Southwest Airlines – 2008 (A)[1]

Accounting for Leases

> "Without a doubt, 2008 was one of the most difficult years of the most challenging decade in aviation history. Despite the rapid surge then collapse of jet fuel prices, despite a worldwide credit crisis, and despite the worst recession in many decades, Southwest Airlines was well prepared. We were profitable for the 36th consecutive year, a record unmatched in commercial airline history." (Letter to Shareholders, page 1, 2008 annual report)

The domestic airline industry continued to struggle throughout 2008 despite reporting industry-wide profits in 2007 for the first time since the terrorist attacks of September 2001. The year began with soaring fuel costs[2] and ended with the collapse of both oil prices and the worldwide economy. Shrinking demand forced many airlines to further reduce capacity and eliminate jobs to bring down costs. Despite the elimination of tens of thousands of jobs across the industry, it appeared that only those companies with a low cost structure and a quality product would succeed over the long term.

In this poor economic environment, Southwest Airlines continued to see itself as the nation's "low fare, high Customer Satisfaction airline." Southwest served short-haul city pairs, providing a single class of service targeting both business and leisure travelers.[3] The company began flight operations in June 1971 with three Boeing 737 aircraft serving three Texas cities – Dallas, Houston and San Antonio. By operating exclusively inside the state of Texas, Southwest avoided then-existing Federal fare and route regulations. Using a lower cost structure aided by minimizing turnaround times, the Company was able to substantially undercut the prices of existing large interstate competitors (e.g., American, Braniff). With deregulation of the airline industry in 1978, Southwest began to apply its concepts outside of Texas. The Company's growth has been unabated since. At yearend 2008, the Company's all-Boeing 737 fleet was the largest in the world and served 64 airports in 32 states that stretch from coast to coast.

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[1] This case was prepared from publicly available data by Professors Robert M. Bowen and Professor Jane Jollineau Kennedy of the University of Washington for class discussion purposes only. Revised, September 7, 2009.

[2] Average fuel cost increased from $1.80 per gallon in 2007 to $2.73 in the third quarter of 2008. (Southwest Airlines 2008 10-K, Part 1, page 1)

[3] In November 2007, Southwest announced business fares that allowed travelers to board early and receive other

Southwest's strategy was to provide frequent, short-haul, high-quality service at affordable prices.

> Before Southwest, it was just too expensive to fly. Even today, in markets we do not serve, fares are three times higher, or more, than our everyday coach fares. That puts air travel out of reach of most Americans and puts Southwest fares in great demand across the United States. Last year alone, there were over 100 cities requesting our service. It is not surprising, given that we are a boost to local economies. And for Southwest, it's a vast market opportunity mostly ignored by our competitors. (1997 annual report, p. 4)
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> "When Southwest Airlines first began flying back in 1971, our goal was to democratize the skies. While other airlines were charging a fistful of dollars to fly from Dallas, Texas, to Houston and San Antonio, Southwest's low fare was a mere $15 – less than bus fare! (2004 annual report, p. 1)

Entering 2009, Southwest maintained its premier position as the most financially stable company in the U.S. airline industry (Exhibit 1). In 2008, the Company reported its 36th consecutive year of profits (Exhibit 2), a remarkable record given the turbulence of the economy that included the tech meltdown of 2000, the terrorist attacks on the World Trade Center in 2001, wildly fluctuating fuel costs throughout the decade and the worldwide financial crisis of 2008-2009. During 2008 alone, the following airlines filed for bankruptcy: Frontier, Aloha, ATA, Skybus, Eos and Champion. Only Frontier continued to operate.

In 2009, *Fortune* magazine again named Southwest as America's most admired airline and Southwest tied for seventh overall as the most admired company in America.[4]

Relentless Pursuit of Efficiency

Southwest was the first airline to establish a home page on the Internet and, in 2008, almost 78% of its passenger revenue came from online bookings. Southwest claimed its cost per booking via the Internet was about $1, versus between $6 and $8 for a travel agent.[5] The cost per booking via the Company's own reservations agents was somewhere in between. With the gradual shift to online bookings, the Company had closed several of its reservation centers. This combined with 'early-out' incentives for employees allowed the Company to reduce headcount per aircraft from 85 in 2003 to 66 by yearend 2007. The Company touts its success by claiming to have "one of the lowest operating cost structures in the domestic airline industry" as well as "the best cumulative Customer Satisfaction record among those carriers with whom we compete" (2007 annual report, p. 2).

