

**MARCH 18, 2005**

**2004  
FINANCIAL STATEMENTS & NOTES**

**ACE AVIATION HOLDINGS INC.**

March 17, 2005

## **Auditors' Report**

### **To the Shareholders of ACE Aviation Holdings Inc.**

We have audited the consolidated statement of financial position of **ACE Aviation Holdings Inc.** (the "Successor") as at December 31, 2004 and the consolidated statement of operations, retained earnings and cash flows for the period from June 29, 2004, date of incorporation, to December 31, 2004. These financial statements are the responsibility of the Successor's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Successor as at December 31, 2004 and the results of its operations and the change in its cash flows for the period from June 29, 2004 to December 31, 2004 in accordance with Canadian generally accepted accounting principles.

*PricewaterhouseCoopers LLP*

Chartered Accountants

### **Comments by Auditors on Canadian/United States Reporting Differences**

In the United States, reporting standards for auditors require the addition of an explanatory paragraph when there is a change in accounting principles that has a material effect on the comparability of the Successor's consolidated financial statements, such as the changes described in Notes 4 and 25 to the consolidated financial statements. In addition, the auditors' report would emphasize in a separate paragraph certain matters regarding the financial statements such as those described in notes 2, 3 and 5 to the consolidated financial statements. Accordingly, it should be noted that the Ontario Superior Court of Justice confirmed the consolidated plan of reorganization, compromise and arrangement of Air Canada and certain of its subsidiaries (the "Applicants") on August 23, 2004. Confirmation of the



Plan resulted in the settlement of all claims against the Applicants that arose before April 1, 2003 and substantially altered the rights and interests of equity security holders of Air Canada as provided for in the Plan. The Plan was substantially consummated on September 30, 2004 and the Predecessor emerged from creditor protection. In connection with Air Canada's emergence from creditor protection, creditors and shareholders received shares of ACE Aviation Holdings Inc., a newly formed holding company. As a result consolidated financial statements of ACE Aviation Holdings Inc. reflect a fresh start basis of accounting as of September 30, 2004 as described in Note 5 to the consolidated financial statements. Our report to the shareholders dated March 14, 2005 is expressed in accordance with Canadian reporting standards which do not require a reference to such changes in accounting principles or events in the auditor's report when the matters are properly accounted for and adequately disclosed in the financial statements.

*Price Waterhouse Coopers LLP*

Chartered Accountants

March 17, 2005

**Auditors' Report**

**To the Shareholder of  
Air Canada**

We have audited the consolidated statement of financial position of **Air Canada** (the "Predecessor") as at December 31, 2003 and the consolidated statements of operations, retained earnings (deficit) and cash flows for the nine-month period ended September 30, 2004 and the year ended December 31, 2003. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express and opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements presents fairly, in all material respects, the financial position of the Corporation as at December 31, 2003 and the results of its operations and the change in its cash flows for the nine-month period ended September 30, 2004 and the year ended December 31, 2003 in accordance with Canadian generally accepted accounting principles.

*PricewaterhouseCoopers LLP*

Chartered Accountants

**ACE Aviation Holdings Inc.**  
**Consolidated Statement of Operations and Retained Earnings (Deficit)**

(in millions except per share figures - Canadian dollars)	Successor Company - ACE (note 3)		Predecessor Company - Air Canada (note 3)	
	Period ended		Nine Months	Twelve Months
	December 31		ended September 30	ended December 31
	2004		2004	2003
<b>Operating revenues</b>				
Passenger	\$ 1,681	\$	5,628	\$ 6,858
Cargo	151		405	519
Other	230		805	996
	2,062		6,838	8,373
<b>Operating expenses</b>				
Salaries, wages and benefits	596		1,989	2,828
Aircraft fuel	432		1,174	1,253
Aircraft rent	111		521	1,008
Airport and navigation fees	198		616	743
Aircraft maintenance, materials and supplies	78		265	385
Communications and information technology	66		236	390
Food, beverages and supplies	76		264	334
Depreciation, amortization and obsolescence	85		312	366
Commissions	65		240	273
Other	358		1,101	1,477
	2,065		6,718	9,057
<b>Operating income (loss) before reorganization and restructuring items</b>	(3)		120	(684)
Reorganization and restructuring items (note 6)	-		(871)	(1,050)
<b>Non-operating income (expense)</b>				
Interest income	11		6	25
Interest expense	(60)		(169)	(115)
Interest capitalized	2		-	4
Loss on sale of and provisions on assets (note 8)	-		(75)	(168)
Other	(20)		(10)	(28)
	(67)		(248)	(282)
<b>Loss before foreign exchange on non-compromised long-term monetary items and income taxes</b>	(70)		(999)	(2,016)
Foreign exchange gain on long-term monetary items	98		106	137
<b>Income (loss) before income taxes</b>	28		(893)	(1,879)
Recovery of (provision for) income taxes	(13)		(2)	12
<b>Income (loss)</b>	\$ 15	\$	(895)	\$ (1,867)
Plan of arrangement and fresh start reporting (note 5)			6,042	-
<b>Retained earnings (deficit), beginning of period</b>	-		(5,147)	(3,280)
<b>Retained earnings (deficit), end of period</b>	\$ 15	\$	-	\$ (5,147)
<b>Earnings (Loss) per share (note 20)</b>				
- Basic	\$ 0.17	\$	(7.45)	\$ (15.53)
- Diluted	\$ 0.17	\$	(7.45)	\$ (15.53)

The accompanying notes are an integral part of the consolidated financial statements.

**ACE Aviation Holdings Inc.**  
**Consolidated Statement of Financial Position**

(in millions of Canadian dollars)

	Successor Company - ACE (note 3)		Predecessor Company - Air Canada	
	December 31		December 31	
	2004		2003	
<b>ASSETS</b>				
<b>Current</b>				
Cash and cash equivalents	\$	1,632	\$	670
Restricted cash (note 4)		118		157
Accounts receivable		547		502
Spare parts, materials and supplies		237		211
Prepaid expenses		161		171
		2,695		1,711
Property and equipment (note 8)		3,696		1,700
Deferred charges (note 9)		167		2,340
Goodwill		-		510
Intangible assets (note 10)		2,691		164
Other assets (note 11)		137		485
	\$	9,386	\$	6,910
<b>LIABILITIES</b>				
<b>Current</b>				
Accounts payable and accrued liabilities	\$	1,197	\$	1,508
Advance ticket sales and loyalty program deferred revenues		1,076		721
Current portion of long-term debt and capital lease obligations (note 12)		218		173
		2,491		2,402
Long-term debt and capital lease obligations (note 12)		2,328		332
Convertible preferred shares (note 19)		132		-
Future income taxes (note 14)		243		11
Pension and other benefit liabilities (note 15)		2,344		964
Other long-term liabilities (note 16)		1,645		1,216
Deferred credits (note 17)		-		827
		9,183		5,752
Liabilities subject to compromise (note 13)		-		5,313
		9,183		11,065
Commitments (note 22) and Contingencies, Guarantees and Indemnities (note 24)				
<b>SHAREHOLDERS' EQUITY</b>				
Share capital and other equity (note 19)		187		967
Contributed surplus		1		25
Retained earnings (deficit)		15		(5,147)
		203		(4,155)
	\$	9,386	\$	6,910

The accompanying notes are an integral part of the consolidated financial statements.

On behalf of the Board of Directors:

signed **Robert A. Milton**  
Chairman, President and Chief Executive Officer

signed **David I. Richardson**  
Chairman of the Audit, Finance and Risk Committee

**ACE Aviation Holdings Inc.**  
**Consolidated Statement of Cash Flow**

(in millions of Canadian dollars)

	Successor Company	Predecessor Company - Air Canada	
	Period ended December 31 2004	Nine Months ended September 30 2004	Twelve Months ended December 31 2003
<b>Cash flows from (used for)</b>			
<b>Operating</b>			
Income (loss) for the period	\$ 15	\$ (895)	\$ (1,867)
Adjustments to reconcile to net cash provided by operations			
Reorganization and restructuring items (note 6)	-	786	986
Depreciation, amortization and obsolescence	85	312	366
Loss on sale of and provisions on assets (note 8)	-	75	168
Foreign exchange	(98)	(106)	(137)
Future income taxes	11	(5)	(19)
Employee future benefit funding less than expense	(52)	98	204
Decrease (increase) in accounts receivable	269	(191)	183
Decrease (increase) in spare parts, materials and supplies	(30)	-	55
Increase (decrease) in accounts payable and accrued liabilities	(256)	34	50
Increase (decrease) in advance ticket sales, net of restricted cash	(103)	196	(71)
Aircraft lease payments (in excess of) less than rent expense	(14)	(31)	363
Other	61	87	(142)
Cash flows from (used for) operating activities before under noted items	(112)	360	139
Settlement of lease obligations (note 2)	(290)	-	-
Rebate on lease settlement	33	-	-
Payment of restructuring obligation (note 2)	(45)	-	-
Fees conditional on emergence	(12)	-	-
	(426)	360	139
<b>Financing</b>			
GE DIP financing	(300)	300	-
Drawdown of Exit Financing	527	-	-
Aircraft related borrowings	-	233	-
Credit facility borrowings	-	80	315
Reduction of long-term debt and capital lease obligations	(67)	(358)	(240)
Preferred shares issued to Cerberus for cash	238	-	-
Shares issued for cash under Rights Offering	852	-	-
Issue of share capital (note 19)	1	-	-
DIP financing fees	-	-	(62)
Other	-	(2)	9
	1,251	253	22
<b>Investing</b>			
Additions to property and equipment	(129)	(328)	(96)
Proceeds from sale of assets	-	2	45
Investments and advances	-	-	2
Cash collateralization of lines of credit (note 2)	(21)	-	-
	(150)	(326)	(49)
<b>Increase (decrease) in cash and cash equivalents</b>	<b>675</b>	<b>287</b>	<b>112</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>-</b>	<b>670</b>	<b>558</b>
<b>Cash and cash equivalents transferred to the Successor Company</b>	<b>957</b>	<b>(957)</b>	<b>-</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 1,632</b>	<b>\$ -</b>	<b>\$ 670</b>

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(currencies in millions – Canadian dollars)**

**1. Nature of Operations**

ACE Aviation Holdings Inc. ("ACE") was incorporated on June 29, 2004 for the purpose of becoming the parent company of Air Canada and its subsidiaries upon the implementation of the consolidated plan of reorganization, compromise and arrangement ("the Plan") as further described in note 2. From the date of incorporation until the implementation of the plan, ACE did not issue any equity securities, acquire any assets, assume any liabilities of Air Canada, did not carry on any operations or have cash flows.

In accordance with the implementation of the Plan involving Air Canada, as the predecessor company, and certain subsidiaries, pursuant to the provisions of the Companies' Creditors Arrangement Act (Canada) ("CCAA"), on September 30, 2004, ACE became the successor and parent holding company of the reorganized Air Canada and its subsidiaries. Reference to "Corporation" in these consolidated financial statements and notes thereto refers to, as the context may require, ACE and its subsidiaries collectively, ACE and one or more of its subsidiaries, one or more of ACE's subsidiaries, or ACE itself. As part of the Plan, in addition to Aeroplan Limited Partnership ("Aeroplan"), Jazz Air Inc. ("Jazz"), Destina.ca Inc. ("Destina") and Touram Inc. ("Air Canada Vacations"), which were already established as separate legal entities, Air Canada Technical Services ("ACTS"), Air Canada Cargo, Air Canada Groundhandling and AC Online were established as stand-alone limited partnerships under ACE. In addition, Jazz was reorganized into Jazz Limited Partnership.

The Corporation's businesses on a consolidated basis are operated through four reporting segments which include:

**Transportation Services**

Transportation services includes the Corporation's principal passenger and cargo transportation services covering Air Canada and related ancillary services, and effective September 30, 2004, the Corporation records the transportation revenues earned on Jazz operations and the fees related to Jazz operations as provided for under a capacity purchase agreement.

Air Canada is Canada's largest domestic and international full-service airline and the largest provider of scheduled passenger services in the domestic market, the Canada-U.S. market as well as Canada-International markets. Through Air Canada's global route network, virtually every major market throughout the world is served either directly or through the Star Alliance which is the world's largest airline network.

Destina and AC Online manage Air Canada's commercial web sites in addition to operating an online travel site offering customers both air and non-air products.

Air Canada Vacations is a major Canadian tour operator providing vacation packages.

Air Canada and Air Canada Cargo provide air cargo services on domestic, transborder and international flights. Air Canada Cargo is a major domestic air cargo carrier and manages the entire cargo capacity on aircraft operated by Air Canada and Jazz on domestic and transborder routes. Air Canada continues to offer cargo services on its international passenger flights.

Air Canada Groundhandling provides passenger handling services to Air Canada, Jazz and other airlines with a primary focus on Canadian stations. Services covered include "above and below the wing"



passenger and baggage handling services and ancillary services such as de-icing, ground support, and equipment maintenance.

### **Loyalty Program**

Aeroplan is a premier loyalty program which offers miles accumulation and redemption as an incentive to the Corporation's and other partners' customers. Accumulated mileage may be redeemed for travel rewards or for goods and services from non-airline partners.

### **Technical Services**

ACTS provides technical services and competes on a global basis as an aircraft maintenance, repair and overhaul service provider.

### **Regional Operations**

Jazz is responsible for regional operations and provides service throughout Canada and to certain destinations in the United States under a capacity purchase agreement between Air Canada and Jazz that came into effect September 30, 2004. Under the capacity purchase agreement, Jazz focuses on the operations and customer service and Air Canada is responsible for scheduling, marketing, pricing and related commercial activities of the regional operations. Under this agreement, Jazz records revenues from Air Canada based upon fees relating to flight operations performed, passengers carried and other items covered by the agreement. These inter-company transactions are eliminated in the consolidated financial statements.

Financial information on ACE operating segments is outlined in Note 21, Segment Information.

## 2. The Plan and Other Restructuring Arrangements

### The Plan

On April 1, 2003, Air Canada obtained an order from the Ontario Superior Court of Justice (the "Court") providing creditor protection under CCAA. On April 1, 2003, Air Canada, through its Court-appointed Monitor, also made a concurrent petition for recognition and ancillary relief under Section 304 of the U.S. Bankruptcy Code. The CCAA and U.S. proceedings covered Air Canada and the following of its wholly-owned subsidiaries: Jazz Air Inc., ZIP Air Inc., 3838722 Canada Inc., Air Canada Capital Ltd., Manoir International Finance Inc., Simco Leasing Ltd., and Wingco Leasing Inc. (collectively, the "Applicants"). Aeroplan, Air Canada Vacations, Maple Leaf Holdings USA Inc. and Destina were not included in the filings. During the proceedings, the Applicants continued to operate under Court protection.

On August 17, 2004, the creditors approved the Plan and on August 23, 2004, the Plan was confirmed pursuant to an order of the Court. The Plan was implemented through a series of steps which were completed on September 30, 2004 (except as to the winding up of Zip which occurred on October 1, 2004). Accordingly, on September 30, 2004, the Applicants emerged from CCAA and ACE became the parent company of Air Canada and its subsidiaries.

The confirmed Plan provided for the following:

- A corporate reorganization of Air Canada and its subsidiaries into separate business units resulting in the following operating subsidiaries of ACE: Air Canada, Aeroplan, Jazz, Destina, Air Canada Vacations, ACTS, Air Canada Cargo, Air Canada Groundhandling and AC Online.
- The affected unsecured creditors' claims were settled, compromised and released in exchange for 46,250,000 shares in ACE and rights to acquire further shares pursuant to a rights offering (the "Rights Offering"). Additional information on the share capital of ACE is described in Note 19. In accordance with the Plan, 5,188,985 shares are being held in escrow pending resolution of disputed unsecured claims. Once claims are resolved, the disbursing agent will distribute the shares in accordance with the provisions of the Plan. None of these shares held in escrow will return to ACE or any of its subsidiaries.
- All issued and outstanding options of Air Canada, including the conversion feature in the convertible subordinated debentures, and warrants were cancelled without payment or consideration.
- Holders of Air Canada's Class A non-voting common shares received a nominal number of ACE Class A Variable Voting Shares and holders of Air Canada's common shares received a nominal number of ACE Class B Voting Shares representing approximately 0.01% of the fully diluted equity of ACE. In total, 10,104 shares were issued to the holders of Air Canada's common shares.
- Air Canada's Class A Convertible Participating Non-Voting Convertible Preferred Shares (Series 1) were converted into Air Canada Redeemable Shares which were redeemed for an aggregate consideration of one dollar.
- A comprehensive release in favour of the Applicants of all claims of Affected Unsecured Creditors based upon any matters up until September 30, 2004 other than certain categories of excluded claims (including affirmed contracts and claims arising from the supply of goods

and services after the date of filing) as specified in the Plan and Sanction Order.

### **Global Restructuring Agreement**

All transactions contemplated by the Global Restructuring Agreement (“GRA”) with General Electric Capital Corporation and its affiliates (“GECC”) became effective on September 30, 2004.

Under the GRA, leases related to 106 operating, parked and undelivered aircraft were restructured resulting in a reduction of lease rates for 47 aircraft, termination of obligations for 20 parked aircraft, the cancellation of four future aircraft lease commitments and the restructuring of the overall obligations with respect to six aircraft.

Prior to filing for CCAA on April 1, 2003, the Predecessor Company had payment and purchase obligations in respect of two B747 aircraft with GECC. As a condition of the GRA, on September 30, 2004, Air Canada acquired these two aircraft, with a fair market value of \$63, from GECC for an aggregate amount of \$353. GECC provided financing in the amount of US\$50, of which US\$25 was repaid during the three months ended December 31, 2004 upon the sale of one of the aircraft. Terms and conditions of this loan are set out in note 12. The difference of \$290 was paid to GECC on September 30, 2004, under the terms of the GRA. This one-time payment of \$290 has been classified as a cash flow used for the operating activities of ACE.

GECC provided ACE with an Exit Facility in the amount of \$540 before fees of \$13. The terms and conditions of this Exit Facility are set out in note 12. Cash proceeds received under the Exit Facility have been reduced by the amount drawn under the DIP Loan Agreement as at September 30, 2004 of \$300. In addition, ACE provided cash collateralization of certain outstanding letters of credit totaling \$21. This amount is recorded under other assets. The Corporation further paid an amount of \$45 to GECC related to restructuring certain obligations with GECC. An amount of \$37 has been allocated to certain ongoing lease arrangements and \$8 to standby financing with GECC in the Successor Company. As a result of this payment, the warrants as outlined in the GRA were not issued.

### **Rights Offering and Standby Purchase Agreement**

As part of the Plan, the affected unsecured creditors were entitled to subscribe for up to 42,500,000 ACE Class B Voting Shares and/or ACE Class A Variable Voting Shares or approximately 42.06% of the Fully Diluted Equity of ACE as of September 30, 2004 pursuant to the Rights Offering. In accordance with a Standby Purchase Agreement (the “Standby Purchase Agreement”) entered into with Deutsche Bank Securities Inc. (“DB”), ACE completed the issuance of 42,500,000 shares under its rights offering for proceeds of \$865 before fees of \$13. DB and its participants acquired, as standby purchasers, 9,829,339 Class A Variable Voting Shares relating to unexercised rights.

### **Investment Agreement**

In accordance with an investment agreement (the “Investment Agreement”) with Cerberus ACE Investment, LLC and Promontoria Holding III B.V., affiliates of Cerberus Capital Management L.P. (collectively, “Cerberus”), ACE issued 12,500,000 Convertible Preferred Shares for an aggregate consideration of \$250 before expenses of \$12. See note 19 for further details related to the Convertible Preferred Shares.

**Pension Plan Arrangements**

On September 30, 2004, with the agreement of the Office of the Superintendent of Financial Institutions, Air Canada issued a series of subordinated security promissory notes in the aggregate amount of approximately \$347 in favour of its pension plan sponsors. See note 15 for further details on these notes.

### **3. Basis of Presentation**

In accordance with Section 1625 of the CICA Handbook, Comprehensive Revaluation of Assets and Liabilities ("CICA 1625"), ACE adopted fresh start reporting on September 30, 2004. References to "Predecessor Company" in these consolidated financial statements and notes thereto refer to Air Canada and its subsidiaries prior to September 30, 2004. References to "Successor Company" refer to ACE and its subsidiaries on and after June 29, 2004. In accordance with CICA 1625, prior period financial information has not been restated to reflect the impact of the fair value adjustments, and accordingly certain amounts in the Predecessor Company are not directly comparable. See note 5 for information related to fresh start reporting.

