Proposed Leasing Standard: Impact on the Airline Industry

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ABSTRACT

Operating lease obligations avoid balance sheet recognition. Critics assert that these off-balance sheet arrangements lack transparency. To address the criticism, the Financial Accounting Standards Board (FASB) issued a leasing proposal that requires balance sheet reporting of most right-of-use leased assets and debt, and improves alignment with the International Accounting Standards Board (IASB) standards. This paper summarizes the current status of the FASB lease proposal and illustrates the anticipated impact on airlines – an industry heavily reliant on operating leases. Finally, the paper recommends steps for implementing the standard.

Keywords: Lease proposals; FASB and IASB; financial impact; airlines

INTRODUCTION

In 2009, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) created a task force to align domestic and international reporting for leases and off-balance sheet disclosures. The task force aimed to address the recognition of lease assets and liabilities for all leases extending beyond 12 months, and alignment of the accounting between lessees and lessors.

The latest exposure draft issued jointly by the FASB and the IASB (May 2013) required broad application of lease capitalization and balance sheet reporting. Real estate and property leases were classified as Type B leases requiring lessees to sum total interest and depreciation expense over the lease term (where no options and title delivery exists) and allocate this total cost to the income statement on a straight-line basis. All other capital leases were classified as Type A financing leases and accounted for using procedures very similar to those currently used to account for direct financing leases.

Meanwhile, the IASB (August 2014) issued a separate proposal that in large part recognized only Type A leases. While the essence of both proposals is to move debt out of the footnotes and into the balance sheet, the FASB proposal accomplishes this in two categories while the IASB proposal uses only one. Both proposals require a right-of-use (ROU) model that classifies most operating leases as debt on the balance sheet along with the assets associated with their right-of-use. In the remainder of this paper, the FASB proposal will be the main focus.

PURPOSE

There is no argument that the main objective of the proposals is to shift lessee debt into the balance sheet and out of the footnotes. Companies reliant on operating leases are heavily impacted by this standard because debt formerly nestled in the footnotes will be added to their balance sheets. Accordingly, this paper illustrates the financial consequences of this proposal on the airline industry – a sector heavily reliant on operating leases. Guidance for companies transitioning toward implementation of the proposal is provided along conclusions and implications for future research.

This study is relevant to all sectors of the economy, including governmental and professional sectors, due to the far-reaching implications of this proposal involving debt associated with leases that will either be moved out of the footnotes and into the balance sheet, or expensed when paid at amounts greater than previously required. For many entities, the accounting changes will have an adverse impact on financial statements and general credit conditions. In addition, companies will spend significant resources overhauling their accounting systems and legal contracts.

As an illustration for companies outside the airline sector analyzed in this paper, the effects of this proposal may be significant for large retailers like Walgreen's, Target, and Kohl. Walgreen's leases more than 8,000 drugstore properties and reports approximately $35 billion of operating leases currently avoiding balance sheet recognition. While the proposed lease accounting will have little impact on Walgreen's profits (lease expense will remain mostly unchanged when shifting from operating leases to Type B real-estate leases under the new standard), the debt/equity ratio will increase and the company will experience an elevated risk profile. Riley and Shortridge (2013) predict debt will increase 16% for Target and 66% for Kohl. Target's current ratio will decrease by 1% and Kohl's by 8%. Similarly, the changes in solvency ratios for Kohl's will be very large. The company's debt/equity ratio would increase from 0.64 to 1.06 (66% increase) and return on assets would decline by 13%. These large shifts may represent significant concerns for creditors and investors, despite the fact that no contracts are altered and the economic circumstances of both companies remain unchanged.

On a broader scale, in Europe, outstanding leases totaled $928 billion in 2011. In 2012, United States companies had about $1.5 trillion of operating leases, with real estate leases making up about $1.1 trillion of the total. The accounting for many of these leases will change with this proposal. Reporting additional lease liabilities on the balance sheet may breach corporate loan covenants or trigger credit ranking changes. In sum, all businesses, governmental organizations, and accounting firms should have knowledge of the economic impact of the new rules and prepare for their implementation to make the transition process smoother.

