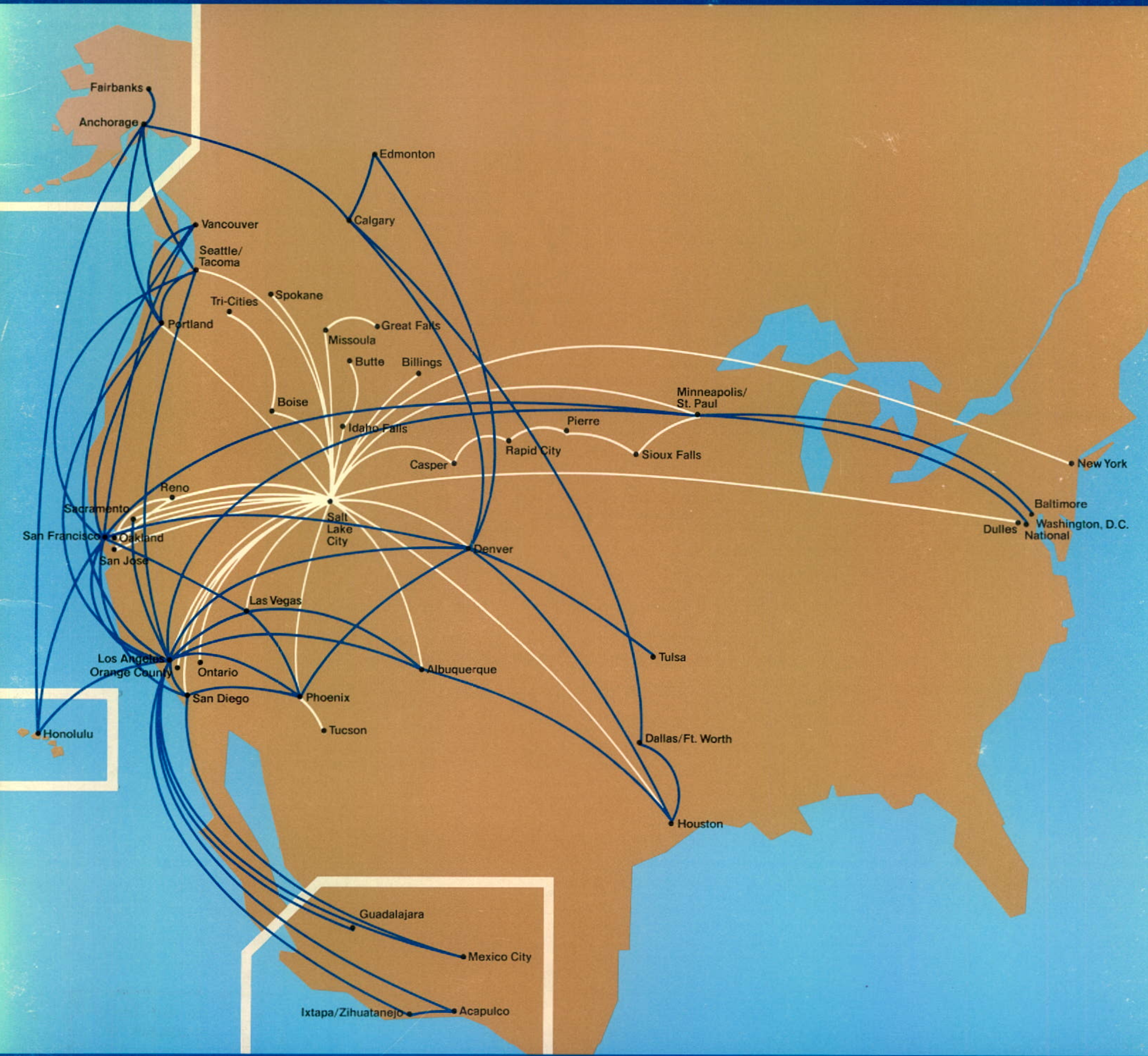
Western Airlines Nineteen Eighty One Annual Report



Our Cover:

On May 1, 1982, Western will launch a major restructuring of its route system. The key feature will be the establishment of a hub-and-spoke operation at Salt Lake City where arrival and departure times of flights will be coordinated to provide connecting services to a broad range of destinations. This system will permit Western to "feed" its flights with passenger and cargo from connecting services and will increase fleet utilization. Routes serving the new hub are shown in white.

WESTERN AIR LINES, INC. 1981 ANNUAL REPORT

Description of Business

Western Air Lines, Inc. is a certificated air carrier originally organized in 1925. The company is engaged in one industry—the scheduled air transportation of passengers, air cargo and mail. It serves cities in the United States, Canada and Mexico.

1981 was a disastrous year for Western Airlines. Capped by a fourth quarter loss of $56.1 million, the largest quarterly deficit in company history, Western experienced a net loss of $73.4 million for the year.

There were a number of reasons for this result: a recession-related slowdown in air travel, excess capacity in the marketplace, rate wars that diluted revenues, and continuing inflation that drove up costs. Hardest hit by these conditions were a number of established carriers like Western that had developed their route systems and their cost structures in the regulated environment that existed prior to October 1978 and had not changed them significantly since that time.

These systems, based almost entirely on point-to-point linear routes, were generally profitable during the era of controlled competition. However, because this type of system does not produce or control connecting traffic, linear routes are vulnerable to competition and rate wars. Compounding the problem for Western was the fact that it had higher costs than many of its competitors, which left the company in the position of either matching competitors fare cuts at a loss or abandoning markets.

When I came to Western Airlines on December 8, I found the company on the verge of collapse. It had lost money for two years and monthly losses had increased at a frightening rate. It was virtually out of cash, and because it was not in compliance with certain tests under its loan agreements, it was unable to borrow additional funds. As a consequence, Western had retained bankruptcy counsel, which the new management team decided was premature. A thorough analysis of the problems showed that in order to survive and prosper Western would have to make major changes in its structure and its way of doing business and that it must develop a strategy that would be responsive to the deregulated environment.

We determined that because of its sizeable fixed costs the company would have great difficulty becoming profitable by shrinking to a new size or shape. Under-utilized aircraft and facilities, which could not be disposed of at anywhere near their true value, would have to be put to more productive use along with Western's employees. In short, we would have to fly our way back into the black by doing more, not less. And in order to do this and survive, we would have to control our costs.

As essential elements of this plan we concluded that we would have to:

- develop a new marketing organization and a more competitive marketing philosophy;
- reduce overhead costs by eliminating excess layers of management, by cutting salaries and by getting more productivity out of those who remain;
- obtain from unionized employees wage cuts and changes in work rules that would increase productivity;
- convince our lenders that we have formulated a workable short-term survival plan and a long-term strategy for profitability in order to obtain

additional working capital and waivers of defaults under existing loan agreements.

Programs to accomplish all of these objectives are well underway.

On May 1, Western will launch the most dramatic route realignment in its history. The new route system will reflect our conviction that the proper role for Western Airlines is as a strong regional carrier serving the West through a strategically located hub and a cohesive pattern of regional service. Our objective is to develop a hub-and-spoke system that will enable us to control a greater share of the passenger and cargo travel that emanates from cities we serve. Western's hub will be at Salt Lake City, a city that is located in a rapidly growing region, is near the center of our route system and is an established Western city in which we have excellent facilities and a long history of service. Most flights from throughout our system will be routed through Salt Lake City where connections will be available to other Western cities.

We will strengthen the hub further by inaugurating service to new cities in the West and to New York City, Baltimore and Washington, D.C.'s Dulles Airport. Our Seattle/Tacoma gateway to Alaska and California gateways to Mexico and Hawaii also will be strengthened by direct links with the Salt Lake City hub.

Implementation of these changes will not require additional aircraft or other major capital expenditures. The realignment will be achieved by increasing the use of existing resources. For example, we will increase the average daily utilization of our fleet by almost two hours per day per aircraft. This figure will rise even more as additional routes and schedules are blended into the new system.

Our marketing strategy will be very simple. We will price our product competitively, provide good schedules and service and make it easy for our customers to do business with us by answering our reservations phones promptly, simplifying our fare structure and making ticketing easier.

