

UNITED PARCEL SERVICE INC

Form 10-Q

August 03, 2017

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United States

Securities and Exchange Commission

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2017, or

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

For the transition period from _____ to _____

Commission file number 001-15451

United Parcel Service, Inc.

(Exact name of registrant as specified in its charter)

Delaware

58-2480149

(State or Other Jurisdiction of

(IRS Employer

Incorporation or Organization)

Identification No.)

55 Glenlake Parkway, NE Atlanta, Georgia 30328

(Address of Principal Executive Offices) (Zip Code)

(404) 828-6000

(Registrant's telephone number, including area code)

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

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

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

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ☐

There were 177,194,206 Class A shares, and 688,774,014 Class B shares, with a par value of \$0.01 per share, outstanding at July 24, 2017.

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UNITED PARCEL SERVICE, INC.

QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTER ENDED JUNE 30, 2017

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PART I. FINANCIAL INFORMATION

Cautionary Statement About Forward-Looking Statements

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

Our disclosure and analysis in this report, in our Annual Report on Form 10-K for the year ended December 31, 2016 and in our other filings with the Securities and Exchange Commission contain forward-looking statements regarding our intent, belief and current expectations about our strategic direction, prospects and future results. From time to time, we also provide forward-looking statements in other materials we release as well as oral forward-looking statements. Such statements give our current expectations or forecasts of future events; they do not relate strictly to historical or current facts. Management believes that these forward-looking statements are reasonable as and when made. However, caution should be taken not to place undue reliance on any such forward-looking statements because such statements speak only as of the date when made.

Forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from our historical experience and our present expectations or anticipated results. These risks and uncertainties include, but are not limited to: general economic conditions, both in the U.S. and internationally; significant competition on a local, regional, national, and international basis; changes in our relationships with our significant customers; the existing complex and stringent regulation in the U.S. and internationally, changes to which can impact our business; increased security requirements that may increase our costs of operations and reduce operating efficiencies; legal, regulatory or market responses to global climate change; negotiation and ratification of labor contracts; strikes, work stoppages and slowdowns by our employees; the effects of changing prices of energy, including gasoline, diesel and jet fuel, and interruptions in supplies of these commodities; changes in exchange rates or interest rates; our ability to maintain the image of our brand; breaches in data security; disruptions to the Internet or our technology infrastructure; interruption of our business from natural or manmade disasters including terrorism; our ability to accurately forecast our future capital investment needs; exposure to changing economic, political and social developments in international and emerging markets; changes in business strategy, government regulations, or economic or market conditions that may result in substantial impairment of our assets; increases in our expenses or funding obligations relating to employee health, retiree health and/or pension benefits; the potential for various claims and litigation related to labor and employment, personal injury, property damage, business practices, environmental liability and other matters; our ability to realize the anticipated benefits from acquisitions, joint ventures or strategic alliances; our ability to manage insurance and claims expenses; and other risks discussed in our filings with the Securities and Exchange Commission from time to time, including our Annual Report on Form 10-K for the year ended December 31, 2016 or described from time to time in our future reports filed with the Securities and Exchange Commission. You should consider the limitations on, and risks associated with, forward-looking statements and not unduly rely on the accuracy of predictions contained in such forward-looking statements. We do not undertake any obligation to update forward-looking statements to reflect events, circumstances, changes in expectations, or the occurrence of unanticipated events after the date of those statements.

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Item 1. Financial Statements

UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

June 30, 2017 (unaudited) and December 31, 2016

(In millions)

| | June 30, 2017 | December 31, 2016 |
|---|------------------|----------------------|
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$3,544 | \$ 3,476 |
| Marketable securities | 1,060 | 1,091 |
| Accounts receivable, net | 6,553 | 7,695 |
| Other current assets | 1,237 | 1,587 |
| Total Current Assets | 12,394 | 13,849 |
| Property, Plant and Equipment, Net | 19,841 | 18,800 |
| Goodwill | 3,845 | 3,757 |
| Intangible Assets, Net | 1,829 | 1,758 |
| Non-Current Investments and Restricted Cash | 479 | 476 |
| Deferred Income Tax Assets | 362 | 591 |
| Other Non-Current Assets | 974 | 1,146 |
| Total Assets | \$39,724 | \$ 40,377 |
| LIABILITIES AND SHAREOWNERS' EQUITY | | |
| Current Liabilities: | | |
| Current maturities of long-term debt and commercial paper | \$3,817 | \$ 3,681 |
| Accounts payable | 2,648 | 3,042 |
| Accrued wages and withholdings | 2,293 | 2,317 |
| Hedge margin liabilities | 138 | 575 |
| Self-insurance reserves | 705 | 670 |
| Accrued group welfare and retirement plan contributions | 607 | 598 |
| Other current liabilities | 874 | 847 |
| Total Current Liabilities | 11,082 | 11,730 |
| Long-Term Debt | 14,257 | 12,394 |
| Pension and Postretirement Benefit Obligations | 9,981 | 12,694 |
| Deferred Income Tax Liabilities | 95 | 112 |
| Self-Insurance Reserves | 1,746 | 1,794 |
| Other Non-Current Liabilities | 1,289 | 1,224 |
| Shareowners' Equity: | | |
| Class A common stock (178 and 180 shares issued in 2017 and 2016, respectively) | 2 | 2 |
| Class B common stock (688 and 689 shares issued in 2017 and 2016, respectively) | 7 | 7 |
| Additional paid-in capital | — | — |
| Retained earnings | 5,437 | 4,879 |
| Accumulated other comprehensive loss | (4,202) | (4,483) |
| Deferred compensation obligations | 36 | 45 |
| Less: Treasury stock (1 share in 2017 and 2016) | (36) | (45) |
| Total Equity for Controlling Interests | 1,244 | 405 |
| Noncontrolling Interests | 30 | 24 |
| Total Shareowners' Equity | 1,274 | 429 |
| Total Liabilities and Shareowners' Equity | \$39,724 | \$ 40,377 |
| See notes to unaudited consolidated financial statements. | | |

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UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

STATEMENTS OF CONSOLIDATED INCOME

(In millions, except per share amounts)

(unaudited)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|----------------------------------|-----------------------------------|----------|------------------------------|----------|
| | 2017 | 2016 | 2017 | 2016 |
| Revenue | \$15,750 | \$14,629 | \$31,065 | \$29,047 |
| Operating Expenses: | | | | |
| Compensation and benefits | 8,105 | 7,738 | 16,236 | 15,591 |
| Repairs and maintenance | 392 | 383 | 782 | 764 |
| Depreciation and amortization | 562 | 555 | 1,116 | 1,107 |
| Purchased transportation | 2,443 | 2,070 | 4,809 | 4,094 |
| Fuel | 616 | 505 | 1,237 | 939 |
| Other occupancy | 264 | 245 | 563 | 514 |
| Other expenses | 1,152 | 1,095 | 2,322 | 2,177 |
| Total Operating Expenses | 13,534 | 12,591 | 27,065 | 25,186 |
| Operating Profit | 2,216 | 2,038 | 4,000 | 3,861 |
| Other Income and (Expense): | | | | |
| Investment income and other | 14 | 8 | 29 | 25 |
| Interest expense | (111) | (94) | (213) | (187) |
| Total Other Income and (Expense) | (97) | (86) | (184) | (162) |
| Income Before Income Taxes | 2,119 | 1,952 | 3,816 | 3,699 |
| Income Tax Expense | 735 | 683 | 1,274 | 1,299 |
| Net Income | \$1,384 | \$1,269 | \$2,542 | \$2,400 |
| Basic Earnings Per Share | \$1.59 | \$1.43 | \$2.91 | \$2.71 |
| Diluted Earnings Per Share | \$1.58 | \$1.43 | \$2.90 | \$2.69 |

STATEMENTS OF CONSOLIDATED COMPREHENSIVE INCOME

(In millions)

(unaudited)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|-----------------------------------|---------|---------------------------------|---------|
| | 2017 | 2016 | 2017 | 2016 |
| Net Income | \$1,384 | \$1,269 | \$2,542 | \$2,400 |
| Change in foreign currency translation adjustment, net of tax | 24 | (31) | 54 | (5) |
| Change in unrealized gain (loss) on marketable securities, net of tax | 1 | 2 | 1 | 5 |
| Change in unrealized gain (loss) on cash flow hedges, net of tax | (151) | 43 | (192) | (119) |
| Change in unrecognized pension and postretirement benefit costs, net of tax | 386 | 27 | 418 | 53 |
| Comprehensive Income | \$1,644 | \$1,310 | \$2,823 | \$2,334 |

See notes to unaudited consolidated financial statements.

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

| | Six Months Ended June 30, 2017 2016 | |
|--|---|----------|
| Cash Flows From Operating Activities: | | |
| Net income | \$2,542 | \$2,400 |
| Adjustments to reconcile net income to net cash from operating activities: | | |
| Depreciation and amortization | 1,116 | 1,107 |
| Pension and postretirement benefit expense | 463 | 537 |
| Pension and postretirement benefit contributions | (2,530) | (89) |
| Self-insurance reserves | (17) | (25) |
| Deferred tax (benefit) expense | 175 | (31) |
| Stock compensation expense | 345 | 346 |
| Other (gains) losses | (11) | (105) |
| Changes in assets and liabilities, net of effects of business acquisitions: | | |
| Accounts receivable | 1,138 | 1,054 |
| Other current assets | 440 | 230 |
| Accounts payable | (534) | (310) |
| Accrued wages and withholdings | (18) | (73) |
| Other current liabilities | (456) | (356) |
| Other operating activities | (32) | 8 |
| Net cash from operating activities | 2,621 | 4,693 |
| Cash Flows From Investing Activities: | | |
| Capital expenditures | (2,009) | (963) |
| Proceeds from disposals of property, plant and equipment | 14 | 11 |
| Purchases of marketable securities | (1,084) | (3,131) |
| Sales and maturities of marketable securities | 1,111 | 2,340 |
| Net (increase) decrease in finance receivables | (16) | (13) |
| Cash paid for business acquisitions, net of cash and cash equivalents acquired | (57) | (3) |
| Other investing activities | 14 | (35) |
| Net cash used in investing activities | (2,027) | (1,794) |
| Cash Flows From Financing Activities: | | |
| Net change in short-term debt | (810) | (1,781) |
| Proceeds from borrowings | 3,815 | 2,890 |
| Repayments of borrowings | (1,220) | (1,134) |
| Purchases of common stock | (898) | (1,329) |
| Issuances of common stock | 132 | 147 |
| Dividends | (1,389) | (1,327) |
| Other financing activities | (186) | (50) |
| Net cash used in financing activities | (556) | (2,584) |
| Effect Of Exchange Rate Changes On Cash And Cash Equivalents | 30 | 14 |
| Net Increase (Decrease) In Cash And Cash Equivalents | 68 | 329 |
| Cash And Cash Equivalents: | | |
| Beginning of period | 3,476 | 2,730 |
| End of period | \$3,544 | \$3,059 |

See notes to unaudited consolidated financial statements.

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UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION AND ACCOUNTING POLICIES

Principles of Consolidation

In our opinion, the accompanying interim, unaudited, consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. These consolidated financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly our financial position as of June 30, 2017, our results of operations for the three and six months ended June 30, 2017 and 2016, and cash flows for the six months ended June 30, 2017 and 2016. The results reported in these consolidated financial statements should not be regarded as necessarily indicative of results that may be expected for any other period or the entire year. The interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2016. For interim consolidated financial statement purposes, we provide for accruals under our various employee benefit plans for each three month period based on one quarter of the estimated annual expense.

Fair Value of Financial Instruments

The carrying amounts of our cash and cash equivalents, accounts receivable, finance receivables and accounts payable approximate fair value as of June 30, 2017. The fair values of our investment securities are disclosed in note 4, our recognized multiemployer pension withdrawal liabilities in note 6, our short and long-term debt in note 8 and our derivative instruments in note 13. We utilized Level 1 inputs in the fair value hierarchy of valuation techniques to determine the fair value of our cash and cash equivalents, and Level 2 inputs to determine the fair value of our accounts receivable, finance receivables and accounts payable.

Self-Insurance Accruals

We self-insure costs associated with workers' compensation claims, automotive liability, health and welfare and general business liabilities, up to certain limits. Insurance reserves are established for estimates of the loss that we will ultimately incur on reported claims, as well as estimates of claims that have been incurred but not yet reported. Recorded balances are based on reserve levels, which 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.

Workers' compensation, automobile liability and general liability insurance claims may take several years to completely settle. Consequently, actuarial estimates are required to project the ultimate cost that will be incurred to fully resolve the claims. A number of factors can affect the actual cost of a claim, including the length of time the claim remains open, trends in healthcare costs and the results of related litigation. Furthermore, claims may emerge in future years for events that occurred in a prior year at a rate that differs from previous actuarial projections. Changes in state legislation with respect to workers' compensation can affect the adequacy of our self-insurance accruals. All of these factors can result in revisions to prior actuarial projections and produce a material difference between estimated and actual operating results. Prior to 2017, outside actuarial studies were performed semi-annually and we used the studies to estimate the liability in intervening quarters. Beginning in 2017, outside actuarial studies are now performed quarterly as we believe this provides us with better quarterly estimates of our outstanding workers compensation liability.

We sponsor a number of health and welfare insurance plans for our employees. These liabilities and related expenses are based on estimates of the number of employees and eligible dependents covered under the plans, anticipated medical usage by participants and overall trends in medical costs and inflation.

Accounting Estimates

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

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UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. RECENT ACCOUNTING PRONOUNCEMENTS

Adoption of New Accounting Standards

In March 2016, the Financial Accounting Standards Board ("FASB") issued an accounting standards update that simplified the income tax accounting and cash flow presentation related to share-based compensation by requiring the recognition of all excess tax benefits and deficiencies directly on the income statement and classification as cash flows from operating activities on the statements of consolidated cash flows. This update also made several changes to the accounting for forfeitures and employee tax withholding on share-based compensation. This new guidance became effective for us in the first quarter of 2017 and we adopted the statements of consolidated cash flows presentation on a prospective basis. The impact to income tax expense in the statements of consolidated income, for the second quarter of 2017, was a benefit of \$7 million (\$62 million year-to-date). Additionally, we have elected to continue estimating forfeitures expected to occur to determine the amount of compensation cost to be recognized each period.

Other accounting pronouncements adopted during the periods covered by the consolidated financial statements did not have a material impact on our consolidated financial position, results of operations or cash flows.

Accounting Standards Issued But Not Yet Effective

In May 2017, the FASB issued an accounting standards update to provide clarity and reduce complexity on when to apply modification accounting to existing share-based payment awards. The guidance will generally be applied prospectively and will become effective for annual periods beginning after December 15, 2017, but early adoption is permitted. We are currently evaluating this update to determine the full impact of its adoption but do not expect this accounting standards update to have a material impact on our consolidated financial position, results of operations or cash flows.

In March 2017, the FASB issued an accounting standards update to require the premium on callable debt securities to be amortized to the earliest call date. The amortization period for callable debt securities purchased at a discount would not be impacted by the proposed update. Under current generally accepted accounting principles ("GAAP"), premiums on callable debt securities are generally amortized over the contractual life of the security. Only in cases when an entity has a large number of similar securities is it allowed to consider estimates of principal prepayments. Amortization of the premium over the contractual life of the instrument can result in losses being recorded for the unamortized premium if the issuer exercises the call feature prior to maturity. The standard will be effective for us in the first quarter of 2019, but early adoption is permitted. We are currently evaluating this update to determine the full impact of its adoption but do not expect this accounting standards update to have a material impact on our consolidated financial position, results of operations or cash flows.

In March 2017, the FASB issued an accounting standards update to improve the presentation of net periodic pension cost and net periodic postretirement benefit cost. The update requires employers to report the current service cost component in the same line item as other compensation costs arising from services rendered by employees during the period. The other components of net benefit cost are required to be presented separately from service cost and outside of income from operations. In accordance with the update, only the service cost component will be eligible for capitalization. The guidance in this update should be applied retrospectively for the presentation of service cost and other components of net benefit cost, and prospectively for the capitalization of the service cost component in assets, and becomes effective for us in the first quarter of 2018. As a result of this update, the net amount of interest cost, prior service cost and expected return on plan assets will be presented as other income. For the three months ended June 30, 2017 and 2016, non-service cost components amounted to a \$179 and \$104 million benefit (\$359 and \$208 million for the six months ended June 30, 2017 and 2016), respectively, which was recognized in "compensation and benefits" on the statements of consolidated income. After adoption, the non-service cost components will be recognized in "other income and expense" on the statements of consolidated income.

