We see...

UPS Annual Report 2003

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Vision. Execution. Growth. At UPS, we know success begins by seeing opportunities to grow the business. With a powerful brand, rapidly expanding capabilities, and a finely tuned network, we see a world of opportunity.

Dear fellow shareowners,

At UPS, we see a world poised for strong and sustainable growth. And, we see a company positioned to capitalize on that growth.

Mike Eskew

Chairman and
Chief Executive Officer

The global economic sluggishness of the past three years is giving way to growing consumer optimism, greater business investment, decreasing inventory-to-sales ratios, and a renewed commitment to innovation, execution, and growth.

Over the past year, I've had the opportunity to meet with scores of customers and hear their stories about the need to rethink their business models and the way in which they interact with their customers, suppliers, partners, and employees. They talk about new technologies, emerging global markets, and supply chain strategies to reach those markets. I walk away from these meetings energized because I sense that this world in transition bodes extremely well for UPS. Our people, customers, and shareowners sense it too.

U.S. Package Business Remains Strong

Five years ago, we extended our mission beyond package delivery to enabling global commerce by creating new services that bring buyers and sellers closer together. At the same time, we said that our U.S. package delivery business would remain important to our future growth. It still is. In 2003, we began to reengineer our U.S. operations on a scale unmatched in the history of our industry.

We initiated a $600 million investment in new package flow technologies that will help us simplify the loading and delivery process, improve customer service, reduce vehicle mileage by more than 100 million miles each year, and save 14 million gallons of fuel annually. When fully implemented in 2007, we expect a $600 million savings in annual operating costs and the opportunity to create new services and solutions for our customers.

Our U.S. operations gained significant momentum over the course of 2003. U.S. domestic volume increased 4.9 percent for the fourth quarter in contrast to a 1.2 percent decline in the first quarter. In 2004, we anticipate volume growth will be about 4 percent, with margins continuing to improve.

Part of that momentum was driven by the opportunity we gave to Mail Boxes Etc. franchisees in the United States to convert to The UPS Store.™ More than 3,000, or almost 90 percent, did so. The UPS Store is an important channel in our growing number of customer access points, which now include more than 125,000 points of entry through our drivers, customer centers, and drop boxes.

The stores give us a platform to launch new services in the coming years. They are a central part of our retail strategy that is guided by the forces of e-commerce and consumer pull, the expanding ranks of entrepreneurs, and the growing numbers of home office and mobile corporate workers.

International Growth Drives Industry-Leading Profits

Five years ago, we told the world that our international business showed great promise as advances in technology, consumer empowerment, and deregulation were making it easier — and indeed imperative — for businesses and societies to trade more freely with one another.

Today, our international business has arrived. In fact, our international operating margin is higher than it's ever been. This is due to well-established customer relationships that have been enhanced through technology and an expansive product portfolio that addresses local, regional, and global distribution and supply chain needs.

In 2003, our international segment had a record year with operating profit of $709 million, a 128 percent increase over adjusted 2002 results. In fact, over the past five years, international operating profits have grown more than 200 percent — driven by a favorable combination of good operations management, cost control, economies of scale, excellent yield management, a strong product mix, and favorable currency exchange rates.

Financial highlights

IN MILLIONS		2003		2002	% CHANGE
Revenue	$	**33,485**	$	31,272	7.1%
Operating Expenses	$	**29,040**	$	27,176	6.9%
Net Income (Adjusted)	$	**2,772**[(1)]	$	2,422[(2)]	14.5%
Diluted Earnings Per Share (Adjusted)	$	**2.44**[(1)]	$	2.14[(2)]	14.0%
Assets	$	**28,909**	$	26,357	9.7%
Capital Expenditures	$	**1,947**	$	1,658	17.4%
Long-Term Debt	$	**3,149**	$	3,495	(9.9%)
Shareowners' Equity	$	**14,852**	$	12,455	19.2%

(1) 2003 excludes after-tax gain from sale of Mail Technologies ($14 million, $0.01 per share) and Aviation Technologies ($15 million, $0.01 per share), gain on redemption of long-term debt ($18 million, $0.02 per share), impairment of investments ($37 million, $0.03 per share) and credits to income tax expense for a lower effective state tax rate in the fourth quarter ($39 million, $0.03 per share), the resolution of various tax contingencies ($55 million, $0.05 per share), and a favorable ruling on the tax treatment of jet engine maintenance costs ($22 million, $0.02 per share).

(2) 2002 excludes after-tax impact of tax assessment reversal ($776 million, $0.68 per share), credit from vacation policy change ($121 million, $0.11 per share), restructuring charge and related expenses ($65 million, $0.06 per share), and charge upon adoption of FAS 142 ($72 million, $0.06 per share).

Our international network gained expanded reach in 2003 with the award of 12 frequencies to fly beyond Hong Kong and connect to Cologne, Germany, and to our intra-Asia hub in the Philippines.

Asia, in particular, remains an important link in our international strategy. Export volume from China alone has doubled since the launch of air services to Beijing and Shanghai in 2001.

In Europe, we continue to see solid export volume growth, and we continue to expand our network to handle even more. We recently began construction on a $135 million, 30,000-square-meter facility at Cologne/Bonn Airport in Germany, which will be the largest UPS facility outside the United States. And, we're expanding our operations in the 10 countries slated to join the European Union.

For our customers and shareowners, partnering with UPS has proven to be a powerful and profitable way to participate in the growth of global commerce.

Synchronizing Commerce For Our Customers

Five years ago, we talked about supply chain management mostly in conceptual terms. We talked about coordinating business processes to help companies operate more efficiently and serve their customers better.

Today, UPS Supply Chain Solutions is a $2 billion-plus business that is helping companies like IBM, National Semiconductor, Nikon, and others streamline their distribution systems, reach markets faster, serve customers better, and achieve their business plan goals.

In 2003, UPS Supply Chain Solutions successfully integrated more than 20 acquisitions made over the preceding four years. This integration, coupled with concentrated cross-enterprise sales efforts, has resulted in growth and steadily improving profit margins that we believe will continue to expand in 2004.

We're encouraged by customer interest in UPS's comprehensive supply chain management services, which include handling our customers' air and ocean freight, configuring and managing their warehouses and distribution systems, helping them manage returns and service-parts replacement, and financing their inventory, among other services.

Ensuring Future Stakeholder Value

Globalization and technology advancements continue to fuel greater worldwide economic opportunity, mobility, spending power, entrepreneurial activity, and multinational business expansion. This means a bright future for our business segments. In fact, by 2007, we anticipate operating margins of more than 15 percent in each of our business segments.

We're also excited by the momentum that is building through the launch of the new UPS brandmark — only the fourth change to our corporate identity since our founding in 1907. The rebranding effort is the largest in corporate history and has already made tremendous inroads in enhancing awareness of UPS's expanding capabilities.

But, the success of UPS extends beyond our brand awareness and financial performance to our social and environmental responsibilities. In the fall, we unveiled our first *Corporate Sustainability Report* that analyzes the progress we've made — and the challenges that lie ahead — in areas of economic, social, and environmental performance. Running a sustainable company is good for business and for the world we live in and has been ingrained in UPS culture since our founding in 1907. This report shows how that philosophy is manifested in our operations around the globe.

We see every aspect of our business working cohesively to synchronize commerce — helping companies simultaneously manage goods, information, and funds with speed, precision, security, and efficiency.

Customers tell us they need the strategic advantages gained by synchronizing every aspect of their business operations, from order-entry through delivery and returns. For UPS, this means offering new services made possible by our integrated global network, powerful technologies, intellectual capital, and the service ethic of some 355,000 UPS people around the globe who have made our company one of the world's most admired businesses.

We believe the world of synchronized commerce — and its promise of bringing businesses, economies, cultures, and people closer together — will continue to create significant benefits for our customers, shareowners, and employees around the world.

As we enter 2004, we see a company with a strong vision and the agility to execute that vision.

At UPS, we see a world of opportunity.

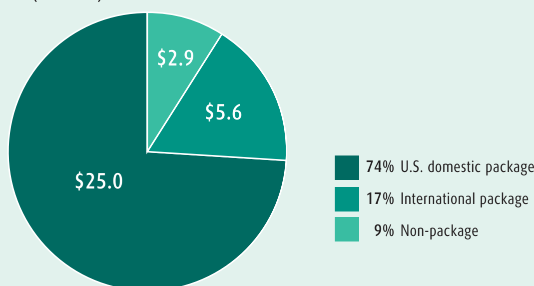
Michael L. Eskew
Chairman and Chief Executive Officer

We see growth in all segments of our business.

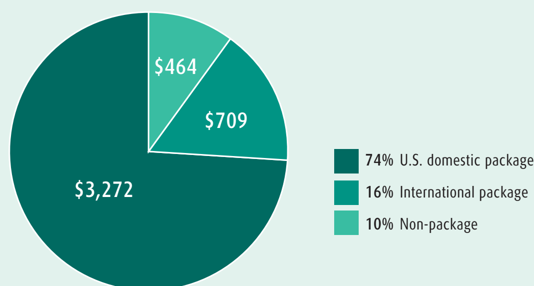
2003 Highlights

- Adjusted earnings per share increased 14%
- Quarterly dividend increased 32%
- Return on equity over 20%
- Introduced new corporate brand for the first time in over 40 years to symbolize the broad scope of UPS services and capabilities, in addition to package delivery
- Published first *Corporate Sustainability Report*

2003 Revenue by Segment
(in billions)



2003 Operating Profit by Segment
(in millions)



International Package

Air and ground shipment of packages that cross countries' borders, including packages shipped into and out of the United States, referred to as "international export." This segment also includes packages shipped within the borders of a non-U.S. country, referred to as "international domestic."

2003 Highlights

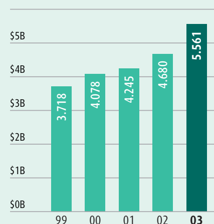
- Operating margin of 12.7% was the highest ever for this business
- Adjusted operating profit was up 128%
- Export volume up 8.6%; Asia, Canada, and the Americas all up over 10%
- Awarded 12 air rights that connect Hong Kong to our international hub in Cologne, Germany, and to our intra-Asia hub in the Philippines
- Began expansion of our international air hub in Cologne, Germany, to double sorting capacity

2004 Outlook*

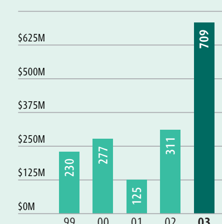
- Export volume expected to increase 8% or more
- Operating margin expected to continue expanding
- Operating profit should increase about 20%
- Air and ground network expanding in the 10 countries slated to join the European Union in 2004

* The statements made under "2004 Outlook" are forward-looking statements that involve certain risks and uncertainties. Many factors may cause actual results to differ materially from those contained in the forward-looking statements, including the factors set forth in this annual report under the heading "Risk Factors."

International Package Revenue
(in billions)



International Package Adjusted Operating Profit[1]
(in millions)



Non-Package

Operations outside of the traditional delivery of packages. Includes UPS Capital, Mail Innovations, retail operations (The UPS Store and Mail Boxes Etc. franchises), consulting, insurance, and UPS Supply Chain Solutions. UPS Supply Chain Solutions is the largest component of the non-package segment and provides international management of customer supply chains, consisting of transportation management, freight forwarding services, international customs brokerage, international trade management, service parts logistics, inventory fulfillment, and distribution services.

2003 Highlights

- Successfully completed integration of more than 20 UPS Supply Chain Solutions acquisitions made over the preceding four years
- Completed restructuring of UPS Supply Chain Solutions operations, resulting in more than $100 million profit improvement in the segment

2004 Outlook*

- Operating profit expected to increase $50 million or more
- Supply chain revenues expected to improve by more than 10%
- Supply chain operating margin expected to increase 100 to 200 basis points

U.S. Domestic Package

Air and ground shipment of packages within the 50 states. Includes next-day delivery, deferred delivery, which is air with a two- to three-day delivery commitment, and ground delivery, which has a one- to five-day delivery commitment.

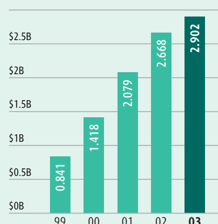
2003 Highlights

- Began implementation of new package flow technologies, based on data- and technology-driven platforms, to simplify and optimize package sorting and delivery; $600 million investment in 1,000 facilities expected to result in $600 million annual savings fully realized in 2007
- Provided opportunity for more than 3,000 Mail Boxes Etc. franchisees to rebrand to The UPS Store
- Implemented largest time-in-transit improvements in seven years, slashing a day off many previous delivery times without changing rates or pickup/delivery hours

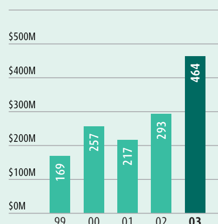
2004 Outlook*

- Domestic volume expected to increase about 4%
- Domestic operating margin expected to increase 100 basis points

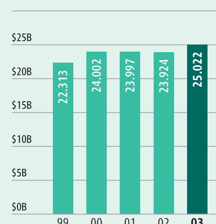
Non-Package Revenue
(in billions)



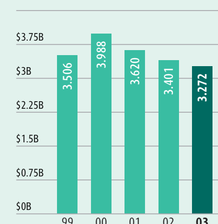
Non-Package Adjusted Operating Profit[1]
(in millions)



U.S. Domestic Package Revenue
(in billions)



U.S. Domestic Package Adjusted Operating[1]
Profit (in billions)



(1) 2000 Non-package operating profit excludes $49 million gain on sale of UPS Truck Leasing; 2000 U.S. Domestic package operating profit excludes $59 million charge related to arbitration ruling on Teamsters contract; 2002 excludes credit to operating profit from change in vacation policy for non-union employees ($175 million - U.S. Domestic, $11 million - International, $11 million - Non-package); 2002 Non-package excludes $106 million restructuring charge and related expenses.

We see $600 million in operational efficiencies.

By investing hundreds of millions in leading-edge package flow technologies, we are improving upon what was already a highly efficient U.S. package network.

For nearly a century we've innovated, perfected, and invested in our network to create a system that runs like clockwork. Our uniquely integrated business model, which flows packages of all kinds through one system, and our use of technology differentiate UPS, allowing for optimum performance and the broadest capabilities.

Most recently, we've begun implementing new operational technologies that allow us to use precise package information to streamline our operations. In addition, new routing and dispatch technologies are expected to reduce miles driven by more than 100 million per year and save 14 million gallons of fuel annually. They are expected to save more than $600 million annually once fully operational in 2007.

These industry-leading technologies will allow UPS to be even more nimble in our responsiveness to individual customer needs and ultimately create the potential for proactive services.

Facts:

- **UPS Worldport℠ processes in excess of 304,000 packages per hour.**
- **Our mobile radio network transmits more than 3 million packets of tracking data each day.**
- **Our mainframe capacity allows the transmission of more than 22 million instructions per second.**
- **UPS shipping tools are embedded in more than 65,000 customer Web sites.**
- **Using Global Positioning Satellite technology, we will have the capability to pinpoint a package within 30 feet of its location.**

We see great opportunity in a $3 trillion industry.

Our rapidly expanding capabilities help customers manage the complexity of global commerce and establish us as a leader in a vast supply chain and logistics marketplace.

At UPS, we're operating as an increasingly globalized and synchronized business that is in step with a changing world marketplace. UPS Supply Chain Solutions provides customized solutions, taking advantage of the full strength of our small package network and creating deeper relationships with our customers.

