nging More of the World
to Our Customers

AIR CANADA

1996
Annual Report

Bring
to O

Corporate Profile

Air Canada is a Canadian-based international air carrier, providing scheduled and charter air transportation for passengers and for cargo. The Corporation is Canada's largest air carrier. The airline's route network, including regional airline subsidiaries, provides air transportation services to 125 cities worldwide.

Air Canada serves 17 cities in Canada with an additional 46 Canadian communities served by its regional airlines. The Corporation provides air transportation services to 34 cities in the United States and to 22 cities in Europe, Asia, the Middle East and the Caribbean. Charter passenger services are also offered to six international destinations. The airline's cargo division serves directly 65 destinations in Canada and internationally.

Air Canada operates a large aircraft and engine maintenance business providing maintenance services to airlines and other customers. Computer and ground handling services are also offered. The Corporation holds 100% interest in five Canadian regional airlines, AirBC, Air Ontario, Air Alliance, Air Nova and NWT Air; in Galileo Canada, the largest Canadian computer reservations system and in Air Canada Vacations (Touram Inc.), a major Canadian tour operator. The Corporation also holds minority interests in other travel and transportation-related businesses.

Shareholder Base

Air Canada's shareholder base is comprised of the following: approximately, 78 per cent, Institutional; 17 per cent, Retail; and five per cent, Employees. Ninety-three per cent of the voting shares are held by Canadian residents and seven per cent by non-residents (as defined in the Air Canada Public Participation Act and Air Canada's Articles of Continuance).

The Air Canada fleet*

	Boeing 747	Boeing 767	A340	A320	A319	DC-9	CL-65	Total
Owned	5	11	0	23	0	35	0	74
Op. Lease	4	18	4	11	1	0	24	62
In service	9	29	4	34	1	35	24	136
Orders	0	0	4	6**	34	0	0	44

*Not included are two L-1011 aircraft which are out of service pending disposal.
**Six A320s are on order and may be cancelled without penalty.

The Regional Airline Fleets – In Service*

	Beech 1900D	BAe 146	DHC-8-300	DHC-8-100	Boeing 737 combi	Hercules Cargo	Total
Air Nova	0	5	0	14	0	0	19
Air Alliance	5	0	0	7	0	0	12
Air Ontario	0	0	6	17	0	0	23
NWT Air	0	0	0	0	3	1	4
AirBC	0	5	6	13	0	0	24
	5	10	12	51	3	1	82

*Not included are 5 BAe J-31 aircraft for AirBC which have been leased to a third party.

Overview of the Year

January to March

- The first Xerox Business Centre opens at the Toronto (domestic) Maple Leaf Lounge.
- A major new alliance with Lufthansa confirms Air Canada as Canada's premier carrier to Germany. The two plan expanded service to Frankfurt as well as code shared connections beyond to more of Germany and Europe.
- Calgary-Edmonton becomes Air Canada's fourth Rapidair shuttle service.
- The first quarter will prove to be the toughest of the year. The airline's $92 million loss is $4 million higher than the same quarter of 1995.

April to June

- Lamar Durrett is installed as president and chief executive, succeeding the retiring Hollis Harris. In August, John Fraser succeeds Harris as chairman.
- Selling 44 percent of Air Canada's stake in Continental Airlines yields an after tax gain of $129 million, enabling the company to post a second quarter profit of $110 million.

July to September

- Ticketless travel now is available across most of Air Canada's North American route system.
- The opening of a new Saint John, New Brunswick, call centre caps a major upgrading of the airline's reservations processing capability.
- A newly expanding alliance with All Nippon Airways heralds an expansion of service to Japan. Vancouver-Osaka will become a daily service in winter as well as summer, and plans are unveiled for a Toronto-Osaka service in 1997.
- Third quarter earnings reached $149 million, the most ever for a quarter excluding one time items. Operating income is a record $208 million.

October to December

- In November, Raleigh/Durham joins Kansas City, Nashville and Philadelphia as US jet destinations introduced in 1996. That's 13 cities added in the first two years of Canada-US Open Skies.
- SAS – Scandinavian Airlines System – becomes Air Canada's newest global alliance partner.
- The airline takes delivery of the first of 35 A319s, the 112 seat aircraft destined to replace the workhorse DC-9.

Year at a Glance

Financial		1996		1995	Change
(Millions except per share figures)					
Operating revenues	**$**	**4,880**	$	4,507	8%
Operating expenses	**$**	**4,665**	$	4,232	10%
Operating income	**$**	**215**	$	275	
Income for the year	**$**	**149**	$	62	
Operating margin		**4%**		6%	
Cash flow from operations	**$**	**64**	$	59	
Average common shares outstanding (basic)*		**155.4**		144.0	
Average common shares outstanding (fully diluted)*		**189.1**		168.7	
Income for the year per common share (basic)*	**$**	**0.86**	$	0.36	
Income for the year per common share (fully diluted)*	**$**	**0.82**	$	0.36	
Cash flow from operations per common share (basic and fully diluted)*	**$**	**0.41**	$	0.41	
Return on equity		**17%**		10%	

* Per share amounts have been calculated using the weighted average number of common shares outstanding during the year.

Operating Statistics	1996	1995	Change
(Scheduled and Charter – not consolidated)			
Revenue passengers carried (millions)*	**12.6**	10.8	17%
Revenue passenger miles (millions)*	**19,199**	16,747	15%
Available seat miles (millions)	**29,431**	26,578	11%
Passenger load factor*	**65.2%**	63.0%	2.2 pts.
Yield per revenue passenger mile (cents)*	**17.6**	18.0	(2)%
Average number of employees	**19,868**	19,559	2%

* Excludes frequent flyer redemptions.

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The Annual Meeting of Shareholders of Air Canada will be held at 8:30 a.m. on Wednesday, April 30, 1997 at The Sheraton Wall Centre Hotel, (Ballroom), 1088 Burrard Street, Vancouver, British Columbia.

There are two sides to every ledger: revenues and expenditures. Expenditures can be predicted and controlled, revenues less so. Revenues are a measure of the esteem in which customers hold our product. To win for shareholders, Air Canada also must win for customers. That means improving the Air Canada travel experience by implementing a revenue growth strategy which is both creative and cost effective and which respects four values key to customer satisfaction.

customer

recognition

convenience

comfort

reliability

Chairman's Report to Shareholders

Sixty years ago, on September 1, 1937, pilots E.P. "Billy" Wells and Maurice McGregor flew their twin-engine Lockheed Electra from Vancouver to Seattle with a load of mail, inaugurating commercial service by the newly constituted Trans-Canada Air Lines. Posterity doesn't tell us whether Wells and McGregor knew they were making history, but I would like to think they felt at least a twinge of the pride that generations of Canadians from coast to coast would invest in the airline known since 1965 as Air Canada.

My generation grew up with TCA, watching it become a pillar of global aviation and a respected ambassador of Canada to the world, first as a Crown corporation and from 1989 as a fully privatized company.

Even now, wherever I am travelling in the world, the sight of that big red Maple Leaf on an Air Canada tail feels very reassuring.

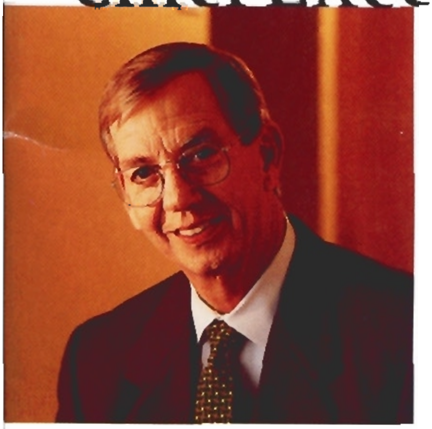
It is noteworthy that at a time when many Canadians feel that other national symbols and institutions have been diluted or downsized, Air Canada is as strong and as vital as ever. It has invested wisely in international diversification. The network and fleet have never been larger, assuring the most comprehensive domestic schedule and the most extensive network of non-stop services from Canada to the United States, Europe, the Caribbean, and the Middle East of any airline. Air Canada is building a strong presence in the growth markets of India and the Pacific Rim.

As a born and bred western Canadian, I feel strongly that Air Canada is neither the airline of East nor West, but of all Canadians, and I am immensely proud to have been named chairman of the board last August. This was done in the aftermath of the installation last May of a new executive management team headed by your president and chief executive, Lamar Durrett.

This separation of the chairman's functions from the day to day running of the airline is in keeping with currently recommended practice in corporate governance to separate the two spheres. It allows the board to provide additional support to Lamar's team, and underscores our commitment to increasing shareholder value, for Air Canada's seventh decade should not only be its most auspicious – but also its most prosperous.