The consolidated balance sheet as of December 31, 2004 includes the accounts of the Successor Company. The consolidated balance sheet as of December 31, 2003 includes the accounts of the Predecessor Company. The consolidated statement of operations for the period from incorporation of ACE to December 31, 2004 reflects the operations of the Successor Company; the nine months ended September 30, 2004 and the year ended 2003 reflect the results of operations of the Predecessor Company. The consolidated statement of cash flow for the period from incorporation of ACE to December 31, 2004 reflects the cash flows of the Successor Company. The nine months ended September 30, 2004 and the year ended 2003 reflect the cash flows of the Predecessor Company.

For the period from April 1, 2003 through to September 30, 2004, while Air Canada and certain of its subsidiaries operated under CCAA proceedings, the Predecessor Company followed accounting policies, including disclosures, applicable to entities under creditor protection. In addition to generally accepted accounting principles applicable in Canada, the Predecessor Company applied the guidance in American Institute of Certified Public Accountant Statement of Position 90-7, "Financial Reporting by Entities in Reorganization under the Bankruptcy Code" (SoP 90-7). Accordingly, revenues, expenses (including professional fees), realized gains and losses and provisions for losses directly associated with the reorganization and restructuring of the business were reported separately as reorganization items. In addition, the consolidated balance sheet of the Predecessor Company distinguished between liabilities subject to compromise and post-filing liabilities. Liabilities subject to compromise were reported at the amounts expected to be allowed, even if they were settled for lesser amounts.

For the period April 1, 2003 to September 30, 2004, interest expense on compromised liabilities was reported only to the extent that it would be paid under the Plan or that it was probable that it would be an allowed claim. The consolidated statement of financial position of the Predecessor Company distinguishes pre-filing liabilities subject to compromise from both those pre-filing liabilities that are not subject to compromise together with post-filing liabilities. Cash flows related to reorganization items have been disclosed separately in the consolidated statement of cash flows. Consolidated financial statements that include one or more entities in reorganization proceedings and one or more entities not in reorganization proceedings include disclosure of condensed combined financial statements of the entities in reorganization proceedings, including disclosure of the amount of intercompany receivables and payables therein between Applicants and non-Applicants. This information is presented in note 7.

#### **4. Accounting Policies**

The financial statements of the Successor and Predecessor Companies are expressed in Canadian dollars and are prepared in accordance with Canadian generally accepted accounting policies ("GAAP"). The accounting policies of ACE are consistent with those of the Predecessor Company, with the exception of the fair value adjustments applied under fresh start reporting and certain accounting policies as outlined below.

The consolidated financial statements of the Predecessor Company were prepared in accordance with Canadian GAAP on a going concern basis, which assumed that the Predecessor Company would be able to realize its assets and discharge its liabilities in the normal course of business in the foreseeable future, with no adjustments made in the carrying amounts of the assets, liabilities, revenues and expenses.

##### **a) Basis of Valuation**

With the application of fresh start reporting on September 30, 2004 by the Successor Company, all assets and liabilities, except for future income taxes, were reported at fair values as further described in note 5. Goodwill is not recorded under GAAP applicable to fresh start reporting. In addition, the estimated useful lives of certain assets were also adjusted, including buildings where useful lives were extended to periods not exceeding 50 years.

##### **b) Generally Accepted Accounting Principles**

CICA 1100, Generally Accepted Accounting Principles became effective January 1, 2004. CICA 1100 establishes standards for financial reporting in accordance with generally accepted accounting principles as well as describes what constitutes GAAP and its sources. This Section also provides guidance on sources to consult when selecting accounting policies and determining appropriate disclosures when a matter is not dealt with explicitly in the primary sources of GAAP. There have been no changes in accounting policies as a result of the adoption of CICA 1100.

##### **c) Principles of Consolidation**

These consolidated financial statements include the accounts of the Predecessor Company and Successor Company. All intercompany balances and transactions are eliminated.

##### **d) Use of Estimates**

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

##### **e) Air Transportation Revenues**

Airline passenger and cargo advance sales are deferred and included in current liabilities. Passenger and cargo revenues are recognized when the transportation is provided. The Corporation has formed alliances with other airlines encompassing loyalty program participation, code sharing and coordination of services including reservations, baggage handling and flight schedules. Revenues are allocated based upon formulas specified in the agreements and are recognized as transportation is provided. As described further under Loyalty Program, beginning September 30, 2004, the estimated fair value of Aeroplan Miles earned through qualifying air travel is deferred at the time the qualifying air travel is provided. Deferred revenues from the issue of Miles to customers, including Miles sold to loyalty program partners are recorded

as passenger revenues at the time the Miles are redeemed for air travel. Redemptions for non-passenger services are included in other revenues.

The Corporation performs regular evaluations on the deferred revenue liability which may result in adjustments being recognized as revenue. Due to the complex pricing structures; the complex nature of interline and other commercial agreements used throughout the industry; historical experience over a period of many years; and other factors including refunds, exchanges and unused tickets, certain relatively small amounts are recognized as revenue based on estimates. Events and circumstances may result in actual results that are different from estimates, however these differences have historically not been material.

#### **f) Employee Future Benefits**

As a result of the application of fresh start reporting, pension and other future benefit obligations were adjusted to reflect the estimated net accrued benefit obligation at September 30, 2004. Thus, all unrecognized net actuarial losses, prior service costs, and net transition obligations of the Predecessor Company were eliminated.

The significant policies related to employee future benefits are as follows:

- The cost of pensions and other post-retirement benefits earned by employees is actuarially determined using the projected benefit method prorated on service, market interest rates, and management's best estimate of expected plan investment performance, salary escalation, retirement ages of employees and expected health care costs.
- A market-related value method is used to value plan assets for the purpose of calculating the expected return on plan assets. Under the selected method, the differences between investment returns during a given year and the expected investment returns are amortized on a straight line basis over 4 years.
- Past service costs arising from plan amendments are amortized on a straight-line basis over the average remaining service period of employees active at the date of amendment. This period does not exceed the average remaining service period of such employees up to the full eligibility date.
- Cumulative unrecognized net actuarial gains and losses in excess of 10% of the greater of the projected benefit obligation or market-related value of plan assets at the beginning of the year are amortized over the remaining service period of active employees.

#### **g) Property and Equipment**

Property and equipment is originally recorded at cost. Property under capital leases and the related obligation for future lease payments are initially recorded at an amount equal to the lesser of fair value of the property or equipment and the present value of those lease payments. On the application of fresh start accounting effective September 30, 2004, the cost of property and equipment was adjusted to fair value in the Successor Company. In addition, the estimated useful lives of certain assets were also adjusted, including buildings where useful lives were extended to periods not exceeding 50 years.

Property and equipment, including property under capital lease, are depreciated to estimated residual values based on the straight-line method over their estimated service lives. Mainline aircraft and flight equipment are depreciated over 20 to 25 years, with 10 to 15% estimated residual values. Regional aircraft and flight equipment are depreciated over 20 to 30 years, with 20% estimated residual values. Aircraft reconfiguration costs are amortized over 3 years. Betterments to owned aircraft are capitalized and amortized over the remaining service life of the aircraft. Betterments to aircraft on operating leases are amortized over the term of the lease.

Buildings are depreciated over their useful lives not exceeding 50 years on a straight line basis (30 years in the Predecessor Company). An exception to this is where the useful life of the building is greater than the term of the land lease. In these circumstances, the building is depreciated over the life of the lease. Leasehold improvements are amortized over the lesser of the lease term or 5 years. Ground equipment is depreciated over 3 to 25 years (5 to 25 years in the Predecessor Company). Computer equipment is depreciated over 3 years (5 years in the Predecessor Company).

#### **h) Loyalty Program**

As a result of the application of fresh start reporting, the outstanding loyalty program mileage credits ("Miles") were adjusted to reflect the estimated fair value of Miles to be redeemed in the future. As a consequence of this fair value adjustment and the evolving nature of the Aeroplan loyalty program, the Successor Company changed the accounting policy as of September 30, 2004 for the recognition of its obligations relating to the loyalty program. The Predecessor Company recognized the obligation related to Miles earned through transportation services based on the incremental cost of providing future transportation services. On a prospective basis from the date of fresh start reporting, Miles earned by members through transportation services provided by the Corporation and the transportation services are treated as multiple elements. Miles are recorded at fair values with the residual allocated to transportation services. Consistent with the accounting policy of the Predecessor Company, the proceeds from the sale of Miles to loyalty program partners are deferred.

Revenues from Miles issued to members are recognized at the time the Miles are redeemed except for breakage as noted below. Effective September 30, 2004, Miles redeemed for travel on Air Canada and Jazz are included in passenger revenue and Miles redeemed for other than travel are included in Other revenues. Under the previous accounting policy in the Predecessor Company, Aeroplan redemption revenues from Miles earned by members through loyalty program partners were included in Other revenues. These revenues amounted to \$173 for the nine months ended September 30, 2004 (\$177 for the twelve months ended December 31, 2003). Based on historical experience and current program policies the Successor Company estimates the percentage of Miles that may never be redeemed, defined as breakage. The amount allocated to breakage is recognized on a straight line basis over a period of 30 months in Other revenues. The Corporation performs regular evaluations on the breakage estimate which may result in certain adjustments.

The current portion of loyalty program deferred revenues of \$497 (\$192 at December 31, 2003 as recorded under the previous accounting policy) are reported in Advance ticket sales and loyalty program deferred revenues. The determination of the current portion is based on Management's estimate as to the portion of the liabilities that will be redeemed in the next twelve months. The remainder of the liabilities is carried in Other long-term liabilities.

#### **i) Income Taxes**

The Corporation utilizes the liability method of accounting for income taxes under which future income tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amount and the tax basis of assets and liabilities. Future income tax assets and liabilities are measured using substantively enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is recognized in earnings in the period that includes the enactment date. Future income tax assets are recognized to the extent that realization is considered more likely than not. The benefit of future income tax assets that exist at fresh start, and for which a valuation allowance is recorded against, will be recognized first to reduce to nil any remaining intangible assets (on a pro-rata basis) that were recorded upon fresh start reporting with any remaining



amount as a credit to shareholders' equity. The benefit of future income tax assets that arise after fresh start will be recognized in the income statement.

#### **j) Impairment of Long-Lived Assets**

Long-lived assets are tested for impairment whenever the circumstances indicate that the carrying value may not be recoverable. When events or circumstances indicate that the carrying amount of long-lived assets are not recoverable, the long-lived assets are tested for impairment by comparing the estimate of future expected cash flows to the carrying amount of the assets or groups of assets. If the carrying value is not recoverable from future expected cash flows, any loss is measured as the amount by which the asset's carrying value exceeds fair value. Recoverability is assessed relative to undiscounted cash flows from the direct use and disposition of the asset or group of assets.

Indefinite lived assets are also subject to annual impairment tests under GAAP. On the application of fresh start reporting, intangible assets have been reported at their estimated fair value. Any impairment would be recognized as an expense in the period of impairment.

Effective January 1, 2004, the Predecessor Company adopted the CICA accounting standard on impairment of long-lived assets which includes assets with a finite life. The Predecessor Company did not record any impairment loss as a direct result of the transition to the new standard.

#### **k) Financial Instruments and Hedging Activities**

Accounting Guideline 13 – Hedging Relationships (AcG 13) was adopted on January 1, 2004. The new guideline outlines criteria related to the identification, designation, documentation and effectiveness of hedging relationships, for the purpose of applying hedge accounting; and the discontinuance of hedge accounting.

Concurrent with the adoption of AcG 13, Emerging Issues Committee (“EIC”) Abstract 128 – Accounting for Trading, Speculative, or Non-Hedging Derivative Financial Instruments was also adopted. For derivative financial instruments that do not qualify for hedge accounting or are entered into for trading or speculative purposes, EIC 128 requires that these derivative financial instruments be measured at fair value, with changes in fair value recognized currently in income. Under the Corporation's risk management policy, derivative financial instruments are used only for risk management purposes, not for generating trading profits. To the extent that a derivative financial instrument does not qualify for hedge accounting or to the extent of hedge ineffectiveness, changes in the fair value of derivative financial instruments are recorded in non-operating income (expense).

As a result of the CCAA filing, the majority of outstanding derivative contracts were terminated. Currency swaps for five Canadair Regional Jet operating leases with lease terminations in 2007 and for three Airbus A330 operating leases were in effect as of January 1, 2004. These currency swaps, with unrelated creditworthy third parties, were put in place on the inception of the leases and, after review in accordance with AcG 13, Management elected not to apply hedge accounting with respect to these swaps. As a result, the fair value of these swaps of \$12 was recorded as at January 1, 2004, in other assets with the offset being a deferred credit, which is amortized over the remaining term of the related aircraft leases. During the quarter ended September 30, 2004, the swaps for three Airbus A330 operating leases were terminated, resulting in a gain of \$2 recorded in reorganization and restructuring items of the Predecessor Company. During the nine months ended September 30, 2004, a loss of \$5 was recorded in other non-operating income (expense) representing the amortization of the opening deferred credit and the change in the fair value of the remaining swaps. As a result of the application of fresh start reporting, the deferred credit has been eliminated. During the period ended December 31, 2004, ACE recorded a loss of \$2 in non-operating income (expense) related to these swaps.

#### **l) Foreign Currency Translation**

Monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars at rates of exchange in effect at the date of the consolidated statement of financial position. Net gains of \$81 are included in income in the Successor Company for the period ended December 31, 2004, of which a loss of \$17 is included in Other non-operating expenses. Gains of \$190 are included in income in the Predecessor Company for the nine months ended September 30, 2004, of which \$84 is included in Reorganization and restructuring items (2003 \$311, of which a loss of \$9 is included in other non operating expenses and a gain of \$183 is included in Reorganization and restructuring items). Non-monetary assets, non-monetary liabilities, revenues and expenses arising from transactions denominated in foreign currencies, are translated at rates of exchange in effect at the date of the transaction.

#### **m) Cash and Cash Equivalents**

Cash includes short-term investments of \$1,557 (2003 \$458). Short-term investments, comprised of bankers acceptances, bankers discount notes, and commercial paper may be liquidated promptly and have maturities of less than ninety days at the date of purchase. The weighted average interest rate on short-term investments as at December 31, 2004 is 2.6% (2003 2.9%).

#### **n) Restricted Cash**

As at December 31, 2004, the Corporation has recorded \$118 (2003 \$157) in restricted cash, under current assets, representing funds held in trust by Air Canada Vacations in accordance with regulatory requirements governing advance ticket sales, recorded under current liabilities, for certain travel related activities. In addition, the Corporation has \$32 (2003 \$32) placed in a Directors' and Officers' Trust for the use of the Directors and Officers under certain circumstances which have been recorded in other assets (note 11).

#### **o) Spare Parts, Materials and Supplies**

Spare parts, materials and supplies are valued at the lower of average cost and net realizable value. A provision for the obsolescence of flight equipment spare parts is accumulated over the estimated service lives of the related flight equipment to a 30% residual value. Upon the application of fresh start accounting effective September 30, 2004, cost was adjusted to replacement cost in the Successor Company.

#### **p) Non -Transportation Revenues**

Non-transportation revenue includes certain loyalty program revenues, as described in note 4h, as well as revenues from technical services maintenance and other airline related services. The Predecessor Company recorded all loyalty program revenues under non-transportation revenues prior to September 30, 2004.

Maintenance revenues are recognized in other revenues as services are performed. Certain maintenance contracts are referred to as power by the hour whereby the customer makes payments based on their aircraft utilization. Customer receipts under a power by the hour contract are deferred in current liabilities and recognized as revenues as maintenance services are performed.

Other airline related service revenues are recognized as services are provided.

**q) Maintenance and Repairs**

Maintenance and repair costs are charged to operating expenses as incurred, with the exception of maintenance and repair costs related to return conditions on short-term aircraft leases, which are accrued over the term of the lease.

**r) Other Operating Expenses**

Included in other operating expenses are expenses related to building rent and maintenance, terminal handling, professional fees and services, crew meals and hotels, advertising and promotion, insurance costs, credit card fees, Aeroplan redemptions and other expenses. Expenses are recognized as incurred.

**s) Interest Capitalized**

Interest on funds used to finance the acquisition of new flight equipment and other property and equipment is capitalized for periods preceding the dates the assets are available for service.

**t) Stock-Based Compensation Plans**

The Corporation has a stock option plan as described in note 18. The fair value of stock options granted is recognized as a charge to salary and wage expense on a straight line basis over the applicable vesting period, with an offset to contributed surplus. The amount of compensation cost recognized at any date at least equals the value of the vested portion of the options at that date. When stock options are exercised, the consideration paid by employees, together with the amount in contributed surplus, is credited to share capital.

**u) Employee Profit Sharing Plan**

The Corporation has implemented an employee profit sharing plan which is calculated annually on full calendar year results and recorded in interim periods as a charge to salary and wage expense based on the estimated annual payment under the plan.

**v) Intangible Assets**

As a result of the application of fresh start reporting, intangible assets were recorded at their estimated fair values at September 30, 2004. Indefinite life assets are not amortized while assets with finite lives are amortized to nil over their estimated useful lives.

	<u>Estimated Useful Life</u>
International route rights and slots	Indefinite
Air Canada trade name	Indefinite
Aeroplan trade name	Indefinite
Other marketing based trade names	Indefinite
Aeroplan contracts	25 years
Star Alliance membership	25 years
Other contract and customer based intangible assets	10 to 15 years
Technology based intangible assets	1 to 25 years

**w) Deferred Financing Costs**

Deferred financing costs are amortized on an effective interest basis over the term of the related obligation.

**x) Aircraft Lease Payments in Excess of or Less Than Rent Expense**

Total aircraft operating lease rentals over the lease term are amortized to operating expense on a straight-line basis. Included in deferred charges and long-term liabilities is the difference between the straight line aircraft rent expense and the payments as stipulated under the lease agreement. As a result of the application of fresh start reporting, these deferred charges and amounts in other long-term liabilities were valued at nil, with the exception of the fair value of shares issued to lessors as a result of the claim on renegotiated lease agreements and the allocation of lease damages paid to GECC as described in Note 2 which is included in deferred charges.

For leases entered into prior to October 1999, the Predecessor Company accrued for any expected deficiency under a residual value guarantee if it was probable the Predecessor Company would have to make a payment based on the Corporation's expected use of the aircraft taking into consideration its ability to exercise any purchase or renewal options. On a prospective basis, regardless of when the lease was entered into, the Successor Company accrues for any expected deficiency under a residual value guarantee, regardless of whether the Corporation expects to exercise any purchase or renewal options. When there is an expected deficiency, the Corporation accrues the deficiency over the remaining lease term. Any accruals for residual value guarantees are included in other long-term liabilities.

**y) Capacity Purchase Agreements**

The Corporation has capacity purchase agreements with certain unaffiliated regional carriers, which are referred to as Tier III carriers, operating aircraft of 18 seats or less. Under these agreements, the Corporation is responsible for the marketing, ticketing and commercial arrangements relating to these flights and records the earned revenues in passenger revenue. During the quarter ended December 31, 2004, passenger revenues under capacity purchase agreements with Tier III carriers amounted to \$16 in the Successor Company and \$46 in the Predecessor Company for the nine months ended September 30, 2004 (\$58 for the year ended December 31, 2003). Operating expenses are recorded primarily in the aircraft fuel, airport and navigation fees and other operating expense categories.

**z) Future Accounting Standard Changes**

The following is an overview of accounting standard changes that the Corporation will be required to adopt in future years:

**Consolidation of Variable Interest Entities**

Accounting Guideline 15 – Consolidation of Variable Interest Entities (AcG 15) is effective for periods beginning on or after November 1, 2004; as a result, ACE will be adopting this standard effective January 1, 2005. AcG 15 relates to the application of consolidation principles to certain entities that are subject to control on a basis other than ownership of voting interests. The purpose of AcG 15 is to provide guidance for determining when an enterprise includes the assets, liabilities and results of activities of such an entity (a "variable interest entity") in its consolidated financial statements.