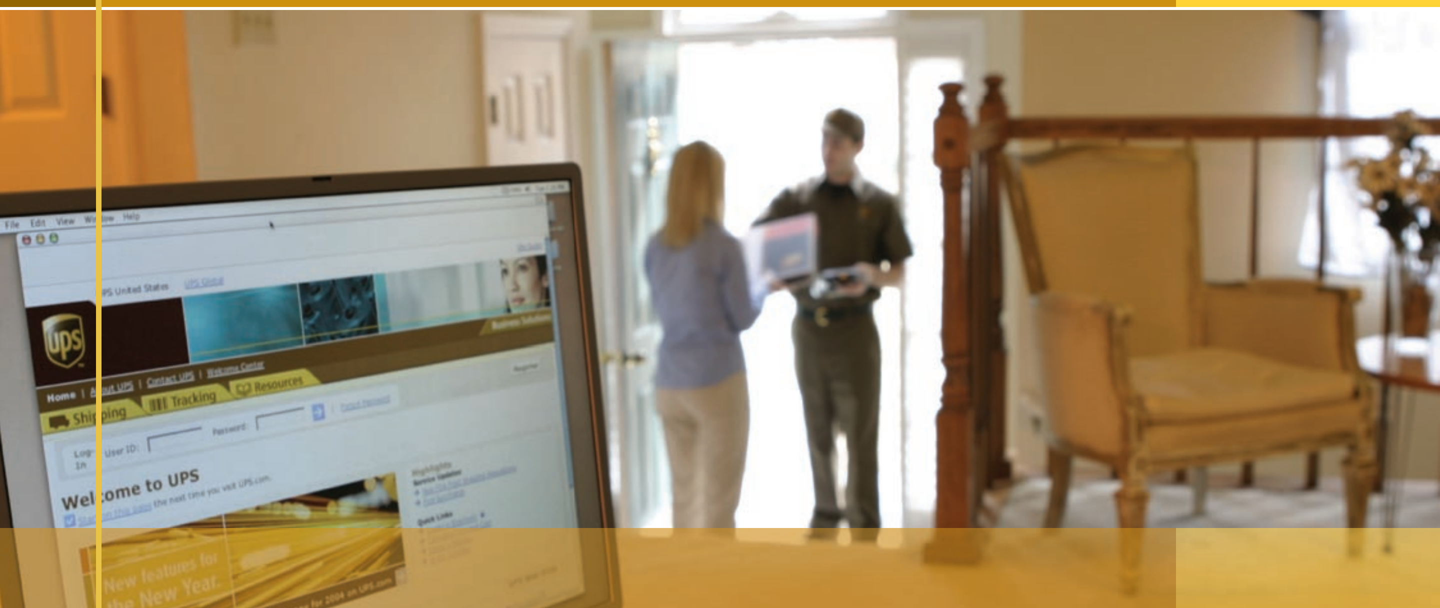
With more than 750 worldwide distribution centers, we're simplifying complex supply chains for businesses through multimodal freight shipments, customs clearance, order and inventory management, returns, parts distribution, international trade support, and financial services.

By doing so, we allow customers to focus on what they do best while we help increase their cash flow, improve service to their customers, differentiate their products from competitors, and find new ways to reach their customers around the world with efficiency and ease.

Facts:

- **UPS Supply Chain Solutions has operations in more than 120 countries around the world.**
- **UPS Supply Chain Solutions files more than 4 million customs entries in the United States, making it the nation's largest broker.**
- **UPS Supply Chain Solutions has hundreds of engineers to help remap supply chains for greater efficiency and market responsiveness.**
- **UPS Supply Chain Solutions was rated as the No. 1 logistics provider in *Inbound Logistics'* annual "Top 10 3PL Excellence Award" survey.**
- **UPS is ranked as the largest third-party logistics provider in North America by *Traffic World* magazine.**

We see more than 125,000 ways to connect.



Through drop boxes, retail outlets, and customer centers — even through our more than 70,000 drivers — we offer customers a broad range of access points.

By expanding and diversifying our customer access points, we not only offer customers convenience and accessibility, we're also invigorating our U.S. ground business and increasing our brand presence.

The UPS Store locations offer a full range of shipping and business services and represent a considerable package volume opportunity. Store locations have seen significant increases in UPS volume from both small businesses and retail customers. In fact, since the more than 3,000 Mail Boxes Etc. centers in the United States opted to convert to The UPS Store in March 2003, their UPS volume has more than doubled.

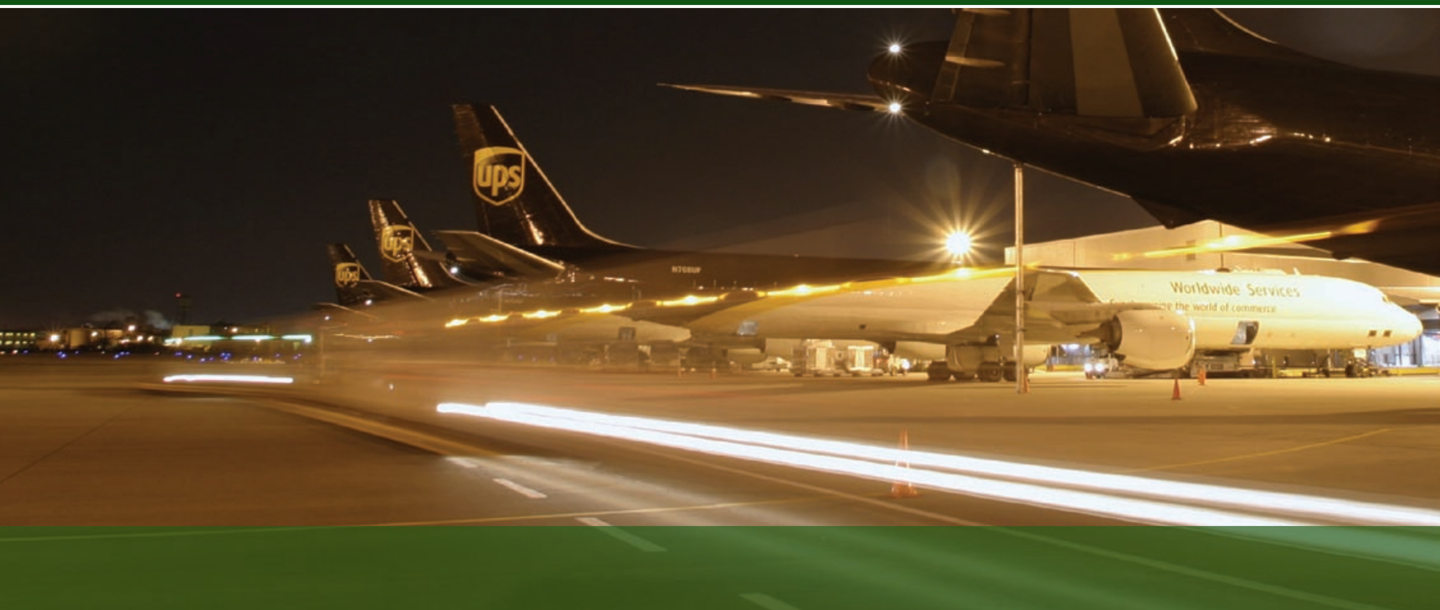
UPS also has thousands of drop boxes strategically located near businesses and retail areas for air express and expedited shipments, as well as in-store shipping and third-party retail pack-and-ship locations. What's more, customers can give their packages to any of our drivers who deliver more than 13 million packages and documents to customer loading docks, offices, and homes every day around the world.

Facts:

- **We have 4,500 retail locations worldwide — more than all other franchised shipping chains put together.**
- **In the United States and Canada, we have more than 41,000 drop boxes.**
- **There are 7,500 third-party retail pack-and-ship locations.**
- **We operate 1,400 customer centers within our operating facilities worldwide.**
- **We have more than 12,900 in-store shipping locations and commercial counters.**

We see 4 billion addresses.

Spanning the globe, we deliver more than 13.6 million packages and documents to customers in more than 200 countries and territories every day.



As the only company in the industry with an integrated global network and a substantial presence in every major market around the world, we saw international operating profit more than double in 2003. Our international export volume has grown at an annual compound rate of more than 13 percent in the last five years, generating the best margins in the industry.

Globalization has helped spur such growth, and our unparalleled product portfolio offers solutions addressing customers' local, regional, and global needs. Those solutions are possible through our use of sophisticated technologies, allowing us to consolidate shipments, speed packages through customs, and improve transit times.

We continue to expand our presence throughout the world via additional air rights and routes in Asia, and we're building upon our already extensive network with new facilities in Vancouver, Canada and Cologne, Germany. We're also set to expand our pan-European air and ground network in the 10 countries that are joining the European Union.

Facts:

- **We serve more than 850 airports around the world, flying more than 1,800 flight segments each day.**
- **We operate the 11th largest airline in the world.**
- **Local country management people average 14 years of UPS experience.**
- **With expanded air rights to Hong Kong, we now offer direct service to our two largest hubs in Europe and Asia and enhanced service to China's fastest growing express and cargo region.**
- **We have begun construction on a $135 million, 30,000-square-meter facility at Cologne/Bonn Airport in Germany, which will be the largest UPS facility outside the United States.**

We see margins over 15 percent.

Our integrated network, operational efficiencies, dedicated people, brand equity, and broad service portfolio create the best returns in the industry. By 2007, we expect even more — with operating profit margins expected to be above 15 percent in each of our business segments.

With a committment to employee stock ownership, UPS is a company run by investors for investors. UPS operates with the innovative qualities of a start-up company and the vision, discipline, and execution of a well-established industry leader. In fact, UPS strives to be the most efficient, cost effective, environmentally responsible, and profitable company in the industry.

And, we see a continued, positive outlook for growth in our industry. As trade barriers fall, free trade agreements are signed, and the movement towards globalization redefines the marketplace, companies increasingly are outsourcing services and moving goods around the world.

UPS is embracing these globalization trends. The strength of our brand has allowed us to expand beyond borders and cultures and given us the opportunity to offer innovative solutions to our customers. We are becoming synonymous with world commerce, and it's translating to the bottom line.

Facts:

- **We have a 96-year history of revenue growth.**
- **We are one of seven companies in the United States that has a Triple-A credit rating from both Standard & Poor's and Moody's.**
- **Our quarterly dividend increased 32 percent in 2003.**
- **We delivered 3.44 billion packages in 2003, an average of 13.6 million per day.**
- **Active and former employees and their families own more than 50 percent of UPS stock.**
- **For the sixth straight year, *FORTUNE* magazine named UPS a "World's Most Admired Company," and for the 21st consecutive year, *FORTUNE* named UPS "America's Most Admired" company in its industry.**

UPS 2003 Board of Directors

(left to right) John W. Thompson, James P. Kelly, Lea N. Soupata, Carol B. Tomé, Gary E. MacDougal, Victor A. Pelson, Joseph R. Moderow, Michael L. Eskew, Calvin Darden, Thomas H. Weidemeyer, Robert M. Teeter, Ann M. Livermore

Calvin Darden
Senior Vice President, UPS

Michael L. Eskew
Chairman and
Chief Executive Officer, UPS

James P. Kelly
Former Chairman and
Chief Executive Officer, UPS

Ann M. Livermore
Executive Vice President,
Hewlett-Packard Company

Gary E. MacDougal
Former Chairman and
Chief Executive Officer,
Mark Controls Corporation

Joseph R. Moderow*
Senior Vice President, UPS

Victor A. Pelson
Senior Advisor,
UBS Securities LLC

Lea N. Soupata
Senior Vice President, UPS

Robert M. Teeter
President,
Coldwater Corporation

John W. Thompson
Chairman and Chief
Executive Officer,
Symantec Corporation

Carol B. Tomé
Chief Financial Officer,
The Home Depot

Thomas H. Weidemeyer*
Senior Vice President, UPS

**After many years of distinguished service and leadership, Joe Moderow and Tom Weidemeyer retired effective January 1, 2004.*

Management Committee

This committee is responsible for the overall day-to-day management of our business.

David Abney
Senior Vice President and
President, UPS International

John J. Beystehner
Senior Vice President,
Chief Operating Officer, and
President, UPS Airlines

Calvin Darden
Senior Vice President,
U.S. Operations

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

Michael L. Eskew
Chairman and
Chief Executive Officer

Allen E. Hill
Senior Vice President,
General Counsel, and
Corporate Secretary

Kurt Kuehn
Senior Vice President,
Worldwide Sales and
Marketing

Kenneth W. Lacy
Senior Vice President and
Chief Information Officer

Christopher D. Mahoney
Senior Vice President,
Global Transportation Services

John McDevitt
Senior Vice President,
Strategic Integration

Joseph M. Pyne
Senior Vice President,
UPS Supply Chain Solutions

Lea N. Soupata
Senior Vice President,
Human Resources

Senior Operations Management

Jovita Carranza
Air Operations

Scott. E. Corrigan
Pacific Region

Wolfgang Flick
Europe Region

Stephen D. Flowers
Americas Region

Alan Gershenhorn
Canada Region

Myron A. Gray
Southwest Region

Wayne C. Herring
East Central Region

Michael J. Kamienski
West Region

Robert L. Lekites
UPS Airlines

Stephen R. Miele
Northeast Region

Christine M. Owens
Southeast Region

Robert E. Stoffel
UPS Supply Chain Solutions

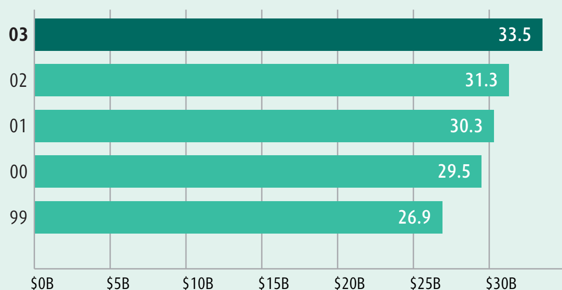
Kenneth A. Torok
Asia Pacific Region

James F. Winestock
North Central Region

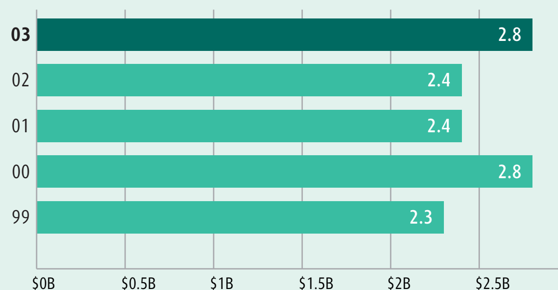
Northeast Region Manager Joe Farinacci, Europe Region Manager John Warrick, and East Central Region Manager Joe Zito recently retired after many years of dedicated service.