THEORETICAL AND TECHNICAL ISSUES

The latest FASB lease proposal focuses on assets that can be explicitly or implicitly identified, either as separate assets or physically distinct portions of assets that the lessee has exclusive use. In the past, only long-term property, plant and equipment leases were subject to capitalization. The new proposal widens the number of leases requiring capitalization by broadening the type of assets covered by the standard. In addition, the proposal suggests a new probability test that will result in the inclusion of renewal periods in the computation of the lease term. Purchase options are considered similar to renewal options.

The proposal covers contracts that convey a right-of-use and control of an asset for a period of 12 months or longer. Control is conveyed when parties exchange rights to direct and obtain benefits from the asset's use. While the timing of the implementation of the new proposal is unknown, it is expected that both the FASB and the IASB will issue their final standards sometime this year. In May 2014, speaking at the 13th Annual Baruch College Financial Reporting Conference, the FASB Technical Director, Susan Casper, forecasted the new rules may be issued in 2015 and be effective in 2017. In the latest joint meeting of the FASB and IASB on January 21, 2015, the Boards recommended revised disclosures assessing the nature, timing and uncertainty of lease related cash flows. Additional joint meetings may yet occur before the standards are finalized.

As specified above, asset capitalization under the current proposal applies to long-term lease arrangements of almost all types of assets with a lease term (including renewals and extensions) of 12 months or longer. Renewal periods may make the difference between classifying a lease as a capital lease (12 months or longer) or an operating lease (less than 12 months). This probability test focuses on significant economic incentives that may lead a lessee to use renewal options (Boyle et al, 2014). Thus, renewal periods of one year or less with large termination penalties are included when calculating the term of the lease. For example, the proposal capitalizes a typical fleet/split lease for less than 12 months, with month-to-month renewals carrying significant penalties for failure to renew.

The proposal excludes the following lease arrangements:
* Short-term leases of 12 months or less with low penalties for failure to renew;
* Leases of intangibles;
* Leases for the right to explore and use non-regenerative resources;
* Leases of timber and other biological assets; and
* Leases of service concessions arrangements.

Should the market reaction to this standard increase demand for short-term leases to avoid capitalization, lessees will report less debt, and lessors will convey fewer assets (Craig, 2013). In addition, these short-term leases will reduce the predictability of cash flows for readers of the financial statements by shortening the duration of cash flows and therefore diminishing the ability to refine economic expectations over an expanded horizon. This paper outlines the new rules and illustrates the estimated impact on airlines.

CURRENT LEASE CAPITALIZATION RULES

Domestic and international lease standards require similar procedures for the capitalization of leases, as described in Table 1. Both standards use similar language to define a lease as an arrangement conveying the right to use an asset for an agreed time period. In addition, both standards use similar concepts for capitalization.

In practice, the four FAS13 criteria for capitalization (referred to as bright-line tests) are often used to interpret the IAS17 indicators. With both standards, be advised that a lessee and lessor may classify the same lease differently. For example, if the lessee unknowingly uses a higher interest rate than the lessor, the lessee may avoid capitalization and the lessor will not. The major changes in the new proposals are the elimination of bright-line rules (e.g., 75% of useful life, 90% of fair market value) and the capitalization of all leases covering more than 12 months.