Air Canada has entered into aircraft and engine lease transactions with several special purpose entities, referred to as variable interest entities under AcG 15. On adoption of AcG 15 the Corporation anticipates consolidating leasing entities covering 51 aircraft and 22 engines accounted for as operating leases under Canadian GAAP as at December 31, 2004. In addition, the Corporation participates in fuel facilities

arrangement, along with other airlines that contract for fuel services at various airports. The Fuel Facilities Corporations operate on a cost recovery basis. Under AcG 15, the Corporation anticipates consolidating those Fuel Facilities Corporations where the Corporation uses more than 50% of the services of the Fuel Facilities Corporation.

A summary of the anticipated impact on the consolidated balance sheet of ACE of consolidating the variable interest entities as noted as at January 1, 2005 is as follows:

	Aircraft and engines	Fuel Facilities	Total
Property and equipment	\$ 1,304	\$ 113	\$ 1,417
Deposits and other assets, net	57	-	57
Current portion - Long-term debt	77	-	77
Long-term debt	1,179	51	1,230
Minority interest	170	8	178
Other liabilities, net	(158)	2	(156)
	<u>1,268</u>	<u>61</u>	<u>1,329</u>
Credit to retained earnings	<u>\$ 93</u>	<u>\$ 52</u>	<u>\$ 145</u>

#### **Financial Instruments and Hedges**

The Accounting Standards Board has issued three new standards dealing with financial instruments: (i) Financial Instruments – Recognition and Measurement (ii) Hedges and (iii) Comprehensive Income. The key principles under these standards are all financial instruments, including derivatives, are to be included on a company's balance sheet and measured, either at their fair values or, in limited circumstances when fair value may not be considered most relevant, at cost or amortized cost. Financial instruments intended to be held-to-maturity should be measured at amortized cost. Existing requirements for hedge accounting are extended to specify how hedge accounting should be performed. Also, a new location for recognizing certain gains and losses – other comprehensive income – has been introduced. This provides an ability for certain gains and losses arising from changes in fair value to be temporarily recorded outside the income statement but in a transparent manner. The new standards are effective for the Corporation beginning January 1, 2007 and are applied prospectively. As the Corporation has financial instruments, implementation planning will be necessary to review the new standards to determine the consequences for the Corporation.

## **5. Fresh Start Reporting**

ACE applied fresh start reporting on September 30, 2004. As a result, all consolidated assets and liabilities of the Successor Company have been reported at fair values, except for future income taxes which are reported in accordance with the requirements of Section 3465 of the CICA Handbook, Income Taxes. As a result of the implementation of the Plan and the application of fresh start reporting, a revaluation adjustment of \$3,342 has been recorded as a credit to the Predecessor's Shareholders' Equity and the deficit and contributed surplus of Air Canada as at September 30, 2004 has been reclassified to the Predecessor's Shareholders' Equity. The resulting deficit of \$2,700, net of contributed surplus of \$175 was reclassified to the Predecessor's share capital and other equity. The fair values of the consolidated assets and liabilities of the Successor Company have been based on Management's best estimates and on valuation techniques as of September 30, 2004. As the result of the application of fresh start accounting (whereby the liabilities of the Corporation exceed the total assets of the Corporation excluding any implied goodwill) and the financing transactions that occurred on September 30, 2004, the Successor's Shareholders' Equity is \$186. Fresh start values reported in Note 5 to the unaudited Interim Third Quarter 2004 Consolidated Financial Statements were preliminary estimates; valuations have now been finalized and are reflected in these statements. The impact of changes since the unaudited Third Quarter 2004 Consolidated Financial Statements is an increase to assets of \$876 and an increase to liabilities of \$79, resulting in an increase to Shareholders' Equity of \$797.

	Air Canada Predecessor Company - September 30, 2004	Plan of Arrangement (a)	Fresh Start Reporting (f)	Equity and Other Financing Transactions	ACE Successor Company - September 30, 2004
<b>ASSETS</b>					
<b>Current assets</b>					
Cash and cash equivalents	\$ 957	\$ -	\$ -	\$ 227 <sup>(b)</sup> 852 <sup>(c)</sup> 238 <sup>(d)</sup> (335) <sup>(e)</sup>	\$ 1,939
Restricted cash	62	-	-	-	62
Accounts receivable	723	-	-	-	723
Spare parts, materials and supplies	190	-	11	-	201
Prepaid expenses	129	-	10	-	139
	<u>2,061</u>	<u>-</u>	<u>21</u>	<u>982</u>	<u>3,064</u>
<b>Property and equipment</b>	3,749	-	(149)	64	3,664
<b>Deferred charges</b>	3,175	-	(3,033)	19	161
<b>Goodwill</b>	510	-	(510)	-	-
<b>Intangible assets</b>	158	-	2,561	-	2,719
<b>Other assets</b>	443	-	(343)	-	100
<b>TOTAL ASSETS</b>	<u>\$ 10,096</u>	<u>\$ -</u>	<u>\$ (1,453)</u>	<u>\$ 1,065</u>	<u>\$ 9,708</u>
<b>LIABILITIES</b>					
<b>Liabilities not subject to compromise</b>					
<b>Current liabilities</b>					
Accounts payable and accrued liabilities	\$ 1,199	\$ -	\$ 112	\$ -	\$ 1,311
Advance ticket sales and loyalty program deferred revenues	861	-	268	-	1,129
Current portion of long-term debt and capital lease obligations	558	-	(319)	-	239
	<u>2,618</u>	<u>-</u>	<u>61</u>	<u>-</u>	<u>2,679</u>
<b>Long-term debt and capital lease obligations</b>	1,425	-	789	303	2,517
<b>Convertible preferred shares</b>	-	-	-	127	127
<b>Future income taxes (h)</b>	8	-	235	-	243
<b>Pension and other benefit liabilities (g)</b>	1,072	-	1,296	-	2,368
<b>Other long-term liabilities</b>	1,284	-	304	-	1,588
<b>Deferred credits</b>	758	-	(424)	(334)	-
	<u>7,165</u>	<u>-</u>	<u>2,261</u>	<u>96</u>	<u>9,522</u>
<b>Liabilities subject to compromise (i)</b>	7,981	(7,981)	-	-	-
	<u>15,146</u>	<u>(7,981)</u>	<u>2,261</u>	<u>96</u>	<u>9,522</u>
<b>SHAREHOLDERS' EQUITY</b>					
<b>Share capital and other equity</b>	967	925	(2,525)	852	186
		(125)		117	
		(25)	-		
<b>Contributed surplus</b>	25	150	(175)	-	-
<b>Deficit</b>	(6,042)	7,056	(1,014)	-	-
	<u>(5,050)</u>	<u>7,981</u>	<u>(3,714)</u>	<u>969</u>	<u>186</u>
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<u>\$ 10,096</u>	<u>\$ -</u>	<u>\$ (1,453)</u>	<u>\$ 1,065</u>	<u>\$ 9,708</u>

The following legend describes the adjustments made to the Predecessor accounts resulting from the implementation of the Plan and consummation of the various agreements described in note 2:

- a) Implementation of the Plan.
- b) Implementation of the Exit Facility under the GRA.
- c) Issuance of shares for cash under the Rights Offering and the Standby Purchase Agreement.
- d) Issuance of Convertible Preferred Shares for cash under the Investment Agreement.
- e) Implementation, under the GRA, of the purchase of two B747 aircraft with GECC and the payment of \$45 to GECC related to restructuring certain obligations with GECC.
- f) Comprehensive revaluation of assets and liabilities.
- g) The effect of the issuance of the subordinated security promissory notes described in note 15 is also included within the fair value of the obligation for pension benefits as at September 30, 2004.
- h) Future income taxes have been adjusted to reflect the tax effects of differences between the fair value of identifiable assets and liabilities and their estimated tax bases and the benefits of any unused tax losses and other deductions to the extent that these amounts are more likely than not to be realized. The resulting future income tax amounts have been measured based on the rates substantively enacted that are expected to apply when the temporary differences reverse or the unused tax losses and other deductions are realized. It has been assumed that certain intangibles with a fair value of approximately \$1,431, with no underlying tax cost, have indefinite lives and accordingly, the associated future income tax liability of \$243 is not expected to reverse until the intangible assets are disposed of or become amortizable.
- i) Liabilities subject to compromise as accrued by the Applicants totaled \$7,981. Differences from the minimum potential claims of \$8,205 as reported by the Monitor arise primarily from the difference in foreign exchange rates as at April 1, 2003, the rates used in the claims resolution process, and the current rates as at September 30, 2004.



## 6. Reorganization and Restructuring Items

Cash expenditures related to reorganization and restructuring items for the nine months ended September 30, 2004 amounted to \$85 (\$64 for the year ended December 31, 2003) and relate mainly to the payment of professional fees. The table below summarizes reorganization and restructuring charges recorded by the Predecessor Company.

	Nine Months Ended	
	September 30, 2004	2003 <sup>(1)</sup>
Repudiated and renegotiated leases and contracts (a)	\$ 529	\$ 550
Labour related items (b)	279	195
Foreign exchange adjustments on compromised debt	(84)	(183)
Professional fees	158	57
Interest income on accumulated cash (c)	(17)	(14)
Residual value guarantees (d)	-	223
Other	6	222
Reorganization and restructuring items, net	<u>\$ 871</u>	<u>\$ 1,050</u>

<sup>(1)</sup> Since filing for creditor protection on April 1, 2003

a) Repudiated and renegotiated contracts, including aircraft lease agreements, represents the estimated allowable claim resulting from contracts that have been terminated and the amortization of deferred charges related to deficiency claims on renegotiated contracts.

b) Labour related items of \$279 during the nine months ended September 30, 2004 include voluntary and involuntary severance programs accruals of \$117 as well as \$162 of amortization on the estimated compromised claim related to the Predecessor Company's employee groups. Labour related items of \$195 recorded during the year ended December 31, 2003 are summarized as follows:

- A pension curtailment charge of \$128 as a result of the Corporation's review of the impact of the reduction in the level of employees on the expected average remaining service life of the employees as part of the CCAA restructuring program on its pension liability and expense;
- An accrual related to accepted voluntary separation program ("VSP") offers of \$44;
- An accrual of \$80 for contractual termination benefits and the cost of involuntary separation payments;
- The reversal of previously accrued bonus payments of \$32 that are no longer payable as a result of the ratified labour agreements; and
- A reduction of \$20 to accrued vacation liabilities as a result of lower wage rates and reduced vacation entitlements, as well as a reduction of \$5 related to other labour-related programs.

An involuntary severance program pertaining to the Predecessor and Successor Company's workforce reduction plan with respect to non-unionized employees was approved by Management in 2003. Implementation of the plan began in May 2003 and is expected to continue into 2005.

Implementation of the workforce reduction plan pertaining to the Predecessor Company's unionized employees commenced in the second quarter of 2003 as a result of agreed modifications to all collective agreements between employee unions and the Company. Further agreed modifications to all collective agreements were reached in July 2004. The modifications to certain collective agreements include VSP's. For those VSP's which will be offered to the members of the affected employee unions over the next several years, the estimated cost of the VSP is approximately an additional \$69 and will be recorded as a liability and a salary and wage expense as the affected employees accept the offer.

Refer to Note 16 Other long-term liabilities for additional information on these and other labour related restructuring provisions.

c) Interest income earned by an entity under creditor protection, that it would not have earned but for the proceedings, should be reported as a reorganization and restructuring item. The interest income recorded in reorganization items is due mainly to the cash balances retained by the Predecessor Company as a result of the moratorium on aircraft lease payments and the stay on actions to collect pre-filing indebtedness, including trade payables.

d) As part of the restructuring, the Predecessor Company changed its previously planned use of certain B747-400 aircraft that are currently accounted for as operating leases entered into prior to October 1999. They were not expected to remain in active service beyond the end of 2004 and, as described in note 2 under "Global Restructuring Agreement", two of these aircraft have been acquired. As a result of the change in planned use, Management determined that there was a residual value guarantee deficiency of \$223. This deficiency has been recorded as a charge to reorganization and restructuring items reflective of the diminished future use of the aircraft to the Corporation.

## 7. Condensed Combined Financial Statements

Consolidated financial statements of an entity under creditor protection that include one or more entities in reorganization proceedings and one or more entities not in reorganization proceedings should include disclosure of condensed combined financial statements of the entities in reorganization proceedings, including disclosure of the amount of intercompany receivables and payables therein. The following are the condensed combined financial statements of the Applicants of the Predecessor Company as at and for the period ended September 30, 2004 and December 31, 2003. Included in current assets are intercompany receivables with non-Applicants of \$142. Included in current liabilities are intercompany payables with non-Applicants of \$628. Included in other assets are long-term receivables of \$205 from non-Applicants. Included in the Statement of Operations for the nine months ended September 30, 2004 are intercompany revenues of \$301 and expenses of \$184 with non-Applicants. The 2003 figures below relate only to the period since filing for CCAA on April 1, 2003.

### Condensed Combined Statement of Operations

	Nine Months Ended	
	September 30	December 31
	2004	2003
Operating revenues	\$ 6,581	\$ 5,929
Operating expenses	6,596	6,455
Operating loss before reorganization and restructuring items	(15)	(526)
Reorganization and restructuring items (note 6)	(871)	(1,050)
Net interest expense	(171)	(38)
Loss on sale of assets	(74)	(145)
Other non-operating income, including equity income of non-applicants	129	158
Loss before foreign exchange on non-compromised long-term monetary items and income taxes	(1,002)	(1,601)
Foreign exchange on non-compromised long-term monetary items	107	5
Loss before income taxes	(895)	(1,596)
Provision for income taxes	-	(1)
Loss for the period	\$ (895)	\$ (1,597)

### Condensed Combined Statement of Financial Position

	September 30		December 31	
	2004		2003	
<b>ASSETS</b>				
Current assets	\$	2,184	\$	1,489
Property and equipment		3,713		1,614
Deferred charges		3,175		2,346
Goodwill		510		510
Intangible assets		158		164
Other assets		1,127		1,256
	\$	10,867	\$	7,379
<b>LIABILITIES</b>				
Current liabilities	\$	3,132	\$	2,744
Long-term debt and capital lease obligations		1,425		332
Future income taxes		8		11
Pension and other benefit liabilities		1,072		964
Other long-term liabilities		514		298
Deferred credits		1,266		1,364
Liabilities subject to compromise		7,990		5,313
<b>SHAREHOLDERS' DEFICIENCY</b>		(4,540)		(3,647)
	\$	10,867	\$	7,379

### Condensed Combined Statement of Cash Flow

	Nine Months Ended			
	September 30		December 31	
	2004		2003	
Net cash provided by operating activities	\$	320	\$	208
<b>Financing</b>				
Drawdown on GE DIP financing		300		-
Credit facility borrowings		80		315
Aircraft related borrowings		233		-
Reduction of long-term debt and capital lease obligations		(358)		(171)
DIP financing fees		-		(62)
Other		-		(6)
		255		76
<b>Investing</b>				
Additions to property and equipment		(320)		(36)
Investments and advances		-		(15)
Proceeds from sale of assets		1		35
		(319)		(16)
<b>Increase (decrease) in cash and cash equivalents</b>		256		268
<b>Cash and cash equivalents, beginning of period</b>		697		429
<b>Cash and cash equivalents, end of period</b>	\$	953	\$	697

## 8. Property and Equipment

	Successor Company December 31, 2004	Predecessor Company December 31, 2003
Cost		
Flight equipment	\$ 1,179	\$ 2,021
Buildings and leasehold improvements	520	781
Ground equipment and other	176	477
Computer equipment	1	88
	1,876	3,367
Accumulated depreciation and amortization		
Flight equipment	18	1,243
Buildings & leasehold improvements	10	507
Ground equipment and other	5	297
Computer equipment	-	49
	33	2,096
	1,843	1,271
Capital leases, net of accumulated depreciation of \$22 (2003 - \$79) (a)	1,736	270
Purchase deposits	117	159
	3,696	1,700
Property and equipment at net book value	\$ 3,696	\$ 1,700

In accordance with the application of fresh start reporting, the cost of property and equipment values was adjusted to estimated fair value at September 30, 2004 in the Successor Company.

- a) As a result of renegotiated lease terms, 35 leases previously classified as operating leases have been converted to capital leases, three leases previously classified as capital leases have been converted to operating leases, three aircraft have been returned and one aircraft under capital lease has been purchased. Included in capital leases are 35 aircraft (2003-seven) with a cost of \$1,684 (2003- cost of \$245) less accumulated depreciation of \$20 (2003- \$60) for a net book value of \$ 1,664 (2003- \$185), computer equipment with a cost of \$28 (2003- cost of \$50) less accumulated depreciation of \$2 (2003- \$17) for a net book value of \$ 26 (2003- \$33) and facilities with a cost of \$46 (2003- cost of \$54) less accumulated depreciation of nil (2003- \$2) for a net book value of \$46 (2003- \$52)

Interest capitalized for the period ended December 31, 2004 amounted to \$2 using the Corporation's weighted average interest rate. No interest was capitalized during the nine months ended September 30, 2004 by the Predecessor Company. In 2003, interest was capitalized prior to April 1, 2003 in the Predecessor Company and amounted to \$4 using an average interest rate of 8%.

During the period ended December 31, 2004, the Successor Company recorded depreciation expense of \$65 and during the nine months ended September 30, 2004, the Predecessor Company recorded depreciation expense of \$259 (2003 - \$286).

During the nine months ended September 30, 2004, the Predecessor Company recorded provisions of \$75 relating mainly to non-operating aircraft, including \$18 for spare parts. The provisions reflect the excess of net book value over fair value.

During the year ended December 31, 2003, the Predecessor Company recorded net provisions of \$168 mainly related to the write down of non-operating aircraft, other investments and included \$37 for spare parts.

During the nine months ended September 30, 2004, the Predecessor Company received a refund of \$13 from the federal government relating to costs incurred for upgrading cockpit security.

As at December 31, 2004, flight equipment included 16 DC-9's (2003 - 18), three B747-200's (2003 - three), eight B767-200's (2003 - seven), three B737 (2003 - three) and 27 F28 aircraft (2003 - 26) which are retired from active service with a net book value of \$6 (2003 - \$28) which approximates fair value.

As at December 31, 2004, one aircraft, with a net book value of \$31 and an equivalent fair value, was held for sale. The sale was completed in January 2005.

**9. Deferred Charges**

	Successor Company December 31, 2004	Predecessor Company December 31, 2003
Aircraft lease payments in excess of rent expense (a) \$	141	\$ 1,791
Financing costs	26	67
Deficiency claims on renegotiated aircraft leases and contracts	-	448
Aircraft introduction costs	-	12
Other	-	22
Deferred charges	<u>\$ 167</u>	<u>\$ 2,340</u>

a) The deferred charge related to aircraft lease payments in excess of rent expense represents the fair value of shares issued to lessors as a result of the claim on renegotiated lease agreements and the allocation of lease damages paid to GECC, less the net amortization recorded. This deferred charge is amortized to Aircraft rent over the term of the lease agreements.



## 10. Intangible Assets

The fair value of the identifiable intangible assets of the Successor Company were based on valuation techniques for the purposes of financial reporting under the fresh start requirements as described in note 5.

	Successor Company December 31, 2004	Predecessor Company December 31, 2003 (a)
Indefinite life assets		
International route rights and slots	\$ 688	\$ 84
Air Canada trade name	628	-
Aeroplan trade name	135	-
Other marketing based trade names	131	-
	<u>1,582</u>	<u>84</u>
Finite life assets		
Aeroplan contracts	499	-
Star Alliance membership	246	-
Other contract and customer based	260	9
Technology based	121	414
	<u>1,126</u>	<u>423</u>
Accumulated amortization		
Aeroplan contracts	(3)	-
Star Alliance membership	(1)	-
Other contract and customer based	(7)	-
Technology based	(6)	(343)
	<u>1,109</u>	<u>80</u>
	<u>\$ 2,691</u>	<u>\$ 164</u>

- a) Previously recorded in property and equipment and other asset categories before being reclassified to conform to the financial statement presentation adopted in the current period.

As a result of recognizing the benefit during the three months ended December 31, 2004 of future income tax assets that existed at fresh start, and for which a valuation allowance was recorded, intangible assets were reduced on a pro-rata basis by \$11 during the period.