In order to be a tough competitor we also must reduce our costs to a level that will permit us to make a profit from the low fares that now dominate and will continue to dominate high-density routes.

Since December, we have been taking the necessary steps to lower Western's costs. We have reduced annual payroll costs for the management staff, have obtained wage concessions from some of our unionized employees and we are attempting to obtain similar concessions from the remaining group. Although our new schedules and contractual concessions from our pilots will provide some gains in productivity, we need more and are working toward that end.

We are confident that the route realignment and our marketing program will stimulate traffic over the Western system and increase revenues. We are not optimistic that we will receive any help from an improvement in the economy in 1982 nor are we relying on such an upswing to make Western profitable, although such a development certainly would be beneficial and welcome.

The key to 1982 and the future of Western Airlines lies in our ability to control our costs and increase the productivity of our work force. We believe that Western can be a viable company. Your management is doing everything possible to ensure that this objective is achieved as soon as possible.

Neil G. Bergt
Chairman and Chief
Executive Officer

April 22, 1982

The Year At A Glance

(in millions of dollars)

	1981	1980	% Change
Operating revenues	**$1,059.8**	995.7	6
Operating expenses	**1,125.8**	1,041.5	8
Operating loss	**(66.0)**	(45.8)	44
Other Income (Expenses):			
Interest expense, net	**(45.0)**	(38.5)	17
Gain on disposition of equipment	**16.9**	32.1	(47)
Other-net	**1.3**	3.0	(57)
Loss before income taxes	**(92.8)**	(49.2)	89
Income tax	**(19.4)**	(19.6)	(1)
Net loss	**$ (73.4)**	(29.6)	148
Passengers carried (000)	**8,402**	9,130	(8)
Available seat miles (000,000)	**14,496**	15,516	(7)
Revenue passenger miles (000,000)	**8,548**	8,832	(3)
Passenger load factor—actual %	**59.0**	56.9	4
—breakeven %	**65.8**	62.0	6

Results of Operations

The last several years have been very difficult for Western. The company reported net losses in 1980 and 1981 and a 24 percent decline in net profits in 1979. Prior to December 1981, when the company's new management embarked on a rebuilding program, the company had responded to this downturn by reducing its production of available seat miles (ASM's) in 1981 and 1980. Since 1979 ASM's have decreased 13 percent; however, revenues escalated 14 percent because of fare increases. This level of revenue growth was not adequate to support the cost base Western had established in the regulated environment. Operating expenses increased 23 percent from the 1979 level, more than offsetting the 14 percent increase in revenues and creating the company's substantial operating losses.

The largest contributor to the rise in operating expenses was fuel costs, which increased 45 percent since 1979. Consumption actually decreased during this period by 21 percent but the average cost per gallon increased 82 percent, from $0.57 in 1979 to $1.04 in 1981. Early in 1982 fuel prices dropped to slightly under $1.00 per gallon. They are expected to remain at this level or decline slightly throughout 1982.

Wages, salaries and employee benefits increased by nearly $47 million from 1979 through 1981 despite the fact that the number of employees decreased by more than 1,100 during that period. The company is currently negotiating with its labor unions to reduce wage levels and increase productivity during 1982. Labor costs for the company in 1982 and subsequent years depend in large part on these negotiations.

Other operating expenses, which are susceptible to inflationary pressures, include costs such as aircraft and ground equipment rentals, advertising and commissions. Commission expense increased 20 percent from 1980 to 1981, reflecting the impact of deregulation on the industry. Because scheduled carriers are no longer permitted to jointly establish travel agency commission rates, competition for the agents' business has forced commission rates up. This has resulted in increasing the commission rate paid by Western to travel agents from an average of 8.9 percent in 1980 to 10.4 percent in 1981. Also, higher fares and increased ticket purchases through agencies have contributed to the rapid growth in commission expense. These conditions are not expected to change in 1982.

New equipment financed at higher interest rates, as well as a higher level of interest rates in general, have resulted in increased interest expense of the company in 1979, 1980, and 1981. Depreciation expense also has increased because of significant equipment purchases. In 1981, sales of aircraft helped maintain the level of depreciation expense despite the acquisition of three new aircraft.

For a detailed discussion of the impact of inflation on operating results see Note 13 to financial statements.

Western's operations have been affected in these years by activities within the industry. In 1981, revenues during the peak season of the third quarter were reduced slightly by the walkout of air traffic controllers on August 3. The grounding of the DC-10 aircraft in 1979 affected operations in that year, as did strikes against major competitors.

Liquidity

During the first six months of 1981 Western was able to fund current operations and debt repayment with cash generated from operations and the sales of excess aircraft. In addition, $30 million of the $50 million outstanding at December 31, 1980, on its revolving line of credit was repaid.

In the second half of 1981, however, traffic and revenues were significantly lower than anticipated. Operations no longer generated enough cash to meet operating requirements. The company borrowed additional funds of $20 million from two foreign banks and $7 million on its revolving line of credit. During that same period, the company also sold and leased back two 737s and sold tax benefits under the provisions of the Economic Recovery Tax Act of 1981, generating cash of approximately $11 million and $5.6 million, respectively. Throughout 1981 Western made all scheduled debt payments and paid preferred dividends regularly.

The effects of the losses on retained earnings and equity resulted in Western's default of some of the covenants of its various loan agreements. Since these defaults allow certain of Western's lenders to demand immediate payment of the total amounts owed to them and because Western has not obtained waivers for a period in excess of one year, a portion of the long-term debt has been classified as current. Decisive steps have been taken by Western to cut its labor force, reduce the wages paid to remaining employees, modify current labor contracts, negotiate the sale of additional assets and negotiate additional loan and security agreements with its various lenders.

Western entered into agreements in January 1982 with its lenders to waive the company's defaults under its loan agreements until June 10, 1982. Western also entered into an agreement with its previously unsecured lenders to secure their loans with 29 of Western's aircraft and 77 of its engines. In addition, the company obtained a $30 million line of credit due April 30, 1982, all of which had been drawn down as of March 15, 1982. (See Note 6 to financial statements.) The company is continuing to negotiate with its lenders to restructure a portion of its debt. This restructuring is essential to the continuing operations of the company. Western has entered into agreements with third parties to sell certain other assets, which will generate approximately $31 million. Western is required to use the proceeds from asset sales to pay off any amounts outstanding on the new line of credit. See Note 14 to financial statements.

Capital Resources

Western has on order six 767 aircraft and three 767 spare engines, the deliveries of which have been delayed until 1984 and 1985. The total commitment for the acquisition of these aircraft and spare engines is approximately $305 million. Long-term secured debt or capital lease financing is expected to be utilized to finance these acquisitions although no assurances can be given that such methods of financing will be available. Western also holds options for the purchase of six additional 767s which would be delivered in 1985 and 1986. (See Note 3 to financial statements.)

Shareholders and Stock

As of December 31, 1981, there were 13,043,621 shares of Western common stock outstanding held by approximately 15,000 individuals and institutions. Holders of the common stock last received a dividend in the third quarter of 1980. Because of continuing losses, Western has not paid a dividend on the common stock since that time. Retained earnings available for payment of common stock dividends are restricted by various debt agreements. At December 31, 1981, no retained earnings were available for dividends on common or preferred stock.

Western has 2,992,300 shares of common stock reserved for issuance upon conversion of its preferred stock and an additional 1,952,554 shares reserved for issuance upon conversion of its 5¼% Convertible Subordinated Debentures.

At December 31, 1981, there were 1,196,920 shares of the $2.00 Series A Cumulative Convertible Preferred Stock outstanding held by 1,353 individuals and institutions who have been paid regular quarterly dividends. On January 29, 1982, Western's board of directors voted to defer payment of the quarterly dividend payable at the end of March 1982 on the preferred stock. This is the first preferred stock dividend to be omitted since the stock was issued in September 1977. If six consecutive dividends are omitted, the holders of the preferred stock have the right, voting as a class, to elect two board members. See Note 6 to financial statements.