Table 1: Main Characteristics of Domestic and Global Lease Accounting

FAS13	IAS17
Capitalization as a Direct Financing Lease if arrangement transfers substantially the risks and benefits of ownership. Required if any of the following are met for a Lessee (Lessor must also assure that no uncertainties exist and collection is assured):	Capitalization as a Finance Lease if arrangement transfers substantially the risks and benefits of ownership. Required if any of the following are met:
Transfer of title	Transfer of title
Bargain purchase option	Bargain purchase option
Lease term is 75% or more of the asset's life	Lease term is the major part of the leased asset's useful life
Present value of the minimum lease payments is 90% or more of the asset's fair market value	Present value of the minimum lease payments is equal to substantially all of the leased asset's value
	The asset is of a specified nature
	Lessee guarantees the lessor's investment if the lessee cancels the lease
	Lessee receives residual upside and bears the residual losses at lease-end
	Bargain renewal options

FASB LEASE PROPOSAL: AN ACCOUNTING EXAMPLE

The FASB lease proposal recognizes two types of leases (Types A and B leases) and the IASB proposal recognizes only one (essentially equivalent to Type A leases). The FASB proposal is a hybrid of existing domestic and international practices. For lessees, all leases that are twelve months or longer are added to the balance sheet to conform to the international practice of capitalization and are expensed over time. The convergence ends at this point: Type B leases are expensed using one expense account (similar to traditional operating leases), and Type A leases are expensed using two-line items of interest and amortization (resembling domestic Direct Financing leases and all global IASB leases).

Type A and B lease accounting is summarized in Illustration 1 using a five (5) year lease at 8% interest, with the first payment due at inception. Data used in this example is adapted from Lightner et al (January 2013). When measuring assets and liabilities arising from a lease, the lessee and the lessor exclude most variable lease payments. In addition, a lessee and a lessor include payments to be made in optional periods if the lessee has a significant economic incentive to exercise an option to extend the lease or not to exercise an option to terminate the lease (Lightner et al, September, 2013).

Illustration 1: Accounting for Type A and B Leases Under the FASB Proposal

Panel A – Facts

Asset Cost	$580,000
Asset Gross Profit	$ 20,000 [$14,896 (74.5%) recognized and $5,104 (25.5%) deferred–see below]
Asset Fair Market Value	$600,000
Lease payments	$103,631
PV of Lease Payments	$446,869 (74.5% of fair value)
PV of Lease Residual Interest	$153,131 (25.5% of fair value) (unguaranteed residual value)
Total PV	$600,000 (100.0%)
Other information:	No title passing; no options; no renewals; no initial direct costs

Type A Lease Expense (two items):

Interest (first year)	$ 27,459 ($446,869-$103,631)*.08	[Note:Principal reduction (first year) 76,172 (total payment - $27,459 interest)]
Depreciation (straight-line)	$ 89,374 per year	
First Year Expense:	$116,833	

Type B Lease Expense (one item – same each year):

Depreciation (straight-line)	$ 89,374 per year ($446,869 for 5 years)
Interest expense each year	$ 14,257[total interest over 5 years $71,286:5]
S-L expensing of interest and depr. for lessee (type B lease)	$103,631

Panel B - Lessee Accounting

Proposed Lessee Accounting for Right of Use (ROU) Assets	**Type A Leases: Same as most existing Capital Leases involving most leases other than real estate requiring interest and**	**Type B Leases: Same as most existing Operating Leases involving real estate that require straight-line expensing**
Balance Sheet Reporting	$446,869 ROU asset and debt measured using present value of lease payments.	$446,869 ROU asset and debt measured using present value of lease payments.
Income Statement Reporting	Interest (measured by the effective interest method) and asset amortization reported separately.	$103,631 combined interest and asset amortization reported as one line-item.

Panel C - Lessor Accounting

Proposed Lessor Accounting for Right of Use (ROU) Assets	**Type A Leases: Same as existing Direct Financing/Sale-Type Leases involving most leases other than real estate**	**Type B Leases: Same as existing Operating Leases involving real estate**
Balance Sheet Reporting	Remove the underlying asset and replace it with a net receivable (net of deferred interest) and a residual asset to total $600,000.	Continue to recognize the entire underlying asset.
Income Statement Reporting	Recognize $14,896 guaranteed portion of gross profit and defer the rest. Recognize interest income over the lease term (using effective interest method). Do not depreciate the residual asset.	Recognize lease income over the lease term typically on a straight-line basis.