In January 2017, the FASB issued an accounting standards update to simplify the accounting for goodwill impairment. The update removes Step 2 of the goodwill impairment test, which requires a hypothetical purchase price allocation. A goodwill impairment will now be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. The standard will be effective for us in the first quarter of 2020, but early adoption is permitted. We are currently evaluating this update to determine the full impact of its adoption but do not expect this accounting standards update to have a material impact on our consolidated financial position, results of operations or cash flows.

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UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

In November 2016, the FASB issued an accounting standards update that is intended to reduce diversity in practice by adding or clarifying guidance on classification and presentation of changes in restricted cash on the statement of cash flows. The update should be applied retrospectively and becomes effective for us in the first quarter of 2018, but early adoption is permitted. As a result of this update, restricted cash will be included within cash and cash equivalents on our statements of consolidated cash flows. As of June 30, 2017 and December 31, 2016, we classified \$112 and \$310 million in restricted cash on our consolidated balance sheets in "non-current investments and restricted cash", respectively.

In August 2016, the FASB issued an accounting standards update that addresses the classification and presentation of specific cash flow issues that currently result in diverse practices. The guidance also clarifies how the predominance principle should be applied when cash receipts and cash payments have aspects of more than one class of cash flows. The guidance will generally be applied retrospectively and becomes effective for us in the first quarter of 2018, but early adoption is permitted. We are currently evaluating the impact of this standard on our statements of consolidated cash flows, but do not expect this standard to have a material impact.

In February 2016, the FASB issued an accounting standards update that requires lessees to recognize a right-of-use asset and lease liability on the balance sheet for all leases with terms beyond twelve months. Although the distinction between operating and finance leases will continue to exist under the new standard, the recognition and measurement of expenses and cash flows will not change significantly from the current treatment. This new guidance requires modified retrospective application and becomes effective for us in the first quarter of 2019, but early adoption is permitted. We are currently evaluating this update to determine the full impact of its adoption on our consolidated financial position, results of operations, cash flows and related disclosures, as well as the impact of adoption on policies, practices and systems. As of December 31, 2016, we had \$1.470 billion of future minimum operating lease commitments that are not currently recognized on our consolidated balance sheets. Therefore, we expect material changes to our consolidated balance sheets.

In January 2016, the FASB issued an accounting standards update which addresses certain aspects of the recognition, measurement, presentation and disclosure of financial instruments. The amendment will be effective for us beginning the first quarter of 2018. At this time, we do not expect this accounting standards update to have a material impact on our consolidated financial position, results of operations or cash flows.

In May 2014, the FASB issued an accounting standards update that changes the revenue recognition for companies that enter into contracts with customers to transfer goods or services. The standard is a comprehensive new revenue recognition model that requires revenue to be recognized in a manner depicting the transfer of goods or services to a customer at an amount that reflects the consideration expected to be received in exchange for those goods or services. The FASB has also issued a number of updates to this standard. We are planning to adopt the standard on January 1, 2018. Companies may use either a full retrospective or a modified retrospective approach to adopt this standard. We are currently evaluating this standard and the related updates, including which transition approach to use as well as the impact of adoption on policies, practices and systems.

At this stage in the evaluation, we have determined that revenue recognition will be accelerated for the transportation businesses as the standard requires revenue to be recognized as control is transferred to the customer over time rather than upon delivery. We are currently quantifying the impact of this change to the statements of consolidated income. The standard also requires us to evaluate whether our businesses promise to transfer services to the customer itself (as a principal) or to arrange for services to be provided by another party (as an agent). To make that determination, the standard uses a control model rather than the risks-and-rewards model in current GAAP. Based on our evaluation of the control model, we determined that certain Supply Chain & Freight businesses act as the principal rather than the agent within their revenue arrangements. This change will require the affected businesses to report transportation revenue gross of associated purchase transportation costs rather than net of such amounts within the statements of consolidated income. We expect that this change will result in an approximately \$720 million reclassification from operating expenses to revenue on the statement of consolidated income for the period ended December 31, 2016. This

amount may change as we continue to evaluate other businesses. Additionally, contract reviews are ongoing, and more businesses could be impacted by the adoption of the standard.

Other accounting pronouncements issued, but not effective until after June 30, 2017, are not expected to have a material impact on our consolidated financial position, results of operations or cash flows.

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UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3. STOCK-BASED COMPENSATION

We issue employee share-based awards under the UPS Incentive Compensation Plan, which permits the grant of non-qualified and incentive stock options, stock appreciation rights, restricted stock and stock units, and restricted performance shares and performance units, to eligible employees (restricted stock and stock units, restricted performance shares and performance units are herein referred to as "Restricted Units"). Upon vesting, Restricted Units result in the issuance of the equivalent number of UPS class A common shares after required tax withholdings. Dividends accrued on Restricted Units are reinvested in additional Restricted Units at each dividend payable date, and are subject to the same vesting and forfeiture conditions as the underlying Restricted Units upon which they are earned.

The primary compensation programs offered under the UPS Incentive Compensation Plan include the UPS Management Incentive Award program, the UPS Long-Term Incentive Performance Award program and the UPS Stock Option program. We also maintain an employee stock purchase plan which allows eligible employees to purchase shares of UPS class A common stock at a discount. Additionally, our matching contributions to the primary employee defined contribution savings plan are made in shares of UPS class A common stock.

Management Incentive Award Program ("MIP")

During the first quarter of 2017, we granted Restricted Units under MIP to certain eligible management employees. Restricted Units granted under MIP generally vest over a five-year period with approximately 20% of the award vesting on January 15th of each of the years following the grant date (except in the case of death, disability or retirement, in which case immediate vesting occurs). The entire grant is expensed on a straight-line basis (less estimated forfeitures) ratably over the requisite service period. Based on the date that the eligible management population and performance targets were approved for MIP, we determined the award measurement date to be February 7, 2017 (for U.S.-based employees), March 1, 2017 (for management committee employees) and March 27, 2017 (for international-based employees); therefore, the Restricted Units awarded were valued for stock compensation expense purposes using the closing New York Stock Exchange price of \$105.69, \$106.87 and \$104.78 on those dates, respectively.

Long-Term Incentive Performance Award Program ("LTIP")

We award Restricted Units under LTIP to certain eligible management employees. The performance targets are equally-weighted among consolidated operating return on invested capital, growth in currency-constant consolidated revenue and total shareowner return ("RTSR") relative to a peer group of companies. These Restricted Units generally vest at the end of a three-year period (except in the case of death, disability, or retirement, in which case immediate vesting occurs on a prorated basis). The number of Restricted Units earned will be based on the percentage achievement of the performance targets established on the grant date.

For the two-thirds of the award related to consolidated operating return on invested capital and growth in currency-constant consolidated revenue, we recognize the grant date fair value of these Restricted Units (less estimated forfeitures) as compensation expense ratably over the vesting period, based on the number of awards expected to be earned. Based on the date that the eligible management population and performance targets were approved for the 2017 LTIP Award, we determined the award measurement date to be March 24, 2017; therefore, the target Restricted Units awarded for this portion of the award were valued for stock compensation expense using the closing New York Stock Exchange price of \$105.05 on that date.

The remaining one-third of the award related to RTSR is valued using a Monte Carlo model. This portion of the award was valued with a grant date fair value of \$119.29 per unit and is recognized as compensation expense (less estimated forfeitures) ratably over the vesting period.

The weighted-average assumptions used and the calculated weighted-average fair values of the RTSR portion of the LTIP awards granted in 2017 and 2016 are as follows:

| | 2017 | | 2016 | |
|-------------------------|------|---|------|---|
| Risk-free interest rate | 1.46 | % | 1.01 | % |

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Expected volatility 16.59 % 16.45 %

Weighted-average fair value of units granted \$119.29 \$135.57

Share payout 113.55 % 128.59 %

There is no expected dividend yield as units earn dividend equivalents.

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Non-Qualified Stock Options

During the first quarter of 2017, we granted non-qualified stock option awards to a limited group of eligible senior management employees under the UPS Stock Option program. Stock option awards generally vest over a five-year period with approximately 20% of the award vesting at each anniversary date of the grant (except in the case of death, disability, or retirement, in which case immediate vesting occurs). The options granted will expire ten years after the date of the grant. In the first quarter of 2017 and 2016, we granted 0.3 and 0.2 million stock options, respectively, at a grant price of \$106.87 and \$98.77, respectively. The grant price was based on the closing New York Stock Exchange price of March 1, 2017 and March 2, 2016, respectively.

The fair value of each option grant is estimated using the Black-Scholes option pricing model. The weighted-average assumptions used and the calculated weighted-average fair values of options granted in 2017 and 2016 are as follows:

| | 2017 | | 2016 | |
|--|---------|---|---------|---|
| Expected dividend yield | 2.89 | % | 2.94 | % |
| Risk-free interest rate | 2.15 | % | 1.66 | % |
| Expected life (in years) | 7.5 | | 7.5 | |
| Expected volatility | 17.81 | % | 23.60 | % |
| Weighted-average fair value of options granted | \$14.70 | | \$17.32 | |

Compensation expense for share-based awards recognized in "Compensation and benefits" on the statements of consolidated income for the three months ended June 30, 2017 and 2016 was \$133 and \$131 million pre-tax, respectively. Compensation expense for share-based awards recognized in "Compensation and benefits" on the statements of consolidated income for the six months ended June 30, 2017 and 2016 was \$345 and \$346 million pre-tax, respectively.

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UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4. INVESTMENTS AND RESTRICTED CASH

The following is a summary of marketable securities classified as trading and available-for-sale as of June 30, 2017 and December 31, 2016 (in millions):

| | Cost | Unrealized Gains | Unrealized Losses | Estimated Fair Value |
|--|---------|---------------------|----------------------|-------------------------|
| June 30, 2017: | | | | |
| Current trading marketable securities: | | | | |
| Corporate debt securities | \$353 | \$ — | \$ — | \$ 353 |
| Carbon credit investments ⁽¹⁾ | 87 | 1 | — | 88 |
| Total trading marketable securities | \$440 | \$ 1 | \$ — | \$ 441 |
| Current available-for-sale securities: | | | | |
| U.S. government and agency debt securities | \$289 | \$ — | \$ (2) | \$ 287 |
| Mortgage and asset-backed debt securities | 91 | 1 | — | 92 |
| Corporate debt securities | 197 | 1 | (1) | 197 |
| U.S. state and local municipal debt securities | 38 | — | — | 38 |
| Equity securities | 2 | — | — | 2 |
| Non-U.S. government debt securities | 3 | — | — | 3 |
| Total available-for-sale marketable securities | \$620 | \$ 2 | \$ (3) | \$ 619 |
| Total current marketable securities | \$1,060 | \$ 3 | \$ (3) | \$ 1,060 |
| | Cost | Unrealized Gains | Unrealized Losses | Estimated Fair Value |
| December 31, 2016: | | | | |
| Current trading marketable securities: | | | | |
| Corporate debt securities | \$427 | \$ — | \$ — | \$ 427 |
| Carbon credit investments ⁽¹⁾ | 80 | 10 | — | 90 |
| Total trading marketable securities | \$507 | \$ 10 | \$ — | \$ 517 |
| Current available-for-sale securities: | | | | |
| U.S. government and agency debt securities | \$314 | \$ — | \$ (2) | \$ 312 |
| Mortgage and asset-backed debt securities | 90 | 1 | — | 91 |
| Corporate debt securities | 167 | — | (1) | 166 |
| Equity securities | 2 | — | — | 2 |
| Non-U.S. government debt securities | 3 | — | — | 3 |
| Total available-for-sale marketable securities | \$576 | \$ 1 | \$ (3) | \$ 574 |
| Total current marketable securities | \$1,083 | \$ 11 | \$ (3) | \$ 1,091 |

⁽¹⁾ These investments are hedged with forward contracts that are not designated in hedging relationships. See Note 13 for offsetting statement of consolidated income impact.

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UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Investment Other-Than-Temporary Impairments

We have concluded that no material other-than-temporary impairment losses existed as of June 30, 2017. In making this determination, we considered the financial condition and prospects of the issuer, the magnitude of the losses compared with the investments' cost, the probability that we will be unable to collect all amounts due according to the contractual terms of the security, the credit rating of the security and our ability and intent to hold these investments until the anticipated recovery in market value occurs.

Maturity Information

The amortized cost and estimated fair value of marketable securities at June 30, 2017, 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 | \$410 | \$ 410 |
| Due after one year through three years | 431 | 428 |
| Due after three years through five years | 19 | 19 |
| Due after five years | 111 | 113 |
| | 971 | 970 |
| Equity and carbon credit investments | 89 | 90 |
| | \$1,060 | \$ 1,060 |

Non-Current Investments and Restricted Cash

Non-current investments and restricted cash is primarily associated with our self-insurance requirements. We entered into an escrow agreement with an insurance carrier to guarantee our self-insurance obligations. This agreement requires us to provide collateral to the insurance carrier, which is invested in various marketable securities. Collateral provided is reflected in "other investing activities" in the statements of consolidated cash flows. At June 30, 2017 and December 31, 2016, we had \$447 and \$445 million in self-insurance investments and restricted cash, respectively. We held a \$19 and \$18 million investment in a variable life insurance policy to fund benefits for the UPS Excess Coordinating Benefit Plan at June 30, 2017 and December 31, 2016, respectively. The quarterly change in investment fair value is recognized in "investment income and other" on the statements of consolidated income. Additionally, we held escrowed cash related to the acquisition and disposition of certain assets, primarily real estate, of \$13 million as of June 30, 2017 and December 31, 2016, respectively.

The amounts described above are classified as "Non-current investments and restricted cash" in the consolidated balance sheets.

Fair Value Measurements

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

We maintain holdings in certain investment partnerships that are measured at fair value utilizing Level 3 inputs (classified as "other non-current investments" in the tables below, and as "other non-current assets" in the consolidated balance sheets). These partnership holdings do not have quoted prices, nor can they be valued using inputs based on observable market data. These investments are valued internally using a discounted cash flow model with two significant inputs: (1) the after-tax cash flow projections for each partnership, and (2) a risk-adjusted discount rate consistent with the duration of the expected cash flows for each partnership. The weighted-average discount rates used to value these investments were 7.75% and 8.06% as of June 30, 2017 and December 31, 2016, respectively. These inputs, and the resulting fair values, are updated on a quarterly basis.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

The following table presents information about our investments measured at fair value on a recurring basis as of June 30, 2017 and December 31, 2016, and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value (in millions):

| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Balance |
|--|---|---|--|----------|
| June 30, 2017: | | | | |
| Marketable Securities: | | | | |
| U.S. government and agency debt securities | \$ 287 | \$ — | \$ — | \$ 287 |
| Mortgage and asset-backed debt securities | — | 92 | — | 92 |
| Corporate debt securities | — | 550 | — | 550 |
| U.S. state and local municipal debt securities | — | 38 | — | 38 |
| Equity securities | — | 2 | — | 2 |
| Non-U.S. government debt securities | — | 3 | — | 3 |
| Carbon credit investments | 88 | — | — | 88 |
| Total marketable securities | 375 | 685 | — | 1,060 |
| Other non-current investments | 19 | — | 9 | 28 |
| Total | \$ 394 | \$ 685 | \$ 9 | \$ 1,088 |
| December 31, 2016: | | | | |
| Marketable Securities: | | | | |
| U.S. government and agency debt securities | \$312 | \$— | \$— | \$312 |
| Mortgage and asset-backed debt securities | — | 91 | — | 91 |
| Corporate debt securities | — | 593 | — | 593 |
| Equity securities | — | 2 | — | 2 |
| Non-U.S. government debt securities | — | 3 | — | 3 |
| Carbon credit investments | 90 | — | — | 90 |
| Total marketable securities | 402 | 689 | — | 1,091 |
| Other non-current investments | 18 | — | 13 | 31 |
| Total | \$420 | \$689 | \$13 | \$1,122 |

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UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the changes in the above Level 3 instruments measured on a recurring basis for the three months ended June 30, 2017 and 2016 (in millions):

| | Marketable Securities | Other Non-Current Investments | Total |
|--|--------------------------|-------------------------------------|-------|
| Balance on April 1, 2017 | \$ — | \$ 11 | \$ 11 |
| Transfers into (out of) Level 3 | — | — | — |
| Net realized and unrealized gains (losses): | | | |
| Included in earnings (in investment income and other) | — | (2) | (2) |
| Included in accumulated other comprehensive income (pre-tax) | — | — | — |
| Purchases | — | — | — |
| Sales | — | — | — |
| Balance on June 30, 2017 | \$ — | \$ 9 | \$ 9 |
| | Marketable Securities | Other Non-Current Investments | Total |
| Balance on April 1, 2016 | \$ — | \$ 27 | \$ 27 |
| Transfers into (out of) Level 3 | — | — | — |
| Net realized and unrealized gains (losses): | | | |
| Included in earnings (in investment income and other) | — | (5) | (5) |
| Included in accumulated other comprehensive income (pre-tax) | — | — | — |
| Purchases | — | — | — |
| Sales | — | — | — |
| Balance on June 30, 2016 | \$ — | \$ 22 | \$ 22 |

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UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the changes in the above Level 3 instruments measured on a recurring basis for the six months ended June 30, 2017 and 2016 (in millions):

| | Marketable Securities | Other Investments | Total |
|--|--------------------------|----------------------|-------|
| Balance on January 1, 2017 | \$ | —13 | 13 |
| Transfers into (out of) Level 3 | — | — | — |
| Net realized and unrealized gains (losses): | | | |
| Included in earnings (in investment income and other) | — | (4) | (4) |
| Included in accumulated other comprehensive income (pre-tax) | — | — | — |
| Purchases | — | — | — |
| Sales | — | — | — |
| Balance on June 30, 2017 | \$ | —\$ 9 | \$9 |

| | Marketable Securities | Other Investments | Total |
|--|--------------------------|----------------------|-------|
| Balance on January 1, 2016 | \$ | —32 | 32 |
| Transfers into (out of) Level 3 | — | — | — |
| Net realized and unrealized gains (losses): | | | |
| Included in earnings (in investment income and other) | — | (10) | (10) |
| Included in accumulated other comprehensive income (pre-tax) | — | — | — |
| Purchases | — | — | — |
| Sales | — | — | — |
| Balance on June 30, 2016 | \$ | —\$ 22 | \$22 |

There were no transfers of investments between Level 1 and Level 2 during the three and six months ended June 30, 2017 and 2016.

