

UNITED PARCEL SERVICE INC
Form 10-Q
August 04, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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, 2006, 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

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)

30328
(Zip Code)

(404) 828-6000

(Registrant's telephone number, including area 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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer

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

There were 419,409,841 Class A shares, and 661,608,402 Class B shares, with a par value of \$0.01 per share, outstanding at August 1, 2006.

PART I. FINANCIAL INFORMATION

Item 1. *Financial Statements*

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

June 30, 2006 (unaudited) and December 31, 2005

(In millions, except per share amounts)

| | June 30, 2006 | December 31, 2005 |
|---|------------------|----------------------|
| ASSETS | | |
| Current Assets: | | |
| Cash & cash equivalents | \$ 945 | \$ 1,369 |
| Marketable securities & short-term investments | 1,905 | 1,672 |
| Accounts receivable, net | 5,711 | 5,950 |
| Finance receivables, net | 476 | 411 |
| Deferred income taxes | 534 | 475 |
| Other current assets | 954 | 1,126 |
| Total Current Assets | 10,525 | 11,003 |
| Property, Plant & Equipment, Net | 15,903 | 15,289 |
| Prepaid Pension Costs | 3,398 | 3,932 |
| Goodwill | 2,539 | 2,549 |
| Intangible Assets, Net | 737 | 684 |
| Other Assets | 1,772 | 1,765 |
| | \$ 34,874 | \$ 35,222 |
| LIABILITIES AND SHAREOWNERS EQUITY | | |
| Current Liabilities: | | |
| Current maturities of long-term debt and commercial paper | \$ 545 | \$ 821 |
| Accounts payable | 2,360 | 2,352 |
| Accrued wages & withholdings | 1,625 | 1,324 |
| Dividends payable | | 364 |
| Other current liabilities | 2,083 | 1,932 |
| Total Current Liabilities | 6,613 | 6,793 |
| Long-Term Debt | 3,077 | 3,159 |
| Accumulated Postretirement Benefit Obligation, Net | 1,774 | 1,704 |
| Deferred Taxes, Credits & Other Liabilities | 6,395 | 6,682 |
| Shareowners Equity: | | |
| Preferred stock, no par value, authorized 200 shares, none issued | | |
| Class A common stock, par value \$.01 per share, authorized 4,600 shares, issued 424 and 454 in 2006 and 2005 | 4 | 5 |
| Class B common stock, par value \$.01 per share, authorized 5,600 shares, issued 660 and 646 in 2006 and 2005 | 7 | 6 |
| Additional paid-in capital | | |
| Retained earnings | 17,122 | 17,037 |
| Accumulated other comprehensive loss | (118) | (164) |
| Deferred compensation obligations | 146 | 161 |

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| | | |
|--|-----------|-----------|
| | 17,161 | 17,045 |
| Less: Treasury stock (2 and 3 shares in 2006 and 2005) | (146) | (161) |
| | 17,015 | 16,884 |
| | \$ 34,874 | \$ 35,222 |

See notes to unaudited consolidated financial statements.

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

STATEMENTS OF CONSOLIDATED INCOME

Three and Six Months Ended June 30, 2006 and 2005

(In millions, except per share amounts)

(unaudited)

| | Three Months Ended | | Six Months Ended | |
|-----------------------------|--------------------|------------------|------------------|------------------|
| | June 30, 2006 | June 30, 2005 | June 30, 2006 | June 30, 2005 |
| Revenue | \$ 11,736 | \$ 10,191 | \$ 23,257 | \$ 20,077 |
| Operating Expenses: | | | | |
| Compensation and benefits | 5,990 | 5,389 | 12,009 | 10,786 |
| Other | 4,051 | 3,253 | 7,998 | 6,357 |
| | 10,041 | 8,642 | 20,007 | 17,143 |
| Operating Profit | 1,695 | 1,549 | 3,250 | 2,934 |
| Other Income and (Expense): | | | | |
| Investment income | 23 | 38 | 46 | 68 |
| Interest expense | (54) | (46) | (102) | (83) |
| | (31) | (8) | (56) | (15) |
| Income Before Income Taxes | 1,664 | 1,541 | 3,194 | 2,919 |
| Income Taxes | 603 | 555 | 1,158 | 1,051 |
| Net Income | \$ 1,061 | \$ 986 | \$ 2,036 | \$ 1,868 |
| Basic Earnings Per Share | \$ 0.98 | \$ 0.88 | \$ 1.87 | \$ 1.67 |
| Diluted Earnings Per Share | \$ 0.97 | \$ 0.88 | \$ 1.86 | \$ 1.66 |

See notes to unaudited consolidated financial statements.

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF SHAREOWNERS EQUITY

Six Months Ended June 30, 2006 and 2005

(In millions, except per share amounts)

(unaudited)

| | 2006 | | 2005 | |
|---|--------|---------|--------|---------|
| | Shares | Dollars | Shares | Dollars |
| Class A Common Stock | | | | |
| Balance at beginning of period | 454 | \$ 5 | 515 | \$ 5 |
| Common stock purchases | (10) | | (8) | |
| Stock award plans | 1 | | 1 | |
| Common stock issuances | 1 | | 1 | |
| Conversions of Class A to Class B common stock | (22) | (1) | (22) | |
| Balance at end of period | 424 | 4 | 487 | 5 |
| Class B Common Stock | | | | |
| Balance at beginning of period | 646 | 6 | 614 | 6 |
| Common stock purchases | (8) | | (11) | |
| Conversions of Class A to Class B common stock | 22 | 1 | 22 | |
| Balance at end of period | 660 | 7 | 625 | 6 |
| Additional Paid-In Capital | | | | |
| Balance at beginning of period | | | | 417 |
| Stock award plans | | 181 | | 177 |
| Common stock purchases | | (270) | | (688) |
| Common stock issuances | | 89 | | 94 |
| Balance at end of period | | | | |
| Retained Earnings | | | | |
| Balance at beginning of period | | 17,037 | | 16,192 |
| Net income | | 2,036 | | 1,868 |
| Dividends (\$0.76 and \$0.66 per share) | | (829) | | (739) |
| Common stock purchases | | (1,122) | | (717) |
| Balance at end of period | | 17,122 | | 16,604 |
| Accumulated Other Comprehensive Income (Loss) | | | | |
| Foreign currency translation adjustment: | | | | |
| Balance at beginning of period | | (163) | | (127) |
| Aggregate adjustment for the period | | 70 | | (37) |
| Balance at end of period | | (93) | | (164) |
| Unrealized gain (loss) on marketable securities, net of tax: | | | | |
| Balance at beginning of period | | 11 | | (5) |
| Current period changes in fair value (net of tax effect of \$(8) and \$(3)) | | (14) | | (5) |
| Reclassification to earnings (net of tax effect of \$3 and \$0) | | 4 | | 1 |
| Balance at end of period | | 1 | | (9) |

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| | | | | |
|---|-----|-----------|-----|-----------|
| Unrealized gain (loss) on cash flow hedges, net of tax: | | | | |
| Balance at beginning of period | | 83 | | (29) |
| Current period changes in fair value (net of tax effect of \$14 and \$63) | | 24 | | 111 |
| Reclassification to earnings (net of tax effect of \$(22) and \$0) | | (36) | | |
| Balance at end of period | | 71 | | 82 |
| Additional minimum pension liability, net of tax: | | | | |
| Balance at beginning of period | | (95) | | (81) |
| Minimum pension liability adjustment (net of tax effect of \$(1) and \$0) | | (2) | | |
| Balance at end of period | | (97) | | (81) |
| Accumulated other comprehensive income (loss) at end of period | | (118) | | (172) |
| Deferred Compensation Obligations | | | | |
| Balance at beginning of period | | 161 | | 169 |
| Common stock held for deferred compensation obligations | | (15) | | (9) |
| Balance at end of period | | 146 | | 160 |
| Treasury Stock | | | | |
| Balance at beginning of period | (3) | (161) | (3) | (169) |
| Common stock held for deferred compensation obligations | 1 | 15 | | 9 |
| Balance at end of period | (2) | (146) | (3) | (160) |
| Total Shareowners Equity at End of Period | | \$ 17,015 | | \$ 16,443 |
| Comprehensive Income | | \$ 2,082 | | \$ 1,938 |

See notes to unaudited consolidated financial statements.

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

Six Months Ended June 30, 2006 and 2005

(In millions)

(unaudited)

| | 2006 | 2005 |
|--|----------|----------|
| Cash Flows From Operating Activities: | | |
| Net income | \$ 2,036 | \$ 1,868 |
| Adjustments to reconcile net income to net cash from operating activities: | | |
| Depreciation and amortization | 875 | 801 |
| Pension & postretirement benefit expense | 282 | 199 |
| Pension & postretirement contributions | (80) | (46) |
| Deferred taxes, credits, and other liabilities | (5) | (51) |
| Stock compensation expense | 156 | 80 |
| Other (gains) losses | 59 | 94 |
| Changes in assets and liabilities, net of effect of acquisitions: | | |
| Accounts receivable | 227 | 135 |
| Other current assets | (38) | 418 |
| Accounts payable | 36 | (58) |
| Accrued wages & withholdings | 296 | 445 |
| Income taxes payable | (124) | 47 |
| Other current liabilities | 244 | 144 |
| Net cash from operating activities | 3,964 | 4,076 |
| Cash Flows From Investing Activities: | | |
| Capital expenditures | (1,456) | (1,043) |
| Disposals of property, plant and equipment | 31 | 10 |
| Purchases of marketable securities and short-term investments | (4,034) | (3,433) |
| Sales and maturities of marketable securities and short-term investments | 3,781 | 3,637 |
| Net decrease in finance receivables | 10 | 56 |
| Cash paid for business acquisitions | (4) | (92) |
| Other investing activities | 107 | (24) |
| Net cash (used in) investing activities | (1,565) | (889) |
| Cash Flows From Financing Activities: | | |
| Net change in short-term debt | (352) | (477) |
| Proceeds from long-term borrowings | 40 | 216 |
| Repayments of long-term borrowings | (35) | (36) |
| Purchases of common stock | (1,421) | (1,405) |
| Issuances of common stock | 89 | 85 |
| Dividends | (1,168) | (1,033) |
| Other financing activities | | 2 |
| Net cash (used in) financing activities | (2,847) | (2,648) |
| Effect Of Exchange Rate Changes On Cash | 24 | (18) |
| Net Increase (Decrease) In Cash And Cash Equivalents | (424) | 521 |

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Cash And Cash Equivalents:

| | | |
|---------------------|--------|----------|
| Beginning of period | 1,369 | 739 |
| End of period | \$ 945 | \$ 1,260 |

See notes to unaudited consolidated financial statements.

