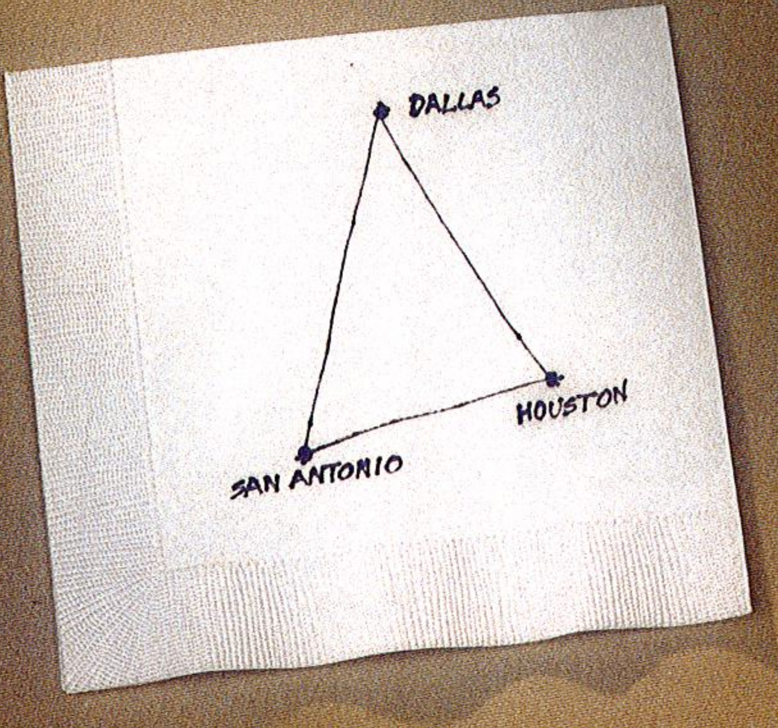
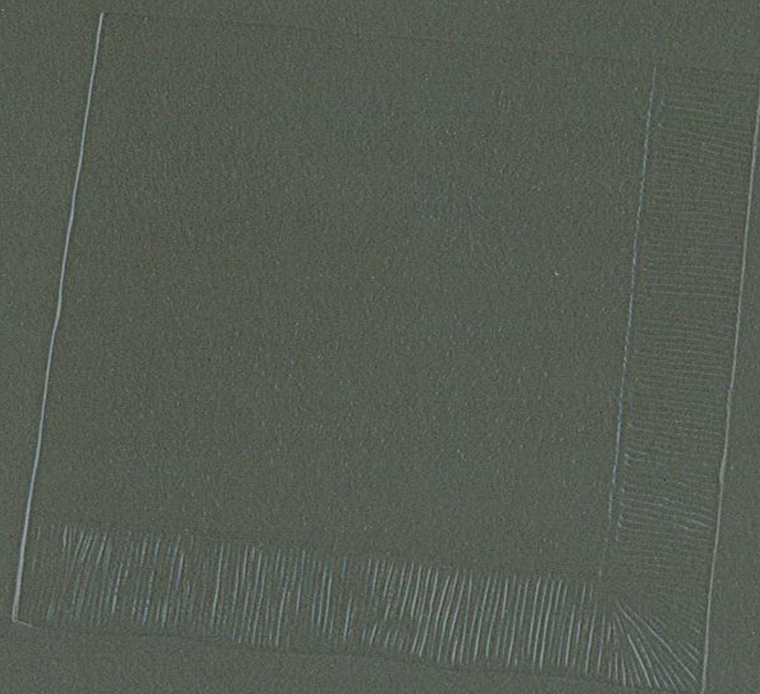
SOUTHWEST AIRLINES CO. 1985 ANNUAL REPORT



"Herb, let's
start an airline."



"Herb, let's start an airline."

In time, Rollin W. King would be heralded a visionary dreamer. But Herb Kelleher's response that afternoon in 1966 was decidedly less flattering:

"Rollin, you're crazy...

Let's do it."

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H I G H L I G H T S

	1985*	1984	Percent Change
OPERATING DATA			
Trips operated	230,227	200,124	15.0
Passengers carried	12,651,239	10,697,544	18.3
Revenue passenger miles (000)	5,971,400	4,669,435	27.9
Available seat miles (000)	9,884,526	7,983,093	23.8
Passenger load factor	60.4%	58.5%	n/a
Average revenue per passenger mile	11.00¢	11.12¢	(1.1)
Number of employees at year-end	5,271	3,934	34.0
INCOME DATA			
Operating revenues	$679,672,000	$535,948,000	26.8
Operating expenses	601,148,000	467,451,000	28.6
Operating income	78,524,000	68,497,000	14.6
Net income—			
Amount	$47,278,000	$49,724,000	(4.9)
Per share:			
Primary	$1.54	$1.69	(8.9)
Fully diluted	$1.51	$1.64	(7.9)
Average shares outstanding	30,766,000	29,472,000	4.4
FINANCIAL DATA			
Working capital	$ 46,019,000	$ 15,459,000	197.7
Property and equipment—net	881,530,000	580,109,000	52.0
Capital expenditures	214,516,000	184,259,000	16.4
Stockholders' equity	466,004,000	361,768,000	28.8
Return on stockholders' equity	11.4%	14.7%	n/a
Long-term debt as a % of total invested capital	45.0%	29.8%	n/a
Book value per share	$14.45	$12.25	18.0

*Includes Muse Air (TranStar) since the June 30, 1985 effective date of acquisition.

Letter To Stockholders

Highlights Of 1985

The TranStar (formerly Muse Air) acquisition . . . record operating revenues of $679,672,000 . . . record operating income of $78,524,000 . . . total assets of over $1,000,000,000 . . . record stockholders' equity of $466,004,000 . . . record book value per share of $14.45 . . . record revenue passenger miles of 5,971,399,880 . . . record Customers originated of 12,651,239 . . . an excellent first year of service for the Boeing 737-300.

Profitability

Although TranStar experienced a loss of $83,000 in the fourth quarter of 1985, it contributed $303,000 to Southwest's consolidated pre-tax income for the year, as well as $8,324,000 to consolidated operating income.

For Southwest itself, operating revenues increased 13.1% in 1985 and operating expenses 14.6%. Operating income of $70,200,000 was 2.5% higher than the $68,497,000 of 1984. Net non-operating expense rose from $649,000 in 1984 to $9,719,000 in 1985.

Southwest's fourth quarter 1985 net income of $6,075,000 was down 46.8% from its fourth quarter 1984 net income of $11,420,000. This decline is principally attributable to adverse conditions affecting the airline industry as a whole in fourth quarter 1985, causing most carriers to report either losses or reduced net income from operations as compared to fourth quarter 1984. In the classic airline industry syndrome, capacity increased as Customer traffic dwindled, producing numerous "special fares" which depressed yields per revenue passenger mile. Since these conditions have extended into the first quarter of 1986, Southwest has initiated a sweeping first quarter cost containment program and has introduced several special fares designed to stimulate incremental revenues. This program and these fares will be reevaluated toward the end of the first quarter in light of the trends then developing within our industry.

On a consolidated basis, net income of $47,278,000 was 4.9% lower than the $49,724,000 of 1984, while earnings per share for 1985 were $1.54 ($1.51 fully diluted) on an average of 4.4% more shares outstanding, as compared to the $1.69 per share ($1.64 fully diluted) earned in 1984.

Traffic

On a consolidated basis, 12,651,239 Customers were originated in 1985, an 18.3% increase over the record established in 1984. Revenue passenger miles increased by 27.9%.

Southwest's load factor improved from 58.5% in 1984 to 61.2% in 1985, but its yield per revenue passenger mile decreased from 11.12¢ to 10.99¢. Operating expense per available seat mile increased from 5.86¢ in 1984 to 6.15¢ in 1985.

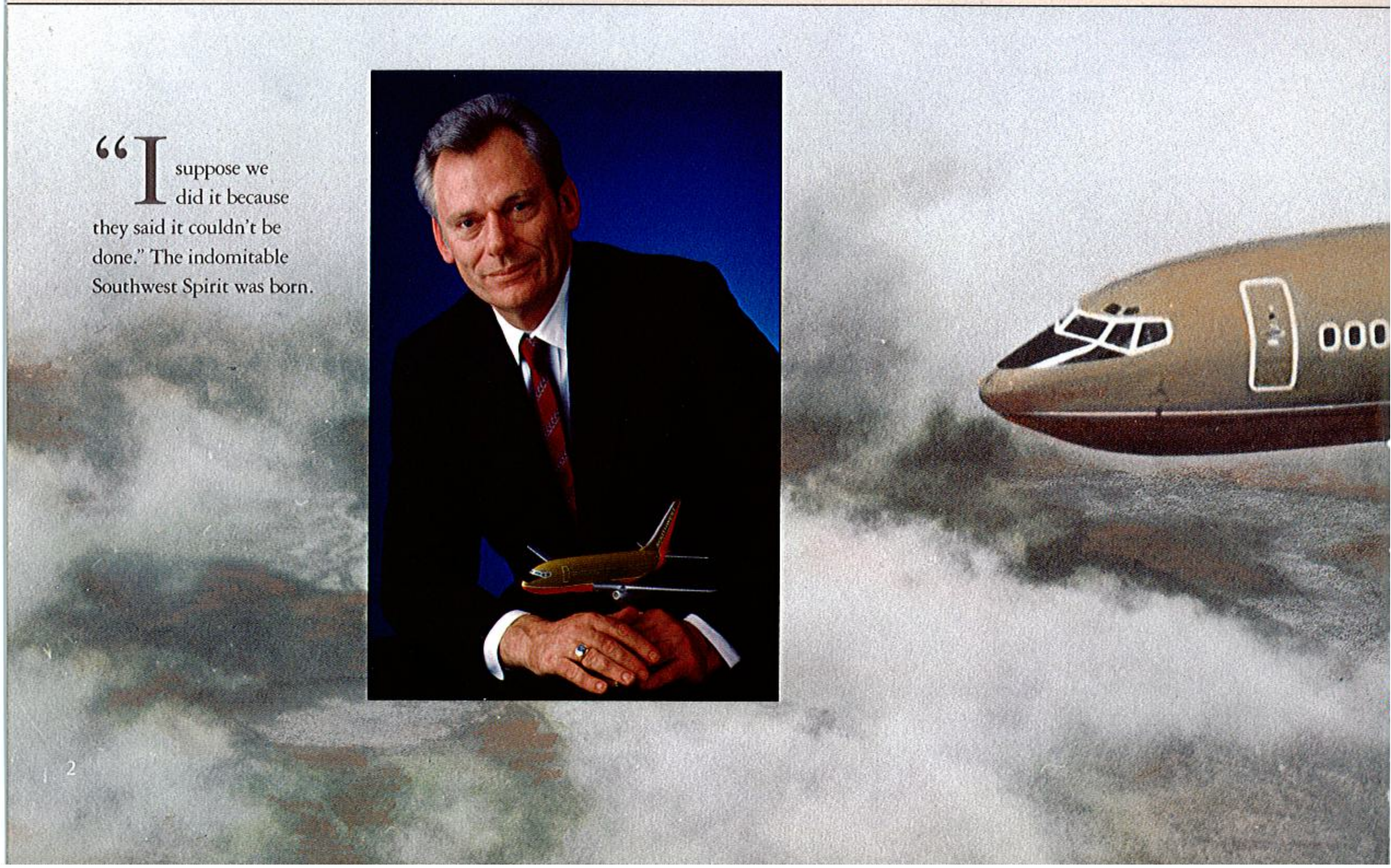
Recent declines in jet fuel prices promise some cost relief for 1986, but, in all likelihood, the actual cost benefits of lowered fuel prices will be offset, to some degree, by reduced Customer traffic in the energy producing states served by Southwest. If this should occur, Southwest will attempt to emphasize expansion in areas not as economically dependent upon energy production and prices.

Routes

Southwest has recently announced that it will add Nashville to its route system on March 18, 1986. Nonstop service will be provided between Nashville and Houston's Hobby Airport and between Nashville and Chicago's Midway Airport. This addition will increase Southwest's route system to 26 cities and 27 airports in 12 states.

TranStar has just announced that it will begin service between Houston's Hobby Airport and Miami in March, 1986. With the addition of Miami, TranStar will serve

"I suppose we did it because they said it couldn't be done." The indomitable Southwest Spirit was born.



14 cities in 5 states.

Together, Southwest and its wholly owned subsidiary, TranStar, provide air service from Florida to California and from Chicago to the Lower Rio Grande Valley of Texas.

Fleet

Southwest is presently operating a fleet of 46 737-200's and 10 737-300's. Seven more 737-300's will be delivered during 1986. As of this writing, Southwest's net increase in capacity during 1986 is anticipated to approximate 15.8%. Southwest also has on firm order nine 737-300's for 1987 delivery; six for 1988 delivery; and three for 1989 delivery, plus options to purchase ten more such aircraft through 1989.

TranStar currently operates six MD-80 and eight DC9-51 aircraft. Enhanced utilization over longer stage lengths will increase its capacity during 1986. In order to strengthen its financial position, TranStar plans to sell its 1986 and 1987 contract rights to purchase four DC9-51's.

Customer Service

In 1985, Southwest maintained its five-year leadership, among carriers serving the Continental United States, with the fewest DOT Customer complaints per 100,000 Customers carried. Truly, service is attitude, and Southwest's employees have splendid spirits and attitudes.

Financing

In December, 1985, Southwest consummated a $20,200,000 export financing on its CFM56-3 engines and $40,500,000 in finance leasing on two of its 737-300's. The proceeds from these two financings were used to purchase aircraft and retire bank debt.

TranStar entered into a $55,000,000 leveraged lease on five of its DC9-51's in December, 1985, thereby generating cash and reducing its monthly expenses.

Outlook 1986

Southwest's strength and diversity have been enhanced by the acquisition of TranStar, which, under Southwest's stewardship and Bill Franklin's leadership, has experienced a quick, six month "turnaround" from losses to small profits and from financial instability to a more secure financial condition. It now seems apparent that the acquisition has been, and will be, beneficial to the employees of both Companies and to the shareholders of Southwest, among whom Southwest's employees are numbered as a result of their profit sharing plan.

