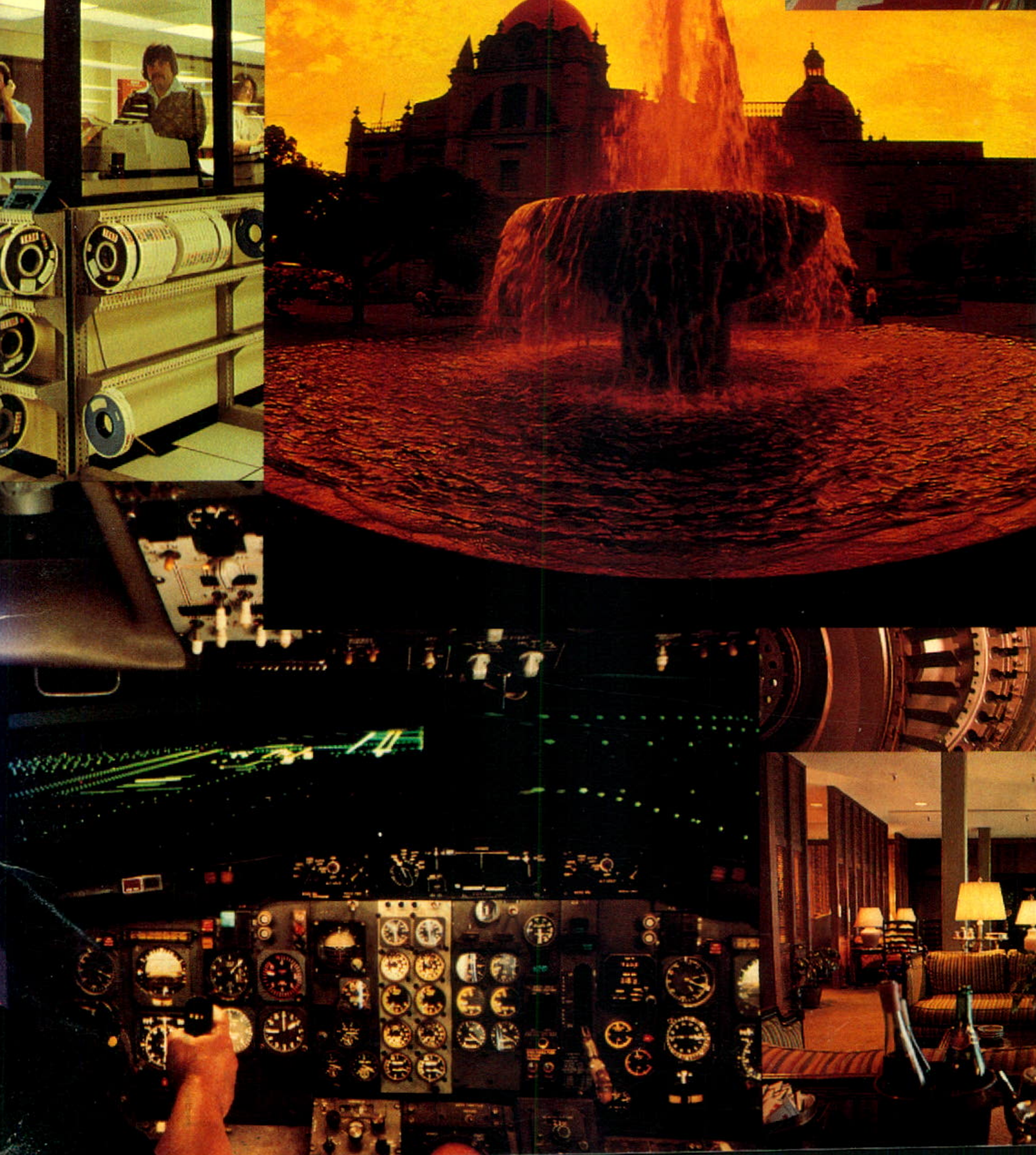
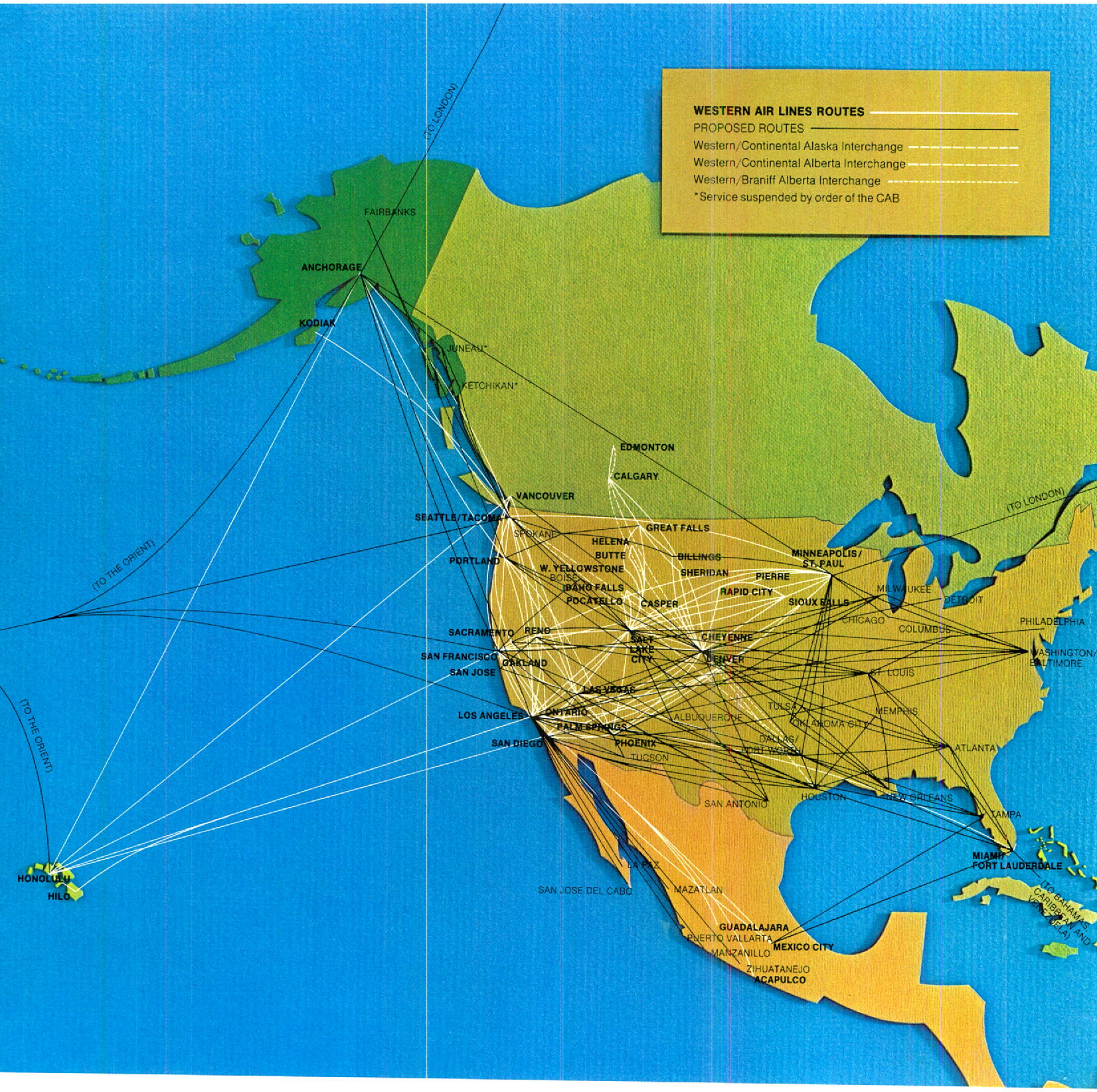


Western Airlines 1978 Annual Report



Description of Business

Western Air Lines, Inc., is a certificated air carrier engaged in scheduled air transportation of passengers, cargo and mail over approximately 34,000 route miles. The company was organized in 1925 and currently serves 43 cities in 15 states, Canada and Mexico. Western has competition from other airlines on substantially all of its routes. It is regulated by the United States and foreign governments.

WESTERN AIR LINES, INC.
1978 ANNUAL REPORT

HIGHLIGHTS OF 1978
(in thousands of dollars)

	1978	1977*	Change 1978 vs. 1977
Operating revenues	**$834,513**	691,464	21%
Operating expenses	**779,657**	662,010	18
Operating income	**54,856**	29,454	86
Other income (expenses):			
Interest expense, net	**(20,179)**	(17,530)	15
Gain on sale of equipment	**6,754**	4,549	48
Other—net	**3,924**	3,388	16
Earnings before provision for taxes on income and cumulative effect of a change in accounting principle	**45,355**	19,861	128
Provision for taxes on income	**6,808**	7,137	−5
Earnings before cumulative effect of a change in accounting principle	**38,547**	12,724	**
Cumulative effect of a change in accounting principle	**16,201**	—	**
Net earnings	**$ 54,748**	12,724	**
Passengers carried (000)	**10,447**	8,757	19%
Available seat miles (000,000)	**16,255**	14,964	9
Revenue passenger miles (000,000)	**10,635**	8,589	24
Passenger load factor—actual (%)	**65.4**	57.4	14
—breakeven (%)	**61.1**	56.1	9

*Restated. See Note 2 of Financial Statements.
**Not computed.

Notice to Stockholders.

A rule adopted by the Civil Aeronautics Board ("CAB") in July 1970, as amended on December 29, 1972, imposes obligations on certain stockholders of air carriers. Any person who owns as of December 31 of any year or subsequently acquires, either beneficially or as a trustee, more than 5% of any class of capital stock of an air carrier must file with the CAB a report containing the information required by Part 245.12 of the CAB's Economic Regulations on or before April 1 as to the capital stock owned as of December 31 and/or a report containing the information required by Part 245.13 of the CAB's Economic Regulations within 10 days after acquisition as to the capital stock acquired after December 31. Any bank or broker which holds as trustee more than 5% of any class of capital stock of an air carrier on the last day of any quarter of a calendar year must file with the CAB within 30 days after the end of the quarter a report in accordance with the provisions of Part 245.14 of the CAB's Economic Regulations.

Any person required to report under either Part 245.12, Part 245.13 or Part 245.14 of the CAB's Economic Regulations who grants a security interest in more than 5% of any class of capital stock of an air carrier must within 30 days after granting such security interest file with the CAB a report containing the information required in Part 245.15. Any stockholder who believes that he may be required to file such a report may obtain further information by writing to the Director, Bureau of Pricing and Domestic Aviation, Civil Aeronautics Board, Washington, D. C. 20428.

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 Secretary, P. O. Box 92005, World Way Postal Center, Los Angeles, California 90009.

LETTER TO SHAREHOLDERS

Dominic P. Renda   Arthur F. Kelly

Fellow Shareholders:

As indicated in the financial data and descriptive text of this annual report, the year 1978 was an important one in the history of your company and the airline industry.

For Western, it was a record year in every respect, with all-time highs in net earnings, operating revenues, passengers boarded, air freight carried and many other categories.

Net earnings were a record $54.7 million, or $4.09 per share. And, although these earnings included a credit of $16.2 million (or $1.27 per share) from the cumulative effect of an accounting change on prior years, 1978 earnings would have set a record without the change.

Western carried 10.4 million passengers in 1978, the first time the company has passed the 10 million passenger mark in a single year, and our load factor of 65.4 percent was the highest of any U.S. trunkline.

Traffic grew dramatically on all segments, reflecting the popularity of new deep discount fares that were introduced during 1978.

And while this was a year of great achievement of which we are all very proud, it also ushered in a new era in U.S. air transportation.

As detailed in the Regulatory Matters section of this report, the Airline Deregulation Act of 1978, along with drastic and rapid changes in the philosophy of the Civil Aeronautics Board, is bringing to the airline industry the greatest change since the first Civil Aeronautics Act was passed in 1938.

During 1978, this new regulatory climate was manifested largely in the area of ratemaking as the CAB liberalized its policies and permitted carriers to introduce, almost at will, the greatest array of discount fares ever offered to the traveling public.

These bargain rates, along with a high level of consumer spending power, stimulated an enormous amount of new travel.

During the first nine months of the year in particular, revenues generated from this upsurge in demand far outgained increases in expenses.

In the fourth quarter, however, the

combination of low fares and continuing inflation began to have an adverse effect on industry earnings.

In Western's case, the company had an increase of 21.5 percent in traffic, as expressed in revenue passenger miles, on an increase of only 11.0 percent in available seat miles, which produced the highest fourth quarter load factor in Western's history. However, because 44 percent of this traffic moved at a discount our average revenue per revenue passenger mile decreased five percent from the same quarter of 1977. As a result, the 21.5 percent increase in traffic produced only a 15.5 percent increase in operating revenues and the company suffered a loss of $3.1 million during the fourth quarter. Had we been able to hold our yield at the same level as the 1977 fourth quarter without any loss of traffic, our fourth quarter would have been profitable.

The reversal of this fourth quarter trend is our No. 1 priority for 1979. However, the task will not be easy. On the one hand, we are faced with the continuing pressure of increasing costs and on the other increased competition on our routes and a depressed passenger ticket yield.

On the expense side, we are hopeful that the Federal Wage and Price Guidelines will be successful in slowing the upward spiral in labor costs and the prices of goods and services we use. Western did an excellent job of increasing productivity during 1978. Our 19 percent increase in the number of passengers carried during the year was accomplished with only a 3.4 percent increase in airplane miles flown and an increase of less than five percent in the number of employees. Nevertheless, our expenses increased 18 percent for the year. These increases and the reasons for them are detailed in the Management's Discussion section.

Our goal in 1979 will be to again increase productivity with the help of our employees, who have proven amazingly resilient and resourceful in meeting the challenges of our rapidly changing industry.

Although our average price of aircraft fuel stabilized somewhat during 1978, we expect a much larger increase during the coming year. Increases by the Organization of Petroleum Exporting Countries (OPEC), other costs that oil companies are experiencing and competitive bidding for reduced supplies brought on by the interruption of production in Iran will increase Western's per-gallon costs significantly during 1979.

Of equal concern to us is the matter of supply. As a result of the reduction of supplies from Iran and the increasing demand for jet fuel brought about by the new services authorized by the CAB, our industry is faced with shortages that could cause cutbacks in service.

Although one major feature of deregulation—the freedom to lower fares—was a major factor in 1978, the other key feature—increased competition through liberalized market entry—had little actual effect on 1978 results.

However, through the enactment of deregulation legislation and a procompetition philosophy of the Civil Aeronautics Board the groundwork was laid for a substantial increase in competition in 1979. As explained in the Regulatory Matters section of this report, carriers will have considerable discretion in determining what routes they want to fly.

This freedom to enter markets is resulting in new competition and will have an effect on airline revenues.

Also affecting revenues in 1979 will be the matter of our average revenue per passenger mile, or yield. While we will continue to provide discount fares, one of our major goals during 1979 is to reach an improved balance in which we will reduce the number of discount seats available during peak periods and increase them during off-peak periods. In so doing, we hope to stimulate travel and continue our traffic growth but at the same time raise our yield to a level that is more consistent with the cost of providing such service.