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UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment as of June 30, 2017 and December 31, 2016 consist of the following (in millions):

| | 2017 | 2016 |
|---|-----------|-----------|
| Vehicles | \$8,879 | \$8,638 |
| Aircraft | 15,678 | 15,653 |
| Land | 1,591 | 1,397 |
| Buildings | 3,571 | 3,439 |
| Building and leasehold improvements | 3,718 | 3,612 |
| Plant equipment | 8,714 | 8,430 |
| Technology equipment | 1,810 | 1,741 |
| Equipment under operating leases | 29 | 29 |
| Construction-in-progress | 1,598 | 735 |
| | 45,588 | 43,674 |
| Less: Accumulated depreciation and amortization | (25,747) | (24,874) |
| | \$19,841 | \$18,800 |

We continually monitor our aircraft fleet utilization in light of current and projected volume levels, aircraft fuel prices and other factors. Additionally, we monitor our other property, plant and equipment categories for any indicators that the carrying value of the assets may not be recoverable. No impairment charges on property, plant and equipment were recorded during the three and six months ended June 30, 2017 and 2016.

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NOTE 6. EMPLOYEE BENEFIT PLANS

Company-Sponsored Benefit Plans

Information about net periodic benefit cost for our company-sponsored pension and postretirement benefit plans is as follows for the three and six months ended June 30, 2017 and 2016 (in millions):

| | U.S. Pension Benefits | | U.S. Postretirement Medical Benefits | | International Pension Benefits | |
|------------------------------------|-----------------------|--------|--------------------------------------|-------|--------------------------------|-------|
| | 2017 | 2016 | 2017 | 2016 | 2017 | 2016 |
| Three Months Ended June 30: | | | | | | |
| Service cost | \$ 389 | \$ 353 | \$ 7 | \$ 7 | \$ 14 | \$ 13 |
| Interest cost | 462 | 457 | 28 | 30 | 10 | 11 |
| Expected return on assets | (712) | (629) | (1) | (1) | (16) | (15) |
| Amortization of prior service cost | 48 | 42 | 2 | 1 | — | — |
| Net periodic benefit cost | \$ 187 | \$ 223 | \$ 36 | \$ 37 | \$ 8 | \$ 9 |

| | U.S. Pension Benefits | | U.S. Postretirement Medical Benefits | | International Pension Benefits | |
|------------------------------------|-----------------------|----------|--------------------------------------|-------|--------------------------------|-------|
| | 2017 | 2016 | 2017 | 2016 | 2017 | 2016 |
| Six Months Ended June 30: | | | | | | |
| Service cost | \$ 779 | \$ 706 | \$ 14 | \$ 14 | \$ 29 | \$ 25 |
| Interest cost | 924 | 914 | 56 | 60 | 20 | 21 |
| Expected return on assets | (1,424) | (1,258) | (3) | (2) | (32) | (29) |
| Amortization of prior service cost | 96 | 84 | 4 | 2 | — | — |
| Net periodic benefit cost | \$ 375 | \$ 446 | \$ 71 | \$ 74 | \$ 17 | \$ 17 |

During the first six months of 2017, we contributed \$2.334 billion and \$196 million to our company-sponsored pension and U.S. postretirement medical benefit plans, respectively. We also expect to contribute \$43 and \$45 million over the remainder of the year to the pension and U.S. postretirement medical benefit plans, respectively.

Plan Amendments and Curtailments

The UPS Retirement Plan was closed to new non-union participants effective July 1, 2016. In the quarter ended June 30, 2017, we amended the UPS Retirement Plan and the UPS Excess Coordinating Benefit Plan (single-employer defined benefit pension plans sponsored by UPS) to cease accruals of additional benefits for future service and compensation for non-union participants effective January 1, 2023. We remeasured plan assets and pension benefit obligations for the affected pension plans as of June 30, 2017, resulting in a net actuarial gain of \$569 million. This reflects a curtailment gain of \$1.525 billion resulting from the benefit plan changes that was partially offset by net actuarial losses of \$956 million, driven by a reduction of approximately 32 basis points in the discount rate compared to December 31, 2016, offset by actual assets returns approximately 275 basis points above our expected return as of the remeasurement date. The net curtailment gain reduced the actuarial loss recorded in "accumulated other comprehensive loss" in the equity section of the consolidated balance sheet. As actuarial losses are within the corridor (defined as 10% of the greater of the fair value of plan assets and the plan's projected benefit obligation), there is no impact to the statement of consolidated income for the quarter ended June 30, 2017.

Effective July 1, 2016, the Company amended the UPS 401(k) Savings Plan so that employees who would have been eligible for participation in the UPS Retirement Plan instead began earning a UPS Retirement Contribution. For employees eligible to receive the Retirement Contribution, UPS contributes 3% to 8% of eligible pay to the UPS 401(k) Savings Plan based on years of vesting service and business unit. Contributions are made annually in cash to the accounts of participants who are employed on December 31st of each calendar year.

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Effective June 23, 2017, the Company amended the UPS 401(k) Savings Plan so that non-union employees who currently participate in the UPS Retirement Plan will, in addition to current benefits under the UPS 401(k) Savings Plan, earn a UPS Retirement Contribution beginning January 1, 2023. UPS will contribute 5% to 8% of eligible compensation to the UPS 401(k) Savings Plan based on years of vesting service. The amendment also provides for transition contributions for certain participants. There was no impact to the statement of consolidated income for the quarter ended June 30, 2017 as a result of the above changes.

Multiemployer Benefit Plans

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

As of June 30, 2017 and December 31, 2016 we had \$862 and \$866 million, respectively, recorded in "other non-current liabilities," as well as \$6 million as of June 30, 2017 and December 31, 2016 recorded in "other current liabilities," on our consolidated balance sheets associated with our previous withdrawal from a multiemployer pension plan. This liability is payable in equal monthly installments over a remaining term of approximately 45 years. Based on the borrowing rates currently available to us for long-term financing of a similar maturity, the fair value of this withdrawal liability as of June 30, 2017 and December 31, 2016 was \$888 and \$861 million, respectively. We utilized Level 2 inputs in the fair value hierarchy of valuation techniques to determine the fair value of this liability.

UPS was a contributing employer to the Central States Pension Fund ("CSPF") until 2007 when we withdrew from the plan and fully funded our allocable share of unfunded vested benefits by paying a \$6.1 billion withdrawal liability. Under a collective bargaining agreement with the International Brotherhood of Teamsters ("IBT"), UPS agreed to provide coordinating benefits in the UPS/IBT Full Time Employee Pension Plan ("UPS/IBT Plan") for UPS participants whose last employer was UPS and who had not retired as of January 1, 2008 ("the UPS Transfer Group") in the event that benefits are lawfully reduced by the CSPF in the future consistent with the terms of our withdrawal agreement with the CSPF.

In December 2014, Congress passed the Multiemployer Pension Reform Act ("MPRA"), which for the first time ever allowed multiemployer pension plans to reduce benefit payments to retirees, subject to specific guidelines in the statute and government approval. In September 2015, the CSPF submitted a proposed pension benefit reduction plan to the U.S. Department of the Treasury under the MPRA. The CSPF plan proposed to reduce retirement benefits to the CSPF participants, including the UPS Transfer Group. We vigorously challenged the proposed benefit reduction plan because we believed that it did not comply with the law and that the CSPF failed to comply with its contractual obligation to obtain our consent to reduce benefits to the UPS Transfer Group under the terms of the withdrawal agreement with the CSPF. On May 6, 2016, the U.S. Department of the Treasury rejected the proposed plan submitted by the CSPF, stating that it failed to satisfy a number of requirements set forth in the MPRA.

The CSPF has asserted that it will become insolvent in 2025 which could lead to the reduction of retirement benefits. Although there are numerous factors that could affect the CSPF's funding status, if the CSPF were to become insolvent as they have projected, UPS may be required to provide coordinating benefits, thereby increasing the current projected benefit obligation for the UPS/IBT Plan by approximately \$4 billion. The CSPF has said that it believes a legislative solution to its funding status is necessary, and we expect that the CSPF will continue to explore options to avoid insolvency.

The potential obligation to pay coordinating benefits from the UPS/IBT Plan is subject to a number of significant uncertainties, including actions that may be taken by the CSPF, the federal government or others. These actions include whether the CSPF will submit a revised pension benefit reduction plan or otherwise seek federal government assistance, the extent to which benefits are paid by the Pension Benefit Guaranty Corporation and our ability to successfully defend our legal positions, as well as the effect of discount rates and various other actuarial assumptions.

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We account for this potential obligation under Accounting Standards Codification Topic 715- Compensation-Retirement Benefits ("ASC 715"). Under ASC 715 we are required to provide a best estimate of various actuarial assumptions, including the eventual outcome of this matter, in measuring our pension benefit obligation at the December 31st measurement date. While we currently believe the most likely solution to this matter and the broader systemic problems facing multiemployer pension plans is intervention by the federal government, ASC 715 does not permit anticipation of changes in law in making a best estimate of pension liabilities. Our best estimate as of the measurement date of December 31, 2016 does not incorporate this solution. Rather, our best estimate of the next most likely outcome to resolve the CSPF's solvency concerns is that the CSPF will make another MPRA filing to forestall insolvency without reducing benefits to the UPS Transfer Group. If the CSPF attempts to reduce benefits for the UPS Transfer Group under a MPRA filing we would be in a strong legal position to prevent that from occurring given that these benefits cannot be reduced without our consent and such a reduction, without first exhausting reductions to other groups in the CSPF, would be contrary to the statute. Accordingly, our best estimate as of the measurement date of December 31, 2016 is that there is no liability to be recognized for additional coordinating benefits of the UPS/IBT Plan. However, the projected benefit obligation could materially increase as these uncertainties are resolved. We will continue to assess the impact of these uncertainties on the projected benefit obligation of the UPS/IBT Plan in accordance with ASC 715.

Collective Bargaining Agreements

As of December 31, 2016, we had approximately 268,000 employees employed under a national master agreement and various supplemental agreements with local unions affiliated with the Teamsters. During 2014, the Teamsters ratified a new national master agreement ("NMA") with UPS that will expire on July 31, 2018. The economic provisions in the NMA included wage rate increases, as well as increased contribution rates for healthcare and pension benefits. We have approximately 2,600 pilots who are employed under a collective bargaining agreement with the Independent Pilots Association ("IPA"). During 2016, the IPA members voted to ratify a new five-year labor contract. Terms of the agreement became effective September 1, 2016 and run through September 1, 2021. The economic provisions in the agreement included pay increases, a signing bonus and enhanced pension benefits.

Our airline mechanics are covered by a collective bargaining agreement with Teamsters Local 2727, which became amendable November 1, 2013. We are currently in negotiations with Teamsters Local 2727. In addition, approximately 3,000 of our auto and maintenance mechanics who are not employed under agreements with the Teamsters are employed under collective bargaining agreements with the International Association of Machinists and Aerospace Workers ("IAM") that will expire on July 31, 2019.

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UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 7. GOODWILL AND INTANGIBLE ASSETS

The following table indicates the allocation of goodwill by reportable segment as of June 30, 2017 and December 31, 2016 (in millions):

| | U.S. Domestic Package | International Package | Supply Chain & Freight | Consolidated |
|-----------------------|--------------------------|--------------------------|---------------------------|--------------|
| December 31, 2016: \$ | 715 | \$ 407 | \$ 2,635 | \$ 3,757 |
| Acquired | — | 18 | 21 | 39 |
| Currency / Other | — | 11 | 38 | 49 |
| June 30, 2017: \$ | 715 | \$ 436 | \$ 2,694 | \$ 3,845 |

The goodwill acquired in the Supply Chain & Freight segment was related to our January 2017 acquisition of Freightex Ltd. ("Freightex"), a U.K.-based asset-light provider of truckload, less-than truckload and specialized over-the-road services. The acquisition of Freightex was paid for with cash from operations. The acquisition of Freightex was not material to our consolidated financial position or results of operations.

The goodwill acquired in the International Package segment was related to our June 2017 acquisition of Eirpost Group Unlimited Company ("Nightline"), an Ireland-based express delivery and logistics company. The acquisition of Nightline was paid for with cash from operations. The acquisition of Nightline was not material to our consolidated financial position or results of operations.

In December 2016, we acquired Maze 1 Limited ("Marken"), a global provider of supply chain solutions to the life sciences industry and leader in clinical trials material storage and distribution, for approximately \$570 million. As of June 30, 2017, we had no material changes to our estimated fair values of assets acquired and liabilities assumed. The financial results of Marken are included in the Supply Chain & Freight segment from the date of acquisition and were not material to our results of operations.

The estimates of the fair value of assets acquired and liabilities assumed are subject to change based on the completion of purchase accounting. The purchase price allocation for acquired companies can be modified for up to one year from the date of acquisition.

The remaining change in goodwill for both the International Package and Supply Chain & Freight segments was due to the impact of changes in the value of the U.S. Dollar on the translation of non-U.S. Dollar goodwill balances.

