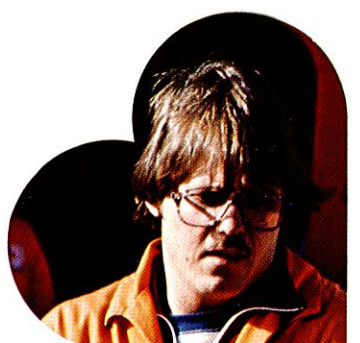
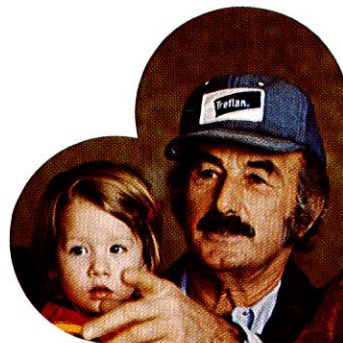


## Southwest Airlines Co. 1978 Annual Report

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The heart of Southwest Airlines is its people — and it's to *people*, our employees and our passengers, that this Annual Report of Southwest Airlines is dedicated. Although Southwest faced many challenges during 1978 one thing remained constant, the dedication of our people to provide the finest service possible to our customers.

## Highlights

	1978	1977	Percent Change
<b>OPERATING DATA</b>			
Trips operated . . . . .	54,816	35,415	54.8%
Passengers carried . . . . .	3,528,105	2,339,524	50.8
Passenger miles flown (000) . . . . .	1,048,624	675,668	55.2
Available seat miles flown (000) . . . . .	1,556,173	1,011,048	53.9
Passenger load factor . . . . .	67.4%	66.8%	0.9
Average revenue per passenger mile . . . . .	7.40 ¢	6.95 ¢	6.5
Number of employees at year end . . . . .	1,119	892	25.4%
<b>INCOME DATA</b>			
Operating revenues . . . . .	\$ 81,065,000	\$ 49,047,000	65.3%
Operating expenses . . . . .	59,943,000	38,785,000	54.6
Net Income—			
Amount . . . . .	\$ 17,004,000	\$ 7,545,000	125.4
Per share* . . . . .	\$ 3.78	\$ 1.68	125.0
Average shares outstanding* . . . . .	4,500,000	4,486,845	0.3
Shares outstanding at end of period* . . . . .	4,500,000	4,500,000	0.0%
<b>FINANCIAL DATA</b>			
Working capital . . . . .	\$ 9,667,000	\$ 5,052,000	91.4%
Flight and ground equipment—net . . . . .	104,744,000	69,853,000	49.9
Capital expenditures . . . . .	40,204,000	41,442,000	(3.0)
Stockholders' equity . . . . .	42,889,000	26,606,000	61.2
Long-term debt/equity . . . . .	1.45/1	1.77/1	N/A
Book value per share* . . . . .	\$ 9.53	\$ 5.91	61.2%

\*Adjusted to reflect effect of 3-for-2 stock split on March 24, 1978 and 3-for-2 stock split on February 23, 1979.

## Letter to Stockholders

Herbert D. Kelleher



By every measure, 1978 was the most successful year in Southwest Airlines' history. Operating revenues were \$81.1 million, compared to \$49.0 million for 1977, an increase of 65 percent. Income from operations reached \$21.1 million, compared to \$10.3 million last year, an increase of 106 percent.

Income before federal income tax of \$24.0 million for the year included a gain on the disposition of aircraft of \$8.5 million. Net income per share was \$5.67 compared to \$2.52 for 1977. This represents an increase of 125 percent.

The most important factors in improved revenues were a 51 percent increase in the number of passengers carried and a fare increase which became effective in July 1978. Continuation of a stringent cost control program and high productivity helped bring the general revenue increase below the line to a very healthy per share increase.

Effective February 23, 1979, your Board approved a 3-for-2 stock split and continuation of the \$.07 per share quarterly dividend, resulting in adjusted income per share figures of \$3.78 for 1978, compared to an adjusted figure of \$1.68 for 1977, and a 50% increase in dividend rate.

As a result of our aircraft acquisition and exchange program, we ended the year 1978 with 13 aircraft, averaging only 18 months in age. This is one of the youngest fleets of jet aircraft in the airline industry and each aircraft meets all federal noise standards for 1985. This means that every new aircraft we purchase is for growth and not for replacement purposes in order to meet federal regulations. As of this date, we are flying 14 Boeing 737-200's, have four more 737's on order for 1979 and three for 1980, and have already received a leased 727 for use between Love Field in Dallas and Hobby Airport in Houston.

In October 1978, the Texas Aeronautics Commission awarded Southwest Airlines two new routes, adding the cities of Amarillo and Beaumont/Port Arthur/Orange. The commencement of service to Amarillo on December 12, 1978 and to Beaumont/Port Arthur/Orange on March 5, 1979 brings our number of Texas metropolitan areas served to 11. In January 1979, our first full month of operations, we were the number one carrier at Amarillo in terms of passengers boarded.

In December 1978, we obtained our first interstate route between Houston and New Orleans. This authority was granted by the Civil Aeronautics Board, and service began with a single roundtrip on January 25, 1979 and increased to seven daily roundtrips on February 12, 1979. As of this writing, we have also been tentatively granted Dallas-New Orleans authority by the CAB, subject to objections and possible hearing on our right to provide this interstate service through Love Field. The potential revenue contributions of these new routes are significant.

In the summer of 1978, we announced a deferral of proposed service by our wholly owned subsidiary, Midway (Southwest) Airway Co., through Chicago's Midway Airport. Since then, the subsidiary has been an active participant in the Chicago-Midway Expanded Service Proceeding, which is currently awaiting initial decision by an Administrative Law Judge of the CAB. The Expanded Service Proceeding involves the right to provide non-stop and one-stop service between Chicago's Midway Airport and 24 domestic cities, including Dallas and Houston. Provided that Midway (Southwest) receives Love Field authority, at present we intend to institute Texas-Midway Airport service as soon as possible after final certification by the CAB. In light of equipment delivery schedules, this could not occur earlier than the fourth quarter of this year, however.

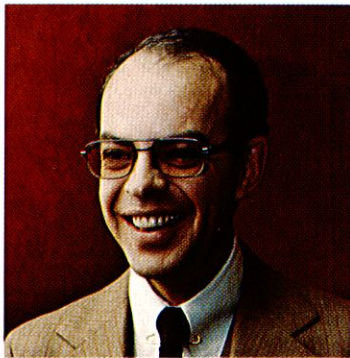
Historically, as an intrastate airline, Southwest has been subject solely to the economic regulatory jurisdiction of the Texas Aeronautics Commission. Prior to enactment on October 24, 1978 of the Federal Airline Deregulation Act of 1978, your Company's Board of Directors did not wish to become, to any extent, a CAB air carrier because, in its opinion, the added burdens of federal regulation were not recompensed by adequate, offsetting opportunities and advantages.

Analysis of the substance of the Deregulation Act has caused Southwest to change its views of CAB regulation. The prime attractions are the emphasis the Act places upon freedom of competition in the interstate airline industry and the provision of numerous relatively expeditious and inexpensive mechanisms for obtaining new routes. The Act also will afford Southwest the opportunity to introduce its intrastate fare structure on interstate routes and to effect fare increases and decreases within a specified range.

Some of the CAB's existing regulations are not particularly compatible with Southwest's operations, and, as of this moment, the issue of the degree and extent to which Southwest will be subjected to such regulations is pending before the CAB.

Our philosophy for Southwest Airlines was reaffirmed during 1978 in discussions with your Board of Directors and bears repeating here. Briefly, these are the strategies that have guided us and that will continue to guide us in the future:

- Concentrate on short-haul passenger business, with maximum flight times of around two hours per segment.
- Continue to standardize on the 737 aircraft as our primary aircraft.
- Continue high aircraft utilization (over ten hours daily) and quick turn-around times on the ground (ten minutes in most cases).



Howard D. Putnam

- Concentrate on passengers (no large pieces of air freight or mail) and emphasize small packages which have high profitability and low handling costs.
- Continue low fares and high frequency of service and utilize close-in airports whenever possible.
- Avoid food service which is expensive and unnecessary on short-haul flights.
- Avoid interlining (the interchange of passengers and cargo by agreement with other carriers through standardized ticketing, reservations, and baggage handling), which increases costs and could result in fare increases.
- Stay with Texas as our number one priority, only adding intrastate and interstate routes that fit our short-haul, high-volume format.
- Retain the personal warmth and concern for people basic in our service approach. This refers to both employees and passengers.
- Keep it simple, meaning cash register tickets, uncomplicated boarding procedures, simplified computer system, and so forth. Utilize only one major maintenance and crew facility at Dallas Love Field.

Turning to operations, our ten-minute turn-around time continued to be standard for most flights. It's interesting to note that if this ten minutes were expanded to twenty, it would cost us in 1979 the equivalent of two more 737's to fly the same number of flights. Obviously, we continue to concentrate on high productivity per aircraft and per employee, a formula which has been so successful for us in the past.

In mid-1979, we will increase our seating capacity with new, more comfortable, slimline seats which will add six seats per aircraft and still retain our popular lounges. This is a five percent seating increase and is equivalent to adding another 737 to our fleet, at a cost of less than one-fourth that of a new aircraft.

We are pleased that during the first two months of 1979 our revenue passenger miles increased 45% over the comparable 1978 period, while our load factor went from 61.33% to 65.95%. Although this demonstrates the significant growth potential of our present routes, we continue to study very carefully additional short-haul out-of-state possibilities affording us the same kind of passenger volume and return that we have experienced to date. Under the Deregulation Act of 1978, new opportunities for new routes will continue to present themselves and give us the potential for strong future growth on a planned and controlled basis.

