UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 8-K

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

Date of Report (Date of earliest event reported):
May 17, 2005

United Parcel Service, Inc.
(Exact name of registrant as specified in its charter)

Delaware	001-15451	58-2480149
(State or other jurisdiction of incorporation)	(Commission File Number)	(IRS Employer Identification Number)

55 Glenlake Parkway, N.E. **Atlanta, Georgia**	**30328**
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (404) 828-6000

Not applicable
(Former Name or Former Address, if Changed Since Last Report)

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions (*see* General Instruction A.2. below):

☐ Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)

☐ Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)

☐ Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))

☐ Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))

Item 8.01 Other Events

Beginning with our fiscal year that commenced on January 1, 2005, we have changed our reporting segments to reflect recent changes in our business. Prior to this change, our reporting segments were U.S. Domestic Package, International Package and Non-package. Our reporting segments now are U.S. Domestic Package, International Package and Supply Chain Solutions. Previously reported revenue and operating profit for each segment have been restated for each of the three years in the period ended December 31, 2004 to reflect these changes, although the changes did not impact total consolidated revenue or operating profit for such periods.

U.S. domestic package operations include the time-definite delivery of letters, documents, and packages throughout the United States. The domestic portion of the former excess value package insurance business has been replaced by a declared value product that is now managed as part of this segment. Consequently, the revenue and expenses in prior periods associated with the domestic portion of the former excess value package insurance business have been moved to the U.S. Domestic Package segment for comparative purposes. In addition, intersegment operating profit previously included in the results of our former Non-package segment has been eliminated within the U.S. domestic package segment.

International package operations include the time-definite delivery of letters, documents, and packages to more than 200 countries and territories worldwide, including shipments wholly outside the U.S., as well as shipments with either origin or destination outside the U.S. Our international package reporting segment includes the operations of our Europe, Asia-Pacific, and Americas regions. The international portion of the former excess value package insurance business has been replaced by a declared value product that is now managed as part of this segment. Consequently, the revenue and expenses in prior periods associated with the international portion of the former excess value package insurance business have been moved to the International Package segment for comparative purposes.

Supply chain solutions includes our freight services and logistics operations and other aggregated business units, which are individually and in the aggregate not significant. Our freight services and logistics operations are comprised of our former UPS Freight Services and UPS Logistics Group, including the operations acquired with the purchase of Menlo Worldwide Forwarding. Freight services and logistics includes supply chain design and management, freight distribution and customs brokerage services. Other aggregated business units within this segment include Mail Boxes, Etc. (the franchisor of Mail Boxes, Etc. and The UPS Store), UPS Capital, mail, consulting and professional services.

The following items from our Annual Report on Form 10-K for the year ended December 31, 2004 have been updated to reflect the change in our reporting segments, and are presented in Exhibits 99.1 through 99.3:

- Portions of Item 6. Selected Financial Data
- Portions of Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations
- Notes 12 and 17 to the Consolidated Financial Statements as of December 31, 2004 and 2003 and for the three years in the period ended December 31, 2004 included in Item 8. Financial Statements and Supplementary Data.

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 hereunto duly authorized.

UNITED PARCEL SERVICE, INC.

Date: May 17, 2005

By: /s/ D. Scott Davis

Name: D. Scott Davis
Title: Senior Vice President, Treasurer and Chief Financial Officer

Exhibit Index

23 – Consent of Deloitte & Touche LLP

99.1 – Item 6. Selected Financial Data

99.2 – Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

99.3 – Item 8. Financial Statements and Supplementary Data

Exhibit 23

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in Registration Statements No. 333-08369-01, 333-108272, and 333-112329 of United Parcel Service, Inc. on Form S-3 and in Registration Statements No. 333-90792, 333-93213, 333-34054, 333-61112, 333-65096, 333-65606, and 333-70708 of United Parcel Service, Inc. on Form S-8 and in Registration Statements No. 333-72127, 333-24805, 333-23969, and 333-23971 of United Parcel Service of America, Inc. on Form S-8 of our reports dated March 14, 2005 relating to the consolidated financial statements of United Parcel Service, Inc. (May 16, 2005 as to Notes 12 and 18), (which report expresses an unqualified opinion and includes an explanatory paragraph relating to the Company’s change in its method of accounting for goodwill and other intangible assets to conform with Statement of Financial Accounting Standards No. 142, effective January 1, 2002, and to the Company’s change in its method of accounting for stock compensation to conform with Statement of Financial Accounting Standards No. 123, effective January 1, 2003) and management’s report of the effectiveness of internal control over financial reporting, appearing in this Current Report on Form 8-K of United Parcel Service, Inc.

/s/ Deloitte & Touche LLP

Atlanta, Georgia
May 16, 2005

Item 6. ***Selected Financial Data***

The following table sets forth selected financial data for each of the five years in the period ended December 31, 2004 (amounts in millions, except per share amounts). This financial data should be read together with our consolidated financial statements and related notes, Management's Discussion and Analysis of Financial Condition and Results of Operations, and other financial data appearing elsewhere in this report.

	Years Ended December 31,				
	2004	2003	2002	2001	2000 *
Selected Income Statement Data					
Revenue:					
U.S. domestic package	$26,960	$25,362	$24,280	$24,391	
International package	6,809	5,609	4,720	4,280	
Supply chain solutions	2,813	2,514	2,272	1,650	
Total revenue	36,582	33,485	31,272	30,321	29,498
Operating expenses:					
Compensation and benefits	20,916	19,328	17,940	17,397	16,546
Other	10,677	9,712	9,236	8,962	8,440
Total operating expenses	31,593	29,040	27,176	26,359	24,986
Operating profit (loss):					
U.S. domestic package	3,702	3,657	3,925	3,969	
International package	1,149	732	338	139	
Supply chain solutions	138	56	(167)	(146)	
Total operating profit	4,989	4,445	4,096	3,962	4,512
Other income (expense):					
Investment income	82	18	63	159	527
Interest expense	(149)	(121)	(173)	(184)	(205)
Gain on redemption of long-term debt	—	28	—	—	—
Tax assessment	—	—	1,023	—	—
Income before income taxes	4,922	4,370	5,009	3,937	4,834
Income taxes	(1,589)	(1,472)	(1,755)	(1,512)	(1,900)
Cumulative effect of changes in accounting principles	—	—	(72)	(26)	—
Net income	$ 3,333	$ 2,898	$ 3,182	$ 2,399	$ 2,934
Per share amounts:					
Basic earnings per share	$ 2.95	$ 2.57	$ 2.84	$ 2.13	$ 2.54
Diluted earnings per share	$ 2.93	$ 2.55	$ 2.81	$ 2.10	$ 2.50
Dividends declared per share	$ 1.12	$ 0.92	$ 0.76	$ 0.76	$ 0.68
Weighted Average Shares Outstanding					
Basic	1,129	1,128	1,120	1,126	1,153
Diluted	1,137	1,138	1,134	1,144	1,175

	As of December 31,				
	2004	2003	2002	2001	2000
Selected Balance Sheet Data					
Working capital	$ 6,076	$ 4,335	$ 3,183	$ 2,811	$ 2,623
Long-term debt	3,261	3,149	3,495	4,648	2,981
Total assets	33,026	29,734	26,868	24,636	21,662
Shareowners' equity	16,384	14,852	12,455	10,248	9,735

* Revenue and operating profit by segment in 2000 has not been restated.

Item 7. ***Management's Discussion and Analysis of Financial Condition and Results of Operations***

Operations

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:

	Year Ended December 31, 2004	Year Ended December 31, 2003	Change $	Change %
Revenue (in millions):				
U.S. domestic package:				
Next Day Air	$ 6,084	$ 5,621	$ 463	8.2%
Deferred	3,193	3,015	178	5.9
Ground	17,683	16,726	957	5.7
Total U.S. domestic package	26,960	25,362	1,598	6.3
International package:				
Domestic	1,346	1,134	212	18.7
Export	4,991	4,049	942	23.3
Cargo	472	426	46	10.8
Total International package	6,809	5,609	1,200	21.4
Supply chain solutions:				
Freight services and logistics	2,379	2,126	253	11.9
Other	434	388	46	11.9
Total Supply chain solutions	2,813	2,514	299	11.9
Consolidated	$36,582	$33,485	$3,097	9.2%

	2004	2003	#	%
Average Daily Package Volume (in thousands):				
U.S. domestic package:				
Next Day Air	1,194	1,185	9	0.8%
Deferred	910	918	(8)	(0.9)
Ground	10,676	10,268	408	4.0
Total U.S. domestic package	12,780	12,371	409	3.3
International package:				
Domestic	815	786	29	3.7
Export	541	481	60	12.5
Total International package	1,356	1,267	89	7.0
Consolidated	14,136	13,638	498	3.7%
Operating days in period	254	252		

	2004	2003	$	%
Average Revenue Per Piece:				
U.S. domestic package:				
Next Day Air	$ 20.06	$ 18.82	$ 1.24	6.6%
Deferred	13.81	13.03	0.78	6.0
Ground	6.52	6.46	0.06	0.9
Total U.S. domestic package	8.31	8.14	0.17	2.1
International package:				
Domestic	6.50	5.73	0.77	13.4
Export	36.32	33.40	2.92	8.7
Total International package	18.40	16.23	2.17	13.4
Consolidated	$ 9.27	$ 8.89	$ 0.38	4.3%

	Year Ended December 31, 2003	2002	Change $	%
Revenue (in millions):				
U.S. domestic package:				
Next Day Air	$ 5,621	$ 5,393	$ 228	4.2%
Deferred	3,015	2,902	113	3.9
Ground	16,726	15,985	741	4.6
Total U.S. domestic package	25,362	24,280	1,082	4.5
International package:				
Domestic	1,134	943	191	20.3
Export	4,049	3,316	733	22.1
Cargo	426	461	(35)	(7.6)
Total International package	5,609	4,720	889	18.8
Supply chain solutions:				
Freight services and logistics	2,126	1,969	157	8.0
Other	388	303	85	28.1
Total Supply chain solutions	2,514	2,272	242	10.7
Consolidated	$33,485	$31,272	$2,213	7.1%
			#	
Average Daily Package Volume (in thousands):				
U.S. domestic package:				
Next Day Air	1,185	1,111	74	6.7%
Deferred	918	895	23	2.6
Ground	10,268	10,112	156	1.5
Total U.S. domestic package	12,371	12,118	253	2.1
International package:				
Domestic	786	779	7	0.9
Export	481	443	38	8.6
Total International package	1,267	1,222	45	3.7
Consolidated	13,638	13,340	298	2.2%
Operating days in period	252	252		
			$	
Average Revenue Per Piece:				
U.S. domestic package:				
Next Day Air	$ 18.82	$ 19.26	$ (0.44)	(2.3)%
Deferred	13.03	12.87	0.16	1.2
Ground	6.46	6.27	0.19	3.0
Total U.S. domestic package	8.14	7.95	0.19	2.4
International package:				
Domestic	5.73	4.80	0.93	19.4
Export	33.40	29.70	3.70	12.5
Total International package	16.23	13.83	2.40	17.4
Consolidated	$ 8.89	$ 8.49	$ 0.40	4.7%

Operating Profit

The following tables set forth information showing the change in operating profit, both in dollars (in millions) and in percentage terms:

	Year Ended December 31,		Change	
	2004	2003	$	%
Operating Segment				
U.S. domestic package	$3,702	$3,657	$ 45	1.2%
International package	1,149	732	417	57.0
Supply chain solutions	138	56	82	146.4
Consolidated Operating Profit	$4,989	$4,445	$ 544	12.2%

	Year Ended December 31,		Change	
	2003	2002	$	%
Operating Segment				
U.S. domestic package	$3,657	$3,925	$(268)	(6.8)%
International package	732	338	394	116.6
Supply chain solutions	56	(167)	223	N/A
Consolidated Operating Profit	$4,445	$4,096	$ 349	8.5%

U.S. Domestic Package Operations

2004 compared to 2003

U.S. domestic package revenue increased $1.598 billion, or 6.3%, for the year, which resulted from a 3.3% increase in average daily package volume and a 2.1% increase in revenue per piece. Ground volume increased 4.0% during the year, driven in part by the improving U.S. economy, and reflects growth in both commercial and residential deliveries. Ground volume increased 4.8% during the first nine months of the year, but slowed to 1.5% during the fourth quarter. Total Next Day Air volume (up 0.8%) and total deferred volume (down 0.9%) were both significantly affected by declines in letter volume, but offset by an increase in Next Day Air package volume. The 2004 decline in Next Day Air and deferred letter volume is largely due to the slowdown in mortgage refinancing, which was notably strong in 2003.

Ground revenue per piece increased 0.9% for the year primarily due to the impact of a rate increase that took effect in 2004, but growth was adversely impacted by approximately 130 basis points due to the removal of the fuel surcharge on ground products, as discussed below. Next Day Air revenue per piece increased 6.6%, while deferred revenue per piece increased 6.0%, primarily due to the shift in product mix from letters to packages, the rate increase, and the modified fuel surcharge on domestic air products.

On January 5, 2004, a rate increase took effect which was in line with previous years' rate increases. We increased rates for standard ground shipments an average of 1.9% for commercial deliveries. The ground residential surcharge increased $0.25 to $1.40 over the commercial ground rate. An additional delivery area surcharge of $1.00 was implemented for commercial deliveries in certain ZIP codes. Rates for UPS Hundredweight increased 5.9%. In addition, we increased rates for UPS Next Day Air an average of 2.9% and increased rates for deferred services by 2.9%.

In addition, we discontinued the fuel surcharge on ground products, while we began to apply a new indexed surcharge to domestic air products. This indexed fuel surcharge for the domestic air products is 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 applied to our air products during 2004 was 7.07%, compared with the average surcharge of 1.47% applied to both air and ground products in 2003, resulting in an increase in domestic fuel surcharge revenue of $290 million during the year.

U.S. domestic package operating profit increased $45 million, or 1.2%, primarily due to the increase in volume and revenue growth discussed previously, but somewhat offset by increased aircraft impairment charges ($91 million in 2004 compared to $69 million in 2003) and a $63 million pension charge related to the consolidation of data systems used to collect and accumulate plan participant data.

2003 compared to 2002

U.S. domestic package revenue increased $1.082 billion, or 4.5%, for the year, which was driven by a 2.1% increase in average daily package volume and a 2.4% increase in revenue per piece. Ground volume increased by 1.5% in 2003, reversing a 2.0% decline in 2002, reflecting the improving U.S. economy and the impact that labor negotiations had on lowering volume during portions of 2002. The volume for our UPS Next Day Air products increased by 6.7% during the year, driven by double-digit growth in overnight letters which was influenced by the strength in mortgage refinancing activity during 2003. The increase in U.S. domestic average daily package volume was more significant in the latter half of the year. In the third and fourth quarters of 2003, total U.S. domestic average daily package volume increased 3.2% and 4.9%, respectively.

The overall improvement in revenue per piece was primarily due to the rate increase that became effective in January 2003, with some additional benefit from the fuel surcharge as described below. The decline in revenue per piece for the Next Day Air products, and the relatively smaller increase for the deferred products, was primarily due to the relatively higher growth in letter volume compared with the growth in package volume for these products.

On January 6, 2003, we increased rates for standard ground shipments an average of 3.9% for commercial deliveries. The ground residential surcharge increased $0.05 to $1.15 over the commercial ground rate. The additional delivery area surcharge added to residential deliveries in certain ZIP codes increased $0.25 to $1.75. Rates for UPS Hundredweight increased 5.9%. In addition, we increased rates for UPS Next Day Air an average of 3.4% and increased rates for deferred services by 4.5%.

During 2003, the index-based fuel surcharge reset on a monthly basis and was based on the National U.S. Average On-Highway Diesel Fuel Prices as reported by the U.S. Department of Energy. Based on published rates, the average fuel surcharge increased to 1.47% in 2003 from 0.78% in 2002, resulting in an increase in fuel surcharge revenue of $144 million. Effective in 2004, we discontinued the fuel surcharge on ground service, while an indexed surcharge was applied to our Next Day Air and deferred products. This indexed fuel surcharge for the domestic air products was based on the U.S. Energy Department’s Gulf Coast spot price for a gallon of kerosene-type jet fuel.

U.S. domestic package operating profit declined $268 million, or 6.8%, primarily due to the slow volume and revenue growth combined with an increase in operating expenses (discussed further below under the section titled “Operating Expenses and Operating Margin”). U.S. domestic package operating profit increased 4.1% in the third quarter and decreased by 7.5% in the fourth quarter. In the fourth quarter of 2002, U.S. domestic package operating profit benefited from a $175 million credit due to a change in our vacation policy for non-union employees.

During the third quarter of 2003, we sold our Aviation Technologies business unit and recognized a pre-tax gain of $24 million ($15 million after-tax, or $0.01 per diluted share), which is recorded in other operating expenses within the U.S. domestic package segment. The operating results of the Aviation Technologies unit were previously included in our U.S. domestic package segment, and were not material to our consolidated operating results in any of the periods presented.

International Package Operations

2004 compared to 2003

International package revenue improved $1.200 billion, or 21.4%, for the year primarily due to the 12.5% volume growth for our export products and strong revenue per piece improvements. Revenue increased $295 million during the year due to currency fluctuations. Revenue growth was also impacted by the change to our fuel surcharge (discussed below) as well as rate changes, which vary by geographical market and occur throughout the year. Rates for international shipments originating in the United States (Worldwide Express, Worldwide Express Plus, UPS Worldwide Expedited and UPS International Standard service) increased an average of 3.5%.

In January 2004, changes were made to the calculation of our fuel surcharge on international products (including U.S. export products). The surcharge is now indexed to fuel prices in our different international regions, depending on where the shipment takes place. The current surcharge is only applied to our international express products, while the previous surcharge was applied to all international products. These changes, along with higher fuel prices, had the effect of increasing international package revenue by $231 million during the year.

