

SOUTHWEST AIRLINES CO.
1976 ANNUAL REPORT



HIGHLIGHTS

| | 1976 | 1975 | Percent Increase |
|------------------------------------------|---------------------|--------------|------------------|
| INCOME DATA | | | |
| Operating revenues | \$30,966,000 | \$22,828,000 | 35.7% |
| Operating expenses | 22,332,000 | 17,416,000 | 28.2 |
| Operating income | 8,634,000 | 5,412,000 | 59.5 |
| Income before extraordinary item — | | | |
| Amount | 4,939,000 | 2,164,000 | 128.2 |
| Per share* | 3.15 | 1.62 | 94.5 |
| Net Income — | | | |
| Amount | \$ 4,939,000 | \$ 3,400,000 | 45.3 |
| Per share* | \$ 3.15 | \$ 2.54 | 23.8 |
| Average shares outstanding* | 1,569,344 | 1,337,666 | 17.3 |
| Shares outstanding at end of period* | 1,980,000 | 1,340,864 | 47.7 |
| FINANCIAL DATA | | | |
| Working capital | \$ 8,164,000 | \$ 1,504,000 | 442.9% |
| Shareholders' equity | 19,345,000 | 7,415,000 | 160.9 |
| Book value per share* | \$ 9.77 | \$ 5.53 | 76.7 |
| OPERATING DATA | | | |
| Trips operated | 22,311 | 17,552 | 27.1% |
| Passengers carried | 1,539,113 | 1,136,318 | 35.4 |
| Passenger miles flown (000) | 406,269 | 298,458 | 36.1 |
| Available seat miles flown (000) | 618,732 | 477,166 | 29.7 |
| Passenger load factor | 65.7% | 62.5% | 5.0 |
| Average revenue per passenger mile | 7.26¢ | 7.26¢ | — |
| No. of employees at year end | 517 | 392 | 31.9 |

* Adjusted to reflect effect of 5-for-4 stock split on March 16, 1977.

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PRESIDENT'S LETTER



TO OUR SHAREHOLDERS:

Southwest Airlines continued its high flight in 1976 with net income of \$4.9 million, as compared to \$2.2 million before extraordinary credit and \$3.4 million net income in 1975. Earnings per share of \$3.15 were up 95% from the earnings per share of \$1.62 before extraordinary item during 1975.

REVENUES

Operating revenues increased 36% to \$31 million on a 35% increase in passengers carried and a 36% increase in passenger miles flown.

Unquestionably, Southwest was the only major airline in the entire air transport industry which operated throughout the 1975 and 1976 period with no upward adjustment in its fare level. Southwest's average yield per revenue passenger mile in both years was 7.26¢.

EXPENSES

Total costs of operation increased 28%

in 1976 to \$24.5 million as a result of a 27% increase in number of trips operated, a 28% increase in plane miles flown, and a 30% increase in seat miles made available to the public. Unquestionably, Southwest was the only major airline in the entire air transport industry whose unit costs of operation remained constant during this inflationary period. In fact, on a per passenger basis, the Company's unit costs declined 6% during 1976.

FINANCES

On September 30, 1976, Southwest raised, net of all costs, \$6.4 million of additional equity through the sale of 366,242 new common shares to the public at \$17.50 per share and the exercise by warrant holders, on or prior to that date, of 115,000 warrants at \$6.05 per share. In late December, Southwest signed a \$50 million credit agreement with four leading Texas banks headed by the Mercantile National Bank at Dallas, designed to repay all prior long-term debt and to provide the necessary capital funds for the purchase of six additional Boeing 737 aircraft and related equipment being acquired in connection with its expansion program. As of December 31, 1976, \$20 million of the \$50 million credit was being utilized by the Company, with the remaining \$30 million to be drawn down at the rate of \$5 million upon delivery of each of the six aircraft, four of which will be delivered in 1977 and two in the first quarter of 1978.

ROUTE EXPANSION

Proceedings before the Texas Aeronautics Commission were completed in late 1976 with the issuance to the Company of a Certificate of Public

Convenience and Necessity authorizing the Company to extend its low-fare, commuter-type service to the five additional metropolitan areas previously applied for. The service will be inaugurated during 1977, as set forth on page 8 of this report.

LEGAL PROCEEDINGS

Southwest has received a second favorable opinion by the Fifth Circuit Court of Appeals relative to its right to serve Love Field in Dallas. The opposing parties have moved for a rehearing by the Circuit Court and can petition the U. S. Supreme Court for review. As a result of a favorable State Court opinion and the failure to appeal that decision to a higher court by Texas International, Southwest's legal right to continue providing service to the Rio Grande Valley has been finally upheld. While the City of Fort Worth has recently filed suit in State Court contesting the grant of the new service to be inaugurated in 1977, it has not to this date asked for preliminary injunction relief. Thus, the new service will be inaugurated during the pendency of the appeal, which should be decided during 1977.

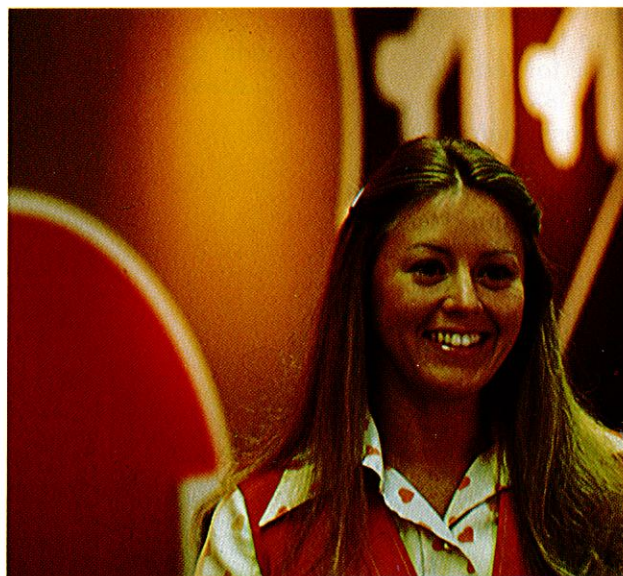
GOALS FOR 1977

The goals for 1975 and 1976, as set forth in our Annual Reports to (1) strengthen our dominant position in the markets we serve, (2) vastly expand business and pleasure travel in our new markets, and (3) continue the very favorable net income and cash flow margins experienced in the past, have been reasonable goals always exceeded. With no good reason to change these goals, we adopt them again for 1977 and trust that, with the continued support of our passengers, employees, and

shareholders, they will be met in 1977, as they were in prior years.
Cordially yours,