ESTIMATED IMPACT ON THE AIRLINE INDUSTRY

Anticipated changes with this new proposal will be felt by nearly every member of the domestic airline industry due to the industry's heavy reliance on operating leases that will shift to balance sheet recognition with adoption of this standard. This paper illustrates the financial consequences of this lease proposal to the financial statements of six domestic carriers with operating lease exposures measured as a percentage of total assets at 2011 amounts ranging from (least to most) – 1) Jet Blue (22% operating leases to total assets); 2) Alaska Air (23%); 3) United Continental Holdings (25%); 4) Republic (42%); 5) US Air (46%); and 6) Sky West (70%).

The financial statements are restated for all six carriers illustrating the implementation of the proposed standard (see Appendix). Resulting differences from implementation of the standard are analyzed by first computing the net present value (NPV) of the operating lease obligations, as proposed by Grossman and

Grossman (2010). The short term lease payments are assumed to range from one to four years and the fifth-year lease payments are assumed to be constant over the remaining life of the lease. Similar long-term obligations are assumed to occur during the 1-4 year short-term period (Durocher, 2008; Erickson and Trevino, 1994). The discount rate used in NPV calculations of each company is calculated by dividing the company's interest expense by its total debt (Durocher and Fortin, 2009).

To illustrate, Exhibit 3 reports restated data for United Continental Holdings representing a low operating lease carrier. Using a calculated internal interest rate of 7.45%, the NPV of the minimum lease payments was determined to be $15,367 (all amounts are in millions of dollars). This amount is added to the asset side of the balance sheet (adjusted for additional deferred tax assets of $94 and reduced by $1,397 amortization) resulting in a pro-forma increase in total assets of $14,064 ($37,988 to $52,052). The same NPV of the minimum lease payments adds to the liability portion of the balance sheet because it is used to record the company's additional indebtedness. The liability is reduced by $1,128 representing the principal repayment of the lease obligations in the current year. Therefore, the proposed regulations will increase the total liabilities for United Continental Holdings from $36,182 to $50,420 (39%).

As to be expected, the impact on wealth is also unfavorable. Replacing $2,274 operating lease expense with an increase in $1,397 depreciation expense and $1,145 interest expense, results in a decrease in profits of $268. After taxes, this amounts to a reduction in wealth of $174 (21% reduction). Thus, Exhibits 1 through 6 confirm that the proposed standard may significantly impact financial ratios in lease-prone industries. Nearly all airline carriers studied report an increase in their debt-to-equity ratio, demonstrating an increase in risk, and a worsening of the return on assets as summarized in Table 2.

Table 2: Illustration of Impact of Standard on Key Ratios of the Airline Industry

Airlines (ranked from lowest to highest operating lease exposure)	Debt to Equity Percentage Increase (Decrease) with the Implementation of Standard	Return on Assets Percentage Increase (Decrease) with the Implementation of Standard
Jet Blue	20%	(11%)
Alaska Air	51%	(14%)
United Continental Holdings	135%	(27%)
Republic	47%	(20%)
US Air	(17%)	(11%)
Sky West Inc.	117%	(33%)

At present, the probability of a issuing a converged standard is slight. FASB support is fragile. The 2013 exposure draft cleared the board by just a 4-3 vote. Since that time, the FASB elected a new chair and one of the board members who supported the proposal has been replaced. Leasing industry lobbying groups and a coalition led by the U.S. Chamber of Commerce and real estate groups are opposing the standard. These opponents secured allies in Washington. Sixty members of Congress asked the standard-setters last year to rethink the rules.

TRANSITION

The rules may become effective on January 1, 2017 or later. The proposed transition rules require lessees to capitalize their operating leases by discounting the remaining lease payments at their incremental borrowing rate. If an existing operating lease is determined to be Type B, the ROU asset recorded at the transition date will equal the liability added to the balance sheet.