We experienced double-digit export volume growth in each region throughout the world, with the Asia-Pacific region leading with 24% export volume growth, including a 101% increase in China export volume. Export volume continues to benefit from our expanding international network, such as the six additional flights to Shanghai, China that were added in the fourth quarter. European export volume grew in excess of 10%, and was positively influenced by the addition of 10 countries to the European Union. Non-U.S. domestic volume increased 3.7% for the year, and primarily reflects improvements in our European and Canadian domestic delivery businesses.

Export revenue per piece increased 8.7% for the year (2.9% currency-adjusted), benefiting from rate increases and the impact of the fuel surcharge. In total, international average daily package volume increased 7.0% and average revenue per piece increased 13.4% (6.5% currency-adjusted).

The improvement in operating profit for our international package operations was $417 million, or 57.0%, for the year, $54 million of which was due to favorable currency fluctuations. This increase in operating profit was primarily due to the strong export volume growth and revenue per piece increases described previously, and a strong increase in operating margin through better network utilization. International operating profit was adversely affected by aircraft impairment charges of $19 million in 2004, compared to a $6 million charge in 2003.

2003 compared to 2002

International package revenue improved $889 million, or 18.8%, for the year due primarily to the 8.6% volume growth for our export products and strong revenue per piece improvements, a portion of which can be attributed to the impact of currency. Revenue increased $443 million during the year due to currency fluctuations. Export volume increased throughout the world, with Asia-Pacific, Canada, and the Americas showing double-digit export volume growth, and U.S. and European export volume increasing slightly over 6%. European export volume growth was adversely impacted by the strength of the Euro and the weak European economy. Domestic volume increased 0.9% for the year, reversing a 3.2% decline from the previous year, which was also negatively affected by the weak European economy.

Export revenue per piece increased 12.5% for the year (3.3% currency-adjusted), due to improvements in product mix and continued focus on yield management. In total, international average daily package volume increased 3.7% and average revenue per piece increased 17.4% (6.2% currency-adjusted). The 7.6% decline in cargo revenue during the year was largely due to a reduction of flights in our air network in the Americas.

Rates for international shipments originating in the United States (UPS Worldwide Express, UPS Worldwide Express Plus, UPS Worldwide Expedited and UPS Standard service) increased an average of 3.9%. Rate changes for shipments originating outside the United States generally are made throughout the year and vary by geographic market.

The improvement in operating profit for our international package operations was $394 million for the year, $117 million of which was due to favorable currency fluctuations. This increase in operating profit was primarily due to the strong export volume growth and revenue per piece increases described previously. In 2002, international operating profit benefited from an $11 million credit to operating expense as a result of a change in our vacation policy for non-union employees.

Supply Chain Solutions Operations

2004 compared to 2003

Supply chain solutions revenue increased $299 million, or 11.9%, for the year. Freight services and logistics revenue increased by 11.9% during the year, with strong growth in our air and ground freight forwarding businesses, as well as our logistics business. The acquisition of Menlo Worldwide Forwarding, which was completed in December 2004, increased freight services and logistics revenue by $33 million. Favorable currency fluctuations provided $73 million of the increase in revenue for the year. The other businesses within supply chain solutions, which includes our retail franchising business, our mail and consulting services, and our financial business, increased revenue by 11.9% for the year, largely due to strong double-digit franchise and royalty revenue growth at our retail franchising business resulting from an expanding store base.

Supply chain solutions operating profit increased $82 million, or 146.4%, for the year, primarily due to improved results from our financial business (largely due to a lower loan loss provision), and our mail services business, which was affected in 2003 by the sale of our Mail Technologies business unit as described in the next paragraph. Our retail franchising business also experienced profit growth, due to the increased franchise and royalty revenue noted previously.

During the second quarter of 2003, we sold our Mail Technologies business unit in a transaction that increased net income by $14 million, or $0.01 per diluted share. The gain consisted of a pre-tax loss of $24 million recorded in other operating expenses within the supply chain solutions segment, and a tax benefit of $38 million recognized in conjunction with the sale. The tax benefit exceeded the pre-tax loss from this sale primarily because the goodwill impairment charge we previously recorded for the Mail Technologies business unit was not deductible for income tax purposes. Consequently, our tax basis was greater than our book basis, thus producing the tax benefit described above. The operating results of the Mail Technologies unit were previously included in our supply chain solutions segment, and were not material to our consolidated operating results in any of the periods presented.

2003 compared to 2002

Supply chain solutions revenue increased $242 million, or 10.7%, for the year. Freight services and logistics revenue increased by 8.0% during the year. This increase was due to growth in our supply chain management and other logistics businesses, with international revenues growing faster than in the United States, partially as a result of favorable currency fluctuations. Favorable currency fluctuations accounted for $74 million of the increase in revenue. Freight forwarding revenue increased at a slower rate, which was influenced by global economic conditions and increased air revenue in 2002 as a result of the work disruption at U.S. west coast ports. The other businesses within supply chain solutions, which includes our retail franchising business, our mail and consulting services, and our financial business, increased revenue by 28.1% for the year, primarily due to increased franchise revenue at our retail franchising business and improvements at our mail services unit.

Supply chain solutions operating profit increased $223 million for the year. This increase was primarily due to higher operating profit from our freight services and logistics business, which was driven by the increase in revenue as well as the cost savings produced by our integration and restructuring program. Supply chain solutions operating profit in 2002 was reduced by the $106 million restructuring charge and related expenses, and was increased by $11 million due to the change in our vacation policy for non-union employees.

Operating Expenses and Operating Margin

2004 compared to 2003

Consolidated operating expenses increased by $2.553 billion, or 8.8%, for the year, $311 million of which was due to currency fluctuations in our international package and supply chain solutions segments. Compensation and benefits increased by $1.588 billion, or 8.2%, for the year, largely due to increased payroll costs, increased health and welfare expense, and higher pension expense for our union pension plans. Stock-based compensation expense increased $167 million, or 23.2%, during the year, primarily as a result of increased management incentive awards expense and adopting the measurement provisions of FAS 123 prospectively beginning with 2003 stock-based compensation awards.

Other operating expenses increased by $965 million, or 9.9%, for the year, largely due to a 34.9% increase in fuel expense and a 12.6% increase in purchased transportation, but were somewhat offset by a decline in depreciation and amortization expense. The increase in fuel expense was primarily due to higher prices for Jet-A, diesel, and unleaded gasoline, in addition to somewhat higher fuel usage and lower hedging gains. The increase in purchased transportation expense was influenced by the impact of currency, higher fuel prices, and volume growth in our international package business. The decline in depreciation and amortization for the year was impacted by lower depreciation expense on aircraft engines, largely due to the retirement of some older aircraft. The increase in repairs and maintenance expense was affected by increased expense on vehicle parts and airframe and engine maintenance. The increase in other occupancy expense was largely related to higher rent expense, but somewhat offset by lower real estate taxes. The increase in other expenses was affected by the $110 million impairment of aircraft, engines, and parts, as well as the $63 million pension charge discussed previously, in addition to higher advertising costs.

Our consolidated operating margin, defined as operating profit as a percentage of revenue, increased in 2004 compared with 2003. The operating margins for our three business segments were as follows:

	Year Ended December 31,		
	2004	**2003**	**2002**
Operating Segment			
U.S. domestic package	13.7%	14.4%	16.2%
International package	16.9%	13.1%	7.2%
Supply chain solutions	4.9%	2.2%	(7.4)%
Consolidated	13.6%	13.3%	13.1%

2003 compared to 2002

Consolidated operating expenses increased by $1.864 billion, or 6.9%, for the year, $398 million of which was due to currency fluctuations in our international package and supply chain solutions segments. Compensation and benefits increased by $1.388 billion, or 7.7%, for the year, primarily due to increased health and welfare benefit costs and higher pension expense. Stock-based compensation expense totaled $724 million in 2003, a 14.0% increase over 2002, primarily as a result of increased Management Incentive Awards expense and adopting the measurement provisions of FAS 123 for 2003 stock-based compensation awards.

Other operating expenses increased by $476 million, or 5.2%, for the year, largely due to a 12.3% increase in occupancy costs, a 10.3% increase in fuel expense, and smaller increases in purchased transportation, repairs and maintenance, and depreciation and amortization. Other operating expenses in 2002 were affected by the $106 million restructuring charge and related expenses incurred in the integration of our Freight Services and Logistics Group operations into our supply chain solutions business. The growth in other occupancy expense was impacted by higher rent expense on buildings and facilities, higher real estate taxes, and weather-related increases in natural gas and utilities expense. The fuel expense increase was due to higher fuel prices in 2003, somewhat offset by hedging gains and lower fuel usage. The increase in purchased transportation expense was influenced by the impact of currency and growth in our international package and supply chain solutions businesses. The growth in depreciation and amortization reflects the addition of new aircraft, the completion of facilities projects (including UPS Worldport), and increased amortization of capitalized software. The increase in repairs and maintenance was primarily due to higher vehicle, aircraft, and equipment maintenance expense.

The increase in other expenses was primarily due to a $75 million impairment charge recorded in the fourth quarter of 2003, resulting from an impairment evaluation performed when we permanently removed a number of Boeing 727 and DC-8 aircraft from service.

Investment Income/Interest Expense

2004 compared to 2003

Investment income increased by $64 million during the year, primarily due to a $58 million impairment charge recognized during 2003. We periodically review our investments for indications of other than temporary impairment considering many factors, including the extent and duration to which a security's fair value has been less than its cost, overall economic and market conditions, and the financial condition and specific prospects for the issuer. During the first quarter of 2003, after considering the continued decline in the U.S. equity markets, we recognized an impairment charge of $58 million, primarily related to our investment in S&P 500 equity portfolios. Investment income also increased in 2004 due to higher interest rates earned on cash balances, but was somewhat offset by increased equity-method losses on certain investment partnerships.

The $28 million increase in interest expense during 2004 was primarily due to the impact of higher interest rates on variable rate debt and certain interest rate swaps, as well as the impact of currency exchange rates and imputed interest expense associated with certain investment partnerships. The impact of higher interest rates was somewhat offset by lower average debt balances outstanding in 2004 compared to 2003.

In December 2003, we redeemed $300 million in cash-settled convertible senior notes at a price of 102.703, and also terminated the swap transaction associated with the notes. The redemption amount paid was lower than the amount recorded for the fair value of the notes at the time of redemption, which, along with the cash settlement received on the swap, resulted in a $28 million non-operating gain recorded in 2003 results.

2003 compared to 2002

The decrease in investment income of $45 million in 2003 is primarily due to the $58 million impairment charge recognized during the first quarter of 2003. The $52 million decline in interest expense in 2003 was primarily the result of lower commercial paper balances outstanding, lower interest rates on variable rate debt, and lower floating rates on interest rate swaps.

Net Income and Earnings Per Share

2004 compared to 2003

2004 net income was $3.333 billion, a 15.0% increase from the $2.898 billion in 2003, resulting in an increase in diluted earnings per share to $2.93 in 2004 from $2.55 in 2003. Net income in 2004 was adversely impacted by a $70 million after-tax impairment charge ($0.06 per diluted share) on Boeing 727, 747, and McDonnell Douglas DC-8 aircraft, engines, and parts, as well as a $40 million after-tax charge ($0.04 per diluted share) to pension expense resulting from the consolidation of data systems used to collect and accumulate plan participant data. Net income was positively impacted by credits to income tax expense totaling $142 million ($0.13 per diluted share) related to various items, including the resolution of certain tax matters, the removal of a portion of the valuation allowance on certain deferred tax assets on net operating loss carryforwards, and an adjustment for identified tax contingency items.

Net income in 2003 was favorably impacted by the $14 million after-tax gain ($0.01 per diluted share) on the sale of Mail Technologies, the $15 million after-tax gain ($0.01 per diluted share) on the sale of Aviation Technologies, and the $18 million after-tax gain ($0.02 per diluted share) recognized upon redemption of our $300 million cash-settled senior convertible notes. Net income in 2003 was adversely impacted by the $37 million after-tax investment impairment charge ($0.03 per diluted share) described previously. Net income in 2003 was also favorably impacted by reductions in income tax expense of $116 million ($0.10 per diluted share) due to the resolution of various tax issues with the IRS, a favorable court ruling on the tax treatment of jet engine maintenance costs, and a lower effective state tax rate.

2003 compared to 2002

Net income for 2003 was $2.898 billion, a decrease of $284 million from the $3.182 billion achieved in 2002, resulting in a decrease in diluted earnings per share to $2.55 in 2003 from $2.81 in 2002. Net income in 2003 was affected by the items noted above. Net income in 2002 was favorably impacted by a $776 million after-tax ($0.68 per diluted share) benefit resulting from the reversal of a portion of the previously established tax assessment liability, and by $121 million after-tax ($0.11 per diluted share) from the credit to expense as a result of the change in our vacation policy for non-union employees. Net income in 2002 was adversely impacted by $65 million after-tax ($0.06 per diluted share) due to the restructuring charge and related expenses and by $72 million after-tax ($0.06 per diluted share) due to the FAS 142 cumulative expense adjustment.

Liquidity and Capital Resources

Net Cash From Operating Activities

Net cash provided by operating activities was $5.331, $4.576, and $5.688 billion in 2004, 2003 and 2002, respectively. The increase in 2004 operating cash flows compared with 2003 was primarily due to higher net income, decreased pension and retirement plan fundings, and cash received upon the resolution of various tax matters. In 2004, we funded $450 million to our pension plans as compared to $1.136 billion in 2003. As discussed in Note 5 to the consolidated financial statements, projected pension contributions to plan trusts in 2005 are approximately $723 million. In 2004, we received $610 million from our previously disclosed settlement with the Internal Revenue Service (IRS) primarily on tax matters related to excess value package insurance for tax years 1983-84 and 1991-98 (see "Contingencies" section below). As of December 31, 2004, we had a $371 million receivable recorded for the settlement related to tax years 1985-90.

On October 28, 2004, we announced a rate increase and a change in the fuel surcharge that will take effect on January 3, 2005. We increased rates 2.9% on UPS Next Day Air, UPS 2nd Day Air, UPS 3 Day Select, and UPS Ground. We also increased rates 2.9% 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 an increase of $0.25 for delivery area surcharge on both residential and commercial services to certain ZIP codes. The residential surcharge will increase $0.10 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 2005 we will modify the fuel surcharge on domestic and international air services by setting a maximum cap of 9.5%. A fuel surcharge of 2% will be applied to UPS Ground services that will fluctuate after January 2005 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 was $3.638, $2.742, and $3.281 billion in 2004, 2003 and 2002, respectively. The primary reason for the increased cash used in investing activities has been the increasing net purchases of marketable securities, due to the excess of cash generated over our capital investment needs. The increase in funds used for business acquisitions is primarily due to the Menlo Worldwide Forwarding and UPS Yamato Express Co. acquisitions in 2004 (see Note 7 to the consolidated financial statements). The cash generated from finance receivables was primarily due to principal payments on finance receivables and sales of portions of our portfolio, primarily in the receivable factoring business.

Capital expenditures represent a primary use of cash in investing activities, as follows (in millions):

	2004	2003	2002
Buildings and facilities	$ 547	$ 451	$ 528
Aircraft and parts	829	1,019	638
Vehicles	393	161	41
Information technology	358	316	451
	$2,127	$1,947	$1,658

As described in the "Commitments" section below, we have commitments for the purchase of aircraft, vehicles, equipment and other fixed assets to provide for the replacement of existing capacity and anticipated future growth. We fund our capital expenditures with our cash from operations.

Net Cash Used In Financing Activities

Net cash used in financing activities was $2.014, $2.110 and $2.090 billion in 2004, 2003 and 2002, respectively. Our primary use of cash in financing activities has been to repurchase stock, pay dividends, and repay long-term debt. In October 2004, a total of $2.0 billion was authorized for share repurchases as part of our continuing share repurchase program. As of December 31, 2004, $1.817 billion of this authorization was available for future share repurchases. We repurchased a total of $1.310 billion of common stock in 2004.

We increased our cash dividends per share to $1.12 in 2004 from $0.92 in 2003, resulting in an increase in total cash dividends paid to $1.208 billion from $956 million. 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. In February 2005, the Board of Directors declared a $0.33 per share dividend, which represents a 17.9% increase over the $0.28 previous quarterly dividend. The dividend is payable on March 9, 2005 to shareowners of record on February 22, 2005.

During 2004, we repaid $468 million in debt, primarily consisting of $264 million in commercial paper, $56 million in redemptions of UPS Notes, $57 million in scheduled principal payments on capital lease obligations, and $60 million for the redemption of our Singapore Dollar notes issue. Issuances of debt primarily consisted of $735 million in commercial paper and $41 million in UPS Notes. We consider the overall fixed and floating interest rate mix of our portfolio and the related overall cost of borrowing when planning for future issuances and non-scheduled repayments of debt.

Sources of Credit

We maintain two commercial paper programs under which we are authorized to borrow up to $7.0 billion. Approximately $1.015 billion was outstanding under these programs as of December 31, 2004, with an average interest rate of 2.10%. The entire balance outstanding has been classified as a current liability in our balance sheet. In addition, we maintain an extendable commercial notes program under which we are authorized to borrow up to $500 million. No amounts were outstanding under this program at December 31, 2004.

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 21, 2005 and the other on April 24, 2008. 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 December 31, 2004.

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 December 31, 2004, all of which consists of issuances under our UPS Notes program.

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 passed as of December 31, 2004.

