

UNITED PARCEL SERVICE INC

Form 10-Q

August 03, 2012

Table of Contents

United States

Securities and Exchange Commission

Washington, D.C. 20549

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Form 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2012, or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 001-15451

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United Parcel Service, Inc.

(Exact name of registrant as specified in its charter)

Delaware

(State or Other Jurisdiction of

Incorporation or Organization)

58-2480149

(IRS Employer

Identification No.)

55 Glenlake Parkway, NE Atlanta, Georgia

(Address of Principal Executive Offices)

(404) 828-6000

(Registrant's telephone number, including area code)

30328

(Zip Code)

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Former name, former address and former fiscal year, if changed since last report.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "accelerated filer", "large accelerated filer", and "smaller reporting company" in Rule 12b-2 of the Exchange Act. Check one: Large accelerated filer  Accelerated filer  Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

There were 232,112,145 Class A shares, and 726,328,912 Class B shares, with a par value of \$0.01 per share, outstanding at July 20, 2012.

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Table of Contents

UNITED PARCEL SERVICE, INC.  
 QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTER ENDED JUNE 30, 2012  
 TABLE OF CONTENTS

PART I—FINANCIAL INFORMATION

|                           |                                                                                              |           |
|---------------------------|----------------------------------------------------------------------------------------------|-----------|
|                           | <u>Cautionary Statement About Forward-Looking Statements</u>                                 | <u>1</u>  |
| Item 1.                   | <u>Financial Statements</u>                                                                  | <u>2</u>  |
|                           | <u>Consolidated Balance Sheets</u>                                                           | <u>2</u>  |
|                           | <u>Statements of Consolidated Income</u>                                                     | <u>3</u>  |
|                           | <u>Statements of Consolidated Comprehensive Income</u>                                       | <u>3</u>  |
|                           | <u>Statements of Consolidated Cash Flows</u>                                                 | <u>4</u>  |
|                           | <u>Notes to Consolidated Financial Statements</u>                                            | <u>5</u>  |
|                           | <u>Note 1—Basis of Presentation</u>                                                          | <u>5</u>  |
|                           | <u>Note 2—Recent Accounting Pronouncements</u>                                               | <u>5</u>  |
|                           | <u>Note 3—Stock-Based Compensation</u>                                                       | <u>6</u>  |
|                           | <u>Note 4—Investments and Restricted Cash</u>                                                | <u>8</u>  |
|                           | <u>Note 5—Property, Plant and Equipment</u>                                                  | <u>11</u> |
|                           | <u>Note 6—Employee Benefit Plans</u>                                                         | <u>12</u> |
|                           | <u>Note 7—Goodwill and Intangible Assets</u>                                                 | <u>13</u> |
|                           | <u>Note 8—Debt and Financing Arrangements</u>                                                | <u>14</u> |
|                           | <u>Note 9—Legal Proceedings and Contingencies</u>                                            | <u>15</u> |
|                           | <u>Note 10—Shareowners’ Equity</u>                                                           | <u>17</u> |
|                           | <u>Note 11—Segment Information</u>                                                           | <u>20</u> |
|                           | <u>Note 12—Earnings Per Share</u>                                                            | <u>21</u> |
|                           | <u>Note 13—Derivative Instruments and Risk Management</u>                                    | <u>22</u> |
|                           | <u>Note 14—Income Taxes</u>                                                                  | <u>27</u> |
|                           | <u>Note 15—Business Acquisitions</u>                                                         | <u>27</u> |
| Item 2.                   | <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u> | <u>28</u> |
|                           | <u>Overview</u>                                                                              | <u>28</u> |
|                           | <u>Items Affecting Comparability</u>                                                         | <u>29</u> |
|                           | <u>Results of Operations - Segment Review</u>                                                | <u>29</u> |
|                           | <u>U.S. Domestic Package Operations</u>                                                      | <u>30</u> |
|                           | <u>International Package Operations</u>                                                      | <u>32</u> |
|                           | <u>Supply Chain &amp; Freight Operations</u>                                                 | <u>34</u> |
|                           | <u>Consolidated Operating Expenses</u>                                                       | <u>36</u> |
|                           | <u>Investment Income and Interest Expense</u>                                                | <u>38</u> |
|                           | <u>Income Tax Expense</u>                                                                    | <u>38</u> |
|                           | <u>Liquidity and Capital Resources</u>                                                       | <u>39</u> |
|                           | <u>Net Cash from Operating Activities</u>                                                    | <u>39</u> |
|                           | <u>Net Cash used in Investing Activities</u>                                                 | <u>40</u> |
|                           | <u>Net Cash Provided by Financing Activities</u>                                             | <u>41</u> |
|                           | <u>Sources of Credit</u>                                                                     | <u>42</u> |
|                           | <u>Contingencies</u>                                                                         | <u>43</u> |
|                           | <u>Recent Accounting Pronouncements</u>                                                      | <u>46</u> |
| Item 3.                   | <u>Quantitative and Qualitative Disclosures About Market Risk</u>                            | <u>47</u> |
| Item 4.                   | <u>Controls and Procedures</u>                                                               | <u>47</u> |
| PART II—OTHER INFORMATION |                                                                                              |           |
| Item 1.                   | <u>Legal Proceedings</u>                                                                     | <u>48</u> |

|          |                                                                    |           |
|----------|--------------------------------------------------------------------|-----------|
| Item 1A. | <u>Risk Factors</u>                                                | <u>48</u> |
| Item 2.  | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | <u>48</u> |
| Item 3.  | <u>Defaults Upon Senior Securities</u>                             | <u>48</u> |
| Item 5.  | <u>Other Information</u>                                           | <u>48</u> |
| Item 6.  | <u>Exhibits</u>                                                    | <u>49</u> |

---

Table of Contents

PART I. FINANCIAL INFORMATION

Cautionary Statement About Forward-Looking Statements

This report includes certain “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. Statements in the future tense, and all statements accompanied by terms such as “believe,” “project,” “expect,” “estimate,” “assume,” “intend,” “anticipate,” “target,” “plan,” and variations thereof and similar terms are intended to be forward-looking statements. We intend that all forward-looking statements we make will be subject to safe harbor protection of the federal securities laws pursuant to Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934.

Our disclosure and analysis in this report, in our Annual Report on Form 10-K for the year ended December 31, 2011 and in our other filings with the Securities and Exchange Commission contain some forward-looking statements regarding our intent, belief and current expectations about our strategic direction, prospects and future results. From time to time, we also provide forward-looking statements in other materials we release as well as oral forward-looking statements. Such statements give our current expectations or forecasts of future events; they do not relate strictly to historical or current facts. Management believes that these forward-looking statements are reasonable as and when made. However, caution should be taken not to place undue reliance on any such forward-looking statements because such statements speak only as of the date when made.

Forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from our historical experience and our present expectations or anticipated results. These risks and uncertainties are described in Part I, “Item 1A. Risk Factors” of our Annual Report on Form 10-K for the year ended December 31, 2011 and may also be described from time to time in our future reports filed with the Securities and Exchange Commission. You should consider the limitations on, and risks associated with, forward-looking statements and not unduly rely on the accuracy of predictions contained in such forward-looking statements. We do not undertake any obligation to update forward-looking statements to reflect events, circumstances, changes in expectations, or the occurrence of unanticipated events after the date of those statements.

Table of Contents

## Item 1. Financial Statements

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS

June 30, 2012 (unaudited) and December 31, 2011

(In millions)

|                                                                   | June 30,<br>2012 | December 31,<br>2011 |
|-------------------------------------------------------------------|------------------|----------------------|
| <b>ASSETS</b>                                                     |                  |                      |
| Current Assets:                                                   |                  |                      |
| Cash and cash equivalents                                         | \$6,718          | \$3,034              |
| Marketable securities                                             | 604              | 1,241                |
| Accounts receivable, net                                          | 5,541            | 6,246                |
| Deferred income tax assets                                        | 593              | 611                  |
| Other current assets                                              | 1,246            | 1,152                |
| Total Current Assets                                              | 14,702           | 12,284               |
| Property, Plant and Equipment, Net                                | 17,597           | 17,621               |
| Goodwill                                                          | 2,147            | 2,101                |
| Intangible Assets, Net                                            | 620              | 585                  |
| Non-Current Investments and Restricted Cash                       | 304              | 303                  |
| Other Non-Current Assets                                          | 1,807            | 1,807                |
| Total Assets                                                      | \$37,177         | \$34,701             |
| <b>LIABILITIES AND SHAREOWNERS' EQUITY</b>                        |                  |                      |
| Current Liabilities:                                              |                  |                      |
| Current maturities of long-term debt and commercial paper         | \$1,911          | \$33                 |
| Accounts payable                                                  | 2,046            | 2,300                |
| Accrued wages and withholdings                                    | 1,780            | 1,843                |
| Self-insurance reserves                                           | 779              | 781                  |
| Income taxes payable                                              | 390              | 146                  |
| Other current liabilities                                         | 1,494            | 1,411                |
| Total Current Liabilities                                         | 8,400            | 6,514                |
| Long-Term Debt                                                    | 11,112           | 11,095               |
| Pension and Postretirement Benefit Obligations                    | 5,425            | 5,505                |
| Deferred Income Tax Liabilities                                   | 1,778            | 1,900                |
| Self-Insurance Reserves                                           | 1,878            | 1,806                |
| Other Non-Current Liabilities                                     | 859              | 773                  |
| Shareowners' Equity:                                              |                  |                      |
| Class A common stock (235 and 240 shares issued in 2012 and 2011) | 3                | 3                    |
| Class B common stock (725 and 725 shares issued in 2012 and 2011) | 7                | 7                    |
| Additional paid-in capital                                        | —                | —                    |
| Retained earnings                                                 | 10,827           | 10,128               |
| Accumulated other comprehensive loss                              | (3,192)          | (3,103)              |
| Deferred compensation obligations                                 | 76               | 88                   |
| Less: Treasury stock (2 shares in 2012 and 2011)                  | (76)             | (88)                 |
| Total Equity for Controlling Interests                            | 7,645            | 7,035                |
| Total Equity for Non-Controlling Interests                        | 80               | 73                   |
| Total Shareowners' Equity                                         | 7,725            | 7,108                |
| Total Liabilities and Shareowners' Equity                         | \$37,177         | \$34,701             |

See notes to unaudited consolidated financial statements.

2

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Table of Contents

## UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

## STATEMENTS OF CONSOLIDATED INCOME

(In millions, except per share amounts)

(unaudited)

|                                  | Three Months Ended |          | Six Months Ended |          |
|----------------------------------|--------------------|----------|------------------|----------|
|                                  | June 30,           |          | June 30,         |          |
|                                  | 2012               | 2011     | 2012             | 2011     |
| Revenue                          | \$13,349           | \$13,191 | \$26,485         | \$25,773 |
| Operating Expenses:              |                    |          |                  |          |
| Compensation and benefits        | 6,747              | 6,636    | 13,582           | 13,198   |
| Repairs and maintenance          | 303                | 317      | 605              | 632      |
| Depreciation and amortization    | 459                | 443      | 918              | 884      |
| Purchased transportation         | 1,733              | 1,762    | 3,450            | 3,410    |
| Fuel                             | 1,014              | 1,057    | 2,039            | 1,965    |
| Other occupancy                  | 213                | 225      | 450              | 486      |
| Other expenses                   | 1,090              | 1,006    | 2,082            | 1,981    |
| Total Operating Expenses         | 11,559             | 11,446   | 23,126           | 22,556   |
| Operating Profit                 | 1,790              | 1,745    | 3,359            | 3,217    |
| Other Income and (Expense):      |                    |          |                  |          |
| Investment income                | 6                  | 9        | 12               | 20       |
| Interest expense                 | (92                | ) (83    | ) (186           | ) (168   |
| Total Other Income and (Expense) | (86                | ) (74    | ) (174           | ) (148   |
| Income Before Income Taxes       | 1,704              | 1,671    | 3,185            | 3,069    |
| Income Tax Expense               | 588                | 579      | 1,099            | 1,062    |
| Net Income                       | \$1,116            | \$1,092  | \$2,086          | \$2,007  |
| Basic Earnings Per Share         | \$1.16             | \$1.11   | \$2.17           | \$2.03   |
| Diluted Earnings Per Share       | \$1.15             | \$1.09   | \$2.15           | \$2.01   |

## STATEMENTS OF CONSOLIDATED COMPREHENSIVE INCOME

(In millions)

(unaudited)

|                                                                             | Three Months Ended |         | Six Months Ended |         |
|-----------------------------------------------------------------------------|--------------------|---------|------------------|---------|
|                                                                             | June 30,           |         | June 30,         |         |
|                                                                             | 2012               | 2011    | 2012             | 2011    |
| Net income                                                                  | \$1,116            | \$1,092 | \$2,086          | \$2,007 |
| Change in foreign currency translation adjustment, net of tax               | (158               | ) 7     | (67              | ) 132   |
| Change in unrealized gain (loss) on marketable securities, net of tax       | 2                  | (3      | ) 1              | (7      |
| Change in unrealized gain (loss) on cash flow hedges, net of tax            | (43                | ) (5    | ) (84            | ) (68   |
| Change in unrecognized pension and postretirement benefit costs, net of tax | 27                 | 47      | 61               | 102     |
| Comprehensive income                                                        | \$944              | \$1,138 | \$1,997          | \$2,166 |
| See notes to unaudited consolidated financial statements.                   |                    |         |                  |         |

Table of Contents

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
 STATEMENTS OF CONSOLIDATED CASH FLOWS  
 (In millions)  
 (unaudited)

|                                                                            | Six Months Ended |         |
|----------------------------------------------------------------------------|------------------|---------|
|                                                                            | June 30,         |         |
|                                                                            | 2012             | 2011    |
| Cash Flows From Operating Activities:                                      |                  |         |
| Net income                                                                 | \$2,086          | \$2,007 |
| Adjustments to reconcile net income to net cash from operating activities: |                  |         |
| Depreciation and amortization                                              | 918              | 884     |
| Pension and postretirement benefit expense                                 | 473              | 419     |
| Pension and postretirement benefit contributions                           | (450)            | (1,296) |
| Self-insurance reserves                                                    | 70               | 42      |
| Deferred taxes, credits and other                                          | (148)            | 242     |
| Stock compensation expense                                                 | 295              | 272     |
| Other (gains) losses                                                       | 115              | 91      |
| Changes in assets and liabilities, net of effect of acquisitions:          |                  |         |
| Accounts receivable                                                        | 490              | 185     |
| Other current assets                                                       | (50)             | 105     |
| Accounts payable                                                           | (163)            | (23)    |
| Accrued wages and withholdings                                             | (34)             | 169     |
| Other current liabilities                                                  | 304              | 221     |
| Other operating activities                                                 | (56)             | (4)     |
| Net cash from operating activities                                         | 3,850            | 3,314   |
| Cash Flows From Investing Activities:                                      |                  |         |
| Capital expenditures                                                       | (949)            | (951)   |
| Proceeds from disposals of property, plant and equipment                   | 32               | 22      |
| Purchases of marketable securities                                         | (1,940)          | (2,306) |
| Sales and maturities of marketable securities                              | 2,604            | 2,208   |
| Net decrease in finance receivables                                        | 42               | 81      |
| Cash paid for business acquisitions                                        | (100)            | —       |
| Other investing activities                                                 | 4                | (123)   |
| Net cash used in investing activities                                      | (307)            | (1,069) |
| Cash Flows From Financing Activities:                                      |                  |         |
| Net change in short-term debt                                              | 1,877            | 1,172   |
| Proceeds from long-term borrowings                                         | 4                | 169     |
| Repayments of long-term borrowings                                         | (8)              | (179)   |
| Purchases of common stock                                                  | (885)            | (1,052) |
| Issuances of common stock                                                  | 194              | 163     |
| Dividends                                                                  | (1,068)          | (1,007) |
| Other financing activities                                                 | 44               | (237)   |
| Net cash provided by (used in) financing activities                        | 158              | (971)   |
| Effect Of Exchange Rate Changes On Cash And Cash Equivalents               | (17)             | 47      |
| Net Increase In Cash And Cash Equivalents                                  | 3,684            | 1,321   |
| Cash And Cash Equivalents:                                                 |                  |         |
| Beginning of period                                                        | 3,034            | 3,370   |
| End of period                                                              | \$6,718          | \$4,691 |



See notes to unaudited consolidated financial statements.

4

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Table of Contents

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS  
NOTE 1. BASIS OF PRESENTATION

Principles of Consolidation

In our opinion, the accompanying interim, unaudited, consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. These consolidated financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly our financial position as of June 30, 2012, our results of operations for the three and six months ended June 30, 2012 and 2011, and cash flows for the six months ended June 30, 2012 and 2011. The results reported in these consolidated financial statements should not be regarded as necessarily indicative of results that may be expected for the entire year. The interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2011.

For interim consolidated financial statement purposes, we provide for accruals under our various employee benefit plans and self-insurance reserves for each three month period based on one quarter of the estimated annual expense. Certain prior year amounts have been reclassified to conform to the current year presentation. These reclassifications had no impact on our financial position or results of operations.

Fair Value of Financial Instruments

The carrying amounts of our cash and cash equivalents, accounts receivable, finance receivables and accounts payable approximate fair value as of June 30, 2012. The fair values of our investment securities are disclosed in Note 4, our short and long-term debt in Note 8 and our derivative instruments in Note 13. We utilized Level 1 inputs in the fair value hierarchy of valuation techniques to determine the fair value of our cash and cash equivalents, and Level 2 inputs to determine the fair value of our accounts receivable, finance receivables and accounts payable.

Accounting Estimates

The preparation of the accompanying interim, unaudited, consolidated financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingencies at the date of the consolidated financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Estimates have been prepared on the basis of the most current and best information and actual results could differ materially from those estimates.

Change in Accounting Methodology

As described in our Annual Report on Form 10-K for the year ended December 31, 2011, we elected to change our accounting methodologies for recognizing expense for our company-sponsored U.S. and international pension and other postretirement benefit plans. The impact of these changes in our accounting methodologies was reported through retrospective application of the new policies to all periods presented. Accordingly, all relevant information as of, and for the quarter and year-to-date periods ended, June 30, 2011 has been adjusted to reflect the application of the new policies.

NOTE 2. RECENT ACCOUNTING PRONOUNCEMENTS

Adoption of New Accounting Standards

In May 2011, the Financial Accounting Standards Board ("FASB") issued an Accounting Standards Update to disclosure requirements for fair value measurement. These amendments, which became effective for us in the first quarter of 2012, result in a common definition of fair value and common measurement and disclosure requirements between U.S. GAAP and IFRS. Consequently, the amendments change some fair value measurement principles and disclosure requirements. The implementation of this amended accounting guidance had an immaterial impact on our consolidated financial position and results of operations.

Table of Contents

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

In June 2011, the FASB issued an Accounting Standards Update that increases the prominence of items reported in other comprehensive income in the financial statements. This update requires companies to present comprehensive income in a single statement below net income or in a separate statement of comprehensive income immediately following the income statement. This requirement became effective for us beginning with the first quarter of 2012, and we have included the required presentation in all applicable filings since that date.

Other accounting pronouncements adopted during the periods covered by the consolidated financial statements had an immaterial impact on our consolidated financial position and results of operations.

Accounting Standards Issued But Not Yet Effective

Accounting pronouncements issued, but not effective until after June 30, 2012, are not expected to have a significant impact on our consolidated financial position or results of operations.

NOTE 3. STOCK-BASED COMPENSATION

We issue employee share-based awards under the UPS Incentive Compensation Plan, which permits the grant of nonqualified stock options, incentive stock options, stock appreciation rights, restricted stock, performance shares, performance units and management incentive awards to eligible employees. The primary compensation programs offered under the UPS Incentive Compensation Plan include the UPS Management Incentive Award program, the UPS Long-Term Incentive Performance Award program and the UPS Stock Option program. We also maintain an employee stock purchase plan which allows eligible employees to purchase shares of UPS class A common stock at a discount. Additionally, our matching contributions to the primary employee defined contribution plan are made in shares of UPS class A common stock.

Compensation Program Changes

Effective January 1, 2011, we modified certain components of our management compensation programs for future award grants, as follows:

We eliminated our Long-Term Incentive program, and incorporated the value of the award into our Management Incentive Award program. The combined award is referred to as the Management Incentive Award program.