As an offset against the increasing prices of fuel and other commodities, we also plan to seek such fare increases as we feel can be justified and which will be consistent with the Wage and Price guidelines.

On November 15, 1978, your board of directors approved an agreement to consolidate with Continental Airlines to form a new company to be known as Western & Continental Airlines, Inc. The details of this proposal were submitted to you for your approval in our proxy statement of February 15, 1979, preparatory to a special Shareholders' Meeting set for March 22, 1979. While awaiting approval of our proposed consolidation with Continental by the shareholders of both companies and the CAB, we have continued to operate Western as though no merger were contemplated. We have ordered new aircraft for future delivery and have taken option positions for the aircraft that will be needed with or without the merger.

We are continuing to seek new routes that will strengthen our system, particularly international routes that represent logical extensions of the Western Airlines system. These include routes to the West Coast of Mexico, an Anchorage-London route (which has been set down for a CAB hearing) and a route between Minneapolis/St. Paul and London, which could be designated by our government as its "wild card" selection for operation by a U.S. carrier under the new U.S.-United Kingdom air service agreement.

Although there are many uncertainties facing the airline industry and the U.S. economy, we believe that 1979 should produce a reasonable level of profits. We will continue to maintain tight controls on costs and will concentrate our efforts on the two major ingredients of revenue generation: continued traffic growth and improved yield.

These are not new challenges to the management and employees of Western Airlines. With your continued support we will meet them as we have in the past.

Chairman of the Board and
Chief Executive Officer

President and Chief Operating Officer

March 15, 1979

YEAR IN REVIEW

Earnings

Net earnings in 1978 totaled $54,748,000, compared to restated earnings of $12,724,000 for 1977.

The company's decision to change to the flow-through method of accounting for investment credits, effected in the first quarter of 1978, increased the 1978 net by $29,107,000 of which $16,201,000 was the cumulative effect of the change from prior years.

For comparative purposes, 1978 earnings were $38.5 million before inclusion of the prior years' cumulative effect, exceeding the previous record of $23.5 million for 1974.

The restatement of 1977 earnings, as well as those for earlier years, is in compliance with the Statement of Financial Accounting Standards No. 13 which requires that certain leases, primarily on flight equipment, be classified and accounted for as capital leases. For financial statement purposes, such assets are accounted for as if they were owned, rather than leased, and therefore the assets and corresponding liabilities appear on the balance sheet.

Western's rate of return on investment for 1978 was 14 percent, compared to nine percent in 1977.

Operating income for 1978 totaled $54.9 million, up from $29.5 million in 1977 as a result of a 21 percent increase in operating revenues and an 18 percent increase in operating expenses.

Aircraft sales accounted for $6.7 million before taxes, compared to $4.5 million in 1977.

Revenues

The company's operations generated revenues of $835 million, up from $691 million in 1977.

Passenger revenues from scheduled service increased 19 percent to $734 million. Cargo revenues increased 20 percent to $57 million and other revenues, including charter operations, were up 49 percent to $44 million.

The passenger revenue increase resulted from a 22 percent increase in scheduled traffic. Coach and economy passengers accounted for 93 percent of the passenger revenues.

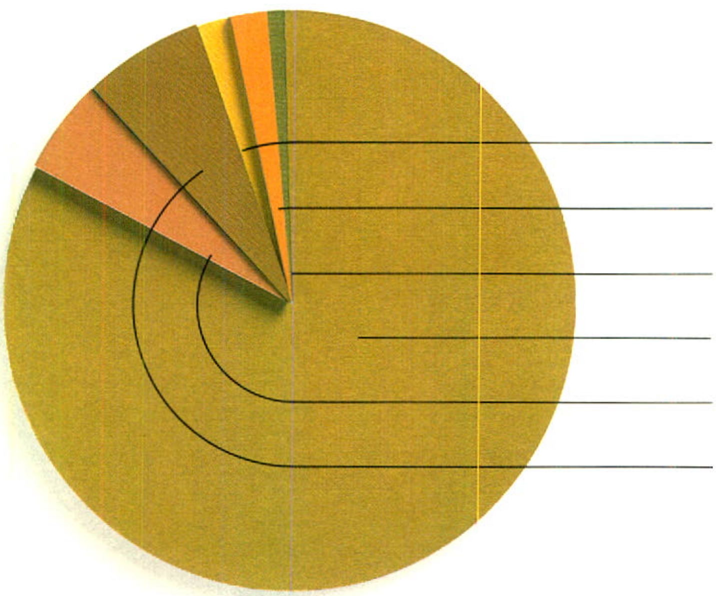
Western's passenger traffic experienced its largest rate of growth in Mexico markets, a reversal of the downward trend that began after the devaluation of the peso in September 1976. The new Los Angeles-Guadalajara route, inaugurated June 30, accounted for 44 percent of the growth in this market.

The company's 48 states and Canada routes provided 71 percent of Western's passenger revenues.

Cargo revenues for 1978 were up over 1977 as the result of a favorable combination of increasing yield (or average revenue per ton mile) and the amount of cargo transported.

Expenses

Western's operating expenses increased to $780 million in 1978, up from $662 million in 1977. Wages, salaries and employee benefits, which represent 40 percent of this total, reached $309 million, while fuel expenses—20 percent of the total—were $155 million.



Revenue Dollar
(dollars in thousands)

		Percent of total
Charter	$ 15,772	2%
Transport Related	19,886	2
Other	7,914	1
Coach passenger service	681,664	82
Deluxe passenger service	52,341	6
Cargo	56,936	7
	$834,513	100%

The employee cost increases were mainly attributable to the impact of collective bargaining agreements. The increased levels of passenger traffic brought added costs in the areas of commissions to travel agents, in-flight service expenses, and passenger and cargo claims.

Of the 12 percent increase in fuel expense, 54 percent was caused by higher average prices and 46 percent because of increased consumption.

Depreciation and interest expense increases were related to the acquisition of the seven new aircraft.

Included in 1978 expenses was $10 million paid to a struck carrier under the Airlines Mutual Aid Pact, an agreement which has been terminated in accordance with provisions of the Airline Deregulation Act of 1978.

Shareholders, Stock and Financial Position

Western's net earnings per common share for the year 1978 were $4.09, including $1.27 per share from prior years' cumulative effect of a change in accounting principle.

Holders of common stock were paid 40 cents per share through quarterly cash dividends of 10 cents per share in February, May, August and November.

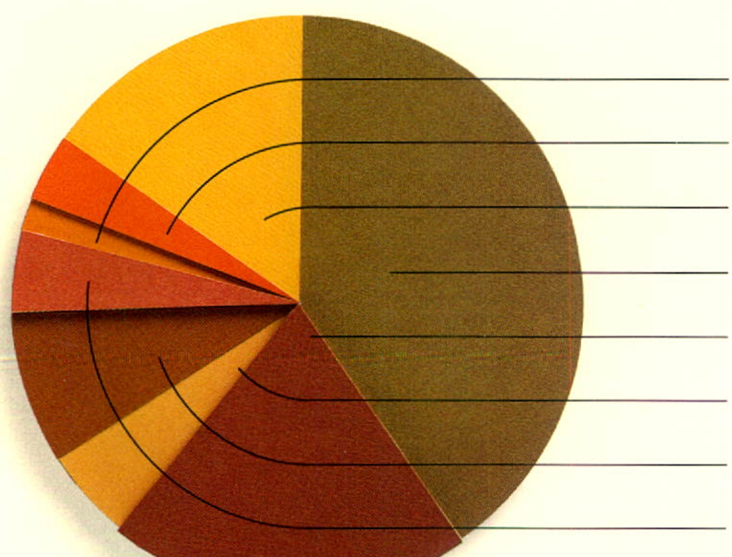
The 1978 record net earnings increased shareholders equity to $199 million at the end of 1978, compared to a restated $147 million at the end of 1977. Equity per share of common stock (or book value) was $12.96, compared to $9.28 at the end of 1977.

As of December 31, 1978, there were outstanding 13,010,000 shares of Western common stock held by approximately 18,200 individuals and institutions. Western's common and preferred stock were traded on the New York Stock Exchange at the following prices:

	Common Stock		Preferred Stock	
1978	High	Low	High	Low
First Quarter	8⅜	7	25¼	23
Second Quarter	12⅜	7⅞	30½	23¾
Third Quarter	14⅝	10⅞	37	27
Fourth Quarter	11⅞	8⅛	31	25
1977				
First Quarter	10⅜	8	—	—
Second Quarter	9½	8⅛	—	—
Third Quarter	8⅝	7	—	—
Fourth Quarter	7¾	6¼	23¾	22⅛

Western has 2,992,000 shares of common stock reserved for issuance upon conversion of its preferred stock and an additional 2,119,000 shares reserved for issuance upon conversion of its 5¼ percent Convertible Subordinated Debentures. Holders of the debentures receive interest payments on February 1 and August 1; the debentures are held by 555 individuals and institutions. The $2.00 Series A Cumulative Convertible Preferred Stock was held by 1,935 individuals and institutions, who are paid dividends quarterly.

Western's long-term debt was $158 million at the end of 1978, compared to $101 million at the end of



Expense Dollar *(dollars in thousands)*		*Percent of total*
Rentals	$ 15,239	2%
Food and beverages	27,781	4
Other	110,201	14
Wages, salaries and employee benefits	309,445	40
Fuel	154,876	20
Depreciation	47,094	6
Materials and services	73,955	9
Commissions	41,066	5
	$779,657	100%

1977. The increase resulted from Western's entering into an equipment trust agreement in May 1978 in which nine insurance companies agreed to supply 80 percent of the cost of six aircraft delivered during 1978 and one to be delivered in 1979. Under these agreements, the trustee receives a security interest in the aircraft. When rental payments total enough to pay both principal and interest on the certificates issued under the agreement, Western's title to the aircraft will be free and clear. A complete listing of long-term debt is contained in Note 8 to Financial Statements.

During 1978, Western entered into a new bank loan agreement which provides a $125 million revolving line of credit until June 30, 1981, at which time it can be replaced by term notes which will mature on June 30, 1985. Funds provided by this agreement are available for the purchase of new equipment or for other corporate purposes.

Sources of working capital totaled $181 million in 1978, compared to $147 million in 1977. Of the 1978 amount, operations provided $81 million, proceeds from issuance of long-term obligations $72 million, reimbursements of advance deposits for aircraft and facilities $13 million and proceeds from the sale of aircraft provided $11 million.

Applications of working capital totaled $179 million in 1978. Purchases of property and equipment and advance deposits required $151 million, reductions in long-term obligations $21 million and cash dividends $8 million. Included in the advance deposits is approximately $35 million for 727s and DC-10s scheduled for delivery in 1979.

Fares and Rates

Pricing attracted more public attention in 1978 than any other aspect of the airline business.

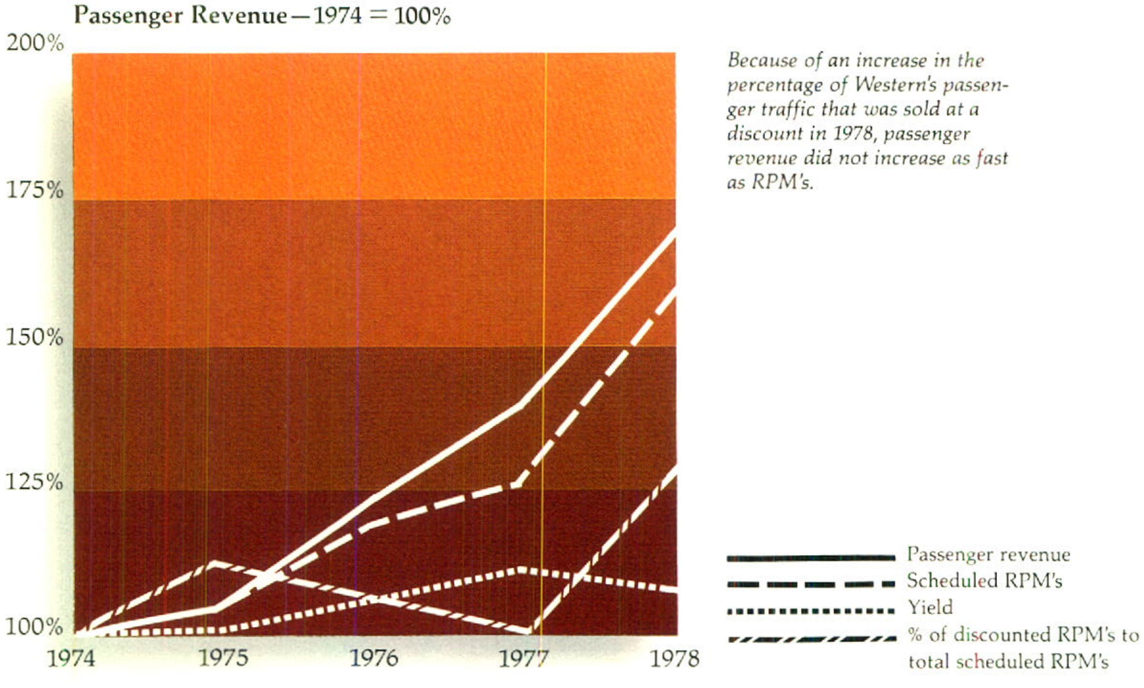
By mid-1978, Super Saver fares, which were gaining momentum in the early part of the year, were available in some form over nearly all of Western's routes. These fares, which have had advance booking, minimum/maximum stay and capacity limitation features, gave the industry the opportunity to offer bargain rates while controlling their availability. In the fourth quarter, eight percent of Western's total passenger traffic moved on Super Saver fares.

In order to simplify discounts for travelers and at the same time gather empirical evidence as to whether or not reduced fares were economically sound, Western introduced two innovations to its fare structure in the early part of 1978.

On the Los Angeles-Miami/Ft. Lauderdale route, Western introduced "No Strings" fares effective April 13. This had the effect of lowering fares across-the-board in first class, coach and economy by 35 to 48 percent with no advance purchase, stay or capacity requirements involved. As a result, Western's load factors on the route increased sharply and the company made a small profit on this route for the last nine months of 1978.

Using another concept, Western began offering 30 percent discounts on all flights operating during "off peak" periods in the Las Vegas-Los Angeles and Las Vegas-Portland/Seattle markets effective June 30.

Passenger Revenue—1974 = 100%



Because of an increase in the percentage of Western's passenger traffic that was sold at a discount in 1978, passenger revenue did not increase as fast as RPM's.

Overhaul of the engines for Western's 76 jet aircraft is performed at the company's main maintenance base in Los Angeles. Computer-generated images of terrain enhance the realism of simulator flight at Western's pilot training facility.

The peak/off-peak pricing concept is especially suitable for markets like Las Vegas which have high demand on Fridays and Sundays and are less popular during other periods of the week. It also resulted in a profit rebound for the short-haul Las Vegas-Los Angeles route, which had operated at a loss in 1977. This concept has since been expanded to other Nevada markets and to intra-California markets.