During the period ended December 31, 2004, the Successor Company recorded amortization expense of \$17 and during the nine months ended September 30, 2004, the Predecessor Company recorded amortization expense of \$39 (2003 - \$63).

**11. Other Assets**

	Successor Company December 31, 2004	Predecessor Company December 31, 2003
Prepaid pension asset (note 15)	\$ -	\$ 375
Security and other deposits	94	57
Directors' and Officers' Trust	32	32
Other	11	21
Other assets	<u>\$ 137</u>	<u>\$ 485</u>

The Directors' and Officers' Trust represents restricted funds placed in trust for the use of the Directors and Officers of the Corporation under certain circumstances.

## 12. Long-Term Debt and Capital Lease Obligations

	Final Maturity	Current Interest Rate (%)	Successor Company December 31, 2004	Predecessor Company December 31, 2003
GECC Exit Financing (a)	2011	6.88	\$ 540	\$ -
Air Canada - Lufthansa Cooperation Agreement (b)	2009	6.495	76	98
GECC Limited Recourse Loan (c)	2005	6.306	30	-
GECC Loan (d)	2015	8.47	55	65
Amex Financing (e)	2006	4.25	43	-
CIBC Financing	2004	4.50	-	105
Other (f)	2007 - 2019	4.55 - 6.85	232	-
			976	268
Capital lease obligations (g)	2004-2027	8.0	1,570	237
			2,546	505
Current portion			(218)	(173)
Long-term debt and capital lease obligations			\$ 2,328	\$ 332

For a discussion on the financing transactions effective upon implementation of the Plan, please refer to note 2.

Principal repayment requirements on long-term debt and capital lease obligations through to 2009 are as follows:

	2005	2006	2007	2008	2009
Long-term debt	\$ 75	\$ 33	\$ 128	\$ 181	\$ 160
Capital lease principal obligations	\$ 143	\$ 144	\$ 180	\$ 180	\$ 87

- a) Tranche A, a non-revolving term loan in the amount of US\$425 or CDN equivalent, bears interest at a BA rate plus a margin. The loan was drawn in Canadian dollars as at September 30, 2004 in the amount of \$540. The margin is currently set at 4.25% subject to a later adjustment based upon ACE's credit rating, or, if not available, based on earnings performance. The term is seven years with no principal payments required for the first three years. Equal quarterly principal payments are required for the four years thereafter. The loan may be prepaid at ACE's option early in 2005, upon the payment of a fee of 3%. The loan is secured by a first priority security interest on all of the existing and after acquired property of the Successor Company, other than leased assets, assets financed by other parties, and certain other excluded property of ACE and its subsidiaries.
- b) US\$63 borrowing maturing in 2009, with semi annual repayments, at a fixed interest rate of 4.495% plus an annual 2.0% guarantee fee.
- c) US\$25 borrowing, secured by one B747-400 aircraft, maturing in 2014 at an interest rate equal to the one month LIBOR rate plus a margin of 4.0% and is accrued in arrears at the end of each LIBOR period. Prior to the maturity date of this loan, Air Canada will be required to apply the proceeds from the sale of the aircraft against the principal amount plus accrued interest. Air Canada completed a sales agreement with a third party in January 2005, resulting in the repayment of this borrowing.
- d) US\$46 borrowing maturing in 2015, with semi annual repayments, at a floating interest rate equal to the six month LIBOR rate plus 5.75% prepayable on any interest payment date after December 23, 2007 secured by certain flight training equipment with a carrying value of \$73.
- e) The Amex Financing requires monthly principal and interest payments over the term of the Canadian dollar loan which extends to January 5, 2006 and may be extended in six month intervals by mutual consent. Under the terms of the agreement, the facility is repaid as loyalty points are purchased and as amounts may be due to Air Canada or Aeroplan under various Amex agreements. The facility bears interest at the Bank of Montreal's prime lending rate (4.25% as at December 31, 2004) and is secured by all accounts due to Amex under the agreements and all of the present and future licenses, trademarks and design marks owned by Air Canada and Aeroplan and used by Amex in connection with the agreement.
- f) Other includes mainly financings secured by two A340-500 aircraft. These aircraft purchases were financed through conditional sales agreements for an initial value of US\$174. Principal and interest is paid quarterly until maturity in 2019. The purchase price instalments bear interest at a three month LIBOR rate plus 2.9% (5.45% as at December 31, 2004).
- g) Capital lease obligations, related to computer equipment, facilities and 35 aircraft, total \$1,570 (\$94 and US\$1,226). Future minimum lease payments are \$2,348, which includes \$778 of interest. Certain aircraft lease agreements contain a fair value test, beginning on July 1, 2009, and annually thereafter until lease expiry. This test relates to 38 aircraft under lease of which 33 are accounted for as capital leases. Under the test, the Corporation may be required to prepay certain lease amounts, based on aircraft fair values, as of the date of the test. Any amounts prepaid are recoverable to the extent that aircraft fair values exceed certain thresholds and to the extent that the Corporation has obtained residual value support on lease expiry. The maximum amount payable on July 1, 2009, assuming the related aircraft are worth nil, is US\$871, of which US\$818 relates to capital leases. This amount declines over time to nil upon lease expiry.

Interest paid on long-term debt and capital lease obligations was \$38 during the period ended December 31, 2004. During the nine months ended September 30, 2004, the Predecessor Company paid interest expense of \$131 (2003 \$86).

### 13. Liabilities Subject to Compromise

Liabilities subject to compromise refers to liabilities incurred by the Predecessor Company prior to the filing date that will be dealt with as claims under the CCAA, as well as claims arising out of renegotiated and repudiated leases and contracts. The amounts described in this note were the Predecessor Company's estimate of expected compromised claims as at December 31, 2003. The final amount related to accepted compromised claims may reflect material adjustments.

Details of long-term and subordinated perpetual debt and capital lease obligations subject to compromise are as follows:

	Final Maturity	Interest Rate (%)		
US dollar debt (i)	2005-2011	2.1 - 10.25	\$	890
Canadian dollar debt (ii)	2004-2009	5.0 - 10.0		951
Euro debt (iii)	2005-2011	6.63 - 10.25		498
Japanese yen notes (iv)	2007	1.9		86
Convertible subordinated debentures (v)				150
Subordinated perpetual debt (note vi)				<u>1,099</u>
Long-term and subordinated perpetual debt				3,674
Aircraft leases, including capital lease obligations				871
Accounts payable, accrued liabilities, supplier repudiation and other				<u>768</u>
			\$	<u>5,313</u>

The CCAA filings triggered defaults on substantially all of the Applicants' debt and lease obligations. The Court orders stay most actions against the Applicants, including actions to collect pre-filing indebtedness or to exercise control over the Applicants' property. As a result of the stay, the Applicants ceased making payments of interest and principal on substantially all debt. As interest ceases to accrue on unsecured debt that is subject to compromise subsequent to the CCAA filings, interest expense was not reported on unsecured debt subject to compromise of the Applicants subsequent to April 1, 2003. Since the date of filing, interest expense on unsecured debt of approximately \$179 would have been recorded had the CCAA filings not occurred.

i) As at December 31, 2003, compromised US dollar debt totalled US\$689 and is comprised of the following:

- US\$115 borrowing maturing in 2005 redeemable on any interest payment date.

- US\$154 borrowing maturing in 2007 redeemable on any interest payment date.
- US\$51 borrowing maturing in 2008 redeemable in whole or in part any time, with an indemnity.
- US\$89 borrowing maturing in 2009 redeemable in whole or in part at any time.
- US\$280 borrowing maturing in 2011 redeemable in whole or in part at any time, with an indemnity.

ii) As at December 31, 2003, compromised Canadian dollar debt totalled \$951 and is comprised of

- \$175 borrowing maturing in 2004
- \$250 borrowing maturing in 2006
- \$204 borrowing maturing in 2007 redeemable in whole or in part any time, with an indemnity.

These borrowings have fixed rates of interest.

- A committed and unsecured revolving credit facility at a floating interest rate with a group of financial institutions in Canada. As at December 31, 2003, the facility was fully drawn at \$288.
- Various other Canadian dollar denominated subsidiary debt totalling \$34 at floating interest rates.

iii) As at December 31, 2003, compromised fixed rate Euro debt totalled 310 EUR and was comprised of the following:

- 85 EUR borrowing maturing in 2011 redeemable in whole or in part any time, with an indemnity.
- 130 EUR borrowing maturing in 2006.
- 95 EUR borrowing maturing in 2005

iv) As at December 31, 2003, compromised Japanese yen debt was comprised of 7,143 JPY notes to be repaid in equal semi-annual instalments ending October 2007. The interest rate on the notes was reset in 2002 based on interest rate indices. These notes were redeemable in whole on any interest payment date.

v) In December 1999, the Predecessor Company issued \$150 convertible subordinated debentures which had an annual interest rate of 7.25%, payable quarterly, and convertible at \$16.00, at the holder's option, into Air Canada common shares and Class A non-voting common shares at any time up to and including maturity in December 2009. There were no principal payments until maturity in 2009. Under certain circumstances, the Predecessor Company could force conversion into common shares and Class A shares at any time following the seventh anniversary of the issue.

(vi) Details of the subordinated perpetual debt are as follows:

	Predecessor Company December 31, 2003
34,000 Japanese yen at 2.60% until 2004 Callable in 2004 and every fifth year thereafter at par	\$ 411
300 Swiss francs at 6.25% Callable in 2006 and every fifth year thereafter at 102% of par	313
200 Swiss francs at 5.75% Callable at 102% of par in 2004 and every fifth year thereafter at 102% of par	209
102 Euro at 3.25% Callable in 2006 and every third year thereafter at par	166
Subordinated perpetual debt	<u>\$ 1,099</u>

The maturity of this subordinated perpetual debt was only upon the liquidation, if ever, of the Predecessor Company. Principal and interest payments on the debt were unsecured and were subordinated to the prior payment in full of all indebtedness for borrowed money.

#### 14. Future Income Taxes

Significant components of the Corporation's future tax assets and liabilities as at December 31, 2004 are as follows:

	Successor Company December 31, 2004	Predecessor Company December 31, 2003
Future tax assets		
Non-capital loss carry forward	\$ 558	\$ 83
Deferred gains on sale and leaseback of assets	-	255
Post-employment obligations	775	203
Accounting provisions not currently deductible for tax	242	423
Tax basis of fixed assets over book basis	396	414
Eligible capital expenditures	40	196
Unearned revenues	372	130
Unrealized foreign exchange losses	-	61
Intangible assets	81	-
Net other	62	-
Total future tax assets	<u>2,526</u>	<u>1,765</u>
Future tax liabilities		
Intangible assets	435	-
Book basis of fixed assets over tax basis	-	55
Net other	-	66
Total future tax liabilities	<u>435</u>	<u>121</u>
Net future tax assets	<u>2,091</u>	<u>1,644</u>
Less valuation allowance	<u>2,334</u>	<u>1,655</u>
Net recorded future income tax liability	<u>\$ (243)</u>	<u>\$ (11)</u>

Future income tax assets are recognized to the extent that realization is considered more likely than not. Since the Corporation has determined that it is more likely than not that the future income tax assets are not recoverable, the net future tax assets have been offset by a valuation allowance. However, the future tax deductions underlying the future tax assets remain available for use in the future to reduce taxable income. The benefit of future income tax assets that exist at fresh start, and for which a valuation allowance is recorded against, will be recognized first to reduce to nil any remaining intangible assets (on a pro-rata basis) that were recorded upon fresh start reporting with any remaining amount as a credit to shareholders' equity. The benefit of future income tax assets that arise after fresh start will be recognized in the income statement.



It has been assumed that certain intangibles with a fair value of approximately \$1,431, with no underlying tax cost, have indefinite lives and accordingly, the associated future income tax liability of \$243 is not expected to reverse until the intangible assets are disposed of or become amortizable.

The reconciliation of income tax attributable to continuing operations, computed at the statutory tax rates, to income tax expense (recovery) is as follows:

	Successor Company Period ended December 31, 2004	Predecessor Company Nine months ended September 30, 2004	Predecessor Company Twelve months ended December 31, 2003
Provision (recovery) based on combined federal and provincial tax rates	\$ 10	\$ (304)	\$ (675)
Non-taxable portion of capital gains	(3)	(4)	(40)
Large corporations tax	2	7	5
Non-deductible expenses	3	14	69
Effect of tax rate changes on future income taxes	-	(1)	(57)
Effect of declining tax rates in future years	-	-	61
Other	-	(1)	14
	12	(289)	(623)
Valuation allowance - recovery offset	1	291	611
Valuation allowance - asset write-off	-	-	-
	1	291	611
Provision for (recovery of) income taxes	\$ 13	\$ 2	\$ (12)

Significant components of the provision for (recovery of) income taxes attributable to continuing operations are as follows:

	Successor Company Period ended December 31, 2004	Predecessor Company Nine months ended September 30, 2004	Predecessor Company Twelve months ended December 31, 2003
Current tax expense	\$ 2	\$ 7	\$ 5
Future income tax expense (recovery) relating to temporary differences	10	(296)	(571)
Future income tax expense (recovery) from tax rate changes	-	-	(57)
Valuation allowance	1	291	611
Provision for (recovery of) income taxes	\$ 13	\$ 2	\$ (12)

Income taxes paid in 2004 by the Successor Company were less than \$1. Income taxes paid in 2004 by the Predecessor Company were less than \$1 (2003 \$1).

The balances of tax attributes as at December 31, 2004, namely the balances of non capital loss carryforward, vary amongst different taxing jurisdictions. The following are the Federal tax loss expiry dates:

Year of expiry	Tax losses
2005	\$ 6
2006	-
2007	4
2008	-
2009	82
2010	112
2011	1,368
	<u>\$ 1,572</u>

Bill C-33, a second Act to implement certain provisions of the Federal budget tabled in Parliament on March 23, 2004, passed third reading in the House of Commons on February 25, 2005. Hence, \$49 of tax losses would expire in 2013 instead of 2010 and \$1,368 of tax losses would expire in 2014 instead of 2011.

## 15. Pension and Other Benefit Liabilities

The Corporation and its subsidiaries maintain several defined benefit and defined contribution plans providing pension, other retirement and post-employment benefits to its employees. The Corporation is the administrator and sponsoring employer of a number of pension plans registered under the Pension Benefits Standard Act, 1985 (Canada). In addition, the Corporation maintains a number of supplementary pension plans, which are not registered.

The defined benefit pension plans provide benefits upon retirement, termination or death based on the member's years of service and final average earnings for a specified period. The other employee benefits consist of health, life and disability.

The measurement date used for financial reporting of the pension and other benefit obligations is December 31. The most recent actuarial valuation of the pension plans for funding purposes was as of January 1, 2004 and the next funding valuation will be as of January 1, 2005.

The accrued benefit liability is included in the balance sheet as follows:

	Successor Company December 31, 2004	Predecessor Company December 31, 2003
Pension benefits	\$ 1,563	\$ 19
Other employee future benefits	875	581
	<hr/> 2,438	<hr/> 600
Current portion	94	11
	<hr/> 2,344	<hr/> 589
Pension asset recorded in other assets	-	375
Pension and other benefit liabilities	<hr/> \$ 2,344	<hr/> \$ 964

The current portion is included in Accounts payable and accrued liabilities.

Total cash payments made by the Predecessor Company were \$196 (2003 - \$185) for the pension and other benefits for 2004. The Successor Company made cash payments in the amount of \$123 for the pension and other benefits for 2004. The cash payments with respect to the pension plans are estimated to be \$259 for 2005.

Pension and other employee future benefit obligations are adjusted to reflect the net accrued benefit obligation based on management's best estimate assumptions on a going forward basis. The liability recorded is as follows:

	Pension Benefits			Other Benefits		
	Successor Company December 31, 2004	Predecessor Company September 30, 2004	Predecessor Company December 31, 2003	Successor Company December 31, 2004	Predecessor Company September 30, 2004	Predecessor Company December 31, 2003
<b>Change in benefit obligation</b>						
Benefit obligation at beginning of period	\$ 10,783	\$ 10,873	\$ 9,850	\$ 866	\$ 819	\$ 673
Current service cost	46	139	167	23	69	71
Interest cost	163	468	624	13	40	46
Employees' contributions	24	67	101	-	-	-
Benefits paid	(133)	(387)	(463)	(18)	(53)	(57)
Plan amendments	-	-	(9)	-	-	20
Increase (decrease) due to curtailment	-	-	67	-	-	(14)
Actuarial (gain) loss	331	(370)	599	(34)	(9)	103
Foreign exchange	(7)	(7)	(63)	(8)	-	(23)
Benefit obligation at end of period	11,207	10,783	10,873	842	866	819
<b>Change in plan assets</b>						
Fair value of plan assets at beginning of period	9,149	9,022	8,077	10	10	14
Actual return on plan assets	533	301	1,233	1	-	1
Employer contributions	106	151	133	17	45	52
Employees' contributions	24	67	101	-	-	-
Benefits paid	(133)	(387)	(463)	(18)	(45)	(57)
Foreign exchange	(6)	(5)	(59)	-	-	-
Fair value of plan assets at end of period	9,673	9,149	9,022	10	10	10
Deficit at end of period	1,534	1,634	1,851	832	856	809
Unrecognized net transition obligation	-	-	7	-	-	-
Unrecognized past service cost	-	(605)	(672)	-	(30)	(35)
Unrecognized net actuarial (gain) loss	29	(957)	(1,167)	43	(190)	(193)
Net benefit obligation	1,563	72	19	875	636	581
Current portion	82	-	-	12	12	11
Pension and other benefits liability	\$ 1,481	\$ 72	\$ 19	\$ 863	\$ 624	\$ 570
<b>Weighted average assumptions used to determine the accrued benefit liability</b>						
Discount rate	5.75%	6.00%	6.00%	4.75%-5.75%	6.00%	6.00%
Rate of compensation increase	4.00%	4.00%	4.00%			

On August 9, 2004, the Government of Canada adopted the Air Canada Pension Plan Solvency Deficiency Funding Regulations (the "Pension Regulations"). The Pension Regulations allow Air Canada to fund the solvency deficiencies in its ten Canadian defined benefit registered pension plans as of January 1, 2004 over ten years, rather than the five years required under the ordinary rules, and to pay down such deficiencies by way of an agreed schedule of variable annual contributions rather than by way of equal annual contributions as required under the ordinary rules. The Pension Regulations came into force upon Air Canada's emergence from CCAA protection on September 30, 2004, on which date the Company issued subordinated secured promissory notes in an aggregate amount of approximately \$347 in favour of the pension plan trustee. Such notes will be reduced as the principal amount of the solvency deficiencies is paid down, and will only be called on the occurrence of certain specified events of default. The effect of the issuance of the subordinated security promissory notes is included within the fair value of the obligation for pension benefits as reflected in the Successor Company's balance sheet.

Plan assets consist of the following:

	Percentage of plan assets		
	Successor December 31, 2004	Predecessor December 31, 2003	Target Allocation
Equity securities	64.8%	64.8%	65.0%
Bonds and mortgages	33.1%	32.9%	35.0%
Real estate	0.2%	0.3%	0.0%
Short-term and Other	1.9%	2.0%	0.0%
Total	100.0%	100.0%	100.0%

For the Domestic Registered Pension Plans, the investments conform to the Statement of Investment Policy and Objectives of the Air Canada Pension Master Trust Fund. The Audit, Finance and Risk Committee of the Board of Directors reviews and confirms the policy annually. The investment return objective of the fund is to achieve a total annualized rate of return that exceeds inflation by at least 3.75% over the long term.

In addition to the broad asset allocation, as summarized in the asset allocation section above, the following policies apply to individual asset classes:

- Equity investments can include convertible securities, and are required to be diversified among industries and economic sectors. Foreign equities can comprise 27% to 33% of the total market value of the trust. Limitations are placed on the overall allocation to any individual security at both cost and market value. Derivatives are permitted to the extent they are not used for speculative purposes or to create leverage.
- Fixed income investments are oriented toward risk averse, long term, investment grade securities rated "A" or higher. With the exception of Government of Canada securities or a province thereof, in which the plan may invest the entire fixed income allocation, fixed income investments are required to be diversified among individual securities and sectors. The target return is comprised of 50% of the total return of the Scotia Capital Long Term Bond Index.

Similar investment policies are established for the other pension plans sponsored by Air Canada.