Western's common and preferred stock are traded on the New York and Pacific Stock Exchanges.

Market Prices

	Common Stock		Preferred Stock	
1980	**High**	**Low**	**High**	**Low**
First Quarter	11⅝	6	29	19
Second Quarter	7⅞	6¼	23⅛	19
Third Quarter	8¾	6	24¾	21¾
Fourth Quarter	10	6¾	25	20⅝
1981				
First Quarter	10½	8	26½	21
Second Quarter	11⅞	8½	30	22⅛
Third Quarter	11¾	6	29¼	15⅝
Fourth Quarter	8⅛	4⅝	20¾	14

On December 8, 1981, the Board of Directors of Western elected Neil G. Bergt as Chairman and Chief Executive Officer. Bergt is a principal shareholder of Eagle International Corporation (Eagle), a privately held corporation which agreed in November 1981 to acquire Wien Air Alaska, Inc., (Wien) from Household International, Inc.

In connection with Bergt's selection as Chief Executive Officer, Western, Eagle, and Mr. Bergt signed an agreement in principle dated December 8, 1981, regarding (a) Eagle completing its acquisition of Wien, and (b) the preparation and execution of a definitive agreement pursuant to which Western shall acquire Wien or a business combination shall otherwise be accomplished between Western and Wien.

The letter of intent indicates that in connection with the acquisition by Western of Wien, 5,000,000 shares of a new series of preferred stock of Western or the surviving corporation (the "Preferred Stock") will be issued to Eagle or its shareholders. The Preferred Stock will be convertible into 12,500,000 shares of common stock and will be substantially equivalent to the outstanding Western Series A Preferred Stock, except that it will have voting rights equivalent to those of the common shares issuable upon conversion and no dividends will be payable in respect of the Preferred Stock for the first year after it is issued.

The proposed acquisition will be subject to approval of Western's shareholders, lenders, and the Civil Aeronautics Board.

Regulatory Matters

The required filings in the Bergt-AIA-Western-Wien Acquisition and Control Case have been made with the Civil Aeronautics Board, and the board's decision should be announced by the end of July 1982. Details of this proposed acquisition, which is subject to approval of Western's shareholders and lenders, are contained in proxy materials being mailed to shareholders in connection with the 1982 Annual Meeting of shareholders, presently scheduled for June 1982.

The Civil Aeronautics Board has approved Air Florida System, Inc.'s application to acquire control of Western. Air Florida had filed its application with the CAB in July 1981 and been given permission to purchase up to 50 percent of Western's outstanding common stock to be placed in a voting trust pending the outcome of the CAB's hearings. The final CAB decision in the matter was announced January 29, 1982. Air Florida, which holds approximately 12.6 percent of Western's common stock, has not announced its intentions.

Western's planned merger with Continental Air Lines, Inc. was thwarted by the successful takeover of that carrier by Texas International. Western withdrew from the merger agreement in September 1981.

With the suspension of its services to Great Britain in late 1981 and to Nassau, the Bahamas, earlier in the year, Western now serves three countries—the United States, Canada, and Mexico. In its service to Canada and Mexico, Western is subject to conditions of bilateral agreements between these nations and the United States as well as to policies of each of the governments with respect to air transportation and pricing.

Service within the United States has been given increased flexibility since the passage of the Airline Deregulation Act of 1978. Effective January 1, 1982, Western and other air carriers have authority to fly between any points within the U.S. that they desire. However, the air traffic controllers strike has temporarily limited flights at 22 busy airports in the U.S.

Under terms of the Deregulation Act, the Civil Aeronautics Board will cease to exist January 1, 1985. Certain of the Board's functions will be transferred to other governmental departments, primarily the Departments of Transportation and Justice.

Western's Fleet

	In Operation* Owned	In Operation* Leased	1984/1985 Delivery	1985/1986 Options
DC-10-10	7	3		
DC-10-30		1		
727-200	33	14		
737-200	10	2		
767-200			6	6

*As of March 15, 1982.

Western's present fleet is in compliance with federal noise regulations with the exception of the two-engine 737s. An undetermined number of these aircraft will be retrofitted at a cost of approximately $275,000 each in advance of the 1985 deadline for compliance.

Schedule reductions in 1981 caused Western's traditionally high level of aircraft utilization to drop. The 727s, which represent more than half of the company's available seat miles, flew a daily hourly average of 7:58, down from 8:23 in 1980, while DC-10-10 utilization was down to 9:18 from 10:46 in 1980. Average daily hours flown by all aircraft during 1981 was 7:57, compared with 8:24 the year before.

Ground Properties and Equipment

Western's general office and principal overhaul and maintenance base are located at Los Angeles International Airport. These facilities, including a DC-10 hangar and a parking structure completed in 1975, have been built by the company as improvements on leased land. The lease on the land and buildings expires in 1993, subject to the right of the City of Los Angeles to terminate the lease on March 31, 1988, or any March 31 thereafter.

The company also leases hangars at Seattle/Tacoma, San Francisco and Minneapolis/St. Paul, as well as terminal facilities at all airports served, plus ticket and administrative offices throughout its system. A leasehold interest in a hangar at Denver was transferred to another carrier in March 1982. Public airports are utilized for flight operations generally under contractual arrangements with municipalities or agencies controlling them.

Western's Management

Major changes took place in Western's management structure during the latter part of 1981 and early 1982.

On December 8, 1981, Neil G. Bergt was elected chairman and chief executive officer of Western. Mr. Bergt, 46, is chairman and sole owner of Alaska International Industries, Inc., which has subsidiaries active in construction, energy development and international air cargo. He also is the principal shareholder of Eagle International Corporation, a privately held corporation that was formed in November 1981 to acquire Wien Air Alaska Inc. from Household International, Inc.

Employees

The number of Western employees during 1981 averaged 10,120, down from an average of 10,657 in 1980. Labor unions represent approximately 92 percent of Western's employees. These unions include the Air Line Pilots Association, Air Transport Employees, 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:

	Number of Employees 1-1-82	Union	Contract Open for Amendment
Mechanics & Related Employees and Stock Clerks	1,810	IBT	1-1-83
Pilots	1,271	ALPA	5-1-84
Flight Attendants	1,677	AFA	12-31-82
Agent & Clerical—			
U.S.	3,740	ATE	7-1-82
Canada	110	BRAC	7-1-82
Mexico	212	SNTA	1-18-83
Flight Superintendents	21	TWU	10-31-83
Ground School Instructors	30	IBT	1-1-83

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 $57 million. 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, O'Melveny & Myers of Los Angeles, believe 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, 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 the company.

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. In light of this litigation, operators of certain airports, including those at Los Angeles, Orange County, San Diego, Calif., and Washington, D.C.'s National, 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 specified noise standards. In the case of Orange County, the local board of supervisors adopted an airport access plan for John Wayne Airport which would have the effect of denying Western access to that airport. Implementation of the plan was enjoined by a Federal District Court and that decision presently is on appeal. Generally speaking, enforcement of such restrictions at a major airport served by Western could have a materially adverse effect upon its operations.

A number of actions have been filed in both federal and state courts against Western and other defendants seeking damages for death or injury suffered in the October 31, 1979, crash of a Western aircraft at the Mexico City airport. Western has ample insurance coverage for this type of accident, although insurance may not cover liability for punitive damages which are sought in several of the actions premised on bodily injury. Most of the claims arising from the accident have been settled, and Western does not believe that such claims for punitive damages will result in any material liability to Western.

Western is also involved in various other litigation, including cases alleging discrimination (including age discrimination) in employment practices. In one such action involving the ability of Western pilots to continue after age 60 as second officers, a judgment was entered during 1981 directing the company to allow three pilots to continue working as second officers after age 60 and awarding those pilots back pay and attorneys fees. That case presently is on appeal, and at least one other similar action has been filed. Western does not believe such claims will result in any material liability to Western.

