



# SOUTHWEST

# AIRLINES



# TURNED

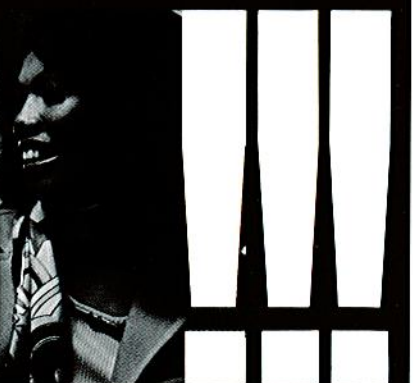


# THE

# CORNER



# IN 1973



# !!!



## Statistical Highlights

	<u>1973</u>	<u>1972</u>	<u>Percent Change</u>
No. of flights	10,619	10,576	—%
No. of passengers	543,407	308,999	76
Average passengers per flight	51.2	29.2	75
Operating revenue	\$9,208,841	\$5,994,161	54
Average revenue — per flight	867.20	566.77	53
— per passenger	16.95	19.40	(13)
Operating costs (including interest)	\$9,034,085	\$8,117,972	11
Average cost — per flight	850.75	767.58	11
— per passenger	16.62	26.27	(37)
Net income (loss)	\$ 174,756	(\$1,591,175)	
Outstanding common shares (average)	1,108,758	1,062,924	
Net Income (loss) per share	\$ .16	(\$ 1.50)	





## To Our Shareholders

1973 is the first year in which our operating results can be compared to the results of the full preceding year. While the number of flights operated stayed almost constant, passengers increased some 76% to 543,407. Passengers utilizing Southwest paid 13% less for their tickets in 1973 than they did in 1972, resulting in a 54% increase over 1972's operating revenues.

During the same period, our total cost of operation increased 11%, or \$916,000. Over half of this increase represented larger pay checks to our expanded family of employees, with the remaining cost increases being primarily attributable to much higher interest rates on our debt; security costs for our passengers, all of which were absorbed by the Company; and the other direct costs associated with a substantial increase in passengers handled.

Overall, the net effect of our improved operating results was to eliminate the 1972 net loss of \$1,591,175 (\$1.50 per share) and produce a 1973 net income of \$174,756 (\$.16 per share). It was clearly the year in which Southwest Airlines turned the corner.

The year 1974 presents challenges and opportunities. In Dallas, our operations, barring reversal by the Fifth Circuit Court of Appeals, will continue to be provided from centrally located

Love Field with almost wingtip-to-wingtip competition from our principal competitor. Service by all other air carriers will be provided from the new Regional Airport located between Dallas and Fort Worth at Grapevine. Our Houston operations will continue to be provided exclusively from the close-in Hobby Airport. Before the end of 1974, we hope to receive from the Texas Aeronautics Commission approval to provide our brand of excellent commuter service to the Rio Grande Valley through Harlingen's airport, the most centrally located facility in that fast-growing area of Texas.

In September, 1974 Southwest will accept delivery of a new Boeing 737-200 advanced model aircraft from the manufacturer at a cost of \$5¼ million. After pre-delivery progress payments of \$1½ million out of available Company funds, the balance of \$3¾ million will be financed by the manufacturer on the same terms as our present three aircraft.

Traffic results in the first quarter of 1974 are expected to be some

31% higher than the same 1973 period, producing net income estimated to be \$600,000, as compared to a net loss of \$176,000 in the 1973 first quarter. It is believed that this increase is due to (1) our ability to continue to operate from Dallas' close-in Love Field and (2) the diversion of highway travel to air as a result of the energy crisis which has created higher prices for scarce fuel and lower speed limits, thus making our service just that much more competitive with travel by private automobile.

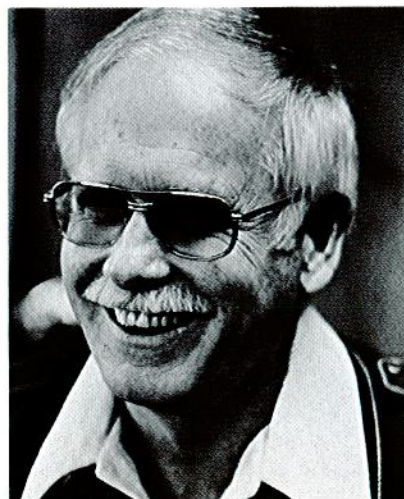
Availability of jet fuel for our own operations has not presented any serious problem to date. Recent 1974 price increases averaging 25% represent an overall cost increase of less than 3%. Quite obviously, trading off the 3% cost increase for up to 31% traffic increase is good business.

Healthy increases in passengers at an improved average fare should produce operating revenues substantially in excess of anticipated 1974 cost increases and thus produce for the first time earnings per share worthy of the substantial investment which each share represents. This will be the goal of each and every Southwest Airlines employee during 1974.