M. Lamar Muse
President and Chief Executive Officer



FIVE YEAR SUMMARY OF OPERATIONS

| | Compound Annual Growth Rate 1972 - 76 | Year ended December 31, | | | | |
|----------------------------------------------------------------------------------------------|---------------------------------------------|-------------------------|-----------|-----------|-----------|------------|
| | | 1976 | 1975 | 1974 | 1973 | 1972 |
| TRAFFIC | | | | | | |
| Passengers carried | 49.4% | 1,539,113 | 1,136,318 | 759,721 | 543,407 | 308,999 |
| Passenger miles flown (000) .. | 53.6 | 406,269 | 298,458 | 183,596 | 130,533 | 73,079 |
| Passenger load factor | 24.1 | 65.7% | 62.5% | 58.4% | 50.1% | 27.7% |
| Average revenue per — | | | | | | |
| Passenger | 1.4 | \$ 19.18 | \$ 19.07 | \$ 18.50 | \$ 16.14 | \$ 18.17 |
| Passenger mile | (1.4) | 7.26¢ | 7.26¢ | 7.66¢ | 6.72¢ | 7.68¢ |
| Trip flown | 25.1 | \$ 1,388 | \$ 1,301 | \$ 1,199 | \$ 867 | \$ 567 |
| OPERATIONS | | | | | | |
| Trips flown | 20.5 | 22,311 | 17,552 | 12,382 | 10,619 | 10,576 |
| Revenue plane miles | 22.4 | 5,524,395 | 4,309,478 | 2,957,255 | 2,505,926 | 2,463,114 |
| Available seat miles (000) | 23.8 | 618,732 | 477,166 | 314,407 | 260,616 | 263,808 |
| Operating expenses per trip flown | 9.9 | \$ 1,000 | \$ 992 | \$ 903 | \$ 749 | \$ 685 |
| FINANCIAL (000) | | | | | | |
| Revenues | | | | | | |
| Passenger | 50.8 | \$ 29,998 | \$ 22,031 | \$ 14,313 | \$ 8,996 | \$ 5,804 |
| Other | 50.2 | 968 | 797 | 539 | 213 | 190 |
| Total | 50.8 | 30,966 | 22,828 | 14,852 | 9,209 | 5,994 |
| Expenses | | | | | | |
| Personnel | 41.1 | 6,708 | 4,559 | 3,042 | 2,136 | 1,694 |
| Fuel & oil | 55.2 | 5,302 | 4,007 | 2,054 | 963 | 914 |
| Services purchased and materials utilized net of changes in A/W reserve .. | 36.7 | 5,139 | 4,278 | 2,767 | 1,878 | 1,471 |
| Landing fees and rentals .. | 36.8 | 1,292 | 946 | 343 | 333 | 369 |
| Insurance, taxes, advertising and other | 13.7 | 2,443 | 1,959 | 1,580 | 1,304 | 1,462 |
| Cost of borrowed funds | 8.8 | 1,220 | 1,297 | 1,357 | 1,076 | 871 |
| Depreciation and amortization | 15.2 | 2,352 | 2,111 | 1,569 | 1,344 | 1,337 |
| Total | 31.7% | 24,456 | 19,157 | 12,712 | 9,034 | 8,118 |
| Income (loss) before federal income tax | | 6,510 | 3,671 | 2,140 | 175 | (2,124) |
| Provisions for federal income tax | | 1,571 | 1,507 | 1,095 | 122 | — |
| Income (loss) before extraordinary item | | 4,939 | 2,164 | 1,045 | 53 | (2,124) |
| Gain on sale of flight equipment .. | | — | — | — | — | 533 |
| Reduction of federal income tax arising from carryforward of prior years' losses | | — | 1,236 | 1,095 | 122 | — |
| Net income (loss) | | \$ 4,939 | \$ 3,400 | \$ 2,140 | \$ 175 | \$ (1,591) |
| Earnings per share—unadjusted | | | | | | |
| Before extraordinary item | | \$ 3.93 | \$ 2.02 | \$.94 | \$.05 | \$ (2.00) |
| Net income | | 3.93 | 3.18 | 1.93 | .16 | (1.50) |
| Earnings per share adjusted for 5-for-4 stock split on March 16, 1977 | | | | | | |
| Before extraordinary item .. | | 3.15 | 1.62 | .76 | .04 | (1.60) |
| Net income | | 3.15 | 2.54 | 1.55 | .13 | (1.20) |

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FIVE YEAR SUMMARY OF OPERATIONS

Southwest Airlines operates as a scheduled intrastate air carrier wholly within the State of Texas under authority granted by the Texas Aeronautics Commission, which has permitted the Company to provide Texas with a level of service which fully meets its needs at prices which have had the effect of dramatically increasing the Texas markets Southwest serves and in turn producing operating margins and returns on investment for the Company unlike those of any of the federally regulated air transport industry.

Southwest's management has been most fortunate in being able to price its product at optimum fares as opposed to interstate air carriers who must charge the market stifling fares mandated by the Civil Aeronautics Board, a federal agency.

Scheduled service by Southwest was commenced on June 18, 1971, thus calendar year 1972 was the Company's first full year of operation. Between 1972 and 1976 passengers carried grew at an annual compound rate of 49.4%, with passenger miles growing 53.6% per year, reflecting a slight increase in average length of haul as a result of instituting service to the Rio Grande Valley in early 1975. During 1976 Southwest enjoyed a highly efficient passenger load factor of 65.7%, which produced average revenues per trip flown of \$1,388, at fare levels basically unchanged over Southwest's operating history.