Previously, the restricted stock units granted under the Management Incentive Award program were granted in the fourth quarter of each year, while the restricted performance units granted under the Long-Term Incentive program were granted in the second quarter of each year (restricted stock units and restricted performance units are referred to as "Restricted Units"). Prospectively, Restricted Units granted under the modified Management Incentive Award will generally be granted in the first quarter of each year.

Management Incentive Award

During 2012, we granted Restricted Units under the Management Incentive Award program to eligible management employees. Restricted Units under the Management Incentive Award program will generally vest over a five-year period with approximately 20% of the award vesting on January 15th of each of the years following the grant date (except in the case of death, disability, or retirement, in which case immediate vesting occurs). The entire grant is expensed on a straight-line basis over the requisite service period. Based on the dates that the eligible management population and performance targets were approved for the Management Incentive Award program, we determined the award measurement dates to be February 6, 2012 (for U.S.-based employees) and April 2, 2012 (for internationally-based employees); therefore, the Restricted Unit grants were valued for stock compensation expense purposes using the closing New York Stock Exchange price of \$76.92 and \$80.67 on those dates, respectively.

As discussed in the Compensation Program Changes, we eliminated our Long-Term Incentive program and incorporated the value of the award into our Management Incentive Award program, beginning with the 2012 awards. Accordingly, no award was granted under the Long-Term Incentive program during 2012. During the second quarter of 2011, we granted 1.6 million Restricted Units at a grant price of \$74.25 related to eligible management employees under the former UPS Long-Term Incentive program.



Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## Long-Term Incentive Performance Award

During the first quarter of 2012, we also granted target Restricted Units under the UPS Long-Term Incentive Performance Award program to eligible management employees. Of the total 2012 target award, 90% of the target award will be divided into three substantially equal tranches, one for each calendar year in the three-year award cycle from 2012 to 2014, using performance criteria targets established each year. For 2012, those targets consist of consolidated operating return on invested capital and growth in consolidated revenue. The remaining 10% of the total 2012 target award will be based upon our achievement of adjusted earnings per share in 2014 compared to a target established at the grant date.

The number of Restricted Units earned each year will be the target number adjusted for the percentage achievement of performance criteria targets for the year. The percentage of achievement used to determine the Restricted Units earned may be a percentage less than or more than 100% of the target Restricted Units for each tranche. Based on the date that the eligible management population and performance targets were approved for the 2012 performance tranches, we determined the award measurement date to be March 1, 2012; therefore the target Restricted Units grant was valued for stock compensation expense purposes using the closing New York Stock Exchange price of \$76.89 on that date.

## Nonqualified Stock Options

Historically, awards granted under the UPS Stock Option program were granted during the second quarter of each year to a limited group of eligible senior management employees. Stock option awards generally vest over a five-year period with approximately 20% of the award vesting at each anniversary date of the grant (except in the case of death, disability, or retirement, in which case immediate vesting occurs). The options granted will expire ten years after the date of the grant. In the first quarter of 2012, we granted 0.2 million stock options at a weighted average grant price of \$76.94. In the second quarter of 2011, we granted 0.2 million stock options at a grant price of \$74.25. The weighted average fair value of our employee stock options granted, as determined by the Black-Scholes valuation model, was \$14.88 and \$15.92 for 2012 and 2011 respectively, using the following assumptions:

|                          |       |   |       |   |
|--------------------------|-------|---|-------|---|
|                          | 2012  |   | 2011  |   |
| Expected life (in years) | 7.5   |   | 7.5   |   |
| Risk-free interest rate  | 1.63  | % | 2.90  | % |
| Expected volatility      | 25.06 | % | 24.26 | % |
| Expected dividend yield  | 2.77  | % | 2.77  | % |

Compensation expense for share-based awards recognized in net income for the three months ended June 30, 2012 and 2011 was \$133 and \$152 million pre-tax, respectively. Compensation expense for share-based awards recognized in net income for the six months ended June 30, 2012 and 2011 was \$295 and \$272 million pre-tax, respectively.

Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 4. INVESTMENTS AND RESTRICTED CASH

The following is a summary of marketable securities classified as available-for-sale as of June 30, 2012 and December 31, 2011 (in millions):

|                                                | Cost   | Unrealized<br>Gains | Unrealized<br>Losses | Estimated<br>Fair Value |
|------------------------------------------------|--------|---------------------|----------------------|-------------------------|
| June 30, 2012                                  |        |                     |                      |                         |
| Current marketable securities:                 |        |                     |                      |                         |
| U.S. government and agency debt securities     | \$ 189 | \$ 3                | \$—                  | \$ 192                  |
| Mortgage and asset-backed debt securities      | 181    | 3                   | —                    | 184                     |
| Corporate debt securities                      | 199    | 4                   | —                    | 203                     |
| U.S. state and local municipal debt securities | 15     | —                   | —                    | 15                      |
| Other debt and equity securities               | 9      | 1                   | —                    | 10                      |
| Total marketable securities                    | \$ 593 | \$ 11               | \$—                  | \$ 604                  |

|                                                | Cost     | Unrealized<br>Gains | Unrealized<br>Losses | Estimated<br>Fair Value |
|------------------------------------------------|----------|---------------------|----------------------|-------------------------|
| December 31, 2011                              |          |                     |                      |                         |
| Current marketable securities:                 |          |                     |                      |                         |
| U.S. government and agency debt securities     | \$ 184   | \$ 3                | \$—                  | \$ 187                  |
| Mortgage and asset-backed debt securities      | 188      | 4                   | (1                   | ) 191                   |
| Corporate debt securities                      | 835      | 4                   | (2                   | ) 837                   |
| U.S. state and local municipal debt securities | 15       | —                   | —                    | 15                      |
| Other debt and equity securities               | 10       | 1                   | —                    | 11                      |
| Total marketable securities                    | \$ 1,232 | \$ 12               | \$(3                 | ) \$ 1,241              |

## Auction Rate Securities

During the first quarter 2011, we sold all remaining investments in auction rate securities, which had been classified as non-current marketable securities. These sales did not have a material impact on our statement of consolidated income.

## Investment Other-Than-Temporary Impairments

We have concluded that no other-than-temporary impairment losses existed as of June 30, 2012. In making this determination, we considered the financial condition and prospects of the issuers, the magnitude of the losses compared with the investments' cost, the length of time the investments have been in an unrealized loss position, the probability that we will be unable to collect all amounts due according to the contractual terms of the securities, the credit rating of the securities and our ability and intent to hold these investments until the anticipated recovery in market value occurs.

## Maturity Information

The amortized cost and estimated fair value of marketable securities at June 30, 2012, by contractual maturity, are shown below (in millions). Actual maturities may differ from contractual maturities because the issuers of the securities may have the right to prepay obligations without prepayment penalties.

|                                          | Cost  | Estimated<br>Fair Value |
|------------------------------------------|-------|-------------------------|
| Due in one year or less                  | \$ 32 | \$ 33                   |
| Due after one year through three years   | 219   | 220                     |
| Due after three years through five years | 53    | 54                      |
| Due after five years                     | 287   | 295                     |
|                                          | 591   | 602                     |

|                   |       |       |
|-------------------|-------|-------|
| Equity securities | 2     | 2     |
|                   | \$593 | \$604 |

8

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Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## Non-Current Investments and Restricted Cash

We had \$286 million of restricted cash related to our self-insurance requirements as of June 30, 2012 and December 31, 2011, which is reported in “Non-Current Investments and Restricted Cash” on the consolidated balance sheets.

At June 30, 2012 and December 31, 2011 we held an \$18 and \$17 million, respectively, investment in a variable life insurance policy to fund benefits for the UPS Excess Coordinating Benefit Plan. This investment is classified as “Non-Current Investments and Restricted Cash” in the consolidated balance sheets with the quarterly change in investment value recognized in the statements of consolidated income.

## Fair Value Measurements

Marketable securities utilizing Level 1 inputs include active exchange-traded equity securities and equity index funds, and most U.S. Government debt securities, as these securities all have quoted prices in active markets. Marketable securities utilizing Level 2 inputs include asset-backed securities, corporate bonds and municipal bonds. These securities are valued using market corroborated pricing, matrix pricing or other models that utilize observable inputs such as yield curves.

We maintain holdings in certain investment partnerships that are measured at fair value utilizing Level 3 inputs (classified as “other investments” in the tables below, and as “Other Non-Current Assets” in the consolidated balance sheets). These partnership holdings do not have quoted prices, nor can they be valued using inputs based on observable market data. These investments are valued internally using a discounted cash flow model based on each partnership’s financial statements and cash flow projections. The significant unobservable inputs used in the fair value measurement of the investment partnerships are state and federal tax credits provided by each partnership, tax benefits from investment losses and tax benefits on interest expense. Significant increases or decreases in any of these inputs in isolation would result in changes in the fair value measurement.

The following table presents information about our investments measured at fair value on a recurring basis as of June 30, 2012 and December 31, 2011, and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value (in millions):

|                                                | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant Other<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Balance |
|------------------------------------------------|-------------------------------------------------------------------------------|-----------------------------------------------------|----------------------------------------------------|---------|
| June 30, 2012                                  |                                                                               |                                                     |                                                    |         |
| Marketable Securities:                         |                                                                               |                                                     |                                                    |         |
| U.S. government and agency debt securities     | \$192                                                                         | \$ —                                                | \$—                                                | \$192   |
| Mortgage and asset-backed debt securities      | —                                                                             | 184                                                 | —                                                  | 184     |
| Corporate debt securities                      | —                                                                             | 203                                                 | —                                                  | 203     |
| U.S. state and local municipal debt securities | —                                                                             | 15                                                  | —                                                  | 15      |
| Other debt and equity securities               | —                                                                             | 10                                                  | —                                                  | 10      |
| Total marketable securities                    | 192                                                                           | 412                                                 | —                                                  | 604     |
| Other investments                              | 18                                                                            | —                                                   | 190                                                | 208     |
| Total                                          | \$210                                                                         | \$ 412                                              | \$190                                              | \$812   |



Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

|                                                | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant Other<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Balance  |
|------------------------------------------------|-------------------------------------------------------------------------------|-----------------------------------------------------|----------------------------------------------------|----------|
| December 31, 2011                              |                                                                               |                                                     |                                                    |          |
| Marketable Securities:                         |                                                                               |                                                     |                                                    |          |
| U.S. government and agency debt securities     | \$ 187                                                                        | \$ —                                                | \$—                                                | \$ 187   |
| Mortgage and asset-backed debt securities      | —                                                                             | 191                                                 | —                                                  | 191      |
| Corporate debt securities                      | —                                                                             | 837                                                 | —                                                  | 837      |
| U.S. state and local municipal debt securities | —                                                                             | 15                                                  | —                                                  | 15       |
| Other debt and equity securities               | —                                                                             | 11                                                  | —                                                  | 11       |
| Total marketable securities                    | 187                                                                           | 1,054                                               | —                                                  | 1,241    |
| Other investments                              | 17                                                                            | —                                                   | 217                                                | 234      |
| Total                                          | \$ 204                                                                        | \$ 1,054                                            | \$ 217                                             | \$ 1,475 |

The following table presents the changes in the above Level 3 instruments measured on a recurring basis for the three months ended June 30, 2012 and 2011 (in millions):

|                                                              | Marketable<br>Securities | Other<br>Investments | Total  |
|--------------------------------------------------------------|--------------------------|----------------------|--------|
| Balance on April 1, 2012                                     | \$—                      | \$ 204               | \$ 204 |
| Transfers into (out of) Level 3                              | —                        | —                    | —      |
| Net realized and unrealized gains (losses):                  |                          |                      |        |
| Included in earnings (in investment income)                  | —                        | (14                  | ) (14  |
| Included in accumulated other comprehensive income (pre-tax) | —                        | —                    | —      |
| Purchases                                                    | —                        | —                    | —      |
| Sales                                                        | —                        | —                    | —      |
| Balance on June 30, 2012                                     | \$—                      | \$ 190               | \$ 190 |
|                                                              | Marketable<br>Securities | Other<br>Investments | Total  |
| Balance on April 1, 2011                                     | \$—                      | \$ 254               | \$ 254 |
| Transfers into (out of) Level 3                              | —                        | —                    | —      |
| Net realized and unrealized gains (losses):                  |                          |                      |        |
| Included in earnings (in investment income)                  | —                        | (14                  | ) (14  |
| Included in accumulated other comprehensive income (pre-tax) | —                        | —                    | —      |
| Purchases                                                    | —                        | —                    | —      |
| Sales                                                        | —                        | —                    | —      |
| Balance on June 30, 2011                                     | \$—                      | \$ 240               | \$ 240 |

Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the changes in the above Level 3 instruments measured on a recurring basis for the six months ended June 30, 2012 and 2011 (in millions):

|                                                              | Marketable<br>Securities | Other<br>Investments | Total |
|--------------------------------------------------------------|--------------------------|----------------------|-------|
| Balance on January 1, 2012                                   | \$—                      | \$217                | \$217 |
| Transfers into (out of) Level 3                              | —                        | —                    | —     |
| Net realized and unrealized gains (losses):                  |                          |                      |       |
| Included in earnings (in investment income)                  | —                        | (27                  | ) (27 |
| Included in accumulated other comprehensive income (pre-tax) | —                        | —                    | —     |
| Purchases                                                    | —                        | —                    | —     |
| Sales                                                        | —                        | —                    | —     |
| Balance on June 30, 2012                                     | \$—                      | \$190                | \$190 |
|                                                              | Marketable<br>Securities | Other<br>Investments | Total |
| Balance on January 1, 2011                                   | \$138                    | \$267                | \$405 |
| Transfers into (out of) Level 3                              | —                        | —                    | —     |
| Net realized and unrealized gains (losses):                  |                          |                      |       |
| Included in earnings (in investment income)                  | —                        | (27                  | ) (27 |
| Included in accumulated other comprehensive income (pre-tax) | —                        | —                    | —     |
| Purchases                                                    | —                        | —                    | —     |
| Sales                                                        | (138                     | ) —                  | (138  |
| Balance on June 30, 2011                                     | \$—                      | \$240                | \$240 |

There were no transfers of investments between Level 1 and Level 2 during the three and six months ended June 30, 2012 and 2011.

## NOTE 5. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment as of June 30, 2012 and December 31, 2011 consist of the following (in millions):

|                                                 | 2012     | 2011      |
|-------------------------------------------------|----------|-----------|
| Vehicles                                        | \$5,898  | \$5,981   |
| Aircraft                                        | 15,050   | 14,616    |
| Land                                            | 1,101    | 1,114     |
| Buildings                                       | 3,092    | 3,095     |
| Building and leasehold improvements             | 2,987    | 2,943     |
| Plant equipment                                 | 6,861    | 6,803     |
| Technology equipment                            | 1,659    | 1,593     |
| Equipment under operating leases                | 78       | 93        |
| Construction-in-progress                        | 376      | 303       |
|                                                 | 37,102   | 36,541    |
| Less: Accumulated depreciation and amortization | (19,505  | ) (18,920 |
|                                                 | \$17,597 | \$17,621  |

Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 6. EMPLOYEE BENEFIT PLANS

Information about net periodic benefit cost for our company-sponsored pension and postretirement benefit plans is as follows for the three and six months ended June 30, 2012 and 2011 (in millions):

|                             | U.S. Pension Benefits |        | U.S. Postretirement<br>Medical Benefits |      | International<br>Pension Benefits |       |
|-----------------------------|-----------------------|--------|-----------------------------------------|------|-----------------------------------|-------|
|                             | 2012                  | 2011   | 2012                                    | 2011 | 2012                              | 2011  |
| Three Months Ended June 30: |                       |        |                                         |      |                                   |       |
| Service cost                | \$250                 | \$218  | \$22                                    | \$22 | \$14                              | \$9   |
| Interest cost               | 352                   | 327    | 52                                      | 52   | 10                                | 10    |
| Expected return on assets   | (493                  | ) (489 | ) (5                                    | ) (4 | ) (12                             | ) (11 |
| Amortization of:            |                       |        |                                         |      |                                   |       |
| Transition obligation       | —                     | —      | —                                       | —    | —                                 | —     |
| Prior service cost          | 44                    | 43     | 1                                       | 2    | —                                 | —     |
| Other net (gain) loss       | —                     | 29     | —                                       | —    | —                                 | 1     |
| Actuarial (gain) loss       | —                     | —      | —                                       | —    | —                                 | —     |
| Net periodic benefit cost   | \$153                 | \$128  | \$70                                    | \$72 | \$12                              | \$9   |

|                           | U.S. Pension Benefits |        | U.S. Postretirement<br>Medical Benefits |       | International<br>Pension Benefits |       |
|---------------------------|-----------------------|--------|-----------------------------------------|-------|-----------------------------------|-------|
|                           | 2012                  | 2011   | 2012                                    | 2011  | 2012                              | 2011  |
| Six Months Ended June 30: |                       |        |                                         |       |                                   |       |
| Service cost              | \$499                 | \$436  | \$44                                    | \$44  | \$29                              | \$18  |
| Interest cost             | 705                   | 654    | 104                                     | 104   | 21                                | 20    |
| Expected return on assets | (985                  | ) (978 | ) (9                                    | ) (8  | ) (24                             | ) (22 |
| Amortization of:          |                       |        |                                         |       |                                   |       |
| Transition obligation     | —                     | —      | —                                       | —     | —                                 | —     |
| Prior service cost        | 87                    | 86     | 2                                       | 4     | —                                 | —     |
| Other net (gain) loss     | —                     | 59     | —                                       | —     | —                                 | 2     |
| Actuarial (gain) loss     | —                     | —      | —                                       | —     | —                                 | —     |
| Net periodic benefit cost | \$306                 | \$257  | \$141                                   | \$144 | \$26                              | \$18  |

During the first six months of 2012, we contributed \$394 million and \$56 million to our company-sponsored pension and postretirement medical benefit plans, respectively. We also expect to contribute \$33 and \$415 million over the remainder of the year to the pension and U.S. postretirement medical benefit plans, respectively.

As of December 31, 2011, we had approximately 245,000 employees employed under a national master agreement and various supplemental agreements with local unions affiliated with the International Brotherhood of Teamsters (“Teamsters”). These agreements run through July 31, 2013. We have approximately 2,700 pilots who are employed under a collective bargaining agreement with the Independent Pilots Association, which became amendable at the end of 2011. Our airline mechanics are covered by a collective bargaining agreement with Teamsters Local 2727, which runs through November 1, 2013. In addition, approximately 3,200 of our ground mechanics who are not employed under agreements with the Teamsters are employed under collective bargaining agreements with the International Association of Machinists and Aerospace Workers (“IAM”). Our agreement with the IAM runs through July 31, 2014.

Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

We contribute to a number of multiemployer defined benefit and health and welfare plans under terms of collective bargaining agreements that cover our union-represented employees. Our current collective bargaining agreements set forth the annual contribution increases allotted to the plans that we participate in, and we are in compliance with these contribution rates. These limitations will remain in effect throughout the terms of the existing collective bargaining agreements.

## NOTE 7. GOODWILL AND INTANGIBLE ASSETS

The following table indicates the allocation of goodwill by reportable segment as of June 30, 2012 and December 31, 2011 (in millions):

|                    | U.S. Domestic<br>Package | International<br>Package | Supply Chain &<br>Freight | Consolidated |
|--------------------|--------------------------|--------------------------|---------------------------|--------------|
| December 31, 2011: | \$—                      | \$361                    | \$ 1,740                  | \$2,101      |
| Acquired           | —                        | 67                       | —                         | 67           |
| Currency / Other   | —                        | (4                       | ) (17                     | ) (21        |
| June 30, 2012:     | —                        | \$424                    | \$ 1,723                  | \$2,147      |

The increase in goodwill in the International Package segment was due to the February 2012 acquisition of Kiala S.A., a firm based in Brussels that provides e-commerce retailers a platform to offer delivery options to consumers. The purchase price allocation was not complete as of June 30, 2012 and therefore adjustments to the recorded amount of goodwill may occur prior to the one year anniversary of the acquisition. The remaining decrease in goodwill for both the International Package and Supply Chain & Freight segments was due to the impact of the strengthening U.S. Dollar on the translation of non-U.S. Dollar goodwill balances.