Commitments

We have contractual obligations and commitments in the form of operating leases, capital leases, debt obligations and purchase commitments. We intend to satisfy these obligations through the use of cash flow from operations. The following table summarizes our contractual obligations and commitments as of December 31, 2004 (in millions):

Year	Capitalized Leases	Operating Leases	Debt Principal	Purchase Commitments
2005	$ 97	$ 370	$ 1,110	$ 1,012
2006	70	327	6	488
2007	121	242	—	223
2008	132	169	27	274
2009	76	128	84	637
After 2009	62	590	2,777	1,129
Total	$ 558	$ 1,826	$ 4,004	$ 3,763

In December 2004, we amended our existing aircraft purchase agreement with Airbus Industries. The amended agreement will reduce Airbus A300-600 aircraft on order from 50 to 13, and the number of options on this aircraft from 37 to zero. These 13 aircraft remaining on order will be delivered to UPS by July 2006. Additionally, we placed a firm order for 10 Airbus A380 freighter aircraft, and obtained options to purchase 10 additional A380 aircraft. The Airbus A380 aircraft will be delivered to UPS between 2009 and 2012. The purchase commitments information above reflects the amended agreement.

In January 2005, we also announced an agreement to purchase an additional 11 Boeing MD-11 pre-owned aircraft. These aircraft will be delivered to UPS between 2005 and 2007.

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

Contingencies

On August 9, 1999, the United States Tax Court held that we were liable for tax on income of Overseas Partners Ltd., a Bermuda company that had reinsured excess value (“EV”) insurance purchased by our customers beginning in 1984, and that we were liable for additional tax for the 1983 and 1984 tax years. The IRS took similar positions to those advanced in the Tax Court decision for tax years subsequent to 1984 through 1998. On June 20, 2001, the U.S. Court of Appeals for the Eleventh Circuit ruled in our favor and reversed the Tax Court decision. In January 2003, we and the IRS finalized settlement of all outstanding tax issues related to EV package insurance. Under the terms of settlement, we agreed to adjustments that will result in income tax due of approximately $562 million, additions to tax of $60 million and related interest. The amount due to the IRS as a result of the settlement is less than amounts we previously had accrued. As a result, we recorded income, before taxes, of $1.023 billion ($776 million after tax) during the fourth quarter of 2002. In the first quarter of 2004, we received a refund of $185 million pertaining to the 1983 and 1984 tax years.

The IRS had proposed adjustments, unrelated to the EV package insurance matters discussed above, regarding the allowance of deductions and certain losses, the characterization of expenses as capital rather than ordinary, the treatment of certain income, and our entitlement to tax credits in the 1985 through 1998 tax years. In the third quarter of 2004, we settled all outstanding issues related to each of the tax years 1991 through 1998. In the fourth quarter of 2004, we received a refund of $425 million pertaining to the 1991 through 1998 tax years. We expect to receive the $371 million of refunds related to the 1985 through 1990 tax years within the next six months.

The IRS may take similar positions with respect to some of the non-EV package insurance matters for each of the years 1999 through 2004. If challenged, we expect that we will prevail on substantially all of these issues. Specifically, we believe that our practice of expensing the items that the IRS alleges should have been capitalized is consistent with the practices of other industry participants. We believe that the eventual resolution of these issues will not have a material adverse effect on our financial condition, results of operations or liquidity.

We were named as a defendant in twenty-three now-dismissed lawsuits that sought to hold us liable for the collection of premiums for EV insurance in connection with package shipments since 1984. Based on state and federal tort, contract and statutory claims, these cases generally claimed that we failed to remit collected EV premiums to an independent insurer; we failed to provide promised EV insurance; we acted as an insurer without complying with state insurance laws and regulations; and the price for EV insurance was excessive. These actions were all filed after the August 9, 1999 U.S. Tax Court decision, discussed above, which the U.S. Court of Appeals for the Eleventh Circuit later reversed.

These twenty-three cases were consolidated for pre-trial purposes in a multi-district litigation proceeding ("MDL Proceeding") in federal court in New York. In addition to the cases in which UPS was named as a defendant, there also was an action, Smith v. Mail Boxes Etc., against Mail Boxes Etc. and its franchisees relating to UPS EV insurance and related services purchased through Mail Boxes Etc. centers. That case also was consolidated into the MDL Proceeding.

In late 2003, the parties reached a global settlement resolving all claims and all cases in the MDL proceeding. In reaching the settlement, we and the other defendants expressly denied any and all liability. On July 30, 2004, the court issued an order granting final approval to the substantive terms of the settlement. No appeals were filed and the settlement became effective on September 8, 2004.

Pursuant to the settlement, UPS has provided qualifying settlement class members with vouchers toward the purchase of specified UPS services and will pay the plaintiffs' attorneys' fees, the total amount of which still remains to be determined by the court. Other defendants have contributed to the costs of the settlement, including the attorneys' fees. The ultimate cost to us of the proposed settlement will depend on a number of factors, including how many vouchers settlement class members actually use. We do not believe that this proposed settlement will have a material effect on our financial condition, results of operations, or liquidity.

We are a defendant in a number of lawsuits filed in state 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 California state court, plaintiffs allege that they improperly were denied overtime, penalties for missed meal and rest periods, interest and attorneys' fees. Plaintiffs purport to represent a class of 1,200 full-time supervisors.

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.

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 cash flows could result from our participation in these plans.

Due to the events of September 11, 2001, increased security requirements for air carriers may be forthcoming; however, we do not anticipate that such measures will have a material adverse effect on our financial condition, results of operations, or liquidity. In addition, our insurance premiums have risen and we have taken several actions, including self-insuring certain risks, to mitigate the expense increase.

As of December 31, 2004, we had approximately 229,000 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. The majority of our pilots are employed under a collective bargaining agreement with the Independent Pilots Association, which became amendable January 1, 2004. Negotiations are ongoing with the assistance of the National Mediation Board. 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.

Market Risk

We are exposed to market risk from changes in certain commodity prices, foreign currency exchange rates, interest rates, and equity prices. All of these market risks arise 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 following analysis provides quantitative information regarding our exposure to commodity price risk, foreign currency exchange risk, interest rate risk, and equity price risk. We utilize valuation models to evaluate the sensitivity of the fair value of financial instruments with exposure to market risk that assume instantaneous, parallel shifts in exchange rates, interest rate yield curves, and commodity and equity prices. For options and instruments with non-linear returns, models appropriate to the instrument are utilized to determine the impact of market shifts. There are certain limitations inherent in the sensitivity analyses presented, primarily due to the assumption that exchange rates change in a parallel fashion and that interest rates change instantaneously. In addition, the analyses are unable to reflect the complex market reactions that normally would arise from the market shifts modeled.

A discussion of our accounting policies for derivative instruments and further disclosures are provided in Note 16 to the consolidated financial statements.

Commodity Price Risk

We are exposed to an increase in the prices of refined fuels, principally jet-A, diesel, and unleaded gasoline, which are used in the transportation of packages. Additionally, we are exposed to an increase in the prices of other energy products, primarily natural gas and electricity, used in our operating facilities throughout the world. We use a combination of options, swaps, and futures contracts to provide some protection from rising fuel and energy prices. These derivative instruments generally cover forecasted fuel and energy consumption for periods of one to three years. The net fair value of such contracts subject to price risk, excluding the underlying exposures, as of December 31, 2004 and 2003 was an asset of $101 and $30 million, respectively. The potential loss in the fair value of these derivative contracts, assuming a hypothetical 10% change in the underlying commodity price, would be approximately $32 and $17 million at December 31, 2004 and 2003, respectively. This amount excludes the offsetting impact of the price risk inherent in the physical purchase of the underlying commodities.

Foreign Currency Exchange Risk

We have foreign currency risks related to our revenue, operating expenses, and financing transactions in currencies other than the local currencies in which we operate. We are exposed to currency risk from the potential changes in functional currency values of our foreign currency-denominated assets, liabilities, and cash flows. Our most significant foreign currency exposures relate to the Euro, the British Pound Sterling and the Canadian Dollar. We use a combination of purchased and written options and forward contracts to hedge cash flow currency exposures. These derivative instruments generally cover forecasted foreign currency exposures for periods up to one year. As of December 31, 2004 and 2003, the net fair value of the hedging instruments described above was a liability of $(28) and $(48) million, respectively. The potential loss in fair value for such instruments from a hypothetical 10% adverse change in quoted foreign currency exchange rates would be approximately $117 and $97 million at December 31, 2004 and 2003, respectively. This sensitivity analysis assumes a parallel shift in the foreign currency exchange rates. Exchange rates rarely move in the same direction. The assumption that exchange rates change in a parallel fashion may overstate the impact of changing exchange rates on assets and liabilities denominated in a foreign currency.

Interest Rate Risk

As described in Note 8 to the consolidated financial statements, we have issued debt instruments, including debt associated with capital leases, that accrue expense at fixed and floating rates of interest. We use a combination of derivative instruments, including interest rate swaps and cross-currency interest rate swaps, as part of our program to manage the fixed and floating interest rate mix of our total debt portfolio and related overall cost of borrowing. These swaps are generally entered into concurrently with the issuance of the debt that they are intended to modify, and the notional amount, interest payment, and maturity dates of the swaps match the terms of the associated debt.

Our floating rate debt and interest rate swaps subject us to risk resulting from changes in short-term (primarily LIBOR) interest rates. The potential change in annual interest expense resulting from a hypothetical 100 basis point change in short-term interest rates applied to our floating rate debt and swap instruments at December 31, 2004 and 2003 would be approximately $29 and $25 million, respectively.

As described in Note 1 and Note 2 to the consolidated financial statements, we have certain investments in debt, auction rate, and preferred securities that accrue income at variable rates of interest. The potential change in annual investment income resulting from a hypothetical 100 basis point change in interest rates applied to our investments exposed to variable interest rates at December 31, 2004 and 2003 would be approximately $45 and $31 million, respectively.

Additionally, as described in Note 3 to the consolidated financial statements, we hold a portfolio of finance receivables that accrue income at fixed and floating rates of interest. The potential change in the annual income resulting from a hypothetical 100 basis point change in interest rates applied to our variable rate finance receivables at December 31, 2004 and 2003 would be immaterial.

This interest rate sensitivity analysis assumes interest rate changes are instantaneous, parallel shifts in the yield curve. In reality, interest rate changes are rarely instantaneous or parallel. While this is our best estimate of the impact of the specified interest rate scenarios, these estimates should not be viewed as forecasts. We adjust the fixed and floating interest rate mix of our interest rate sensitive assets and liabilities in response to changes in market conditions.

Equity Price Risk

We hold investments in various common equity securities that are subject to price risk, and for certain of these securities, we utilize options to hedge this price risk. At December 31, 2004 and 2003, the fair value of such investments was $77 and $95 million, respectively. The potential change in the fair value of such investments, assuming a 10% change in equity prices net of the offsetting impact of any hedges, would be approximately $8 and $10 million at December 31, 2004 and 2003.

Credit Risk

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.

New Accounting Pronouncements

In December 2004, the FASB issued Statement No. 123 (revised 2004), "Share-Based Payment" ("FAS 123R"), which replaces FAS 123 and supercedes APB 25. FAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values, beginning with the first interim or annual period after June 15, 2005, with early adoption encouraged. We will adopt FAS 123R in the third quarter of 2005, using the prospective method of adoption. The prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of FAS 123R. There will be no impact upon adoption, as we will already be expensing all unvested option and restricted stock awards.

In December 2004, the FASB issued FASB Staff Position ("FSP") No. 109-2, "Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004" ("FSP 109-2"). FSP 109-2 provides guidance under FAS 109 with respect to recording the potential impact of the repatriation provisions of the American Jobs Creation Act of 2004 (the "Jobs Act") on enterprises' income tax expense and deferred tax liability. The Jobs Act was enacted on October 22, 2004. FSP 109-2 states that an enterprise is allowed time beyond the financial reporting period of enactment to evaluate the effect of the Jobs Act on its plan for reinvestment or repatriation of foreign earnings for purposes of applying FAS 109. We have not yet completed our evaluation of the impact of the repatriation provisions of the Jobs Act. Accordingly, as provided for in FSP 109-2, we have not adjusted our income tax provision or deferred tax liabilities to reflect the repatriation provisions of the Jobs Act.

The adoption of the following recent accounting pronouncements did not have a material impact on our results of operations or financial condition:

- FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others—An Interpretation of FASB Statements No. 5, 57, and 107 and Rescission of FASB Interpretation No. 34";
- FASB Interpretation No. 46(R), "Consolidation of Variable Interest Entities—An Interpretation of ARB No. 51";
- FASB Statement No. 132(R) (revised 2003), "Employer's Disclosures about Pensions and Other Post-Retirement Benefits—An Amendment of FASB Statements No. 87, 88, and 106";
- FASB Statement No. 146, "Accounting for Costs Associated with Exit or Disposal Activities";
- FASB Statement No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities";
- FASB Statement No. 150, "Accounting for Certain Instruments with Characteristics of Both Liabilities and Equity"; and
- FSP 106-2, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003".

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which are prepared in accordance with accounting principles generally accepted in the United States of America. As indicated in Note 1 to our consolidated financial statements, the amounts of assets, liabilities, revenue, and expenses reported in our financial statements are affected by estimates and judgments that are necessary to comply with generally accepted accounting principles. We base our estimates on prior experience and other assumptions that we consider reasonable to our circumstances. Actual results could differ from our estimates, which would affect the related amounts reported in our financial statements. While estimates and judgments are applied in arriving at many reported amounts, we believe that the following matters may involve a higher degree of judgment and complexity.

Contingencies—As discussed in Note 10 to our consolidated financial statements, we are involved in various legal proceedings and contingencies. We have recorded liabilities for these matters in accordance with Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies" ("FAS 5"). FAS 5 requires a liability to be recorded based on our estimate of the probable cost of the resolution of a contingency. The actual resolution of these contingencies may differ from our estimates. If a contingency is settled for an amount greater than our estimate, a future charge to income would result. Likewise, if a contingency is settled for an amount that is less than our estimate, a future credit to income would result.

Goodwill Impairment—The Financial Accounting Standards Board issued Statement No. 142, "Goodwill and Other Intangible Assets" ("FAS 142"), in June 2001. As a result of the issuance of this standard, goodwill is no longer amortized, but is subjected to annual impairment testing. Goodwill impairment testing requires that we estimate the fair value of our goodwill and compare that estimate to the amount of goodwill recorded on our balance sheet. The estimation of fair value requires that we make judgments concerning future cash flows and appropriate discount rates. Our estimate of the fair value of goodwill could change over time based on a variety of factors, including the actual operating performance of the underlying reporting units. Upon adoption of FAS 142, we recorded a non-cash impairment charge of $72 million ($0.06 per diluted share), as of January 1, 2002, related to our Mail Technologies business. The primary factor resulting in the impairment charge was the lower than anticipated growth experienced in the expedited mail delivery business. In conjunction with our annual test of goodwill in 2002, we recorded an additional impairment charge of $2 million related to our Mail Technologies business, resulting in total goodwill impairment of $74 million for 2002. Our annual impairment tests performed in 2003 and 2004 resulted in no goodwill impairment. As of December 31, 2004, our recorded goodwill was $1.255 billion.

Self-Insurance Accruals—We self-insure costs associated with workers' compensation claims, automotive liability, health and welfare, and general business liabilities, up to certain limits. Insurance reserves are established for estimates of the loss that we will ultimately incur on reported claims, as well as estimates of claims that have been incurred but not yet reported. Recorded balances are based on reserve levels determined by outside actuaries, who incorporate historical loss experience and judgments about the present and expected levels of cost per claim. Trends in actual experience are a significant factor in the determination of such reserves. We believe our estimated reserves for such claims are adequate, but actual experience in claim frequency and/or severity could materially differ from our estimates and affect our results of operations.

Pension and Postretirement Medical Benefits—The Company's pension and other postretirement benefit costs are calculated using various actuarial assumptions and methodologies as prescribed by Statement of Financial Accounting Standards No. 87, "Employers' Accounting for Pensions" and Statement of Financial Accounting Standards No. 106, "Employers' Accounting for Postretirement Benefits Other than Pensions." These assumptions include discount rates, health care cost trend rates, inflation, rate of compensation increases, expected return on plan assets, mortality rates, and other factors. Actual results that differ from our assumptions are accumulated and amortized over future periods and, therefore, generally affect our recognized expense and recorded obligation in such future periods. We believe that the assumptions utilized in recording the obligations under our plans are reasonable based on input from our outside actuaries and other advisors and information as to historical experience and performance. Differences in actual experience or changes in assumptions may affect our pension and other postretirement obligations and future expense.

Financial Instruments—As discussed in Notes 2, 3, 8, and 16 to our consolidated financial statements, and in the "Market Risk" section of this report, we hold and issue financial instruments that contain elements of market risk. Certain of these financial instruments are required to be recorded at fair value. Fair values are based on listed market prices, when such prices are available. To the extent that listed market prices are not available, fair value is determined based on other relevant factors, including dealer price quotations. Certain financial instruments, including over-the-counter derivative instruments, are valued using pricing models that consider, among other factors, contractual and market prices, correlations, time value, credit spreads, and yield curve volatility factors.

Changes in the fixed income, equity, foreign exchange, and commodity markets will impact our estimates of fair value in the future, potentially affecting our results of operations.

Depreciation, Residual Value, and Impairment of Fixed Assets—As of December 31, 2004, we had approximately $14.0 billion of net fixed assets, the most significant category of which is aircraft. In accounting for fixed assets, we make estimates about the expected useful lives and the expected residual values of the assets, and the potential for impairment based on the fair values of the assets and the cash flows generated by these assets.

In estimating the lives and expected residual values of aircraft, we have relied upon actual experience with the same or similar aircraft types. Subsequent revisions to these estimates could be caused by changes to our maintenance program, changes in the utilization of the aircraft, governmental regulations on aging aircraft, and changing market prices of new and used aircraft of the same or similar types. We periodically evaluate these estimates and assumptions, and adjust the estimates and assumptions as necessary. Adjustments to the expected lives and residual values are accounted for on a prospective basis through depreciation expense.

When appropriate, we evaluate our fixed assets for impairment. Factors that would indicate potential impairment may include, but are not limited to, a significant change in the extent to which an asset is utilized, a significant decrease in the market value of an asset, and operating or cash flow losses associated with the use of the asset.

