income taxes (Note 7) | 149,158 | 92,606 |
| Prepaid expenses and other | 35,132 | 48,527 |
| Total current assets | 2,132,589 | 1,728,261 |
| **Property and Equipment, at Cost** (Notes 1, 3, 4 and 12): | | |
| Flight equipment | 3,741,407 | 3,372,647 |
| Package handling and ground support equipment | 2,403,806 | 2,148,509 |
| Computer and electronic equipment | 1,714,662 | 1,439,883 |
| Other | 1,959,061 | 1,717,478 |
| | 9,818,936 | 8,678,517 |
| Less accumulated depreciation and amortization | 5,196,856 | 4,561,916 |
| Net property and equipment | 4,622,080 | 4,116,601 |
| **Other Assets:** | | |
| Goodwill (Note 1) | 365,327 | 380,748 |
| Equipment deposits and other assets (Note 12) | 505,490 | 473,361 |
| Total other assets | 870,817 | 854,109 |
| | $7,625,486 | $6,698,971 |

| LIABILITIES AND STOCKHOLDERS' INVESTMENT | 1997 | 1996 |
|---|---|---|
| **Current Liabilities:** | | |
| Current portion of long-term debt (Note 3) | $ 126,666 | $ 8,009 |
| Accounts payable | 828,421 | 705,532 |
| Accrued expenses (Note 2) | 1,007,696 | 904,856 |
| Total current liabilities | 1,962,783 | 1,618,397 |
| **Long-Term Debt, Less Current Portion** (Note 3) | 1,397,954 | 1,325,277 |
| **Deferred Income Taxes** (Note 7) | 159,165 | 64,034 |
| **Other Liabilities** (Note 1) | 1,143,070 | 1,115,124 |
| **Commitments and Contingencies** (Notes 4, 12 and 13) | | |
| **Common Stockholders' Investment** (Note 6): | | |
| Common Stock, $.10 par value; 200,000 shares authorized; | | |
| 114,907 and 56,885 shares issued | 11,491 | 5,689 |
| Additional paid-in capital | 850,616 | 815,137 |
| Retained earnings | 2,118,015 | 1,766,578 |
| | 2,980,122 | 2,587,404 |
| Less deferred compensation | 17,608 | 11,265 |
| Total common stockholders' investment | 2,962,514 | 2,576,139 |
| | $7,625,486 | $6,698,971 |

The accompanying Notes to Consolidated Financial Statements are an integral part of these balance sheets.

Years ended May 31 In thousands

| | 1997 | 1996 | 1995 |
|---|---|---|---|
| **OPERATING ACTIVITIES** | | | |
| Net income | $ 361,227 | $ 307,777 | $ 297,588 |
| Adjustments to reconcile net income to cash provided by operating activities: | | | |
| Depreciation and amortization | 777,374 | 719,609 | 652,287 |
| Provision for uncollectible accounts | 40,634 | 38,963 | 36,334 |
| Provision for deferred income taxes and other | 45,737 | 26,489 | 25,976 |
| Gain from disposals of property and equipment | (19,567) | (5,397) | (39,997) |
| Changes in assets and liabilities, net of effects from dispositions of businesses: | | | |
| Increase in receivables | (334,448) | (191,334) | (167,319) |
| Increase in other current assets | (450,945) | (41,992) | (24,101) |
| Increase in accounts payable, accrued expenses and other liabilities | 597,980 | 100,515 | 258,373 |
| Other, net | (10,500) | (8,050) | (8,424) |
| Cash provided by operating activities | 1,007,492 | 946,580 | 1,030,717 |
| **INVESTING ACTIVITIES** | | | |
| Purchases of property and equipment, including deposits on aircraft of $26,107, $68,202 and $113,073 | (1,470,592) | (1,412,242) | (1,060,761) |
| Proceeds from dispositions of property and equipment: | | | |
| Sale-leaseback transactions | 162,400 | 176,500 | — |
| Reimbursements of A300 deposits | 63,039 | 143,859 | 138,203 |
| Other dispositions | 29,147 | 26,504 | 59,523 |
| Other, net | 24,612 | 77,208 | 87,925 |
| Cash used in investing activities | (1,191,394) | (988,171) | (775,110) |
| **FINANCING ACTIVITIES** | | | |
| Proceeds from debt issuances | 200,904 | 17,298 | 45,460 |
| Proceeds from stock issuances | 31,013 | 36,566 | 13,081 |
| Principal payments on debt | (9,670) | (264,004) | (349,523) |
| Other, net | (9,741) | (12,398) | — |
| Cash provided by (used in) financing activities | 212,506 | (222,538) | (290,982) |
| **CASH AND CASH EQUIVALENTS** | | | |
| Increase (decrease) during the year | 28,604 | (264,129) | (35,375) |
| Balance at beginning of year | 93,419 | 357,548 | 392,923 |
| Balance at end of year | $ 122,023 | $ 93,419 | $ 357,548 |

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

## Consolidated Statements of Changes in Common Stockholders' Investment

In thousands, except shares

| | Common Stock | Additional Paid-in Capital | Retained Earnings | Treasury Stock | Deferred Compensation |
|---|---|---|---|---|---|
| **BALANCE AT MAY 31, 1994** | $ 5,589 | $ 759,229 | $ 1,162,160 | $ (775) | $ (1,498) |
| Forfeiture of restricted stock | — | — | — | (231) | — |
| Issuance of common stock under employee incentive plans (288,724 shares) | 28 | 16,026 | — | — | — |
| Amortization of deferred compensation | — | — | — | — | 774 |
| Foreign currency translation adjustment | — | — | 6,679 | — | — |
| Net income | — | — | 297,588 | — | — |
| **BALANCE AT MAY 31, 1995** | 5,617 | 775,255 | 1,466,427 | (1,006) | (724) |
| Purchase of treasury stock | — | — | — | (12,398) | — |
| Forfeiture of restricted stock | — | — | — | (1,068) | 1,130 |
| Issuance of common and treasury stock under employee incentive plans (886,195 shares) | 72 | 39,882 | — | 14,472 | (13,898) |
| Amortization of deferred compensation | — | — | — | — | 2,227 |
| Foreign currency translation adjustment | — | — | (7,626) | — | — |
| Net income | — | — | 307,777 | — | — |
| **BALANCE AT MAY 31, 1996** | 5,689 | 815,137 | 1,766,578 | — | (11,265) |
| Purchase of treasury stock | — | — | — | (9,741) | — |
| Forfeiture of restricted stock | — | — | — | (803) | 720 |
| Two-for-one stock split in the form of a 100% stock dividend (56,994,074 shares) | 5,699 | — | (5,699) | — | — |
| Issuance of common and treasury stock under employee incentive plans (1,225,454 shares) | 103 | 35,479 | — | 10,544 | (10,484) |
| Amortization of deferred compensation | — | — | — | — | 3,421 |
| Foreign currency translation adjustment | — | — | (4,091) | — | — |
| Net income | — | — | 361,227 | — | — |
| **BALANCE AT MAY 31, 1997** | **$11,491** | **$850,616** | **$2,118,015** | **$ —** | **$(17,608)** |

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

## NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Principles of consolidation.** The consolidated financial statements include the accounts of Federal Express Corporation and its wholly-owned subsidiaries (the "Company"). All significant intercompany accounts and transactions have been eliminated.