Air Canada's expected long-term rate of return on assets assumption is selected based on the facts and circumstances that exist as of the measurement date, and the specific portfolio mix of plan assets. Management, in conjunction with its actuaries, reviewed anticipated future long-term performance of individual asset categories and considered the asset allocation strategy adopted by the company, including the longer duration in its bond portfolio in comparison to other pension plans. These factors are used to determine the average rate of expected return on the funds invested to provide for the pension plan benefits. While the review considers recent fund performance and historical returns, the assumption is primarily a long-term, prospective rate.

The Corporation has recorded net defined benefit pension and other employee future benefits expense as follows:

	Pension Benefits			Other Benefits		
	Successor Company December 31, 2004	Predecessor Company September 30, 2004	Predecessor Company December 31, 2003	Successor Company December 31, 2004	Predecessor Company September 30, 2004	Predecessor Company December 31, 2003
<b>Components of Net Periodic Pension Cost</b>						
Current service cost	\$ 46	\$ 139	\$ 167	\$ 23	\$ 69	\$ 71
Interest cost	163	468	624	13	40	46
Actual return on plan assets	(533)	(301)	(1,233)	(1)	-	(1)
Actuarial loss (gain) on benefit obligation	331	(370)	602	(34)	(9)	103
Plan amendments	-	-	(9)	-	-	20
Curtailement loss (gain)	-	-	128	-	-	1
<b>Costs arising in the period</b>	<b>7</b>	<b>(64)</b>	<b>279</b>	<b>1</b>	<b>100</b>	<b>240</b>
Differences between costs arising in the period and costs recognized in the period in respect of:						
Return on plan assets	360	(186)	592	-	-	1
Actuarial loss (gain)	(331)	390	(590)	34	20	(96)
Plan amendments/prior service cost	-	67	105	-	5	(14)
Transitional obligation (asset)	-	(6)	(21)	-	-	-
Negative balances due to limit	-	4	10	-	-	-
<b>Net periodic pension cost recognized</b>	<b>\$ 36</b>	<b>\$ 205</b>	<b>\$ 375</b>	<b>\$ 35</b>	<b>\$ 125</b>	<b>\$ 131</b>
Weighted average assumptions used to determine pension costs						
Discount rate	6.00%	6.00%	6.50%	4.75%-5.75%	6.00%	6.00%
Expected long term rate of return on plan assets	7.50%	7.50%	7.50%	7.50%	7.50%	8.00%
Rate of compensation increase	4.00%	4.00%	4.25%			

The expense for the defined contribution plan recorded by the Predecessor Company is \$3 (2003 \$5). The expense for the defined contribution plan recorded by the Successor Company is \$1.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 10.75% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2004 (2003 10%). The rate is assumed to decrease gradually to 5% by 2013. A one percentage point increase in assumed health care trend rates would have increased the service and interest costs by \$1 and the obligation by \$13. A one percentage point decrease in assumed health care trend rates would have decreased the service and interest costs by \$2 and the obligation by \$17.

## 16. Other Long-term Liabilities

	Successor Company December 31, 2004	Predecessor Company December 31, 2003
Loyalty program deferred revenues (note 4h) (a)	\$ 1,102	\$ 541
Unfavourable contract liability on aircraft leases (b)	290	-
Long-term employee liabilities (c)	130	69
Aircraft rent in excess of lease payments	33	537
Other	90	69
Other long-term liabilities	<u>\$ 1,645</u>	<u>\$ 1,216</u>

a) The current portion of loyalty program deferred revenues of \$497 are reported in Advance ticket sales and loyalty program deferred revenues.

b) As a result of fresh start reporting, the Successor Company fair valued all aircraft lease arrangements. The unfavourable contract liability on aircraft leases represents the net present value of lease payments in excess of estimated market rents.

c) The following table outlines the changes to the labour related provisions which include those related to restructuring:

	Successor Company	Predecessor Company	
	Period ended December 31, 2004	Nine months ended September 30, 2004	12 months ended December 31, 2003
Beginning of period	\$ 198	\$ 121	\$ 37
Charges recorded	2	117	124
Amounts disbursed	(8)	(40)	(40)
End of period	\$ 192	\$ 198	\$ 121
Current portion	62	68	52
Long-term employee liabilities	\$ 130	\$ 130	\$ 69

The current portion is included in Accounts payable and accrued liabilities.



**17. Deferred Credits**

	Successor Company December 31, 2004	Predecessor Company December 31, 2003
Gain on sale and leaseback of assets	\$ -	\$ 761
Contributions received in exchange for extensions of commercial agreements	-	64
Other	-	2
Deferred credits	<u>\$ -</u>	<u>\$ 827</u>

## 18. Stock Based Compensation

Pursuant to the Plan, a stock option plan of ACE has been established as an on-going program and will comprise a maximum of 5% of the fully diluted equity of ACE as at September 30, 2004 (approximately 5,000,000 shares). On October 3, 2004, options to purchase 3,027,509 shares were granted pursuant to the Plan at an exercise price of \$20 per share. Participation in the plan will be limited to employees holding positions that, in view of the Board of Directors of ACE or a committee selected by the Board, that have a significant impact on ACE's long-term results.

A summary of the Company's stock option plan and activity is as follows:

	<u>Successor Company</u>	
	Shares (000)	Exercise price
<u>Common Shares</u>		
June 29, 2004	-	\$ -
Granted	3,028	20.00
Exercised	-	-
Forfeited	-	-
December 31, 2004	<u>3,028</u>	<u>\$ 20.00</u>

The fair value of stock options granted is recognized as a charge to salary and wage expense over the applicable vesting period, with an offset to contributed surplus. No options are exercisable before the expiry of one year following October 3, 2004. Fifty percent of all options vest over four years. The remaining options will vest based upon performance conditions. All options expire after seven years. When options are exercised, the consideration paid by employees, together with the amount in contributed surplus, is credited to share capital.

The fair value of options granted in 2004 was estimated on the date of grant using the Black-Scholes option valuation model with the following assumptions: (i) risk-free interest rate of 3.90%, (ii) expected option life of 4.5 years, (iii) expected volatility of 51.59% and (iv) expected dividends of 0%. The aggregated fair value of options issued during the period ended December 31, 2004 was \$23. The weighted average fair value per option granted was \$7.73. The charge to compensation expense during the period ended December 31, 2004 for stock options issued by the Successor Corporation is \$1. None of the options issued can be exercised prior to October 3, 2005.

### **Predecessor Company**

The details of the Predecessor Company's stock option plan, under which eligible employees were granted options to purchase common shares and Class A shares, at a price not less than the market value of the shares at the date of granting, are as follows:

Stock Option Plan

Total Outstanding	Weighted Average Remaining Contractual Life (Years)	Range of Exercise Price	Outstanding Weighted Average Exercise Price	Total Exercisable	Exercisable Weighted Average Exercise Price	Expiry Dates
<b>Common</b>						
1,849	5	\$4.73 - \$6.99	\$6.21	1,773	\$6.21	2004 - 2012
2,782	7	\$7.00 - \$9.99	\$8.73	1,579	\$8.62	2005 - 2011
2,294	6	\$10.00 - \$12.99	\$10.57	1,824	\$10.70	2008 - 2010
375	6	\$13.00 - \$19.67	\$16.05	282	\$16.05	2010
<u>7,300</u>			<u>\$9.05</u>	<u>5,458</u>	<u>\$8.91</u>	
<b>Class A Non-Voting</b>						
714	6	\$1.54 - \$4.99	\$4.14	427	\$4.52	2006 - 2013
430	5	\$5.00 - \$6.99	\$5.62	393	\$5.67	2004 - 2011
841	6	\$7.00 - \$7.99	\$7.25	525	\$7.28	2005 - 2011
331	5	\$8.00 - \$12.49	\$11.10	302	\$11.27	2008 - 2010
<u>2,316</u>			<u>\$6.54</u>	<u>1,647</u>	<u>\$6.91</u>	

A summary of option activities for the Predecessor Company is as follows:

	<u>2004</u>		<u>2003</u>	
	Shares (000)	Weighted average share price	Shares (000)	Weighted average share price
<b><u>Common Shares</u></b>				
Beginning of period	7,300	\$ 9.05	7,451	\$ 9.07
Granted	-	-	-	-
Exercised	-	-	(6)	2.79
Forfeited	(7,300)	-	(145)	10.27
End of period	<u>-</u>	<u>\$ -</u>	<u>7,300</u>	<u>\$ 9.05</u>
<b><u>Class A Shares</u></b>				
Beginning of period	2,316	\$ 6.54	2,334	\$ 6.57
Granted	-	-	50	1.54
Exercised	-	-	-	-
Forfeited	(2,316)	-	(68)	3.74
End of period	<u>-</u>	<u>\$ -</u>	<u>2,316</u>	<u>\$ 6.54</u>

All options were exercisable on the basis of 25% of the options granted per year on a cumulative basis, beginning after one year and expiring after ten years. The fair value of options issued in 2003 was nominal. In the Predecessor Corporation, none of the options issued since January 1, 2002 had been exercised.

All outstanding options of the Predecessor Company were cancelled without payment or consideration.

## 19. Share Capital and Other Equity

The issued and outstanding common shares of ACE as at December 31, 2004, along with other equity instruments, are as follows:

	Authorized (000)	Outstanding (000)
Issued and outstanding common shares		
Class A variable voting shares (a)	unlimited	74,813
Class B voting shares (b)	unlimited	8,813
Shares held in escrow (note 2)		<u>5,189</u>
Total issued and outstanding common shares as at December 31, 2004		<u>88,815</u>

5,000 Class A Variable Voting Shares and 50,000 Class B Voting Shares were subscribed for in cash of \$1 by the Directors of ACE on September 30, 2004 at the subscription price under the Rights Offering. No stock issued to Directors may be sold, before the expiry of one year following September 30, 2004.

Share capital and other equity summary as at December 31, 2004 (net of issue costs):

Common shares <sup>(1)</sup>	\$ 1,777
Convertible preferred shares (c)	<u>117</u>
	1,894
Adjustment to shareholders' equity <sup>(2)</sup>	<u>(1,708)</u>
Share capital and other equity at September 30, 2004	\$ 186
Issue of common shares during period ended December 31, 2004	<u>1</u>
Share capital and other equity at December 31, 2004	<u>\$ 187</u>

(1) The fair value of outstanding common shares includes the net proceeds received under the Rights Offering and Standby Purchase Agreement of \$852 and the fair value of common shares issued to creditors under the Plan of \$925 based upon the issue price from the Rights Offering.

(2) Under fresh start reporting, when there is a negative balance in shareholders' equity after a comprehensive revaluation, share capital is disclosed at a nominal value and the balance is disclosed as a capital deficiency resulting from the financial reorganization. CICA 1625 - Comprehensive Revaluation of Assets and Liabilities, does not permit goodwill to be recorded even if the fair value of net assets is less than the fair value of the enterprise as a whole.

### a) Class A Variable Voting Shares

The Class A Variable Voting Shares may be held only by persons who are not Canadians and are entitled to one vote per Class A Variable Voting Share unless (i) the number of Class A Variable Voting Shares outstanding (including the Convertible Preferred Shares, on an as-converted basis), as a percentage of the total number of votes attaching to voting shares outstanding exceeds 25% or (ii) the total number of votes cast by or on behalf of holders of Class A Variable Voting Shares (including the Convertible Preferred Shares on an as-converted basis) at any meeting exceeds 25%

of the total number of votes that may be cast at such meeting. If either of the above noted thresholds would otherwise be surpassed at any time, the vote attached to each Class A Variable Voting Share will decrease proportionately such that (i) the Class A Variable Voting Shares as a class (including the Convertible Preferred Shares on an as-converted basis) do not carry more than 25% of the aggregate votes attached to all issued and outstanding voting shares of ACE and (ii) the total number of votes cast by or on behalf of holders of Class A Variable Voting Shares (including the Convertible Preferred Shares on an as-converted basis) at any meeting do not exceed 25% of the votes that may be cast at such meeting.

Each issued and outstanding Class A Variable Voting Share shall be converted into one Class B Voting Share, automatically and without any further act of ACE or of the holder, if (i) such Class A Variable Voting Share becomes held, beneficially owned and controlled, directly or indirectly, otherwise than by way of security only, by a Canadian; or (ii) the provisions contained in the Canada Transportation Act (the "CTA") relating to foreign ownership restrictions are repealed and not replaced with similar provisions.

**b) Class B Voting Shares**

Each Class B Voting Share shall confer the right to one (1) vote in person or by proxy at all meetings of shareholders of the ACE.

Subject to the foreign ownership restrictions of the CTA, an issued and outstanding Class B Voting Share shall be converted into one Class A Variable Voting Share, automatically and without any further act of the ACE or of the holder, if such Class B Voting Share becomes held, beneficially owned and controlled, directly or indirectly, otherwise than by way of security only, by a person who is not a Canadian.

**c) Convertible Preferred Shares**

As at September 30, 2004, 12,500 Convertible Preferred Shares were issued to an affiliate of Cerberus for consideration of \$250 before fees of \$12. These Convertible Preferred Shares are convertible into 9,259 common shares, based on the conversion ratio applicable as at December 31, 2004.

For accounting purposes, the Convertible Preferred Shares are presented as a compound instrument. At the date of issuance, the value ascribed to the holders' conversion option, which is presented as equity, was \$123 less allocated fees of \$6; the value ascribed to the financial liability was \$127. The total value will increase by 5% per annum, compounded semi-annually from the date of issuance ("Fully Accreted Value") resulting in an effective interest rate of 12% on the financial liability.

Each preferred share shall confer on its holder the right to that number of votes as is equal to the number of ACE shares into which each preferred share held by such holder could be converted on the date for determination of shareholders entitled to vote at the meeting or on the date of any written consent, based on the conversion ratio in effect on such date; provided, however, that if any Convertible Preferred Shares are held by persons who are not Canadians, such Convertible Preferred Shares shall be subject to the same proportionate reduction in voting percentage as described for Class A Variable Voting Shares above as if, for voting purposes only, such Convertible Preferred Shares had been converted into Class A Variable Voting Shares.

The Convertible Preferred Shares may be converted at any time, at the option of the holder thereof, into fully paid and nonassessable Class B Voting Shares (if the holder is a Canadian) or fully paid and nonassessable Class A Variable Voting Shares (if the holder is not a Canadian) at the conversion ratio applicable upon the date of conversion. The conversion price is initially equal to 135% of the subscription price of each Class B Voting Share under the Rights Offering. The conversion price is adjusted automatically downward on the first anniversary of the issuance date of the Convertible Preferred Shares to 130% of the subscription price of each ACE Class B Voting Share. The conversion is based upon the Fully Accreted Value at the time of conversion.

The holders of ACE Convertible Preferred Shares will be required to convert the ACE Convertible Preferred Shares into fully paid and nonassessable common shares at the conversion ratio applicable upon the date of conversion, if:

- i) at any time during the period between the effective date until and including the first anniversary thereof, the closing price of the ACE shares on the principal market for each of thirty consecutive trading days exceeds 200% of the then applicable conversion price; or
- ii) at any time during the period following the first anniversary of the effective date, the closing price of the ACE shares on the principal market for each of thirty consecutive trading days exceeds 175% of the then applicable conversion price.

The Convertible Preferred Shares will be subject to mandatory conversion into fully paid and nonassessable common shares within ten days of each mandatory conversion date, at the conversion ratio applicable upon the date of conversion, upon the following terms and conditions:

- i) if the closing price of the ACE shares on the principal market exceeds the Fully Accreted Value of a preferred share on at least thirty of the one hundred trading days immediately prior to a particular mandatory conversion date; or
- ii) if the closing price of the ACE shares on the principal market does not exceed the Fully Accreted Value of a preferred share on at least thirty of the one hundred trading days immediately prior to a particular mandatory conversion date, (i) the holders of the Convertible Preferred Shares will not be required to convert their Convertible

- iii) Preferred Shares into ACE shares and (ii) as of such mandatory conversion date, the then applicable conversion price shall be automatically reduced by 3.75%; and if the closing price of the ACE shares on the principal market does not exceed the Fully Accreted Value of a preferred share on at least thirty of the one hundred trading days immediately prior to the final maturity date, then holders of Convertible Preferred Shares will be entitled, upon written notice to ACE given within ten days following the final maturity date, to require ACE to redeem each of the Convertible Preferred Shares in cash at a redemption price equal to the Fully Accreted Value as of the final maturity date.

The first mandatory conversion date is seven years from the date of issuance.

The Convertible Preferred Shares (including the shares into which they are convertible) may not be sold, assigned or in any way transferred by Cerberus (other than to its affiliates) including pursuant to hedging transactions, swaps or other arrangements transferring any of the economic consequences of the ownership of the Convertible Preferred Shares acquired by Cerberus for a period of 24 months after the closing; provided that, if at any time during such 24 month period Cerberus is required to convert the Convertible Preferred Shares, then the restrictions on transfer with respect to 50% of the Convertible Preferred Shares (and any shares into which they are converted or convertible) shall be of no force and effect and the restrictions on transfer with respect to the remaining 50% of the Convertible Preferred Shares (and any shares into which they are converted or convertible) shall be limited only to sales of beneficial ownership of the Convertible Preferred Shares (and any shares into which they are convertible) to third parties. Notwithstanding the foregoing, the transfer restrictions shall cease to be in effect as to all Convertible Preferred Shares (and any shares into which they are convertible) in the event of a tender offer for any of the shares of ACE, any change in control transaction, any liquidation, dissolution, bankruptcy or other similar proceedings of ACE.

Subject to the rights, privileges, restrictions and conditions attaching to the shares of ACE ranking prior to the Convertible Preferred Shares, upon the liquidation, dissolution or winding-up or distribution of the assets of ACE, the holders of the Convertible Preferred Shares will be entitled to receive, prior to and in preference to the holders of ACE shares, an amount equal to the Fully Accreted Value of the Convertible Preferred Shares as of the date of the liquidation, dissolution, winding-up or distribution.

The holders of Convertible Preferred Shares participate on an as-converted basis with respect to all dividends, distributions, spin-off, split-off, subscription rights or other offers made to holders of Class A Variable Voting Shares and Class B Voting Shares and any other similar transactions.

### **Predecessor Company**

The authorized capital of the Predecessor Company consisted of an unlimited number of common shares, Class A non-voting common shares ("Class A shares"), Class A preferred shares issuable in series and Class B preferred shares issuable in series.

In 1999, the Predecessor Company issued 10 million Class A Convertible Participating Non-Voting Preferred Shares, Series 1 ("Series 1 preferred shares") to Expo Investment Partnership, L.P. ("Expo"), a partnership formed by UAL Corporation ("UAL") and Deutsche Lufthansa AG ("Lufthansa"), two of Air Canada's Star Alliance partners. These shares were entitled to receive dividends equal to the amount paid to holders of the Predecessor Company's common shares. The shares were not redeemable by the Predecessor Company prior to December 31, 2009, unless either of the partners ceased to be a participant in the Star Alliance and as a result the Predecessor

Company would have terminated its Alliance Agreement or either partner was in breach of any Alliance Agreement which would have led to the Predecessor Company terminating its Alliance Agreement. On or after December 31, 2009, the Predecessor Company may have redeemed the shares for \$25.00 per share plus declared and unpaid dividends and a gross-up for dividends and deemed dividends. The holder of the Preferred Shares had the option to require the Predecessor Company to redeem the Preferred Shares at \$25.00 per share (plus a premium of 1% in the event there was a change of control of the Predecessor Company and a gross-up for dividends and deemed dividends) if: the Predecessor Company breached an Alliance Agreement in a manner which did or could reasonably be expected to have a material impact; a breach of certain covenants occurred; a change of control of the Predecessor Company occurred that did or was reasonably expected to have a material impact; or the Predecessor Company refused to extend the Alliance Agreements after they expired at any time on or after December 31, 2009. The holder may have converted each preferred share at any time into a) 1.0417 Class A shares for \$24.00 or b) an equal number of Class A Convertible Participating Non-Voting Preferred Shares, Series 2, which were transferable to third parties but did not contain certain of the covenants described above. The holder was entitled to receive, in priority to common and Class A shares, \$25.00 per share plus any declared and unpaid dividends in the event of liquidation of the Predecessor Company. In the event the Predecessor Company breached its obligations under the Alliance Agreements in a manner material and adverse to the revenues of UAL or Lufthansa and the Alliance Agreements were terminated, the Predecessor Company had agreed to pay liquidated damages in amounts declining over a ten year period from \$250 to \$37, which claims were subject to compromise.