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Basis of Presentation

In our opinion, the accompanying interim, unaudited, consolidated financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly our financial position as of June 30, 2006, our results of operations for the three and six months ended June 30, 2006 and 2005, and cash flows for the six months ended June 30, 2006 and 2005. 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, 2005.

For interim consolidated financial statement purposes, we compute our tax provision on the basis of our estimated annual effective income tax rate, and provide for accruals under our various employee benefit plans for each three month period based on one quarter of the estimated annual expense.

Certain prior period amounts have been reclassified to conform to the current period presentation.

Note 2. Stock-Based Compensation

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123 (revised 2004), Share-Based Payment (FAS 123(R)), which replaces FAS 123 and supercedes APB 25. FAS 123(R) requires all share-based awards to employees, including grants of employee stock options, to be measured based on their fair values and expensed over the period during which an employee is required to provide service in exchange for the award (the vesting period). We had previously adopted the fair value recognition provisions of the original FAS 123, prospectively for all new stock compensation awards granted to employees subsequent to January 1, 2003. FAS 123(R) was effective beginning with the first interim or annual period after June 15, 2005; the Securities and Exchange Commission (SEC) deferred the effective date, and as a result, we adopted FAS 123(R) on January 1, 2006 using the modified prospective method. On that date, there were no unvested stock options or other forms of employee stock compensation issued prior to January 1, 2003, and thus all unvested stock-based awards were being expensed. A comparison of reported net income for the six months ended June 30, 2006 and 2005, and pro-forma net income for the six months ended June 30, 2005, including the effects of expensing stock-based awards, is as follows (in millions, except per share amounts):

| | For the three months ended | | For the six months ended | |
|---|----------------------------|---------------|--------------------------|---------------|
| | June 30, 2006 | June 30, 2005 | June 30, 2006 | June 30, 2005 |
| Net income | \$ 1,061 | \$ 986 | \$ 2,036 | \$ 1,868 |
| Add: Stock-based employee compensation expense included in net income, net of tax effects | 57 | 29 | 101 | 55 |
| Less: Total pro forma stock-based employee compensation expense, net of tax effects | (57) | (31) | (101) | (63) |
| Pro forma net income | \$ 1,061 | \$ 984 | \$ 2,036 | \$ 1,860 |
| Basic earnings per share | | | | |
| As reported | \$ 0.98 | \$ 0.88 | \$ 1.87 | \$ 1.67 |
| Pro forma | \$ 0.98 | \$ 0.88 | \$ 1.87 | \$ 1.66 |
| Diluted earnings per share | | | | |
| As reported | \$ 0.97 | \$ 0.88 | \$ 1.86 | \$ 1.66 |
| Pro forma | \$ 0.97 | \$ 0.88 | \$ 1.86 | \$ 1.66 |

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

We issue employee share-based awards under the UPS Incentive Compensation Plan (the Plan) that are subject to specific vesting conditions; generally, the awards cliff vest or vest ratably over a five year period, the nominal vesting period, or at the date the employee retires (as defined by the plan), if earlier. For awards that specify an employee vests in the award upon retirement, we account for the awards using the nominal vesting period approach. Under this approach, we record compensation expense over the nominal vesting period. If the employee retires before the end of the nominal vesting period, any remaining unrecognized compensation expense is recorded at the date of retirement.

Upon our adoption of FAS 123(R), we revised our approach to apply the non-substantive vesting period approach to all new share-based compensation awards. Under this approach, compensation cost is recognized immediately for awards granted to retirement-eligible employees, or over the period from the grant date to the date retirement eligibility is achieved, if that is expected to occur during the nominal vesting period. We continue to apply the nominal vesting period approach for any awards granted prior to January 1, 2006, and for the remaining portion of the then unvested outstanding awards.

If we had accounted for all share-based compensation awards granted prior to January 1, 2006 under the non-substantive vesting period approach, the impact to our net income and earnings per share would have been immaterial for all prior periods. The adoption of the non-substantive vesting period approach is expected to reduce 2006 net income by an estimated \$29 million, or \$0.03 per diluted share, based on share-based awards that we anticipate granting in 2006.

Incentive Compensation Plan

The Plan 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 number of shares reserved for issuance under the Plan is 112 million, with the number of shares reserved for issuance as restricted stock limited to 34 million. As of June 30, 2006, management incentive awards, restricted stock, stock options, restricted performance units, and restricted stock units had been granted under the Incentive Compensation Plan.

Management Incentive Awards & Restricted Stock Units

Persons earning the right to receive management incentive awards are determined annually by the Compensation Committee of the UPS Board of Directors. Our management incentive awards program provides that half of the annual management incentive award, with certain exceptions, be made in restricted stock units (RSUs), which generally vest over a five-year period. The other half of the award is in the form of cash or unrestricted shares of Class A common stock and is fully vested at the time of grant. These management incentive awards are generally granted in the fourth quarter of each year.

Upon vesting, RSUs result in the issuance of the equivalent number of UPS Class A common shares after required tax withholdings. Except in the case of death, disability, or retirement, RSUs granted for our management incentive awards generally vest over a five year period with approximately 20% of the award vesting at each anniversary date of the grant. The entire grant is expensed on a straight-line basis over the requisite service period. All RSUs granted are subject to earlier cancellation or vesting under certain conditions. Dividends earned on management incentive award RSUs are reinvested in additional RSUs at each dividend payable date.

We also award RSUs in conjunction with our long-term incentive performance awards program to certain eligible employees. The RSUs ultimately granted under the long-term incentive performance award will be based upon the achievement of certain performance measures, including growth in consolidated revenue, operating return on invested capital, and consolidated earnings, each year during the three year performance award cycle.

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As of June 30, 2006, we had the following RSUs outstanding, including reinvested dividends:

| | Shares (in thousands) | Weighted Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value (in millions) |
|--------------------------------|--------------------------|---|--|
| Outstanding at January 1, 2006 | 5,108 | | |
| Vested | (2) | | |
| Granted | | | |
| Reinvested Dividends | 50 | | |
| Forfeited / Expired | (150) | | |
| Outstanding at June 30, 2006 | 5,006 | 2.33 | \$ 397 |
| RSUs Expected to Vest | 4,899 | 2.30 | \$ 389 |

No RSUs were granted during the first six months of 2006 or 2005. As of June 30, 2006, there was \$306 million of total unrecognized compensation cost related to nonvested RSUs. That cost is expected to be recognized over a weighted average period of 4 years and 4 months.

Nonqualified Stock Options

We maintain fixed stock option plans, under which options are granted to purchase shares of UPS Class A common stock. Stock options granted in connection with the Plan must have an exercise price at least equal to the New York Stock Exchange (NYSE) closing price of UPS class B common stock on the date the option is granted.

Persons earning the right to receive stock options are determined each year by the Compensation Committee. Except in the case of death, disability, or retirement, options granted under the Plan are generally exercisable three to five years from the date of grant and before the expiration of the option 10 years after the date of grant. All options granted are subject to earlier cancellation or exercise under certain conditions. Option holders may exercise their options via the tender of cash or Class A common stock, and new Class A shares are issued upon exercise. Options granted to eligible employees will generally be granted annually during the second quarter of each year at the discretion of the Compensation Committee.

The following is an analysis of options to purchase shares of Class A common stock issued and outstanding:

| | Shares (in thousands) | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value (in millions) |
|--------------------------------|--------------------------|--|---|--|
| Outstanding at January 1, 2006 | 18,734 | \$ 61.84 | | |
| Exercised | (1,335) | 56.64 | | |
| Granted | 2,433 | 80.88 | | |

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| | | | | |
|------------------------------|--------|----------|------|--------|
| Forfeited / Expired | (119) | 66.86 | | |
| Outstanding at June 30, 2006 | 19,713 | \$ 64.51 | 6.68 | \$ 297 |
| Exercisable at June 30, 2006 | 9,551 | \$ 57.22 | 4.93 | \$ 212 |
| Options Expected to Vest | 9,693 | \$ 71.16 | 8.28 | \$ 83 |

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The fair value of each option grant is estimated using the Black-Scholes option pricing model. The weighted-average assumptions used, by year, and the calculated weighted average fair values of options are as follows:

| | Six Months Ended | |
|-------------------------------|------------------|----------|
| | June 30, | |
| | 2006 | 2005 |
| Expected dividend yield | 1.80% | 1.60% |
| Risk-free interest rate | 5.13% | 4.18% |
| Expected life in years | 7 | 7 |
| Expected volatility | 18.42% | 18.21% |
| Fair value of options granted | \$ 21.05 | \$ 17.33 |

Expected volatilities are based on the historical returns on our stock and an index of peer companies. The expected dividend yield is based on the recent historical dividend yields for our stock, taking into account changes in dividend policy. The risk-free interest rate is based on the term structure of interest rates at the time of the option grant. The expected life represents an estimate of the period of time options are expected to remain outstanding.

We received cash of \$24 and \$13 million during the six months ended June 30, 2006 and 2005 from option holders resulting from the exercise of stock options. We received a tax benefit of \$8 and \$4 million during the six months ended June 30, 2006 and 2005 from the exercise of stock options. The adoption of FAS 123(R) required us to change the statement of cash flow classification of these tax benefits. As a result, in our consolidated statements of cash flows, we reclassified the \$4 million tax benefit in the first six months of 2005 as cash from financing activities rather than cash from operating activities.

The total intrinsic value of options exercised during the six months ended June 30, 2006 and 2005 was \$31 and \$15 million, respectively. As of June 30, 2006, there was \$116 million of total unrecognized compensation cost related to nonvested options. That cost is expected to be recognized over a weighted average period of 3 years and 9 months.