**Property and equipment.** Expenditures for major additions, improvements, flight equipment modifications, and certain overhaul costs are capitalized. Maintenance and repairs are charged to expense as incurred, except for B747 airframe and engine overhaul maintenance which is accrued and charged to expense on the basis of hours flown. The cost and accumulated depreciation of property and equipment disposed of are removed from the related accounts, and any gain or loss is reflected in the results of operations.

For financial reporting purposes, depreciation and amortization of property and equipment is provided on a straight-line basis over the asset's service life or related lease term as follows:

| | |
|---|---|
| Flight equipment | 5 to 20 years |
| Package handling and ground support equipment | 5 to 30 years |
| Computer and electronic equipment | 3 to 10 years |
| Other | 2 to 30 years |

Aircraft airframes and engines are assigned residual values ranging from 10% to 20% of asset cost. All other property and equipment have no assigned residual values. Vehicles, which are included in package handling and ground support equipment, are depreciated on a straight-line basis over 5 to 10 years.

For income tax purposes, depreciation is generally computed using accelerated methods.

**Deferred gains.** Gains on the sale and leaseback of aircraft and other property and equipment are deferred and amortized over the life of the lease as a reduction of rent expense. Included in other liabilities at May 31, 1997 and 1996, were deferred gains of $340,166,000 and $337,118,000, respectively.

**Deferred lease obligations.** While certain of the Company's aircraft and facility leases contain fluctuating or escalating payments, the related rent expense is recorded on a straight-line basis over the lease term. Included in other liabilities at May 31, 1997 and 1996, were $289,822,000 and $260,977,000, respectively, representing the cumulative difference between rent expense and rent payments.

**Self-insurance reserves.** The Company is self-insured up to certain levels for workers' compensation, employee health care and vehicle liabilities. Reserves are based on the actuarially estimated cost of claims. Included in other liabilities at May 31, 1997 and 1996, were $256,000,000 and $278,000,000, respectively, representing the long-term portion of self-insurance reserves for the Company's workers' compensation and vehicle liabilities.

**Capitalized interest.** Interest on funds used to finance the acquisition and modification of aircraft and construction of certain facilities up to the date the asset is placed in service is capitalized and included in the cost of the asset. Capitalized interest was $39,449,000, $39,254,000 and $27,381,000 for 1997, 1996 and 1995, respectively.

**Advertising.** Advertising costs are generally expensed as incurred and are included in other operating expenses. Advertising expenses were $153,399,000, $138,408,000 and $147,288,000 in 1997, 1996 and 1995, respectively.

**Cash equivalents.** Cash equivalents are cash in excess of current operating requirements invested in short-term, interest-bearing instruments with maturities of three months or less at the date of purchase and are stated at cost, which approximates market value. Interest income was $5,055,000 in 1997, $9,850,000 in 1996 and $16,236,000 in 1995.

**Spare parts, supplies and fuel.** Spare parts are stated principally at weighted average cost; supplies and fuel are stated principally at standard cost which approximates actual cost on a first-in, first-out basis. Neither method values inventory in excess of current replacement cost.

**Goodwill.** Goodwill is the excess of the purchase price over the fair value of net assets of businesses acquired. It is amortized on a straight-line basis over periods ranging up to 40 years. Accumulated amortization was $129,404,000 and $114,606,000 at May 31, 1997 and 1996, respectively.

**Foreign currency translation.** Translation gains and losses of the Company's foreign operations that use local currencies as the functional currency are accumulated and reported, net of related deferred income taxes, as a separate component of common stockholders' investment. Transaction gains and losses that arise from exchange rate fluctuations on transactions denominated in a currency other than the local functional currency are included in the results of operations.

**Income taxes.** Deferred income taxes are provided for the tax effect of temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements. The Company uses the liability method to account for income taxes, which requires deferred taxes to be recorded at the statutory rate expected to be in effect when the taxes are paid.

The Company has not provided for U.S. federal income taxes on its foreign subsidiaries' earnings deemed to be permanently reinvested. Quantification of the deferred tax liability, if any, associated with permanently reinvested earnings is not practicable.

**Revenue recognition.** Revenue is generally recognized upon delivery of shipments. For shipments in transit, revenue is recorded based on the percentage of service completed.

**Earnings per share.** Earnings per share is computed based on the weighted average number of common and common equivalent shares outstanding during the period. Common equivalent shares are the shares of common stock that would be issued upon the exercise of all dilutive outstanding stock options, less the assumed repurchase of treasury shares. Earnings per share assuming full dilution is substantially the same as earnings per share as stated and, accordingly, is not shown separately.

In February 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings per Share." SFAS No. 128 specifies new standards for computing and disclosing earnings per share effective for financial statements issued for periods ending after December 15, 1997. The Company does not expect the adoption of SFAS No. 128 to have a material effect on the results of the earnings per share calculation for the years ended May 31, 1997, 1996 and 1995.

**Reclassifications.** Certain amounts for 1996 and 1995 have been reclassified to conform to the 1997 presentation.

**Use of estimates.** The preparation of the consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

## NOTE 2: ACCRUED EXPENSES

May 31 In thousands

| | 1997 | 1996 |
|---|---|---|
| Compensated absences | $ 234,284 | $211,499 |
| Insurance | 207,059 | 194,209 |
| Taxes other than income taxes | 143,541 | 153,905 |
| Employee benefits | 108,679 | 111,912 |
| Salaries | 101,694 | 78,384 |
| Aircraft overhaul | 84,006 | 59,343 |
| Other | 128,433 | 95,604 |
| | $1,007,696 | $904,856 |

## NOTE 3: LONG-TERM DEBT

May 31 In thousands

| | 1997 | 1996 |
|---|---|---|
| Unsecured notes payable, interest rates of 6.25% to 10.57%, due through 2013 | $ 928,525 | $ 934,181 |
| Unsecured sinking fund debentures, interest rate of 9.63%, due through 2020 | 98,461 | 98,392 |
| Commercial paper, effective interest rate of 5.75% | 200,904 | — |
| Capital lease obligations and tax exempt bonds, due through 2017, interest rates of 6.75% to 8.30% | 255,100 | 255,100 |
| Less bond reserves | 11,096 | 11,096 |
| | 244,004 | 244,004 |
| Other debt, interest rates of 9.68% to 9.98% | 52,726 | 56,709 |
| | 1,524,620 | 1,333,286 |
| Less current portion | 126,666 | 8,009 |
| | $1,397,954 | $1,325,277 |

The Company has a revolving credit agreement with domestic and foreign banks that provides for a commitment of $1,000,000,000 through May 31, 2000, of which $799,096,000 was available at May 31, 1997. Interest rates on borrowings under this agreement are generally determined by maturities selected and prevailing market conditions. The agreement contains certain covenants and restrictions, none of which are expected to significantly affect operations or the ability to pay dividends. As of May 31, 1997, approximately $1,259,000,000 was available for the payment of dividends under the restrictive covenant of the agreement. Commercial paper borrowings are backed by unused commitments under the revolving credit agreement and reduce the amount available under the agreement. Borrowings under this credit agreement and commercial paper borrowings are classified as long-term based on the Company's ability and intent to refinance such borrowings.