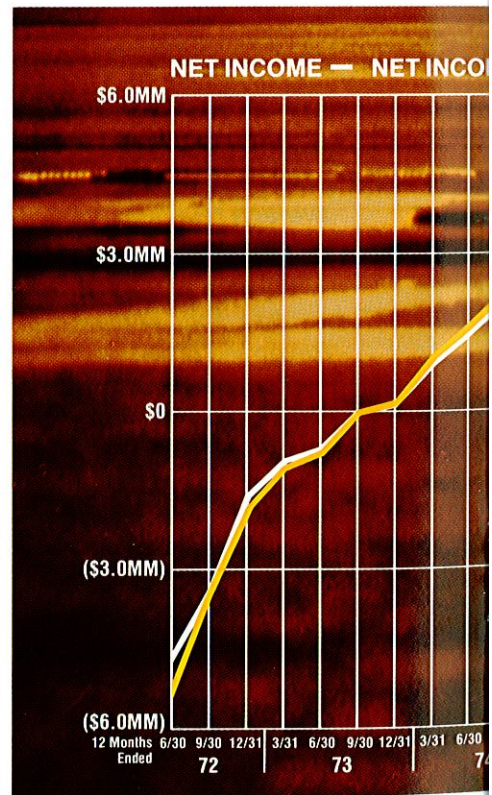
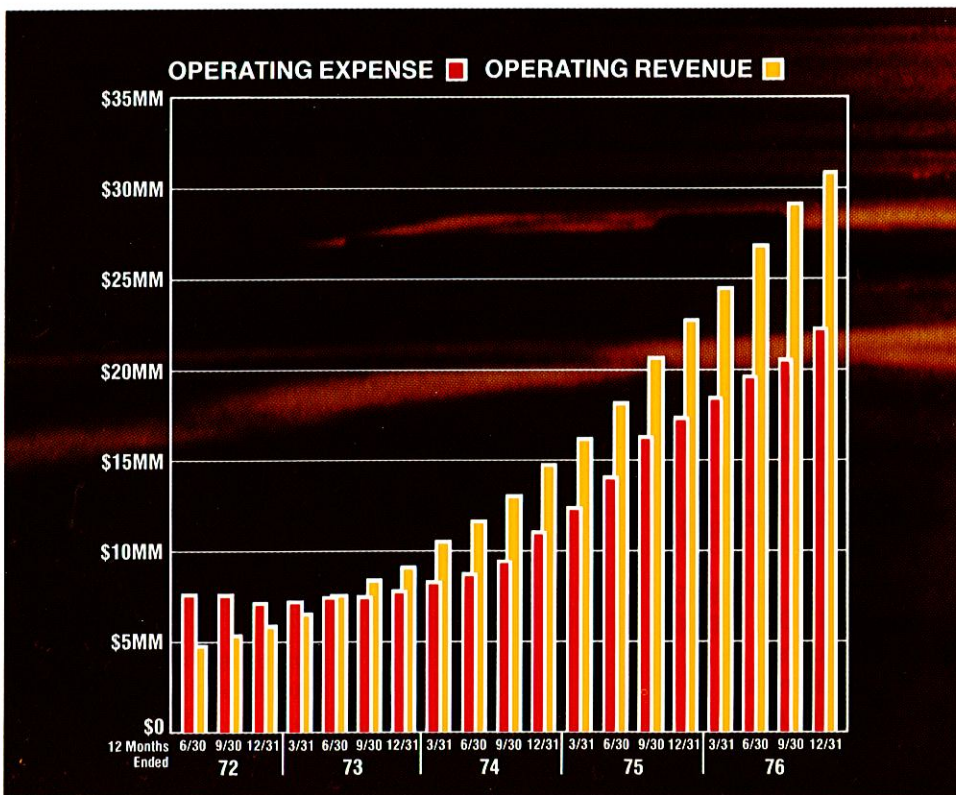
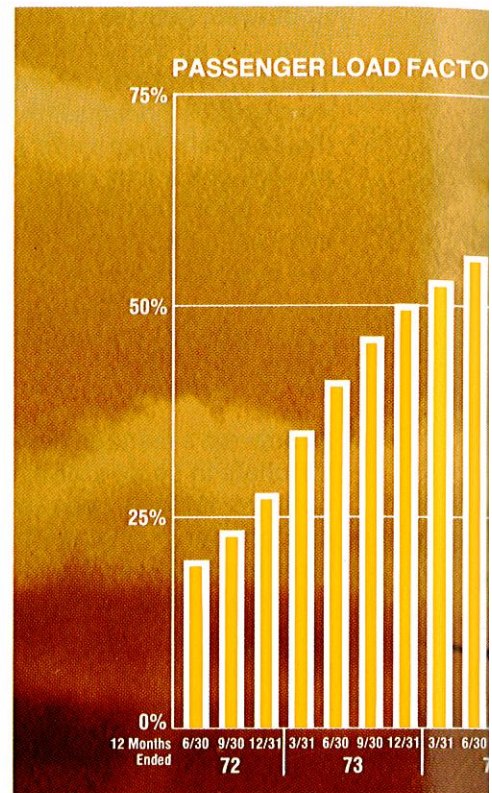
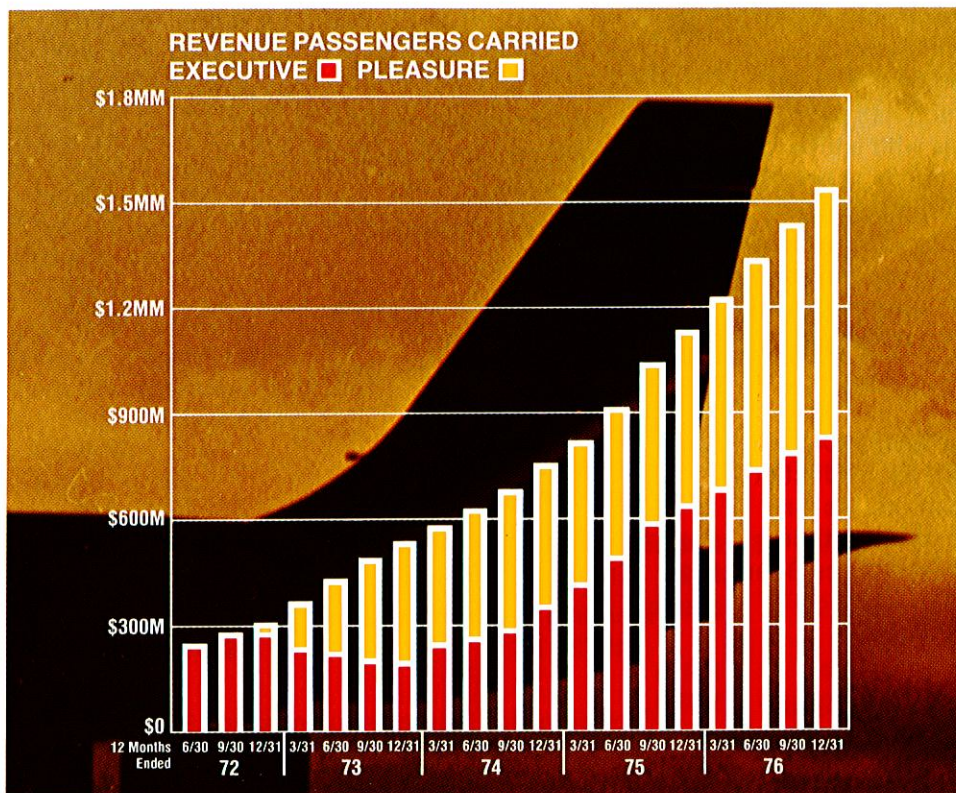
Revenues of \$31 million in 1976 represent an annual compound growth rate between 1972 and 1976 of 50.8%, very comparable to the traffic growth rates. Since total costs increased at compound annual rates of only 31.7%, the 1972 pre-tax loss of \$2.1 million was converted into \$6.5 million of pre-tax income by 1976.