TEN YEARS OF WESTERN PERFORMANCE
SELECTED FINANCIAL DATA

(In millions except per share amounts and other items indicated by *)

		1981	1980
Summary of Operations			
Operating Revenues:			
Passenger	$	949.6	887.9
Cargo, charter, and other		110.2	107.8
Total operating revenues		1,059.8	995.7
Operating Expenses:			
Wages, salaries, and employee benefits		403.4	384.2
Fuel		326.6	296.4
Other[a]		395.8	360.9
Total operating expenses		1,125.8	1,041.5
Operating income (loss)		(66.0)	(45.8)
Interest expense, net		(45.0)	(38.5)
Other income, net		18.2	35.1
Earnings (loss) before income taxes and cumulative effect of changes in accounting principles		(92.8)	(49.2)
Income taxes		(19.4)	(19.6)
Earnings (loss) before cumulative effect of changes in accounting principles		(73.4)	(29.6)
Cumulative effect of changes in accounting principles		—	—
Net earnings (loss)		(73.4)	(29.6)
Preferred stock dividends		2.4	2.4
Net earnings (loss) available for common stock	$	(75.8)	(32.0)
Earnings (Loss) per Common Share:			
Primary:			
Before cumulative effect of changes in accounting principles	$	(5.81)	(2.46)
Net earnings (loss)	$	(5.81)	(2.46)
Fully diluted:			
Before cumulative effect of changes in accounting principles	$	(5.81)	(2.46)
Net earnings (loss)	$	(5.81)	(2.46)
Number of Shares Used to Compute Earnings (Loss) per Share:			
Primary		13.0	13.0
Fully diluted		13.0	13.0
Other Financial Data			
Cash dividends paid per share of common stock	$	—	0.25
Total assets	$	834.6	917.0
Property and equipment—net	$	662.4	718.8
Long-term obligations	$	248.5	435.1
Shareholders' equity	$	121.7	197.3
Operations			
Airplanes operated at end of year*		70	71
Passengers carried		8.4	9.1
Available seat miles		14,495.8	15,515.6
Revenue passenger miles		8,547.9	8,832.1
Passenger load factor—actual (%)*		59.0	56.9
—breakeven point (%)*		65.8	62.0
—profit margin (point difference)*		(6.8)	(5.1)
Average revenue per passenger mile*	$	.1113	.1010
Average length in miles per passenger trip*		1,017	965
Operating expense per available seat mile*	$	.0777	.0671
Cargo revenue ton miles		151.3	163.2
Average number of employees*		10,120	10,657

NOTES APPLICABLE TO FIVE YEARS ENDED DECEMBER 31, 1981

(in millions of dollars except per share amounts)

(a) Changes in the estimated useful lives of certain aircraft were implemented in January 1978 and October 1976. These changes increased net income in 1978 and 1977 by approximately $1.5, or $0.12 per share (primary), and $2.4, or $0.19 per share (primary), respectively.

1979	1978	1977	1976	1975	1974	1973	1972
827.7	734.0	614.6	544.2	465.1	437.3	376.7	342.9
104.4	100.5	76.9	61.0	53.9	51.1	44.6	31.1
932.1	834.5	691.5	605.2	519.0	488.4	421.3	374.0
356.6	309.4	263.1	226.4	201.7	182.3	165.4	147.3
225.7	154.9	138.0	108.3	93.1	71.4	44.5	40.1
331.6	315.3	260.9	235.1	211.1	192.5	168.3	160.8
913.9	779.6	662.0	569.8	505.9	446.2	378.2	348.2
18.2	54.9	29.5	35.4	13.1	42.2	43.1	25.8
(24.9)	(20.2)	(17.5)	(16.3)	(14.4)	(15.3)	(13.0)	(11.8)
46.1	10.7	7.8	3.1	4.3	13.8	4.2	2.7
39.4	45.4	19.8	22.2	3.0	40.7	34.3	16.7
(2.1)	6.9	7.1	8.2	(1.5)	17.2	14.4	5.9
41.5	38.5	12.7	14.0	4.5	23.5	19.9	10.8
—	16.2[b]	—	—	7.2	—	—	—
41.5	54.7	12.7	14.0	11.7	23.5	19.9	10.8
2.4	2.4	0.5	—	—	—	—	—
39.1	52.3	12.2	14.0	11.7	23.5	19.9	10.8
2.99	2.82	0.96	1.03	0.30	1.55	1.32	0.72
2.99	4.09	0.96	1.03	0.77	1.55	1.32	0.72
2.31	2.15	0.85	0.92	0.29	1.38	1.18	0.66
2.31	3.04	0.85	0.92	0.70	1.38	1.18	0.66
13.1	12.8	12.7	13.6	15.2	15.1	15.1	15.0
18.2	18.2	15.9	16.1	17.6	17.6	17.5	17.5
0.40	0.40	0.40	0.40	0.47	0.39	0.23	0.08
821.4	710.1	574.9	515.1	488.3	448.8	431.7	372.7
634.6	519.7	427.9	378.6	367.6	350.3	316.4	262.1
318.3	265.7	214.5	192.5	175.4	167.4	178.0	158.6
232.6	198.5	147.4	112.1	133.9	129.3	110.8	94.4
76	78	77	75	75	72	74	71
11.2	10.4	8.8	8.1	7.5	7.4	7.4	6.9
16,630.5	16,254.9	14,963.8	13,450.4	11,696.5	11,123.5	11,175.5	10,300.2
10,494.8	10,634.8	8,588.8	7,833.8	7,102.9	6,747.5	6,476.1	5,995.9
63.1	65.4	57.4	58.2	60.7	60.7	57.9	58.2
63.2	61.1	56.1	56.0	59.7	56.1	52.5	54.6
(0.1)	4.3	1.3	2.2	1.0	4.6	5.4	3.6
.0807	.0720	.0734	.0705	.0665	.0660	.0593	.0578
926	994	966	963	942	902	877	865
.0550	.0480	.0442	.0424	.0433	.0401	.0338	.0338
162.0	176.3	157.3	135.0	108.6	95.2	76.5	76.2
11,256	10,787	10,413	9,799	9,357	9,696	9,826	9,383

(b) Effective January 1, 1978, Western changed its method of accounting for post-1971 investment credits for financial reporting purposes from the deferral to the flow-through method. The cumulative effect of the change, amounting to $16.2, has been included in net earnings for 1978.

WESTERN AIR LINES, INC.
BALANCE SHEETS

December 31, 1981 and 1980
(in thousands of dollars)

	1981	1980
ASSETS		
Current Assets:		
Cash (Note 6)	**$ 24,057**	8,759
Temporary investments	**—**	25,579
	24,057	34,338
Receivables (less allowance for doubtful accounts of $2,959—1981 and $2,379—1980)	**89,311**	121,859
Receivable from sale of aircraft (Note 11)	**20,212**	—
Flight equipment expendable parts at average cost (less allowance for obsolescence of $15,422—1981 and $14,062—1980)	**20,953**	26,908
Prepaid expenses and other current assets	**12,646**	8,025
Total current assets	**167,179**	191,130
Property and Equipment at Cost (Notes 2, 3, and 6):		
Flight equipment	**828,276**	848,111
Facilities and ground equipment	**139,400**	130,703
Deposits on equipment purchase contracts	**21,508**	37,966
	989,184	1,016,780
Less allowance for depreciation and amortization	**326,737**	297,962
	662,447	718,818
Deferred Charges and Other Assets	**4,944**	7,100
	$834,570	917,048

See accompanying notes to financial statements.