As a result of the CCAA filings, Expo filed a claim in the amount of \$250. A Notice of Disallowance was sent and the ten day period for the filing of a dispute expired without a Notice of Dispute being filed and consequently the Notice of Disallowance was deemed binding.

The preferred shares were cancelled for nominal consideration and the Class A and common shares were converted into a nominal amount of the post-restructuring equity of ACE.

The issued capital of the Predecessor Company consisted of common shares, Class A shares and Series 1 preferred shares. The changes during 2003 in the outstanding number of common and Class A shares and their aggregate stated value during that year were as follows:

	Common Shares		Class A Shares	
	Number (000)	Amount	Number (000)	Amount
December 31, 2002	79,070	\$ 521	41,115	\$ 296
Share purchase options exercised	6	-	-	-
December 31, 2003	79,076	521	41,115	296
Restructuring arrangements under the Plan	(79,076)	(521)	(41,115)	(296)
September 30, 2004	-	\$ -	-	\$ -



Share Capital and Other Equity Summary (net of issue costs):	2003
Common shares	\$521
Class A shares	296
Series 1 preferred shares	125
Warrants <sup>(1)</sup>	-
Convertible subordinated debenture conversion option	<u>25</u>
Total	<u><u>\$967</u></u>

## 20. Earnings Per Share

The following table outlines the calculation of basic and diluted earnings per share (in millions, except per share amounts):

	Successor Company	Predecessor Company	
	Period ended December 31 2004	Nine months ended September 30 2004	Twelve months ended December 31 2003
<b>Numerator:</b>			
Numerator for basic earnings per share:			
Income (loss) from continuing operations	\$ 15	\$ (895)	\$ (1,867)
Effect of potential dilutive securities:			
After tax income from:			
Convertible preferred shares	3	-	-
Convertible subordinated debentures	-	8	3
Add back anti-dilutive impact	(3)	(8)	(3)
Adjusted earnings (loss) for diluted earnings per share	\$ 15	\$ (895)	\$ (1,867)
<b>Denominator:</b>			
Denominator for basic earnings per share:			
Weighted-average shares	89	120	120
Effect of potential dilutive securities:			
Stock options	1	-	-
Class A non-voting preferred shares	-	10	10
Convertible subordinated debentures	-	9	9
Convertible preferred shares	9	-	-
	10	19	19
Add back anti-dilutive impact	(9)	(19)	(19)
Denominator for diluted earnings per share:			
Adjusted weighted-average shares	90	120	120
Basic earnings (loss) per share:	\$ 0.17	\$ (7.45)	\$ (15.53)
Diluted earnings (loss) per share:	\$ 0.17	\$ (7.45)	\$ (15.53)

The calculation of earnings per share is based on whole dollars and not on rounded millions. As a result, the above amounts may not be recalculated to the per share amount disclosed above.

Pursuant to the Plan as further described in note 2, all issued and outstanding options of Air Canada and warrants were cancelled without payment or consideration. In addition a new share capital was established under ACE, as further described in note 19.

The effect of potential dilutive securities was not included in the calculation of diluted earnings per share for both the Successor Company and the Predecessor Company as the result would be anti-dilutive.

The dilutive effect of outstanding stock options on earnings per share is based on the application of the treasury stock method. For the Successor Company, under the treasury stock method, the proceeds from the exercise of such securities are assumed to be used to purchase Class B Voting Shares. For the Predecessor Company, proceeds were assumed to be used to purchase common shares and Class A shares.

For the year ended December 31, 2003, the following securities were not included in the calculation of dilutive potential common shares as the exercise price exceeded the average trading value of the shares: 7,300,394 options for common shares with an exercise price between \$4.73 - \$19.67; 2,316,094 options

for Class A shares with an exercise price between \$1.54 - \$12.49; and 4,700,000 warrants with an exercise price of \$24.00.

## 21. Segment Information

As a result of the corporate restructuring, the segment reporting structure has been adjusted to reflect four reportable segments consistent with the current management of the business: transportation services, the loyalty program, technical services, and regional operations. In the Predecessor Company, Technical Services was a cost centre within Air Canada and discrete financial information is not available. As described in note 1, a capacity purchase agreement between Air Canada and Jazz came into effect on September 30, 2004. The Jazz segment information in the Successor Company is not directly comparable as a result of this new agreement.

As described in note 4 (h), the Successor Company changed the accounting as of September 30, 2004 for the recognition of its obligations relating to the loyalty program. As a result of this transitional period, Loyalty Program results are not comparable to prior periods.

The accounting policies for each of these segments are the same as those described in Note 4. Segment financial information has been prepared consistent with how financial information is produced internally for the purposes of making operating decisions as further described in Note 1. Segments negotiate transactions between each other as if they were unrelated parties. A reconciliation of the total amounts reported by each segment to the applicable amounts in the consolidated financial statements follows:

	Successor Company					ACE
	period ended December 31, 2004					Consolidated
	Transportation Services (a)	Loyalty Program (b)	Technical Services	Regional Operations (c)	Inter-Segment Elimination	Total
Passenger revenue	\$ 1,680	\$ -	\$ -	\$ 1	\$ -	\$ 1,681
Cargo revenue	151	-	-	-	-	151
Other revenue	40	126	62	2	-	230
External revenue	1,871	126	62	3	-	2,062
Inter-segment revenue	54	6	122	185	(367)	-
Total revenue	1,925	132	184	188	(367)	2,062
Operating expenses, before the following	1,925	105	155	162	(367)	1,980
Amortization of capital assets	72	2	7	4	-	85
Significant non cash and special items	-	-	-	-	-	-
Total operating expenses	1,997	107	162	166	(367)	2,065
Operating income (loss)	(72)	25	22	22	-	(3)
Net interest expense	(39)	-	(4)	(4)	-	(47)
Foreign exchange on long-term monetary items	98	-	-	-	-	98
Income tax expense	(13)	-	-	-	-	(13)
Other non operating items	(19)	-	-	(1)	-	(20)
	27	-	(4)	(5)	-	18
Segment Results	\$ (45)	\$ 25	\$ 18	\$ 17	\$ -	\$ 15

a) Includes revenues and costs for Air Canada Mainline operations, Jazz transportation revenues and fees to Air Canada Mainline for Jazz operations under the capacity purchase agreement, as well as Air Canada Cargo, Destina, AC Online, Air Canada Groundhandling, Air Canada Vacations, and ACE. Foreign exchange on long-term monetary items is included by management in the Transportation Services segment. Interest expense in the Transportation Services segment represents interest on third party debt. Interest expense included in other segments represents interest on intercompany debt and third party debt. Management reflects all income taxes within the Transportation Services segment including any income taxes that may be applicable to amounts earned in the other segments because the activities of the other

segments are carried out as limited partnerships and the income is taxable in one of the entities included in Transportation Services.

b) Other revenue of \$126 includes revenue recognized on redemption of points accumulated through both air and third party contracts. Inter-segment revenue of \$6 represents the management fee charged to Air Canada by Aeroplan relating to the redemption of points accumulated prior to January 1, 2002. The value of points earned through air, charged by Aeroplan to Air Canada, is recorded in Aeroplan's accounts as deferred revenues.

c) Includes Jazz operations under the capacity purchase agreement effective September 30, 2004.

	<b>Predecessor Company</b>				ACE Consolidated Total
	<b>nine months ended September 30, 2004</b>				
	Transportation Services	Loyalty Program	Regional Operations (d)	Inter-Segment Elimination	
Passenger revenue	\$ 5,040	\$ -	\$ 588	\$ -	\$ 5,628
Cargo revenue	393	-	12	-	405
Other revenue	463	334	8	-	805
External revenue	5,896	334	608	-	6,838
Inter-segment revenue	372	43	7	(422)	-
<b>Total revenue</b>	<b>6,268</b>	<b>377</b>	<b>615</b>	<b>(422)</b>	<b>6,838</b>
Operating expenses, before the following	5,914	305	609	(422)	6,406
Amortization of capital assets	286	3	23	-	312
Significant non cash and special items	-	-	-	-	-
<b>Total operating expenses</b>	<b>6,200</b>	<b>308</b>	<b>632</b>	<b>(422)</b>	<b>6,718</b>
Operating income (loss) before reorganization and restructuring items	68	69	(17)	-	120
Reorganization and restructuring items	(819)		(52)		(871)
Operating income (loss)	(751)	69	(69)	-	(751)
Net interest expense	(160)	5	(8)	-	(163)
Foreign exchange on long-term monetary items	106	-	-	-	106
Income tax expense	(2)	-	-	-	(2)
Other non operating items	(77)	-	(8)	-	(85)
	(133)	5	(16)	-	(144)
<b>Segment Results</b>	<b>\$ (884)</b>	<b>\$ 74</b>	<b>\$ (85)</b>	<b>\$ -</b>	<b>\$ (895)</b>

	<b>Predecessor Company</b>				
	twelve months ended December 31, 2003				
	Transportation Services	Loyalty Program	Regional Operations (d)	Inter-Segment Elimination	ACE Consolidated Total
Passenger revenue	\$ 6,082	\$ -	\$ 776	\$ -	\$ 6,858
Cargo revenue	500	-	19	-	519
Other revenue	861	124	11	-	996
External revenue	7,443	124	806	-	8,373
Inter-segment revenue	240	83	11	(334)	-
<b>Total revenue</b>	<b>7,683</b>	<b>207</b>	<b>817</b>	<b>(334)</b>	<b>8,373</b>
Operating expenses, before the following	8,038	131	856	(334)	8,691
Amortization of capital assets	333	3	30	-	366
Significant non cash and special items	-	-	-	-	-
<b>Total operating expenses</b>	<b>8,371</b>	<b>134</b>	<b>886</b>	<b>(334)</b>	<b>9,057</b>
Operating income (loss) before reorganization and restructuring items	(688)	73	(69)	-	(684)
Reorganization and restructuring items	(1,037)		(13)		(1,050)
Operating income (loss)	(1,725)	73	(82)	-	(1,734)
Net interest expense	(86)	13	(13)	-	(86)
Foreign exchange on long-term monetary items	137	-	-	-	137
Income tax expense	(5)	-	17	-	12
Other non operating items	(192)	-	(4)	-	(196)
	(146)	13	-	-	(133)
<b>Segment Results</b>	<b>\$ (1,871)</b>	<b>\$ 86</b>	<b>\$ (82)</b>	<b>\$ -</b>	<b>\$ (1,867)</b>

d) Includes Jazz transportation revenues and costs from Jazz operations as reported prior to implementation of the capacity purchase agreement on September 30, 2004.

For passenger revenue, the allocation to geographic destinations is determined based on flight destination.

	<b>Successor Company</b>		<b>Predecessor Company</b>	
	Period ended December 31 2004		Nine Months ended September 30 2004	Twelve Months ended December 31 2003
Passenger revenue				
Canada	\$ 713		\$ 2,236	\$ 2,919
US Transborder	321		1,160	1,578
Atlantic	318		1,212	1,472
Pacific	204		650	502
Other	125		370	387
<b>Total passenger revenue</b>	<b>\$ 1,681</b>		<b>\$ 5,628</b>	<b>\$ 6,858</b>

Cargo revenues are not allocated by geographic destination as these revenues are not significant. Non-transportation revenues are primarily attributable to Canada.

### **Property and Equipment**

ACE is a Canadian based domestic and international carrier and while the Corporation's flight equipment is used on various routes internationally, for purposes of segment reporting, the Corporation attributes the location of flight equipment to Canada. As a consequence, substantially all of the Corporation's property and equipment and goodwill are related to operations in Canada.

## 22. Commitments

Air Canada has signed definitive purchase agreements with Empresa Brasileira de Aeronautica S.A. ("Embraer"), and Bombardier Inc. ("Bombardier"). The agreement with Embraer covers firm orders for 45 Embraer 190 series aircraft as well as 15 Embraer 175 series aircraft. The purchase agreement also contains rights to exercise options for up to 60 additional Embraer 190 series aircraft as well as providing for conversion rights to other Embraer models. Deliveries of the Embraer 175 series aircraft are scheduled to commence in July 2005, with the Embraer 190 series deliveries scheduled to begin in November 2005. The agreement with Bombardier covers firm orders for 15 Bombardier CRJ700 Series 705 aircraft and 30 Bombardier CRJ200 aircraft of which 15 of the Bombardier CRJ200 may be cancelled without penalty. The purchase agreement also contains options for an additional 45 aircraft. Deliveries of the 50-seat Bombardier CRJ200 commenced in October 2004, with the 75-seat CRJ700 Series 705 deliveries scheduled to begin in May 2005. The first 8 of the CRJ200 aircraft were delivered in 2004. These aircraft are being accounted for as operating leases. The estimated aggregate cost of the future firm deliveries approximates US\$1.9 billion excluding the 15 Bombardier CRJ200 aircraft which may be cancelled without penalty. The estimated aggregate cost is based on aircraft delivery prices that have been escalated at 3 percent per annum. The Corporation has received financing commitments from the manufacturers and a third party for the entire commitment. Payments under the commitments of US\$1,919 are payable as follows:

		US
2005	\$	833
2006		466
2007		597
2008		23
2009		-
	\$	<u>1,919</u>

Other purchase commitments for 2005 for property, ground equipment and spare parts, amount to approximately \$89.

Future minimum lease payments under existing operating leases of aircraft and other property amount to \$3,347 (December 31, 2003 \$5,417) using period end exchange rates.

	Aircraft		Other Property	
2005	\$	498	\$	96
2006		452		57
2007		441		48
2008		326		46
2009		322		33
Thereafter		912		116
	\$	<u>2,951</u>	\$	<u>396</u>

Lease payments for aircraft classified as capital leases for accounting purposes are disclosed in note 12 "Long-Term Debt and Capital Lease Obligations".

The future minimum noncancelable commitments under the capacity purchase agreements with unaffiliated regional carriers are \$10 in 2005.



## **23. Financial Instruments and Risk Management**

Under its risk management policy, the Corporation may manage its exposure to changes in interest rates, foreign exchange rates and jet fuel prices through the use of various derivative financial instruments. Senior management is responsible for setting acceptable levels of risk and reviewing risk management activities as necessary. The Corporation uses derivative financial instruments only for risk management purposes, not for generating trading profit.

As a result of CCAA filings, the majority of derivative contracts were terminated during 2003, with the exception of the currency swap agreements noted below.

### **Interest Rate Risk Management**

The Corporation may enter into forward interest rate agreements, with maturities of less than 18 months, to manage the risks associated with interest rate movement on US and Canadian floating rate debt and investments. The Corporation has no forward interest rate agreements outstanding as at December 31, 2004.

### **Foreign Exchange Risk Management**

The Corporation may enter into certain foreign exchange forward contracts or currency swaps to manage the risks associated with foreign currency exchange rates. The Corporation has no foreign exchange forward contracts outstanding as at December 31, 2004.

The Corporation has entered into currency swap agreements for five Canadair Regional Jet operating leases until lease terminations in 2007. These currency swaps, with unrelated creditworthy third parties, were put in place on the inception of the leases and have a fair value at December 31, 2004 of \$12 in favour of the third parties (2003 \$7 in favour of unrelated creditworthy third parties), taking into account foreign exchange rates in effect at that time. These have not been designated as hedges for hedge accounting purposes.

The Predecessor Corporation had entered into currency swaps with an unrelated creditworthy third party for three Airbus A330 operating leases until 2010. These currency swaps were terminated during the quarter ended September 30, 2004. The fair value of these currency swaps at December 31, 2003 was \$19 in favour of the Corporation.

### **Fuel Price Risk Management**

The Corporation may enter into contracts with financial intermediaries to manage its exposure to jet fuel price volatility. The Corporation has no fuel hedging agreements outstanding as at December 31, 2004.

### **Concentration of Credit Risk**

The Corporation does not believe it is subject to any significant concentration of credit risk. Cash and short-term investments are in place with major financial institutions, Canadian governments and major corporations. Accounts receivable are generally the result of sales of tickets to individuals through geographically dispersed travel agents, corporate outlets, or other airlines, often through the use of major credit cards.

### **Statement of Financial Position Financial Instruments - Fair Values**

The carrying amounts reported in the consolidated statement of financial position for the Successor Company and Predecessor Company for cash and short-term investments, accounts receivable and accounts payable approximate fair values due to the immediate or short-term maturities of these financial instruments.

The fair value of long-term debt and capital lease obligations for the Successor Company approximates net book value given the fair valuing of liabilities under fresh start reporting as at September 30, 2004 as described further in Note 5. The fair value of long-term debt, including the current portion, and subordinated perpetual debt in the Predecessor Company was not reasonably determinable given the status of the Predecessor Company while under credit protection.

## **24. Contingencies, Guarantees and Indemnities**

### **Contingencies**

The Predecessor Company as well as Zip Air, Inc. have filed an action in the Ontario Superior Court against WestJet Airlines Ltd. (WestJet) and seven of its current and former employees, arising out of their misuse of Air Canada's confidential information relating to flights and load factors from an internal web site. The Predecessor Company successfully sought an injunction prohibiting WestJet from making further use of the confidential information. The claim seeks an order requiring WestJet to disgorge incremental revenue and profits arising from the misuse of such confidential information, damages for spoliation and punitive damages aggregating in excess of \$220. WestJet and Mark Hill have each counterclaimed against Air Canada, Zip Air Inc, IPSA (security firm engaged by Air Canada) and two of the latter's employees alleging trespass and illegal access and use of confidential information of WestJet and Mark Hill. The claim is for \$10 plus certain other unquantified damages. In addition, WestJet has filed a separate lawsuit against the Predecessor Company, Zip Air, Inc., and certain of their present and former officers alleging abuse of process, tortious litigation and conspiracy to injure WestJet. The amount claimed is \$30 million plus other unquantified damages.

The above-described litigation is at a preliminary stage. It is the opinion of Management that the claims and counterclaims of WestJet and Hill are without merit and further that the resolution of these lawsuits will not have a material adverse effect on the Corporation's consolidated financial position. The outcome of these claims and counterclaims cannot be determined at this point and the financial statements do not include any amounts related to these claims or counterclaims.

Complaints filed in 1991 and 1992 with the Canadian Human Rights Commission against Air Canada and the former Canadian Airlines International on behalf of flight attendants at the two airlines alleging discrimination in negotiated wages were referred to the Canadian Human Rights Tribunal in 1996 for inquiry. By agreement of all parties, the inquiry before the Tribunal was limited to whether flight attendants at each airline were in the same establishment as pilots and technical operations personnel. Under the applicable legislation, a complaint can only compare the value of employees work and their wages if they work in the same establishment. In December 1998 the Tribunal found that pilots, flight attendants and technical operations personnel were in different establishments at each airline. This decision was upheld on judicial review by the Federal Court Trial Division, but overturned by the Federal Court of Appeal in 2004. Air Canada successfully sought leave to appeal to the Supreme Court of Canada from the Federal Court of Appeal's decision. Air Canada's appeal is scheduled to be heard in December 2005. The Company believes, supported by counsel, that it has good defences to the complaints and has taken the position that they should be dismissed.

Various other lawsuits and claims, including claims filed by various of the Company's labour groups, are pending by and against the Successor Company and provisions have been recorded where appropriate. It is the opinion of management that final determination of these claims will not have a significant material adverse effect on the financial position or the results of the Corporation.

Claims against the Predecessor Company, whether filed or unfiled, for events that occurred before April 1, 2003 and in certain cases up to September 30, 2004 (as described in Note 2) have been compromised and discharged pursuant to the CCAA Plan and Sanction Order.

### **Residual Value Guarantees in Aircraft Leasing Agreements**

Under certain aircraft lease agreements accounted for as operating leases, the Corporation may be required to provide residual value support not exceeding \$382. Any potential payment under the guarantee would

be payable on lease expiry, and the amount of the loss is dependent on the net proceeds received on the sale of the aircraft, or the fair value of the aircraft in the event that the Corporation exercises its purchase option, where applicable. The current carrying value of amounts recorded under residual value guarantees is \$133 and is included in the unfavourable contract liability recorded under these leases.