As stated earlier, the first quarter of 1986 embodies some of the airline industry depressants affecting the last quarter of 1985, and it is impossible, at this point, to forecast to what extent the remainder of 1986 will be affected by overcapacity (as related to "normal fare" Customer traffic), and, thus, by resultant fare skirmishes or even wars. As it celebrates its 15th anniversary of air service, however, the strength of Southwest is still founded on Vince Lombardi "fundamentals," most specifically including the positive attitudes, tremendous resilience, and "can do" dedication of its people. I anticipate that Southwest and TranStar will be industry leaders at the end of 1986 just as they were at its beginning.

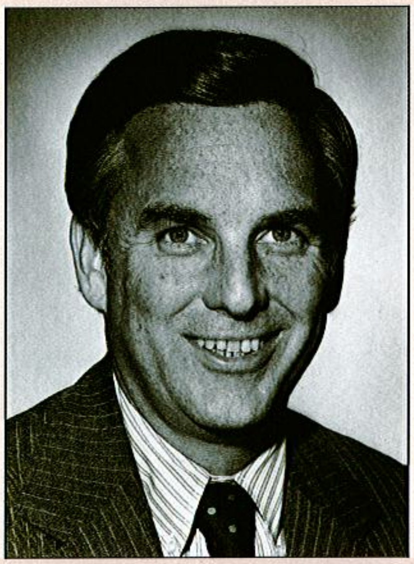
Most sincerely,

Herbert D. Kelleher

Herbert D. Kelleher
Chairman, President, and CEO
of Southwest and
Chairman of TranStar

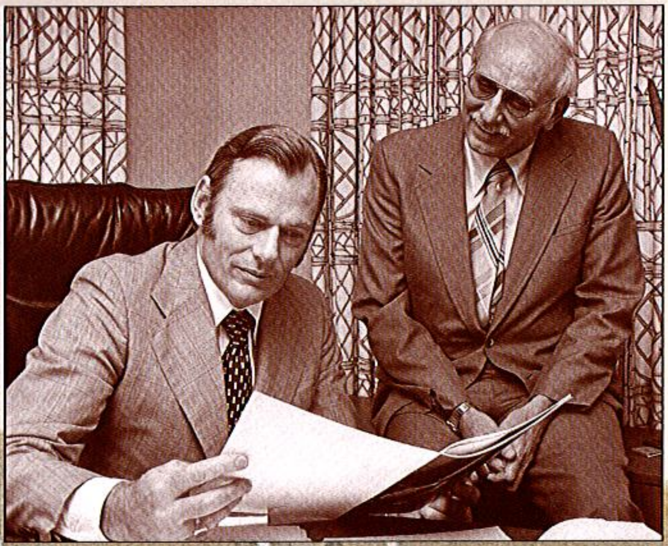
February 3, 1986

N21SW, Southwest's very first Boeing 737, in a fleet that now numbers 56 and counting.

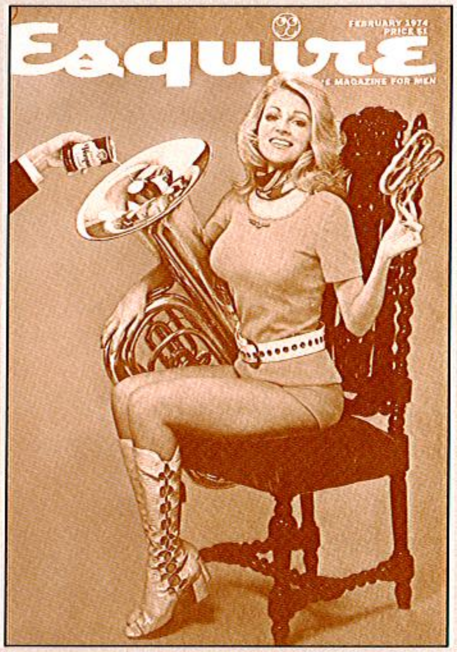


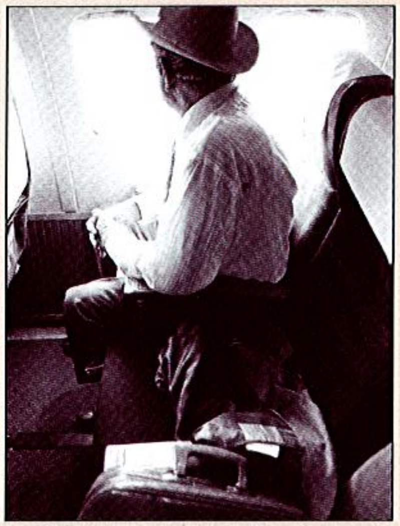
Texas in the late 1960's needed faster, cheaper, more frequent travel between its major cities than existing airlines were providing. Rollin King's idea was one whose time had come.

Kelleher's legal acumen was complemented by William W. "Bill" Franklin's operational skills. Franklin is credited with Southwest's "Ten Minute Turnaround," which prompted on-time performance, increased productivity and reduced costs.



"The Best Stewardesses in America." Even *Esquire* Magazine was lovestruck, and said so in this cover story in their February, 1974 issue.





So low were Southwest's original fares ($20 between Houston Hobby and Dallas Love Field), many Texas businessmen stopped driving and started flying.

Cheerleaders in the sky. Sporting hotpants, high boots and miles of smiles, Southwest's first hostesses made flying "part frugality, part fantasy."

Description Of Business

Southwest Airlines Co. ("Southwest") provides single class, high frequency air service to more than 25 cities, primarily in the southwestern United States. Southwest principally concentrates on short-haul markets and stresses high levels of aircraft utilization and employee productivity. In Southwest's opinion, its service is characterized by low fares, convenient schedules and reliability. The principal hub airports in Southwest's system are Dallas Love Field and Houston Hobby Airport, satellite airports located substantially closer to downtown business centers than other major airports serving these cities.

The Company acquired Muse Air Corporation ("Muse Air") in June 1985, and Muse Air operates as an independent subsidiary of the Company. Muse Air provides dual class air service to several Texas cities including Dallas (Love Field) and Houston (Hobby Airport) as well as to several other cities in the southern half of the United States. Muse Air changed its corporate name in February 1986 to TranStar Airlines Corp. (Southwest and Muse Air are referred to collectively as the "Company".)

Review Of Operations

Fleet

The combined fleets of Southwest and Muse Air at year-end 1985 consisted of forty-six Boeing ("B") 737-200's, ten B737-300's, six McDonnell Douglas ("MD")-80's and eight DC9-51's of which one MD-80 and five DC9-51's were being operated subject to long-term lease agreements. The average age of the aircraft in the combined fleet at year-end was 4.8 years.

During 1985 Southwest placed into service eight new aircraft, seven of which were third generation B737-300's and one was the familiar B737-200. Southwest returned six leased B727-200's during 1985 at their lease termination dates.

Muse Air had six MD-80's and eight DC9-51's in service at the June 30, 1985 effective date of acquisition, of which one MD-80 was leased. At year-end Muse Air completed a sale-leaseback on five of its DC9-51's which was classified as a long-term operating lease.

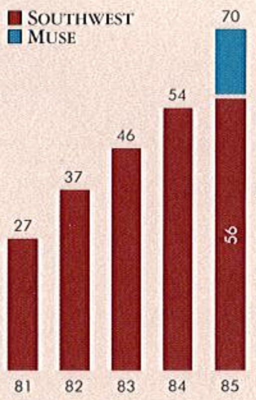
Capacity

During 1985, Southwest's aircraft capacity was composed of a weighted average of 45.1 B737-200, 4.9 B737-300 aircraft and 3.7 B727-200 leased aircraft. Beginning June 30, 1985, the acquisition of Muse Air provided additional capacity of an average of 5.7 MD-80's and 7.8 DC9-51's.

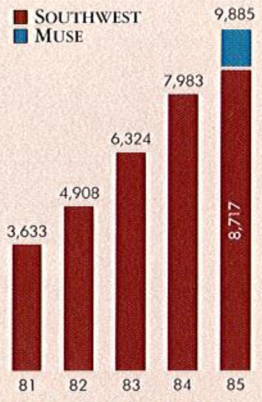
On a combined basis the average number of aircraft in service during 1985 was 60.44 having an average number of seats of 126 each. This represents a 23.4% increase over the 48.96 average aircraft assigned to service by Southwest during 1984 and compares to 40.70 in 1983. The average number of seats per aircraft in 1984 was 124 and in 1983 was 119.

Routes

Southwest added St. Louis, Missouri; Chicago, Illinois; and Ontario, California to its route system in 1985. Also, as a result of the acquisition of Muse Air, several other new cities were added, including Orlando



Fleet Size
(At year-end)



Available Seat Miles
(In Millions)

and Tampa/St. Petersburg in Florida, and McAllen and Brownsville in Texas.

Traffic

Passenger boardings on a combined basis for 1985 were 12,651,239 and the average length of passenger haul was 472 miles, generating total revenue passenger miles of 5,971,400,000. These statistics represent increases of 18.3%, 8.3% and 27.9%, respectively, over the 10,697,544 passenger boardings, 436 mile average length of passenger haul, and 4,669,435,000 revenue passenger miles recorded in 1984.

Management's Discussion And Analysis Of Results Of Operations And Financial Condition

Operating Revenues

Consolidated passenger revenues, which represent more than 96% of operating revenues, increased in 1985 by $138 million or 26.5%. Approximately $68 million of the increase is attributable to the 14.3% increase during 1985 in revenue passenger miles flown on Southwest's route system offset by a decrease of 1.2% in the average revenue per passenger mile (yield). The remaining $70 million of the increase is attributable to the passenger revenues generated by Muse Air subsequent to the mid-year acquisition date.

In 1984 passenger revenues increased 19.8% over 1983 due to the same increase in revenue passenger miles with no change in yield.

Operating Expenses

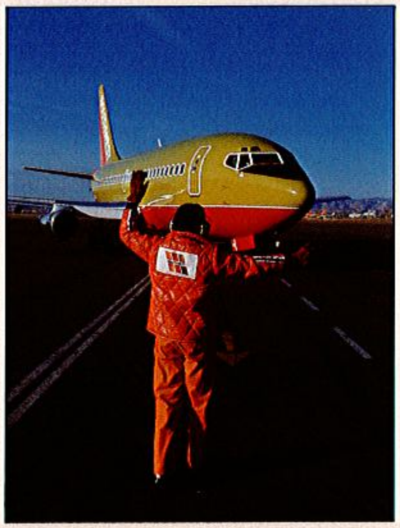
Consolidated operating expenses increased in 1985 by 28.6% over 1984. The increase is attributable to the inclusion of $66 million of expenses of Muse Air from June 30 through year-end and $68 million of additional expenses primarily associated with the increase in the operations of Southwest during 1985. Operating expenses per available seat mile ("ASM") increased by 3.8% from 5.86¢ in 1984 to 6.08¢ in 1985. The table below depicts the various components of operating expenses per ASM and the changes in these components over the past two years.

In 1985 the average combined cost per gallon of jet fuel was 78.17¢ while in 1984 and 1983 the costs were 82.44¢ and 85.92¢, respectively. Fuel efficiency, as measured in gallons consumed per hour of service (ramp to ramp), was a combined average in 1985 of 854 compared to 862 in 1984 and 829 in 1983. (Southwest averaged 843 gallons per hour in 1985.)

The category entitled "Other" includes advertising, crew overnight and per diem expenses, charge sale discounts, outside services and repairs other than maintenance, communications and utilities, insurance, training expenses, passenger beverages and supplies, state and local taxes, legal fees, printing expenses and other miscellaneous expenses. The category of costs referred to below as "Agency commissions" includes, beginning in 1985, booking fees paid to other airlines for the use of their booking systems by travel agents selling tickets for travel on Southwest or Muse Air. "Landing fees and rentals" includes aircraft rental expenses.

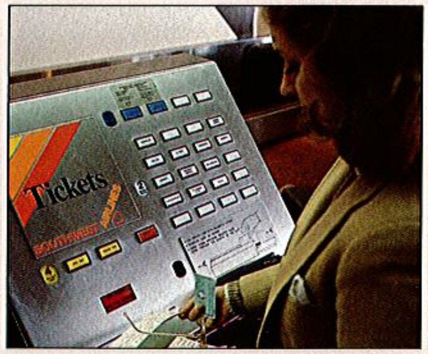
	Per Available Seat Mile	Increase (Decrease)	Per Available Seat Mile	Increase (Decrease)	Per Available Seat Mile
Category Of Costs	1985		1984		1983
Aircraft fuel & oil	1.67¢	(.16¢)	1.83¢	(.12¢)	1.95¢
Wages & benefits	1.58	.04	1.54	–	1.54
Maintenance	.39	.07	.32	.06	.26
Agency commissions	.34	.09	.25	–	.25
Landing fees & rentals	.37	(.03)	.40	.11	.29
Other	1.11	.16	.95	(.14)	1.09
Depreciation	.54	.10	.44	(.03)	.47
Profit sharing	.08	(.05)	.13	(.02)	.15
Total	6.08¢	.22¢	5.86¢	(.14¢)	6.00¢

Cheerful gate areas were a welcome oasis for travelers in the mid-1970's. Southwest's simple boarding procedure set industry standards for speed and efficiency.