In Texas our market continues to grow in population and in economic potential. The Dallas/Fort Worth area is the fourth fastest growing region in the nation, and Houston is growing

even faster. In San Antonio, Dallas, and Houston, we serve three of the ten largest and most rapidly expanding cities in the United States.

Businesses are migrating to Texas in large numbers. A recent survey of major U.S. cities ranked the Dallas/Fort Worth area as the number one choice of business executives nationwide for relocation. Houston ranked very high also. In banking, in trade facilities, and in economic activity generally, Texas ranks very near the top of the 50 states.

As a result of these and other factors, we believe that Texas will feel little, if any, effect from any economic slowdown during 1979 or beyond, should it occur. Certainly our experience during the 1974-1975 recessionary period would bear this out.

Any review of 1978 and any forward look would be incomplete without reference to the people of Southwest Airlines, both our employees and our passengers.

Our employees are the principal reason for our growth and success. Without their cooperation, enthusiasm, and productivity, the earnings growth which we've reported for this past year and earlier years could never have been achieved. With their continued loyalty and support, we look forward to a strong and secure future for our company. We expect to earn that loyalty by a continued deep concern for the welfare and growth potential of every single Southwest Airlines employee.

We also are fortunate to have as customers people who appreciate the simplicity and informality of our operation, as well as our low fares and frequent service. We enjoy our work, and we try hard to make flying not only convenient but fun for our passengers. As we continue to grow, that emphasis will never change.

Sincerely yours,

*Herbert D. Kelleher* *Howard D. Putnam*

Herbert D. Kelleher  
Chairman of the Board

Howard D. Putnam  
President and  
Chief Executive Officer

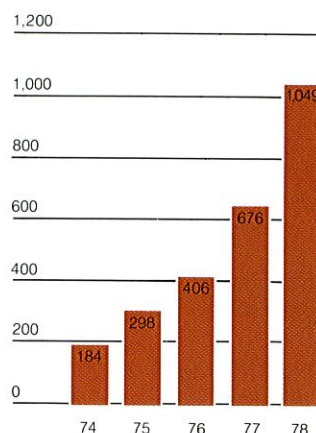
March 12, 1979

## Description of Business

Southwest Airlines Co. provides a single-class, commuter-type service principally between major cities in Texas. It operates scheduled air service, currently utilizing 14 owned Boeing 737-200 — 112 seat aircraft and one leased 727-200 — 155 seat aircraft, between Houston, Dallas, San Antonio, the Lower Rio Grande Valley (served through Harlingen Airport) and, since 1977, Austin, Corpus Christi, El Paso, Lubbock, and Midland/Odessa. In 1978 it extended service to Amarillo and, in January 1979, between Houston and New Orleans. Service between Dallas and Beaumont/Port Arthur/Orange began March 5, 1979. Southwest is the sole carrier offering service over its routes from the close-in airports of Dallas (Love Field) and Houston (Hobby).

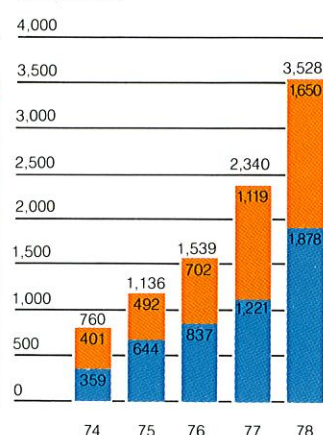
Prior to December 1978, Southwest operated as an intrastate airline subject to economic regulation only by the Texas Aeronautics Commission (TAC). In December 1978, as a result of its obtaining authority to extend service interstate to New Orleans, Southwest became subject to the jurisdiction of the Civil Aeronautics Board (CAB). The CAB has taken the position that such authority gives it plenary jurisdiction to regulate Southwest's entire system, thereby preempting any further economic regulation by the TAC. Under the Federal Aviation Act, as amended by the Airline Deregulation Act of 1978, the preexisting authority granted Southwest by the TAC to serve Texas routes (including Love Field and Hobby) is now part of its Federal authority, subject to any subsequent CAB action. Southwest believes that it is not required to file any application with the CAB for further authority to continue service inaugurated under TAC certificates. It has also applied to the CAB for total or partial exemption from CAB regulation, a matter now pending.

**Revenue Passenger Miles**  
(In Millions)



**Revenue Passengers Carried**

Executive Pleasure  
(In Thousands)



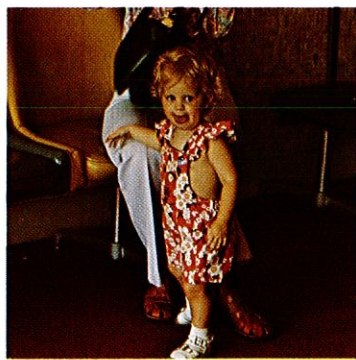
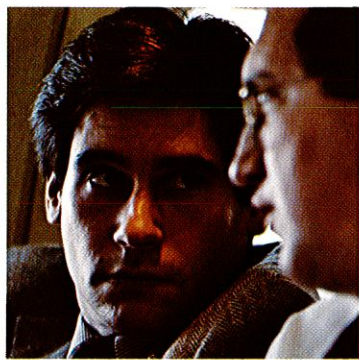
*Executive: Monday through Friday, 6:30 AM to 6:59 PM*

*Pleasure: All weekends and after 6:59 PM weekdays.*

Southwest's wholly owned and presently inoperative subsidiary, Midway (Southwest) Airway Co., holds a non-exclusive CAB certificate authorizing it to provide air service between Chicago's Midway Airport and Minneapolis/St. Paul, Detroit, Kansas City, St. Louis, Pittsburgh and Cleveland. In addition, this subsidiary is an active participant in the CAB's pending Chicago-Midway Expanded Service Proceeding, wherein numerous airlines are seeking the right to provide non-stop and one-stop service between Chicago's Midway Airport and 24 domestic cities, including Dallas and Houston. Provided that Midway (Southwest) Airway Co. receives Love Field authority, it is the present intention to institute Texas-Midway Airport service as soon after final certification as reasonably permitted by flight equipment delivery schedules.

Southwest does not carry the United States mail, interline passengers or engage in carrying air freight (other than smaller packages).

Southwest Airlines employs approximately 1,325 employees.



## Review of Operations

The successful and profitable operation of an airline requires an efficient combination of routes, aircraft and people.

Since 1977, expansions of Southwest Airlines' route system to Austin, Corpus Christi, El Paso, Midland/Odessa, Amarillo, and Lubbock, coupled with continuing growth on the Company's original routes, has yielded a significant increase in revenue passenger miles. This key airline performance indicator is one revenue-producing passenger carried one mile. Total revenue passenger miles increased from 675,668,000 in 1977 to 1,048,624,000 in 1978, an increase of 55.2%. The number of revenue passengers carried increased 50.8%, with Executive and Pleasure Class passengers growing 53.8% and 47.4%, respectively.

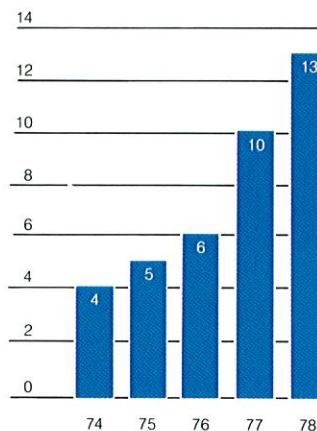
During 1978, the number of Boeing 737-200 aircraft serving Southwest's customers increased from 10 to 13. The net effect of 1978 aircraft additions and exchanges is an average age of only 18 months, which is one of the youngest jet aircraft fleets in the airline industry.

The combined impact of expanded routes and schedules and the larger aircraft fleet yielded a 53.9% increase in available seat miles flown from the 1977 level of 1,011,048,000 to 1,556,173,000 in 1978.

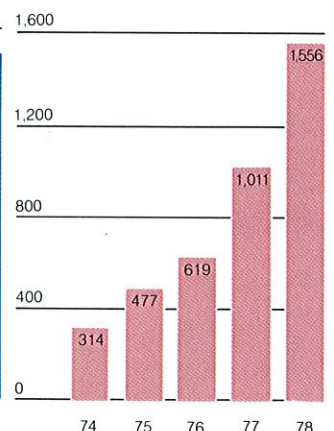
Even more important than the fleet increase is Southwest Airlines' continuing industry leadership in the efficient utilization of its fleet. The daily average hours of aircraft utilization increased 3.5% from 10:14 in 1977 to 10:36 in 1978, an all-time Company peak. Additionally, this improved usage of capacity represented the seventh consecutive year of uninterrupted increases in aircraft utilization. This utilization is accomplished even though the average segment flight time is only 42 minutes.

Another indicator of operating efficiency and asset utilization in which Southwest continues to be an industry leader is load factor, which represents the percentage relationship between available passenger miles and revenue passenger miles. A slight increase to 67.4% in 1978 from the previously high level of 1977 was experienced.