Restricted Performance Units

Beginning in 2003, we issued restricted performance units (RPU) under the Plan. Upon vesting, RPUs result in the issuance of the equivalent number of UPS Class A common shares after required tax withholdings. Persons earning the right to receive RPUs are determined each year by the Compensation Committee. Except in the case of death, disability, or retirement, RPUs vest five years after the date of grant. All RPUs granted are subject to earlier cancellation or vesting under certain conditions. Dividends earned on RPUs are reinvested in additional restricted performance units at each dividend payable date. RPUs also allow for 10% bonus shares to be issued if certain company-wide performance goals are attained in the year of vesting. RPUs granted to eligible employees will generally be granted annually during the second quarter of each year at the discretion of the Compensation Committee.

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As of June 30, 2006, we had the following RPU's outstanding, including reinvested dividends:

| | Shares | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|--------------------------------|----------------|---|---------------------------------|
| | (in thousands) | (in years) | (in millions) |
| Outstanding at January 1, 2006 | 3,264 | | |
| Vested | (2) | | |
| Granted | 990 | | |
| Reinvested Dividends | 46 | | |
| Forfeited / Expired | (31) | | |
| Outstanding at June 30, 2006 | 4,267 | 3.29 | \$ 339 |
| RPU's Expected to Vest | 4,065 | 3.26 | \$ 323 |

As of June 30, 2006, there was \$208 million of total unrecognized compensation cost related to nonvested RPU's. That cost is expected to be recognized over a weighted average period of 3 years and 9 months.

Discounted Employee Stock Purchase Plan

We maintain an employee stock purchase plan for all eligible employees. Under the plan, shares of UPS Class A common stock may be purchased at quarterly intervals at 90% of the lower of the NYSE closing price of UPS Class B common stock on the first or the last day of each quarterly period. Employees purchased 1.0 and 0.9 million shares at average prices of \$65.24 and \$67.18 per share during the six months ended June 30, 2006 and 2005, respectively. Compensation cost is measured for the fair value of employees' purchase rights under our discounted employee stock purchase plan using the Black-Scholes option pricing model. The weighted average assumptions used and the calculated weighted average fair value of employees' purchase rights granted, are as follows:

| | Six Months Ended | |
|---|---------------------|----------|
| | June 30, 2006 | 2005 |
| Expected dividend yield | 1.71% | 1.48% |
| Risk-free interest rate | 4.29% | 2.52% |
| Expected life in years | 0.25 | 0.25 |
| Expected volatility | 15.85% | 15.12% |
| Weighted average fair value of purchase rights* | \$ 10.16 | \$ 10.00 |

* Includes the 10% discount from the market price.

Expected volatilities are based on the historical price volatility on our publicly-traded Class B shares. The expected dividend yield is based on the recent historical dividend yields for our stock, taking into account changes in dividend policy. The risk-free interest rate is based on the term structure of interest rates on U.S. Treasury securities at the time of the option grant. The expected life represents the three month option period applicable to the purchase rights.

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. New Accounting Pronouncements

In June 2006, the FASB issued FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109) which is effective for fiscal years beginning after December 15, 2006. This interpretation was issued to clarify the accounting for uncertainty in income taxes recognized in the financial statements by prescribing a recognition threshold and measurement attribute for tax positions taken or expected to be taken in a tax return. We are currently evaluating the potential impact of this interpretation.

Note 4. Marketable Securities and Short-Term Investments

The following is a summary of marketable securities and short-term investments at June 30, 2006 and December 31, 2005 (in millions):

| | Cost | Unrealized Gains | Unrealized Losses | Estimated Fair Value |
|--|----------|---------------------|----------------------|-------------------------|
| June 30, 2006 | | | | |
| U.S. government & agency securities | \$ 382 | \$ | \$ 5 | \$ 377 |
| U.S. mortgage & asset-backed securities | 522 | | 8 | 514 |
| U.S. corporate securities | 394 | | 6 | 388 |
| U.S. state and local municipal securities | 198 | | | 198 |
| Other debt securities | 3 | | | 3 |
| Total debt securities | 1,499 | | 19 | 1,480 |
| Common equity securities | 42 | 11 | 3 | 50 |
| Preferred equity securities | 370 | 5 | | 375 |
| Current marketable securities & short-term investments | 1,911 | 16 | 22 | 1,905 |
| Non-current common equity securities | 24 | 7 | | 31 |
| Total marketable securities & short-term investments | \$ 1,935 | \$ 23 | \$ 22 | \$ 1,936 |
| | Cost | Unrealized Gains | Unrealized Losses | Estimated Fair Value |
| December 31, 2005 | | | | |
| U.S. government & agency securities | \$ 400 | \$ 1 | \$ 3 | \$ 398 |
| U.S. mortgage & asset-backed securities | 393 | 1 | 5 | 389 |
| U.S. corporate securities | 425 | | 4 | 421 |
| U.S. state and local municipal securities | 70 | | | 70 |
| Other debt securities | 2 | | | 2 |
| Total debt securities | 1,290 | 2 | 12 | 1,280 |
| Common equity securities | 42 | 19 | | 61 |
| Preferred equity securities | 331 | | | 331 |
| Current marketable securities & short-term investments | 1,663 | 21 | 12 | 1,672 |
| Non-current common equity securities | 21 | 7 | | 28 |

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| | | | | |
|--|----------|-------|-------|----------|
| Total marketable securities & short-term investments | \$ 1,684 | \$ 28 | \$ 12 | \$ 1,700 |
|--|----------|-------|-------|----------|

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The amortized cost and estimated fair value of marketable securities and short-term investments at June 30, 2006, 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 Fair Value |
|--|----------|-------------------------|
| Due in one year or less | \$ 138 | \$ 136 |
| Due after one year through three years | 597 | 589 |
| Due after three years through five years | 97 | 96 |
| Due after five years | 667 | 659 |
| | 1,499 | 1,480 |
| Equity securities | 436 | 456 |
| | \$ 1,935 | \$ 1,936 |

Note 5. Property, Plant and Equipment

Property plant and equipment as of June 30, 2006 and December 31, 2005 consists of the following (in millions):

| | June 30, 2006 | December 31, 2005 |
|--|------------------|----------------------|
| Vehicles | \$ 4,466 | \$ 4,286 |
| Aircraft (including aircraft under capitalized leases) | 12,888 | 12,289 |
| Land | 984 | 968 |
| Buildings | 2,583 | 2,404 |
| Leasehold improvements | 2,412 | 2,469 |
| Plant equipment | 5,072 | 4,982 |
| Technology equipment | 1,666 | 1,639 |
| Equipment under operating lease | 108 | 87 |
| Construction-in-progress | 497 | 433 |
| | 30,676 | 29,557 |
| Less: Accumulated depreciation and amortization | (14,773) | (14,268) |
| | \$ 15,903 | \$ 15,289 |

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 6. Employee Benefit Plans

Information about net periodic benefit cost for the pension and postretirement benefit plans is as follows for the three and six months ended June 30, 2006 and 2005 (in millions):

| | Three Months Ended June 30, | | | |
|---------------------------|-----------------------------|-------|---------------------------------|-------|
| | Pension Benefits | | Postretirement Medical Benefits | |
| | 2006 | 2005 | 2006 | 2005 |
| Net Periodic Cost: | | | | |
| Service cost | \$ 124 | \$ 89 | \$ 26 | \$ 22 |
| Interest cost | 188 | 145 | 42 | 42 |
| Expected return on assets | (285) | (222) | (10) | (9) |
| Amortization of: | | | | |
| Transition obligation | | 1 | | |
| Prior service cost | 9 | 9 | (2) | (2) |
| Actuarial (gain) loss | 38 | 17 | 7 | 8 |
| Settlements | 1 | | | |
| Net periodic benefit cost | \$ 75 | \$ 39 | \$ 63 | \$ 61 |

| | Six Months Ended June 30, | | | |
|---------------------------|---------------------------|--------|---------------------------------|--------|
| | Pension Benefits | | Postretirement Medical Benefits | |
| | 2006 | 2005 | 2006 | 2005 |
| Net Periodic Cost: | | | | |
| Service cost | \$ 247 | \$ 177 | \$ 51 | \$ 45 |
| Interest cost | 375 | 290 | 85 | 84 |
| Expected return on assets | (563) | (444) | (21) | (19) |
| Amortization of: | | | | |
| Transition obligation | 1 | 2 | | |
| Prior service cost | 18 | 18 | (4) | (4) |
| Actuarial (gain) loss | 77 | 34 | 14 | 16 |
| Settlements | 2 | | | |
| Net periodic benefit cost | \$ 157 | \$ 77 | \$ 125 | \$ 122 |

During the first six months of 2006, we contributed \$41 and \$39 million to our pension and postretirement medical benefit plans, respectively. We expect to contribute \$1.162 billion and \$91 million over the remainder of the year to the pension and postretirement medical benefit plans, respectively.

Note 7. Business Acquisitions

In December 2004, we agreed with Sinotrans Air Transportation Development Co., Ltd. (Sinotrans) to acquire direct control of the international express operations in 23 cities within China, and to purchase Sinotrans' interest in our current joint venture in China. The agreement will result in the payment of \$121 million to Sinotrans in 2005 and 2006. Since the inception of the agreement, we have paid a total of \$71 million, and have taken direct control of operations in all 23 locations. The operations being acquired are reported within our International Package reporting segment from the dates of acquisition.

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In May 2005, we acquired Messenger Service Stolica S.A. (Stolica), one of the leading parcel and express delivery companies in Poland. Stolica s operating results are included in our International Package reporting segment from the date of acquisition.

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In August 2005, we acquired Overnite Corporation (Overnite) for approximately \$1.225 billion in cash. Overnite offers a variety of less-than-truckload and truckload services to more than 60,000 customers in North America. The operating results of Overnite, which is now known as UPS Freight, are included in our Supply Chain & Freight reporting segment from the date of acquisition.

In September 2005, we acquired Lynx Express Ltd. (Lynx) for approximately \$68 million in cash. Lynx Express was one of the largest independent parcel carriers in the United Kingdom. Lynx also offers customers a broad suite of logistics and spare parts logistics services. The operating results of Lynx are included in our International Package reporting segment from the date of acquisition.