Tax exempt bonds were issued by the Memphis-Shelby County Airport Authority ("MSCAA") and the City of Indianapolis. A lease agreement with the MSCAA and a loan agreement with the City of Indianapolis covering the facilities and equipment financed with the bond proceeds obligate the Company to pay rentals and loan payments, respectively, equal to principal and interest due on the bonds.

Scheduled annual principal maturities of long-term debt for the five years subsequent to May 31, 1997, are as follows: $126,700,000 in 1998; $263,300,000 in 1999; $14,900,000 in 2000; $11,300,000 in 2001; and $206,700,000 in 2002.

The Company's long-term debt, exclusive of capital leases, had carrying values of $1,122,000,000 and $1,130,000,000 at May 31, 1997 and 1996, respectively, compared with fair values of approximately $1,223,000,000 and $1,245,000,000 at those dates. The estimated fair values were determined based on quoted market prices or on the current rates offered for debt with similar terms and maturities.

## NOTE 4: LEASE COMMITMENTS

The Company utilizes certain aircraft, land, facilities and equipment under capital and operating leases which expire at various dates through 2025. In addition, supplemental aircraft are leased under agreements which generally provide for cancellation upon 30 days' notice.

Property and equipment recorded under capital leases at May 31 was as follows:

In thousands

| | 1997 | 1996 |
|---|---|---|
| Package handling and ground support equipment | $274,017 | $303,756 |
| Facilities | 133,435 | 133,435 |
| Computer and electronic equipment and other | 6,520 | 7,143 |
| | 413,972 | 444,334 |
| Less accumulated amortization | 276,855 | 296,317 |
| | $137,117 | $148,017 |

Rent expense under operating leases for the years ended May 31 was as follows:

In thousands

| | 1997 | 1996 | 1995 |
|---|---|---|---|
| Minimum rentals | $930,977 | $820,896 | $707,182 |
| Contingent rentals | 57,806 | 61,164 | 43,005 |
| | $988,783 | $882,060 | $750,187 |

Contingent rentals are based on mileage under supplemental aircraft leases.

A summary of future minimum lease payments under capital leases and noncancelable operating leases (principally aircraft and facilities) with an initial or remaining term in excess of one year at May 31, 1997, follows:

In thousands

| | Capital Leases | Operating Leases |
|---|---|---|
| 1998 | $ 15,561 | $ 827,483 |
| 1999 | 15,561 | 838,904 |
| 2000 | 15,561 | 788,552 |
| 2001 | 15,561 | 749,014 |
| 2002 | 15,561 | 685,268 |
| Thereafter | 340,524 | 7,789,492 |
| | $418,329 | $11,678,713 |

At May 31, 1997, the present value of future minimum lease payments for capital lease obligations was $199,004,000.

## NOTE 5: PREFERRED STOCK

The Certificate of Incorporation authorizes the Board of Directors, at its discretion, to issue up to 4,000,000 shares of Series Preferred Stock. The stock is issuable in series which may vary as to certain rights and preferences and has no par value. As of May 31, 1997, none of these shares had been issued.

## NOTE 6: COMMON STOCKHOLDERS' INVESTMENT

On October 1, 1996, the Board of Directors declared a two-for-one stock split in the form of a 100% stock dividend, which was paid on November 4, 1996, to stockholders of record on October 15, 1996. All share and per share amounts have been adjusted to reflect the stock split.

### Stock Compensation Plans

At May 31, 1997, the Company had options and awards outstanding under nine stock-based compensation plans consisting of seven fixed stock option plans and two restricted stock plans, which are described below. As of May 31, 1997, there were 7,218,819 shares of common stock reserved for issuance under five of these plans. In 1988, the Board of Directors authorized the purchase of up to approximately 10,600,000 shares of the Company's common stock on the open market. As of May 31, 1997, a total of 6,006,517 shares at an average cost of $22.88 per share had been purchased and reissued under the above-mentioned plans.

The Company applies Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations in accounting for its plans. Accordingly, no compensation cost was recognized for its fixed stock option plans. The compensation cost charged against income for its restricted stock plans was $3,421,000, $2,227,000 and $774,000 for 1997, 1996 and 1995, respectively.

Had compensation cost for the Company's stock-based compensation plans been determined consistent with SFAS No. 123, "Accounting for Stock-Based Compensation," the Company's net income and earnings per share would have been the pro forma amounts indicated below:

In thousands, except per share data

| | 1997 | 1996 |
|---|---|---|
| Net Income: | | |
| As reported | $361,227 | $307,777 |
| Pro forma | 352,747 | 302,504 |
| Earnings per share: | | |
| As reported | $ 3.12 | $ 2.69 |
| Pro forma | 3.05 | 2.65 |

The pro forma disclosures, applying SFAS No. 123, are not likely to be representative of pro forma disclosures for future years. The pro forma effect is not expected to be fully reflected until 2002 since SFAS No. 123 is applicable to options granted by the Company after May 31, 1995, and because options vest over several years and additional grants could be made.

### Fixed Stock Option Plans

Under the provisions of the Company's stock incentive plans, options may be granted to certain key employees (and, under the 1993 plan, to directors who are not employees of the Company) to purchase shares of common stock of the Company at a price not less than its fair market value at the date of grant. Options granted have a maximum term of 10 years. Vesting requirements are determined at the discretion of the Compensation Committee of the Board of Directors. Presently, option vesting periods range from one to seven years. At May 31, 1997, there were 963,692 shares available for future grants under these plans.

Beginning with the grants made on or after June 1, 1995, the fair value of each option grant was estimated on the grant date using the Black-Scholes option-pricing model with the following assumptions for each option grant:

| | 1997 | 1996 |
|---|---|---|
| Dividend yield | 0% | 0% |
| Expected volatility | 25% | 25% |
| Risk-free interest rate | 5.82%–6.91% | 5.86%–6.43% |
| Expected lives | 2.5–8.5 years | 2.5–7.5 years |

The following table summarizes information about the Company's fixed stock option plans for the years ended May 31:

| | 1997 | | 1996 | | 1995 | |
|---|---|---|---|---|---|---|
| | Shares | Weighted-Average Exercise Price | Shares | Weighted-Average Exercise Price | Shares | Weighted-Average Exercise Price |
| Outstanding at beginning of year | 6,398,560 | $31.44 | 6,337,730 | $27.49 | 5,751,572 | $25.78 |
| Granted | 1,188,000 | 38.84 | 1,818,000 | 40.69 | 1,343,600 | 32.71 |
| Exercised | (1,136,503) | 27.30 | (1,421,890) | 25.41 | (577,448) | 20.95 |
| Forfeited | (268,030) | 35.98 | (335,280) | 32.46 | (179,994) | 23.18 |
| Outstanding at end of year | 6,182,027 | 33.43 | 6,398,560 | 31.44 | 6,337,730 | 27.49 |
| Exercisable at end of year | 2,265,149 | 27.84 | 2,452,800 | 25.10 | 2,956,178 | 24.60 |

The weighted-average fair value of options granted during the year was $16.23 and $13.07 for the years ended May 31, 1997 and 1996, respectively.