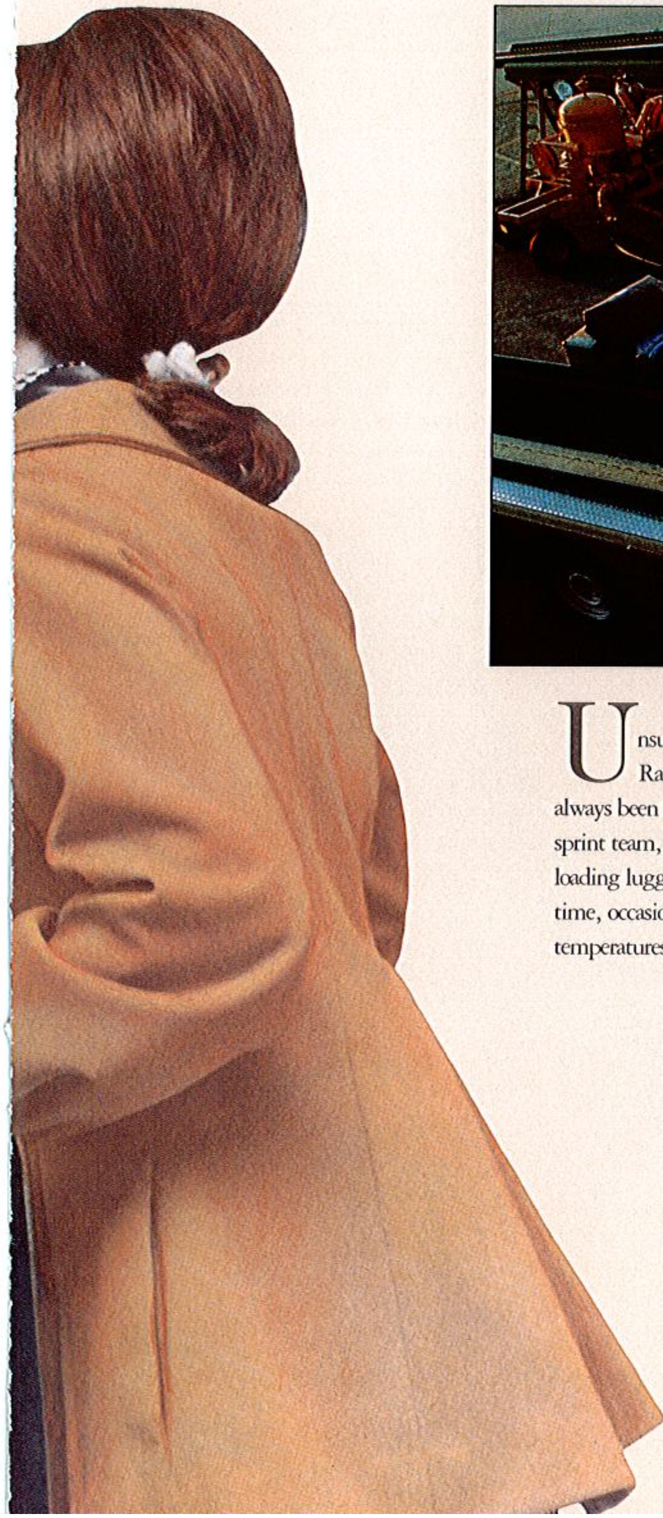


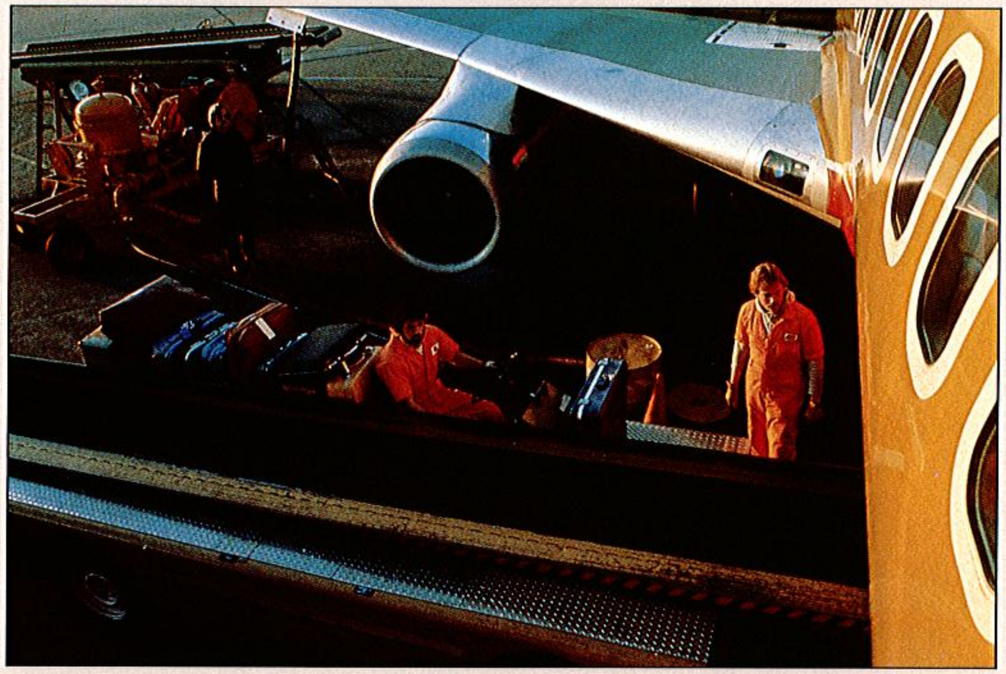
Another on-time departure. Southwest has consistently ranked among the leaders in on-time performance, a tribute to teamwork from the ground up.

The Two Millionth Man. Genovevo Muniz of Raymondville became Southwest's second millionth Customer, exceeding our expectations and, no doubt, his.



Automated Ticket Machines, introduced in 1979, signaled Southwest's continued commitment to Customer convenience.





Unsung heroes. Ramp agents have always been Southwest's sprint team, unloading and loading luggage in record time, occasionally in record temperatures.

Southwest pioneered fast, efficient inflight service. Avoiding cumbersome serving carts allows freedom of movement in the cabin, and a welcome second beverage on even the shortest flights.

Operating Income

1985 consolidated operating income of $78.5 million was 14.6% higher than the prior year and represents an operating margin of 11.6%, which compares to a 12.8% margin in 1984 and a 15.3% margin in 1983. The decrease in operating margin in 1985 is a result of a 1.9 percentage point increase in combined load factor offset by a 3.8% increase in operating costs per ASM and a 1.1% decrease in yield per revenue passenger mile. Otherwise, operating income would have been approximately $86.8 million, which is calculated by multiplying 1985 ASM's by the 1984 per ASM contribution margin of 0.645¢ (yield times load factor less cost per ASM) plus other operating revenues.

Non-Operating Income And Expense

Interest expense increased by approximately $10.8 million in 1985 to $26.9 million. Approximately $6.6 million of this increase is attributable to the interest expense of Muse Air, while the remainder is attributable to interest of approximately $2.3 million on a net increase in borrowings by Southwest to purchase new aircraft and interest of approximately $1.9 million on funds borrowed to purchase Muse Air. Interest expense increased by $3.7 million in 1984 to $16.1 million due primarily to the effect of a full year's interest expense associated with the $35 million of 6¾% Debentures issued in June of 1983.

Capitalized interest increased in both 1985 and 1984 due to higher average balances of outstanding progress payments on aircraft.

Interest income, which had increased dramatically in 1984 due to the interim investment of excess working capital, decreased sharply in 1985 since the excess working capital had been utilized by late 1984.

Income Taxes

The Company's effective income tax rates per books for 1983, 1984 and 1985 were 36%, 27% and 22%, respectively. These effective rates were less than the 46% statutory corporate income tax rate in effect during these years due principally to the utilization of investment tax credits generated by new aircraft purchases and other capital expenditures.

In each of the years 1983 through 1985 payment of the majority or all of the provision for federal income taxes was deferred due to timing differences between financial and tax reporting.

For additional analysis of income tax expense for 1985 and the two prior years, see Note 7 to the Consolidated Financial Statements included herein.

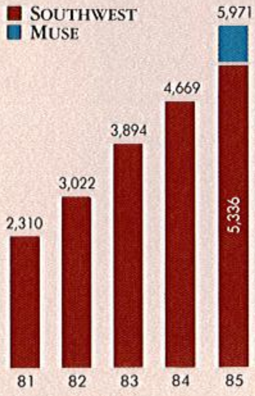
Earnings Per Share

On a primary basis, earnings per share for 1985 decreased by 8.9%, due to a 4.9% decrease in net income and an increase of 4.4% in the weighted average number of shares outstanding.

Primary earnings per share in 1984 increased by 20.7% over 1983, due to a 21.7% increase in net income offset partially by an increase of 1.0% in the weighted average number of shares outstanding.

Stockholders' Equity

Of the 28.8% increase in Stockholders' Equity in 1985, 7.4% is attributable to securities issued in connection with the acquisition of Muse Air, 9.4% is attributable to the conversion of debentures in 1985 and 12.0% is attributable to increased retained earnings. For 1984,



Revenue Passenger Miles *(In Millions)*

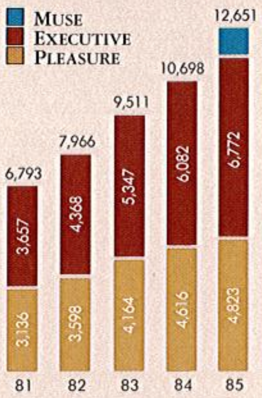
Passenger Load Factor

the 15.0% increase in Stockholders' Equity is primarily attributable to net income.

Return on Stockholders' Equity for 1985 was 11.4%, compared to 14.7% in 1984 and 14.2% in 1983. Book value per share at year-end was $14.45 in 1985, compared to $12.25 in 1984 and $10.68 in 1983.

Profit Sharing Contributions

Each employee of Southwest or Muse Air is eligible to participate in his employer's Profit Sharing Plan. These plans create a visible linkage for each employee between the overall financial performance of his employer and his compensation. Thus, the plans provide a significant financial incentive for employee productivity, one of the keys to the Company's financial success. Employer contributions to Southwest's Profit Sharing Plan are a function of Southwest's pre-tax profits. Muse Air's Profit Sharing Plan provides for quarterly cash bonuses based upon pre-tax profits of Muse Air in excess of pre-determined amounts.



Revenue Passengers Carried *(In Thousands)*

In 1985, Southwest's Employee Stock Ownership Plan resulted in $618,000 of additional employee benefits. Southwest's contribution to this plan is offset by federal tax credits.

The total 1985 provision for employee profit sharing of $8,329,000 relates solely to Southwest's Profit Sharing Plan and its ESOP, as Muse Air's profits were not sufficient to produce profit sharing under its plan. Similar provisions for 1984 and 1983 were $10,038,000 and $9,254,000, respectively.

For additional information see Note 6 to the Consolidated Financial Statements.

Liquidity And Capital Resources

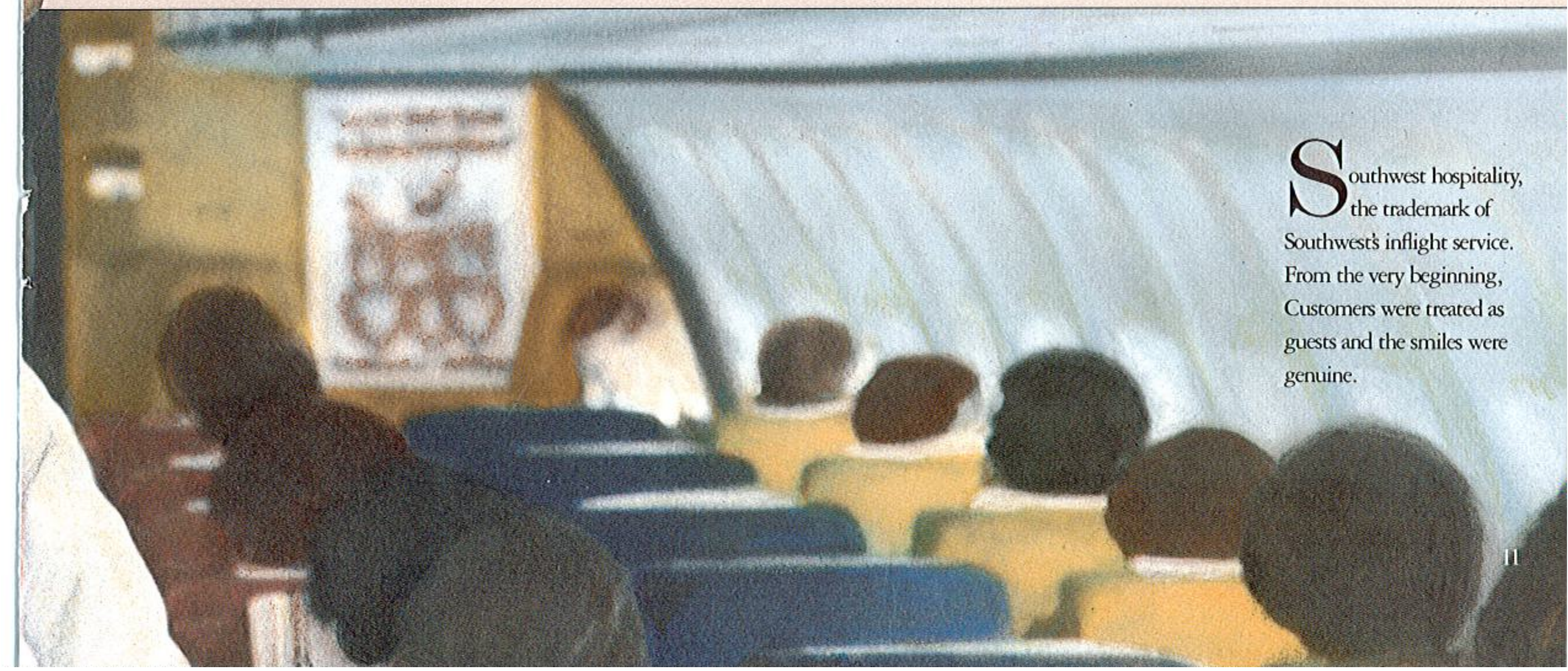
At December 31, 1985, the Company's working capital was $46,019,000 as compared to $15,459,000 and $104,828,000 at December 31, 1984 and 1983, respectively.