With respect to 35 GECC owned aircraft leases and 10 GECC managed aircraft leases, the difference between the amended rents and amounts due under the original lease contracts will be forgiven at the expiry date of the leases if no material defaults have occurred. If a material default occurs, this difference plus interest will become due and payable and all future rent will be based on the original contracted rates. Rent expense is being recorded on the renegotiated lease agreements and any liability would be recorded only at the time management believes the amount is likely to occur.

### **Guarantees in Fuel Facilities Arrangements**

The Corporation participates in fuel facilities arrangements, along with other airlines that contract for fuel services at various airports in Canada. The Fuel Facilities Corporations operate on a cost recovery basis. The purpose of the Fuel Facilities Corporations is to own and finance the system that distributes the fuel to the Contracting Airlines, including leasing the Land Rights under the land lease. The aggregate debt of the Fuel Facilities Corporations in Canada as at December 31, 2004 is approximately \$135, which is the Successor Company's maximum exposure to loss without taking into consideration any cost sharing that would occur amongst the other contracting airlines. The Successor Company views this loss potential as remote. Each Contracting Airline shares pro rata, based on system usage, in the guarantee of this debt.

Under the terms of its land leases, the Fuel Facilities Corporations have an obligation to restore the land to vacant condition at the end of the lease and to rectify any environmental damage for which it is responsible. No provision has been recorded by the Fuel Facilities Corporations for such costs. If it was found that the Fuel Facilities Corporations had to contribute to any remediation costs, each Contracting Airline would share pro rata, based on system usage, in the costs.

### **Indemnification Agreements**

The Corporation enters into real estate leases or operating agreements, which grant a license to the Corporation to use certain premises, in substantially all cities that it serves. It is common in such commercial lease transactions for the Corporation as the lessee to agree to indemnify the lessor and other related third parties for tort liabilities that arise out of or relate to the Corporation's use or occupancy of the leased or licensed premises. In some cases, this indemnity extends to related liabilities arising from the negligence of the indemnified parties, but usually excludes any liabilities caused by their gross negligence or wilful misconduct. Additionally, the Corporation typically indemnifies such parties for any environmental liability that arises out of or relates to its use or occupancy of the leased or licensed premises.

In aircraft financing or leasing agreements, the Corporation typically indemnifies the financing parties, trustees acting on their behalf and other related parties and/or lessors against liabilities that arise from the manufacture, design, ownership, financing, use, operation and maintenance of the aircraft and for tort liability, whether or not these liabilities arise out of or relate to the negligence of these indemnified parties, except for their gross negligence or wilful misconduct. In addition, in aircraft financing or leasing transactions, including those structured as leveraged leases, the Corporation typically provides indemnities in respect of certain tax consequences.

Under its general by-laws, the Corporation has indemnification obligations to its directors and officers. Pursuant to such obligations, the Corporation indemnifies these individuals, to the extent permitted by

law, against any and all claims or losses (including amounts paid in settlement of claims) incurred as a result of their service to the Corporation.

The maximum amount payable under the foregoing indemnities cannot be reasonably estimated. The Corporation expects that it would be covered by insurance (subject to deductibles) for most tort liabilities and related indemnities described above.

**25. ACE Aviation Holdings Inc. / Air Canada  
Differences Between Generally Accepted Accounting Principles in Canada and the United States  
(Canadian dollars – millions except per share data)**

The consolidated financial statements of the Corporation (and Predecessor Company) have been prepared in accordance with Canadian generally accepted accounting policies (“Canadian GAAP”), which differ in certain respects from accounting principles generally accepted in the United States (US GAAP). The following represents the principal differences affecting statements of operations and retained earnings (deficit), financial position, and cash flows as well as additional disclosures required by US GAAP.

As outlined in notes 1, 2, 3 and 5, Air Canada emerged from creditor protection on September 30, 2004 and became a subsidiary of ACE Aviation Holdings Inc.

	Successor Company - ACE (note 3)	Predecessor Company - Air Canada (note 3)	
	Period ended	Nine Months	Twelve Months
	December 31	ended September 30	ended December 31
	2004	2004	2003
Income (loss) for the period in accordance with Canadian GAAP	\$ 15	\$ (895)	\$ (1,867)
Aircraft introduction costs (1)	-	5	9
Derivative instruments (2)	-	(32)	46
Aircraft lease adjustment (3)	-	-	70
Residual value guarantee adjustment (4)	-	14	66
Pension valuation allowance (5)	-	(6)	(1)
Pre-operating costs (6)	-	6	5
Convertible securities (7)	(99)	-	19
Variable interest entity adjustment (8)	35	11	-
Employee severance costs (10)	-	-	-
Gain on discharge of compromised liabilities (9)	-	7,056	-
Fresh start reporting (9)	-	(1,501)	-
Income adjustments for the period before the following	(64)	5,553	214
Cumulative effect of change in accounting policy - Variable interest entity adjustment (8)	-	(178)	-
Income tax adjustment	(2)	-	-
Non-controlling interest - Variable interest entity adjustment (8)	(2)	(5)	-
Respective period income adjustments	(68)	5,370	214
Income (loss) for the period in accordance with US GAAP	(53)	4,475	(1,653)
Minimum pension liability adjustment (5)	(2)	(2)	(284)
Adjustment related to derivative instruments (2)	-	-	12
Fresh start reporting (9)	-	491	-
Comprehensive income (loss) for the period in accordance with US GAAP	\$ (55)	\$ 4,964	\$ (1,925)
Earnings (loss) per share - US GAAP			
- Basic	\$ (0.65)	\$ 38.27	\$ (13.75)
- Diluted	\$ (0.65)	\$ 33.05	\$ (13.75)

	December 31, 2004 Successor Company	December 31, 2003 Predecessor Company
<b>Property and equipment</b>		
Balance under Canadian GAAP	\$ 3,696	\$ 1,700
Aircraft lease adjustment (3)	-	358
Variable interest entity adjustment (accumulated depreciation \$24) (8)	1,417	-
Balance under US GAAP	<u>\$ 5,113</u>	<u>\$ 2,058</u>
<b>Deferred charges</b>		
Balance under Canadian GAAP	\$ 167	\$ 2,340
Aircraft lease adjustment (3)	-	(136)
Derivative instruments (2)	-	(13)
Aircraft introduction costs (1)	-	(12)
Deferred finance charges (7)	(6)	-
Pre-operating costs (6)	-	(6)
Variable interest entity adjustment (8)	(15)	-
Balance under US GAAP	<u>\$ 146</u>	<u>\$ 2,173</u>
<b>Goodwill</b>		
Balance under Canadian GAAP	\$ -	\$ 510
Pension valuation allowance (5)	-	(75)
Employee severance costs (10)	-	(100)
Amortization adjustment (10)	-	9
CAIL equity accounting adjustment (10)	-	(124)
Goodwill (9)	1,583	-
Balance under US GAAP	<u>\$ 1,583</u>	<u>\$ 220</u>
<b>Intangible Assets</b>		
Balance under Canadian GAAP	\$ 2,691	\$ 164
Variable interest entity adjustment (8)	(39)	-
Goodwill (9)	11	-
Balance under US GAAP	<u>\$ 2,663</u>	<u>\$ 164</u>
<b>Other assets</b>		
Balance under Canadian GAAP	\$ 137	\$ 485
Derivative instruments (2)	-	27
Minimum pension liability adjustment (5)	-	446
CAIL pension adjustment	-	144
Variable interest entity adjustment (8)	111	-
Balance under US GAAP	<u>\$ 248</u>	<u>\$ 1,102</u>
<b>Current portion of long-term debt</b>		
Balance under Canadian GAAP	\$ 218	\$ 173
Variable interest entity adjustment (8)	77	-
Balance under US GAAP	<u>\$ 295</u>	<u>\$ 173</u>
<b>Long-term debt and capital lease obligations</b>		
Balance under Canadian GAAP	\$ 2,328	\$ 332
Aircraft lease adjustment (3)	-	241
Variable interest entity adjustment (8)	1,230	-
Balance under US GAAP	<u>\$ 3,558</u>	<u>\$ 573</u>
<b>Convertible preferred shares</b>		
Balance under Canadian GAAP	\$ 132	\$ -
Reclassification of preferred shares (7)	(132)	-
Balance under US GAAP	<u>\$ -</u>	<u>\$ -</u>
<b>Pension and other benefit liabilities</b>		
Balance under Canadian GAAP	\$ 2,344	\$ 964
Minimum pension liability adjustment (5)	2	930
Balance under US GAAP	<u>\$ 2,346</u>	<u>\$ 1,894</u>



	December 31, 2004 Successor Company	December 31, 2003 Predecessor Company
<b>Other long-term liabilities</b>		
Balance under Canadian GAAP	\$ 1,645	\$ 1,216
Preferred shares - embedded derivative (7)	180	-
Variable interest entity adjustment (8)	(156)	-
Residual value guarantee adjustment (4)	-	156
Balance under US GAAP	<u>\$ 1,669</u>	<u>\$ 1,372</u>
<b>Minority interest</b>		
Balance under Canadian GAAP	\$ -	\$ -
Variable interest entity adjustment (8)	178	-
Balance under US GAAP	<u>\$ 178</u>	<u>\$ -</u>
<b>Temporary equity</b>		
Balance under Canadian GAAP	\$ -	\$ -
Reclassification of convertible preferred shares (7)	167	125
Balance under US GAAP	<u>\$ 167</u>	<u>\$ 125</u>
<b>Shareholders' equity</b>		
Balance under Canadian GAAP	\$ 203	\$ (4,155)
Convertible securities (7)	(5)	(25)
Reclassification of preferred shares (7)		(125)
Current year income adjustments	(68)	214
Convertible preferred shares (7)	(117)	
Variable interest entity adjustment (8)	112	
Goodwill recorded at fresh start (9)	1,596	
Current year adjustments for comprehensive income		
Derivative instruments adjustment (2)		12
Minimum pension liability adjustment (5)	(2)	(284)
Cumulative prior year adjustments for:		
Convertible securities (7)		6
CAIL equity accounting adjustment (10)		(124)
Goodwill amortization adjustment (10)		9
Aircraft introduction costs (1)		(21)
Derivative instruments (2)		(27)
Aircraft lease adjustment (3)		(89)
Residual value guarantee adjustment (4)		(222)
Future income tax		108
Pension valuation allowance (5)		15
Employee severance costs (10)		(173)
Pre-operating costs (6)		(11)
Comprehensive income		
Minimum pension liability adjustment (5)		(187)
Derivative instruments (2)		(10)
Balance under US GAAP	<u>\$ 1,719</u>	<u>\$ (5,089)</u>

	<b>Successor Company - ACE (note 3)</b>	<b>Predecessor Company - Air Canada (note 3)</b>	
	<b>Period ended December 31</b>	<b>Nine Months ended September 30</b>	<b>Twelve Months ended December 31</b>
	<b>2004</b>	<b>2004</b>	<b>2003</b>
<b>Cash flows from (used for)</b>			
Operating - Canadian GAAP	\$ (426)	\$ 360	\$ 139
Addback: principal repayments on variable interest entities and lease accounting	10	59	-
Operating - US GAAP	(416)	419	139
Financing - Canadian GAAP	1,251	253	22
Less: principal repayments on variable interest entities and lease accounting	(10)	(59)	-
Financing - US GAAP	1,241	194	22
Investing	(150)	(326)	(49)
<b>Increase (decrease) in cash and cash equivalents</b>	<b>675</b>	<b>287</b>	<b>112</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>-</b>	<b>670</b>	<b>558</b>
<b>Cash and cash equivalents transferred to the Successor Company</b>	<b>957</b>	<b>(957)</b>	<b>-</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 1,632</b>	<b>\$ -</b>	<b>\$ 670</b>

### **1. Aircraft Introduction Costs**

Under Canadian GAAP, the Predecessor Company deferred and amortized aircraft introduction costs. Under US GAAP, these costs are expensed as incurred. The Successor Company expenses aircraft introduction costs as incurred. Under Canadian GAAP, the Predecessor Company recorded amortization expense of \$5 for the nine months ended September 30, 2004 (2003 - \$9).

### **2. Derivative Financial Instruments**

Prior to January 1, 2004, under Canadian GAAP, the Predecessor Company disclosed the nature and fair value of derivative instruments qualifying as hedges. The fair values of derivative instruments were not recorded on the statement of financial position. The Predecessor Company applied hedge accounting to financial instruments being hedged by anticipated transactions as explained in note 2 to the audited financial statements of Air Canada for the year ended December 31, 2003. On April 1, 2003 as a result of the creditor protection proceedings, all derivative instruments were terminated by third parties with the exception of certain derivatives instruments related to operating lease commitments.

Under US GAAP, all derivatives are recorded on the balance sheet at fair value. The Corporation and Predecessor Company has elected not to designate any derivatives as hedging instruments for US GAAP purposes and as such, changes in the fair value of all derivative instruments are recorded in income.

As described in note 4, effective January 1, 2004 under Canadian GAAP, derivative instruments that are not part of a designated hedging relationship are recorded at fair value, with changes in fair value recognized currently in income. The opening deferred credit related to the fair value adjustment of the Predecessor Company is amortized over the life of the related derivative instruments. Under US GAAP, this deferred credit is reversed to income. As a result of the application of fresh start reporting, this deferred credit was valued at nil in the Successor Company.

### **3. Lease Accounting**

Under Canadian GAAP, certain of the Corporation's and the Predecessor Company's aircraft leases are accounted for as operating leases. Under US GAAP, for periods prior to January 1, 2004, certain of the Predecessor's aircraft leases are accounted for as if they were owned, with the assets, liabilities, expenses and cash flows related to these aircraft reported as such in the Predecessor's financial statements. Effective with the adoption of FIN 46R – Consolidation of Variable Interest Entities on January 1, 2004, the previous US GAAP guidance under EITF 96-21 that resulted in the consolidation of these entities has been nullified (see footnote 8). The adjustment reflects the reversal of rent expense recorded under Canadian GAAP for 2003 of \$51, depreciation of \$21, foreign exchange gain (loss) of \$58 and interest expense of \$18.

### **4. Residual Value Guarantees under Operating Leased Aircraft**

Under Canadian GAAP, the portion of the gain on sale-leasebacks that includes a residual value guarantee is deferred until the end of the lease term for leases entered into after September 1999, whereas under US GAAP, the amount would be deferred until the end of the lease term for leases entered into after September 1986. Further under Canadian GAAP, the expected deficiency under a residual value guarantee is accrued over the remaining lease term irrespective of the end of lease term options for leases entered into after September 1999; however, under US GAAP, the accrual of an expected deficiency is required for leases entered into after September 1996. In the Successor Company, all aircraft lease agreements with residual value guarantees are consolidated under the Variable Interest Entity adjustment described under note 8. The adjustment for the nine months ended September 30, 2004 relates to the amortization of the previous accrual of the residual value guarantee on renegotiated leases where the residual value guarantee has been removed.

#### **5. Employee Future Benefits**

Under Canadian GAAP, a minimum pension liability is not recognized if the accumulated benefit obligation related to employee pensions exceeds the fair value of plans assets; however, a pension valuation allowance is required to limit the pension asset to the amount that can be realized in the future. Under US GAAP, a minimum pension liability has been recorded (including the recognition of an intangible asset related to prior period services as applicable in the Predecessor Company); however, a pension valuation allowance is not permitted.

#### **6. Pre-operating Costs**

Under Canadian GAAP, eligible pre-operating costs are deferred and amortized. Under US GAAP, these costs are expensed as incurred. Under Canadian GAAP, the Predecessor Company recorded amortization expense of \$6 for the nine months ended September 30, 2004 (2003 - \$5), related to the development of ZIP and Destina.

#### **7. Convertible Securities**

Under Canadian GAAP, proceeds from the issue of convertible securities are split between their liability and equity components, resulting in a discount that is amortized to expense over the term of the security. In addition, under Canadian GAAP, the direct costs of issuing the securities are split with costs related to the liability component included in deferred charges and the costs related to the equity component netted against the equity component. Under US GAAP, the convertible preferred shares issued by the Successor Company contain an embedded derivative which has been reported separately as an other long-term liability at its fair value of \$180 as at December 31, 2004 (\$76 as at September 30, 2004). The convertible preferred shares were initially recorded at \$162 which is the proceeds received less direct costs of issuance and the fair value of the embedded derivative, as of the date of issuance, and is included in temporary equity as the conditions of redemption are not solely within the control of the Successor Company. The adjustment to deferred charges reflects applying the direct costs of issuance, recorded in deferred charges under Canadian GAAP, against the amount recorded in temporary equity.

During 2003 under Canadian GAAP, the Predecessor Company recorded a reorganization and restructuring charge of \$19 in order to reflect the debenture balance at the anticipated claim amount. This charge is reversed under US GAAP as the convertible securities are treated as long-term debt in their entirety.

Under Canadian GAAP, the liability component of the convertible security is accreted to the redemption value of over the period to the redemption date with the charge recorded as interest expense in addition to any contractual payments. Under US GAAP, interest expense only includes the contractual payments related to the convertible debentures. For the convertible preferred shares, the changes in the fair value of the embedded derivative is included in income and the accretion of the temporary equity to the redemption value over the period to redemption is reflected as a charge to retained earnings.

The adjustment reflects the reversal of interest expense under Canadian GAAP of \$5 (September 30, 2004 – nil; 2003 - \$19); change in the fair values of the embedded derivative amounted to \$104 (Predecessor – nil); and the amount charged to retained earnings under US GAAP of \$5 (Predecessor – nil).

## 8. FIN46R – Consolidation of Variable Interest Entities

On January 1, 2004, the Predecessor Company was required to adopt the provisions of Interpretation No. 46R – Consolidation of Variable Interest Entities (“FIN 46R”), issued by the Financial Accounting Standards Board. An entity is subject to FIN 46R and is called a variable interest entity (“VIE”) if it has (1) equity that is insufficient to permit the entity to finance its activities without additional subordinated financial support from other parties; or (2) equity investors that cannot make significant decisions about the entity's operations, or that do not absorb the expected losses or receive the expected returns of the entity. A VIE is consolidated by its primary beneficiary, which is the party involved with the VIE that will absorb a majority of the expected losses or will receive the majority of the expected residual returns or both, as a result of ownership, contractual or other financial interests in the VIE. Under Canadian GAAP, VIEs are only required to be consolidated for periods commencing on or after January 1, 2005.

Air Canada entered into aircraft and engine lease transactions with several special purpose entities that qualify as VIEs under FIN46R. As a result of the adoption of FIN 46R, the Predecessor Company has consolidated leasing entities covering 51 aircraft and 22 engines accounted for as operating leases under Canadian GAAP. On initial adoption of FIN46R, the consolidation of VIEs where the Predecessor Company was the primary beneficiary for the period has resulted in the following adjustments to the consolidated statement of financial position under US GAAP:

Increase to property and equipment	\$ 2,158
Increase to accumulated depreciation	(464)
Decrease to deferred charges	(488)
Increase to other assets	123
Increase to current portion of long-term debt	90
Increase to long-term debt	1,406
Increase to non-controlling interest	331
Decrease to deferred credits	(308)
Cumulative effect of change in accounting policy	\$ (190)

The adjustments to other assets represents restricted cash held in the variable interest entities. The previously reported cumulative effect of a change in accounting policy in the unaudited third quarter 2004 consolidated financial statements related to the implementation of FIN46R has been increased by a charge of \$136. Adjustments related to deferred charges and deferred credits reverse amounts deferred for aircraft lease payments in excess of or less than rent expense.

The following disclosure relates to the arrangements in existence in the aircraft and engine VIEs; consolidation of these VIEs under FIN46R does not alter the underlying contractual arrangements between Air Canada, as lessee and the VIE, as lessor. The long-term debt in the VIEs has maturities ranging from 2007 to 2017 at interest rates ranging from 3.0-8.7%. As a result of fresh start reporting as described in item 9, the debt has been revalued to an effective interest rate of 8%. The aircraft are charged as collateral against the debt by the owners thereof. The creditors under these leasing arrangements have recourse to Air Canada, as lessee, in the event of default or early termination of the lease and in certain other circumstances. The events of default are customary in aircraft lease arrangements.

Certain of VIEs are not Canadian based entities and many of the monetary assets and liabilities of the VIEs are denominated in foreign currencies, principally US dollars. Monetary assets and liabilities of the VIEs are translated at rates of exchange in effect at the date of the consolidated statement of financial position. Non monetary items are translated at historical exchange rates.