The following is a summary of intangible assets as of June 30, 2012 and December 31, 2011 (in millions):

|                                          | Gross Carrying<br>Amount | Accumulated<br>Amortization | Net Carrying<br>Value |
|------------------------------------------|--------------------------|-----------------------------|-----------------------|
| June 30, 2012:                           |                          |                             |                       |
| Trademarks, licenses, patents, and other | \$186                    | \$(75                       | ) \$111               |
| Customer lists                           | 128                      | (72                         | ) 56                  |
| Franchise rights                         | 111                      | (61                         | ) 50                  |
| Capitalized software                     | 2,106                    | (1,703                      | ) 403                 |
| Total Intangible Assets, Net             | \$2,531                  | \$(1,911                    | ) \$620               |
| December 31, 2011:                       |                          |                             |                       |
| Trademarks, licenses, patents, and other | \$146                    | \$(54                       | ) \$92                |
| Customer lists                           | 120                      | (66                         | ) 54                  |
| Franchise rights                         | 109                      | (58                         | ) 51                  |
| Capitalized software                     | 2,014                    | (1,626                      | ) 388                 |
| Total Intangible Assets, Net             | \$2,389                  | \$(1,804                    | ) \$585               |

Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 8. DEBT AND FINANCING ARRANGEMENTS

The carrying value of our outstanding debt as of June 30, 2012 and December 31, 2011 consists of the following (in millions):

|                            | Maturity  | 2012     | 2011     |
|----------------------------|-----------|----------|----------|
| Commercial paper           | 2012      | \$1,874  | \$—      |
| 4.50% senior notes         | 2013      | 1,766    | 1,778    |
| 3.875% senior notes        | 2014      | 1,044    | 1,050    |
| 5.50% senior notes         | 2018      | 850      | 841      |
| 5.125% senior notes        | 2019      | 1,137    | 1,119    |
| 8.375% debentures          | 2020      | 512      | 504      |
| 3.125% senior notes        | 2021      | 1,656    | 1,641    |
| 8.375% debentures          | 2030      | 284      | 284      |
| 6.20% senior notes         | 2038      | 1,480    | 1,480    |
| 4.875% senior notes        | 2040      | 489      | 489      |
| Floating rate senior notes | 2049-2053 | 376      | 376      |
| Facility notes and bonds   | 2015-2036 | 320      | 320      |
| Pound Sterling notes       | 2031/2050 | 774      | 777      |
| Capital lease obligations  | 2012-3004 | 457      | 469      |
| Other debt                 | 2022      | 4        | —        |
| Total Debt                 |           | 13,023   | 11,128   |
| Less: Current Maturities   |           | (1,911   | ) (33    |
| Long-term Debt             |           | \$11,112 | \$11,095 |
| Debt Classification        |           |          |          |

We have classified our 4.50% senior notes with a principal balance of \$1.750 billion due in January 2013 as a long-term liability, based on our intent and ability to refinance the debt as of June 30, 2012.

## Sources of Credit

We are authorized to borrow up to \$10.0 billion under the U.S. commercial paper program we maintain. We had \$1.775 billion outstanding under this program as of June 30, 2012, with an average interest rate of 0.07%. We also maintain a European commercial paper program under which we are authorized to borrow up to €1.0 billion in a variety of currencies. As of June 30, 2012, we had CNY 630 million (equivalent to \$99 million) outstanding under this program, with an average interest rate of 2.17%. As of June 30, 2012, we have classified the entire commercial paper balance as a current liability in our consolidated balance sheets.

We maintain two credit agreements with a consortium of banks. One of these agreements provides revolving credit facilities of \$1.5 billion, and expires on April 11, 2013. Generally, amounts outstanding under this facility bear interest at a periodic fixed rate equal to LIBOR for the applicable interest period and currency denomination, plus an applicable margin. Alternatively, a fluctuating rate of interest equal to Citibank's publicly announced base rate, plus an applicable margin, may be used at our discretion. In each case, the applicable margin for advances bearing interest based on LIBOR is a percentage determined by quotations from Markit Group Ltd. for our 1-year credit default swap spread, subject to a minimum rate of 0.10% and a maximum rate of 0.75%. The applicable margin for advances bearing interest based on the base rate is 1.00% below the applicable margin for LIBOR advances (but not lower than 0.00%). We are also able to request advances under this facility based on competitive bids for the applicable interest rate. There were no amounts outstanding under this facility as of June 30, 2012.

Table of Contents

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

The second agreement provides revolving credit facilities of \$1.0 billion, and expires on April 12, 2017. Generally, amounts outstanding under this facility bear interest at a periodic fixed rate equal to LIBOR for the applicable interest period and currency denomination, plus an applicable margin. Alternatively, a fluctuating rate of interest equal to Citibank's publicly announced base rate, plus an applicable margin, may be used at our discretion. In each case, the applicable margin for advances bearing interest based on LIBOR is a percentage determined by quotations from Markit Group Ltd. for our credit default swap spread, interpolated for a period from the date of determination of such credit default swap spread in connection with a new interest period until the latest maturity date of this facility then in effect (but not less than a period of one year). The applicable margin is subject to certain minimum rates and maximum rates based on our public debt ratings from Standard & Poor's Rating Service and Moody's Investors Service. The minimum applicable margin rates range from 0.100% to 0.375%, and the maximum applicable margin rates range from 0.750% to 1.250%. The applicable margin for advances bearing interest based on the base rate is 1.00% below the applicable margin for LIBOR advances (but not less than 0.00%). We are also able to request advances under this facility based on competitive bids. There were no amounts outstanding under this facility as of June 30, 2012.

Debt Covenants

Our existing debt instruments and credit facilities subject us to certain financial covenants. As of June 30, 2012 and for all prior periods, we have satisfied these financial covenants. These covenants limit the amount of secured indebtedness that we may incur, and limit the amount of attributable debt in sale-leaseback transactions, to 10% of net tangible assets. As of June 30, 2012, 10% of net tangible assets was equivalent to \$2.601 billion; however, we have no covered sale-leaseback transactions or secured indebtedness outstanding. Additionally, we are required to maintain a minimum net worth, as defined, of \$5.0 billion on a quarterly basis. As of June 30, 2012, our net worth, as defined, was equivalent to \$10.837 billion. We do not expect these covenants to have a material impact on our financial condition or liquidity.

Fair Value of Debt

Based on the borrowing rates currently available to the Company for long-term debt with similar terms and maturities, the fair value of long-term debt, including current maturities, was approximately \$14.789 and \$12.035 billion as of June 30, 2012 and December 31, 2011, respectively. We utilized Level 2 inputs in the fair value hierarchy of valuation techniques to determine the fair value of all of our debt instruments.

NOTE 9. LEGAL PROCEEDINGS AND CONTINGENCIES

We are involved in a number of judicial proceedings and other matters arising from the conduct of our business activities.

Although there can be no assurance as to the ultimate outcome, we have generally denied, or believe we have a meritorious defense and will deny, liability in all litigation pending against us, including (except as otherwise noted herein) the matters described below, and we intend to defend vigorously each case. We have accrued for legal claims when, and to the extent that, amounts associated with the claims become probable and can be reasonably estimated. The actual costs of resolving legal claims may be substantially higher or lower than the amounts accrued for those claims.

For those matters as to which we are not able to estimate a possible loss or range of loss, we are not able to determine whether the loss will have a material adverse effect on our business, financial condition or results of operations or liquidity. For matters in this category, we have indicated in the descriptions that follow the reasons that we are unable to estimate the possible loss or range of loss.

Judicial Proceedings

We are a defendant in a number of lawsuits filed in state and federal courts containing various class action allegations under state wage-and-hour laws. At this time, we do not believe that any loss associated with these matters, would

have a material adverse effect on our financial condition, results of operations or liquidity.

UPS and our subsidiary Mail Boxes Etc., Inc. are defendants in two lawsuits about the rebranding or purchase of The UPS Store franchises-Morgate (California Superior Court) and Samica (United States District Court).

Table of Contents

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

In Morgate, the plaintiffs are 125 individual franchisees who did not rebrand to The UPS Store and a certified class of all franchisees who did rebrand. The trial court entered judgment against a bellwether individual plaintiff, which was affirmed in January 2012. The trial court granted our motion for summary judgment against the certified class, which was reversed in January 2012.

In Samica, about half of the approximately 200 plaintiffs rebranded and half purchased new The UPS Store franchises. Summary judgment for UPS was affirmed by the United States Court of Appeals, Ninth Circuit, in December 2011. Plaintiffs have filed a petition for certiorari with the United States Supreme Court.

There are multiple factors that prevent us from being able to estimate the amount of loss, if any, that may result from whatever remaining aspects of these cases proceed including: (1) we are vigorously defending ourselves and believe we have a number of meritorious legal defenses; and (2) it remains uncertain what evidence of damages, if any, plaintiffs will be able to present. Accordingly, at this time, we are not able to estimate a possible loss or range of loss that may result from these matters or to determine whether such loss, if any, would have a material adverse effect on our financial condition, results of operations or liquidity.

In AFMS LLC v. UPS and FedEx Corporation, a lawsuit filed in federal court in the Central District of California in August 2010, the plaintiff asserts that UPS and FedEx violated U.S. antitrust law by conspiring to refuse to negotiate with third party negotiators retained by shippers and by individually imposing policies that prevent shippers from using such negotiators. The Antitrust Division of the U.S. Department of Justice (“DOJ”) has informed us that it has opened a civil investigation of our policies and practices for dealing with third party negotiators. We are cooperating with this investigation. We deny any liability with respect to these matters and intend to vigorously defend ourselves. There are multiple factors that prevent us from being able to estimate the amount of loss, if any, that may result from these matters including: (1) we believe that we have a number of meritorious defenses; (2) discovery is ongoing; and (3) the DOJ investigation is ongoing. Accordingly, at this time, we are not able to estimate a possible loss or range of loss that may result from these matters or to determine whether such loss, if any, would have a material adverse effect on our financial condition, results of operations or liquidity.

In Canada, three purported class-action cases were filed against us in British Columbia (2006); Ontario (2007) and Québec (2006). The cases each allege inadequate disclosure concerning the existence and cost of brokerage services provided by us under applicable provincial consumer protection legislation and infringement of interest restriction provisions under the Criminal Code of Canada. The British Columbia class-action was declared inappropriate for certification and dismissed by the trial judge. That decision was upheld by the British Columbia Court of Appeal in March 2010, which ended the case in our favor. The Ontario class action was certified in September 2011. Partial summary judgment was granted to us and the plaintiffs by the Ontario motions court. The complaint under the Criminal Code was dismissed. No appeal is being taken from that decision. The allegations of inadequate disclosure were granted and we are appealing that decision. The request to certify the case in Québec was heard in February 2012. We have denied all liability and are vigorously defending the two outstanding cases. There are multiple factors that prevent us from being able to estimate the amount of loss, if any, that may result from these matters, including: (1) we are vigorously defending ourselves and believe that we have a number of meritorious legal defenses; and (2) there are unresolved questions of law and fact that could be important to the ultimate resolution of these matters. Accordingly, at this time, we are not able to estimate a possible loss or range of loss that may result from these matters or to determine whether such loss, if any, would have a material adverse effect on our financial condition, results of operation or liquidity.

**Other Matters**

In May and December 2007 and August 2008 we received and responded to grand jury subpoenas from the DOJ in the Northern District of California in connection with an investigation by the Drug Enforcement Administration. We also have responded to informal requests for information in connection with this investigation, which relates to transportation of packages on behalf of on-line pharmacies that may have operated illegally. We have been



cooperating with this investigation and are exploring the possibility of resolving this matter, which could include our undertaking further enhancements to our compliance program and/or a payment. Such a payment may exceed the amounts previously accrued with respect to this matter, but we do not expect that the amount of such additional loss would have a material adverse effect on our financial condition, results of operations or liquidity.

Table of Contents

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

We received a grand jury subpoena from the Antitrust Division of the DOJ regarding the DOJ's investigation into certain pricing practices in the freight forwarding industry in December 2007.

In August 2010, competition authorities in Brazil opened an administrative proceeding to investigate alleged anticompetitive behavior in the freight forwarding industry. Approximately 45 freight forwarding companies and individuals are named in the proceeding, including UPS, UPS SCS Transportes (Brasil) S.A., and a former employee in Brazil. UPS will have an opportunity to respond to these allegations.

We are cooperating with each of these investigations, and intend to continue to vigorously defend ourselves. There are multiple factors that prevent us from being able to estimate the amount of loss, if any, that may result from these matters including: (1) we are vigorously defending each matter and believe that we have a number of meritorious legal defenses; (2) there are unresolved questions of law that could be of importance to the ultimate resolutions of these matters, including the calculation of any potential fine; and (3) there is uncertainty about the time period that is the subject of the investigations. Accordingly, at this time, we are not able to estimate a possible loss or range of loss that may result from these matters or to determine whether such loss, if any, would have a material adverse effect on our financial condition, results of operations or liquidity.

On March 28, 2012, the European Commission ("Commission") announced a decision finding that 14 freight forwarders, including UPS, had infringed EU competition law. The Commission assessed a fine on UPS in the amount of €10 million. While UPS does not consider the decision to be correct, it has elected to bring the matter to a conclusion and paid the fine to the Commission.

In January 2008, a class action complaint was filed in the United States District Court for the Eastern District of New York alleging price-fixing activities relating to the provision of freight forwarding services. UPS was not named in this case. In July 2009, the plaintiffs filed a first amended complaint naming numerous global freight forwarders as defendants. UPS and UPS Supply Chain Solutions are among the 60 defendants named in the amended complaint. We intend to vigorously defend ourselves in this case. There are multiple factors that prevent us from being able to estimate the amount of loss, if any, that may result from these matters including: (1) the magistrate judge recommended that the district court grant our motion to dismiss, with leave to amend, and the scope of the plaintiffs' claims is therefore unclear; (2) the scope and size of the proposed class is ill-defined; (3) there are significant legal questions about the adequacy and standing of the putative class representatives; and (4) we believe that we have a number of meritorious legal defenses. Accordingly, at this time, we are not able to estimate a possible loss or range of loss that may result from these matters or to determine whether such loss, if any, would have a material adverse effect on our financial condition, results of operations or liquidity.

We are a defendant in various other lawsuits that arose in the normal course of business. We do not believe that the eventual resolution of these other lawsuits (either individually or in the aggregate), including any reasonably possible losses in excess of current accruals, will have a material adverse effect on our financial condition, results of operations or liquidity.

**NOTE 10. SHAREOWNERS' EQUITY**

**Capital Stock, Additional Paid-In Capital and Retained Earnings**

We maintain two classes of common stock, which are distinguished from each other primarily by their respective voting rights. Class A shares are entitled to 10 votes per share, whereas class B shares are entitled to one vote per share. Class A shares are primarily held by UPS employees and retirees, and these shares are fully convertible into class B shares at any time. Class B shares are publicly traded on the New York Stock Exchange under the symbol "UPS." Class A and B shares both have a \$0.01 par value, and as of June 30, 2012, there were 4.6 billion class A shares and 5.6 billion class B shares authorized to be issued. Additionally, there are 200 million preferred shares, with a \$0.01 par value, authorized to be issued; as of June 30, 2012, no preferred shares had been issued.



Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

The following is a rollforward of our common stock, additional paid-in capital and retained earnings accounts for the six months ended June 30, 2012 and 2011 (in millions, except per share amounts):

|                                                           | 2012   |          | 2011   |          |   |
|-----------------------------------------------------------|--------|----------|--------|----------|---|
|                                                           | Shares | Dollars  | Shares | Dollars  |   |
| <b>Class A Common Stock</b>                               |        |          |        |          |   |
| Balance at beginning of period                            | 240    | \$3      | 258    | \$3      |   |
| Common stock purchases                                    | (3     | ) —      | (4     | ) —      |   |
| Stock award plans                                         | 4      | —        | 2      | —        |   |
| Common stock issuances                                    | 2      | —        | 2      | —        |   |
| Conversions of class A to class B common stock            | (8     | ) —      | (11    | ) —      |   |
| Class A shares issued at end of period                    | 235    | \$3      | 247    | \$3      |   |
| <b>Class B Common Stock</b>                               |        |          |        |          |   |
| Balance at beginning of period                            | 725    | \$7      | 735    | \$7      |   |
| Common stock purchases                                    | (8     | ) —      | (10    | ) —      |   |
| Conversions of class A to class B common stock            | 8      | —        | 11     | —        |   |
| Class B shares issued at end of period                    | 725    | \$7      | 736    | \$7      |   |
| <b>Additional Paid-In Capital</b>                         |        |          |        |          |   |
| Balance at beginning of period                            |        | \$—      |        | \$—      |   |
| Stock award plans                                         |        | 291      |        | 236      |   |
| Common stock purchases                                    |        | (606     | )      | (209     | ) |
| Common stock issuances                                    |        | 144      |        | 126      |   |
| Option premiums received (paid)                           |        | 206      |        | (150     | ) |
| Unsettled portion of accelerated stock repurchase program |        | (35      | )      | —        |   |
| Balance at end of period                                  |        | \$—      |        | \$3      |   |
| <b>Retained Earnings</b>                                  |        |          |        |          |   |
| Balance at beginning of period                            |        | \$10,128 |        | \$10,604 |   |
| Net income                                                |        | 2,086    |        | 2,007    |   |
| Dividends (\$1.14 and \$1.04 per share)                   |        | (1,123   | )      | (1,048   | ) |
| Common stock purchases                                    |        | (264     | )      | (846     | ) |
| Balance at end of period                                  |        | \$10,827 |        | \$10,717 |   |

From time to time, we enter into share repurchase programs with large financial institutions to assist in our buyback of company stock. These programs allow us to repurchase our shares at a price below the weighted average UPS share price for a given period. During the second quarter of 2012, we entered into an accelerated share repurchase program, which allowed us to repurchase \$230 million of shares (2.9 million shares). As of June 30, 2012, the remaining unsettled portion of this accelerated stock repurchase program was \$35 million of shares.

In total, we repurchased a total of 11.3 million shares of class A and class B common stock for \$870 million during the six months ended June 30, 2012, and 14.4 million shares for \$1.055 billion during the six months ended June 30, 2011. On May 3, 2012, the Board of Directors approved a new share repurchase authorization of \$5.0 billion, which replaces an authorization previously announced in 2008. The new share repurchase authorization has no expiration date.

In order to lower the average cost of acquiring shares in our ongoing share repurchase program, we periodically enter into structured repurchase agreements involving the use of capped call options for the purchase of UPS class B shares. We pay a fixed sum of cash upon execution of each agreement in exchange for the right to receive either a pre-determined amount of cash or stock. Upon expiration of each agreement, if the closing market price of our common stock is above the pre-determined price, we will have our initial investment returned with a premium in

either cash or shares (at our election). If the closing market price of our common stock is at or below the pre-determined price, we will receive the number of shares specified in the agreement. During the six months ended June 30, 2012, we did not pay premiums on options for the purchase of shares; however, we received \$206 million in premiums for options that were entered into during 2011 that expired during the six months ended June 30, 2012. During the six months ended June 30, 2011, we paid \$150 million in premiums on options for the purchase of shares, and had not received any premiums in excess of our initial investment.