In December 2003, we permanently removed from service a number of Boeing 727 and McDonnell Douglas DC-8 aircraft. As a result, we conducted an impairment evaluation, which resulted in a $75 million impairment charge during the fourth quarter for these aircraft (including the related engines), $69 million of which impacted the U.S. domestic package segment and $6 million of which impacted the international package segment.

In December 2004, we permanently removed from service a number of Boeing 727, 747 and McDonnell Douglas DC-8 aircraft. As a result of the actual and planned retirement of these aircraft, we conducted an impairment evaluation, which resulted in a $110 million impairment charge during the fourth quarter for these aircraft (including the related engines and parts), $91 million of which impacted the U.S. domestic package segment and $19 million of which impacted the international package segment.

These charges are classified in the caption “other expenses” within other operating expenses (see Note 13 to the consolidated financial statements). UPS continues to operate all of its other aircraft and continues to experience positive cash flow.

Income Taxes—We operate in numerous countries around the world and are subject to income taxes in many jurisdictions. We estimate our annual effective income tax rate based on statutory income tax rates in these jurisdictions and taking into consideration items that are treated differently for financial reporting and tax purposes. The process of estimating our effective income tax rate involves judgments related to tax planning and expectations regarding future events. The increasing profitability of our International segment increases the significance of our non-U.S. income tax provision to our overall effective income tax rate. We recognize deferred tax assets for items that will generate tax deductions or credits in future years. Realization of deferred tax assets requires sufficient future taxable income (subject to any carry-forward limitations) in the applicable jurisdictions. We make judgments regarding the realizability of deferred tax assets based, in part, on estimates of future taxable income. A valuation allowance is established for the portion, if any, of the deferred tax assets that we conclude cannot be realized. Income tax related contingency matters also affect our effective income tax rate. In this regard, we make judgments related to the identification and quantification of income tax related contingency matters.

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,” “we see,” 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.

Risk Factors

The following are some of the factors that could cause our actual results to differ materially from the expected results described in our forward-looking statements:

- The effect of general economic and other conditions in the markets in which we operate, both in the United States and internationally. Our operations in international markets are also affected by currency exchange and inflation risks.
- The impact of competition on a local, regional, national, and international basis. Our competitors include the postal services of the U.S. and other nations, various motor carriers, express companies, freight forwarders, air couriers and others. Our industry is undergoing rapid consolidation, and the combining entities are competing aggressively for business.
- The impact of complex and stringent aviation, transportation, environmental, labor, employment and other governmental laws and regulations, and the impact of new laws and regulations that may result from increased security concerns following the events of September 11, 2001. Our failure to comply with applicable laws, ordinances or regulations could result in substantial fines or possible revocation of our authority to conduct our operations.
- Strikes, work stoppages and slowdowns by our employees. Such actions may affect our ability to meet our customers needs, and customers may do more business with competitors if they believe that such actions may adversely affect our ability to provide service. We may face permanent loss of customers if we are unable to provide uninterrupted service. The terms of future collective bargaining agreements also may affect our competitive position and results of operations.
- Possible disruption of supplies, or an increase in the prices, of gasoline, diesel and jet fuel for our aircraft and delivery vehicles as a result of war or other factors. We require significant quantities of fuel and are exposed to the commodity price risk associated with variations in the market price for petroleum products.
- Cyclical and seasonal fluctuations in our operating results due to decreased demand for our services.

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

INDEX TO FINANCIAL STATEMENTS AND FINANCIAL STATEMENT SCHEDULES

Item 8—Financial Statements

Management's Report on Internal Control Over Financial Reporting

UPS management is responsible for establishing and maintaining adequate internal controls over financial reporting for United Parcel Service, Inc. and subsidiaries ("the Company"). Based on the criteria for effective internal control over financial reporting established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission, management has assessed the Company's internal control over financial reporting as effective as of December 31, 2004. The scope of management's assessment of the effectiveness of internal control over financial reporting includes all of the Company's businesses except for Menlo Worldwide Forwarding, a business acquired on December 20, 2004. Menlo constituted less than 3% of total assets as of December 31, 2004 and less than 1% of total revenue and net income for the year then ended. Further discussion of this acquisition can be found in Note 7 to our consolidated financial statements. The registered independent public accounting firm of Deloitte & Touche LLP, as auditors of the consolidated balance sheet of United Parcel Service, Inc. and its subsidiaries as of December 31, 2004 and the related consolidated statements of income, shareowners' equity and cash flows for the year ended December 31, 2004, has issued an attestation report on management's assessment of the Company's internal control over financial reporting.

United Parcel Service, Inc.
March 14, 2005

Report of Independent Registered Public Accounting Firm on Internal Control over Financial Reporting

Board of Directors and Shareowners
United Parcel Service, Inc.
Atlanta, Georgia

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that United Parcel Service, Inc. and its subsidiaries (the "Company") maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. As described in Management's Report on Internal Control over Financial Reporting, management excluded from their assessment the internal control over financial reporting at Menlo Worldwide Forwarding, Inc., which was acquired on December 20, 2004 and whose financial statements reflect total assets and revenues constituting less than 3% and 1%, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 2004. Accordingly, our audit did not include the internal control over financial reporting at Menlo Worldwide Forwarding, Inc. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of United Parcel Service, Inc. and its subsidiaries as of December 31, 2004, and the related consolidated statements of income, shareowners equity, and cash flows for the year ended December 31, 2004 of the Company and our report dated March 14, 2005 expressed an unqualified opinion on those financial statements.

Deloitte & Touche LLP

Atlanta, Georgia
March 14, 2005

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareowners
United Parcel Service, Inc.
Atlanta, Georgia

We have audited the accompanying consolidated balance sheets of United Parcel Service, Inc. and its subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of income, shareowners' equity, and cash flows for each of the three years in the period ended December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of United Parcel Service, Inc. and its subsidiaries at December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America.

As described in Note 1 to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets," effective January 1, 2002; and began applying prospectively the provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," effective January 1, 2003.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2004, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 14, 2005 expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Deloitte & Touche LLP

Atlanta, Georgia
March 14, 2005
(May 16, 2005 as to Notes 12 and 18)

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
(In millions, except per share amounts)

	December 31, 2004	December 31, 2003
ASSETS		
Current Assets:		
Cash & cash equivalents	$ 739	$ 1,064
Marketable securities & short-term investments	4,458	2,888
Accounts receivable, net	5,156	4,004
Finance receivables, net	524	840
Income tax receivable	371	—
Deferred income taxes	392	316
Other current assets	965	847
Total Current Assets	12,605	9,959
Property, Plant & Equipment—at cost, net of accumulated depreciation & amortization of $13,505 and $12,516 in 2004 and 2003	13,973	13,298
Prepaid Pension Costs	3,160	2,922
Goodwill and Intangible Assets, Net	1,924	1,883
Other Assets	1,364	1,672
	$33,026	$29,734
LIABILITIES AND SHAREOWNERS' EQUITY		
Current Liabilities:		
Current maturities of long-term debt and commercial paper	$ 1,187	$ 674
Accounts payable	2,312	2,003
Accrued wages & withholdings	1,197	1,166
Dividends payable	315	282
Other current liabilities	1,518	1,499
Total Current Liabilities	6,529	5,624
Long-Term Debt	3,261	3,149
Accumulated Postretirement Benefit Obligation, Net	1,470	1,335
Deferred Taxes, Credits & Other Liabilities	5,382	4,774
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 515 and 571 in 2004 and 2003	5	6
Class B common stock, par value $.01 per share, authorized 5,600 shares, issued 614 and 560 in 2004 and 2003	6	5
Additional paid-in capital	417	662
Retained earnings	16,192	14,356
Accumulated other comprehensive loss	(236)	(177)
Deferred compensation obligations	169	136
	16,553	14,988
Less: Treasury stock (3 and 2 shares in 2004 and 2003)	(169)	(136)
	16,384	14,852
	$33,026	$29,734

See notes to consolidated financial statements.

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

STATEMENTS OF CONSOLIDATED INCOME
(In millions, except per share amounts)

	Years Ended December 31, 2004	2003	2002
Revenue	$36,582	$33,485	$31,272
Operating Expenses:			
Compensation and benefits	20,916	19,328	17,940
Other	10,677	9,712	9,236
	31,593	29,040	27,176
Operating Profit	4,989	4,445	4,096
Other Income and (Expense):			
Investment income	82	18	63
Interest expense	(149)	(121)	(173)
Gain on redemption of long-term debt	—	28	—
Tax assessment reversal	—	—	1,023
	(67)	(75)	913
Income Before Income Taxes And Cumulative Effect of Change In Accounting Principle	4,922	4,370	5,009
Income Taxes	1,589	1,472	1,755
Income Before Cumulative Effect of Change In Accounting Principle	3,333	2,898	3,254
Cumulative Effect of Change In Accounting Principle, Net of Taxes	—	—	(72)
Net Income	$ 3,333	$ 2,898	$ 3,182
Basic Earnings Per Share Before Cumulative Effect Of Change In Accounting Principle	$ 2.95	$ 2.57	$ 2.91
Basic Earnings Per Share	$ 2.95	$ 2.57	$ 2.84
Diluted Earnings Per Share Before Cumulative Effect Of Change In Accounting Principle	$ 2.93	$ 2.55	$ 2.87
Diluted Earnings Per Share	$ 2.93	$ 2.55	$ 2.81

See notes to consolidated financial statements.

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

STATEMENTS OF CONSOLIDATED SHAREOWNERS' EQUITY
(In millions, except per share amounts)

	2004		2003		2002	
	Shares	Dollars	Shares	Dollars	Shares	Dollars
Class A Common Stock						
Balance at beginning of year	571	$ 6	642	$ 7	772	$ 8
Common stock purchases	(12)	—	(5)	—	(10)	—
Stock award plans	12	—	12	—	11	—
Common stock issuances	3	—	2	—	2	—
Conversions of Class A to Class B common stock	(59)	(1)	(80)	(1)	(133)	(1)
Balance at end of year	515	5	571	6	642	7
Class B Common Stock						
Balance at beginning of year	560	5	482	4	349	3
Common stock purchases	(5)	—	(2)	—	—	—
Conversions of Class A to Class B common stock	59	1	80	1	133	1
Balance at end of year	614	6	560	5	482	4
Additional Paid-In Capital						
Balance at beginning of year		662		387		414
Stock award plans		677		545		477
Common stock purchases		(1,075)		(398)		(604)
Common stock issuances		153		128		100
Balance at end of year		417		662		387
Retained Earnings						
Balance at beginning of year		14,356		12,495		10,162
Net income		3,333		2,898		3,182
Dividends ($1.12, $0.92, and $0.76)		(1,262)		(1,037)		(849)
Common stock purchases		(235)		—		—
Balance at end of year		16,192		14,356		12,495
Accumulated Other Comprehensive Income						
Foreign currency translation adjustment:						
Balance at beginning of year		(56)		(328)		(269)
Aggregate adjustment for the year		(71)		272		(59)
Balance at end of year		(127)		(56)		(328)
Unrealized gain (loss) on marketable securities, net of tax:						
Balance at beginning of year		14		(34)		(21)
Current period changes in fair value (net of tax effect of $(10), $13, and $(9))		(18)		21		(16)
Reclassification to earnings (net of tax effect of $(1), $17, and $1)		(1)		27		3
Balance at end of year		(5)		14		(34)
Unrealized gain (loss) on cash flow hedges, net of tax:						
Balance at beginning of year		(72)		(26)		(49)
Current period changes in fair value (net of tax effect of $21, $(6), and $6)		37		(9)		10
Reclassification to earnings (net of tax effect of $4, $(21), and $9)		6		(37)		13
Balance at end of year		(29)		(72)		(26)
Additional minimum pension liability, net of tax:						
Balance at beginning of year		(63)		(50)		—
Minimum pension liability adjustment (net of tax effect of $(5), $(6), and $(31))		(12)		(13)		(50)
Balance at end of year		(75)		(63)		(50)
Accumulated other comprehensive income at end of year		(236)		(177)		(438)
Deferred Compensation Obligations						
Balance at beginning of year		136		84		47
Common stock held for deferred compensation obligations		33		52		37
Balance at end of year		169		136		84
Treasury Stock						
Balance at beginning of year	(2)	(136)	(1)	(84)	(1)	(47)
Common stock held for deferred compensation obligations	(1)	(33)	(1)	(52)	—	(37)
Balance at end of year	(3)	(169)	(2)	(136)	(1)	(84)

Total Shareowners' Equity at End of Year	$16,384	$14,852	$12,455
Comprehensive Income	$ 3,274	$ 3,159	$ 3,083

See notes to consolidated financial statements.

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

STATEMENTS OF CONSOLIDATED CASH FLOWS
(In millions)

	Years Ended December 31,		
	2004	2003	2002
Cash Flows From Operating Activities:			
Net income	$ 3,333	$ 2,898	$ 3,182
Adjustments to reconcile net income to net cash from operating activities:			
Depreciation and amortization	1,543	1,549	1,464
Postretirement benefits	135	84	121
Deferred taxes, credits and other	289	317	162
Stock award plans	610	497	445
Tax assessment reversal	—	—	(776)
Vacation policy change	—	—	(121)
Restructuring charge and related expenses	—	—	85
Loss (gain) on impairment or disposal of assets	129	55	19
Other (gains) losses	15	96	116
Changes in assets and liabilities, net of effect of acquisitions:			
Accounts receivable, net	(686)	(264)	312
Other assets	390	13	403
Prepaid pension costs	(238)	(990)	(87)
Accounts payable	318	66	(56)
Accrued wages and withholdings	(73)	83	112
Income taxes payable	(399)	204	16
Other current liabilities	(35)	(32)	291
Net cash from operating activities	5,331	4,576	5,688
Cash Flows From Investing Activities:			
Capital expenditures	(2,127)	(1,947)	(1,658)
Disposals of property, plant and equipment	75	118	89
Purchases of marketable securities and short-term investments	(6,322)	(8,083)	(3,833)
Sales and maturities of marketable securities and short-term investments	4,724	7,118	2,654
Net (increase) decrease in finance receivables	318	50	(495)
Cash received (paid) for business acquisitions / dispositions	(238)	8	(14)
Other investing activities	(68)	(6)	(24)
Net cash (used in) investing activities	(3,638)	(2,742)	(3,281)
Cash Flows From Financing Activities:			
Proceeds from borrowings	811	361	419
Repayments of borrowings	(468)	(1,245)	(1,099)
Purchases of common stock	(1,310)	(398)	(604)
Issuances of common stock	193	154	116
Dividends	(1,208)	(956)	(840)
Other financing activities	(32)	(26)	(82)
Net cash (used in) financing activities	(2,014)	(2,110)	(2,090)
Effect Of Exchange Rate Changes On Cash	(4)	216	(51)
Net Increase (Decrease) In Cash And Cash Equivalents	(325)	(60)	266
Cash And Cash Equivalents:			
Beginning of period	1,064	1,124	858
End of period	$ 739	$ 1,064	$ 1,124
Cash Paid During The Period For:			
Interest (net of amount capitalized)	$ 120	$ 126	$ 190
Income taxes	$ 2,037	$ 1,097	$ 1,416

See notes to consolidated financial statements.

NOTE 1. SUMMARY OF ACCOUNTING POLICIES

Basis of Financial Statements and Business Activities

The accompanying financial statements include the accounts of United Parcel Service, Inc., and all of its consolidated subsidiaries (collectively "UPS" or the "Company"). All intercompany balances and transactions have been eliminated.

UPS concentrates its operations in the field of transportation services, primarily domestic and international letter and package delivery. Through our supply chain solutions segment, we are also a global provider of specialized transportation, logistics, and financial services.

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

Revenue Recognition

U.S. Domestic and International Package Operations—Revenue is recognized upon delivery of a letter or package.

Supply Chain Solutions—Revenue is recognized as follows:

Freight services and logistics—Freight forwarding revenue and the expense related to the transportation of freight is recognized at the time the services are performed in accordance with EITF 99-19 "Reporting Revenue Gross as a Principal Versus Net as an Agent". Material management and distribution revenue is recognized upon performance of the service provided. Customs brokerage revenue is recognized upon completing documents necessary for customs entry purposes.

Financial services—Income on loans and direct finance leases is recognized on the effective interest method. Accrual of interest income is suspended at the earlier of the time at which collection of an account becomes doubtful or the account becomes 90 days delinquent. Income on operating leases is recognized on the straight-line method over the terms of the underlying leases.

Cash and Cash Equivalents

Cash and cash equivalents consist of highly liquid investments that are readily convertible into cash. We consider securities with maturities of three months or less, when purchased, to be cash equivalents. The carrying amount of these securities approximates fair value because of the short-term maturity of these instruments.

In 2004, we began classifying all auction rate preferred and debt instruments as marketable securities. Previously, such securities were classified as cash equivalents if the auction reset periods were three months or less. Auction rate securities held at December 31, 2003 totaling $1.887 billion were reclassified from cash equivalents into marketable securities for consistent presentation on our consolidated balance sheet.

Marketable Securities and Short-Term Investments

Marketable securities are classified as available-for-sale and are carried at fair value, with related unrealized gains and losses reported, net of tax, as accumulated other comprehensive income ("OCI"), a separate component of shareowners' equity. The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and accretion is included in investment income, along with interest and dividends. The cost of securities sold is based on the specific identification method; realized gains and losses resulting from such sales are included in investment income.

Investment securities are reviewed for impairment in accordance with FASB Statement No. 115 “Accounting for Certain Investments in Debt and Equity Securities” and EITF 03-01 “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments.” We periodically review our investments for indications of other than temporary impairment considering many factors, including the extent and duration to which a security’s fair value has been less than its cost, overall economic and market conditions, and the financial condition and specific prospects for the issuer. Impairment of investment securities results in a charge to income when a market decline below cost is other than temporary.