The following table summarizes information about fixed stock options outstanding at May 31, 1997:

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| Range of Exercise Prices | Number Outstanding | Weighted-Average Remaining Contractual Life | Weighted-Average Exercise Price | Number Exercisable | Weighted-Average Exercise Price |
| $15.28 – $22.56 | 842,955 | 2.3 years | $19.82 | 818,755 | $19.81 |
| 23.13 – 43.94 | 5,339,072 | 7.5 years | 35.58 | 1,446,394 | 32.38 |
| 15.28 – 43.94 | 6,182,027 | 6.8 years | 33.43 | 2,265,149 | 27.84 |

### Restricted Stock Plans

Under the terms of the Company's Restricted Stock Plans, shares of the Company's common stock are awarded to key employees. All restrictions on the shares expire over periods varying from two to five years from their date of award. Shares are valued at the market price of the Company's common stock at the date of award. Compensation expense related to these plans is recorded as a reduction of common stockholders' investment and is being amortized as restrictions on such shares expire. The following table summarizes information about restricted stock awards for the years ended May 31:

| | 1997 | | 1996 | | 1995 | |
|---|---|---|---|---|---|---|
| | **Shares** | **Weighted-Average Fair Value** | Shares | Weighted-Average Fair Value | Shares | Weighted-Average Fair Value |
| Awarded | **201,900** | **$51.93** | 350,500 | $39.65 | — | $ — |
| Forfeited | **18,000** | **40.03** | 29,000 | 38.96 | 7,500 | 18.56 |

At May 31, 1997, there were 73,100 shares available for future awards under this plan.

## NOTE 7: INCOME TAXES

The components of the provision for income taxes for the years ended May 31 were as follows:

In thousands

| | **1997** | 1996 | 1995 |
|---|---|---|---|
| Current provision: | | | |
| Federal | **$144,647** | $142,512 | $137,041 |
| Foreign | **44,165** | 37,759 | 29,787 |
| State | **19,827** | 18,007 | 23,405 |
| | **208,639** | 198,278 | 190,233 |
| Deferred provision: | | | |
| Federal | **50,717** | 27,962 | 24,058 |
| Foreign | **2,336** | 2,351 | 9,072 |
| State | **5,302** | 3,591 | 1,133 |
| | **58,355** | 33,904 | 34,263 |
| | **$266,994** | $232,182 | $224,496 |

The Company's operations included the following income (loss) with respect to entities in foreign locations for the years ended May 31:

In thousands

| | 1997 | 1996 | 1995 |
|---|---|---|---|
| Entities with pre-tax income | $ 204,000 | $ 153,000 | $ 149,000 |
| Entities with pre-tax losses | (186,000) | (228,000) | (173,000) |
| | $ 18,000 | $ (75,000) | $ (24,000) |

Income (losses) from entities which are structured as foreign subsidiaries are not included in the U.S. consolidated income tax return. Approximately $78,000,000, $60,000,000 and $29,000,000 of net foreign subsidiary income were not taxable for federal income tax purposes in 1997, 1996 and 1995, respectively. Income taxes have been provided for foreign operations based upon the various tax laws and rates of the countries in which the Company's operations are conducted. There is no direct relationship between the Company's overall foreign income tax provision and foreign pre-tax book income due to the different methods of taxation used by countries throughout the world.

A reconciliation of the statutory federal income tax rate to the Company's effective income tax rate for the years ended May 31 follows:

| | 1997 | 1996 | 1995 |
|---|---|---|---|
| Statutory U.S. income tax rate | 35.0% | 35.0% | 35.0% |
| Increase resulting from: | | | |
| Goodwill amortization | 0.8 | 0.9 | 1.0 |
| Foreign operations | 1.1 | 1.7 | 0.9 |
| State income taxes, net of federal benefit | 2.6 | 2.6 | 3.1 |
| Other, net | 3.0 | 2.8 | 3.0 |
| | 42.5% | 43.0% | 43.0% |

The significant components of deferred tax assets and liabilities as of May 31 were as follows:

In thousands

| | 1997 | | 1996 | |
|---|---|---|---|---|
| | Deferred Tax Assets | Deferred Tax Liabilities | Deferred Tax Assets | Deferred Tax Liabilities |
| Depreciation | $ — | $409,563 | $ — | $324,221 |
| Deferred gains on sales of assets | 83,413 | — | 81,370 | — |
| Employee benefits | 77,590 | — | 45,137 | — |
| Self-insurance reserves | 162,443 | — | 165,020 | — |
| Other | 171,356 | 95,246 | 151,355 | 90,089 |
| | $494,802 | $504,809 | $442,882 | $414,310 |

## NOTE 8: PENSION AND PROFIT SHARING PLANS

The Company sponsors pension plans covering substantially all employees. The largest plan covers U.S. domestic employees age 21 and over, with at least one year of service and provides benefits based on final average earnings and years of service. Plan funding is actuarially determined, subject to certain tax law limitations.

International defined benefit plans provide benefits primarily based on final earnings and years of service and are funded in accordance with local laws and income tax regulations.

The following table sets forth the funded status of the plans as of May 31:

In thousands

| | **1997** | 1996 |
|---|---|---|
| Plan assets at fair value | **$3,275,641** | $2,725,896 |
| Actuarial present value of the projected benefit obligation for service rendered to date | **2,911,584** | 2,571,086 |
| Plan assets in excess of projected benefit obligation | **364,057** | 154,810 |
| Unrecognized net gains from past experience different from that assumed and effects of changes in assumptions | **(281,274)** | (74,425) |
| Prior service cost not yet recognized in net periodic cost | **(2,335)** | (7,398) |
| Unrecognized transition amount | **3,169** | 3,239 |
| Pension asset | **$ 83,617** | $ 76,226 |
| Accumulated benefit obligation | **$1,892,635** | $1,626,877 |
| Vested benefit obligation | **$1,768,619** | $1,538,267 |

Net periodic pension cost for the years ended May 31 included the following components:

In thousands

| | **1997** | 1996 | 1995 |
|---|---|---|---|
| Service cost — benefits earned during the period | **$232,491** | $ 184,305 | $ 182,617 |
| Interest cost on projected benefit obligation | **206,359** | 165,635 | 143,408 |
| Actual return on plan assets | **(423,871)** | (463,819) | (192,939) |
| Net amortization and deferral | **130,529** | 256,968 | 19,333 |
| | **$145,508** | $ 143,089 | $ 152,419 |

The weighted-average discount rate and rate of increase in future compensation levels used in determining the actuarial present value of the projected benefit obligation were 8.1% and 5.5%, respectively, in 1997, 8.0% and 5.5%, respectively, in 1996 and 8.6% and 6.0%, respectively, in 1995. The expected long-term rate of return on assets was 10.5% in 1997 and 9.5% in 1996 and 1995. Plan assets consist primarily of marketable equity securities and fixed income instruments.