Principal repayment requirements on aircraft and engine debt consolidated under FIN46 through to 2009 are as follows:

	2005	2006	2007	2008	2009
Total payments	178	164	205	191	123
Less applied to interest	101	94	89	80	71
Principal reduction	77	70	116	111	52

These commitments, under Canadian GAAP, are included as operating lease commitments (note 24).

Air Canada and Jazz participate in fuel facilities arrangements, along with other airlines that contract for fuel services at various domestic airports. The Fuel Facilities Corporations in Canada are not-for-profit organizations incorporated under federal or provincial business corporations acts in order to acquire, finance and lease assets used in connection with the fuelling of aircraft and ground support equipment. The Fuel Facilities Corporations operate on a cost recovery basis.

Under FIN46R, the Predecessor Company was and the Corporation is the primary beneficiary of certain of the Fuel Facilities Corporations. On January 1, 2004 the Predecessor Company consolidated three Fuel Facilities Corporations, resulting in an opening January 1, 2004 increase to property and equipment of \$67, long term debt of \$47, minority interest of \$8 and a cumulative effect of a change in accounting policy of \$12. The long-term debt has an average stated interest rate of 5%, with varying maturities. The debt is secured by a general security agreement covering all assets of the Fuel Facility Corporation. Under the terms of the land lease, the Fuel Facility Corporation has the obligation to restore the land to vacant condition at the end of the lease and to rectify any environmental damage for which is it responsible. The Successor Company has recorded an obligation of \$2 (\$12 undiscounted) representing the present value of the decommissioning and remediation obligations at the end of the lease, with lease term expiry dates ranging from 2032 to 2039. This estimate is based on numerous assumptions including the overall cost of decommissioning and remediation and the selection of alternative decommissioning and remediation approaches.

The remaining five fuel facilities in Canada that are not consolidated have aviation facilities assets recorded of approximately \$103 and debt of approximately \$90, which is Successor Company's maximum exposure to loss without taking into consideration any cost sharing that would occur amongst the other contracting airlines and any value of the assets. The Successor Company views this loss potential as remote.

For all entities consolidated under FIN46, depreciation expense of \$24 (Predecessor - \$73), interest expense of \$24 (Predecessor - \$80) and a foreign exchange gain of \$53 (Predecessor - \$30) was recorded for the period ended December 31, 2004 offset by the reversal of aircraft rent expense of \$30 (Predecessor - \$134) recorded under Canadian GAAP.

Upon the application of fresh start reporting, the assets and liabilities of the VIEs consolidated by the Successor Company were adjusted to fair value, resulting in certain differences between the amounts reported by the VIE and the amounts reported in the consolidated statement of financial position.

## **9. Fresh Start Reporting**

Under Canadian GAAP, the effects of the fresh start reporting adjustments, including the settlement of the compromised debt, are accounted for as a capital transaction and recorded within the Predecessor's shareholders' equity. Under US GAAP, the effect of the fresh start reporting adjustments, including the settlement of the compromised debt, are reflected in the Predecessor's statement of operations. See item 13 a) below for additional disclosures regarding fresh start reporting.

Under Canadian GAAP, upon emergence from creditor protection, the identifiable assets and liabilities of an enterprise are revalued based on the fair values of such assets and liabilities in a manner similar to that used for a business combination. The difference between the fair value of the Successor's equity over the fair value of the identifiable assets and liabilities is not permitted to be recorded as an asset (goodwill) under Canadian GAAP. US GAAP does not prohibit the recognition of goodwill to the extent that the reorganization value exceeds the fair value of the specific tangible and identifiable intangibles of the Successor. The resulting goodwill under US GAAP is not amortized and is subject to an impairment test on an annual basis or earlier if an event occurs or circumstances change that would more likely than not reduce of the fair value of the respective reporting unit below the carrying amount.

Under Canadian GAAP, the benefit of future income tax assets that exist at fresh start, and for which a valuation allowance is recorded against, will be recognized first to reduce to nil any remaining intangible assets (on a pro-rata basis) that were recorded upon fresh start reporting with any remaining amount as a credit to shareholders' equity. Under US GAAP the benefit of future income tax assets that exist at fresh start will be recognized first to reduce to nil any goodwill, then intangibles with any remaining amount taken to income. As a result, under US GAAP the Successor recorded an increase of \$11 to intangibles, a reduction of \$13 to goodwill and a tax expense of \$2.

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## **10. Goodwill Amortization and Employee Severance Costs**

Under Canadian GAAP, for business combinations prior to January 1, 2003, liabilities assumed on the purchase of a business may include benefits to be paid to employees for their voluntary termination provided certain criteria are met. The treatment of these costs as an assumed liability results in an increase in goodwill recognized on the acquisition. Under US GAAP, a liability and expense for such benefits is required to be expensed by the acquirer in the period employees accept the offer rather than as an adjustment of goodwill. For periods subsequent to January 1, 2001, there is no GAAP difference related to the statement of operations as goodwill is no longer amortized for both Canadian and US GAAP.

Under Canadian GAAP, investments accounted for by the cost method are not restated retroactively to the equity method when the investor acquires control of the business and thus consolidates the investment. US GAAP requires this restatement. As a result of the retroactive application of the equity method under US GAAP in 2000, goodwill reported for the acquisition under Canadian GAAP differs from that reported for US GAAP.

## **11. Comprehensive Income**

Under US GAAP, comprehensive income must be reported which is defined as all changes in equity other than those resulting from investments by owners and distributions to owners. Cumulative other comprehensive income (loss) as at December 31, 2004 is \$(2), (2003 \$(469)). For the periods presented, under Canadian GAAP, the Predecessor and the Successor were not permitted to use the concept of comprehensive income. The adjustments to cumulative other comprehensive income relate mainly to the minimum pension liability adjustment described under item 5.

## 12. Earnings per share

	Successor Company - ACE (note 3) Period ended December 31	Predecessor Company - Air Canada (note 3)	
	2004	Nine Months ended September 30 2004	Twelve Months ended December 31 2003
Numerator:			
Numerator for basic earnings per share:			
Income (loss)	\$ (53)	\$ 4,475	\$ (1,653)
Accretion of convertible preferred shares	(5)	-	-
Settlement of convertible debentures	-	125	-
Adjusted numerator for income (loss) per share	(58)	4,600	(1,653)
Effect of potential dilutive securities:			
After tax income from:			
Convertible preferred shares	3	-	-
Convertible subordinated debentures	-	-	3
Add back anti-dilutive impact	(3)	-	(3)
Adjusted income (loss) for diluted earnings per share	\$ (58)	\$ 4,600	\$ (1,653)
Denominator:			
Denominator for basic earnings per share:			
Weighted-average shares	89	120	120
Effect of potential dilutive securities:			
Stock options	1	-	-
Class A non-voting preferred shares	-	10	10
Convertible subordinated debentures	-	9	9
Convertible preferred shares	9	-	-
	10	19	19
Add back anti-dilutive impact	(10)	-	(19)
Denominator for diluted earnings per share:	89	139	120
Adjusted weighted-average shares	89	139	120
Basic earnings (loss) per share	\$ (0.65)	\$ 38.27	\$ (13.75)
Diluted earnings (loss) per share	\$ (0.65)	\$ 33.05	\$ (13.75)
Income (loss) per share before cumulative effect of change in accounting principle			
	\$ (0.65)	\$ 39.75	\$ (13.75)
Impact of cumulative effect of change in accounting principle			
	-	(1.48)	-
Income (loss) per share	\$ (0.65)	\$ 38.27	\$ (13.75)
Income (loss) per share, assuming dilution, before cumulative effect of change in accounting principle			
	\$ (0.65)	\$ 34.32	\$ (13.75)
Impact of cumulative effect of change in accounting principle			
	-	(1.28)	-
Income (loss) per share, assuming dilution	\$ (0.65)	\$ 33.05	\$ (13.75)



### **13. Supplementary Information under US GAAP**

In the opinion of management, the consolidated financial statements prepared in accordance with Canadian GAAP and the US GAAP information included in this note reflect adjustments, consisting of normal recurring accruals, except for adjustments referred to above under FIN 46R – Consolidation of Variable Interest Entities and Fresh Start Reporting, which are necessary to present fairly the Successor and Predecessor Companies' financial position, results of operations and cash flows for the periods indicated.

#### **a) Fresh start reporting**

Note 5 describes the impact of fresh start reporting under Canadian GAAP.

For US GAAP, it was determined that the Successor Company's reorganization value was \$11,753 as at September 30, 2004. The reorganization value represents the fair value of the entity before considering liabilities and approximates the amount a willing buyer would pay for the assets of the entity immediately after the plan of arrangement. The reorganization value does not include proceeds received from new investors outlined in Note 2. The reorganization value was determined with reference to the value established under the Rights Offering.

The fair values of the consolidated assets and liabilities of the Successor Company have been based on Management's best estimates and on valuation techniques as of September 30, 2004. Fresh start values reported in Note 17 to unaudited the Interim Third Quarter 2004 Consolidated Financial Statements were preliminary estimates; valuations have now been finalized and are reflected in these statements. The impact of changes since the Third Quarter 2004 Consolidated Financial Statements is an increase to assets of \$37, a decrease to liabilities of \$4 and an increase to Temporary Equity of \$41. The previously reported unaudited income of the Predecessor for the nine months ended September 30, 2004 has been adjusted by \$125 to \$4,964 to remove the gain on the settlement of certain preferred shares of the Predecessor Company which should have been reported as a credit to deficit.

The effect of the Plan and other transactions on the Predecessor Company's consolidated balance sheet, as of September 30, 2004, is outlined in the table below and consists of the following components:

- **Plan of Arrangement:**

Extinguishment of compromised liabilities of approximately \$7,981 by the issuance of common shares of the Successor Company with a value of \$925, resulting in a gain on extinguishment of debt in the amount \$7,056 included in the statement of operations under US GAAP.

Certain preferred shares with a carrying value of \$125 were settled for a nominal amount resulting in a gain of \$125 included as a credit to deficit.

Exchange of the existing common shares of the Predecessor for new common stock of the Successor resulting in a reduction of common stock by \$817 and an increase in contributed surplus by \$817.

- **Financing and Other Post-Emergence Transactions:**

The Rights Offering and Standby Purchase Agreement generated net proceeds of \$852 in exchange for share capital. The Investment Agreement provided net cash proceeds of \$238. As the convertible preferred shares include an embedded derivative, \$76 was included in liabilities and \$162 in temporary equity. Additional funds were received under the Exit Facility as described under the Global Restructuring Agreement providing cash of \$227, net of costs of \$13. Implementation of components of the Global Restructuring Agreement (other than the Exit

Financing) resulting in a net cash outlay of \$323, issuance of additional debt amounting to \$63, acquisition of aircraft for \$64 and settlement of certain obligations related to leases totaling \$334. In addition, fees to the Corporation's advisors of \$12 were paid on emergence.

- **Fresh Start Reporting:**  
Fresh start adjustments were recorded to reflect the fair values of assets and liabilities and the elimination of the contributed surplus and deficit. In the Predecessor Company, fresh start reporting resulted in a loss of \$1,501 reported in income and a gain of \$491 reported in comprehensive income.

	Air Canada Predecessor Company - September 30, 2004	Plan of Arrangement	Fresh Start Reporting	Equity and Other Financing Transactions	ACE Successor Company - September 30, 2004
<b>ASSETS</b>					
<b>Current assets</b>					
Cash and cash equivalents	\$ 957	\$ -	\$ -	227 852 238 (335)	\$ 1,939
Restricted cash	62	-	-	-	62
Accounts receivable	723	-	-	-	723
Spare parts, materials and supplies	190	-	11	-	201
Prepaid expenses	129	-	10	-	139
	2,061	-	21	982	3,064
<b>Property and equipment</b>	5,497	-	(456)	64	5,105
<b>Deferred charges</b>	2,661	-	(2,526)	13	148
<b>Goodwill</b>	220	-	1,376	-	1,596
<b>Intangible assets</b>	158	-	2,521	-	2,679
<b>Other assets</b>	1,166	-	(946)	-	220
<b>TOTAL ASSETS</b>	<b>\$ 11,763</b>	<b>\$ -</b>	<b>\$ (10)</b>	<b>\$ 1,059</b>	<b>\$ 12,812</b>
<b>LIABILITIES</b>					
<b>Liabilities not subject to compromise</b>					
<b>Current liabilities</b>					
Accounts payable and accrued liabilities	\$ 1,288	\$ -	\$ 23	\$ -	\$ 1,311
Advance ticket sales and loyalty program deferred revenues	861	-	268	-	1,129
Current portion of long-term debt and capital lease obligations	558	-	(230)	-	328
	2,707	-	61	-	2,768
<b>Long-term debt and capital lease obligations</b>	2,777	-	726	303	3,806
<b>Future income taxes</b>	8	-	235	-	243
<b>Pension and other benefit liabilities</b>	2,036	-	332	-	2,368
<b>Other long-term liabilities</b>	1,192	-	245	76	1,513
<b>Minority Interest</b>	344	-	(169)	-	175
<b>Deferred credits</b>	764	-	(430)	(334)	-
	9,828	-	1,000	45	10,873
<b>Liabilities subject to compromise</b>	7,981	(7,981)	-	-	-
	17,809	(7,981)	1,000	45	10,873
<b>Temporary Equity</b>	125	(125)	-	162	162
<b>SHAREHOLDERS' EQUITY</b>					
<b>Share capital and other equity</b>	817	925 (25)	(792)	852	1,777
<b>Contributed surplus</b>	25	150	(175)	-	-
<b>Deficit</b>	(6,522)	7,056	(534)	-	-
<b>Other Comprehensive Loss</b>	(491)	-	491	-	-
	(6,171)	8,106	(1,010)	852	1,777
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$ 11,763</b>	<b>\$ -</b>	<b>\$ (10)</b>	<b>\$ 1,059</b>	<b>\$ 12,812</b>

**b) Accounts payable and accrued liabilities**

The components of accounts payable and accrued liabilities at December 31 are as follows:

	2004	2003
Trade payables	\$ 408	\$ 360
Accrued liabilities	224	275
Aircraft lease payment moratorium	-	523
Payroll related liabilities	404	310
Other	161	40
	<u>\$ 1,197</u>	<u>\$ 1,508</u>

**c) Pension plans**

The accrued benefit obligation for the defined benefit pension plans as at December 31, 2004 is \$10,283 (2003 - \$9,867). Total cash payments made by the Predecessor Company were \$196 (2003 - \$185) for the pension and other benefits for 2004. The Successor Company made cash payments in the amount of \$123 for the pension and other benefits for 2004. The cash payments with respect to the pension plans are estimated to be \$259 for 2005.

**d) Consolidated statement of operations**

The components of depreciation, amortization and obsolescence for the periods presented below are as follows:

	<b>Successor Company</b>	<b>Predecessor Company</b>	
	<b>Period ended December 31, 2004</b>	<b>Nine months ended September 30, 2004</b>	<b>Twelve months ended December 31, 2003</b>
Depreciation of tangible assets	\$ 89	\$ 332	\$ 307
Amortization of intangible assets	17	-	-
Amortization of capitalized software costs	-	39	63
Obsolescence provision on spare parts materials and supplies	3	14	17
	<u>\$ 109</u>	<u>\$ 385</u>	<u>\$ 387</u>

The components of other operating expenses for periods presented below are as follows:

	<b>Successor Company</b>	<b>Predecessor Company</b>	
	<b>Period ended December 31, 2004</b>	<b>Nine months ended September 30, 2004</b>	<b>Twelve months ended December 31, 2003</b>
Terminal handling and services	\$ 47	\$ 146	\$ 196
Building rent and maintenance	31	93	130
Flight and cabin crew expense	28	89	130
Credit card fees	28	97	124
Miscellaneous fees and services	22	58	84
Advertising and promotion (a)	25	70	73
Customer maintenance and materials	28	55	66
Other	149	493	674
	\$ 358	\$ 1,101	\$ 1,477

a) Advertising and promotion costs are expensed when incurred.

e) Rent expense, including aircraft rent, building and other equipment rentals, amounts to \$113 for the period ended December 31, 2004 under the Successor Company (\$484 for the nine months ended September 30, 2004 and \$1,031 in 2003 under the Predecessor Company)

**f) Capital lease commitments**

As at December 31, 2004, obligations under capital leases for future minimum lease payments are as follows:

2005	\$	284
2006		245
2007		270
2008		256
2009		154
Thereafter		1139
Total minimum lease payments		2348
Less amount representing interest		(778)
Total obligations under capital lease	\$	1,570

## g) Valuation and Qualifying Accounts and Reserves

	Balance at Beginning of Year	Additions charged to costs and expenses	Deductions/ Other	Balance at end of Year
<b>Allowance for obsolescence of spare parts, materials and supplies</b>				
Predecessor Company 2003	\$ 135	\$ 17	\$ (1)	\$ 151
Predecessor nine months ended September 30, 2004	151	14	(165)	-
Successor Company three months ended December 31, 2004	\$ -	\$ 3	\$ -	\$ 3
<b>Allowance for uncollectible accounts</b>				
Predecessor Company 2003	\$ 12	\$ 20	\$ (18)	\$ 14
Predecessor nine months ended September 30, 2004	14	12	(9)	17
Successor Company three months ended December 31, 2004	\$ 17	\$ 2	\$ (3)	\$ 16
<b>Future income tax valuation allowance</b>				
Predecessor Company 2003	\$ 1,044	\$ 611	\$ -	\$ 1,655
Predecessor nine months ended September 30, 2004	1,655	678	-	2,333
Successor Company three months ended December 31, 2004	\$ 2,333	\$ 1	\$ -	\$ 2,334

Upon the application of fresh start reporting, spare parts, materials and supplies were adjusted to replacement cost.

The increase to the future income tax valuation allowance includes the impact of the valuation allowance recorded for the nine months ended September 30, 2004 of \$291, the impact of fresh start reporting and the future income tax liability recorded of \$243.

### New Accounting Policies

In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123R"). This standard replaces SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123") and supersedes Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"). It requires that the compensation cost of share-based payment transactions be recognized in financial statements based on the fair value of the equity or liability instruments issued. The Corporation will adopt this statement as of the beginning the third quarter 2005. The Corporation is evaluating the impact of SFAS 123R, including the transition options for adoption of this standard, on our 2005 Consolidated Financial Statements. Under Canadian GAAP as described in note 4t), the fair value of stock options granted is recognized as a charge to salary and wage expense on a straight line basis over the applicable vesting period, with an offset to contributed surplus. The amount of compensation cost recognized at any date at least equals the value of the vested portion of the options at that date. When stock options are exercised, the consideration paid by employees, together with the amount in contributed surplus, is credited to share capital.

## **26. Subsequent Events**

### **Revolving Credit Facility**

On February 7, 2005, ACE and Air Canada entered into a commitment letter with BMO Nesbit Burns Inc. and its Canadian chartered bank parent in respect of the establishment of a senior secured syndicated revolving credit facility in favour of Air Canada, as borrower, in an aggregate amount of up to \$300 or the US dollar equivalent, subject to satisfaction of certain conditions. The revolving credit facility will have a two year term which can be extended at Air Canada's option for additional one-year periods on each anniversary of closing starting on the second anniversary, subject to approval by a majority of the lenders. A swingline facility of up to \$20 will also be provided for cash management and working capital purposes. The amount available to be drawn by Air Canada under the revolving credit facility will be limited to the lesser of \$300 and the amount of a borrowing base determined with reference to certain eligible accounts receivable of Air Canada and certain eligible real property on owned and leased land of Air Canada. The credit facility will be secured by a first priority security interest and hypothec over the present and after acquired property of Air Canada, subject to certain exclusions and permitted encumbrances.

### **CRJ-200 Aircraft**

On March 8, 2005, the Board of Directors approved the addition of eight Bombardier CRJ-200 aircraft to Jazz's fleet in 2005 under operating leases.

### **MD-11 Cargo Freighter Aircraft**

On March 17, 2005, the Corporation announced the signing of a two-year lease agreement for an additional MD-11 Cargo freighter aircraft. As well, the Corporation announced an extension of an existing leased MD-11 Cargo freighter for a further two years effective March 1, 2005.