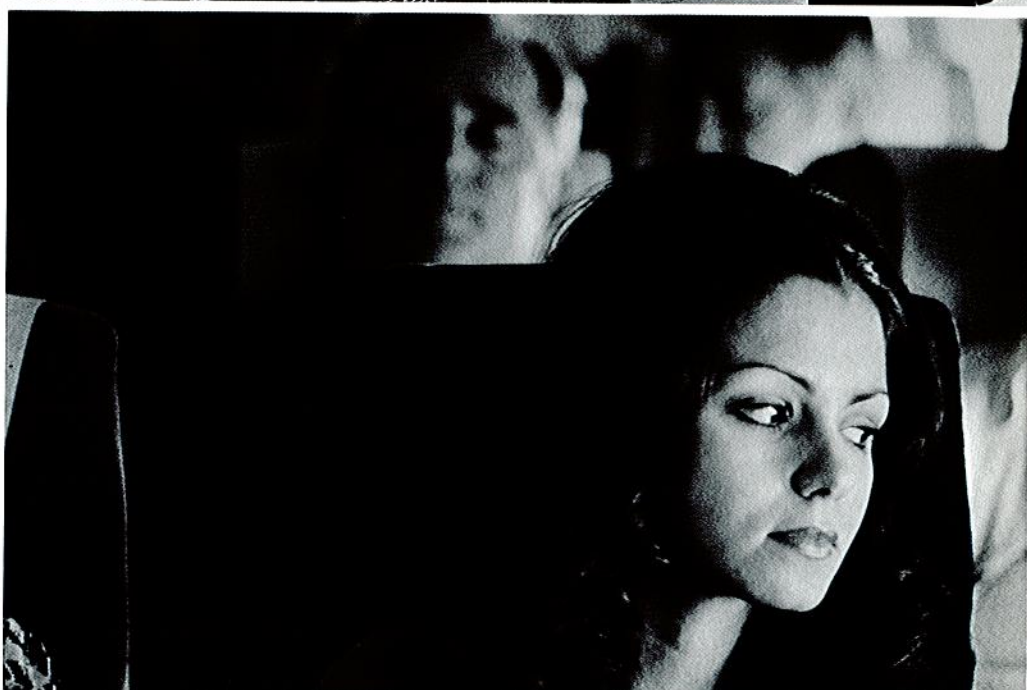
Cordially yours,



M. Lamar Muse  
President and  
Chief Executive Officer







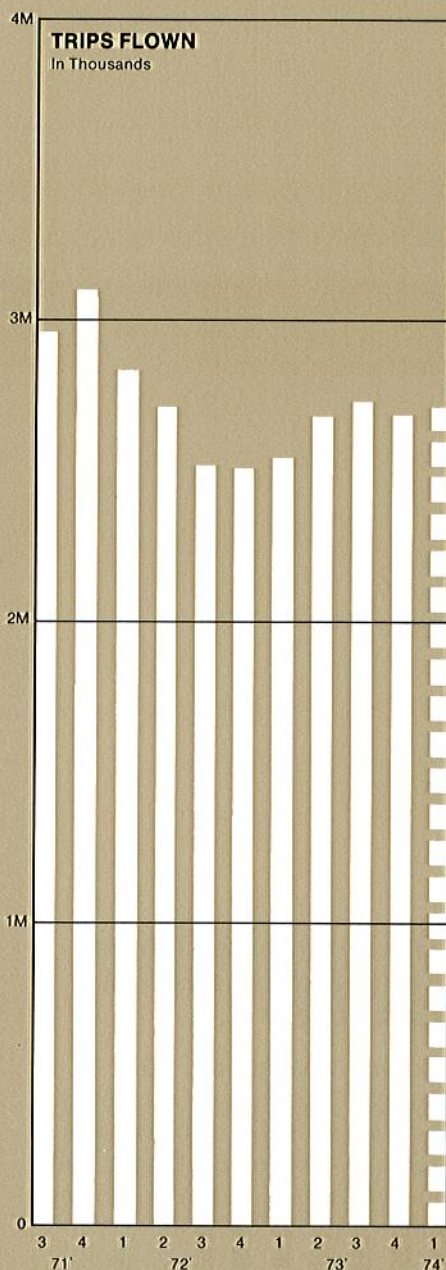




### **The Southwest Airlines Story (Continued From Last Year)**

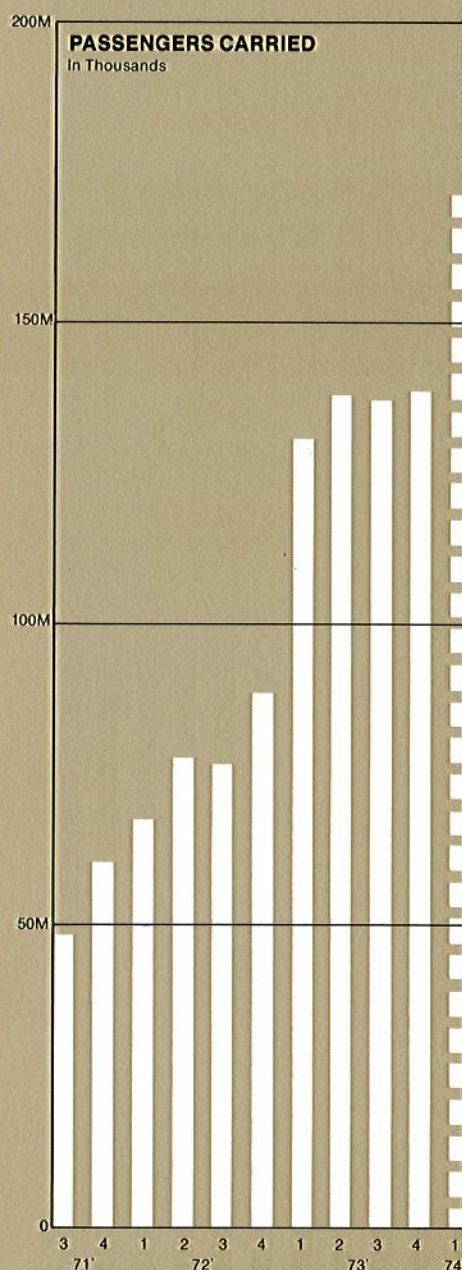
In Southwest Airlines' 1972 Annual Report there was included a comprehensive discussion of some of the problems faced and the strategies used by Southwest management in developing the markets we serve and obtaining for itself a reasonable share of such expanded markets. This year we would like to show you in the form of the twelve graphs which follow the progress which Southwest Airlines has made each quarter from its first full quarter of operations ending September 30, 1971, through the quarter ended December 31, 1973, on an actual basis and including an estimate for the first quarter of 1974 in each of the categories graphically presented. The 1974 first quarter estimate is based on actual results for the months of January and February with estimated amounts added for the month of March.





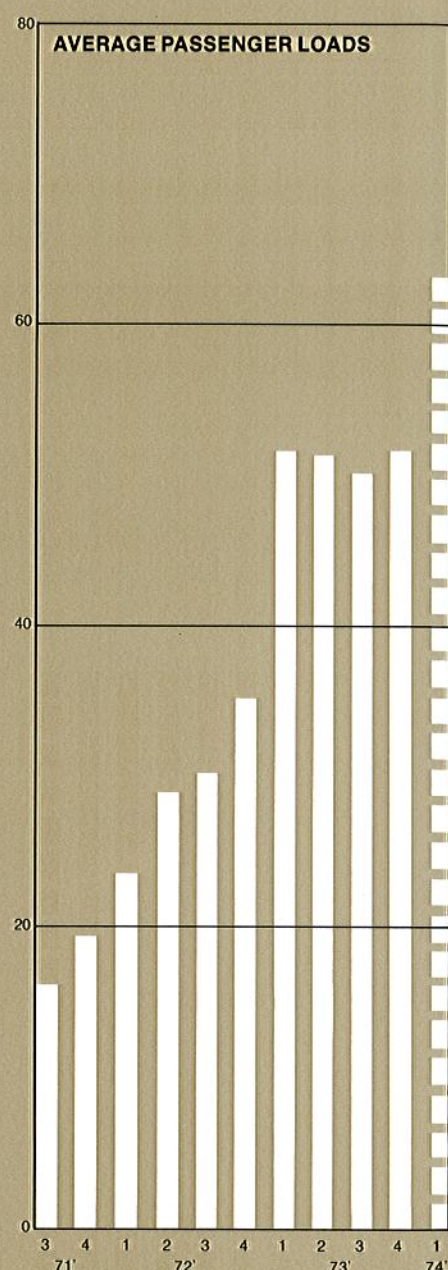
#### TRIPS FLOWN

This graph shows that the Company currently is operating slightly fewer trips per quarter than in its initial two quarters of operation, the first quarter being with three aircraft and the second period being with four aircraft. The fourth aircraft was disposed of in May, 1972. The 1972 dip in trips was further depressed by the discontinuance of all Saturday operations until November, 1972 when they were resumed at lower fares.



#### PASSENGERS CARRIED

Passengers carried through 1972 showed steady increases each quarter. An inordinate jump occurred in the first quarter of 1973 when during the months of February and March the Company was engaged in a price war with its principal competitor. The Company was able to maintain these higher traffic levels at its regular fares in the remaining three quarters of 1973. The first quarter estimate for 1974 again indicates a strong increase as a result of (1) the Company's premium service from Love Field in Dallas subsequent

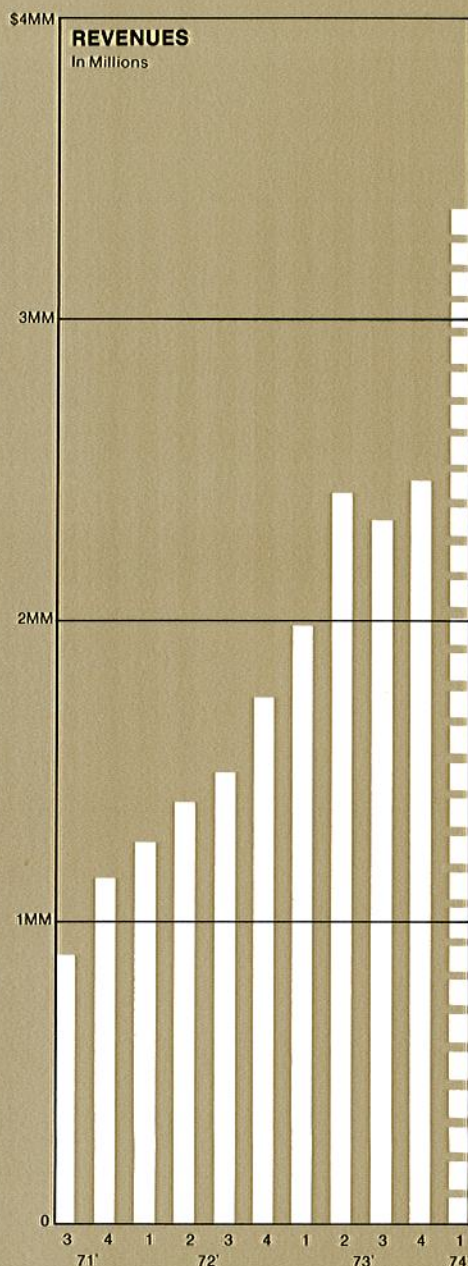


to the move from that airport to the new Regional Airport by all other carriers except our principal competitor and (2) a noticeable shift from highway travel to air in our short-haul markets since the energy crisis.