Financial highlights

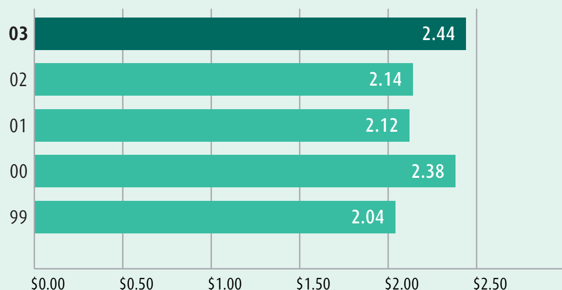
Revenue
(in billions)



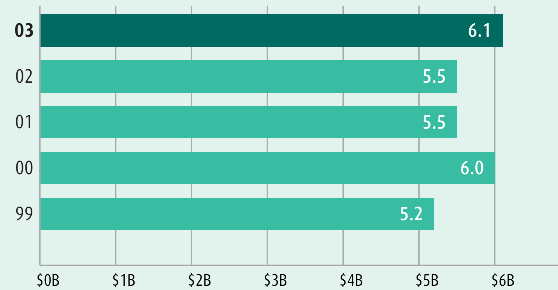
Adjusted Net Income (1,2,3,4,5)
(in billions)



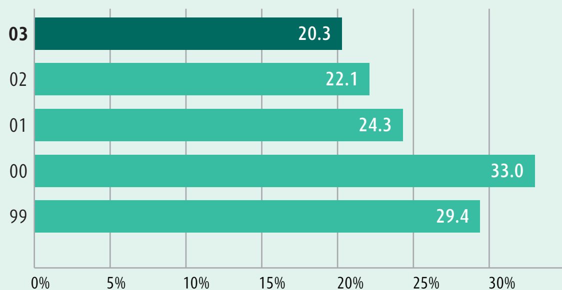
Adjusted Diluted EPS (1,2,3,4,5)
(in dollars)



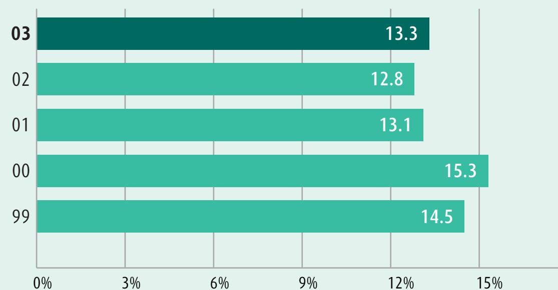
Adjusted EBITDA (1,2,3,4,5,7)
(in billions)



Adjusted Return on Equity (1,2,3,4,5,6)
(in percent)



Adjusted Operating Margin (1,2,3,4,5)
(in percent)



(1) 1999 excludes after-tax impact of tax assessment charge ($1.442 billion, $1.27 per share).
(2) 2000 excludes after-tax impact of charge from Teamsters contract arbitration ruling ($35 million, $0.03 per share), gain on sale of UPS Truck Leasing ($29 million, $0.03 per share), and investment gains ($145 million, $0.12 per share).
(3) 2001 excludes after-tax charge from adoption of FAS 133 ($26 million, $0.02 per share).
(4) 2002 excludes after-tax impact of tax assessment reversal ($776 million, $0.68 per share), credit from vacation policy change ($121 million, $0.11 per share), restructuring charge and related expenses ($65 million, $0.06 per share), and charge upon adoption of FAS 142 ($72 million, $0.06 per share).
(5) 2003 excludes after-tax gain from sale of Mail Technologies ($14 million, $0.01 per share) and Aviation Technologies ($15 million, $0.01 per share), gain on redemption of long-term debt ($18 million, $0.02 per share), impairment of investments ($37 million, $0.03 per share) and credits to income tax expense for a lower effective tax rate in the fourth quarter ($39 million, $0.03 per share), the resolution of various tax contingencies ($55 million, $0.05 per share), and a favorable ruling on the tax treatment of jet engine maintenance costs ($22 million, $0.02 per share).
(6) Excludes $5.266 billion net IPO proceeds in 1999 and 2000.
(7) EBITDA defined as earnings before interest, taxes, depreciation, and amortization.

Selected financial data

The following table sets forth selected financial data for each of the five years in the period ended December 31, 2003 (amounts in millions, except per share amounts). This financial data should be read together with our consolidated financial statements and the related notes, Management's Discussion and Analysis of Financial Condition and Results of Operations, and other financial data appearing elsewhere in this report.

Selected Income Statement Data

	Years Ended December 31,				
	2003	2002	2001	2000	1999
Revenue:					
U.S. domestic package	**$ 25,022**	$ 23,924	$ 23,997	$ 24,002	$ 22,313
International package	**5,561**	4,680	4,245	4,078	3,718
Non-package	**2,902**	2,668	2,079	1,418	841
Total revenue	**33,485**	31,272	30,321	29,498	26,872
Operating expenses:					
Compensation and benefits	**19,328**	17,940	17,397	16,546	15,285
Other	**9,712**	9,236	8,962	8,440	7,682
Total operating expenses	**29,040**	27,176	26,359	24,986	22,967
Operating profit:					
U.S. domestic package	**3,272**	3,576	3,620	3,929	3,506
International package	**709**	322	125	277	230
Non-package	**464**	198	217	306	169
Total operating profit	**4,445**	4,096	3,962	4,512	3,905
Other income (expense):					
Investment income	**18**	63	159	527	197
Interest expense	**(121)**	(173)	(184)	(205)	(228)
Gain on redemption of long-term debt	**28**	—	—	—	—
Tax assessment	**—**	1,023	—	—	(1,786)
Income before income taxes	**4,370**	5,009	3,937	4,834	2,088
Income taxes	**(1,472)**	(1,755)	(1,512)	(1,900)	(1,205)
Cumulative effect of changes in accounting principles	**—**	(72)	(26)	—	—
Net income	**$ 2,898**	$ 3,182	$ 2,399	$ 2,934	$ 883
Per share amounts:					
Basic earnings per share	**$ 2.57**	$ 2.84	$ 2.13	$ 2.54	$ 0.79
Diluted earnings per share	**$ 2.55**	$ 2.81	$ 2.10	$ 2.50	$ 0.77
Dividends declared per share	**$ 0.92**	$ 0.76	$ 0.76	$ 0.68	$ 0.58
Weighted average shares outstanding					
Basic	**1,128**	1,120	1,126	1,153	1,121
Diluted	**1,138**	1,134	1,144	1,175	1,141
As adjusted net income data:					
Net income	**$ 2,772**[(1)]	$ 2,422[(2)]	$ 2,425[(3)]	$ 2,795[(4)]	$ 2,325[(5)]
Basic earnings per share	**$ 2.46**	$ 2.16	$ 2.15	$ 2.42	$ 2.07
Diluted earnings per share	**$ 2.44**	$ 2.14	$ 2.12	$ 2.38	$ 2.04

Selected Balance Sheet Data

	As of December 31,				
	2003	2002	2001	2000	1999
Working capital	**$ 4,335**	$ 3,183	$ 2,811	$ 2,623	$ 5,994
Long-term debt	**$ 3,149**	$ 3,495	$ 4,648	$ 2,981	$ 1,912
Total assets	**$ 28,909**	$ 26,357	$ 24,636	$ 21,662	$ 23,028
Shareowners' equity	**$ 14,852**	$ 12,455	$ 10,248	$ 9,735	$ 12,474

(1) Excludes (on an after-tax basis) the gain on sale of Mail Technologies ($14 million) and Aviation Technologies ($15 million), the gain on redemption of long-term debt ($18 million), the loss on impairment of investments ($37 million), a reduction of income tax expense due to a lower effective tax rate from improvements in state income taxes ($39 million), a reduction of income tax expense due to the resolution of various tax contingency matters ($55 million), and a reduction of income tax expense from a favorable ruling on the tax treatment for jet engine maintenance costs ($22 million).

(2) Excludes (on an after-tax basis) $121 million gain related to change in vacation policy, $65 million restructuring charge and related expenses, $72 million charge related to the adoption of FAS 142, and $776 million gain related to the settlement of a previously established tax assessment liability.

(3) Excludes $26 million after-tax charge related to the adoption of FAS 133.

(4) Excludes (on an after-tax basis) $145 million in investment gains, a $29 million gain on the sale of our UPS Truck Leasing subsidiary, and a $35 million charge related to an arbitration ruling under our 1997 contract with the Teamsters.

(5) Excludes a $1.442 billion tax assessment charge.

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Independent auditors' report

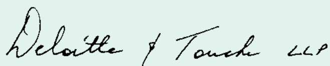
Board of Directors and Shareowners
United Parcel Service, Inc.
Atlanta, Georgia

We have audited the accompanying consolidated balance sheets of United Parcel Service, Inc. and its subsidiaries as of December 31, 2003 and 2002, and the related consolidated statements of income, shareowners' equity, and cash flows for each of the three years in the period ended December 31, 2003. 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 auditing standards generally accepted in the United States of America. 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, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003 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. 133, "Accounting for Derivative Instruments and Hedging Activities," effective January 1, 2001; 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.



Deloitte & Touche LLP

Atlanta, Georgia
March 5, 2004

Consolidated balance sheets

As of December 31,

(in millions except per share amounts)	2003	2002
ASSETS		
Current Assets:		
Cash & cash equivalents	**$ 2,951**	$ 2,211
Marketable securities & short-term investments	**1,001**	803
Accounts receivable, net	**4,004**	3,756
Finance receivables, net	**840**	868
Deferred income taxes	**316**	268
Other current assets	**741**	832
Total Current Assets	**9,853**	8,738
Property, Plant, and Equipment—at cost, net of accumulated depreciation & amortization of $13,007 and $11,749 in 2003 and 2002	**13,908**	13,612
Prepaid Pension Costs	**2,922**	1,932
Goodwill and Intangible Assets, Net	**1,273**	1,180
Other Assets	**953**	895
	$ 28,909	$ 26,357
LIABILITIES AND SHAREOWNERS' EQUITY		
Current Liabilities:		
Current maturities of long-term debt and commercial paper	**$ 674**	$ 1,107
Accounts payable	**2,003**	1,908
Accrued wages & withholdings	**1,166**	1,084
Dividends payable	**282**	212
Other current liabilities	**1,393**	1,244
Total Current Liabilities	**5,518**	5,555
Long-Term Debt	**3,149**	3,495
Accumulated Postretirement Benefit Obligation, Net	**1,335**	1,251
Deferred Taxes, Credits & Other Liabilities	**4,055**	3,601
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 571 and 642 in 2003 and 2002	**6**	7
Class B common stock, par value $.01 per share, authorized 5,600 shares, issued 560 and 482 in 2003 and 2002	**5**	4
Additional paid-in capital	**662**	387
Retained earnings	**14,356**	12,495
Accumulated other comprehensive loss	**(177)**	(438)
Deferred compensation arrangements	**136**	84
	14,988	12,539
Less: Treasury stock (2 and 1 shares in 2003 and 2002)	**(136)**	(84)
	14,852	12,455
	$ 28,909	$ 26,357

See notes to consolidated financial statements.

Statements of consolidated income

Years Ended December 31,

(in millions except per share amounts)	**2003**	2002	2001
Revenue	**$ 33,485**	$ 31,272	$ 30,321
Operating Expenses:			
Compensation and benefits	**19,328**	17,940	17,397
Other	**9,712**	9,236	8,962
	29,040	27,176	26,359
Operating Profit	**4,445**	4,096	3,962
Other Income and (Expense):			
Investment income	**18**	63	159
Interest expense	**(121)**	(173)	(184)
Gain on redemption of long-term debt	**28**	—	—
Tax assessment reversal	—	1,023	—
	(75)	913	(25)
Income Before Income Taxes and Cumulative Effect of Changes in Accounting Principles	**4,370**	5,009	3,937
Income Taxes	**1,472**	1,755	1,512
Income Before Cumulative Effect of Changes in Accounting Principles	**2,898**	3,254	2,425
Cumulative Effect of Changes in Accounting Principles, Net of Taxes	—	(72)	(26)
Net Income	**$ 2,898**	$ 3,182	$ 2,399
Basic Earnings Per Share Before Cumulative Effect of Changes in Accounting Principles	**$ 2.57**	$ 2.91	$ 2.15
Basic Earnings Per Share	**$ 2.57**	$ 2.84	$ 2.13
Diluted Earnings Per Share Before Cumulative Effect of Changes in Accounting Principles	**$ 2.55**	$ 2.87	$ 2.12
Diluted Earnings Per Share	**$ 2.55**	$ 2.81	$ 2.10

See notes to consolidated financial statements.

Statements of consolidated shareowners' equity

Years Ended December 31,

	2003		2002		2001	
(in millions except per share amounts)	**Shares**	**Dollars**	Shares	Dollars	Shares	Dollars
Class A Common Stock						
Balance at beginning of year	**642**	**$ 7**	772	$ 8	936	$ 9
Common stock purchases	**(5)**	**—**	(10)	—	(26)	—
Stock award plans	**12**	**—**	11	—	13	—
Common stock issuances	**2**	**—**	2	—	1	—
Conversions of Class A to Class B common stock	**(80)**	**(1)**	(133)	(1)	(152)	(1)
Balance at end of year	**571**	**6**	642	7	772	8
Class B Common Stock						
Balance at beginning of year	**482**	**4**	349	3	199	2
Common stock purchases	**(2)**	**—**	—	—	(10)	—
Common stock issued for acquisitions	**—**	**—**	—	—	8	—
Conversions of Class A to Class B common stock	**80**	**1**	133	1	152	1
Balance at end of year	**560**	**5**	482	4	349	3
Additional Paid-In Capital						
Balance at beginning of year		**387**		414		267
Stock award plans		**545**		477		521
Common stock issued for acquisitions		**—**		—		510
Common stock purchases		**(398)**		(604)		(954)
Common stock issuances		**128**		100		70
Balance at end of year		**662**		387		414
Retained Earnings						
Balance at beginning of year		**12,495**		10,162		9,684
Net income		**2,898**		3,182		2,399
Dividends ($0.92, $0.76, and $0.76 in 2003, 2002, and 2001, respectively)		**(1,037)**		(849)		(856)
Common stock purchases		**—**		—		(1,065)
Balance at end of year		**14,356**		12,495		10,162
Accumulated Other Comprehensive Income						
Foreign currency translation adjustment:						
Balance at beginning of year		**(328)**		(269)		(223)
Aggregate adjustment for the year		**272**		(59)		(46)
Balance at end of year		**(56)**		(328)		(269)
Unrealized gain (loss) on marketable securities, net of tax:						
Balance at beginning of year		**(34)**		(21)		(4)
Current period changes in fair value (net of tax effect of $13, $(9), and $0)		**21**		(16)		(1)
Reclassification to earnings (net of tax effect of $17, $1, and $(11))		**27**		3		(16)
Balance at end of year		**14**		(34)		(21)
Unrealized gain (loss) on cash flow hedges, net of tax:						
Balance at beginning of year		**(26)**		(49)		—
FAS 133 transition adjustment		**—**		—		23
Current period changes in fair value (net of tax effect of $(6), $6, and $(24))		**(9)**		10		(39)
Reclassification to earnings (net of tax effect of $(21), $9, and $(21))		**(37)**		13		(33)
Balance at end of year		**(72)**		(26)		(49)
Additional minimum pension liability, net of tax:						
Balance at beginning of year		**(50)**		—		—
Minimum pension liability adjustment (net of tax effect of $(6), $(31), and $0)		**(13)**		(50)		—
Balance at end of year		**(63)**		(50)		—
Accumulated other comprehensive income at end of year		**(177)**		(438)		(339)
Deferred Compensation Obligations						
Balance at beginning of year		**84**		47		—
Common stock held for deferred compensation arrangements		**52**		37		47
Balance at end of year		**136**		84		47
Treasury Stock						
Balance at beginning of year	**(1)**	**(84)**	(1)	(47)	—	—
Common stock held for deferred compensation arrangements	**(1)**	**(52)**	—	(37)	(1)	(47)
Balance at end of year	**(2)**	**(136)**	(1)	(84)	(1)	(47)
Total Shareowners' Equity At End Of Year		**$14,852**		$ 12,455		$ 10,248
Comprehensive Income		**$ 3,159**		$ 3,083		$ 2,287

See notes to consolidated financial statements.

