



Southwest Airlines – 2002 (A)*

Accounting for Leases

“Southwest was ‘not your typical airline’ in the year 2002... Southwest was the only major airline that made a profit; the other major airlines reported an aggregate net loss in excess of \$10 billion, as two of them filed petitions in bankruptcy. And as of the end of 2002, Southwest Airlines’ market capitalization (or total stock market value) exceeded that of all other major airlines, combined.

Viewed in the context of the economic holocaust that continued to ravage the U.S. airline industry in 2002, Southwest Airlines attainment of its 30th consecutive annual profit ... was a triumphant accomplishment for its Shareholders and Shareholder-Employees...” (2002 letter to shareholders)

In early 2003, 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. The company was incorporated in Texas and 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 2002, the Company’s all-Boeing 737 fleet was the largest in the world and served 58 communities in 30 states that stretch from coast to coast.

Southwest's strategy was to provide frequent, short-haul, high-quality service at affordable prices. The Company claimed to have the lowest cost structure of any domestic airline and one of the best overall customer service records.

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

* 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, 8/21/03.

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)

Southwest was the first airline to establish a home page on the Internet and, in early 2003, over 50% of its passenger revenue was due to online bookings. Southwest claimed its cost per booking via the Internet was about \$1, versus between \$6 and \$8 for a travel agent. The cost per booking via the Company's own reservations agents was somewhere in between. See Southwest's web site at "www.southwest.com" for more details about the Company and its on-line reservation system.

The Company's Theme and the Early 1990s Recession

Southwest's stock exchange symbol, "LUV," was selected to represent the Company's home airport (Dallas Love Field) and its theme for employee and customer relationships. For example, in his 1990 annual letter to shareholders (p. 3), CEO Herbert Kelleher discussed how the dual blows of an economic recession and high Gulf War fuel prices caused a decline in earnings. However, he stated that, given these conditions, 1990 profits are a source of Company pride. This brief statement dominated the cover of the Annual Report "In 1990, we made a profit." (In fact, Southwest was the only major carrier in 1990, 1991, and 1992 to earn net and operating profits.) Finally, he thanked employees for their support of Southwest:

For multitudinous years I have written about the dedication, warmth, and special accomplishments of the people of Southwest. Their feats are legendary; their will indomitable; and their hearts huge. Their caring for their Company has caused them to establish voluntarily a "Fuel from the Heart" program whereby many are incurring payroll deductions in order to purchase fuel for Southwest, demonstrating once more that ours is not just a corporation; not only a business; but a lovely and loving family.

With tears in my eyes and heartfelt thanksgiving, I dedicate this annual report to the "Fuel from the Heart" program. Thank you!

Most sincerely,
Herbert D. Kelleher (signature), Chairman, President and Chief Executive Officer.
January 27, 1991

Current Situation

By 2001, the Company had grown to become the fifth largest U.S. airline (in terms of domestic customers carried) and yearend results for 2002 marked Southwest Airlines' 30th consecutive year of profitability despite the aftermath of terrorist attacks on September 11, 2001, which continued to disrupt the U.S. Airline industry.

Entering 2003, the company maintained its premier position as the most financially stable company in the U.S. airline industry. In 2003, for the eighth consecutive year, *Fortune* magazine

again named Southwest as America's most admired airline and Southwest continued to rank second (behind General Electric) as the most admired company in America. Still, the future continued to look uncertain. The letter to shareholders in the 2002 annual report closed as follows:

Although we cannot predict what external, uncontrollable events might transpire during 2003, we can forecast with considerable certainty that our valorous, caring, nimble, good-hearted, and resilient People will ensure that Southwest ends 2003 just the way it ended 2002 – at the forefront of our industry. For as we wrote to our shareholders last year, our wonderful People's brave hearts are both informed and inspired by Todd Beamer's brave words – and his devotion to the concept of duty with honor: “*LET'S ROLL.*”

January 20, 2003

Most sincerely,

Herbert D. Kelleher (signature), Chairman of the Board.

James F. Parker (signature), Vice Chairman of the Board and Chief Executive Officer.