#### AVERAGE PASSENGER LOADS

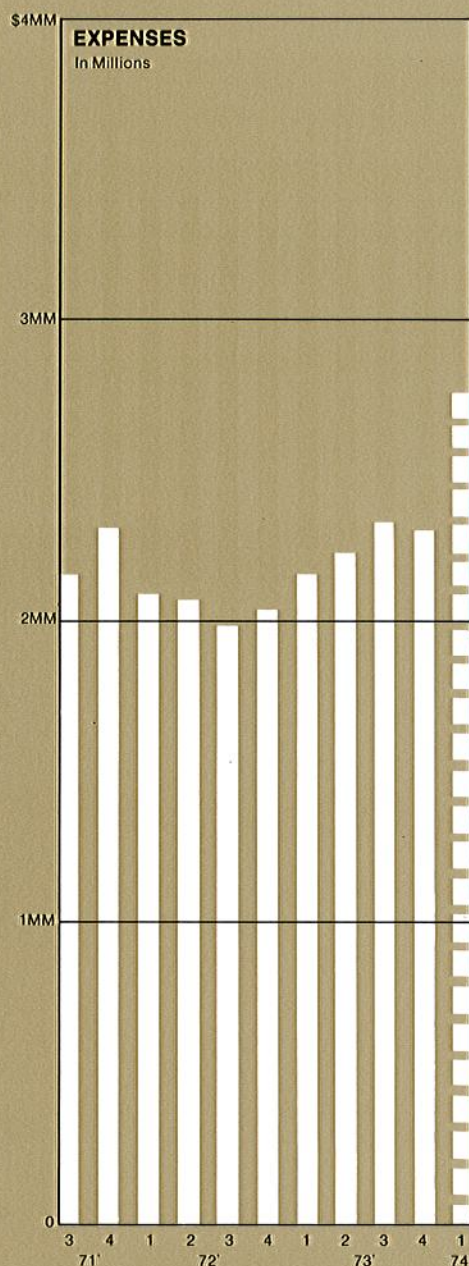
The average passenger loads which started out at some 17 passengers per flight and which in 1973 averaged 51.2 passengers per flight further increased in the first quarter of 1974 to an estimated overall average of 63 passengers per flight.





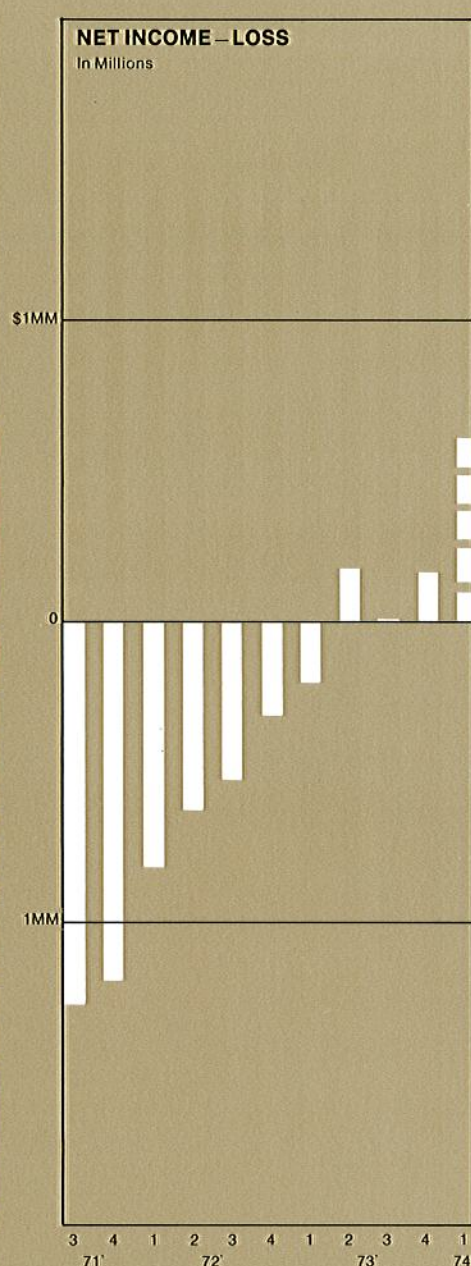
#### REVENUES

Total revenues started out at less than \$1 million per quarter and averaged some \$2.3 million in each of the 1973 quarters. Total revenues are estimated to move above  $3\frac{1}{3}$  million in the first quarter of 1974, partially as a result of a fare increase in the amount of \$2 placed into effect on December 1, 1973.



#### EXPENSES

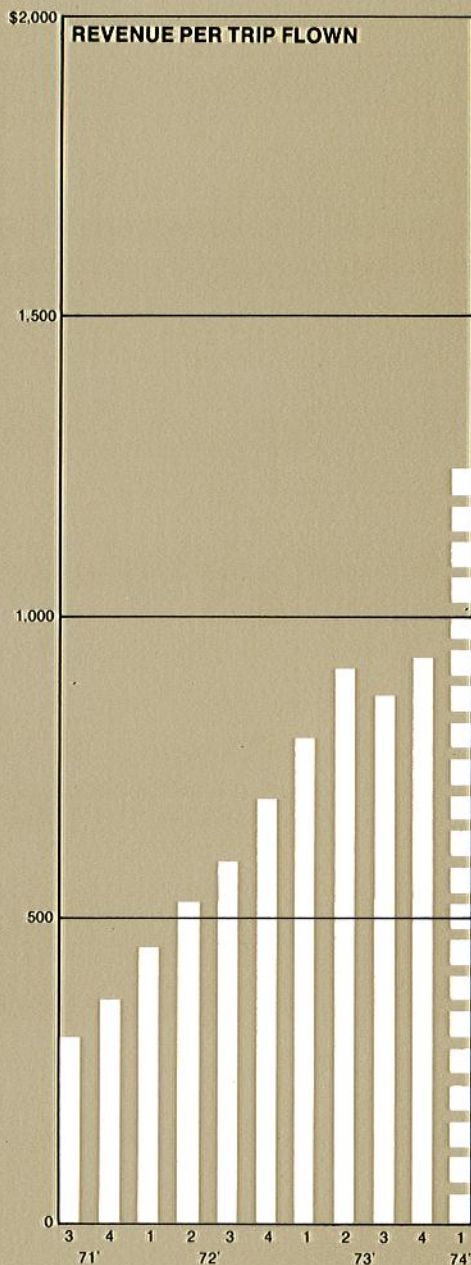
Total expenses have been relatively constant throughout our operating period except for the increases experienced in the 1973 quarters attributable to substantial additional traffic being handled. A further increase in the first quarter of 1974 is forecast recognizing the cost of handling some 30,000 additional passengers during that quarter over earlier quarters, as well as up to a 25% increase in our fuel cost per gallon.



#### NET INCOME - LOSS

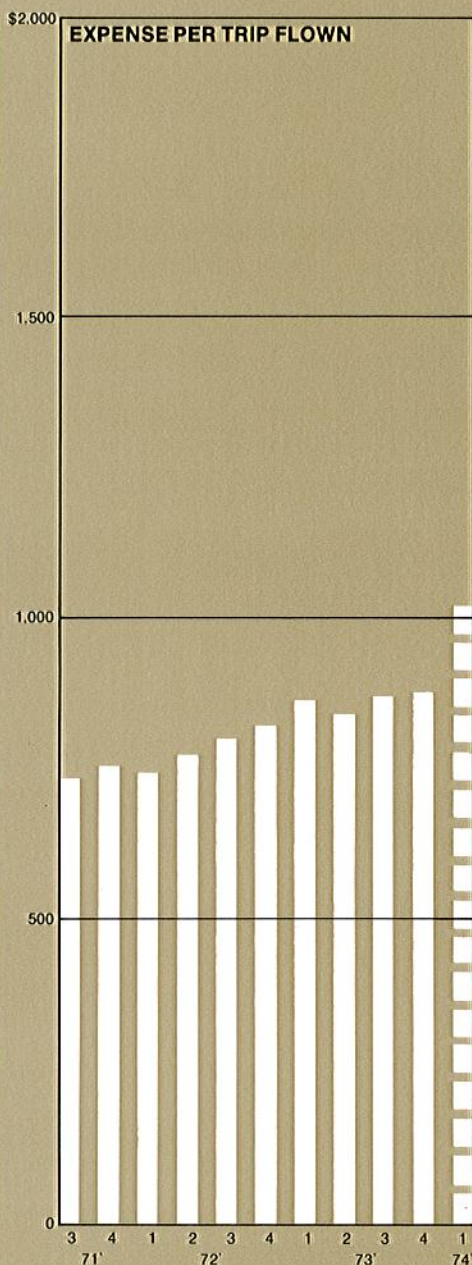
The Company's progress toward profitability has been sustained and steady from its very inception. The initial losses, which were as great as \$1,260,000 during our first full quarter of operation, were eliminated in the second quarter of 1973 when our first net income was realized. It is anticipated that the net income to the Company during the first quarter of 1974 will further increase to approximately \$600,000 without tax effect as a result of the loss carryforwards which the Company incurred in 1971 and 1972.