Capital commitments for 1986 and thereafter principally consist of scheduled aircraft acquisitions. Seven Boeing 737-300's are scheduled for delivery in 1986, nine additional -300's will be delivered in 1987, six in 1988 and three in 1989. The Company also has a spare engine on order for delivery in 1986 and a flight simulator scheduled for completion in 1986. The remainder of payments due on these capital commitments (including escalation, capitalized interest and buyer-furnished equipment) is $494,939,000. In addition the Company has options to purchase ten -300's for delivery in 1987 through 1990. Also, at December 31, 1985, Muse Air had outstanding purchase commitments for (i) twenty-three engine performance kits at $517,000 each for installation during 1986 and 1987 and (ii) two used DC9-51 aircraft at $9.2 million each scheduled for delivery in March 1986.

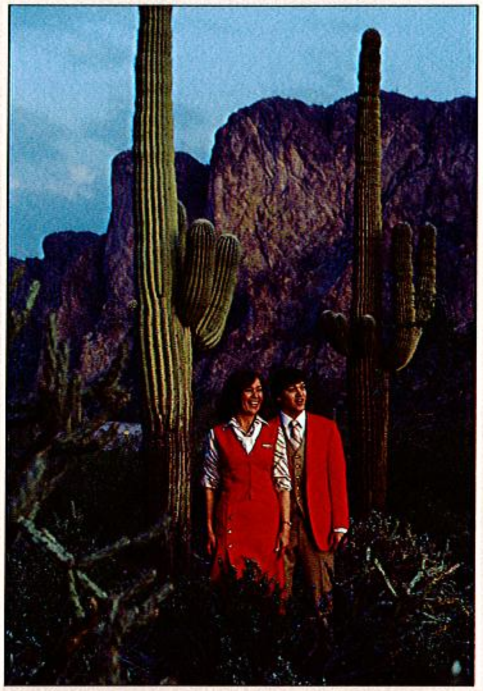
Aircraft Utilization
(Hours and Minutes Per Day)

The Company has two revolving credit lines available to it: $150 million from a group of domestic banks and an additional $50 million from a group of European banks. At December 31, 1985, $57,000,000 and $50,000,000, respectively, had been borrowed under these agreements. There were no outstanding loans under either line of credit at December 31, 1984.

Historically, the Company has utilized a combination of externally and internally generated funds to finance asset acquisitions. In 1985, the Company generated $114 million from operations and utilized $214 million for net additions to property and equipment. Southwest Common Stock was issued in 1985 upon conversion of $34 million of 10% Convertible Subordinated Debentures and $27 million of common stock and warrants were issued in the acquisition of Muse Air. After its acquisition by Southwest, Muse Air renegotiated $33 million, including $5 million of current maturities, of its notes to banks and at

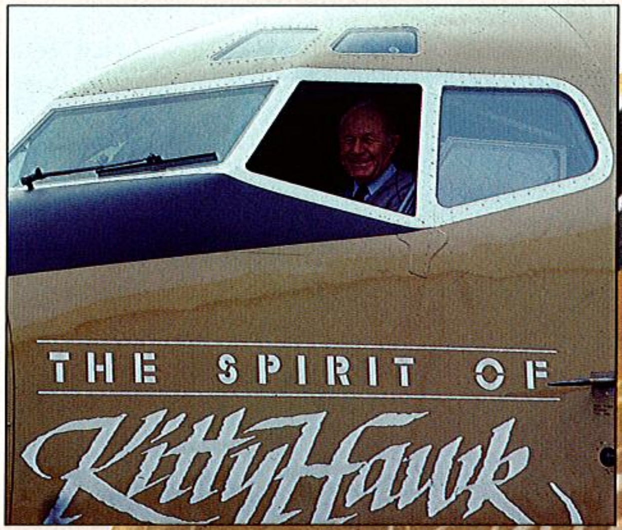


Southwest hospitality, the trademark of Southwest's inflight service. From the very beginning, Customers were treated as guests and the smiles were genuine.

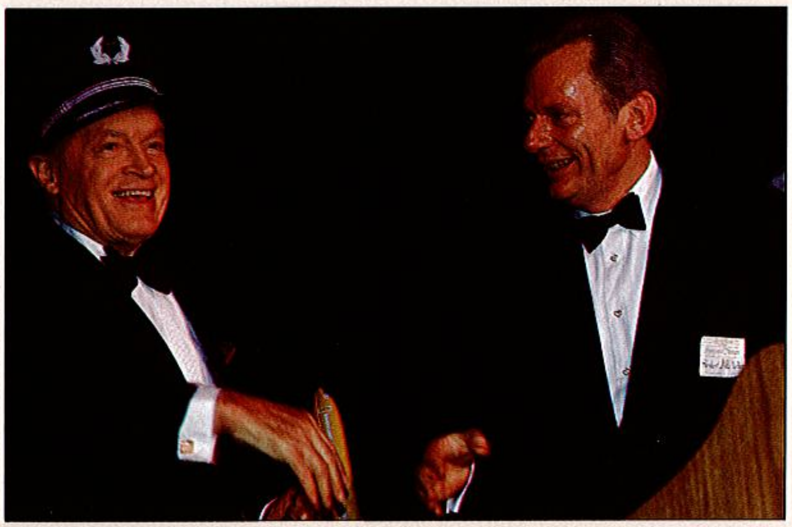


Southwest Territory. By 1982, Southwest had expanded beyond Texas' neighboring states to Phoenix and points west.

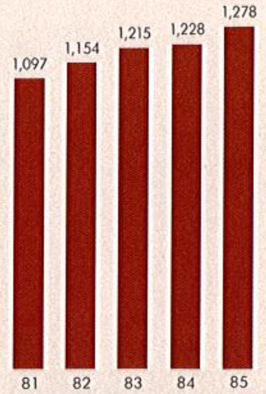
December 17, 1984. Southwest unveiled the first 300 Series aircraft in our Boeing 737 fleet, on the same day and time as the Wright Brothers' historic flight. Co-hosting with Chairman Kelleher, Brigadier General Charles E. "Chuck" Yeager.



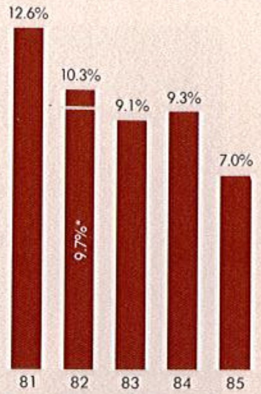
Thanks for the memories. Surprise guest Bob Hope entertained guests at the 737-300 Inaugural Dinner, to Kelleher's obvious delight.



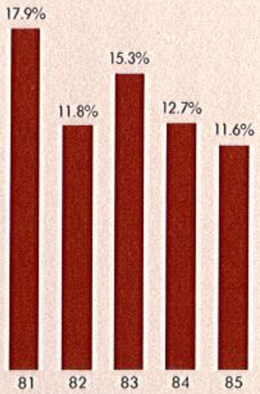
Sitting pretty. By year-end 1984, Southwest's entire fleet was outfitted with wider, more comfortable seats, covered in cool, natural fabrics, trimmed in supple leather.



Revenue Passenger Miles Per Employee
(In Thousands)



Net Profit Margin
(Net Income/Operating Revenues)
**Excluding non-recurring items*



Net Operating Margin *(Operating Income/Operating Revenues)*

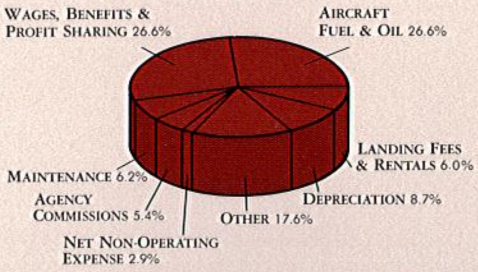
year-end used a portion of the $55 million proceeds from the sale-leaseback of five DC9-51's to retire this debt. Southwest borrowed a net of $107 million under its Bank Credit Agreements, $23 million under its new Euro Note Programme and $18 million under a new French Export Credit Agreement (see Note 5 to the Consolidated Financial Statements for a description of these agreements). Southwest also generated $40.5 million of working capital through a capital lease of two aircraft in December 1985. Southwest utilized $75 million of the working capital generated from these borrowings to acquire the net non-current assets of Muse Air and the remainder for other operating purposes, primaily the acquisition of new aircraft.

During 1984, of the $196 million of funds utilized, $104 million was generated through operations and $89 million derived from prior year's accumulated working capital, while only $3 million came from other sources. Funds of $155 million were utilized for aircraft acquisitions and progress payments and $29 million was used to purchase support flight equipment, ground equipment and facilities, $7 million for retirement of debt and $5 million for the payment of dividends and other purposes.

During 1983, net proceeds of approximately $72 million were derived from public sales of the Company's securities, $90 million was generated from operations, another $42 million was added through the net effect of a sale-leaseback of three aircraft and an additional $3 million was obtained from other debt. The $91 million increase in working capital for 1983 was the net result of funds generated less the use of approximately $73 million for aircraft acquisitions and progress payments, $20 million for the purchase of other flight equipment, ground equipment and facilities, $17 million for retirement of debt and $6 million for the payment of dividends and other purposes.

In addition to the use of internally gener-

Distribution Of Expenses



NET INCOME *(In Millions)*
PRIMARY EARNINGS PER SHARE
**Excluding non-recurring items*

ated funds in 1986 and thereafter, the Company expects to seek external financing to meet its capital needs. In December 1985, Southwest filed a registration statement with the Securities and Exchange Commission for future unsecured debt issues of up to $200 million. The Company is not aware of any restrictions on its ability to raise capital externally through either the debt or equity markets.

For Supplementary Information on Effects of Changing Prices, see page 30 of this Annual Report.

QUARTERLY EARNINGS

Unaudited quarterly financial results are summarized as follows (in thousands except per share amounts):

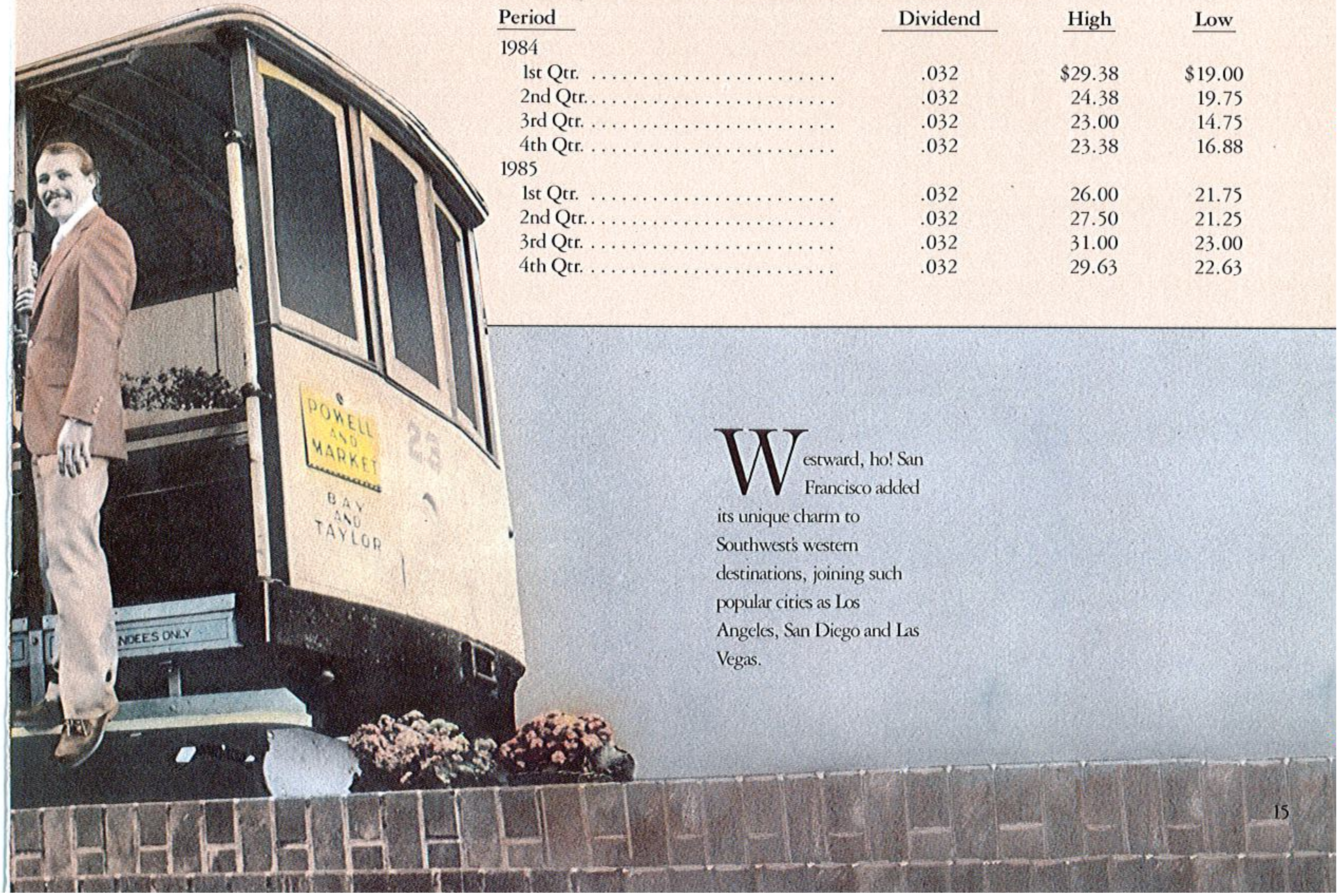
1984	Three Months Ended March 31	June 30	Sept. 30	Dec. 31
Revenues	$125,068	$137,565	$139,806	$133,509
Operating income	15,547	19,343	17,985	15,622
Income before tax	15,491	18,926	18,197	15,234
Net income	10,224	13,921	14,159	11,420
Income per share:				
Primary	.35	.47	.48	.39
Fully diluted	.34	.46	.46	.38

1985	Three Months Ended March 31	June 30	Sept. 30	Dec. 31
Revenues	$135,673	$169,805	$195,501	$178,693
Operating income	8,958	28,159	27,857	13,550
Income before tax	6,998	25,963	21,693	6,130
Net income	5,323	19,154	16,809	5,992
Income per share:				
Primary	.18	.65	.53	.18
Fully diluted	.18	.63	.51	.18