Western also was forced to meet discount fares of other carriers in order to remain competitive. In many markets there also were some upward adjustments of basic fares during the year; however, the net effect on Western's yield, or average revenue per passenger mile, was downward, from 7.34 cents for 1977 to 7.20 cents for 1978.

Under the new regulatory climate, Western and other airlines will be allowed to establish fares on a market-by-market basis free from government restraint. The objective is to stimulate price competition among airlines. Under the new rules, carriers may increase fares 10 percent in certain competitive markets and reduce fares by 50 percent in all markets. Peak/off-peak pricing will be encouraged. Moreover, first class fares no longer must exceed coach fares by a prescribed percentage.

Provisions of the Airline Deregulation Act of 1978 provide for pre-emption of state regulation regarding rates, routes and services of air carriers which also have interstate routes. However, the Public Utilities Commission of California has resisted federal pre-emption and has indicated it will continue to assert jurisdiction until such time as a definitive ruling is obtained through the courts.

The ultimate impact of the new regulatory climate related to passenger air fares is yet to be determined. While early 1979 has seen a proliferation of free or reduced children's and companion fares, it should be pointed out that these are being offered during light travel periods. Indications are that the limited, capacity-controlled discounts of 1978 will continue to be available for the foreseeable future.

Domestic air cargo is no longer subject to the jurisdiction of the CAB and carriers are free to set their own air freight rates and charges without prior notification to any federal or state agency. The only domestic cargo tariffs which remain under CAB jurisdiction involve the structure and level of mail rates.

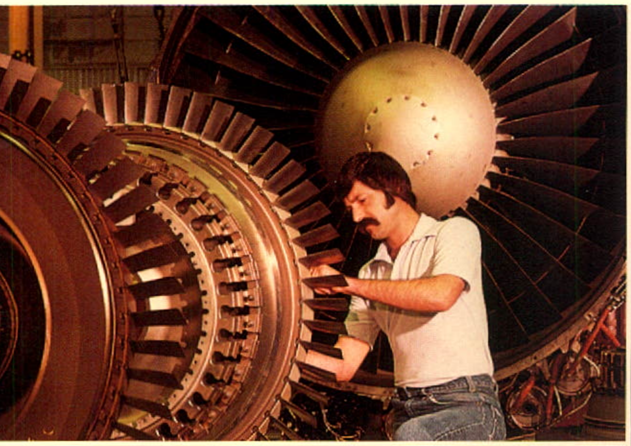
International passenger and cargo rates continue to be subject to CAB and foreign government regulation.

Regulatory Matters

The regulatory climate under which Western and other U.S. air carriers operate has changed dramatically within the past year.

While the Civil Aeronautics Board remains the primary body responsible for airline routes and rates, the Airline Deregulation Act of 1978, which was enacted in October, and changes in regulatory philosophy which preceded passage of the Act have resulted in a new environment for the airlines.

The Airline Deregulation Act is



designed to phase out the CAB's regulatory authority over the airline industry. After December 31, 1981, the Board will no longer have authority over route certification and effective January 1, 1983, it will be deprived of authority over fares and intercarrier transactions, including mergers. Total abolishment of the CAB is scheduled for January 1, 1985.

In the transition period, the legislation calls for substantial changes in the regulation of air transportation. The nature and extent of airline services offered and the pricing of those services are to be determined largely by market forces. Carriers are to be given greater freedom of entry and exit from markets and greater freedom for raising and lowering prices.

The evolution of this new philosophy of regulation was evident in CAB rulings in the months leading up to the passage of the Deregulation Act.

The CAB's initial step was a decision to favor carriers offering the lowest fares in choosing among applicants seeking new authority. This approach evolved into a policy of "open entry" under which multiple awards are being made in most route cases. Limited and controlled competition, the rule for nearly 40 years, has been replaced by free and open competition. As a corollary, the CAB has adopted a policy of making new awards permissive instead of mandatory as had been customary in the past. Traffic diversion from an incumbent carrier is no longer relevant in deciding whether to grant applications for new authority over a route.

This presents a two-fold impact on existing air carriers: a carrier's opportunities to obtain route extensions are increased, while its exposure to new competition on existing routes also is increased. Faced with this situation, Western and most air carriers have adopted a practice of applying for new authority in almost every case which the CAB institutes in order to gain a potential offset for the diversionary impact of competitive authorizations.

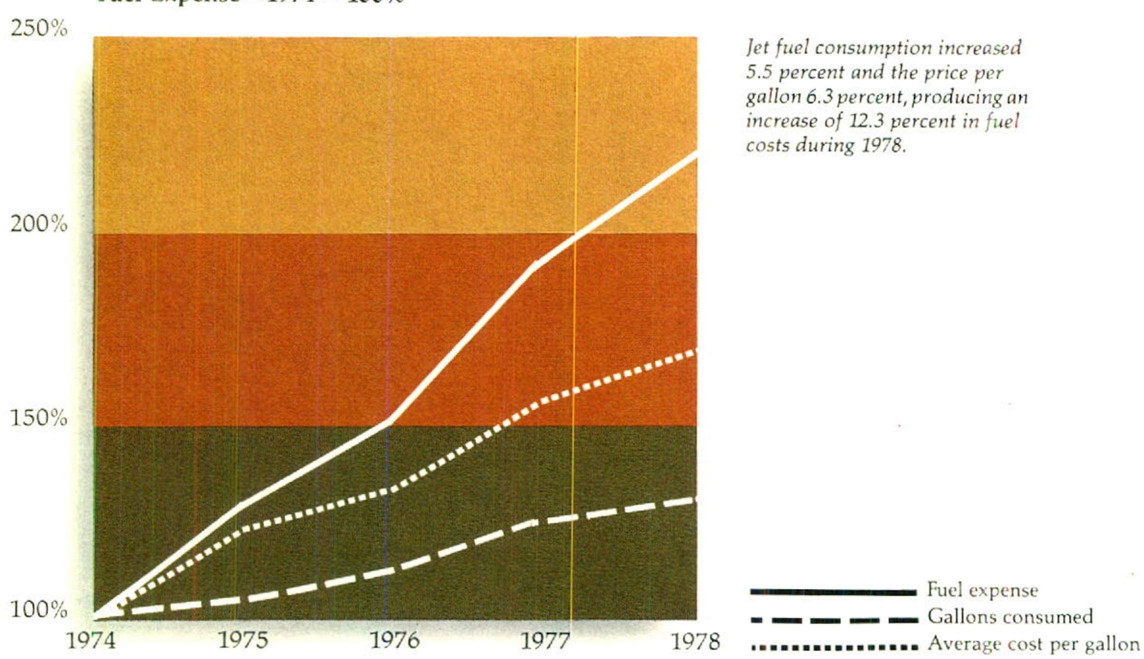
In addition to the traditional route proceedings, the Deregulation Act provides for two other methods of gaining new route authority: automatic market entry and claims for unused authority of other airlines. Under automatic market entry, each carrier may enter one new domestic market each year for the next three years without CAB approval. In each of these years, each carrier also can protect one market from automatic market entry by other carriers.

For 1979, Western selected the Reno-Seattle/Tacoma route for automatic entry. The Minneapolis/St. Paul-Los Angeles route was selected for protection against automatic entry.

Because of its extremely high levels of crew and equipment utilization and evaluation of unused routes, the company has not yet laid claim to any dormant authority. However, this opportunity under the Deregulation Act may be exercised at any time, and Western is continuing to study potential markets.

While it is too early to fully determine the impact of new competition and new opportunities provided by the Deregulation Act, Western will inevitably be subjected to increased competition on most of its major

Fuel Expense—1974 = 100%



Jet fuel consumption increased 5.5 percent and the price per gallon 6.3 percent, producing an increase of 12.3 percent in fuel costs during 1978.

Reservations and passenger service personnel handled a record number of passengers in 1978. Aiding them was the company's updated computer and new data processing facility which gave Western one of the finest data-handling systems in the industry.

routes. Under automatic market entry, two trunk airlines selected the nonstop Seattle/Tacoma-Los Angeles market while routes from California to Phoenix, Las Vegas and Reno were the prime targets for carriers who were previously limited to intrastate operations. Other carriers have applied for and have been or will be granted authority competitive to Western in markets such as Twin Cities-Las Vegas/Phoenix/San Diego, San Francisco-Portland/Seattle/Tacoma, and Denver-Salt Lake City, Denver-Reno and Denver-San Diego.

The Deregulation Act does not directly impact international air transportation since these authorizations are subject to government agreements. However, the new philosophy of competition is being carried by the Administration into negotiations for new and amended bilateral agreements with other countries. When more liberal agreements permit, the CAB has implemented them by granting multiple authorizations on individual routes.

During 1978, Western received authority to serve Guadalajara, Mexico's second largest city. Nonstop flights between Los Angeles and Guadalajara were inaugurated on June 30.

The U.S.-Mexico bilateral agreement, signed in January 1978, also provided for new U.S. carrier services between the West Coast and the Mexican cities of Mazatlan, Puerto Vallarta, Zihuatanejo, Manzanillo and La Paz, Loreto and San Jose del Cabo. Selection of the airline or airlines to serve these routes is currently before the CAB in the *California/Southwest-Western Mexico Route Proceeding*. Hearings before the administrative law judge were held in October 1978. His recommendation to the CAB is pending.

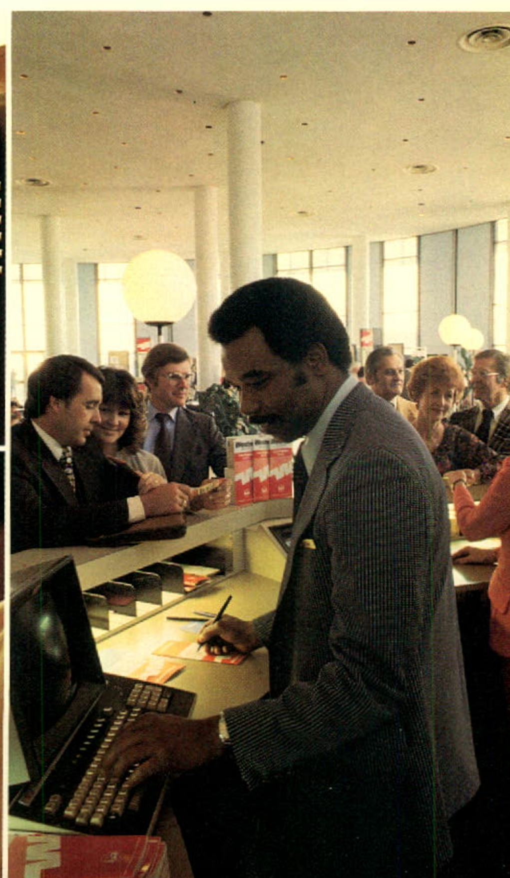
Western is also an applicant in the *Florida-Mexico City Service Investigation* in which the route between Miami/Tampa and Mexico City is at issue. This route was dropped by Pan American during 1978 and Eastern Airlines was given exemption authority to operate the route until a final decision is made by the CAB.

Two other proceedings in which Western is hopeful of receiving new international authority involve routes between Minneapolis/St. Paul and London and between Anchorage and London.

While the U.S.-United Kingdom Bilateral Agreement concluded in 1977 did not specifically name Minneapolis/St. Paul as a terminal point, it did provide for the naming of an additional U.S. city, called the "wild card" city, for service by a U.S. carrier to London by July 1980. The Twin Cities is one of eight U.S. destinations being considered for this nonstop authority. Should the Twin Cities be selected, the CAB has indicated it will consider Western's application along with that of another carrier for these rights. Comments relative to wild card city selection were submitted in early 1978 and are awaiting board action.

The U.S.-U.K. agreement also contained authority for a U.S. carrier to operate between Anchorage and London, a route in which Western has long expressed interest. An Anchorage-London Service Case has been instituted by the board to consider applications of Western as well as those of other carriers for this route.

Western also is an active applicant in the *Transpacific Low-Fare Route*



Investigation which covers authority from all U.S. points to Hong Kong, South Korea, Taiwan, Japan, Philippines, Singapore, Thailand, Sri Lanka, India, Indonesia and Malaysia and in the *U.S.-Benelux Low-Fare Proceeding* in which Western seeks authority from Anchorage, San Francisco and the Twin Cities to Amsterdam and Brussels.

In addition to CAB regulation, the Federal Aviation Administration regulates the safety aspects of airline operations and exercises jurisdiction over certain personnel, aircraft and ground facilities and other technical aspects of operations. The U.S. Postal Service has jurisdiction over the transportation of mail.

Marketing

Western carried 10,447,000 passengers in 1978, marking the first time in its 52-year history that the airline had topped 10 million passengers in a year. The 1978 record represented a 19 percent increase over the 8,757,000 passengers carried in 1977 which had been the previous all-time high.

The availability of bargain discount fares and their appeal to an inflation-weary public brought about the surge in 1978 air travel.

Western's marketing programs were geared for the upsurge and its advertising aimed toward the new emphasis. An up-dated computerized reservations system, installed in May, gave the company added capability for handling the increased volume of traffic and its summer peaks. This reservations network handles in excess of one million messages a day from airport, sales and reservations outlets.

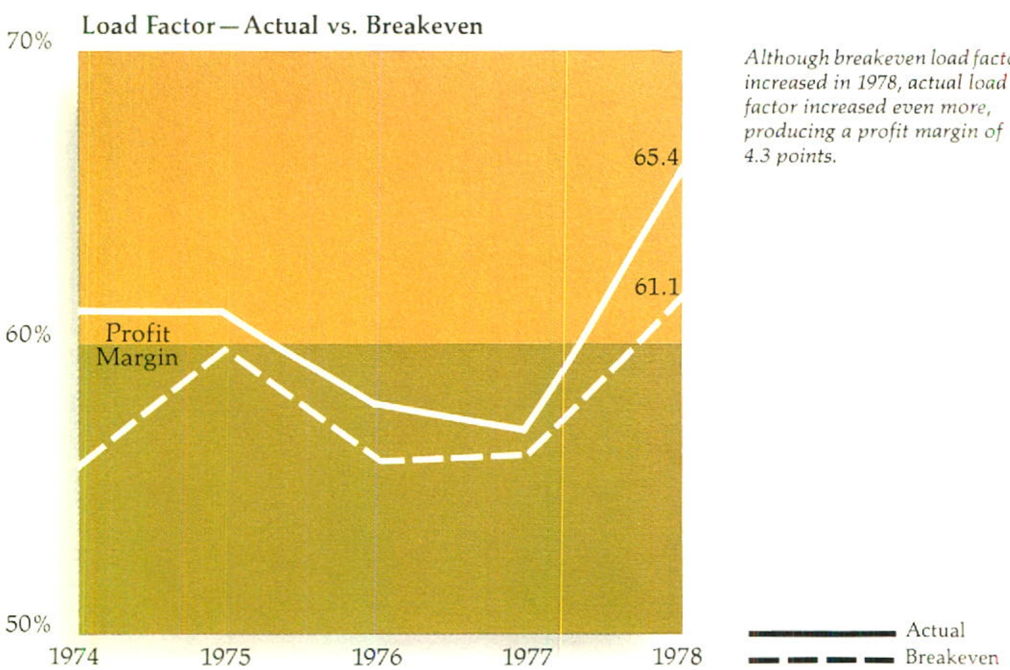
Western achieved a 65.4 percent average load factor for 1978, which was the highest load factor produced by a U.S. trunkline in scheduled service.

