



In 1986
we didn't
merge.

Southwest Airlines, we're pleased to report, did not merge in 1986.

♥ Instead, we directed our energies and efforts toward the people who *truly* affect our bottom line—our Customers. ♥ We successfully marketed the first systemwide weekend package in the industry. ♥ We introduced a third tier to our low fare pricing structure. ♥ To the frequent business flyer, we became The Company Plane.™ ♥ We breathed new life into Chicago's Midway Airport, in the tradition of Dallas Love Field and Houston Hobby. ♥ We unveiled the first Boeing 737-200/300 convertible flight simulator in the country. ♥ TranStar, our newly renamed sister airline, moved its headquarters to Houston. ♥ We upgraded our reservation system, adding an important capacity control capability. ♥ We tested an innovative Youth Standby Fare. ♥ Nashville became our first foray into the promising Southeast market. ♥ We earned a Presidential Award for our Senior Citizens Program. ♥ We continued our support of our primary charity, Ronald McDonald House, across our system. ♥ For the sixth year in a row, we received the fewest complaints per Customer carried of any airline serving the continental U.S. ♥ **Setting trends, not following them, is what sets us apart.**

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Highlights

	1986	1985*	Percent Change
INCOME DATA			
Operating revenues	\$768,790,000	\$679,672,000	13.1
Operating expenses	679,827,000	601,148,000	13.1
Operating income	88,963,000	78,524,000	13.3
Net income —			
Amount	\$ 50,035,000	\$ 47,278,000	5.8
Per share:			
Primary	\$1.55	\$1.54	0.6
Fully diluted	\$1.55	\$1.51	2.7
Average shares outstanding	32,254,000	30,766,000	4.8
FINANCIAL DATA			
Working capital	\$ 45,206,000	\$ 46,019,000	(1.8)
Property and equipment — net	925,174,000	881,530,000	5.0
Capital expenditures	181,763,000	214,516,000	(15.2)
Stockholders' equity	511,850,000	466,004,000	9.8
Return on stockholders' equity	10.3%	11.4%	n/a
Long-term debt as a % of total invested capital	39.8%	45.0%	n/a
Book value per share	\$15.87	\$14.45	9.8
OPERATING DATA			
Trips operated	262,082	230,227	13.8
Passengers carried	13,637,515	12,651,239	7.8
Revenue passenger miles (000)	7,388,401	5,971,400	23.7
Available seat miles (000)	12,574,484	9,884,526	27.2
Passenger load factor	58.8%	60.4%	n/a
Average revenue per passenger mile	10.05¢	11.00¢	(8.6)
Number of employees at year-end	5,819	5,271	10.4

*Includes TranStar since the June 30, 1985 effective date of acquisition.

Letter to Stockholders

Highlights of 1986 Record operating revenues of \$768,790,000 ... record operating income of \$88,963,000 ... record net income of \$50,035,000 ... record shareholders' equity of \$511,850,000 ... record book value per share of \$15.87 ... successful inauguration of third tier, restricted fares ... installation of a new reservation system ... completion of our Love Field training center featuring two 737 simulators ... a favorable agreement with the City of Dallas concerning proposed noise limitations on Love Field ... celebration of our 15th year of commercial air service.

Profitability Although TranStar, Southwest's wholly owned but independently operated subsidiary, incurred a loss of \$1,400,000 in the fourth quarter of 1986, its annual profit of \$1,666,000 enabled the combined companies to achieve record net earnings of

\$50,035,000 for the year. In addition, TranStar contributed \$7,727,000 to consolidated operating income.

For Southwest itself, operating revenues increased 2.2% in 1986 and operating expenses .5%. Operating income of \$81,236,000 was 15.7% higher than the \$70,200,000 of 1985. Net non-operating expense rose from \$9,719,000 in 1985 to \$17,456,000 in 1986. 1986 net income was \$48,369,000.

Southwest's fourth quarter 1986 net income of \$10,427,000 was up 71.6% from its fourth quarter 1985 net income of \$6,075,000.

On a consolidated basis, net income of \$50,035,000 was 5.8% higher than the \$47,278,000 of 1985, while earnings per share for 1986 were \$1.55 (\$1.55 fully diluted) on an average of 4.8% more shares outstanding, as compared to the \$1.54 per share (\$1.51 fully diluted) earned in 1985.

The first quarter of 1986 produced the worst financial results in the history of the American airline industry, which, in the aggregate, lost over \$660,000,000. Southwest and TranStar together recorded a first quarter profit of only \$2,727,000, down 49% from the first quarter of 1985. The attainment of all-time record annual earnings despite such a discouraging first quarter is indeed a notable accomplishment and a special pleasure to report to our shareholders.

Traffic On a consolidated basis, 13,637,515 Customers were originated in 1986, a 7.8% increase from the previous record established in 1985. Revenue passenger miles increased by 23.7% to a record 7,388,401,000.

Southwest's load factor declined from 61.2% in 1985 to 58.3% in 1986, and its yield per revenue mile decreased from 10.99¢ to 10.58¢. Operating expense per available seat



In response to the ongoing fare wars, Southwest added an important capacity control capability to our reservation system.

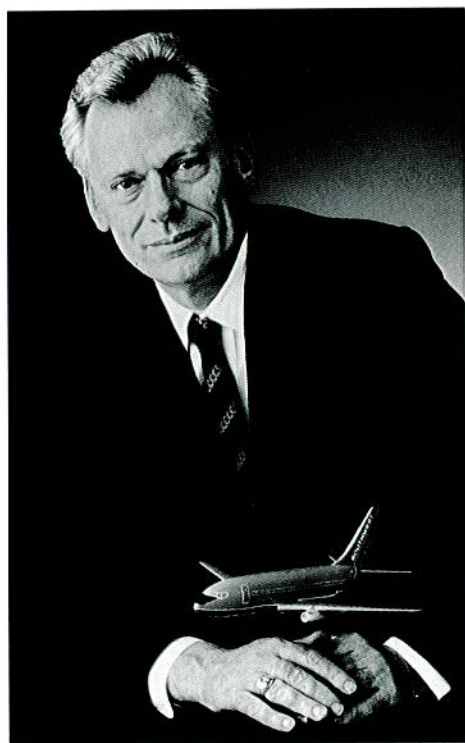
Senior citizens eagerly took advantage of our super low Senior Fares. Our "Home For the Holidays" promotion earned us a Presidential Citation for Private Sector Initiatives.



mile declined from 6.15¢ in 1985 to 5.54¢ in 1986.

During 1986 Southwest coped very effectively with the energy belt economic malaise brought to pass by drastically reduced energy prices. To the extent that energy prices recover in 1987 and beyond, Southwest should experience benefits, offsetting its increased fuel costs, from the enhanced Customer traffic attendant upon a better business and economic energy belt climate and the return to the air of Customers now traveling by automobile because of low gasoline prices. In addition, Southwest should obtain a relative advantage with respect to some competitors because of its extremely fuel efficient fleet of 737-200/300's and its ability to buy most of its fuel requirements where fuel is least expensive: the energy belt.

Routes Nashville was a very successful addition to Southwest's route system



in 1986. Shortly after entry, additional service was required by Customer demand and more service will be added in 1987. Southwest will commence service to Birmingham in March, 1987, initially providing nonstop flights to Nashville, New Orleans and Houston. Several other new cities may be opened by Southwest in 1987.

Since opening Miami in March, 1986, TranStar has experienced steady growth in its Miami markets.

Fleets Southwest is presently operating a fleet of forty-six 737-200's and seventeen 737-300's. Nine more 737-300's will be delivered during 1987. As of this writing, Southwest's net increase in capacity during 1987 is anticipated to approximate 15%. Southwest also has on firm order ten 737-300's for 1988 delivery and three for 1989 delivery, plus options to purchase six more such aircraft through 1989.

TranStar currently operates eight MD-80 aircraft and eight DC9-51 aircraft. Four more MD-80's are scheduled for delivery in 1987, and TranStar's capacity, on its smaller fleet base, is expected to expand by approximately 30% in 1987.

The joint capacity expansion of Southwest and TranStar in 1987 is anticipated to be 18-20%.

Customer Service In 1986, Southwest maintained its six year leadership, among carriers serving the Continental United States, with the fewest DOT Customer complaints per Customer carried.

Financing In March, 1986, Southwest issued \$100,000,000 of 9% notes.

In the fourth quarter, 1986, Southwest consummated \$100,000,000 in leveraged lease financings on four of its 737-300's. It is anticipated that the proceeds of these financings, together with internally generated funds, will

be sufficient to meet all of Southwest's obligations for aircraft delivery and progress payments in 1987.