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benefits.

[4] See http://money.cnn.com/magazines/fortune/mostadmired/2009/full_list/.

[5] See "www.southwest.com" for more details about the Company and its on-line reservation system.

Leases and Non Current Assets

Flight equipment was by far the largest asset reported on Southwest's balance sheets. As of December 31, 2008 Southwest operated 537 Boeing 737 aircraft with an average age of ten years.[6] Of these aircraft, the Company owned 446 while 82 and 9 were under operating and capital leases, respectively.

The major purpose of this case is to examine the implications of accounting for leases on the financial reports of Southwest Airlines. In addition to aircraft, Southwest leased airport facilities, real property and other assets. Note 8 to the financial statements (Exhibit 4) provides information about Southwest's leasing activities and can be viewed as having five parts.

- The first paragraph and table below describe the *asset value* of the *capital* leases.
- The second paragraph describes the sale and leaseback of ten of the Company's 737-700 aircraft.
- The first two sentences of the third paragraph describe the Company's *operating* leases.
- The remainder of the third paragraph and table below describe the *reported liability* related to the *capital* leases and the *unrecorded (off-balance sheet) liability* that can be associated with *noncancelable operating leases*.
- The final paragraph discusses renewal terms and purchase options.

Data

Included on the following pages are excerpts from the Company's fiscal 2007 annual report including:

- Exhibit 1: Consolidated Balance Sheet
- Exhibit 2: Consolidated Statement of Income
- Exhibit 3: Note 7 – Long-term debt (excerpt)
- Exhibit 4: Note 8 – Leases

Questions:

1. Prepare a journal entry to record rent expense for leases categorized as "operating" leases in 2008. Of this total rent expense, how much appears to relate to aircraft rentals?

2. a. What is the net amount of flight equipment under "capital" leases included among Assets on the Balance Sheet of Southwest as of December 31, 2008?
   b. What is the net amount of capitalized lease obligations included among Liabilities on the Balance Sheet of Southwest as of December 31, 2008?
   c. Why are these amounts different?

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[6] Southwest was the "launch customer" for the Boeing model 737-700. The first 737-700 aircraft was delivered in December 1997 and entered service in January 1998. At yearend 2008, Southwest had 327 737-700 aircraft in service, firm orders to purchase 104 Boeing 737-700 aircraft and options for an additional 116 through 2018.

3. a. Prepare a journal entry to record the capital lease payment for 2009 (*not* 2008). To simplify, assume no new capital leases are signed during 2009 and that capital lease payments are made annually on December 31. [Hint: study part 4 of Note 8 to obtain the needed amounts.]
   b. Estimate the amount by which 2009 (*not* 2008) expenses would be higher or lower *if* Southwest were accounting for its capital leases as operating leases. [Hint: you need to use data from your journal entry in 3a. above and estimate the amount of amortization for 2009.]

4. What would be the present value of the lease obligation *if* Southwest had capitalized all of its noncancelable operating leases discussed in note 8? What would be the amount of long-term debt *if* Southwest had capitalized all of these noncancelable operating leases? To simplify your analysis, assume that Southwest's noncancelable lease obligation can be summarized as:

   - Annual payments of $203 million for the next 10 years starting with the first payment at the end of 2009 and continuing with annual payments through the end of 2018. (This is obviously a simplification but a reasonable one given $203 million x 10 years = $2,030 million, which is obviously close to the $2,032 million of total minimum lease payments under noncancelable operating leases reported in Note 8.);
   - The Company has no commitment beyond 2018; and
   - The prevailing annual interest rate for leases of similar risk is (and has been) 8%.