Travel agency sales contributed more than 60 percent of Western's passenger revenues during the year. In order to improve the links between the travel agent and Western's reservations system, the company has entered into a program of automating travel agencies, thereby giving them the latest technology in booking and ticketing customers and at the same time reducing time-consuming verbal telephone communications between the agencies and airlines.

The inauguration of the first nonstop service by a U.S. carrier between Los Angeles and Guadalajara on June 30 was heralded by a hard-hitting marketing and advertising campaign which resulted in excellent passenger response. Western experienced an average load factor of over 70 percent during the first six months of this operation.

In its major leisure markets, Western continued to hold the largest share of the market against competitors to Alaska and Mexico and, as it has for the last several years, held the No. 2 position in passenger boardings to Hawaii in 1978.

Charter business, which waned somewhat with the onslaught of individual discount fares, nevertheless increased dramatically for Western during the early months of 1978, with revenues from this source growing more than 100 percent for the year.



Although breakeven load factor increased in 1978, actual load factor increased even more, producing a profit margin of 4.3 points.

Western's flight attendants received new uniforms in mid-1978. The new look has proven extremely popular with the flight attendants and Western's passengers.

Western's cargo business, which experienced increased competition as a result of air cargo deregulation in early 1978, maintained a healthy growth with revenue ton miles growing approximately 12 percent, while revenues generated were up nearly 20 percent. The Mexico air cargo market attained the greatest traffic increase, 39 percent, reflecting that country's lifting of import restrictions on thousands of items and Western's successful efforts in developing new cargo business to and through Mexico from Europe, South America and the Orient. Alaska cargo decreased almost three percent as a result of new competition.

While the new regulatory environment is increasing the level of competition on most routes, new route authorizations at the same time are providing Western with the opportunity to expand its profitable contract services with other carriers at cities the company currently serves. Such relationships also are beneficial in adding to the volume of Western's traffic. Airlines launching service for the first time in a city often contract with another airline for essential passenger and ramp services. This represents new business for Western at many locations.

Another source of this type of revenue is Western's flight kitchen in Anchorage which continues to provide catering services to a number of international and U.S. airlines serving that city.

Flight Equipment

	In Operation*	1979 Delivery	1980 Delivery	1981/82 Options
DC-10-10**	9	2	2	4
727-200**	33	6**	5	10
737-200	21			
720B	8			
707-300C	5			
	76	8	7	14

*As of March 15, 1979.

**Four DC-10s and eleven 727s are leased. One of the 727s that will be delivered in 1979 will be leased. (See Note 8 of Notes to Financial Statements.)

Western made steady progress in its fleet planning and acquisition programs during 1978. As a result, the company increased the efficiency of its fleet and made significant progress toward meeting federal noise regulations.

During the year 1978, seven three-engine jets were added to the fleet while seven aircraft which do not meet the noise requirements were sold at prices in excess of their book values.

The three-engine DC-10s and 727-200s now comprise more than half of Western's total fleet. These aircraft have been deemed best for meeting the company's present route and marketing needs while providing improved fuel efficiency. They also comply with the federal noise regulations which became effective January 1, 1977. The company's plan for complying with the regulations will require the ultimate sale of 720B's

and 707s, modification of an undetermined number of 737s and sale of the balance of those aircraft.

While there had been indications in 1978 that Congress might act to provide some financial assistance to the airlines for the purpose of retrofitting or replacing noncomplying aircraft, no legislation was enacted prior to adjournment.

The level of capacity offered by any airline is not only determined by the number and size of the aircraft in its fleet, but also by the utilization of those aircraft, or the average daily hours flown. In 1978, the average daily revenue utilization for all aircraft types was 8 hours 38 minutes, up from 8 hours 27 minutes in 1977.

Western continued to lead all DC-10 Series 10 operators in average daily utilization with the 1978 figure of 11 hours 45 minutes topping its own 1977 record of 11 hours 23 minutes.

Legal Proceedings

Western and other airlines are parties to numerous actions in state courts wherein owners of property located in the vicinity of major airports, primarily Los Angeles International Airport, are seeking to enjoin certain aircraft operations at the airport and/or to recover damages because of aircraft noise and engine emissions.

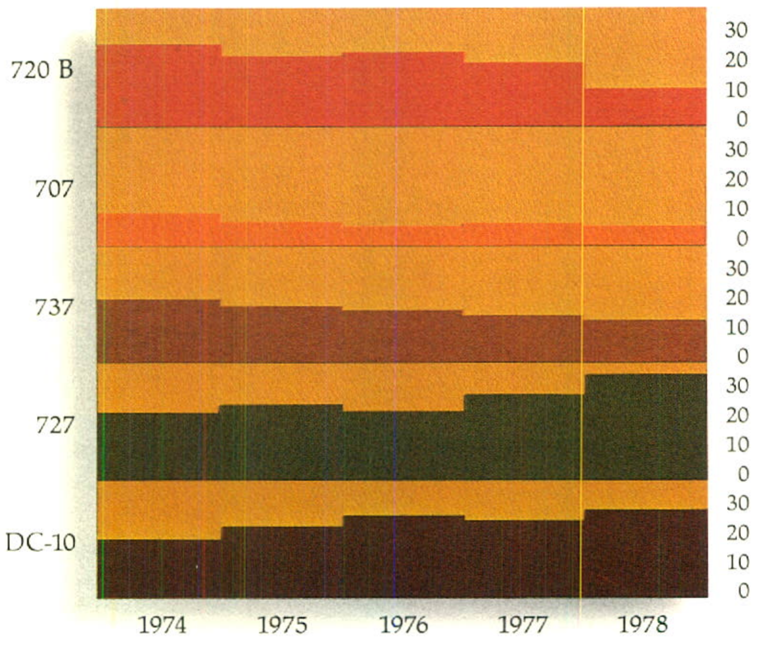
Most of these cases have been brought in the Los Angeles County Superior Court against the City of Los Angeles, which in a number of these cases has in turn cross-complained against the airlines for indemnification. The aggregate amount of damages sought in cases against the city has been reported by the city to be in excess of $3 billion. The aggregate amount of damages sought in actions to which Western is a party as cross-defendant is in excess of $36 million.

Western and its counsel in these actions feel that the damages claimed are not a realistic measure of the airlines' exposure and that in most cases the request for relief is wholly out of proportion to any actual damage that may have been suffered. Western's counsel in these actions, which also represents most of the other airlines, is of the opinion, based on the current state of the law, that the airlines have substantial defenses to the imposition of any liability. Moreover, in each case to date in which the issue of the airlines' duty to indemnify the airport proprietor has been tried the airlines have obtained favorable rulings.

However, all the issues of law involved in these matters have not been finally settled, and, pending further judicial clarification, the relative rights and liabilities among such owners of adjacent areas, the airport operators, the air carriers and the federal, state and local governments are not entirely clear. Unfavorable decisions against Western in these actions could have a materially adverse effect on it. Further, any liability of airport operators, or the granting of any injunctive relief against them, could result in higher costs to air carriers, for example through higher landing fees.

The California Supreme Court has

% of Total Fleet Output, Based on ASM's (system)



An increasing percentage of Western's available seat miles are being produced in our more efficient three-engine DC-10s and 727-200s.

The company opened a new terminal building at Salt Lake City in December 1978, providing passengers with functional check-in facilities, a comfortable Horizon Club and the city's first jet bridges. In June, Western inaugurated service to Guadalajara, a Mexican city noted for its fountains and flowers.

decided that jet noise damage litigation is not appropriate for class action determination because of an insufficient community of interest to sustain a class suit. This holding has significance with respect to the Los Angeles situation where several of the cases purportedly are on behalf of classes.

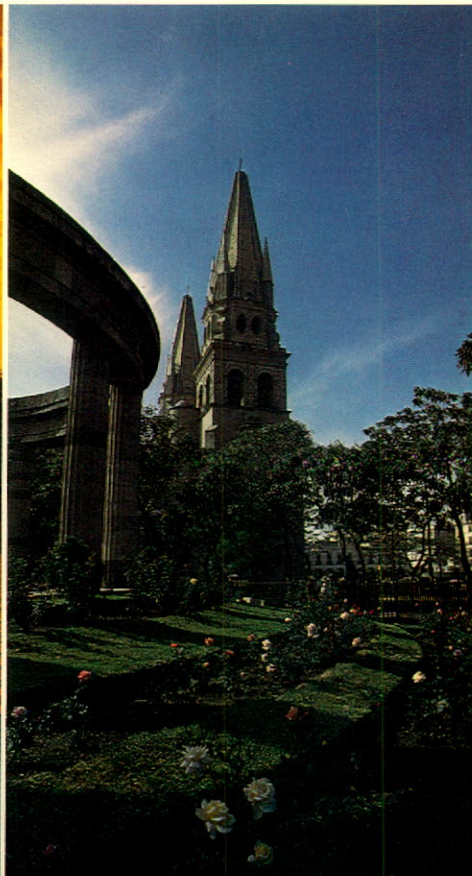
In light of this litigation certain communities which own and operate airports, including Los Angeles and San Diego, have imposed or are considering imposition of limitations on frequency and timing of airline flights or upon the proportion of an airline's fleet which may continue to operate without complying with federal noise standards. Enforcement of such restrictions at a major airport served by Western could have a materially adverse effect upon its operations.

When the Los Angeles airport authorities in 1976 adopted a noise regulation similar to that now under consideration, several airlines, including Western, challenged the constitutionality of that regulation in federal court and subsequently the Los Angeles airport authorities directed that enforcement of the Los Angeles regulation be withheld pending such time as it might be approved by the City Council by ordinance. As a result of this action the litigation challenging the constitutionality of the Los Angeles regulation was ordered dismissed but a similar action may be instituted should the regulation now under consideration by the Los Angeles airport authorities receive City Council approval.

In the summer of 1978 the California authorities directed the proprietor of San Diego's Lindbergh Field (the San Diego Unified Port District) to extend the curfew hours then in effect as a condition of approval of the Port District's application for a variance from noise standards adopted by the California authorities. The Port District refused to comply and brought an action in United States District Court for the Southern District of California for an injunction restraining California authorities from enforcement of their directive. Several airlines, including Western, intervened in the action on behalf of the Port District. On August 21, 1978, the court issued a preliminary injunction on grounds of federal preemption. The defendants have filed an appeal from the decision to the United States Court of Appeals for the Ninth Circuit.

Western and three other airlines are defendants in an action brought in November 1973 by a defunct tour operator-travel agency in the United States District Court for the Northern District of California in which the defendants are charged with having conspired and attempted to monopolize and with actually monopolizing the group leisure tour market in competition with said agency by packaging their own tours and appropriating tour packages developed by said agency. The complaint seeks injunctive relief plus three times actual damages according to proof plus punitive damages. In the opinion of Western's counsel, the action will not result in any material liability to Western.

Western is also involved in various other litigation, including certain cases alleging discrimination in employment practices, that management believes will not have a materially adverse effect upon Western.



Management

Western's management organization is headed by a board of directors which ably represents the business and civic interests of the major areas the company serves. Directors come from Alaska, Hawaii, Mexico, the Midwest, the Pacific Northwest and the Rocky Mountain States, as well as California.

Four Western officers are members of the board of directors. They are Arthur F. Kelly, chairman and chief executive officer; Dominic P. Renda, president and chief operating officer; Richard P. Ensign, senior vice president-marketing, and Robert O. Kinsey, senior vice president-finance and administration. Mr. Ensign, 60, and Mr. Kinsey, 62, were elected to the board in 1978.

Mr. Kelly, 66, completed his 41st year with Western and his 29th year as a company officer in 1978. He has served on the board of directors since 1968. Mr. Renda, 65, completed his 31st year in the industry in 1978, having served as a Western officer for 26 of those years and as a member of the board of directors since 1973.

Other principal officers of Western include Anton B. Favero, 65, senior vice president-operations; James L. Mitchell, 57, senior vice president-corporate planning; Gerald P. O'Grady, 65, senior vice president-legal and secretary; Richard O. Hammond, 49, vice president and treasurer, and Roderick G. Leith, 50, vice president and controller.

Mr. Ensign, who previously served Western as an officer from 1963 to 1971, held senior officer positions with Pan American World Airways, Inc., between 1971 and 1975 when he returned to Western. Mr. Mitchell served as an officer of Western from 1965 to 1968 when he became a vice president of Continental Air Lines, Inc. He returned to Western in early 1977.

Western's management staff reflects a strong combination of expertise and experience. The officers of Western have an average age of 55 years and an average of 25 years of service with the company. Members of the second echelon of management average 46 years of age and have an average of 19 years of service with Western.

Complete listings of all company directors and officers are detailed starting on page 32 of this report. The principal occupation of each Western officer is his position with the company.

Employees

Western employed an average of 10,787 people during 1978, compared to 10,413 during 1977.

Wages and salaries for 1978 amounted to $253,188,000, up 17 percent from the $216,004,000 in 1977. Social Security and other taxes plus company contributions to group insurance and employee retirement plans increased 19 percent to $56,257,000 in 1978.

Western is committed to a policy of equal employment opportunity with hiring and advancement being determined on the basis of merit and ability. This company policy is the basis for viable, results-oriented affirmative action plans which are submitted annually to government agencies.

Labor unions represent approximately 91 percent of Western's employees. These unions include the Air Line Pilots Association, Association of Flight Attendants, Brotherhood of Railway and Airline Clerks, International Brotherhood of Teamsters, Sindicato Nacional de Trabajadores de Aviacion y Similares and the Transport Workers Union.

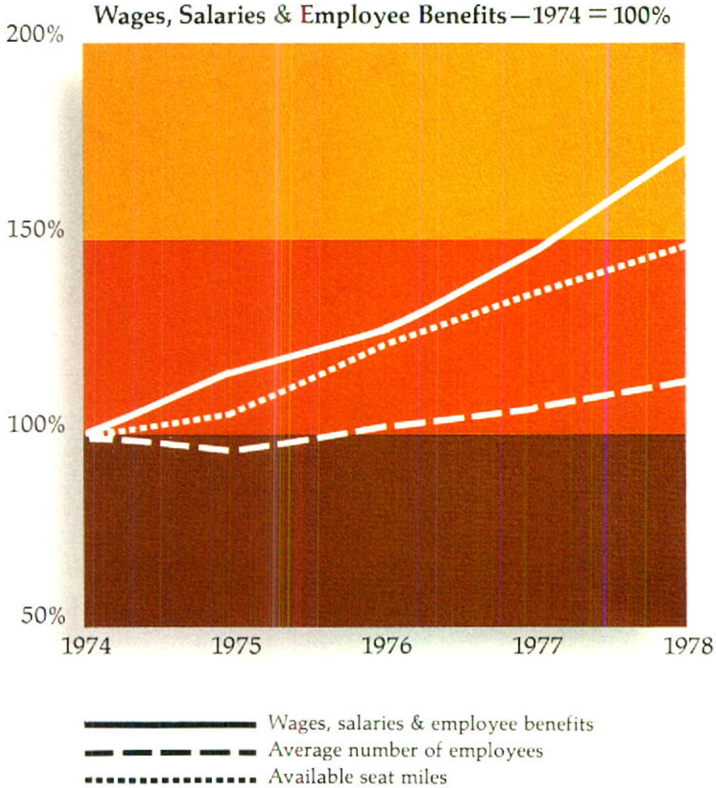
Following is the contractual status of each of these collective bargaining groups.