For Type A leases, the ROU will be measured based upon the lease payments remaining at the commencement date. For example, assume that a 10-year lease originally treated as an operating lease has seven years remaining at the transition date. If the lessee estimates that the present value of the liability at the commencement date was $10,000, the ROU asset will be recorded at $7,000 at the date of transition ($10,000 multiplied by 70% remaining life). Furthermore, assuming that the present value of the remaining lease payments at the transition date was $8,000, the lessee would recognize a $7,000 asset, an $8,000 liability, and a $1,000 debit adjustment to retained earnings.

Companies with significant lease exposure need advice to take (or, not to take) action. Should they renegotiate, maintain, or replace their lease contracts? Best practices can be summarized as follows (Chambers et al, 2015; Wheeler et al, 2013):

1. Compile a complete inventory of leases.
2. Identify any additional required terms and accounting assumptions.
3. Determine if existing systems meet the measurement and reporting requirements of:
    a. Lease classification
    b. Residual value accretion
    c. Fair value determination
    d. Sale profit allocation
    e. Initial direct cost accounting
    f. Segregation of lease and service payments
    g. Taxes
4. Measure the impact on processes and people:
    a. Expenditures move from operating to capital
    b. Decision-making moves towards the CFO
    c. Lessor sales systems need to provide more information for decision-making.
    d. A sales car fleet may require changes in supervision of accounting from human resources to facilities.
    e. New product opportunities.
5. Centralize leasing operations and administration.

CONCLUSIONS & SUGGESTIONS FOR FUTURE RESEARCH

Both U.S. and international lease accounting standards are likely to change. One of the most important changes will be the addition of a number of right-to-use assets and lease liabilities on lessees' balance sheets. In addition, expense recognition patterns and lease disclosures are poised to change and more expense will be recognized under Type A leases than are currently recognized under direct financing leases. Some lessees could experience significant impacts to their financial statements under the new lease accounting standard as illustrated among the airline carriers. Companies with significant lease exposure should prepare for the new rules by following the steps described above. Knowledge of the new rules and careful preparation for the proposed standard will make the transition process smoother.

While the study demonstrates the adverse impact of the proposals on the airline industry, results are relevant to all sectors of the economy, including governmental and professional sectors. Future research may determine the impact of the proposals on other sectors of the economy such as retailing and real-estate. In addition, the impact on lease contracts and regulations that govern leasing arrangements may be studied. Finally, the economic and financial consequences of the proposals on the broader economy and capital flows may be analyzed.

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APPENDIX –

THE FINANCIAL IMPACT OF THE PROPOSALS ON AIRLINES

Exhibit One

Jet Blue Pro-forma Analysis Illustrating Impact of Leasing Standard

JETBLUE

Restated FY2011 Financials (millions)

Lease Payments

	Reported	Short term	Long term	Total
2011 rental payment	$269	$192	$77	$269
2012	147	70	77	147
2013	127	50	77	127
2014	132	55	77	132
2015	138	61	77	138
2016	77	0	77	77
2017		0	79	79
2018		0	79	79
2019		0	79	79
2020			79	79
2021			79	79
Thereafter	8,129			
Total	$9,019	$428	$858	$1,286
NPV of minimum lease payments				$1,000

Income Statement

		Actual	Pro Forma
Operating Revenue		$4,504	$4,504
Rent		269	0
Incremental Depreciation		0	91
Total Deprec		233	324
EBIT		324	502
Incremental Interest		0	57
Interest Expense		179	236
Income (Loss) before taxes		145	266
Income Tax Exp (Benefit)		59	101
Net Income (Loss)		$86	$165
Assumed Income Tax Rate	35%		
Internal Interest Rate	5.71%		

Balance Sheet

Assets	Actual	Pro Forma
Capitalized Operating Leases - Right of Use Assets		
Beginning 2011		$1,000
ST Lease		377
LT Leases		623
Less Amortization		91
Ending 2011		$909
Incremental Tax Deferred Asset		-42
Total Assets - Year end 2011	7,071	$7,938