Statements of consolidated cash flows

Years Ended December 31,

(in millions)	**2003**	2002	2001
Cash Flows From Operating Activities:			
Net income	**$ 2,898**	$ 3,182	$ 2,399
Adjustments to reconcile net income to net cash from operating activities:			
Depreciation and amortization	**1,549**	1,464	1,396
Postretirement benefits	**84**	121	81
Deferred taxes, credits, and other	**317**	162	481
Stock award plans	**497**	445	495
Loss (gain) on investments	**57**	16	4
Loss (gain) on impairment or disposal of assets	**55**	19	29
Provision for losses on finance receivables	**39**	26	7
Restructuring charge and related expenses	**—**	85	—
Impairment of goodwill	**—**	74	—
Vacation policy change	**—**	(121)	—
Tax assessment reversal	**—**	(776)	—
Changes in assets and liabilities, net of effect of acquisitions:			
Accounts receivable, net	**(264)**	312	415
Other current assets	**13**	403	(142)
Prepaid pension costs	**(990)**	(87)	(252)
Accounts payable	**66**	(56)	(313)
Accrued wages and withholdings	**83**	112	27
Dividends payable	**70**	—	20
Income taxes payable	**204**	16	35
Other current liabilities	**(32)**	291	(112)
Net cash from operating activities	**4,646**	5,688	4,570
Cash Flows From Investing Activities:			
Capital expenditures	**(1,947)**	(1,658)	(2,372)
Disposals of property, plant, and equipment	**118**	89	136
Purchases of marketable securities and short-term investments	**(6,074)**	(2,303)	(3,361)
Sales and maturities of marketable securities and short-term investments	**5,909**	2,211	3,686
Net (increase) decrease in finance receivables	**50**	(495)	(637)
Cash received (paid) for business acquisitions/dispositions	**8**	(14)	(466)
Other asset receipts (payments)	**(6)**	(24)	(39)
Net cash (used in) investing activities	**(1,942)**	(2,194)	(3,053)
Cash Flows From Financing Activities:			
Proceeds from borrowings	**361**	419	2,312
Repayments of borrowings	**(1,245)**	(1,099)	(1,089)
Purchases of common stock	**(398)**	(604)	(2,019)
Issuances of common stock	**154**	116	219
Dividends	**(1,026)**	(840)	(847)
Other transactions	**(26)**	(82)	(69)
Net cash (used in) financing activities	**(2,180)**	(2,090)	(1,493)
Effect Of Exchange Rate Changes On Cash	**216**	(51)	(45)
Net Increase (Decrease) In Cash And Cash Equivalents	**740**	1,353	(21)
Cash And Cash Equivalents:			
Beginning of period	**2,211**	858	879
End of period	**$ 2,951**	$ 2,211	$ 858
Cash Paid During The Period For:			
Interest (net of amount capitalized)	**$ 126**	$ 190	$ 164
Income taxes	**$ 1,097**	$ 1,416	$ 1,042

See notes to consolidated financial statements.

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 non-package subsidiaries, 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.

UPS Supply Chain Solutions — Freight forwarding revenue is recognized net of the expense related to the transportation of freight at the time the services are performed. 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.

UPS Capital — Income on loans and direct finance leases is recognized on the 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 (including investments in debt, auction rate securities, and other money market instruments of $2.493 and $1.780 billion at December 31, 2003 and 2002, respectively) 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.

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 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 Financial Accounting Standards Board Statement No. 115 "Accounting for Certain Investments in Debt and Equity Securities." 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 – 5 to 8 1/3 years; Technology Equipment (including capitalized software) – 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, $25, and $47 million for 2003, 2002, and 2001, 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 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, $69 million of which impacted the U.S. domestic package segment and $6 million of which impacted the international package segment. This charge is 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"). The amortization of goodwill and indefinite-lived intangibles ceased upon the implementation of FAS 142 on January 1, 2002. Had the non-amortization provisions of FAS 142 been applied to 2001, then our net income would have been increased by $59 million, or $0.05 per diluted share in that year.

Also upon adoption of FAS 142, we were required to test all existing goodwill for impairment as of that date, 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 is reported as a cumulative effect of a change in accounting principle and resulted in a restatement of our first quarter 2002 quarterly financial statements (see Note 19). 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 test performed in 2003 resulted in no goodwill impairment.

Self-Insurance Accruals

We self-insure costs associated with workers' compensation claims, automotive liability, 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.

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 $21, $27, and $16 million in 2003, 2002, and 2001, 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 has been 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 in 2003 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 2003 net income by $20 million, or $0.02 per diluted share.

Notes to consolidated financial statements

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).

	2003	2002	2001
Net income	**$ 2,898**	$ 3,182	$ 2,399
Add: Stock-based employee compensation expense included in net income, net of tax effects	**456**	391	440
Less: Total pro forma stock-based employee compensation expense, net of tax effects	**(507)**	(459)	(491)
Pro forma net income	**$ 2,847**	$ 3,114	$ 2,348
Basic earnings per share			
As reported	**$ 2.57**	$ 2.84	$ 2.13
Pro forma	**$ 2.52**	$ 2.78	$ 2.08
Diluted earnings per share			
As reported	**$ 2.55**	$ 2.81	$ 2.10
Pro forma	**$ 2.50**	$ 2.75	$ 2.05

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:

Stock options:	**2003**	2002	2001
Expected yield	**1.22%**	1.10%	1.10%
Risk-free interest rate	**3.70%**	4.67%	4.64%
Expected life in years	**8**	5	5
Expected volatility	**19.55%**	20.24%	32.40%
Weighted-average fair value of options granted	**$ 17.02**	$ 21.27	$ 25.49

Discounted stock purchase plan:	**2003**	2002	2001
Expected yield	**1.12%**	1.10%	1.10%
Risk-free interest rate	**1.06%**	1.70%	2.36%
Expected life in years	**0.25**	0.25	0.25
Expected volatility	**19.79%**	20.45%	22.85%
Weighted-average fair value of purchase rights*	**$ 8.53**	$ 8.20	$ 7.19

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

Derivative Instruments

Effective January 1, 2001, we adopted FASB Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("FAS 133"), as amended by Statements No. 137 and No. 138. FAS 133, as amended, 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.

At January 1, 2001, our financial statements were adjusted to record cumulative effect of adopting FAS 133, as follows (in millions, except per share amounts):

	Income	OCI
Adjustment to fair value of derivative instruments	$ (42)	$ 37
Income tax effects	16	(14)
Adjustment, net of tax	$ (26)	$ 23
Effect on diluted earnings per share [(a)]	$ (0.02)	

(a) For income effect, amount shown is net of adjustment to hedged items.

The cumulative effect on income resulted primarily from marking to market the time value of option contracts used in commodity and foreign currency cash flow hedging. The cumulative effect on OCI resulted primarily from marking to market swap contracts used as cash flow hedges of anticipated foreign currency cash flows and anticipated purchases of energy products.

New Accounting Pronouncements

In June 2002, the FASB issued Statement No. 146 "Accounting for Costs Associated with Exit or Disposal Activities" ("FAS 146"). FAS 146 provides guidance on the recognition and measurement of liabilities associated with exit or disposal activities and requires that such liabilities be recognized when incurred. This statement was effective for exit or disposal activities initiated on or after January 1, 2003.

As discussed in Note 17, we implemented a restructuring program involving the business unit integration of our Freight Services and Logistics Group operations in the fourth quarter of 2002. As this restructuring program was initiated in 2002, we accounted for this restructuring program using the existing guidance in EITF 94-3 "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)." Therefore, the adoption of FAS 146 on January 1, 2003 had no effect on our results of operations or financial condition. In the fourth quarter of 2002, we recorded a pre-tax restructuring charge and related expenses in the amount of $106 million, which is classified in other operating expenses.

In November 2002, the FASB issued Interpretation No. 45 "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("FIN 45"). FIN 45 requires that a liability be recognized at fair value at the inception of certain guarantees for the obligations undertaken by the guarantor. FIN 45 also requires additional disclosures for certain guarantee contracts. The disclosure provisions of FIN 45 were effective for financial statements ending after December 15, 2002, while the recognition and initial measurement provisions were applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The adoption of FIN 45 was not material to our results of operations or financial condition.

In January 2003, the FASB issued Interpretation No. 46 "Consolidation of Variable Interest Entities," to address perceived weaknesses in accounting for entities commonly known as special purpose or off balance sheet. In addition to numerous FASB Staff Positions written to clarify and improve the application of FIN 46, the FASB recently announced a deferral for certain entities, and an amendment to FIN 46 entitled FASB Interpretation No. 46 (revised December 2003) "Consolidation of Variable Interest Entities" ("FIN 46").

FIN 46 provides guidance for identifying the party with a controlling financial interest resulting from arrangements or financial instruments rather than voting interests. FIN 46 defines the term "variable interest entity" and is based on the premise that if a business enterprise absorbs a majority of such an entity's expected losses and/or receives a majority of its expected residual returns, that enterprise has a controlling financial interest, and would thus require consolidation of the variable interest entity. As of December 31, 2003, we have adopted FIN 46, and the effects of adoption were not material to our results of operations or financial condition.

On July 1, 2003, we adopted FASB Statement No. 149 "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" ("FAS 149"). FAS 149 amends FAS 133 for certain decisions made by the FASB as part of the Derivatives Implementation Group process. FAS 149 also amends FAS 133 to incorporate clarifications of the definition of a derivative. The adoption of FAS 149 was not material to our results of operations or financial condition.

On July 1, 2003, we adopted FASB Statement No. 150 "Accounting for Certain Instruments with Characteristics of Both Liabilities and Equity" ("FAS 150"). FAS 150 establishes how an issuer measures certain freestanding financial instruments with characteristics of both liabilities and equity, and requires that such instruments be classified as liabilities. The adoption of FAS 150 was not material to our results of operations or financial condition.

In December 2003, the FASB revised Statement No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits" ("FAS 132"). The revised standard requires new disclosures in addition to those required by the original standard about the assets, obligations, cash flows, and net periodic benefit cost of defined benefit pension plans and other defined benefit postretirement plans. As revised, FAS 132 is effective for financial statements with fiscal years ending after December 15, 2003, and we have included these disclosures in Note 5 – Employee Benefit Plans.

Changes in Presentation

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

Notes to consolidated financial statements

NOTE 2. MARKETABLE SECURITIES AND SHORT-TERM INVESTMENTS

The following is a summary of marketable securities and short-term investments at December 31, 2003 and 2002 (in millions):

2003	Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
U.S. government & agency securities	$ 126	$ 1	$ —	$ 127
U.S. mortgage & asset-backed securities	315	1	—	316
U.S. corporate securities	160	2	1	161
U.S. state and local municipal securities	158	—	—	158
Other debt securities	5	—	1	4
Total debt securities	764	4	2	766
Common equity securities	66	29	—	95
Preferred equity securities	149	—	9	140
	$ 979	$ 33	$ 11	$ 1,001

2002	Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
U.S. government & agency securities	$ 79	$ 3	$ —	$ 82
U.S. mortgage & asset-backed securities	72	3	—	75
U.S. corporate securities	147	2	1	148
U.S. state and local municipal securities	53	—	—	53
Other debt securities	4	—	1	3
Total debt securities	355	8	2	361
Common equity securities	379	5	62	322
Preferred equity securities	125	—	5	120
	$ 859	$ 13	$ 69	$ 803

The gross realized gains on sales of marketable securities totaled $21, $11, and $34 million in 2003, 2002, and 2001, respectively. The gross realized losses totaled $7, $10, and $7 million in 2003, 2002, and 2001, respectively. Impairment losses recognized on marketable securities and short-term investments totaled $58, $5, and $0 million during 2003, 2002, and 2001, 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, 2003 (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	$ 24	$ —	$ 1	$ —	$ 25	$ —
U.S. mortgage & asset-backed securities	9	—	1	—	10	—
U.S. corporate securities	38	1	10	—	48	1
U.S. state and local municipal securities	10	—	—	—	10	—
Other debt securities	—	1	—	—	—	1
Total debt securities	81	2	12	—	93	2
Common equity securities	—	—	—	—	—	—
Preferred equity securities	—	—	91	9	91	9
	$ 81	$ 2	$ 103	$ 9	$ 184	$ 11

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, 2003, 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	$ 19	$ 19
Due after one year through three years	150	150
Due after three years through five years	19	19
Due after five years	576	578
	764	766
Equity securities	215	235
	$ 979	$ 1,001

NOTE 3. FINANCE RECEIVABLES

The following is a summary of finance receivables at December 31, 2003 and 2002 (in millions):

	2003	2002
Commercial term loans	**$ 438**	$ 523
Investment in finance leases	**270**	218
Asset-based lending	**290**	381
Receivable factoring	**468**	400
Gross finance receivables	**1,466**	1,522
Less: Allowance for credit losses	**(52)**	(38)
Balance at December 31	**$ 1,414**	$ 1,484

Outstanding receivable balances at December 31, 2003 and 2002 are net of unearned income of $48 and $35 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, 2003 and 2002 (in millions):

	2003	2002
Customer receivable balances	**$ 468**	$ 400
Less: Amounts due to client	**(195)**	(176)
Net funds employed	**$ 273**	$ 224

Non-earning finance receivables were $67 and $41 million at December 31, 2003 and 2002, respectively. The following is a roll-forward of the allowance for credit losses on finance receivables (in millions):

	2003	2002
Balance at January 1	**$ 38**	$ 30
Provisions charged to operations	**39**	26
Charge-offs, net of recoveries	**(25)**	(18)
Balance at December 31	**$ 52**	$ 38

The carrying value of finance receivables at December 31, 2003, 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	$ 872
Due after one year through three years	144
Due after three years through five years	107
Due after five years	343
	$ 1,466

Based on interest rates for financial instruments with similar terms and maturities, the fair value of finance receivables is approximately $1.384 and $1.492 billion as of December 31, 2003 and 2002, respectively. At December 31, 2003, we had unfunded loan commitments totaling $493 million, consisting of standby letters of credit of $68 million and other unfunded lending commitments of $425 million.

Notes to consolidated financial statements

NOTE 4. PROPERTY, PLANT, AND EQUIPMENT

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

	2003	2002
Vehicles	**$ 3,486**	$ 3,467
Aircraft (including aircraft under capitalized leases)	**10,897**	10,151
Land	**721**	704
Buildings	**2,083**	2,049
Leasehold improvements	**2,219**	2,159
Plant equipment	**4,410**	4,248
Technology equipment (including capitalized software)	**2,366**	1,998
Equipment under operating lease	**53**	50
Construction-in-progress	**680**	535
	26,915	25,361
Less: Accumulated depreciation and amortization	**(13,007)**	(11,749)
	$ 13,908	$ 13,612

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.

Our accumulated postretirement benefit obligation and net periodic cost for our postretirement medical benefits do not reflect the effects of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (the "Act"). The provisions of the Act provide for a federal subsidy for plans that provide prescription drug benefits and meet certain qualifications. Specific authoritative guidance on the accounting for the federal subsidy is pending, and when that guidance is issued, it could require us to change information related to our actuarially determined, accumulated postretirement benefit obligation, and net periodic cost for our postretirement medical benefit plans.

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	
	2003	2002	**2003**	2002
Net benefit obligation at October 1, prior year	**$ 6,670**	$ 5,347	**$ 2,149**	$ 1,759
Service cost	**282**	217	**79**	63
Interest cost	**465**	413	**148**	134
Plan participants' contributions	**—**	—	**6**	3
Plan amendments	**3**	100	**(22)**	38
Actuarial (gain) loss	**876**	777	**337**	236
Gross benefits paid	**(204)**	(184)	**(105)**	(84)
Net benefit obligation at September 30	**$ 8,092**	$ 6,670	**$ 2,592**	$ 2,149

Weighted-average assumptions used to determine benefit obligations:	Pension Benefits		Postretirement Medical Benefits	
	2003	2002	**2003**	2002
Discount rate	**6.25%**	6.75%	**6.25%**	6.75%
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, 2003 and 2002 was $7.325 and $5.977 billion, respectively. We use a measurement date of September 30 for our pension and postretirement benefit plans.