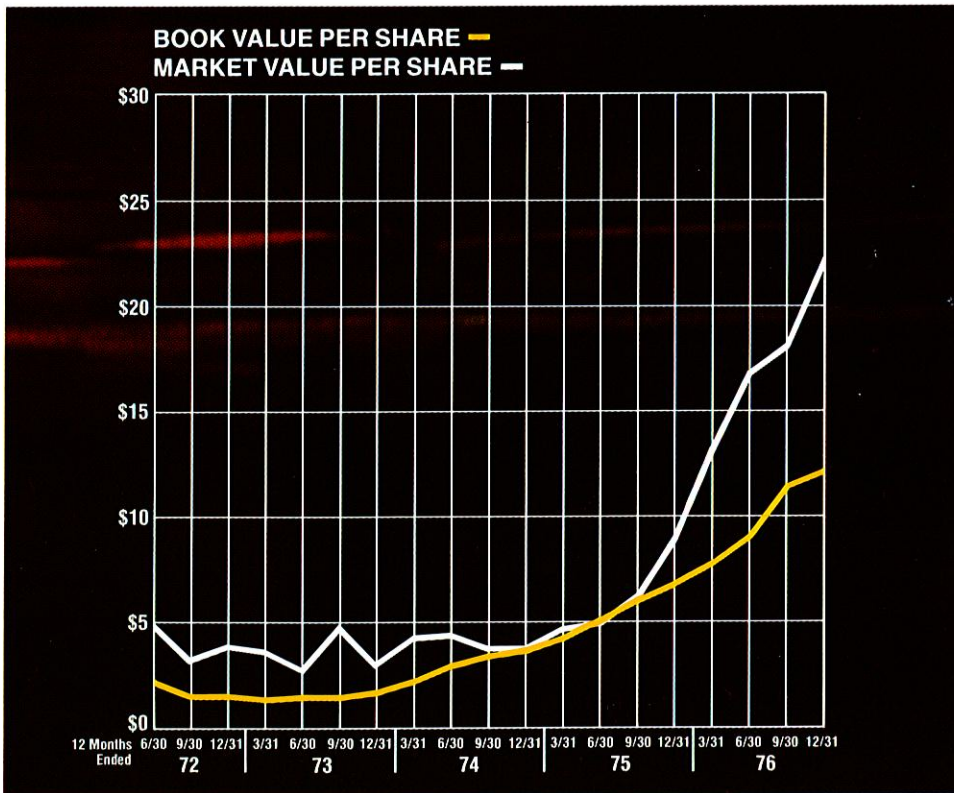
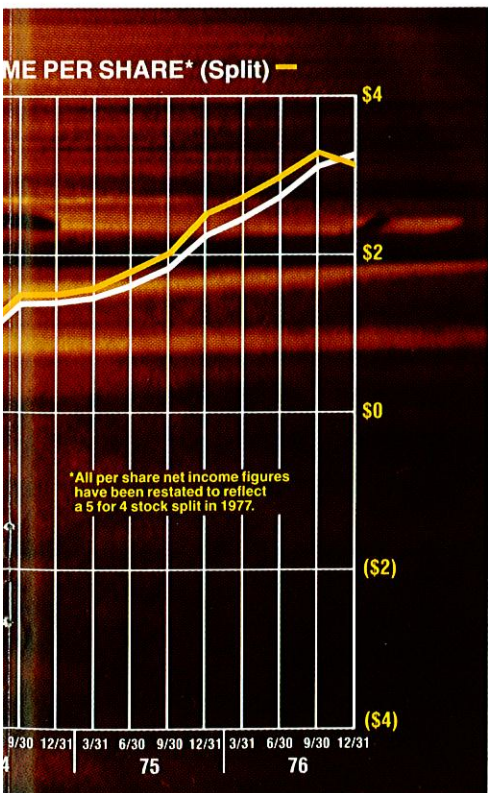
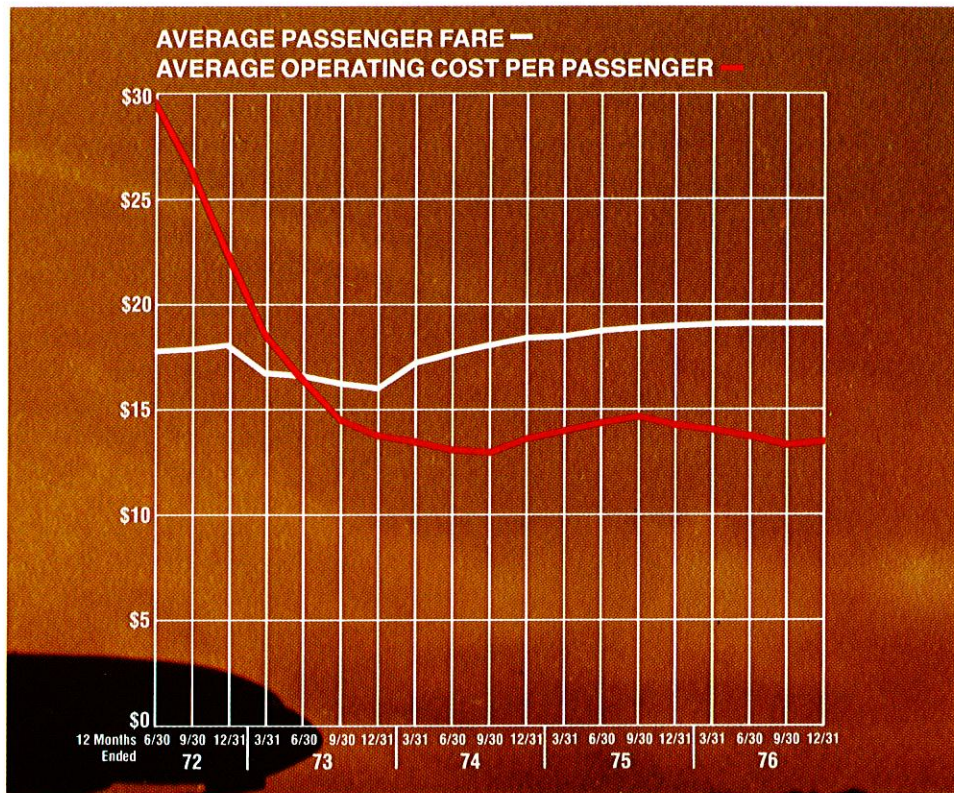
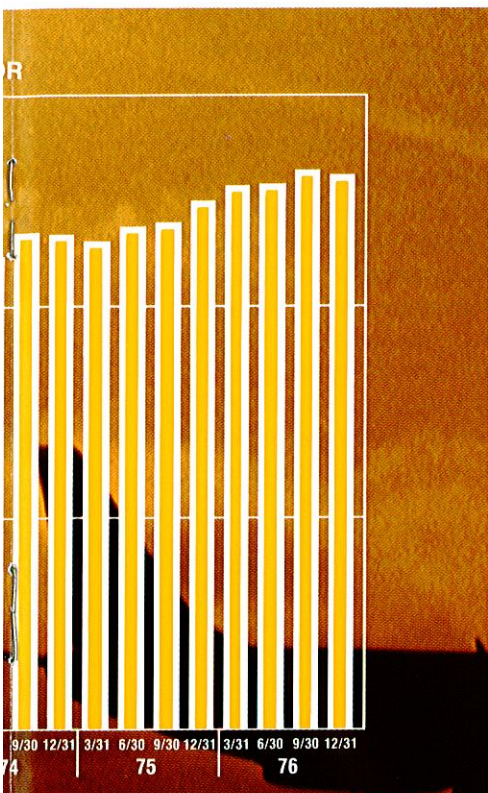
Operating expenses per trip flown of \$1,000 in 1976 were up 46% over the similar costs incurred during Southwest's first full calendar year, 1972. Some 98% of this increase in unit cost per trip flown is attributable to three cost factors as set forth in the following tabulation:

| | Increase in cost per trip flown | |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------|---------|
| | Amount | Percent |
| Jet fuel increased from 11.2¢ per gallon to 30.7¢ per gallon | \$152 | 161% |
| Landing fees increased from \$13.00 to \$42.00 | 29 | 229 |
| Passenger handling costs increased from \$90.00 per trip (\$3.10 per passenger) to \$216.00 per trip (\$2.95 per passenger) as a result of significantly higher passenger load factors | 126 | 139 |
| All other unit cost increases (net) | 8 | 2 |
| Increase in per trip cost — 1972 - 76 | \$315 | 46% |

Provisions for federal income tax in 1976 reflect full utilization of investment tax credits on the flow through basis for an effective rate of 24.1% as compared to an effective rate of 41.1% in 1975 when tax loss carryforwards largely prohibited their use. As of December 31, 1976, Southwest had unused investment tax credits for book purposes of \$363,000, which will be supplemented in 1977 and 1978 in the approximate amount of \$5,260,000 in connection with the delivery of six additional Boeing 737-200 aircraft, and related support equipment, during those years.

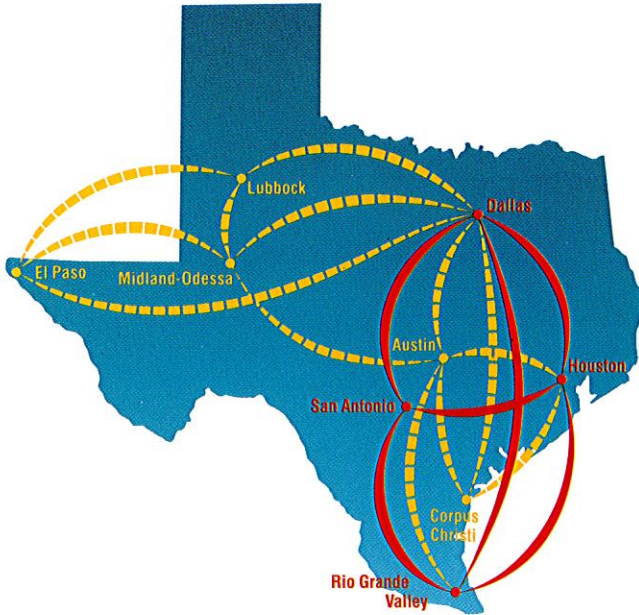
GRAPHIC SUMMARY OF OPERATIONS





SOUTHWEST AIRLINES' PLANS FOR CONTINUED GROWTH

IN THE 70's



The approximate 50% annual growth rate maintained by Southwest Airlines during the past five years will be extended during 1977 and 1978 by the inauguration of service to five additional metropolitan areas in the state of Texas during mid-1977, and the further development of these markets during the full year 1978.