Employee Group	Number of Employees 1/1/79	Union	Contract Open for Amendment
Mechanics & Related Employees and Stock Clerks	2,150	IBT	Jan. 1, 1979 (In negotiation)
Pilots	1,515	ALPA	Sept. 1, 1979
Flight Attendants	1,917	ALPA/AFA	Dec. 1, 1979
Agent & Clerical—U.S.	3,886	BRAC	June 30, 1980
Canada	123	BRAC	July 1, 1980
Mexico	189	SNTA	Jan. 18, 1980
Flight Superintendents	33	TWU	Oct. 31, 1980
Ground School Instructors	31	IBT	*

*The IBT has recently been certified by the National Mediation Board as the representative of this group.

Although Western was able to produce nine percent more seat miles with less than four percent more employees in 1978, the cost of wages, salaries and benefits increased 18 percent.

Wages, Salaries & Employee Benefits—1974 = 100%



MANAGEMENT'S DISCUSSION

Year 1978 compared to year 1977

Net earnings for 1978 were $54,748,000 compared to restated earnings of $12,724,000 for 1977 (see Note (a) to Summary of Operations relating to restatement for capitalized leases). As a result of the change to the flow-through method of accounting for investment credits, net earnings for 1978 were increased by $29,107,000 of which $16,201,000 was the cumulative effect of the change on prior years.

Operating revenues for 1978 were $834,513,000 compared to $691,464,000 for 1977, an increase of $143,049,000, or 21% over the previous year. Passenger revenue amounted to 83% of this increase, cargo revenue 7% and other revenue (which includes charter) 10%.

The following table shows the increases in operating revenues and traffic, 1978 compared to 1977.

	1978 Versus 1977		
	Increase		Percent of Total
	Amount	Percent	Increase
	(000s)		
Operating revenues			
Passenger	$ 119,424	19	83
Cargo	9,323	20	7
Other (including charter)	14,302	49	10
	$ 143,049	21	100
Revenue passenger miles			
48 States and Canada	1,057,860	21	58
Hawaii	371,988	16	21
Mexico	210,849	40	12
Alaska	172,263	29	9
Total scheduled	1,812,960	22	100
Charter (mostly Hawaii)	233,102	109	
Total system	2,046,062	24	
Cargo revenue ton miles	19,028	12	

The increase in passenger revenue was attributable to a 22% growth in scheduled traffic over the previous year. Average revenue per passenger mile decreased 1.9% from 7.34¢ for 1977 to 7.20¢ for 1978. General fare increases were more than offset by the increased use of discount fares. Discount revenue passenger miles for 1978 increased to 42% of the scheduled revenue passenger miles compared to 33% for 1977. Coach and economy passengers contributed 93% of the scheduled passenger revenue for both 1978 and 1977.

While revenue passenger miles on scheduled flights increased significantly over 1977, they were partially impacted by a strike against a competing carrier whose operations were substantially suspended from April 29, 1978, through August 15, 1978. Scheduled available seat miles increased by only 7% over 1977. This, coupled with a 22% increase in scheduled revenue passenger miles, resulted in a scheduled load factor for 1978 of 65% compared to 57% for 1977.

Of the four major market areas, the greatest rate of growth in scheduled service was in Mexico, a reversal of a downward trend in traffic that had taken hold with the devaluation of the peso in September 1976. The new Los Angeles-Guadalajara route inaugurated June 30, 1978, accounted for 44% of the growth and 12% of total passenger miles in the Mexico market.

The 48 States and Canada continues to account for the greatest portion of the scheduled market growth with 58% of the 1978 total.

Alaska routes, which had a slowing of traffic growth in 1977, experienced a 29% rate of growth in 1978, the increase coming primarily from discount traffic.

Scheduled revenue passenger miles for Hawaii had the lowest growth rate of all the markets for 1978, but with the inclusion of Hawaii charters, which represent 80% of system charters in 1978, the overall rate of growth for Hawaii equals that of the 48 States and Canada.

Cargo revenue increased 20% over 1977 as a result of the positive combination of a yield increase of 6.7% and a 12.1% increase in revenue ton miles.

Other revenue increased principally from expanded charter business in 1978. Charter traffic increased 109% and charter revenue increased 120%, accounting for 60% of the growth in other revenue.

In the fourth quarter of 1978, average revenue per passenger mile (yield) decreased 5% from 7.56¢ in 1977 to 7.18¢ in 1978.

A fourth quarter 2.5% fare increase in the 48 States was offset by the increased use of discount fares and a reduction in deluxe fares to 120% of coach fares. Discount traffic represented 44% of total traffic compared to 31% for the fourth quarter 1977. Total scheduled revenue passenger miles increased 22%.

The combination of increased discount traffic, a slowing in the rate of growth of revenue passenger miles, and a yield decrease resulted in passenger revenue rising by only 16% over the fourth quarter of 1977.

Operating expenses for 1978 were $779,657,000 compared to $662,010,000 for 1977, an increase of 18%. Wages, salaries and employee benefits totaled $309,445,000 and fuel expense totaled $154,876,000, representing 40% and 20% respectively of total operating expenses.

The following table represents increases in selected operating expenses, 1978 compared to 1977.

	1978 Versus 1977		
	Increase		Percent of Total Increase
	Amount (000s)	Percent	
Wages and salaries	$ 37,184	17	32
Employee benefits	9,178	19	8
	46,362	18	40
Depreciation	4,382	10	4
Fuel	16,907	12	14
Other			
Materials and repairs	9,636	25	8
Commissions	9,458	30	8
Services purchased	4,574	22	4
Food and beverage	3,536	15	3
Travel—flight crews	2,668	25	2
Passenger service claims	2,815	72	2
Communications	1,123	15	1
Other	16,186	20	14
	49,996	23	42
Total operating expense	$ 117,647	18	100
Available Seat Miles	1,291,117	9	

Wages, salaries, employee benefits and fuel continue to have the greatest dollar impact, accounting for 54% of the total operating expense increase over the previous year.

Higher rates of pay resulting from scheduled periodic increases in collective bargaining agreements were primarily responsible for the increase in wages and salaries. Of the $37,184,000 increase, 65% was attributable to wage rate increases, 19% to increased personnel and 16% to other work rules.

Employee benefit costs are comprised of pensions, group insurance and payroll taxes. Pension costs accounted for $4,698,000, or 51% of the increase in employee benefits, and were up 21% over the previous year. Of this increase, 75% was due to improved benefits and higher wages while 25% was attributable to the increased number of employees. The cost of group medical, dental and life insurance rose by 15%, primarily because of the impact of inflation on health services. Payroll taxes increased 17%, due in the main to legislated rate increases and higher wage rates.

Depreciation expense increased with the acquisition of two DC-10 and five 727-200 aircraft during the first seven months of the year. The depreciation on this new equipment amounted to $4,027,000 for 1978.

Fuel increased 12% of which 54% was attributable to higher average prices and 46% to increased consumption.

Commissions to travel agents were higher as a result of two factors: increased traffic and a higher percentage of sales made by travel agents. Sales by travel agencies were 60% of total passenger sales in 1978 compared to 57% in 1977.

The increase in materials and repairs reflects the rise in the price of materials and in the cost of outside labor required for aircraft and engine maintenance.

Services purchased were higher than 1977 primarily in two areas: credit card service fees and costs of security, janitorial, cleaning and other support services. Service fees were related to increased traffic and support services were related to higher rates.

Food and beverage expenses continued to increase from the growth in passenger traffic and to a lesser extent, from higher prices.

Flight crew travel expenses were up 25%, or $2,668,000, primarily as a result of a new contract provision to provide individual accommodations for flight attendant personnel while away from their home bases.

Passenger service claims were up because of increased passenger traffic, weather problems and changes in mandatory payments related to flight interruptions and baggage claims.

Communications expense increased with the installation of additional equipment, increased usage of communications facilities and higher service rates.

Other expenses increased by $16,186,000, attributable in the main to payments of $9,834,000 to a struck carrier under the Mutual Aid Agreement.

Operating income increased to a record $54,856,000, an improvement of 86%, or $25,402,000, over 1977. This was caused by a 21% increase in operating revenues while operating expenses increased 18%.

Interest expense increased $2,967,000, or 15%, with the issuance of equipment trust certificates to finance the acquisition of one DC-10 and five 727-200 aircraft. The gain on sale of equipment reflects the sale of seven aircraft in 1978. This is part of Western's continuing program to replace its older aircraft and improve the overall efficiency of its fleet.

The fourth quarter of 1978 experienced a slightly higher overall rate of increase in operating expenses over the fourth quarter 1977. While labor and employee welfare increased at a lower rate, 15% compared to 18% for the year, depreciation was 18%, fuel 15% and other 24%. This, coupled with an increase of only 15% in operating revenues, resulted in a loss of $3,131,000 for the fourth quarter 1978 compared to earnings of $1,397,000 for the fourth quarter of 1977.

Provision for taxes on income is reconciled to the tax rate of 48% in Note 7 to Financial Statements.

Year 1977 compared to year 1976

Western's net earnings for 1977 were $12,724,000 compared to $13,996,000 for 1976. Net earnings for 1977 included $2,400,000 resulting from the extension of depreciable lives of 727 and 737 aircraft and $2,100,000 from gain on sales of aircraft. Net earnings for 1976 included $600,000 and $930,000, respectively, from these items.

Increases in operating revenues in 1977 over 1976 resulted from growth in traffic, and to a lesser degree, increases in passenger yield. Passenger revenues constitute close to 90% of Western's operating revenues and 93% of passenger revenues came from coach and economy travelers.

The following table shows increases and decreases in operating revenues and traffic.

	1977 Versus 1976		
	Increase/Decrease		Percent of Total
	Amount	Percent	Increase
	(000s)		
Operating revenues			
Passenger	$ 70,393	13	81
Cargo	9,687	26	11
Other (including charter)	6,179	27	8
	$ 86,259	14	100
Revenue passenger miles			
48 States and Canada	489,931	11	75
Hawaii	190,565	9	29
Alaska	30,946	6	5
Mexico	(55,468)	(9)	(9)
Total scheduled	655,974	8	100
Charter (mostly Hawaii)	98,969	87	
Total system	754,943	10	
Cargo revenue ton miles	22,336	17	

Although revenue passenger miles on scheduled flights increased in 1977, the growth was smaller than in 1976 because traffic on Western's Mexico routes declined in 1977. This decline was caused by the devaluation of the peso, which had an unfavorable effect on sales in Mexico. The Los Angeles-Miami and Honolulu-Vancouver routes, added to the company's system in the summer of 1976, contributed 69% of the increase in revenue passenger miles in 1977 compared to 21% in 1976.

Of the four major areas shown in the chart above, the fastest growing area in 1977 was the 48 States and Canada. Although the Los Angeles-Miami route contributed significantly to this growth rate, the remainder of the 48 States and Canada market also experienced an increased rate of growth.

Most of the 1977 increase in traffic on Hawaii routes came from the Honolulu-Vancouver segment. The rate of growth on other Hawaii segments decreased in 1977, as did the rate of growth of seats offered for sale in this market.

Alaska routes, which experienced the highest growth rate in 1976, continued to grow in 1977 but the rate of traffic growth decreased because of the completion of the oil pipeline.

The four percent increase in average revenue per passenger mile in 1977 was caused by fare increases and, to a lesser degree, a reduced proportion in the use of discounted fares.

Cargo revenues for the past three years have increased primarily because of traffic growth. In addition, 1977 revenues were increased by $2,000,000 from current and retroactive mail rate adjustments.

"Other" revenues increased principally from expanded charter business in 1977.

Operating expenses in both periods increased largely because of inflation and expanded operations with wages, salaries and employee benefits and fuel having the largest dollar impact. Increases in these categories represent 71% of the total increase in operating expenses and of this roughly two-thirds relates to inflation and one-third to expanded operations.

Periodic wage increases in collective bargaining agreements were primarily responsible for increases of $36,716,000 (16%) during 1977 in wages, salaries and employee benefits. Pilots, flight attendants, and mechanics and related employees and stock clerks reached amended agreements in 1977. The higher wage rates resulting from these agreements had a significant effect on expenses starting in the second half of 1977.

Employee benefit costs, consisting mainly of pensions, group insurance and payroll taxes, increased $9,130,000 (24%) in 1977. Pensions increased in 1977 because of higher wages for all employees and improved benefits as provided for in the amended agreements. The cost of group insurance benefits was higher in 1977, and payroll taxes increased because of legislated changes.

Fuel expense escalated by $29,690,000 (27%) in 1977 because of higher prices and greater consumption. Higher prices represented 65% of the increase in 1977 with 35% coming from greater consumption.

The reduction in depreciation expense in 1977 reflects reductions from the extension of the depreciable lives of 727 and 737 aircraft from 12 years to 15 years and 14 years, respectively, partially offset by added costs from the acquisition of seven 727-200 aircraft.

Materials and repairs expense increased $4,423,000 (13%) in 1977. The 1977 increase reflects higher costs for parts and scheduled airframe maintenance.

Commissions to travel agents increased $4,391,000 (16%) in 1977 because of traffic growth and a higher proportion of total sales being made by travel agents.

Increases in food and beverage expense of $2,775,000 (13%) in 1977 resulted from more passengers being carried and higher costs.

Operating income in 1977 decreased $5,992,000 (17%) despite traffic growth and some fare increases because Western was unsuccessful in offsetting inflated operating expenses that were coupled with expanded operations.

Gain on sales of equipment reflects the disposition of four aircraft in 1977.

Provision for taxes on income is reconciled to the tax rate of 48% in Note 7 of Notes to Financial Statements.