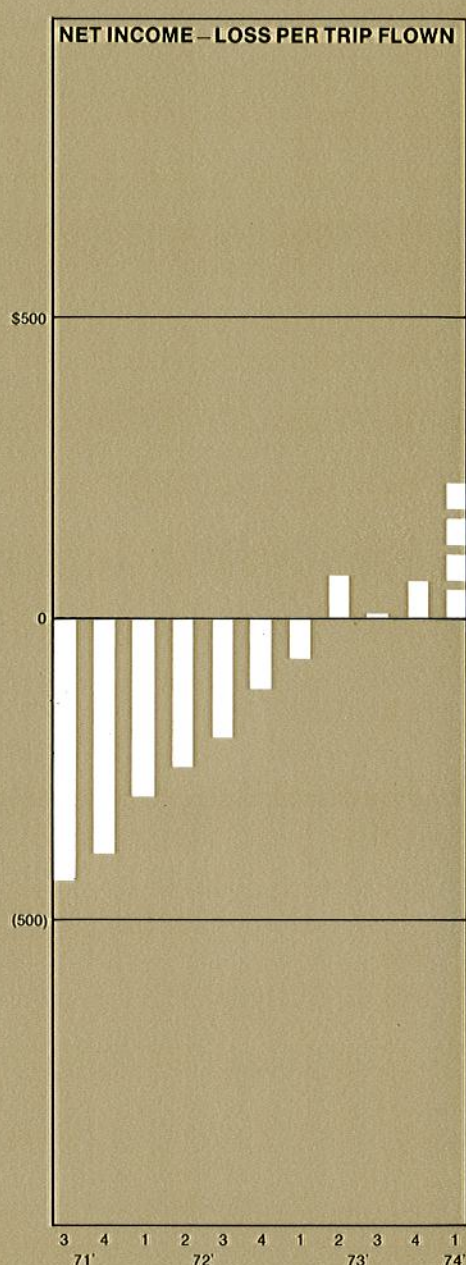
#### REVENUE PER TRIP FLOWN

Average revenues per trip flown, which were \$300 during the Company's first full quarter, increased steadily to \$920 per flight operated in the final quarter of 1973 with a forecasted further increase during the first quarter of 1974 to \$1,236 per flight operated.



#### EXPENSE PER TRIP FLOWN

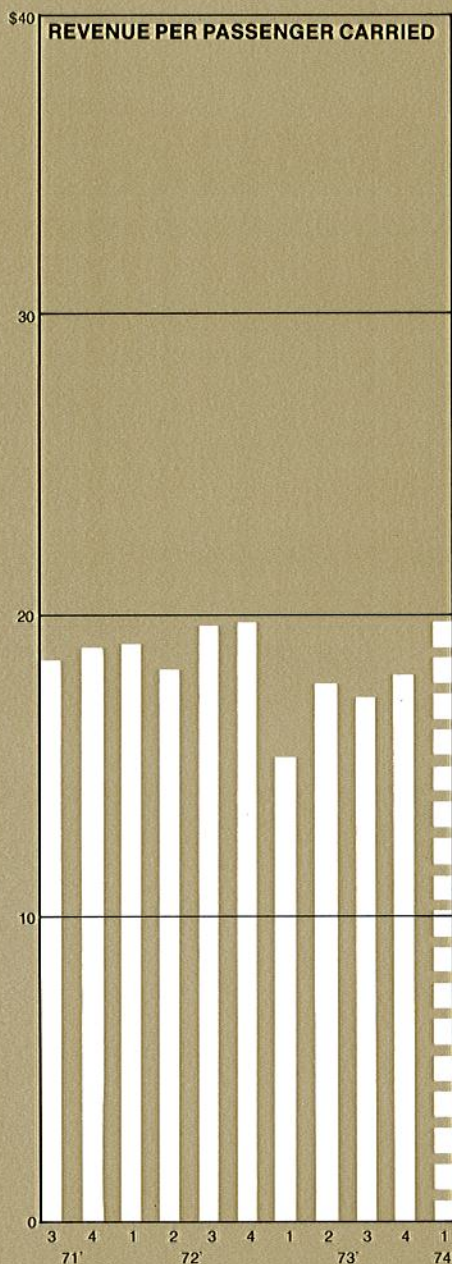
The Company incurs variable costs of some \$2.29 for each additional passenger carried. As our average loads per flight have increased, our average expense per trip flown has reflected this increase. Additionally, during the Company's almost three years of operation, very substantial wage and salary increases have been extended to our employees. At the present time most categories of employees are receiving income roughly comparable to the interstate carriers' salary and wage scales.



#### NET INCOME - LOSS PER TRIP FLOWN

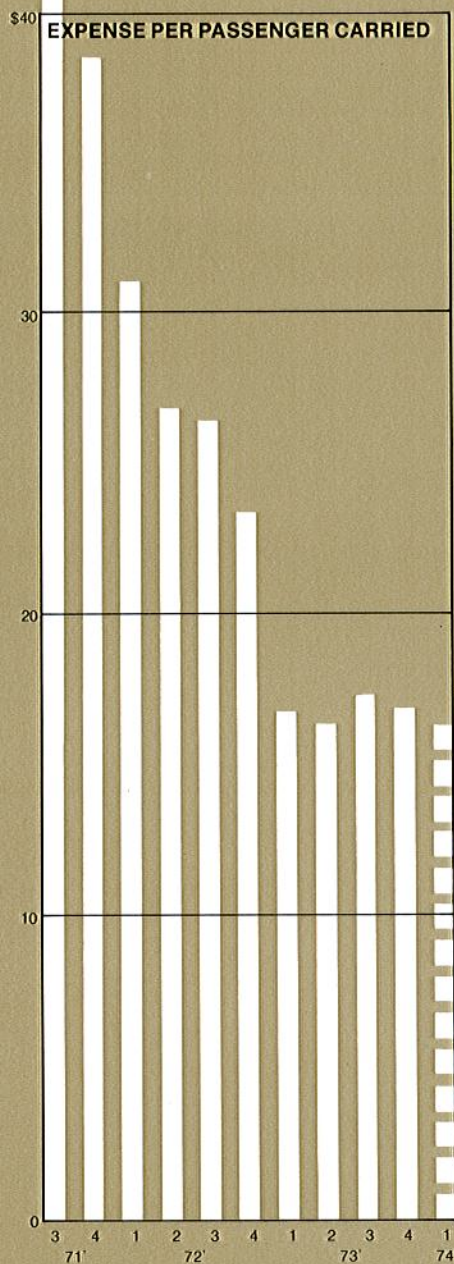
Again, steady progress is shown toward profitability from the initial loss per trip flown of \$427 to the forecast \$221 profit per trip flown in the first quarter of 1974.





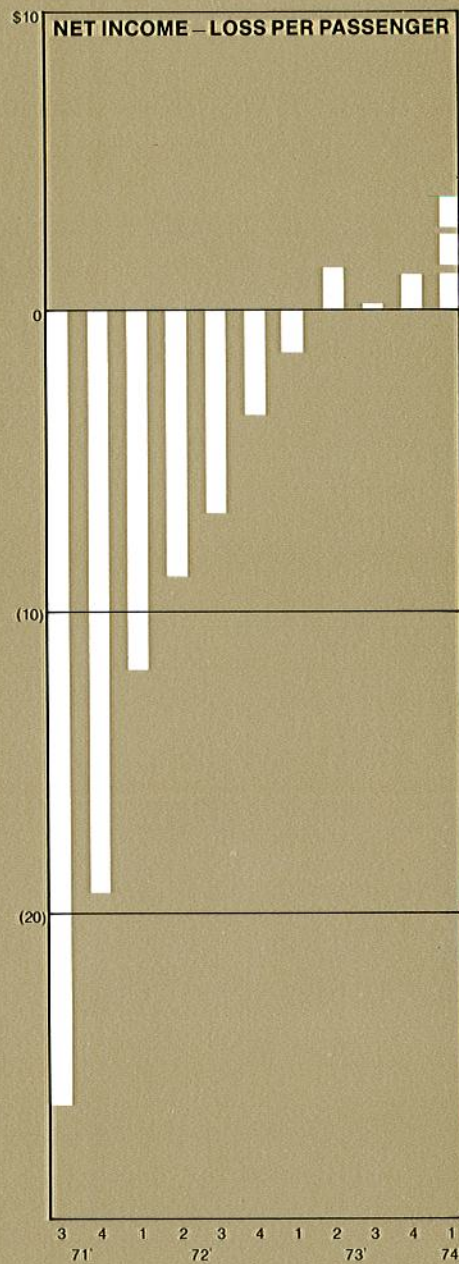
#### REVENUE PER PASSENGER CARRIED

Even though changes have been made in fares in different markets over the period of our operating history, the net effect has been that the average fare received by Southwest from each of its passengers was less in 1973 than in either 1972 or 1971. As a result of the \$2 increase put into effect December 1, 1973, it is estimated that the average revenue per passenger carried in the first quarter of 1974 will be equal to the average revenue per passenger received during the last half of 1972.