The results of operations of each acquired company are included in our statements of consolidated income from the date of acquisition. The purchase price allocations of acquired companies can be modified up to one year after the date of acquisition.

We are in the process of finalizing the third party appraisals for certain assets and liabilities to assist management in allocating the purchase price of Lynx to the individual assets acquired and liabilities assumed. This may result in adjustments to the carrying values of Lynx's recorded assets and liabilities, including the amount of any residual value allocated to goodwill. The preliminary allocation of the purchase price included in the current period balance sheet is based on the current best estimates of management and is subject to revision based on final determination of fair values of acquired assets and assumed liabilities. We anticipate the valuations and other studies will be completed prior to the anniversary dates of the acquisitions.

Note 8. Goodwill, Intangibles, and Other Assets

The following table indicates the allocation of goodwill by reportable segment as of June 30, 2006 and December 31, 2005 (in millions):

| | December 31, 2005 | Goodwill Acquired | Purchase Accounting Adjustments | Currency/ Other | June 30, 2006 |
|------------------------|----------------------|----------------------|---------------------------------------|--------------------|------------------|
| Goodwill by Segment: | | | | | |
| U.S. Domestic Package | \$ | \$ | \$ | \$ | \$ |
| International Package | 290 | | (44) | 2 | 248 |
| Supply Chain & Freight | 2,259 | 4 | 12 | 16 | 2,291 |
| | \$ 2,549 | \$ 4 | \$ (32) | \$ 18 | \$ 2,539 |

The reduction in goodwill for the International Package segment was primarily the result of adjustments to the purchase price allocation of Lynx, while the increase in goodwill for the Supply Chain & Freight segment was primarily the result of adjustments to the purchase price allocation of Overnite. These acquisition transactions are described in Note 7.

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following is a summary of intangible assets as of June 30, 2006 and December 31, 2005 (in millions):

| | Trademarks, Licenses, Patents, and Other | | | Franchise Rights | Capitalized Software | Intangible Pension Asset | Total Intangible Assets | |
|---------------------------|--|------|----|---------------------|-------------------------|--------------------------------|-------------------------------|---------|
| June 30, 2006: | | | | | | | | |
| Gross carrying amount | \$ | 219 | \$ | 108 | \$ | 1,501 | \$ | 1,841 |
| Accumulated amortization | | (43) | | (26) | | (1,035) | | (1,104) |
| Net carrying value | \$ | 176 | \$ | 82 | \$ | 466 | \$ | 737 |
| December 31, 2005: | | | | | | | | |
| Gross carrying amount | \$ | 139 | \$ | 108 | \$ | 1,391 | \$ | 1,651 |
| Accumulated amortization | | (31) | | (23) | | (913) | | (967) |
| Net carrying value | \$ | 108 | \$ | 85 | \$ | 478 | \$ | 684 |

Other assets as of June 30, 2006 and December 31, 2005 consist of the following (in millions):

| | June 30, 2006 | December 31, 2005 |
|---|------------------|----------------------|
| Non-current finance receivables, net of allowance for credit losses | \$ 389 | \$ 471 |
| Other non-current assets | 1,383 | 1,294 |
| | \$ 1,772 | \$ 1,765 |

Note 9. Deferred Taxes, Credits and Other Liabilities

Deferred taxes, credits and other liabilities as of June 30, 2006 and December 31, 2005 consist of the following (in millions):

| | June 30, 2006 | December 31, 2005 |
|---|------------------|----------------------|
| Deferred income taxes | \$ 3,505 | \$ 3,425 |
| Insurance reserves | 1,440 | 1,354 |
| Accrued pension cost | 341 | 750 |
| Other credits and non-current liabilities | 1,109 | 1,153 |
| | \$ 6,395 | \$ 6,682 |

Note 10. Legal Proceedings, Contingencies and Commitments

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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. In one of these cases, Marlo v. UPS, which has been certified as a class action in a California federal court, plaintiffs allege that they improperly were denied overtime, and seek penalties for missed meal and rest periods, and interest and attorneys' fees. Plaintiffs purport to represent a class of 1,200 full-time supervisors. The court granted Summary Judgment in favor of UPS on all claims and plaintiffs have appealed.

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In another case, *Cornn v. UPS*, which has been certified as a class action in a California federal court, plaintiffs allege that they were improperly denied wages and/or overtime and meal and rest periods. Plaintiffs purport to represent a class of approximately 20,000 drivers and seek back wages, penalties, interest and attorneys' fees.

We have denied any liability with respect to these claims and intend to vigorously defend ourselves in these cases. At this time, we have not determined the amount of any liability that may result from these matters or whether such liability, if any, would have a material adverse effect on our financial condition, results of operations, or liquidity.

We have been named as a defendant in four putative class action lawsuits filed in federal courts between March and June 2006, alleging a conspiracy relating to certain surcharges that a number of air cargo carriers imposed. We were not named as a defendant in at least seventy-six related cases that make similar allegations. These cases likely will be consolidated in a Multi-District Litigation proceeding pending in the United States District Court for the Eastern District of New York. In addition, in July 2006, we were named as a defendant in a comparable lawsuit filed in the Ontario (Canada) Superior Court of Justice. We intend to vigorously defend ourselves in these cases.

In addition, we are a defendant in various other lawsuits that arose in the normal course of business. We believe that the eventual resolution of these cases will not have a material adverse effect on our financial condition, results of operations, or liquidity.

We participate in a number of trustee-managed multi-employer pension and health and welfare plans for employees covered under collective bargaining agreements. Several factors could result in potential funding deficiencies which could cause us to make significantly higher future contributions to these plans, including unfavorable investment performance, changes in demographics, and increased benefits to participants. At this time, we are unable to determine the amount of additional future contributions, if any, or whether any material adverse effect on our financial condition, results of operations, or liquidity would result from our participation in these plans.

As of December 31, 2005, we had approximately 241,000 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, 2008. In June 2006, we announced that we will begin formal negotiations in the third quarter with the Teamsters on a new agreement. We have approximately 2,800 pilots who are employed under a collective bargaining agreement with the Independent Pilots Association (IPA), which became amendable December 31, 2003. On June 30, 2006, UPS and the IPA announced a tentative agreement on a new labor contract. The IPA is in the midst of presenting the terms of this tentative agreement to all of our pilots as part of the ratification process. If ratified, this new contract would not become amendable until the end of 2011. Our airline mechanics are covered by a collective bargaining agreement with Teamsters Local 2727, which becomes amendable on November 1, 2006. In addition, the majority 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. These agreements run through July 31, 2009.

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.

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

International Package operations include delivery to more than 200 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 & Freight includes our forwarding and logistics operations, the operations of Overnite Corp. (acquired in August 2005, and now known as UPS Freight), and other aggregated business units. Our forwarding and logistics business includes the operations acquired with the purchase of Menlo Worldwide Forwarding, Inc. (now collectively known as UPS Supply Chain Solutions). Forwarding and logistics 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 services to customers in North America. Other aggregated business units within this segment include Mail Boxes, Etc. (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 financial statements in our Annual Report on Form 10-K for the year ended December 31, 2005, with certain expenses allocated between the segments using activity-based costing methods. Unallocated assets are comprised primarily of cash, marketable securities, short-term investments, and equity-method real estate investments.

Segment information for the three and six months ended June 30, 2006 and 2005 is as follows (in millions):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--------------------------|--------------------------------|------------------|------------------------------|------------------|
| | 2006 | 2005 | 2006 | 2005 |
| Revenue: | | | | |
| U.S. Domestic Package | \$ 7,462 | \$ 6,942 | \$ 14,925 | \$ 13,753 |
| International Package | 2,233 | 1,997 | 4,394 | 3,839 |
| Supply Chain & Freight | 2,041 | 1,252 | 3,938 | 2,485 |
| Consolidated | \$ 11,736 | \$ 10,191 | \$ 23,257 | \$ 20,077 |
| Operating Profit: | | | | |
| U.S. Domestic Package | \$ 1,234 | \$ 1,118 | \$ 2,419 | \$ 2,146 |
| International Package | 414 | 397 | 809 | 745 |
| Supply Chain & Freight | 47 | 34 | 22 | 43 |
| Consolidated | \$ 1,695 | \$ 1,549 | \$ 3,250 | \$ 2,934 |

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 12. Other Operating Expenses

The major components of other operating expenses for the three and six months ended June 30, 2006 and 2005 are as follows (in millions):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---------------------------------------|--------------------------------|-----------------|------------------------------|-----------------|
| | 2006 | 2005 | 2006 | 2005 |
| Repairs and Maintenance | \$ 289 | \$ 271 | \$ 578 | \$ 530 |
| Depreciation and Amortization | 436 | 403 | 875 | 801 |
| Purchased Transportation | 1,358 | 887 | 2,629 | 1,734 |
| Fuel | 668 | 465 | 1,246 | 855 |
| Other Occupancy | 222 | 201 | 474 | 427 |
| Other Expenses | 1,078 | 1,026 | 2,196 | 2,010 |
| Total Other Operating Expenses | \$ 4,051 | \$ 3,253 | \$ 7,998 | \$ 6,357 |

Note 13. Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share (in millions, except per share amounts):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|---------|------------------------------|----------|
| | 2006 | 2005 | 2006 | 2005 |
| Numerator: | | | | |
| Net income | \$ 1,061 | \$ 986 | \$ 2,036 | \$ 1,868 |
| Denominator: | | | | |
| Weighted average shares | 1,084 | 1,113 | 1,088 | 1,117 |
| Deferred compensation obligations | 3 | 3 | 3 | 3 |
| Denominator for basic earnings per share | 1,087 | 1,116 | 1,091 | 1,120 |
| Effect of dilutive securities: | | | | |
| Restricted performance units | 1 | 1 | 1 | 1 |
| Restricted stock units | 1 | | 1 | |
| Stock option plans | 3 | 2 | 3 | 2 |
| Denominator for diluted earnings per share | 1,092 | 1,119 | 1,096 | 1,123 |
| Basic earnings per share | \$ 0.98 | \$ 0.88 | \$ 1.87 | \$ 1.67 |
| Diluted earnings per share | \$ 0.97 | \$ 0.88 | \$ 1.86 | \$ 1.66 |

Note 14. Air Freight Restructuring Program and Related Expenses

In February 2005, we announced our intention to transfer the heavy air freight operations currently taking place at the facility in Dayton, Ohio (acquired with the operations of Menlo Worldwide Forwarding in December 2004) to other UPS facilities over approximately 12 to 18 months.