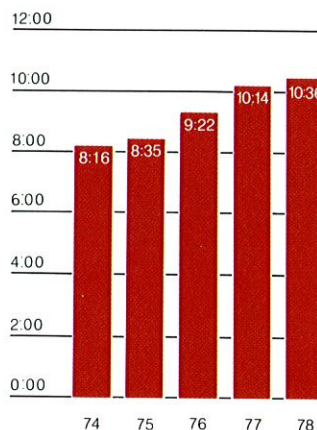
**Fleet Size**  
(Boeing 737-200's)



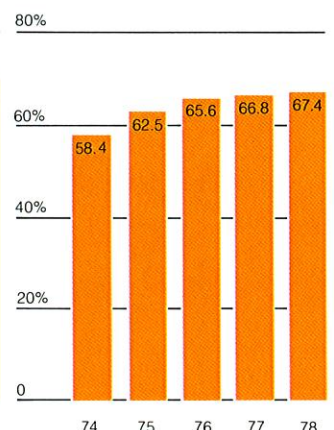
**Available Seat Miles**  
(In Millions)

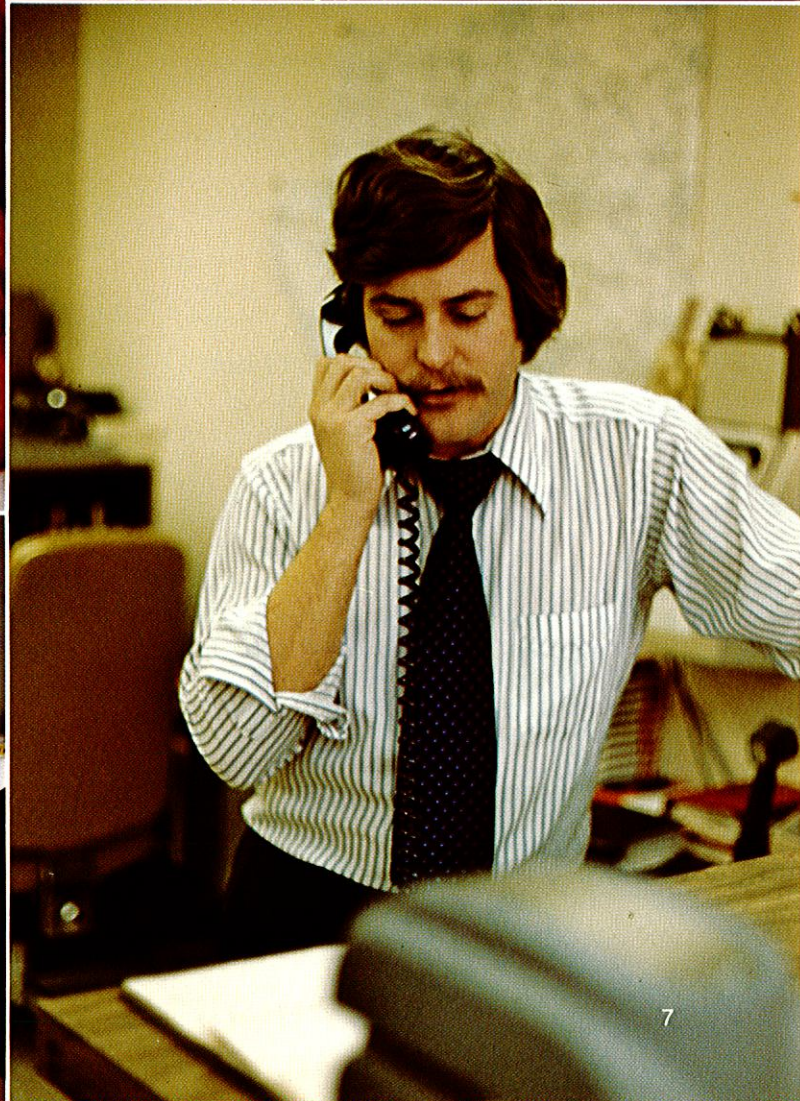


**Aircraft Utilization**  
Hours and Minutes per Day



**Passenger Load Factor**





## Five Year Summary of Operations and Financial Results

	Years ended December 31,				
	1978	1977	1976	1975	1974
<b>TRAFFIC</b>					
Passengers carried .....	3,528,105	2,339,524	1,539,113	1,136,318	759,721
Passenger miles flown (000) .....	1,048,624	675,668	406,269	298,458	183,596
Passenger load factor .....	67.4%	66.8%	65.7%	62.5%	58.4%
Average passenger fare .....	\$ 21.99	\$ 20.07	\$ 19.18	\$ 19.07	\$ 18.50
Yield per passenger mile .....	7.40 ¢	6.95 ¢	7.26 ¢	7.26 ¢	7.66 ¢
Operating revenues per trip flown ..	\$ 1,479	\$ 1,385	\$ 1,386	\$ 1,300	\$ 1,196
<b>OPERATIONS</b>					
Trips flown .....	54,816	35,415	22,311	17,552	12,382
Revenue plane miles .....	13,894,400	9,027,213	5,524,395	4,309,478	2,957,255
Available seat miles (000) .....	1,556,173	1,011,048	618,732	477,166	314,407
Operating expenses per trip flown ..	\$ 1,094	\$ 1,095	\$ 1,041	\$ 1,018	\$ 917
<b>FINANCIAL (000)</b>					
Operating revenues:					
Passenger .....	\$78,537	\$47,645	\$29,998	\$22,031	\$14,313
Package express .....	2,364	1,318	865	757	478
Other .....	164	84	57	29	22
Total operating revenues .....	81,065	49,047	30,920	22,817	14,813
Operating expenses:					
Flight operations, excluding					
fuel .....	7,049	4,255	2,590	1,888	974
Fuel and oil .....	16,509	10,152	5,302	4,007	2,054
Maintenance .....	5,711	4,834	3,147	2,385	1,712
Passenger services .....	3,723	2,233	1,404	1,052	736
Terminal operations .....	9,220	6,048	3,250	2,250	1,356
Promotion and sales .....	3,719	2,588	1,594	1,328	1,142
Insurance, taxes and					
administrative .....	5,223	3,834	2,693	2,394	1,636
Depreciation and amortization ..	6,436	3,880	2,352	2,111	1,569
Employee profit sharing .....	2,353	961	904	445	175
Total operating expenses .....	59,943	38,785	23,236	17,860	11,354
Operating income .....	21,122	10,262	7,684	4,957	3,459
Non-Operating income (expense):					
Interest and other income .....	194	66	46	10	41
Gain on disposition of aircraft ...	8,521	—	—	—	—
Interest expense .....	(5,881)	(2,783)	(1,220)	(1,296)	(1,360)
	2,834	(2,717)	(1,174)	(1,286)	(1,319)
Income before federal income tax ..	23,956	7,545	6,510	3,671	2,140
Provision for federal income tax ...	7,687	—	1,571	1,507	1,095
Income before extraordinary items					
and accounting change .....	16,269	7,545	4,939	2,164	1,045
Extraordinary items .....	—	—	—	1,236	1,095
Net cumulative effect of accounting					
change .....	735	—	—	—	—
Net income .....	\$17,004	\$ 7,545	\$ 4,939	\$ 3,400	\$ 2,140

*Certain items previously reported have been reclassified to conform to the presentation at December 31, 1978.*

## Five Year Summary of Operations and Financial Results

	Years ended December 31,				
	1978	1977	1976	1975	1974
PER SHARE DATA					
Income per common and common equivalent share:					
Before 1979 stock split (1974-1977 adjusted for 1977 and 1978 stock splits):					
Weighted average common and common equivalent shares outstanding .....	<u>3,000,000</u>	<u>2,991,230</u>	<u>2,354,016</u>	<u>2,006,499</u>	<u>2,075,157</u>
Before extraordinary items and net cumulative effect of accounting change .....	<u>\$ 5.42</u>	<u>\$ 2.52</u>	<u>\$ 2.10</u>	<u>\$ 1.08</u>	<u>\$ .50</u>
Net income .....	<u>\$ 5.67</u>	<u>\$ 2.52</u>	<u>\$ 2.10</u>	<u>\$ 1.69</u>	<u>\$ 1.03</u>
After 1979 stock split:					
Weighted average common and common equivalent shares outstanding .....	<u>4,500,000</u>	<u>4,486,845</u>	<u>3,531,024</u>	<u>3,009,749</u>	<u>3,112,736</u>
Before extraordinary items and net cumulative effect of accounting change .....	<u>\$ 3.62</u>	<u>\$ 1.68</u>	<u>\$ 1.40</u>	<u>\$ .72</u>	<u>\$ .36</u>
Net income .....	<u>\$ 3.78</u>	<u>\$ 1.68</u>	<u>\$ 1.40</u>	<u>\$ 1.13</u>	<u>\$ .69</u>
Pro forma amounts assuming the accounting change had been applied retroactively:					
Net income (000) .....	<u>\$16,269</u>	<u>\$7,697</u>	<u>\$4,628</u>	<u>\$2,944</u>	<u>\$2,426</u>
Per share:					
Before 1979 stock split .....	<u>\$ 5.42</u>	<u>\$ 2.57</u>	<u>\$ 1.97</u>	<u>\$ 1.47</u>	<u>\$ 1.17</u>
After 1979 stock split .....	<u>\$ 3.62</u>	<u>\$ 1.72</u>	<u>\$ 1.31</u>	<u>\$ .98</u>	<u>\$ .78</u>

## Review of Financial Results

Southwest Airlines' financial strength and liquidity markedly increased from 1977 to 1978. Record revenues, profits, and cash flow are reflected in significant increases in flight and ground equipment, cash dividends, and stockholders' equity.

### Revenues and Cash Flow

Sales in 1978 increased 65.3% to \$81,065,000 from \$49,047,000 in 1977. Total cash flow from operations was \$30,556,000 in 1978, up 156.8% from \$11,898,000 in 1977. An additional \$15,000,000 of long-term debt was issued in 1978, thereby increasing total funds available to \$45,556,000.