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The following is a summary of intangible assets as of June 30, 2017 and December 31, 2016 (in millions):

| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Value |
|-------------------------------|--------------------------|-----------------------------|-----------------------|
| June 30, 2017: | | | |
| Capitalized software | \$ 3,100 | \$ (2,229) |) \$ 871 |
| Licenses | 126 | (63) |) 63 |
| Franchise rights | 128 | (93) |) 35 |
| Customer relationships | 744 | (123) |) 621 |
| Trade name | 200 | — | 200 |
| Trademarks, patents and other | 70 | (31) |) 39 |
| Total Intangible Assets, Net | \$ 4,368 | \$ (2,539) |) \$ 1,829 |
| December 31, 2016: | | | |
| Capitalized software | \$ 2,933 | \$ (2,157) |) \$ 776 |
| Licenses | 131 | (70) |) 61 |
| Franchise rights | 128 | (90) |) 38 |
| Customer relationships | 724 | (85) |) 639 |
| Trade name | 200 | — | 200 |
| Trademarks, patents and other | 67 | (23) |) 44 |
| Total Intangible Assets, Net | \$ 4,183 | \$ (2,425) |) \$ 1,758 |

As of June 30, 2017, we had a trade name with a carrying value of \$200 million and licenses with a carrying value of \$4 million, which are deemed to be indefinite-lived intangible assets and are included in the table above.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. DEBT AND FINANCING ARRANGEMENTS

The carrying value of our outstanding debt as of June 30, 2017 and December 31, 2016 consists of the following (in millions):

| | Principal Amount | Maturity | Carrying Value | |
|----------------------------|---------------------|-----------|----------------|----------|
| | | | 2017 | 2016 |
| Commercial paper | \$3,383 | 2017-2018 | \$3,383 | \$3,250 |
| Fixed-rate senior notes: | | | | |
| 1.125% senior notes | 375 | 2017 | 374 | 374 |
| 5.50% senior notes | 750 | 2018 | 759 | 769 |
| 5.125% senior notes | 1,000 | 2019 | 1,033 | 1,043 |
| 3.125% senior notes | 1,500 | 2021 | 1,576 | 1,584 |
| 2.40% senior notes | 500 | 2026 | 497 | 497 |
| 2.45% senior notes | 1,000 | 2022 | 990 | 986 |
| 2.35% senior notes | 600 | 2022 | 596 | — |
| 6.20% senior notes | 1,500 | 2038 | 1,482 | 1,481 |
| 4.875% senior notes | 500 | 2040 | 489 | 489 |
| 3.625% senior notes | 375 | 2042 | 367 | 367 |
| 3.40% senior notes | 500 | 2046 | 491 | 491 |
| Floating rate senior notes | 400 | 2022 | 398 | — |
| 8.375% Debentures: | | | | |
| 8.375% debentures | 424 | 2020 | 456 | 461 |
| 8.375% debentures | 276 | 2030 | 282 | 282 |
| Pound Sterling notes: | | | | |
| 5.50% notes | 86 | 2031 | 81 | 76 |
| 5.125% notes | 590 | 2050 | 564 | 535 |
| Euro senior notes: | | | | |
| 1.625% notes | 798 | 2025 | 793 | 732 |
| 1.00% notes | 570 | 2028 | 566 | 523 |
| Floating rate senior notes | 570 | 2020 | 569 | 525 |
| Canadian senior notes: | | | | |
| 2.125% notes | 577 | 2024 | 573 | — |
| Floating rate senior notes | 979 | 2049-2067 | 969 | 824 |
| Capital lease obligations | 448 | 2017-3005 | 448 | 447 |
| Facility notes and bonds | 320 | 2029-2045 | 319 | 319 |
| Other debt | 19 | 2017-2022 | 19 | 20 |
| Total debt | \$18,040 | | 18,074 | 16,075 |
| Less: Current maturities | | | (3,817) | (3,681) |
| Long-term debt | | | \$14,257 | \$12,394 |

Debt Classification

We have classified our 5.50% senior notes due January 2018 with a principal balance of \$750 million as a long-term liability, based on our intent and ability to refinance the debt as of June 30, 2017. We have also classified certain floating rate senior notes that are putable by the note holders as a long-term liability, due to our intent and ability to refinance the debt if the put option is exercised by the note holders.

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Debt Issuances

In March, we issued floating rate senior notes in principal amount of \$147 million. These notes bear interest at three-month LIBOR less 30 basis points and mature in 2067. 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 one year at a stated percentage of par value.

On May 16, 2017 we issued U.S. senior rate notes. These senior notes consist of two separate series, as follows:

Two series of notes, in the principle amounts of \$600 and \$400 million were issued. These notes bear interest at a 2.35% fixed rate and at a three-month LIBOR plus 38 basis points, respectively, and mature May 2022. Interest on the fixed rate senior notes will be paid semi-annually, beginning November 2017. Interest on the floating rate senior notes will be paid quarterly beginning August 2017. The 2.35% notes are callable at our option at a redemption price equal to the greater of 100% of the principal amount, or the sum of the present values of the remaining scheduled payments of principal and interest thereon discounted to the redemption date on a semi-annual basis at the discount rate of the treasury rate plus 10 basis points and accrued interest. The floating rate senior notes are not callable.

On May 18, 2017 we issued Canadian senior notes. These senior notes consist of a single series as follows:

Notes in the principal amount of C\$750 million (\$547 million), and bear a 2.125% fixed interest rate were issued. Interest on the notes is payable semi-annually beginning November 2017. The notes are callable at our option, in whole or in part at the Government of Canada yield plus 21.5 basis points, and on or after the par call date, at par value.

Commercial Paper

We are authorized to borrow up to \$10.0 billion under a U.S. commercial paper program and €5.0 billion (in a variety of currencies) under a European commercial paper program. We had the following amounts outstanding under these programs as of June 30, 2017: \$2.299 billion with an average interest rate of 0.92% and €951 million (\$1.084 billion) with an average interest rate of -0.39%. As of June 30, 2017, we have classified the entire commercial paper balance as a current liability on our consolidated balance sheet.

Sources of Credit

We maintain two credit agreements with a consortium of banks. One of these agreements provides revolving credit facilities of \$1.5 billion, and expires on March 23, 2018. Generally, amounts outstanding under this facility bear interest at a periodic fixed rate equal to LIBOR for the applicable interest period and currency denomination, plus an applicable margin. Alternatively, a fluctuating rate of interest equal to the highest of (1) JPMorgan Chase Bank's publicly announced prime rate; (2) the Federal Funds effective rate plus 0.50%; and (3) LIBOR for a one month interest period plus 1.00%, plus an applicable margin, may be used at our discretion. In each case, the applicable margin for advances bearing interest based on LIBOR is a percentage determined by quotations from Markit Group Ltd. for our 1-year credit default swap spread, subject to a minimum rate of 0.10% and a maximum rate of 0.75%. The applicable margin for advances bearing interest based on the prime rate is 1.00% below the applicable margin for LIBOR advances (but not lower than 0.00%). We are also able to request advances under this facility based on competitive bids for the applicable interest rate. There were no amounts outstanding under this facility as of June 30, 2017.

The second agreement provides revolving credit facilities of \$3.0 billion, and expires on March 24, 2022. Generally, amounts outstanding under this facility bear interest at a periodic fixed rate equal to LIBOR for the applicable interest period and currency denomination, plus an applicable margin. Alternatively, a fluctuating rate of interest equal to the highest of (1) JPMorgan Chase Bank's publicly announced prime rate; (2) the Federal Funds effective rate plus 0.50%; and (3) LIBOR for a one month interest period plus 1.00%, plus an applicable margin, may be used at our discretion. In each case, the applicable margin for advances bearing interest based on LIBOR is a percentage determined by quotations from Markit Group Ltd. for our 1-year credit default swap spread, interpolated for a period from the date of determination of such credit default swap spread in connection with a new interest period until the latest maturity date of this facility then in effect (but not less than a period of one year). The minimum applicable margin rate is 0.10%

and the maximum applicable margin rate is 0.75% per annum. The applicable margin for advances bearing interest based on the prime rate is 1.00% below the applicable margin for LIBOR advances (but not less than 0.00%). We are also able to request advances under this facility based on competitive bids. There were no amounts outstanding under this facility as of June 30, 2017.

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UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Debt Covenants

Our existing debt instruments and credit facilities subject us to certain financial covenants. As of June 30, 2017 and for all prior periods, we have satisfied these financial covenants. These covenants limit the amount of secured indebtedness that we may incur, and limit the amount of attributable debt in sale-leaseback transactions, to 10% of net tangible assets. As of June 30, 2017, 10% of net tangible assets was equivalent to \$2.297 billion; however, we have no covered sale-leaseback transactions or secured indebtedness outstanding. We do not expect these covenants to have a material impact on our financial condition or liquidity.

Fair Value of Debt

Based on the borrowing rates currently available to the Company for long-term debt with similar terms and maturities, the fair value of long-term debt, including current maturities, was approximately \$18.897 and \$17.134 billion as of June 30, 2017 and December 31, 2016, respectively. We utilized Level 2 inputs in the fair value hierarchy of valuation techniques to determine the fair value of all of our debt instruments.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 9. LEGAL PROCEEDINGS AND CONTINGENCIES

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

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

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

Judicial Proceedings

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

UPS and our subsidiary The UPS Store, Inc. are defendants in *Morgate v. The UPS Store, Inc. et al.*, an action in the Los Angeles Superior Court brought on behalf of a certified class of all franchisees who chose to rebrand their Mail Boxes Etc. franchises to The UPS Store in March 2003. Plaintiff alleges that UPS and The UPS Store, Inc. misrepresented and omitted facts to the class about the market tests that were conducted before offering the class the choice of whether to rebrand to The UPS Store. We have filed a motion to decertify the class, which was heard in May 2017. A trial setting conference is scheduled for August 2017.

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

In *AFMS LLC v. UPS and FedEx Corporation*, a lawsuit filed in federal court in the Central District of California in August 2010, the plaintiff asserts that UPS and FedEx violated U.S. antitrust law by conspiring to refuse to negotiate with third-party negotiators retained by shippers and by individually imposing policies that prevent shippers from using such negotiators. The Court granted summary judgment motions filed by UPS and FedEx, entered judgment in favor of UPS and FedEx, and dismissed the case. Plaintiff appealed to the Court of Appeals for the Ninth Circuit, briefing is complete and oral argument was heard in March 2017. The Antitrust Division of the U.S. Department of Justice ("DOJ") opened a civil investigation of our policies and practices for dealing with third-party negotiators. We have cooperated with this investigation. We deny any liability with respect to these matters and intend to vigorously defend ourselves. There are multiple factors that prevent us from being able to estimate the amount of loss, if any, that may result from these matters including: (1) the DOJ investigation is pending; (2) the Court granted our motion for summary judgment; and (3) the appeal remains pending. Accordingly, at this time, we are not able to estimate a possible loss or range of loss that may result from these matters or to determine whether such loss, if any, would have a material adverse effect on our financial condition, results of operations or liquidity.

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We are a defendant in Ryan Wright and Julia Zislin v. United Parcel Service Canada Ltd., an action brought on behalf of a certified class of customers in the Superior Court of Justice in Ontario, Canada. Plaintiffs filed suit in February 2007, alleging inadequate disclosure concerning the existence and cost of brokerage services provided by us under applicable provincial consumer protection legislation and infringement of interest restriction provisions under the Criminal Code of Canada. Partial summary judgment was granted to us and the plaintiffs by the Ontario motions court in August 2011, when it dismissed plaintiffs' complaint under the Criminal Code and granted plaintiffs' complaint of inadequate disclosure. We appealed the Court's decision pertaining to inadequate disclosure in September 2011 and continue to vigorously defend all other allegations. There are multiple factors that prevent us from being able to estimate the amount of loss, if any, that may result from this matter, including: (1) we are vigorously defending ourselves and believe that we have a number of meritorious legal defenses; and (2) there are unresolved questions of law and fact that could be important to the ultimate resolution of this matter. Accordingly, at this time, we are not able to estimate a possible loss or range of loss that may result from this matter or to determine whether such loss, if any, would have a material adverse effect on our financial condition, results of operations or liquidity.

In February 2015, the State and City of New York filed suit against UPS in the U.S. District Court for the Southern District of New York, arising from alleged shipments of cigarettes to New York State and City residents. The complaint asserted claims under various federal and state laws. The complaint also included a claim that UPS violated the Assurance of Discontinuance it entered into with the New York Attorney General in 2005 concerning cigarette deliveries. On March 24, 2017, the District Court issued an opinion and order finding liability against UPS on each of the plaintiffs' causes of action. On May 25, 2017, the District Court issued a corrected opinion and order on liability and an order awarding the plaintiffs damages of \$9.4 million and penalties of \$237.6 million. An accrual of \$9.4 million with respect to the damages awarded by the court is included on our consolidated balance sheet at June 30, 2017. We estimate that the amount of losses could be up to \$247 million, plus interest; however, the amount of penalties ultimately payable, if any, is subject to a variety of complex factors and potential outcomes that remain to be determined in future legal proceedings. Consequently, we are unable to reasonably estimate a likely amount of loss within that range. We strongly disagree with the District Court's analysis and conclusions, and have filed a notice of appeal from the judgment to the United States Court of Appeals for the Second Circuit.

In May 2016, a purported shareowner derivative suit was filed in the Delaware Court of Chancery naming certain of UPS's current and former officers and directors as defendants, alleging that they breached their fiduciary duties by failing to monitor UPS's compliance with the Assurance of Discontinuance and other federal and state laws relating to cigarette deliveries. The Company's and individual defendants' motion to dismiss was heard in October 2016. In January 2017, the Court of Chancery dismissed the plaintiffs' suit in its entirety. No appeal was filed and the deadline for doing so has lapsed.

Other Matters

In August 2016, Spain's National Markets and Competition Commission ("CNMC") opened an investigation into 10 companies in the commercial delivery and parcel industry, including UPS, related to alleged nonaggression agreements to allocate customers. In May 2017, UPS received a Statement of Objections issued by the CNMC. In July 2017, UPS received a Decision Proposal from the CNMC. These documents do not prejudge the final decision (which is subject to appeal) as to facts or law. There are multiple factors that prevent us from being able to estimate the amount of loss, if any, that may result from this matter, including: (1) we are vigorously defending ourselves and believe that we have a number of meritorious legal defenses; and (2) there are unresolved questions of law and fact that could be important to the ultimate resolution of this matter. Accordingly, at this time, we are not able to estimate a possible loss or range of loss that may result from this matter or to determine whether such loss, if any, would have a material adverse effect on our financial condition, results of operations or liquidity.

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

or liquidity.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10. SHAREOWNERS' EQUITY

Capital Stock, Additional Paid-In Capital and Retained Earnings

We maintain two classes of common stock, which are distinguished from each other primarily by their respective voting rights. Class A shares are entitled to 10 votes per share, whereas class B shares are entitled to one vote per share. Class A shares are primarily held by UPS employees and retirees, and these shares are fully convertible on a one-to-one basis into class B shares at any time. Class B shares are publicly traded on the New York Stock Exchange under the symbol "UPS". Class A and B shares both have a \$0.01 par value, and as of June 30, 2017, there were 4.6 billion class A shares and 5.6 billion class B shares authorized to be issued. Additionally, there are 200 million preferred shares, with a \$0.01 par value, authorized to be issued. As of June 30, 2017, no preferred shares had been issued.

The following is a rollforward of our common stock, additional paid-in capital and retained earnings accounts for the six months ended June 30, 2017 and 2016 (in millions, except per share amounts):

| | 2017 | 2016 |
|--|--------------|--------------|
| | ShareDollars | ShareDollars |
| Class A Common Stock | | |
| Balance at beginning of period | 180 \$2 | 194 \$2 |
| Common stock purchases | (2) — | (3) — |
| Stock award plans | 4 — | 4 — |
| Common stock issuances | 1 — | 2 — |
| Conversions of class A to class B common stock | (5) — | (8) — |
| Class A shares issued at end of period | 178 \$2 | 189 \$2 |
| Class B Common Stock | | |
| Balance at beginning of period | 689 \$7 | 693 \$7 |
| Common stock purchases | (6) — | (10) — |
| Conversions of class A to class B common stock | 5 — | 8 — |
| Class B shares issued at end of period | 688 \$7 | 691 \$7 |
| Additional Paid-In Capital | | |
| Balance at beginning of period | \$— | \$— |
| Stock award plans | 157 | 289 |
| Common stock purchases | (412) | (561) |
| Common stock issuances | 203 | 168 |
| Option premiums received (paid) | 52 | 104 |
| Balance at end of period | \$— | \$— |
| Retained Earnings | | |
| Balance at beginning of period | \$4,879 | \$6,001 |
| Net income attributable to common shareowners | 2,542 | 2,400 |
| Dividends (\$1.66 and \$1.56 per share) | (1,495) | (1,409) |
| Common stock purchases | (489) | (769) |
| Balance at end of period | \$5,437 | \$6,223 |

We repurchased 8.4 million shares of class A and class B common stock for \$901 million during the six months ended June 30, 2017, and 13.1 million shares for \$1.330 billion during the six months ended June 30, 2016. In May 2016, the Board of Directors approved a share repurchase authorization of \$8.0 billion, which has no expiration date. As of June 30, 2017, we had \$5.253 billion of this share repurchase authorization available.

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From time to time, we enter into share repurchase programs with large financial institutions to assist in our buyback of company stock. These programs allow us to repurchase our shares at a price below the weighted average UPS share price for a given period. During the second quarter of 2017, we did not enter into any accelerated share repurchase transactions.