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This action is being taken to remove redundancies between the Dayton air freight facility and existing UPS transportation networks, and thus provide efficiencies and better leverage the current UPS facilities in the movement of air freight. During the third quarter

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

of 2005, we finalized our plans to exit the Dayton facility, as well as various other acquired facilities, and accrued certain costs related to employee severance, lease terminations, and related items. As part of this program, the recorded value of the Dayton facility was reduced to its fair market value as of the date of the acquisition. These accrued costs, and related reductions in the fair value of recorded assets, resulted in an adjustment of \$160 million to the amount of goodwill initially recorded in the Menlo Worldwide Forwarding acquisition.

Additionally, we are incurring costs related to integration activities, such as employee relocations, the moving of inventory and fixed assets, and the consolidation of information systems, and these amounts are being expensed as incurred. We anticipate the entire air freight restructuring program will be completed by the end of 2006.

Set forth below is a summary of activity related to the restructuring program and resulting liability for the six months ended June 30, 2006 (in millions):

| | Employee Severance | Facility Consolidation | Other | Total |
|------------------------------|-------------------------------|-----------------------------------|--------------|--------------|
| Balance at December 31, 2005 | \$ 24 | \$ 47 | \$ 25 | \$ 96 |
| Costs accrued | | | | |
| Cash spent | (3) | | (1) | (4) |
| Charges against assets | | | | |
| Balance at June 30, 2006 | \$ 21 | \$ 47 | \$ 24 | \$ 92 |

Employee Severance

Employee severance costs relate to severance packages for approximately 550 people. The packages are involuntary and are formula-driven based on salary levels and past service. The current and planned separations span the entire business unit, including the operations, information technology, finance, and business development functions.

Facility Consolidation

Facility consolidation costs are associated with terminating operating leases on offices, warehouses, and other acquired facilities.

Other Costs

Other costs consist primarily of costs associated with the termination of certain acquired legal entities and joint ventures, as well as environmental remediation costs.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations
Revenue, Volume and Revenue Per Piece

The following tables set forth information showing the change in revenue, average daily package volume and average revenue per piece, both in dollars or amounts and in percentage terms:

| | Three Months Ended June 30, | | Change | |
|---|--------------------------------|------------------|-----------------|--------------|
| | 2006 | 2005 | \$ | % |
| Revenue (in millions): | | | | |
| U.S. Domestic Package: | | | | |
| Next Day Air | \$ 1,687 | \$ 1,560 | \$ 127 | 8.1% |
| Deferred | 822 | 767 | 55 | 7.2 |
| Ground | 4,953 | 4,615 | 338 | 7.3 |
| Total U.S. Domestic Package | 7,462 | 6,942 | 520 | 7.5 |
| International Package: | | | | |
| Domestic | 473 | 381 | 92 | 24.1 |
| Export | 1,614 | 1,492 | 122 | 8.2 |
| Cargo | 146 | 124 | 22 | 17.7 |
| Total International Package | 2,233 | 1,997 | 236 | 11.8 |
| Supply Chain & Freight: | | | | |
| Forwarding and Logistics | 1,444 | 1,173 | 271 | 23.1 |
| Freight | 510 | | 510 | N/A |
| Other | 87 | 79 | 8 | 10.1 |
| Total Supply Chain & Freight | 2,041 | 1,252 | 789 | 63.0 |
| Consolidated | \$ 11,736 | \$ 10,191 | \$ 1,545 | 15.2% |
| # | | | | |
| Average Daily Package Volume (in thousands): | | | | |
| U.S. Domestic Package: | | | | |
| Next Day Air | 1,240 | 1,190 | 50 | 4.2% |
| Deferred | 936 | 870 | 66 | 7.6 |
| Ground | 11,074 | 10,592 | 482 | 4.6 |
| Total U.S. Domestic Package | 13,250 | 12,652 | 598 | 4.7 |
| International Package: | | | | |
| Domestic | 1,062 | 859 | 203 | 23.6 |
| Export | 656 | 616 | 40 | 6.5 |
| Total International Package | 1,718 | 1,475 | 243 | 16.5 |
| Consolidated | 14,968 | 14,127 | 841 | 6.0% |
| Operating days in period | 64 | 64 | | |
| \$ | | | | |
| Average Revenue Per Piece: | | | | |
| U.S. Domestic Package: | | | | |
| Next Day Air | \$ 21.26 | \$ 20.48 | \$ 0.78 | 3.8% |
| Deferred | 13.72 | 13.78 | (0.06) | (0.4) |
| Ground | 6.99 | 6.81 | 0.18 | 2.6 |
| Total U.S. Domestic Package | 8.80 | 8.57 | 0.23 | 2.7 |

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| | | | | |
|-----------------------------|---------|---------|---------|-------|
| International Package: | | | | |
| Domestic | 6.96 | 6.93 | 0.03 | 0.4 |
| Export | 38.44 | 37.84 | 0.60 | 1.6 |
| Total International Package | 18.98 | 19.84 | (0.86) | (4.3) |
| Consolidated | \$ 9.97 | \$ 9.75 | \$ 0.22 | 2.3% |

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| | Six Months Ended June 30, | | Change | |
|--|------------------------------|-----------|----------|-------|
| | 2006 | 2005 | \$ | % |
| Revenue (in millions): | | | | |
| U.S. Domestic Package: | | | | |
| Next Day Air | \$ 3,371 | \$ 3,060 | \$ 311 | 10.2% |
| Deferred | 1,653 | 1,531 | 122 | 8.0 |
| Ground | 9,901 | 9,162 | 739 | 8.1 |
| Total U.S. Domestic Package | 14,925 | 13,753 | 1,172 | 8.5 |
| International Package: | | | | |
| Domestic | 939 | 739 | 200 | 27.1 |
| Export | 3,175 | 2,858 | 317 | 11.1 |
| Cargo | 280 | 242 | 38 | 15.7 |
| Total International Package | 4,394 | 3,839 | 555 | 14.5 |
| Supply Chain & Freight: | | | | |
| Forwarding and Logistics | 2,783 | 2,326 | 457 | 19.6 |
| Freight | 987 | | 987 | N/A |
| Other | 168 | 159 | 9 | 5.7 |
| Total Supply Chain & Freight | 3,938 | 2,485 | 1,453 | 58.5 |
| Consolidated | \$ 23,257 | \$ 20,077 | \$ 3,180 | 15.8% |
| # | | | | |
| Average Daily Package Volume (in thousands): | | | | |
| U.S. Domestic Package: | | | | |
| Next Day Air | 1,247 | 1,168 | 79 | 6.8% |
| Deferred | 944 | 865 | 79 | 9.1 |
| Ground | 11,093 | 10,528 | 565 | 5.4 |
| Total U.S. Domestic Package | 13,284 | 12,561 | 723 | 5.8 |
| International Package: | | | | |
| Domestic | 1,076 | 823 | 253 | 30.7 |
| Export | 656 | 590 | 66 | 11.2 |
| Total International Package | 1,732 | 1,413 | 319 | 22.6 |
| Consolidated | 15,016 | 13,974 | 1,042 | 7.5% |
| Operating days in period | 128 | 128 | | |
| \$ | | | | |
| Average Revenue Per Piece: | | | | |
| U.S. Domestic Package: | | | | |
| Next Day Air | \$ 21.12 | \$ 20.47 | \$ 0.65 | 3.2% |
| Deferred | 13.68 | 13.83 | (0.15) | (1.1) |
| Ground | 6.97 | 6.80 | 0.17 | 2.5 |
| Total U.S. Domestic Package | 8.78 | 8.55 | 0.23 | 2.7 |
| International Package: | | | | |
| Domestic | 6.82 | 7.02 | (0.20) | (2.8) |
| Export | 37.81 | 37.84 | (0.03) | (0.1) |
| Total International Package | 18.56 | 19.89 | (1.33) | (6.7) |
| Consolidated | \$ 9.91 | \$ 9.70 | \$ 0.21 | 2.2% |

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The following table sets forth information showing the change in UPS Freight's less-than-truckload revenue, shipments, and weight hauled, both in dollars or amounts and in percentage terms:

| | Three Months Ended | | | |
|---|--------------------|------|----------|-----|
| | June 30, | | Change | |
| | 2006 | 2005 | \$ | % |
| LTL revenue (in millions) | \$ 439 | | \$ 439 | N/A |
| LTL revenue per LTL hundredweight | \$ 18.35 | | \$ 18.35 | N/A |
| LTL shipments (in thousands) | 2,397 | | 2,397 | N/A |
| LTL shipments per day (in thousands) | 37 | | 37 | N/A |
| LTL gross weight hauled (in millions of pounds) | 2,390 | | 2,390 | N/A |
| LTL weight per shipment | 997 | | 997 | N/A |

| | Six Months Ended | | | |
|---|------------------|------|----------|-----|
| | June 30, | | Change | |
| | 2006 | 2005 | \$ | % |
| LTL revenue (in millions) | \$ 853 | | \$ 853 | N/A |
| LTL revenue per LTL hundredweight | \$ 17.91 | | \$ 17.91 | N/A |
| LTL shipments (in thousands) | 4,852 | | 4,852 | N/A |
| LTL shipments per day (in thousands) | 38 | | 38 | N/A |
| LTL gross weight hauled (in millions of pounds) | 4,760 | | 4,760 | N/A |
| LTL weight per shipment | 981 | | 981 | N/A |

Overnite Corp., now known as UPS Freight, was acquired on August 5, 2005. Information for comparable prior year periods will be reported beginning in the third quarter of 2006.