These substantial increases in revenues and cash flow are the result of Southwest's continuing emphasis on planned and controlled growth within the guidelines and objectives outlined in the letter to stockholders, coupled with high levels of asset utilization. This continuing emphasis on generating higher cash flow levels will support the Company's projected growth in sales, earnings, and dividends, while continuing to improve the Company's long-term liquidity.

Another factor contributing to the increase in passenger revenue is the six month effect of the first overall fare increase since 1973. This increase of approximately 11.5%, which became effective in July 1978, represents less than one-fourth of the cumulative increases instituted by CAB carriers during the decade of the 70's.

### Balance Sheet

Southwest's balance sheet at December 31, 1978 includes total assets of \$118,706,000, an increase of 52.3% from the prior year. Stockholders' equity at December 31, 1978 was \$42,889,000, a 61.2% increase over the \$26,606,000 at the beginning of the year. Book value per common share increased similarly to \$9.53 a share at December 31, 1978, from \$5.91 at the beginning of the year.

Working capital at December 31, 1978 totaled \$9,667,000, a 91.4% increase for the year. The ratio of current assets to current liabilities improved to 3.39 to 1 compared with 2.82 to 1 at December 31, 1977.

Overall balance sheet liquidity also improved in 1978 as reflected by the long-term debt to total capitalization ratio which decreased from 1.77 to 1 at the end of 1977 to 1.45 to 1 at December 31, 1978.

### Capital Expenditures

During 1978, total capital expenditures amounted to \$40,204,000 compared to \$41,442,000 in 1977. The major factor in 1978 is the net addition of three aircraft, plus deposits and progress payments on future aircraft deliveries. The remaining capital expenditures were concentrated on ground support equipment related to route and schedule expansions.

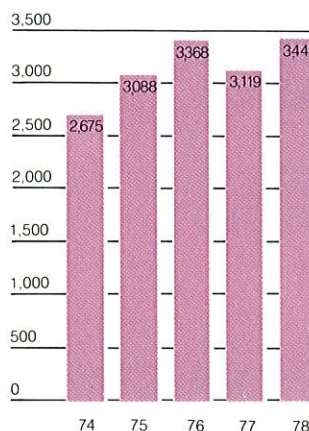
Southwest currently anticipates that capital expenditures for 1979 will be approximately \$51,000,000, which includes the purchase of five Boeing 737-200 aircraft.

### Cost Structure and Productivity

During 1978, operating revenues increased 65.3% while operating expenses increased only 54.6%. This

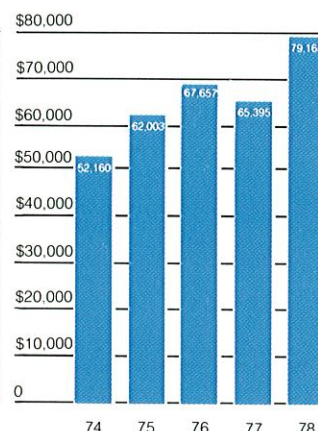
#### Passengers Boarded per Employee

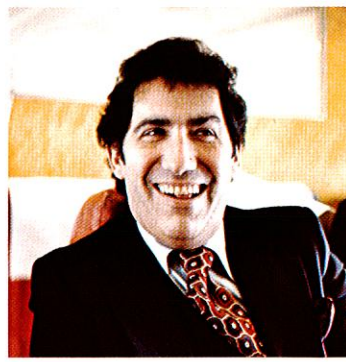
(Based on average month-end staffing)



#### Operating Revenues per Employee

(Based on average month-end staffing)





performance reflects the Company's emphasis on not only asset utilization, as outlined in the Review of Operations, but also employee productivity.

Passengers boarded per employee, a key productivity indicator, improved in 1978 by 10.5% to 3,445. This increase more than offsets the slight decline experienced in 1977 due to the significant personnel increases required prior to and during system expansion. Over the last five years, passengers boarded per employee has improved by 28.8%.

Operating revenues per employee have shown similar improvements, reaching \$79,165 per employee for the year 1978.

The combined effects of asset utilization and employee productivity on Southwest's unit cost per passenger carried are outlined below:

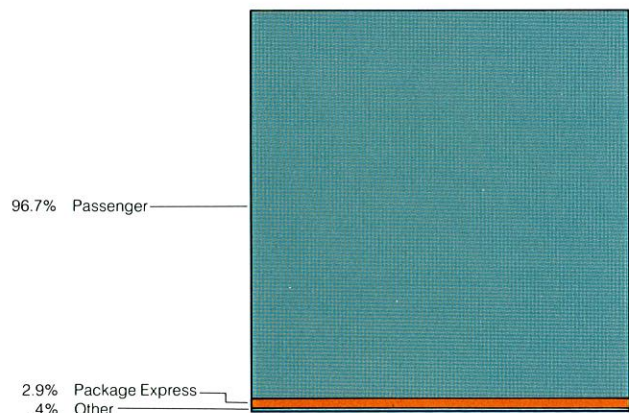
Category of Costs	Unit Cost Per Passenger Carried	
	1978	1977
Payroll and related .....	\$ 5.60	\$ 5.24
Aircraft fuel and oil .....	4.68	4.34
Landing fees .....	.64	.63
Aircraft costs .....	4.45	4.03
All other .....	3.29	3.53
Total costs .....	\$18.66	\$17.77

The unit cost increase outlined above is approximately 5%. Stringent cost controls and the emphasis placed on productivity are responsible for the containment of costs below the rate of inflation.

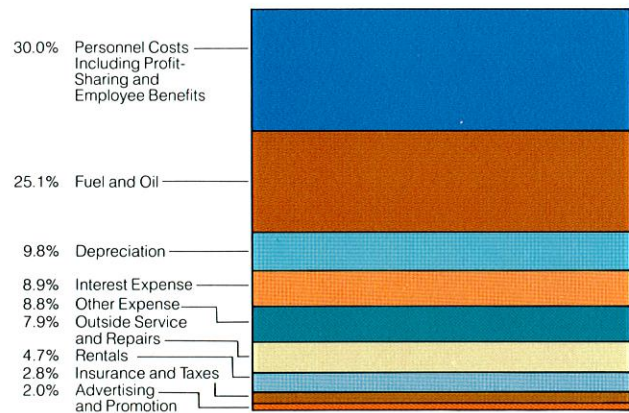
#### Income Taxes

Total federal income taxes provided for 1978 were \$7,687,000, yielding an effective tax rate of 32%, compared to the statutory income tax rate of 48%. The difference between the actual and statutory rates is primarily the result of \$3,775,000 of investment tax credit. During 1977, no federal income taxes were paid as available investment tax credits exceeded the tax liability.

#### Source of Revenues - 1978



#### Distribution of Expenses - 1978



Deferred income taxes at December 31, 1978 were \$9,411,000 arising from the timing differences between financial and taxable income. These differences are principally due to the use of accelerated depreciation methods for tax reporting and no recognition of gain on disposition of aircraft for federal income tax reporting.

## Net Income

Total net income increased 125.4% in 1978 to \$17,004,000. Increases in interest expense and federal income taxes were partially offset by gain realized on the disposition of aircraft.

Operating income for 1978 was \$21,122,000, a 105.8% increase compared to 1977.

Operating margin for 1978 was 26.1% of total revenues, an all-time high. The 1978 increase in margin offset the decline in 1977 brought about by increased operating expenses during system expansion. Net profit margins, (after tax and non-operating items, which include the gain on disposition of aircraft) reflected an even stronger increase over 1977, reaching 21.0% of total revenues.

### Net Profit Margin

(Net Income as a Percentage of Operating Revenues)

30%

20%

10%

0

74

75

76

77

78

14.5

14.9

16.0

15.4

21.0

### Net Operating Margin

(Operating Income as a Percentage of Operating Revenues)

30%

20%

10%

0

74

75

76

77

78

23.4

21.7

24.8

20.9

26.1

## Profit Sharing Contributions

The Company's Employee Profit Sharing Plan contributions, as defined by the contribution formula in the Plan, are structured to provide an incentive for continuing improvements in Company productivity and profitability. For 1978, total contributions to the Plan were \$2,353,000, an increase of 144.9% from 1977.

## Quarterly Earnings Statements

Unaudited quarterly financial results are outlined in footnote 8 to the audited financial statements.