#### EXPENSE PER PASSENGER CARRIED

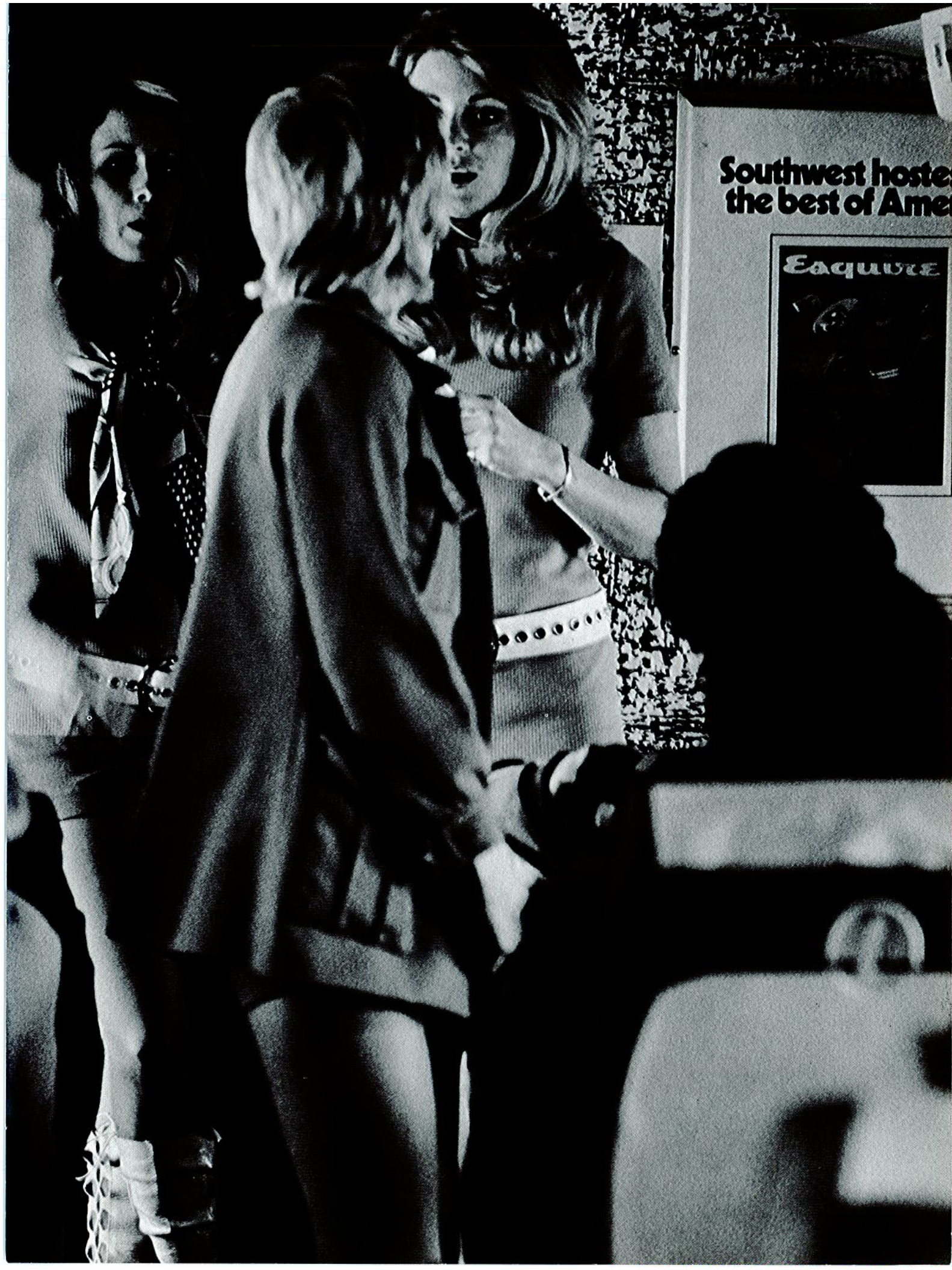
This graph shows the extremely high cost of carrying a few passengers on a large airplane and the dramatic reduction which can be made as average passengers per flight operated increase, thus reflecting the high fixed cost nature of the airline business. Once the average loads reach 50 passengers or above, the reductions in expense per passenger carried come very slowly.



#### NET INCOME - LOSS PER PASSENGER

Contrary to the other two net income-loss graphs, the progress toward profitability measured in this manner shows progressive non-linear improvement from a loss per passenger carried during the first full quarter of operation of some \$26.24 to an estimated profit during the first quarter of 1974 per passenger carried of \$3.52. This declining rate of change results from the high fixed-cost nature of the airline industry.





Southwest hosted  
the best of America





## Statement of Operations and Deficit

Years ended December 31, 1973 and 1972

	<u>1973</u>	<u>1972</u>
Revenues:		
Transportation:		
Passenger	\$ 8,996,360	\$ 5,804,484
Package express	189,777	107,433
Interest	13,525	82,244
Other	9,179	—
	<u>9,208,841</u>	<u>5,994,161</u>
Expenses:		
Operating costs:		
Operations and maintenance (Note 1)	4,674,082	3,859,156
Marketing and promotion	793,570	896,197
General and administrative	759,056	700,474
	<u>6,226,708</u>	<u>5,455,827</u>
Ownership costs:		
Property insurance and taxes	386,987	454,299
Depreciation and amortization (Note 1)	1,343,715	1,337,382
Cost of borrowed funds (Note 2)	1,076,675	870,464
	<u>2,807,377</u>	<u>2,662,145</u>
	<u>9,034,085</u>	<u>8,117,972</u>
Income (loss) before federal income taxes and extraordinary items	174,756	(2,123,811)
Provision for federal income taxes (Note 6)	121,756	—
Income (loss) before extraordinary items	53,000	(2,123,811)
Extraordinary items:		
Gain on sale of aircraft	—	532,636
Reduction of federal income tax arising from carryforward of prior years' operating losses	121,756	—
Net income (loss)	174,756	(1,591,175)
Deficit at beginning of period	5,343,798	3,752,623
Deficit at end of period	<u>\$ 5,169,042</u>	<u>\$ 5,343,798</u>
Income (loss) per share of common stock (based on average shares outstanding):		
Before extraordinary item	<u>\$ .05</u>	<u>\$(2.00)</u>
Net income (loss)	<u>\$ .16</u>	<u>\$(1.50)</u>

See accompanying notes.



## Balance Sheet

December 31, 1973 and 1972

### Assets

	<u>1973</u>	<u>1972</u>
Current assets:		
Cash	\$ 759,821	\$ 133,839
Certificates of deposit	—	1,250,000
Accounts receivable:		
Trade	552,423	397,664
Other	61,341	81,777
	<u>613,764</u>	<u>479,441</u>
Less allowance for doubtful accounts	5,000	86,363
	<u>608,764</u>	<u>393,078</u>
Inventories of parts and supplies, at cost	160,283	154,121
Prepaid insurance and other	104,488	75,625
Total current assets	<u>1,633,356</u>	<u>2,006,663</u>
Property and equipment, at cost (Notes 1 and 2):		
Boeing 737-200 jet aircraft	12,409,772	12,409,772
Progress payments on additional aircraft	701,333	—
Support flight equipment	2,447,728	2,423,480
Ground equipment	450,101	346,377
	<u>16,008,934</u>	<u>15,179,629</u>
Less accumulated depreciation and airworthiness reserve	4,029,545	2,521,646
	<u>11,979,389</u>	<u>12,657,983</u>
Deferred charges (Note 1):		
Certification costs	265,068	371,095
Love Field case costs	148,802	—
	<u>413,870</u>	<u>371,095</u>
	<u>\$14,026,615</u>	<u>\$15,035,741</u>

See accompanying notes.



## Liabilities and Stockholders' Equity

	<u>1973</u>	<u>1972</u>
Current liabilities:		
Notes payable to banks	\$ —	\$ 950,000
Accounts payable	223,472	124,890
Accrued salaries and wages	76,950	55,293
Other accrued liabilities	230,421	136,437
Long-term debt due within one year (Note 2)	600,000	1,226,457
Total current liabilities	<u>1,130,843</u>	<u>2,493,077</u>
Long-term debt due after one year:		
Conditional purchase agreements (Note 2) —		
Boeing Financial Corporation		
(1½ % over prime rate)	11,455,451	11,942,056
Deferred compensation — officer (Note 4)	38,500	—
	<u>11,493,951</u>	<u>11,942,056</u>
Less amounts due within one year	600,000	1,226,457
	<u>10,893,951</u>	<u>10,715,599</u>
Contingencies (Note 7)		
Stockholders' equity (Notes 2 and 3):		
Common stock, \$1.00 par value, 2,000,000 shares		
authorized, 1,108,758 issued	1,108,758	1,108,758
Capital in excess of par value	6,062,105	6,062,105
Deficit	(5,169,042)	(5,343,798)
	<u>2,001,821</u>	<u>1,827,065</u>
	<u>\$14,026,615</u>	<u>\$15,035,741</u>

See accompanying notes.