The Company also has a profit sharing plan, which covers substantially all U.S. domestic employees age 21 and over, with at least one year of service with the Company as of the contribution date. The plan provides for discretionary contributions by the Company which are determined annually by the Board of Directors. The plan also provides for a matching contribution by the Company equal to 50% of each participant's contribution up to a maximum of $500 per participant annually. Profit sharing expense was $90,800,000 in 1997, $80,400,000 in 1996 and $76,600,000 in 1995. The 1997 amount consists of contributions to the plan of $62,200,000 and cash distributions made outside the plan directly to employees of $28,600,000.

## NOTE 9: POSTRETIREMENT BENEFIT PLANS

The Company offers medical and dental coverage to all eligible U.S. domestic retirees and their eligible dependents. Vision coverage is provided for retirees, but not their dependents. Substantially all of the Company's U.S. domestic employees become eligible for these benefits at age 55 and older, if they have permanent, continuous service with the Company of at least 10 years after attainment of age 45 if hired prior to January 1, 1988, or at least 20 years after attainment of age 35, if hired on or after January 1, 1988. Life insurance benefits are provided only to retirees of the former Tiger International, Inc. who retired prior to acquisition.

The following table sets forth the accrued postretirement benefit cost as of May 31:

In thousands

| | **1997** | 1996 |
|---|---|---|
| Accumulated postretirement benefit obligation: | | |
| Retirees | **$ 41,552** | $ 39,539 |
| Fully eligible active employees | **38,430** | 31,472 |
| Other active employees, not fully eligible | **88,607** | 80,001 |
| | **168,589** | 151,012 |
| Unrecognized net gain | **24,089** | 15,402 |
| | **$192,678** | $166,414 |

Net postretirement benefit cost for the years ended May 31 was as follows:

In thousands

| | **1997** | 1996 | 1995 |
|---|---|---|---|
| Service cost | **$16,952** | $12,085 | $12,870 |
| Interest cost | **12,592** | 11,275 | 10,617 |
| Amortization of accumulated gains | **—** | (780) | — |
| | **$29,544** | $22,580 | $23,487 |

Future medical benefit costs were estimated to increase at an annual rate of 10.0% during 1998, decreasing to an annual growth rate of 5.75% in 2007 and thereafter. Future dental benefit costs were estimated to increase at an annual rate of 8.25% during 1998, decreasing to an annual growth rate of 5.75% in 2008 and thereafter. The Company's cost is capped at 150% of 1993 employer cost and, therefore, will not be subject to medical and dental trends after the capped cost is attained, projected to be in 2000. Primarily because of the cap on the Company's cost, a 1% increase in these annual trend rates would not have a significant impact on the accumulated postretirement benefit obligation at May 31, 1997, or 1997 benefit expense. The weighted average discount rates used in estimating the accumulated postretirement obligation were 7.8% and 7.4% at May 31, 1997 and 1996, respectively. The Company pays claims as incurred.

## NOTE 10: BUSINESS SEGMENT INFORMATION

The Company is in a single line of business—the worldwide transportation and distribution of goods and documents. For reporting purposes, operations are classified into two geographic areas, U.S. domestic and international. Shipments which either originate in or are destined to locations outside the U.S. are categorized as international.

A summary of selected financial information for U.S. domestic and international operations for the years ended May 31 follows:

In thousands

| | U.S. Domestic | International | Total Worldwide |
|---|---|---|---|
| Revenues: | | | |
| **1997** | **$8,322,037** | **$3,197,713** | **$11,519,750** |
| 1996 | 7,466,311 | 2,807,308 | 10,273,619 |
| 1995 | 6,839,418 | 2,552,655 | 9,392,073 |
| Operating Income: | | | |
| **1997** | **$ 558,040** | **$ 141,002** | **$ 699,042** |
| 1996 | 542,168 | 81,656 | 623,824 |
| 1995 | 465,527 | 125,617 | 591,144 |
| Identifiable Assets: | | | |
| **1997** | **$6,122,885** | **$1,502,601** | **$ 7,625,486** |
| 1996 | 5,449,353 | 1,249,618 | 6,698,971 |
| 1995 | 5,321,811 | 1,111,561 | 6,433,372 |

Identifiable assets used jointly in U.S. domestic and international operations (principally aircraft) have been allocated based on estimated usage. International revenues related to services originating in the U.S. totaled $1,433,700,000, $1,316,100,000 and $1,201,100,000 for the years ended May 31, 1997, 1996 and 1995, respectively.

## NOTE 11: SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest expense and income taxes for the years ended May 31 was as follows:

In thousands

| | 1997 | 1996 | 1995 |
|---|---|---|---|
| Interest (net of capitalized interest) | **$ 95,364** | $108,052 | $138,833 |
| Income taxes | **184,668** | 204,487 | 185,964 |

Non-cash investing and financing activities for the years ended May 31 were as follows:

In thousands

| | 1997 | 1996 | 1995 |
|---|---|---|---|
| Fair value of assets surrendered under exchange agreements (with two airlines) | **$62,018** | $ — | $ — |
| Fair value of assets acquired under exchange agreements | **46,662** | — | — |
| Fair value of assets receivable under exchange agreements | **15,356** | — | — |
| Liabilities assumed in buyout of a leased B747 aircraft | — | — | 50,300 |

## NOTE 12: COMMITMENTS AND CONTINGENCIES

The Company's annual purchase commitments under various contracts as of May 31, 1997, were as follows:

In thousands

| | Aircraft | Aircraft-Related[1] | Other[2] | Total |
|---|---|---|---|---|
| 1998 | $504,400 | $276,300 | $313,800 | $1,094,500 |
| 1999 | 406,100 | 161,400 | 57,300 | 624,800 |
| 2000 | 369,500 | 364,900 | 13,300 | 747,700 |
| 2001 | 278,000 | 180,500 | — | 458,500 |
| 2002 | 38,000 | 165,300 | — | 203,300 |

(1) Primarily aircraft modifications, rotables, and spare parts and engines.

(2) Facilities, vehicles, computer and other equipment.