	1981	1980
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities:		
Current portion of debt (Note 6)	**$ 26,650**	23,756
Current portion of capital leases (Note 2)	**7,962**	7,183
Notes payable (Note 6)	**20,000**	—
Long-term debt classified as current (Note 6)	**153,369**	—
Accounts payable	**76,504**	58,965
Airline traffic liability	**81,006**	90,058
Salaries, wages and vacation benefits payable	**41,838**	43,624
Accrued liabilities	**24,460**	22,947
Total current liabilities	**431,789**	246,533
Long-term Obligations:		
Debt (Note 6)	**149,331**	353,525
Capital leases (Notes 2 and 6)	**99,184**	81,526
	248,515	435,051
Deferred Credits and Other Liabilities:		
Deferred taxes on income (Note 5)	**11,002**	29,067
Deferred gain on sale and lease back of aircraft (Note 11)	**9,335**	—
Other	**12,265**	9,051
	32,602	38,118
Shareholders' Equity (Notes 6, 7, and 9):		
Preferred stock—authorized 25,000,000 shares $2.00 Series A Cumulative Convertible $25.00 stated value per share Issued 1,196,920—1981 and 1,196,940—1980	**29,923**	29,923
Common stock—authorized 35,000,000 shares $1.00 par value per share Issued 13,043,621—1981 and 13,030,915—1980	**13,044**	13,031
Additional paid-in capital	**31,062**	30,963
Retained earnings	**47,635**	123,429
	121,664	197,346
Commitments and Contingent Liabilities (Notes 2 and 3)		
	$834,570	917,048

STATEMENTS OF OPERATIONS

Years ended December 31, 1981, 1980 and 1979
(in thousands of dollars except per share amounts)

	1981	1980	1979
Operating Revenues:			
Passenger	$ **949,576**	887,901	827,675
Cargo	**62,983**	63,821	61,209
Charter and other	**47,282**	44,033	43,235
	1,059,841	995,755	932,119
Operating Expenses:			
Wages, salaries, and employee benefits (Note 4)	**403,428**	384,201	356,621
Fuel	**326,606**	296,365	225,682
Depreciation and amortization	**63,632**	61,310	50,058
Other	**332,129**	299,640	281,522
	1,125,795	1,041,516	913,883
Operating income (loss)	**(65,954)**	(45,761)	18,236
Other Income (Expenses):			
Interest, principally on long-term obligations	**(49,836)**	(43,507)	(29,600)
Interest capitalized	**4,805**	4,940	4,706
Interest income	**4,641**	3,168	4,957
Gains on disposition of equipment	**16,869**	32,099	31,332
Settlement with vendor	**—**	—	10,000
Other, net (Note 11)	**(3,333)**	(178)	(192)
	(26,854)	(3,478)	21,203
Earnings (loss) before income taxes	**(92,808)**	(49,239)	39,439
Income taxes (Note 5)	**(19,408)**	(19,607)	(2,101)
Net earnings (loss)	$ **(73,400)**	(29,632)	41,540
Earnings (Loss) per Common Share (Note 8):			
Primary	$ **(5.81)**	(2.46)	2.99
Fully diluted	$ **(5.81)**	(2.46)	2.31

See accompanying notes to financial statements.

STATEMENTS OF CHANGES IN FINANCIAL POSITION

Years ended December 31, 1981, 1980 and 1979
(in thousands of dollars)

	1981	1980	1979
Sources of Working Capital:			
Earnings (loss)	**$ (73,400)**	(29,632)	41,540
Add (Deduct) Items Which did not Affect Working Capital:			
Depreciation and amortization	**61,780**	60,146	49,581
Deferred income taxes	**(18,617)**	(21,219)	(4,788)
Gains on disposition of equipment	**(16,869)**	(32,099)	(31,332)
Other	**(4,005)**	(3,557)	(4,706)
Total provided (used) by operations	**(51,111)**	(26,361)	50,295
Reimbursements of deposits and capital expenditures upon acquisition of aircraft	**15,457**	10,746	10,563
Proceeds from disposition of equipment	**61,208**	50,120	50,950
Proceeds from issuance of long-term obligations	**73,212**	198,350	104,941
Other, net	**4,000**	172	(5,097)
Total sources	**102,766**	233,027	211,652
Applications of Working Capital:			
Purchase of and deposits on property and equipment	**49,810**	171,123	182,752
Reduction of long-term obligations including transfers to current liabilities	**106,400**	81,667	52,402
Long-term debt classified as current (Note 6)	**153,369**	—	—
Cash dividends	**2,394**	5,652	7,604
Total applications	**311,973**	258,442	242,758
Decrease in working capital	**$(209,207)**	(25,415)	(31,106)
Summary of Increases (Decreases) in Working Capital:			
Cash and temporary investments	**$ (10,281)**	(15,975)	(21,147)
Receivables—trade	**(32,548)**	16,568	13,252
—from sale of aircraft	**20,212**	—	—
Expendable parts and prepaid expenses	**(1,334)**	9,143	3,718
Current liabilities—long-term debt classified as current	**(153,369)**	—	—
—other	**(31,887)**	(35,151)	(26,929)
Decrease in working capital	**$(209,207)**	(25,415)	(31,106)

See accompanying notes to financial statements.

STATEMENTS OF SHAREHOLDERS' EQUITY

Years ended December 31, 1981, 1980 and 1979

(In thousands of dollars)

	Preferred Stock $25.00 Stated Value	Common Stock $1.00 Par Value	Additional Paid-in Capital	Retained Earnings	Total Shareholders' Equity
Balance at January 1, 1979	$29,923	13,010	30,792	124,777	198,502
Exercise of stock options		17	132		149
Conversion of debentures		3	35		38
Net earnings				41,540	41,540
Cash Dividends:					
Preferred stock				(2,394)	(2,394)
Common stock				(5,210)	(5,210)
Balance at December 31, 1979	29,923	13,030	30,959	158,713	232,625
Conversion of debentures		1	4		5
Net loss				(29,632)	(29,632)
Cash Dividends:					
Preferred stock				(2,394)	(2,394)
Common stock				(3,258)	(3,258)
Balance at December 31, 1980	29,923	13,031	30,963	123,429	197,346
Exercise of stock options		12	90		102
Conversion of debentures		1	9		10
Net loss				(73,400)	(73,400)
Cash Dividends:					
Preferred stock (Note 9)				(2,394)	(2,394)
Balance at December 31, 1981 (Notes 6, 7, and 9)	$29,923	13,044	31,062	47,635	121,664

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

Owned property and equipment, exclusive of residual values, are depreciated over the estimated useful lives by the straight-line method. Assets recorded under capital leases are depreciated over the life of the lease by the straight-line method. The estimated useful lives and residual values of owned aircraft are as follows:

	Estimated Useful Life	Residual Value
DC-10	16 years	10%
727	15 years	15%
737	14 years	15%

Estimated useful lives of ground equipment range from four to ten years. Buildings and improvements on leased property are depreciated over the life of the lease. Depreciation expense for assets recorded under capital leases is included in depreciation and amortization expense.

Interest Capitalized

Certain interest costs, primarily related to deposits on aircraft purchase contracts, are capitalized and amortized over the lives of the related assets.

Investment Credits

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

Obsolescence of Expendable Parts

An allowance for obsolescence of expendable parts is accrued over the estimated 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 billed by other carriers for transportation provided by them.

Note 2. Lease Commitments

Western leases certain flight equipment and facilities and ground equipment. Lease terms for flight equipment are 11½ to 15 years for 727 aircraft, 4 years for 737 aircraft, and 15 to 18 years for DC-10 aircraft. Lease terms for facilities and ground equipment range up to 29 years. Interest expense is accrued on the basis of the outstanding obligations under capital leases. Equipment under capital leases included in the balance sheets at December 31, 1981 and 1980, follows:

	1981	1980
Flight equipment	**$137,283**	113,219
Ground equipment	**2,006**	2,006
	139,289	115,225
Less allowance for depreciation	**57,501**	49,028
	$ 81,788	66,197

At December 31, 1981, minimum lease payments under leases expiring after December 31, 1982, were as follows:

	Capital Leases	**Operating Leases**
1982	**$ 20,451**	**22,619**
1983	**20,399**	**21,429**
1984	**19,969**	**19,588**
1985	**15,784**	**16,223**
1986	**15,790**	**12,784**
Thereafter	**100,113**	**106,688**
Total minimum lease payments	**192,506**	**199,331**
Less: Amount representing interest	**85,360**	
Present value of obligations—capital leases	**107,146**	
Less: Current portion of capital leases	**7,962**	
Long-term obligations—capital leases	**$ 99,184**	

See the second and third paragraphs of Note 6 regarding defaults and potential payment acceleration.