TEN YEARS OF WESTERN PROGRESS

Years prior to 1978 have been restated. See Note (a).
(In thousands except per share amounts and other items indicated by*)

Summary of Operations	1978	1977
Operating revenues:		
Passenger	$ 734,005	614,581
Cargo	56,936	47,613
Other	43,572	29,270
Total operating revenues	834,513	691,464
Operating expenses:		
Wages, salaries and employee benefits	309,445	263,083
Fuel	154,876	137,969
Depreciation and amortization	47,094[c]	42,712[c]
Other[d]	268,242	218,246
Total operating expenses	779,657	662,010
Operating income (loss)	54,856	29,454
Interest, principally on long-term obligations	(23,089)	(20,122)
Interest capitalized[f]	2,910	2,592
Gain on sale of equipment	6,754	4,549
Other income (expense) net	3,924	3,388
Earnings (loss) before provision for taxes on income and cumulative effect of changes in accounting principles	45,355	19,861
Provision for taxes on income[g]	6,808	7,137
Earnings (loss) before cumulative effect of changes in accounting principles	38,547	12,724
Cumulative effect of changes in accounting principles[e, g]	16,201	—
Net earnings (loss)	54,748	12,724
Preferred stock dividend requirement	2,397	567
Net earnings (loss) available for common stock	$ 52,351	12,157
Earnings (loss) per common share[h]:		
Primary:		
Before cumulative effect of changes in accounting principles	$ 2.82	0.96
Net earnings (loss)	$ 4.09	0.96
Fully diluted:		
Before cumulative effect of changes in accounting principles	$ 2.15	0.85
Net earnings (loss)	$ 3.04	0.85
Pro-forma amounts assuming the accounting changes are applied retroactively[e,g]:		
Net earnings (loss)	$ 38,547	14,743
Net earnings (loss) per common share—primary[h]	$ 2.82	1.12
Net earnings (loss) per common share—fully diluted[h]	$ 2.15	0.97
Cash dividends paid per share on common stock[i]	$ 0.40	0.40
Other Financial Data		
Return on investment (%)*	14.0	9.1
Average common shares outstanding[h]	12,795	12,659
Shareholders' equity	$ 198,502	147,439
Long-term obligations	$ 265,746	214,465
Property and equipment—net	$ 519,737	427,942
Total assets	$ 703,940	574,943
Operations		
Airplanes operated at end of year*	78	77
Passengers carried	10,447	8,757
Available seat miles	16,254,879	14,963,762
Revenue passenger miles	10,634,848	8,588,786
Passenger load factor—actual (%)*	65.4	57.4
—breakeven point (%)*	61.1	56.1
—profit margin (point difference)*	4.3	1.3
Average revenue per passenger mile*	$ .0720	.0734
Average length in miles per passenger trip*	994	966
Operating expense per available seat mile*	$ .0480	.0442
Cargo revenue ton miles	176,319	157,291
Average number of employees*	10,787	10,413

1976	1975	1974	1973	1972	1971	1970	1969
544,188	465,081	437,345	376,722	342,851	295,807	274,792	220,530
37,926	31,329	27,662	23,040	20,819	20,231	18,745	16,472
23,091	22,563	23,390	21,524	10,321	12,009	9,926	5,245
605,205	518,973	488,397	421,286	373,991	328,047	303,463	242,247
226,367[b]	201,661	182,334	165,363	147,282	127,075	113,116	97,156
108,279	93,134	71,437	44,510	40,137	38,663	37,357	32,857
43,465[c]	40,239[c]	44,085	41,183	38,376	37,295	38,639	35,158
191,648	170,846	148,367	127,123	122,433	106,838	101,566	89,311
569,759	505,880	446,223	378,179	348,228	309,871	290,678	254,482
35,446	13,093	42,174	43,107	25,763	18,176	12,785	(12,235)
(17,127)	(14,788)	(16,428)	(14,457)	(13,227)	(14,372)	(17,631)	(15,939)
786	440	1,161	1,489	1,453	116	3	689
1,809	379	9,575	945	582	1,349	111	26
1,237	3,919	4,222	3,235	2,114	3,114	1,009	(151)
22,151	3,043	40,704	34,319	16,685	8,383	(3,723)	(27,610)
8,155	(1,445)	17,188	14,436	5,901	2,562	(3,243)	(15,235)
13,996	4,488	23,516	19,883	10,784	5,821	(480)	(12,375)
—	7,160	—	—	—	—	—	—
13,996	11,648	23,516	19,883	10,784	5,821	(480)	(12,375)
—	—	—	—	—	—	—	—
13,996	11,648	23,516	19,883	10,784	5,821	(480)	(12,375)
1.03	0.30	1.55	1.32	0.72	0.39	(0.03)	(0.82)
1.03	0.77	1.55	1.32	0.72	0.39	(0.03)	(0.82)
0.92	0.29	1.38	1.18	0.66	0.38	(0.03)	(0.82)
0.92	0.70	1.38	1.18	0.66	0.38	(0.03)	(0.82)
14,515	6,958	28,980	19,016	12,549	7,611	2,215	(10,840)
1.07	0.46	1.92	1.26	0.83	0.51	0.15	(0.72)
0.95	0.44	1.69	1.13	0.76	0.48	0.15	(0.72)
0.40	0.47	0.39	0.23	0.08	—	—	0.16
9.5	5.9	12.4	11.9	8.5	6.8	5.5	1.2
13,601	15,163	15,125	15,050	15,030	15,012	15,011	15,010
112,055	133,862	129,314	110,830	94,404	84,510	78,654	79,133
192,537	175,350	167,404	177,956	158,621	181,593	205,028	227,346
378,573	367,607	350,313	316,372	262,095	242,031	275,505	315,484
515,084	488,339	448,832	431,702	372,743	372,011	389,272	402,142
75	75	72	74	71	70	72	78
8,098	7,531	7,391	7,382	6,931	6,206	6,188	5,752
13,450,395	11,696,478	11,123,544	11,175,518	10,300,178	9,776,869	9,839,299	8,509,441
7,833,843	7,102,917	6,747,451	6,476,087	5,995,925	5,251,989	5,159,081	4,021,296
58.2	60.7	60.7	57.9	58.2	53.7	52.4	47.3
56.0	59.7	56.1	52.5	54.6	52.4	52.6	53.2
2.2	1.0	4.6	5.4	3.6	1.3	(0.2)	(5.9)
.0705	.0665	.0660	.0593	.0578	.0577	.0542	.0551
963	942	902	877	865	846	834	699
.0424	.0433	.0401	.0338	.0338	.0317	.0295	.0299
134,955	108,619	95,239	76,474	76,233	73,249	68,646	60,514
9,799	9,357	9,696	9,826	9,383	8,951	8,961	9,286

NOTES APPLICABLE TO FIVE YEARS ENDED DECEMBER 31, 1978

(In thousands of dollars except per share amounts)

(a) As of August 31, 1978, Western changed its method of accounting for leases to conform to Statement of Financial Accounting Standards (SFAS) No. 13. The effect of this change in accounting method was to restate the Summary of Operations as follows:

	1977	1976	1975	1974
Decreases in operating expenses	$ 7,321	5,588	4,532	3,814
(Increases) in interest expense	(10,472)	(7,452)	(5,824)	(4,933)
Decreases in deferred federal income taxes	1,513	895	620	537
(Decreases) in earnings before cumulative effect of changes in accounting principles and net earnings	$ (1,638)	(969)	(672)	(582)
(Decreases) in earnings before cumulative effect of changes in accounting principles and net earnings per common share:				
Primary	$ (0.13)	(0.07)	(0.04)	(0.04)
Fully diluted	(0.10)	(0.06)	(0.04)	(0.03)

Because Western capitalized leases, earnings before cumulative effect of changes in accounting principles and net earnings for 1978 were decreased by $2,159 or $0.17 per common share (primary) and $0.12 per common share (fully diluted).

See Note 2 to Financial Statements.

(b) Effective January 1, 1976, Western amended certain employee benefit plans to comply with pension legislation and to streamline benefits. In addition, the actuarial method was changed for one plan and certain actuarial assumptions were changed for all plans. These amendments and changes decreased expenses for 1976 by approximately $1,200; earnings before cumulative effect of changes in accounting principles and net earnings were increased by approximately $600, or $0.04 per common share (primary) for 1976.

(c) Effective January 1, 1978, the estimated depreciable lives of five 707 aircraft were extended from 12 years to 15 years. For 1978, depreciation expense was decreased by approximately $1,800; earnings before cumulative effect of changes in accounting principles and net earnings were increased by approximately $1,508 or $0.12 per common share (primary).

Effective October 1, 1976, the estimated depreciable lives of fifteen 727 aircraft and twenty-four 737 aircraft were extended from 12 years to 15 and 14 years, respectively. For 1977 and 1976, depreciation expense was decreased by approximately $4,800 and $1,200; earnings before cumulative effect of changes in accounting principles and net earnings were increased by approximately $2,400 and $600 or $0.19 and $0.04 per common share (primary), respectively.

Effective January 1, 1975, the estimated depreciable lives of eighteen 720B aircraft were extended to a common expiration date of December 31, 1978. For 1975 depreciation expense was decreased by approximately $5,300; earnings before cumulative effect of changes in accounting principles and net earnings were increased by approximately $2,600, or $0.17 per common share (primary).

The changes in 1978, 1976 and 1975 reflected management's decision to continue using these aircraft beyond the time at which they would have become fully depreciated.

(d) Mutual aid payments included in other operating expenses amounted to $9,834—1978, $899—1976, $4,832—1975 and $1,203—1974.

(e) In 1975 Western changed its method of accounting for costs of major flight equipment maintenance from one of charging such costs to reserves (accumulated by charges to income on an hours-flown basis) to one of direct expensing of such costs as incurred. The $7,160 cumulative effect of this change on prior years ($13,785 less deferred income taxes of $6,625) is included in net earnings for 1975. This change had no other material effect on net earnings for 1975. The pro forma amounts reflect the retroactive effect of this change on net earnings.

(f) If Western did not follow a policy of capitalizing interest related to deposits on aircraft purchase contracts, earnings before cumulative effect of changes in accounting principles and net earnings would have been decreased as follows: $2,078—1978; $1,088—1977; $198—1976; $28—1975; and $412—1974. Earnings before cumulative effect of changes in accounting principles per common share (primary) and net earnings per common share (primary) would have been decreased by $0.16—1978; $0.09—1977; $0.01—1976; and $0.03—1974. Earnings before cumulative effect of changes in accounting principles and net earnings per common share would not have been affected in 1975.

(g) The provision for taxes on income before cumulative effect of changes in accounting principles is summarized as follows:

	1978	1977	1976	1975	1974
Current income taxes:					
Federal:					
Provision	$23,447	10,875	8,550	(7,980)	10,700
Investment credits applied	(23,447)	(11,900)	(4,145)	2,555	(5,375)
	— *	(1,025)*	4,405	(5,425)	5,325
State	1,814	1,150	1,075	225	1,375
Deferred federal income taxes:					
Provision	(2,655)	(2,063)	1,455	9,285	7,763
Investment credits:					
Applied	(15,240)	(3,791)	(1,925)	(4,024)	(5,934)
Transferred to (from) current	23,447	11,900	4,145	(2,555)	5,375
	5,552	6,046	3,675	2,706	7,204
Deferred investment credits	—	3,791	1,925	4,024	5,934
	7,366	9,962	11,080	1,530	19,838
Amortization of deferred investment credits	(558)	(2,825)	(2,925)	(2,975)	(2,650)
	$ 6,808	7,137	8,155	(1,445)	17,188

*The Tax Reform Act of 1976 provides for 100% application of unapplied investment credits against federal income tax liabilities for 1977 and 1978. This 100% application is reduced 10% annually until 1980. Under the Revenue Act of 1978 the application remains at 80% in 1981 and returns to 90% in 1982 where it remains thereafter.

Effective January 1, 1978, Western changed its method of accounting for investment credits for financial reporting purposes from the deferral to the flow-through method. The pro forma amounts appearing on the Summary of Operations display the effect of retroactive application had the new method been in effect in prior years. See Note 7 to Financial Statements.

In 1975 the Internal Revenue Service concluded examinations of Western's federal income tax returns through 1972. Western was successful in accelerating depreciation for tax purposes which resulted in a refund for certain of the years under review. The provision for taxes on income for 1975 includes reclassifications relating to timing differences (decreased current federal taxes of $4,025 and restored deferred investment credits of $1,130, which are offset by increased deferred federal income taxes of $5,155).

(h) Earnings per share data are based on the weighted average number of shares of common stock outstanding during the respective years, adjusted when applicable to give retroactive effect to 5% and 3% stock dividends paid in 1974 as follows: 1978—12,795,000, 1977—12,659,000, 1976—13,601,000, 1975—15,163,000 and 1974—15,125,000. The fully diluted per share data are based on the following number of shares: 1978—18,215,000, 1977—15,913,000, 1976—16,066,000, 1975—17,628,000 and 1974—17,590,000. Net earnings are reduced by dividends on preferred stock to determine primary net earnings.

(i) Cash dividends per share are stated on the basis of Western's shares outstanding at the date such dividends were declared.

ACCOUNTANTS' REPORT

PEAT, MARWICK, MITCHELL & CO.
CERTIFIED PUBLIC ACCOUNTANTS
555 SOUTH FLOWER STREET
LOS ANGELES, CALIFORNIA 90071

The Board of Directors
Western Air Lines, Inc.:

We have examined the Balance Sheets of Western Air Lines, Inc. as of December 31, 1978 and 1977 and the related Statements of Earnings, Shareholders' Equity, and Changes in Financial Position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned financial statements present fairly the financial position of Western Air Lines, Inc. at December 31, 1978 and 1977 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 consistently applied during the periods except for the change, with which we concur, in the method of accounting for investment credits as described in Note 7 of Notes to Financial Statements; and after restatement for the change, with which we concur, in the method of accounting for leases as described in Notes 1 and 2 of Notes to Financial Statements.

Peat, Marwick, Mitchell & Co.

Los Angeles, California
February 2, 1979

BALANCE SHEETS

WESTERN AIR LINES, INC.
December 31, 1978 and 1977
(in thousands of dollars)

ASSETS	1978	1977*
Current Assets:		
Cash	$ 6,306	6,748
Certificates of deposit	10,268	14,710
Commercial paper at cost and accrued interest (which approximate market)	48,686	27,459
	65,260	48,917
Receivables (net of allowance for doubtful accounts of $1,532—1978 and $1,594—1977)	92,039	70,790
Flight equipment expendable parts, at average cost (less allowance for obsolescence of $12,365—1978 and $11,914—1977)	14,263	13,645
Prepaid expenses and other current assets	7,809	6,379
Total current assets	179,371	139,731
Properties and Equipment at Cost (Notes 2, 3, 4 and 5):		
Flight equipment	694,908	601,010
Facilities and ground equipment	117,833	105,574
Deposits on aircraft purchase contracts	36,820	40,641
	849,561	747,225
Less allowance for depreciation and amortization	329,824	319,283
	519,737	427,942
Deferred Charges and Other Assets	4,832	7,270
	$703,940	574,943

*Restated. See Note 2.
See accompanying notes to financial statements.