Liabilities	Actual	Pro Forma
Capitalized Operating Leases - ROU Liabilities		
Beginning of 2011		$1,000
Less Principal Payments		211.92
Year-End 2011		788.11
Total Debt	3,136	3,924.11
Total Liabilities	5,314	6,102.11
Equity	1,757	1,835.66
Total Liabilities and Equity - Year End 2011	$7,071	$7,938

Ratio Analysis

		Actual	Pro Forma
Debt to Equity	Debt/Equity	178.5%	213.8%
Interest Coverage	EBIT/Interest Expense	181.0%	171.3%
Operating Margin	EBIT/Revenue	7.2%	11.1%
Return on Assets	Net Income/Total Assets	63.7%	56.7%

Exhibit Two
Alaska Air Pro-forma Analysis Illustrating Impact of Leasing Standard

ALASKA AIR
Restated FY2011 Financials (millions)

Lease Payments

	Reported	Short term	Long term	Total
2011 rental payment	$275	$184	$91	$275
2012	200	109	91	200
2013	167	76	91	167
2014	153	63	91	153
2015	122	31	91	122
2016	91	0	91	91
2017		0	81	81
2018		0	81	81
2019		0	81	81
2020				
2021				
Thereafter	242			
Total	$1,250	$463	$787	$1,250
NPV of minimum lease payments				$983

Income Statement

		Actual	Pro Forma
Operating Revenue		$4,318	$4,318
Rent		275	0
Incremental Depreciation		0	109
Total Deprec		247	356
EBIT		481	647
Incremental Interest		0	66
Interest Expense		87	153
Income (Loss) before taxes		394	494
Income Tax Exp (Benefit)		149	184
Net Income (Loss)		$245	$309
Assumed Income Tax Rate	35%		
Internal Interest Rate	6.68%		

Balance Sheet

Assets	Actual	Pro Forma
Capitalized Operating Leases - Right of Use Assets		
Beginning 2011		$983
ST Lease		402
LT Leases		582
Less Amortization		109
Ending 2011		$874
Incremental Tax Deferred Asset		-35
Total Assets - Year end 2011	5,195	$6,034

Liabilities	Actual	Pro Forma
Capitalized Operating Leases - ROU Liabilities		
Beginning of 2011		$983
Less Principal Payments		209.21
Year-End 2011		774.23
Total Debt	1,307	2,081.13
Total Liabilities	4,022	4,796.03
Equity	1,173	1,238.16
Total Liabilities and Equity - Year End 2011	$5,195	$6,034

Ratio Analysis

		Actual	Pro Forma
Debt to Equity	Debt/Equity	111.4%	168.1%
Interest Coverage	EBIT/Interest Expense	551.0%	295.7%
Operating Margin	EBIT/Revenue	11.1%	15.0%
Return on Assets	Net Income/Total Assets	83.1%	71.6%

Exhibit Three

United Continental Holdings Pro-forma Analysis Illustrating Impact of Leasing Standard

UNITED CONTINENTAL HOLDINGS

Restated FY2011 Financials (millions)

Lease Payments

	Reported	Short term	Long term	Total
2011 rental payment	$2,274	$567	$1,707	$2,274
2012	2,910	1,203	1,707	2,910
2013	2,595	888	1,707	2,595
2014	2,437	730	1,707	2,437
2015	2,038	331	1,707	2,038
2016	1,707	0	1,707	1,707
2017		0	1,626	1,626
2018		0	1,626	1,626
2019		0	1,626	1,626
2020			1,626	1,626
2021			1,626	1,626
Thereafter	8,129			
Total	$22,090	$3,719	$18,371	$22,090
NPV of minimum lease payments				$15,367

Income Statement

		Actual	Pro Forma
Operating Revenue		$37,110	$37,110
Rent		2,274	0
Incremental Depreciation		0	1,397
Total Deprec		1,547	2,944
EBIT		1,794	2,671
Incremental Interest		0	1,145
Interest Expense		949	2,094
Income (Loss) before taxes		845	577
Income Tax Exp (Benefit)		5	-89
Net Income (Loss)		$840	$666
Assumed Income Tax Rate	35%		
Internal Interest Rate	7.45%		