Property, Plant and Equipment

Property, plant and equipment are carried at cost. Depreciation and amortization are provided by the straight-line method over the estimated useful lives of the assets, which are as follows: Vehicles—9 years; Aircraft—12 to 20 years; Buildings—20 to 40 years; Leasehold Improvements—lives of leases; Plant Equipment—8 1/3 years; Technology Equipment—3 to 5 years. The costs of major airframe and engine overhauls, as well as routine maintenance and repairs, are charged to expense as incurred.

Interest incurred during the construction period of certain property, plant and equipment is capitalized until the underlying assets are placed in service, at which time amortization of the capitalized interest begins, straight-line, over the estimated useful lives of the related assets. Capitalized interest was $25 million for each of the years 2004, 2003, and 2002, respectively.

Impairment of Long-Lived Assets

In accordance with the provisions of FASB Statement No. 144 “Accounting for the Impairment or Disposal of Long-Lived Assets,” we review long-lived assets for impairment when circumstances indicate the carrying amount of an asset may not be recoverable based on the undiscounted future cash flows of the asset. If the carrying amount of the asset is determined not to be recoverable, a write-down to fair value is recorded. Fair values are determined based on quoted market values, discounted cash flows, or external appraisals, as applicable. We review long-lived assets for impairment at the individual asset or the asset group level for which the lowest level of independent cash flows can be identified.

In December 2003, we permanently removed from service a number of Boeing 727 and McDonnell Douglas DC-8 aircraft. As a result, we conducted an impairment evaluation, which resulted in a $75 million impairment charge during the fourth quarter for these aircraft (including the related engines), $69 million of which impacted the U.S. domestic package segment and $6 million of which impacted the international package segment.

In December 2004, we permanently removed from service a number of Boeing 727, 747 and McDonnell Douglas DC-8 aircraft. As a result of the actual and planned retirement of these aircraft, we conducted an impairment evaluation, which resulted in a $110 million impairment charge during the fourth quarter for these aircraft (including the related engines and parts), $91 million of which impacted the U.S. domestic package segment and $19 million of which impacted the international package segment.

These charges are classified in the caption “other expenses” within other operating expenses (see Note 13). UPS continues to operate all of its other aircraft and continues to experience positive cash flow.

Goodwill and Intangible Assets

Costs of purchased businesses in excess of net assets acquired (goodwill), and intangible assets are accounted for under the provisions of FASB Statement No. 142 “Goodwill and Other Intangible Assets” (“FAS 142”). Upon adoption of FAS 142, we were required to test all existing goodwill for impairment as of January 1, 2002, and at least annually thereafter, unless changes in circumstances indicate an impairment may have occurred sooner. We are required to test goodwill on a “reporting unit” basis. A reporting unit is the operating segment unless, for businesses within that operating segment, discrete financial information is prepared and regularly reviewed by management, in which case such a component business is the reporting unit.

A fair value approach is used to test goodwill for impairment. An impairment charge is recognized for the amount, if any, by which the carrying amount of goodwill exceeds its fair value. Fair values are established using discounted cash flows. When available and as appropriate, comparative market multiples were used to corroborate discounted cash flow results.

We recorded a non-cash goodwill impairment charge of $72 million ($0.06 per diluted share) as of January 1, 2002, related to our Mail Technologies business. This charge was reported as a cumulative effect of a change in accounting principle. The primary factor resulting in the impairment charge was the lower than anticipated growth experienced in the expedited mail delivery business. In conjunction with our annual test of goodwill in 2002, we recorded an additional impairment charge of $2 million related to our Mail Technologies business, resulting in total goodwill impairment of $74 million for 2002. We sold the Mail Technologies business unit during the second quarter of 2003 (see Note 7). Our annual impairment tests performed in 2004 and 2003 resulted in no goodwill impairment.

Finite-lived intangible assets, including trademarks, licenses, patents, and franchise rights are amortized over the estimated useful lives of the assets, which range from 5 to 20 years. Capitalized software is amortized over periods ranging from 3 to 5 years. In 2004, we began classifying software as intangible assets. Previously, capitalized software was classified within property, plant and equipment. Capitalized software at December 31, 2003 totaling $610 million was reclassified from property, plant and equipment into intangible assets for consistent presentation on our consolidated balance sheet.

Self-Insurance Accruals

We self-insure costs associated with workers' compensation claims, automotive liability, health and welfare, and general business liabilities, up to certain limits. Insurance reserves are established for estimates of the loss that we will ultimately incur on reported claims, as well as estimates of claims that have been incurred but not yet reported. Recorded balances are based on reserve levels determined by outside actuaries, who incorporate historical loss experience and judgments about the present and expected levels of cost per claim.

Income Taxes

Income taxes are accounted for under FASB Statement No. 109, "Accounting for Income Taxes" ("FAS 109"). FAS 109 is an asset and liability approach that requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in our financial statements or tax returns. In estimating future tax consequences, FAS 109 generally considers all expected future events other than proposed changes in the tax law or rates. Valuation allowances are provided if it is more likely than not that a deferred tax asset will not be realized.

We record accruals for tax contingencies related to potential assessments by tax authorities. Such accruals are based on management's judgment and best estimate as to the ultimate outcome of any potential tax audits. Actual tax audit results could vary from these estimates.

Foreign Currency Translation

We translate the results of operations of our foreign subsidiaries using average exchange rates during each period, whereas balance sheet accounts are translated using exchange rates at the end of each period. Balance sheet currency translation adjustments are recorded in OCI. Net currency transaction gains and losses included in other operating expenses were pre-tax gains of $44, $21, and $27 million in 2004, 2003 and 2002, respectively.

Stock-Based Compensation

Effective January 1, 2003, we adopted the fair value measurement provisions of FASB Statement No. 123 "Accounting for Stock-Based Compensation" ("FAS 123"). In years prior to 2003, we used the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"). Under APB 25, we did not have to recognize compensation expense for our stock option grants and our discounted stock purchase plan, however we did recognize compensation expense for our management incentive awards and certain other stock awards (see Note 11 for a description of these plans).

Under the provisions of FASB Statement No. 148 "Accounting for Stock-Based Compensation—Transition and Disclosure," we have elected to adopt the measurement provisions of FAS 123 using the prospective method. Under this approach, all stock-based compensation granted subsequent to January 1, 2003 will be expensed to compensation and benefits over the vesting period based on the fair value at the date the stock-based compensation is granted. Stock compensation awards granted to date include stock options, management incentive awards, restricted performance units, and employer matching contributions (in shares of UPS stock) for a defined contribution benefit plan. The adoption of the measurement provisions of FAS 123 reduced 2004 and 2003 net income by $35 million ($0.03 per diluted share) and $20 million ($0.02 per diluted share), respectively.

The following provides pro forma information as to the impact on net income and earnings per share if we had used the fair value measurement provisions of FAS 123 to account for all stock-based compensation awards granted prior to January 1, 2003 (in millions, except per share amounts).

	2004	2003	2002
Net income	$3,333	$2,898	$3,182
Add: Stock-based employee compensation expense included in net income, net of tax effects	563	456	391
Less: Total pro forma stock-based employee compensation expense, net of tax effects	(588)	(507)	(459)
Pro forma net income	$3,308	$2,847	$3,114
Basic earnings per share			
As reported	$ 2.95	$ 2.57	$ 2.84
Pro forma	$ 2.93	$ 2.52	$ 2.78
Diluted earnings per share			
As reported	$ 2.93	$ 2.55	$ 2.81
Pro forma	$ 2.91	$ 2.50	$ 2.75

The fair value of each option grant is estimated using the Black-Scholes option pricing model. Compensation cost is also measured for the fair value of employees' purchase rights under our discounted stock purchase plan using the Black-Scholes option pricing model. The weighted-average assumptions used, by year, and the calculated weighted average fair value of options and employees' purchase rights granted, are as follows:

	2004	2003	2002
Stock options:			
Expected dividend yield	1.50%	1.22%	1.10%
Risk-free interest rate	4.31%	3.70%	4.67%
Expected life in years	7	8	5
Expected volatility	15.69%	19.55%	20.24%
Weighted average fair value of options granted	$16.24	$17.02	$21.27
Discounted stock purchase plan:			
Expected dividend yield	1.42%	1.12%	1.10%
Risk-free interest rate	1.18%	1.06%	1.70%
Expected life in years	0.25	0.25	0.25
Expected volatility	16.83%	19.79%	20.45%
Weighted average fair value of purchase rights*	$ 9.56	$ 8.53	$ 8.20

* Includes the 10% discount from the market price (see Note 11).

Derivative Instruments

Derivative instruments are accounted for in accordance with FASB Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("FAS 133"), as amended, which requires all financial derivative instruments to be recorded on our balance sheet at fair value. Derivatives not designated as hedges must be adjusted to fair value through income. If a derivative is designated as a hedge, depending on the nature of the hedge, changes in its fair value that are considered to be effective, as defined, either offset the change in fair value of the hedged assets, liabilities, or firm commitments through income, or are recorded in OCI until the hedged item is recorded in income. Any portion of a change in a derivative's fair value that is considered to be ineffective, or is excluded from the measurement of effectiveness, is recorded immediately in income.

New Accounting Pronouncements

In December 2004, the FASB issued Statement No. 123 (revised 2004), “Share-Based Payment” (“FAS 123R”), which replaces FAS 123 and supercedes APB 25. FAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values, beginning with the first interim or annual period after June 15, 2005, with early adoption encouraged. We will adopt FAS 123R in the third quarter of 2005, using the prospective method of adoption. The prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of FAS 123R. There will be no impact upon adoption, as we will already be expensing all unvested option and restricted stock awards.

In December 2004, the FASB issued FASB Staff Position (“FSP”) No. 109-2, “Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004” (“FSP 109-2”). FSP 109-2 provides guidance under FAS 109 with respect to recording the potential impact of the repatriation provisions of the American Jobs Creation Act of 2004 (the “Jobs Act”) on enterprises’ income tax expense and deferred tax liability. The Jobs Act was enacted on October 22, 2004. FSP 109-2 states that an enterprise is allowed time beyond the financial reporting period of enactment to evaluate the effect of the Jobs Act on its plan for reinvestment or repatriation of foreign earnings for purposes of applying FAS 109. We have not yet completed our evaluation of the impact of the repatriation provisions of the Jobs Act. Accordingly, as provided for in FSP 109-2, we have not adjusted our income tax provision or deferred tax liabilities to reflect the repatriation provisions of the Jobs Act.

The adoption of the following recent accounting pronouncements did not have a material impact on our results of operations or financial condition:

- FASB Interpretation No. 45, “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others—An Interpretation of FASB Statements No. 5, 57, and 107 and Rescission of FASB Interpretation No. 34”;
- FASB Interpretation No. 46(R), “Consolidation of Variable Interest Entities—An Interpretation of ARB No. 51”;
- FASB Statement No. 132(R) (revised 2003), “Employer’s Disclosures about Pensions and Other Post-Retirement Benefits—An Amendment of FASB Statements No. 87, 88, and 106”;
- FASB Statement No. 146, “Accounting for Costs Associated with Exit or Disposal Activities”;
- FASB Statement No. 149, “Amendment of Statement 133 on Derivative Instruments and Hedging Activities”;
- FASB Statement No. 150, “Accounting for Certain Instruments with Characteristics of Both Liabilities and Equity”; and
- FSP 106-2, “Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003”.

Changes in Presentation

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

NOTE 2. MARKETABLE SECURITIES AND SHORT-TERM INVESTMENTS

The following is a summary of marketable securities and short-term investments at December 31, 2004 and 2003 (in millions):

	Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
2004				
U.S. government & agency securities	$ 269	$ 1	$ 1	$ 269
U.S. mortgage & asset-backed securities	1,042	1	1	1,042
U.S. corporate securities	446	1	1	446
U.S. state and local municipal securities	1,098	—	—	1,098
Other debt securities	2	—	—	2
Total debt securities	2,857	3	3	2,857
Common equity securities	63	14	—	77
Preferred equity securities	1,546	—	22	1,524
	$4,466	$ 17	$ 25	$ 4,458

	Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
2003				
U.S. government & agency securities	$ 151	$ 1	$ —	$ 152
U.S. mortgage & asset-backed securities	474	1	—	475
U.S. corporate securities	192	2	1	193
U.S. state and local municipal securities	561	—	—	561
Other debt securities	4	—	1	3
Total debt securities	1,382	4	2	1,384
Common equity securities	66	29	—	95
Preferred equity securities	1,418	—	9	1,409
	$2,866	$ 33	$ 11	$ 2,888

The gross realized gains on sales of marketable securities totaled $7, $21, and $11 million in 2004, 2003, and 2002, respectively. The gross realized losses totaled $5, $7, and $10 million in 2004, 2003, and 2002, respectively. Impairment losses recognized on marketable securities and short-term investments totaled $0, $58, and $5 million during 2004, 2003, and 2002, respectively.

The following table presents the age of gross unrealized losses and fair value by investment category for all securities in a loss position as of December 31, 2004 (in millions):

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. government & agency securities	$ 189	$ 1	$ 5	$ —	$194	$ 1
U.S. mortgage & asset-backed securities	111	1	2	—	113	1
U.S. corporate securities	197	1	22	—	219	1
U.S. state and local municipal securities	—	—	—	—	—	—
Other debt securities	—	—	—	—	—	—
Total debt securities	497	3	29	—	526	3
Common equity securities	—	—	—	—	—	—
Preferred equity securities	10	—	98	22	108	22
	$ 507	$ 3	$127	$ 22	$634	$ 25

The unrealized losses in the preferred equity securities relate to securities issued by the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC), and are primarily due to changes in market interest rates. Due to the periodic interest rate adjustment features on these securities, we do not consider these losses to be other-than-temporary. We have both the intent and ability to hold the securities contained in the previous table for a time necessary to recover the cost basis.

The amortized cost and estimated fair value of marketable securities and short-term investments at December 31, 2004, 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	$ 37	$ 37
Due after one year through three years	459	458
Due after three years through five years	75	75
Due after five years	2,286	2,287
	2,857	2,857
Equity securities	1,609	1,601
	$4,466	$ 4,458

NOTE 3. FINANCE RECEIVABLES

The following is a summary of finance receivables at December 31, 2004 and 2003 (in millions):

	2004	2003
Commercial term loans	$ 360	$ 438
Investment in finance leases	188	270
Asset-based lending	285	290
Receivable factoring	191	468
Gross finance receivables	1,024	1,466
Less: Allowance for credit losses	(25)	(52)
Balance at December 31	$ 999	$1,414

Outstanding receivable balances at December 31, 2004 and 2003 are net of unearned income of $35 and $48 million, respectively. When we “factor” (i.e., purchase) a customer invoice from a client, we record the customer receivable as an asset and also establish a liability for the funds due to the client, which is recorded in accounts payable on the consolidated balance sheet. The following is a reconciliation of receivable factoring balances at December 31, 2004 and 2003 (in millions):

	2004	2003
Customer receivable balances	$ 191	$ 468
Less: Amounts due to client	(112)	(195)
Net funds employed	$ 79	$ 273

Non-earning finance receivables were $38 and $67 million at December 31, 2004 and 2003, respectively. The following is a rollforward of the allowance for credit losses on finance receivables (in millions):

	2004	2003
Balance at January 1	$ 52	$ 38
Provisions charged to operations	14	39
Charge-offs, net of recoveries	(41)	(25)
Balance at December 31	$ 25	$ 52

The carrying value of finance receivables at December 31, 2004, by contractual maturity, is shown below (in millions). Actual maturities may differ from contractual maturities because some borrowers have the right to prepay these receivables without prepayment penalties.

	Carrying Value
Due in one year or less	$ 530
Due after one year through three years	81
Due after three years through five years	99
Due after five years	314
	$ 1,024

Based on interest rates for financial instruments with similar terms and maturities, the estimated fair value of finance receivables is approximately $991 million and $1.384 billion as of December 31, 2004 and 2003, respectively. At December 31, 2004, we had unfunded loan commitments totaling $344 million, consisting of standby letters of credit of $53 million and other unfunded lending commitments of $291 million.

NOTE 4. PROPERTY, PLANT AND EQUIPMENT

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

	2004	2003
Vehicles	$ 3,784	$ 3,486
Aircraft (including aircraft under capitalized leases)	11,590	10,897
Land	760	721
Buildings	2,164	2,083
Leasehold improvements	2,347	2,219
Plant equipment	4,641	4,410
Technology equipment	1,596	1,495
Equipment under operating lease	57	53
Construction-in-progress	539	450
	27,478	25,814
Less: Accumulated depreciation and amortization	(13,505)	(12,516)
	$ 13,973	$ 13,298

NOTE 5. EMPLOYEE BENEFIT PLANS

We maintain the following defined benefit pension plans (the "Plans"): UPS Retirement Plan, UPS Excess Coordinating Benefit Plan, and the UPS Pension Plan.

The UPS Retirement Plan is noncontributory and includes substantially all eligible employees of participating domestic subsidiaries who are not members of a collective bargaining unit. The Plan provides for retirement benefits based on average compensation levels earned by employees prior to retirement. Benefits payable under this Plan are subject to maximum compensation limits and the annual benefit limits for a tax qualified defined benefit plan as prescribed by the Internal Revenue Service.

The UPS Excess Coordinating Benefit Plan is a non-qualified plan that provides benefits to participants in the UPS Retirement Plan for amounts that exceed the benefit limits described above.

The UPS Pension Plan is noncontributory and includes certain eligible employees of participating domestic subsidiaries and members of collective bargaining units that elect to participate in the plan. The Plan provides for retirement benefits based on service credits earned by employees prior to retirement.

Our funding policy is consistent with relevant federal tax regulations. Accordingly, our contributions are deductible for federal income tax purposes. Because the UPS Excess Coordinating Benefit Plan is non-qualified for federal income tax purposes, this plan is not funded.