Colleen C. Barrett (signature), President and Chief Operating Officer.

Leases and Non Current Assets

Flight equipment was by far the largest asset reported on Southwest's balance sheets. As of December 31, 2002 Southwest operated 375 Boeing 737 aircraft with an average age of 9.2 years. Of these aircraft, 278 were owned by the Company while 90 and 7 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 provides information about Southwest's leasing activities and can be viewed as having four parts.

- The first paragraph and table below describe the *asset value* of the *capital* leases.
- The first two sentences of the second paragraph describe the *operating* leases.
- The remainder of the second 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.

Southwest was the “launch customer” for the newest generation of Boeing aircraft – the model 737-700. The first 737-700 aircraft was delivered in December 1997 and entered service in January 1998. At yearend 2002, Southwest had 129 737-700 aircraft in service, firm orders to purchase 117 Boeing 737-700 aircraft and options for an additional 45 in 2004 through 2006.

Data

Included on the following pages are excerpts from the Company's fiscal 2002 annual report including:

- Consolidated Statement of Income
- Consolidated Balance Sheet
- Note 8 (Leases)

Questions:

1. Prepare a journal entry to record rent expense for leases categorized as “operating” leases in 2002. 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, 2002?
 - b. What is the net amount of capitalized lease obligations included among Liabilities on the Balance Sheet of Southwest as of December 31, 2002?
 - c. Why are these amounts different?
3.
 - a. Prepare a journal entry to record the capital lease payment for 2003 (*not* 2002). To simplify, assume no new capital leases are signed during 2003 and that capital lease payments are made annually on December 31. [Hint: study part 3 of Note 8 to obtain the needed amounts.]
 - b. Estimate the amount by which 2003 (*not* 2002) 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 2003.]
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. To simplify your analysis, assume that Southwest’s noncancelable lease obligation can be summarized as:
 - Annual payments of \$200,000(000) for the next 13 years from the end of 2003 through the end of 2015 (This is obviously a simplification but a reasonable one given \$200 million x 13 years = \$2.6 billion, which is essentially equal to the \$2,602,777(000) of total minimum lease payments under noncancelable operating leases reported in Note 8.);
 - The Company has no commitment beyond 2015; and
 - The prevailing annual interest rate for leases of similar risk is (and has been) 8%.
5. 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, 2002? Consider in general terms what the effect would be on the 2002 income statement.
6.
 - 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?

**SOUTHWEST AIRLINES CO.
CONSOLIDATED BALANCE SHEETS**

DECEMBER 31,

(In thousands, except per share amounts)

	2002	2001
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 1,815,352	\$ 2,279,861
Accounts and other receivables	174,393	71,283
Inventories of parts and supplies, at cost	86,016	70,561
Deferred income taxes	-	46,400
Fuel hedge contracts	112,847	-
Prepaid expenses and other current assets	43,352	52,114
	-----	-----
Total current assets	2,231,960	2,520,219
Property and equipment, at cost:		
Flight equipment	8,024,719	7,534,119
Ground property and equipment	1,041,844	899,421
Deposits on flight equipment purchase contracts	389,094	468,154
	-----	-----
	9,455,657	8,901,694
Less allowance for depreciation	2,810,193	2,456,207
	-----	-----
	6,645,464	6,445,487
Other assets	76,326	31,435
	-----	-----
	\$ 8,953,750	\$ 8,997,141
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 362,027	\$ 504,831
Accrued liabilities	529,109	547,540
Air traffic liability	412,238	450,407
Aircraft purchase obligations	-	221,840
Short-term borrowings	-	475,000
Current maturities of long-term debt	130,454	39,567
	-----	-----
Total current liabilities	1,433,828	2,239,185
Long-term debt less current maturities	1,552,781	1,327,158
Deferred income taxes	1,227,475	1,058,143
Deferred gains from sale and leaseback of aircraft	183,797	192,342
Other deferred liabilities	134,252	166,260
Commitments and contingencies		
Stockholders' equity:		
Common stock, \$1.00 par value: 2,000,000 shares authorized; 776,663 and 766,774 shares issued in 2002 and 2001, respectively	776,663	766,774
Capital in excess of par value	135,848	50,409
Retained earnings	3,455,448	3,228,408
Accumulated other comprehensive income (loss)	53,658	(31,538)
	-----	-----
Total stockholders' equity	4,421,617	4,014,053
	-----	-----
	\$ 8,953,750	\$ 8,997,141
	=====	=====

See accompanying notes.