At May 31, 1997, the Company was committed to purchase 17 Airbus A300s, two Airbus A310s, eight MD11s and 50 Ayers ALM 200s to be delivered through 2002. Deposits and progress payments of $141,090,000 had been made toward these purchases. The Company may be required to purchase seven additional MD11 aircraft for delivery beginning no later than 2000 under a put option agreement.

During 1997, the Company entered into agreements with two airlines to acquire 53 DC10s, spare parts, aircraft engines and other equipment, and maintenance services in exchange for a combination of aircraft engine noise reduction kits and cash. Delivery of these aircraft began in 1997 and will continue through 2001. Additionally, these airlines may exercise put options through December 31, 2003, requiring the Company to purchase up to 29 additional DC10s along with additional aircraft engines and equipment.

The Company has entered into contracts which are designed to limit its exposure to fluctuations in jet fuel prices. Under these contracts, the Company makes (or receives) payments based on the difference between a specified lower (or upper) limit and the market price of jet fuel, as determined by an index of spot market prices representing various geographic regions. The difference is recorded as an increase or decrease in fuel expense. At May 31, 1997, the Company had contracts with various financial institutions covering a total notional volume of 396,900,000 gallons (approximately 54% of the Company's annual jet fuel consumption), with some contracts extending through May 1998. At May 31, 1996, the Company had similar contracts covering a total notional volume of 365,300,000 gallons (approximately 54% of the Company's annual jet fuel consumption), with some contracts extending through May 1997. The Company received $15,162,000 (net of payments) and $1,977,000 under jet fuel contracts during 1997 and 1996, respectively. Based on current market prices, the fair value of these contracts was a liability of approximately $418,000 at May 31, 1997, and an asset of approximately $1,370,000 at May 31, 1996.

## NOTE 13: LEGAL PROCEEDINGS

Customers of the Company have filed four separate class-action lawsuits against the Company generally alleging that the Company has breached its contract with the plaintiffs in transporting packages shipped by them. These lawsuits allege that the Company continued to collect a 6.25% federal excise tax on the transportation of property shipped by air after the tax expired on December 31, 1995, until it was reinstated in August of 1996. The plaintiffs seek certification as a class action, damages, an injunction to enjoin the Company from continuing to collect the excise tax referred to above, and an award of attorneys' fees and costs. Three of those cases were consolidated in Minnesota Federal District Court. That court stayed the consolidated cases in favor of a case filed in Circuit Court of Greene County, Alabama. The complaint in the Alabama case also alleges that the Company continued to collect the excise tax on the transportation of property shipped by air after the tax expired again on December 31, 1996.

A fifth case, filed in the Supreme Court of New York, New York County, containing allegations and requests for relief substantially similar to the other four cases, originally alleged that the Company continued to collect the excise tax on the transportation of property shipped by air after the tax expired on December 31, 1996. The New York complaint has been amended to cover the first expiration period of the tax (December 31, 1995 through August 27, 1996) covered in the original Alabama complaint.

The air transportation excise tax expired on December 31, 1995, was reenacted by Congress effective August 27, 1996, and expired again on December 31, 1996. The excise tax was then reenacted by Congress effective March 7, 1997, and is scheduled to expire on September 30, 1997. The expiration of the tax relieved the Company of its obligation to pay the tax during the periods of expiration. Legislation to reenact the tax for a ten-year period as of October 1, 1997, is currently pending in Congress.

The Company intends to vigorously defend itself in these cases. No amount has been reserved for these contingencies.

The Company is subject to other legal proceedings and claims which arise in the ordinary course of its business. In the opinion of management, the aggregate liability, if any, with respect to these other actions will not materially adversely affect the financial position or results of operations of the Company.

## NOTE 14: UNUSUAL EVENTS

In 1997, operating income included a $15,000,000 pre-tax benefit from the settlement of a Tennessee personal property tax matter. Also in 1997, the Company recorded a $17,100,000 non-operating gain from an insurance settlement for a DC10 aircraft destroyed by fire in September 1996.

The Company received $7,800,000 and $9,700,000 in 1996 and 1995, respectively, from the bankruptcy estate of a firm engaged by the Company in 1990 to remit payments of employee withholding taxes. This amount is a partial recovery of a $32,000,000 loss incurred by the Company in 1991 that resulted from the firm's failure to remit certain of these tax payments to appropriate authorities. The Company has received $17,900,000 from the bankruptcy estate of the firm. All major issues pertaining to the bankruptcy have been resolved, and any additional amounts the Company may receive are expected to be insignificant.

In January 1995, the Company sold two dedicated warehousing and contract distribution companies in the United Kingdom. A gain of $35,700,000 was recorded from the sale.

## NOTE 15: SUMMARY OF QUARTERLY OPERATING RESULTS (UNAUDITED)

| In thousands, except earnings per share | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
|---|---|---|---|---|
| **1997** | | | | |
| Revenues | **$2,692,312** | **$2,852,369** | **$2,906,819** | **$3,068,250** |
| Operating income | **129,918** | **184,927** | **132,927** | **251,270** |
| Income before income taxes | **107,739** | **180,378** | **109,544** | **230,560** |
| Net income | **61,950** | **103,717** | **62,988** | **132,572** |
| Earnings per share | **$ .54** | **$ .90** | **$ .54** | **$ 1.14** |
| Average shares outstanding | **114,934** | **115,132** | **115,849** | **116,649** |
| 1996 | | | | |
| Revenues | $2,453,394 | $2,547,012 | $2,535,470 | $2,737,743 |
| Operating income | 149,230 | 170,905 | 77,943 | 225,746 |
| Income before income taxes | 129,886 | 154,952 | 52,637 | 202,484 |
| Net income | 75,334 | 89,871 | 27,156 | 115,416 |
| Earnings per share | $ .66 | $ .78 | $ .24 | $ 1.01 |
| Average shares outstanding | 113,376 | 114,520 | 114,515 | 114,691 |

## Report of Independent Public Accountants

To the Stockholders of Federal Express Corporation:

We have audited the accompanying consolidated balance sheets of Federal Express Corporation (a Delaware corporation) and subsidiaries as of May 31, 1997 and 1996, and the related consolidated statements of income, common stockholders' investment and cash flows for each of the three years in the period ended May 31, 1997. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Federal Express Corporation and subsidiaries as of May 31, 1997 and 1996, and the results of their operations and their cash flows for each of the three years in the period ended May 31, 1997, in conformity with generally accepted accounting principles.