Operating Profit

The following table sets forth information showing the change in operating profit, both in dollars (in millions) and in percentage terms, as well as the operating margin for each reporting segment:

| Reporting Segment | Three Months Ended | | | |
|-------------------------------|--------------------|----------|--------|-------|
| | June 30, | | Change | |
| | 2006 | 2005 | \$ | % |
| U.S. Domestic Package | \$ 1,234 | \$ 1,118 | \$ 116 | 10.4% |
| International Package | 414 | 397 | 17 | 4.3 |
| Supply Chain & Freight | 47 | 34 | 13 | 38.2 |
| Consolidated Operating Profit | \$ 1,695 | \$ 1,549 | \$ 146 | 9.4% |

| Reporting Segment | Three Months Ended | |
|-------------------------------|--------------------|---------------|
| | June 30, 2006 | June 30, 2005 |
| U.S. Domestic Package | 16.5% | 16.1% |
| International Package | 18.5% | 19.9% |
| Supply Chain & Freight | 2.3% | 2.7% |
| Consolidated Operating Margin | 14.4% | 15.2% |

| <i>Reporting Segment</i> | Six Months Ended June 30, | | Change | |
|--------------------------------------|------------------------------|-----------------|---------------|--------------|
| | 2006 | 2005 | \$ | % |
| U.S. Domestic Package | \$ 2,419 | \$ 2,146 | \$ 273 | 12.7% |
| International Package | 809 | 745 | 64 | 8.6 |
| Supply Chain & Freight | 22 | 43 | (21) | (48.8) |
| Consolidated Operating Profit | \$ 3,250 | \$ 2,934 | \$ 316 | 10.8% |

| <i>Reporting Segment</i> | Six Months Ended June 30, | |
|--------------------------------------|------------------------------|--------------|
| | 2006 | 2005 |
| U.S. Domestic Package | 16.2% | 15.6% |
| International Package | 18.4% | 19.4% |
| Supply Chain & Freight | 0.6% | 1.7% |
| Consolidated Operating Margin | 14.0% | 14.6% |

U.S. Domestic Package Operations

U.S. domestic package revenue increased \$520 million, or 7.5%, for the quarter (\$1.172 billion, or 8.5%, year-to-date), with average daily package volume up 4.7% (5.8% year-to-date). Volume gains in the quarter and year-to-date periods were realized across all products primarily due to a solid U.S. economy, strong small package market and continuing efforts to generate new volume.

Pricing remained firm as overall revenue per piece was up 2.7% for the quarter and year-to-date. Ground revenue per piece increased 2.6%, and Next Day Air revenue per piece increased 3.8%, for the quarter, primarily due to the impact of a rate increase that took effect in 2006 and the impact of an increased fuel surcharge rate in 2006 compared to 2005. Deferred revenue per piece was down as a result of growth in lighter weight, lower revenue packages.

On January 2, 2006, a rate increase took effect which was in line with previous years' rate increases. We increased rates 5.5% on UPS Next Day Air, UPS 2nd Day Air, and UPS 3 Day Select, and 3.9% on UPS Ground. Other pricing changes include a new charge for undeliverable packages after three delivery attempts and an increase in rates for proof of delivery features for our Delivery Required and Signature Confirmation services. The residential surcharge increased \$0.25 for UPS Ground services and \$0.35 for UPS Next Day Air, UPS 2nd Day Air and UPS 3 Day Select.

In January 2006, we modified the fuel surcharge on domestic air services by reducing the index used to determine the fuel surcharge by 2%. The air fuel surcharge was subject to a maximum cap of 12.5% through June 4, 2006. Effective June 5, 2006, we reduced the index by another 2% and no longer applied a cap to the air fuel surcharge. This fuel surcharge continues to be based on the U.S. Energy Department's Gulf Coast spot price for a gallon of kerosene-type jet fuel. Based on published rates, the average fuel surcharge on domestic air products was 13.70% in the second quarter of 2006 (13.10% year-to-date 2006), as compared with 9.50% in the second quarter of 2005 (9.50% year-to-date 2005). Additionally, the UPS Ground fuel surcharge continues to fluctuate based on the U.S. Energy Department's On-Highway Diesel Fuel Price. Based on published rates, the average fuel surcharge on domestic ground products was 3.84% in the second quarter of 2006 (3.67% year-to-date 2006), as compared to 2.42% in the second quarter of 2005 (2.17% year-to-date 2005). Total domestic fuel surcharge revenue increased by \$149 million in the second quarter (\$288 year-to-date), due to higher jet and diesel fuel prices, volume growth, and the modifications to our fuel surcharges noted above.

U.S. domestic package operating profit increased \$116 million, or 10.4%, for the quarter (\$273 million, or 12.7%, year-to-date) primarily as a result of the revenue growth described previously, combined with efficiencies from leveraging our integrated ground and air networks.

International Package Operations

International package revenue improved \$236 million, or 11.8%, for the quarter (\$555 million, or 14.5%, year-to-date) primarily due to the 6.5% volume growth for our export products and the impact of acquisitions completed in 2005. Total international revenue per piece declined for the quarter due to changes in product mix, as lower-yielding domestic products comprised a larger proportion of overall international volume. The change in revenue was positively affected by \$5 million during the quarter due to currency fluctuations, net of hedging activity (adverse impact of \$50 million year-to-date). Revenue increased by \$77 million during the quarter due to acquisitions (\$172 million year-to-date).

In January 2006, we increased rates 5.5% for international shipments originating in the United States (Worldwide Express, Worldwide Express Plus, UPS Worldwide Expedited and UPS International Standard service). Rate changes for international shipments originating outside the United States vary by geographical market and occur throughout the year.

In January 2006, 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 air fuel surcharge continued to remain subject to a maximum cap of 12.5% through June 4, 2006. Effective June 5, 2006, we reduced the index by another 2% and no longer applied a cap to the air fuel surcharge. The fuel surcharge for products originating outside the United States continues to be indexed to fuel prices in our different international regions, depending upon where the shipment takes place. Total international fuel surcharge revenue increased by \$51 million in the second quarter (\$102 million year-to-date) due to higher jet fuel prices and increased international air volume.

Export volume increased throughout the world, with solid volume increases in all regions, however export volume in Europe was adversely affected by fewer working days in the quarter. International domestic volume increased 23.6% for the quarter, due to volume growth in Canada and Europe, which also benefited from the acquisition of Messenger Service Stolica S.A. in Poland during the second quarter of 2005 and the acquisition of Lynx in the U.K. during the third quarter of 2005. Excluding the impact of acquisitions, international domestic volume increased 4.8% and international domestic revenue increased 4.7% for the quarter (8.5% and 5.5% on a year-to-date basis, respectively).

Export revenue per piece increased 1.6% for the quarter, largely due to the rate increases discussed previously and the impact of the fuel surcharge, partially offset by relatively higher growth in lower revenue per piece transborder products. In total, international average daily package volume increased 16.5% and average revenue per piece decreased 4.3% (4.6% currency-adjusted) for the quarter.

The improvement in operating profit for our international package operations was \$17 million for the quarter, or 4.3% (\$64 million, or 8.6%, year-to-date). Currency fluctuations did not have an impact on operating profit for the quarter, but adversely impacted operating profit by \$9 million year-to-date. The increase in operating profit was positively impacted by the volume and revenue growth described previously, however operating profit was negatively affected by fewer working days in Europe during the quarter.

Supply Chain & Freight Operations

Supply Chain & Freight revenue increased \$789 million, or 63.0%, for the quarter (\$1.453 billion, or 58.5%, year-to-date). UPS Freight, formerly known as Overnite Corp. (acquired August 2005), provided \$510 million or 40.7% of the overall 63.0% increase in revenues. Year-to-date, UPS Freight provided \$987 million, or 39.7% of the total 58.5% increase in revenues. UPS Freight offers a variety of LTL and truckload services to customers in North America. The results of operations have been included in the Supply Chain & Freight reporting segment since the August 5, 2005 acquisition date. UPS Freight had improvements in total revenue and average LTL revenue per LTL hundredweight in the post-acquisition period versus the same period a year ago when it was not a part of UPS, however average daily LTL shipments declined as we proactively reduced less profitable accounts and focused on higher yielding customer segments.

Forwarding and logistics revenue increased \$271 million, or 23.1% for the quarter (\$457 million, or 19.6%, year-to-date), largely due to ongoing changes in the business model for this unit. The forwarding and logistics business is continuing to move towards a model that places more transactional ownership risk on UPS including increased utilization of UPS-owned assets. This has the effect of increasing revenue as well as purchased transportation expense. The increased revenue associated with these forwarding transactions was somewhat offset by certain revenue management initiatives, which involve reducing less profitable accounts. In addition, revenue increased by \$6 million during the quarter (decreased by \$16 million year-to-date) due to currency fluctuations.

The other businesses within Supply Chain & Freight, which include our retail franchising business and our financial business, increased revenue by 10.1% during the quarter (5.7% year-to-date). This revenue growth was primarily due to increased revenue at our financial services unit.

Operating profit for the Supply Chain & Freight segment increased by \$13 million, or 38.2% for the quarter, primarily due to the operating profits generated by UPS Freight. Year-to-date, operating profit declined by \$21 million, or 48.8%, largely due to first quarter lost sales resulting from customer turnover at our forwarding and logistics unit and first quarter air freight integration costs. Currency fluctuations did not affect operating profit during the quarter or year-to-date period.

Operating Expenses and Operating Margin

Consolidated operating expenses increased by \$1.399 billion, or 16.2%, for the quarter, and were significantly impacted by the acquisitions of Overnite Corp., Lynx Express Ltd. and Messenger Service Stolica during 2005. Currency fluctuations in our International Package and Supply Chain & Freight segments resulted in operating expenses increasing by \$11 million for the quarter (decreasing \$58 million year-to-date).

Compensation and benefits increased by \$601 million, or 11.2%, for the quarter (\$1.223 billion, or 11.3%, year-to-date), largely due to the acquisitions of Overnite, Lynx and Stolica, as well as increased health and welfare benefit costs and higher pension expense. Excluding the effect of acquisitions, compensation and benefits expense increased 5.5% for the quarter and 5.7% year-to-date. Stock-based and other management incentive compensation expense increased \$25 million, or 22.0%, in the quarter (\$53 million, or 23.6%, year-to-date), primarily due to the expensing of restricted stock units granted under our Management Incentive Awards program and the impact of a new grant of stock options and restricted performance units in the second quarter.

Other operating expenses increased by \$798 million, or 24.5%, for the quarter (\$1.641 billion, or 25.8%, year-to-date), largely due to the acquisitions mentioned above, as well as increases in fuel expense and purchased transportation. The table below indicates the impact of business acquisitions completed in 2005 on the increase in operating expenses by category in the second quarter and year-to-date periods of 2006.