Future postretirement medical benefit costs were forecasted assuming an initial annual increase of 9.00%, decreasing to 5.00% by the year 2013 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	$ 78	$ (76)

Because the UPS Excess Coordinating Plan is not funded, the Company has recorded an additional minimum pension liability for this plan of $105 and $88 million at December 31, 2003 and 2002, respectively. This liability is included in the other credits and non-current liabilities portion of Note 9. As of December 31, 2003 and 2002, the Company has recorded an intangible asset of $5 and $7 million, respectively, representing the net unrecognized prior service cost for this plan. A total of $63 and $50 million at December 31, 2003 and 2002, respectively, was recorded as a reduction of other comprehensive income in Shareowners' Equity (net of the tax effect of $37 and $31 million, respectively). The unfunded accumulated benefit obligation of the UPS Excess Coordinating Benefit Plan was $154 and $121 million as of December 31, 2003 and 2002, respectively.

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	
	2003	2002	**2003**	2002
Fair value of plan assets at October 1, prior year	**$ 6,494**	$ 6,496	**$ 337**	$ 372
Actual return on plan assets	**1,143**	77	**47**	3
Employer contributions	**390**	105	**124**	43
Plan participants' contributions	**—**	—	**6**	3
Gross benefits paid	**(204)**	(184)	**(105)**	(84)
Fair value of plan assets at September 30	**$ 7,823**	$ 6,494	**$ 409**	$ 337

Notes to consolidated financial statements

The asset allocation for our pension and other postretirement plans as of September 30, 2003 and 2002 and the target allocation for 2004, by asset category, are as follows:

	Weighted Average Target Allocation	Percentage of Plan Assets at September 30,	
	2004	**2003**	2002
Equity securities	55% - 65%	**60.2%**	60.0%
Fixed income securities	20% - 30%	**28.5%**	25.4%
Real estate/other	10% - 15%	**11.3%**	14.6%
Total		**100.0%**	100.0%

Equity securities include UPS Class A shares of common stock in the amounts of $392 (4.8% of total plan assets) and $384 million (5.6% of total plan assets), as of September 30, 2003 and 2002, 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	
	2003	2002	**2003**	2002
Fair value of plan assets at September 30	**$ 7,823**	$ 6,494	**$ 409**	$ 337
Benefit obligation at September 30	**(8,092)**	(6,670)	**(2,592)**	(2,149)
Funded status at September 30	**(269)**	(176)	**(2,183)**	(1,812)
Amounts not yet recognized:				
Unrecognized net actuarial (gain) loss	**2,085**	1,712	**820**	516
Unrecognized prior service cost	**331**	364	**11**	35
Unrecognized net transition obligation	**23**	31	**—**	—
Employer contributions	**752**	1	**17**	10
Net asset (liability) recorded at December 31	**$ 2,922**	$ 1,932	**$ (1,335)**	$ (1,251)
Prepaid pension cost	**$ 2,970**	$ 1,964	**$ —**	$ —
Accrued benefit cost	**(153)**	(120)	**(1,335)**	(1,251)
Intangible asset	**5**	7	**—**	—
Accumulated other comprehensive income (pre-tax)	**100**	81	**—**	—
Net asset (liability) recorded at December 31	**$ 2,922**	$ 1,932	**$ (1,335)**	$ (1,251)

At September 30, 2003 and 2002, 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	
As of September 30	**2003**	2002	**2003**	2002
Projected benefit obligation	**$ 6,772**	$ 5,640	**$ 178**	$ 141
Accumulated benefit obligation	**$ 6,004**	$ 4,948	**$ 154**	$ 121
Fair value of plan assets	**$ 6,479**	$ 5,461	**$ —**	$ —

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):

Employer Contributions:	Pension Benefits	Other Benefits
2004 (expected) to plan trusts	$ 426	$ 64

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		
Net Periodic Cost:	**2003**	2002	2001	**2003**	2002	2001
Service cost	**$ 282**	$ 217	$ 192	**$ 79**	$ 63	$ 55
Interest cost	**465**	413	363	**148**	134	118
Expected return on assets	**(669)**	(654)	(616)	**(29)**	(33)	(42)
Amortization of:						
Transition obligation	**8**	8	8	**—**	—	—
Prior service cost	**37**	30	30	**1**	(1)	(1)
Actuarial (gain) loss	**28**	4	(7)	**15**	4	—
Net periodic benefit cost (benefit)	**$ 151**	$ 18	$ (30)	**$ 214**	$ 167	$ 130

Weighted-average assumptions used to determine net cost:						
Discount rate	**6.75%**	7.50%	7.75%	**6.75%**	7.50%	7.75%
Rate of compensation increase	**4.00%**	4.00%	4.00%	**N/A**	N/A	N/A
Expected return on plan assets	**9.21%**	9.42%	9.50%	**9.25%**	9.50%	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, 2003 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	$ 6	$ (6)

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 $1.066 and $1.028 billion, and $977 million during 2003, 2002, and 2001, 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 $691, $604, and $553 million during 2003, 2002, and 2001, 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 $87, $79, and $71 million for 2003, 2002, and 2001, 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

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

	2003	2002
Non-current finance receivables, net of allowance for credit losses	**$ 574**	$ 616
Other non-current assets	**379**	279
	$ 953	$ 895

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

	U.S. Domestic Package	International Package	Non-Package	Consolidated
December 31, 2001 balance	$ —	$ 102	$ 1,014	$ 1,116
Acquired	—	—	—	—
Impaired	—	—	(74)	(74)
Currency/Other	—	—	28	28
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**

The goodwill added in the non-package segment resulted from the purchase of the remaining minority interest in a previously acquired company.

The following is a summary of intangible assets at December 31, 2003 and 2002 (in millions):

	Trademarks, Franchise Rights, Licenses, Patents, and Other	Intangible Pension Asset	Total Intangible Assets
December 31, 2003:			
Gross carrying amount	**$ 118**	**$ 5**	**$ 123**
Accumulated amortization	**(23)**	**—**	**(23)**
Net carrying value	**$ 95**	**$ 5**	**$ 100**
December 31, 2002:			
Gross carrying amount	$ 118	$ 7	$ 125
Accumulated amortization	(15)	—	(15)
Net carrying value	$ 103	$ 7	$ 110

Amortization of intangible assets was $9, $8, and $7 million during 2003, 2002 and 2001, respectively. Expected amortization of finite-lived intangibles for the next five years is as follows (in millions): 2004 - $9; 2005 - $9; 2006 - $9; 2007 - $9; 2008 - $6.

NOTE 7. BUSINESS ACQUISITIONS AND DISPOSITIONS

We regularly explore opportunities to make acquisitions that would enhance our package delivery business and our various non-package businesses. Our acquisitions include both domestic and international transactions. During the three years ended December 31, 2003, we completed 10 acquisitions that 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 $30, $14, and $466 million in 2003, 2002, and 2001, respectively, and issued aggregate UPS Class B common shares of 8.4 million in 2001. 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 expect such adjustments to the purchase price allocations to be immaterial.

During 2001, we completed several acquisitions that were added to the non-package segment. We acquired Mail Boxes Etc., the world's largest franchisor of independently owned and operated business, communication, and shipping centers worldwide, for cash of $185 million. We acquired Fritz Companies, Inc., a freight forwarding, customs brokerage, and logistics company, for 7.3 million Class B common shares valued at $456 million. Additionally, we acquired First International Bancorp, Inc., a provider of structured trade finance, commercial, and government-backed lending products, for 1.1 million Class B common shares valued at $54 million.

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 non-package 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.

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 non-package segment. The operating results of both the Mail Technologies unit and the Aviation Technologies unit were previously included in our non-package segment, and were not material to our consolidated operating results in any of the periods presented.

In January 2004, we announced the acquisition of the remaining 49% minority interest in UPS Yamato Express Co., which is currently a joint venture with Yamato Transport Co. in Japan. UPS Yamato Express provides express package delivery services in Japan. Upon the close of the acquisition, UPS Yamato Express will become a wholly-owned subsidiary of UPS. The acquisition of UPS Yamato Express Co. will not have a material effect on our financial condition or results of operations.

Notes to consolidated financial statements

NOTE 8. LONG-TERM DEBT AND COMMITMENTS

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

	2003	2002
$8^{3/8}$% Debentures, due April 1, 2020 (i)	**$ 444**	$ 424
$8^{3/8}$% Debentures, due April 1, 2030 (i)	**276**	276
Commercial paper (ii)	**544**	1,036
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**	341
1.75% Cash-settled convertible senior notes, due September 27, 2007 (vi)	**—**	323
Capitalized lease obligations (vii)	**451**	469
UPS Notes (viii)	**419**	568
5.50% Pound Sterling notes, due February 12, 2031	**887**	801
4.50% Singapore Dollar notes, due November 11, 2004	**59**	58
Installment notes, mortgages, and bonds at various rates	**53**	57
	3,823	4,602
Less current maturities	**(674)**	(1,107)
	$ 3,149	$ 3,495

(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 $8^{3/8}$% 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 payouts 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, 2003 and 2002, was 0.96% and 1.3%, respectively. At December 31, 2003 and 2002, the entire commercial paper balance has been classified as a current liability. The amount of commercial paper outstanding in 2004 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, 2003.

(iii) The industrial development bonds bear interest at a daily variable rate. The average interest rates for 2003 and 2002 were 0.9% and 1.3%, respectively.

(iv) The special facilities revenue bonds bear interest at a daily variable rate. The average interest rates for 2003 and 2002 were 1.0% and 1.4%, respectively.

(v) The floating rate senior notes bear interest at one-month LIBOR less 45 basis points. The average interest rates for 2003 and 2002 were 0.8% and 1.4%, 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.

(vi) The cash-settled convertible senior notes have a par value of $300 million, accrued interest at a stated rate of 1.75% and were callable after three years. The notes were exchangeable for an amount of cash that was indexed to the trading price of our Class B common stock. In conjunction with the debt offering, we entered into a swap transaction in which UPS paid 30 Day LIBOR less 38 basis points, and received the 1.75% cash coupon plus any equity appreciation payable in cash on the notes. The average interest rate payable on the swap for 2003 and 2002 was 0.9% and 1.4%, respectively.

In December 2003, we redeemed the 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 gain recorded in 2003 results.

(vii) We have capitalized lease obligations for certain aircraft, which are included in Property, Plant, and Equipment at December 31 as follows (in millions):

	2003	2002
Aircraft	**$ 1,474**	$ 1,169
Accumulated amortization	**(198)**	(149)
	$ 1,276	$ 1,020

(viii) The UPS Notes program involves the periodic issuance of fixed rate notes in $1,000 increments with various terms and maturities. At December 31, 2003, the coupon rates of the outstanding notes varied between 3.00% and 6.25%, and the interest payments are made either monthly, quarterly, or semiannually. The maturities of the notes range from 2006 to 2018. 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 2003 and 2002 was 0.8% and 1.5%, respectively.

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 $4.1 and $4.9 billion as of December 31, 2003 and 2002, 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 $678, $685, and $747 million for 2003, 2002, and 2001, 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
2004	$ 68	$ 314	$ 621	$ 858
2005	96	264	2	747
2006	69	187	2	833
2007	119	128	1	798
2008	128	99	27	697
After 2008	137	457	2,697	604
Total	617	$ 1,449	$ 3,350	$ 4,537
Less: Imputed interest	(166)			
Present value of minimum capitalized lease payments	451			
Less: Current portion	(56)			
Long-term capitalized lease obligations	$ 395			

As of December 31, 2003, we had outstanding letters of credit totaling approximately $1.667 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 22, 2004 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, 2003, there were no outstanding borrowings under these facilities. In addition, we maintain an extendible commercial notes program under which we are authorized to borrow up to $500 million. No amounts were outstanding under this program at December 31, 2003.

We have a $2.0 billion shelf registration statement under which we may issue debt securities in the United States. The debt may be denominated in a variety of currencies. There was approximately $85 million issued under this shelf registration statement at December 31, 2003. We also maintain a $1.0 billion European medium-term note program. Under this program, we may issue notes from time to time, denominated in a variety of currencies. At December 31, 2003, $1.0 billion was available under this program.

NOTE 9. DEFERRED TAXES, CREDITS, AND OTHER LIABILITIES

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

	2003	2002
Deferred federal and state income taxes	**$ 2,491**	$ 2,307
Insurance reserves	**923**	779
Other credits and non-current liabilities	**641**	515
	$ 4,055	$ 3,601

NOTE 10. LEGAL PROCEEDINGS AND CONTINGENCIES

On August 9, 1999, the U. S.Tax Court held that we were liable for tax on income of Overseas Partners Ltd., a Bermuda company that had reinsured excess value ("EV") package insurance purchased by our customers beginning in 1984, and that we were liable for additional tax for the 1983 and 1984 tax years. The Internal Revenue Service (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's 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. The refunds and credits associated with this settlement are expected to occur over the next several years.

Notes to consolidated financial statements

The IRS has 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 the investment tax credit and the research tax credit in the 1985 through 1990 tax years. The proposed adjustments would result in $10 million of additional income tax. The IRS has also issued a report taking a similar position with respect to some of these issues for each of the years from 1991 through 1994. That report proposes adjustments that would result in $42 million in additional income tax. The IRS's proposed adjustments include penalties and penalty interest. We believe that the possibility that such penalties and penalty interest will be sustained is remote. In November 2002, the IRS issued a report taking a similar position with respect to some of these issues for each of the years 1995 through 1998. That report proposes adjustments that would result in $7 million in additional income tax. For the 1985 through 1998 tax years, unpaid interest on these adjustments through December 31, 2003 could aggregate up to approximately $178 million, after the benefit of related tax deductions. 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. The IRS may take similar positions with respect to some of these issues for each of the years 1999 through 2003. 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 are named as a defendant in 23 pending lawsuits that seek 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 claim 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.

These 23 cases have been 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 is named as a defendant, there also is 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. This case also has been consolidated into the MDL Proceeding.

While expressly denying any and all liability, the parties have obtained preliminary court approval of a global settlement resolving all claims and all cases in the MDL Proceeding. The proposed settlement requires several steps before it becomes final, including notice to the settlement class, and obtaining final court approval. If the proposed settlement becomes final, we would provide to qualifying settlement class members vouchers toward the purchase of specified UPS services and pay a portion of the plaintiffs' attorneys' fees, the total amount of which will be determined by the Court. The ultimate cost to us of the proposed settlement will depend on a number of factors. We do not believe that this proposed settlement will have a material 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 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 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 non-qualified 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, 2003, management incentive awards, stock options, and restricted stock 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 $606, $556, and $651 million during 2003, 2002, and 2001, respectively.

Nonqualified Stock Options

We maintain fixed stock option plans, under which options are granted to purchase shares of UPS Class A common stock. Prior to adoption of the Incentive Compensation Plan, these options were granted at the current price of UPS shares as determined by the UPS Board of Directors on the date of option grant. 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 and the UPS Board of Directors. Except in the case of death, disability, or retirement, options granted prior to the adoption of our Incentive Compensation Plan are exercisable only during a limited period after the expiration of five years from the date of grant, while 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:

	2003		2002		2001	
	Weighted Average Price	Shares (in thousands)	Weighted Average Price	Shares (in thousands)	Weighted Average Price	Shares (in thousands)
Outstanding at beginning of year	**$ 38.73**	**27,745**	$ 29.64	29,224	$ 20.57	29,312
Exercised	**18.59**	**(7,297)**	15.91	(6,434)	13.50	(5,918)
Granted	**62.40**	**2,860**	60.22	5,760	56.90	5,522
Assumed in acquisitions	—	—	—	—	58.41	727
Forfeited/expired	**44.63**	**(563)**	46.08	(805)	19.94	(419)
Outstanding at end of year	**$ 48.02**	**22,745**	$ 38.73	27,745	$ 29.64	29,224

Notes to consolidated financial statements

Options were granted to eligible employees under the 1996 Stock Option Plan in March 1999, but options will no longer be granted under that plan. 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 Board of Directors.