John F. Fraser
Chairman of the Board

Report from the President and Chief Executive Officer



One of my more pleasant duties after succeeding Hollis Harris as Chief Executive last May was the opportunity to chat informally with shareholders. Many of you had two things on your mind: What changes am I planning for Air Canada? And how will they boost the share price? To both, I reply that the strategic vision Air Canada has been implementing for the past three years has brought us to the brink of sustained prosperity. Profit excluding one time gains is rising. The economic fundamentals for 1997 are bullish: a strengthening economy, low inflation and low interest rates. As part of its restructuring, our principal competitor has announced domestic capacity reductions, another favorable sign for the near term recovery of the entire domestic market.

As one of the architects of Air Canada's growth strategy, I believe that staying the course – pursuing further disciplined expansion – offers the surest way to boost the durable value of your investment. Diversifying into new international markets paid off handsomely last year. While domestic yields – revenue per passenger mile travelled – fell four percent and intercontinental yields were down six percent, yields on our US routes rose 10 percent. Of the 33 transborder routes we launched since Canada-US Open Skies began in February 1995, several already rank among our most profitable. Transborder revenue growth accelerated from the second quarter onward as these new routes matured, enabling Air Canada last year to record net earnings of $16 million before one time gains, a $28 million improvement. With a $129 million gain from selling part of our stake in Continental Airlines, total after tax earnings reached $149 million.

We have known for several years that excess capacity and the instability generated by Canadian Airlines' recurring financial crises would depress domestic margins. By expanding internationally, Air Canada has lessened its domestic exposure without lessening its presence. Last year, for the first time, this airline generated more than half its passenger revenues from international services, but also raised its share of the domestic passenger market by one point to 57 percent. Frankly, I can't imagine our prospects had we passed up timely opportunities like Open Skies. I only regret that by refusing Air Canada's request to fully participate in a high growth market like Hong Kong – instead of the current four flights – the federal government is letting a similar opportunity to strengthen Air Canada and improve global access for Canadians gather dust.

Despite our US success, the stock price languished early last year, bottoming at $4.11 in July as the domestic market began absorbing a huge amount of additional capacity from new, no-frills airlines, then rallying to $6.60 in December as it became apparent Canadian would reduce its domestic operations.

We constantly strive to do things better for our customers

Air Canada's response to the no-frills airlines was uncompromising: We competed on fares and beat them on service. The ensuing fare wars, along with soaring fuel prices, helped slice operating income by $60 million to $215 million. However, non-operating expense declined even more.

I place great emphasis on building durable value. As last year's events demonstrated, this industry is singularly volatile. By building up Air Canada's underlying fundamentals, we strengthen our ability to withstand any competitive realignment. For example, expanding at a rate of 11 percent annually since 1994 has enabled the airline to add critical mass in major markets. To customers, critical mass means Air Canada and its partners can take them to more of the places they want to go. The airline has built an unassailable lead at the Toronto hub, reinforced Ottawa, Montreal and Calgary and built a substantial international gateway at Vancouver. No other carrier, Canadian or American, comes close to matching our expanded transborder system. With United Airlines, Lufthansa, SAS and Thai International, we are building a dynamic global network.

Going forward, our plan for building durable value for shareholders embraces three main elements: one – increase revenues through expansion and product enhancement; two – reduce debt; three – pursue cost reduction opportunities and operational efficiencies. This year, capacity will grow by a further nine percent, mainly through more transborder expansion and by serving Osaka, Tel Aviv and Frankfurt from more points in Canada, with the caveat in some cases that overseas flights are allowed to operate from Montreal's Dorval Airport.

By the time my first 18 months as CEO are up, the debt will have been pared by over $600 million, partly by applying proceeds from the final tranche of Continental shares sold in January. Air Canada invested US$55 million in Continental in 1993 to secure greater US access. While Open Skies freed us to fly across the border at will, the investment still will be remembered for generating a $359 million or 550 percent profit.

If the Continental profit helped repair the damage to the balance sheet from the last recession, the lessons from those difficult years continue to shape our thinking. Our current fleet renewal entails much less risk than the purchase nine years ago of 34 A320s in a seller's market. The 35 A319s and six A340s being delivered through 1998 were ordered three years ago in a buyer's market, at hefty discounts, and are being acquired under operating leases. We continue to find economies in the operation. Almost $60 million will be saved annually by refinancing aircraft leases, capping travel agent commissions and exchanging Air Canada in-house overhauls of Boeing 747s for third party work on Boeing 767s. Through a joint initiative with the International Association of Machinists, maintenance productivity will be boosted by 30 percent in coming years, enabling the airline to do still more third party work for profit.

Late last year, as Canadian Airlines faced another crisis, the media sought to understand Air Canada's comparative prosperity. My list would include the creation of our internationally renowned Executive First business class, our rapid thrust into the US and Asian markets, our unbeatable Rapidair products, the enormous popularity of Aeroplan, Canada's leading frequent flyer program, and the acquisition of the 50 seat Canadair Regional Jet, ideally suited for launching many of our new routes.

Furthermore, if one judges from awards won and the findings of leading travel surveys, Air Canada's approval rating with Canadian travellers is higher than our competitors' and still rising. This speaks well for the job our Air Canada people are doing each and every day. But there will be no resting on laurels. Turn the page and you will see that much creative effort is going into adding value to our product by anticipating changing customer needs and preferences.

My belief is that no airline can achieve lasting prosperity through austerity alone, and certainly not by forsaking customers. A quality carrier must have a comprehensive revenue strategy, embracing innovative and intuitive approaches to cement brand loyalty. I expect our revenue strategy will continue to be a major contributor to Air Canada's growing success.

Finally, no airline can prosper without vision, and we are indebted to the many contributions made by my predecessor, Hollis Harris. His tenure strengthened the Corporation, and we wish him a good retirement.

R. Lamar Durrett
President and
Chief Executive Officer

Programs like Skyriders®
for younger travellers
reaffirm our commitment
to make every Air Canada
customer feel special.

customer recognition

Building success is a little like walking a tightrope over Niagara Falls. To win for shareholders, Air Canada must win for customers. That means maintaining a precarious balance between revenue enhancement and cost containment. Each should complement the other, like the head and heart. While the head is cool, rational – eyes fixed firmly on the cost side of the ledger – the heart is emotional and empathic, anticipating the evolving needs of customers and reshaping the Air Canada product by heeding four values key to customer satisfaction: Recognition, Convenience, Comfort, Reliability.

Building our customer strategy for the 21st century will involve upgrading the total trip experience. Step 1 includes fine tuning our understanding of what influences travellers to make a brand choice.

We want all customers to feel they matter to us

Each has a unique mindset about travel. Some go with the flow, some go against it. The challenge is to provide what each expects in an airline.

Take the case of Jill. Jill definitely goes against the flow. Leaving her Toronto home at 6:10 am to catch the 7 am Rapidair flight to Montreal is her idea of a low risk gamble. If there are no undue delays in traffic she makes the flight. If she misses it, she gets out on the 7:30 flight. For the next 50 minutes, normally mild mannered Jill becomes Type A, heart pounding, one eye on her watch. She's been through the drill so many times she could navigate Rapidair's dedicated check-in area blindfolded. The Rapidair agents know plenty of men and women like her who press their luck for a few minutes of extra sleep or to stretch a meeting. For Jill, who values Rapidair's unbeatable schedule, fleet, gates and on-time performance, we added more flights at half hour and quarter hour intervals and put on more large aircraft to improve her odds of getting a seat. From Montreal, by using the quiet Canadair Regional Jet, Air Canada now gets off three flights to Toronto each morning before the competition gets off its first. For Jill, that flexibility defines travel. (And for people like her in Edmonton and Calgary, Air Canada inaugurated Rapidair service between those cities last year.)

At the other end of the spectrum is Jack, who always gets to the airport at least 90 minutes prior to departure. For Jack, Air Canada is upgrading most Maple Leaf lounges – starting with Montreal, Toronto, Vancouver and Edmonton last year – to provide quiet, welcoming, full service work environments where he can refine a presentation and E-mail it to the office. The new transborder lounge at Toronto, opened this year, is double the size of the old. For Jack (and many Jills, too), that functionality and comfort defines travel.

Each traveller has his or her perceptions about what defines a good air travel experience and what would enhance it. Some swear by Executive First, because no other carrier from Canada to Europe or Asia offers wider seats or more legroom in business class. So many like it that a global survey of 2,200 travellers last year by Inflight Research Services named Air Canada best long haul business class carrier to the Americas. Others cite Daytripper, the only morning service from Canada to Europe, the flight with the evening arrival in London.

Everyone's basic expectations are a nonstop flight, a safe, on time arrival and fast service. Smiles go over big. Frequent business travellers – the people who comprise 21 percent of the customer base but generate 49 percent of passenger revenues – also covet recognition. Aeroplan Elite and Executive Class passengers have their own check-in desk and can board the aircraft first. They have dedicated phone numbers for making reservations. Our objective is to develop a more personal rapport with all customers, but especially this elite group. As the technology is developed, we will attach an advisory to their computer file identifying them as such when they check in with Air Canada. That notation will include the customer's recent travel history, enabling the agent to redress a late flight or missed connection with an upgrade or other compensation. Achieving mutual recognition of frequent flyers is one of the first tasks being tackled in developing a new global network with partners United, Lufthansa, SAS and Thai International. Already, if an Air Canada customer is eligible to use a Maple Leaf lounge, similar privileges are extended him or her by our partners in over 200 cities worldwide.