18

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Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## Accumulated Other Comprehensive Income (Loss)

We experience activity in AOCI for unrealized holding gains and losses on available-for-sale securities, foreign currency translation adjustments, unrealized gains and losses from derivatives that qualify as hedges of cash flows and unrecognized pension and postretirement benefit costs. The activity in AOCI for the six months ended June 30, 2012 and 2011 is as follows (in millions):

|                                                                                        | 2012     |   | 2011     |   |
|----------------------------------------------------------------------------------------|----------|---|----------|---|
| Foreign currency translation gain (loss):                                              |          |   |          |   |
| Balance at beginning of period                                                         | \$(160   | ) | \$(68    | ) |
| Aggregate adjustment for the period (net of tax effect of \$(3) and \$(9))             | (67      | ) | 132      | ) |
| Balance at end of period                                                               | (227     | ) | 64       | ) |
| Unrealized gain (loss) on marketable securities, net of tax:                           |          |   |          |   |
| Balance at beginning of period                                                         | 6        |   | 12       |   |
| Current period changes in fair value (net of tax effect of \$2 and \$5)                | 4        |   | 9        |   |
| Reclassification to earnings (net of tax effect of \$(1) and \$(8))                    | (3       | ) | (16      | ) |
| Balance at end of period                                                               | 7        |   | 5        |   |
| Unrealized gain (loss) on cash flow hedges, net of tax:                                |          |   |          |   |
| Balance at beginning of period                                                         | (204     | ) | (239     | ) |
| Current period changes in fair value (net of tax effect of \$(57) and \$(50))          | (94      | ) | (84      | ) |
| Reclassification to earnings (net of tax effect of \$6 and \$9)                        | 10       |   | 16       |   |
| Balance at end of period                                                               | (288     | ) | (307     | ) |
| Unrecognized pension and postretirement benefit costs, net of tax:                     |          |   |          |   |
| Balance at beginning of period                                                         | (2,745   | ) | (2,340   | ) |
| Reclassification to earnings (net of tax effect of \$34 and \$57)                      | 55       |   | 94       |   |
| Adjustment for Early Retirement Reinsurance Program (net of tax effect of \$4 and \$4) | 6        |   | 8        |   |
| Balance at end of period                                                               | (2,684   | ) | (2,238   | ) |
| Accumulated other comprehensive income (loss) at end of period                         | \$(3,192 | ) | \$(2,476 | ) |

## Deferred Compensation Obligations and Treasury Stock

Activity in the deferred compensation program for the six months ended June 30, 2012 and 2011 is as follows (in millions):

|                                    | 2012   |         | 2011   |         |   |
|------------------------------------|--------|---------|--------|---------|---|
|                                    | Shares | Dollars | Shares | Dollars |   |
| Deferred Compensation Obligations: |        |         |        |         |   |
| Balance at beginning of period     |        | \$88    |        | \$103   |   |
| Reinvested dividends               |        | 2       |        | 2       |   |
| Benefit payments                   |        | (14     | )      | (19     | ) |
| Balance at end of period           |        | \$76    |        | \$86    |   |
| Treasury Stock:                    |        |         |        |         |   |
| Balance at beginning of period     | (2     | )       | \$(88  | )       |   |
| Reinvested dividends               | —      | (2      | )      | —       |   |
| Benefit payments                   | —      | 14      | —      | 19      |   |
| Balance at end of period           | (2     | )       | \$(76  | )       |   |

Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## Noncontrolling Interests:

We have noncontrolling interests in certain consolidated subsidiaries in our International Package and Supply Chain & Freight segments. The noncontrolling interests on our consolidated balance sheets primarily relate to a joint venture in Dubai that operates in the Middle East, Turkey and portions of the Central Asia region. The activity related to our noncontrolling interests is presented below for the six months ended June 30, 2012 and 2011 (in millions):

|                                                     | 2012 | 2011 |
|-----------------------------------------------------|------|------|
| Noncontrolling Interests:                           |      |      |
| Balance at beginning of period                      | \$73 | \$68 |
| Acquired noncontrolling interests                   | 7    | 7    |
| Dividends attributable to noncontrolling interests  | —    | —    |
| Net income attributable to noncontrolling interests | —    | —    |
| Balance at end of period                            | \$80 | \$75 |

## NOTE 11. SEGMENT INFORMATION

We report our operations in three segments: U.S. Domestic Package operations, International Package operations and Supply Chain & Freight operations. Package operations represent our most significant business and are broken down into regional operations around the world. Regional operations managers are responsible for both domestic and export operations within their geographic area.

## U.S. Domestic Package

Domestic Package operations include the time-definite delivery of letters, documents and packages throughout the United States.

## International Package

International Package operations include delivery to more than 220 countries and territories worldwide, including shipments wholly outside the United States, as well as shipments with either origin or distribution outside the United States. Our International Package reporting segment includes the operations of our Europe, Asia and Americas operating segments.

## Supply Chain &amp; Freight

Supply Chain & Freight includes the operations of our forwarding, logistics and freight units, as well as other aggregated businesses. Our forwarding and logistics business provides services in more than 195 countries and territories worldwide, and includes supply chain design and management, freight distribution, customs brokerage, mail and consulting services. UPS Freight offers a variety of less-than-truckload (“LTL”) and truckload (“TL”) services to customers in North America. Other aggregated business units within this segment include Mail Boxes Etc., Inc. (the franchisor of Mail Boxes Etc. and The UPS Store) and UPS Capital.

In evaluating financial performance, we focus on operating profit as a segment’s measure of profit or loss. Operating profit is before investment income, interest expense and income taxes. The accounting policies of the reportable segments are the same as those described in the summary of accounting policies included in the consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2011, with certain expenses allocated between the segments using activity-based costing methods. Unallocated assets are comprised primarily of cash, marketable securities and investments in limited partnerships.

Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Segment information for the three and six months ended June 30, 2012 and 2011 is as follows (in millions):

|                        | Three Months Ended |          | Six Months Ended |          |
|------------------------|--------------------|----------|------------------|----------|
|                        | June 30,<br>2012   | 2011     | June 30,<br>2012 | 2011     |
| Revenue:               |                    |          |                  |          |
| U.S. Domestic Package  | \$8,058            | \$7,737  | \$16,062         | \$15,280 |
| International Package  | 3,014              | 3,139    | 5,980            | 6,039    |
| Supply Chain & Freight | 2,277              | 2,315    | 4,443            | 4,454    |
| Consolidated           | \$13,349           | \$13,191 | \$26,485         | \$25,773 |
| Operating Profit:      |                    |          |                  |          |
| U.S. Domestic Package  | \$1,134            | \$997    | \$2,129          | \$1,877  |
| International Package  | 454                | 505      | 862              | 958      |
| Supply Chain & Freight | 202                | 243      | 368              | 382      |
| Consolidated           | \$1,790            | \$1,745  | \$3,359          | \$3,217  |

## NOTE 12. EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share for the three and six months ended June 30, 2012 and 2011 (in millions, except per share amounts):

|                                               | Three Months Ended |         | Six Months Ended |         |
|-----------------------------------------------|--------------------|---------|------------------|---------|
|                                               | June 30,<br>2012   | 2011    | June 30,<br>2012 | 2011    |
| Numerator:                                    |                    |         |                  |         |
| Net income attributable to common shareowners | \$1,116            | \$1,092 | \$2,086          | \$2,007 |
| Denominator:                                  |                    |         |                  |         |
| Weighted average shares                       | 959                | 984     | 959              | 986     |
| Deferred compensation obligations             | 2                  | 2       | 2                | 2       |
| Vested portion of restricted shares           | 1                  | 2       | 1                | 2       |
| Denominator for basic earnings per share      | 962                | 988     | 962              | 990     |
| Effect of dilutive securities:                |                    |         |                  |         |
| Restricted performance units                  | 3                  | 3       | 4                | 3       |
| Restricted stock units                        | 5                  | 6       | 5                | 6       |
| Stock option plans                            | 1                  | 1       | 1                | 1       |
| Denominator for diluted earnings per share    | 971                | 998     | 972              | 1,000   |
| Basic earnings per share                      | \$1.16             | \$1.11  | \$2.17           | \$2.03  |
| Diluted earnings per share                    | \$1.15             | \$1.09  | \$2.15           | \$2.01  |

Diluted earnings per share for the three months ended June 30, 2012 and 2011 exclude the effect of 2.6 and 5.1 million shares of common stock (2.6 and 5.0 million for the six months ended June 30, 2012 and 2011), respectively, that may be issued upon the exercise of employee stock options, because such effect would be antidilutive.



Table of Contents

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 13. DERIVATIVE INSTRUMENTS AND RISK MANAGEMENT

Risk Management Policies

We are exposed to market risk, primarily related to foreign exchange rates, commodity prices and interest rates. These exposures are actively monitored by management. To manage the volatility relating to certain of these exposures, we enter into a variety of derivative financial instruments. Our objective is to reduce, where it is deemed appropriate to do so, fluctuations in earnings and cash flows associated with changes in foreign currency rates, commodity prices and interest rates. It is our policy and practice to use derivative financial instruments only to the extent necessary to manage exposures. As we use price sensitive instruments to hedge a certain portion of our existing and anticipated transactions, we expect that any loss in value for those instruments generally would be offset by increases in the value of those hedged transactions. We do not hold or issue derivative financial instruments for trading or speculative purposes.

Credit Risk Management

The forward contracts, swaps and options discussed below contain an element of risk that the counterparties may be unable to meet the terms of the agreements. However, we minimize such risk exposures for these instruments by limiting the counterparties to banks and financial institutions that meet established credit guidelines, and monitoring counterparty credit risk to prevent concentrations of credit risk with any single counterparty.

We have agreements with substantially all of our active counterparties containing early termination rights and/or bilateral collateral provisions whereby cash is required whenever the net fair value of derivatives associated with those counterparties exceed specific thresholds. Events such as a counterparty credit rating downgrade (depending on the ultimate rating level) would typically require an increase in the amount of collateral required of the counterparty and/or allow us to take additional protective measures such as early termination of trades. At June 30, 2012, we held cash collateral of \$122 million under these agreements.

In connection with the agreements described above, we could also be required to provide collateral or terminate transactions with certain counterparties in the event of a downgrade of our credit rating. The amount of collateral required would be determined by our credit rating and the net fair value of the associated derivatives with each counterparty. At June 30, 2012, the aggregate fair value of the instruments covered by these contractual features that were in a net liability position was \$277 million; however, we were not required to post any collateral with our counterparties as of that date.

We have not historically incurred, and do not expect to incur in the future, any losses as a result of counterparty default.

Accounting Policy for Derivative Instruments

We recognize all derivative instruments as assets or liabilities in the consolidated balance sheets at fair value. The accounting for changes in the fair value of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and, further, on the type of hedging relationship. For those derivative instruments that are designated and qualify as hedging instruments, a company must designate the derivative, based upon the exposure being hedged, as a cash flow hedge, a fair value hedge or a hedge of a net investment in a foreign operation.

A cash flow hedge refers to hedging the exposure to variability in expected future cash flows that is attributable to a particular risk. For derivative instruments that are designated and qualify as a cash flow hedge, the effective portion of the gain or loss on the derivative instrument is reported as a component of AOCI, and reclassified into earnings in the same period during which the hedged transaction affects earnings. The remaining gain or loss on the derivative instrument in excess of the cumulative change in the present value of future cash flows of the hedged item, or hedge components excluded from the assessment of effectiveness, are recognized in the statements of consolidated income during the current period.

A fair value hedge refers to hedging the exposure to changes in the fair value of an existing asset or liability on the consolidated balance sheets that is attributable to a particular risk. For derivative instruments that are designated and

qualify as a fair value hedge, the gain or loss on the derivative instrument is recognized in the statements of consolidated income during the current period, as well as the offsetting gain or loss on the hedged item.

Table of Contents

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

A net investment hedge refers to the use of cross currency swaps, forward contracts or foreign currency denominated debt to hedge portions of our net investments in foreign operations. For hedges that meet the effectiveness requirements, the net gains or losses attributable to changes in spot exchange rates are recorded in the cumulative translation adjustment within other AOCI. The remainder of the change in value of such instruments is recorded in earnings.

Types of Hedges

Commodity Risk Management

Currently, the fuel surcharges that we apply to our domestic and international package and LTL services are the primary means of reducing the risk of adverse fuel price changes on our business. We periodically enter into option contracts on energy commodity products to manage the price risk associated with forecasted transactions involving refined fuels, principally jet-A, diesel and unleaded gasoline. The objective of the hedges is to reduce the variability of cash flows, due to changing fuel prices, associated with the forecasted transactions involving those products. We have designated and account for these contracts as cash flow hedges of the underlying forecasted transactions involving these fuel products and, therefore, the resulting gains and losses from these hedges are recognized as a component of fuel expense or revenue when the underlying transactions occur.

Foreign Currency Risk Management

To protect against the reduction in value of forecasted foreign currency cash flows from our international package business, we maintain a foreign currency cash flow hedging program. Our most significant foreign currency exposures relate to the Euro, the British Pound Sterling and the Canadian Dollar. We hedge portions of our forecasted revenue denominated in foreign currencies with option contracts. We have designated and account for these contracts as cash flow hedges of anticipated foreign currency denominated revenue and, therefore, the resulting gains and losses from these hedges are recognized as a component of international package revenue when the underlying sales transactions occur.

We also hedge portions of our anticipated cash settlements of intercompany transactions subject to foreign currency remeasurement using foreign currency forward contracts. We have designated and account for these contracts as cash flow hedges of forecasted foreign currency denominated transactions; therefore, the resulting gains and losses from these hedges are recognized as a component of other operating expense when the underlying transactions are subject to currency remeasurement.

We have foreign currency denominated debt obligations and capital lease obligations associated with our aircraft. For some of these debt obligations and leases, we hedge the foreign currency denominated contractual payments using cross-currency interest rate swaps, which effectively convert the foreign currency denominated contractual payments into U.S. Dollar denominated payments. We have designated and account for these swaps as cash flow hedges of the forecasted contractual payments; therefore, the resulting gains and losses from these hedges are recognized in the statements of consolidated income when the currency remeasurement gains and losses on the underlying debt obligations and leases are incurred.

Interest Rate Risk Management

Our indebtedness under our various financing arrangements creates interest rate risk. We use a combination of derivative instruments, including interest rate swaps and cross-currency interest rate swaps, as part of our program to manage the fixed and floating interest rate mix of our total debt portfolio and related overall cost of borrowing. The notional amount, interest payment date and maturity date of the swaps match the terms of the associated debt being hedged. Interest rate swaps allow us to maintain a target range of floating rate debt within our capital structure. We have designated and account for the majority of our interest rate swaps that convert fixed rate interest payments into floating rate interest payments as hedges of the fair value of the associated debt instruments. Therefore, the gains and losses resulting from fair value adjustments to the interest rate swaps and fair value adjustments to the associated debt instruments are recorded to interest expense in the period in which the gains and losses occur. We have

designated and account for interest rate swaps that convert floating rate interest payments into fixed rate interest payments as cash flow hedges of the forecasted payment obligations. The gains and losses resulting from fair value adjustments to the interest rate swaps are recorded to AOCI.

We periodically hedge the forecasted fixed-coupon interest payments associated with anticipated debt offerings, using forward starting interest rate swaps, interest rate locks or similar derivatives. These agreements effectively lock a portion of our interest rate exposure between the time the agreement is entered into and the date when the debt offering is completed, thereby mitigating the impact of interest rate changes on future interest expense. These derivatives are settled commensurate with the issuance of the debt, and any gain or loss upon settlement is amortized as an adjustment to the effective interest yield on the debt.

Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## Outstanding Positions

As of June 30, 2012 and December 31, 2011, the notional amounts of our outstanding derivative positions were as follows (in millions):

|                                       | June 30, 2012 | December 31, 2011 |
|---------------------------------------|---------------|-------------------|
| Currency hedges:                      |               |                   |
| Euro                                  | EUR 1,849     | EUR 1,685         |
| British Pound Sterling                | GBP 830       | GBP 870           |
| Canadian Dollar                       | CAD 389       | CAD 318           |
| Mexican Peso                          | MXN 2,800     | MXN —             |
| Malaysian Ringgit                     | MYR 600       | MYR —             |
| Interest rate hedges:                 |               |                   |
| Fixed to Floating Interest Rate Swaps | \$ 6,424      | \$ 6,424          |
| Floating to Fixed Interest Rate Swaps | \$ 784        | \$ 791            |
| Interest Rate Basis Swaps             | \$ 2,500      | \$ —              |
| Forward Starting Swaps                | \$ 1,000      | \$ —              |

As of June 30, 2012, we had no outstanding commodity hedge positions. The maximum term over which we are hedging exposures to the variability of cash flow is 38 years.

## Balance Sheet Recognition and Fair Value Measurements

The following table indicates the location on the consolidated balance sheets in which our derivative assets and liabilities have been recognized, the fair value hierarchy level applicable to each derivative type and the related fair values of those derivatives (in millions). The table is segregated between those derivative instruments that qualify and are designated as hedging instruments and those that are not, as well as by type of contract and whether the derivative is in an asset or liability position.

| Asset Derivatives                     | Balance Sheet Location        | Fair Value Hierarchy Level | June 30, 2012 | December 31, 2011 |
|---------------------------------------|-------------------------------|----------------------------|---------------|-------------------|
| Derivatives designated as hedges:     |                               |                            |               |                   |
| Foreign exchange contracts            | Other current assets          | Level 2                    | \$147         | \$164             |
| Foreign exchange contracts            | Other non-current assets      | Level 2                    | 30            | —                 |
| Interest rate contracts               | Other non-current assets      | Level 2                    | 437           | 401               |
| Derivatives not designated as hedges: |                               |                            |               |                   |
| Foreign exchange contracts            | Other current assets          | Level 2                    | —             | 2                 |
| Interest rate contracts               | Other non-current assets      | Level 2                    | 99            | 82                |
| Total Asset Derivatives               |                               |                            | \$713         | \$649             |
| Liability Derivatives                 | Balance Sheet Location        | Fair Value Hierarchy Level | June 30, 2012 | December 31, 2011 |
| Derivatives designated as hedges:     |                               |                            |               |                   |
| Foreign exchange contracts            | Other current liabilities     | Level 2                    | \$10          | \$—               |
| Foreign exchange contracts            | Other non-current liabilities | Level 2                    | 256           | 185               |
| Interest rate contracts               | Other non-current liabilities | Level 2                    | 73            | 13                |
| Derivatives not designated as hedges: |                               |                            |               |                   |
| Foreign exchange contracts            | Other current liabilities     | Level 2                    | 4             | —                 |
| Interest rate contracts               | Other non-current liabilities | Level 2                    | 33            | 10                |
| Total Liability Derivatives           |                               |                            | \$376         | \$208             |



Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Our foreign currency, interest rate and energy derivatives are largely comprised of over-the-counter derivatives, which are primarily valued using pricing models that rely on market observable inputs such as yield curves, currency exchange rates and commodity forward prices; therefore, these derivatives are classified as Level 2.

**Income Statement Recognition**

The following table indicates the amount and location in the statements of consolidated income for the three and six months ended June 30, 2012 and 2011 in which derivative gains and losses, as well as the related amounts reclassified from AOCI, have been recognized for those derivatives designated as cash flow hedges (in millions):

**Three Months Ended June 30:**

| Derivative Instruments in Cash Flow Hedging Relationships | 2012                                                                      | 2011                                                                      | Location of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) | 2012                                                                                    | 2011                                                                                    |
|-----------------------------------------------------------|---------------------------------------------------------------------------|---------------------------------------------------------------------------|-------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------|
|                                                           | Amount of Gain (Loss) Recognized in OCI on Derivative (Effective Portion) | Amount of Gain (Loss) Recognized in OCI on Derivative (Effective Portion) |                                                                                           | Amount of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) | Amount of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) |
| Interest rate contracts                                   | \$ (53 )                                                                  | \$ (1 )                                                                   | Interest Expense                                                                          | \$ (5 )                                                                                 | \$ (5 )                                                                                 |
| Foreign exchange contracts                                | (113 )                                                                    | (21 )                                                                     | Interest Expense                                                                          | (19 )                                                                                   | (3 )                                                                                    |
| Foreign exchange contracts                                | (10 )                                                                     | (5 )                                                                      | Other Operating Expense                                                                   | —                                                                                       | —                                                                                       |
| Foreign exchange contracts                                | 92                                                                        | (31 )                                                                     | Revenue                                                                                   | 9                                                                                       | (42 )                                                                                   |
| Commodity contracts                                       | —                                                                         | 9                                                                         | Fuel Expense                                                                              | —                                                                                       | 9                                                                                       |
| <b>Total</b>                                              | <b>\$ (84 )</b>                                                           | <b>\$ (49 )</b>                                                           |                                                                                           | <b>\$ (15 )</b>                                                                         | <b>\$ (41 )</b>                                                                         |

**Six Months Ended June 30:**

| Derivative Instruments in Cash Flow Hedging Relationships | 2012                                                                      | 2011                                                                      | Location of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) | 2012                                                                                    | 2011                                                                                    |
|-----------------------------------------------------------|---------------------------------------------------------------------------|---------------------------------------------------------------------------|-------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------|
|                                                           | Amount of Gain (Loss) Recognized in OCI on Derivative (Effective Portion) | Amount of Gain (Loss) Recognized in OCI on Derivative (Effective Portion) |                                                                                           | Amount of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) | Amount of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) |
| Interest rate contracts                                   | \$ (61 )                                                                  | \$ (1 )                                                                   | Interest Expense                                                                          | \$ (10 )                                                                                | \$ (10 )                                                                                |
| Foreign exchange contracts                                | (72 )                                                                     | (3 )                                                                      | Interest Expense                                                                          | (3 )                                                                                    | 31                                                                                      |
| Foreign exchange contracts                                | (15 )                                                                     | (5 )                                                                      | Other Operating Expense                                                                   | —                                                                                       | —                                                                                       |
| Foreign exchange contracts                                | (3 )                                                                      | (134 )                                                                    | Revenue                                                                                   | (3 )                                                                                    | (55 )                                                                                   |
| Commodity contracts                                       | —                                                                         | 9                                                                         | Fuel Expense                                                                              | —                                                                                       | 9                                                                                       |
| <b>Total</b>                                              | <b>\$ (151 )</b>                                                          | <b>\$ (134 )</b>                                                          |                                                                                           | <b>\$ (16 )</b>                                                                         | <b>\$ (25 )</b>                                                                         |

As of June 30, 2012, \$53 million of pre-tax gains related to cash flow hedges that are currently deferred in AOCI are expected to be reclassified to income over the 12 month period ended June 30, 2013. The actual amounts that will be reclassified to income over the next 12 months will vary from this amount as a result of changes in market conditions.