During 2001, we assumed employee stock options in connection with our acquisitions of Fritz Companies, Inc. and First International Bancorp, Inc. (see Note 7), which were converted into options to purchase UPS Class A common shares. Existing stock option plans at Fritz Companies, Inc. were assumed by UPS; however, options will no longer be granted under these plans. Existing stock option plans at First International Bancorp, Inc. were terminated upon the completion of the acquisition.

The following table summarizes information about stock options outstanding and exercisable at December 31, 2003:

	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 - $21.50	6,197	0.33	$ 21.49	10	$ 17.85
$34.37 - $50.63	2,796	5.82	49.93	2,749	49.93
$56.25 - $59.45	5,265	7.21	56.97	153	59.02
$60.22 - $60.61	5,576	8.32	60.22	—	—
$61.88 - $143.13	2,911	9.16	63.12	83	87.56
	22,745	5.69	$ 48.02	2,995	$ 51.34

Restricted Performance Units

During 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. Persons earning the right to receive restricted performance units are determined each year by the Compensation Committee and 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 exercise under certain conditions. During 2003, we issued 1.164 million restricted performance units with a weighted average fair value of $62.40.

Discounted Employee Stock Purchase Plan

During 2001, we initiated 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 1.9, 1.8, and 0.4 million shares at average prices of $54.08, $50.79, and $46.78 per share during 2003, 2002, and 2001, respectively.

Deferred Compensation Arrangements

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 Arrangements" in the shareowners' equity section of the balance sheet. The amount of shares needed to settle the liability for deferred compensation arrangements 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 non-package operations. Package operations represent our most significant business and are broken down into regional operations around the world. Regional operations managers are responsible for both domestic and export operations within their geographic area.

U.S. Domestic Package

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

International Package

International package operations include delivery to more than 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, Canada, and Americas operating segments.

Non-Package

Non-package operations include UPS Supply Chain Solutions, Mail Boxes Etc. (the franchisor of Mail Boxes Etc. and The UPS Store), UPS Capital Corporation, our mail and consulting services, and our excess value package insurance business. UPS Supply Chain Solutions, which comprises our former UPS Freight Services and UPS Logistics Group businesses, provides supply chain design and management, freight forwarding, and customs brokerage services.

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):

	2003	2002	2001
Revenue:			
U.S. domestic package	**$ 25,022**	$ 23,924	$ 23,997
International package	**5,561**	4,680	4,245
Non-package	**2,902**	2,668	2,079
Consolidated	**$ 33,485**	$ 31,272	$ 30,321
Operating Profit:			
U.S. domestic package	**$ 3,272**	$ 3,576	$ 3,620
International package	**709**	322	125
Non-package	**464**	198	217
Consolidated	**$ 4,445**	$ 4,096	$ 3,962
Assets:			
U.S. domestic package	**$ 15,446**	$ 14,662	$ 16,180
International package	**4,287**	3,271	2,969
Non-package	**6,038**	6,245	4,846
Unallocated	**3,138**	2,179	641
Consolidated	**$ 28,909**	$ 26,357	$ 24,636

Non-package operating profit included $114, $112, and $113 million for 2003, 2002, and 2001, respectively, of intersegment profit, with a corresponding amount of operating expense, which reduces operating profit, included in the U.S. domestic package segment.

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

	2003	2002	2001
U.S. domestic package:			
Next Day Air	**$ 5,580**	$ 5,349	$ 5,433
Deferred	**2,982**	2,868	2,893
Ground	**16,460**	15,707	15,671
Total U.S. domestic package	**25,022**	23,924	23,997
International package:			
Domestic	**1,134**	943	907
Export	**4,001**	3,276	2,931
Cargo	**426**	461	407
Total International package	**5,561**	4,680	4,245
Non-package:			
UPS Supply Chain Solutions	**2,126**	1,969	1,479
Other	**776**	699	600
Total Non-package	**2,902**	2,668	2,079
Consolidated	**$ 33,485**	$ 31,272	$ 30,321

Notes to consolidated financial statements

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

	2003	2002	2001
U.S.:			
Revenue	**$ 26,968**	$ 26,284	$ 26,163
Long-lived assets	**$ 14,915**	$ 14,129	$ 13,717
International:			
Revenue	**$ 6,517**	$ 4,988	$ 4,158
Long-lived assets	**$ 3,567**	$ 2,874	$ 3,050
Consolidated:			
Revenue	**$ 33,485**	$ 31,272	$ 30,321
Long-lived assets	**$ 18,482**	$ 17,003	$ 16,767

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):

	2003	2002	2001
Repairs and maintenance	**$ 1,109**	$ 1,013	$ 1,050
Depreciation and amortization	**1,549**	1,464	1,396
Purchased transportation	**1,828**	1,665	1,652
Fuel	**1,050**	952	1,000
Other occupancy	**576**	513	524
Restructuring charge and related expenses (Note 17)	**9**	106	—
Other expenses	**3,591**	3,523	3,340
	$ 9,712	$ 9,236	$ 8,962

NOTE 14. INCOME TAXES

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

	2003	2002	2001
Current:			
Federal	**$ 1,103**	$ 1,208	$ 1,065
State	**112**	148	151
Foreign	**87**	62	38
Total Current	**1,302**	1,418	1,254
Deferred:			
Federal	**181**	323	225
State	**(11)**	14	33
Total Deferred	**170**	337	258
Total	**$ 1,472**	$ 1,755	$ 1,512

Income before income taxes includes income of foreign subsidiaries of $237, $16, and $8 million in 2003, 2002, and 2001, 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:

	2003	2002	2001
Statutory federal income tax rate	**35.0%**	35.0%	35.0%
State income taxes (net of federal benefit)	**1.5**	2.1	3.1
Tax assessment reversal (tax portion)	**—**	(2.8)	—
Other	**(2.8)**	0.7	0.3
Effective income tax rate	**33.7%**	35.0%	38.4%

During the first quarter of 2003, we reduced deferred taxes by $55 million due to the favorable resolution of several outstanding contingency matters with the IRS. During the third quarter of 2003, we reduced deferred taxes by $22 million 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 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 comprise the following at December 31 (in millions):

	2003	2002
Excess of tax over book depreciation	**$ 2,802**	$ 2,725
Pension plans	**1,266**	835
Other	**473**	550
Gross deferred tax liabilities	**4,541**	4,110
Other postretirement benefits	**588**	582
Loss carryforwards (foreign)	**117**	92
Insurance reserves	**347**	348
Vacation pay accrual	**131**	179
Excess deposits and interest to be refunded	**627**	619
Other	**673**	343
Gross deferred tax assets	**2,483**	2,163
Deferred tax assets valuation allowance	**(117)**	(92)
Net deferred tax assets	**2,366**	2,071
Net deferred tax liability	**2,175**	2,039
Current deferred tax (asset) liability	**(316)**	(268)
Long-term portion — see Note 9	**$ 2,491**	$ 2,307

The valuation allowance increased by $25 and $23, and decreased by $32 million during the years ended December 31, 2003, 2002 and 2001, respectively.

We have foreign loss carryforwards of approximately $1.035 billion as of December 31, 2003, the majority of which may be carried forward indefinitely. These foreign loss carryforwards have been fully reserved in the deferred tax assets valuation allowance due to the uncertainty resulting from a lack of previous foreign taxable income within certain foreign tax jurisdictions.

Undistributed earnings of our foreign subsidiaries amounted to approximately $727 million at December 31, 2003. Those earnings are considered to be indefinitely reinvested and, accordingly, no U.S. federal and 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 both U.S. income taxes (subject to an adjustment for foreign tax credits) and withholding taxes payable to the various foreign countries. Determination of the amount of unrecognized deferred U.S. income tax liability is not practicable because of the complexities associated with its hypothetical calculation.

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):

	2003	2002	2001
Numerator:			
Net income before the cumulative effect of changes in accounting principles	**$ 2,898**	$ 3,254	$ 2,425
Denominator:			
Weighted-average shares	**1,125**	1,117	1,124
Management incentive awards	**1**	1	2
Deferred compensation arrangements	**2**	2	—
Denominator for basic earnings per share	**1,128**	1,120	1,126
Effect of dilutive securities:			
Management incentive awards	**4**	4	5
Stock option plans	**6**	10	13
Denominator for diluted earnings per share	**1,138**	1,134	1,144
Basic Earnings Per Share Before Cumulative Effect of Changes in Accounting Principles	**$ 2.57**	$ 2.91	$ 2.15
Diluted Earnings Per Share Before Cumulative Effect of Changes in Accounting Principles	**$ 2.55**	$ 2.87	$ 2.12

Diluted earnings per share for the years ended December 31, 2003, 2002, and 2001 exclude the effect of 0.1, 0.1, and 6.6 million shares, respectively, of common stock that may be issued upon the exercise of employee stock options because such effect would be antidilutive.

Notes to consolidated financial statements

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 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, 2003 and 2002 was an asset (liability) of approximately $30 and $34 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 and the British Pound Sterling. We use a combination of purchased and written options and forward contracts to hedge currency cash flow exposures. As of December 31, 2003 and 2002, the net fair value of the hedging instruments described above was an asset (liability) of approximately $(48) and $(3) 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, 2003 and 2002 was an asset (liability) of approximately $(27) and $(62) million, respectively.

Equity Price Risk Management

We hold investments in various available-for-sale equity securities that are subject to price risk. We use combinations of options to hedge the price risk exposure inherent in these securities. The fair value of such options contracts designated as hedges, as of December 31, 2003 and 2002, was an asset of approximately $0 and $219 million, respectively, which is classified in marketable securities and short-term investments. A large investment derivative used to hedge equity price risk settled in 2003 (which resulted in UPS receiving cash of $222 million) resulting in the decline in value of our investment derivatives since December 31, 2002.

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.

Derivatives Not Designated As Hedges

Derivatives not designated as hedges primarily consist of interest rate swaps that are used to hedge a portfolio of small debt instruments. Although these instruments are effective as hedges from an economic perspective, they do not qualify for hedge accounting under FAS 133, as amended. The impact from these interest rate swaps on our results was immaterial. Additionally, we have 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 each of the three years ending December 31, 2003.

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 each of the three years ending December 31, 2003.

As of December 31, 2003, $37 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, 2004. 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 2003 in connection with forecasted transactions that were no longer considered probable of occurring.

At December 31, 2003, the maximum term of derivative instruments that hedge forecasted transactions, except those related to cross-currency interest rate swaps on existing financial instruments, was four years. We maintain cross-currency interest rate swaps that extend through 2009.

Fair Value of Financial Instruments

At December 31, 2003 and 2002, 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. RESTRUCTURING CHARGE AND RELATED EXPENSES

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 ("UPS Supply Chain Solutions"). In connection with this restructuring program, we also recorded certain costs related to the integration of activities between UPS Capital and First International Bank. 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.

A summary of the amounts expensed under the restructuring program follows below. The costs incurred in connection with this program are classified in other operating expenses in the income statement (see Note 13) (amounts in millions):

	2003	2002
Employee severance	**$ —**	$ 19
Asset impairment	**1**	42
Facility consolidation	**2**	25
Other	**6**	20
	$ 9	$ 106

Employee severance costs relate to severance packages for approximately 800 people. The packages are involuntary and are formula-driven based on salary levels and past service. Asset impairment charges consist primarily of capitalized software that is no longer used as a result of changes in business strategy due to the restructuring. Facility consolidation costs are associated with terminating operating leases on offices, warehouses, and other facilities. Other costs consist primarily of employee relocations; legal costs associated with establishing the new organizational structure; costs associated with moving equipment, records, and inventories between locations; and conforming accounting policies among recently acquired entities within UPS Supply Chain Solutions.

Notes to consolidated financial statements

NOTE 18. SEPTEMBER 11, 2001 EVENTS

In response to the September 11, 2001 terrorist attacks, the FAA issued a federal ground stop order prohibiting all flights to, from, and within the United States. Due to this order, all domestic UPS aircraft were grounded, and international flights into the United States were diverted on September 11 and 12. We were able to transport many of our express shipments through our extensive ground network until the FAA order was lifted and our air operations resumed on the evening of September 13. Due to the economic disruption caused by these events, we sustained significant declines in our U.S. origin package volume during the weeks following the attacks.

On September 22, 2001, President George W. Bush signed into law the Air Transportation Safety and System Stabilization Act (the "Act"), a $15 billion emergency economic assistance package to mitigate the dramatic financial losses experienced by the nation's air carriers. The Act, among other things, provides for the following: (1) $5 billion in compensation for direct losses incurred as a result of the federal ground stop order, and for incremental losses incurred through December 31 as a result of the attacks, (2) $10 billion in federal loan guarantees and credits, (3) expanded war risk insurance coverage for air carriers, and (4) government assistance for short-term increases in insurance premiums. We submitted a claim for compensation to the Department of Transportation and recognized a pre-tax amount of $74 million related to this reimbursement as a credit to the other expenses line item of other operating expenses (see Note 13) in 2001 under the provisions of EITF 01-10 "Accounting for the Impact of Terrorist Attacks of September 11, 2001."

NOTE 19. QUARTERLY INFORMATION (unaudited)

	First Quarter		Second Quarter		Third Quarter		Fourth Quarter	
	2003	2002	**2003**	2002	**2003**	2002	**2003**	2002
Revenue:								
U.S. domestic package	**$ 6,020**	$ 5,903	**$ 6,124**	$ 5,908	**$ 6,219**	$ 5,889	**$ 6,659**	$ 6,224
International package	**1,302**	1,054	**1,371**	1,144	**1,370**	1,184	**1,518**	1,298
Non-package	**693**	622	**731**	630	**723**	681	**755**	735
Total revenue	**8,015**	7,579	**8,226**	7,682	**8,312**	7,754	**8,932**	8,257
Operating profit:								
U.S. domestic package	**704**	862	**832**	899	**825**	809	**911**	1,006
International package	**134**	30	**158**	62	**176**	65	**241**	165
Non-package	**107**	55	**90**	67	**146**	76	**121**	—
Total operating profit	**945**	947	**1,080**	1,028	**1,147**	950	**1,273**	1,171
Net income	**$ 611**	$ 491	**$ 692**	$ 611	**$ 739**	$ 578	**$ 856**	$ 1,502
Earnings per share:								
Basic	**$ 0.54**	$ 0.44	**$ 0.61**	$ 0.55	**$ 0.66**	$ 0.52	**$ 0.76**	$ 1.34
Diluted	**$ 0.54**	$ 0.43	**$ 0.61**	$ 0.54	**$ 0.65**	$ 0.51	**$ 0.75**	$ 1.32

Fourth quarter 2002 net income was affected by the impact of the tax assessment reversal ($776 million after-tax, $0.68 per diluted share), the credit from our vacation policy change ($121 million after-tax, $0.11 per diluted share), and the restructuring charge and related expenses ($65 million after-tax, $0.06 per diluted share). First quarter 2002 net income reflects the charge upon adoption of FAS 142 ($72 million after-tax, $0.06 per diluted share).

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 qurater 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).