Recognition also means reward. The principle of reward is entrenched in Aeroplan. Air Canada's frequent flyer program has seen double digit growth in every year of its 12 year existence, rising another 20 percent last year to three million members. New partners added last year included Lufthansa, SAS, Hertz and the Stentor alliance of telephone companies. The loyalty Aeroplan cements is key to the success of Air Canada's expansion. Aeroplan members comprise a substantial percentage of customers on Air Canada's new US routes. Fifteen years ago, before Aeroplan and alliances, Air Canada couldn't make a go of Texas. Now, with Aeroplan and our United and Continental alliances, Air Canada is serving Houston and Dallas/Fort Worth again – with twice as many flights.

Relax, be productive: That's no contradiction in the Xerox Business Centres now in many Maple Leaf Lounges.

convenience

We're remaking Air Canada to provide the best travel experience possible

For travellers who define convenience as nonstop flights to the places they want to go, Open Skies was a seminal event. The old lament that you can't get there from here is heard a lot less often now that Air Canada has opened 33 routes to major US cities in two years.

Now, Jack or Jill can fly to Raleigh/Durham in half the time it used to take via a US hub – and do it as a day trip. That's one reason why the airline has raised its transborder market share from 31 to 37 percent and increased transborder revenues by 61 percent to $864 million, all in just under two years. The network also reached further abroad last year through new alliances with Lufthansa and SAS and a partnership with All Nippon Airways. Working with ANA will spur a further increase of service to Osaka this year, including the first Toronto nonstops. Historically, Air Canada has been a point to point carrier to Western Europe, serving a few major gateways. With as many as five flights a day to Germany this year – up from one in 1995 – Air Canada is developing a Frankfurt hub to serve more of Europe over the Lufthansa and SAS networks. In addition, London will be developed as a minihub with our partners to supplement Frankfurt.

Even so, the edge gained in the air can be lost on the ground. The most frustrating moments in travel usually happen when making a booking, or at the airport. From the traveller's perspective, nothing is more dehumanizing than queuing, or interminable waits between connecting flights. To cut connecting times with our partners, Air Canada is moving next to United's terminal in Chicago and has moved right into Lufthansa's Terminal 1 in Frankfurt. Next up is a complete refashioning of the ground experience. New technology will accelerate the flow of our customers through airports, producing substantial cost savings and increasing the numbers which the existing infrastructure can handle at peak times. Technophiles will flock to it. Technophobes will see it speed up their dealings with Air Canada people. This new world will include the Internet, smart cards and self service machines. Let's take a walk through it from booking to boarding.

Reserving a seat: Seat sales stimulate the market in low season, but can tie up our reservations lines, as bargain hunters crowd out full fare customers. The introduction last year of automated front end processing to sort incoming calls now ensures that people travelling in the next 48 hours are dealt with on a priority basis. The opening last August of a new call centre in Saint John, New Brunswick, was the catalyst for restructuring the domestic reservations network for greater productivity. Saint John now takes toll calls, leaving the Toronto, Montreal, Winnipeg and Vancouver call centres to focus on their area markets. Air Canada and United also automated code share booking, which speeds our internal processing of code share booking, making it possible in recent months to start selling many more US destinations as Air Canada connecting services over the United domestic system.

Booking by Internet: More and more customers are becoming Internet wise. Now, they can log on to Air Canada's home page <http://www.aircanada.ca> and click on GO AC WEBSAVER™ to get information on special last minute deals for weekend travel. Travel agents will use WEBSAVER™ as a new sales tool. Air Canada is the first major Canadian carrier to offer weekend selloffs via the Net. Within months, Internet users worldwide will be able to book any Air Canada travel online. Introduced two years ago, Air Canada's home page often attracts upwards of 30,000 "hits", or visits, a day.

Electronic ticketing: Last year, Air Canada became the first Canadian carrier to introduce electronic ticketing for direct bookings. By summer, all travel agents will be able to sell E-tickets, too, another Air Canada first and another indication of how we are enhancing our partnership with the travel agent community. With E-ticketing, all the customer needs is a file number and ID to get a boarding pass at the airport. Paper tickets can be lost or stolen, have to be reissued when itineraries change and returned for a refund when trips are canceled.

Airport automation: Every traveller wants to breeze through airports without lining up. We're trying to oblige. That's the inspiration for this year's introduction of Qik-Chek and self service ticketing. Qik-Chek is a computer program which simplifies check-in procedures. The result is fewer keystrokes and faster check-ins. Later this year, customer trials of self service machines begin, with general introduction following next year. These machines can issue boarding passes and baggage tags, process upgrades or seat changes.

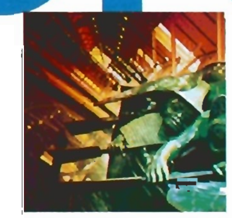
Customs and immigration: Airlines can't promise an end to lineups at security, but there is good news about customs and immigration, where the Canadian and US governments plan to give qualifying travellers – usually frequent flyers – access to automated fast track lanes, bypassing queues.

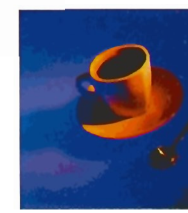
Cargo track and trace: Automation also serves cargo customers. Any customer now can track and trace the whereabouts of their shipments in the system by logging into Air Canada's Internet site.

Not all these innovations are unique to this airline, but together, they will accentuate the advantages of flying Air Canada.

With so much personal space to enjoy, flying in Executive First can feel like travelling in your favorite easy chair.

comfort





One area that strikes a chord with all Air Canada customers, whether they fly once a year or once a week, on business or for pleasure, is comfort. Along with adding utility through new destinations and more frequencies on existing routes, Air Canada is enjoying great success by widening the comfort gap over competitors. Be it the five star feeling of Maple Leaf Lounges, like the new rooftop lounge at Montreal's Dorval Airport opened last year, or the extra legroom on board – several inches more than most North American carriers – the comfort gap establishes the cachet of Air Canada's product. It converts travellers to Air Canada every day, and helps explain why our premium revenues – Executive Class/Executive First – rose over 25 percent last year.

We make each customer's journey a pleasure, from airport to airport

The strategy is to widen the gap further – not by throwing money at it, but by investing in basics while assembling partnerships of major suppliers in the world of business, communications, food service and entertainment industries to develop unique features like Xerox Business Centres.

Customers tell us the comfort element they value most is extra personal space – a wider seat and more legroom. Widebody aircraft are used for most flights over four hours, and with the conversion of several domestic 767s to international configuration last year, more customers flying long haul in Executive Class now get the international seat and legroom – a 21-inch wide seat and a minimum seat pitch of 55 inches. Internationally, we upped the ante even further, giving all Executive First customers 58-60 inches of legroom on the A340-300s. That's 20 percent more than the competition offers where the 340s are flying in 1997, including Osaka, Tel Aviv, Seoul, Hong Kong and Frankfurt.

To reinforce the real estate edge, two abreast seating for Executive Class became standard in the narrowbody fleet – DC-9s, A319s and A320s, doing away with three abreast on 320s. Economy passengers in 767s also received more legroom.

Comfort also means paying attention to small details, like adjusting the height and tilt adjustment of tray tables on A320s to make it easier to work with a laptop computer. It is improving creature comforts, by introducing multiplex sound systems, and doubling the amount of audio programming to 20 hours on long haul flights. Not only is the entertainment hardware a winner, so is the programming. The World Airlines Entertainment Association awarded Air Canada its silver medal for multichannel TV programming for a lineup that includes the only continuous festival of Canadian cinema.

For coffee connoisseurs, Air Canada introduced freshly brewed expresso and cappuccino for Executive First passengers on the Airbus 340s as well as special Air Canada blends of Second Cup coffee from Canada's leading chain of gourmet coffee bistros now served aboard all flights.

Air Canada became the first airline to offer a digital telephone within easy reach of every seat in the fleet. Digital is superior to analog technology. Customers can hook their laptop to a digital phone, even receive calls.

The introduction of Xerox Business Centres underscored Air Canada's leadership in developing premium co-branded products. Located inside Maple Leaf Lounges and staffed by a concierge, these centres raise the standard for airline lounges. Privacy, the ultimate comfort for those who crave it and a rarity in most airport business centres, is provided for in the work station designs by Steelcase. The Document Company Xerox, supplies office machines which fax, print, copy and scan. IBM provides computers and Internet access via the IBM Global Network. UPS adds worldwide courier service. The partners get to showcase their newest products to a cross section of the corporate elite. Air Canada contributes the space. And for those who prefer to do anything in a Maple Leaf Lounge but work, another partnership is bringing a Sony Entertainment Centre to every lounge, offering multi-screen viewing choices.