The amount of ineffectiveness recognized in income on derivative instruments designated in cash flow hedging relationships was immaterial for the three and six months ended June 30, 2012 and 2011.



Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

The following table indicates the amount and location in the statements of consolidated income in which derivative gains and losses, as well as the associated gains and losses on the underlying exposure, have been recognized for those derivatives designated as fair value hedges for the three and six months ended June 30, 2012 and 2011 (in millions):

| Derivative Instruments in Fair Value Hedging Relationships | Location of Gain (Loss) Recognized in Income | 2012                                       | 2011                                       | Hedged Items in Fair Value Hedging Relationships | Location of Gain (Loss) Recognized In Income | 2012                                       | 2011                                       |
|------------------------------------------------------------|----------------------------------------------|--------------------------------------------|--------------------------------------------|--------------------------------------------------|----------------------------------------------|--------------------------------------------|--------------------------------------------|
|                                                            |                                              | Amount of Gain (Loss) Recognized in Income | Amount of Gain (Loss) Recognized in Income |                                                  |                                              | Amount of Gain (Loss) Recognized in Income | Amount of Gain (Loss) Recognized in Income |
| Three Months Ended June 30:                                |                                              |                                            |                                            |                                                  |                                              |                                            |                                            |
| Interest rate contracts                                    | Interest Expense                             | \$72                                       | \$140                                      | Fixed-Rate Debt and Capital Leases               | Interest Expense                             | \$(72 )                                    | \$(140 )                                   |
| Six Months Ended June 30:                                  |                                              |                                            |                                            |                                                  |                                              |                                            |                                            |
| Interest rate contracts                                    | Interest Expense                             | \$36                                       | \$113                                      | Fixed-Rate Debt and Capital Leases               | Interest Expense                             | \$(36 )                                    | \$(113 )                                   |

Additionally, we maintain some interest rate swap and foreign exchange forward contracts that are not designated as hedges. These interest rate swap contracts are intended to provide an economic hedge of a portfolio of interest bearing receivables. These foreign exchange forward contracts are intended to provide an economic offset to foreign currency remeasurement risks for certain assets and liabilities in our consolidated balance sheets.

We also periodically terminate interest rate swaps and foreign currency options by entering into offsetting swap and foreign currency positions with different counterparties. As part of this process, we de-designate our original swap and foreign currency contracts. These transactions provide an economic offset that effectively eliminates the effects of changes in market valuation.

We have entered into several interest rate basis swaps, which effectively convert cash flows based on variable LIBOR-based interest rates to cash flows based on the prevailing federal funds interest rate. These swaps are not designated as hedges, and all amounts related to fair value changes and settlements are recorded to interest expense in the statements of consolidated income.

The following is a summary of the amounts recorded in the statements of consolidated income related to fair value changes and settlements of these interest rate swaps and foreign currency forward contracts not designated as hedges (in millions):

| Derivative Instruments not Designated in Hedging Relationships | Location of Gain (Loss) Recognized in Income | 2012                                       | 2011                                       |
|----------------------------------------------------------------|----------------------------------------------|--------------------------------------------|--------------------------------------------|
|                                                                |                                              | Amount of Gain (Loss) Recognized in Income | Amount of Gain (Loss) Recognized in Income |
| Three Months Ended June 30:                                    |                                              |                                            |                                            |
| Interest Rate Swap Contract                                    | Interest Expense                             | \$(2 )                                     | \$—                                        |
| Foreign Exchange Contracts                                     | Other Operating Expenses                     | \$42                                       | \$(3 )                                     |
| Six Months Ended June 30:                                      |                                              |                                            |                                            |
| Interest Rate Swap Contracts                                   | Interest Expense                             | \$(5 )                                     | \$—                                        |
| Foreign Exchange Contracts                                     | Other Operating Expenses                     | \$34                                       | \$(13 )                                    |



Table of Contents

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 14. INCOME TAXES

Our effective tax rate was 34.5% in the second quarter and year-to-date periods of 2012, remaining relatively constant with the 34.6% rate in the corresponding periods of 2011.

We file income tax returns in the U.S. federal jurisdiction, most U.S. state and local jurisdictions and many non-U.S. jurisdictions. We have substantially resolved all U.S. federal income tax matters for tax years prior to 2005. During the fourth quarter of 2010, we received a refund of \$139 million as a result of the resolution of tax years 2003 through 2004 with the IRS Appeals Office. We have filed all required U.S. state and local returns reporting the result of the resolution of the U.S. federal income tax audit of the tax years 2003 and 2004. A limited number of U.S. state and local matters are the subject of ongoing audits, administrative appeals or litigation.

A number of years may elapse before an uncertain tax position is audited and ultimately settled. It is difficult to predict the ultimate outcome or the timing of resolution for uncertain tax positions. It is reasonably possible that the amount of unrecognized tax benefits could significantly increase or decrease within the next twelve months. Items that may cause changes to unrecognized tax benefits include the timing of interest deductions and the allocation of income and expense between tax jurisdictions. These changes could result from the settlement of ongoing litigation, the completion of ongoing examinations, the expiration of the statute of limitations or other unforeseen circumstances. At this time, an estimate of the range of the reasonably possible change cannot be made.

In June 2011, we received IRS reports covering income taxes and excise taxes for tax years 2005 through 2007 and 2003 through 2007, respectively. The reports propose assessments related to amounts paid for software, research credit expenditures and deductibility of financing and post-acquisition integration costs as well as taxes on amounts paid for air transportation. Receipt of the reports represents only the conclusion of the examination process. We disagree with the proposed assessments related to these matters. Therefore, we have filed protests and protective tax refund claims. During the third quarter of 2011, the IRS responded to our protests and forwarded the cases to IRS Appeals. There are multiple factors that prevent us from being able to estimate the amount of loss, if any, that may result from these matters including: (1) we are vigorously defending these matters and believe that we have a number of meritorious legal defenses; (2) we have filed refund claims in excess of the proposed assessments; (3) there are unresolved questions of law and fact that could be of importance to the ultimate resolutions of these matters, including the calculation of any additional taxes and/or tax refunds; and (4) these matters are at the initial stage of a multi-level administrative appeals process that may ultimately be resolved by litigation. Accordingly, at this time, we are not able to estimate a possible loss or range of loss that may result from these matters or to determine whether such loss, if any, would have a material adverse effect on our financial condition, results of operations or liquidity.

NOTE 15. BUSINESS ACQUISITIONS

Kiala S.A.

In February 2012, we acquired Kiala S.A. ("Kiala"), a Belgium-based developer of a platform that enables e-commerce retailers to offer their shoppers the option of having goods delivered to a convenient retail location. Kiala currently operates in Belgium, France, Luxembourg, the Netherlands and Spain. The acquisition will broaden our service portfolio for business-to-consumer deliveries. Kiala is not material to our consolidated financial position or results of operations.

TNT Express N.V.

On March 19, 2012, we announced an agreement to purchase TNT Express N.V. ("TNT Express") for €9.50 per ordinary share. The transaction will create a global leader in the logistics industry and an enhanced, integrated global network. The combination will expand our express capabilities and logistics solutions in Europe, while deepening our existing position in fast-growing regions such as Asia and Latin America. The offer values the issued and outstanding share capital of TNT Express at €5.16 billion (approximately \$6.54 billion at the June 30, 2012 exchange rate).

On July 13, 2012, the European Commission announced that the proposed acquisition would move to a Phase II review, which can take up to 25 weeks to complete. In conjunction with the move to a Phase II review, we expect to

extend the public offer for all of the issued and outstanding ordinary shares of TNT Express beyond the August 31, 2012 date initially set forth in the Offer Memorandum. We anticipate that the acquisition will be completed in the fourth quarter of 2012.

Table of Contents

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

## Overview

The U.S. economic expansion continued at a moderate pace in the second quarter of 2012, which provided for growth in the overall U.S. small package delivery market compared with 2011. Additionally, continued growth in industrial production and retail sales, particularly online retail sales, have expanded the small package market in the U.S. These economic trends provided for a solid increase in our U.S. Domestic Package volume in the second quarter and year-to-date periods of 2012, and our products most aligned with business-to-consumer shipments showed the strongest growth. In the second half of 2012, we expect the U.S. economy to grow at a slower pace, the deceleration of growth in our premium products and a further deterioration in the commercial small package marketplace, compared with the first half of the year; however, we do anticipate continued solid growth in our business-to-consumer product offerings.

Outside of the U.S., economic growth has slowed considerably due to volatility in world markets and fiscal austerity measures, particularly in Europe. This slower economic growth has created an environment in which customers are more likely to trade-down from premium express products to standard delivery products. Additionally, the uneven nature of economic growth worldwide has led to shifting trade patterns whereby transcontinental trade is being pressured, but intra-regional trade is continuing to grow. These circumstances have led us to adjust our air capacity and cost structure in our transportation network to the prevailing volume mix levels; for example, in Asia, we are planning for a 10% capacity reduction in our air network for the third quarter of 2012. Our broad portfolio of product offerings and the flexibilities inherent in our transportation network have helped us adapt to these changing trends, which has led to a continued overall solid performance in our International Package business.

While the worldwide economic environment has been challenging in 2012, we have continued to undertake initiatives to improve yield management, increase operational efficiency and contain costs across all segments. This has directly helped to improve the operating margin and profit in our U.S. Domestic Package and Supply Chain & Freight segments. Continued deployment of technology improvements should lead to further gains in our operational efficiency, flexibility, and reliability, thus restraining cost increases and improving margins. In our International Package segment, we have adjusted our air network and utilized newly constructed or expanded operating facilities to improve time-in-transit for shipments in each region. We have also continued to optimize our aircraft network, to leverage the new route authority we have gained over the last several years and to take full advantage of faster growing trade lanes. Additionally, in the first quarter of 2012, we acquired Kiala S.A., which will expand our service offerings for business-to-consumer deliveries in Europe.

Our consolidated results are presented in the table below:

|                                             | Three Months Ended |          |      | Change | Six Months Ended |          |     | Change |
|---------------------------------------------|--------------------|----------|------|--------|------------------|----------|-----|--------|
|                                             | June 30,           |          | %    |        | June 30,         |          | %   |        |
|                                             | 2012               | 2011     |      |        | 2012             | 2011     |     |        |
| Revenue (in millions)                       | \$13,349           | \$13,191 | 1.2  | %      | \$26,485         | \$25,773 | 2.8 | %      |
| Operating Expenses (in millions)            | 11,559             | 11,446   | 1.0  | %      | 23,126           | 22,556   | 2.5 | %      |
| Operating Profit (in millions)              | \$1,790            | \$1,745  | 2.6  | %      | \$3,359          | \$3,217  | 4.4 | %      |
| Operating Margin                            | 13.4               | % 13.2   | %    |        | 12.7             | % 12.5   | %   |        |
| Average Daily Package Volume (in thousands) | 15,356             | 14,946   | 2.7  | %      | 15,474           | 14,951   | 3.5 | %      |
| Average Revenue Per Piece                   | \$11.12            | \$11.21  | (0.8 | )%     | \$10.99          | \$10.99  | —   | %      |
| Net Income (in millions)                    | \$1,116            | \$1,092  | 2.2  | %      | \$2,086          | \$2,007  | 3.9 | %      |
| Basic Earnings Per Share                    | \$1.16             | \$1.11   | 4.5  | %      | \$2.17           | \$2.03   | 6.9 | %      |
| Diluted Earnings Per Share                  | \$1.15             | \$1.09   | 5.5  | %      | \$2.15           | \$2.01   | 7.0 | %      |



Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND  
RESULTS OF OPERATIONS

## Items Affecting Comparability

The year-over-year comparisons of our financial results were affected by the following items (amounts in millions):

|                                         | Three Months Ended |         | Six Months Ended |         |
|-----------------------------------------|--------------------|---------|------------------|---------|
|                                         | June 30,           |         | June 30,         |         |
|                                         | 2012               | 2011    | 2012             | 2011    |
| Operating Expenses:                     |                    |         |                  |         |
| Net gain on real estate transactions    | \$—                | \$(33 ) | \$—              | \$(33 ) |
| Income Tax Expense:                     |                    |         |                  |         |
| Income tax expense from the items above | —                  | 13      | —                | 13      |
| Net Gain on Real Estate Transactions    |                    |         |                  |         |

In the second quarter of 2011, we recognized a pre-tax loss from certain real estate transactions within our U.S. Domestic Package segment of \$15 million (\$11 million after-tax) and a pre-tax gain from certain real estate transactions within our Supply Chain & Freight segment of \$48 million (\$31 million after-tax).

## Results of Operations—Segment Review

The results and discussions that follow are reflective of how our executive management monitors the performance of our reporting segments. From time to time, we supplement the reporting of our financial information determined under generally accepted accounting principles (“GAAP”) with certain non-GAAP financial measures, including operating profit, operating margin, pre-tax income, effective tax rate, net income and earnings per share adjusted for the non-comparable items. We believe that these adjusted measures provide meaningful information to assist investors and analysts in understanding our financial results and assessing our prospects for future performance. We believe these adjusted financial measures are important indicators of our results of operations because they exclude items that may not be indicative of, or are unrelated to, our core operating results, and provide a better baseline for analyzing trends in our underlying businesses.

Certain operating expenses are allocated between our reporting segments based on activity-based costing methods. These activity-based costing methods require us to make estimates that impact the amount of each expense category that is attributed to each segment. Changes in these estimates will directly impact the amount of expense allocated to each segment, and therefore the operating profit of each reporting segment. There were no significant changes in our expense allocation methodology during 2012 or 2011.

Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND  
RESULTS OF OPERATIONS

## U.S. Domestic Package Operations

|                                              | Three Months Ended |         |      | Change | Six Months Ended |          |      | Change |
|----------------------------------------------|--------------------|---------|------|--------|------------------|----------|------|--------|
|                                              | June 30,           |         | %    |        | June 30,         |          | %    |        |
|                                              | 2012               | 2011    |      |        | 2012             | 2011     |      |        |
| Average Daily Package Volume (in thousands): |                    |         |      |        |                  |          |      |        |
| Next Day Air                                 | 1,231              | 1,172   | 5.0  | %      | 1,222            | 1,164    | 5.0  | %      |
| Deferred                                     | 924                | 851     | 8.6  | %      | 954              | 873      | 9.3  | %      |
| Ground                                       | 10,920             | 10,604  | 3.0  | %      | 10,981           | 10,611   | 3.5  | %      |
| Total Avg. Daily Package Volume              | 13,075             | 12,627  | 3.5  | %      | 13,157           | 12,648   | 4.0  | %      |
| Average Revenue Per Piece:                   |                    |         |      |        |                  |          |      |        |
| Next Day Air                                 | \$20.42            | \$20.82 | (1.9 | )%     | \$20.24          | \$20.52  | (1.4 | )%     |
| Deferred                                     | 13.60              | 14.03   | (3.1 | )%     | 13.30            | 13.58    | (2.1 | )%     |
| Ground                                       | 8.08               | 7.97    | 1.4  | %      | 8.02             | 7.88     | 1.8  | %      |
| Total Avg. Revenue Per Piece                 | \$9.63             | \$9.57  | 0.6  | %      | \$9.54           | \$9.44   | 1.1  | %      |
| Operating Days in Period                     | 64                 | 64      |      |        | 128              | 128      |      |        |
| Revenue (in millions):                       |                    |         |      |        |                  |          |      |        |
| Next Day Air                                 | \$1,609            | \$1,562 | 3.0  | %      | \$3,166          | \$3,057  | 3.6  | %      |
| Deferred                                     | 804                | 764     | 5.2  | %      | 1,624            | 1,517    | 7.1  | %      |
| Ground                                       | 5,645              | 5,411   | 4.3  | %      | 11,272           | 10,706   | 5.3  | %      |
| Total Revenue                                | \$8,058            | \$7,737 | 4.1  | %      | \$16,062         | \$15,280 | 5.1  | %      |
| Operating Expenses (in millions):            |                    |         |      |        |                  |          |      |        |
| Operating Expenses                           | \$6,924            | \$6,740 | 2.7  | %      | \$13,933         | \$13,403 | 4.0  | %      |
| Gain (Loss) on Real Estate Transactions      | —                  | (15 )   |      |        | —                | (15 )    |      |        |
| Adjusted Operating Expenses                  | \$6,924            | \$6,725 | 3.0  | %      | \$13,933         | \$13,388 | 4.1  | %      |
| Operating Profit (in millions) and Margin:   |                    |         |      |        |                  |          |      |        |
| Operating Profit                             | \$1,134            | \$997   | 13.7 | %      | \$2,129          | \$1,877  | 13.4 | %      |
| Adjusted Operating Profit                    | \$1,134            | \$1,012 | 12.1 | %      | \$2,129          | \$1,892  | 12.5 | %      |
| Operating Margin                             | 14.1               | % 12.9  | %    |        | 13.3             | % 12.3   | %    |        |
| Adjusted Operating Margin                    | 14.1               | % 13.1  | %    |        | 13.3             | % 12.4   | %    |        |

## Revenue

The change in overall revenue was impacted by the following factors for the second quarter and year-to-date periods of 2012 compared with the corresponding periods of 2011:

|                              | Volume | Rates /<br>Product Mix | Fuel<br>Surcharge | Total<br>Revenue<br>Change |
|------------------------------|--------|------------------------|-------------------|----------------------------|
| Net Revenue Change Drivers:  |        |                        |                   |                            |
| Second quarter 2012 vs. 2011 | 3.5    | % 0.4                  | % 0.2             | % 4.1                      |
| Year-to-date 2012 vs. 2011   | 4.0    | % 0.1                  | % 1.0             | % 5.1                      |

## Volume

Our overall volume increased in the second quarter of 2012 compared with the same period in 2011, largely due to continued solid growth in retail e-commerce and strong customer demand for our lightweight products.

Business-to-consumer shipments, which represent approximately 40% of total U.S. Domestic Package volume, grew



rapidly and drove growth in both air and ground shipments. Commercial volume declined slightly in the second quarter as the U.S. economy weakened, after experiencing volume growth in the first quarter of 2012. Among our air products, Next Day Air package volume increased 5.0% with particular growth in our Next Day Air Saver product, while volume for our deferred air products increased 8.6% for the quarter (5.0% and 9.3%, respectively, year-to-date). This strong growth was driven by business-to-consumer shipments from e-commerce retailers.

30

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Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND  
RESULTS OF OPERATIONS

The increase in ground volume was driven by our lightweight service offerings, including SurePost, which target low-cost, non-urgent residential deliveries. These lightweight products experienced volume growth of 25%, and accounted for over half of the total increase in ground shipments in the second quarter. Growth continues to be driven by business-to-consumer shipping activity from e-commerce retailers.

**Rates and Product Mix**

Overall revenue per piece increased in the second quarter and year-to-date periods of 2012 due to a combination of base price increases and a shift in overall product mix from our ground products to our air products. Fuel surcharge rate changes, which are discussed further below, adversely impacted revenue per piece growth in the second quarter of 2012 compared with 2011, but positively impacted the year-to-date comparison. The strong volume growth in Next Day Air Saver and our lightweight products negatively impacted overall yield growth, as these relatively lower-yielding products accounted for a greater portion of our overall volume in the second quarter and year-to-date periods of 2012, compared with the corresponding periods of 2011.

Revenue per piece for our ground and air products was also positively impacted by an increase in base rates that took effect on January 2, 2012. We increased the base rates 6.9% on UPS Next Day Air, UPS 2nd Day Air, and UPS 3 Day Select, and 5.9% on UPS Ground, while reducing our fuel surcharge indices (discussed further below). Other pricing changes included an increase in the residential surcharge, and an increase in the delivery area surcharge on certain residential and commercial services. These rate changes are customary and occur on an annual basis.