Southwest inaugurated service to Corpus Christi on March 1, 1977, with four round trips daily to Houston and Dallas, Texas, with connections in Houston for service to San Antonio. Inauguration of service to Corpus Christi permits, for the very first time, full utilization of Southwest's sixth Boeing 737 received in September, 1976. With the delivery of our seventh aircraft in May, service will be inaugurated with four round trips daily from Dallas to both Midland-Odessa and Lubbock. Through and connecting service to the rest of our system will be available at Dallas' Love Field. The eighth aircraft, to be delivered in late June, will permit inauguration of service to El Paso, with six round trips daily from Dallas' Love Field, two of which will be non-stop.

The ninth aircraft, to be delivered in July, will be utilized to begin a pattern of service to Texas' capitol city of Austin, with the tenth aircraft, to be delivered in September, rounding out that pattern of service, as well as supplementing service in other markets, as most urgently needed. Two additional aircraft to be delivered in the first quarter of 1978 will similarly be used to inaugurate direct service between Houston and Austin and between Austin and West Texas, as directed by the Texas Aeronautics Commission in their order authorizing the above described new service.

Southwest plans, in due course, to apply to the Texas Aeronautics Commission for authority to further extend its route system to include Amarillo in the upper Panhandle and the Beaumont-Port Arthur-Orange area on the Gulf Coast. If such authority is granted to the Company, we would hope to begin service in early 1979.

Thus, the rapid growth which Southwest's intrastate service has enjoyed since inaugurating flights in 1971 should continue unabated throughout the 1970's.

IN THE 80's



Southwest's management, realizing that even the state of Texas has certain geographic limitations, devoted substantial time during 1976 to the question of, "Where do we go from here?". After reviewing the various possibilities

and alternatives at great length, it was decided that there was no place to go within a single state whereby operations could be conducted outside of the jurisdiction of the Civil Aeronautics Board. Having made this decision, we then conducted research in some detail of the various sections of the country and decided that our type of frequent, low-fare, commuter service could best be applied in the very substantial commuter markets radiating out of Chicago, Illinois, with the service to be provided through the close-in and convenient Midway Airport in Chicago, as opposed to the distant and overcrowded O'Hare Airport.

Therefore, during 1976 Southwest Airlines Co. formed a wholly-owned subsidiary company, Midway (Southwest) Airway Co., (a Texas company) for the purpose of filing an application with the Civil Aeronautics Board for interstate route authority in 14 markets out of Chicago's Midway Airport. The 14 markets are to cities located more than 200 miles and less than 500 miles from Chicago, and whose local passengers in such markets exceeded 100,000 passengers in 1975. The fourteen cities are listed below:

- Buffalo, New York
- Cincinnati, Ohio
- Cleveland, Ohio
- Columbus, Ohio
- Dayton, Ohio
- Des Moines, Iowa
- Detroit, Michigan
- Kansas City, Missouri
- Louisville, Kentucky
- Memphis, Tennessee
- Minneapolis/St. Paul, Minnesota
- Omaha, Nebraska
- Pittsburgh, Pennsylvania
- St. Louis, Missouri

Prior to this particular time period, an application for interstate authority by a new entrant of the magnitude described above would have been ignored by the Civil Aeronautics Board. However, largely as a result of the outstanding success experienced by Southwest in its Texas intrastate operations outside the jurisdiction of the Civil Aeronautics Board,

there has been a public clamor for less regulation and more competition in the air transport industry.

Our application to the Civil Aeronautics Board stipulates that we will accept a Certificate of Public Convenience & Necessity only if (1) we are permitted to utilize the same low, two-tier fare structure which has been so successful in our Texas operations, as opposed to the market-stifling interstate fares currently dictated by the CAB in accordance with their general passenger fare investigation formulas, and (2) that the granting of such authority would in no way subject Southwest's Texas operations to the jurisdiction of the CAB.

The proposed Chicago (Midway) operations are substantial. The investment required to begin operations would exceed the total investment in Southwest Airlines, and likewise, the annual revenues in the first year of full operations would approximate the revenues we anticipate from our Texas intrastate operations in the 1979-80 time period.

In response to our application, the Civil Aeronautics Board has established a new case styled the CHICAGO MIDWAY LOW-FARE ROUTE PROCEEDING, and will shortly set down for hearing our application for route authority. In spite of tremendous political pressures by the CAB and the City of Chicago on the carriers presently serving Chicago to serve Midway Airport, currently there are only two round-trips per day by one trunk carrier. As a result of our application to the CAB, however, there are now ten carriers who allege that they want authority to serve the identical markets which Southwest proposes to serve.

We are very hopeful that the detailed proceedings before the Civil Aeronautics Board will result in the granting to our subsidiary of the necessary operating authority by late 1978 or early 1979, and we would hope to commence service on these routes no later than January 1, 1980. Favorable action by the Civil Aeronautics Board would thus assure continued extraordinary growth in the 1980's.

DESCRIPTION OF BUSINESS

Southwest Airlines Co. (a Texas corporation) operates frequent, commuter-type, low-fare schedules between Dallas, Houston, San Antonio, and the Lower Rio Grande Valley, utilizing a current fleet of six 112-seat Boeing 737-200 aircraft. The company operates under authority granted by the Texas Aeronautics Commission and does not carry United States mail nor carry or solicit interstate passengers.

During 1977 the company will inaugurate new

service to the cities of Austin, Corpus Christi, El Paso, Lubbock, and Midland-Odessa pursuant to new authority granted by the Texas Aeronautics Commission. To provide this new service the Company will utilize four additional new Boeing 737's to be delivered in 1977. In addition, the Company has on order another two Boeing 737's to be delivered in early 1978. At year-end the Company employed a staff of 517 employees. All of the Company's operations are profitable.

COMPARATIVE QUARTERLY INFORMATION

QUARTERLY FINANCIAL SUMMARY

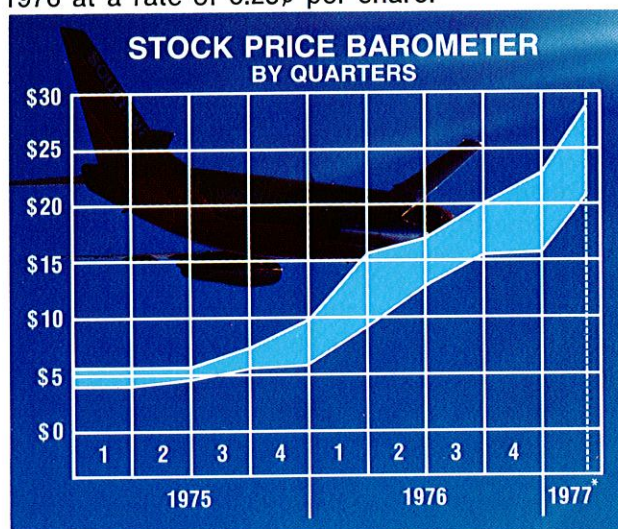
(In Thousands Except for Per Share Amounts)

| | 1976 | 1975 |
|------------------------|---------|---------|
| FIRST QUARTER | | |
| Revenues | \$6,591 | \$4,728 |
| Expenses | 5,577 | 4,055 |
| Net income | 1,014 | 673 |
| Net income per share — | | |
| Before stock split | .89 | .62 |
| After stock split | \$.71 | \$.50 |
| SECOND QUARTER | | |
| Revenues | \$7,769 | \$5,555 |
| Expenses | 6,338 | 4,559 |
| Net income | 1,431 | 996 |
| Net income per share — | | |
| Before stock split | 1.24 | .93 |
| After stock split | \$ 1.00 | \$.74 |
| THIRD QUARTER | | |
| Revenues | \$8,322 | \$6,257 |
| Expenses | 6,888 | 5,354 |
| Net income | 1,434 | 903 |
| Net income per share — | | |
| Before stock split | 1.23 | .85 |
| After stock split | \$.98 | \$.68 |
| FOURTH QUARTER | | |
| Revenues | \$8,284 | \$6,288 |
| Expenses | 7,224 | 5,460 |
| Net income | 1,060 | 828 |
| Net income per share — | | |
| Before stock split | .68 | .78 |
| After stock split | \$.54 | \$.62 |