TranStar closed a leveraged lease financing on two new MD-80's in December 1986, and it is anticipated that a similar financing will be completed for TranStar in 1987.

Outlook 1987 The consensus among airline industry analysts and economic forecasters appears to be that 1987 will be a good year for our industry.

In the hope that this will be the case, we plan to focus upon increasing our profitability. To this end, we instituted a 4.5-5.0% system fare increase in early January, 1987, which was promptly met by our competitors. In addition, we offered another special Senior Citizens Fare in an attempt to fill otherwise empty seats prior to the commencement of heavy summer travel. This edition of our Seniors' Fare is limited by flight as to seat availability and involves a \$39.00, rather than \$25.00, charge for our longer haul routings.

Our new, third tier, 14-day advance purchase FUN FARE was responsible for the upsurge in our Customer traffic in the second half of 1986, and we have extended that fare through May 30, 1987 at a higher level. Our "Great Take-off," long weekend, vacation package was very successful in 1986, and we intend to continue that special, leisure travel offering through 1987 on a system wide basis.

TranStar was buffeted in the fourth quarter of 1986 by severe price and schedule competition at its Hobby Airport hub. It is hoped that this situation will somewhat abate in 1987, permitting TranStar's yields to increase to a reasonable level.

A Texas District Court has ruled that Continental Airlines may provide air service between Dallas Love Field and

Houston's Hobby Airport. Although the City of Dallas has appealed this decision, Continental is free to commence such service during the pendency of the appeal. It is not known, of course, whether, or when, Continental actually intends to commence Love Field-Hobby Airport flights. Such service would not connect with Continental's enormous banks of flights at Houston's Intercontinental Airport; could not carry passengers destined beyond either airport; and would encounter up to 73 flights per day offered by Southwest and TranStar. At present, approximately 3.3% of TranStar's revenue passenger miles and approximately 5.0% of Southwest's revenue passenger miles are generated in the Love-Hobby market.

Southwest's low operating costs, strong balance sheet, tremendous record of Customer service, effective marketing programs, and superb people provide the enduring strength necessary to do well in times both bad and good. Albeit intangible, the spirit of our people is the most essential ingredient of our success over the last 15 years, and I thank them for their goodness and salute them for their greatness.

Most sincerely,



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

January 27, 1987

Description of Business

Southwest Airlines Co. (Southwest) and its wholly owned subsidiary, TranStar Airlines Corporation (TranStar), are engaged in providing air transportation services. Southwest, which initiated service in Texas in 1971, provides single class, high frequency service to more than 25 cities, primarily in the midwestern and southwestern regions of the United States. Southwest principally concentrates on short-haul markets, emphasizing high aircraft utilization and high employee productivity. Southwest is characterized by its simple low fares, friendly service, convenient schedules and reliable, on-time performance. Simple boarding procedures ensure speedy and efficient turnaround. Primary hubs in the Southwest system include Dallas Love Field, Houston Hobby Airport and

Phoenix Sky Harbor International. Southwest initiated new service in 1986 to Nashville and may add several more destinations in 1987, in addition to Birmingham which is planned for March, 1987. Southwest's simple fare structure, offering peak and off-peak fares, was modified in 1986 through the addition of 14-day advance purchase fares (Fun Fares). Southwest's corporate headquarters are located in Dallas, Texas.

TranStar, formerly Muse Air Corporation, began operation in 1981 and was acquired by Southwest in 1985. TranStar offers dual class, long-haul service with its principal hub at Houston's Hobby Airport. TranStar provides service to several Texas cities including Dallas Love Field as well as to several other cities in the southern United States. TranStar complements the Southwest system and service via such amenities as Business Class, meal service and assigned seating. TranStar's corporate headquarters are located in Houston, Texas.

Review of Operations

Fleet At the end of 1985, Southwest had forty-six Boeing B 737-200's and ten B737-300's. During 1986, Southwest added another seven -300's for a total at the end of 1986 of seventeen -300's. Six B737-300 and three B737-200 aircraft were being operated subject to long-term lease agreements. TranStar began 1986 with 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. TranStar added two leased MD-80's in 1986 bringing its total fleet to sixteen. The average age of the combined fleet at year-end was 6.0 years.

Southwest has committed to take delivery of nine more B737-300's in

**Frequent business flyers,
impressed with our
frequent flights, personal
attention and everyday
low fares, dubbed us The
Company Plane.™**



Dallas Love Field. Houston Hobby. In the Southwest tradition of convenient downtown airports, we began service to Chicago's Midway Airport, much to O'Hare travelers' delight.

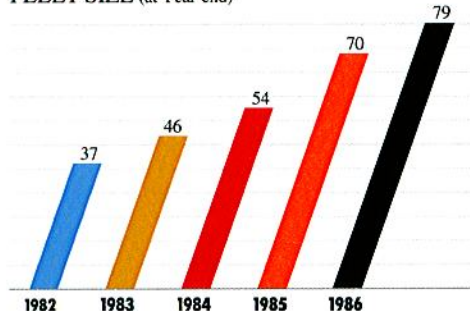




To keep our pilots on the leading edge of avionic technology, Southwest unveiled the first Boeing 737-200/300 convertible flight simulator in the country.

1987 while TranStar has committed to add four MD-80's in 1987 to meet additional capacity requirements.

FLEET SIZE (at Year-end)



Capacity During 1986, the Company's operating capacity was comprised of a weighted average of 44.9 B737-200's, 14.4 B737-300's, 5.9 MD-80's and 7.8 DC9-51's.

The average number of aircraft in service in 1986 was 73, having an average number of 127 seats. This represents a 20.8% increase over the 60.44 average during 1985 and compares with 48.96 in 1984 (prior to the acquisition of TranStar). The average number of seats per aircraft was 126 in 1985 and 124 in 1984.

Routes Southwest added Nashville, Tennessee to its route system and discontinued service to Denver, Colorado in 1986 and added St. Louis, Missouri; Chicago, Illinois; and Ontario, California in 1985. TranStar added Miami, Florida in 1986. In addition, Southwest announced plans to commence service to Birmingham, Alabama in 1987.

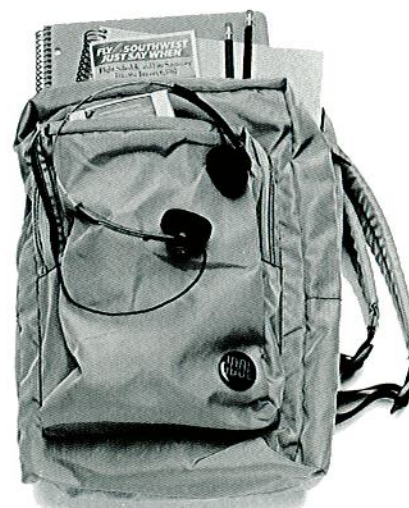
Traffic Revenue passenger miles (RPM's) were 7,388,401,000 in 1986, a 23.7% increase over 1985 with 13,637,515 passenger boardings and an average length of haul of 542 miles. Individually, Southwest accounted for 5,666,037,000 RPM's, 11,333,893 passenger boardings and a 500-mile average length of haul. TranStar had

1,722,364,000 RPM's, 2,303,622 passenger boardings and a 748-mile average length of haul.

Management's Discussion and Analysis of Results of Operations and Financial Condition 1986 Compared with 1985

The Company's consolidated net income was \$50 million in 1986 compared with \$47.3 million in 1985, an increase of 5.8%. This growth in earnings was primarily attributable to an increase in operating income to \$89 million, partially offset by increases in interest expense and the provision for federal income tax.