Arthur Andersen LLP

Memphis, Tennessee
June 30, 1997

## Selected Consolidated Financial Data

Years ended May 31 — In thousands, except per share amounts and Other Operating Data

| | 1997 | 1996 | 1995 |
|---|---|---|---|
| **OPERATING RESULTS** | | | |
| Revenues | $11,519,750 | $10,273,619 | $9,392,073 |
| Operating income | 699,042 | 623,824 | 591,144 |
| Income (loss) before income taxes | 628,221 | 539,959 | 522,084 |
| Income (loss) from continuing operations | 361,227 | 307,777 | 297,588 |
| Net income (loss) | $ 361,227 | $ 307,777 | $ 297,588 |
| **PER SHARE DATA** | | | |
| Earnings (loss) per share: | | | |
| Before cumulative effect of changes in accounting principles | $ 3.12 | $ 2.69 | $ 2.63 |
| Cumulative effect of changes in accounting principles | — | — | — |
| Net earnings (loss) per share | $ 3.12 | $ 2.69 | $ 2.63 |
| Average shares outstanding | 115,641 | 114,276 | 112,987 |
| Cash dividends | — | — | — |
| **FINANCIAL POSITION** | | | |
| Property and equipment, net | $ 4,622,080 | $ 4,116,601 | $3,715,244 |
| Total assets | 7,625,486 | 6,698,971 | 6,433,372 |
| Long-term debt | 1,397,954 | 1,325,277 | 1,324,711 |
| Common stockholders' investment | 2,962,514 | 2,576,139 | 2,245,569 |
| **OTHER OPERATING DATA** | | | |
| Express package: | | | |
| Average daily package volume | 2,715,894 | 2,437,662 | 2,247,594 |
| Average pounds per package | 7.2 | 6.4 | 6.3 |
| Average revenue per pound* | $ 2.11 | $ 2.31 | $ 2.31 |
| Average revenue per package* | $ 15.11 | $ 14.87 | $ 14.62 |
| Airfreight: | | | |
| Average daily pounds | 2,542,226 | 2,144,225 | 2,153,041 |
| Average revenue per pound | $ .94 | $ 1.01 | $ 1.06 |
| Operating weekdays | 254 | 256 | 255 |
| Aircraft fleet: | | | |
| Airbus A300-600 | 19 | 16 | 9 |
| Airbus A310-200 | 35 | 25 | 15 |
| Boeing 747-100 | — | — | — |
| Boeing 747-200 | — | 4 | 5 |
| McDonnell Douglas MD11 | 23 | 18 | 13 |
| McDonnell Douglas DC10-10 | 26 | 13 | 13 |
| McDonnell Douglas DC10-30 | 22 | 22 | 22 |
| McDonnell Douglas DC8 | — | — | — |
| Boeing 727-100 | 68 | 68 | 68 |
| Boeing 727-200 | 95 | 95 | 90 |
| Cessna 208A | 10 | 10 | 10 |
| Cessna 208B | 254 | 254 | 219 |
| Fokker F27 | 32 | 32 | 32 |
| Vehicle fleet | 38,500 | 36,900 | 35,900 |
| Average number of employees (based on a standard full-time workweek) | 107,827 | 99,999 | 94,201 |

*Beginning in 1995, certain service fee revenues were classified as package-related revenue. Data for prior periods has been restated where applicable to

| 1994 | 1993 | 1992 | 1991 | 1990 | 1989 | 1988 |
|---|---|---|---|---|---|---|
| $8,479,456 | $7,808,043 | $7,550,060 | $7,688,296 | $7,015,069 | $5,166,967 | $3,882,817 |
| 530,632 | 377,173 | 22,967 | 252,126 | 387,355 | 414,787 | 379,452 |
| 378,462 | 203,576 | (146,828) | 40,942 | 218,423 | 298,332 | 302,328 |
| 204,370 | 109,809 | (113,782) | 5,898 | 115,764 | 166,451 | 187,716 |
| $ 204,370 | $ 53,866 | $ (113,782) | $ 5,898 | $ 115,764 | $ 184,551 | $ 187,716 |
| $ 1.82 | $ 1.00 | $ (1.05) | $ .06 | $ 1.09 | $ 1.59 | $ 1.78 |
| — | (.51) | — | — | — | .18 | — |
| $ 1.82 | $ .49 | $ (1.05) | $ .06 | $ 1.09 | $ 1.77 | $ 1.78 |
| 112,024 | 109,437 | 107,923 | 106,701 | 106,323 | 104,544 | 105,339 |
| — | — | — | — | — | — | — |
| $3,449,093 | $3,476,268 | $3,411,297 | $3,624,026 | $3,566,321 | $3,431,814 | $2,231,875 |
| 5,992,498 | 5,793,064 | 5,463,186 | 5,672,461 | 5,675,073 | 5,293,422 | 3,008,549 |
| 1,632,202 | 1,882,279 | 1,797,844 | 1,826,781 | 2,148,142 | 2,138,940 | 838,730 |
| 1,924,705 | 1,671,381 | 1,579,722 | 1,668,620 | 1,649,187 | 1,493,524 | 1,330,679 |
| 1,925,105 | 1,710,561 | 1,472,642 | 1,310,890 | 1,234,174 | 1,059,882 | 877,543 |
| 6.0 | 5.8 | 5.7 | 5.6 | 5.4 | 5.4 | 5.3 |
| $ 2.51 | $ 2.62 | $ 2.90 | $ 3.08 | $ 3.13 | $ 3.04 | $ 3.10 |
| $ 15.12 | $ 15.30 | $ 16.38 | $ 17.33 | $ 16.76 | $ 16.28 | $ 16.32 |
| 1,844,270 | 2,050,033 | 2,258,303 | 2,650,204 | 3,148,290 | 4,019,353 | — |
| $ 1.06 | $ 1.09 | $ 1.22 | $ 1.20 | $ 1.13 | $ 1.06 | — |
| 257 | 255 | 254 | 255 | 255 | 255 | 257 |
| 2 | — | — | — | — | — | — |
| — | — | — | — | — | — | — |
| — | — | 4 | 8 | 9 | 9 | — |
| 6 | 8 | 9 | 10 | 10 | 12 | — |
| 13 | 8 | 4 | 1 | — | — | — |
| 11 | 11 | 11 | 11 | 10 | 8 | 8 |
| 19 | 19 | 17 | 16 | 16 | 16 | 13 |
| — | — | — | — | 6 | 6 | — |
| 69 | 80 | 85 | 92 | 89 | 80 | 47 |
| 90 | 87 | 66 | 57 | 41 | 26 | 21 |
| 10 | 10 | 10 | 10 | 37 | 38 | 38 |
| 206 | 206 | 206 | 183 | 147 | 109 | 71 |
| 32 | 32 | 32 | 26 | 19 | 7 | 5 |
| 30,900 | 28,100 | 30,400 | 32,800 | 31,000 | 28,900 | 21,000 |
| 88,502 | 84,104 | 84,162 | 81,711 | 75,102 | 58,136 | 48,556 |

conform to this presentation.