## Statement of Changes in Financial Position

Years ended December 31, 1973 and 1972

	<u>1973</u>	<u>1972</u>
Sources of working capital:		
Operations:		
Income (loss) before extraordinary items	\$ 53,000	\$(2,123,811)
Items not affecting working capital in the current period:		
Depreciation	1,237,688	1,231,355
Net change in airworthiness reserve	272,648	490,599
Amortization of certification costs	106,027	106,027
Deferred compensation — officer	38,500	—
Working capital provided from (used in) operations for the period, exclusive of extraordinary items	1,707,863	(295,830)
Reduction of federal income tax arising from carryforward of prior years' operating losses	121,756	—
Common stock issued	—	100,000
Proceeds from sale of aircraft	—	4,090,000
	<u>1,829,619</u>	<u>3,894,170</u>
Application of working capital:		
Net additions to property and equipment	831,742	78,575
Net (increase) decrease in long-term debt	(139,852)	5,838,046
Love Field case costs	148,802	—
	<u>840,692</u>	<u>5,916,621</u>
Increase (decrease) in working capital	<u>\$ 988,927</u>	<u>\$(2,022,451)</u>
Changes in components of working capital:		
Increase (decrease) in current assets:		
Cash	\$ 625,982	\$ (97,691)
Certificates of deposit	(1,250,000)	(1,600,000)
Accounts receivable	215,686	55,234
Inventories	6,162	(17,544)
Prepaid insurance and other	28,863	(80,869)
	<u>(373,307)</u>	<u>(1,740,870)</u>
Increase (decrease) in current liabilities:		
Notes payable	(950,000)	950,000
Accounts payable	98,582	(230,649)
Accrued salaries and wages	21,657	580
Other accrued liabilities	93,984	(164,807)
Long-term debt due within one year	(626,457)	(273,543)
	<u>(1,362,234)</u>	<u>281,581</u>
Increase (decrease) in working capital	<u>\$ 988,927</u>	<u>\$(2,022,451)</u>

See accompanying notes.







## Notes to Financial Statements

Year Ended December 31, 1973

### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Basis of presentation**— Certain 1972 amounts have been reclassified in the accompanying financial statements to conform to the 1973 classifications.

**Depreciation and overhaul allowances**— Provisions for depreciation of flight and other equipment have been computed on the straight-line method. The estimated useful lives and salvage values currently used for the principal asset classifications are as follows:

	Estimated life	Salvage value
Boeing 737-200 aircraft and related spare engines and flight equipment	12 years	4%
Ground equipment	10 years	10%
Surface transport vehicles and equipment	5 years	20%
Furniture and fixtures	10 years	10%
Leasehold improvements	Period of leases	—

The Company is providing for future major maintenance and overhaul to be performed on its aircraft by accruing a reserve for

airworthiness during the current year of \$95 (\$90 in 1972) for each flight hour. The Company charges against this reserve its actual expenditures for certain aircraft maintenance materials and outside repair costs. A net reserve for future period maintenance has been accumulated in the amount of \$1,063,240 at December 31, 1973. Routine aircraft maintenance inspections are charged to expense as incurred.

**Deferred charges**— Deferred certification costs are being amortized on a straight-line basis over a five year period ending June 30, 1976. Deferred court costs pertaining to the Company's continued operations at Dallas' Love Field are being amortized on a straight-line basis over two years ending December 31, 1975. See Note 7.

### 2. LONG-TERM DEBT

At December 31, 1973 the Company owed Boeing Financial Corporation, under the terms of conditional Purchase Agreements, \$11,455,451 in connection with purchase of three Boeing 737-200 aircraft together with spare engines, parts, and support and test equipment. Debt service payments, including interest, are \$1,650,000 in 1974 and \$1,800,000

in 1975 and 1976, respectively. The Agreements provide that any balance due at the end of six years (1977) after the delivery of the aircraft shall be paid in full at that time. Interest on the unpaid balance of such debt shall be accrued and/or paid at a rate equivalent to 1½% above the base commercial rate at a specified bank.

During 1973 the Company entered into an agreement with The Boeing Company to purchase a 737-200 aircraft (to be delivered in September 1974) at a cost of \$5,279,525. In compliance with the terms of the agreement, the Company, at December 31, 1973, has made advance payments totaling \$701,333 with additional payments of \$438,333 payable on February 1, 1974 and May 1, 1974, respectively. Pursuant to the above agreements Boeing has agreed to participate in financing the purchase price of the aircraft not to exceed \$3,739,184 at a rate equivalent to 1½% above the base commercial rate at a specified bank, repayable in 31 consecutive monthly payments of \$50,000 each, including interest, commencing October 1, 1974 and continuing through April 1, 1977, with the remaining balance to be paid in full on May 1, 1977.



The Company's 7% Convertible Promissory Notes in the amount of \$1,250,000 due March 10, 1973 were retired in December 1972, through a special alternative offer to the noteholders. As a result, notes with a face value of \$1,150,000 were retired by making cash payments totaling \$1,009,125 equivalent to 87.75% of the face value of such notes. The 12.25% discount was equivalent to the interest which had been paid on those notes from the date of issuance and such amount was applied to 1972's cost of borrowed funds. Notes with a face value of \$100,000 were exchanged into 50,000 shares of the Company's unregistered common stock, \$1.00 par value, at a rate of \$2.00 per share. Common stock and capital in excess of par value were each increased by \$50,000 in 1972.

### **3. STOCKHOLDERS' EQUITY**

The Company has reserved for issuance on exercise of 1976 warrants, 115,000 shares exercisable at \$6.05 per share and on exercise of 1978 warrants, 10,000 shares exercisable at \$4.00 per share.

Certain officers and directors (or associates thereof) of the Company have waived their rights to

participate in dividends and distributions of assets with respect to an aggregate of 235,000 outstanding shares of common stock and 15,000 shares of common stock issuable on the exercise of warrants until the Commissioner of Corporations of the State of California shall by order eliminate the requirement for such waiver.

### **4. DEFERRED COMPENSATION**

Under a deferred compensation agreement with the President of the Company adopted by the Board of Directors on July 26, 1972 the Company is obligated to accrue for the benefit of the President, in addition to his regular salary, deferred compensation of \$88,000 over the two-year term of his current agreement ending September 30, 1974, or the net after tax earnings of the Company (as defined by the agreement), whichever is lower. In the event the agreement should be terminated at any time prior to its end, the net earnings of the Company shall be calculated on a cumulative basis to the quarter ending nearest the date on which the agreement is so terminated. During 1973, \$38,500 was accrued and charged to operations in connection with this agreement.

The deferred compensation shall be paid at a rate not to exceed \$30,000 per year, commencing in the year following termination of the President's employment with the Company.

### **5. EMPLOYEE PROFIT SHARING PLAN**

Under a noncontributory employee profit sharing plan adopted by the Company in 1973, each regular Company employee on January 1, 1973 is eligible to become a Member as of such date. Other regular employees will be eligible to become Members as of January 1 following their date of hire.

The plan provides that the Company may contribute, as determined by the Board of Directors, up to 15% of its adjusted pre-tax income (as defined in the plan) in excess of \$1,150,000 for the year. All contributions will be invested by the Trustee of the plan in common stock of Southwest Airlines. No contribution was made for the year 1973. The plan may be terminated at any time at the discretion of the Company's Board of Directors.

### **6. FEDERAL INCOME TAX**

At December 31, 1973 the Company has a net operating loss carryforward of approximately



\$3,900,000 which may be utilized in future periods as an offset to taxable income. In addition, unused investment tax credits aggregate approximately \$500,000.

The principal difference between pre-tax financial income and taxable income relates to the amortization of deferred certification costs, which costs are not deductible for federal income tax purposes.

#### **7. CONTINGENCIES**

The cities of Dallas and Ft. Worth and the Regional Airport Board filed suit to evict the Company from Love Field upon the opening of the D/FW Regional Airport. The United States District Court for the Northern District of Texas decided that the Company has the right to remain at Love Field as long as Love Field continues to operate as a public airport. The plaintiffs are now seeking to overturn the District Court's decision in an appeal to the Fifth Circuit Court of Appeals. Oral argument on the case is set for March 18, 1974. The extent of the effect of a reversal in this litigation on the Company's future financial position and operations is not predictable at this time.