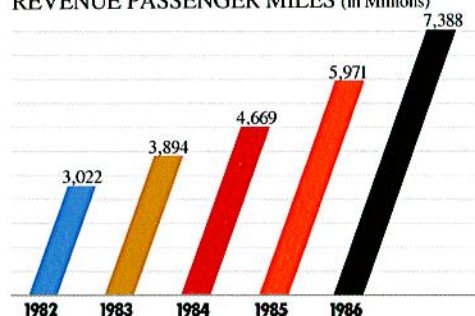
Operating Revenues Consolidated passenger revenues, which accounted for more than 96% of total consolidated operating revenues, increased by \$86 million in 1986, or 13%, to an all-time



Southwest tested an innovative Youth Standby Fare—students 18–21 had an opportunity to purchase \$15 standby tickets at automated teller machines in participating convenience stores.

high of \$742 million. RPM's increased 1.4 billion and accounted for \$155 million of the increase offset by a decrease in yield (average revenue per RPM) of 8.6%, or \$70 million. The growth in RPM's was primarily attributable to the inclusion of TranStar for a full year in 1986 (approximately 1.1 billion RPM's)

REVENUE PASSENGER MILES (in Millions)



and additional capacity at Southwest which generated approximately .3 billion additional RPM's. The passenger load factor declined slightly in 1986 to 58.8%, reflecting a softening in the Texas and surrounding state economies and leading to further growth in markets outside these energy dependent regions. The load factor decline was partially offset by positive responses from Customers to marketing initiatives such as the Senior Citizens, Fun Fare

and Great Takeoff programs together with increased Customer acceptance of the capacity added outside Southwest's traditional markets. The decrease in yield was due to an increase in the average passenger trip length from 472 miles in 1985 to 542 miles in 1986 and an increase in discounted fare traffic.

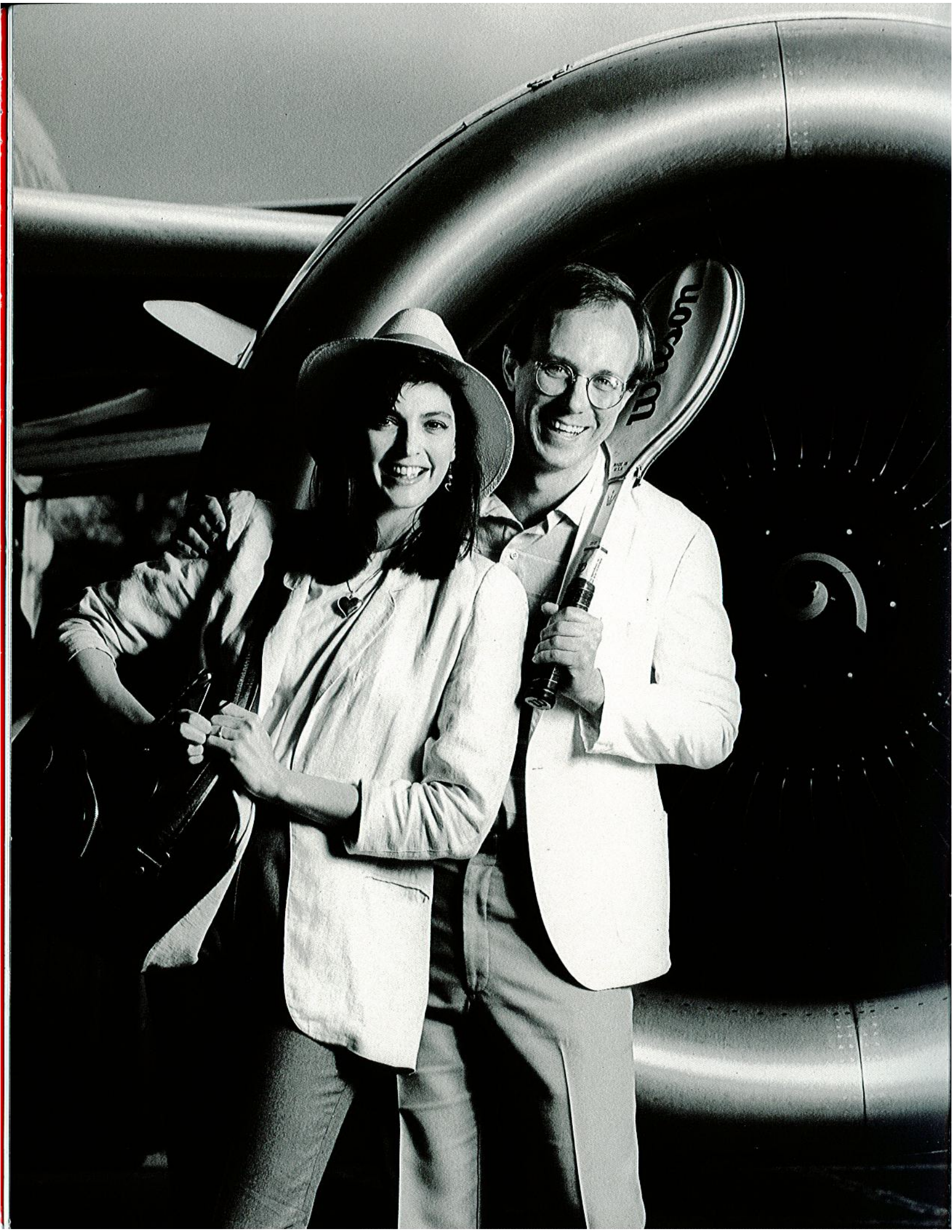
Operating Expenses Consolidated operating expenses increased by 13.1% primarily attributable to a 27.2% growth in ASM's offset by a decline in costs per ASM to 5.41¢, a decrease of 11%. The principal contributor to this decrease was fuel which, in total, decreased 39% in 1986 as a result of the decline in crude oil prices. For 1986, the average cost of fuel per gallon was \$.51 versus \$.78 in 1985. The table on this page depicts the components of operating expenses per ASM compared to the previous two years.

Other "Other expenses (income)" increased \$5.8 million in 1986, principally as a result of higher interest expense from borrowings by TranStar (\$10.8 million). Offsetting the increase from interest expense was a \$4 million gain from the sale of certain aircraft delivery positions, included in "Interest income and other."

Category of Costs	Per Available Seat Mile	Increase (Decrease)	Per Available Seat Mile	Increase (Decrease)	Per Available Seat Mile
	1986		1985		1984
Aircraft fuel & oil	1.03¢	(.64¢)	1.67¢	(.16¢)	1.83¢
Wages & benefits	1.58	—	1.58	.04	1.54
Maintenance	.39	—	.39	.07	.32
Agency commissions	.35	.01	.34	.09	.25
Landing fees & rentals	.35	(.02)	.37	(.03)	.40
Other	1.10	(.01)	1.11	.16	.95
Depreciation	.54	—	.54	.10	.44
Profit sharing	.07	(.01)	.08	(.05)	.13
Total	5.41¢	(.67¢)	6.08¢	22¢	5.86¢

**Ronald McDonald House®,
a home away from home
for out-of-town families
who have seriously ill
children undergoing
treatment at a nearby
hospital, continues to be
our primary charity.**

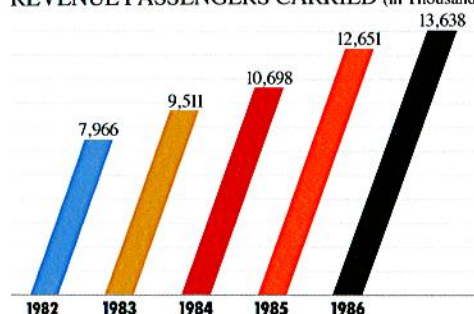




"Fun Fares" added an exciting new third tier to our low fare pricing structure. Also successful, the industry's first systemwide weekend package—"Fun Packs" prompted Thursday through Monday pleasure travel.

The "Provision for federal income tax" increased as a percentage of income before federal income tax from 22.2% in 1985 to 23.5% in 1986, primarily as a result of the effect of the new tax law. Federal income tax was provided at the 46% rate in effect for 1986 of which \$14 million was deferred

REVENUE PASSENGERS CARRIED (in Thousands)



and \$1.4 million was currently payable. The Financial Accounting Standards Board issued an Exposure Draft in 1986 on Accounting for Income Taxes which, if adopted, would become effective in 1988. The effects of this proposed Statement would significantly reduce the Company's "Deferred federal income tax" liability account in 1988, if the Statement is adopted in its current form.

1985 Compared with 1984

The Company's consolidated net income was \$47.3 million in 1985 versus \$49.7 million in 1984, a decrease of approximately \$2.4 million or 4.8%. Although operating income increased 14.6% from 1984 to \$78.5 million, interest expense, net of capitalized interest and interest income, increased approximately \$17 million due to the mid-year acquisition of TranStar in 1985. Additionally, a major financing was completed in late 1983 which was invested for the majority of 1984, generating a higher than usual amount of

interest income in 1984 as compared with 1985. The provision for federal income tax decreased in 1985 by 25%.