Rental expense for operating leases amounted to $25,967, $20,050, and $17,384 in 1981, 1980, and 1979, respectively.

Note 3. Commitments and Contingent Liabilities

At December 31, 1981, Western had on firm order flight equipment which included six 767-200 aircraft scheduled for delivery in 1984 and 1985 and three 767 engines scheduled for delivery in 1984. Western recorded advance deposits on these orders which amounted to $15,799 as of December 31, 1981. The balance of the purchase price on delivery will be approximately $288,700.

Outstanding commitments for flight equipment modification and spare parts amounted to approximately $3,300 and for facilities and ground equipment amounted to approximately $1,100 as of December 31, 1981.

Western has options to purchase six 767-200 aircraft for delivery in 1985 and 1986. Deposits on these options amounted to $1,125 at December 31, 1981.

For information regarding the status of legal proceedings at December 31, 1981, see "Legal Proceedings" on pages 8 and 9 of this report.

Note 4. Retirement Plans

Western has retirement plans, including a union-sponsored plan, which cover substantially all employees. Western's contributions to the Company-sponsored plans, together with the participants' required contributions, are sufficient to fund current service costs annually and prior service costs over ten to twenty years. Actuarial gains and losses are amortized over ten year periods.

Western participates in a collectively bargained multi-employer pension plan and is therefore subject to the provisions of the Multi-employer Pension Plan Amendments Act of 1980. Under this complex law the union plan Board of Trustees, as sponsor, is required to obtain an actuarial valuation of the present value of vested and nonvested accumulated plan benefits. Western has been advised that its share of the liability for unfunded vested benefits in this plan is not available. Accordingly, the table that follows excludes data applicable to this multi-employer pension plan.

A comparison of accumulated plan benefits and plan net assets for the Company-sponsored defined benefit plans follows:

	January 1,		
	1981	1980	1979
Actuarial Present Value of Accumulated Plan Benefits:			
Vested	**$140,331**	137,246	114,597
Nonvested	**11,984**	9,876	9,015
	$152,315	147,122	123,612
Net assets available for benefits	**$163,995**	139,000	111,559

The weighted average assumed rate of return used in determining the actuarial present value of accumulated plan benefits was six percent for all years.

The cost of the retirement plans, including the union-sponsored plan, charged to operating expense, was $34,711, $34,193 and $30,304 for 1981, 1980 and 1979, respectively, which included amortization of prior service costs over periods ranging from ten to twenty years for certain of the plans.

Note 5. Income Taxes

Income taxes are summarized as follows:

	1981	1980	1979
Current			
Federal:			
Provision	**$ —**	(3,647)	18,901
Investment credits applied	**—**	5,751	(17,792)
	—	2,104*	1,109*
State	**(791)**	(492)	1,578
Deferred:			
Provision	**(12,974)**	(5,073)	(5,597)
Operating loss carryforward recognized	**(5,091)**	(15,533)	—
Investment Credits:			
Applied	**—**	5,697	(16,420)
Transferred to current	**—**	(5,751)	17,792
	(18,065)	(20,660)	(4,225)
Amortization of deferred investment credits	**(552)**	(559)	(563)
	$ (19,408)	(19,607)	(2,101)

*The Tax Reform Act of 1976 provided for 90% application of unapplied investment credits against Federal income tax liabilities for 1979. This application was reduced to 80% for 1980. Under the Revenue Act of 1978 the application remains at 80% in 1981 and returns to 90% for 1982 and beyond.

Deferred income taxes arise from timing differences between financial and tax reporting. The effects of these differences on income taxes are as follows:

	1981	1980	1979
Depreciation and amortization	**$ (13,409)**	(3,454)	(4,825)
Sale of tax benefits	**2,560**	—	—
Capital leases	**(1,754)**	(1,084)	(114)
Interest capitalized	**1,183**	1,140	1,903
Employee benefits	**(847)**	(718)	(1,626)
Other	**(707)**	(957)	(935)
	$ (12,974)	(5,073)	(5,597)

Reconciliations of income taxes at the United States statutory rate to the provision for income taxes follow:

	1981	1980	1979
Income taxes at the United States statutory rate	$ (42,692)	(22,650)	18,142
Increases (reductions) in taxes resulting from:			
Effect of operating loss carryforward for which no tax credit may be recognized	24,490	–	–
Amortization of deferred investment credits	(552)	(559)	(563)
Investment credits recognized on flow-through method	—	5,697	(16,420)
State income taxes net of federal income tax benefit	(427)	(266)	852
Capital gains	—	–	(3,800)
Other	(227)	(1,829)	(312)
Income taxes	$ (19,408)	(19,607)	(2,101)

A net operating loss carryforward of $98,400 has not been utilized on tax returns. For income tax purposes, $34,100 expires in 1995 and $64,300 expires in 1996. For financial statement purposes, $53,200 of the carryforward has not been recognized and expires in 1996.

Investment credits available to reduce future years' Federal income tax liability for financial and tax purposes amount to $23,000 at December 31, 1981. For income tax purposes, $5,800 expires in 1994, $16,200 expires in 1995, and $1,000 expires in 1996.

In November 1981 tax benefits were sold under the provisions of the Economic Recovery Tax Act of 1981. The proceeds from this sale of $5,565 are included in Other income (expenses) on the statements of operations.

Note 6. Debt

At December 31, 1981 and 1980 long-term debt included:

	1981	1980
9.55% equipment trust certificates due May 1, 1993, with semi-annual principal payments of $3,458	$ 79,525	86,440
10% equipment trust certificates due April 1, 1994, with quarterly principal payments of $1,000	48,992	52,991
Floating-rate equipment trust certificates due June 30, 1995, with semi-annual principal payments of $2,609 starting June 30, 1984	60,000	60,000
13.29% installment notes due May 1, 1995, with semi-annual principal payments of $1,100	29,700	31,900
Revolving credit notes	27,000	50,000
5¼% installment notes due September 1, 1981	—	4,000
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	21,000	23,000
7¾% installment notes due May 4, 1986, with semi-annual principal payments of $352 starting November 4, 1981	3,165	2,869
Notes payable to manufacturers, ¼% above prime and 8¾%, payable in varying installments to 1985	27,166	29,844
5¼% convertible subordinated debentures due February 1, 1993, with annual sinking fund payments of $1,500 starting in 1983	22,552	23,562
10% subordinated sinking fund notes due April 15, 1984, with annual sinking fund payments of $2,300	10,250	12,675
	329,350	377,281
Less: Current portion	(26,650)	(23,756)
Long term amounts classified as current	(153,369)	–
	$ 149,331	353,525

The revolving credit notes represent borrowings under the 1978 Amended and Restated Bank Loan Agreement. This line of credit was reduced to $27,000 in 1981 and extends to June 30, 1982, at which date it may be replaced by term notes. The term notes are due June 30, 1990, with quarterly payments starting September 30, 1982. The interest rate at December 31, 1981, was 105% of prime commercial rate on $15,000 (domestic loans) and 13.2% on $12,000 (Eurodollar loans). Although the 1978 Bank Loan Agreement does not require compensating balances, Western had on deposit with its banks until November 1981 non-interest bearing certificates of deposit of approximately $2,500. Since November 1981, no compensating balances have been maintained.

Western's various debt agreements contain requirements pertaining to working capital, liquid assets, and net worth levels, as well as restrictions on amounts of cash dividends and creation of rental liabilities and additional debt. At December 31, 1981, Western was not in compliance with some of these requirements. This non-compliance resulted in technical non-compliance with certain other debt agreements. Western may not resume the payment of cash dividends on its common stock, which were discontinued in 1980, nor may it pay dividends on its preferred stock, until certain of the financial tests referred to above have been met.

The agreements with which Western was not in compliance at December 31, 1981, include provisions whereby the lenders may, at their option, accelerate the scheduled maturities. Western has not obtained waivers of these defaults for a period in excess of one year. Therefore, a portion of the long-term debt has been classified as current obligations.