Second Quarter 2006:

| | Total % Increase | Acquisition Impact | % Increase without Acquisitions |
|----------------------------------|-----------------------------|-------------------------------|--|
| Other Operating Expenses: | | | |
| Repairs and maintenance | 6.6% | 5.1% | 1.5% |
| Depreciation and amortization | 8.2% | 4.7% | 3.5% |
| Purchased transportation | 53.1% | 7.9% | 45.2% |
| Fuel | 43.7% | 13.8% | 29.9% |
| Other occupancy | 10.4% | 6.4% | 4.0% |
| Other expenses | 5.1% | 6.5% | (1.4)% |
| | 24.5% | 7.6% | 16.9% |

Year-to-Date 2006:

| | Total % Increase | Acquisition Impact | % Increase without Acquisitions |
|----------------------------------|---------------------|-----------------------|---------------------------------------|
| Other Operating Expenses: | | | |
| Repairs and maintenance | 9.1% | 5.1% | 4.0% |
| Depreciation and amortization | 9.2% | 5.1% | 4.1% |
| Purchased transportation | 51.6% | 8.6% | 43.0% |
| Fuel | 45.7% | 13.9% | 31.8% |
| Other occupancy | 11.0% | 6.8% | 4.2% |
| Other expenses | 9.3% | 6.4% | 2.9% |
| | 25.8% | 7.8% | 18.0% |

The 29.9% increase in fuel expense for the quarter was impacted by higher prices for jet-A, diesel and unleaded gasoline as well as higher usage, but was partially mitigated with hedging gains. The 45.2% increase in purchased transportation was influenced by volume growth in our International Package business, currency fluctuations, higher fuel prices, increased rail costs, and changes to the freight forwarding business model described previously. The 1.5% increase in repairs and maintenance was largely due to higher expense on vehicle parts and repairs. The 3.5% increase in depreciation and amortization for the quarter was impacted by higher depreciation expense on plant equipment, aircraft and engines, and higher amortization expense on intangible assets due to recent acquisitions. The 4.0% increase in other occupancy expense was largely due to higher electricity and other utilities expenses. The decrease in other expenses was impacted by several items, including realized currency gains.

Investment Income/Interest Expense

The decrease in investment income of \$15 million during the quarter (\$22 million year-to-date) was primarily due to a lower average balance of interest-earning investments and increased equity-method losses on certain investment partnerships. These were partially offset by a higher average interest rate earned on investments.

The \$8 million increase in interest expense during the quarter (\$19 million year-to-date) was due to higher average interest rates on variable rate debt and interest rate swaps, partially offset by lower average debt balances.

Net Income and Earnings Per Share

Net income for the second quarter of 2006 was \$1.061 billion, a 7.6% increase from the \$986 million achieved in the second quarter of 2005, resulting in a 10.2% increase in diluted earnings per share to \$0.97 in 2006 from \$0.88 in 2005. On a year-to-date basis, net income in 2006 was \$2.036 billion, a 9.0% increase from the \$1.868 billion achieved in the comparable period of 2005, resulting in a 12.0% increase in diluted earnings per share to \$1.86 in 2006 from \$1.66 in 2005. Diluted earnings per share has increased at a faster rate than the growth in net income due to the reduction in shares outstanding as a result of our ongoing share repurchase program. The increase in net income for the second quarter and year-to-date periods was largely due to higher operating profits for both our U.S. Domestic and International Package segments.

Liquidity and Capital Resources

Net Cash From Operating Activities

Net cash provided by operating activities decreased to \$3.964 billion in the first half of 2006 from \$4.076 billion during the comparable period of 2005. Operating cash flow in the 2005 period included a \$374 million cash receipt from the Internal Revenue Service as a result of a previously settled tax matter.

As discussed in Note 6, we contributed \$41 million to our pension plans and \$39 million to our postretirement medical benefit plans in the first six months of 2006. We expect to contribute an additional \$1.162 billion and \$91 million over the remainder of the year to the pension and postretirement medical benefit plans, respectively.

On January 2, 2006, a rate increase took effect which was in line with previous years' rate increases. We increased rates 5.5% on UPS Next Day Air, UPS 2nd Day Air, and UPS 3 Day Select, and 3.9% on UPS Ground. We also increased rates 5.5% for international shipments originating in the United States (Worldwide Express, Worldwide Express Plus, UPS Worldwide Expedited and UPS International Standard service). Other pricing changes include a new charge for undeliverable packages after three delivery attempts and an increase in rates for proof of delivery features for our Delivery Required and Signature Confirmation services. The residential surcharge increased \$0.25 for UPS Ground services and \$0.35 for UPS Next Day Air, UPS 2nd Day Air and UPS 3 Day Select. These rate changes are customary, and are consistent with previous years' rate increases. Additionally, in January 2006, we modified the fuel surcharge on domestic and certain U.S.-related international air services by reducing the index used to determine the fuel surcharge by 2%. The air fuel surcharge on domestic and certain U.S.-related international air services continues to remain subject to a maximum cap of 12.5% through June 4, 2006. Effective June 5, 2006, we reduced the index by another 2% and no longer applied a cap to the air fuel surcharge. The UPS Ground fuel surcharge continues to fluctuate based on the U.S. Energy Department's On-Highway Diesel Fuel Price. Rate changes for shipments originating outside the U.S. were made throughout the past year and varied by geographic market.

Net Cash Used In Investing Activities

Net cash used in investing activities increased to \$1.565 billion in the first six months of 2006 from \$889 million during 2005, primarily due to increased capital expenditures and the purchase of marketable securities and short-term investments. During 2006, we generated cash of \$252 million due to the settlement of energy and currency derivative contracts. Also in 2006, we increased our purchase contract deposits on aircraft to be delivered in future periods by \$215 million. We expect to make additional payments related to business acquisitions of approximately \$50 million during the remainder of 2006, primarily related to the Sinotrans acquisition.

We had capital expenditures of \$1.456 billion in the first six months of 2006, an increase over the \$1.043 billion in 2005, primarily due to additional deliveries of aircraft and vehicles. We fund our capital expenditures with our cash from operations. We have commitments for the purchase of aircraft, vehicles, technology equipment and other fixed assets to provide for the replacement of existing capacity and anticipated future growth. During the first six months of 2006, we placed orders for four additional Boeing MD-11 aircraft.

Net Cash Used In Financing Activities

Net cash used in financing activities increased to \$2.847 billion in the first six months of 2006 from \$2.648 billion during 2005, primarily due to increased dividend payments, repayments of debt, and share repurchases. We repurchased a total of 17.8 million shares of Class A and Class B common stock for \$1.421 billion in the first six months of 2006, and 19.0 million shares for \$1.405 billion in the first six months of 2005. In July 2006, the Board of Directors authorized an additional \$2.0 billion for future share repurchases.

We increased our quarterly cash dividend payment to \$0.38 per share in 2006 from \$0.33 per share in 2005, resulting in an increase in total cash dividends paid to \$1.168 billion from \$1.033 billion. 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 expect to continue the practice of paying regular cash dividends.

Issuances of debt during the first six months of 2006 consisted of debt related to our investment in certain equity-method real estate partnerships. Repayments of debt consisted primarily of paydowns of commercial

paper, scheduled principal payments on our capitalized lease obligations and principal payments on debt related to our investment in equity-method real estate partnerships. 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.

Sources of Credit

We maintain two commercial paper programs under which we are authorized to borrow up to \$7.0 billion in the United States. We had \$387 million outstanding under these programs as of June 30, 2006, with an average interest rate of 4.98%. The entire balance outstanding has been classified as a current liability in our balance sheet.

We maintain a European commercial paper program under which we are authorized to borrow up to 1.0 billion in a variety of currencies. We had no borrowings outstanding under this program at June 30, 2006.

We maintain two credit agreements with a consortium of banks. These agreements provide revolving credit facilities of \$1.0 billion each, with one expiring on April 19, 2007 and the other on April 21, 2010. Interest on any amounts we borrow under these facilities would be charged at 90-day LIBOR plus 15 basis points. There were no borrowings under either of these agreements as of June 30, 2006.

In August 2003, we filed a \$2.0 billion shelf registration statement under which we may issue debt securities in the United States. There was approximately \$126 million issued under this shelf registration statement at June 30, 2006, all of which consists of issuances under our UPS Notes program.

The nature and amounts of our principal repayment obligations under our debt, and capital and operating lease agreements as of June 30, 2006 have not materially changed from those disclosed in our Annual Report on Form 10-K for the year ended December 31, 2005.

Our existing debt instruments and credit facilities do not have cross-default or ratings triggers, however these debt instruments and credit facilities do subject us to certain financial covenants. These covenants generally require us to maintain a \$3.0 billion minimum net worth and limit the amount of secured indebtedness available to the company. These covenants are not considered material to the overall financial condition of the company, and all covenant tests were satisfied as of June 30, 2006.

Legal Proceedings, Commitments & Contingencies

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. In one of these cases, Marlo v. UPS, which has been certified as a class action in a California federal court, plaintiffs allege that they improperly were denied overtime, and seek penalties for missed meal and rest periods, and interest and attorneys' fees. Plaintiffs purport to represent a class of 1,200 full-time supervisors. The court granted Summary Judgment in favor of UPS on all claims and plaintiffs have appealed.

In another case, Cornn v. UPS, which has been certified as a class action in a California federal court, plaintiffs allege that they were improperly denied wages and/or overtime and meal and rest periods. Plaintiffs purport to represent a class of approximately 20,000 drivers and seek back wages, penalties, interest and attorneys' fees.

We have denied any liability with respect to these claims and intend to vigorously defend ourselves in these cases. At this time, we have not determined the amount of any liability that may result from these matters or whether such liability, if any, would have a material adverse effect on our financial condition, results of operations, or liquidity.

We have been named as a defendant in four putative class action lawsuits filed in federal courts between March and June 2006, alleging a conspiracy relating to certain surcharges that a number of air cargo carriers imposed. We were not named as a defendant in at least seventy-six related cases that make similar allegations. These cases likely will be consolidated in a Multi-District Litigation proceeding pending in the United States District Court for the Eastern District of New York. In addition, in July 2006, we were named as a defendant in a comparable lawsuit filed in the Ontario (Canada) Superior Court of Justice. We intend to vigorously defend ourselves in these cases.