Balance Sheet

Assets	Actual	Pro Forma
Capitalized Operating Leases - Right of Use Assets		
Beginning 2011		$15,367
ST Lease		3,064
LT Leases		12,303
Less Amortization		1,397
Ending 2011		$13,970
Incremental Tax Deferred Asset		94
Total Assets - Year end 2011	37,988	$52,052

Liabilities	Actual	Pro Forma
Capitalized Operating Leases - ROU Liabilities		
Beginning of 2011		$15,367
Less Principal Payments		1,128.84
Year-End 2011		14,238.50
Total Debt	12,735	26,973.50
Total Liabilities	36,182	50,420.50
Equity	1,806	1,631.68
Total Liabilities and Equity - Year End 2011	$37,988	$52,052

Ratio Analysis

		Actual	Pro Forma
Debt to Equity	Debt/Equity	705.1%	1653.1%
Interest Coverage	EBIT/Interest Expense	189.0%	82.5%
Operating Margin	EBIT/Revenue	4.8%	7.2%
Return on Assets	Net Income/Total Assets	97.7%	71.3%

Exhibit Four

Republic Pro-forma Analysis Illustrating Impact of Leasing Standard

REPUBLIC

Restated FY2011 Financials (millions)

Lease Payments

	Reported	Short term	Long term	Total
2011 rental payment	$330	$139	$192	$330
2012	276	84	192	276
2013	265	73	192	265
2014	244	53	192	244
2015	222	30	192	222
2016	192	0	192	192
2017		0	222	222
2018		0	222	222
2019				
2020				
2021				
Thereafter	444			
Total	$1,972	$379	$1,593	$1,972
NPV of minimum lease payments				$1,571

Income Statement

		Actual	Pro Forma
Operating Revenue		$2,865	$2,865
Rent		330	0
Incremental Depreciation		0	196
Total Deprec		200	397
EBIT		-105	29
Incremental Interest		0	91
Interest Expense		137	229
Income (Loss) before taxes		-242	-200
Income Tax Exp (Benefit)		-91	-76
Net Income (Loss)		-$152	-$124
Assumed Income Tax Rate	35%		
Internal Interest Rate	5.82%		

Balance Sheet

Assets	Actual	Pro Forma
Capitalized Operating Leases - Right of Use Assets		
Beginning 2011		$1,571
ST Lease		333
LT Leases		1,238
Less Amortization		196
Ending 2011		$1,374
Incremental Tax Deferred Asset		-15
Total Assets - Year end 2011	$3,902	$5,261

Liabilities	Actual	Pro Forma
Capitalized Operating Leases - ROU Liabilities		
Beginning of 2011		$1,571
Less Principal Payments		238.69
Year-End 2011		1,331.95
Total Debt	2,359	3,691.05
Total Liabilities	3,441	4,773.15
Equity	461	488.03
Total Liabilities and Equity - Year End 2011	$3,902	$5,261

Ratio Analysis

		Actual	Pro Forma
Debt to Equity	Debt/Equity	512.3%	756.3%
Interest Coverage	EBIT/Interest Expense	-76.5%	9.0%
Operating Margin	EBIT/Revenue	-3.7%	1.0%
Return on Assets	Net Income/Total Assets	73.4%	54.4%

Exhibit Five
US Air Pro-forma Analysis Illustrating Impact of Leasing Standard

US AIR

Restated FY2011 Financials (millions)

Lease Payments

	Reported	Short term	Long term	Total
2011 rental payment	$1,240	$668	$572	$1,240
2012	1,018	446	572	1,018
2013	853	281	572	853
2014	737	165	572	737
2015	629	57	572	629
2016	572	0	572	572
2017		0	558	558
2018		0	558	558
2019		0	558	558
2020			558	558
2021				
Thereafter	2,232			
Total	$7,281	$1,617	$5,664	$7,281
NPV of minimum lease payments				$5,362