#### **Auditor's Report**

February 8, 1974

The Board of Directors and  
Stockholders  
Southwest Airlines Co.

We have examined the accompanying balance sheet of Southwest Airlines Co. at December 31, 1973 and the related statements of operations and deficit and changes in the financial position for the year then ended. Our examination was 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. We have previously made a similar examination of the financial statements for the prior year.

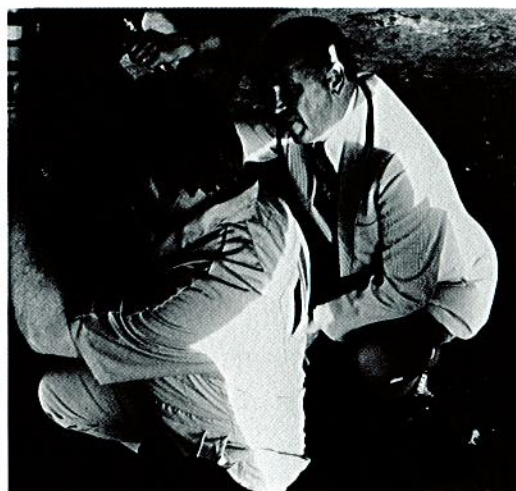
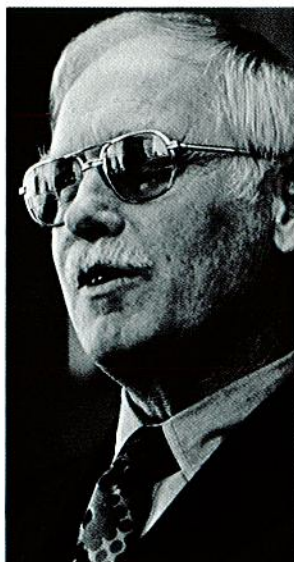
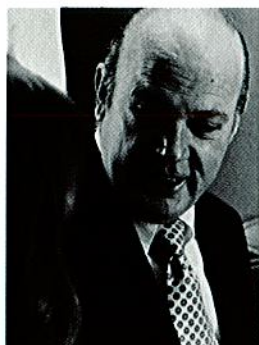
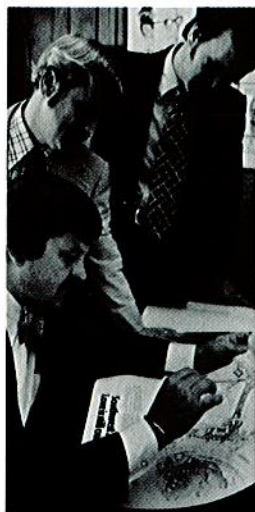
In our report dated February 10, 1973 related to the financial statements at December 31, 1972 and for the year then ended, our opinion was qualified with respect to the recovery of the carrying value of the Company's assets being dependent upon its ability to achieve profitable operations. Inasmuch as

profitable operations have been achieved in the current year, the qualification of our opinion is removed.

In our opinion, the statements mentioned above present fairly the financial position of Southwest Airlines Co. at December 31, 1973 and 1972 and the results of its operations and changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis during the period.

Arthur Young & Company  
4800 One Shell Plaza  
Houston, Texas 77002





## Directors

Sidney A. Adger  
*Houston, Texas*  
Todd Alexander  
*New York, New York*  
A. A. Bradford  
*Midland, Texas*  
Herbert D. Kelleher  
*San Antonio, Texas*  
Rollin W. King  
*Dallas, Texas*  
M. Lamar Muse  
*Dallas, Texas*  
John Peace  
*San Antonio, Texas*

## Officers

M. Lamar Muse  
*President*  
Rollin W. King  
*Executive Vice  
President-Operations*  
Jess R. Coker  
*Vice President-Marketing*  
William W. Franklin  
*Vice President-  
Ground Operations*  
J. L. Herring  
*Vice President-  
Inflight Service*  
Donald G. Ogden  
*Vice President-  
Flight Operations*  
John A. Vidal  
*Vice President-  
Maintenance & Engineering*  
Herman H. Farr  
*Treasurer*  
Herbert D. Kelleher  
*Secretary & General Counsel*  
Carole Ann Brown  
*Assistant Secretary*  
Fred A. Rigby, Jr.  
*Comptroller*

## Transfer Agent and Registrar

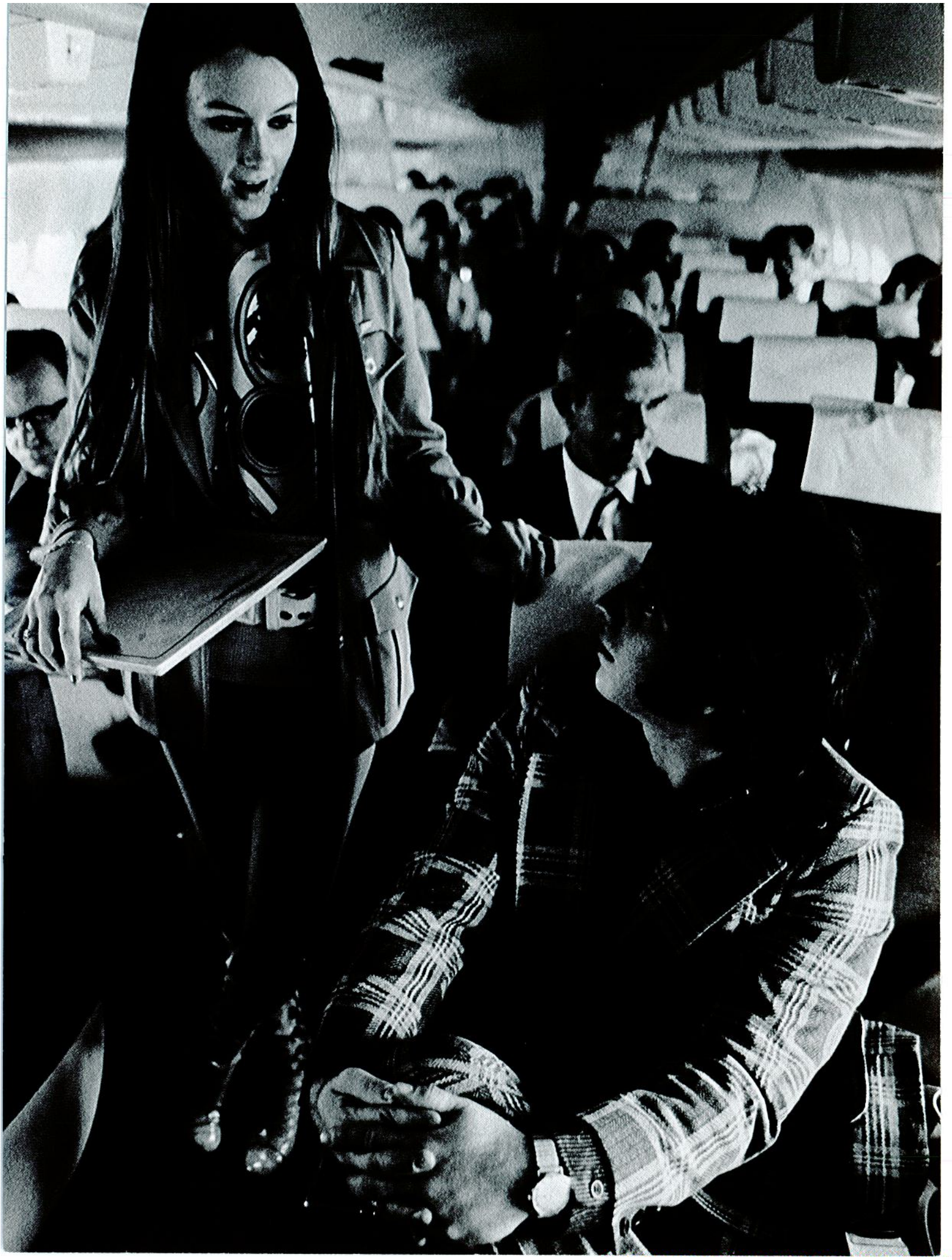
First National Bank in Dallas  
Dallas, Texas

## Auditors

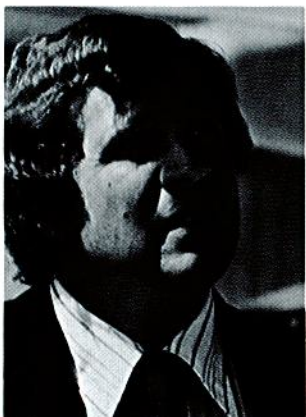
Arthur Young & Company  
Houston, Texas

The Annual Meeting of Shareholders of Southwest Airlines Co. will be held at 10:00 a.m. on Tuesday, April 30, 1974 in the Auditorium of the Mercantile National Bank located on its fourth floor at 1704 Main Street, Dallas, Texas.