## Common Stock Price Ranges, Dividends, and Stock-Splits

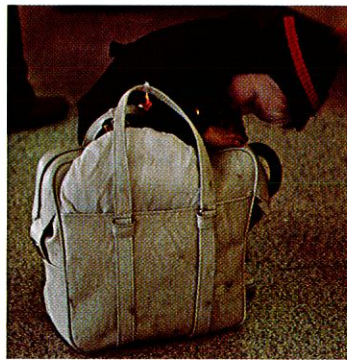
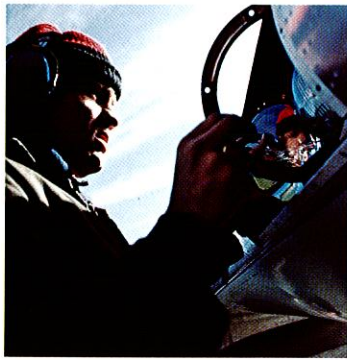
During 1977 and 1978 the Common Stock of the Company was listed for trading on the New York Stock Exchange (commencing June 27, 1977). On February 22, 1978 the Company's Common Stock was delisted from trading on the AMEX, at the request of the Company, because of extremely low trading volume on the AMEX once trading in the Company's Common Stock commenced on the New York Stock Exchange. The Company's Common Stock continues to trade on the New York Stock Exchange under the symbol "LUV". The reported high and low sale prices and the quarterly cash dividends paid on each share of Common Stock (adjusted for a 5-for-4 stock split distributed March 16, 1977, a 3-for-2 stock split distributed March 24, 1978, and a 3-for-2 stock split distributed February 23, 1979) for each quarterly period during the last two years were as follows:

	Dividends Paid per share*	Market Price of Common Shares*	
		High	Low
1977			
First	.0222	\$10.49	\$ 7.96
Second	.0311	11.33	8.33
Third	.0311	11.39	9.72
Fourth	.0311	10.78	8.72
1978			
First	\$.0311	\$12.58	\$10.44
Second	.0467	15.50	10.42
Third	.0467	20.33	13.67
Fourth	.0467	17.92	12.58

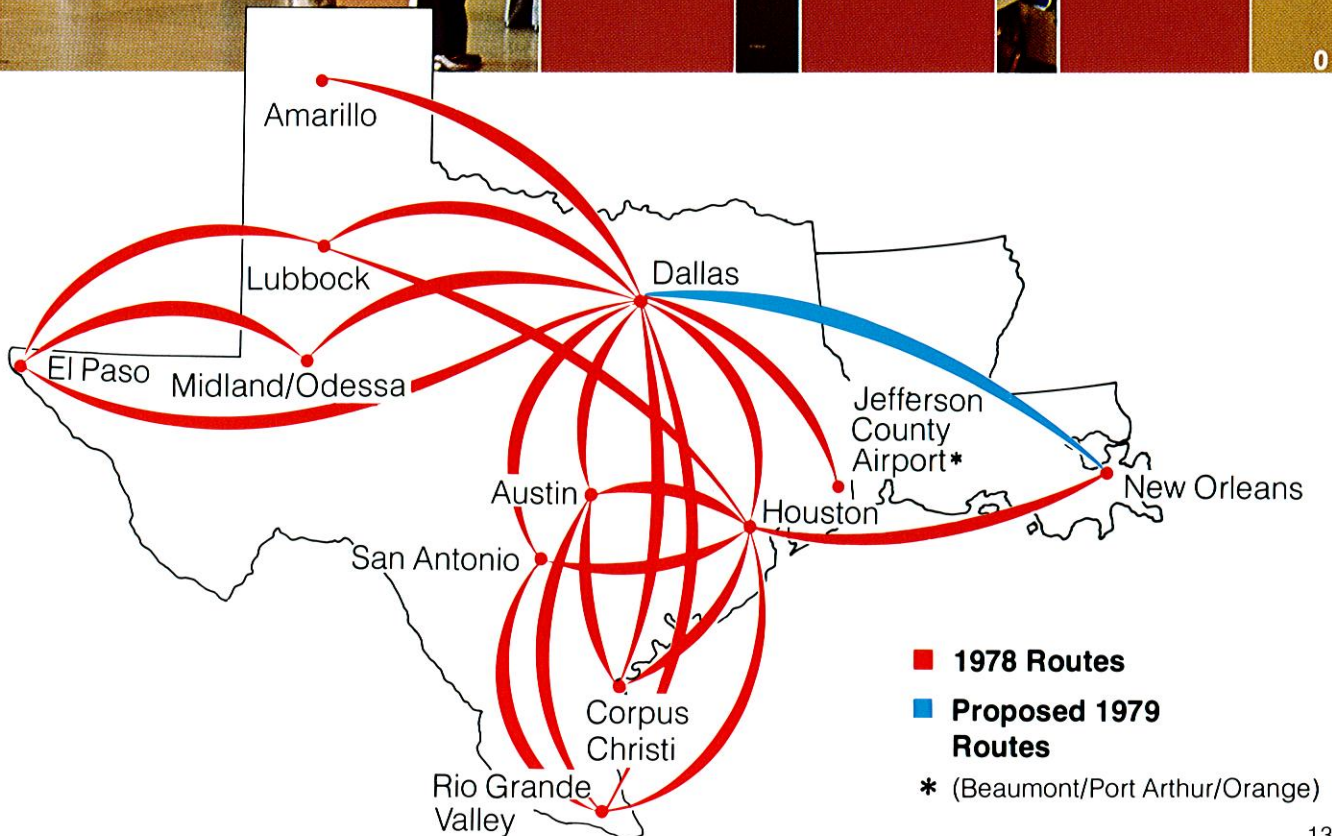
\*Adjusted for stock splits

During the first two months of 1979, the high and low sale prices of a share of the Company's Common Stock, as reported on the New York Stock Exchange, and as adjusted for the 3-for-2 stock split distributed February 23, 1979 were \$18.92 and \$13.50 respectively.

Also during the first quarter of 1979 the Company paid a cash dividend of \$.07 per share on the post-split shares of Common Stock now outstanding, representing a 50% increase in the quarterly cash dividend rate.



**Company Growth - (Percentage Increase 1973-1978 Over 1973 Base Year)**



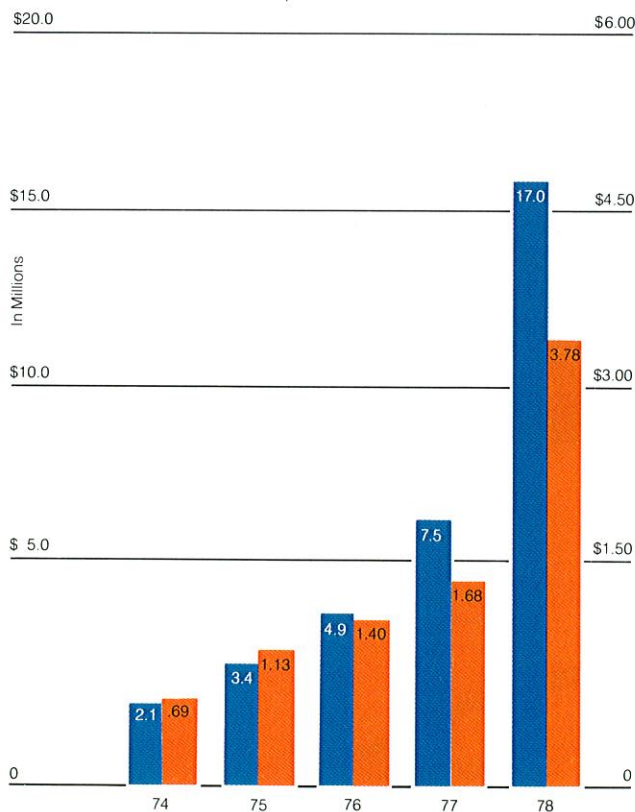
## Management's Discussion and Analysis of the Summary of Operations

Following is management's discussion and analysis of the consolidated statement of income as required under Rule 14a-3 of the Securities and Exchange Commission.

### Net Income

### Net Income Per Share (Split)\*

\*All per share net income figures have been restated to reflect a 3 for 2 stock split in 1979.



Passenger revenues increased, as compared to the prior corresponding period, 59% in 1977 and 65% in 1978, due primarily to increases in passengers carried of 52% in 1977 and 51% in 1978 and a general fare increase of approximately 11.5% implemented on July 1, 1978. The increases in passengers carried were at-

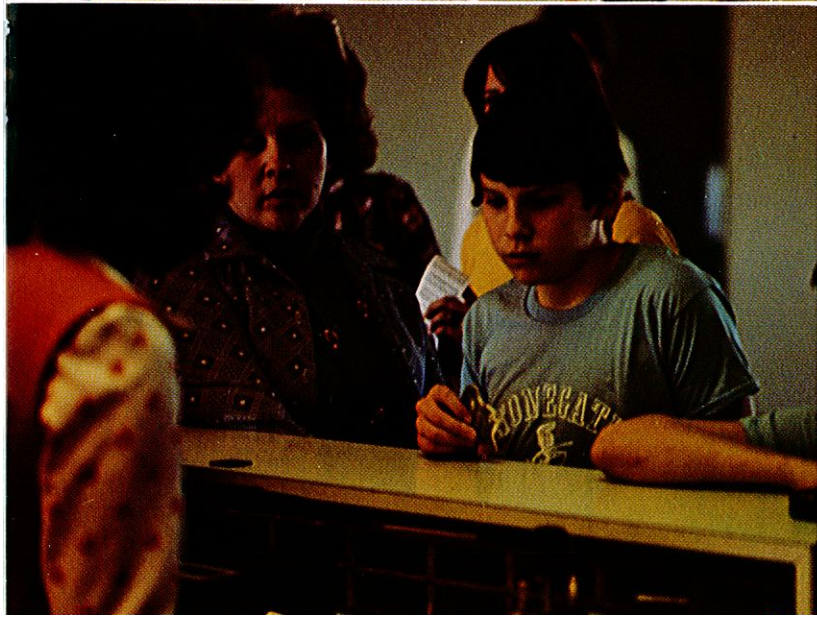
tributable to increases in available seat miles of 63% in 1977 and 54% in 1978 due to the addition of four Boeing 737-200 aircraft in 1977 and three in 1978. These additional aircraft were used to expand service on our existing routes and to service the new routes to Austin, Corpus Christi, El Paso, Lubbock and Midland/Odessa which were added in 1977 and Amarillo which was added in December 1978. Also contributing to increased operating revenues were increases in package express revenue of 52% in 1977 and 79% in 1978.

Operating expenses increased by 67% from 1976 to 1977 and 55% from 1977 to 1978. The primary factor contributing to increased expenses is the number of trips flown which increased by 59% from 1976 to 1977 and 55% from 1977 to 1978. The operating expenses per trip flown increased by 5% in 1977 due primarily to a 19% increase in price per gallon of jet fuel while the operating expenses per trip in 1978 decreased slightly, as a direct result of maintaining high productivity levels of employees and aircraft.