Operating Revenues Consolidated passenger revenues, which were more than 96% of operating revenues, increased in 1985 by \$138 million or 26.5%. Approximately \$68 million of the increase was attributable to an increase of 14.3% in RPM's at Southwest, offset by a decrease of 1.2% in yield. TranStar accounted for the remaining \$70 million increase in revenues as its results were included in the consolidated results from the date of acquisition, June 30, 1985. Southwest's RPM growth stemmed from an increase in 1985 of 734 million ASM's (approximately 429 million RPM's or \$47 million) coupled with an improved load factor of 1.9% (approximately 166 million RPM's or \$18 million).



For the sixth year in a row, Southwest received the fewest complaints per Customer carried of any airline serving the continental United States.

Operating Expenses Consolidated operating expenses increased approximately 28.6% in 1985 versus 1984. The increase was a result of the inclusion of TranStar expenses from June 30, 1985 forward of \$66 million and \$68 million from Southwest principally due to an increase in ASM's of 734 million. Additionally, operating expenses per ASM increased 3.8% in 1985 to 6.08¢, as described in the table on page 10. Fuel cost per ASM declined in 1985 primarily as a result of a drop in the average cost per gallon of jet fuel from \$.82 in 1984 to \$.78 in 1985.

Other "Other expenses (income)" increased by approximately \$17 million in 1985 due to an increase of \$10.8 million in interest expense and a decrease in interest income of approximately \$8 million. Approximately \$6.6 million of the increase in interest expense was attributable to the interest expense of TranStar with the remainder 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



TranStar, a wholly owned, separately operated subsidiary of Southwest Airlines, moved its corporate headquarters to Houston.

TranStar. 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.

The Company's effective income tax rates were 22% and 27% for 1985 and 1984, 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. The majority of the tax provisions for these years was deferred due to timing differences between financial and tax reporting.

Liquidity and Capital Resources

The Company had \$45 million in working capital at December 31, 1986 as compared to \$46 million at the end of 1985 and \$15 million at the end of 1984. Funds provided by operations increased to \$133 million in 1986, up from the \$114 million and \$103 million generated in 1985 and 1984, respectively. Additional funds were provided in 1986 through the sale of \$100 million of public debt, which represented one-half of the \$200 million shelf registration of debt securities. In addition, Southwest completed approximately \$100 million of financings in the fourth quarter of 1986 via the sale and leaseback of four aircraft. The proceeds were used to retire debt and finance aircraft acquisitions. TranStar also consummated two long-term operating leases in the fourth quarter to finance the delivery of two aircraft.

During 1985, Southwest common stock was issued upon conversion of \$34 million of 10% Convertible Subordinated Debentures and \$27 million of common stock and warrants were

Nashville became an overnight sensation to business and pleasure travelers alike, as Southwest ventured into the promising Southeastern United States.



Quarterly Financial Data (Unaudited)

(in thousands except per share amounts)

1986	Three Months Ended			
	March 31	June 30	Sept. 30	Dec. 31
Revenues	\$173,256	\$193,916	\$207,628	\$193,990
Operating income	7,111	28,171	34,699	18,982
Income before tax	3,219	21,275	27,873	13,079
Net income	2,727	17,100	21,181	9,027
Income per share:				
Primary	.08	.53	.66	.28
Fully diluted	.08	.53	.65	.28

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
1986			
1st Qtr.	\$.032	\$27.50	\$20.00
2nd Qtr.	.032	22.50	18.25
3rd Qtr.	.032	24.00	19.00
4th Qtr.	.032	26.13	19.75
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

As of January 31, 1987, there were approximately 6,150 holders of record of the Company's common stock.

issued in the acquisition of TranStar. After its acquisition by Southwest, TranStar renegotiated \$33 million of its notes to banks and at year-end 1985, with the \$55 million proceeds from the sale and leaseback of five aircraft, retired this debt. Southwest borrowed a net \$107 million under its bank credit agreements, \$23 million under its Euro Note Programme and \$18 million under its French Credit Export Agreement. In addition, Southwest generated \$40 million through a capital lease of two aircraft. Southwest used \$75 million of the proceeds from these borrowings to acquire the net non-current assets of TranStar and the remainder for aircraft acquisitions and working capital.

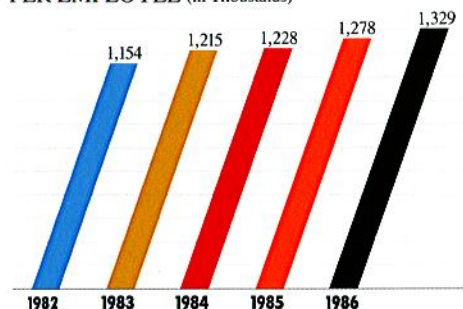
During 1984, of the \$196 million

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 were primarily utilized for aircraft acquisitions and progress payments.

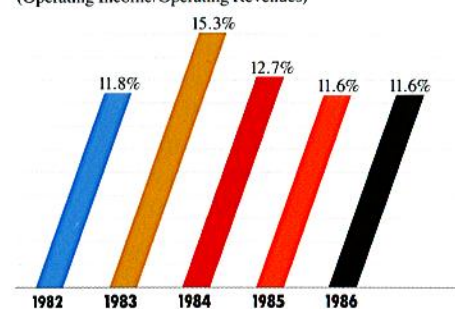
Capital expenditures were \$182 million in 1986 versus \$214 million in 1985 and \$184 million in 1984. These included the purchase of three B737-300's in 1986 (four more were delivered in 1986 pursuant to operating leases); seven B737-300's and one B737-200 in 1985; and three B737-300's and four B737-200's in 1984.

Capital commitments for the Company consisted primarily of scheduled aircraft acquisitions. At year-end 1986,

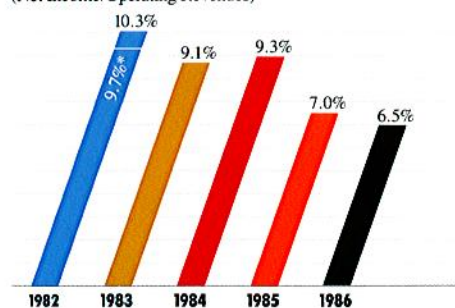
REVENUE PASSENGER MILES
PER EMPLOYEE (in Thousands)



NET OPERATING MARGIN
(Operating Income/Operating Revenues)

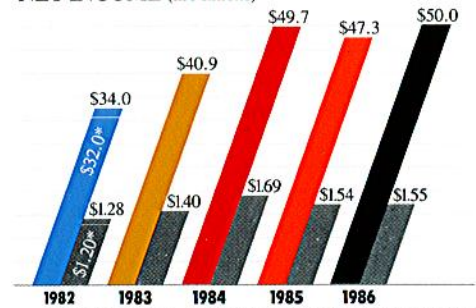


NET PROFIT MARGIN
(Net Income/Operating Revenues)



*Excluding non-recurring items

NET INCOME (in Millions)



■ NET INCOME ■ PRIMARY EARNINGS PER SHARE

*Excluding non-recurring items

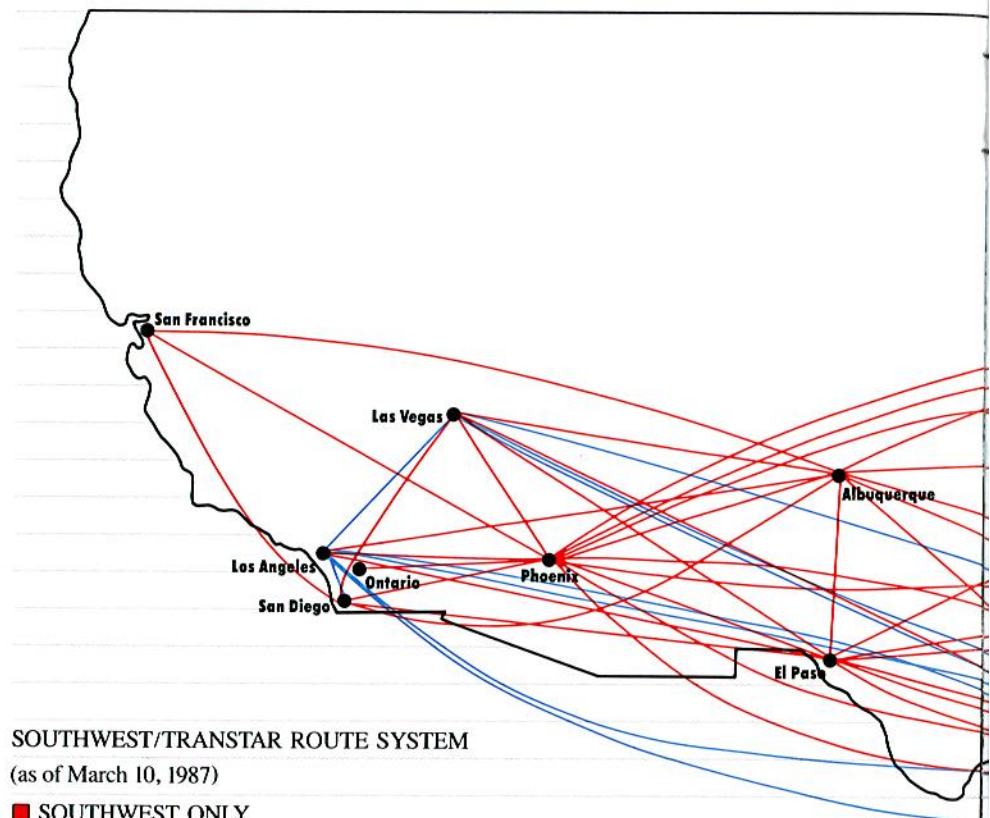
Southwest had twenty B737-300's and TranStar had four MD-80's on order. Aggregate future funding required for these commitments was \$473 million at year-end. Subsequent to year-end 1986, Southwest placed an order for two more B737-300's, bringing the total number on order to twenty-two.