COMMON STOCK PRICE RANGES AND DIVIDENDS

Southwest's Common Stock is listed on the New York Stock Exchange and trades under the symbol "LUV". The high and low sales prices of the Common Stock on the Composite Tape, and the quarterly dividends per share paid on the Common Stock were:

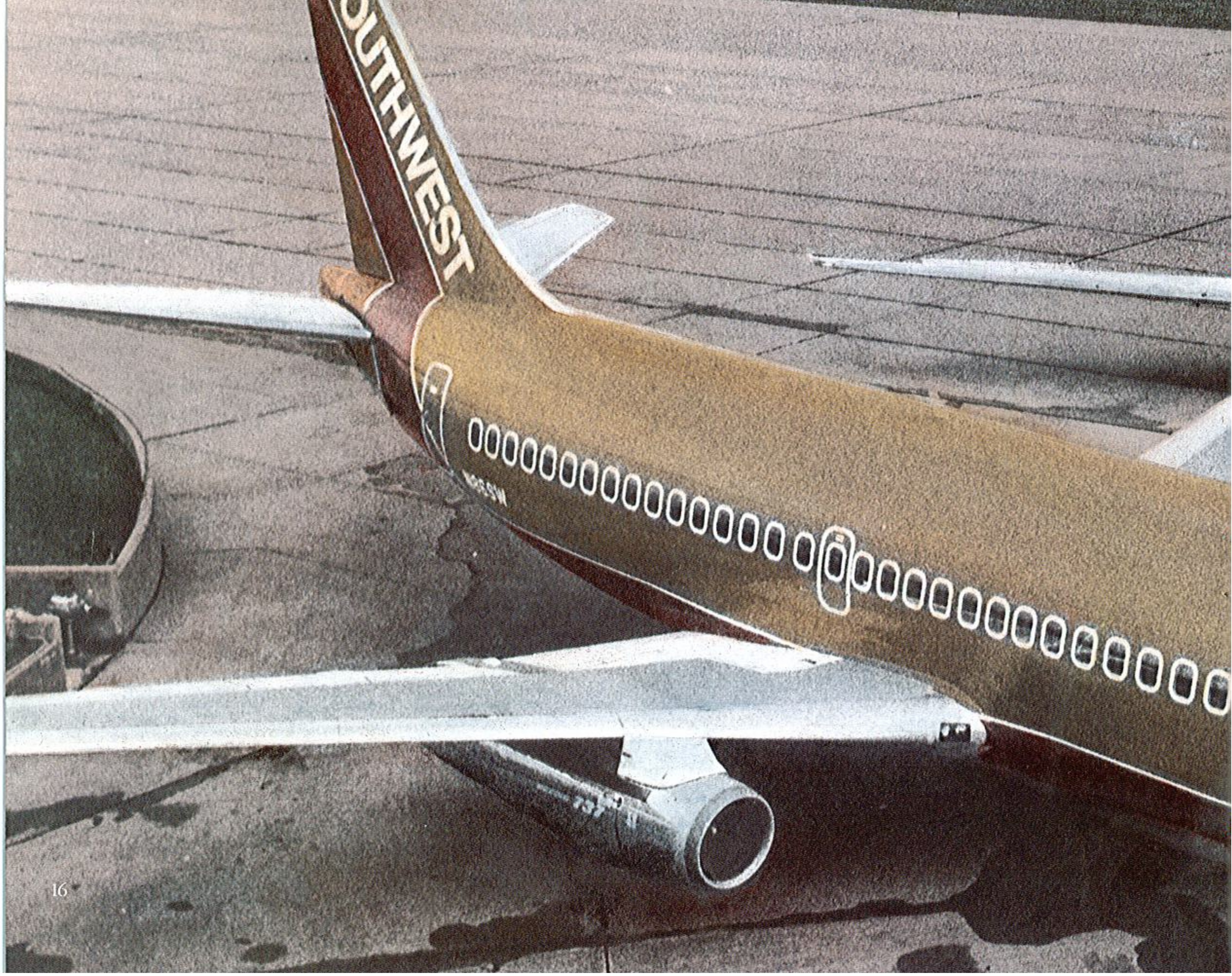
Period	Dividend	High	Low
1984			
1st Qtr.	.032	$29.38	$19.00
2nd Qtr.	.032	24.38	19.75
3rd Qtr.	.032	23.00	14.75
4th Qtr.	.032	23.38	16.88
1985			
1st Qtr.	.032	26.00	21.75
2nd Qtr.	.032	27.50	21.25
3rd Qtr.	.032	31.00	23.00
4th Qtr.	.032	29.63	22.63



Westward, ho! San Francisco added its unique charm to Southwest's western destinations, joining such popular cities as Los Angeles, San Diego and Las Vegas.

On June 25, 1985 Southwest acquired Muse Air. Kelleher, chairman of the board of the two companies, named William W. Franklin president and chief executive officer of Muse Air.

Franklin unveils the new name and new look of Muse Air's successor, TranStar.



The House That Love Built.™ Ronald McDonald House was the Official 1985 Charity of The Airline That Love Built.

From a bold vision sketched on a cocktail napkin, one of the country's most successful airlines is born.

Some highlights from our first fifteen years:

June 18, 1971.
Southwest Airlines' Inaugural Flight links the "Texas Triangle"—Dallas to Houston and San Antonio.

July 9, 1972.
Southwest introduces "Executive Class" service, includes complimentary cocktails.

April 28, 1973.
Judge Wm. W. Taylor rules Southwest can continue to operate from Dallas Love Field.

January 23, 1974.
Southwest carries one-millionth Customer.

October 24, 1975.
Southwest Airlines common stock is listed for public trading and assigned the ticker symbol "LUV".

June 18, 1976.
Southwest celebrates our fifth anniversary with parties in Dallas, Houston, San Antonio and our newest destination, the Rio Grande Valley.

December 31, 1977.
By year-end, Southwest is flying to five new Texas cities—Corpus Christi, Lubbock, Midland/Odessa, El Paso and Austin.

March 31, 1978.
New Maintenance Operations Center opens at Love Field.

August 30, 1979.
Southwest introduces automated ticket machines at 10 airports.

December 31, 1980.
Southwest ends the year flying to three new cities—Tulsa, Oklahoma City and Albuquerque.

June 18, 1981.
Southwest celebrates a decade of service 1971-1981.

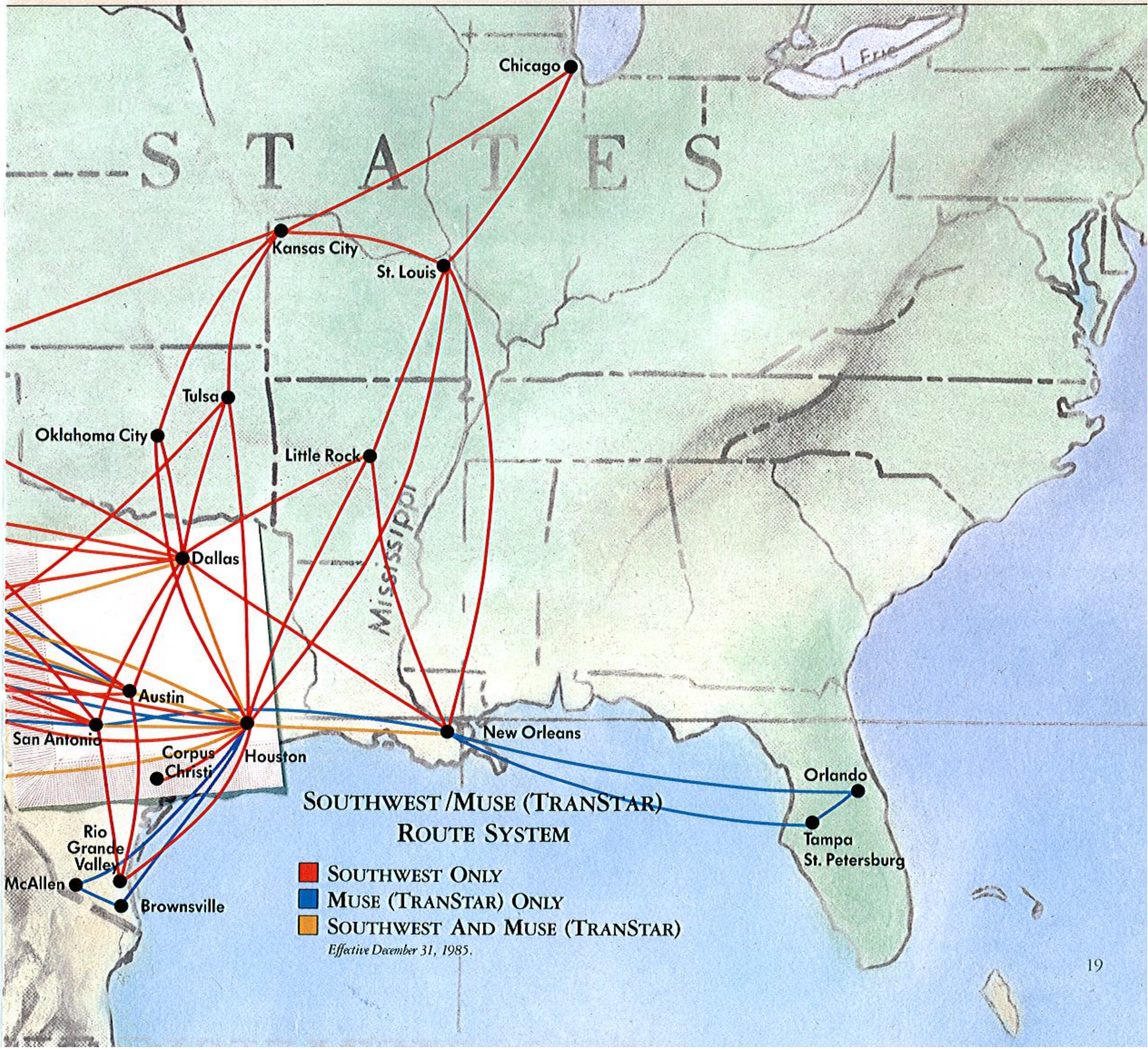
December 31, 1982.
Southwest Territory extends to six new cities—Kansas City, Las Vegas, Phoenix, San Diego, Los Angeles and San Francisco.

May 26, 1983.
Denver joins the ranks of Southwest cities.

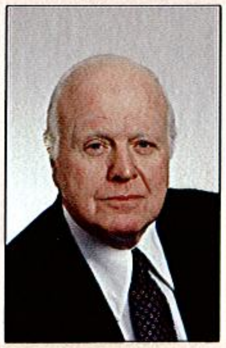
December 17, 1984.
Herbert D. Kelleher and Brigadier General Charles E. "Chuck" Yeager host the Inaugural Flight ceremonies unveiling the first 300 Series aircraft in Southwest's Boeing 737 fleet.

June 25, 1985.
Southwest Airlines acquires Muse Air, which becomes a wholly-owned subsidiary.

1986 & Beyond.
Muse Air will change its name to TranStar. The resulting Southwest/TranStar System will serve cities from coast-to-coast. Southwest will celebrate its fifteenth birthday.

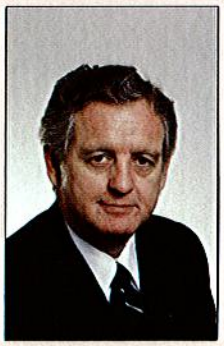


Directors Of Southwest Airlines Co.



Sidney A. Adger,
Consultant, Milchem, Inc., Houston, Texas; Audit and Compensation Committees

Samuel E. Barshop,
Chairman of the Board and President, La Quinta Motor Inns, Inc., San Antonio, Texas; Audit and Compensation Committees

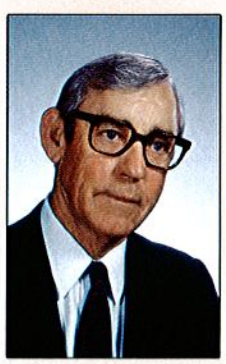


Gene H. Bishop,
Chairman of the Board and Chief Executive Officer, MCorp, Dallas, Texas; Audit, Compensation, and Executive Committees

Herbert D. Kelleher,
Chairman of the Board and President of Southwest Airlines Co., Dallas, Texas; Executive Committee

Travis C. Johnson,
Partner, Johnson & Bowen, El Paso, Texas; Audit Committee

Rollin W. King,
Executive Director, Russell Reynolds Associates, Inc., Dallas, Texas; Audit and Executive Committees



Walter M. Mischer, Sr.,
Chairman of the Board, Allied Bancshares, Inc., Chairman of the Board and Chief Executive Officer of the Mischer Corporation, Houston, Texas; Audit and Compensation Committees

Officers Of Southwest Airlines Co.