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,		Change	
	2003	2002	$	%
Revenue (in millions):				
U.S. domestic package:				
Next Day Air	**$ 5,580**	$ 5,349	$ 231	4.3%
Deferred	**2,982**	2,868	114	4.0
Ground	**16,460**	15,707	753	4.8
Total U.S. domestic package	**25,022**	23,924	1,098	4.6
International package:				
Domestic	**1,134**	943	191	20.3
Export	**4,001**	3,276	725	22.1
Cargo	**426**	461	(35)	(7.6)
Total International package	**5,561**	4,680	881	18.8
Non-package:				
UPS Supply Chain Solutions	**2,126**	1,969	157	8.0
Other	**776**	699	77	11.0
Total Non-package	**2,902**	2,668	234	8.8
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	**$ 18.69**	$ 19.11	$ (0.42)	(2.2)%
Deferred	**12.89**	12.72	0.17	1.3
Ground	**6.36**	6.16	0.20	3.2
Total U.S. domestic package	**8.03**	7.83	0.20	2.6
International package:				
Domestic	**5.73**	4.80	0.93	19.4
Export	**33.01**	29.35	3.66	12.5
Total International package	**16.08**	13.70	2.38	17.4
Consolidated	**$ 8.77**	$ 8.37	$ 0.40	4.8%

Management's discussion and analysis of financial condition and results of operations

	Year Ended December 31,		Change	
	2002	2001	$	%
Revenue (in millions):				
U.S. domestic package:				
Next Day Air	$ 5,349	$ 5,433	$ (84)	(1.5)%
Deferred	2,868	2,893	(25)	(0.9)
Ground	15,707	15,671	36	0.2
Total U.S. domestic package	23,924	23,997	(73)	(0.3)
International package:				
Domestic	943	907	36	4.0
Export	3,276	2,931	345	11.8
Cargo	461	407	54	13.3
Total International package	4,680	4,245	435	10.2
Non-package:				
UPS Supply Chain Solutions	1,969	1,479	490	33.1
Other	699	600	99	16.5
Total Non-package	2,668	2,079	589	28.3
Consolidated	$ 31,272	$ 30,321	$ 951	3.1%
Average Daily Package Volume (in thousands):			#	
U.S. domestic package:				
Next Day Air	1,111	1,116	(5)	(0.4)%
Deferred	895	917	(22)	(2.4)
Ground	10,112	10,317	(205)	(2.0)
Total U.S. domestic package	12,118	12,350	(232)	(1.9)
International package:				
Domestic	779	805	(26)	(3.2)
Export	443	408	35	8.6
Total International package	1,222	1,213	9	0.7
Consolidated	13,340	13,563	(223)	(1.6)%
Operating days in period	252	252		
Average Revenue Per Piece:			$	
U.S. domestic package:				
Next Day Air	$ 19.11	$ 19.32	$ (0.21)	(1.1)%
Deferred	12.72	12.52	0.20	1.6
Ground	6.16	6.03	0.13	2.2
Total U.S. domestic package	7.83	7.71	0.12	1.6
International package:				
Domestic	4.80	4.47	0.33	7.4
Export	29.35	28.51	0.84	2.9
Total International package	13.70	12.56	1.14	9.1
Consolidated	$ 8.37	$ 8.14	$ 0.23	2.8%

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	
	2003	2002	$	%
U.S. domestic package	**$ 3,272**	$ 3,576	$ (304)	(8.5)%
International package	**709**	322	387	120.2
Non-package	**464**	198	266	134.3
Consolidated Operating Profit	**$ 4,445**	$ 4,096	$ 349	8.5%

	Year Ended December 31,		Change	
	2002	2001	$	%
U.S. domestic package	$ 3,576	$ 3,620	$ (44)	(1.2)%
International package	322	125	197	157.6
Non-package	198	217	(19)	(8.8)
Consolidated Operating Profit	$ 4,096	$ 3,962	$ 134	3.4%

Non-GAAP Financial Measures

In the discussion and analysis below, in "Selected Financial Data," and in other parts of this report, we sometimes refer to information extracted from consolidated financial information but not required by generally accepted accounting principles (GAAP) to be presented in financial statements. Certain of this information is considered "non-GAAP financial measures" under Securities and Exchange Commission rules. Specifically, we refer to operating profit, operating margin, net income and earnings per share on an "as adjusted" basis, excluding certain transactions that we believe are not indicative of future results. We have presented these measures since we believe that meaningful analysis of our financial performance requires an understanding of the factors underlying that performance and our judgments about the likelihood that particular factors will repeat. When these "non-GAAP financial measures" have been used, we have provided reconciliations of these adjusted measures to the appropriate GAAP measure for comparability purposes.

U.S. Domestic Package Operations

2003 compared to 2002

U.S. domestic package revenue increased $1.098 billion, or 4.6%, for the year, which was driven by a 2.1% increase in average daily package volume and a 2.6% 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%.

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.

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.

Management's discussion and analysis of financial condition and results of operations

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 have discontinued the fuel surcharge on ground service, while a new indexed surcharge is being applied to our Next Day Air and deferred products. This new 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. This change will have a negative impact on revenue for our ground products, while having a beneficial impact on revenue for our Next Day Air and deferred products.

U.S. domestic package operating profit declined $304 million, or 8.5%, primarily due to the slow volume and revenue growth combined with an increase in operating expenses (discussed further under the section titled "Operating Expenses and Operating Margin"). U.S. domestic package operating profit increased 2.0% in the third quarter and decreased by 9.4% in the fourth quarter. However, 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. Without the vacation-related credit in the 2002 results, fourth quarter operating profit would have increased 9.6% and the decline for the year ending December 31, 2003 would have been $129 million, or 3.8%.

2002 compared to 2001

U.S. domestic package revenue decreased $73 million, or 0.3%, for the year. This decrease was driven by a 1.9% decrease in average daily package volume, and partially offset by a 1.6% increase in revenue per piece. The decline in volume was a result of the impact of volume diversion to competitors prior to the agreement reached on a new six-year contract with the International Brotherhood of Teamsters, combined with the continued weakness in the U.S. economy. The decline in volume was most pronounced in the period surrounding the July 31, 2002 expiration date of the previous contract.

On January 7, 2002, we increased rates for standard ground shipments an average of 3.5% for commercial deliveries. The ground residential charge increased $0.05 to $1.10 over the commercial ground rate, and this charge also was applied to express deliveries in 2002. The additional delivery area surcharge added to residential deliveries in certain ZIP codes, remained at $1.50, and also was applied to express deliveries in 2002. Rates for UPS Hundredweight increased 5.9%.

We also increased rates for UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, and 3 Day Select an average of 4.0%. The surcharge for UPS Next Day Air Early A.M. increased from $27.50 to $28.50. 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 3.9%. Rate changes for shipments originating outside the U.S. were made throughout 2002 and varied by geographic market.

An index-based fuel surcharge, which began in February 2002 and reset on a monthly basis, replaced a fixed fuel surcharge of 1.25%. The indexed surcharge 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 for the year ended December 31, 2002 was 0.78%. Approximately $251 million in revenue was recorded in 2002 as a result of our fuel surcharge, a decrease of $97 million from the prior year.

U.S. domestic package operating profit decreased $44 million, or 1.2%, for the year ended December 31, 2002, primarily due to the decrease in average daily volume discussed previously and an increase in operating expenses (discussed further under the section titled "Operating Expenses and Operating Margin"). In 2002, operating profit benefited from a credit to operating expense of $175 million that occurred related to a change in our vacation policy for non-union employees. In 2001, we recorded a credit to expense related to the Air Transportation Safety and System Stabilization Act, which benefited the U.S. domestic package segment by $28 million.

International Package Operations

2003 compared to 2002

International package revenue improved $881 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, which reversed a 3.2% decline from the previous year, and 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.

The improvement in operating profit for our international package operations was $387 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.

2002 compared to 2001

For the year ended December 31, 2002, international package revenue improved $435 million, or 10.2% (8.1% currency-adjusted), due primarily to volume growth for our export products and strong revenue per piece improvements. This volume growth was driven primarily by the Asia-Pacific region, which had an increase in average daily export volume of 17.1%, and the Europe region, which had an increase in average daily export volume of 13.6%. In total, international average daily package volume increased 0.7% and average revenue per piece increased 9.1% (6.8% currency-adjusted)

The improvement in operating profit for our international package operations was $197 million for the year, $22 million of which was due to currency fluctuations. The increase in operating profit was primarily due to export volume growth of 8.6% and a strong increase in revenue per piece. In addition, the shutdown of the U.S. West Coast ports during the latter part of 2002 had a beneficial impact on our international package results. In 2002, operating profit benefited from an $11 million reduction to expense related to the change in vacation policy. Operating profit in 2002 benefited, compared with 2001, from an $11 million reduction of expense due to the elimination of goodwill amortization. In 2001, operating profit benefited from a $46 million credit to expense related to the Air Transportation Safety and System Stabilization Act.

Non-Package Operations

2003 compared to 2002

Non-package revenue increased $234 million, or 8.8%, for the year. UPS Supply Chain Solutions, which comprises our former UPS Freight Services and UPS Logistics Group businesses, increased revenue 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 remainder of our non-package operations, which includes Mail Boxes Etc. (the franchisor of Mail Boxes Etc. and The UPS Store), UPS Capital Corp., our mail and consulting services, and our excess value package insurance business, increased revenue by 11.0% for the year, primarily due to increased franchise revenue at Mail Boxes Etc. and strong results from our Mail Innovations unit.

Non-package operating profit increased $266 million, or 134.3%, for the year. This increase was primarily due to higher operating profit from our Supply Chain Solutions unit, which was driven by the increase in revenue as well as the cost savings produced by our integration and restructuring program.

Non-package 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. Non-package operating profit includes $114 million (compared to $112 million in 2002) of intersegment profit, with a corresponding amount of operating expense, which reduces operating profit, in the U.S. domestic package segment.

During 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 non-package segment, and a tax benefit of $38 million recognized in conjunction with the sale. The tax benefit exceeds 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.

Also during 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 non-package segment. The operating results of both the Mail Technologies unit and the Aviation Technologies unit were previously included in our non-package segment, and were not material to non-package operating results in any of the periods presented.

2002 compared to 2001

Non-package revenue increased $589 million, or 28.3% during 2002. Of this revenue growth, 20.4% was due to acquisitions and the remaining 7.9% was due to organic growth.

Management's discussion and analysis of financial condition and results of operations

UPS Supply Chain Solutions revenue was up $490 million or 33.1% for the year, much of which was due to having a full year of revenue from Fritz Companies Inc., which we acquired in May 2001, and other acquisitions. Revenue growth at UPS Supply Chain Solutions was hindered by the sale of the FedEx brokerage business in March 2002. Excluding the impact of business acquisitions and dispositions, UPS Supply Chain Solutions would have reported revenue growth of approximately 8% during 2002.

Non-package operating profit decreased by $19 million, or 8.8%, for the year. In 2002, operating profit was affected by a restructuring charge and related expenses of $106 million primarily related to the integration of our Freight Services and Logistics Group operations, and an $11 million reduction to expense related to a change in our vacation policy for non-union employees. Operating profit in 2002 benefited, compared with 2001, from a $61 million reduction in goodwill expense as a result of the elimination of goodwill amortization. Non-package operating profit includes $112 million in 2002 (compared to $113 million in 2001) of intersegment profit, with a corresponding amount of operating expense, which reduces operating profit, in the U.S. domestic package segment.

Operating Expenses and Operating Margin

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 non-package 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 UPS Supply Chain Solutions unit. 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 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. Of the total $75 million impairment charge, $69 million impacted the U.S. domestic package segment and $6 million impacted the international package segment.

Our operating margin, defined as operating profit as a percentage of revenue, increased to 13.3% in 2003 from 13.1% in 2002. This increase is due to the growth in operating margin in our international package and non-package segments, which benefited from the revenue increases described previously.

The operating margin for our three business segments was as follows:

	Year Ended December 31,			
		Reported	Adjusted	
Operating Segment	**2003**	2002	2002	2001
U.S. domestic package	**13.1%**	14.9%	14.2%	15.1%
International package	**12.7%**	6.9%	6.6%	2.9%
Non-package	**16.0%**	7.4%	11.0%	10.4%

Adjusted operating margins for 2002 exclude the effects of the vacation change, which increased operating profit (U.S. domestic – $175 million, 0.7% effect on operating margin; international package – $11 million, 0.3%; and non-package – $11 million, 0.4%), and the effects of the restructuring charge, which reduced non-package operating profit by $106 million, and operating margin by 4.0%.

2002 compared to 2001

Consolidated operating expenses increased by $817 million, or 3.1%, for the year ended December 31, 2002. Compensation and benefits increased $543 million, or 3.1%, due primarily to increased costs associated with health and retirement benefits. In 2002, compensation and benefits were reduced by the $197 million credit to expense related to the change in our vacation policy for non-union employees.

Other operating expenses increased by $274 million, or 3.1%, for the year. In 2002, other operating expenses were affected by the $106 million restructuring charge and related expenses. In 2002, depreciation and amortization benefited from the absence of $72 million of expense related to the elimination of goodwill amortization. In 2001, other operating expenses were reduced by $74 million for compensation under the Air Transportation Safety and System Stabilization Act.

The non-package segment accounted for $513 million of the $817 million total increase in operating expenses. This was principally due to acquisitions that we completed during the first nine months of 2001. Our consolidated operating margin, defined as operating profit as a percentage of revenue, remained at 13.1% during 2001 and 2002.

Investment Income/Interest Expense

2003 compared to 2002

The decrease in investment income of $45 million in 2003 is primarily due to a $58 million impairment charge recognized during the first quarter of 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.

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.

2002 compared to 2001

The decrease in investment income of $96 million for 2002 is primarily due to a combination of lower interest rates and lower balances available for investment in 2002.

Net Income and Earnings Per Share

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 from $2.81 in 2002 to $2.55 in 2003. Net income in 2002 was favorably impacted by $776 million after-tax ($0.68 per diluted share) 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. Excluding the effect of the preceeding items, net income for 2002 would have been $2.422 billion, or $2.14 per diluted share.

Net income in 2003 benefited from the $14 million after-tax gain ($0.01 per diluted share) on the sale of our Mail Technologies unit in the second quarter of 2003, the $15 million after-tax gain ($0.01 per diluted share) on the sale of our Aviation Technologies unit in the third quarter of 2003, and the $18 million after-tax gain ($0.02 per diluted share) due to the redemption of our $300 million cash-settled convertible senior notes. In addition, 2003 income tax expense was reduced by $55 million ($0.05 per diluted share) due to the resolution of various tax issues with the Internal Revenue Service during the first quarter, by $22 million ($0.02 per diluted share) due to a tax contingency accrual adjustment resulting from a favorable ruling on the tax treatment for jet engine maintenance costs during the third quarter, and by $39 million ($0.03 per share) due to a lower effective state tax rate in the fourth quarter. Net income in 2003 was adversely affected by the $37 million after-tax ($0.03 per diluted share) investment impairment charge described previously. Excluding the effect of the preceeding items, net income for 2003 would have been $2.772 billion, or $2.44 per diluted share. This would represent a 14.0% increase in diluted earnings per share over the $2.14 achieved in 2002 (after taking into account the items discussed previously).

2002 compared to 2001

Net income for 2002 was $3.182 billion, an increase of $783 million from $2.399 billion in 2001, resulting in an increase in diluted earnings per share to $2.81 in 2002 from $2.10 in 2001. Net income in 2001 was adversely impacted by the FAS 133 cumulative expense adjustment of $26 million after-tax ($0.02 per diluted share), without which net income would have been $2.425 billion, or $2.12 per diluted share. In 2002, our results were affected by the fourth quarter restructuring charge and related expenses of $65 million after-tax ($0.06 per diluted share), the FAS 142 cumulative expense adjustment of $72 million after-tax ($0.06 per diluted share), the credit to compensation and benefits resulting from the change in our vacation policy for non-union employees of $121 million after-tax ($0.11 per diluted share), and the credit related to the reversal of a portion of the previously established tax assessment liability of $776 million after-tax ($0.68 per diluted share). Excluding the effect of the preceeding items, net income for 2002 would have been $2.422 billion, or $2.14 per diluted share.