Non-operating income of approximately \$8,500,000 was generated in 1978 from the disposition of aircraft. Interest expense increased due to the addition of \$27,000,000 of long-term debt in 1977 and \$15,000,000 in 1978 plus an increase in the prime interest rate.

Federal income taxes were not incurred in 1977 due to the fact that sufficient investment tax credits were available from current year 1977 additions and prior year carryforwards. However, in 1978 the small investment credit carryforward remaining from 1977 was utilized by the net cumulative effect of the accounting change. Therefore, the taxes, generated from operating income and the gain on disposition of aircraft, totaling approximately \$11,462,000 were offset only by investment tax credits generated in the current year of 1978 in the approximate amount of \$3,775,000.

As a result of the factors mentioned above, in addition to the cumulative effect of an accounting change in 1978 as described in Note 9 to the consolidated financial statements, final net income increased by 53% from 1976 to 1977 and by 125% from 1977 to 1978.



# Southwest Airlines Co. Consolidated Balance Sheet

	December 31,	
	1978	1977
<b>Assets</b>		
<b>CURRENT ASSETS:</b>		
Cash, including certificates of deposit of \$2,214,741 in 1978 (Note 3) .....	\$ 8,665,173	\$ 4,847,418
Accounts receivable .....	3,986,757	2,258,856
Inventories of parts and supplies, at cost .....	586,096	484,992
Prepaid expenses .....	473,130	238,532
<b>TOTAL CURRENT ASSETS</b> .....	<b>13,711,156</b>	<b>7,829,798</b>
<b>Flight and ground equipment:</b>		
Flight equipment—aircraft (Note 3) .....	94,015,391	57,641,921
Other flight and ground equipment (Note 2) .....	22,402,960	24,306,382
	<b>116,418,351</b>	<b>81,948,303</b>
Less allowance for depreciation (including maintenance reserve of \$1,122,971 in 1977) (Note 9) .....	11,674,073	12,095,154
	<b>104,744,278</b>	<b>69,853,149</b>
Deferred charges and other assets .....	250,590	284,230
	<b>\$118,706,024</b>	<b>\$77,967,177</b>
<b>Liabilities and Stockholders Equity</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable .....	\$ 2,419,734	\$ 1,422,882
Accrued liabilities .....	1,624,082	1,355,196
<b>TOTAL CURRENT LIABILITIES</b> .....	<b>4,043,816</b>	<b>2,778,078</b>
Long-term debt (Note 3) .....	62,000,000	47,000,000
Deferred federal income tax (Note 7) .....	9,410,587	1,297,000
Deferred compensation (Note 5) .....	362,752	285,751
<b>Total liabilities</b> .....	<b>75,817,155</b>	<b>51,360,829</b>
Commitments and contingencies (Notes 2 and 10)		
<b>STOCKHOLDERS' EQUITY (Notes 3 and 4):</b>		
Common stock, \$1.00 par value; 5,000,000 shares authorized; 3,000,000 shares issued and outstanding in 1978 (2,000,000 in 1977) .....	3,000,000	2,000,000
Capital in excess of par value .....	11,414,943	12,366,698
Retained earnings .....	28,473,926	12,239,650
<b>Total Stockholders' Equity</b> .....	<b>42,888,869</b>	<b>26,606,348</b>
	<b>\$118,706,024</b>	<b>\$77,967,177</b>
See accompanying notes.		

# Southwest Airlines Co.

## Consolidated Statement of Income

	Years Ended December 31,	
	1978	1977
OPERATING REVENUES:		
Passenger .....	\$78,537,035	\$47,645,159
Package express .....	2,363,764	1,318,146
Other .....	163,793	83,267
Total operating revenues .....	81,064,592	49,046,572
OPERATING EXPENSES:		
Flight operations excluding fuel .....	7,049,433	4,255,254
Fuel and oil .....	16,509,257	10,152,168
Maintenance .....	5,710,702	4,833,593
Passenger services .....	3,722,580	2,232,528
Terminal operations .....	9,220,463	6,047,950
Promotion and sales .....	3,718,475	2,587,884
Insurance, taxes, and administrative .....	5,223,211	3,834,170
Depreciation .....	6,435,771	3,880,304
Employee profit sharing expense (Note 6) .....	2,353,100	960,818
Total operating expenses .....	59,942,992	38,784,669
OPERATING INCOME .....	21,121,600	10,261,903
NON-OPERATING INCOME (expense):		
Interest and other income .....	194,149	66,242
Gain on disposition of aircraft .....	8,521,508	—
Interest expense (Note 3) .....	(5,881,403)	(2,783,512)
	2,834,254	(2,717,270)
Income before federal income tax .....	23,955,854	7,544,633
Provision for federal income tax (Note 7) .....	7,686,968	—
Income before accounting change .....	16,268,886	7,544,633
Net cumulative effect of accounting change (Note 9) .....	735,390	—
NET INCOME .....	\$17,004,276	\$ 7,544,633

See accompanying notes.

# Southwest Airlines Co.

## Consolidated Statement of Income

	Years Ended December 31,	
	1978	1977
INCOME PER COMMON AND COMMON EQUIVALENT SHARE (Note 4):		
Before 1979 stock split:		
Weighted average common and common equivalent shares outstanding (1977 adjusted for 1978 stock split) .....	3,000,000	2,991,230
Net income before accounting change .....	\$ 5.42	\$ 2.52
Net effect of accounting change .....	.25	—
Net income .....	<u>\$ 5.67</u>	<u>\$ 2.52</u>
After 1979 stock split:		
Weighted average common and common equivalent shares outstanding .....	4,500,000	4,486,845
Net income before accounting change .....	\$ 3.62	\$ 1.68
Net effect of accounting change .....	.16	—
Net income .....	<u>\$ 3.78</u>	<u>\$ 1.68</u>
PRO FORMA AMOUNTS ASSUMING THE ACCOUNTING CHANGE HAD BEEN APPLIED RETROACTIVELY (Note 9):		
Net income .....	<u>\$16,268,886</u>	<u>\$7,696,861</u>
Per share:		
Before 1979 stock split .....	\$ 5.42	\$ 2.57
After 1979 stock split .....	<u>\$ 3.62</u>	<u>\$ 1.72</u>

See accompanying notes.

# Southwest Airlines Co.

## Consolidated Statement of Stockholders' Equity

	Years ended December 31, 1978 and 1977				
	Common stock	Capital in excess of par value	Retained earnings	Treasury stock	Total
BALANCE AT DECEMBER 31, 1976 .....	\$1,590,000	\$12,568,432	\$ 5,212,996	\$ (25,950)	\$19,345,478
Issuance of 10,000 shares of common stock upon exercise of warrants .....	10,000	30,000			40,000
Purchase of 20,000 shares of treasury stock .....				(433,731)	(433,731)
Contribution of 26,000 shares of treasury stock to profit- sharing trust .....		168,818		459,681	628,499
Five-for-four stock split .....	400,000	(400,552)			(552)
Cash dividends, \$.1156 per share .....			(517,979)		(517,979)
Net income— 1977 .....			7,544,633		7,544,633
BALANCE AT DECEMBER 31, 1977 .....	2,000,000	12,366,698	12,239,650	—	26,606,348
Three-for-two stock split .....	1,000,000	(999,824)			176
Cash dividends, \$.1711 per share .....			(770,000)		(770,000)
Grant of executive options (Note 5) .....		48,069			48,069
Net income— 1978 .....			17,004,276		17,004,276
BALANCE AT DECEMBER 31, 1978 .....	<u>\$3,000,000</u>	<u>\$11,414,943</u>	<u>\$28,473,926</u>	<u>\$ —</u>	<u>\$42,888,869</u>

See accompanying notes.

# Southwest Airlines Co.

## Consolidated Statement of Changes in Financial Position

	Years Ended December 31,	
	1978	1977
FINANCIAL RESOURCES WERE PROVIDED BY:		
Working capital provided from operations:		
Income before cumulative effect of accounting change .....	\$16,268,886	\$ 7,544,633
Items not affecting working capital during the period:		
Depreciation and reserve for maintenance .....	6,435,771	4,288,171
Deferred compensation and grant of executive options .....	125,070	65,424
Deferred federal income tax .....	7,726,006	—
Total from operations .....	30,555,733	11,898,228
Proceeds from exercise of warrants .....	—	40,000
Issuance of long-term debt .....	15,000,000	27,000,000
Contribution of treasury stock to profit-sharing trust (Note 6) .....	—	628,499
Total source of funds .....	45,555,733	39,566,727
FINANCIAL RESOURCES WERE UTILIZED FOR:		
Net additions to flight and ground equipment .....	40,203,929	41,442,436
Cash dividends .....	770,000	517,979
Purchase of treasury stock .....	—	433,731
Other .....	(33,816)	146,680
Total application of funds .....	40,940,113	42,540,826
INCREASE (DECREASE) IN WORKING CAPITAL .....	\$ 4,615,620	\$ (2,974,099)
CHANGES IN COMPONENTS OF WORKING CAPITAL:		
Increase (decrease) in current assets:		
Cash and certificates of deposit .....	\$ 3,817,755	\$ (4,065,160)
Accounts receivable .....	1,727,901	755,990
Inventories .....	101,104	181,716
Prepaid expenses .....	234,598	91,586
	5,881,358	(3,035,868)
Increase (decrease) in current liabilities:		
Accounts payable .....	996,852	165,659
Federal income taxes .....	—	(545,000)
Accrued liabilities .....	268,886	317,572
	1,265,738	(61,769)
INCREASE (DECREASE) IN WORKING CAPITAL .....	\$ 4,615,620	\$ (2,974,099)

See accompanying notes.