Sony and Sega are also partners in Skyriders*, the world's first fully integrated program for young flyers. We think of it as just plain fun – a frequent (or infrequent) flyer club for children aged 2-12. A dozen sponsors contributed program elements: preflight play centres, carry-on kits of inflight reading, games, puzzles and a log book. Kids meals are served and there are special libraries on board with books, board games and toys. Each young flyer receives a free subscription to Skygram, their own newsletter – so we can keep in touch with the next generation of frequent travellers. Over 20,000 signed up in the first summer. Air Canada wants to be the child friendly airline. Common sense also dictates that every youngster entertained by Skyriders puts a smile on Mom and Dad – and a planeful of fellow passengers.

reliability

Customers give the exceptionally quiet Canadair regional jet a thumbs up for the new nonstop services they make possible.

When customers are surveyed about what motivates their choice of airlines, most cite better schedules, more destinations, frequent flyer benefits or a generally favorable opinion of the service. Rarely do they mention reliability, though it permeates everyhody's thinking.

Reliability will always be the cornerstone of Air Canada's strategy. It's not a flashy or exciting virtue. We're striving to make the product so enjoyable that every one of the over 40,000 passengers flying Air Canada daily will get off the plane and say, "Great flight!" However, if the worst they can say about it is "uneventful", as in on time, smooth, hassle free, that would be hard for any airline to beat.

Reliability embraces many virtues. It is consistency – meeting or exceeding customer expectations

Air Canada's modern fleet is our trump card

year after year for 60 years. That's why in launching a new VISA card which enables cardholders to earn vacation holiday packages, the Canadian Imperial Bank of Commerce chose the most respected brand – Air Canada Vacations – as its partner for CIBC VACATIONGOLD.

It is predictability, why all four Rapidair routes use the same prime gates and leave at the same time every hour, meaning regulars don't need a timetable.

Reliability is why many of the world's largest freight forwarders are major customers of Air Canada Cargo. These forwarders provide just in time logistical services to many of the world's leading manufacturers. They must deliver value and reliability to their customers, so they demand both from their carriers. Last year, 11 of those forwarders accounted for almost 25 percent of Air Canada's $347 million in cargo revenues, as Cargo enjoyed its best year since 1990, raising its net contribution to Air Canada's bottom line by a further 18 percent.

Reliability means optimizing productivity – reassuring customers that Air Canada is providing the best travel value in a full service airline product. In 1990, it took a work force of 23,100 to operate a fleet of 106 jets. This year, the airline will operate 140 jets by year end with 21,300 employees. Between 1990 and 1996, employee productivity rose 47 percent, but there is more to the story than statistics. By 1994, restructuring had reduced the work force to 18,400, but the subsequent growth of staff in support of expansion has not only been rejuvenating, it has made our front line people more representative of Canada's multicultural reality as well as the new Asian and Middle Eastern points Air Canada now serves.

Rapid growth has necessitated great adjustment to maintain system integrity. At the Toronto hub, a just completed expansion of transborder facilities which includes a satellite terminal for CRJs and commuter aircraft linked by a continuous bus service to Terminal 2 will allow Air Canada to keep adding US destinations pending the redevelopment of Pearson Airport.

Growth must also respect the high corporate and community standards which people associate with Air Canada. Last year, the Corporation was cited for exceptional leadership in working to reduce Canada's greenhouse gas emissions. Air Canada was the only transportation company among 41 recipients of the Climate Change Challenge Award from the Climate Change Voluntary Challenge and Registry program. The Corporation's climate action plan calls for stabilizing fossil fuel emissions by unit of output at or below 1990 levels by 2000.

Perhaps nothing says more about Air Canada's commitment to reliability than fleet renewal. A brand new plane is a lot like a brand new car. Both have that factory fresh smell. If one word could summarize what the smell of a new aircraft interior conveys to passengers, it's reliability. It says, you're flying in style, and it's a trump card in Air Canada's customer strategy.

By adding 41 new aircraft through 1998, Air Canada will have one of the youngest fleets of any major airline worldwide. Excluding some DC-9s and 747s retained as interim lift to support expansion, the fleet will have an average age of six years. The cachet and added amenities these new aircraft bring is a strong selling point for discerning travellers. With a range of 7,400 nautical miles, the newest A340s are the first aircraft in the Air Canada fleet capable of flying Toronto-Asia nonstop, and they will take over all routes of 11 hours or more, including all Pacific routes.

Deliveries of 35 A319s began in December. The A319s, with 112 seats compared with 92 for the DC-9s, are being introduced on major transborder routes to New York (LaGuardia and Newark), Boston, Chicago, and Dallas/Fort Worth where they will be an undeniable competitive edge, offering more legroom than a DC-9 and a complete video capability. The A319s and A340s are significantly quieter and more fuel efficient than the aircraft they replace, making them better for the environment.

The introduction of the A319 will have a cascading effect. The DC-9s they displace will take over some of the new Open Skies routes which are outgrowing the 50-seat CRJs, freeing the latter to launch still more transborder routes or take over existing turboprop routes. Those DC-9s being kept are getting new interiors and modifications to enhance comfort and reliability. They, like the classic 747s, are fully depreciated and can be parked or sold if markets slump, or used by schedulers as backup aircraft. That way, when problems do occur, they won't have a serious ripple effect through the system, one of the many ways customers are being assured of the same high standard of reliability they have associated with Air Canada for 60 years now.

Air Canada recorded consolidated income of $149 million or $0.86 per share in 1996 as compared to income of $62 million or $0.36 per share in 1995. This represented an improvement of $87 million from the prior year. Higher gains, in 1996, from sales of Continental Airlines holdings contributed $72 million to the improvement in income results.

Operating income for the year was $215 million versus the record $275 million achieved in 1995. Operating results were adversely affected by reduced contribution from domestic operations and by a major runup in fuel prices. Fuel price increases, alone, accounted for $40 million of additional expense compared to 1995. Lower operating income from subsidiaries, notably AirBC in Western Canada, was also a factor.

In 1996, Air Canada continued its strategy to diversify its transportation revenue base by expanding services in selected international markets while limiting the growth in domestic capacity. In the year, the Corporation added seven new routes to the United States and expanded its codeshare operations with United Airlines. Since the February 1995 implementation of the Canada-US "Open Skies" agreement, Air Canada has added and currently operates 33 new scheduled US services. The US transborder services generated significantly improved contribution, in 1996 from both new and previously existing routes.

However, the profitability of domestic operations declined in the year. Lower average yields in Canada combined with higher costs relating to aircraft fuel were the main factors. Significant price discounting occurred due to new low-cost, low-fare entrants operating in Western Canada and on certain Canadian transcontinental routes. This, together with competition from Canadian Airlines, adversely affected operating results, particularly in Western Canada markets, leading to reduced profitability on domestic services for both Air Canada and AirBC. Additionally, expanded services were offered on other key business routes by Air Canada's main domestic competitor, which encountered financial difficulties in the latter part of 1996. While fare increases were instituted in 1996, revenue growth for the year did not keep pace with the costs involved in domestic operations.

In 1996, the Corporation pursued a strategy to lower non-operating expense and limit the growth in aircraft lease expense. Major elements of this strategy

Operating Revenues
(in millions)

Year ended December 31	1996	1995	1994	1993	1992
Domestic Routes					
Passenger	**$ 1,925**	$ 1,898	$ 1,814	$ 1,691	$ 1,677
Cargo	**110**	101	151	191	205
Total	**2,035**	1,999	1,965	1,882	1,882
International Routes					
Passenger	**2,055**	1,683	1,358	1,158	1,136
Cargo	**237**	222	183	144	137
Total	**2,292**	1,905	1,541	1,302	1,273
Other	**553**	603	518	414	346
Total	**$ 4,880**	$ 4,507	$ 4,024	$ 3,598	$ 3,501

were the repayment of long-term debt, refinancing of Airbus A320 aircraft lease arrangements and through realizing value from Air Canada's investment in Continental Airlines, Inc. (Continental). In the year, the Corporation sold 44 per cent of its Continental common share holding for cash proceeds of $156 million. In early January 1997, the remaining common share holding of Continental was sold for cash proceeds of $207 million and a pre-tax gain of $171 million.

Net non-operating expense declined $131 million from 1995 of which $72 million resulted from higher gains from the sales of Continental holdings. Net interest expense and amortization of deferred foreign exchange losses on long-term debt declined $67 million due to more favourable foreign exchange rates, lower average debt balances and lower US dollar interest rates in 1996.

In the year, Air Canada added 12 new jet aircraft to its fleet, comprised of two Boeing 767-300s, seven Canadair Regional Jets and, in the latter part of 1996, two Airbus A340 aircraft and the first of 35 Airbus A319 aircraft. Three L-1011 aircraft were retired in January 1996.