We also sponsor postretirement medical plans that provide health care benefits to our retirees who meet certain eligibility requirements and who are not otherwise covered by multi-employer plans. Generally, this includes employees with at least 10 years of service who have reached age 55 and employees who are eligible for postretirement medical benefits from a Company-sponsored plan pursuant to collective bargaining agreements. We have the right to modify or terminate certain of these plans. In many cases, these benefits have been provided to retirees on a noncontributory basis; however, in certain cases, retirees are required to contribute toward the cost of the coverage.

Benefit Obligations

The following table provides a reconciliation of the changes in the plans' benefit obligations as of September 30 (in millions):

	Pension Benefits		Postretirement Medical Benefits	
	2004	2003	2004	2003
Net benefit obligation at October 1, prior year	$8,092	$6,670	$2,592	$2,149
Service cost	332	282	91	79
Interest cost	521	465	164	148
Plan participants' contributions	—	—	9	6
Plan amendments	3	3	(115)	(22)
Actuarial (gain) loss	290	876	36	337
Gross benefits paid	(201)	(204)	(129)	(105)
Net benefit obligation at September 30	$9,037	$8,092	$2,648	$2,592
Weighted-average assumptions used to determine benefit obligations:				
Discount rate	6.25%	6.25%	6.25%	6.25%
Rate of annual increase in future compensation levels	4.00%	4.00%	N/A	N/A

The accumulated benefit obligation for our pension plans as of September 30, 2004 and 2003 was $8.113 and $7.325 billion, respectively. We use a measurement date of September 30 for our pension and postretirement benefit plans.

In December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the "Act") was enacted. The Act established a prescription drug benefit under Medicare, known as "Medicare Part D", and a federal subsidy to sponsors of retiree health care plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. We believe that benefits provided to certain participants will be at least actuarially equivalent to Medicare Part D, and, accordingly may be entitled to a subsidy.

In May 2004, the FASB issued FSP 106-2, which requires (a) that the effects of the federal subsidy be considered an actuarial gain and recognized in the same manner as other actuarial gains and losses and (b) certain disclosures for employers that sponsor postretirement health care plans that provide prescription drug benefits. We determined the effects of the Act were not a significant event requiring an interim remeasurement under FAS 106. Consequently, as permitted by FSP 106-2, net periodic benefit cost for 2004 does not reflect the effects of the Act. The accumulated postretirement benefit obligation (APBO) was remeasured as of September 30, 2004 to reflect the effects of the Act, which resulted in an immaterial reduction in the APBO and expected net employer benefit payments.

Future postretirement medical benefit costs were forecasted assuming an initial annual increase of 9.0%, decreasing to 5.0% by the year 2009 and with consistent annual increases at those ultimate levels thereafter.

Assumed health care cost trends have a significant effect on the amounts reported for the postretirement medical plans. A one-percent change in assumed health care cost trend rates would have the following effects (in millions):

	1% Increase	1% Decrease
Effect on postretirement benefit obligation	$ 69	$ (75)

Because the UPS Excess Coordinating Plan is not funded, the Company has recorded an additional minimum pension liability for this plan of $91 and $105 million at December 31, 2004 and 2003, respectively. This liability is included in the other credits and non-current liabilities portion of Note 9. As of December 31, 2004 and 2003, the Company has recorded an intangible asset of $4 and $5 million, respectively, representing the net unrecognized prior service cost for this plan. A total of $55 and $63 million at December 31, 2004 and 2003, respectively, were recorded as a reduction of other comprehensive income in shareowners' equity (net of the tax effect of $32 and $37 million, respectively). The unfunded accumulated benefit obligation of the UPS Excess Coordinating Benefit Plan was $160 and $154 million as of December 31, 2004 and 2003, respectively.

Additionally, we maintain several non-U.S. defined benefit pension plans. As of December 31, 2004, we have recorded a prepaid pension asset of $5 million, an additional minimum pension liability of $30 million, and a $20 million (net of the tax effect of $11 million) reduction of other comprehensive income in shareowners' equity. The impact of these non-U.S. plans is not material to our operating results or financial position.

Plan Assets

The following table provides a reconciliation of the changes in the plans' assets as of September 30 (in millions):

	Pension Benefits		Postretirement Medical Benefits	
	2004	2003	2004	2003
Fair value of plan assets at October 1, prior year	$7,823	$6,494	$ 409	$ 337
Actual return on plan assets	1,140	1,143	51	47
Employer contributions	1,200	390	115	124
Plan participants' contributions	—	—	9	6
Gross benefits paid	(201)	(204)	(129)	(105)
Fair value of plan assets at September 30	$9,962	$7,823	$ 455	$ 409

Employer contributions and benefits paid under the pension plans include $6 million and $5 million paid from employer assets in 2004 and 2003, respectively. Employer contributions and benefits paid (net of participant contributions) under the postretirement medical benefit plans include $57 and $45 million paid from employer assets in 2004 and 2003, respectively.

The asset allocation for our pension and other postretirement plans as of September 30, 2004 and 2003 and the target allocation for 2005, by asset category, are as follows:

	Weighted Average Target Allocation 2005	Percentage of Plan Assets at September 30, 2004	2003
Equity securities	55% - 65%	60.6%	60.2%
Fixed income securities	20% - 30%	28.0%	28.5%
Real estate / other	10% - 15%	11.4%	11.3%
Total		100.0%	100.0%

Equity securities include UPS Class A shares of common stock in the amounts of $466 (4.5% of total plan assets) and $392 million (4.8% of total plan assets), as of September 30, 2004 and 2003, respectively.

The UPS benefit plan committees establish investment guidelines and strategies, and regularly monitor the performance of the funds and portfolio managers. Our investment strategy with respect to pension assets is to invest the assets in accordance with ERISA and fiduciary standards. The long-term primary objectives for our pension assets are to (1) provide for a reasonable amount of long-term growth of capital, without undue exposure to risk; and protect the assets from erosion of purchasing power, and (2) provide investment results that meet or exceed the plans' actuarially assumed long-term rate of return.

Funded Status

The funded status of the plans, reconciled to the amounts on the balance sheet, is as follows (in millions):

	Pension Benefits		Postretirement Medical Benefits	
	2004	2003	2004	2003
Fair value of plan assets at September 30	$ 9,962	$ 7,823	$ 455	$ 409
Benefit Obligation at September 30	(9,037)	(8,092)	(2,648)	(2,592)
Funded status at September 30	925	(269)	(2,193)	(2,183)
Amounts not yet recognized:				
Unrecognized net actuarial loss	1,918	2,085	810	820
Unrecognized prior service cost	297	331	(104)	11
Unrecognized net transition obligation	18	23	—	—
Employer contributions	2	752	17	17
Net asset (liability) recorded at December 31	$ 3,160	$ 2,922	$(1,470)	$(1,335)
Prepaid pension cost	$ 3,227	$ 2,970	$ —	$ —
Accrued benefit cost	(188)	(153)	(1,470)	(1,335)
Intangible asset	4	5	—	—
Accumulated other comprehensive income (pre-tax)	117	100	—	—
Net asset (liability) recorded at December 31	$ 3,160	$ 2,922	$(1,470)	$(1,335)

At September 30, 2004 and 2003, the projected benefit obligation, the accumulated benefit obligation, and the fair value of plan assets for pension plans with a projected benefit obligation in excess of plan assets and for pension plans with an accumulated benefit obligation in excess of plan assets were as follows (in millions):

	Projected Benefit Obligation Exceeds the Fair Value of Plan Assets		Accumulated Benefit Obligation Exceeds the Fair Value of Plan Assets	
	2004	2003	2004	2003
As of September 30				
Projected benefit obligation	$ 200	$ 6,772	$ 200	$ 178
Accumulated benefit obligation	$ 160	$ 6,004	$ 160	$ 154
Fair value of plan assets	$ —	$ 6,479	$ —	$ —

The accumulated postretirement benefit obligation exceeds plan assets for all of our other postretirement benefit plans.

Expected Cash Flows

Information about expected cash flows for the pension and postretirement benefit plans is as follows (in millions):

	Pension Benefits	Other Benefits
Employer Contributions:		
2005 (expected) to plan trusts	$ 723	$ 62
2005 (expected) to plan participants	7	56
Expected Benefit Payments:		
2005	$ 214	$ 126
2006	257	133
2007	266	141
2008	303	150
2009	332	158
2010 - 2014	2,363	975

Expected benefit payments for pensions will be primarily paid from plan trusts. Expected benefit payments for postretirement benefits will be paid from plan trusts and corporate assets.

Net Periodic Benefit Cost

Information about net periodic benefit cost for the pension and postretirement benefit plans is as follows (in millions):

	Pension Benefits			Postretirement Medical Benefits		
	2004	2003	2002	2004	2003	2002
Net Periodic Cost:						
Service cost	$ 332	$ 282	$ 217	$ 91	$ 79	$ 63
Interest cost	521	465	413	164	148	134
Expected return on assets	(800)	(669)	(654)	(34)	(29)	(33)
Amortization of:						
Transition obligation	6	8	8	—	—	—
Prior service cost	37	37	30	—	1	(1)
Actuarial (gain) loss	119	28	4	30	15	4
Net periodic benefit cost (benefit)	$ 215	$ 151	$ 18	$ 251	$ 214	$ 167
Weighted-average assumptions used to determine net cost:						
Discount rate	6.25%	6.75%	7.50%	6.25%	6.75%	7.50%
Rate of compensation increase	4.00%	4.00%	4.00%	N/A	N/A	N/A
Expected return on plan assets	8.96%	9.21%	9.42%	9.00%	9.25%	9.50%

The expected return on plan assets assumption was developed using various market assumptions in combination with the plans' asset allocations and active investment management. These assumptions and allocations were evaluated using input from a third-party consultant and various pension plan asset managers, including their review of asset class return expectations and long-term inflation assumptions. The 10-year U.S. Treasury yield is the foundation for all other market assumptions, and various risk premiums are added to determine the expected return for each allocation. As of our September 30, 2004 measurement date, it was projected that the funds could achieve an 8.96% net return over time, using the plans' asset allocations and active management strategy.

Assumed health care cost trends have a significant effect on the amounts reported for the postretirement medical plans. A one-percent change in assumed health care cost trend rates would have the following effects (in millions):

	1% Increase	1% Decrease
Effect on total of service cost and interest cost	$ 5	$ (5)

Other Plans

We also contribute to several multi-employer pension plans for which the previous disclosure information is not determinable. Amounts charged to operations for pension contributions to these multi-employer plans were $1.163, $1.066, and $1.028 billion during 2004, 2003, and 2002, respectively.

We also contribute to several multi-employer health and welfare plans that cover both active and retired employees for which the previous disclosure information is not determinable. Amounts charged to operations for contributions to multi-employer health and welfare plans were $761, $691, and $604 million during 2004, 2003, and 2002, respectively.

We also sponsor a defined contribution plan for all employees not covered under collective bargaining agreements. The Company matches, in shares of UPS common stock, a portion of the participating employees' contributions. Matching contributions charged to expense were $94, $87, and $79 million for 2004, 2003, and 2002, respectively.

In the fourth quarter of 2002, our vacation policy for non-union employees was amended to require that vacation pay be earned ratably throughout the year. Previously, an employee became vested in the full year of vacation pay at the beginning of each year. As a result of this policy change, a credit to compensation and benefits of $197 million was taken in the fourth quarter to reduce the vacation pay liability as of December 31, 2002.

NOTE 6. GOODWILL, INTANGIBLES, AND OTHER ASSETS

The following table indicates the allocation of goodwill by reportable segment (in millions):

	U.S. Domestic Package	International Package	Supply Chain Solutions	Consolidated
December 31, 2002 balance	$ —	$ 102	$ 968	$ 1,070
Acquired	—	—	30	30
Impaired	—	—	—	—
Currency / Other	—	(2)	75	73
December 31, 2003 balance	—	100	1,073	1,173
Acquired	—	41	38	79
Impaired	—	—	—	—
Currency / Other	—	—	3	3
December 31, 2004 balance	$ —	$ 141	$ 1,114	$ 1,255

The goodwill acquired in the supply chain solutions segment during 2004 resulted primarily from the purchase of Menlo Worldwide Forwarding. The purchase price allocation for this acquisition was not complete as of December 31, 2004, therefore we anticipate that future purchase price adjustments may change the amount allocated to goodwill. The goodwill acquired in the International package segment during 2004 resulted from the purchase of the remaining minority interest in UPS Yamato Express Co. (See Note 7 for further discussion of these acquisitions). The currency/other balance in the supply chain solutions segment includes escrow reimbursements and the resolution of other pre-acquisition contingencies from acquisitions completed prior to 2004.

The following is a summary of intangible assets at December 31, 2004 and 2003 (in millions):

	Trademarks, Licenses, Patents, and Other	Franchise Rights	Capitalized Software	Intangible Pension Asset	Total Intangible Assets
December 31, 2004:					
Gross carrying amount	$ 29	$ 97	$ 1,249	$ 4	$ 1,379
Accumulated amortization	(16)	(18)	(676)	—	(710)
Net carrying value	$ 13	$ 79	$ 573	$ 4	$ 669
December 31, 2003:					
Gross carrying amount	$ 30	$ 88	$ 1,101	$ 5	$ 1,224
Accumulated amortization	(10)	(13)	(491)	—	(514)
Net carrying value	$ 20	$ 75	$ 610	$ 5	$ 710

Amortization of intangible assets was $221, $196, and $129 million during 2004, 2003 and 2002, respectively. Expected amortization of finite-lived intangible assets recorded as of December 31, 2004 for the next five years is as follows (in millions): 2005—$198; 2006—$198; 2007—$198; 2008—$12; 2009—$11. Amortization expense in future periods will be affected by business acquisitions, software development, and other factors.

Other assets as of December 31 consist of the following (in millions):

	2004	2003
Non-current finance receivables, net of allowance for credit losses	$ 475	$ 574
Other non-current assets	889	1,098
	$1,364	$1,672

NOTE 7. BUSINESS ACQUISITIONS AND DISPOSITIONS

We regularly explore opportunities to make acquisitions that would enhance our package delivery business and our supply chain solutions businesses. During the three years ended December 31, 2004, we completed several acquisitions, including both domestic and international transactions, which were accounted for under the purchase method of accounting. In connection with the foregoing transactions, we paid cash (net of cash acquired) in the aggregate amount of $238, $30, and $14 million in 2004, 2003, and 2002, respectively. Pro forma results of operations have not been presented for any of the acquisitions because the effects of these transactions were not material on either an individual or aggregate basis. 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, however we generally expect such adjustments to the purchase price allocations to be immaterial.

During the second quarter of 2003, we sold our Mail Technologies business unit in a transaction that increased net income by $14 million, or $0.01 per diluted share. The gain consisted of a pre-tax loss of $24 million recorded in other operating expenses within the supply chain solutions segment, and a tax benefit of $38 million recognized in conjunction with the sale. The tax benefit exceeded the pre-tax loss from this sale primarily because the goodwill impairment charge we previously recorded for the Mail Technologies business unit was not deductible for income tax purposes. Consequently, our tax basis was greater than our book basis, thus producing the tax benefit described above. The operating results of the Mail Technologies unit were previously included in our supply chain solutions segment, and were not material to our consolidated operating results in any of the periods presented.

During the third quarter of 2003, we sold our Aviation Technologies business unit and recognized a pre-tax gain of $24 million ($15 million after-tax, or $0.01 per diluted share), which was recorded in other operating expenses within the U.S. domestic package segment. The operating results of the Aviation Technologies unit were previously included in our U.S. domestic package segment, and were not material to our consolidated operating results in any of the periods presented.

In March 2004, we acquired the remaining 49% minority interest in UPS Yamato Express Co., which was previously a joint venture with Yamato Transport Co. in Japan, for $65 million in cash. UPS Yamato Express provides express package delivery services in Japan. Upon the close of the acquisition, UPS Yamato Express became a wholly-owned subsidiary of UPS. The acquisition had no material effect on our financial condition or results of operations.

In December 2004, we acquired the Menlo Worldwide Forwarding unit from CNF Inc. for $150 million in cash (net of cash acquired) plus the assumption of $110 million in par value of debt and capital lease obligations. Menlo Worldwide Forwarding is a global freight forwarder that provides a full suite of heavy air freight forwarding services, ocean services and international trade management, including customs brokerage. The acquisition had no material effect on our results of operations in 2004.

We are in the process of finalizing the independent appraisals for certain assets and liabilities to assist management in allocating the Menlo purchase price to the individual assets acquired and liabilities assumed. This may result in adjustments to the carrying values of Menlo's recorded assets and liabilities, including the amount of any residual value allocated to goodwill. We are also completing our analysis of integration plans that may result in additional purchase price adjustments. 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 date of the acquisition.

In February 2005, we announced our intention to transfer operations currently taking place at the Menlo facility in Dayton, Ohio to other UPS facilities over approximately 12 to 18 months. This action is being taken to remove redundancies between the Menlo and existing UPS transportation networks, and thus provide efficiencies and better leverage the current UPS facilities in the movement of air freight. We are currently evaluating our plans for this facility, including potential alternate uses or closure. As a result, we anticipate possibly incurring costs related to employee severance, lease terminations, fixed asset impairments, and related items. Depending upon the nature of these costs, some of these items could result in charges to expense, while other items could result in adjustments to the purchase price allocation. We are in process of finalizing our plan for this facility, and therefore the purchase price allocation does not reflect liability accruals or fair value adjustments that may result from this decision.