**Fuel Surcharges**

UPS applies a fuel surcharge on our domestic air and ground services. The air fuel surcharge is based on the U.S. Department of Energy's ("DOE") Gulf Coast spot price for a gallon of kerosene-type jet fuel, while the ground fuel surcharge is based on the DOE's On-Highway Diesel Fuel price. Based on published rates, the average fuel surcharge for domestic air and ground products was as follows:

|                         | Three Months Ended |        | Change   | Six Months Ended |        | Change  |   |
|-------------------------|--------------------|--------|----------|------------------|--------|---------|---|
|                         | June 30,           |        |          | June 30,         |        |         |   |
|                         | 2012               | 2011   | % Point  | 2012             | 2011   | % Point | % |
| Next Day Air / Deferred | 14.3               | % 14.7 | % (0.4 ) | % 13.7           | % 12.4 | % 1.3   | % |
| Ground                  | 8.3                | % 8.5  | % (0.2 ) | % 8.2            | % 7.2  | % 1.0   | % |

On January 2, 2012, in connection with our base rate increase, we modified the fuel surcharge on air and ground services by reducing the index used to determine the fuel surcharge by 2% and 1%, respectively. Total domestic fuel surcharge revenue increased by \$13 million in the second quarter of 2012 compared with the same period of 2011, primarily due to the increase in volume, but partially offset by the lower second quarter fuel surcharge rates. On a year-to-date basis, total domestic fuel surcharge revenue increased \$156 million compared with 2011 due to increased volume and higher year-to-date fuel surcharge rates. These increased fuel surcharge rates were driven by higher jet and diesel fuel prices, but partially offset by the reduction in the index on the air and ground surcharges.

**Operating Expenses**

Adjusted operating expenses for the segment increased \$199 million for the second quarter of 2012 compared with the same period of 2011 (\$545 million year-to-date). This increase was primarily due to pick-up and delivery costs, which grew \$175 million (\$373 million year-to-date), as well as the cost of operating our domestic integrated air and ground network, which increased \$45 million for the second quarter (\$183 million year-to-date). The growth in pick-up and delivery and network costs were due largely to increased volume and higher employee compensation costs, which were impacted by a union contractual wage increase (package driver wage rates rose 2.2%), an increase in driver hours (up 0.8%) and increased employee health care costs.

Cost increases have been mitigated as we adjust our air and ground networks to better match higher volume levels and utilize technology to increase package sorting efficiency. Improved delivery densities, particularly for our residential products, have also contained increases in cost. These network efficiency improvements allowed us to process

increased volume at a faster rate than the increase in direct labor hours (up 1.2%), aircraft block hours (down 1.2%) and miles driven (up 0.7%) in the second quarter of 2012 compared with the same period of 2011, resulting in a reduction in the total cost per piece of 0.6% (no change year-to-date).

Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND  
RESULTS OF OPERATIONS

## Operating Profit and Margin

The increase in revenue per piece in excess of the growth in cost per piece resulted in strong operating leverage, leading to a 100 basis point increase in the adjusted operating margin during the second quarter of 2012 compared with the same period of 2011 (90 basis points on a year-to-date basis). Additionally, because fuel prices decreased rapidly during the second quarter of 2012, operating profit benefited by approximately \$60 million from the two month time lag between the fuel price changes and when the monthly surcharge rates are applied to package shipments. The operating margin improvement, combined with volume growth and the fuel surcharge time lag, resulted in a solid operating profit increase in the second quarter and year-to-date periods of 2012 compared with the same periods of 2011.

## International Package Operations

|                                                       | Three Months Ended |         | Change   | Six Months Ended |         | Change   |          |  |
|-------------------------------------------------------|--------------------|---------|----------|------------------|---------|----------|----------|--|
|                                                       | June 30,<br>2012   | 2011    |          | June 30,<br>2012 | 2011    |          |          |  |
| Average Daily Package Volume (in thousands):          |                    |         |          |                  |         |          |          |  |
| Domestic                                              | 1,358              | 1,403   | (3.2 )%  | 1,384            | 1,398   | (1.0 )%  |          |  |
| Export                                                | 923                | 916     | 0.8 %    | 933              | 905     | 3.1 %    |          |  |
| Total Avg. Daily Package Volume                       | 2,281              | 2,319   | (1.6 )%  | 2,317            | 2,303   | 0.6 %    |          |  |
| Average Revenue Per Piece:                            |                    |         |          |                  |         |          |          |  |
| Domestic                                              | \$7.08             | \$7.48  | (5.3 )%  | \$7.08           | \$7.27  | (2.6 )%  |          |  |
| Export                                                | 38.12              | 39.51   | (3.5 )%  | 37.24            | 38.39   | (3.0 )%  |          |  |
| Total Avg. Revenue Per Piece                          | \$19.64            | \$20.13 | (2.4 )%  | \$19.23          | \$19.50 | (1.4 )%  |          |  |
| Operating Days in Period                              | 64                 | 64      |          | 128              | 128     |          |          |  |
| Revenue (in millions):                                |                    |         |          |                  |         |          |          |  |
| Domestic                                              | \$615              | \$672   | (8.5 )%  | \$1,255          | \$1,301 | (3.5 )%  |          |  |
| Export                                                | 2,252              | 2,316   | (2.8 )%  | 4,447            | 4,447   | — %      |          |  |
| Cargo                                                 | 147                | 151     | (2.6 )%  | 278              | 291     | (4.5 )%  |          |  |
| Total Revenue                                         | \$3,014            | \$3,139 | (4.0 )%  | \$5,980          | \$6,039 | (1.0 )%  |          |  |
| Operating Expenses (in millions)                      | \$2,560            | \$2,634 | (2.8 )%  | \$5,118          | \$5,081 | 0.7 %    |          |  |
| Operating Profit (in millions)                        | \$454              | \$505   | (10.1 )% | \$862            | \$958   | (10.0 )% |          |  |
| Operating Margin                                      | 15.1 %             | 16.1 %  |          | 14.4 %           | 15.9 %  |          |          |  |
| Currency Translation Benefit / (Cost)—(in millions)*: |                    |         |          |                  |         |          |          |  |
| Revenue                                               |                    |         |          | \$               |         |          | \$       |  |
| Operating Expenses                                    |                    |         |          | \$(104 )         |         |          | \$(160 ) |  |
| Operating Profit                                      |                    |         |          | 106              |         |          | 145      |  |
|                                                       |                    |         |          | \$2              |         |          | \$(15 )  |  |

\* Net of currency hedging; amount represents the change compared to the prior year.

## Revenue

The change in overall revenue was impacted by the following factors for the second quarter and year-to-date periods of 2012 compared with the corresponding periods of 2011:

| Volume | Rates /<br>Product Mix | Fuel<br>Surcharge | Currency | Total<br>Revenue<br>Change |
|--------|------------------------|-------------------|----------|----------------------------|
|--------|------------------------|-------------------|----------|----------------------------|

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Net Revenue Change Drivers:

|                              |      |    |     |   |      |    |      |    |      |    |
|------------------------------|------|----|-----|---|------|----|------|----|------|----|
| Second quarter 2012 vs. 2011 | (1.6 | )% | 1.0 | % | (0.1 | )% | (3.3 | )% | (4.0 | )% |
| Year-to-date 2012 vs. 2011   | 0.6  | %  | —   | % | 1.0  | %  | (2.6 | )% | (1.0 | )% |

32

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Table of Contents

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND  
RESULTS OF OPERATIONS

Volume

Export volume increased in the second quarter and year-to-date periods of 2012 compared to the corresponding periods of 2011; however, volume growth has been significantly impacted by the worldwide economic slowdown. Export volume growth was driven by intra-regional shipments, particularly intra-Europe and intra-Asia, with our Transborder Standard product experiencing solid growth. This growth in intra-regional shipments was largely offset by declines in transcontinental volume, which was impacted by double-digit declines in exports from Asia (particularly from China) to the U.S. and Europe. Additionally, transcontinental volume into Europe declined, largely due to the economic weakness within the European Union in the second quarter and year-to-date periods of 2012. Domestic volume decreased during the second quarter and year-to-date periods of 2012 compared to the same periods in 2011, and was negatively impacted by economic weakness in southern Europe and revenue management initiatives in Germany and Turkey. These declines were somewhat offset by domestic volume growth in the Netherlands, the U.K., Mexico and Poland.

Rates and Product Mix

Total average revenue per piece increased 2.1% for the second quarter of 2012 (2.0% year-to-date) on a currency-adjusted basis. Currency-adjusted export revenue per piece decreased 0.3% for the second quarter (0.6% year-to-date), as the shift in product mix from our premium express products to our standard products more than offset the increase in base rates. Additionally, currency-adjusted export revenue per piece was adversely impacted by a shortening of average trade lanes, as we experienced greater volume growth among our lower-yielding Transborder and Trade Direct products relative to our higher-yielding transcontinental volume.

Currency-adjusted domestic revenue per piece increased 3.5% for second quarter (4.0% year-to-date), largely due to base rate increases.

On January 2, 2012, we increased the base rates 6.9% for international shipments originating in the United States (Worldwide Express, Worldwide Express Plus, UPS Worldwide Expedited and UPS International Standard service), while reducing fuel surcharge indices. Rate changes for shipments originating outside the U.S. are made throughout the year and vary by geographic market.

Fuel Surcharges

On January 2, 2012, in connection with our base rate increases, we modified the fuel surcharge on certain U.S.-related international air services by reducing the index used to determine the fuel surcharge by 2%. The fuel surcharges for air products originating outside the United States are indexed to the DOE's Gulf Coast spot price for a gallon of kerosene-type jet fuel, while the fuel surcharges for ground products originating outside the United States are indexed to fuel prices in the international region or country where the shipment takes place. Total international fuel surcharge revenue decreased by \$10 million for the second quarter of 2012 when compared with 2011, primarily due to lower package volume and reduced fuel surcharge rates caused by declining fuel prices.

On a year-to-date basis, fuel surcharge revenue increased by \$50 million in 2012 compared to 2011, due to higher fuel surcharge rates and a year-to-date increase in international air volume.

Operating Expenses

Overall operating expenses for the segment decreased \$74 million for the second quarter of 2012 compared with the same period in 2011. The largest component of this decrease relates to the cost of operating our international integrated air and ground network, which decreased \$48 million for the second quarter due largely to lower fuel costs, a 3.4% reduction in aircraft block hours and the impact of currency exchange rate changes. Pick-up and delivery costs decreased \$35 million for the second quarter, primarily as a result of lower fuel prices, decreased package volume and the impact of currency exchange rate movements.

On a year-to-date basis, operating expenses for the segment increased by \$37 million in 2012 compared to 2011. This increase was impacted by the February 2012 acquisition of Kiala S.A., which added \$26 million to operating expenses for the segment in 2012. Additionally, our non-operating costs increased \$31 million, primarily associated with our

investment in enhanced security screening for our international locations as well as business acquisition activities, including our proposed acquisition of TNT Express N.V. These increases were partially offset by a \$14 million decrease in pick-up and delivery costs, largely due to lower non-U.S. domestic volume and the impact of currency exchange rate movements.

Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND  
RESULTS OF OPERATIONS

Excluding the impact of currency exchange rate changes, the total cost per piece for the segment increased 3.0% for the second quarter (3.1% year-to-date).

**Operating Profit and Margin**

The operating margin declined 100 basis points in the second quarter of 2012 (150 basis points year-to-date) compared with the same period of 2011. This decline in operating margin was impacted by the volume declines in the key Asia and U.S.-origin transcontinental trade lanes, as these routes have a larger cost infrastructure (relative to the remainder of the International Package segment) to support the air express volume in each region. Operating margin was also adversely impacted by the product mix change from our premium express products to our standard products. Additionally, we incurred approximately \$15 million in costs during the second quarter of 2012 related to business acquisition activities, including our proposed acquisition of TNT Express N.V. These factors combined to result in a 10% decline in operating profit for the second quarter and year-to-date periods of 2012 compared with 2011.

**Supply Chain & Freight Operations**

|                                                                | Three Months Ended |         | Change | Six Months Ended |         | Change |    |
|----------------------------------------------------------------|--------------------|---------|--------|------------------|---------|--------|----|
|                                                                | June 30,           | 2011    |        | June 30,         | 2011    |        |    |
|                                                                | 2012               |         | %      | 2012             |         | %      |    |
| <b>Freight LTL Statistics:</b>                                 |                    |         |        |                  |         |        |    |
| Revenue (in millions)                                          | \$597              | \$592   | 0.8    | % \$1,155        | \$1,138 | 1.5    | %  |
| Revenue Per Hundredweight                                      | \$21.50            | \$20.91 | 2.8    | % \$21.48        | \$20.73 | 3.6    | %  |
| Shipments (in thousands)                                       | 2,583              | 2,660   | (2.9)  | )% 5,051         | 5,186   | (2.6)  | )% |
| Shipments Per Day (in thousands)                               | 40.4               | 41.6    | (2.9)  | )% 39.5          | 40.5    | (2.6)  | )% |
| Gross Weight Hauled (in millions of lbs)                       | 2,778              | 2,833   | (1.9)  | )% 5,375         | 5,489   | (2.1)  | )% |
| Weight Per Shipment (in lbs)                                   | 1,076              | 1,065   | 1.0    | % 1,064          | 1,059   | 0.5    | %  |
| Operating Days in Period                                       | 64                 | 64      |        | 128              | 128     |        |    |
| <b>Revenue (in millions):</b>                                  |                    |         |        |                  |         |        |    |
| Forwarding and Logistics                                       | \$1,485            | \$1,539 | (3.5)  | )% \$2,909       | \$2,968 | (2.0)  | )% |
| Freight                                                        | 660                | 660     | —      | % 1,278          | 1,264   | 1.1    | %  |
| Other                                                          | 132                | 116     | 13.8   | % 256            | 222     | 15.3   | %  |
| Total Revenue                                                  | \$2,277            | \$2,315 | (1.6)  | )% \$4,443       | \$4,454 | (0.2)  | )% |
| <b>Operating Expenses (in millions):</b>                       |                    |         |        |                  |         |        |    |
| Operating Expenses                                             | \$2,075            | \$2,072 | 0.1    | % \$4,075        | \$4,072 | 0.1    | %  |
| Gain (Loss) on Real Estate Transactions                        | —                  | 48      |        | —                | 48      |        |    |
| Adjusted Operating Expenses                                    | \$2,075            | \$2,120 | (2.1)  | )% \$4,075       | \$4,120 | (1.1)  | )% |
| <b>Operating Profit (in millions) and Margin:</b>              |                    |         |        |                  |         |        |    |
| Operating Profit                                               | \$202              | \$243   | (16.9) | )% \$368         | \$382   | (3.7)  | )% |
| Adjusted Operating Profit                                      | \$202              | \$195   | 3.6    | % \$368          | \$334   | 10.2   | %  |
| Operating Margin                                               | 8.9                | % 10.5  | %      | 8.3              | % 8.6   | %      |    |
| Adjusted Operating Margin                                      | 8.9                | % 8.4   | %      | 8.3              | % 7.5   | %      |    |
| <b>Currency Translation Benefit / (Cost) – (in millions)*:</b> |                    |         |        |                  |         |        |    |
| Revenue                                                        |                    |         | \$     |                  |         | \$     |    |
| Operating Expenses                                             |                    |         | \$(42) | )                |         | \$(52) | )  |
| Operating Profit                                               |                    |         | 40     |                  |         | 49     |    |
|                                                                |                    |         | \$(2)  | )                |         | \$(3)  | )  |

\* Amount represents the change compared to the prior year.





Table of Contents

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND  
RESULTS OF OPERATIONS

Revenue

Forwarding and logistics revenue decreased \$54 million in the second quarter of 2012 (\$59 million year-to-date) compared with the corresponding period in 2011. Forwarding revenue decreased in the second quarter and year-to-date periods of 2012 primarily due to lower rates in our international air forwarding business and the adverse impact of foreign currency exchange rates; however, this was partially offset by improved tonnage in both our air and ocean forwarding businesses. In our logistics products, revenue increased in the second quarter and year-to-date periods of 2012 as we experienced solid growth in our mail services and healthcare solutions. The improved revenue in our healthcare solutions business was driven by organic growth as well as the December 2011 acquisition of Pieffe Group.

Freight revenue was flat for the second quarter, as an increase in LTL revenue per hundredweight was offset by a decline in overall LTL shipments. The decline in average daily LTL shipments was impacted by increased competitiveness in the LTL market and the slowdown in the U.S. economy. The increase in LTL revenue per hundredweight was largely due to our focus on yield management and profitable revenue growth. The increase in LTL revenue per hundredweight was also impacted by a base rate increase that took effect on August 1, 2011, which increased minimum charge, LTL and TL rates an average of 6.9%, covering non-contractual shipments in the United States, Canada and Mexico. On a year-to-date basis, freight revenue increased \$14 million in 2012 compared with 2011, as the increase in LTL revenue per hundredweight more than offset the decline in overall LTL shipments. Fuel surcharge revenue declined in the second quarter by \$5 million, while increasing on a year-to-date basis by \$6 million, in 2012 compared with 2011, due to changes in diesel fuel prices and overall LTL shipment volume.

The other businesses within Supply Chain & Freight increased revenue by \$16 million for the quarter (\$34 million year-to-date), primarily due to growth at UPS Capital, the UPS Store, UPS Customer Solutions and our contract to provide domestic air transportation services for the U.S. Postal Service.

Operating Expenses

Forwarding and logistics adjusted operating expenses decreased \$43 million for the second quarter of 2012 compared with the same period of 2011 (\$72 million year-to-date), due to several factors. Compensation and benefits expense declined by \$10 million in the second quarter (\$20 million year-to-date), largely due to reduced payroll and lower pension costs. Purchased transportation expense fell by \$40 million in the second quarter (\$61 million year-to-date), primarily due to lower rates charged to us by third-party transportation carriers. Operating expenses in the year-to-date period of 2012 were also reduced by a \$9 million gain realized upon the sale of an operating facility.

Freight adjusted operating expenses decreased \$11 million in the second quarter of 2012, due to several factors. The combined cost associated with pick-up and delivery and operating our linehaul network declined by \$4 million, largely due to a slight decline in volume, lower fuel costs and decreased fuel surcharge rates passed to us from outside transportation carriers. The combination of these factors more than offset union contractual driver wage increases. Our truckload division experienced a \$7 million reduction in costs associated with reduced volume, and was impacted by the loss of lower-margin customers. On a year-to-date basis, freight adjusted operating expenses increased \$4 million in 2012 compared with 2011, largely due to the impact of union contractual wage increases on pick-up and delivery and linehaul costs.

Adjusted operating expenses for the other businesses within Supply Chain & Freight increased \$9 million in the second quarter of 2012 compared with 2011 (\$23 million year-to-date).

Operating Profit and Margin

Adjusted operating profit for the forwarding and logistics unit decreased by \$11 million in the second quarter of 2012 compared to the same period in 2011. This decrease was primarily due to reduced profitability in our international air forwarding business, as European economic uncertainty, continued weakness in China and a slowing U.S. economy all contributed to a reduction in overall air freight market demand. On a year-to-date basis, adjusted operating profit for the forwarding and logistics unit increased by \$13 million in 2012 compared with 2011, as forwarding operating

margins expanded due to cost reductions and growth in our ocean freight, North American brokerage and transportation services businesses. Our logistics business had a year-to-date 2012 increase in operating profit, largely due to strong growth in our higher-margin mail services, as well as a \$9 million gain on the sale of an operating facility in the first quarter of 2012.

Adjusted operating profit for our freight unit increased \$11 million in the second quarter of 2012 compared to the same period in 2011 (\$10 million year-to-date), as gains in pick-up and delivery stops per hour, dock bills per hour and linehaul network utilization, as well as improved yields, more than offset volume declines.

Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND  
RESULTS OF OPERATIONS

The combined adjusted operating profit for all of our other businesses in this segment increased \$7 million during the second quarter (\$11 million year-to-date), largely due to growth from our contract to provide domestic air transportation services for the U.S. Postal Service.