In addition, we are a defendant in various other lawsuits that arose in the normal course of business. We believe that the eventual resolution of these cases will not have a material adverse effect on our financial condition, results of operations, or liquidity.

We participate in a number of trustee-managed multi-employer pension and health and welfare plans for employees covered under collective bargaining agreements. Several factors could result in potential funding deficiencies which could cause us to make significantly higher future contributions to these plans, including unfavorable investment performance, changes in demographics, and increased benefits to participants. At this time, we are unable to determine the amount of additional future contributions, if any, or whether any material adverse effect on our financial condition, results of operations, or liquidity would result from our participation in these plans.

As of December 31, 2005, we had approximately 241,000 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, 2008. In June 2006, we announced that we will begin formal negotiations in the third quarter with the Teamsters on a new agreement. We have approximately 2,800 pilots who are employed under a collective bargaining agreement with the Independent Pilots Association (IPA), which became amendable December 31, 2003. On June 30, 2006, UPS and the IPA announced a tentative agreement on a new labor contract. The IPA is in the midst of presenting the terms of this tentative agreement to all of our pilots as part of the ratification process. If ratified, this new contract would not become amendable until the end of 2011. Our airline mechanics are covered by a collective bargaining agreement with Teamsters Local 2727, which becomes amendable on November 1, 2006. In addition, the majority 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. These agreements run through July 31, 2009.

Other Matters

With the assistance of outside counsel, we have undertaken an internal investigation of certain conduct within our Supply Chain Solutions subsidiary in certain locations outside the United States. Our investigation has determined that certain conduct, which commenced prior to our subsidiary's 2001 acquisition of a freight forwarding business that was part of Fritz Companies Inc., may have violated the United States Foreign Corrupt Practices Act. The monetary value involved in this conduct appears to be immaterial. We have implemented numerous remediation steps, and our investigation continues. In March 2006 we informed the SEC and the U.S. Department of Justice (DOJ) of our investigation, and we intend to cooperate fully with any review by the government of these issues. We do not believe that the results of this investigation, the remediation or related penalties, if any, will have a material adverse effect on our financial condition, liquidity or results of operations, nor do we believe that these matters will have a material adverse effect on our business and prospects.

On July 14, 2006, we received a grand jury subpoena from the Antitrust Division of the DOJ. The subpoena relates to the DOJ's publicly-announced criminal investigation of the air cargo pricing practices of a number of domestic and foreign airlines. We do not believe that we are a target of this investigation and will cooperate.

New Accounting Pronouncements

In June 2006, the FASB issued FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109) which is effective for fiscal years beginning after December 15,

2006. This interpretation was issued to clarify the accounting for uncertainty in income taxes recognized in the financial statements by prescribing a recognition threshold and measurement attribute for tax positions taken or expected to be taken in a tax return. We are currently evaluating the potential impact of this interpretation.

Forward-Looking Statements

Management's Discussion and Analysis of Financial Condition and Results of Operations, Liquidity and Capital Resources, and other parts of this report contain forward-looking statements about matters that inherently are difficult to predict. The words believes, expects, anticipates, and similar expressions are intended to identify forward-looking statements. These statements include statements regarding our intent, belief and current expectations about our strategic direction, prospects and future results. We have described some of the important factors that affect these statements as we discussed each subject. Forward-looking statements involve risks and uncertainties, and certain factors may cause actual results to differ materially from those contained in the forward-looking statements. Some of the factors that could cause our actual results to differ materially from the expected results are described in our Annual Report on Form 10-K for the year ended December 31, 2005.

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, 2006 | December 31, 2005 |
|---------------------------|------------------|----------------------|
| Energy Derivatives | \$ | \$ 192 |
| Currency Derivatives | 62 | 52 |
| Interest Rate Derivatives | (109) | (47) |
| | \$ (47) | \$ 197 |

In the second quarter of 2006, we terminated several energy derivatives and received \$229 million in cash. These derivatives were designated as hedges of forecasted cash outflows for purchases of fuel products. As these derivatives maintained their effectiveness and qualified for hedge accounting, we anticipate that the gains associated with these hedges will be recognized in income over the original term of the hedges through 2007. Other than this derivative settlement, our market risks, hedging strategies, and financial instrument positions at June 30, 2006 have not materially changed from those disclosed in our Annual Report on Form 10-K for the year ended December 31, 2005. The market risk sensitivities of the contracts noted above are not materially different from the amounts disclosed in our Annual Report on Form 10-K for the year ended December 31, 2005.

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 large banks and financial institutions that meet established credit guidelines. We do not expect to incur any losses as a result of counterparty default.

The information concerning market risk under the sub-caption Market Risk of the caption Management's Discussion and Analysis on pages 30-31 of our consolidated financial statements contained in our Annual Report on Form 10-K for the year ended December 31, 2005, is hereby incorporated by reference in this Quarterly Report on Form 10-Q.

Item 4. *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 and internal controls over financial reporting. Based upon, and as of the date of the evaluation, our chief executive officer and chief financial officer concluded that the disclosure controls and procedures and internal controls over financial reporting were effective to ensure that information required to be disclosed in the reports we file and submit under the Exchange Act is recorded, processed, summarized and reported as and when required.

There were no changes in the Company's internal controls over financial reporting during the quarterly period ended June 30, 2006 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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 Legal Proceedings, Commitments & Contingencies and Other Matters of the caption Management's Discussion and Analysis included in this report.

Item 1A. Risk Factors

There have been no material changes to the Company's risk factors previously disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

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 2006 is as follows (in millions, except per share amounts):

| | | Total Number of Shares Purchased(1) | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Program | Approximate Dollar Value of Shares that May Yet be Purchased Under the Program |
|---------------|----------------|---|------------------------------------|---|--|
| April 1 | April 30, 2006 | 3.4 | \$ 81.42 | 3.2 | \$ 217 |
| May 1 | May 31, 2006 | 2.1 | 81.24 | 1.9 | 64 |
| June 1 | June 30, 2006 | 1.5 | 80.12 | 1.5 | |
| Total April 1 | June 30, 2006 | 7.0 | \$ 81.08 | 6.6 | \$ |

(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.

In August 2005, the Board of Directors authorized an increase in our share repurchase program of \$2.0 billion. This amount was in addition to the remaining authority available under the previously authorized \$2.0 billion share repurchase program approved in October 2004. In July 2006, the Board of Directors authorized a further increase in our share repurchase program of \$2.0 billion. 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 4. Submission of Matters to a Vote of Security Holders

Our annual meeting of shareowners was held on May 4, 2006.

Proxies for the meeting were solicited pursuant to Regulation 14A under the Securities Exchange Act of 1934. There was no solicitation in opposition to management's nominees for director as listed in Item No. 1 in the proxy statement, and all of such nominees were elected.

1. The results of the voting by the shareowners for directors are presented below.

| Director | | Number of Votes | | Percent of |
|---------------------|----------|-----------------|--|--------------|
| | | | | Total Voting |
| John J. Beystehner | For | 2,755,227,081 | | 96.34% |
| | Withheld | 104,690,126 | | 3.66% |
| Michael J. Burns | For | 2,757,243,408 | | 96.41% |
| | Withheld | 102,673,799 | | 3.59% |
| D. Scott Davis | For | 2,737,844,857 | | 95.73% |
| | Withheld | 122,072,350 | | 4.27% |
| Stuart E. Eizenstat | For | 2,765,651,846 | | 96.70% |
| | Withheld | 94,265,361 | | 3.30% |
| Michael L. Eskew | For | 2,747,809,662 | | 96.08% |
| | Withheld | 112,107,545 | | 3.92% |
| James P. Kelly | For | 2,571,981,588 | | 89.93% |
| | Withheld | 287,935,619 | | 10.07% |
| Ann M. Livermore | For | 2,760,217,667 | | 96.51% |
| | Withheld | 99,699,540 | | 3.49% |
| Gary E. MacDougal | For | 2,733,563,450 | | 95.58% |
| | Withheld | 126,353,757 | | 4.42% |
| Victor A. Pelson | For | 2,758,202,304 | | 96.44% |
| | Withheld | 101,714,903 | | 3.56% |
| John W. Thompson | For | 2,763,433,566 | | 96.63% |
| | Withheld | 96,483,641 | | 3.37% |
| Carol B. Tomé | For | 2,766,001,833 | | 96.72% |
| | Withheld | 93,915,374 | | 3.28% |
| Ben Verwaayan | For | 2,767,729,817 | | 96.78% |
| | Withheld | 92,187,390 | | 3.22% |

2. The proposal and the results of the voting by the shareowners for ratification of our appointment of independent auditors are presented below.

| | | Number of Votes | | Percent of |
|---|---------|-----------------|--|--------------|
| | | | | Total Voting |
| To ratify the appointment of Deloitte & Touche LLP, independent auditors, as auditors of UPS and its subsidiaries for the year ending December 31, 2006 | For | 2,781,558,744 | | 97.26% |
| | Against | 62,925,421 | | 2.20% |
| | Abstain | 15,433,042 | | 0.54% |

Item 5. Other Information

None.

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 June 30, 2002).
- 3.2 Form of Bylaws of United Parcel Service, Inc. (incorporated by reference to Exhibit 3.2 on Form S-4 (No. 333-83349), filed on July 21, 1999, as amended).
- 10.1 Form of Restricted Stock Award Agreement under the Incentive Compensation Plan (incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K, filed on March 7, 2006).
- 10.2 Form of Nonqualified Stock Option Award Agreement (incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K, filed on May 5, 2006).
- 10.3 Form of Restricted Performance Unit Award Agreement (incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K, filed on May 5, 2006).
- 11 Statement regarding Computation of per Share Earnings (incorporated by reference to Note 13 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), 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), 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.

Filed herewith.

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 4, 2006

By: /s/ D. SCOTT DAVIS
D. Scott Davis

Senior Vice President,

Treasurer and

Chief Financial Officer

(Duly Authorized Officer and

Principal Financial Officer)