The preliminary allocation of the total purchase price of Menlo resulted in the following condensed balance sheet of assets acquired and liabilities assumed as of December 31, 2004 (in millions):

	Assets
Cash and cash equivalents	$ 47
Accounts receivable	466
Other current assets	21
Property, plant, and equipment	141
Goodwill and intangible assets	26
Other assets	4
	$ 705

	Liabilities
Accounts payable	$ 28
Accrued wages and withholdings	104
Other current liabilities	161
Long-term debt	124
Deferred Taxes, Credits and Other Liabilities	45
Accumulated postretirement benefit obligation	46
	$ 508

In December 2004, we announced an agreement 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 requires a payment of $100 million to Sinotrans in 2005, which can be increased or decreased based on certain contingent factors. The acquisition will be completed in stages throughout 2005. In February 2005, we took direct control of operations in five locations, while the additional 18 locations will be acquired by December 2005. The operations being acquired will be reported within our International package reporting segment.

In February 2005, we announced an agreement to acquire Messenger Service Stolica S.A., one of the leading parcel and express delivery companies in Poland. Stolica offers customers a full suite of domestic delivery services, and had 2004 revenue of approximately $64 million. Upon completion of the transaction, which is expected in the second quarter of 2005, Stolica will be included in our International package reporting segment.

NOTE 8. LONG-TERM DEBT AND COMMITMENTS

Long-term debt, as of December 31, consists of the following (in millions):

	2004	2003
8.38% debentures, due April 1, 2020 (i)	$ 463	$ 444
8.38% debentures, due April 1, 2030 (i)	276	276
Commercial paper (ii)	1,015	544
Industrial development bonds, Philadelphia Airport facilities, due December 1, 2015 (iii)	100	100
Special facilities revenue bonds, Louisville Airport facilities, due January 1, 2029 (iv)	149	149
Floating rate senior notes (v)	441	441
Capitalized lease obligations (vi)	401	451
UPS Notes (vii)	393	419
5.50% Pound Sterling notes, due February 12, 2031	961	887
4.50% Singapore Dollar notes, due November 11, 2004	—	59
Special facilities revenue bonds, Dayton, OH facilities (viii)	121	—
Installment notes, mortgages, and bonds at various rates	128	53
	4,448	3,823
Less current maturities	(1,187)	(674)
	$ 3,261	$3,149

(i) On January 22, 1998, we exchanged $276 million of an original $700 million in debentures for new debentures of equal principal with a maturity of April 1, 2030. The new debentures have the same interest rate as the 8.38% debentures due 2020 until April 1, 2020, and, thereafter, the interest rate will be 7.62% for the final 10 years. The 2030 debentures are redeemable in whole or in part at our option at any time. The redemption price is equal to the greater of 100% of the principal amount and accrued interest or the sum of the present values of the remaining scheduled payout of principal and interest thereon discounted to the date of redemption at a benchmark treasury yield plus five basis points plus accrued interest. The remaining $424 million of 2020 debentures are not subject to redemption prior to maturity. Interest is payable semiannually on the first of April and October for both debentures and neither debenture is subject to sinking fund requirements.

(ii) The weighted average interest rate on the commercial paper outstanding as of December 31, 2004 and 2003, was 2.10% and 0.96%, respectively. At December 31, 2004 and 2003, the entire commercial paper balance has been classified as a current liability. The amount of commercial paper outstanding in 2005 is expected to fluctuate. We are authorized to borrow up to $7.0 billion under the two commercial paper programs we maintain as of December 31, 2004.

(iii) The industrial development bonds bear interest at a daily variable rate. The average interest rates for 2004 and 2003 were 1.08% and 0.89%, respectively.

(iv) The special facilities revenue bonds bear interest at a daily variable rate. The average interest rates for 2004 and 2003 were 1.20% and 1.02%, respectively.

(v) The floating rate senior notes bear interest at one-month LIBOR less 45 basis points. The average interest rates for 2004 and 2003 were 1.00% and 0.78%, respectively. These notes are callable at various times after 30 years at a stated percentage of par value, and putable by the note holders at various times after 10 years at a stated percentage of par value. The notes have maturities ranging from 2049 through 2053.

(vi) We have certain aircraft subject to capital leases. Some of the obligations associated with these capital leases have been legally defeased. The recorded value of aircraft subject to capital leases, which are included in Property, Plant and Equipment is as follows as of December 31 (in millions):

	2004	2003
Aircraft	$1,795	$1,474
Accumulated amortization	(257)	(198)
	$1,538	$1,276

(vii) The UPS Notes program involves the periodic issuance of fixed rate notes in $1,000 increments with various terms and maturities. At December 31, 2004, the coupon rates of the outstanding notes varied between 3.00% and 6.20%, and the interest payments are made either monthly, quarterly or semiannually. The maturities of the notes range from 2006 to 2024. Substantially all of the fixed obligations associated with the notes were swapped to floating rates, based on different LIBOR indices plus or minus a spread. The average interest rate payable on the swaps for 2004 and 2003 was 1.13% and 0.81%, respectively.

(viii) The special facilities revenue bonds were assumed in the acquisition of Menlo Worldwide Forwarding in December 2004 (see Note 7). The bonds have a par value of $108 million, $62 million of which is due in 2009, while the remaining $46 million is due in 2018. The bonds due in 2018 are callable beginning in 2008. The bonds due in 2018 bear interest at a fixed rate of 5.63%, while the bonds due in 2009 bear interest at fixed rates ranging from 6.05% to 6.20%. The bonds were recorded at fair value on the date of acquisition.

Based on the borrowing rates currently available to the Company for long-term debt with similar terms and maturities, the fair value of long-term debt, including current maturities, is approximately $4.708 and $4.109 billion as of December 31, 2004 and 2003, respectively.

We lease certain aircraft, facilities, equipment and vehicles under operating leases, which expire at various dates through 2054. Certain of the leases contain escalation clauses and renewal or purchase options. Rent expense related to our operating leases was $693, $678 and $685 million for 2004, 2003 and 2002, respectively.

The following table sets forth the aggregate minimum lease payments under capitalized and operating leases, the aggregate annual principal payments due under our long-term debt, and the aggregate amounts expected to be spent for purchase commitments (in millions).

Year	Capitalized Leases	Operating Leases	Debt Principal	Purchase Commitments
2005	$ 97	$ 370	$ 1,110	$ 1,012
2006	70	327	6	488
2007	121	242	—	223
2008	132	169	27	274
2009	76	128	84	637
After 2009	62	590	2,777	1,129
Total	558	$ 1,826	$ 4,004	$ 3,763
Less: imputed interest	(157)			
Present value of minimum capitalized lease payments	401			
Less: current portion	(78)			
Long-term capitalized lease obligations	$ 323			

As of December 31, 2004, we had outstanding letters of credit totaling approximately $2.161 billion issued in connection with routine business requirements.

We maintain two credit agreements with a consortium of banks that provide revolving credit facilities of $1.0 billion each, with one expiring April 21, 2005 and the other April 24, 2008. Interest on any amounts we borrow under these facilities would be charged at 90-day LIBOR plus 15 basis points. At December 31, 2004, there were no outstanding borrowings under these facilities. In addition, we maintain an extendable commercial notes program under which we are authorized to borrow up to $500 million. No amounts were outstanding under this program at December 31, 2004.

We have a $2.0 billion shelf registration statement under which we may issue debt securities in the U.S. The debt may be denominated in a variety of currencies. There was approximately $126 million issued under this shelf registration statement at December 31, 2004.

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 passed as of December 31, 2004.

In December 2003, we redeemed our $300 million cash-settled convertible senior notes at a price of 102.703, and also terminated the swap transaction associated with the notes. The redemption amount paid was lower than the amount recorded for the fair value of the notes at the time of redemption, which, along with the cash settlement received on the swap, resulted in a $28 million pre-tax gain recorded in 2003 results.

NOTE 9. DEFERRED TAXES, CREDITS, AND OTHER LIABILITIES

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

	2004	2003
Deferred income taxes (see Note 14)	$3,274	$3,118
Insurance reserves	1,136	923
Other credits and non-current liabilities	972	733
	$5,382	$4,774

NOTE 10. LEGAL PROCEEDINGS AND CONTINGENCIES

On August 9, 1999, the United States Tax Court held that we were liable for tax on income of Overseas Partners Ltd., a Bermuda company that had reinsured excess value (“EV”) insurance purchased by our customers beginning in 1984, and that we were liable for additional tax for the 1983 and 1984 tax years. The IRS took similar positions to those advanced in the Tax Court decision for tax years subsequent to 1984 through 1998. On June 20, 2001, the U.S. Court of Appeals for the Eleventh Circuit ruled in our favor and reversed the Tax Court decision. In January 2003, we and the IRS finalized settlement of all outstanding tax issues related to EV package insurance. Under the terms of settlement, we agreed to adjustments that will result in income tax due of approximately $562 million, additions to tax of $60 million and related interest. The amount due to the IRS as a result of the settlement is less than amounts we previously had accrued. As a result, we recorded income, before taxes, of $1.023 billion ($776 million after tax) during the fourth quarter of 2002. In the first quarter of 2004, we received a refund of $185 million pertaining to the 1983 and 1984 tax years.

The IRS had proposed adjustments, unrelated to the EV package insurance matters discussed above, regarding the allowance of deductions and certain losses, the characterization of expenses as capital rather than ordinary, the treatment of certain income, and our entitlement to tax credits in the 1985 through 1998 tax years. In the third quarter of 2004, we settled all outstanding issues related to each of the tax years 1991 through 1998. In the fourth quarter of 2004, we received a refund of $425 million pertaining to the 1991 through 1998 tax years. We expect to receive the $371 million of refunds related to the 1985 through 1990 tax years within the next six months.

The IRS may take similar positions with respect to some of the non-EV package insurance matters for each of the years 1999 through 2004. If challenged, we expect that we will prevail on substantially all of these issues. Specifically, we believe that our practice of expensing the items that the IRS alleges should have been capitalized is consistent with the practices of other industry participants. We believe that the eventual resolution of these issues will not have a material adverse effect on our financial condition, results of operations or liquidity.

We were named as a defendant in twenty-three now-dismissed lawsuits that sought to hold us liable for the collection of premiums for EV insurance in connection with package shipments since 1984. Based on state and federal tort, contract and statutory claims, these cases generally claimed that we failed to remit collected EV premiums to an independent insurer; we failed to provide promised EV insurance; we acted as an insurer without complying with state insurance laws and regulations; and the price for EV insurance was excessive. These actions were all filed after the August 9, 1999 U.S. Tax Court decision, discussed above, which the U.S. Court of Appeals for the Eleventh Circuit later reversed.

These twenty-three cases were consolidated for pre-trial purposes in a multi-district litigation proceeding ("MDL Proceeding") in federal court in New York. In addition to the cases in which UPS was named as a defendant, there also was an action, Smith v. Mail Boxes Etc., against Mail Boxes Etc. and its franchisees relating to UPS EV insurance and related services purchased through Mail Boxes Etc. centers. That case also was consolidated into the MDL Proceeding.

In late 2003, the parties reached a global settlement resolving all claims and all cases in the MDL proceeding. In reaching the settlement, we and the other defendants expressly denied any and all liability. On July 30, 2004, the court issued an order granting final approval to the substantive terms of the settlement. No appeals were filed and the settlement became effective on September 8, 2004.

Pursuant to the settlement, UPS has provided qualifying settlement class members with vouchers toward the purchase of specified UPS services and will pay the plaintiffs' attorneys' fees, the total amount of which still remains to be determined by the court. Other defendants have contributed to the costs of the settlement, including the attorneys' fees. The ultimate cost to us of the proposed settlement will depend on a number of factors, including how many vouchers settlement class members actually use. We do not believe that this proposed settlement will have a material effect on our financial condition, results of operations, or liquidity.

We are a defendant in a number of lawsuits filed in state 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 California state court, plaintiffs allege that they improperly were denied overtime, penalties for missed meal and rest periods, interest and attorneys' fees. Plaintiffs purport to represent a class of 1,200 full-time supervisors.

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.

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 cash flows could result from our participation in these plans.

NOTE 11. CAPITAL STOCK AND STOCK-BASED COMPENSATION

Capital Stock

We maintain two classes of common stock, which are distinguished from each other by their respective voting rights. Class A shares of UPS are entitled to 10 votes per share, whereas Class B shares are entitled to one vote per share. Class A shares are primarily held by UPS employees and retirees, and these shares are fully convertible into Class B shares at any time. Class B shares are publicly traded on the New York Stock Exchange (NYSE) under the symbol "UPS."

Incentive Compensation Plan

The UPS Incentive Compensation 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 December 31, 2004, management incentive awards, stock options, and restricted performance units had been granted under the Incentive Compensation Plan.

Management Incentive Awards

Persons earning the right to receive management incentive awards are determined annually by the Compensation Committee of the UPS Board of Directors. This Committee, in its sole discretion, determines the total award, which consists of UPS Class A common stock, given in any year. Amounts expensed for management incentive awards were $738, $606, and $556 million during 2004, 2003, and 2002, respectively.

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 Incentive Compensation Plan must have an exercise price at least equal to the NYSE closing price of UPS class B common stock on the date the option was granted.

Persons earning the right to receive stock options are determined each year by the Compensation Committee of the UPS Board of Directors. Except in the case of death, disability, or retirement, options granted under the Incentive Compensation 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.

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

	2004		2003		2002	
	Weighted Average Price	Shares (in thousands)	Weighted Average Price	Shares (in thousands)	Weighted Average Price	Shares (in thousands)
Outstanding at beginning of year	$ 48.02	22,745	$ 38.73	27,745	$ 29.64	29,224
Exercised	26.97	(7,351)	18.59	(7,297)	15.91	(6,434)
Granted	70.70	2,663	62.40	2,860	60.22	5,760
Forfeited / expired	58.70	(356)	44.63	(563)	46.08	(805)
Outstanding at end of year	$ 59.96	17,701	$ 48.02	22,745	$ 38.73	27,745

Beginning in November 1999, options were granted under the Incentive Compensation Plan, and a limited option grant to certain employees under this plan occurred in 2000. Beginning in 2001 and in future years, options to eligible employees will generally be granted annually during the first half of each year at the discretion of the Compensation Committee of the UPS Board of Directors.

The following table summarizes information about stock options outstanding and exercisable at December 31, 2004:

	Options Outstanding			Options Exercisable	
Exercise Price Range	Shares (in thousands)	Average Life (in years)	Average Exercise Price	Shares (in thousands)	Average Exercise Price
$ 13.94 - $50.63	2,424	4.82	$49.89	2,397	$49.89
$ 56.25 - $57.50	4,467	6.24	56.90	4,467	56.90
$ 59.38 - $60.61	5,381	7.27	60.20	141	59.54
$ 61.88 - $65.00	2,757	8.32	62.41	11	64.20
$ 68.44 - $143.13	2,672	9.23	71.23	48	99.88
	17,701	7.13	$59.96	7,064	$54.88

Restricted Performance Units

Beginning in 2003, we issued restricted performance units under the Incentive Compensation Plan. Upon vesting, restricted performance units result in the issuance of the equivalent number of UPS Class A common shares after required tax withholdings. Persons earning the right to receive restricted performance units are determined each year by the Compensation Committee of the UPS Board of Directors. Except in the case of death, disability, or retirement, restricted performance units vest five years after the date of grant. All restricted performance units granted are subject to earlier cancellation or vesting under certain conditions. Dividends earned on restricted performance units are reinvested in additional restricted performance units at each dividend payable date. During 2004 and 2003, the Company issued 1.083 and 1.164 million restricted performance units with a weighted average fair value of $70.70 and $62.40, respectively. As of December 31, 2004, we had the following restricted performance units outstanding:

Year of Award	Units Outstanding (in thousands)	Remaining Vesting Period (in years)	Avg. Fair Value at Grant Date
2003	1,140	3.33	$ 62.40
2004	1,074	4.33	70.70
	2,214	3.82	$ 66.43

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 on the first or the last day of each quarterly period. Employees purchased 1.8, 1.9, and 1.8 million shares at average prices of $62.75, $54.08, and $50.79 per share during 2004, 2003, and 2002, respectively.

Deferred Compensation Obligations

We maintain a deferred compensation plan whereby certain employees may elect to defer the gains on stock option exercises by deferring the shares received upon exercise into a rabbi trust. The shares held in this trust are classified as treasury stock, and the liability to participating employees is classified as “Deferred compensation obligations” in the shareowners’ equity section of the balance sheet. The amount of shares needed to settle the liability for deferred compensation obligations is included in the denominator in both the basic and diluted earnings per share calculations.

NOTE 12. SEGMENT AND GEOGRAPHIC INFORMATION

We report our operations in three segments: U.S. domestic package operations, international package operations, and supply chain solutions operations. Package operations represent our most significant business and are broken down into regional operations around the world. Regional operations managers are responsible for both domestic and export operations within their geographic area.

U.S. Domestic Package

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

International Package

International package operations include the time-definite delivery of letters, documents and packages 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-Pacific, and Americas operating segments.

Supply Chain Solutions

Supply chain solutions includes our freight services and logistics operations, which are comprised of our former UPS Freight Services and UPS Logistics Group, including the operations acquired with the purchase of Menlo Worldwide Forwarding. Freight services and logistics includes supply chain design and management, freight distribution and customs brokerage services. Other operations within this segment include our retail franchising business (Mail Boxes Etc. and The UPS Store), our financial services, mail services, consulting and professional services operations.

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 (see Note 1), with certain expenses allocated between the segments using activity-based costing methods. Unallocated assets are comprised primarily of cash, marketable securities, and short-term investments.