Herbert D. Kelleher
Chairman of the Board, President & Chief Executive Officer

Robert W. Lawless
Executive Vice President, Chief Operations Officer, & Chief Financial Officer

Gary A. Barron
Executive Vice President–Corporate Services

James G. Amos
Vice President–Flight Operations

Colleen C. Barrett
Vice President–Administration & Secretary

C. James Brunjes
Vice President–Systems

J. L. Herring
Vice President–Energy & Provisioning

Camille T. Keith
Vice President–Special Marketing

Marcy E. Lawless
Vice President–Personnel

William Q. Miller
Vice President–Inflight Service

James F. Parker
Vice President–General Counsel

Paul J. Quinn
Vice President–Schedule Planning

Ronnie L. Ricks
Vice President–Governmental Affairs

Donald G. Valentine
Vice President–Marketing

John A. Vidal
Vice President–Maintenance

James C. Wimberly
Vice President–Ground Operations

Earl L. Doolin
Controller

John D. Owen
Treasurer

Directors Of Muse Air Corporation

(TranStar Airlines Corp. Effective February 17, 1986)

Herbert D. Kelleher,
Chairman of the Board, Muse Air Corporation, Dallas, Texas

M. Lamar Muse,
Vice Chairman of the Board, Muse Air Corporation, Dallas, Texas

William W. Franklin,
President and Chief Executive Officer, Muse Air Corporation, Dallas, Texas

Officers Of Muse Air Corporation

(TranStar Airlines Corp. Effective February 17, 1986)

William W. Franklin
President & Chief Executive Officer

David C. Cummings
Vice President–Market Planning

Sally Glenn
Vice President–Inflight Services

C. Douglas Lane
Vice President–Purchasing

John L. Matter
Vice President–Flight Operations

W. Jack Mercer
Vice President–Ground Operations

Buford A. Minter
Vice President–Maintenance & Engineering

W. James Thomson
Vice President–Special Projects

Ronald E. Thornton
Vice President–Sales & Marketing

Patti C. McClendon
Secretary

Debra K. Cline
Controller

Jean Wetzel
Treasurer

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Southwest Airlines Co.
Consolidated Balance Sheet

(in thousands except for share and per share amounts)
December 31, 1985 and 1984

	1985	1984
Assets		
CURRENT ASSETS:		
Cash, including short-term investments of $64,920 ($25,797 in 1984)	$ 69,299	$ 26,498
Accounts receivable	31,864	19,524
Inventories of parts and supplies, at cost	8,581	4,564
Federal income tax refundable	—	5,460
Prepaid and other	8,153	6,713
TOTAL CURRENT ASSETS	117,897	62,759
Property and equipment, at cost (Note 5):		
Flight equipment – aircraft (Note 8)	828,841	540,504
Other flight and ground equipment (Note 3)	216,356	156,617
Land and building	9,826	8,665
	1,055,023	705,786
Less allowance for depreciation	173,493	125,677
	881,530	580,109
Deferred charges and other assets	2,976	3,376
Cost in excess of net assets acquired (net of accumulated amortization of $291)	19,993	—
	$1,022,396	$646,244
Liabilities and Stockholders' Equity		
CURRENT LIABILITIES:		
Current maturities of long-term debt	$ 12,478	$ 6,761
Accounts payable	25,819	19,648
Unearned revenues	4,228	2,528
Accrued liabilities (Note 4)	29,353	18,363
TOTAL CURRENT LIABILITIES	71,878	47,300
Long-term debt less current maturities (Note 5)	381,308	153,314
Deferred federal income tax	98,591	82,364
Deferred compensation	988	515
Other deferred items	3,627	983
Total liabilities	556,392	284,476
Commitments (Notes 3 and 8)		
STOCKHOLDERS' EQUITY:		
Common stock, $1.00 par value; 75,000,000 shares authorized; 32,254,220 shares issued and outstanding (29,532,572 in 1984)	32,254	29,570
Capital in excess of par value	175,166	117,643
Retained earnings	258,584	215,322
	466,004	362,535
Less 37,200 shares of treasury stock, at cost	—	767
TOTAL STOCKHOLDERS' EQUITY	466,004	361,768
	$1,022,396	$646,244

See accompanying notes.

Southwest Airlines Co.
Consolidated Statement of Income
(in thousands except share and per share amounts)

	Years ended December 31, 1985	1984	1983
OPERATING REVENUES:			
Passenger	$ 656,689	$ 519,106	$ 433,388
Package express	13,643	12,115	10,357
Other	9,340	4,727	4,491
Total operating revenues	679,672	535,948	448,236
OPERATING EXPENSES:			
Fuel and oil	165,008	146,232	123,629
Salaries, wages and benefits	156,339	123,024	97,681
Maintenance materials and repairs	38,272	25,312	16,345
Agency commissions	33,342	19,925	15,675
Landing fees and rentals	36,934	31,864	18,542
Other operating expenses	109,291	76,116	68,759
Depreciation	53,633	34,940	29,853
Employee profit sharing (Note 6)	8,329	10,038	9,254
Total operating expenses	601,148	467,451	379,738
OPERATING INCOME	78,524	68,497	68,498
NON-OPERATING (INCOME) EXPENSE:			
Interest and other income	(2,055)	(10,349)	(5,279)
Interest expense (Note 5)	26,914	16,145	12,423
Capitalized interest	(7,410)	(5,147)	(2,217)
Amortization of cost in excess of net assets acquired	291	—	—
Net non-operating expense	17,740	649	4,927
Income before federal income tax	60,784	67,848	63,571
Provision for federal income tax (Note 7)	13,506	18,124	22,704
NET INCOME	$ 47,278	$ 49,724	$ 40,867
NET INCOME PER COMMON SHARE:			
Weighted average common shares outstanding (adjusted for stock split)	30,766,000	29,472,000	29,193,000
Net income per share:			
Primary	$1.54	$1.69	$1.40
Fully diluted	$1.51	$1.64	$1.38

See accompanying notes.

Southwest Airlines Co.
Consolidated Statement of Stockholders' Equity
(in thousands except per share amounts)

	Three Years Ended December 31, 1985				
	Common stock	Capital in excess of par value	Retained earnings	Treasury stock	Total
BALANCE AT DECEMBER 31, 1982	$22,352	$ 85,943	$132,332	$ —	$240,627
Five-for-four stock split	5,888	(5,888)	—	—	—
Proceeds from issuance of common stock	1,200	35,630	—	—	36,830
Cash dividends, $.13 per share	—	—	(3,768)	—	(3,768)
Net income — 1983	—	—	40,867	—	40,867
BALANCE AT DECEMBER 31, 1983	29,440	115,685	169,431	—	314,556
Proceeds from issuance of common stock	130	1,958	—	(767)	1,321
Cash dividends, $.13 per share	—	—	(3,833)	—	(3,833)
Net income — 1984	—	—	49,724	—	49,724
BALANCE AT DECEMBER 31, 1984	29,570	117,643	215,322	(767)	361,768
Issuance of common stock and warrants for acquisition (Note 2)	793	25,365	—	767	26,925
Issuance of common stock upon conversion of debentures	1,891	32,158	—	—	34,049
Cash dividends $.13 per share	—	—	(4,016)	—	(4,016)
Net income — 1985	—	—	47,278	—	47,278
BALANCE AT DECEMBER 31, 1985	$32,254	$175,166	$258,584	$ —	$466,004

See accompanying notes.

Southwest Airlines Co.
Consolidated Statement of Changes in Financial Position

(in thousands)

	Years ended December 31, 1985	1984	1983
FINANCIAL RESOURCES WERE PROVIDED BY:			
Working capital provided from operations:			
Net income	$ 47,278	$ 49,724	$ 40,867
Items not affecting working capital during the current period:			
Depreciation	53,633	34,940	29,853
Deferred compensation and compensation element of executive stock options	516	325	370
Deferred federal income tax	12,535	19,033	18,895
Amortization of debt discount and debt premium	(456)	—	—
Amortization of cost in excess of net assets acquired	291	—	—
Other deferred items	255	(71)	128
Total from operations	114,052	103,951	90,113
Issuance of common stock and warrants	60,974	1,321	36,830
Issuance of long-term debt			
— Due to acquisition	41,230	—	—
— Other	121,302	1,320	69,504
Proceeds from sale and leaseback of aircraft under operating leases	54,865	—	—
Total source of funds	392,423	106,592	196,447
FINANCIAL RESOURCES WERE UTILIZED FOR:			
Net additions to property and equipment	214,516	184,259	83,253
Net non-current assets of Muse Air acquired (Note 2)	74,943	—	—
Cash dividends	4,016	3,833	3,768
Reduction of long-term debt	72,560	6,707	17,109
Other	(4,172)	1,162	1,745
Total application of funds	361,863	195,961	105,875
INCREASE (DECREASE) IN WORKING CAPITAL	$ 30,560	$ (89,369)	$ 90,572
CHANGES IN COMPONENTS OF WORKING CAPITAL:			
Working capital deficiency of Muse Air acquired	$ (7,213)	$ —	$ —
Increase (decrease) in current assets:			
Cash, including short-term investments	39,021	(104,203)	113,979
Accounts receivable	2,681	1,717	1,936
Inventories	3,308	1,429	864
Federal income tax refundable	(5,460)	5,336	(4,673)
Prepaid and other	731	5,260	(485)
	40,281	(90,461)	111,621
Increase (decrease) in current liabilities:			
Current maturities of long-term debt	(1,743)	301	1,387
Accounts payable	3,000	(153)	7,496
Unearned revenues	200	—	1,000
Accrued liabilities	1,051	(1,240)	11,166
	2,508	(1,092)	21,049
Increase (decrease) in working capital	$ 30,560	$ (89,369)	$ 90,572

See accompanying notes.

1. Summary of significant accounting policies

Basis of presentation —
The consolidated financial statements include the accounts of Southwest Airlines Co. (Southwest) and its wholly owned subsidiaries, Muse Air Corporation (Muse Air) and Southwest Airlines Eurofinance N.V. (collectively referred to as the "Company"). All significant intercompany balances and transactions have been eliminated. Certain reclassifications of amounts previously reported in the financial statements at December 31, 1984, have been made to conform to the presentation at December 31, 1985.

Property and equipment —
Depreciation is provided by the straight-line method to residual values over periods ranging from fifteen to eighteen years for aircraft, three to twenty years on other flight and ground equipment and over thirty years for buildings. The Company charges major aircraft maintenance costs to operations as incurred. Property under capital leases and related obligations are recorded at an amount equal to the present value of future minimum lease payments computed on the basis of the lessee's incremental borrowing rate or, when known, the interest rate implicit in the lease. Property under capital leases is amortized on a straight-line basis over their fifteen and nineteen year lease terms.

Cost in excess of net assets acquired —
Cost in excess of net assets acquired resulting from the acquisition of Muse Air is being amortized over forty years on a straight-line basis.

Investment tax credits —
Investment tax credits are accounted for by the flow-through method.

Unearned revenues —
Unearned revenues represent the sale of tickets through travel agents for which travel has not yet been provided.

Per share amounts —
Primary earnings per share computations are based upon the weighted average number of shares outstanding during the respective periods. Fully diluted earnings per share are computed as if the 10% and the 6¾% Convertible Subordinated Debentures were converted into shares of common stock at the beginning of each period presented.

2. Business acquisition

Southwest acquired Muse Air, a corporation engaged in public air transportation, which has been accounted for as a purchase.

Effective June 30, 1985 Southwest acquired 100 percent of the stock of Muse Air for consideration to the former Muse Air shareholders of (i) approximately $40.5 million in cash and (ii) 830,320 shares of Southwest Common Stock, $1.00 par value, and (iii) 1,080,320 warrants to purchase Southwest Common Stock at $35 per share, subject to adjustment, expiring on June 25, 1990.

The following summarizes the net assets of Muse Air acquired:

Working capital deficiency	$ (7,213)
Flight equipment — aircraft	170,676
Other non-current assets	24,807
Excess cost over net assets acquired	20,284
Long-term debt and other non-current liabilities assumed	(140,824)
Total purchase price	$ 67,730

The following unaudited pro forma information presents condensed results of operations for the years ended December 31, 1985 and 1984 as though the purchase of Muse Air were made at the beginning of each period presented. Such figures are not represented to be indicative of what actual sales and earnings would have been for either period or will be in the future. The results are based upon purchase accounting adjustments recognized on consolidating Muse Air and include additional interest expense as if funds borrowed in connection with the acquisition had been outstanding from the beginning of each year.

(in thousands except per share data)

	Pro forma unaudited Year ended December 31,	
	1985	1984
Revenues	$737,660	$637,866
Net income	$ 42,485	$ 40,106
Net income per share:		
Primary	$ 1.36	$ 1.32
Fully diluted	$ 1.35	$ 1.31

3. Flight and ground equipment

At December 31, 1985, Southwest's contractual commitments consist primarily of scheduled aircraft acquisitions. Seven Boeing 737-300's will be delivered in 1986, nine in 1987, six in 1988 and three in 1989. Southwest also has a spare engine on order for 1986 and a flight simulator scheduled for completion in 1986. The remainder of payments due on these capital commitments (including escalation, capitalized interest and buyer-furnished equipment) was $494,939,000 at December 31, 1985. These commitments will be due as follows: $165,129,000 in 1986, $169,175,000 in 1987, $110,815,000 in 1988 and $49,820,000 in 1989. In addition, Southwest has options to purchase ten Boeing 737-300 aircraft. Deposits totaling $250,000 have been made to secure delivery positions in years 1987 through 1990 in the event Southwest exercises its purchase options. Also, at December 31, 1985, Muse Air had outstanding purchase commitments for (i) twenty-three engine performance kits at $517,000 each for installation during 1986 and 1987 and (ii) two used DC-9-51 aircraft at $9.2 million each scheduled for delivery in March 1986.

Other flight and ground equipment consists of (in thousands):

	1985	1984
Progress payments on aircraft	$71,381	$59,106
Support flight equipment	63,336	38,759
Ground equipment	38,479	29,527
Leasehold improvements	22,612	16,659
Construction in progress	20,548	12,566
	$216,356	$156,617

4. Accrued liabilities

Accrued liabilities consist of (in thousands):

	1985	1984
Profit sharing (Note 6)	$ 5,985	$ 3,207
Interest	5,964	5,611
Vacation pay	6,288	4,850
Ad valorem taxes	5,205	3,505
Other	5,911	1,190
	$29,353	$18,363

5. Long-term debt

Long-term debt less current maturities consists of (in thousands):

	1985	1984
Southwest:		
Bank Credit Agreements	$107,000	$ —
Euro Note Programme	23,090	—
10.4% ETC's due July 1, 1994	14,330	16,120
10.3% ETC's due January 1, 1995	11,901	13,301
10.3% ETC's due July 1, 1995	13,313	14,792
10% Convertible Subordinated Debentures due 2007	—	34,887
6¾% Convertible Subordinated Debentures due 1998	35,000	35,000
Capital Leases (Note 8)	71,642	31,634
French Export Credit Agreement	17,676	—
Industrial Revenue Bonds	4,300	5,400
Other	440	2,180
Muse Air:		
Notes payable to banks due December 31, 1991	27,060	—
ETC's due June 15, 1999	50,000	—
Debt discount	(2,146)	—
Debt premium	7,702	—
	$381,308	$153,314

The Credit Agreement with a group of domestic banks permits Southwest to borrow through December 18, 1988 on a revolving credit basis up to the lesser of the primary commitment ($74,000,000 at December 31, 1985) or 80% of the net book value of Southwest's unencumbered aircraft ($402,848,000 at December 31, 1985). The primary commitment can be increased to as much as $150,000,000 or decreased to as little as $40,000,000 at Southwest's option. Interest rates on borrowings under the Credit Agreement can be, at the option of Southwest, the agent bank's prime rate, ½% over LIBOR or ½% over domestic certificate of deposit rates. The commitment fee is ⅜% per annum on the unused portion of the primary commitment and ⅛% per annum on the difference between $150,000,000 and the amount of the primary commitment. As of December 31, 1985, $57,000,000 was outstanding under this agreement.