## Consolidated Operating Expenses

|                                                  | Three Months Ended |          |       | Change | Six Months Ended |          |       | Change |   |
|--------------------------------------------------|--------------------|----------|-------|--------|------------------|----------|-------|--------|---|
|                                                  | June 30,<br>2012   | 2011     | %     |        | June 30,<br>2012 | 2011     | %     |        |   |
| Operating Expenses (in millions):                |                    |          |       |        |                  |          |       |        |   |
| Compensation and Benefits                        | \$6,747            | \$6,636  | 1.7   | %      | \$13,582         | \$13,198 | 2.9   | %      |   |
| Repairs and Maintenance                          | 303                | 317      | (4.4) | )%     | 605              | 632      | (4.3) | )%     |   |
| Depreciation and Amortization                    | 459                | 443      | 3.6   | %      | 918              | 884      | 3.8   | %      |   |
| Purchased Transportation                         | 1,733              | 1,762    | (1.6) | )%     | 3,450            | 3,410    | 1.2   | %      |   |
| Fuel                                             | 1,014              | 1,057    | (4.1) | )%     | 2,039            | 1,965    | 3.8   | %      |   |
| Other Occupancy                                  | 213                | 225      | (5.3) | )%     | 450              | 486      | (7.4) | )%     |   |
| Other Expenses                                   | 1,090              | 1,006    | 8.3   | %      | 2,082            | 1,981    | 5.1   | %      |   |
| Impact of Net Gain from Real Estate Transactions | —                  | 33       |       |        | —                | 33       |       |        |   |
| Adjusted Other Expenses                          | 1,090              | 1,039    | 4.9   | %      | 2,082            | 2,014    | 3.4   | %      |   |
| Total Operating Expenses                         | \$11,559           | \$11,446 | 1.0   | %      | \$23,126         | \$22,556 | 2.5   | %      |   |
| Adjusted Total Operating Expenses                | \$11,559           | \$11,479 | 0.7   | %      | 23,126           | \$22,589 | 2.4   | %      |   |
|                                                  |                    |          |       | \$     |                  |          |       | \$     |   |
| Currency Translation (Benefit) Cost              |                    |          |       | \$(146 | )                |          |       | \$(194 | ) |

## Compensation and Benefits

Benefits expense increased \$128 million for the second quarter of 2012 compared with 2011 (\$273 million year-to-date), primarily due to higher pension expense, health and welfare costs, expense associated with our self-insurance for worker's compensation claims and payroll taxes, as follows:

Health and welfare costs increased \$70 million for the second quarter of 2012 compared with 2011 (\$53 million year-to-date), largely due to a deterioration in our health claims experience.

Pension expense increased \$55 million for the second quarter of 2012 compared with 2011 (\$118 million year-to-date), resulting from higher union contribution rates for multiemployer pension plans, combined with increased service and interest costs for company-sponsored plans. The increase in service and interest costs for company-sponsored plans was largely due to continued service accruals and lower discount rates.

The expense associated with our self-insurance programs for worker's compensation claims increased by \$17 million for the second quarter of 2012 compared with 2011 (\$72 million year-to-date). Insurance reserves are established for estimates of the loss that we will ultimately incur on reported claims, as well as estimates of claims that have been incurred but not reported, and take into account a number of factors including our history of claim losses, payroll growth and the impact of safety improvement initiatives. In 2011, we experienced more favorable actuarial expense adjustments on previous years' claims compared with 2012, thus leading to most of the increase in expense.

Company accruals for employee payroll taxes increased by \$7 million for the second quarter of 2012 compared with 2011 (\$39 million year-to-date), largely due to the change in timing of our management incentive compensation awards.

Table of Contents

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND  
RESULTS OF OPERATIONS

Employee payroll costs decreased \$17 million for the second quarter of 2012 compared with 2011, largely due to reductions in management incentive compensation; however, this was partially offset by an increase in union and other labor payroll, primarily resulting from a 0.7% increase in total union labor hours for the quarter and contractual union wage rate increases that took effect under our collective bargaining agreement with the Teamsters. For the first six months of 2012 compared with the same period of 2011, employee payroll costs increased \$111 million, largely due to contractual union wage rate increases, as well as a 0.5% increase in total union labor hours; however, this was partially offset by a slight decline in management payroll costs due to a reduction in incentive compensation expense.

Repairs and Maintenance

The decrease in repairs and maintenance expense was largely due to lower aircraft maintenance costs, which decreased \$21 million for the second quarter of 2012 compared with 2011 (\$40 million year-to-date). This decrease resulted primarily from the conversion of an engine maintenance agreement with an outside vendor from a cost reimbursement approach to a fixed rate per flight hour. Additionally, aircraft maintenance expense declined due to a reduction in the number of scheduled maintenance checks for our Airbus A300, Boeing 757 and Boeing MD-11 aircraft.

Depreciation and Amortization

The increase in depreciation and amortization expense was primarily the result of an increase in depreciation expense on vehicles of \$14 million for the second quarter of 2012 compared with 2011 (\$31 million year-to-date), primarily resulting from an overall increase in the size of our vehicle fleet in our U.S. Domestic package operations.

Purchased Transportation

The decrease in purchased transportation expense charged to us by third-party air, ocean and truck carriers for the second quarter of 2012 compared with the same period of 2011 was impacted by several factors. In our international air freight forwarding business, lower rates charged to us by third-party air carriers resulted in a \$46 million decline in expense for the second quarter. Additionally, the impact of currency exchange rate fluctuations resulted in a \$25 million decline in expense when comparing the second quarter of 2012 with the corresponding period of 2011. These factors were partially offset by a \$32 million increase in expense due to higher fees paid to the U.S. Postal Service associated with the strong volume growth in our SurePost product.

The increase in purchased transportation expense for the year-to-date period of 2012 compared with 2011 was largely due to higher fees paid to the U.S. Postal Service related to our SurePost product (increase of \$60 million), as well as the expense associated with the use of rail carriers (increase of \$9 million), due to higher rates and increased volume in our U.S. Domestic Package business. These factors were partially offset by the impact of currency exchange rate fluctuations, which reduced the increase in expense by \$39 million.

Fuel

The decrease in fuel expense for the second quarter of 2012 compared with the same period of 2011 was primarily due to lower fuel prices for jet-A fuel and diesel, which decreased expense by \$13 million, as well as lower usage, which decreased expense by \$30 million. The year-to-date fuel expense increase was largely due to higher fuel prices in 2012 compared with 2011 (which increased expense \$98 million); however, this was partially offset by lower usage of fuel products, which decreased expense by \$24 million.

Other Occupancy

Other occupancy expense decreased in the second quarter and year-to-date periods of 2012, compared with the corresponding periods of 2011, primarily due to reductions in personal property and real estate taxes combined with a decrease in utilities expense. The relatively warm winter in the United States, combined with lower natural gas prices, helped to reduce heating and snow removal costs in our facilities in the early months of 2012.

Other Expenses

The second quarter and year-to-date 2012 increase in adjusted other expenses was largely due to higher outside professional fees (part of which were due to the proposed TNT Express N.V. acquisition), foreign currency

remeasurement losses, transportation equipment rentals and bad debt expense. These factors were partially offset by decreases in employee relocation expenses in the second quarter and year-to-date periods of 2012. Additionally, year-to-date 2012 adjusted other expenses were reduced by a \$9 million gain on the sale of a distribution facility in our Supply Chain & Freight segment.

Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND  
RESULTS OF OPERATIONS

## Investment Income and Interest Expense

|                   | Three Months Ended |        |        | Change | Six Months Ended |         |        |   |
|-------------------|--------------------|--------|--------|--------|------------------|---------|--------|---|
|                   | June 30,           |        | %      |        | June 30,         |         | Change |   |
| (in millions)     | 2012               | 2011   |        |        | 2012             | 2011    |        | % |
| Investment Income | \$6                | \$9    | (33.3) | %      | \$12             | \$20    | (40.0) | % |
| Interest Expense  | \$(92)             | \$(83) | 10.8   | %      | \$(186)          | \$(168) | 10.7   | % |

## Investment Income

The decrease in investment income in 2012 compared with 2011 was primarily caused by a decline in investment mark-to-market and realized gains of \$7 million for the quarter (\$16 million year-to-date). This decline was impacted by realized gains on sales of auction-rate and preferred securities and an S&P 500 index fund, as well as a mark-to-market gain on a variable life insurance policy, that occurred in 2011. This decline was partially offset by an increase in interest income, largely due to having a higher average balance of interest-earning cash and investments in our portfolio in the second quarter and year-to-date periods of 2012 compared with the corresponding periods of 2011.

## Interest Expense

Interest expense increased in the second quarter and year-to-date periods of 2012 compared to 2011, largely due to a higher effective interest rate incurred on our debt. The higher effective interest rate largely resulted from two factors: (1) having a greater proportion of fixed-rate debt outstanding relative to lower-yielding variable rate debt, and (2) an increase in the interest rate indices underlying our variable-rate debt and swaps in 2012. The average balance of debt outstanding in the second quarter and year-to-date periods of 2012 remained relatively stable compared with 2011.

## Income Tax Expense

|                                                | Three Months Ended |        |     | Change | Six Months Ended |         |        |   |
|------------------------------------------------|--------------------|--------|-----|--------|------------------|---------|--------|---|
|                                                | June 30,           |        | %   |        | June 30,         |         | Change |   |
| (in millions)                                  | 2012               | 2011   |     |        | 2012             | 2011    |        | % |
| Income Tax Expense                             | \$588              | \$579  | 1.6 | %      | \$1,099          | \$1,062 | 3.5    | % |
| Impact of Net Gain on Real Estate Transactions | —                  | (13)   |     |        | —                | (13)    |        |   |
| Adjusted Income Tax Expense                    | \$588              | \$566  | 3.9 | %      | \$1,099          | \$1,049 | 4.8    | % |
| Effective Tax Rate                             | 34.5               | % 34.6 | %   |        | 34.5             | % 34.6  | %      |   |
| Adjusted Effective Tax Rate                    | 34.5               | % 34.6 | %   |        | 34.5             | % 34.6  | %      |   |

Income tax expense increased due to higher pre-tax income in the second quarter and year-to-date periods of 2012 compared with 2011. Our effective tax rate remained relatively constant at 34.5% in the second quarter and year-to-date periods of 2012, compared with 34.6% in the corresponding periods of 2011.

Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND  
RESULTS OF OPERATIONS

## Liquidity and Capital Resources

## Net Cash From Operating Activities

The following is a summary of the significant sources (uses) of cash from operating activities (amounts in millions):

|                                                                        | Six Months Ended |          |
|------------------------------------------------------------------------|------------------|----------|
|                                                                        | June 30,         |          |
|                                                                        | 2012             | 2011     |
| Net income                                                             | \$2,086          | \$2,007  |
| Non-cash operating activities (a)                                      | 1,723            | 1,950    |
| Pension and postretirement plan contributions (UPS-sponsored plans)    | (450             | ) (1,296 |
| Income tax receivables and payables                                    | 259              | 380      |
| Changes in working capital and other noncurrent assets and liabilities | 288              | 277      |
| Other sources (uses) of cash from operating activities                 | (56              | ) (4     |
| Net cash from operating activities                                     | \$3,850          | \$3,314  |

Represents depreciation and amortization, gains and losses on derivative transactions and foreign exchange, (a) deferred income taxes, provisions for uncollectible accounts, pension and postretirement benefit expense, stock compensation expense, impairment charges, and other non-cash items.

Contributions to our company-sponsored pension plans have varied based primarily on whether any minimum funding requirements are present for individual pension plans. In 2012, we contributed \$450 million to our company-sponsored pension and postretirement medical benefit plans, which included \$355 million in contributions to the UPS IBT Pension Plan. In the first six months of 2011, we made a \$1.2 billion contribution to the UPS IBT Pension Plan. As discussed in Note 6 to the unaudited consolidated financial statements, we expect to contribute \$448 million to our company-sponsored pension and U.S. postretirement medical benefit plans over the remainder of 2012. Operating cash flow was favorably impacted in both 2012 and 2011 by higher net income and seasonal changes in our working capital position. Changes in working capital were largely a result of the timing of salary and wages payable and related tax withholdings, as well as improved collections of receivables during the first six months of 2012 compared with the same period of 2011.



Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND  
RESULTS OF OPERATIONS

## Net Cash Used In Investing Activities

Our primary sources (uses) of cash for investing activities were as follows (amounts in millions):

|                                        | Six Months Ended |      |           |   |
|----------------------------------------|------------------|------|-----------|---|
|                                        | June 30,         |      |           |   |
|                                        | 2012             | 2011 |           |   |
| Net cash used in investing activities  | \$ (307          | )    | \$ (1,069 | ) |
| Capital Expenditures:                  |                  |      |           |   |
| Buildings and facilities               | \$ (217          | )    | \$ (159   | ) |
| Aircraft and parts                     | (368             | )    | (486      | ) |
| Vehicles                               | (147             | )    | (140      | ) |
| Information technology                 | (217             | )    | (166      | ) |
|                                        | \$ (949          | )    | \$ (951   | ) |
| Capital Expenditures as a % of Revenue | 3.6              | %    | 3.7       | % |

## Other Investing Activities:

|                                                          |         |   |         |   |
|----------------------------------------------------------|---------|---|---------|---|
| Proceeds from disposals of property, plant and equipment | \$ 32   |   | \$ 22   |   |
| Net decrease in finance receivables                      | \$ 42   |   | \$ 81   |   |
| Net sales (purchases) of marketable securities           | \$ 664  |   | \$ (98  | ) |
| Cash paid for business acquisitions                      | \$ (100 | ) | \$ —    |   |
| Other sources (uses) of cash for investing activities    | \$ 4    |   | \$ (123 | ) |

We have commitments for the purchase of aircraft, vehicles, equipment and real estate to provide for the replacement of existing capacity and anticipated future growth. We generally fund our capital expenditures with our cash from operations. Capital spending on aircraft is primarily related to contract deposits on open aircraft orders, and final payments associated with the delivery of six Boeing 767-300s in 2012 and two Boeing 747-400s and four Boeing 767-300s in 2011. Capital spending on buildings and facilities and information technology increased in 2012 compared with 2011, largely due to our Cologne hub expansion in Germany as well as various technology deployments. Future capital spending for anticipated growth and replacement assets will depend on a variety of factors, including economic and industry conditions.

The net change in finance receivables was primarily due to customer paydowns, loan sales and new loan origination activity, primarily in our business credit and asset-based lending portfolios. The purchases and sales of marketable securities are largely determined by liquidity needs and the periodic rebalancing of investment types, and will therefore fluctuate from period to period. The cash paid for business acquisitions was related to our acquisition of Kiala S.A., which closed in the first quarter of 2012. Other investing activities include the cash settlement of derivative contracts used in our currency hedging programs and the timing of aircraft purchase contract deposits on our Boeing 767-300 aircraft order.

On March 19, 2012, we announced an agreement to purchase TNT Express N.V. ("TNT Express") for €9.50 per ordinary share. The offer values the issued and outstanding share capital of TNT Express at €5.16 billion (approximately \$6.54 billion at the June 30, 2012 exchange rate). We anticipate the acquisition will close during fourth quarter 2012, and intend to finance the offer by utilizing a combination of available cash and debt backed by existing credit facilities.

Table of ContentsUNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND  
RESULTS OF OPERATIONS

## Net Cash Provided by Financing Activities

Our primary sources (uses) of cash for financing activities are as follows (amounts in millions, except per share data):

|                                                       | Six Months Ended |           |
|-------------------------------------------------------|------------------|-----------|
|                                                       | June 30,         |           |
|                                                       | 2012             | 2011      |
| Net cash provided by (used in) financing activities   | \$ 158           | \$(971)   |
| Share Repurchases:                                    |                  |           |
| Cash expended for shares repurchased                  | \$(885)          | \$(1,052) |
| Number of shares repurchased                          | (11.3)           | (14.4)    |
| Shares outstanding at period end                      | 958              | 981       |
| Percent reduction in shares outstanding               | (0.5)%           | (1.0)%    |
| Dividends:                                            |                  |           |
| Dividends declared per share                          | \$ 1.14          | \$ 1.04   |
| Cash expended for dividend payments                   | \$(1,068)        | \$(1,007) |
| Borrowings:                                           |                  |           |
| Net borrowings of debt principal                      | \$ 1,873         | \$ 1,162  |
| Other Financing Activities:                           |                  |           |
| Cash received for common stock issuances              | \$ 194           | \$ 163    |
| Other sources (uses) of cash for financing activities | \$ 44            | \$(237)   |
| Capitalization (as of June 30 each year):             |                  |           |
| Total debt outstanding at period end                  | \$ 13,023        | \$ 12,161 |
| Total shareowners' equity at period end               | 7,725            | 8,329     |
| Total capitalization                                  | \$ 20,748        | \$ 20,490 |
| Debt to Total Capitalization %                        | 62.8             | % 59.4    |

We repurchased a total of 11.3 million shares of class A and class B common stock for \$870 million during the six months ended June 30, 2012, and 14.4 million shares for \$1.055 billion for the six months ended June 30, 2011 (\$885 million and \$1.052 billion in repurchases for 2012 and 2011, respectively, are reported on the cash flow statement due to the timing of settlements). On May 3, 2012, the Board of Directors approved a new share repurchase authorization of \$5.0 billion, which replaces an authorization previously announced in 2008. The new share repurchase authorization has no expiration date, and as of June 30, 2012, we had \$4.738 billion of this share repurchase authorization remaining. We anticipate repurchasing approximately \$1.5 billion in shares for all of 2012.

The declaration of dividends is subject to the discretion of the Board of Directors and will depend on various factors, including our net income, financial condition, cash requirements, future prospects and other relevant factors. We increased our quarterly cash dividend payment to \$0.57 per share in 2012, compared with the previous \$0.52 quarterly dividend rate in 2011. We expect to continue the practice of paying regular cash dividends.

Issuances of debt in 2012 and 2011 consisted primarily of commercial paper. Repayments of debt in 2012 and 2011 consisted primarily of paydowns of commercial paper and redemptions of certain floating rate notes. We consider the overall fixed and floating interest rate mix of our portfolio and the related overall cost of borrowing when planning for future issuances and non-scheduled repayments of debt.

The cash outflows in other financing activities were primarily due to premiums paid and received on capped call options for the purchase of UPS class B shares, and tax withholdings on vested employee stock awards.

Table of Contents

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND  
RESULTS OF OPERATIONS

Sources of Credit

We are authorized to borrow up to \$10.0 billion under the U.S. commercial paper program we maintain. We had \$1.775 billion outstanding under this program as of June 30, 2012, with an average interest rate of 0.07%. We also maintain a European commercial paper program under which we are authorized to borrow up to €1.0 billion in a variety of currencies. As of June 30, 2012, we had CNY 630 million (equivalent to \$99 million) outstanding under this program, with an average interest rate of 2.17%.

We maintain two credit agreements with a consortium of banks. One of these agreements provides revolving credit facilities of \$1.5 billion, and expires on April 11, 2013. Generally, amounts outstanding under this facility bear interest at a periodic fixed rate equal to LIBOR for the applicable interest period and currency denomination, plus an applicable margin. Alternatively, a fluctuating rate of interest equal to Citibank's publicly announced base rate, plus an applicable margin, may be used at our discretion. In each case, the applicable margin for advances bearing interest based on LIBOR is a percentage determined by quotations from Markit Group Ltd. for our 1-year credit default swap spread, subject to a minimum rate of 0.10% and a maximum rate of 0.75%. The applicable margin for advances bearing interest based on the base rate is 1.00% below the applicable margin for LIBOR advances (but not lower than 0.00%). We are also able to request advances under this facility based on competitive bids for the applicable interest rate. There were no amounts outstanding under this facility as of June 30, 2012.

The second agreement provides revolving credit facilities of \$1.0 billion, and expires on April 12, 2017. Generally, amounts outstanding under this facility bear interest at a periodic fixed rate equal to LIBOR for the applicable interest period and currency denomination, plus an applicable margin. Alternatively, a fluctuating rate of interest equal to Citibank's publicly announced base rate, plus an applicable margin, may be used at our discretion. In each case, the applicable margin for advances bearing interest based on LIBOR is a percentage determined by quotations from Markit Group Ltd. for our credit default swap spread, interpolated for a period from the date of determination of such credit default swap spread in connection with a new interest period until the latest maturity date of this facility then in effect (but not less than a period of one year). The applicable margin is subject to certain minimum rates and maximum rates based on our public debt ratings from Standard & Poor's Rating Service and Moody's Investors Service. The minimum applicable margin rates range from 0.100% to 0.375%, and the maximum applicable margin rates range from 0.750% to 1.250%. The applicable margin for advances bearing interest based on the base rate is 1.00% below the applicable margin for LIBOR advances (but not less than 0.00%). We are also able to request advances under this facility based on competitive bids. There were no amounts outstanding under this facility as of June 30, 2012.

Our Moody's and Standard & Poor's short-term credit ratings are P-1 and A-1+, respectively. Our Moody's and Standard & Poor's long-term credit ratings are Aa3 and AA-, respectively. We currently have a negative outlook from both Moody's and Standard & Poor's.