The Tax Reform Act of 1986 will impact the Company's future earnings and cash flow. As a result of the discontinuance of the investment tax credit, the Company expects that its future effective federal income tax rate will be higher than it has been over the last three years. The Company will benefit, however, from investment tax credits available from transition property. The Company also expects to experience an increase in federal income tax currently payable, as a result of the alternative minimum tax rules.

The Company has various financing options available to it to meet its capital and operating requirements, including internally generated funds, credit agreements with banks of approximately \$200 million and its remaining shelf registration of \$100 million. In addition, the Company may continue to utilize equipment lease financing when cost-effective.

Distribution of Expenses

Wages, benefits & profit sharing	29.5%
Other	19.6%
Aircraft fuel and oil	18.4%
Depreciation	9.6%
Maintenance	7.0%
Agency commissions	6.3%
Landing fees and rentals	6.3%
Net non-operating expense	3.3%
TOTAL	100.0%



SOUTHWEST/TRANSTAR ROUTE SYSTEM

(as of March 10, 1987)

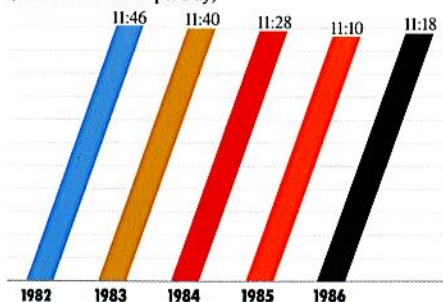
■ SOUTHWEST ONLY

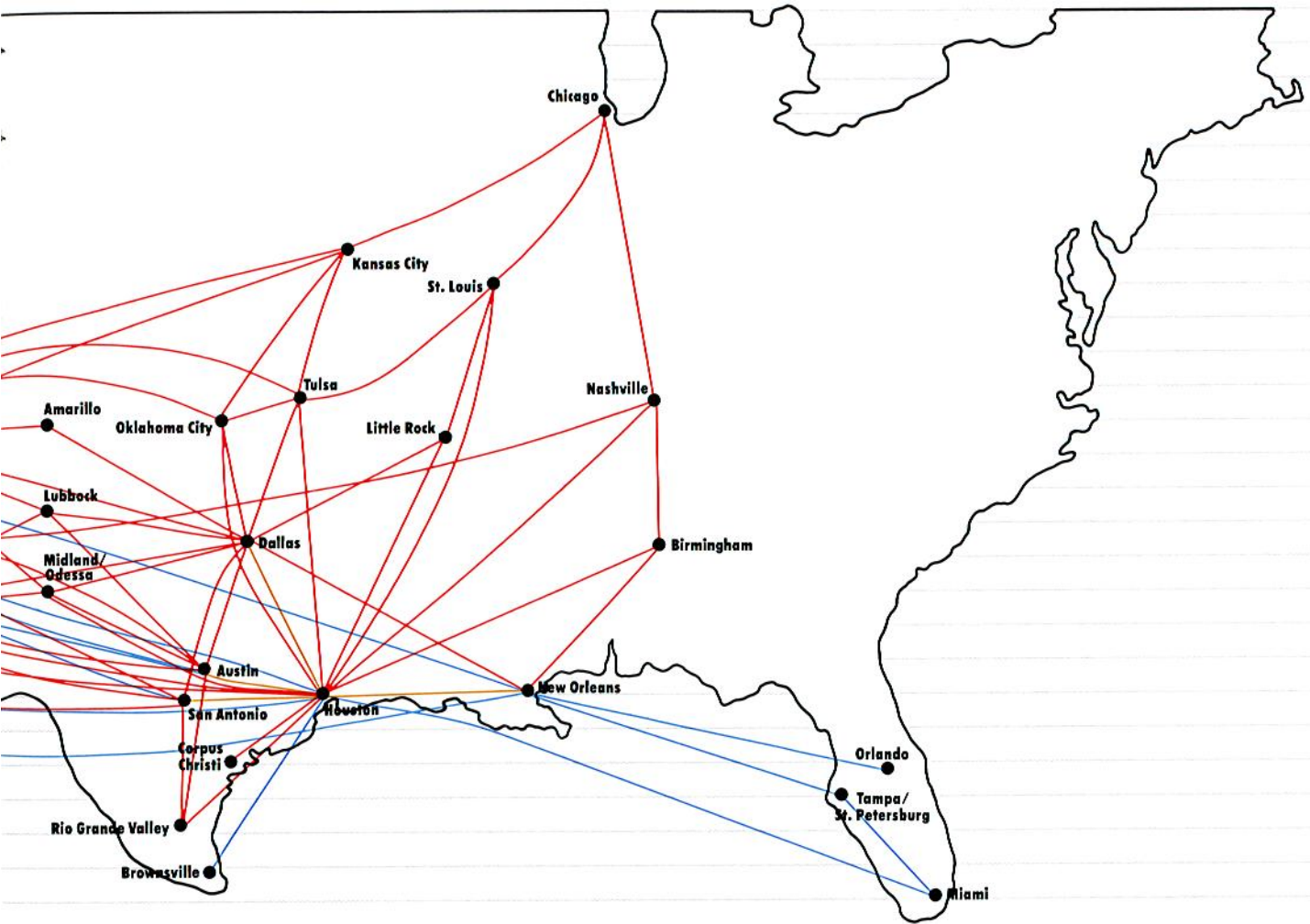
■ TRANSTAR ONLY

■ SOUTHWEST AND TRANSTAR

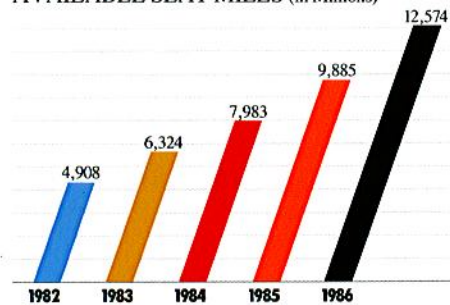
Southwest Airlines and TranStar operate as separate carriers and do not participate in any baggage, ticketing or passenger transfer agreements.