5. Calculate SW Air's long-term debt ratio at yearend 2008 using a) reported total long-term debt in the balance sheet (and in note 7) and b) total long-term debt adjusted for capitalizing noncancelable operating leases in question 4 above. [To compute the long-term debt ratio, use yearend long-term debt including current maturities in the numerator and total long-term debt plus total shareholders' equity in the denominator.] What do you infer?

6. What would be the *approximate* dollar effect on the rest of the accounting identity (i.e., Assets, and Owners' equity) if noncancelable operating leases were capitalized as of December 31, 2008? Consider in general terms what the effect would be on the 2008 income statement.

7. a. What type(s) of users of financial statements would be interested in Southwest's accounting treatment of non-cancelable operating leases?
   b. Taking the perspective of these users, what is your opinion of Southwest's treatment of its non-cancelable operating leases?
   c. Southwest had been reducing the number of aircraft under operating leases for many years. As described in Note 8, in late 2008, the Company sold and leased back ten Boeing 737-700 aircraft. Speculate as to why management chose to reverse this long-standing trend.
   d. Briefly speculate on the potential effect on Southwest's financial statements if the Company adopted International Financial Reporting Standards (IFRS).

Exhibit 1

SOUTHWEST AIRLINES CO.

CONSOLIDATED BALANCE SHEET

	December 31, 2008	December 31, 2007
	(In millions, except share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	**$ 1,368**	$ 2,213
Short-term investments	**435**	566
Accounts and other receivables	**209**	279
Inventories of parts and supplies, at cost	**203**	259
Fuel derivative contracts	**—**	1,069
Deferred income taxes	**365**	—
Prepaid expenses and other current assets	**3 13**	57
Total current assets	**2,893**	4,443
Property and equipment, at cost:		
Flight equipment	**13,722**	13,019
Ground property and equipment	**1,769**	1,515
Deposits on flight equipment purchase contracts	**380**	626
	15,871	15,160
Less allowance for depreciation and amortization	**4,831**	4,286
	11,040	10,874
Other assets	**375**	1,455
	$14,308	$16,772
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	**$ 668**	$ 759
Accrued liabilities	**1,012**	3,107
Air traffic liability	**963**	931
Current maturities of long-term debt	**163**	41
Total current liabilities	**2,806**	4,838
Long-term debt less current maturities	**3,498**	2,050
Deferred income taxes	**1,904**	2,535
Deferred gains from sale and leaseback of aircraft	**105**	106
Other deferred liabilities	**1,042**	302
Commitments and contingencies		
Stockholders' equity:		
Common stock, $1.00 par value: 2,000,000,000 shares authorized; 807,611,634 shares issued in 2008 and 2007	**808**	808
Capital in excess of par value	**1,215**	1,207
Retained earnings	**4,919**	4,788
Accumulated other comprehensive income (loss)	**(984)**	1,241
Treasury stock, at cost: 67,619,062 and 72,814,104 shares in 2008 and 2007, respectively	**(1,005)**	(1,103)
Total stockholders' equity	**4,953**	6,941
	$14,308	$16,772

Exhibit 2

SOUTHWEST AIRLINES CO.

CONSOLIDATED STATEMENT OF INCOME

	Years Ended December 31,		
	2008	**2007**	**2006**
	(In millions, except per share amounts)		
OPERATING REVENUES:			
Passenger	**$10,549**	$9,457	$8,750
Freight	**145**	130	134
Other	**329**	274	202
Total operating revenues	**11,023**	9,861	9,086
OPERATING EXPENSES:			
Salaries, wages, and benefits	**3,340**	3,213	3,052
Fuel and oil	**3,713**	2,690	2,284
Maintenance materials and repairs	**721**	616	468
Aircraft rentals	**154**	156	158
Landing fees and other rentals	**662**	560	495
Depreciation and amortization	**599**	555	515
Other operating expenses	**1,385**	1,280	1,180
Total operating expenses	**10,574**	9,070	8,152
OPERATING INCOME	**449**	791	934
OTHER EXPENSES (INCOME):			
Interest expense	**130**	119	128
Capitalized interest	**(25)**	(50)	(51)
Interest income	**(26)**	(44)	(84)
Other (gains) losses, net	**92**	(292)	151
Total other expenses (income)	**171**	(267)	144
INCOME BEFORE INCOME TAXES	**278**	1,058	790
PROVISION FOR INCOME TAXES	**100**	413	291
NET INCOME	**$ 178**	$ 645	$ 499
NET INCOME PER SHARE, BASIC	**$ .24**	$ .85	$ .63
NET INCOME PER SHARE, DILUTED	**$ .24**	$ .84	$ .61