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Vice President, Controller and
Chief Accounting Officer

## Corporate Information

**Stock listing:** The Company's common stock is listed on The New York Stock Exchange under the ticker symbol FDX.

**Stockholders:** At July 15, 1997, there were 9,565 stockholders of record.

**Market information:** Following are high and low closing prices, by quarter, for Federal Express Corporation common stock in fiscal 1997 and 1996. No cash dividends have been declared.

| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
|---|---|---|---|---|
| **FY 1997** | | | | |
| High | **$41 9/16** | **$44 7/8** | **$53 1/8** | **$57 1/8** |
| Low | **37 1/16** | **36 1/4** | **40 1/8** | **50 3/8** |
| FY 1996 | | | | |
| High | $37 11/16 | $43 | $41 5/16 | $41 1/4 |
| Low | 29 1/4 | 39 13/16 | 33 7/16 | 34 7/16 |

**Corporate headquarters:** 2005 Corporate Avenue, Memphis, Tennessee 38132, (901) 369-3600.

**Annual meeting:** The annual meeting of stockholders will be held at the Memphis Marriott, 2625 Thousand Oaks Boulevard, Memphis, Tennessee, on Monday, September 29, 1997, at 10:00 a.m., CDT.

**Inquiries:** For financial information, contact Rebecca M. Halvorson, Managing Director, Investor Relations and Corporate Contributions, Federal Express Corporation, Box 727, Dept. 1854, Memphis, Tennessee 38194, (901) 395-3478. For general information, contact Gregory M. Rossiter, Managing Director, Public Relations, Federal Express Corporation, Box 727, Dept. 1850, Memphis, Tennessee 38194, (901) 395-3460.

**Form 10-K:** A copy of the Company's Annual Report on Form 10-K (excluding exhibits), filed with the Securities and Exchange Commission (SEC) is available free of charge. You will be mailed a copy upon request to Susan J. McDonough, Manager, Investor Relations, Federal Express Corporation, Box 727, Dept. 1854, Memphis, Tennessee 38194, (901) 395-3478. Company documents filed electronically with the SEC can also be found on the Internet at the SEC's Web site (www.sec.gov).

**Auditors:** Arthur Andersen LLP, Memphis, Tennessee.

**Registrar and transfer agent:** First Chicago Trust Company of New York, Shareholder Services, P.O. Box 2500, Jersey City, New Jersey 07303-2500, (800) 446-2617 / John H. Ruocco (312) 407-5153.

**Equal Employment Opportunity:** Federal Express Corporation is firmly committed to afford Equal Employment Opportunity to all individuals regardless of age, sex, race, color, religion, national origin, citizenship, disability, or status as a Vietnam era or special disabled veteran. We are strongly bound to this commitment because adherence to Equal Employment Opportunity principles is the only acceptable way of life. We adhere to those principles not just because they're the law, but because it's the right thing to do.



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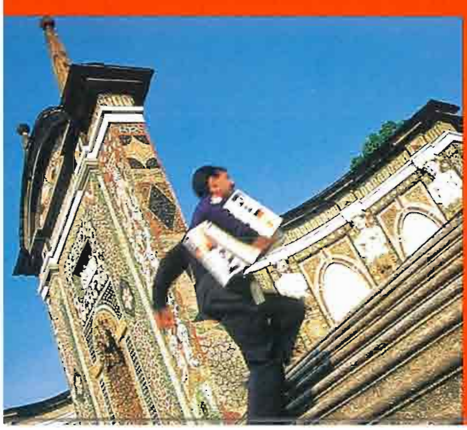

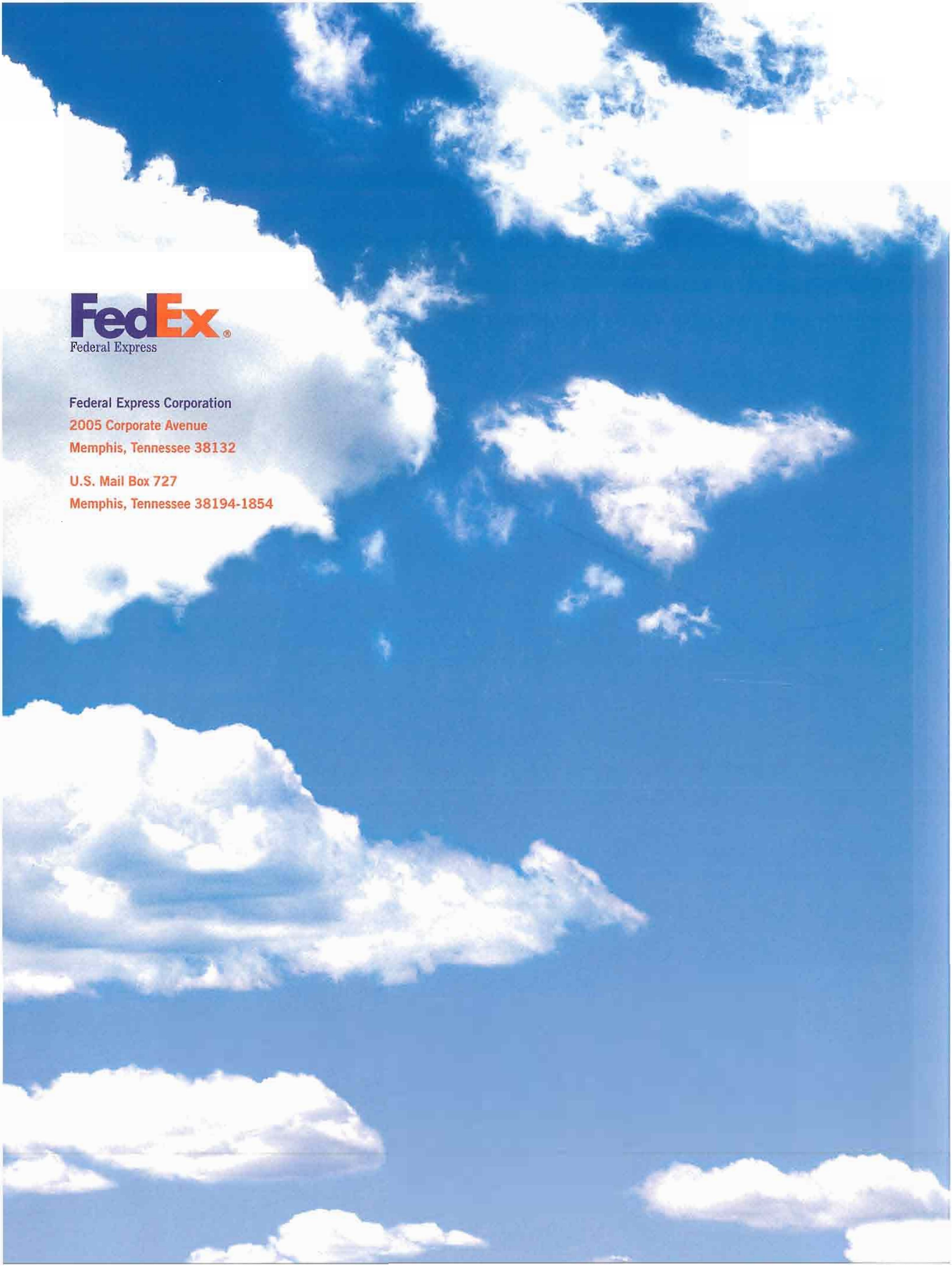

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