Segment information as of, and for the years ended, December 31 is as follows (in millions):

	2004	2003	2002
Revenue:			
U.S. domestic package	$ 26,960	$ 25,362	$ 24,280
International package	6,809	5,609	4,720
Supply chain solutions	2,813	2,514	2,272
Consolidated	$ 36,582	$ 33,485	$ 31,272
Operating Profit (Loss):			
U.S. domestic package	$ 3,702	$ 3,657	$ 3,925
International package	1,149	732	338
Supply chain solutions	138	56	(167)
Consolidated	$ 4,989	$ 4,445	$ 4,096
Assets:			
U.S. domestic package	$ 18,882	$ 18,156	$ 16,775
International package	4,728	4,287	3,271
Supply chain solutions	4,878	4,498	4,932
Unallocated	4,538	2,793	1,890
Consolidated	$ 33,026	$ 29,734	$ 26,868

Revenue by product type for the years ended December 31 is as follows (in millions):

	2004	2003	2002
U.S. domestic package:			
Next Day Air	$ 6,084	$ 5,621	$ 5,393
Deferred	3,193	3,015	2,902
Ground	17,683	16,726	15,985
Total U.S. domestic package	26,960	25,362	24,280
International package:			
Domestic	1,346	1,134	943
Export	4,991	4,049	3,316
Cargo	472	426	461
Total International package	6,809	5,609	4,720
Supply chain solutions:			
Freight services and logistics	2,379	2,126	1,969
Other	434	388	303
Total Supply chain solutions	2,813	2,514	2,272
Consolidated	$ 36,582	$ 33,485	$ 31,272

Geographic information as of, and for the years ended, December 31 is as follows (in millions):

	2004	2003	2002
U.S.:			
Revenue	$ 28,035	$ 26,968	$ 26,284
Long-lived assets	$ 15,971	$ 15,634	$ 14,640
International:			
Revenue	$ 8,547	$ 6,517	$ 4,988
Long-lived assets	$ 3,975	$ 3,567	$ 2,874
Consolidated:			
Revenue	$ 36,582	$ 33,485	$ 31,272
Long-lived assets	$ 19,946	$ 19,201	$ 17,514

Revenue, for geographic disclosure, is based on the location in which service originates. Long-lived assets include property, plant and equipment, prepaid pension costs, long-term investments, goodwill, and intangible assets.

NOTE 13. OTHER OPERATING EXPENSES

The major components of other operating expenses for the years ended December 31 are as follows (in millions):

	2004	2003	2002
Repairs and maintenance	$ 1,005	$ 955	$ 873
Depreciation and amortization	1,543	1,549	1,464
Purchased transportation	2,059	1,828	1,665
Fuel	1,416	1,050	952
Other occupancy	752	730	653
Restructuring charge and related expenses	—	9	106
Other expenses	3,902	3,591	3,523
	$ 10,677	$ 9,712	$ 9,236

In the fourth quarter of 2002, we initiated a restructuring program to combine UPS Freight Services and the UPS Logistics Group into a single business unit ("Freight services and logistics") within our supply chain solutions segment. In connection with this restructuring program, we also recorded certain costs related to the integration of activities between our financial services business and First International Bank, which was acquired in 2001. The program was designed to facilitate business growth, streamline management decision-making, reduce the cost structure, and provide higher levels of service to our customers. Costs of the program included employee severance costs, asset impairments, costs associated with the consolidation of facilities, and other costs directly related to the restructuring program. As of December 31, 2003, the restructuring program was substantially complete.

NOTE 14. INCOME TAXES

The income tax expense (benefit) for the years ended December 31 consists of the following (in millions):

	2004	2003	2002
Current:			
U.S. Federal	$1,675	$1,103	$1,208
U.S. State & Local	71	112	148
Non-U.S.	98	86	62
Total Current	1,844	1,301	1,418
Deferred:			
U.S. Federal	(155)	181	323
U.S. State & Local	(84)	(11)	14
Non-U.S.	(16)	1	—
Total Deferred	(255)	171	337
Total	$1,589	$1,472	$1,755

Income before income taxes includes income of foreign subsidiaries of $270, $237, and $16 million in 2004, 2003, and 2002, respectively.

A reconciliation of the statutory federal income tax rate to the effective income tax rate for the years ended December 31 consists of the following:

	2004	2003	2002
Statutory U.S. federal income tax rate	35.0%	35.0%	35.0%
U.S. state & local income taxes (net of federal benefit)	1.2	1.5	2.1
Tax assessment reversal (tax portion)	—	—	(2.8)
Other	(3.9)	(2.8)	0.7
Effective income tax rate	32.3%	33.7%	35.0%

During the third quarter of 2004, we recognized a $99 million reduction of income tax expense related to the favorable settlement of various U.S. federal tax contingency matters with the IRS pertaining to tax years 1985 through 1998, and various state and non-U.S. tax contingency matters.

During the fourth quarter of 2004, we recognized a $109 million reduction of income tax expense primarily related to the favorable resolution of a U.S. state tax contingency matter, improvements in U.S. state and non-U.S. effective tax rates, and the reversal of valuation allowances associated with certain U.S. state & local and non-U.S. net operating loss and credit carryforwards due to sufficient positive evidence that the related subsidiaries will be profitable and generate taxable income before such carryforwards expire.

During the first quarter of 2003, we recognized a $55 million reduction of income tax expense due to the favorable resolution of several outstanding contingency matters with the IRS. During the third quarter of 2003, we recognized a $22 million credit to income tax expense as a result of a favorable tax court ruling in relation to an outstanding contingency matter with the IRS.

After filing our 2002 state tax returns during the fourth quarter of 2003, we completed a review of the taxability of our operations in various U.S. state taxing jurisdictions and the effects of available state tax credits. As a result of this review, we recorded a decrease of $39 million in the income tax provision in the fourth quarter of 2003. This decrease includes a reduction in our estimated state tax liabilities and the effect of the estimated state income tax effective rate applied to our temporary differences.

Deferred tax liabilities and assets are comprised of the following at December 31 (in millions):

	2004	2003
Property, plant and equipment	$2,624	$2,453
Goodwill and intangible assets	428	349
Pension plans	1,481	1,266
Other	167	473
Gross deferred tax liabilities	4,700	4,541
Other postretirement benefits	684	588
Loss carryforwards (non-U.S. and state)	113	117
Insurance reserves	469	347
Vacation pay accrual	145	131
Other	471	673
Gross deferred tax assets	1,882	1,856
Deferred tax assets valuation allowance	(64)	(117)
Net deferred tax assets	1,818	1,739
Net deferred tax liability	2,882	2,802
Current deferred tax asset	(392)	(316)
Long-term liability—see Note 9	$3,274	$3,118

The valuation allowance increased (decreased) by $(53), $25 and $23 million during the years ended December 31, 2004, 2003 and 2002, respectively. We reclassified $719 million from deferred income taxes to other non-current assets as of December 31, 2003. This amount represents various income tax receivable items that had previously been netted against our deferred tax liabilities.

As of December 31, 2004, we have U.S. state & local operating loss and credit carryforwards of approximately $428 million and $25 million, respectively. The operating loss carryforwards expire at varying dates through 2024. The majority of the credit carryforwards may be carried forward indefinitely. We also have non-U.S. loss carryforwards of approximately $874 million as of December 31, 2004, the majority of which may be carried forward indefinitely. As indicated in the table above, we have established a valuation allowance for certain non-U.S. and state loss carryforwards, due to the uncertainty resulting from a lack of previous taxable income within the applicable tax jurisdictions.

Undistributed earnings of our non-U.S. subsidiaries amounted to approximately $728 million at December 31, 2004. Those earnings are considered to be indefinitely reinvested and, accordingly, no U.S. federal or state deferred income taxes have been provided thereon. Upon distribution of those earnings in the form of dividends or otherwise, we would be subject to U.S. income taxes and withholding taxes payable in various non-U.S. jurisdictions, which could potentially be offset by foreign tax credits. Determination of the amount of unrecognized deferred U.S. income tax liability is not practicable because of the complexities associated with its hypothetical calculation.

We have not changed our position with respect to the indefinite reinvestment of foreign earnings to take into account the possible election of the repatriation provisions contained in the American Jobs Creation Act of 2004. The American Jobs Creation Act of 2004 (the “Jobs Act”), as enacted on October 22, 2004, provides for a temporary 85% dividends received deduction on certain foreign earnings repatriated during a one-year period. The deduction would result in an approximate 5.25% U.S. federal tax rate on any repatriated earnings. To qualify for the deduction, the earnings must be reinvested in the United States pursuant to a domestic reinvestment plan established by the Company’s Chief Executive Officer and approved by the Company’s Board of Directors. Certain other criteria in the Jobs Act must be satisfied as well. The maximum amount of our foreign earnings that qualify for the temporary deduction under the Jobs Act is $500 million.

We are in the process of evaluating whether we will repatriate foreign earnings under the repatriation provisions of the Jobs Act, and if so, the amount that will be repatriated. We are considering repatriating any amount up to $500 million under the Jobs Act. We are awaiting the issuance of further regulatory guidance and passage of statutory technical corrections with respect to certain provisions in the Jobs Act prior to determining the amounts we could repatriate. We expect to determine the amounts and sources of foreign earnings to be repatriated, if any, during the fourth quarter of 2005. We cannot reasonably estimate the impact of a qualifying repatriation, should we choose to make one, on our income tax expense for 2005 at this time.

NOTE 15. EARNINGS PER SHARE

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

	2004	2003	2002
Numerator:			
Net income before the cumulative effect of change in accounting principle	$3,333	$2,898	$3,254
Denominator:			
Weighted average shares	1,125	1,125	1,117
Management incentive awards	1	1	1
Deferred compensation obligations	3	2	2
Denominator for basic earnings per share	1,129	1,128	1,120
Effect of dilutive securities:			
Management incentive awards	4	4	4
Stock option plans	4	6	10
Denominator for diluted earnings per share	1,137	1,138	1,134
Basic earnings per share before cumulative effect of change in accounting principle	$ 2.95	$ 2.57	$ 2.91
Diluted earnings per share before cumulative effect of change in accounting principle	$ 2.93	$ 2.55	$ 2.87

Diluted earnings per share for the years ended December 31, 2004, 2003, and 2002 exclude the effect of 2.7, 2.9, and 0.1 million shares, respectively, of common stock that may be issued upon the exercise of employee stock options because such effect would be antidilutive.

NOTE 16. DERIVATIVE INSTRUMENTS AND RISK MANAGEMENT

We are exposed to market risk, primarily related to foreign exchange rates, commodity prices, equity prices, and interest rates. These exposures are actively monitored by management. To manage the volatility relating to certain of these exposures, we enter into a variety of derivative financial instruments. Our objective is to reduce, where it is deemed appropriate to do so, fluctuations in earnings and cash flows associated with changes in foreign currency rates, commodity prices, equity prices, and interest rates. It is our policy and practice to use derivative financial instruments only to the extent necessary to manage exposures. As we use price sensitive instruments to hedge a certain portion of our existing and anticipated transactions, we expect that any loss in value for those instruments generally would be offset by increases in the value of those hedged transactions.

We do not hold or issue derivative financial instruments for trading or speculative purposes.

Commodity Price Risk Management

We are exposed to an increase in the prices of refined fuels, principally jet-A, diesel, and unleaded gasoline. Additionally, we are exposed to an increase in the prices of other energy products, principally natural gas and electricity. We use a combination of options, swaps, and futures contracts to provide partial protection from rising fuel and energy prices. The net fair value of such contracts subject to price risk, excluding the underlying exposures, as of December 31, 2004 and 2003 was an asset of $101 and $30 million, respectively. We have designated and account for these contracts as cash flow hedges, and, therefore, the resulting gains and losses from these hedges are recognized as a component of fuel expense or other occupancy expense when the underlying fuel or energy product being hedged is consumed.

Foreign Currency Exchange Risk Management

We have foreign currency risks related to our revenue, operating expenses, and financing transactions in currencies other than the local currencies in which we operate. We are exposed to currency risk from the potential changes in functional currency values of our foreign currency denominated assets, liabilities, and cash flows. Our most significant foreign currency exposures relate to the Euro, the British Pound Sterling, and the Canadian Dollar. We use a combination of purchased and written options and forward contracts to hedge currency cash flow exposures. As of December 31, 2004 and 2003, the net fair value of the hedging instruments described above was a liability of $(28) and $(48) million, respectively. We have designated and account for these contracts as cash flow hedges of anticipated foreign currency denominated revenue and, therefore, the resulting gains and losses from these hedges are recognized as a component of international revenue when the underlying sales occur.

Interest Rate Risk Management

Our indebtedness under our various financing arrangements creates interest rate risk. We use a combination of derivative instruments, including interest rate swaps and cross-currency interest rate swaps, as part of our program to manage the fixed and floating interest rate mix of our total debt portfolio and related overall cost of borrowing. These swaps are entered into concurrently with the issuance of the debt that they are intended to modify, and the notional amount, interest payment, and maturity dates of the swaps match the terms of the associated debt. Interest rate swaps allow us to maintain a target range of floating rate debt.

We have designated and account for these contracts as either hedges of the fair value of the associated debt instruments, or as hedges of the variability in expected future interest payments. Any periodic settlement payments are accrued monthly, as either a charge or credit to interest expense, and are not material to net income. The net fair value of our interest rate swaps at December 31, 2004 and 2003 was a liability of $(32) and $(27) million, respectively.

Credit Risk Management

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.

Derivatives Not Designated As Hedges

Derivatives not designated as hedges primarily consist of a small portfolio of stock warrants in public and private companies that are held for investment purposes. These warrants are recorded at fair value, and the impact of these warrants on our results was immaterial for 2004, 2003 and 2002.

Income Effects of Derivatives

In the context of hedging relationships, “effectiveness” refers to the degree to which fair value changes in the hedging instrument offset corresponding changes in the hedged item. Certain elements of hedge positions cannot qualify for hedge accounting under FAS 133 whether effective or not, and must therefore be marked to market through income. Both the effective and ineffective portions of gains and losses on hedges are reported in the income statement category related to the hedged exposure. Both the ineffective portion of hedge positions and the elements excluded from the measure of effectiveness were immaterial for 2004, 2003 and 2002.

As of December 31, 2004, $13 million in losses related to cash flow hedges that are currently deferred in OCI are expected to be reclassified to income over the 12 month period ending December 31, 2005. The actual amounts that will be reclassified to income over the next 12 months will vary from this amount as a result of changes in market conditions. No amounts were reclassified to income during 2004 in connection with forecasted transactions that were no longer considered probable of occurring.

At December 31, 2004, the maximum term of derivative instruments that hedge forecasted transactions, except those related to cross-currency interest rate swaps on existing financial instruments, was three years. We maintain cross-currency interest rate swaps that extend through 2009.

Fair Value of Financial Instruments

At December 31, 2004 and 2003, our financial instruments included cash and cash equivalents, marketable securities and short-term investments, accounts receivable, finance receivables, accounts payable, short-term and long-term borrowings, and commodity, interest rate, foreign currency, and equity options, forwards, and swaps. The fair values of cash and cash equivalents, accounts receivable, and accounts payable approximate carrying values because of the short-term nature of these instruments. The fair value of our marketable securities and short-term investments is disclosed in Note 2, finance receivables in Note 3, and debt instruments in Note 8.

NOTE 17. QUARTERLY INFORMATION (unaudited)

	First Quarter		Second Quarter		Third Quarter		Fourth Quarter	
	2004	2003	2004	2003	2004	2003	2004	2003
Revenue:								
U.S. domestic package	$6,625	$6,108	$6,567	$6,210	$6,581	$6,305	$7,187	$6,739
International package	1,630	1,316	1,627	1,387	1,675	1,378	1,877	1,528
Supply chain solutions	664	591	677	629	696	629	776	665
Total revenue	8,919	8,015	8,871	8,226	8,952	8,312	9,840	8,932
Operating profit:								
U.S. domestic package	912	793	988	913	941	934	861	1,017
International package	277	139	281	166	266	180	325	247
Supply chain solutions	28	13	41	1	51	33	18	9
Total operating profit	1,217	945	1,310	1,080	1,258	1,147	1,204	1,273
Net income	$ 759	$ 611	$ 818	$ 692	$ 890	$ 739	$ 866	$ 856
Earnings per share:								
Basic	$ 0.67	$ 0.54	$ 0.73	$ 0.61	$ 0.79	$ 0.66	$ 0.77	$ 0.76
Diluted	$ 0.67	$ 0.54	$ 0.72	$ 0.61	$ 0.78	$ 0.65	$ 0.76	$ 0.75

First quarter 2003 net income reflects a charge for an impairment of investments ($37 million after-tax, $0.03 per diluted share) and a credit to tax expense upon the resolution of various tax contingencies ($55 million, $0.05 per diluted share). Second quarter 2003 net income was impacted by the gain on the sale of Mail Technologies ($14 million after-tax, $0.01 per diluted share). Third quarter 2003 net income reflects the gain on sale of Aviation Technologies ($15 million after-tax, $0.01 per diluted share) and the credit to tax expense from a favorable ruling on the tax treatment of jet engine maintenance costs ($22 million, $0.02 per diluted share). Fourth quarter 2003 net income was impacted by a gain on the redemption of long-term debt ($18 million after-tax, $0.02 per diluted share) and a credit to income tax expense for a lower effective state tax rate ($39 million, $0.03 per diluted share).

Third quarter 2004 net income includes a credit to tax expense ($99 million, $0.09 per diluted share) related to the resolution of various tax matters. Fourth quarter 2004 net income includes an impairment charge ($70 million after-tax, $0.06 per diluted share) on Boeing 727, 747, and McDonnell Douglas DC-8 aircraft, and related engines and parts, and a charge to pension expense ($40 million after-tax, $0.04 per diluted share) resulting from the consolidation of data collection systems. Fourth quarter 2004 net income also includes credits to income tax expense ($43 million, $0.04 per diluted share) related to various items, including the resolution of certain tax matters, the removal of a portion of the valuation allowances on certain deferred tax assets on net operating loss carryforwards, and an adjustment for identified tax contingency items.

NOTE 18. SUBSEQUENT EVENTS

In May 2005, we announced an agreement to acquire Overnite Corporation for approximately $1.25 billion in cash. Overnite Corporation is one of the leading less-than-truckload carriers in North America, and had 2004 revenue of $1.65 billion. We expect the acquisition to close in the third quarter of 2005, subject to obtaining required regulatory approvals and the approval of Overnite's shareholders.