In order to lower the average cost of acquiring shares in our ongoing share repurchase program, we periodically enter into structured repurchase agreements involving the use of capped call options for the purchase of UPS class B shares. We pay a fixed sum of cash upon execution of each agreement in exchange for the right to receive either a pre-determined amount of cash or stock. Upon expiration of each agreement, if the closing market price of our common stock is above the pre-determined price, we will have our initial investment returned with a premium in either cash or shares (at our election). If the closing market price of our common stock is at or below the pre-determined price, we will receive the number of shares specified in the agreement. We received net premiums of \$52 and \$104 million during the first six months of 2017 and 2016, respectively, related to entering into and settling capped call options for the purchase of class B shares. As of June 30, 2017, we had outstanding options for the purchase of 0.5 million shares with a weighted average strike price of \$94.49 per share that will settle in the third quarter of 2017.

Accumulated Other Comprehensive Income (Loss)

We recognize activity in Accumulated Other Comprehensive Income (loss) ("AOCI") for unrealized holding gains and losses on available-for-sale securities, foreign currency translation adjustments, unrealized gains and losses from derivatives that qualify as hedges of cash flows and unrecognized pension and postretirement benefit costs. The activity in AOCI for the six months ended June 30, 2017 and 2016 is as follows (in millions):

| | 2017 | 2016 |
|--|-----------|-----------|
| Foreign currency translation gain (loss): | | |
| Balance at beginning of period | \$(1,016) | \$(897) |
| Translation adjustment (net tax effect of \$(93) and \$0) | 54 | (5) |
| Balance at end of period | (962) | (902) |
| Unrealized gain (loss) on marketable securities, net of tax: | | |
| Balance at beginning of period | (1) | (1) |
| Current period changes in fair value (net of tax effect of \$0 and \$4) | 1 | 5 |
| Balance at end of period | — | 4 |
| Unrealized gain (loss) on cash flow hedges, net of tax: | | |
| Balance at beginning of period | (45) | 67 |
| Current period changes in fair value (net of tax effect of \$(109) and \$(5)) | (181) | (7) |
| Reclassification to earnings (net of tax effect of \$(7) and \$(67)) | (11) | (112) |
| Balance at end of period | (237) | (52) |
| Unrecognized pension and postretirement benefit costs, net of tax: | | |
| Balance at beginning of period | (3,421) | (2,709) |
| Remeasurement of plan assets and liabilities (net of tax effect of \$214 and \$0) ⁽¹⁾ | 355 | — |
| Reclassification to earnings (net of tax effect of \$37 and \$33) | 63 | 53 |
| Balance at end of period | (3,003) | (2,656) |
| Accumulated other comprehensive income (loss) at end of period | \$(4,202) | \$(3,606) |

⁽¹⁾ See note 6 for further information about plan curtailments resulting in remeasurement of plan assets and liabilities.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Detail of the gains (losses) reclassified from AOCI to the statements of consolidated income for the three and six months ended June 30, 2017 and 2016 is as follows (in millions):

Three Months Ended June 30:

| | Amount Reclassified from AOCI | | Affected Line Item in the Income Statement |
|--|-------------------------------------|--------|--|
| | 2017 | 2016 | |
| Unrealized gain (loss) on cash flow hedges: | | | |
| Interest rate contracts | \$(7) | \$(6) | Interest expense |
| Foreign exchange contracts | 7 | 85 | Revenue |
| Income tax (expense) benefit | — | (29) | Income tax expense |
| Impact on net income | — | 50 | Net income |
| Unrecognized pension and postretirement benefit costs: | | | |
| Prior service costs | (50) | (43) | Compensation and benefits |
| Income tax (expense) benefit | 19 | 16 | Income tax expense |
| Impact on net income | (31) | (27) | Net income |
| Total amount reclassified for the period | \$(31) | \$23 | Net income |

Six Months Ended June 30:

| | Amount Reclassified from AOCI | | Affected Line Item in the Income Statement |
|--|-------------------------------------|--------|--|
| | 2017 | 2016 | |
| Unrealized gain (loss) on cash flow hedges: | | | |
| Interest rate contracts | \$(14) | \$(12) | Interest expense |
| Foreign exchange contracts | 32 | 191 | Revenue |
| Income tax (expense) benefit | (7) | (67) | Income tax expense |
| Impact on net income | 11 | 112 | Net income |
| Unrecognized pension and postretirement benefit costs: | | | |
| Prior service costs | (100) | (86) | Compensation and benefits |
| Income tax (expense) benefit | 37 | 33 | Income tax expense |
| Impact on net income | (63) | (53) | Net income |
| Total amount reclassified for the period | \$(52) | \$59 | Net income |

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UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Deferred Compensation Obligations and Treasury Stock

Activity in the deferred compensation program for the six months ended June 30, 2017 and 2016 is as follows (in millions):

| | 2017 Share Dollars | 2016 Share Dollars |
|------------------------------------|-----------------------|-----------------------|
| Deferred Compensation Obligations: | | |
| Balance at beginning of period | \$ 45 | \$ 51 |
| Reinvested dividends | 1 | 1 |
| Benefit payments | (10) | (8) |
| Balance at end of period | \$ 36 | \$ 44 |
| Treasury Stock: | | |
| Balance at beginning of period | (1) \$ (45) | (1) \$ (51) |
| Reinvested dividends | — (1) | — (1) |
| Benefit payments | — 10 | — 8 |
| Balance at end of period | (1) \$ (36) | (1) \$ (44) |

Noncontrolling Interests:

We have noncontrolling interests in certain consolidated subsidiaries in our International Package and Supply Chain & Freight segments. Noncontrolling interests increased \$6 and \$3 million for the six months ended June 30, 2017 and 2016, respectively.

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NOTE 11. SEGMENT INFORMATION

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

U.S. Domestic Package

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

International Package

International Package operations include delivery to more than 220 countries and territories worldwide, including shipments wholly outside the United States, as well as shipments with either origin or destination outside the United States. Our International Package reporting segment includes the operations of our Europe, Asia, Americas and ISMEA (Indian Subcontinent, Middle East and Africa) operating segments.

Supply Chain & Freight

Supply Chain & Freight includes our Forwarding, Logistics, Coyote, Marken, UPS Mail Innovations, UPS Freight and other aggregated business units. Our Forwarding and Logistics units provide services in more than 195 countries and territories worldwide and include international air and ocean freight forwarding, customs brokerage, truckload freight brokerage, distribution and post-sales services, mail and consulting services. UPS Freight offers a variety of less-than-truckload ("LTL") and truckload ("TL") services to customers in North America. Coyote offers truckload brokerage services primarily in the U.S. Marken provides specialized healthcare logistics in Europe. Other aggregated business units within this segment include The UPS Store and UPS Capital.

In evaluating financial performance, we focus on operating profit as a segment's measure of profit or loss. Operating profit is before investment income and other, interest expense and income taxes. The accounting policies of the reportable segments are the same as those described in the summary of accounting policies included in the consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2016, with certain expenses allocated between the segments using activity-based costing methods. Unallocated assets are comprised primarily of cash, marketable securities and certain investment partnerships.

Segment information for the three and six months ended June 30, 2017 and 2016 is as follows (in millions):

| | Three Months Ended June 30, 2017 | | Six Months Ended June 30, 2017 | |
|------------------------|---|----------|---|----------|
| | 2016 | | 2016 | |
| Revenue: | | | | |
| U.S. Domestic Package | \$9,745 | \$9,015 | \$19,280 | \$18,099 |
| International Package | 3,163 | 3,077 | 6,221 | 5,991 |
| Supply Chain & Freight | 2,842 | 2,537 | 5,564 | 4,957 |
| Consolidated | \$15,750 | \$14,629 | \$31,065 | \$29,047 |
| Operating Profit: | | | | |
| U.S. Domestic Package | \$1,395 | \$1,233 | \$2,471 | \$2,335 |
| International Package | 583 | 613 | 1,112 | 1,187 |
| Supply Chain & Freight | 238 | 192 | 417 | 339 |
| Consolidated | \$2,216 | \$2,038 | \$4,000 | \$3,861 |

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UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 12. EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share for the three and six months ended June 30, 2017 and 2016 (in millions, except per share amounts):

| | Three Months Ended June 30, 2017 | | Six Months Ended June 30, 2016 | |
|---|---|----------|---|----------|
| Numerator: | | | | |
| Net income attributable to common shareowners | \$ 1,384 | \$ 1,269 | \$ 2,542 | \$ 2,400 |
| Denominator: | | | | |
| Weighted average shares | 867 | 881 | 868 | 883 |
| Deferred compensation obligations | 1 | 1 | 1 | 1 |
| Vested portion of restricted units | 4 | 4 | 4 | 3 |
| Denominator for basic earnings per share | 872 | 886 | 873 | 887 |
| Effect of dilutive securities: | | | | |
| Restricted units | 3 | 3 | 3 | 4 |
| Stock options | 1 | 1 | 1 | 1 |
| Denominator for diluted earnings per share | 876 | 890 | 877 | 892 |
| Basic earnings per share | \$ 1.59 | \$ 1.43 | \$ 2.91 | \$ 2.71 |
| Diluted earnings per share | \$ 1.58 | \$ 1.43 | \$ 2.90 | \$ 2.69 |

Diluted earnings per share for the three months ended June 30, 2017 and 2016 excluded the effect of 0.3 and 0.2 million shares of common stock, respectively (0.3 million for the six months ended June 30, 2017 and 2016), that may be issued upon the exercise of employee stock options because such effect would be antidilutive.

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UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 13. DERIVATIVE INSTRUMENTS AND RISK MANAGEMENT

Risk Management Policies

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

Credit Risk Management

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

We have agreements with all of our active counterparties (covering the majority of our derivative positions) containing early termination rights and/or zero threshold bilateral collateral provisions whereby cash is required based on the net fair value of derivatives associated with those counterparties. Events such as a counterparty credit rating downgrade (depending on the ultimate rating level) could also allow us to take additional protective measures such as the early termination of trades. At June 30, 2017 and December 31, 2016, we held cash collateral of \$138 and \$575 million, respectively, under these agreements; this collateral is included in "cash and cash equivalents" on the consolidated balance sheets and its use by UPS is not restricted.

In connection with the agreements described above, we could be required to provide additional collateral or terminate transactions with certain counterparties in the event of a downgrade of our credit rating. The amount of collateral required would be determined by the net fair value of the associated derivatives with each counterparty. At June 30, 2017 and December 31, 2016, \$19 million and \$0, respectively, of additional collateral was required to be posted with our counterparties. The aggregate fair value of instruments not covered by the zero threshold bilateral collateral provisions were in a net liability position of \$1 and \$10 million at June 30, 2017 and December 31, 2016, respectively. We have not historically incurred, and do not expect to incur in the future, any losses as a result of counterparty default.

Accounting Policy for Derivative Instruments

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

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

A fair value hedge refers to hedging the exposure to changes in the fair value of an existing asset or liability on the consolidated balance sheets that is attributable to a particular risk. For derivative instruments that are designated and qualify as a fair value hedge, the gain or loss on the derivative instrument is recognized in the statements of consolidated income during the current period, as well as the offsetting gain or loss on the hedged item.

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

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UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Types of Hedges

Commodity Risk Management

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

Foreign Currency Risk Management

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

We also hedge portions of our anticipated cash settlements of intercompany transactions and interest payments on certain debt subject to foreign currency remeasurement using foreign currency forward contracts. We normally designate and account for these contracts as cash flow hedges of forecasted foreign currency denominated transactions; therefore, the resulting gains and losses from these hedges are recognized as a component of investment income and other when the underlying transactions are subject to currency remeasurement.

We hedge our net investment in certain foreign operations with foreign currency denominated debt instruments. The use of foreign denominated debt as the hedging instrument allows the debt to be remeasured to foreign currency translation adjustment within AOCI to offset the translation risk from those investments. Any ineffective portion of net investment hedging is recognized as a component of investment income and other. Balances in the cumulative translation adjustment accounts remain until the sale or complete liquidation of the foreign entity.

Interest Rate Risk Management

Our indebtedness under our various financing arrangements creates interest rate risk. We use a combination of derivative instruments as part of our program to manage the fixed and floating interest rate mix of our total debt portfolio and related overall cost of borrowing. The notional amount, interest payment date and maturity date of the swaps match the terms of the associated debt being hedged. Interest rate swaps allow us to maintain a target range of floating rate debt within our capital structure.

We have designated and account for the majority of our interest rate swaps that convert fixed rate interest payments into floating rate interest payments as hedges of the fair value of the associated debt instruments. Therefore, the gains and losses resulting from fair value adjustments to the interest rate swaps and fair value adjustments to the associated debt instruments are recorded to interest expense in the period in which the gains and losses occur. We have designated and account for interest rate swaps that convert floating rate interest payments into fixed rate interest payments as cash flow hedges of the forecasted payment obligations. The gains and losses resulting from fair value adjustments to the interest rate swaps are recorded to AOCI.

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

as an adjustment to the effective interest yield on the debt.

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UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Outstanding Positions

As of June 30, 2017 and December 31, 2016, the notional amounts of our outstanding derivative positions were as follows (in millions):

| | June 30, 2017 | December 31, 2016 |
|------------------------|------------------|----------------------|
| Currency hedges: | | |
| Euro | EUR 3,277 | EUR 3,702 |
| British Pound Sterling | GBP 1,753 | GBP 1,380 |
| Canadian Dollar | CAD 1,231 | CAD 1,053 |
| Indian Rupee | INR 262 | INR 76 |
| Mexican Peso | MXN 19 | MXN — |
| Japanese Yen | JPY 3,581 | JPY 3,972 |
| Singapore Dollar | SGD 17 | SGD 32 |

Interest rate hedges:

| | | |
|---------------------------------------|----------|----------|
| Fixed to Floating Interest Rate Swaps | \$ 5,799 | \$ 5,799 |
| Floating to Fixed Interest Rate Swaps | \$ 778 | \$ 778 |

Investment market price hedges:

| | | |
|-----------------------|--------|--------|
| Marketable Securities | EUR 77 | EUR 76 |
|-----------------------|--------|--------|

As of June 30, 2017, we had no outstanding commodity hedge positions.

Balance Sheet Recognition and Fair Value Measurements

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

We have master netting arrangements with substantially all of our counterparties giving us the right of offset for our derivative positions. However, we have not elected to offset the fair value positions of our derivative contracts recorded on our consolidated balance sheets. The columns labeled "Net Amounts if Right of Offset had been Applied" indicate the potential net fair value positions by type of contract and location on the consolidated balance sheets had we elected to apply the right of offset.

| Asset Derivatives | Balance Sheet Location | Fair Value Hierarchy Level | Gross Amounts Presented in Consolidated Balance Sheets | | Net Amounts if Right of Offset had been Applied | |
|---------------------------------------|--------------------------|-------------------------------|---|----------------------|--|----------------------|
| | | | June 30, 2017 | December 31, 2016 | June 30, 2017 | December 31, 2016 |
| Derivatives designated as hedges: | | | | | | |
| Foreign exchange contracts | Other current assets | Level 2 | \$46 | \$ 176 | \$38 | \$ 176 |
| Interest rate contracts | Other current assets | Level 2 | 7 | — | 7 | — |
| Foreign exchange contracts | Other non-current assets | Level 2 | 6 | 131 | 1 | 126 |
| Interest rate contracts | Other non-current assets | Level 2 | 103 | 137 | 89 | 119 |
| Derivatives not designated as hedges: | | | | | | |
| Foreign exchange contracts | Other current assets | Level 2 | 2 | 1 | 2 | 1 |
| Interest rate contracts | Other non-current assets | Level 2 | 38 | 42 | 36 | 40 |

| | | | | |
|-------------------------|-------|--------|-------|--------|
| Total Asset Derivatives | \$202 | \$ 487 | \$173 | \$ 462 |
|-------------------------|-------|--------|-------|--------|

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UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

| Liability Derivatives | Balance Sheet Location | Fair Value Hierarchy Level | Gross Amounts Presented in Consolidated Balance Sheets | | Net Amounts if Right of Offset had been Applied | |
|---------------------------------------|-------------------------------|----------------------------|--|-------------------|---|-------------------|
| | | | June 30, 2017 | December 31, 2016 | June 30, 2017 | December 31, 2016 |
| Derivatives designated as hedges: | | | | | | |
| Foreign exchange contracts | Other current liabilities | Level 2 | \$ 18 | \$ — | \$ 11 | \$ — |
| Interest rate contracts | Other current liabilities | Level 2 | 1 | 1 | — | 1 |
| Foreign exchange contracts | Other non-current liabilities | Level 2 | 74 | 6 | 68 | 1 |
| Interest rate contracts | Other non-current liabilities | Level 2 | 17 | 21 | 4 | 3 |
| Derivatives not designated as hedges: | | | | | | |
| Foreign exchange contracts | Other current liabilities | Level 2 | — | — | — | — |
| Investment market price contracts | Other current liabilities | Level 2 | 1 | 10 | 1 | 10 |
| Interest rate contracts | Other non-current liabilities | Level 2 | 7 | 7 | 5 | 5 |
| Total Liability Derivatives | | | \$ 118 | \$ 45 | \$ 89 | \$ 20 |

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

Income Statement and AOCI Recognition

The following table indicates the amount of gains and losses that have been recognized in AOCI for the three and six months ended June 30, 2017 and 2016 for those derivatives designated as cash flow hedges (in millions):

Three Months Ended June 30:

| Derivative Instruments in Cash Flow Hedging Relationships | Amount of Gain (Loss) Recognized in AOCI on Derivative (Effective Portion) | |
|---|--|--------|
| | 2017 | 2016 |
| Interest rate contracts | \$— | \$(1) |
| Foreign exchange contracts | (243) | 149 |
| Total | \$(243) | \$148 |

Six Months Ended June 30:

| Derivative Instruments in Cash Flow Hedging Relationships | Amount of Gain (Loss) Recognized in AOCI on Derivative (Effective Portion) | |
|---|--|--------|
| | 2017 | 2016 |
| Interest rate contracts | \$— | \$(3) |
| Foreign exchange contracts | (290) | (9) |

| | | |
|-------|---------|---------|
| Total | \$(290) | \$(12) |
|-------|---------|---------|

As of June 30, 2017, \$43 million of pre-tax losses related to cash flow hedges that are currently deferred in AOCI are expected to be reclassified to income over the 12 month period ended June 30, 2018. The actual amounts that will be reclassified to income over the next 12 months will vary from this amount as a result of changes in market conditions. The maximum term over which we are hedging exposures to the variability of cash flow is 15 years.