COMMON STOCK PRICE RANGE (In Dollars)

| | | 1976 | 1975 |
|----------------|------|------|------|
| QUARTER | | | |
| 1st | High | 15¾ | 5½ |
| | Low | 9 | 4 |
| 2nd | High | 16⅞ | 5½ |
| | Low | 12⅝ | 4½ |
| 3rd | High | 20 | 7¼ |
| | Low | 15⅝ | 5½ |
| 4th | High | 22¾ | 9⅞ |
| | Low | 15¾ | 5⅝ |

The Common Stock of Southwest Airlines is traded on the American Stock Exchange with the symbol "LUV". The first quarterly dividend on Southwest Airlines Common Stock was paid on October 22, 1976 at a rate of 6.25¢ per share.



*As of February 28, 1977.



Corporate

M. Lamar Muse
President

Herbert D. Kelleher
Secretary and General Counsel

Michael L. Muse
Vice President - Finance and Administration

Herman H. Farr
Treasurer

W. James Thomson
Assistant Treasurer

Sherry Phelps
Assistant Secretary

Administrative

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

Nancy Andres

Asst. Vice President - Inflight Services

Camille Keith

Asst. Vice President - Public Relations

Edward W. Lang

Asst. Vice President - Human Resources

Dennis Lardon

Asst. Vice President - San Antonio

Jack Mercer

Asst. Vice President - Dallas

Harold Reilly

Asst. Vice President - Flight Control

Carl Warrell

Asst. Vice President - Houston

Clockwise: Muse, Farr, Phelps; Keith, Coker; Thomson, M. Muse, Lang; Mercer, Lardon, Franklin, Warrell; Vidal, Andres, Reilly, Herring, Ogden.



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

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

Gene Bishop
Chairman of the Board
and Chief Executive Officer
of the Mercantile National Bank
at Dallas, Dallas, Texas

A. A. Bradford
Investor
Midland, Texas

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

Rollin W. King
Captain, Southwest Airlines Co.
Dallas, Texas

John D. Murchison
Partner
Murchison Brothers Investments
2300 First National Bank Bldg.
Dallas, Texas

M. Lamar Muse
President
Southwest Airlines Co.
Dallas, Texas

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

Stock Exchange Listing
American Stock Exchange
Ticker Symbol: LUV

Auditors
Arthur Young & Company
Houston, Texas

General Offices
1820 Regal Row
Dallas, Texas 75235

Annual Meeting
The Annual Meeting of
Shareholders of Southwest
Airlines Co. will be held at
2:00 p.m. on Tuesday, April
26, 1977 in the Auditorium of
the Mercantile National Bank
Building located on its fourth
floor at 1704 Main Street,
Dallas, Texas.

SEC Form 10-K
For additional information, see
Statement of Income covering
the five year period 1972/1976
filed with the Securities and
Exchange Commission as part
of the Company's Annual
Report on Form 10-K. A copy
of this report is available upon
written request to the
Treasurer of the Company.

FINANCIAL STATEMENTS



SOUTHWEST AIRLINES CO. STATEMENT OF INCOME

| | Year Ended December 31, | |
|-------------------------------------------------------------------------------------------------------|----------------------------|---------------------|
| | 1976 | 1975 |
| REVENUES | | |
| Passenger | \$29,998,050 | \$22,030,704 |
| Package express | 864,443 | 757,061 |
| Interest | 41,241 | 4,622 |
| Other | 61,971 | 35,143 |
| | <u>30,965,705</u> | <u>22,827,530</u> |
| EXPENSES | | |
| Operations and maintenance | 15,692,860 | 11,582,483 |
| Marketing and promotion | 1,594,286 | 1,328,502 |
| Insurance, taxes and administrative | 3,597,007 | 2,838,617 |
| Depreciation and amortization | 2,351,898 | 2,110,868 |
| Cost of borrowed funds (Note 3) | 1,219,930 | 1,296,232 |
| | <u>24,455,981</u> | <u>19,156,702</u> |
| Income before federal income tax and extraordinary item .. | 6,509,724 | 3,670,828 |
| Provision for federal income tax (Note 7) | 1,571,000 | 1,507,000 |
| Income before extraordinary item | <u>4,938,724</u> | <u>2,163,828</u> |
| Reduction of federal income tax arising from carry- forward of prior years' operating losses | — | 1,236,000 |
| NET INCOME | <u>\$ 4,938,724</u> | <u>\$ 3,399,828</u> |

Income per common and common equivalent share (Note 4):

Before stock split:

| | | |
|---------------------------------------------------------------------------|-----------|-----------|
| Weighted average common and common equivalent shares outstanding | 1,255,475 | 1,070,133 |
| Before extraordinary item | \$ 3.93 | \$ 2.02 |
| Net income | \$ 3.93 | \$ 3.18 |

After stock split:

| | | |
|---------------------------------------------------------------------------|-----------|-----------|
| Weighted average common and common equivalent shares outstanding | 1,569,344 | 1,337,666 |
| Before extraordinary item | \$ 3.15 | \$ 1.62 |
| Net income | \$ 3.15 | \$ 2.54 |

See accompanying notes.

STATEMENT OF FINANCIAL POSITION

| | December 31, | |
|----------------------------------------------------------------------------------------------------------------------|---------------------|---------------------|
| | 1976 | 1975 |
| CURRENT ASSETS | | |
| Cash | \$ 4,411,578 | \$ 1,310,566 |
| Certificate of deposit | 4,500,000 | — |
| Accounts receivable | 1,502,866 | 1,112,725 |
| Inventories of parts and supplies, at cost | 303,276 | 245,134 |
| Other | 286,048 | 183,346 |
| TOTAL CURRENT ASSETS | 11,003,768 | 2,851,771 |
| CURRENT LIABILITIES | | |
| Accounts payable | 1,257,223 | 695,710 |
| Federal income taxes | 545,000 | — |
| Accrued liabilities | 1,037,624 | 652,360 |
| TOTAL CURRENT LIABILITIES | 2,839,847 | 1,348,070 |
| WORKING CAPITAL | 8,163,921 | 1,503,701 |
| Flight and ground equipment, at cost, less reserves (Notes 2 and 3) | 32,698,884 | 20,787,430 |
| Deferred charges | — | 53,013 |
| TOTAL ASSETS LESS CURRENT LIABILITIES | 40,862,805 | 22,344,144 |
| Less: | | |
| Long-term debt (Note 3) | 20,000,000 | 14,500,000 |
| Deferred federal income tax (Note 7) | 1,297,000 | 271,000 |
| Deferred compensation — officer (Note 5) | 220,327 | 158,203 |
| NET ASSETS | \$19,345,478 | \$ 7,414,941 |
| STOCKHOLDERS' EQUITY (Note 4): | | |
| Common stock, \$1.00 par value, 2,000,000 shares authorized, 1,590,000 issued (1,108,758 shares in 1975) | \$ 1,590,000 | \$ 1,108,758 |
| Capital in excess of par value | 12,568,432 | 6,103,812 |
| Retained earnings | 5,212,996 | 371,396 |
| | 19,371,428 | 7,583,966 |
| Less 6,000 shares of treasury stock, at cost (36,067 shares in 1975) | 25,950 | 169,025 |
| TOTAL STOCKHOLDERS' EQUITY | \$19,345,478 | \$ 7,414,941 |

See accompanying notes.