Expanded services were offered on Pacific routes as well as to Europe and the Middle East. Across the Atlantic, modest capacity growth was initiated to the prime United Kingdom market, with significant expansion to Germany as a result of the new international air services policy enabling direct Western Canada-Germany service in late 1995 and the introduction of the Lufthansa strategic alliance in mid-1996. Services were also expanded to Switzerland in conjunction with Swissair and to Tel Aviv, following start-up of this route in 1995.

In the Pacific market, Air Canada introduced new services to Hong Kong in December 1995 and expanded services to Osaka, Japan in 1996 in conjunction with All Nippon Airways.

1996 Income Results

Passenger Revenue

Passenger revenues increased $399 million or 11 per cent to $3,980 million on the basis of strong growth in international markets. Premium revenues from Executive Class and Executive First service on all routes recorded growth of over 25 per cent in the year. System traffic, as measured by revenue passenger miles (RPMs), increased 14 per cent on a 10 per cent growth in capacity, as measured by available seat miles (ASMs). Consolidated passenger load factor (a measure of capacity utilization) improved 2.2 percentage points to 64.0 per cent. Passenger yield, measured by passenger revenue per RPM, declined three per cent due to lower yields in domestic, Atlantic and Pacific markets. Passenger revenue per ASM, a measure of revenue generated per unit of passenger capacity, was one per cent higher for 1996.

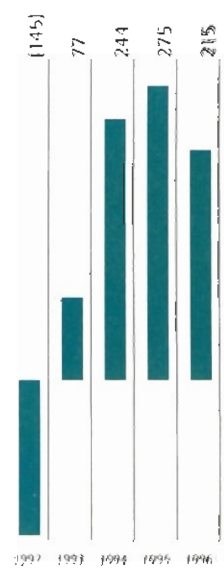
Air Canada's Regional Airlines (Air Nova, Air Alliance, Air Ontario, AirBC and Northwest Territorial Airways) are included in the consolidated revenues and statistics. As a group, the Regional Airlines recorded a six per cent increase in passenger revenues on the basis of a nine per cent increase in traffic, partially offset by a three per cent decline in yield.

Domestic Services

The Corporation's passenger revenue on domestic routes increased $27 million or one per cent to $1,925 million. Domestic traffic rose five per cent to 7.7 billion RPMs while domestic yield per RPM declined four per cent. In 1996, increased capacity was offered by new low-cost, low-fare competitors, mainly on Western Canada routes and certain transcontinental routes. This contributed to widespread fare discounting and yield erosion in these markets. Air Canada maintained competitive pricing and used yield management seat inventory allocation techniques to protect market share and minimize the decline in yield.

The Corporation's share of the domestic market, as measured by the dollar value of tickets sold by Canadian travel agents for travel within Canada, was 57 per cent, an improvement of one percentage point from 1995. Capacity was increased two per cent to 12.5 billion ASMs. Air Canada's capacity was up one per cent from 1995, while Regional Airlines increased their ASM capacity by seven per cent. Overall domestic load factor improved 2.0 percentage points to 61.4 per cent. Passenger revenue per ASM was essentially unchanged from the prior year.

Revenue from Canadian *transcontinental* routes, which accounted for over one-third of domestic revenues, increased one per cent with ASM capacity unchanged from 1995. Traffic grew by five per cent



Operating Income*

* Consolidated
Before staff reduction and retirement costs.

resulting in a three percentage point improvement to load factor. Transcontinental yields however, declined four per cent due to increased discounting in the marketplace.

Representing approximately one quarter of domestic revenues, the Corporation's *commuter* service revenues increased three per cent on ASM capacity growth of four per cent. (The commuter service includes flights within Ontario and Quebec and the Rapidair routes on the Montreal, Toronto and Ottawa corridor.) Commuter traffic was four per cent higher while yield declined one per cent.

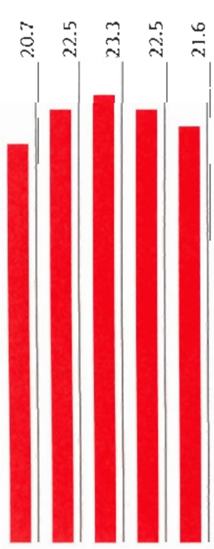
The *regional* routes, which consist of services within Western Canada, including the new western Rapidair service introduced in June 1996, and Atlantic Canada flights, recorded a one per cent revenue improvement on the basis of a nine per cent increase in traffic with yield declining seven per cent. Western Canada revenues fell by six per cent. Significant price discounting in this market stimulated traffic growth of 12 per cent, however yield declined by 16 per cent with increased competition by low-fare carriers. In Atlantic Canada markets, revenues increased nine per cent on the basis of higher traffic and yield.

International Services

Passenger revenues from international routes recorded substantial growth of $372 million or 22 per cent to $2,055 million. Premium revenues from Executive First and Executive Class service increased by over 40 per cent. In 1996, international revenues accounted for 52 per cent of the Corporation's passenger revenue as compared to 47 per cent in 1995. International passenger traffic increased 21 per cent to 12.8 billion RPMs with capacity increasing 17 per cent to 19.5 billion ASMs. This resulted in a 2.0 percentage point improvement in load factor to 65.6 per cent. International yield per RPM improved one per cent, due to the major growth in transborder yields. Passenger revenue per ASM from international services increased four per cent over 1995.

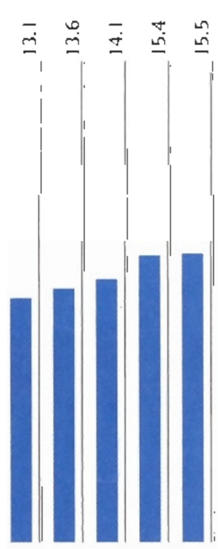
With the Canada-US "Open Skies" air services agreement of February 1995, the Corporation pursued a major growth strategy between Canada and the US. New or expanded services were introduced progressively throughout 1995 and 1996 to Houston, Atlanta, Washington DC, Minneapolis, Denver, Philadelphia, Los Angeles, San Francisco, New York, Chicago, St. Louis, Kansas City, Nashville, Columbus, Raleigh, Spokane, Hartford, Allentown and Harrisburg, together with increased codesharing services with United Airlines. Transborder charter operations were also converted to scheduled service in 1995. The transborder strategy produced significantly improved operating results in 1996.

Transborder revenues, excluding the sun destination of Florida, rose by over $230 million or 36 per cent and accounted for over 40 per cent of international passenger revenues in the year. Traffic grew by 24 per cent on an 18 per cent increase in capacity resulting in a three percentage point improvement to load factor. Contributing to transborder revenue growth was the increase in the number of short haul flights, using smaller aircraft, which catered to business traveller preferences for convenient and direct flights between business centres. Revenues from Executive Class service increased by over 50 per cent. Yield per RPM improved ten per cent due to an increasing number of business travellers utilizing new and previously existing services and due to fare increases during the year. Passenger revenue per ASM increased 16 per cent reflecting the strong demand for transborder travel services. Florida revenues improved one per cent on the basis of higher yield.



Domestic Yield per Revenue Passenger Mile* (cents)

*Not consolidated



International Yield per Revenue Passenger Mile* (cents)

*Not consolidated

The *transatlantic* routes, including routes to India and Israel, recorded a 13 per cent increase in revenue compared to 1995 and represented over one-third of international passenger revenues. Overall transatlantic passenger traffic grew 19 per cent on a capacity growth of 16 per cent. Passenger yields declined six per cent reflecting increased discounting in certain Atlantic markets and weaker European currencies, which lowered the Canadian dollar value of foreign originating sales compared to the prior year.

For the United Kingdom, Air Canada's largest transatlantic market, revenues increased six per cent mainly as a result of traffic growth partially offset by lower yields. Germany recorded a 34 per cent revenue growth over 1995, with expanded services from Western Canada and the new Lufthansa strategic alliance. Switzerland revenues increased some 50 per cent due to a significant increase in traffic with lower yields while revenues from passenger services between France and Canada declined three per cent due to lower yields.

Pacific routes, which include services from Vancouver to Osaka, Japan; Seoul, South Korea and Hong Kong generated incremental passenger revenues of $58 million over 1995. The major component of this growth was the new service to Hong Kong, started in December 1995, together with expanded operations to Japan in 1996. Premium revenues from Executive First service represented an increasing component of Pacific revenues. Pacific traffic grew by 73 per cent on a 70 per cent growth in capacity. Pacific yields, however, declined 10 per cent reflecting a weaker Japanese yen and the addition of the new Hong Kong service.

Cargo Revenue

Consolidated cargo revenue of $347 million rose seven per cent over 1995. Cargo traffic increased 11 per cent while cargo yields declined four per cent, excluding subsidiaries.