# Southwest Airlines Co.

## Notes to Consolidated Financial Statements



December 31, 1978 and 1977

### 1. Basis of presentation and summary of significant accounting policies

#### Basis of presentation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Midway (Southwest) Airway Co. All significant intercompany balances and transactions have been eliminated in consolidation.

Reclassification of amounts previously reported in the financial statements at December 31, 1977 have been made to conform to the presentation at December 31, 1978.

#### Depreciation and overhaul allowances

Depreciation is computed by the straight-line method over the estimated useful lives of the various classes of depreciable assets after allowing for residual values. The estimated useful lives are 12 to 15 years for the Boeing 737-200 aircraft, related spare engines and support flight equipment, and 3 to 10 years for ground equipment and other. Upon sale or retirement of equipment, the cost and related accumulated depreciation are removed from the accounts and the resulting gain or loss is included in income for the period, with the exception of equipment depreciated on a group basis. When such equipment is sold or retired, the cost and an equal amount of accumulated depreciation are eliminated from the accounts and no gain or loss is recognized.

The Company uses the direct expense method of accounting for major aircraft maintenance and overhaul costs whereby all expenditures for major aircraft maintenance and overhaul are expensed as incurred. In prior years, the Company provided an airworthiness reserve for such costs (see Note 9).

#### Per share amounts

Income per share computations are based upon the weighted average number of shares outstanding dur-

ing the respective periods as adjusted for outstanding warrants which were considered as common stock equivalents in periods where their inclusion had a material effect.

### 2. Flight and ground equipment

The Company's investment in flight and ground equipment other than aircraft is summarized as follows:

	1978	1977
Progress payments on additional aircraft . . . . .	\$ 6,768,557	\$10,825,532
Support flight equipment . . . . .	7,568,631	7,051,294
Ground equipment . . . . .	4,434,446	3,527,791
Leasehold improvements . . . . .	3,255,880	1,303,333
Construction in progress . . . . .	375,446	1,598,432
	<u>\$22,402,960</u>	<u>\$24,306,382</u>

At December 31, 1978 the Company had contractual commitments of approximately \$71,650,000 for the purchase of eight Boeing 737-200 aircraft to be delivered in 1979 and 1980 (see Note 3).

### 3. Long-term debt

Under the terms of a loan agreement with various banks dated June 22, 1978, as amended December 28, 1978, the Company may borrow up to \$72,000,000 through December 31, 1979. Pursuant to this agreement the Company had borrowed \$62,000,000 through December 31, 1978. The borrowings bear interest, payable quarterly, at 1½% over the lender's prime rate; however, interest on one-half of total borrowings is limited to a maximum of 9¾%. The principal is to be repaid in twenty-eight quarterly installments from March 31, 1980 through December 31, 1986; and if the full \$72,000,000 is borrowed, such quarterly installments will be in the following amounts: during 1980, \$1,750,000; during 1981, \$2,250,000; during 1982, \$2,500,000; during 1983 and 1984, \$2,750,000; and during 1985 and 1986, \$3,000,000. The borrowings are secured by the Company's aircraft including the aircraft to be delivered in 1979 and 1980 (see Note 2).

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The loan agreement provides, among other things, for the maintenance of certain minimum net worth levels and working capital ratios and for certain restrictions as to additional borrowings, capital expenditures, and cash dividend payments. At December 31, 1978 the Company had retained earnings in the amount of \$3,400,855 available for payment of cash dividends.

The Company and the various banks have an informal understanding that the Company will endeavor to maintain average cash balances approximating 6% of the unpaid balance existing from time to time under the loan agreement. It is understood between the parties that no such funds are restricted from withdrawal by the Company at any time.

#### **4. Stockholders' equity**

A three-for-two common stock split was effected on March 24, 1978 to shareholders of record as of February 28, 1978. The stock split resulted in the issuance of an additional 1,000,000 shares of the Company's common stock.

On January 23, 1979 the Company's Board of Directors authorized a three-for-two common stock split to be distributed on February 23, 1979 to shareholders of record as of February 9, 1979. The stock split will result in the issuance of an additional 1,500,000 shares of the Company's common stock. An amount equal to the par value of additional shares issued will be transferred from capital in excess of par value to the common stock account and the effect of fractional shares will be reflected in the capital in excess of par value account. Per share information has been restated to reflect the common stock splits.

#### **5. Deferred compensation and stock options**

A deferred compensation agreement with a former officer obligates the Company to accrue for his benefit deferred compensation of \$250,000 over the five-year term ending September 30, 1979, or five percent of the net pretax earnings of the Company (as defined by the agreement) whichever is lower, for the period October 1, 1974 through September 30, 1979. During 1978, \$50,000 was accrued and charged to operations in connection with this agreement. Total deferred com-

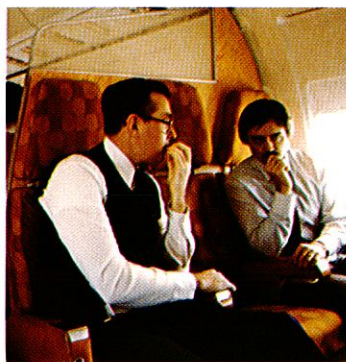
pensation, including amounts pursuant to a prior agreement, will be paid at a rate not to exceed \$50,000 per year, commencing in the year following termination. Until such time as this deferred compensation is paid, the Company is accruing interest at the rate of 7% compounded annually on the unpaid balance beginning October 1, 1974 on the prior agreement and October 1, 1975 on the current agreement. During 1978 the Company accrued approximately \$20,000 of interest pursuant to the agreements.

Under the terms of an employment agreement dated August 21, 1978 with the President of the Company, the Company has granted options to purchase 15,000 shares of its common stock for \$1.00 per share. At December 31, 1978, 5,000 of these options were exercisable. The remaining options become exercisable in 5,000 share increments on August 21, 1980 and 1981, respectively. During 1978, \$48,069 was accrued and charged to operations in connection with the option arrangement.

#### **6. Employee profit-sharing and cash bonus plans**

The Company is accruing costs under a non-contributory profit-sharing plan established January 1, 1973, as amended. All regular employees are eligible to become members as of January 1 following their date of employment. The plan provides that the Company may contribute, as determined by the Board of Directors, up to 15 percent of its adjusted pretax income (as defined by the plan) in excess of \$2,100,000 for the year except that the Company's contribution in any year shall not exceed the maximum amount deductible for federal income tax purposes.

The plan as amended permits the Company to pay currently a portion of each eligible employee's profit-sharing amount in the form of a cash bonus. The remaining profit-sharing amount is contributed to the employees' profit-sharing trust to be invested in the common stock of the Company. The plan may be terminated at any time at the discretion of the Company's Board of Directors.



## 7. Federal income tax

Deferred income taxes as provided in the financial statements arise from timing differences between financial and taxable income, principally due to the use of accelerated depreciation methods for tax reporting and nonrecognition of gain on disposition of aircraft for federal income tax reporting. The provision for federal income tax in 1978 was \$7,686,968 net of utilization of \$3,775,014 of investment tax credit (flow-through method). There was no provision for federal income tax for the year ended December 31, 1977 as the liability was reduced by \$3,611,878 of investment tax credit.

## 8. Quarterly financial data (unaudited)

Summarized quarterly financial data (in thousands of dollars except for per share amounts) for 1978 and 1977 is as follows:

	Three months ended			
	March 31	June 30	Sept. 30	Dec. 31
1978:				
Revenues . . . . .	\$16,052	\$19,668	\$22,488	\$22,857
Income before tax . . . . .	\$ 1,969	\$ 3,543	\$11,055	\$ 7,389
Net income before accounting change . . . . .	\$ 1,969	\$ 3,012	\$ 6,765	\$ 4,523
Net income . . . . .	\$ 2,704	\$ 3,012	\$ 6,765	\$ 4,523
Income per share (Note 4):				
Before 1979 stock split (adjusted for 1978 stock split) . . . . .	\$ .90	\$ 1.00	\$ 2.26	\$ 1.51
After 1979 stock split . . . . .	\$ .60	\$ .67	\$ 1.50	\$ 1.01

1977:

Revenues . . . . .	\$ 8,617	\$10,923	\$14,242	\$15,265
Income before tax . . . . .	\$ 1,433	\$ 1,925	\$ 2,132	\$ 2,055
Net income . . . . .	\$ 1,433	\$ 1,925	\$ 2,132	\$ 2,055
Income per share (Note 4):				
Before 1979 stock split (adjusted for 1978 stock split) . . . . .	\$ .48	\$ .64	\$ .71	\$ .69
After 1979 stock split . . . . .	\$ .32	\$ .43	\$ .47	\$ .46
Pro forma amounts assuming the accounting change had been applied retroactively (Note 9):				
Net income . . . . .	\$ 1,427	\$ 1,744	\$ 2,300	\$ 2,226
Income per share (Note 4):				
Before 1979 stock split (adjusted for 1978 stock split) . . . . .	\$ .48	\$ .58	\$ .77	\$ .74
After 1979 stock split . . . . .	\$ .32	\$ .39	\$ .51	\$ .50

## 9. Accounting change

In years prior to 1978, the Company provided an air-worthiness reserve for major aircraft maintenance and overhaul costs. These costs were accumulated in the reserve on a per flight hour basis (\$2,477,000 in 1977). Actual expenditures for major aircraft maintenance and overhaul costs were relieved from the reserve as incurred.