A Transferable Advances Facility Agreement with a group of European banks permits Southwest to borrow on a revolving credit basis up to $50,000,000 through June 21, 1990. Borrowings bear interest from 0.15% to 0.35% over LIBOR. The agreement provides for commitment fees of (i) 0.15% per annum on the unused portion of the Available Commitment, as defined, (ii) 0.10% per annum on the Reserve Commitment, as defined, and (iii) 0.10% per annum on the Available Commitment, whether or not used. At Southwest's option, the Available Commitment can be increased to as much as $50,000,000 or decreased to as little as $10,000,000. As of December 31, 1985, $50,000,000 was outstanding under the agreement.

During 1985 Southwest established a Euro Note Programme whereby it can issue from time to time up to $50,000,000 of unsecured short-term notes in the European market. The notes are sold through a single dealer on a best efforts basis. At December 31, 1985 the weighted average interest rate on the outstanding notes was 8.33%. These notes have been classified as long-term debt in accordance with Financial Accounting Standards Board Statement No. 6, based on Southwest's ability and intent to refinance the obligations.

The 10.3% and 10.4% Equipment Trust Certificates require semi-annual principal and interest payments and are secured by ten Boeing 737-200 advanced series aircraft with a net book value of $55,753,000 at December 31, 1985.

The 10% Debentures were called for redemption by Southwest in August, 1985. However, substantially all of the Debentures were converted by their holders into Southwest Common Stock pursuant to the terms of the Debentures.

The 6¾% Debentures were issued by Southwest Airlines Eurofinance N.V. and are convertible into Southwest Common Stock at any time on or before July 1, 1998, unless previously redeemed, at a conversion price of $38.30 per share, subject to adjustment in certain events. Interest is payable on July 1 of each year. The 6¾% Debentures are redeemable at the issuer's option prior to July 1, 1986 if the market price of Southwest's Common Stock has been at least 130% of the conversion price for a specified period prior to redemption, at a price of 104% of face value. After July 1, 1986, they are redeemable at prices beginning at 103% of face value in 1986, and declining by 1% per year to 100% in 1989 and thereafter.

The French Export Credit Agreement requires Southwest to make sixteen semi-annual installments of principal and interest beginning in June 1986. The debt is secured by one Boeing 737-300 and one Boeing 737-200 aircraft and bears interest at 10.5% per annum.

The Industrial Revenue Bonds mature in series annually between 1985 and 1994. Interest is payable semi-annually on January 1 and July 1 at an effective rate of 60% of prime but not less than 7½% or more than 15%. The Bonds are secured by Southwest's Reservations Center in San Antonio.

The notes payable to banks due December 31, 1991 are obligations of Muse Air secured by two MD-80 aircraft. The FAA has guaranteed 90% of the principal and all of the interest on the notes. The aircraft manufacturer guarantees the remaining principal payments. The notes bear interest on 90% of the principal balance at the greater of a certificate of deposit rate plus ½% per annum or 115% of a 90-day treasury bill rate (as defined in the loan participation agreement) and prime rate on the remainder. As of December 31, 1985, Muse Air was not in compliance with certain financial covenants respecting this debt. However, a waiver of such compliance through March 31, 1986 has been obtained. These notes have been classified as long-term debt in accordance with Financial Accounting Standards Board Statement No. 6, based on Southwest's ability and intent to refinance the obligations.

During June, 1984, Muse Air issued $50,000,000 of 16⅞% Equipment Trust Certificates due June 15, 1999 secured by three MD-80 aircraft. Interest is payable December 15 and June 15 of each year. The certificates are entitled to an annual sinking fund of $5,000,000 beginning June 15, 1991, calculated to retire 80% of the certificates prior to maturity. The certificates are redeemable, at Muse Air's option, at any time on or after June 15, 1989 at prices beginning at 109.15% of face value and declining to 100% in years 1997 and thereafter.

The Muse Air notes payable to banks and Equipment Trust Certificates were revalued as of the acquisition date at Southwest's borrowing rate for similar debt instruments (approximately 9.1% and 12.5%, respectively). The after-tax net present value of the differential between interest at stated rates and interest at revalued rates has been recorded as a debt premium and is being amortized over the term of the debt using the interest method.

Long-term debt principal payments, exclusive of capital leases, due in the next five years are (in thousands):

1986	$11,945
1987	10,645
1988	10,205
1989	10,205
1990	10,255

6. Employee profit sharing and stock ownership plans

Substantially all of the Company's employees are members of a profit sharing plan.

Southwest's plan provides that Southwest may contribute, as determined by the Board of Directors, the lesser of 15% of its adjusted pretax income (as defined by the plan) or the maximum amount deductible for federal income tax purposes.

Muse Air's plan provides for quarterly cash bonuses equal to 20% of its adjusted pretax income (as defined by the plan).

Southwest also has an Employee Stock Ownership Plan which, under Internal Revenue Service regulations, allows a tax credit equal to ½% of salary and wage expense if this amount is invested in Southwest stock on behalf of its employees.

7. Federal income tax

Provisions for federal income tax are as follows (in thousands):

	1985	1984	1983
Current	$ 971	$ (909)	$ 3,809
Deferred	12,535	19,033	18,895
	$13,506	$18,124	$22,704

The provision for federal income tax reconciles to the statutory rate as follows (in thousands):

	1985		1984		1983	
	Amount	%	Amount	%	Amount	%
Income tax provision at statutory rate	$27,961	46	$31,210	46	$29,243	46
Investment tax credit	(14,001)	(23)	(12,853)	(19)	(6,723)	(10)
Other tax credits	(618)	(1)	(512)	(1)	(403)	(1)
Other	164	—	279	1	587	1
	$13,506	22	$18,124	27	$22,704	36

Deferred federal income tax results from (in thousands):

	1985	1984	1983
Timing differences in flight and ground equipment	$27,318	$22,990	$15,644
Capitalized interest	2,845	2,162	519
Capital leases	(925)	(1,533)	(735)
Tax benefit transfer	(1,030)	(970)	(1,192)
Application of tax credits	(15,693)	(3,755)	3,731
Other	20	139	928
	$12,535	$19,033	$18,895

Timing differences in flight and ground equipment result principally from the use of accelerated depreciation methods for federal income tax reporting.

At December 31, 1985 Muse Air has available $56,142,000 in pre-acquisition operating loss carryforwards and $4,549,000 in pre-acquisition investment tax credit carryforwards for federal income tax purposes. For financial reporting purposes, Muse Air's pre-acquisition carryforwards (net operating loss of $20,253,000 and investment tax credit of $4,549,000) will reduce goodwill in future periods to the extent that their tax effects are utilized. The carryforwards will expire in 1995 through 2000 if they remain unutilized.

Also, at December 31, 1985, Southwest has available $20,307,000 in investment tax credit carryforwards for federal income tax purposes. The carryforwards will expire in 1999 and 2000 if not previously utilized.

8. Other Commitments

Total rental expense charged to operations in 1985, 1984 and 1983, was $23,717,000, $19,465,000 and $8,329,000, exclusive of landing fees of $13,217,000, $12,399,000 and $10,213,000 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 and six aircraft are under operating leases. The following amounts applicable to capital leases are included in property and equipment (in thousands):

	1985	1984
Flight equipment — aircraft	$72,382	$31,904
Less accumulated amortization	4,461	2,334
	$67,921	$29,570

At December 31, 1985, obligations under capital leases and non-cancelable operating leases for future minimum lease payments were as follows (in thousands):

	Capital Leases	Operating Leases
1986	$ 6,110	$ 16,026
1987	7,937	14,845
1988	8,923	14,728
1989	8,923	14,877
1990	8,923	17,989
After 1990	113,594	88,145
Total minimum lease payments	154,410	$166,610
Less amount representing interest	82,305	
Present value of minimum lease payments	72,105	
Less current portion	463	
Long-term portion	$ 71,642	

Auditor's Report

The Board of Directors
Southwest Airlines Co.

We have examined the accompanying consolidated balance sheet of Southwest Airlines Co. at December 31, 1985 and 1984, and the related consolidated statements of income, stockholders' equity and changes in financial position for each of the three years in the period ended December 31, 1985. 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, 1985 and 1984, and the consolidated results of operations and changes in financial position for each of the three years in the period ended December 31, 1985, in conformity with generally accepted accounting principles applied on a consistent basis during the period.

Arthur Young & Company

Dallas, Texas
January 24, 1986

Supplementary Information on Effects of Changing Prices (Unaudited)

Financial reporting and changing prices

Statement of Financial Accounting Standards No. 33, "Financial Reporting and Changing Prices," requires providing certain information about the effects of changes in specific prices (current costs). It is hoped that measuring certain assets and expenses at current costs will provide better information to investors, creditors and others to assess prospective cash flow and current economic resources. The information provided should be viewed as an estimate of the approximate effect of inflation, rather than as a precise measure. In inflationary periods, prices of goods and services will not all necessarily increase at the same rate. The impact of inflation on a specific company may also be measured by estimates of the change in prices of specific goods and services that the company uses.

Methods of computation

The current cost of property and equipment was determined by the following methods:

a) Direct pricing — the Company's aircraft fleet was priced using current new purchase prices and deducting an allowance for the age of each aircraft or aircraft appraisals, when available. Spare rotable equipment was valued by applying the ratio of the historical cost of the aircraft fleet to its current cost to historical cost of rotable equipment.

b) Indexing — all ground equipment, building and facilities were valued by applying the Consumer Price Index for All Urban Consumers (CPI-U) to the appropriate asset account.

Depreciation was computed utilizing the same depreciable life assumptions as used for the historical cost basis financial statements.

Table I "Statement of Income Adjusted for Changing Prices" restates net income for the year based upon the restatement of property and equipment adjusted for changes in specific prices.

Since the depreciable value of the Company's property and equipment was lower when adjusted for its average 1985 current costs than its historical cost, the depreciation expense computed on this lower value was therefore less as reflected in the disclosures of adjusted depreciation expense and adjusted net income in Table I.

Table I "Effect on Relevant Balance Sheet Accounts at December 31, 1985 of Adjustment for Changing Prices" also presents the changes in values of "net monetary assets" which occurred during 1985. The first item is a gain due to inflation based on the decline in purchasing power of net monetary amounts owed. The Company's current assets (except flight equipment parts, fuel inventories and prepaid expenses) and most of its liabilities (except unearned revenue and accrued vacation pay) are monetary items. Since monetary liabilities during 1985 were greater than monetary assets, an unrealized gain of $9,010,000 resulted. It must be noted, however, that the gain may only be realized when such liabilities are paid in the future with then cheaper dollars.

The next three items in Table I show that the value of the Company's net property and equipment has, as valued in current cost 1985 dollars, decreased during the year by $28,921,000. For the same period, the increase in net property and equipment as adjusted for the effects of general inflation was $25,553,000. The difference between the two adjusted amounts reflects the extent to which increases in the general rate of inflation exceeded current costs.

The final item in Table I shows the effect of restating net assets at year-end for the effects of changing prices.

Table II is a five-year summary of certain selected supplementary financial data as adjusted for general inflation (CPI-U) as required by FASB 33.

Current tax laws do not recognize deductions for current cost of depreciation and amortization expense; therefore, income taxes provided are reported in historical dollars as required by FASB 33.

The information presented in response to FASB 33 will continue to be examined by the Financial Accounting Standards Board in order to determine whether or not changes in current valuation of certain assets should continue to be shown or whether another method of calculation would be more useful.

TABLE I

STATEMENT OF INCOME ADJUSTED FOR CHANGING PRICES FOR THE YEAR ENDED DECEMBER 31, 1985

(in thousands except per share amounts)

	As Reported in the Primary Statements	Adjusted for Changes in Specific Prices (Current Costs)
Operating revenues	$679,672	$679,672
Depreciation expense	53,633	52,452
Other expenses	565,255	565,255
Provision for income taxes	13,506	13,506
Total expense	632,394	631,213
Net income	$ 47,278	$ 48,459
Net income per common share — primary	$ 1.54	$ 1.58

EFFECT ON RELEVANT BALANCE SHEET ACCOUNTS AT DECEMBER 31, 1985 OF ADJUSTMENT FOR CHANGING PRICES

(in thousands)

	As Reported in the Primary Statements	Adjusted for Changes in Specific Prices (Current Costs)
Gain from decline in purchasing power of net amounts owed		$ 9,010
Decrease in specific prices (current costs of property and equipment)*		$ 28,921
Increase in general price level (inflation component) of property and equipment		25,553
Excess of increase in general price level over increase in specific prices		$ 54,474
Net assets at year-end	$466,004	$506,745

*At December 31, 1985, current cost of property and equipment net of accumulated depreciation was $843,744,000.