International cargo revenues increased seven per cent to $237 million. Pacific cargo revenues experienced significant growth as a result of new Hong Kong and Japan services, although this was partially offset by the effect of a weaker Japanese yen, lowering the equivalent Canadian dollar value of foreign originating cargo sales compared to 1995. Domestic cargo revenues increased nine per cent over 1995 due to increased premium revenues and higher revenues from Regional Airlines.

Other Revenue

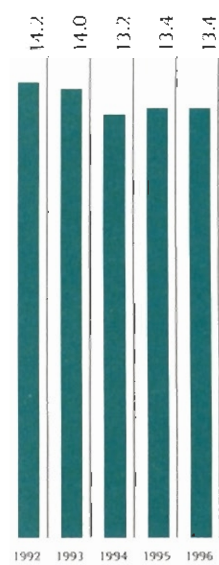
Other revenue was $553 million representing a decline of $50 million from 1995. Reduced third party maintenance work was the main reason, following completion of a large 1995 maintenance contract with Northwest Airlines. Aeroplan partner revenues and Galileo Canada Distribution Systems Inc. (Galileo Canada) showed growth over 1995 while Air Canada Vacations recorded lower revenues due to a decline in tour sales.

Operating Expenses

Consolidated operating expenses of $4,665 million rose $433 million or 10 per cent compared to 1995. Operating expenses increased primarily as a result of the 10 per cent growth in ASM capacity and higher fuel prices in the year. Despite the increased fuel prices, operating expense per available seat mile, excluding subsidiaries, was unchanged from 1995.

The Corporation's operating expense includes those of a number of non-passenger transportation businesses which do not produce available seat miles. These businesses include cargo operations, third party maintenance and ground handling services, Galileo Canada and Air Canada Vacations' packages. Excluding subsidiaries, the 1996 net operating cost per ASM of the passenger transportation business, after deducting the revenue impact of non-ASM generating businesses, was 10.8 cents per ASM (US 7.9 cents), an increase of three per cent over 1995.

Salaries and wages expense increased $66 million or six per cent. Excluding subsidiaries, the average number of employees during the year increased two per cent. Modest manpower increases were required to support the additional seat capacity, while manpower was reduced relating to lower third party maintenance work. Average salaries increased four per cent, mainly as a result of contractual and other wage increases. Significant improvements in productivity were recorded in the year. Employee productivity as measured by available seat miles per employee, rose nine per cent and operating revenue per employee recorded growth of eight per cent, excluding subsidiaries.



Operating Expense per Available Seat Mile* (cents)

*Not consolidated
1993 excludes fuel excise tax rebate.

Benefits expense increased by $13 million or eight per cent. Factors were greater group benefit costs and higher employee levels.

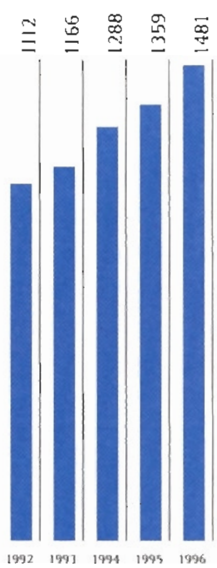
Fuel expense rose $113 million or 21 per cent, far in excess of the 10 per cent growth in ASM capacity. Significantly higher fuel prices accounted for $40 million of this increase, net of hedging. Fuel expense of $640 million includes the favourable effect of fuel hedging. The ongoing fuel hedging program contributed $35 million towards lowering 1996 expenses, as compared to normal market prices.

Depreciation, amortization and obsolescence expense increased by $42 million or 19 per cent, due primarily to higher depreciation on aircraft and related equipment. During the year, seven new Canadair Jet aircraft were acquired as well as six previously leased Airbus A320 aircraft pending financing or refinancing. Higher depreciation expense was also incurred due to the acquisition of nine DC-9 aircraft from operating leases. Remaining increases related to greater amortization on other aircraft as well as on aircraft parts, inventory and on computer development projects.

Commission expense increased $36 million or 10 per cent, generally reflecting growth in passenger revenues and international cargo revenues. Air Canada Vacations' commission expense was $6 million lower due to reduced tour sales. In September 1996, Air Canada revised its domestic commission structure including the introduction of a cap on domestic passenger commissions. The favourable impact on 1996 commissions was approximately $3 million, with higher saving projected for 1997.

Average Number of Employees* (thousands)

*Not consolidated



Average Seat Miles per Employee* (thousands)

*Not consolidated

Food, beverages and supplies expense increased $19 million or 10 per cent over 1995. Increases essentially were due to higher traffic levels and enhanced in-flight entertainment programs.

Aircraft maintenance, materials and supplies expense rose $26 million or 14 per cent. Higher maintenance materials costs for Boeing 747, Airbus A320 and Canadair Jet aircraft accounted for approximately one-half of the increase, net of savings from the retirement of L-1011 aircraft. The other component was higher materials expenditures for Regional Airline operations.

User fees increased $17 million or nine per cent due to greater flight frequencies and higher passenger volumes.

Aircraft rent expense rose $27 million or nine per cent due mainly to the full year impact of Airbus A340, Boeing 767-300 and Canadair Jet aircraft leases entered into in 1995 and, to a lesser extent, new leases in 1996. Two Boeing 767-300s were lease-financed in the first quarter of 1996 as well as seven Canadair Jets, two Airbus A340s and one Airbus A319 aircraft in the latter part of the year. In the year, aircraft rent savings of $26 million were achieved compared to 1995, due to the refinancing of 11 previously leased Airbus A320 aircraft at more attractive lease rates and the temporary ownership of six previously leased A320 aircraft pending refinancing. Upon completion of lease financing for the two remaining Airbus A320s in 1997, Air Canada expects total full year aircraft rent savings to amount to $36 million per annum when compared to the previous A320 leases.

Customer maintenance materials expense, incurred to produce revenues from maintenance services to third party airlines, declined $13 million from 1995. This reflected the planned reduction in contract maintenance services as a result of the completion of the Northwest Airlines contract, partly offset by a changed business mix towards more material-intensive customer work in 1996.

Other operating expense of $1,027 million was $87 million or nine per cent higher than in 1995. Expense growth was mainly related to increases in passenger and flight volumes including airport terminal handling costs, computer reservations charges, credit card fees, flight/cabin crew lodging expenses, building rent, advertising and computer network services as well as the cost of the new uniforms introduced in early 1996. Air Canada Vacations' other operating expense declined by $23 million due to lower tour expenses. Other subsidiary expenses increased by a similar amount with higher Galileo and Regional Airline expenses being the main components.

Non-operating Expense

Consolidated non-operating expense was $62 million representing a decline of $131 million from 1995.

In 1996, Air Canada recorded a gain of $129 million on the sale of Continental Airlines shares compared to a $57 million gain in the prior year, on the sale of warrants for the purchase of Continental shares. This accounted for $72 million of the improvement to non-operating expense.

Net interest expense declined $44 million to $157 million. Interest income declined $10 million mainly as a result of lower interest rates. Interest expense was reduced by $46 million due to a stronger Canadian dollar against Swiss, Japanese and German currencies, lower average debt balances and lower US dollar interest rates during the year. Capitalized interest, related to future aircraft deliveries, was $32 million representing an increase of $8 million. Amortization of deferred foreign exchange losses on long-term debt decreased $23 million due to more favourable foreign exchange rates and repayment of US dollar and Swiss franc debt.

Income Taxes

The Corporation recorded a $56 million income tax provision related to the current year's earnings. This was reduced by $52 million by applying a portion of unrecognized income tax benefits from losses in 1992 and 1993. As at December 31, 1996, the remaining unrecognized potential benefit of future income tax savings amounted to $20 million.

Cash Position

At year-end 1996, Air Canada maintained a strong cash position with cash and short-term investments amounting to $455 million.

In 1996, cash from operations generated inflows of $64 million. Included in cash from operations was a $206 million cash outflow pertaining to scheduled aircraft lease payments in excess of aircraft rent expense (1995 – $85 million). Excluding these lease payments, cash from operations was $270 million, an improvement of $126 million over 1995.

Financing activities consumed $218 million of cash. Net debt repayments amounted to $203 million. In the year, the Corporation repaid debt obligations of $848 million (including a US$400 million Note Issuance Facility in late 1996, Swiss franc 100 million notes and a US$100 million revolving facility in the spring of 1996). Long-term borrowings of $645 million were for the issuance of Deutsche mark 250 million bonds in May 1996, and in late 1996, a US$207 million refinancing of the above-noted US$400 million facility together with a drawdown of US$100 million under the revolving facility.