Our existing debt instruments and credit facilities subject us to certain financial covenants. As of June 30, 2012 and for all prior periods, we have satisfied these financial covenants. These covenants limit the amount of secured indebtedness that we may incur, and limit the amount of attributable debt in sale-leaseback transactions, to 10% of net tangible assets. As of June 30, 2012, 10% of net tangible assets was equivalent to \$2.601 billion; however, we have no covered sale-leaseback transactions or secured indebtedness outstanding. Additionally, we are required to maintain a minimum net worth, as defined, of \$5.0 billion on a quarterly basis. As of June 30, 2012, our net worth, as defined, was equivalent to \$10.837 billion. We do not expect these covenants to have a material impact on our financial condition or liquidity.

Except as described in this quarterly report, the nature and amounts of our payment obligations under our debt, capital and operating lease agreements, purchase commitments, and other liabilities as of June 30, 2012 have not materially changed from those described in our Annual Report on Form 10-K for the year ended December 31, 2011.

We believe that funds from operations and borrowing programs will provide adequate sources of liquidity and capital resources to meet our expected long-term needs for the operation of our business, including anticipated capital expenditures, such as commitments for aircraft purchases, for the foreseeable future.

**Guarantees and Other Off-Balance Sheet Arrangements**

We do not have guarantees or other off-balance sheet financing arrangements, including variable interest entities, which we believe could have a material impact on our financial condition or liquidity.

Table of Contents

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND  
RESULTS OF OPERATIONS

Contingencies

We are involved in a number of judicial proceedings and other matters arising from the conduct of our business activities.

Although there can be no assurance as to the ultimate outcome, we have generally denied, or believe we have a meritorious defense and will deny, liability in all litigation pending against us, including (except as otherwise noted herein) the matters described below, and we intend to defend vigorously each case. We have accrued for legal claims when, and to the extent that, amounts associated with the claims become probable and can be reasonably estimated. The actual costs of resolving legal claims may be substantially higher or lower than the amounts accrued for those claims.

For those matters as to which we are not able to estimate a possible loss or range of loss, we are not able to determine whether the loss will have a material adverse effect on our business, financial condition or results of operations or liquidity. For matters in this category, we have indicated in the descriptions that follow the reasons that we are unable to estimate the possible loss or range of loss.

Judicial Proceedings

We are a defendant in a number of lawsuits filed in state and federal courts containing various class action allegations under state wage-and-hour laws. At this time, we do not believe that any loss associated with these matters, would have a material adverse effect on our financial condition, results of operations or liquidity.

UPS and our subsidiary Mail Boxes Etc., Inc. are defendants in two lawsuits about the rebranding or purchase of The UPS Store franchises-Morgate (California Superior Court) and Samica (United States District Court).

In Morgate, the plaintiffs are 125 individual franchisees who did not rebrand to The UPS Store and a certified class of all franchisees who did rebrand. The trial court entered judgment against a bellwether individual plaintiff, which was affirmed in January 2012. The trial court granted our motion for summary judgment against the certified class, which was reversed in January 2012.

In Samica, about half of the approximately 200 plaintiffs rebranded and half purchased new The UPS Store franchises. Summary judgment for UPS was affirmed by the United States Court of Appeals, Ninth Circuit, in December 2011. Plaintiffs have filed a petition for certiorari with the United States Supreme Court.

There are multiple factors that prevent us from being able to estimate the amount of loss, if any, that may result from whatever remaining aspects of these cases proceed including: (1) we are vigorously defending ourselves and believe we have a number of meritorious legal defenses; and (2) it remains uncertain what evidence of damages, if any, plaintiffs will be able to present. Accordingly, at this time, we are not able to estimate a possible loss or range of loss that may result from these matters or to determine whether such loss, if any, would have a material adverse effect on our financial condition, results of operations or liquidity.

In AFMS LLC v. UPS and FedEx Corporation, a lawsuit filed in federal court in the Central District of California in August 2010, the plaintiff asserts that UPS and FedEx violated U.S. antitrust law by conspiring to refuse to negotiate with third party negotiators retained by shippers and by individually imposing policies that prevent shippers from using such negotiators. The Antitrust Division of the U.S. Department of Justice ("DOJ") has informed us that it has opened a civil investigation of our policies and practices for dealing with third party negotiators. We are cooperating with this investigation. We deny any liability with respect to these matters and intend to vigorously defend ourselves. There are multiple factors that prevent us from being able to estimate the amount of loss, if any, that may result from these matters including: (1) we believe that we have a number of meritorious defenses; (2) discovery is ongoing; and (3) the DOJ investigation is ongoing. Accordingly, at this time, we are not able to estimate a possible loss or range of loss that may result from these matters or to determine whether such loss, if any, would have a material adverse effect on our financial condition, results of operations or liquidity.



Table of Contents

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND  
RESULTS OF OPERATIONS

In Canada, three purported class-action cases were filed against us in British Columbia (2006); Ontario (2007) and Québec (2006). The cases each allege inadequate disclosure concerning the existence and cost of brokerage services provided by us under applicable provincial consumer protection legislation and infringement of interest restriction provisions under the Criminal Code of Canada. The British Columbia class-action was declared inappropriate for certification and dismissed by the trial judge. That decision was upheld by the British Columbia Court of Appeal in March 2010, which ended the case in our favor. The Ontario class action was certified in September 2011. Partial summary judgment was granted to us and the plaintiffs by the Ontario motions court. The complaint under the Criminal Code was dismissed. No appeal is being taken from that decision. The allegations of inadequate disclosure were granted and we are appealing that decision. The request to certify the case in Québec was heard in February 2012. We have denied all liability and are vigorously defending the two outstanding cases. There are multiple factors that prevent us from being able to estimate the amount of loss, if any, that may result from these matters, including: (1) we are vigorously defending ourselves and believe that we have a number of meritorious legal defenses; and (2) there are unresolved questions of law and fact that could be important to the ultimate resolution of these matters. Accordingly, at this time, we are not able to estimate a possible loss or range of loss that may result from these matters or to determine whether such loss, if any, would have a material adverse effect on our financial condition, results of operation or liquidity.

Other Matters

In May and December 2007 and August 2008 we received and responded to grand jury subpoenas from the DOJ in the Northern District of California in connection with an investigation by the Drug Enforcement Administration. We also have responded to informal requests for information in connection with this investigation, which relates to transportation of packages on behalf of on-line pharmacies that may have operated illegally. We have been cooperating with this investigation and are exploring the possibility of resolving this matter, which could include our undertaking further enhancements to our compliance program and/or a payment. Such a payment may exceed the amounts previously accrued with respect to this matter, but we do not expect that the amount of such additional loss would have a material adverse effect on our financial condition, results of operations or liquidity.

We received a grand jury subpoena from the Antitrust Division of the DOJ regarding the DOJ's investigation into certain pricing practices in the freight forwarding industry in December 2007.

In August 2010, competition authorities in Brazil opened an administrative proceeding to investigate alleged anticompetitive behavior in the freight forwarding industry. Approximately 45 freight forwarding companies and individuals are named in the proceeding, including UPS, UPS SCS Transportes (Brasil) S.A., and a former employee in Brazil. UPS will have an opportunity to respond to these allegations.

We are cooperating with each of these investigations, and intend to continue to vigorously defend ourselves. There are multiple factors that prevent us from being able to estimate the amount of loss, if any, that may result from these matters including: (1) we are vigorously defending each matter and believe that we have a number of meritorious legal defenses; (2) there are unresolved questions of law that could be of importance to the ultimate resolutions of these matters, including the calculation of any potential fine; and (3) there is uncertainty about the time period that is the subject of the investigations. Accordingly, at this time, we are not able to estimate a possible loss or range of loss that may result from these matters or to determine whether such loss, if any, would have a material adverse effect on our financial condition, results of operations or liquidity.

On March 28, 2012, the European Commission ("Commission") announced a decision finding that 14 freight forwarders, including UPS, had infringed EU competition law. The Commission assessed a fine on UPS in the amount of €10 million. While UPS does not consider the decision to be correct, it has elected to bring the matter to a conclusion and paid the fine to the Commission.





Table of Contents

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND  
RESULTS OF OPERATIONS

In January 2008, a class action complaint was filed in the United States District Court for the Eastern District of New York alleging price-fixing activities relating to the provision of freight forwarding services. UPS was not named in this case. In July 2009, the plaintiffs filed a first amended complaint naming numerous global freight forwarders as defendants. UPS and UPS Supply Chain Solutions are among the 60 defendants named in the amended complaint. We intend to vigorously defend ourselves in this case. There are multiple factors that prevent us from being able to estimate the amount of loss, if any, that may result from these matters including: (1) the magistrate judge recommended that the district court grant our motion to dismiss, with leave to amend, and the scope of the plaintiffs' claims is therefore unclear; (2) the scope and size of the proposed class is ill-defined; (3) there are significant legal questions about the adequacy and standing of the putative class representatives; and (4) we believe that we have a number of meritorious legal defenses. Accordingly, at this time, we are not able to estimate a possible loss or range of loss that may result from these matters or to determine whether such loss, if any, would have a material adverse effect on our financial condition, results of operations or liquidity.

We are a defendant in various other lawsuits that arose in the normal course of business. We do not believe that the eventual resolution of these other lawsuits (either individually or in the aggregate), including any reasonably possible losses in excess of current accruals, will have a material adverse effect on our financial condition, results of operations or liquidity.

In June 2011, we received IRS reports covering income taxes and excise taxes for tax years 2005 through 2007 and 2003 through 2007, respectively. The reports propose assessments related to amounts paid for software, research credit expenditures and deductibility of financing and post-acquisition integration costs as well as taxes on amounts paid for air transportation. Receipt of the reports represents only the conclusion of the examination process. We disagree with the proposed assessments related to these matters. Therefore, we have filed protests and protective tax refund claims. During the third quarter of 2011, the IRS responded to our protests and forwarded the cases to IRS Appeals. There are multiple factors that prevent us from being able to estimate the amount of loss, if any, that may result from these matters including: (1) we are vigorously defending these matters and believe that we have a number of meritorious legal defenses; (2) we have filed refund claims in excess of the proposed assessments; (3) there are unresolved questions of law and fact that could be of importance to the ultimate resolutions of these matters, including the calculation of any additional taxes and/or tax refunds; and (4) these matters are at the initial stage of a multi-level administrative appeals process that may ultimately be resolved by litigation. Accordingly, at this time, we are not able to estimate a possible loss or range of loss that may result from these matters or to determine whether such loss, if any, would have a material adverse effect on our financial condition, results of operations or liquidity.

**Collective Bargaining Agreements**

As of December 31, 2011, we had approximately 245,000 employees employed under a national master agreement and various supplemental agreements with local unions affiliated with the International Brotherhood of Teamsters ("Teamsters"). These agreements run through July 31, 2013. We have approximately 2,700 pilots who are employed under a collective bargaining agreement with the Independent Pilots Association, which became amendable at the end of 2011. Our airline mechanics are covered by a collective bargaining agreement with Teamsters Local 2727, which runs through November 1, 2013. In addition, approximately 3,200 of our ground mechanics who are not employed under agreements with the Teamsters are employed under collective bargaining agreements with the International Association of Machinists and Aerospace Workers ("IAM"). Our agreement with the IAM runs through July 31, 2014. We contribute to a number of multiemployer defined benefit and health and welfare plans under terms of collective bargaining agreements that cover our union represented employees. Our current collective bargaining agreements set forth the annual contribution increases allotted to the plans that we participate in, and we are in compliance with these contribution rates. These limitations will remain in effect throughout the terms of the existing collective bargaining agreements.

Rate Adjustments

In June 2012, our UPS Freight unit announced a general rate increase averaging 5.9%, covering non-contractual shipments in the United States, Canada and Mexico. The rate adjustment took effect on July 16, 2012, and applies to minimum charge, LTL rates and accessorial charges.

45

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Table of Contents

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND  
RESULTS OF OPERATIONS

Recent Accounting Pronouncements

Adoption of New Accounting Standards

In May 2011, the Financial Accounting Standards Board ("FASB") issued an Accounting Standards Update to disclosure requirements for fair value measurement. These amendments, which became effective for us in the first quarter of 2012, result in a common definition of fair value and common measurement and disclosure requirements between U.S. GAAP and IFRS. Consequently, the amendments change some fair value measurement principles and disclosure requirements. The implementation of this amended accounting guidance had an immaterial impact on our consolidated financial position and results of operations.

In June 2011, the FASB issued an Accounting Standards Update that increases the prominence of items reported in other comprehensive income in the financial statements. This update requires companies to present comprehensive income in a single statement below net income or in a separate statement of comprehensive income immediately following the income statement. This requirement became effective for us beginning with the first quarter of 2012, and we have included the required presentation in all applicable filings since that date.

Other accounting pronouncements adopted during the periods covered by the consolidated financial statements had an immaterial impact on our consolidated financial position and results of operations.

Accounting Standards Issued But Not Yet Effective

Accounting pronouncements issued, but not effective until after June 30, 2012, are not expected to have a significant impact on our consolidated financial position or results of operations.

Table of Contents

## Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to market risk from changes in foreign currency exchange rates, interest rates, equity prices, and certain commodity prices. This market risk arises in the normal course of business, as we do not engage in speculative trading activities. In order to manage the risk arising from these exposures, we utilize a variety of foreign exchange, interest rate, equity and commodity forward contracts, options, and swaps.

The total fair value asset (liability) of our derivative financial instruments is summarized in the following table (in millions):

|                           | June 30,<br>2012 | December 31,<br>2011 |
|---------------------------|------------------|----------------------|
| Currency Derivatives      | \$(93            | ) \$(19              |
| Interest Rate Derivatives | 430              | 460                  |
|                           | \$337            | \$441                |

Our market risks, hedging strategies and financial instrument positions at June 30, 2012 have not materially changed from those disclosed in our Annual Report on Form 10-K for the year ended December 31, 2011. In 2012, we entered into several interest rate basis swaps, which effectively converted cash flows based on variable LIBOR-based interest rates to cash flows based on the prevailing federal funds interest rate. We also entered into new currency options on the Euro, British Pound Sterling and Canadian Dollar, as well as terminated positions that expired during the first six months of 2012. The remaining fair value changes between December 31, 2011 and June 30, 2012 in the preceding table are primarily due to interest rate and foreign currency exchange rate changes between those dates.

The forward contracts, swaps, and options previously discussed contain an element of risk that the counterparties may be unable to meet the terms of the agreements. However, we minimize such risk exposures for these instruments by limiting the counterparties to banks and financial institutions that meet established credit guidelines.

We have agreements with substantially all of our active counterparties containing early termination rights and/or bilateral collateral provisions whereby cash is required whenever the net fair value of derivatives associated with those counterparties exceed specific thresholds. Events, such as a credit rating downgrade (depending on the ultimate rating level) would typically require an increase in the amount of collateral required of the counterparty and/or allow us to take additional protective measures such as early termination of trades. At June 30, 2012, we held cash collateral of \$122 million under these agreements.

We have not historically incurred, and do not expect to incur in the future, any losses as a result of counterparty default.

The information concerning market risk under the caption “Quantitative and Qualitative Disclosures about Market Risk” on pages 56-58 of our consolidated financial statements contained in our Annual Report on Form 10-K for the year ended December 31, 2011, is hereby incorporated by reference in this report.

## Item 4. Controls and Procedures

## Evaluation of Disclosure Controls and Procedures:

As of the end of the period covered by this report, management, including our chief executive officer and chief financial officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934 (“Exchange Act”). Based upon that evaluation, our chief executive officer and chief financial officer concluded that the disclosure controls and procedures were effective to ensure that information required to be disclosed in reports we file or submit under the Exchange Act is (1) recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (2) accumulated and communicated to our management to allow their timely decisions regarding required disclosure.

## Changes in Internal Control over Financial Reporting:

There were no changes in the Company’s internal controls over financial reporting during the quarter ended June 30, 2012 that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.



Table of Contents

## PART II. OTHER INFORMATION

## Item 1. Legal Proceedings

For a discussion of legal proceedings affecting us and our subsidiaries, please see the information under the sub-caption “Contingencies” of the caption “Management’s Discussion and Analysis of Financial Condition and Results of Operations” included in this report.

## Item 1A. Risk Factors

There have been no material changes to the risk factors described in Part 1, Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2011.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(c) A summary of our repurchases of our class A and class B common stock during the second quarter of 2012 is as follows (in millions, except per share amounts):

|                               | Total Number<br>of Shares<br>Purchased(1) | Average<br>Price Paid<br>Per Share | Total Number<br>of Shares Purchased<br>as Part of Publicly<br>Announced Program | Approximate Dollar<br>Value of Shares that<br>May Yet be<br>Purchased<br>Under the Program |
|-------------------------------|-------------------------------------------|------------------------------------|---------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------|
| April 1 – April 30, 2012      | 1.0                                       | \$80.09                            | 0.7                                                                             | \$ 1,925                                                                                   |
| May 1 – May 31, 2012          | 3.2                                       | 77.79                              | 3.1                                                                             | 4,765                                                                                      |
| June 1 – June 30, 2012        | 0.4                                       | 74.91                              | 0.4                                                                             | 4,738                                                                                      |
| Total April 1 – June 30, 2012 | 4.6                                       | \$77.94                            | 4.2                                                                             |                                                                                            |

(1) Includes shares repurchased through our publicly announced share repurchase program and shares tendered to pay the exercise price and tax withholding on employee stock options.

On May 3, 2012, the Board of Directors approved a new share repurchase authorization of \$5.0 billion, which replaces an authorization previously announced in 2008. The new share repurchase authorization has no expiration date. Share repurchases may take the form of accelerated share repurchases, open market purchases, or other such methods as we deem appropriate. The timing of our share repurchases will depend upon market conditions. Unless terminated earlier by the resolution of our Board, the program will expire when we have purchased all shares authorized for repurchase under the program.

## Item 3. Defaults Upon Senior Securities

None.

## Item 5. Other Information

None.

Table of Contents

Item 6. Exhibits

These exhibits are either incorporated by reference into this report or filed with this report as indicated below.

Index to Exhibits:

- 3.1 — Form of Restated Certificate of Incorporation of United Parcel Service, Inc. (incorporated by reference to Exhibit 3.2 to Form 10-Q for the Quarter Ended September 30, 2002).
- 3.2 — Form of Bylaws of United Parcel Service, Inc. (incorporated by reference to Exhibit 3.1 to Form 8-K, filed on November 12, 2008).
- 10.1 — Credit Agreement (364-Day Facility) dated April 12, 2012 among United Parcel Service, Inc., the initial lenders named therein, Citigroup Global Markets, Inc. and J.P. Morgan Securities LLC as joint lead arrangers and joint bookrunners, Barclays Capital and BNP Paribas Securities Corp. as co-lead arrangers, Barclays Bank PLC and BNP Paribas as co-documentation agents, Citibank, N.A. as administrative agent, and JPMorgan Chase Bank, N.A. as syndication agent (incorporated by reference to Exhibit 10.1 to Form 10-Q for the Quarter Ending March 31, 2012).
- 10.2 — Credit Agreement (5 Year Facility) dated April 12, 2012 among United Parcel Service, Inc., the initial lenders named therein, Citigroup Global Markets, Inc. and J.P. Morgan Securities LLC as joint lead arrangers and joint bookrunners, Barclays Capital and BNP Paribas Securities Corp. as co-lead arrangers, Barclays Bank PLC and BNP Paribas as co-documentation agents, Citibank, N.A. as administrative agent, and JPMorgan Chase Bank, N.A. as syndication agent (incorporated by reference to Exhibit 10.1 to Form 10-Q for the Quarter Ending March 31, 2012).
- 11 — Statement regarding Computation of per Share Earnings (incorporated by reference to Note 12 to “Item 1. Financial Statements” of this quarterly report on Form 10-Q).
- †12 — Computation of Ratio of Earnings to Fixed Charges.
- †31.1 — Certification of the Chief Executive Officer Pursuant to Rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- †31.2 — Certification of the Chief Financial Officer Pursuant to Rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- †32.1 — Certification of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- †32.2 — Certification of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- ††101 — The following financial information from the Quarterly Report on Form 10-Q for the quarter ended June 30, 2012, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Cash Flows, and (v) the Notes to the Consolidated Financial Statements.

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† Filed herewith.

†† Furnished electronically herewith

49

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Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

UNITED PARCEL SERVICE, INC.  
(Registrant)

Date: August 3, 2012

By: /S/ KURT P. KUEHN  
Kurt P. Kuehn  
Senior Vice President and  
Chief Financial Officer  
(Duly Authorized Officer and  
Principal Accounting Officer)