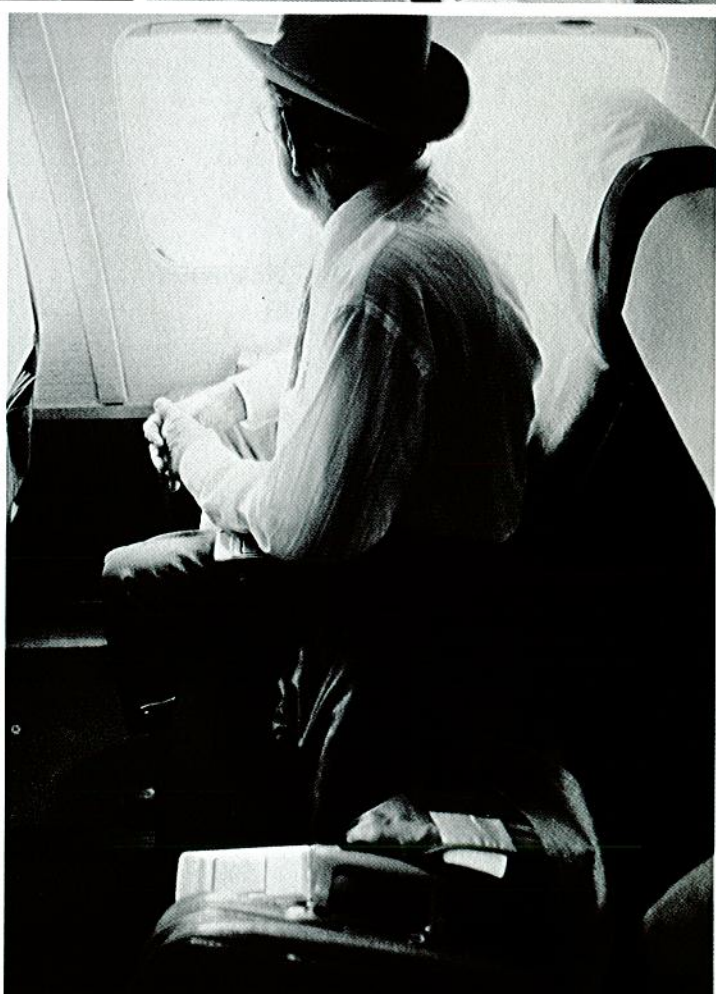
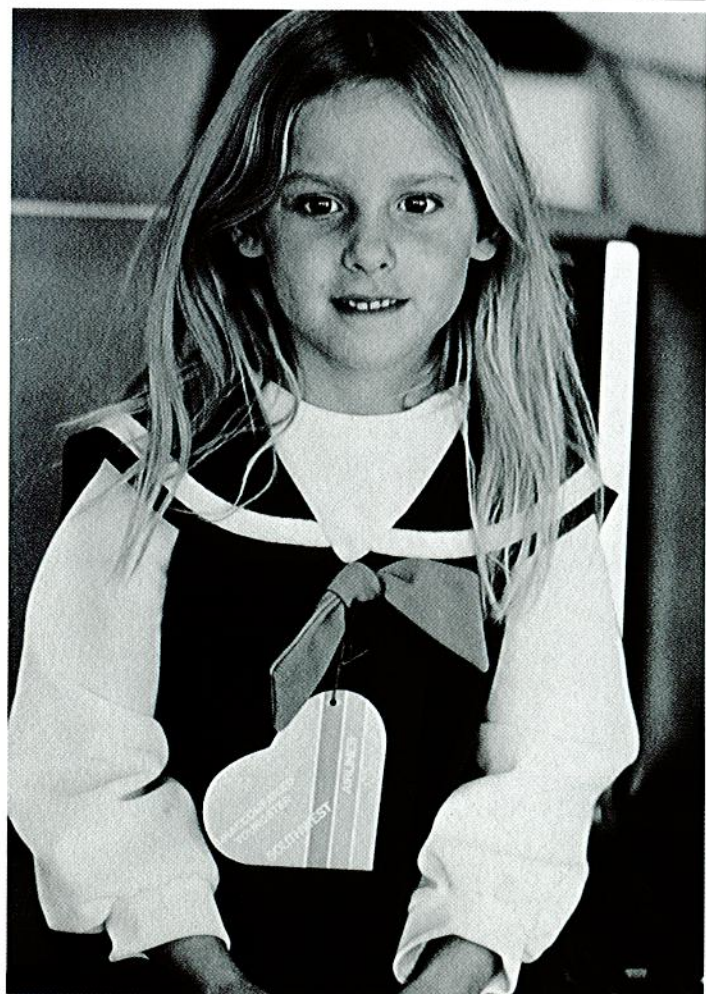
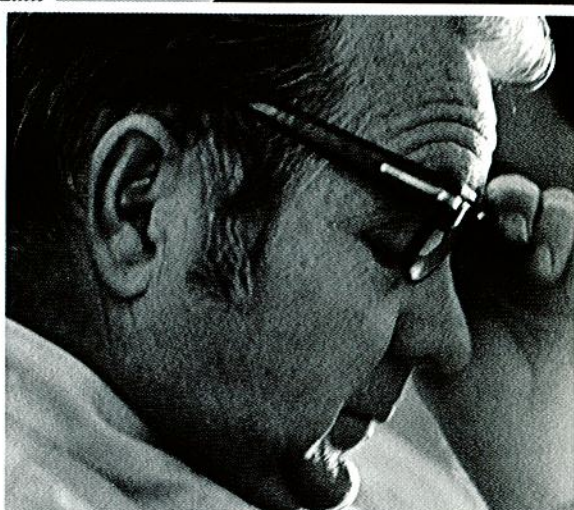
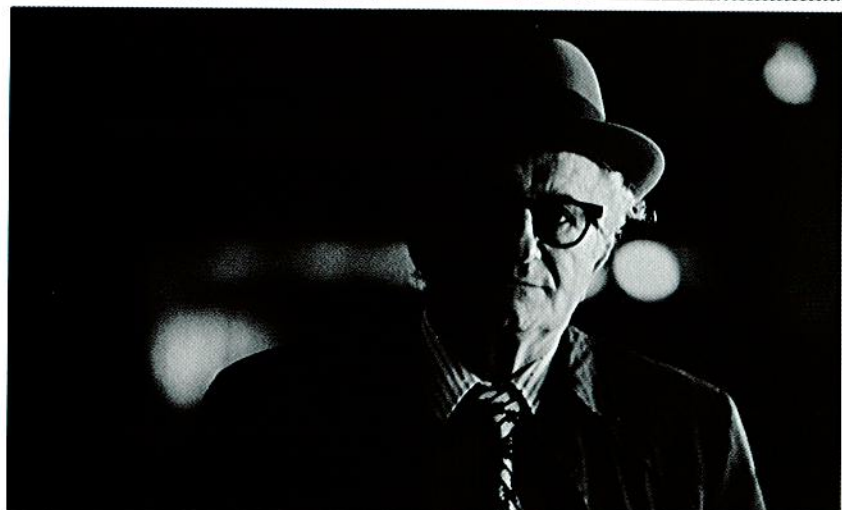
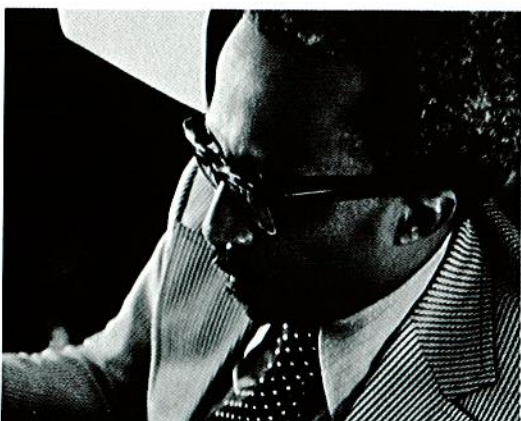
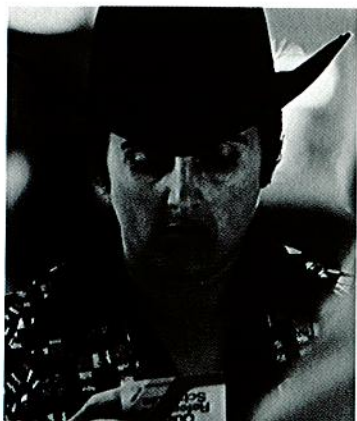
















**SOUTHWEST AIRLINES**  
8300 Love Field Drive  
Dallas, Texas 75235



