



## Southwest Airlines – 2002 (B)<sup>1</sup>

### Accounting for income taxes – financial versus tax reporting

Southwest Airlines Co., 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 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. Differences 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. Tax expense on the income statement (often referred to as "provision for income taxes") 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 14 to Southwest's financial statements (attached) provides information about differences between tax and financial (i.e., "book") reporting. This note has five 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.
- The 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 third paragraph and the table that follows reconciles differences between the amount of tax based on the federal statutory tax rate and the amount of tax expense shown for financial reporting.

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<sup>1</sup> 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. The comments of D. Shores are appreciated. Revised 8/21/03.

- The fourth paragraph discusses the Company’s loss of \$145 million for federal income tax purposes.
- The final paragraph discusses the potential for disputes between the Company and the U.S. Internal Revenue Service over past and current tax returns.

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 2002. [Warning: Do not use the specific deferred income tax accounts affected on the Balance Sheet or at the top of note 14, page 5. Rather, for the current and deferred components of the provision for income taxes, see note 14 – bottom of page 5.]
2. Compute Southwest’s “effective tax rate” for 2002, 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 \$2,693(000) in 2002. Given pre-tax profits of Southwest exceeded \$392,000(000), why do you suppose tax payments were so low?
4. Independent of the actual facts, assume that, in 2002, 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)?

	<u>Effect?</u>
Income tax expense:	_____
Income taxes payable:	_____
Deferred income taxes (liability):	_____

5. Assume you are an 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 prefer that the deferred income tax accounts be eliminated from the financial statements. What amounts would change on Southwest's income statement and balance sheet to restate the Company's books such that tax expense is based on tax payable from the tax return? (Ignore totals and subtotals other than net income.)



**SOUTHWEST AIRLINES CO.  
CONSOLIDATED BALANCE SHEETS**

DECEMBER 31,

(In thousands, except per share amounts)

	----- 2002 -----	----- 2001 -----
<b>ASSETS</b>		
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
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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
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	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
	=====	=====
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
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
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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)
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Total stockholders' equity	4,421,617	4,014,053
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	\$ 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****14. 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, 2002 and 2001, are as follows:

(In thousands)	2002	2001
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DEFERRED TAX LIABILITIES:		
Accelerated depreciation	\$ 1,440,565	\$ 1,246,009
Scheduled airframe maintenance	70,843	89,292
Other	25,854	31,770
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Total deferred tax liabilities	1,537,262	1,367,071
DEFERRED TAX ASSETS:		
Deferred gains from sale and leaseback of aircraft	95,823	101,755
Capital and operating leases	77,033	76,990
Accrued employee benefits	86,227	83,450
State taxes	43,151	37,715
Other	1,722	55,418
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Total deferred tax assets	303,956	355,328
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Net deferred tax liability	\$ 1,233,306	\$ 1,011,743
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The provision for income taxes is composed of the following:

(In thousands)	2002	2001	2000
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CURRENT:			
Federal	\$ (19,018)	\$ 98,378	\$ 197,875
State	1,102	10,212	26,671
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Total current	(17,916)	108,590	224,546
DEFERRED:			
Federal	156,545	187,296	151,694
State	13,084	20,626	15,900
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Total deferred	169,629	207,922	167,594
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	\$ 151,713	\$ 316,512	\$ 392,140
	=====	=====	=====

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

(In thousands)	2002	2001	2000
Tax at statutory			
U.S. tax rates	\$ 137,439	\$ 289,681	\$ 356,077
Nondeductible items	6,418	7,318	6,801
State income taxes, net of federal benefit	9,221	20,045	27,671
Other, net	(1,365)	(532)	1,591
Total income tax provision	\$ 151,713	\$ 316,512	\$ 392,140

At December 31, 2002, Southwest Airlines Co. had an estimated tax net operating loss of \$145 million for federal income tax purposes. The Company estimates that a federal tax refund of \$51 million will be realized as a result of utilizing this net operating loss as a carryback to prior taxable years. The Company has included this refund in "Accounts and other receivables" in the Consolidated Balance Sheet at December 31, 2002.

The Internal Revenue Service (IRS) regularly examines the Company's federal income tax returns and, in the course of which, may propose adjustments to the Company's federal income tax liability reported on such returns. It is the Company's practice to vigorously contest those proposed adjustments that it deems lacking of merit. The Company's management does not expect that the outcome of any proposed adjustments presented to date by the IRS, individually or collectively, will have a material adverse effect on the Company's financial condition, results of operations, or cash flows.