AIRCRAFT UTILIZATION
(Hours and Minutes per Day)

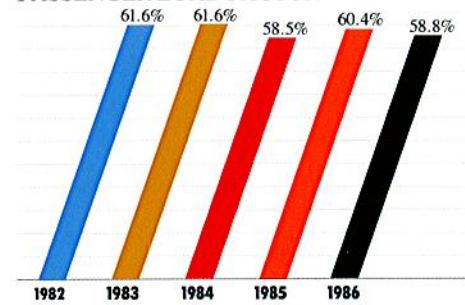




AVAILABLE SEAT MILES (in Millions)



PASSENGER LOAD FACTOR



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

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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

TRAVIS C. JOHNSON,
Partner, Johnson & Bowen,
Attorneys at Law, El Paso, Texas;
Audit Committee

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

ROLLIN W. KING,
Managing Director, Russell Reynolds
Associates, Inc., Dallas, Texas,
Executive Recruiting Consultants;
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WALTER M. MISCHER, SR.,
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Bancshares, Inc., Chairman of the
Board and Chief Executive Officer
of The Mischer Corporation,
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Compensation Committees

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& Chief Executive Officer

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Corporate Services

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Vice President – Flight Operations

COLLEEN C. BARRETT
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Financial Officer

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Vice President – Ground Operations

GARY C. KELLY
Controller

JOHN D. OWEN
Treasurer

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President and Chief
Executive Officer, Houston, Texas

HERBERT D. KELLEHER,
Chairman of the Board,
Dallas, Texas

M. LAMAR MUSE,
Advisory Director,
Montgomery, Texas

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President & Chief
Executive Officer

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& Engineering

JEAN WETZEL
Vice President – Finance
& Treasurer

DEBRA K. CLINE
Assistant Vice President/Controller

ELENORA RECORD
Secretary

Consolidated Financial Statements

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Southwest Airlines Co. Consolidated Balance Sheet

(in thousands except for share and per share amounts)
December 31, 1986 and 1985

	1986	1985
Assets		
Current assets:		
Cash and cash equivalents	\$ 74,861	\$ 69,299
Accounts receivable	33,513	31,864
Inventories of parts and supplies, at cost	11,201	8,581
Prepaid expenses and other current assets	8,443	8,153
Total current assets	128,018	117,897
Property and equipment, at cost (Notes 3, 5 and 6):		
Flight equipment	955,716	892,177
Ground property and equipment	103,295	83,462
Deposits on flight equipment purchase contracts	100,924	79,384
	1,159,935	1,055,023
Less allowance for depreciation	234,761	173,493
	925,174	881,530
Other assets	8,227	2,976
Cost in excess of net assets acquired (net of accumulated amortization of \$708 in 1986 and \$291 in 1985)	16,771	19,993
	<u>\$1,078,190</u>	<u>\$1,022,396</u>
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 25,211	\$ 25,819
Air traffic liability	7,868	4,228
Accrued liabilities (Note 4)	36,834	29,353
Federal income tax payable	1,353	—
Current maturities of long-term debt	11,546	12,478
Total current liabilities	82,812	71,878
Long-term debt less current maturities (Note 5)	339,069	381,308
Deferred federal income tax	108,958	98,591
Deferred gain from sale and leaseback of aircraft	29,424	912
Other deferred liabilities	6,077	3,703
Commitments (Notes 3 and 6)		
Stockholders' equity (Note 7):		
Common stock, \$1.00 par value; 75,000,000 shares authorized; 32,254,269 shares issued and outstanding (32,254,220 in 1985)	32,254	32,254
Capital in excess of par value	175,170	175,166
Retained earnings	304,426	258,584
Total stockholders' equity	511,850	466,004
	<u>\$1,078,190</u>	<u>\$1,022,396</u>

See accompanying notes.

Southwest Airlines Co. Consolidated Statement of Income

(in thousands except per share amounts)

	Years ended December 31,		
	1986	1985	1984
Operating revenues:			
Passenger	\$ 742,287	\$ 656,689	\$ 519,106
Freight	13,621	13,643	12,115
Other	12,882	9,340	4,727
Total operating revenues	768,790	679,672	535,948
Operating expenses:			
Fuel and oil	129,522	165,008	146,232
Salaries, wages and benefits	198,689	156,339	123,024
Maintenance materials and repairs	49,181	38,272	25,312
Agency commissions	44,209	33,342	19,925
Landing fees and rentals	44,593	36,934	31,864
Other operating expenses	137,699	109,291	76,116
Depreciation	67,465	53,633	34,940
Employee profit sharing (Note 8)	8,469	8,329	10,038
Total operating expenses	679,827	601,148	467,451
Operating income	88,963	78,524	68,497
Other expenses (income):			
Interest expense	37,310	26,914	16,145
Capitalized interest	(7,069)	(7,410)	(5,147)
Interest income and other (Note 9)	(7,141)	(2,055)	(10,349)
Amortization of cost in excess of net assets acquired	417	291	—
	23,517	17,740	649
Income before federal income tax	65,446	60,784	67,848
Provision for federal income tax (Note 10)	15,411	13,506	18,124
Net income	\$ 50,035	\$ 47,278	\$ 49,724
Net income per common share (Note 11):			
Primary	\$1.55	\$1.54	\$1.69
Fully diluted	\$1.55	\$1.51	\$1.64

See accompanying notes.

Southwest Airlines Co. **Consolidated Statement of Stockholders' Equity**

(in thousands except per share amounts)

Three Years Ended December 31, 1986

	Common stock	Capital in excess of par value	Retained earnings	Treasury stock	Total
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
Proceeds from issuance of common stock	—	4	—	—	4
Cash dividends, \$.13 per share	—	—	(4,193)	—	(4,193)
Net income — 1986	—	—	50,035	—	50,035
Balance at December 31, 1986	<u>\$ 32,254</u>	<u>\$175,170</u>	<u>\$304,426</u>	<u>\$ —</u>	<u>\$511,850</u>

See accompanying notes.

Southwest Airlines Co.
Consolidated Statement of Changes in Financial Position
(in thousands)

	Years ended December 31,		
	1986	1985	1984
Sources of working capital:			
Operations:			
Net income	\$ 50,035	\$ 47,278	\$ 49,724
Items not affecting working capital:			
Depreciation	67,465	53,633	34,940
Deferred federal income tax	14,058	12,535	19,033
Other	1,791	606	254
Total from operations	133,349	114,052	103,951
Issuance of common stock and warrants	4	60,974	1,321
Issuance of long-term debt:			
Due to acquisition of TranStar	—	41,230	—
Other	101,043	121,302	1,320
Proceeds from sale and leaseback of aircraft under operating leases	99,387	54,865	—
Total sources of working capital	333,783	392,423	106,592
Applications of working capital:			
Net additions to property and equipment	181,763	214,516	184,259
Net non-current assets of TranStar acquired (Note 2)	—	74,943	—
Cash dividends	4,193	4,016	3,833
Reduction of long-term debt	142,235	72,560	6,707
Other	6,405	(4,172)	1,162
Total applications of working capital	334,596	361,863	195,961
Increase (decrease) in working capital	\$ (813)	\$ 30,560	\$ (89,369)
Changes in components of working capital:			
Working capital deficiency of TranStar acquired	\$ —	\$ (7,213)	\$ —
Increase (decrease) in current assets:			
Cash and cash equivalents	5,562	39,021	(104,203)
Accounts receivable	1,649	2,681	1,717
Inventories of parts and supplies	2,620	3,308	1,429
Refundable federal income tax	—	(5,460)	5,336
Prepaid expenses and other current assets	290	731	5,260
Total	10,121	40,281	(90,461)
Increase (decrease) in current liabilities:			
Accounts payable	(608)	3,000	(153)
Air traffic liability	3,640	200	—
Accrued liabilities	7,481	1,051	(1,240)
Federal income tax payable	1,353	—	—
Current maturities of long-term debt	(932)	(1,743)	301
Total	10,934	2,508	(1,092)
Increase (decrease) in working capital	\$ (813)	\$ 30,560	\$ (89,369)

See accompanying notes.

Southwest Airlines Co. Notes to Consolidated Financial Statements

December 31, 1986

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, TranStar Airlines Corporation (TranStar), formerly Muse Air Corporation, 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, 1985 have been made to conform to the presentation at December 31, 1986.

Inventories Inventories of flight equipment expendable parts, materials and supplies are valued at cost. These parts are charged to expense when issued for use.

Property and equipment Depreciation is provided by the straight-line method to residual values over periods ranging from fifteen to eighteen years for flight equipment and three to thirty years on ground property and equipment. 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 the lease term.

Cost in excess of net assets acquired Cost in excess of net assets acquired resulting from the acquisition of TranStar 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.

Revenue recognition Passenger revenue is recognized when the transportation is provided. Tickets sold but not yet used are included in "Air traffic liability".

2. Acquisition

Effective June 30, 1985, Southwest acquired the stock of Muse Air Corporation, which was subsequently renamed TranStar, for approximately \$68 million consisting of (i) approximately \$40.5 million in cash, (ii) 830,320 shares of Southwest common stock, and (iii) 1,080,320 warrants to purchase Southwest common stock at \$35 per share, subject to adjustment, expiring on June 25, 1990. The acquisition was accounted for as a purchase and,

accordingly, the results of operations of TranStar were included in the consolidated financial statements from the date of acquisition.

