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Southwest Airlines – 2008 (B)[1]

Accounting for income taxes – financial versus tax reporting

Southwest Airlines, as a profit-seeking company operating in the U.S., is required to file federal and state income tax returns. Management, operating in the interest of shareholders, makes reporting choices available under federal and state tax codes to defer, and in some instances avoid, the payment of taxes. These choices often differ from accounting policies management uses for reporting to the company's shareholders under generally accepted accounting principles (a.k.a., GAAP). Differences between tax reporting and financial reporting that do not reverse over time are referred to as *permanent*. Differences between tax reporting and financial reporting that reverse over time are referred to as *temporary* differences. These temporary differences are reconciled in *deferred* tax accounts that can appear as assets and/or liabilities on the balance sheet (Exhibit 1). Tax expense on the income statement is often referred to as "provision for income taxes" (Exhibit 2). Tax expense can be more or less than the amount actually owed on the Company's Federal and State tax returns. The difference between tax expense and the amount owed is often shown only in the notes to the financial statements.

Note 16 to Southwest's financial statements (Exhibit 3) provides information about differences between tax and financial (i.e., "book") reporting. This note has three key parts:

- The first paragraph and the table that follows describe how temporary differences between book and tax reporting are shown as deferred tax liabilities and assets on the balance sheet.
- The brief second paragraph and the table that follows reconciles differences between the financial reporting tax expense (shown as "provision for income taxes" on the income statement) and current taxes actually owed to Federal and state tax authorities. This difference between tax expense and current taxes is referred to as the *deferred* portion of tax expense.
- The brief third paragraph and the table that follows reconciles differences between a hypothetical amount of tax based on the federal statutory tax rate (35%) applied to net income before tax ($278 in 2008) and the amount of tax expense shown in the income statement as "provision for income taxes" ($100 in 2008).

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

The major purpose of the questions below is to gain a general understanding of the differences between tax and financial reporting for Southwest Airlines.

Questions:

1. Prepare a journal entry to record the provision for income taxes (i.e., income tax expense) for 2008. [Warning: Do <u>not</u> attempt to use the specific deferred income tax accounts affected on the Balance Sheet or at the top of note 16, page 5. Rather, see note 16 – page 6 for direct information on the current and deferred components of the provision for income taxes.]

2. Compute Southwest's "effective tax rate" for 2008, computed as provision for income taxes divided by income before income taxes. Why is this figure different from the U.S. statutory rate of 35%?

3. Supplementary information to the Statement of Cash Flows (not provided) discloses that cash payments for income taxes totaled $71 million in 2008. Given pre-tax profits of Southwest were $278 million, why do you suppose tax payments were relatively low?

4. Independent of the actual facts, assume that, in 2008, Southwest management considered selecting a *less* accelerated depreciation method for financial (*not tax*) reporting. What would have been the effect on the following amounts by adopting a less accelerated method (i.e., higher, lower, no effect, or cannot be determined)?

	Effect?
Income tax expense:	____________
Income taxes payable:	____________
Deferred income taxes (liability):	____________

5. Assume you are a financial analyst who believes that tax expense for financial reporting purposes should be based on actual taxes owed to Federal and state tax authorities. Accordingly, you restate the financial statements to eliminate the deferred income tax accounts. What amounts would change on Southwest's income statement and balance sheet if the Company's financial statements based tax expense on tax payable from the tax return? (Ignore totals and subtotals other than net income.)

   a. Effect on the Income statement for 2008? (As reported vs. Restated)

   b. Effect on the Balance sheet at December 31, 2008? (As reported vs. Restated)

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.
Note 16 from the financial statements on income taxes (excerpt)

16. Income Taxes

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The components of deferred tax assets and liabilities at December 31, 2008 and 2007, are as follows:

	2008	2007
	(In millions)	
DEFERRED TAX LIABILITIES:		
Accelerated depreciation	**$2,760**	$2,612
Fuel derivative instruments	**—**	884
Other	**29**	19
Total deferred tax liabilities	**2,789**	3,515
DEFERRED TAX ASSETS:		
Fuel derivative instruments	**567**	—
Deferred gains from sale and leaseback of aircraft	**60**	65
Capital and operating leases	**47**	58
Accrued employee benefits	**211**	187
Stock-based compensation	**93**	110
State taxes	**69**	75
Business partner income	**81**	78
Other	**86**	37
Total deferred tax assets	**1,214**	610
Net deferred tax liability	**$1,575**	$2,905

(Continued on next page)

Exhibit 3 (continued)

SOUTHWEST AIRLINES CO.
Note 16 from the financial statements on income taxes (excerpt)

The provision for income taxes is composed of the following:

	2008	2007	2006
		(In millions)	
CURRENT:			
Federal	**$ 23**	$108	$ 64
State	**10**	9	15
Total current	**33**	117	79
DEFERRED:			
Federal	**80**	246	220
State	**(13)**	50	(8)
Total deferred	**67**	296	212
	$100	$413	$291

The effective tax rate on income before income taxes differed from the federal income tax statutory rate for the following reasons:

	2008	2007	2006
		(In millions)	
Tax at statutory U.S. tax rates	**$ 97**	$370	$276
Nondeductible items	**10**	6	10
State income taxes, net of federal benefit	**(2)**	38	4
Other, net	**(5)**	(1)	1
Total income tax provision	**$100**	$413	$291