Exhibit 3

SOUTHWEST AIRLINES CO.
Excerpt from the long-term debt note

7. Long-term Debt

	2008	2007
	(In millions)	
Credit line borrowing (Note 6)	**$ 91**	$ —
Revolving Credit Facility (Note 6)	**400**	—
10.5% Notes due 2011	**400**	—
Term Loan Agreement due 2020	**585**	—
French Credit Agreements due 2012	**26**	32
6.5% Notes due 2012	**410**	386
5.25% Notes due 2014	**391**	352
5.75% Notes due 2016	**300**	300
5.125% Notes due 2017	**358**	311
French Credit Agreements due 2017	**87**	94
Pass Through Certificates	**464**	480
7.375% Debentures due 2027	**133**	103
Capital leases (Note 8)	**39**	52
	3,684	2,110
Less current maturities	**163**	41
Less debt discount and issuance costs	**23**	19
	$3,498	$2,050

Exhibit 4

SOUTHWEST AIRLINES CO. Lease note

8. Leases

The Company had nine aircraft classified as capital leases at December 31, 2008. The amounts applicable to these aircraft included in property and equipment were:

	2008	2007
	(In millions)	
Flight equipment	**$168**	$168
Less accumulated depreciation	**144**	133
	$ 24	$ 35

On December 23, 2008, the Company entered into a two tranche sale and leaseback transaction with a third party aircraft lessor for the sale and leaseback of ten of the Company's Boeing 737-700 aircraft. Under the first tranche of the transaction, which closed on December 23, 2008, the Company sold five of its Boeing 737-700 aircraft for a total of approximately $173 million and immediately leased the aircraft back for twelve years. The leases are accounted for as operating leases. Under the terms of the lease agreements, the Company will continue to operate and maintain the aircraft. Payments under the lease agreements will be reset every six months based on changes in the six-month LIBOR rate. The lease agreements contain standard termination events, including termination upon a breach of the Company's obligations to make rental payments and upon any other material breach of the Company's obligations under the leases, and standard maintenance and return condition provisions. Upon a termination of the lease upon a breach by the Company, the Company would be liable for standard contractual damages, possibly including damages suffered by the lessor in connection with remarketing the aircraft or while the aircraft is not leased to another party. The first tranche of the sale and leasebacks resulted in a deferred gain of $11 million, which will be amortized over the twelve-year term of the leases. The Company closed the second tranche of the transaction, providing for the sale and 16-year leaseback of the remaining five Boeing 737-700 aircraft upon similar terms (including proceeds), in January 2009.

Total rental expense for operating leases, both aircraft and other, charged to operations in 2008, 2007, and 2006 was $527 million, $469 million, and $433 million, respectively. The majority of the Company's terminal operations space, as well as 82 aircraft, were under operating leases at December 31, 2008. Future minimum lease payments under capital leases and noncancelable operating leases with initial or remaining terms in excess of one year at December 31, 2008, were:

	Capital leases	Operating leases
	(In millions)	
2009	$16	$ 376
2010	15	324
2011	12	249
2012	—	203
2013	—	152
After 2013	—	728
Total minimum lease payments	43	$2,032
Less amount representing interest	4	
Present value of minimum lease payments	39	
Less current portion	14	
Long-term portion	$25	

The aircraft leases generally can be renewed at rates based on fair market value at the end of the lease term for one to five years. Most aircraft leases have purchase options at or near the end of the lease term at fair market value, generally limited to a stated percentage of the lessor's defined cost of the aircraft.