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 TranStar was 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 TranStar 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. Commitments

At December 31, 1986, the Company's contractual commitments consisted primarily of scheduled aircraft acquisitions. Nine Boeing 737-300's were scheduled for delivery in 1987, with eight in 1988, and three in 1989. Four MD-80's and four engine performance kits were scheduled for delivery in 1987. The Company also had a flight simulator scheduled for completion in 1987. Aggregate funding needed for these commitments was approximately \$473 million at December 31, 1986, due as follows: \$263 million in 1987, \$151 million in 1988 and \$59 million in 1989. In addition, the Company had options to purchase eight Boeing 737-300 aircraft. (Subsequent to December 31, 1986, the Company exercised two of its options to purchase Boeing 737-300 aircraft.) Deposits totaling \$200,000 were made to secure delivery positions in years 1988 through 1989 in the event the Company exercises its purchase options.

4. Accrued liabilities

(in thousands)	1986	1985
Profit sharing (Note 8)	\$ 4,972	\$ 5,985
Interest	8,949	5,964
Vacation pay	7,371	6,288
Taxes, other than income	6,758	5,205
Other	8,784	5,911
	<u>\$36,834</u>	<u>\$29,353</u>

5. Long-term debt

(in thousands)	1986	1985
Southwest:		
Bank Credit Agreement	\$ —	\$107,000
9% Notes due 1996	100,000	—
Euro Note Programme	—	23,090
10.4% ETC's due July 1, 1994 . .	14,329	16,121
10.3% ETC's due January 1, 1995	11,901	13,301
10.3% ETC's due July 1, 1995 . .	13,313	14,792
6¾% Convertible Subordinated Debentures due 1998	35,000	35,000
Capital Leases (Note 6)	71,642	72,105
French Export Credit Agreement	17,676	20,201
Industrial Revenue Bonds	4,300	4,850
Other	2,199	2,250
TranStar:		
Notes payable to banks due December 31, 1991	27,060	29,520
ETC's due June 15, 1999	50,000	50,000
	<u>347,420</u>	<u>388,230</u>
Less current portion	11,546	12,478
Debt discount	(2,597)	(2,146)
Debt premium	5,792	7,702
	<u>\$339,069</u>	<u>\$381,308</u>

The Bank Credit Agreement with a group of domestic banks permits Southwest to borrow through December 18, 1988 on a revolving credit basis up to the primary commitment (\$40 million at December 31, 1986). The primary commitment can be increased to as much as \$150 million 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 ¾% per annum on the unused portion of the primary

commitment and ¼% per annum on the difference between \$150 million and the amount of the primary commitment. As of December 31, 1986, there were no outstanding borrowings 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 million 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 million or decreased to as little as \$10 million. As of December 31, 1986, there were no outstanding borrowings under the agreement.

In March 1986, Southwest issued \$100 million of unsecured 9% Notes due March 1, 1996. Interest is payable semi-annually on March 1 and September 1 and the entire principal balance is payable at maturity. The Notes are redeemable at the issuer's option on or after March 1, 1993 at par plus accrued interest.

During 1985, Southwest established a Euro Note Programme whereby it can issue, from time to time, up to \$50 million 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, 1986 there were no outstanding borrowings under this program.

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 approximately \$50 million at December 31, 1986.

The 6¾% Convertible Subordinated Debentures were issued by Southwest Airlines Eurofinance N.V. and are convertible into 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 debentures are redeemable at the issuer's option at prices beginning at 103% of face value after July 1, 1986, and declining by 1% per year to 100% in 1989 and thereafter.

The French Export Credit Agreement requires 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 through 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 TransStar obligations 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 has guaranteed 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 at prime rate on the remainder.

During June, 1984, TranStar issued \$50 million 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 million beginning June 15, 1991, calculated to retire 80% of the certificates prior to maturity. The certificates are redeemable, at TranStar'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 TranStar 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 11.2%, 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):

1987	\$10,778
1988	10,338
1989	10,338
1990	11,615
1991	27,605

6. Leases

Excluding landing fees, total rental expense for operating leases charged to operations in 1986, 1985 and 1984, was \$27,851,000, \$23,717,000 and \$19,465,000. The majority of the Company's corporate office and terminal operations space and twelve aircraft are under operating leases. The following amounts applicable to capital leases, principally involving five aircraft, are included in property and equipment (in thousands):

	1986	1985
Flight equipment	\$72,382	\$72,382
Less accumulated amortization ...	8,456	4,461
	<u>\$63,926</u>	<u>\$67,921</u>

At December 31, 1986, obligations under capital leases and non-cancelable operating leases for future minimum lease payments were as follows (in thousands):

	Capital leases	Operating leases
1987	\$7,937	\$ 22,188
1988	8,924	27,938
1989	8,924	26,767
1990	8,924	27,655
1991	8,924	26,776
After 1991	104,667	256,709
Total minimum lease payments	148,300	<u>\$388,033</u>
Less amount representing interest	76,658	
Present value of minimum lease payments	71,642	
Less current portion	768	
Long-term portion	<u>\$70,874</u>	

7. Common stock

At December 31, 1986, the Company had 36,521,012 shares of common stock reserved for issuance upon the conversion of convertible securities and pursuant to employee profit sharing, stock option and stock purchase plans and upon exercise of rights pursuant to the Common Share Purchase Rights Plan (the Plan), described below.

On July 14, 1986, the Board of Directors of the Company adopted the Plan which was effected by a dividend of one common share purchase right (Right) for each outstanding share of the Company's common stock. Each Right entitles its holder to purchase one share of common stock for \$75 and is exercisable only in the event of a proposed takeover, as defined by the Plan. The Company may redeem the Rights at \$.05 per Right prior to the time that 20 percent of the common stock has been acquired by a person or group. If the Company is acquired or if certain self-dealing transactions occur, as defined in the Plan, each Right will entitle its holder to purchase for \$75 that number of the acquiring company's or the Company's common shares, as provided in the Plan, having a market value of \$150. The Rights will expire no later than July 30, 1996.

8. 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.

TranStar'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 1/2% of salary and wage expense if this amount is invested in Southwest stock on behalf of its employees.

9. Interest income and other

The Company sold certain aircraft delivery positions during 1986, realizing a gain of \$3,959,000.

10. Federal income tax

The provision for federal income tax includes deferred tax resulting from timing differences in the recognition of revenue and expense for financial and tax reporting purposes.

The provision for federal income tax consists of (in thousands):

	1986	1985	1984
Current	\$ 1,353	\$ 971	\$ (909)
Deferred:			
Depreciation	33,598	27,318	22,990
Deferred gain on sale/leaseback	(9,424)	—	—
Capitalized interest	1,269	2,845	2,162
Capital leases	(1,587)	(925)	(1,533)
Tax benefit transfer	(2,996)	(1,030)	(970)
Investment tax credits ...	(8,251)	(15,693)	(3,755)
Operating loss carryforward	3,753	(3,753)	—
Other	(2,304)	3,773	139
Total deferred provision .	14,058	12,535	19,033
Total	\$15,411	\$13,506	\$18,124

The provision for income taxes differs from the amount which results from applying the statutory rates to pretax income as follows (in thousands):

	1986	1985	1984
Amount %	Amount %	Amount %	
Income tax provision at statutory rate.	\$30,105 46	\$27,961 46	\$31,210 46
Investment tax credit	(11,089)(17)	(14,001)(23)	(12,853)(19)
Effect of TranStar tax vs. book basis difference ...	(1,554) (2)	(120) —	— —
Other tax credits	(754) (1)	(618) (1)	(512) (1)
Capital gains. ...	(740) (1)	— —	— —
Other, net	(557) (1)	284 —	279 1
	\$15,411 24	\$13,506 22	\$18,124 27

At December 31, 1986, TranStar had available \$52.2 million in pre-acquisition operating loss carryforwards and \$4.5 million in pre-acquisition investment tax credit carryforwards for federal income tax purposes. For financial

reporting purposes, these carryforwards 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.

In addition, at December 31, 1986, the Company had available \$33.7 million in investment tax credit carryforwards for federal income tax purposes. The carryforwards will expire in 1999 through 2001 if not previously utilized.

As a result of the Tax Reform Act of 1986 enacted in the fourth quarter, benefits from the investment tax credits available to the Company were reduced. The effect on the provision for federal income tax was an increase of approximately \$4.5 million.

II. Net income per common share

Net income per common share is computed based on the weighted average number of common and common equivalent shares outstanding (32,254,000 in 1986, 30,766,000 in 1985 and 29,472,000 in 1984).

Net income per common share assuming full dilution is computed based on shares issuable upon conversion of debentures (weighted for the number of days outstanding) and the weighted average number of common and common equivalent shares outstanding (33,168,000 in 1986, 32,757,000 in 1985 and 32,279,000 in 1984). The computation includes an income adjustment of \$1,276,000 in 1986, \$2,148,000 in 1985 and \$3,161,000 in 1984 for debenture interest expense, net of income tax effect.