SOUTHWEST AIRLINES CO.
CONSOLIDATED STATEMENTS OF INCOME

YEARS ENDED DECEMBER 31,

(In thousands, except per share amounts)

	2002	2001	2000
OPERATING REVENUES:			
Passenger	\$ 5,341,349	\$ 5,378,702	\$ 5,467,965
Freight	84,675	91,270	110,742
Other	95,747	85,202	70,853
Total operating revenues	5,521,771	5,555,174	5,649,560
OPERATING EXPENSES:			
Salaries, wages, and benefits	1,992,485	1,856,288	1,683,689
Fuel and oil	762,096	770,515	804,426
Maintenance materials and repairs	390,216	397,505	378,470
Agency commissions	54,669	103,014	159,309
Aircraft rentals	186,992	192,110	196,328
Landing fees and other rentals	344,660	311,017	265,106
Depreciation	356,304	317,831	281,276
Other operating expenses	1,017,011	975,772	859,811
Total operating expenses	5,104,433	4,924,052	4,628,415
OPERATING INCOME	417,338	631,122	1,021,145
OTHER EXPENSES (INCOME):			
Interest expense	106,023	69,827	69,889
Capitalized interest	(16,720)	(20,576)	(27,551)
Interest income	(36,964)	(42,562)	(40,072)
Other (gains) losses, net	(27,683)	(203,226)	1,515
Total other expenses (income)	24,656	(196,537)	3,781
INCOME BEFORE TAXES AND CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	392,682	827,659	1,017,364
PROVISION FOR INCOME TAXES	151,713	316,512	392,140
INCOME BEFORE CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	240,969	511,147	625,224
CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE, NET OF INCOME TAXES	-	-	(22,131)
NET INCOME	\$ 240,969	\$ 511,147	\$ 603,093
NET INCOME PER SHARE, BASIC BEFORE CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	\$.31	\$.67	\$.84
CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	-	-	(.03)
NET INCOME PER SHARE, BASIC	\$.31	\$.67	\$.81
NET INCOME PER SHARE, DILUTED BEFORE CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	\$.30	\$.63	\$.79
CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	-	-	(.03)
NET INCOME PER SHARE, DILUTED	\$.30	\$.63	\$.76

See accompanying notes.

SOUTHWEST AIRLINES CO.
Selected notes

8. LEASES

The Company had seven aircraft classified as capital leases at December 31, 2002. The amounts applicable to these aircraft included in property and equipment were:

(In thousands)	2002	2001
Flight equipment	\$ 165,467	\$ 165,085
Less accumulated depreciation	106,876	99,801
	-----	-----
	\$ 58,591	\$ 65,284
	=====	=====

Total rental expense for operating leases charged to operations in 2002, 2001, and 2000 was \$371.4 million, \$358.6 million, and \$330.7 million, respectively. The majority of the Company's terminal operations space, as well as 90 aircraft, were under operating leases at December 31, 2002. Future minimum lease payments under capital leases and noncancelable operating leases with initial or remaining terms in excess of one year at December 31, 2002, were:

(In thousands)	CAPITAL LEASES	OPERATING LEASES
2003	\$ 17,751	\$ 281,042
2004	17,651	263,343
2005	23,509	233,028
2006	13,379	189,498
2007	13,379	175,905
After 2007	52,016	1,459,961
	-----	-----
Total minimum lease payments	137,685	\$ 2,602,777
	-----	=====
Less amount representing interest	37,122	

Present value of minimum lease payments	100,563	
Less current portion	9,657	

Long-term portion	\$ 90,906	
	=====	

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.