LIABILITIES AND SHAREHOLDERS' EQUITY	1978	1977*
Current Liabilities:		
Accounts payable	$ 41,330	30,880
Salaries, wages and vacation benefits payable	32,819	27,783
Accrued liabilities (Notes 6 and 7)	20,005	21,357
Airline traffic liability	66,588	46,764
Current portion of debt	10,864	8,300
Current portion of capital leases (Note 2)	6,647	6,053
Total current liabilities	178,253	141,137
Long-term Obligations:		
Debt (Note 8)	158,043	100,661
Capital leases (Note 2)	107,703	113,804
	265,746	214,465
Deferred Credits (Note 7):		
Deferred federal taxes on income	53,952	48,400
Unamortized investment credits	1,851	18,610
Other	5,636	4,892
	61,439	71,902
Shareholders' Equity (Notes 8, 9, 10 and 11):		
Preferred stock—authorized 25,000,000 shares		
$2.00 Series A Cumulative Convertible		
$25.00 stated value per share		
Issued 1,197,000 shares—1978 and 1,200,000 shares—1977	29,923	30,000
Common stock—authorized 35,000,000 shares		
$1.00 par value per share		
Issued 13,010,000 shares—1978 and 12,659,000—1977	13,010	12,659
Additional paid-in capital	30,792	27,227
Retained earnings	124,777	77,553
	198,502	147,439
Commitments and Contingent Liabilities (Notes 2 and 4)		
	$703,940	574,943

STATEMENTS OF EARNINGS

Years ended December 31, 1978 and 1977 (in thousands of dollars except per share amounts)	1978	1977*
Operating revenues:		
Passenger	$734,005	614,581
Cargo	56,936	47,613
Other	43,572	29,270
	834,513	691,464
Operating expenses:		
Wages, salaries and employee benefits (Note 6)	309,445	263,083
Fuel	154,876	137,969
Depreciation and amortization (Note 3)	47,094	42,712
Other	268,242	218,246
	779,657	662,010
Operating income	54,856	29,454
Other income (expenses):		
Interest, principally on long-term obligations	(23,089)	(20,122)
Interest capitalized	2,910	2,592
Interest income	3,666	2,302
Gain on sale of equipment	6,754	4,549
Other—net	258	1,086
	(9,501)	(9,593)
Earnings before provision for taxes on income and cumulative effect of a change in accounting principle	45,355	19,861
Provision for taxes on income (Note 7)	6,808	7,137
Earnings before cumulative effect of a change in accounting principle	38,547	12,724
Cumulative effect of a change in accounting principle (Note 7)	16,201	—
Net earnings	54,748	12,724
Earnings per Common Share (Note 12):		
Primary:		
Earnings before cumulative effect of a change in accounting principle	$ 2.82	0.96
Cumulative effect of a change in accounting principle (Note 7)	1.27	—
Net earnings	$ 4.09	0.96
Fully diluted:		
Earnings before cumulative effect of a change in accounting principle	$ 2.15	0.85
Cumulative effect of a change in accounting principle (Note 7)	0.89	—
Net earnings	$ 3.04	0.85
Pro forma amount assuming the accounting change is applied retroactively (Note 2):		
Net earnings	$ 38,547	14,743
Per common share:		
Primary	$ 2.82	1.12
Fully diluted	2.15	0.97

*Restated. See Note 2.

See accompanying notes to financial statements.

STATEMENTS OF CHANGES IN FINANCIAL POSITION

Years ended December 31, 1978 and 1977 (in thousands of dollars)	1978	1977*
Sources of Working Capital:		
Earnings before cumulative effect of a change in accounting principle (Note 7)	$ 38,547	12,724
Add (deduct) items which did not affect working capital:		
Depreciation and amortization (Note 3)	46,715	41,918
Taxes (Note 7):		
Deferred income taxes	5,552	6,046
Deferred investment credits	—	3,791
Amortization of deferred investment credits	(558)	(2,825)
Gain on sale of equipment	(6,754)	(4,549)
Other	(2,246)	(2,942)
Total from operations before cumulative effect of a change in accounting principle	81,256	54,163
Cumulative effect of a change in accounting principle in 1978, amounting to $16,201, which did not affect working capital (Note 7)	—	—
Total from operations	81,256	54,163
Proceeds from issuance of preferred stock (Note 10)	—	30,000
Reimbursements of deposits and capital expenditures upon acquisition of aircraft and facilities	12,633	18,775
Proceeds from sale of equipment	10,794	7,924
Proceeds from issuance of long-term obligations	71,785	38,292
Conversion of debentures	3,550	—
Other—net	1,317	(2,000)
	181,335	147,154
Applications of Working Capital:		
Purchase of property and equipment and advances thereon	150,747	110,193
Reduction of long-term obligations including transfers to current liabilities	20,540	16,404
Cash dividends	7,524	5,630
	178,811	132,227
Increase in working capital	$ 2,524	14,927
Summary of Increases (Decreases) in Working Capital:		
Cash, certificates of deposit and commercial paper	$ 16,343	3,782
Receivables	21,249	8,349
Expendable parts and prepaid expenses	2,048	(2,551)
Accounts payable, airline traffic liability, accrued and other liabilities	(37,116)	5,347
Net increase	$ 2,524	14,927

*Restated. See Note 2.
See accompanying notes to financial statements.

STATEMENTS OF SHAREHOLDERS' EQUITY

Years ended December 31, 1978 and 1977
(in thousands of dollars)

	Preferred Stock $25.00 Stated Value	Common Stock $1.00 Par Value	Additional Paid-in Capital	Retained Earnings	Shareholders' Equity
Balance at January 1, 1977, as previously reported	$ —	12,659	28,937	75,504	117,100
Adjustment to reflect capitalization of leases*	—	—	—	(5,045)	(5,045)
Balance at January 1, 1977, as restated*	—	12,659	28,937	70,459	112,055
Issuance of preferred stock	30,000	—	(1,710)	—	28,290
Net earnings*	—	—	—	12,724	12,724
Cash dividends					
Preferred stock	—	—	—	(567)	(567)
Common stock	—	—	—	(5,063)	(5,063)
Balance at December 31, 1977* . . .	30,000	12,659	27,227	77,553	147,439
Exercise of stock options	—	33	256	—	289
Conversion of debentures	—	310	3,240	—	3,550
Conversion of preferred stock	(77)	8	69	—	—
Net earnings	—	—	—	54,748	54,748
Cash dividends:					
Preferred stock	—	—	—	(2,397)	(2,397)
Common stock	—	—	—	(5,127)	(5,127)
Balance at December 31, 1978 (Notes 8, 9, 10 and 11)	$29,923	13,010	30,792	124,777	198,502

*Restated. See Note 2.
See accompanying notes to financial statements.

NOTES TO FINANCIAL STATEMENTS

(in thousands of dollars except per share amounts)

Note 1. Summary of Significant Accounting Policies.

Property and Equipment

Property and equipment, exclusive of residual values, are depreciated over estimated useful lives by the straight-line method. Leases primarily for flight equipment are classified and accounted for as capital leases under SFAS No. 13. All financial data for periods prior to 1978 have been restated to retroactively reflect these capital leases from the inceptions of the leases. FASB Interpretation No. 23, effective December 1, 1978, requires that leases of terminal space and other airport facilities owned by governmental authorities be classified as capital leases unless all conditions for exemption are met. Because of the early adoption of SFAS No. 13, Western has accounted for such leases entered into prior to December 1, 1978 as operating leases. (See Note 2.) Maintenance and repairs are expensed as incurred. Major renewals and betterments are charged to property and equipment accounts.

Preoperating Costs

Significant costs, such as those for traffic promotion and personnel training, related to the inauguration of service over major new routes and to the introduction of new types of aircraft are deferred and amortized over five years.

Interest Capitalized

Interest related to deposits on aircraft purchase contracts is capitalized and amortized over the useful lives of the aircraft.

Investment Credits

Effective January 1, 1978, investment credits are reflected as a reduction of federal income tax expense, subject to statutory limitations, in the year during which the credit arises or is allowable based on financial statement earnings. For previous periods, investment credits generated by acquisition of assets to the extent used to reduce federal income tax liability were amortized to income on a straight-line basis over the useful lives of the related assets. (See Note 7.)

Obsolescence of Expendable Parts

An allowance for obsolescence of expendable parts is accrued over the useful lives of the related aircraft types.

Airline Traffic Liability

Passenger ticket sales are recorded as a current liability until recognized as revenues for services provided by Western, refunded, or until billed by other carriers for transportation provided by them. The related receivable and payable accounts for prior years have been reclassified to conform with the financial statement presentation in 1978.

Note 2. Lease Commitments.

Western leases flight equipment and facilities and ground equipment. Lease terms for flight equipment range from 11½ to 15 years for 727 aircraft and from 15 to 18 years for DC-10 aircraft. Lease terms for facilities and ground equipment range up to 29 years.

As of August 31, 1978, Western changed its method of accounting for leases to conform to Statement of Financial Accounting Standards (SFAS) No. 13. The effect of this change in accounting method was to decrease retained earnings at January 1, 1977 by $5,045 and to restate the Statement of Earnings for 1977 as follows: decrease operating expenses by $7,321, increase interest expense by $10,472, decrease deferred federal income taxes by $1,513 and decrease earnings before cumulative effect of a change in accounting principle and net earnings by $1,638 or $0.13 per common share (primary) and $0.10 per common share (fully diluted).

The effect of capitalizing leases on 1978 was to decrease earnings before cumulative effect of a change in accounting principle and net earnings by $2,159 or $0.17 per common share (primary) and $0.12 per common share (fully diluted).

The assets and related obligations for capital leases were initially recorded at an amount equal to the present value of future minimum lease payments using incremental borrowing rates at the inceptions of the leases. The assets are amortized over the life of the lease by the straight-line method. Interest expense is accrued on the basis of the outstanding obligations under capital leases. Leased equipment under capital leases is included in the balance sheets at December 31, 1978 and 1977 as follows:

	1978	1977
Flight equipment	$126,310	126,310
Facilities and ground equipment	3,278	2,967
	129,588	129,277
Less allowance for depreciation and amortization	38,944	30,513
	$ 90,644	98,764

At December 31, 1978, minimum lease payments under leases expiring after December 31, 1979 were as follows:

	Capital Leases	Operating Leases
1979	$ 17,038	10,955
1980	16,994	11,641
1981	16,860	11,432
1982	16,860	10,970
1983	16,860	10,697
Thereafter	105,786	115,788
Total minimum lease payments	190,398	171,483
Less: Amount representing interest*	76,048	
Present value of obligations—capital leases	114,350	
Less: Current portion of capital leases	6,647	
Long-term obligations—capital leases	$107,703	

*Amount necessary to reduce minimum lease payments to present value calculated at Western's incremental borrowing rates at the inceptions of the leases.

Rental expense for operating leases for 1978 amounted to $15,239 ($14,079—1977).

Note 3. Depreciation and Amortization.

The estimated useful lives and residual values of aircraft are as follows:

	Estimated Useful Life	Residual Value
DC-10	16 years	10%
727	15 years	15%
737	14 years	15%
707	15 years	15%
720B	Fully depreciated at December 31, 1978	$100

Effective January 1, 1978, the estimated depreciable lives of five 707 aircraft were extended from 12 years to 15 years. For 1978, depreciation expense was decreased by approximately $1,800; earnings before cumulative effect of a change in accounting principle and net earnings were increased by approximately $1,508 or $0.12 per common share (primary). This change reflected management's decision to continue using these aircraft beyond the time at which they would have become fully depreciated.

The estimated useful lives of ground equipment range from four to ten years. For buildings and improvements on leased property, the estimated useful lives are generally the periods of the leases.

"Other" operating expenses included depreciation and amortization of $725 in 1978 ($334—1977).

Note 4. Commitments and Contingent Liabilities.

At December 31, 1978 Western had on firm order six Boeing 727-200 aircraft which are scheduled for delivery in the spring and summer of 1979 (including one aircraft to be leased beginning in July, 1979), and two McDonnell Douglas DC-10 aircraft which are also scheduled for delivery in 1979. Western had made advance payments on these aircraft on order in the approximate amount of $34,700. The balance of the purchase price payable on delivery of the aircraft will be approximately $94,000. Western also had options to purchase ten additional Boeing 727-200 aircraft and four additional McDonnell Douglas DC-10 aircraft for delivery in 1980 and 1981 at a cost estimated to aggregate $294,600 of which $1,550 had been paid.

In January 1979 Western exercised options to purchase five Boeing 727-200 aircraft and two McDonnell Douglas DC-10 aircraft for delivery in 1980 and at the same time obtained options to purchase the same number of both types of aircraft for delivery in 1982.

Outstanding commitments for flight equipment modifications and spares amounted to approximately $10,610 and for facilities and ground equipment amounted to approximately $4,901 at December 31, 1978.

For information regarding the status at December 31, 1978 of legal proceedings, see "Legal Proceedings" on page 12 in this Annual Report.

For discussion of possible impact of environmental regulations, see "Flight Equipment" on pages 11 and 12 in this Annual Report.

Note 5. Description of Impact of Inflation (Unaudited).

Inflation is reflected in operating expenses in the year in which the price increases occur except for the cost of replacing capital assets. Historically, because of the regulatory process, fare increases have lagged behind these price increases.

Replacing capital assets, primarily aircraft and ground property, with assets having equivalent productive capacity has usually required a greater capital investment than was required to purchase the original productive capacity. These higher acquisition costs reflect the cumulative impact of inflation.

Western's annual report on form 10-K (a copy of which is available upon request) contains information with respect to year-end 1978 replacement cost of productive capacity and the approximate effect which replacement cost would have had on the computation of depreciation expense for the year.

Note 6. Retirement Plans.

Western has retirement plans which cover substantially all employees. Western makes contributions to the company-sponsored plans which, together with the participants' required contributions, are sufficient to fund current service costs annually and prior service costs over 10 to 20 years. Actuarial gains and losses are amortized over ten-year periods.

The cost of retirement plans including the union-sponsored plan charged to operating expense amounted to $26,606 for 1978 ($21,908—1977). The increase was caused by increases in wages, higher enrollments and improved benefits.

For selected plans, the actuarially computed value of vested benefits exceeded the pension funds' assets by approximately $2,343 at the most recent valuation date during 1978.

Unfunded prior service costs of the plans amounted to approximately $20,078 at the most recent valuation date during 1978.

Note 7. Taxes on Income.

The provision for taxes on income before cumulative effect of a change in accounting principle is summarized as follows:

	1978	1977
Current income taxes:		
Federal:		
Provision	$23,447	10,875
Investment credits applied	(23,447)	(11,900)
	—*	(1,025)*
State	1,814	1,150
Deferred federal income taxes:		
Provision	(2,655)	(2,063)
Investment credits:		
Applied	(15,240)	(3,791)
Transferred to current	23,447	11,900
	5,552	6,046
Deferred investment credits	—	3,791
	7,366	9,962
Amortization of deferred investment credits	(558)	(2,825)
	$ 6,808	7,137

*The Tax Reform Act of 1976 provides for 100% application of unapplied investment credits against federal income tax liabilities for 1977 and 1978. This 100% application is reduced 10% annually until 1980. Under the Revenue Act of 1978 the application remains at 80% in 1981 and returns to 90% in 1982 where it remains thereafter.

Effective January 1, 1978, Western changed its method of accounting for investment credits for financial reporting purposes from the deferral to the flow-through method. Investment credits generated during 1971 and prior years remain on the deferral method. Under the flow-through method, investment credits are reflected as a reduction of federal income tax expense, subject to statutory limitations, in the year during which the credit arises or is allowable based on financial statement earnings. Under the deferral method, no recognition had been given to investment credits until utilized to reduce tax liabilities, at which time they were deferred in the accounts and amortized over the useful lives of the assets giving rise to the credit. Western believes the newly adopted accounting principle is preferable because it is the method used by the majority of publicly-held companies in the United States and the change will improve the comparability of Western's results of operations with other companies utilizing the flow-through method (particularly those in the air transportation industry). Western has received the consent of the Secretary of the Treasury to change to the flow-through method of accounting for investment credits for financial reporting purposes, which consent is required by the Revenue Act of 1971.