All of Western's long-term obligations, including all capital leases, contain provisions by which the lenders may accelerate scheduled maturities if Western fails to make any required payment on its obligations. As of December 31, 1981, and March 15, 1982, Western had met all required payments of its obligations.

In January 1982, Western entered into agreements with its revolving credit note lenders and certain insurance companies to create short-term loans of up to $30,000. As of March 15, 1982, the entire $30,000 had been received by Western. This loan is due no later than April 30, 1982. The interest rate on funds borrowed is equal to 105% of the agent bank's prime commercial rate. As part of the new short-term loan agreement, the interest rate on previously issued 6⅝% installment notes was increased to 105% of prime while any part of the new short-term notes is outstanding. The commitment fee under the new short-term loans is ½% per annum on the average daily unused portion of the $30,000.

As part of the January 1982 short-term loan, Western was granted waivers on its existing defaults until June 10, 1982. Also granted was forbearance from acceleration and collection of previously unsecured debt. In connection with these arrangements, Western provided security on existing and new debt in the form of a chattel mortgage. The chattel mortgage grants a first priority security interest in 29 aircraft and 77 aircraft engines to the previously unsecured lenders. The net book value of the aircraft and engines encumbered was $141,467 at December 31, 1981. The amount of collateral must be maintained at specified levels until substantially all of Western's debt has been repaid. Western anticipates that following the lenders' evaluation in March 1982 of an appraisal of the existing collateral, additional collateral may be required.

Equipment trust certificates and 13.29% installment notes outstanding at December 31, 1981, are secured by aircraft and engines with a net book value of $255,310 at December 31, 1981. In addition, two holders of equipment trust certificates who are also participants in the new short-term loans referred to above are also collateralized by the chattel mortgage as described above.

The following schedule shows the amount of long-term debt due in each of the five following calendar years, excluding such amounts, if any, which may be due on acceleration, as described above:

1982	$26,650	1984	$50,977	1986	$23,561
1983	29,618	1985	31,771		

During September 1981, Western entered into agreements with two foreign banks for lines of credit up to $10,000 each. In connection with these credit lines, $20,000 was outstanding under demand notes at December 31, 1981. The interest rate on these demand notes, outstanding at December 31, ranged from 17.8% to 13.2% during the outstanding period in 1981. These demand notes also became secured by the collateralization of loans referred to above.

Note 7. Stock Options

Western has a non-qualified stock option plan adopted in 1974 for officers and key personnel. This plan provides for options to purchase a maximum of 1,030,000 shares of Western's common stock at prices not less than the fair market value of the stock at date of grant. The options are exercisable in equal annual increments over a five-year period. The options expire ten years after the date of grant. A summary of activity in the plan follows:

	Number of Shares	Average Price
Options granted and outstanding at December 31, 1978	**790,835**	**$8.56**
Options granted	**71,000**	**8.62**
Options exercised	**(17,630)**	**8.47**
Options cancelled or expired	**(6,550)**	**9.12**
Options granted and outstanding at December 31, 1979	**837,655**	**8.56**
Options granted	**21,500**	**7.27**
Options cancelled or expired	**(12,500)**	**8.65**
Options granted and outstanding at December 31, 1980	**846,655**	**8.53**
Options granted	**12,500**	**9.29**
Options exercised	**(12,050)**	**8.46**
Options cancelled or expired	**(84,430)**	**8.49**
Options granted and outstanding at December 31, 1981	**762,675**	**$8.55**
Options Exercisable at:		
December 31, 1981	**697,319**	**$8.57**
December 31, 1980	**683,493**	**$8.63**

At December 31, 1981, 200,210 shares (128,280 shares at December 31, 1980) were reserved for the issuance of future grants.

Note 8. Earnings (Loss) per Common Share

Earnings (loss) per common share is calculated as follows:

	1981	1980	1979
Adjustment of Net Earnings (Loss)			
Primary:			
Net earnings (loss)	**$(73,400)**	(29,632)	41,540
Preferred stock cash dividends	**(2,394)**	(2,394)	(2,394)
Net earnings (loss) available for common stock	**(75,794)**	(32,026)	39,146
Fully Diluted:			
Net earnings (loss)	**$(73,400)**	(29,632)	41,540
Preferred stock cash dividends	**(2,394)**	(2,394)	—
Reduction in interest expense, net of income taxes, for the assumed conversion of 5¼% convertible subordinated debentures	*	*	653
Adjusted net earnings (loss) assuming full dilution	**$(75,794)**	(32,026)	42,193

	1981	1980	1979
Adjustment of Shares Outstanding (in thousands)			
Primary:			
Weighted average shares outstanding	**13,037**	13,031	13,026
Assumed exercise of stock options	*	*	58
Total average common shares for primary	**13,037**	13,031	13,084
Fully Diluted:			
Weighted average shares outstanding	**13,037**	13,031	13,026
Assumed conversion of subordinated debentures	*	*	2,073
Assumed conversion of preferred stock	*	*	2,992
Assumed exercise of stock options	*	*	146
Total average common shares assuming full dilution	**13,037**	13,031	18,237
Earnings (Loss) per Common Share:			
Primary	**$ (5.81)**	(2.46)	2.99
Fully diluted	**$ (5.81)**	(2.46)	2.31

*The exercise of stock options and conversion of the convertible subordinated debentures and/or the preferred stock into common shares has not been assumed, since the effect of such an assumption would be anti-dilutive.

Note 9. Preferred Stock

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, and may be redeemed in whole or in part at any time at the option of Western. The redemption price of $26.20 at December 31, 1981, decreases periodically until 1987 after which it remains at $25.00 per share. The preference on liquidation is at the stated value plus all accrued and unpaid dividends.

On January 29, 1982, the Board of Directors voted to defer payment of the preferred cash dividend of $0.50 per share payable at the end of March 1982 on the 1,196,920 shares of $2 Series A Cumulative Convertible Preferred Stock outstanding.

Note 10. Regulatory Matters

Western has announced its intention to acquire Wien Air Alaska, Inc., an Alaska regional carrier, and merge it into the Western system. The Civil Aeronautics Board has approved Air Florida System, Inc.'s, application to acquire control of Western. Air Florida, which holds approximately 12.6 percent of Western's common stock, has not announced its intentions. Western's planned merger with Continental Air Lines, Inc., was thwarted by the successful takeover of that carrier by Texas International. Western withdrew from the merger agreement in September 1981. For additional information see the first four paragraphs under Regulatory Matters on Pages 6 and 7 of this report.

Note 11. Other Matters

In May 1981, Western sold two DC-10-10 aircraft to International Air Leases, Inc. for $2,000 of cash and $28,000 of 12% notes which are payable in monthly principal and interest installments of $480 over 50 months with the balance payable in 1985. In December 1981, Western decided to sell the notes receivable and has reached agreement in principle to sell these notes with recourse. This transaction is expected to be consummated by April 30, 1982. During the fourth quarter of 1981, the notes were written down by $6,557 to their estimated net realizable value.

In December 1981, Western sold two 737 aircraft for $11,000 to Batch-Air Leasing, Inc., and then leased back the aircraft from International Air Leases, Inc., under a four-year operating lease with monthly rental payments of $130 per aircraft. The gain on the sale of the aircraft is being recognized on a straight-line basis over the lease term. The owner of International Air Leases, Inc., and Batch-Air Leasing, Inc., holds approximately 7% of the outstanding common stock of Western.

In the opinion of Western's management, the transactions described above were at terms comparable to those which would have been negotiated with unrelated parties.