STATEMENT OF CHANGES IN FINANCIAL POSITION

| | Year Ended December 31, | |
|---------------------------------------------------------------------------------------------|----------------------------|---------------------|
| | 1976 | 1975 |
| FINANCIAL RESOURCES WERE PROVIDED BY: | | |
| Income before extraordinary item | \$ 4,938,724 | \$ 2,163,828 |
| Items not affecting working capital in the current period: | | |
| Depreciation and reserve for maintenance | 1,818,588 | 1,678,777 |
| Amortization of certification and Love Field costs | 53,013 | 228,089 |
| Deferred compensation — officer | 62,124 | 57,759 |
| Noncurrent deferred income tax | 1,026,000 | 271,000 |
| Working capital provided from operations for the period, exclusive of extraordinary item | 7,898,449 | 4,399,453 |
| Proceeds from issuance of common stock in public offering and exercise of warrants | 6,442,494 | — |
| Issuance of long-term debt | 10,500,000 | 4,340,000 |
| Reduction of federal income tax arising from carryforward of prior years' losses | — | 1,236,000 |
| Contribution of treasury stock to profit sharing trust (Note 6) | 646,443 | 105,656 |
| | <u>25,487,386</u> | <u>10,081,109</u> |
| FINANCIAL RESOURCES WERE USED FOR: | | |
| Net additions to flight and ground equipment | 13,730,042 | 6,293,508 |
| Reduction of long-term debt | 5,000,000 | 2,037,423 |
| Cash dividends | 97,124 | — |
| Purchase of treasury stock | — | 162,214 |
| | <u>18,827,166</u> | <u>8,493,145</u> |
| Increase in working capital (Note 10) | <u>\$ 6,660,220</u> | <u>\$ 1,587,964</u> |

See accompanying notes.

STATEMENT OF STOCKHOLDERS' EQUITY

Years ended December 31, 1976 and 1975

| | Common stock | Capital in excess of par value | Retained earnings (deficit) | Treasury stock | Total |
|-------------------------------------------------------------------------------------|---------------------|--------------------------------------|-----------------------------------|--------------------|---------------------|
| Balance at December 31, 1974 .. | \$ 1,108,758 | \$ 6,062,105 | \$ (3,028,432) | \$ (70,760) | \$ 4,071,671 |
| Purchase of 33,167 shares of treasury stock | | | | (162,214) | (162,214) |
| Contribution of 11,500 shares of treasury stock to profit-sharing trust | | 41,707 | | 63,949 | 105,656 |
| Net income — 1975 | | | 3,399,828 | | 3,399,828 |
| Balance at December 31, 1975 .. | 1,108,758 | 6,103,812 | 371,396 | (169,025) | 7,414,941 |
| Issuance of 115,000 shares of common stock upon exercise of warrants | 115,000 | 580,750 | | | 695,750 |
| Issuance of 366,242 shares of common stock in public offering | 366,242 | 5,380,502 | | | 5,746,744 |
| Contribution of 30,067 shares of treasury stock to profit-sharing trust | | 503,368 | | 143,075 | 646,443 |
| Cash dividends, \$.0625 per share | | | (97,124) | | (97,124) |
| Net income — 1976 | | | 4,938,724 | | 4,938,724 |
| Balance at December 31, 1976 .. | <u>\$ 1,590,000</u> | <u>\$12,568,432</u> | <u>\$ 5,212,996</u> | <u>\$ (25,950)</u> | <u>\$19,345,478</u> |

See accompanying notes.

NOTES TO FINANCIAL STATEMENTS

1. Summary of significant accounting policies

Depreciation and overhaul allowances —

Depreciation is provided by the straight-line method over the estimated useful lives of the various classes of depreciable assets after allowing for residual values. The estimated useful lives are 12 to 15 years for the Boeing 737-200 aircraft, related spare engines and support flight equipment and 3 to 10 years for ground equipment and other. When properties are retired or otherwise disposed of the cost and related accumulated depreciation and airworthiness reserves are removed from the accounts and the resulting gain or loss is recorded in income for the period.

The Company is providing for future major maintenance and overhaul to be performed on its aircraft by accruing a reserve for airworthiness of \$100 for each flight hour. Such accruals amounted to \$1,536,500 and \$1,197,100 in 1976 and 1975, respectively. The Company charges against this reserve its actual expenditures for certain aircraft maintenance materials and outside repair costs. Routine aircraft maintenance inspections are charged to expense as incurred.

Per share amounts — Income per share computations are based upon the weighted average number of shares outstanding during the respective periods as adjusted for outstanding warrants which were considered as common stock equivalents in periods where their inclusion had a material effect.

2. Property and equipment

The Company's investment in flight and ground equipment at December 31 is summarized as follows:

| | 1976 | 1975 |
|---------------------------------------------------------------------------------------------------------------------------------------------|---------------------|---------------------|
| Boeing 737-200 jet aircraft | \$28,725,821 | \$22,195,849 |
| Progress payments on additional aircraft | 6,028,714 | 530,219 |
| Support flight equipment | 3,800,750 | 2,877,041 |
| Ground equipment and other | 2,146,076 | 1,423,616 |
| | <u>40,701,361</u> | <u>27,026,725</u> |
| Less reserve for depreciation (including reserve for major maintenance and overhaul of \$715,104 in 1976 and \$1,195,399 in 1975) | <u>8,002,477</u> | <u>6,239,295</u> |
| | <u>\$32,698,884</u> | <u>\$20,787,430</u> |

During 1976 the Company committed approximately \$43,700,000 to purchase six Boeing 737-200 aircraft, plus additional engines and support equipment, to be delivered in 1977 and 1978. In compliance with the terms of the commitments, the Company at December 31, 1976, has made progress payments totalling \$6,028,714.

3. Long-term debt

Under the terms of a loan agreement dated December 22, 1976 with various banks, the Company may borrow up to \$50,000,000 through March 31, 1978. Pursuant to this agreement, the Company has made an initial drawdown in the amount of \$20,000,000. The borrowings bear interest at 1½ % over the lenders prime rate payable quarterly. The principal is to be repaid in twenty quarterly instalments of \$2,000,000 each beginning March 31, 1978 until December 31, 1982 at which time the remaining principal balance will be due in four quarterly instalments of \$2,500,000 each. The borrowings are secured

by the Company's aircraft including the aircraft to be delivered in 1977 and 1978.

Under the terms of the loan agreement, the Company has agreed, among other things, for the maintenance of certain minimums for net worth, working capital ratio and to certain restrictions as to additional borrowings, capital expenditures and cash dividend payments. At December 31, 1976 the Company had retained earnings in the amount of \$987,745 available for payment of cash dividends.

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

4. Stockholders' equity

During 1976 the Company sold 366,242 shares of common stock in a public offering and received proceeds of \$5,746,744 after deducting costs in connection with the offering. Also during 1976, 115,000 shares of \$6.05 common stock warrants were exercised. At December 31, 1976 the Company had 10,000 shares reserved for issuance on exercise of warrants at \$4.00 per share on or before March 10, 1978, all of which were exercised prior to February 23, 1977.