The cumulative effect of the change on years after 1971, amounting to $16,201, has been included in net earnings for 1978. The effect of the change on the results for 1978 was to increase earnings before cumulative effect of a change in accounting principle by $12,906, or $1.00 per common share (primary) and net earnings by $29,107, or $2.27 per common share (primary). The pro forma amounts appearing on the Statements of Earnings display the effect of retroactive application had the new method been in effect during 1977.

Of the $18,610 unamortized investment credit balance at December 31, 1977, $10,548 remained from investment credits utilized by reduction of taxes paid and $8,062 related to investment credits not yet utilized for reduction of taxes paid. The $1,851 unamortized investment credit balance at December 31, 1978 represents investment credits generated in 1971 and prior years.

Investment credits unapplied on tax returns amounted to $1,389 and $9,596 at December 31, 1978 and 1977, respectively.

Deferred income taxes arise from timing differences between financial and tax reporting. The tax effects of these differences on the provision follow:

	1978	1977
Depreciation	$ 109	(1,623)
Capitalized leases	(1,108)	(1,513)
Interest capitalized	1,124	679
Preoperating expense	(502)	(668)
Employee benefits	(2,201)	792
Other	(77)	270
	$(2,655)	(2,063)

A reconciliation between the amount of reported taxes on income and the amount computed by multiplying earnings before provision for taxes on income and cumulative effect of a change in accounting principle by the federal statutory tax rate of 48% follows:

	1978	1977
Taxes on income at 48%	$21,770	9,533
Increases (reductions) in taxes resulting from:		
Amortization of deferred investment credits	(558)	(2,825)
Investment credits recognized on flow-through method	(15,240)	—
State income taxes net of federal income tax benefit	943	598
Other	(107)	(169)
Taxes on income	$ 6,808	7,137

The federal income tax returns for 1973 through 1976 are being examined.

Note 8. Debt.

A December 31, 1978 and December 31, 1977 debt (excluding amounts maturing within one year) was:

	1978	1977
Secured:		
9.55% equipment trust certificates due May 1, 1993 with semi-annual principal payments starting November 1, 1979	$ 69,221	—
Unsecured:		
Senior		
5¼% installment notes due September 1, 1981 with annual principal payments on September 1 of $4,000	8,000	12,000
6⅝% installment notes due September 1, 1984 with annual principal payments of $2,000 on September 1 which will increase to $7,000 in 1982	25,000	27,000
8¾% installment notes due November 16, 1985 with quarterly principal payments of $768 starting in 1981	15,362	15,362
	48,362	54,362
Subordinated		
5¼% convertible subordinated debentures due February 1, 1993, with annual sinking fund payments of $1,500 starting in 1980	24,480	28,055
10% subordinated sinking fund notes due April 15, 1984, less unamortized discount of $119, with annual sinking fund payments of $2,300	15,980	18,244
	40,460	46,299
	$158,043	100,661

As of July 1, Western entered into the 1978 Bank Loan Agreement with an agent bank and twenty-one other banks superseding the 1976 Bank Loan Agreement. The 1976 Bank Loan Agreement dated July 1, 1976 provided Western with a $75,000 revolving line of credit. The interest rate on funds borrowed was ½% over the lead bank's prime commercial rate.

The new agreement provides Western with a $125,000 revolving line of credit until June 30, 1981. At this date the line of credit can be replaced by term notes not to exceed $125,000 which will mature on June 30, 1985 with quarterly payments of principal starting September 30,1981. The interest rate on funds borrowed is equal to the agent bank's prime commercial rate until June 30, 1980 when it will increase to ¼% over such rate. The interest rate on the term notes is equal to ½% over the agent bank's prime commercial rates. At December 31, 1978, $125,000 was available for future drawdowns.

The commitment fee is ½% per annum on the unused portion for both agreements.

Although the bank loan agreements do not require compensating balances, Western has informally agreed to maintain on deposit average balances equal to 10% of the total credit available plus 10% of borrowings. Accordingly, during 1978 the average balance maintained amounted to approximately $10,500 ($7,800 during 1977) and an average of $13,000 would have been maintained on deposit based on available credit at December 31, 1978 ($6,300—1977) after adjustment for the estimated float of $3,500 during 1978 ($3,200 during 1977).

The agreements relating to this line of credit and other long-term debt contain provisions which limit retained earnings from which restricted payments (cash dividends and purchases of Western's common stock) can be made. The most restrictive of these provisions limited amounts available for such payments to $40,415 at December 31, 1978 ($16,653—1977). These agreements also contain, among other things, requirements pertaining to cash and working capital levels and provisions which may restrict additional borrowings.

As of May 1, 1978 Western entered into an equipment trust agreement whereby nine insurance companies agreed to lend to a bank, as trustee, 80% of the cost of seven aircraft (two DC-10s and five 727s) but not to exceed $99,190 in the aggregate and Western agreed to supply the remaining funds to enable the trustee to purchase the aircraft. These loans are evidenced by equipment trust certificates, issued by the trustee and guaranteed by Western. Under these agreements the trustee receives a security interest in the aircraft. When rental payments sufficient in amount to pay the principal and interest on the certificates have been made, Western's title to the aircraft will be free and clear.

During 1978 certificates in the amount of $71,785 were issued by the trustee in connection with the delivery of one DC-10 and five 727 aircraft. An additional DC-10 aircraft will be financed pursuant to this agreement in the spring of 1979.

The following schedule shows the amount of long-term debt due in each of the five following calendar years, including the additional equipment trust certificates but excluding borrowings under the revolving line of credit:

1979	$11,843
1980	16,885
1981	19,957
1982	20,957
1983	20,957

At December 31, 1978 and December 31, 1977, 2,119,000 and 2,429,000 shares of common stock were reserved for conversion of debentures at a conversion price of $11.55 per share.

Note 9. Stock Options.

Western had a qualified stock option plan adopted in 1964 for officers. This plan expired April 30, 1978. The company presently has a nonqualified stock option plan adopted in 1974 for officers and key personnel. These plans are summarized as follows:

	1974 Plan		1964 Plan	
	Number of Shares	Average Price	Number of Shares	Average Price
January 1, 1977	382,075	$9.14	97,473	$11.48
Options granted	378,500	8.28	—	—
Options exercised	—	—	—	—
Options cancelled and expired	(36,155)	9.30	(21,862)	13.36
Balance December 31, 1977	724,420	8.68	75,611	10.93
Options granted	116,280	7.81	—	—
Options exercised	(33,315)	8.69	—	—
Options cancelled and expired	(16,550)	8.54	(75,611)	10.93
Balance December 31, 1978	790,835	$8.56	—	$ —
Shares exercisable at:				
December 31, 1978	484,261	$8.82	—	$ —
December 31, 1977	353,136	8.94	75,611	10.93

At December 31, 1978, 201,730 shares were reserved under the 1974 stock option plan for the issuance of future grants.

Note 10. Issuance of Preferred Stock.

On October 6, 1977, 1,200,000 shares of $2.00 Series A Cumulative Convertible Preferred Stock were issued at a stated value of $25 per share. The shares of preferred stock are convertible into common stock at the rate of 2.5 shares of common stock for each share of preferred stock, subject to adjustment under certain conditions.

Note 11. Proposed Consolidation.

Western has entered into an Agreement of Consolidation with Continental Air Lines, Inc. calling for the consolidation of the two companies into a new company. The agreement has been approved by the respective boards of directors, and is subject to approval by the stockholders of both corporations, by certain of their lenders, and by the CAB.

Note 12. Earnings per Common Share.

Earnings per common share are based on the weighted average number of shares of common stock outstanding during the respective periods.

	1978		1977
	Earnings Before Cumulative Effect of a Change in Accounting Principle	**Net Earnings**	Net Earnings
Adjustment of net earnings:			
Primary:			
Net earnings	**$38,547**	**54,748**	12,724
Preferred dividends	**2,397**	**2,397**	567
Net earnings available for common stock	**$36,150**	**52,351**	12,157

Fully diluted:			
Net earnings	$38,547	54,748	12,724
Reduction in interest expense, net of provision for taxes on income, for the assumed conversion of 5¼% convertible subordinated debentures	680	680	742
Adjusted net earnings assuming full dilution	$39,227	55,428	13,466
Adjustment of shares outstanding (in thousands):			
Weighted average shares outstanding	12,795	12,795	12,659
Adjustment assuming full dilution:			
Assumed conversion of subordinated debentures	2,312	2,312	2,539
Assumed conversion of preferred stock	2,997	2,997	715
Assumed exercise of stock options	111	111	—
Total average common shares assuming full dilution	18,215	18,215	15,913
Earnings per common share:			
Primary	$ 2.82	4.09	0.96
Fully diluted	2.15	3.04	0.85

Note 13. Summarized (unaudited) quarterly financial data for 1977 and 1978 is as follows:

	Three Months Ended			
	March 31	June 30	September 30	December 31
1977				
Operating revenues	$164,748	165,181	188,825	172,710
Operating income	5,806	1,942	18,610	3,096
Net earnings	1,678	1,278	8,371	1,397
Net earnings per common share:				
Primary	0.13	0.10	0.66	0.07
Fully diluted	0.12	0.10	0.56	0.07
1978				
Operating revenues	192,200	201,870	241,023	199,420
Operating income (loss)	11,072	11,541	33,226	(983)
Earnings (loss) before cumulative effect of changes in accounting principles	10,486	5,513	25,679	(3,131)
Net earnings (loss)	26,687	5,513	25,679	(3,131)
Earnings (loss) before cumulative effect of a change in accounting principle per common share:				
Primary	0.78	0.39	1.95	(0.29)
Fully diluted	0.59	0.31	1.41	(0.29)
Net earnings (loss) per common share:				
Primary	2.06	0.39	1.95	(0.29)
Fully diluted	1.49	0.31	1.41	(0.29)

Western extended the depreciable lives of certain aircraft which had the following effects on quarterly results: for each quarter in 1977, operating income was increased by approximately $1,200; net earnings were increased by approximately $600 or $0.05 per common share (primary). For each quarter in 1978 operating income was increased by $450; earnings before cumulative effect of a change in accounting principle and net earnings were increased by approximately $422—first quarter 1978, $350—second quarter 1978, $366—third quarter 1978 and $370—fourth quarter 1978, or $0.03, $0.03, $0.03 and $0.03 per common share (primary).

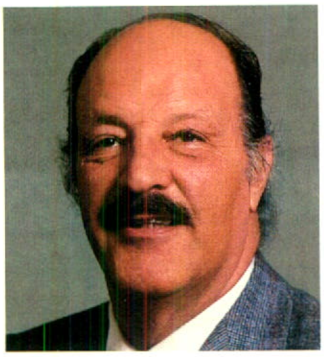
Western changed to the flow-through method of accounting for investment credits which increased (decreased) earnings before cumulative effect of a change in accounting principle for the first, second, third and fourth quarters of 1978 by approximately $4,337, $235, $9,816 and ($1,482), or $0.34, $0.02, $0.76 and $(0.11) per common share (primary).

Fourth quarter 1978 operating revenues and income include $870 from current and retroactive mail rate adjustments, which increased net earnings by $729. Fourth quarter 1977 operating revenues and income include $2,000 from current and retroactive mail rate adjustments, which increased net earnings by $1,000.

Estimates of the annual effective tax rate are made quarterly. Had each of the 1978 quarterly estimates been made on the basis of the year's actual effective tax rate, earnings and per common share (primary) amounts before cumulative effect of a change in accounting principle would have been:

	Three Months Ended			
	March 31	June 30	September 30	December 31
Earnings (loss)	$9,401	7,823	25,691	(4,368)
Per common share (primary)	0.69	0.57	1.95	(0.38)

BOARD OF DIRECTORS



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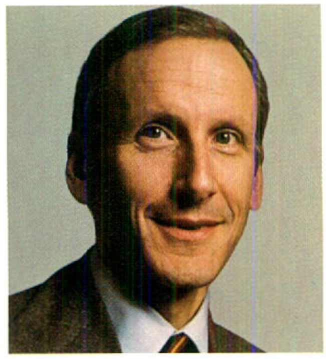

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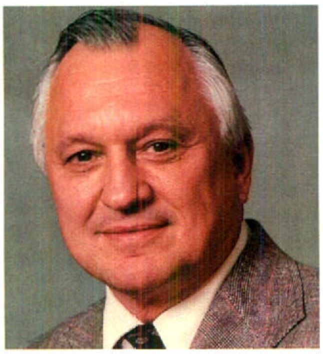

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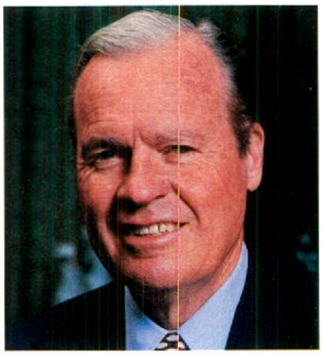

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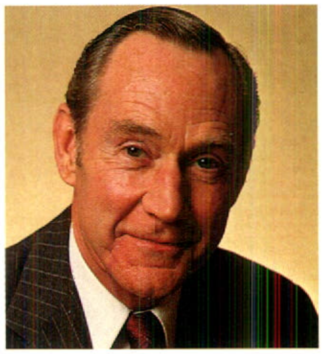

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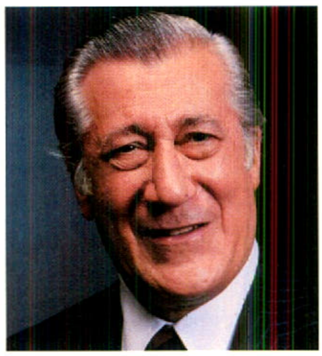

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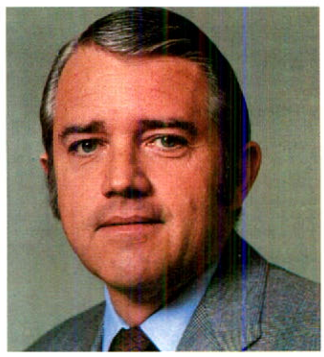

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Consumer Affairs

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Los Angeles International Airport
Los Angeles, California 90045

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Bank of America National Trust & Savings Assn.
555 So. Flower St., Los Angeles, California 90071

Registrar/Transfer Agent—Preferred Stock
Bank of America National Trust & Savings Assn.
555 So. Flower St., Los Angeles, California 90071

Debenture and Subordinated Note Trustee
The Chase Manhattan Bank
1 New York Plaza, New York, New York 10015

Stock Listing—Common Stock
New York Stock Exchange
Pacific Stock Exchange

Stock Listing—Preferred Stock
New York Stock Exchange
Pacific Stock Exchange

Debenture and Subordinated Note Listing
New York Stock Exchange
Pacific Stock Exchange

Ticker Symbols

Common Stock	WAL
Preferred Stock	WALA
5¼% Debentures	WALK
10% Notes	WAL.

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Annual Meeting
Fourth Thursday in April