Note 12. Quarterly Financial Data (Unaudited)

Summarized quarterly financial data (unaudited) for 1981 and 1980 is as follows:

	Three Months Ended			
	March 31	June 30	September 30	December 31
1981				
Operating revenues	$262,159	270,844	293,621	233,217
Operating (loss)	(3,497)	(15,003)	(3,753)	(43,701)
Net (loss)	(1,692)	(8,399)	(7,255)	(56,054)
Net (Loss) per Common Share:				
Primary	$ (0.18)	(0.69)	(0.60)	(4.34)
1980				
Operating revenues	$232,153	237,707	273,720	252,175
Operating income (loss)	(23,006)	(20,177)	7,658	(10,236)
Net (loss)	(8,868)	(5,379)	(6,397)	(8,988)
Net (Loss) per Common Share:				
Primary	$ (0.72)	(0.46)	(0.54)	(0.74)

Western revised its procedures for recording commission expense in the first quarter of 1981 to more closely identify the expense with the period in which the related revenue is recognized. The effect of this change on the first through the fourth quarters of 1981 was to reduce (increase) the net loss by $3,244 ($0.25 per share), $504 ($0.04 per share), $(1,040) ($0.08 per share), and $630 ($0.05 per share).

The quarterly income tax benefits for the first, second, and third quarters of 1981 are based on the statutory rate. The tax benefit available for the fourth quarter 1981 was limited for financial reporting purposes to approximately 5% of the pretax accounting loss because the tax benefits of the remaining net operating loss could not be recognized currently. In the third quarter of 1980, previously recorded investment credits of $12,507 ($0.96 per share) were reversed since they could not be utilized for financial reporting purposes. No investment credits were recognized during 1981.

Note 13. Description of Impact of Inflation (Unaudited)

Statement of Financial Accounting Standards No. 33 (SFAS No. 33) prescribes two supplementary income computations for estimating the impact of inflation. These computations estimate the effects of general inflation (constant dollars) and the effects of changes in specific prices (current cost).

SFAS No. 33 defines constant dollar accounting as a method of reporting financial statement elements in dollars each of which have the same general purchasing power. Current cost accounting is defined as a method of measuring and reporting assets and expenses associated with the use or sale of assets at their current cost or lower recoverable amount at the balance sheet date or at the date of use or sale. Both methods involve the use of assumptions and estimates. Therefore, the resulting measurements should be viewed as estimates rather than as precise indicators of the effects of inflation.

The amounts reported in the primary financial statements have been adjusted for depreciation and amortization expense. Revenues and all other operating expenses are considered to reflect the average price levels and have not been adjusted. Further, there have been no adjustments made to provisions for income taxes.

Constant dollar values were determined by restating historical costs, accumulated depreciation and amortization, and depreciation expense of property and equipment into average 1981 dollars using the Consumer Price Index for all urban consumers (CPI-U) published by the Bureau of Labor Statistics. Current costs for aircraft were determined by using the direct pricing method. Current costs for spare engines and capital rotable spares and assemblies were computed based on the ratio by which the current cost of aircraft fleets exceeds the historic cost of such fleets. Current cost for other property and equipment were determined by indexation using the CPI-U.

An estimate of the net (loss) adjusted for changing prices for the year ended December 31, 1981, follows:

Net (loss) as reported in the statement of operations	$ (73,400)
Adjustment to Restate Costs for the Effect of General Inflation:	
Depreciation and amortization expense	(32,706)
Net (loss) adjusted for general inflation	(106,106)
Adjustment to Reflect the Difference Between General Inflation and Changes in Specific Prices (current costs):	
Depreciation and amortization expense	(26,582)
Net (loss) adjusted for changes in specific prices	$(132,688)
Gain from decline in purchasing power of net amounts owed	$ 41,716
Increase in specific prices (current cost) of properties and equipment held during the year*	$ 186,912
Effect of increase in general price level	(108,810)
Excess of increase in specific prices over increase in the general price level	$ 78,102

*At December 31, 1981 current cost of properties and equipment, net of accumulated depreciation and amortization, was $1,189,243.

A five-year comparison indicating the effect of adjusting historical revenues, purchasing power gains or losses on net monetary items, cash dividends, and common stock market prices to dollar amounts expressed in terms of average 1981 dollars as measured by the CPI-U follows:

	Year Ended December 31,				
	1981	1980	1979	1978	1977
Operating revenues	**$1,059,841**	1,095,330	1,165,149	1,159,973	1,037,196
Historical Cost Information Adjusted for General Inflation:					
Net earnings (loss)	**(106,106)**	(62,434)	26,162		
Net earnings (loss) per common share	**$ (8.32)**	(4.99)	1.77		
Net assets at year-end	**384,364**	483,525	524,169		
Current Cost Information:					
Net earnings (loss)	**(132,688)**	(78,120)	13,904		
Net earnings (loss) per common share	**$ (10.36)**	(6.19)	.84		
Excess of increase in specific prices over increase in the general price level	**78,102**	125,487	7,157		
Net assets at year-end	**654,403**	739,133	670,431		
Gain from decline in purchasing power of net amounts owed	**41,716**	51,532	45,947		
Cash dividends declared per common share	**$ —**	.27	.50	.56	.60
Market price per common share at year-end	**$ 4.87**	10.04	12.97	11.47	11.44
Average Consumer Price Index	**272.4**	246.8	217.4	195.4	181.5

Note 14. Continued Operations

Early in 1982, Western began to implement a new strategic plan designed to return the company to profitability and to strengthen its financial condition. This plan includes, among other factors: (1) establishing a hub and spoke system with operations centered at Salt Lake City, (2) introducing service to nine new cities and increasing service to a number of cities presently on Western's system as a means to more fully utilize the available capacity in Western's fleet, (3) wage and/or work rule concessions from Western's organized labor groups, and (4) continued cooperation from Western's lenders.

If this plan is not substantially achieved, Western may not be able to continue in existence.

ACCOUNTANTS' REPORT

Certified Public Accountants

Peat, Marwick, Mitchell & Co.

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, 1981 and 1980 and the related statements of operations, shareholders' equity and changes in financial position for each of the years in the three-year period ended December 31, 1981. 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.

As shown in the financial statements, the Company incurred net losses of $73,400,000 and $29,632,000 during the years ended December 31, 1981 and 1980, respectively, and, as of December 31, 1981, certain of the Company's long-term debt is subject to demand for accelerated payment after June 10, 1982. These factors, among others, as discussed in Notes 6 and 14, indicate that the Company may be unable to continue in existence. The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or to the amounts and classification of liabilities that might be necessary should the Company be unable to continue in existence.

In our opinion, subject to the effects on the 1981 financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainty about the recoverability and classification of recorded asset amounts and the amounts and classification of liabilities referred to in the preceding paragraph been known, the aforementioned financial statements present fairly the financial position of Western Air Lines, Inc., at December 31, 1981 and 1980 and the results of its operations and the changes in its financial position for each of the years in the three-year period ended December 31, 1981, in conformity with generally accepted accounting principles applied on a consistent basis.

Peat, Marwick, Mitchell & Co.

March 1, 1982, except for the fourth
and fifth paragraphs of Note 6, which
are as of March 15, 1982.

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.

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Los Angeles, California

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Chairman of the Board
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Beverly Hills, California

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Salt Lake City, Utah

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Alaska National Insurance Company
Anchorage, Alaska

Capt. Roy G. Utter
Pilot
Western Air Lines, Inc.
Los Angeles, California

Robert H. Volk
Chairman/Owner
Martin Aviation, Inc.
Torrance, California

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Darling, Hall & Rae
Los Angeles, California

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Los Angeles, California

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Los Angeles, California

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Walker Bank & Trust Company
Salt Lake City, Utah

Arthur G. Woodley
Bellevue, Washington

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Chief Executive Officer

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Service

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Alaska Region

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Airport Operations

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Maintenance & Engineering

Howard L. Culver
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Regulatory Affairs

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Vice President—Airport Services

Donald W. Vena
Vice President—Personnel Relations

George Varney
Assistant Vice President—
Flight Control

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(213) 646-2345

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

Debenture and Subordinated Note Trustee
United States Trust Company of New York
45 Wall Street, New York, New York 10005

Exchange Listing—Common & Preferred Stock Debentures and Subordinated Notes
New York Stock Exchange
Pacific Stock Exchange

Ticker Symbols

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

Independent Accountants
Peat, Marwick, Mitchell & Co.
555 South Flower St., Los Angeles, California 90071

General Offices Western Air Lines Building, 6060 Avion Drive, Los Angeles International Airport, Los Angeles, California 90045