Investing activities reduced cash by $166 million. Proceeds from sale and leaseback transactions contributed $336 million and pertained to the refinancing of four Airbus A320 aircraft together with the lease financing of seven Canadair Jets. Proceeds from the sale of assets amounted to $176 million, with the sale of Continental shares providing $156 million. Additions to property and equipment of $607 million included $410 million for the acquisition of six previously leased Airbus A320 aircraft and seven new Canadair Jets pending completion of new lease financing arrangements, as well as for the exercise of purchase options on nine previously leased DC-9 aircraft. Progress payments for Airbus A319 and A340 aircraft and expenditures for aircraft inventory, spare engines, capitalized interest and betterments were $163 million. Refunds of progress payments on aircraft totalling $129 million were netted against additions to property and equipment. This represented cash proceeds from the lease financing of two new Boeing 767-300 aircraft as well as the financing of two new Airbus A340s and one Airbus A319 aircraft. Facilities, ground equipment and computer project development expenditures accounted for $111 million. Subsidiary capital expenditures amounted to $52 million including the acquisition of five Beech 1900D aircraft by Air Alliance and two de Havilland DHC-8 aircraft from operating lease by Air Nova. Investments and advances totalled $71 million covering mainly long-term investments related to the lease financing of aircraft.

Planned Capital Expenditures and Financing

The table below outlines Air Canada's committed aircraft deliveries in the 1997 to 1999 period:

Aircraft Type	1997	1998	1999
Airbus A340	4	–	–
Airbus A319	22	12	–
Canadair Jet	2	–	–
	28	12	–

The table below summarizes the Corporation's committed and planned capital expenditures, net of committed aircraft financing for the 1997 to 1999 period. After financing, total planned and committed expenditures amount to $157 million in 1997, $90 million in 1998 and $161 million in 1999.

(in millions)	1997	1998	1999
Committed aircraft expenditures before financing	$ 1,153	$ 370	$ –
Committed aircraft financing	1,328	441	–
Net committed aircraft expenditures (proceeds) after financing	(175)	(71)	–
Other planned aircraft expenditures	34	–	–
Planned aircraft engines, inventory, spare parts, modifications and refurbishments	106	36	52
Other planned property and equipment	192	125	109
Planned and committed capital expenditures, after financing	$ 157	$ 90	$ 161

Committed aircraft expenditures before financing represents progress and final payments for four Airbus A340 aircraft and 34 Airbus A319 aircraft. Excluded from the table are progress payments of $39 million (US$29 million) and an equivalent amount of financing on Airbus A340 and Airbus A319 aircraft as these progress payments are being made by a third party. Expenditures for the two Canadair Jets in 1997 are excluded from the table as Air Canada has an option to sell these aircraft in 1997. Air Canada has orders for six Airbus A320 aircraft for 1999 delivery, however no payment amounts have been included for these aircraft as Air Canada has the right to cancel the orders without penalty.

Committed aircraft financing represents operating lease financing proceeds for four Airbus A340 and 24 Airbus A319 aircraft and debt financing for 10 Airbus A319 deliveries. The operating lease financing is shown on the basis that the financing facilities are fully utilized under sale and leaseback arrangements. Formal commitments for essentially 100 per cent financing, under operating leases, have been received for four Airbus A340 aircraft in 1997, 14 Airbus A319 aircraft also in 1997 and for 10 A319 aircraft in 1998. Committed debt financing is in place covering 85 per cent of the purchase price of eight Airbus A319 deliveries in 1997 and two in 1998. Air Canada is in the process of arranging 100 per cent operating lease financing for up to all of the 10 debt-financed Airbus A319 aircraft.

Net committed aircraft proceeds after financing amount to planned cash inflows of $175 million in 1997 and $71 million in 1998. This represents, effectively, the return of a portion of aircraft progress payments made by Air Canada in prior years.

Planned aircraft expenditures of $34 million cover the potential exercise of a purchase option for one leased Boeing 747 aircraft in the fourth quarter of 1997.

Other planned property and equipment is for committed and planned spending on computer development projects, airport improvements, ground equipment, facilities and buildings (including the Air Canada Centre Office Tower in Toronto) as well as capital expenditures by subsidiaries. Remaining committed expenditures total $15 million for improvements to Terminal 2 at Toronto's Pearson International Airport. Air Canada has had discussions regarding potential major development projects at Pearson International Airport. To date, no additional capital expenditures have been planned or committed relating to these projects. User fee arrangements have been proposed as an alternate method of paying for the potential projects.

All uncommitted capital expenditures will be subject to management's assessment of future market and financial conditions prior to final commitment.

Debt Repayment and Financing Strategy

The Corporation's mandatory debt repayment schedule for the next three years is as follows:

(in millions)	1997	1998	1999
Debt repayments	$ 226	$ 104	$ 154

At year-end 1996, Air Canada had the following unsecured, revolving credit facilities in place. These facilities were fully drawn at December 31, 1996:

- US$207 million debt financing, from a group of international financial institutions, available until 2002. Of this amount, US$177 million may be repaid and redrawn subject to a reducing, revolving period.
- US$100 million, representing the total amount available until June 1997, under a revolving debt financing facility from a group of financial institutions in Canada.

In January 1997, using proceeds from the sale of Continental shares, Air Canada repaid debt of US$277 million, re-establishing US$277 million of revolving credit availability under the above facilities.

Air Canada plans to complete by mid-1997, sale and leaseback transactions on two Airbus A320 aircraft for proceeds amounting to over $70 million. The potential sale of aircraft is expected to provide additional cash inflows in the 1997 to 1999 period. Current plans are to sell approximately 20 DC-9 aircraft, subject to operational requirements, in the 1997 to 1998 period as new Airbus A319 aircraft are delivered. Presently, two Lockheed L-1011 aircraft are not in service and available for sale.

The sale and leaseback of owned and unencumbered aircraft represents a potential source of financing. At year-end 1996, 55 per cent of Air Canada's fleet by number (excluding subsidiary aircraft) or 33 per cent by fair market value were owned and unencumbered.

A major priority of the Corporation is to generate improved cash from operations in 1997 and subsequent years. Cash from operations is expected to play an increasing role in providing funds to repay debt and fund capital expenditures in the coming years.

At December 31, 1996, US$738 million or some one-third of the Corporation's total debt was in US dollars, on a floating rate basis. Air Canada manages the exposure to floating US dollar interest rates on an ongoing basis through partial interest rate hedging. At December 31, 1996, approximately one-tenth of the planned 1997 interest rate exposure on US dollar floating rate debt was hedged with short-term interest rate contracts placed with major credit worthy financial institutions. Longer term interest rate agreements were also in place to cover interest rate exposure on a small portion of long-term debt. Depending upon market conditions and the Corporation's view of interest rate movements, a portion or up to all of the floating rate debt could be fixed in the short-term or swapped to fixed rate for terms up to maturity. The Corporation's cash position, which is invested in highly rated interest bearing instruments, provides a partial hedge against interest rate movements on the floating rate debt to the extent short-term US and Canadian interest rates move in tandem. Short-term interest rates on cash balances may be periodically hedged depending upon market conditions. Movements in short-term interest rates can affect financial results due to Air Canada's floating rate debt position and short-term investment portfolio. However, taking into account interest rate hedging as at December 31, 1996, projected short-term investments and planned debt repayments, a one percentage point increase in short-term interest rates would have a $3 million impact on planned net interest expense in 1997.

Air Canada has borrowed in a number of low interest rate currencies such as the Swiss franc and Japanese yen. As at December 31, 1996, principal amounts relating to 200 million of Swiss franc debt, 15 billion of Japanese yen notes and 250 million German marks were exposed to foreign exchange fluctuations. In January 1997, the Corporation entered into swap agreements to effectively convert the 250 million German mark debt into floating rate Canadian dollar debt for both principal and interest obligations. The principal amount of the subordinated perpetual debt is not considered to be subject to economic foreign exchange risk, since the requirement to repay the principal is only upon liquidation, if ever, of the Corporation.

Interest obligations in Swiss francs and Deutsche marks are covered to a large extent by surplus cash flows in European currencies. With expanding operations to Japan, yen denominated cash flow surpluses provide a natural hedge covering yen interest expense.

Based on book value, the weighted average cost of Air Canada's long-term debt, subordinated perpetual debt and convertible debentures was 7.9 per cent in 1996, down from 9.3 per cent in 1995. The lower weighted average cost of debt reflects primarily reduced interest expense caused by a stronger average Canadian dollar against Swiss, German and Japanese currencies.

Air Canada has an ongoing operational requirement for US dollars to cover various expenses such as fuel, aircraft materials, interest and aircraft lease payments. Air Canada obtains US dollars by buying dollars on the spot and forward exchange markets and through the conversion of foreign currency surpluses into US dollars. As at December 31, 1996, approximately one quarter of the net projected 1997 operational requirements for US dollars were covered by short-term forward exchange or option contracts. With expanded operations to the United States, Air Canada is generating increasing US dollar cash flows to cover these operational requirements.