The amount of ineffectiveness recognized in income on derivative instruments designated in cash flow hedging relationships was immaterial for the three and six months ended June 30, 2017 and 2016.

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UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

The following table indicates the amount of gains and losses that have been recognized in AOCI within foreign currency translation adjustment for the three and six months ended June 30, 2017 and 2016 for those instruments designated as net investment hedges (in millions):

Three Months Ended June 30:

| | Amount of Gain (Loss) Recognized in AOCI on Debt (Effective Portion) | |
|--|--|------|
| | 2017 | 2016 |
| Non-derivative Instruments in Net Investment Hedging Relationships | | |
| Foreign denominated debt | \$(210) | \$62 |
| Total | \$(210) | \$62 |

Six Months Ended June 30:

| | Amount of Gain (Loss) Recognized in AOCI on Debt (Effective Portion) | |
|--|--|--------|
| | 2017 | 2016 |
| Non-derivative Instruments in Net Investment Hedging Relationships | | |
| Foreign denominated debt | \$(247) | (23) |
| Total | \$(247) | \$(23) |

The amount of ineffectiveness recognized in income on non-derivative instruments designated in net investment hedging relationships was immaterial for the three and six months ended June 30, 2017 and 2016.

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UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

The following table indicates the amount and location in the statements of consolidated income in which derivative gains and losses, as well as the associated gains and losses on the underlying exposure, have been recognized for those derivatives designated as fair value hedges for the three and six months ended June 30, 2017 and 2016 (in millions):

| Derivative Instruments in Fair Value Hedging Relationships | Location of Gain (Loss) Recognized in Income | Derivative Amount of Gain (Loss) Recognized in Income | | Hedged Items in Fair Value Hedging Relationships | Location of Gain (Loss) Recognized In Income | Hedged Items Amount of Gain (Loss) Recognized in Income | |
|--|--|---|--------|--|--|---|---------|
| | | 2017 | 2016 | | | 2017 | 2016 |
| Three Months Ended June 30: | | | | | | | |
| Interest rate contracts | Interest Expense | \$ 2 | \$ 20 | Fixed-Rate Debt | Interest Expense | \$(2) | \$(20) |
| Six Months Ended June 30: | | | | | | | |
| Interest rate contracts | Interest Expense | \$(22) | \$ 115 | Fixed-Rate Debt | Interest Expense | \$22 | \$(115) |

Additionally, we maintain some interest rate swaps, foreign currency forwards and investment market price forward contracts that are not designated as hedges. These interest rate swap contracts are intended to provide an economic hedge of a portfolio of interest bearing receivables. These foreign exchange forward contracts are intended to provide an economic offset to foreign currency remeasurement and settlement risk for certain assets and liabilities on our consolidated balance sheets. These investment market price forward contracts are intended to provide an economic offset to fair value fluctuations of certain investments in marketable securities.

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

The following is a summary of the amounts recorded in the statements of consolidated income related to fair value changes and settlements of these interest rate swaps, foreign currency forward and investment market price forward contracts not designated as hedges for the three and six months ended June 30, 2017 and 2016 (in millions):

| Derivative Instruments Not Designated in Hedging Relationships | | Location of Gain (Loss) Recognized in Income | Amount of Gain (Loss) Recognized in Income | |
|--|-----------------------------|--|--|---------|
| | | | 2017 | 2016 |
| Three Months Ended June 30: | | | | |
| Interest rate contracts | Interest expense | | \$(2) | \$(2) |
| Foreign exchange contracts | Investment income and other | | 14 | (65) |
| Investment market price contracts | Investment income and other | | (18) | 25 |
| | | | \$(6) | \$(42) |
| Six Months Ended June 30: | | | | |
| Interest rate contracts | Interest expense | | \$(4) | \$(4) |
| Foreign exchange contracts | Investment income and other | | 20 | \$(106) |
| Investment market price contracts | Investment income and other | | 8 | 180 |
| | | | \$24 | \$70 |

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UNITED PARCEL SERVICE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 14. INCOME TAXES

Our effective tax rate decreased to 34.7% in the second quarter of 2017 from 35.0% in the same period of 2016 (33.4% year-to-date in 2017 compared to 35.1% in the same period of 2016). In the first quarter of 2017, we adopted a new accounting standard that requires the recognition of excess tax benefits related to share-based compensation in income tax expense (see note 2), which resulted in discrete tax benefits for the three months ended June 30, 2017 of \$7 million (\$62 million year-to-date) and reduced our second quarter effective tax rate by 0.3% (1.6% year-to-date). As discussed in our Annual Report on Form 10-K for the year ended December 31, 2016, we have recognized liabilities for uncertain tax positions. We reevaluate these uncertain tax positions on a quarterly basis. A number of years may elapse before an uncertain tax position is audited and ultimately settled. It is difficult to predict the ultimate outcome or the timing of resolution for uncertain tax positions. It is reasonably possible that the amount of unrecognized tax benefits could significantly increase or decrease within the next twelve months. However, an estimate of the range of reasonably possible outcomes cannot be made. Items that may cause changes to unrecognized tax benefits include the timing of interest deductions and the allocation of income and expense between tax jurisdictions. These changes could result from the settlement of ongoing litigation, the completion of ongoing examinations, the expiration of the statute of limitations or other unforeseen circumstances.

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

Overview

The U.S. economic environment has generally improved with stable consumer conditions. While there is modest improvement in industrial production, growth is slower than originally anticipated. Business-to-business volume growth is influenced by the retail industry. Retail growth continued in the second quarter, mainly driven by online sales. Continued growth in e-commerce and omni-channel retail sales has driven package volume demand for residential products. Shipments and revenue per piece have increased on a consolidated basis and across all products in our U.S. Domestic Package segment, and given these trends in the retail industry, products most aligned with business-to-consumer shipments have experienced the strongest growth.

Outside of the U.S., emerging markets have stabilized in recent months and most developed nations have seen modest growth. Our broad portfolio of product offerings and the flexibilities inherent in our transportation network have supported our international growth. Demand for our export products has remained high. Europe continues to lead the way, with growth in key trade lanes as well as intra-Europe shipments. Trade from Asia to the United States remained strong during the second quarter.

We have continued several initiatives in the U.S. and internationally to (1) improve the flexibility and capacity in our transportation network; (2) improve yield management; and (3) increase operational efficiency and contain costs across all segments. Most notably, expansion and construction of new facilities, along with the continued deployment of technology improvements, should continue to increase our network capacity and improve operational efficiency, flexibility and reliability.

Our consolidated results are presented in the table below:

| | Three Months Ended June 30, | | | Change | Six Months Ended June 30, | | | Change |
|---|--------------------------------|----------|------|--------|------------------------------|----------|-----|--------|
| | 2017 | 2016 | | % | 2017 | 2016 | | % |
| Revenue (in millions) | \$15,750 | \$14,629 | 7.7 | % | \$31,065 | \$29,047 | 6.9 | % |
| Operating Expenses (in millions) | 13,534 | 12,591 | 7.5 | % | 27,065 | 25,186 | 7.5 | % |
| Operating Profit (in millions) | \$2,216 | \$2,038 | 8.7 | % | \$4,000 | \$3,861 | 3.6 | % |
| Operating Margin | 14.1 | % 13.9 | % | | 12.9 | % 13.3 | % | |
| Average Daily Package Volume (in thousands) | 18,580 | 17,687 | 5.0 | % | 18,561 | 17,761 | 4.5 | % |
| Average Revenue Per Piece | \$10.75 | \$10.57 | 1.7 | % | \$10.63 | \$10.48 | 1.4 | % |
| Net Income (in millions) | \$1,384 | \$1,269 | 9.1 | % | \$2,542 | \$2,400 | 5.9 | % |
| Basic Earnings Per Share | \$1.59 | \$1.43 | 11.2 | % | \$2.91 | \$2.71 | 7.4 | % |
| Diluted Earnings Per Share | \$1.58 | \$1.43 | 10.5 | % | \$2.90 | \$2.69 | 7.8 | % |

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

Results of Operations - Segment Review

The results and discussions that follow are reflective of how our executive management monitors the performance of our reporting segments.

We supplement the reporting of our financial information determined under generally accepted accounting principles ("GAAP") with certain non-GAAP financial measures including, as applicable, "adjusted" compensation and benefits, operating expenses, operating profit, operating margin, income tax expense and effective tax rate. We believe that these adjusted financial measures provide meaningful information to assist investors and analysts in understanding our financial results and assessing our prospects for future performance. We believe these adjusted financial measures are important indicators of our recurring results of operations because they exclude items that may not be indicative of, or are unrelated to, our underlying operating results, and provide a useful baseline for analyzing trends in our underlying businesses. Additionally, these adjusted financial measures are used internally by management for the determination of incentive compensation awards, business unit operating performance analysis and business unit resource allocation. We supplement the reporting of our revenue, revenue per piece and operating profit with similar non-GAAP measures that exclude the period-over-period impact of foreign currency exchange rate changes and hedging activities. We believe currency-neutral revenue, revenue per piece and operating profit information allows users of our financial statements to understand growth trends in our products and results. We evaluate the performance of our International Package and Supply Chain & Freight businesses on a currency-neutral basis.

Currency-neutral revenue, revenue per piece and operating profit are calculated by dividing current period reported U.S. dollar revenue, revenue per piece and operating profit by the current period average exchange rates to derive current period local currency revenue, revenue per piece and operating profit. The derived current period local currency revenue, revenue per piece and operating profit are then multiplied by the average foreign exchange rates used to translate the comparable results for each month in the prior year period (including the period over period impact of foreign currency revenue hedging activities). The difference between the current period reported U.S. dollar revenue, revenue per piece and operating profit and the derived current period U.S. dollar revenue, revenue per piece and operating profit is the period over period impact of currency fluctuations.

Certain operating expenses are allocated between our reporting segments based on activity-based costing methods. These activity-based costing methods require us to make estimates that impact the amount of each expense category that is attributed to each segment. Changes in these estimates will directly impact the amount of expense allocated to each segment and therefore the operating profit of each reporting segment. There were no significant changes in our expense allocation methodologies during 2017 or 2016.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND
RESULTS OF OPERATIONS

U.S. Domestic Package Operations

| | Three Months Ended June 30, | | Change | Six Months Ended June 30, | | Change |
|--|-----------------------------|---------|--------|---------------------------|----------|--------|
| | 2017 | 2016 | % | 2017 | 2016 | % |
| Average Daily Package Volume (in thousands): | | | | | | |
| Next Day Air | 1,395 | 1,311 | 6.4 % | 1,356 | 1,289 | 5.2 % |
| Deferred | 1,253 | 1,129 | 11.0 % | 1,249 | 1,163 | 7.4 % |
| Ground | 13,019 | 12,489 | 4.2 % | 13,016 | 12,606 | 3.3 % |
| Total Avg. Daily Package Volume | 15,667 | 14,929 | 4.9 % | 15,621 | 15,058 | 3.7 % |
| Average Revenue Per Piece: | | | | | | |
| Next Day Air | \$19.62 | \$19.51 | 0.6 % | \$19.68 | \$19.47 | 1.1 % |
| Deferred | 12.72 | 12.44 | 2.3 % | 12.45 | 12.19 | 2.1 % |
| Ground | 8.37 | 8.11 | 3.2 % | 8.33 | 8.10 | 2.8 % |
| Total Avg. Revenue Per Piece | \$9.72 | \$9.44 | 3.0 % | \$9.64 | \$9.39 | 2.7 % |
| Operating Days in Period | 64 | 64 | | 128 | 128 | |
| Revenue (in millions): | | | | | | |
| Next Day Air | \$1,752 | \$1,637 | 7.0 % | \$3,416 | \$3,212 | 6.4 % |
| Deferred | 1,020 | 899 | 13.5 % | 1,990 | 1,814 | 9.7 % |
| Ground | 6,973 | 6,479 | 7.6 % | 13,874 | 13,073 | 6.1 % |
| Total Revenue | \$9,745 | \$9,015 | 8.1 % | \$19,280 | \$18,099 | 6.5 % |
| Operating Expenses (in millions) | \$8,350 | \$7,782 | 7.3 % | \$16,809 | \$15,764 | 6.6 % |
| Operating Profit (in millions) | \$1,395 | \$1,233 | 13.1 % | \$2,471 | \$2,335 | 5.8 % |
| Operating Margin | 14.3 % | 13.7 % | | 12.8 % | 12.9 % | |

The change in overall revenue was impacted by the following factors in 2017 compared with the corresponding period of 2016:

| | Volume | Rates / Product Mix | Fuel Surcharge | Total Revenue Change |
|------------------------------|--------|---------------------|----------------|----------------------|
| Net Revenue Change Drivers: | | | | |
| Second quarter 2017 vs. 2016 | 4.9 % | 2.0 % | 1.2 % | 8.1 % |
| Year-to-date 2017 vs. 2016 | 3.7 % | 1.9 % | 0.9 % | 6.5 % |

Volume

Our overall volume increased in the second quarter and year-to-date periods of 2017 compared with 2016, largely due to continued growth in overall retail sales, of which e-commerce continues to represent a larger percentage of the total growth. Business-to-consumer shipments, which represented more than 47% of the total volume, grew more than 10% for the quarter and drove increases in both air and ground shipments. Business-to-business shipments increased slightly in the second quarter of 2017 compared with 2016, largely due to increased volume from the retail industry and the use of our solutions for returns shipping.

Among our air products, volume increased in the second quarter and year-to-date periods of 2017 for both our Next Day Air and deferred services. Solid air volume growth continued for those products most aligned with business-to-consumer shipping, including our residential Next Day Air Saver and residential Second Day Air package

products as consumers continue to demand faster delivery options. This growth was slightly offset by a decline in Next Day Air letter volume, partly due to declines in the professional services industry as a result of continued growth in digitization.

The increase in ground volume in the second quarter and year-to-date periods of 2017 was driven by growth in residential ground and SurePost volume, which benefited from continued demand for e-commerce.

Business-to-business shipments increased slightly in the quarter, driven by increased volume from returns.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND
RESULTS OF OPERATIONS**Rates and Product Mix**

Overall revenue per piece increased 3.0% for the second quarter of 2017 (2.7% year-to-date) compared with the same period of 2016 and was impacted by changes in base rates, customer and product mix and fuel surcharge rates.