Management's discussion and analysis of financial condition and results of operations

Liquidity and Capital Resources

Net Cash From Operating Activities

Net cash provided by operating activities was $4.646, $5.688 and $4.570 billion in 2003, 2002 and 2001, respectively. The decrease in 2003 operating cash flows from 2002 was primarily the result of the funding of $1.1 billion into our pension plans during 2003. As discussed in Note 5 to the consolidated financial statements, projected pension contributions in 2004 are approximately $426 million.

In November 2003, we announced rate increases, which took effect on January 5, 2004. The overall impact is 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%. 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%. Rate changes for shipments originating outside the U.S. were made throughout the past year and varied by geographic market.

In addition, we discontinued the fuel surcharge on ground service, while a new index is being applied to our Next Day Air, deferred products, and international services. This new 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. The index for shipments originating in Europe will be based on the Rotterdam ARA spot price of kerosene-type jet fuel.

Net Cash Used In Investing Activities

Net cash used in investing activities was $1.942, $2.194, and $3.053 billion in 2003, 2002, and 2001, respectively. The primary reason for these declines has been the slowing growth of our finance receivables portfolio, and the lack of business acquisitions during 2002 and 2003. Capital expenditures represent the primary use of cash in investing activities as follows (in millions):

	2003	2002	2001
Buildings and facilities	**$ 451**	$ 528	$ 763
Aircraft and parts	**1,019**	638	932
Vehicles	**161**	41	303
Information technology	**316**	451	374
	$ 1,947	$ 1,658	$ 2,372

We anticipate capital expenditures of approximately $2.2 billion in 2004. These expenditures will provide for replacement of existing capacity and anticipated future growth and include the projected cost of capitalized software. We fund our capital expenditures with our cash from operations.

Net Cash Used In Financing Activities

Net cash used in financing activities was $2.180, $2.090 and $1.493 billion in 2003, 2002 and 2001, respectively. Our primary use of cash in financing activities has been to repay long-term debt, repurchase stock and pay dividends. During 2003, we repaid over $1.2 billion in debt, primarily consisting of $492 million of commercial paper, $300 million in cash-convertible notes, and $411 million in repayments of UPS Notes. Issuances of debt primarily consisted of 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.

In August 2003, a total of $1.0 billion was authorized for share repurchases as part of our continuing share repurchase program. As of December 31, 2003, $858 million of this authorization was available for future share repurchases. We repurchased a total of $398 million of common stock in 2003.

We increased our cash dividends per share to $0.92 in 2003 from $0.76 in 2002, resulting in an increase in total cash dividends paid to $1.026 billion from $840 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 2004, the Board of Directors declared a $0.28 per share dividend, which represents a 12% increase over the $0.25 previous quarterly dividend. The dividend is payable on March 9, 2004 to shareowners of record on February 23, 2004.

Sources of Credit

We maintain two commercial paper programs under which we are authorized to borrow up to $7.0 billion. Approximately $544 million was outstanding under these programs as of December 31, 2003, with an average interest rate of 0.96%. The entire balance outstanding has been classified as a current liability on our balance sheet. In addition, we maintain an extendible commercial notes program under which we are authorized to borrow up to $500 million. No amounts were outstanding under this program at December 31, 2003.

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 22, 2004 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, 2003.

We also maintain a $1.0 billion European medium-term note program. Under this program, we may issue notes from time to time, denominated in a variety of currencies. No amounts were outstanding under this program at December 31, 2003.

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 $85 million issued under this shelf registration statement at December 31, 2003, all of which consists of issuances under our UPS Notes program.

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, 2003 (in millions):

Year	Capitalized Leases	Operating Leases	Debt Principal	Purchase Commitments
2004	$ 68	$ 314	$ 621	$ 858
2005	96	264	2	747
2006	69	187	2	833
2007	119	128	1	798
2008	128	99	27	697
After 2008	137	457	2,697	604
Total	$ 617	$ 1,449	$ 3,350	$ 4,537

We believe that funds from operations and borrowing programs will provide adequate sources of liquidity and capital resources to met our expected long-term needs for the operation of our business, including anticipated capital expenditures such as commitments for aircraft purchases, through 2009.

Contingencies

On August 9, 1999, the U.S. Tax Court held that we were liable for tax on income of Overseas Partners Ltd., a Bermuda company that had reinsured excess value ("EV") package 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's 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. The refunds and credits associated with this settlement are expected to occur over the next several years.

The IRS has 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 the investment tax credit and the research tax credit in the 1985 through 1990 tax years. The proposed adjustments would result in $10 million of additional income tax. The IRS has also issued a report taking a similar position with respect to some of these issues for each of the years from 1991 through 1994. That report proposes adjustments that would result in $42 million in additional income tax. The IRS's proposed adjustments include penalties and penalty interest. We believe that the possibility that such penalties and penalty interest will be sustained is remote. In November 2002, the IRS issued a report taking a similar position with respect to some of these issues for each of the years 1995 through 1998. That report proposes adjustments that would result in $7 million in additional income tax. For the 1985 through 1998 tax years, unpaid interest on these adjustments through December 31, 2003 could aggregate up to approximately $178 million, after the benefit of related tax deductions. 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. The IRS may take similar positions with respect to some of these issues for each of the years 1999 through 2003. 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 are named as a defendant in 23 pending lawsuits that seek 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 claim 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 United States Tax Court decision.

These 23 cases have been 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 is named as a defendant, there is also 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. This case has also been consolidated into the MDL Proceeding.

While expressly denying any and all liability, the parties have obtained preliminary court approval of a global settlement resolving all claims and all cases in the MDL Proceeding. The proposed settlement requires several steps before it becomes final, including notice to the settlement class, and obtaining final court approval. If the proposed settlement becomes final, we would provide to qualifying settlement class members vouchers toward the purchase of specified UPS services and pay a portion of the plaintiffs' attorneys' fees, the total amount of which will be determined by the Court. The ultimate cost to us of the proposed settlement will depend on a number of factors. We do not believe that this proposed settlement will have a material 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 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, 2003, we had approximately 228,000 employees (64% of our total 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 up to one year. The net fair value of such contracts subject to price risk, excluding the underlying exposures, as of December 31, 2003 and 2002 was an asset (liability) of $30 and $34 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 $17 and $38 million at December 31, 2003 and 2002, 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 and the British Pound Sterling. We use a combination of purchased and written options and forward contracts to hedge cash flow currency exposures. As of December 31, 2003 and 2002, the net fair value of the hedging instruments described above was an asset (liability) of $(48) and $(3) 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 $97 and $42 million at December 31, 2003 and 2002, 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, 2003 and 2002 would be approximately $25 and $28 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, 2003 and 2002 would be approximately $31 and $19 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, 2003 and 2002 would be immaterial.

This interest rate sensitivity analysis assumes interst 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, 2003 and 2002, the fair value of such investments was $95 and $322 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 $10 million at both December 31, 2003 and 2002.

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.

Management's discussion and analysis of financial condition and results of operations

New Accounting Pronouncements

In June 2002, the FASB issued Statement No. 146 "Accounting for Costs Associated with Exit or Disposal Activities" ("FAS 146"). FAS 146 provides guidance on the recognition and measurement of liabilities associated with exit or disposal activities and requires that such liabilities be recognized when incurred. This statement was effective for exit or disposal activities initiated on or after January 1, 2003.

As discussed in Note 17, we implemented a restructuring program involving the business unit integration of our Freight Services and Logistics Group operations in the fourth quarter of 2002. As this restructuring program was initiated in 2002, we accounted for this restructuring program using the existing guidance in EITF 94-3 "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)." Therefore, the adoption of FAS 146 on January 1, 2003 had no effect on our results of operations or financial condition. In the fourth quarter of 2002, we recorded a pre-tax restructuring charge and related expenses in the amount of $106 million, which is classified in other operating expenses.

In November 2002, the FASB issued Interpretation No. 45 "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("FIN 45"). FIN 45 requires that a liability be recognized at fair value at the inception of certain guarantees for the obligations undertaken by the guarantor. FIN 45 also requires additional disclosures for certain guarantee contracts. The disclosure provisions of FIN 45 were effective for financial statements ending after December 15, 2002, while the recognition and initial measurement provisions were applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The adoption of FIN 45 was not material to our results of operations or financial condition.

In January 2003, the FASB issued Interpretation No. 46 "Consolidation of Variable Interest Entities," to address perceived weaknesses in accounting for entities commonly known as special purpose or off balance sheet. In addition to numerous FASB Staff Positions written to clarify and improve the application of FIN 46, the FASB recently announced a deferral for certain entities, and an amendment to FIN 46 entitled FASB Interpretation No. 46 (revised December 2003) "Consolidation of Variable Interest Entities" ("FIN 46").

FIN 46 provides guidance for identifying the party with a controlling financial interest resulting from arrangements or financial instruments rather than voting interests. FIN 46 defines the term "variable interest entity" and is based on the premise that if a business enterprise absorbs a majority of such an entity's expected losses and/or receives a majority of its expected residual returns, that enterprise has a controlling financial interest, and would thus require consolidation of the variable interest entity. As of December 31, 2003, we have adopted FIN 46, and the effects of adoption were not material to our results of operations or financial condition.

On July 1, 2003, we adopted FASB Statement No. 149 "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" ("FAS 149"). FAS 149 amends FAS 133 for certain decisions made by the FASB as part of the Derivatives Implementation Group process. FAS 149 also amends FAS 133 to incorporate clarifications of the definition of a derivative. The adoption of FAS 149 was not material to our results of operations or financial condition.

On July 1, 2003, we adopted FASB Statement No. 150 "Accounting for Certain Instruments with Characteristics of Both Liabilities and Equity" ("FAS 150"). FAS 150 establishes how an issuer measures certain freestanding financial instruments with characteristics of both liabilities and equity, and requires that such instruments be classified as liabilities. The adoption of FAS 150 was not material to our results of operations or financial condition.

In December 2003, the FASB revised Statement No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits" ("FAS 132"). The revised standard requires new disclosures in addition to those required by the original standard about the assets, obligations, cash flows and net periodic benefit cost of defined benefit pension plans and other defined benefit postretirement plans. As revised, FAS 132 is effective for financial statements with fiscal years ending after December 15, 2003, and we have included these disclosures in Note 5 - Employee Benefit Plans.

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 new 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 test performed in 2003 resulted in no goodwill impairment. As of December 31, 2003, our recorded goodwill was $1.173 billion.

Self-Insurance Accruals — We self-insure costs associated with workers' compensation claims, automotive liability, 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. The impact of decreasing the weighted-average expected long-term rate of return on plan assets to 8.96% and the decrease in the discount rate to 6.25%, combined with other factors, such as the additional fundings which occurred during 2003, will increase our pension plan expense by approximately $18 million in 2004.

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, such as the additional fundings which occurred during 2003, 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, 2003, we had approximately $13.9 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.

Management's discussion and analysis of financial condition and results of operations

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 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. This charge is 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.

Forward-Looking Statements

"Management's Discussion and Analysis of Financial Condition and Results of Operations," "Liquidity and Capital Resources," "We see..." and other parts of this report, including statements under the heading "2004 Outlook" 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 aggresively for business at low rates.
- The impact of complex and stringent aviation, transportation, environment, 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 sub stantial 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 and fuel and jet fuel for our aircraft and delivery vehicles as a result of war or other factors.
  We require significant quantities of gasoline and 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.

Price and dividend information

Price and Dividend Information

The following is a summary of our Class B common stock price activity and dividend information for 2003 and 2002. Our Class B common stock is listed on the New York Stock Exchange under the symbol "UPS".

2003:	High	Low	Close	Dividends Declared
First Quarter	$ 64.48	$ 53.00	$ 57.00	$ 0.21
Second Quarter	$ 64.32	$ 56.52	$ 63.70	$ 0.21
Third Quarter	$ 64.99	$ 61.17	$ 63.80	$ 0.25
Fourth Quarter	$ 74.86	$ 63.76	$ 74.55	$ 0.25
2002:				
First Quarter	$ 61.24	$ 54.25	$ 60.80	$ 0.19
Second Quarter	$ 63.00	$ 57.75	$ 61.75	$ 0.19
Third Quarter	$ 67.10	$ 58.80	$ 62.53	$ 0.19
Fourth Quarter	$ 64.50	$ 58.50	$ 63.08	$ 0.19

As of February 28, 2004, there were 169,751 and 14,409 record holders of Class A and Class B stock, respectively.

The policy of our board of directors is to declare dividends each year out of current earnings. The declaration of future dividends is subject to the discretion of the board of directors in light of all relevant facts, including earnings, general business conditions and working capital requirements.

On February 12, 2004, our board declared a dividend of $0.28 per share, which is payable on March 9, 2004 to shareowners of record on February 23, 2004.

Investor information

Annual Meeting

Our annual meeting of shareowners will be held at 8:00 a.m. on May 6, 2004, at the Hotel du Pont, 11th and Market Streets, Wilmington, DE 19801. Shareowners of record as of March 8, 2004, are entitled to vote at the meeting.

Exchange Listing

Our Class B common stock is listed on the New York Stock Exchange under the symbol "UPS."

Form 10-K

A copy of our Annual Report on Form 10-K may be obtained without charge at www.ups.com or at www.sec.gov, the Web site for the Securities and Exchange Commission. It also is available by calling or writing to our Investor Relations Department.

Investor information is available in the Investor Relations section of the UPS Web site at www.ups.com.

Direct Stock Purchase Plan

The Mellon Direct Investment & Dividend Reinvestment Plan provides comprehensive services designed to make investing in UPS Class B common stock easy and convenient. You can participate at no charge if you currently own shares of UPS Class B common stock. If you are not currently a UPS Class B common stock shareowner, you can join the plan for an initial investment of $250 in Class B common shares. The plan also provides a dividend reinvestment feature for plan participants, which allows you to reinvest your UPS Class B common stock dividends in shares of UPS Class B common stock.

If you are a current UPS Class B common stock shareowner, you can enroll in the plan online at www.melloninvestor.com/isd or by calling toll-free 800-758-4674.

If you wish to make an initial purchase of UPS Class B common stock online, visit www.melloninvestor.com and select "For Investors." Follow the instructions provided to search for Direct Investment Plans and access the Enrollment Wizard.

Dividend Reinvestment Plan

UPS provides a dividend reinvestment plan for shareowners of UPS Class A common stock. To learn more about the dividend reinvestment plan, Class A common shareowners can visit www.melloninvestor.com/isd.

UPS Shareowner Services

Convenient access 24 hours a day, 7 days a week

Class A Common Shareowners

www.melloninvestor.com
select MellonOne
888-663-8325

Class B Common Shareowners

www.melloninvestor.com
select Investor ServiceDirect®
800-758-4674

Calls from outside the United States: 201-373-5334
TDD for hearing impaired: 800-231-5469
TDD for non-U.S. shareowners: 201-329-8354

Online Access to Shareowner Materials through MLink℠

Interested in receiving shareowner information electronically? Enroll in MLink, a self-service program that provides electronic notification and secure access to shareowner communications. To enroll, follow the MLink enrollment instructions when you access your UPS Class A or UPS Class B common shareowner account via the Web sites previously noted.

Transfer Agent and Registrar

Account information and transactions are managed by Mellon Investor Services LLC. Please direct notices of address changes or questions regarding account status, stock transfers, lost certificates, or dividend payments to the transfer agent at the address below.

United Parcel Service, Inc.
c/o Mellon Investor Services LLC
P.O. Box 3415
South Hackensack, NJ 07606-3415

or

85 Challenger Road
Ridgefield Park, NJ 07660

Investor Relations

UPS maintains a comprehensive Web site at www.ups.com and has an active Investor Relations program. You can contact the Investor Relations Department at:

UPS
55 Glenlake Parkway, NE
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800-877-1503 or 404-828-6059

We see a company with a strong vision and the agility to execute that vision — **synchronizing global commerce.**

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