TABLE II

FIVE-YEAR COMPARISON OF SELECTED SUPPLEMENTARY FINANCIAL DATA

(dollar amounts in thousands except per share amounts)

	Years ended December 31,				
	1985	1984	1983	1982	1981
Operating revenues	$679,672	$535,948	$448,236	$341,843	$296,163
Historical cost information adjusted for specific prices —					
Net income	48,459	42,184	33,856	28,094	30,049
Net income per share — primary	1.58	1.43	1.16	1.06	1.18
Excess of increase in the general price level over increase in specific prices	54,474	11,433	4,107	3,070	14,865
Net assets	506,745	417,575	370,944	298,776	229,463
Depreciation and amortization	52,452	42,480	36,864	27,586	19,419
Gain from decline in purchasing power of net amounts owed	9,010	4,323	3,699	2,621	5,929
Cash dividends paid per common share	0.13	0.13	0.13	0.13	0.12
Market price per common share at year-end	26.88	22.00	27.20	21.99	12.65
Average consumer price index (1967 = 100)	322.2	311.1	298.4	289.1	272.4

Supplementary Information — Consolidating Financial Statements

The following consolidating financial statements are presented to enable the reader to analyze Southwest Airlines and Muse Air as separate entities. The information labeled as "Southwest" is consolidated information of Southwest Airlines Co. and its 100% owned subsidiary, Southwest Airlines Eurofinance N.V.. The information labeled as "Muse Air" is presented on a "Push-down" basis, meaning that it contains the adjustments necessary to reflect accounting for the acquisition of Muse Air by the purchase method. The provision for federal income tax has been calculated on a consolidated basis and allocated 100% to Southwest.

Southwest Airlines Co.
Consolidating Balance Sheet
December 31, 1985

(in thousands)

	South-west	Muse Air	Elim-inations	Consoli-dated
Assets				
CURRENT ASSETS:				
Cash and short-term investments	$ 36,560	$ 32,739	$	$ 69,299
Accounts receivable, net	24,305	8,713	(1,154) (d)	31,864
Inventories of parts and supplies, at cost	7,708	873		8,581
Prepaid and other	34,639	916	(27,402) (a)(b)	8,153
TOTAL CURRENT ASSETS	103,212	43,241		117,897
Property and equipment, at cost				
Flight equipment — aircraft	703,042	125,799		828,841
Other flight and ground equipment	195,000	21,356		216,356
Land and building	9,826	—		9,826
	907,868	147,155		1,055,023
Less allowance for depreciation	167,648	5,845		173,493
	740,220	141,310		881,530
Deferred charges and other assets	2,896	80		2,976
Investment in Muse Air	73,477	—	(73,477) (c)	—
Cost in excess of net assets acquired	—	19,993		19,993
	$919,805	$204,624	$(102,033)	$1,022,396
Liabilities and Stockholders' Equity				
CURRENT LIABILITIES:				
Current maturities of long-term debt	$ 10,018	$ 27,925	$ (25,465) (a)	$ 12,478
Accounts payable	21,944	4,593	(718) (d)	25,819
Unearned revenues	3,028	1,200		4,228
Accrued liabilities	23,319	8,407	(2,373) (b)(d)	29,353
TOTAL CURRENT LIABILITIES	58,309	42,125		71,878
Long-term debt less current maturities	298,692	82,616		381,308
Deferred federal income tax	94,900	3,691		98,591
Deferred compensation	988	—		988
Other deferred items	912	2,715		3,627
Total liabilities	453,801	131,147	(28,556)	556,392
STOCKHOLDERS' EQUITY:				
Common stock	32,254	—		32,254
Capital in excess of par value	175,166	—		175,166
Investment from Southwest	—	73,477	(73,477) (c)	—
Retained earnings	258,584	—		258,584
TOTAL STOCKHOLDERS' EQUITY	466,004	73,477	(73,477)	466,004
	$919,805	$204,624	$(102,033)	$1,022,396

Southwest Airlines Co.
Consolidating Statement of Income
(in thousands)

	For The Year Ended December 31, 1985 South-west	Muse Air	Elimi-nations	Consoli-dated	Dec. 31, 1984 South-west
OPERATING REVENUES					
Passenger	$586,639	$70,050	$	$656,689	$519,106
Package express	12,711	932		13,643	12,115
Other	6,729	2,881	(270) (d)	9,340	4,727
Total operating revenues	606,079	73,863		679,672	535,948
OPERATING EXPENSES					
Fuel and oil	145,682	19,326		165,008	146,232
Salaries, wages and benefits	144,493	11,846		156,339	123,024
Maintenance materials and repairs	35,367	2,905		38,272	25,312
Agency commissions and fees	28,805	4,554	(17) (d)	33,342	19,925
Landing fees and rentals	32,333	4,601		36,934	31,864
Other operating expenses	95,246	14,298	(253) (d)	109,291	76,116
Depreciation	45,624	8,009		53,633	34,940
Employee profit sharing	8,329	—		8,329	10,038
Total operating expenses	535,879	65,539		601,148	467,451
OPERATING INCOME	70,200	8,324	—	78,524	68,497
NON-OPERATING EXPENSE (INCOME)					
Interest and other income	(3,244)	(159)	1,348 (b)	(2,055)	(10,349)
Interest expense	20,298	7,964	(1,348) (b)	26,914	16,145
Capitalized interest	(7,335)	(75)		(7,410)	(5,147)
Amortization of cost in excess of net assets acquired	—	291		291	—
Net non-operating expense	9,719	8,021		17,740	649
Income before federal income tax	60,481	303		60,784	67,848
Provision for federal income tax	13,506	—		13,506	18,124
NET INCOME	$46,975	$ 303	$ —	$ 47,278	$ 49,724

(a) To eliminate intercompany debt.

(b) To eliminate the interest on intercompany debt.

(c) To eliminate the investment in Muse Air.

(d) To eliminate other intercompany balances and transactions.

Eight Year Summary of Operations and Financial Results

	Year Ended December 31, 1985			
	Consolidated	Southwest	Muse Air	1984
OPERATIONS AND TRAFFIC				
Available seat miles (ASM's) (000)	9,884,526	8,716,608	1,167,918	7,983,093
Trips flown	230,227	208,368	21,859	200,124
Average length of flight segment	341	333	414	321
Size of fleet at year-end	70†	56	14†	54†
Passengers carried	12,651,239	11,595,602	1,055,637	10,697,544
Revenue passenger miles (RPM's) (000)	5,971,400	5,336,560	634,840	4,669,435
Average passenger fare	$ 51.91	$ 50.59	$ 66.36	$ 48.53
Average length of passenger haul	472	460	601	436
Yield per passenger mile	11.00¢	10.99¢	11.03¢	11.12¢
Actual load factor	60.4%	61.2%	54.4%	58.5%
Break-even load factor*	52.9%	52.7%	53.8%	48.3%
FINANCIAL (000)				
Operating revenues	$ 679,672	$ 606,079	$ 73,863	$ 535,948
Operating expenses	601,148	535,879	65,539	467,451
Operating income	78,524	70,200	8,324	68,497
Income before FIT	60,784	60,481	303	67,848
Net income	47,278	46,975	303	49,724
INVESTOR STATISTICS				
Avg. no. of common shares outstanding	30,766,345			29,472,428
Common shares outstanding	32,254,220			29,532,572
Earnings per share	$ 1.54‡			$ 1.69‡
Dividends per share	$ .13			$ .13
Book Value per share	$ 14.45			$ 12.25
Stockholders' equity/investment (000)	$ 466,004	$ 466,004	$ 73,477	$ 361,768
Return on Stockholders' equity/investment	11.4%	11.4%	.7%★	14.7%
CAPITAL STRUCTURE (000)				
Total assets	$ 1,022,396	$ 919,805	$ 204,624	$ 646,244
Aftertax return on total assets	5.5%	6.1%	.2%★	8.1%
Working capital	$ 46,019	$ 44,903	$ 1,116	$ 15,459
Current ratio	1.64:1	1.77:1	1.03:1	1.33:1
Flight and ground equipment-net	$ 881,530	$ 740,220	$ 141,310	$ 580,109
Capital expenditures	$ 214,516	$ 205,735	$ 8,781	$ 184,259
Long-term debt (L-T D)	$ 381,308	$ 298,692	$ 82,616	$ 153,314
L-T D as a % of total invested capital	45.0%	39.1%	52.9%	29.8%
PRODUCTIVITY AND UNIT COSTS				
Number of employees at year-end	5,271	4,228	1,043	3,934
Average number of employees	4,672	4,162	510★	3,804
Passengers boarded per employee	2,708	2,786	2,070★	2,812
RPM's per employee (000)	1,278	1,282	1,244★	1,228
Revenue per employee	$ 145,478	$ 145,622	$ 144,830★	$ 140,891
Fuel costs per available seat mile	1.7¢	1.7¢	1.6¢	1.8¢
All other operating costs per ASM	4.4¢	4.4¢	4.0¢	4.1¢
Total operating cost per ASM	6.1¢	6.1¢	5.6¢	5.9¢
Fuel cost per gallon-average	78.17¢	78.35¢	76.88¢	82.44¢
Fuel cost per gallon-year-end	80.49¢	80.52¢	79.80¢	80.53¢
Fuel as a % of operating costs	27.4%	27.1%	29.4%	31.3%
Daily block hours per aircraft	11:10	11:13	10:43	11:28

*Based on operating revenues per passenger needed to cover total expenses excluding profit sharing and federal income taxes.
†Includes leased aircraft.
‡Earnings per share-fully diluted $1.51 in 1985, $1.64 in 1984, $1.38 in 1983 and $1.26 in 1982.
★Annualized.

Years Ended December 31,

1983	1982	1981	1980	1979	1978
6,324,224	4,907,945	3,633,351	2,969,448	2,320,371	1,556,173
175,421	140,030	110,301	91,143	75,837	54,816
303	297	279	276	264	253
46†	37†	27†	23	18	13
9,511,000	7,965,554	6,792,927	5,976,621	5,000,086	3,528,105
3,893,821	3,022,142	2,310,181	2,024,097	1,585,539	1,048,624
$ 45.57	$ 39.92	$ 38.07	$ 34.18	$ 26.10	$ 21.99
409	379	340	339	317	297
11.13¢	10.52¢	11.19¢	10.09¢	8.23¢	7.40¢
61.6%	61.6%	63.6%	68.2%	68.3%	67.4%
49.7%	52.9%	48.3%	50.6%	53.6%	49.9%
$ 448,236	$ 331,189	$ 270,358	$ 213,048	$ 136,114	$ 81,065
379,738	291,964	221,854	164,219	107,128	59,943
68,498	39,225	48,504	48,829	28,986	21,122
63,571	44,390	48,265	41,290	20,714	23,956
40,867	34,004	34,165	28,447	16,652	17,004
29,193,320	26,646,033	25,299,573	21,893,723	21,093,750	21,093,750
29,439,895	27,939,895	26,018,750	23,675,000	21,093,750	21,093,750
$ 1.40‡	$ 1.28‡***	$ 1.35	$ 1.30	$ .79	$ .81**
$ .13	$ .13	$ .11	$ .09	$ .06	$ .04
$ 10.68	$ 8.61	$ 6.78	$ 4.52	$ 2.77	$ 2.03
$ 314,556	$ 240,627	$ 176,503	$ 106,964	$ 58,412	$ 42,889
14.2%	16.7%***	23.5%	36.0%	33.1%	50.3%**
$ 587,258	$ 420,542	$ 291,823	$ 224,442	$ 172,495	$ 118,706
8.1%	9.6%***	13.0%	14.1%	11.7%	17.2%**
$ 104,828	$ 14,256	$ 5,999	$ 9,979	$ 8,195	$ 9,667
3.17:1	1.52:1	1.23:1	1.53:1	1.64:1	3.39:1
$ 430,790	$ 377,390	$ 258,982	$ 194,908	$ 150,576	$ 104,744
$ 83,253	$ 140,084	$ 79,377	$ 56,504	$ 54,314	$ 40,204
$ 158,701	$ 106,306	$ 58,934	$ 77,892	$ 87,374	$ 62,000
33.5%	30.6%	25.0%	42.1%	59.9%	59.1%
3,462	2,913	2,129	1,839	1,630	1,119
3,206	2,618	2,106	1,741	1,450	1,024
2,967	3,043	3,226	3,433	3,448	3,445
1,215	1,154	1,097	1,163	1,093	1,024
$ 139,812	$ 126,505	$ 128,375	$ 122,371	$ 93,872	$ 79,165
2.0¢	2.2¢	2.5¢	2.1¢	1.6¢	1.1¢
4.0¢	3.7¢	3.6¢	3.4¢	3.0¢	2.8¢
6.0¢	5.9¢	6.1¢	5.5¢	4.6¢	3.9¢
85.92¢	94.51¢	101.67¢	85.0¢	59.3¢	38.2¢
84.10¢	93.35¢	100.73¢	89.7¢	71.3¢	37.5¢
32.6%	36.9%	40.5%	37.7%	35.1%	27.5%
11:40	11:46	11:36	11:16	11:37	10:36

***Includes a gain from the sale of tax benefits relating to three aircraft of approximately $11,070,000 which, after adjustment for tax, increased net income by $2.0 million and earnings per share by $.08.

**Includes a net of tax gain on disposition of aircraft of $4,456,000 and net cumulative effect of an accounting change of $735,000 for a total per share amount of $.25.

Corporate Data

Transfer Agent and Registrar
MBank Dallas N.A.
P.O. Box 225415
Dallas, Texas 75265

Stock Exchange Listing
New York Stock Exchange
Ticker Symbol: LUV

Auditors
Arthur Young & Company
Dallas, Texas

General Offices
P.O. Box 37611
Love Field
Dallas, Texas 75235

Annual Meeting
The Annual Meeting of Shareholders of Southwest Airlines Co. will be held at 10:00 a.m. on Tuesday, April 22, 1986 in the Auditorium of the MBank Building, located on its fourth floor at 1704 Main Street, Dallas, Texas.

SEC Form 10-K
Stockholders may obtain free of charge a copy of the Company's Annual Report on Form 10-K as filed with the Securities and Exchange Commission by writing to the Chief Financial Officer, P.O. Box 37611, Love Field, Dallas, Texas 75235.

P.O. Box 37611
Love Field
Dallas, Texas 75235
214/353-6100