Revenue per piece for ground and air products was positively impacted by a base rate increase on December 26, 2016. UPS Ground rates and UPS Air services rates increased an average net 4.9%. Additionally, effective January 8, 2017, we changed the dimensional weight calculation for packages subject to UPS daily rates.

In the first quarter of 2017, we began our expanded Saturday ground operations to several metropolitan areas in the U.S. Saturday pickup is available for shipments in select areas. A Saturday stop charge that varies depending on the pickup service selected went into effect on May 1, 2017, and will be applied any time a Saturday pickup is requested. Revenue per piece for both our Next Day Air and deferred services increased in the second quarter and year-to-date periods of 2017 compared with 2016. All products were positively impacted by higher fuel surcharge rates. The increase in Next Day Air revenue per piece was driven by an increase in average weight per piece, partially offset by a shift in customer and product mix. We experienced slightly stronger growth in our business-to-business shipments, particularly our Next Day Air commercial package product. Deferred revenue per piece increased primarily due to an increase in average weight per piece, but was partially offset by an unfavorable shift in product mix.

Ground revenue per piece increased for the second quarter and year-to-date periods of 2017, primarily due to base rate increases and an increase in average weight per piece. These factors were partially offset by changes in customer and product mix, as we experienced faster volume growth in our SurePost product.

Fuel Surcharges

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

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|-------------------------|-----------------------------|------|---------|---------------------------|------|---------|
| | 2017 | 2016 | % Point | 2017 | 2016 | % Point |
| Next Day Air / Deferred | 4.6% | 2.8% | 1.8 % | 4.7% | 3.0% | 1.7 % |
| Ground | 5.5% | 4.4% | 1.1 % | 5.4% | 4.7% | 0.7 % |

Effective February 6, 2017, the U.S. fuel surcharge rates are reset weekly instead of monthly. In addition, the price indices have moved from a two month to a two week lag.

Total domestic fuel surcharge revenue increased by \$111 million in the second quarter of 2017 as a result of higher fuel surcharge rates caused by increasing jet and diesel fuel prices, as well as the overall increase in package volume during the quarter. In addition to the factors above, fuel surcharge revenue was positively impacted by the changes to the fuel surcharge calculation, as the rates and price indices are updated more frequently to better align with prevailing market rates. On a year-to-date basis, fuel surcharge revenue increased by \$159 million.

Operating Expenses

Operating expenses for the segment increased \$568 million in the second quarter of 2017 compared with the same period of 2016 (\$1.045 billion year-to-date) due to several factors. The increase was primarily due to increases in pick-up and delivery costs, which grew \$231 million, as well as the cost of operating our domestic integrated air and ground network, which increased \$211 million (\$411 million and \$412 million, respectively, year-to-date). The growth in pick-up and delivery and network costs was largely attributable to increased volume and higher employee

compensation costs, which were impacted by an increase in daily driver hours (up 5.0%) and an increase in employee healthcare expenses (due to headcount and contractual contribution rate increases to multiemployer plans). These increases were partially offset by favorable workers' compensation results. We also incurred higher costs associated with outside contract carriers, primarily due to volume growth, higher fuel surcharges passed onto us by carriers and general rate increases. Additionally, average daily aircraft block hours increased 7.7% for the quarter (5.4% year-to-date), which were driven by increased volume and modifications to our air network.

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The remaining increase in operating expenses for the quarter and year-to-date periods was largely due to the costs of package sorting, which increased \$52 million for the quarter (\$92 million year-to-date) due to increased daily volume, and indirect operating costs, which increased \$68 million for the quarter (\$110 million year-to-date). The increased expenses in the second quarter and year-to-date periods of 2017 were also driven by start-up costs of several investments underway to further expand and modernize our air and ground networks, as well as the costs of implementing Saturday operations in additional markets.

Total cost per piece increased 2.3% for the second quarter of 2017 compared with the second quarter of 2016 (2.8% year-to-date), due to a 70 basis point impact from fuel increases and the cost increases described previously. In order to contain costs, we continually adjust our air and ground networks to better match higher volume levels. In addition, we continue to deploy and utilize technology to increase package sorting and delivery efficiency.

Operating Profit and Margin

Operating profit increased \$162 million for the second quarter of 2017 compared with 2016 (\$136 million year-to-date), as operating margin increased 60 basis points to 14.3% (down 10 basis points to 12.8% year-to-date). Overall volume growth allowed us to better leverage our transportation network, resulting in better pick-up and delivery density supported by the deployment of ORION. Operating profit was also positively impacted by the net impact of fuel, as fuel surcharge rates declined at a slower pace than fuel prices, and due to changes to the calculation of fuel surcharge rates discussed previously.

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International Package Operations

| | Three Months Ended June 30, | | Change | | Six Months Ended June 30, | | Change | |
|--|-----------------------------|---------|--------|----|---------------------------|---------|---------|----|
| | 2017 | 2016 | | | 2017 | 2016 | | |
| Average Daily Package Volume (in thousands): | | | | | | | | |
| Domestic | 1,619 | 1,599 | 1.3 | % | 1,648 | 1,558 | 5.8 | % |
| Export | 1,294 | 1,159 | 11.6 | % | 1,292 | 1,145 | 12.8 | % |
| Total Avg. Daily Package Volume | 2,913 | 2,758 | 5.6 | % | 2,940 | 2,703 | 8.8 | % |
| Average Revenue Per Piece: | | | | | | | | |
| Domestic | \$5.99 | \$6.07 | (1.3 |)% | \$5.85 | \$5.99 | (2.3 |)% |
| Export | 29.22 | 31.36 | (6.8 |)% | 28.67 | 30.90 | (7.2 |)% |
| Total Avg. Revenue Per Piece | \$16.31 | \$16.70 | (2.3 |)% | \$15.88 | \$16.54 | (4.0 |)% |
| Operating Days in Period | 64 | 64 | | | 128 | 128 | | |
| Revenue (in millions): | | | | | | | | |
| Domestic | \$621 | \$621 | — | % | \$1,233 | \$1,195 | 3.2 | % |
| Export | 2,420 | 2,326 | 4.0 | % | 4,742 | 4,529 | 4.7 | % |
| Cargo and Other | 122 | 130 | (6.2 |)% | 246 | 267 | (7.9 |)% |
| Total Revenue | \$3,163 | \$3,077 | 2.8 | % | \$6,221 | \$5,991 | 3.8 | % |
| Operating Expenses (in millions) | \$2,580 | \$2,464 | 4.7 | % | \$5,109 | \$4,804 | 6.3 | % |
| Operating Profit (in millions) | \$583 | \$613 | (4.9 |)% | \$1,112 | \$1,187 | (6.3 |)% |
| Operating Margin | 18.4 | % 19.9 | % | | 17.9 | % 19.8 | % | |
| Currency Benefit / (Cost) – (in millions)*: | | | | | | | | |
| Revenue | | | | | \$(170) | | \$(340) | |
| Operating Expenses | | | | | 56 | | 107 | |
| Operating Profit | | | | | \$(114) | | \$(233) | |

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

Revenue

The change in overall revenue was impacted by the following factors in 2017 compared with the corresponding period of 2016:

| | Volume | Rates / Product Mix | Fuel Surcharge | Currency | Total Revenue Change |
|------------------------------|--------|---------------------|----------------|----------|----------------------|
| Net Revenue Change Drivers: | | | | | |
| Second quarter 2017 vs. 2016 | 5.6 % | (0.2)% | 2.9 % | (5.5)% | 2.8 % |
| Year-to-date 2017 vs. 2016 | 8.8 % | (1.9)% | 2.6 % | (5.7)% | 3.8 % |

Volume

Our overall average daily volume increased in the second quarter and year-to-date periods of 2017 compared with 2016 with growth across both export and domestic products. The growth was due to increased demand across a number of sectors, including retail, healthcare and industrial manufacturing. Additionally, business-to-consumer shipments showed strong growth rates.

Export volume in the second quarter and year-to-date periods of 2017 grew across all major trade lanes, mainly driven by our European and Asian operations. Europe and Asia export volume showed significant growth to all regions, particularly in the Asia-to-U.S., Asia-to-Americas, Europe-to-U.S. and Europe-to-Americas trade lanes. Export volume into the U.S. grew in all trade lanes, led by the Asia and Europe regions. Export volume growth was strong across all major products, with a continued shift towards our premium express products, such as our Worldwide Express services, which outpaced the growth in our standard products.

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The increase in domestic volume in the second quarter and year-to-date periods of 2017 was driven by solid volume growth in several key markets in Europe, including the U.K., Italy, France, Netherlands and Poland.

Rates and Product Mix

On December 26, 2016, we implemented an average 4.9% net increase in base and accessorial rates for international shipments originating in the United States. Rate changes for shipments originating outside the U.S. are made throughout the year and vary by geographic market.

Foreign currency fluctuations had a significant unfavorable impact on revenue per piece for the second quarter and year-to-date periods of 2017 compared with 2016. Total average revenue per piece decreased 2.3% in the second quarter of 2017 (4.0% year-to-date), primarily due to a 540 basis point reduction from the impact of currency (550 basis point reduction year-to-date). Additionally, growth in shorter average trade lanes had a negative impact on revenue per piece during the second quarter of 2017 and year to date periods. These factors were partially offset by an increase in fuel surcharge revenue, as well as an increase in base rates and a shift in product mix, as the growth in higher yielding premium products continued to exceed the growth in our standard products.

Export revenue per piece decreased 6.8% in the second quarter of 2017 compared with 2016 (7.2% year-to-date), primarily due to a 510 basis point reduction from the impact of currency (530 basis point reduction year-to-date) and a shift in customer mix. Additionally, export revenue per piece was adversely impacted by shorter average trade lanes due to faster growth in intra-regional shipments. These factors were partially offset by an increase in base rates, higher fuel surcharges and double digit (revenue) growth of Worldwide Express products.

Domestic revenue per piece decreased 1.3% in the second quarter of 2017 compared with 2016 (2.3% year-to-date), primarily due to a 590 basis point reduction from the impact of currency (530 basis point reduction year-to-date). The currency impact was partially offset by an increase in base rates and higher fuel surcharges.

Fuel Surcharges

We maintain fuel surcharges on our international air and ground services. The fuel surcharges for international air products originating inside or outside the United States are indexed to the DOE's Gulf Coast spot price for a gallon of kerosene-type jet fuel, while the fuel surcharges for ground products originating outside the United States are indexed to fuel prices in the international region or country where the shipment takes place. Total international fuel surcharge revenue increased \$97 million for the second quarter of 2017 compared with 2016 (\$168 million year-to-date), due to volume increases, higher fuel prices and pricing changes made to the fuel surcharge indices from a two month to a two week lag.

Operating Expenses

Overall operating expenses for the segment increased \$116 million in the second quarter of 2017 (\$305 million year-to-date) compared with 2016. This increase was driven by increased volumes and higher fuel prices, but was partially offset by currency fluctuations.

The costs of operating our international integrated air and ground network increased \$124 million for the second quarter of 2017 compared with 2016 (\$248 million year-to-date). The increase in network costs were largely driven by a 4.0% increase in aircraft block hours in the second quarter of 2017 (3.2% increase year-to-date) and higher fuel prices. Additionally, pick-up and delivery costs increased \$54 million in the second quarter of 2017 compared with 2016 (\$95 million year-to-date), largely due to increased volume.

The remaining change in operating expenses in the second quarter of 2017 compared with 2016 was largely due to an increase in the costs of package sorting and decreases in indirect operating cost.

Operating Profit and Margin

Operating profit decreased \$30 million in the second quarter of 2017 compared with 2016 (\$75 million year-to-date), while operating margin decreased 150 basis points to 18.4% (190 basis points to 17.9% year-to-date). Currency impacts of \$114 million for the second quarter of 2017 (\$233 million year-to-date) decreased operating profit due to volatility of both hedged and unhedged currencies.

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Supply Chain & Freight Operations

| | Three Months Ended June 30, | | Change | | Six Months Ended June 30, | | Change | |
|---|-----------------------------------|---------|--------|--------|------------------------------|---------|--------|--------|
| | 2017 | 2016 | % | | 2017 | 2016 | % | |
| Freight LTL Statistics: | | | | | | | | |
| Revenue (in millions) | \$652 | \$600 | 8.7 | % | \$1,270 | \$1,164 | 9.1 | % |
| Revenue Per Hundredweight | \$23.62 | \$23.47 | 0.6 | % | \$23.60 | \$23.36 | 1.0 | % |
| Shipments (in thousands) | 2,633 | 2,540 | 3.7 | % | 5,150 | 4,956 | 3.9 | % |
| Shipments Per Day (in thousands) | 41.1 | 39.7 | 3.7 | % | 40.2 | 38.7 | 3.9 | % |
| Gross Weight Hauled (in millions of lbs) | 2,762 | 2,556 | 8.1 | % | 5,381 | 4,982 | 8.0 | % |
| Weight Per Shipment (in lbs) | 1,049 | 1,006 | 4.3 | % | 1,045 | 1,005 | 4.0 | % |
| Operating Days in Period | 64 | 64 | | | 128 | 128 | | |
| Revenue (in millions): | | | | | | | | |
| Forwarding and Logistics | \$1,893 | \$1,659 | 14.1 | % | \$3,720 | \$3,245 | 14.6 | % |
| Freight | 753 | 693 | 8.7 | % | 1,462 | 1,349 | 8.4 | % |
| Other | 196 | 185 | 6.0 | % | 382 | 363 | 5.2 | % |
| Total Revenue | \$2,842 | \$2,537 | 12.0 | % | \$5,564 | \$4,957 | 12.2 | % |
| Operating Expenses (in millions): | \$2,604 | \$2,345 | 11.0 | % | \$5,147 | \$4,618 | 11.5 | % |
| Operating Profit (in millions): | \$238 | \$192 | 24.0 | % | \$417 | \$339 | 23.0 | % |
| Operating Margin | 8.4 | % 7.6 | % | | 7.5 | % 6.8 | % | |
| Currency Benefit / (Cost) – (in millions)*: | | | | \$ | | | | \$ |
| Revenue | | | | \$(14) | | | | \$(24) |
| Operating Expenses | | | | 14 | | | | 23 |
| Operating Profit | | | | \$— | | | | \$(1) |

* Amount represents the change in currency translation compared to the prior year.

In December 2016, we acquired Marken, a global provider of supply chain solutions to the life sciences industry and leader in clinical trials material storage and distribution. Marken's financial results are included in the above table within Forwarding and Logistics from the date of the acquisition, which has impacted the year-over-year comparability of revenue, operating expenses and operating profit.

Revenue

Total revenue for the Supply Chain & Freight segment increased \$305 million for the second quarter of 2017 (\$607 million year-to-date) compared to 2016.

Forwarding and Logistics revenue increased \$234 million in the second quarter of 2017 (\$475 million year-to-date) compared with 2016, primarily due to tonnage increases in both international and North American air freight forwarding businesses, which were impacted by improving overall market demand. This was partially offset by lower sell rates and currency exchange rate movements. Revenue for our logistics products increased in the second quarter and year-to-date periods of 2017 compared with 2016, as we experienced growth in our mail services, retail and aerospace solutions; however this was partially offset by the adverse impact of currency exchange rates and declines among our high tech customers. Additionally, the Marken acquisition in 2016 and increased Coyote freight volume movement contributed to increased revenue.

UPS Freight revenue increased \$60 million in the second quarter of 2017 (\$113 million year-to-date), driven by increases in tonnage and shipments. These increases were impacted by an overall improvement in market demand and customer mix. LTL revenue per hundredweight increased slightly as LTL base rate increases, averaging 4.9%, took effect September 19, 2016. Additionally, effective June 26, 2017, LTL base rates increased by an additional 4.9% for certain shipments in the U.S., Canada and Mexico. Fuel surcharge revenue also increased \$15 million in the second quarter (\$34 million year-to-date), due to changes in overall LTL shipment volume and diesel fuel prices. Revenue for the other businesses within Supply Chain & Freight increased \$11 million (\$19 million year-to-date) due to revenue growth from UPS Capital and UPS Customer Solutions, as well as service contracts with the U.S. Postal Service.

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Operating Expenses

Total operating expenses for the Supply Chain & Freight segment increased \$259 million in the second quarter of 2017 (\$529 million year-to-date) compared to 2016.