Income Statement

		Actual	Pro Forma
Operating Revenue		$13,055	$13,055
Rent		1,240	0
Incremental Depreciation		0	536
Total Deprec		237	773
EBIT		417	1,121
Incremental Interest		0	384
Interest Expense		327	711
Income (Loss) before taxes		90	410
Income Tax Exp (Benefit)		19	131
Net Income (Loss)		$71	$279
Assumed Income Tax Rate	35%		
Internal Interest Rate	7.16%		

Balance Sheet

Assets	Actual	Pro Forma
Capitalized Operating Leases - Right of Use Assets		
Beginning 2011		$5,362
ST Lease		1,406
LT Leases		3,956
Less Amortization		536
Ending 2011		$4,826
Incremental Tax Deferred Asset		-112
Total Assets - Year end 2011	$37,988	$42,702

Liabilities	Actual	Pro Forma
Capitalized Operating Leases - ROU Liabilities		
Beginning of 2011		$5,362
Less Principal Payments		855.99
Year-End 2011		4,505.99
Total Debt	4,566	9,071.99
Total Liabilities	8,185	12,690.99
Equity	150	357.86
Total Liabilities and Equity - Year End 2011	$8,335	$13,049

Ratio Analysis

		Actual	Pro Forma
Debt to Equity	Debt/Equity	3044.0%	2535.1%
Interest Coverage	EBIT/Interest Expense	127.5%	102.4%
Operating Margin	EBIT/Revenue	3.2%	8.6%
Return on Assets	Net Income/Total Assets	34.4%	30.6%

Exhibit Six

Sky West Inc. Pro-forma Analysis Illustrating Impact of Leasing Standard

SKYWEST INC

Restated FY2011 Financials (millions)

Lease Payments

	Reported	Short term	Long term	Total
2011 rental payment	$347	$107	$240	$347
2012	392	153	240	392
2013	369	129	240	369
2014	348	109	240	348
2015	306	66	240	306
2016	240	0	240	240
2017		0	227	227
2018		0	227	227
2019		0	227	227
2020			227	227
2021				
Thereafter	907			
Total	$2,909	$563	$2,346	$2,909
NPV of minimum lease payments				$2,370

Income Statement

		Actual	Pro Forma
Operating Revenue		$3,655	$3,655
Rent		347	0
Incremental Depreciation		0	237
Total Deprec		254	491
EBIT		30	139
Incremental Interest		0	104
Interest Expense		80	184
Income (Loss) before taxes		-50	-45
Income Tax Exp (Benefit)		-23	-21
Net Income (Loss)		-$27	-$24
Assumed Income Tax Rate	35%		
Internal Interest Rate	4.41%		

Balance Sheet

Assets	Actual	Pro Forma	Liabilities	Actual	Pro Forma
Capitalized Operating Leases - Right of Use Assets			Capitalized Operating Leases - ROU Liabilities		
Beginning 2011		$2,370	Beginning of 2011		$2,370
ST Lease		500	Less Principal Payments		242.04
LT Leases		1,870	Year-End 2011		2,128.00
Less Amortization		237	Total Debt	1,815	3,943.00
Ending 2011		$2,133	Total Liabilities	2,948	5,076.00
Incremental Tax Deferred Asset		-2	Equity	1,334	1,337.27
Total Assets - Year end 2011	4,282	$6,413	Total Liabilities and Equity - Year End 2011	$4,282	$6,413

Ratio Analysis

		Actual	Pro Forma
Debt to Equity	Debt/Equity	136.1%	294.9%
Interest Coverage	EBIT/Interest Expense	37.5%	48.3%
Operating Margin	EBIT/Revenue	0.8%	3.8%
Return on Assets	Net Income/Total Assets	85.4%	57.0%

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