On January 26, 1977 the Company's Board of Directors authorized a five-for-four common stock split to be distributed on March 16, 1977 to shareholders of record as of February 23, 1977. The stock split will result in the issuance of an additional 400,000 shares of the Company's common stock. An amount equal to the par value of additional shares issued will be transferred from capital in excess of par value to the common stock account and the effect of fractional shares will be reflected in the capital in excess of par value account. Per share information has been restated to reflect the common stock split.

5. Deferred compensation

A deferred compensation agreement with the

President of the Company adopted by the Board of Directors on October 29, 1974, obligates the Company to accrue for the benefit of the President, in addition to his regular salary, deferred compensation of \$250,000 over the five-year term of his current agreement ending September 30, 1979, or five percent of the net pretax earnings of the Company (as defined by the agreement) whichever is lower, for the period October 1, 1974 through September 30, 1979. During 1976, \$50,000 was accrued and charged to operations in connection with this agreement.

Total deferred compensation, including amounts pursuant to a prior agreement, will be paid at a rate not to exceed \$50,000 per year, commencing in the year following termination of the President's employment with the Company. Until such time as this deferred compensation is paid, the Company is accruing interest at the rate of 7% compounded annually on the unpaid balance beginning October 1, 1974 on the prior agreement and October 1, 1975 on the current agreement. During 1976 the Company accrued \$12,124 pursuant to this agreement.

6. Employee profit-sharing and cash bonus plans

The Company is accruing costs under a non-contributory profit sharing plan established January 1, 1973 and amended on December 2, 1974, January 15, 1975 and January 1, 1976. All regular employees are eligible to become members as of January 1 following their date of employment. The plan provides that the Company may contribute, as determined by the Board of Directors, up to 15 percent of its adjusted pretax income (as defined in the plan) in excess of \$2,100,000 (\$1,150,000 for periods prior to October 1, 1976) for the year except that the Company contribution in any year shall not exceed the maximum amount deductible for federal income tax purposes for such year.

Effective January 1, 1975 the plan, as amended, permits the Company to pay currently a portion of each eligible employee's profit-sharing in the form of a cash bonus based on a bonus formula, and the remainder is contributed to the employees' profit-sharing trust to be

invested in the common stock of the Company. The plan may be terminated at any time at the discretion of the Company's Board of Directors.

Charges to income under the provisions of the plan amounted to \$903,922 and \$444,845 in 1976 and 1975, respectively.

7. Federal income tax

Deferred federal income taxes arise from timing differences between financial and tax reporting, principally for depreciation and provisions made for future maintenance and overhaul costs which are not deductible for income tax purposes until actually incurred. The provision for federal income tax varies from the amount computed by multiplying income before federal income tax by the statutory federal income tax rate (48%) due primarily to the amortization of deferred certification costs, which costs are not deductible for federal income tax purposes and the utilization (flow-through method) of \$1,596,000 of current year investment tax credit (\$296,329 for the year ended December 31, 1975).

The Company has unused investment tax credit carryovers of approximately \$362,804 at December 31, 1976, which expire in 1983, if not previously utilized.

8. Quarterly financial data (unaudited)

Summarized quarterly financial data (in thousands of dollars except for per share amounts) for 1976 is as follows:

| | Three months ended | | | |
|---------------------------------|--------------------|----------------|----------------|----------------|
| | March 31 | June 30 | September 30 | December 31 |
| Revenues | <u>\$6,591</u> | <u>\$7,769</u> | <u>\$8,322</u> | <u>\$8,284</u> |
| Net income before tax | <u>\$1,343</u> | <u>\$1,883</u> | <u>\$1,895</u> | <u>\$1,389</u> |
| Net income | <u>\$1,014</u> | <u>\$1,431</u> | <u>\$1,434</u> | <u>\$1,060</u> |
| Earnings per share: | | | | |
| Before stock split | <u>\$.89</u> | <u>\$ 1.24</u> | <u>\$ 1.23</u> | <u>\$.68</u> |
| After stock split | <u>\$.71</u> | <u>\$ 1.00</u> | <u>\$.98</u> | <u>\$.54</u> |

9. Contingencies

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

Subsequently, in December 1974 a CAB carrier (the Carrier) filed an action in the Travis County, Texas District Court seeking to exclude the Company from Love Field or, as one of the alternatives, to close Love Field as an airport. The other airlines serving DFW Airport joined the Carrier in requesting this relief. The United States District Court for the Northern District of Texas entered a temporary injunction prohibiting the Carrier and the other CAB air carriers serving DFW from proceeding with that portion of the State Court suit which seeks to relitigate the right of the Company to remain at Love Field. Those carriers have appealed the entry of the temporary injunction to the Fifth Circuit Court of Appeals, which court affirmed the U. S. District Court's entry of the temporary injunction. Some of the defendants have moved for a rehearing on this matter.

The management of the Company and its legal counsel expect to prosecute and defend successfully both the Federal and State Court actions, but, in the event of an adverse decision, no financial liability is indicated, although the effect on future operations is not predictable at this time.

During 1975 the Carrier initiated an action in State Court against the Company and the Texas Aeronautics Commission (TAC) to set aside a February 1975 TAC Certificate of Public Convenience and Necessity allowing the Company to provide service to the Lower Rio Grande Valley through Harlingen, Texas. The trial of this action has been completed and the Court recently entered a final judgment in the favor of the Company and the TAC.

In connection with authority granted the Company in December 1976 by the TAC to

provide expanded service in Texas, the City of Fort Worth and the Fort Worth Area Chamber of Commerce have appealed the TAC's decision to the State District Court. Thus far, the plaintiffs have not sought injunctive relief to prevent the Company from commencing service over its new routes and the appeal does not raise any actual or contingent monetary liability against the Company, although it may involve the Company's authority to continue air

service over such routes.

Total rental expenses charged to operations in 1976 and 1975 were \$359,720 and \$244,672, exclusive of landing fees of \$928,509 and \$701,513, respectively. Landing fees are set by the governing bodies of the airports served by the Company and are based upon usage of airport runways. Lease commitments relating to noncancellable long-term leases are not material.

10. Changes in components of working capital

| | 1976 | 1975 |
|---------------------------------------------|---------------------|---------------------|
| Changes in components of working capital: | | |
| Increase in current assets: | | |
| Cash | \$ 3,101,012 | \$ 424,345 |
| Certificate of deposit | 4,500,000 | — |
| Accounts receivable | 390,141 | 222,382 |
| Inventories | 58,142 | 61,515 |
| Other | 102,702 | 31,685 |
| | <u>8,151,997</u> | <u>739,927</u> |
| Increase (decrease) in current liabilities: | | |
| Accounts payable | 561,513 | 220,918 |
| Federal income taxes | 545,000 | — |
| Accrued liabilities | 385,264 | (128,955) |
| Current maturities of long-term debt | — | (940,000) |
| | <u>1,491,777</u> | <u>(848,037)</u> |
| Increase in working capital | <u>\$ 6,660,220</u> | <u>\$ 1,587,964</u> |

AUDITOR'S REPORT

ARTHUR YOUNG & COMPANY

The Board of Directors and Stockholders
Southwest Airlines Co.

We have examined the accompanying statement of financial position of Southwest Airlines Co. at December 31, 1976 and the related statements of income, stockholders' equity and changes in 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

February 4, 1977

previously made a similar examination of the financial statements for the prior year.

In our opinion, the statements mentioned above present fairly the financial position of Southwest Airlines Co. at December 31, 1976 and 1975 and the results of its operations and the 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



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Dallas, Texas 75235