Forwarding and Logistics operating expenses increased \$208 million for the second quarter of 2017 (\$422 million year-to-date) compared with 2016, largely due to increased purchased transportation and the acquisition of Marken, partially offset by operating efficiencies, impacts of a second quarter \$20 million favorable legal settlement and the impact of currency exchange rate movements. Purchased transportation expense increased \$209 million in the second quarter of 2017 (\$410 million year-to-date) compared to 2016, due to the acquisition of Marken, as well as increased Coyote freight movement and the resulting increased fuel surcharges passed to us from outside transportation providers. Increased tonnage and third party air carrier procurement rates in our international air freight forwarding business and increased volume and rates for mail services also contributed to purchased transportation expenses. UPS Freight operating expenses increased \$43 million for the second quarter of 2017 (\$94 million year-to-date) compared to 2016. Total cost per LTL shipment increased 2.4% for the second quarter of 2017 (3.4% year-to-date) compared with 2016. The increase in operating expense was largely due to costs associated with operating our linehaul network (\$29 million over the prior year quarter and \$60 million year-to-date) and increases in pick-up and delivery costs (\$13 million over the prior year quarter and \$32 million year-to-date). The network costs and pick-up and delivery expenses were driven by higher fuel cost and higher expense for outside transportation carriers (largely due to LTL volume growth and fuel surcharges passed to us by outside carriers).

Operating expenses for the other businesses within Supply Chain & Freight increased \$8 million in 2017 (\$13 million year-to-date) compared with 2016.

Operating Profit and Margin

Total operating profit for the Supply Chain & Freight segment increased \$46 million in the second quarter of 2017 (\$78 million year-to-date) compared with 2016.

Operating profit for the Forwarding and Logistics units increased \$26 million in the second quarter of 2017 (\$53 million year-to-date) compared with 2016. Operating profit and margins for the North American air freight business improved due to tonnage growth and widening of the spreads between the rates we charge our customers and the rates we procure capacity from third party air carriers. Operating profit and margins in our international air freight forwarding business remained flat. Ocean freight profitability was flat as lower shipment volume and margin compression due to over capacity were offset by operating expense reductions. Operating profit for the logistics units improved from 2017 compared to 2016, due to strong performance in the U.S. as well as within our mail services.

UPS Freight operating profit increased \$17 million in the second quarter of 2017 (\$19 million year-to-date) compared with 2016, due to increased volume, tonnage and pricing, partially offset by increased purchased transportation costs. The combined operating profit for all of our other businesses in this segment increased \$3 million in 2017 (\$6 million year-to-date) compared to 2016.

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Consolidated Operating Expenses

| | Three Months | | | | Six Months | | | |
|-----------------------------------|--------------|----------|--------|---|------------|----------|--------|---|
| | Ended | | Change | | Ended | | Change | |
| | June 30, | | | | June 30, | | | |
| | 2017 | 2016 | % | | 2017 | 2016 | % | |
| Operating Expenses (in millions): | | | | | | | | |
| Compensation and Benefits | \$8,105 | \$7,738 | 4.7 | % | \$16,236 | \$15,591 | 4.1 | % |
| Repairs and Maintenance | 392 | 383 | 2.3 | % | 782 | 764 | 2.4 | % |
| Depreciation and Amortization | 562 | 555 | 1.3 | % | 1,116 | 1,107 | 0.8 | % |
| Purchased Transportation | 2,443 | 2,070 | 18.0 | % | 4,809 | 4,094 | 17.5 | % |
| Fuel | 616 | 505 | 22.0 | % | 1,237 | 939 | 31.7 | % |
| Other Occupancy | 264 | 245 | 7.8 | % | 563 | 514 | 9.5 | % |
| Other Expenses | 1,152 | 1,095 | 5.2 | % | 2,322 | 2,177 | 6.7 | % |
| Total Operating Expenses | \$13,534 | \$12,591 | 7.5 | % | \$27,065 | \$25,186 | 7.5 | % |

Currency (Benefit) / Cost - (in millions)*

\$(70)

\$(130)

* Amount represents the change in currency translation compared to the prior year.

Compensation and Benefits

Employee payroll costs increased \$278 million for the second quarter of 2017 (\$421 million year-to-date) compared with 2016 largely due to higher U.S. domestic hourly and management compensation costs. Total compensation costs increased 5.9% for the second quarter 2017 (4.4% year-to-date), while consolidated average daily volume growth was 5.0% (4.5% year-to-date). U.S. domestic compensation costs for hourly employees increased largely due to contractual union wage increases, headcount increases and a 6.5% increase in average daily union labor hours (4.4% year-to-date). Compensation costs for management employees increased primarily due to merit salary increases and growth in the overall size of the workforce.

Benefits expense increased \$89 million for the second quarter of 2017 (\$224 million year-to-date) compared with 2016 primarily due to the following factors:

Health and welfare costs increased \$59 million for the second quarter (\$114 million year-to-date), largely due to increased contributions to multiemployer plans resulting from contractual contribution rate increases and an overall increase in the size of the workforce.

Pension expense increased \$16 million for the second quarter (\$24 million year-to-date), primarily due to additional expense for multiemployer pension plans, which were impacted by contractual contribution rate increases and an overall increase in the size of the workforce. These increases were mostly offset by a decrease in cost from asset earnings on discretionary contributions to company sponsored plans and a favorable mortality assumption change, net of higher costs due to lower discount rates.

Vacation, holiday, bonus, excused absence, payroll tax and other expenses increased \$49 million for the second quarter (\$110 million year-to-date), due to salary increases and growth in the overall size of the workforce.

Workers' compensation expense decreased \$35 million in the second quarter (\$24 million year-to-date), as we experienced a more favorable quarterly actuarial adjustment. This decrease was partially offset by increases in work hours, medical trends and wage increases. Insurance reserves are established for estimates of the loss that we will ultimately incur on reported workers' compensation claims, as well as estimates of claims that have been incurred but not reported, and take into account a number of factors including our history of claim losses, payroll growth and the

impact of safety improvement initiatives.

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Repairs and Maintenance

The \$9 million increase in repairs and maintenance expense for the second quarter of 2017 (\$18 million year-to-date) compared with 2016 was primarily due to routine repairs to buildings and facilities.

Depreciation and Amortization

Depreciation and amortization expense increased \$7 million in the second quarter of 2017 (\$9 million year-to-date) compared with 2016, primarily due to the following factors: (1) depreciation expense on vehicles increased due to the replacement of older, fully-depreciated vehicles, technology upgrades on new vehicles and an overall increase in the size of our vehicle fleet in our U.S. Domestic Package and UPS Freight operations, (2) depreciation expense for buildings and facilities due to facility automation and capacity expansion projects and (3) amortization expense of intangible assets acquired from Marken. These factors were largely offset by a decrease in amortization expense related to longer lived internally developed capitalized software.

Purchased Transportation

The \$373 million increase in purchased transportation expense charged to us by third-party air, rail, ocean and truck carriers for the second quarter of 2017 (\$715 million year-to-date) compared with 2016 was primarily driven by the following factors:

Expense for our Forwarding and Logistics businesses increased \$209 million in the second quarter (\$410 million year-to-date), primarily due to increased Coyote freight loads per day and the resulting increased fuel surcharges passed to us from outside transportation providers; increased volume and rates for mail services and international air freight forwarding. Additionally, purchased transportation expense increased due to the acquisition of Marken in December 2016.

International Package expense increased \$33 million in the second quarter (\$82 million year-to-date), primarily due to the increased usage of third party carriers (higher volume) and higher fuel surcharges passed to us from outside transportation providers. These items were partially offset by the impact of currency exchange rate movements.

Expense for our U.S. Domestic Package segment increased \$83 million for the second quarter (\$141 million year-to-date), primarily due to increased volume, rates and higher fuel surcharges passed to us from outside contract carriers.

Expense for our UPS Freight business increased \$36 million in the second quarter (\$62 million year-to-date), due to an increase in LTL shipments and higher fuel surcharges passed to us from outside transportation providers.

Fuel

The \$111 million increase in fuel expense for the second quarter of 2017 (\$298 million year-to-date) compared with 2016 was primarily due to higher jet fuel, diesel and unleaded gasoline prices, which increased fuel expense by \$71 million (\$234 million year-to-date). Additionally, increased alternative fuel costs and increased fuel consumption, primarily due to increases in total aircraft block hours and Domestic Package delivery miles driven, increased expense by \$47 million in the second quarter of 2017 (\$74 million year-to-date). These increases were partially offset by increased fuel efficiency.

Other Occupancy

Other occupancy expense increased \$19 million in the second quarter of 2017 (\$49 million year-to-date) as compared to 2016 primarily due to an increase in utility costs and the expansion in the number of facilities.

Other Expenses

The \$57 million increase in other expense in the second quarter of 2017 (\$145 million year-to-date) compared with 2016 was attributable to a number of factors:

Transportation equipment rental expense increased by \$12 million in the second quarter of 2017 (\$17 million year-to-date) and was affected by the growth in package volume.

Automotive liability insurance expense increased by \$26 million in the second quarter of 2017 (\$31 million year-to-date) largely due to more miles driven, medical rate trends and unfavorable severity experience trends. We also incurred increases in several other expense categories, including bad debt expense, professional service fees, advertising and maintenance agreements, slightly offset by the impacts from a favorable legal settlement.

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Other Income and (Expense)

| | Three Months | | | Six Months | | |
|-----------------------------|--------------|--------|--------|------------|---------|--------|
| | Ended | | Change | Ended | | Change |
| | June 30, | | | June 30, | | |
| | 2017 | 2016 | % | 2017 | 2016 | % |
| (in millions) | | | | | | |
| Investment income and other | \$14 | \$8 | 75.0 % | \$29 | \$25 | 16.0 % |
| Interest expense | \$(111) | \$(94) | 18.1 % | \$(213) | \$(187) | 13.9 % |

Investment Income and Other

The growth in investment income and other for the second quarter and year-to-date periods of 2017, as compared to 2016, was primarily due to a decrease in losses from fair value adjustments on real estate partnerships and higher yields on invested assets, offset by foreign currency exchange rate movements.

Interest Expense

Interest expense increased in the second quarter and year-to-date periods of 2017, as compared to 2016, primarily due to an increase in average outstanding commercial paper balances, an increase in long-term debt and higher effective interest rates on senior notes.

Income Tax Expense

| | Three Months | | | Six Months Ended | | |
|--------------------|--------------|--------|--------|------------------|---------|--------|
| | Ended | | Change | June 30, | | Change |
| | June 30, | | | June 30, | | |
| | 2017 | 2016 | % | 2017 | 2016 | % |
| (in millions) | | | | | | |
| Income Tax Expense | \$735 | \$683 | 7.6 % | \$1,274 | \$1,299 | (1.9)% |
| Effective Tax Rate | 34.7 % | 35.0 % | | 33.4 % | 35.1 % | |

Our effective tax rate decreased to 34.7% in the second quarter of 2017 from 35.0% in the same period of 2016 (33.4% year-to-date in 2017 compared to 35.1% in the same period of 2016). In the first quarter of 2017, we adopted a new accounting standard that requires the recognition of excess tax benefits related to share-based compensation in income tax expense, which resulted in discrete tax benefits for the three months ended June 30, 2017 of \$7 million (\$62 million year-to-date) and reduced our second quarter effective tax rate by 0.3% (1.6% year-to-date). See note 2 and note 14 to the unaudited consolidated financial statements.

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Liquidity and Capital Resources

Cash Flows From Operating Activities

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

| | Six Months Ended June 30, | |
|---|---------------------------------|---------|
| | 2017 | 2016 |
| Net income | \$2,542 | \$2,400 |
| Non-cash operating activities (a) | 2,071 | 1,829 |
| Pension and postretirement benefit contributions (UPS-sponsored plans) | (2,530) | (89) |
| Hedge margin receivables and payables | (456) | 136 |
| Income tax receivables and payables | 336 | 45 |
| Changes in working capital and other non-current assets and liabilities | 690 | 364 |
| Other operating activities | (32) | 8 |
| Net cash from operating activities | \$2,621 | \$4,693 |

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

Net cash from operating activities decreased \$2.072 billion in the second quarter of 2017 compared with 2016, largely due to higher pension and postretirement benefit contributions and reduced receipts of hedge margin collateral from counterparties. We made discretionary contributions to our three primary company-sponsored U.S. pension plans totaling \$2.446 billion year-to-date 2017, with no comparable payment in 2016. The net hedge margin collateral received from derivative counterparties decreased by \$592 million in 2017 relative to 2016, due to settlements and decreased net fair value asset positions of the derivative contracts used in our currency and interest rate hedging programs. These items were partially offset by \$142 million higher net income, \$326 million improvements in our working capital position and \$291 million increase in net cash tax receipts. The improvement in our working capital position in 2017 was primarily driven by favorable changes in the timing of cash receipts and payments. Net cash receipts for income taxes increased in 2017 compared with 2016 and were impacted by the receipt of refunds and timing of estimated tax payments relative to changes in estimates for the underlying tax liabilities.

As of June 30, 2017, our worldwide holdings of cash, cash equivalents and marketable securities were \$4.604 billion, of which \$2.293 billion was held by non-U.S. subsidiaries. The amount of cash, cash equivalents and marketable securities held by our U.S. and non-U.S subsidiaries fluctuates throughout the year due to a variety of factors, including the timing of cash receipts and disbursements in the normal course of business. Cash provided by operating activities in the U.S. continues to be our primary source of funds to finance U.S. operating needs, capital expenditures, share repurchases and dividend payments to shareowners. To the extent that international profits represent previously untaxed earnings, cash, cash equivalents and marketable securities held by non-U.S. subsidiaries could be subject to tax if such amounts were repatriated in the form of dividends; however, not all non-U.S. cash balances would have to be repatriated in the form of a dividend if returned to the U.S. When amounts earned by non-U.S. subsidiaries are expected to be indefinitely reinvested, no accrual for taxes is provided.

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Cash Flows From Investing Activities

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

| | Six Months Ended June 30, | |
|--|------------------------------|-----------|
| | 2017 | 2016 |
| Net cash used in investing activities | \$(2,027) | \$(1,794) |
| Capital Expenditures: | | |
| Buildings and facilities | \$(1,083) | \$(473) |
| Aircraft and parts | (332) | (14) |
| Vehicles | (329) | (282) |
| Information technology | (265) | (194) |
| | \$(2,009) | \$(963) |
| Capital Expenditures as a % of Revenue | (6.5)% | (3.3)% |

Other Investing Activities:

| | | |
|--|---------|----------|
| Proceeds from disposals of property, plant and equipment | \$14 | \$11 |
| Net (increase) decrease in finance receivables | \$(16) | \$(13) |
| Net (purchases), sales and maturities of marketable securities | \$27 | \$(791) |
| Cash paid for business acquisitions, net of cash and cash equivalents acquired | \$(57) | \$(3) |
| Other investing activities | \$14 | \$(35) |

We have commitments for the purchase of aircraft, vehicles, equipment and real estate to provide for the replacement of existing capacity and anticipated future growth. We generally fund our capital expenditures with our cash from operations. Capital spending on buildings and facilities increased in the first six months of 2017 in our U.S. and international package businesses, largely due to several facility automation and capacity expansion projects. Capital spending on aircraft increased in 2017 compared to 2016, due to contract deposits on open aircraft orders on 14 new Boeing 747-8F cargo aircraft and three previously owned Boeing 767-300 cargo aircraft, with scheduled deliveries starting in 2017. Capital spending on information technology increased in the first six months of 2017 compared to the corresponding period of 2016, largely due to the timing of purchases of hardware and capitalized software projects. Capital spending on vehicles increased in the first six months of 2017 in our U.S. and international package businesses, largely due to the timing of vehicle replacements.

Future capital spending will depend on a variety of factors, including economic and industry conditions. We anticipate that our capital expenditures for 2017 will be approximately \$4.1 to \$4.6 billion, which includes planned purchase deposits for aircraft on order.

The net change in finance receivables was primarily due to growth in our cargo finance products offset by loan principal paydowns in our business credit and leasing portfolios. The purchases and sales of marketable securities are largely determined by liquidity needs and the periodic rebalancing of investment types and will fluctuate from period to period.

Cash paid for business acquisitions during the first six months of 2017 compared to 2016 was related to our acquisition of Freightex Ltd (2017), Nightline (2017) and area franchise rights related to The UPS Store (2016). Other investing activities are impacted by changes in our non-current investments and restricted cash balances, capital contributions into certain investment partnerships and various other items.

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