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, 1986 and 1985, 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, 1986. 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, 1986 and 1985, and the consolidated results of operations and changes in financial position for each of the three years in the period ended December 31, 1986, in conformity with generally accepted accounting principles applied on a consistent basis during the period.



Dallas, Texas
January 23, 1987

Southwest Airlines Co. Supplementary Information

Year ended December 31, 1986

Consolidating Summary of Operations	Southwest	TranStar	Eliminations	Consolidated
(in thousands)				
Operating revenues:				
Passenger	\$ 599,440	\$ 142,847	\$	\$ 742,287
Freight	11,758	1,863		13,621
Other	8,501	5,233	(852)	12,882
Total operating revenues	619,699	149,943		768,790
Operating expenses	538,463	142,216	(852)	679,827
Operating income	81,236	7,727		88,963
Other expense (income)	17,456	6,061		23,517
Income before federal income tax	63,780	1,666		65,446
Provision for federal income tax	15,411	—		15,411
Net income	<u>\$ 48,369</u>	<u>\$ 1,666</u>	<u>\$ —</u>	<u>\$ 50,035</u>

Consolidating Operating Statistics

Passengers carried	11,333,893	2,303,622	13,637,515
Revenue passenger miles (000's)	5,666,037	1,722,364	7,388,401
Available seat miles (ASM) (000's)	9,712,384	2,862,100	12,574,484
Load factor	58.34%	60.18%	58.8%
Average length of passenger haul	500	748	542
Trips flown	218,841	43,241	262,082
Average passenger fare	\$ 52.89	\$ 62.01	\$ 54.43
Yield per passenger mile	10.58¢	8.29¢	10.05¢
Operating expense per ASM	5.54¢	4.97¢	5.41¢
Fuel cost per gallon (average)	51.58¢	50.88¢	51.42¢
No. of employees at period-end	4,610	1,209	5,819
Size of fleet at period-end*	63	16	79

*includes leased aircraft

Note — The Consolidating Summary of Operations is presented to enable the reader to analyze Southwest and TranStar separately. The information labeled "Southwest" is consolidated information of Southwest and its wholly owned subsidiary, Southwest Airlines Eurofinance N.V. The information labeled "TranStar" is presented on a "push-down" basis. That is, it contains those purchase accounting adjustments resulting from the acquisition of TranStar by Southwest. The provision for federal income tax has been calculated on a consolidated basis and allocated 100% to Southwest.

Southwest Airlines Co.

Years ended December 31

Selected Financial Data

	1986	1985 (1)	1984	1983
(in thousands except per share amounts)				
Operating revenues:				
Passenger	\$ 742,287	\$ 656,689	\$ 519,106	\$ 433,388
Freight	13,621	13,643	12,115	10,357
Other	12,882	9,340	4,727	4,491
Total operating revenues	768,790	679,672	535,948	448,236
Operating expenses	679,827	601,148	467,451	379,738
Operating income	88,963	78,524	68,497	68,498
Other expense (income)	23,517 (2)	17,740	649	4,927
Income before federal income tax	65,446	60,784	67,848	63,571
Provision for federal income tax	15,411	13,506	18,124	22,704
Net income	\$ 50,035	\$ 47,278	\$ 49,724	\$ 40,867
Net income per common share:				
Primary	\$ 1.55	\$ 1.54	\$ 1.69	\$ 1.40
Fully diluted	\$ 1.55	\$ 1.51	\$ 1.64	\$ 1.38
Cash dividends per common share	\$.13	\$.13	\$.13	\$.13
Total assets	\$ 1,078,190	\$ 1,022,396	\$ 646,244	\$ 587,258
Long-term obligations	\$ 339,069	\$ 381,308	\$ 153,314	\$ 158,701
Stockholders' equity	\$ 511,850	\$ 466,004	\$ 361,768	\$ 314,556

Financial Ratios

Return on average total assets	4.7%	5.5%	8.1%	8.1%
Return on average stockholders' equity ..	10.28%	11.4%	14.7%	14.2%
Debt as a percentage of equity	39.8%	45.0%	29.8%	33.5%

Consolidated Operating Statistics

Passengers carried	13,637,515	12,651,239	10,697,544	9,511,000
Revenue passenger miles (000's)	7,388,401	5,971,400	4,669,435	3,893,821
Available seat miles (ASM) (000's)	12,574,484	9,884,526	7,983,093	6,324,224
Load factor	58.8%	60.4%	58.5%	61.6%
Average length of passenger haul	542	472	436	409
Trips flown	262,082	230,227	200,124	175,421
Average passenger fare	\$ 54.43	\$ 51.91	\$ 48.53	\$ 45.57
Yield per revenue passenger mile	10.05¢	11.00¢	11.12¢	11.13¢
Operating expense per ASM	5.4¢	6.1¢	5.9¢	6.0¢
Fuel cost per gallon (average)	51.42¢	78.17¢	82.44¢	85.92¢
No. of employees at period-end	5,819	5,271	3,934	3,462
Size of fleet at period-end (5)	79	70	54	46

(1) Includes the accounts of TranStar since June 30, 1985

(2) Includes a gain of \$4 million from the sale of aircraft delivery positions

(3) Includes a gain from the sale of tax benefits relating to three aircraft of \$11 million

(4) Includes a gain of \$8.5 million from the sale of aircraft and net cumulative effect of an accounting change of \$735,000

(5) Includes any aircraft under capital or operating lease

1982	1981	1980	1979	1978	1977
\$ 317,996	\$ 258,612	\$ 204,260	\$ 130,507	\$ 77,583	\$ 46,954
9,469	8,326	6,080	4,057	2,364	1,318
<u>3,724</u>	<u>3,420</u>	<u>2,708</u>	<u>1,550</u>	<u>1,118</u>	<u>775</u>
331,189	270,358	213,048	136,114	81,065	49,047
<u>291,964</u>	<u>221,854</u>	<u>164,219</u>	<u>107,128</u>	<u>59,943</u>	<u>38,785</u>
39,225	48,504	48,829	28,986	21,122	10,262
<u>(5,165)(3)</u>	<u>239</u>	<u>7,539</u>	<u>8,272</u>	<u>(3,569)(4)</u>	<u>2,717</u>
44,390	48,265	41,290	20,714	24,691	7,545
<u>10,386</u>	<u>14,100</u>	<u>12,843</u>	<u>4,062</u>	<u>7,687</u>	<u>—</u>
<u>\$ 34,004</u>	<u>\$ 34,165</u>	<u>\$ 28,447</u>	<u>\$ 16,652</u>	<u>\$ 17,004</u>	<u>\$ 7,545</u>
\$ 1.28	\$ 1.35	\$ 1.30	\$.79	\$.81	\$.36
\$ 1.26	—	—	—	—	—
\$.13	\$.11	\$.09	\$.06	\$.04	\$.02
\$ 420,542	\$ 291,823	\$ 224,442	\$ 172,495	\$ 118,706	\$ 77,967
\$ 106,306	\$ 58,934	\$ 77,892	\$ 87,374	\$ 62,000	\$ 47,000
\$ 240,627	\$ 176,503	\$ 106,964	\$ 58,412	\$ 42,889	\$ 26,606
9.6%	13.0%	14.1%	11.7%	17.2%	12.4%
16.7%	23.5%	36.0%	33.1%	50.3%	33.0%
30.6%	25.0%	42.1%	59.9%	59.1%	63.8%
7,965,554	6,792,927	5,976,621	5,000,086	3,528,105	2,339,524
3,022,142	2,310,181	2,024,097	1,585,539	1,048,624	675,668
4,907,945	3,633,351	2,969,448	2,320,371	1,556,173	1,011,048
61.6%	63.6%	68.2%	68.3%	67.4%	66.8%
379	340	339	317	297	289
140,030	110,301	91,143	75,837	54,816	35,415
\$ 39.92	\$ 38.07	\$ 34.18	\$ 26.10	\$ 21.99	\$ 20.07
10.52¢	11.19¢	10.09¢	8.23¢	7.40¢	6.95¢
5.9¢	6.1¢	5.5¢	4.6¢	3.9¢	3.8¢
94.51¢	101.67¢	85.0¢	59.3¢	38.2¢	36.4¢
2,913	2,129	1,839	1,630	1,119	892
37	27	23	18	13	10

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 May 20, 1987 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.



In 1986 we didn't merge.