Effective January 1, 1978 the Company changed its method of accounting for major maintenance and overhaul costs from the reserve method to that of expensing such costs as incurred. The change was made to conform the Company's accounting for such costs to the predominant method in the airline industry and, in anticipation of possible interstate route awards, to utilize the established accounting policies of the Civil Aeronautics Board (CAB). The Company believes that the direct expense method is preferable because of changes in the physical manner in which airframes and engines are now being maintained and an increase in the Company's fleet size.

Net income for the year ended December 31, 1978 has been increased by approximately \$735,000 (net of applicable federal income taxes and profit sharing of approximately \$388,000), which represents the cumulative effect on years prior to 1978 of the aforementioned change. Had the reserve method been used to provide for major maintenance and overhaul costs for the year ended December 31, 1978, income before cumulative effect of accounting change would have been reduced by approximately \$373,500 (approximately 8 cents per share after the 1979 stock split).

#### 10. Commitments and contingencies

In 1973 the United States District Court for the Northern District of Texas declared that the cities of Dallas and Fort Worth and the Dallas-Fort Worth Regional Airport Board could not prevent the Company from serving Dallas Love Field as long as Love Field remained open as an airport. This decision was affirmed by the Fifth Circuit Court of Appeals, and the United States Supreme Court declined to grant review.

Subsequently, in December 1974 a CAB carrier (the Carrier) filed an action in the Travis County, Texas District Court seeking to exclude the Company from Love Field or, as one of the alternatives, to close Love Field as an airport. Certain other airlines serving DFW Airport joined the Carrier in requesting this relief. The United States District Court for the Northern District of Texas entered a temporary injunction prohibiting the Carrier

and certain other CAB air carriers serving DFW from proceeding with that portion of the State Court suit which seeks to relitigate the right of the Company to remain at Love Field. Those carriers have appealed the entry of the temporary injunction to the Fifth Circuit Court of Appeals which Court ruled in favor of the Company. Some of the defendants petitioned the United States Supreme Court to review the Fifth Circuit Court's decision, which petition was denied by the Supreme Court. Since such denial, no action has been taken by any party on the merits of the case.

The management of the Company and its legal counsel expect to prosecute and defend successfully both the Federal and State Court actions, but, in the event of an adverse decision, no financial liability is indicated, although the effect on future operations is not predictable at this time. The Company is involved in several other legal proceedings, the outcome of which in the opinion of management and counsel will not have a material effect on the financial statements.

Total rental expenses charged to operations in 1978 and 1977 were \$855,843 and \$559,105, exclusive of landing fees of \$2,248,435 and \$1,480,746, respectively. Landing fees are set by the governing bodies of the airports served by the Company and are based upon usage of airport runways.

The majority of the Company's corporate office and terminal operations space is leased through non-cancellable operating leases. In 1978, the Company entered into an operating lease with an unrelated third party for the use of a Boeing 727-200 aircraft beginning in 1979 for a term of 2 years. Minimum future obligations on all leases in effect at December 31, 1978 are as follows:

1979 .....	\$1,766,786
1980 .....	1,895,291
1981 .....	702,435
1982 .....	400,414
1983 .....	411,664
After 1983 .....	3,540,530
	<u>\$8,717,120</u>



## Auditor's Report

The Board of Directors and Stockholders  
Southwest Airlines Co.

We have examined the accompanying consolidated balance sheets of Southwest Airlines Co. at December 31, 1978 and 1977, and the related consolidated statements of income, stockholders' equity and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the statements mentioned above present fairly the consolidated financial position of Southwest Airlines Co. at December 31, 1978 and 1977, and the consolidated results of operations and consolidated changes in financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis during the period except for the change, with which we concur, in the method of accounting for major maintenance and overhaul costs as described in Note 9 to the consolidated financial statements.

*Arthur J. Conroy*

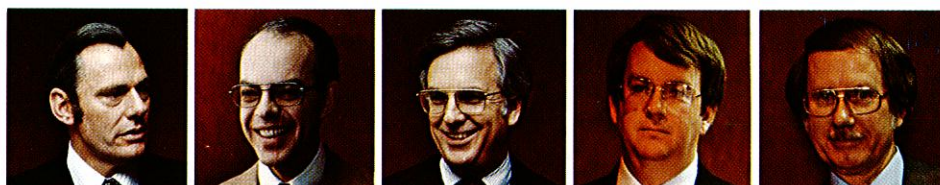
January 30, 1979

## Responsibility for Financial Statements

The Auditor's Report states the opinion of the Company's public accountants in terms of conformity with generally accepted accounting principles. However, Management is responsible for the fairness and integrity of the Company's operating results and financial statements. To address this responsibility, Management maintains formal policies and procedures which reflect high standards of accounting and administrative practices.

The Audit Committee of the Board of Directors, which is comprised of outside directors only, meets periodically with both Management and the public accountants. To assure complete independence, the public accountants have free access to the Audit Committee, with or without the presence of management representatives.

## Officers



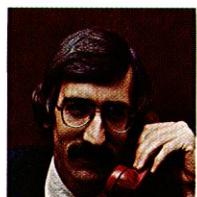
Kelleher

Putnam

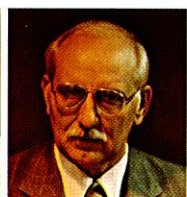
King

Guthrie

Farr



Barron



Franklin



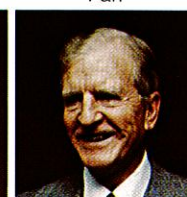
Herring



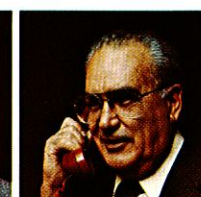
Keith



Lang



Ogden



Vidal



Volz



Barrett



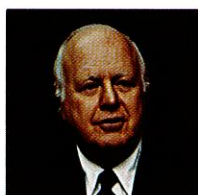
Thomson



Phelps

	Age	Officer Since		Age	Officer Since
Herbert D. Kelleher <i>Chairman of the Board</i>	47	1967	J. L. Herring <i>Vice President — Inflight Service</i>	55	1973
Howard D. Putnam <i>President and Chief Executive Officer</i>	41	1978	Camille T. Keith <i>Vice President — Public Relations</i>	34	1978
Rollin W. King <i>Advisor — Special Projects</i>	47	1967	Edward W. Lang <i>Vice President — Personnel</i>	44	1978
M. Philip Guthrie <i>Vice President — Finance and Chief Financial Officer</i>	34	1979	Donald G. Ogden <i>Vice President — Flight Operations</i>	68	1971
Herman H. Farr <i>Treasurer</i>	55	1973	John A. Vidal <i>Vice President — Maintenance</i>	60	1971
Gary Barron <i>Vice President — Corporate Services</i>	34	1978	Tom J. Volz <i>Vice President — Marketing</i>	35	1979
William W. Franklin <i>Vice President — Ground Operations</i>	51	1971	Colleen C. Barrett <i>Secretary</i>	34	1978
			W. James Thomson <i>Assistant Treasurer</i>	30	1976
			Sherry L. Phelps <i>Assistant Secretary</i>	29	1976

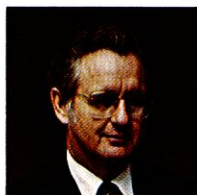
## Directors



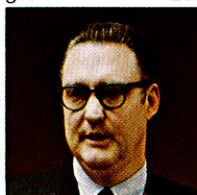
Adger



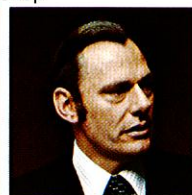
Barshop



Bishop



Johnson



Kelleher



King



Murchison

Sidney A. Adger  
Senior Vice President  
Milchem, Inc.  
Houston, Texas

Samuel E. Barshop  
President and Chairman  
of the Board of Directors  
LaQuinta Motor Inns, Inc.  
San Antonio, Texas

Gene H. Bishop  
Chairman of the Board  
of Directors and Chief  
Executive Officer  
Mercantile Texas Corporation  
Dallas, Texas

Travis C. Johnson  
Attorney  
Johnson & Bowen  
El Paso, Texas

Herbert D. Kelleher  
Attorney  
Oppenheimer, Rosenberg,  
Kelleher & Wheatley, Inc.  
San Antonio, Texas

Rollin W. King  
Advisor—Special Projects  
Southwest Airlines Co.  
Dallas, Texas

John D. Murchison  
Partner  
Murchison Brothers Investments  
Dallas, Texas

## Corporate Data



**Transfer Agent and Registrar**  
First National Bank in Dallas  
Dallas, Texas

**Stock Exchange Listing**  
New York Stock Exchange  
Ticker Symbol: LUV

**Auditors**  
Arthur Young & Company  
Houston, Texas

**General Offices**  
1820 Regal Row  
Dallas, Texas 75235  
(214) 630-5511

**Annual Meeting**  
The Annual Meeting of  
Shareholders of Southwest  
Airlines Co. will be held at 10:00  
a.m. on Tuesday, April 24, 1979  
in the Auditorium of the  
Mercantile National Bank  
Building located on its fourth  
floor at 1704 Main Street, Dallas,  
Texas.

### SEC Form 10-K

For additional information, see  
Statement of Operations  
covering the five year period  
1974/1978 filed with the  
Securities and Exchange  
Commission as part of the  
Company's Annual Report on  
Form 10-K. A copy of this report  
is available upon written request  
to the Treasurer of the Company.





1820 Regal Row  
Dallas, Texas 75235  
(214) 630-5511