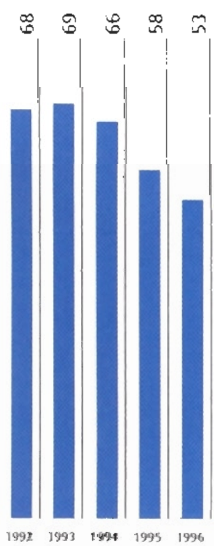
Air Canada manages its US dollar and foreign currency exposure through hedging, which may be adjusted from time to time depending on its view of the foreign currency markets. At December 31, 1996, short-term foreign exchange contracts were in place covering over 45 per cent of the principal amount of the US dollar debt. Aircraft assets, recorded on the balance sheet at historical exchange rates at the time of acquisition, are essentially US dollar-based assets which can provide a longer term economic hedge against currency movements.

Taking into account US dollar currency hedging, a one cent improvement in the value of the Canadian dollar (compared to one US dollar) could positively affect planned operating income by approximately $1 million and non-operating expense by $2 million in 1997, under present Canadian accounting standards. A weakening Canadian dollar can stimulate additional foreign currency sales, reducing the expected negative currency impacts on operating results.

Aircraft fuel is a major expense to the Corporation. Air Canada enters into fuel hedging contracts with credit worthy institutions to protect against increases in the price of fuel. As at December 31, 1996, Air Canada had effectively hedged approximately 35 per cent of its anticipated 1997 equivalent fuel consumption through financial swap agreements at an average effective fixed price of less than US$19.00 per barrel for West Texas Intermediate crude oil. For the portion of Air Canada's projected 1997 fuel consumption which was not hedged at December 31, 1996, a one US dollar per barrel movement in the price of crude oil could result in an approximate CDN$12 million change in annual operating expense.

Outlook

The Canadian domestic market has seen a high degree of volatility and competition over the past several years. Two new low cost airlines are operating primarily in Western Canada and on certain transcontinental routings. Air Canada's main domestic competitor has announced a major realignment of its operations together with a proposed deferral of certain debt and



Percentage* of Long-Term Debt to Debt Plus Fixed Capital** (%)

*Long-term debt divided by the sum of long-term debt subordinated perpetual debt and shareholders' equity
**Consolidated

lease obligations, subject to creditor approval. The announced realignment of operations involves a reduction of domestic capacity offered by this competitor together with selected expansion in US and Pacific markets.

This realignment represents both an opportunity and a risk to Air Canada. While the domestic capacity reduction may provide opportunities to the Corporation to benefit from a more rational capacity environment in Canada, the planned Pacific expansion by this competitor may constrain Air Canada's potential growth in this region. Air Canada has been pursuing the Government of Canada for authority to increase Hong Kong services to at least daily operations. It is uncertain, at this time, whether Air Canada will receive authority to offer expanded service to Hong Kong before 1998.

Since the introduction of the "Open Skies" agreement between Canada and the United States in February 1995, Air Canada has implemented a significant expansion strategy in the transborder market. For the first three years, this agreement contains restrictions governing the number of new US carrier operations at the major airports of Toronto, Montreal and Vancouver. Effective February 1997, these restrictions are being removed at Montreal and Vancouver to allow unlimited US carrier operations. For 1997, restrictions continue at Toronto, allowing four additional US carrier designations to operate twice daily service, effective February 1997, with full access to Toronto to be granted by February 1998.

Competition will be heightened on transborder services as a result of the removal of airport restrictions and increased flights by US carriers. Over the past two years however, the Corporation has built a strong transborder network, particularly for operations from Toronto. Additionally, Air Canada and the US carriers have rationalized, to a certain extent, their transborder operations and eliminated services which did not meet financial expectations. As a result, the removal of restrictions at Montreal and Vancouver is not expected to have a significant impact on the operations of Air Canada. Most of Air Canada's transborder growth has occurred on flights to/from Toronto and this airport will continue to operate as the key hub for transborder operations.

In the early part of 1997, four of the Regional Airlines (AirBC, Air Ontario, Air Alliance and Air Nova) and their pilots (represented by the Air Line Pilots Association – Canada (ALPA)) became involved in a labour disruption and work stoppage relating to ALPA's demands regarding pilot seniority issues. Service to communities served by the Regional Airlines has been affected, however a number of routes are operating through the provision of alternate services. Providing the labour dispute is resolved in an expeditious manner, Air Canada does not expect that this will have a material impact on results for the 1997 year.

Two major Canadian labour agreements covering flight attendants (represented by the Canadian Union of Public Employees (CUPE)) and maintenance, sales and service, cargo employees (represented by the International Association of Machinists (IAM)) are scheduled for renegotiation in 1997. Negotiations are currently underway with the flight attendant group whose current contract expired in October 1996. Negotiations with the IAM are scheduled for the spring of 1997. Air Canada expects that, through the collective bargaining process, new labour agreements will be concluded with these employee groups.

For 1997, the Corporation plans to increase its overall system capacity by approximately nine per cent. This includes a modest reduction to domestic capacity in 1997, together with a planned redesign of the Western Canada flight schedule. International services are expected to grow by approximately 17 per cent with planned Pacific, Atlantic and Transborder expansion being the main components. Expansion of US operations is expected to continue in 1997 but at a slower pace than in 1996. Air Canada continues to press the Canadian government for additional designations to serve Pacific markets. In the event additional designations become available, Air Canada would likely revise its planned flying to expand Pacific operations by redeploying capacity from other markets.

Subject to market conditions, Air Canada is planning to dispose of up to 20 DC-9 aircraft over the next two years as new Airbus A319 aircraft are delivered. Fifteen DC-9 aircraft would continue to be operated to enable expansion on US services. Air Canada also plans to retain six older Boeing 747 aircraft which serve international markets. While ongoing maintenance expenses will be higher, retention of DC-9 and Boeing 747 aircraft reduces Air Canada's overall capital expenditure requirements as compared to new aircraft acquisitions. This provides added flexibility, in the event of an economic downturn or other situation requiring reduced capacity, as these aircraft could be retired or parked with very low carrying expense.

Air Canada is in the preliminary stages of reviewing its longer term fleet requirements for the 1999 to 2002 period, including potential replacement of the DC-9 and older Boeing 747 aircraft as well as the addition of other aircraft for growth in selected markets. It is likely that additional aircraft will be required for replacement or growth purposes, however no additional commitments have been made with respect to future fleet requirements.

In 1997 and subsequent years, aircraft rent expense will increase significantly as Air Canada takes delivery of new Airbus A340 and A319 aircraft under operating leases. Aircraft rent expense for 1997 is projected to increase by approximately $100 million due to new aircraft deliveries and the full year impact of aircraft leases entered into in 1996. New generation aircraft have improved operating efficiencies in the form of reduced fuel consumption, lower maintenance expense and savings in other expense areas. The growing Airbus fleet is projected to provide savings compared to alternative fleet types through improved aircraft commonality which lowers pilot, maintenance, inventory and other costs. Operational and other savings from the replacement of older generation aircraft are expected to offset, to a large extent, aircraft rent expense on the new generation aircraft.

With the privatization of the Canadian air navigation system under NAVCAN, air navigation charges are expected to become payable directly to NAVCAN on a phased basis commencing in late 1997. The Air Transportation Tax (ATT), used by the Government of Canada to fund a portion of the operations of the air navigation system, is expected to be reduced by some 50 per cent in late 1997 with planned elimination of the ATT by late 1998. While the specific arrangements relating to NAVCAN are not finalized and are subject to change, Air Canada is generally planning to recover NAVCAN fees through passenger charges equivalent to the value of the ATT as it is phased out. However, because NAVCAN fees may become a direct operating cost of the airlines, Air Canada's operating expenses and unit costs may be increased with the introduction of the new arrangements in late 1997 and 1998.

Over the next three years, Air Canada plans to invest in excess of $100 million in technology initiatives to improve customer service and operational/cost performance. These investments include product distribution initiatives (such as Electronic Ticketing implemented in 1996), airport processing/handling systems as well as improved financial, human resource, yield management and scheduling systems.

One of the Corporation's major priorities is to maintain a net unit cost profile which is competitive with major US air carriers. Air Canada will continue to focus on measures to improve productivity and on expense reduction initiatives. However, with the projected increase to aircraft rent, aircraft materials, computer services and other expense areas, Air Canada expects a modest increase to its average unit cost per ASM for 1997.

The airline industry is subject to a number of influences over which it has limited or no control including economic conditions, interest rates, fuel prices, foreign exchange rates and regulatory or political events. While economic conditions in Canada are expected to improve in 1997, there are many variables which cannot be predicted including fuel prices and other events such as the financial and operational condition of Air Canada's main domestic competitor as well as the potential for new entrants in the domestic market.

The global airline industry is expected to remain highly competitive in 1997. Passenger traffic and yields will continue to be under pressure as a result of the operation of low cost carriers and consumers demanding greater value for money. Air Canada completed major structural changes over the past several years in order to improve its network, market position, operational efficiency and cost profile. The Corporation will continue to review all aspects of its business including operational processes, labour policies, products and fleet composition, with the objective of improving operating profitability and cash flow in order to enhance shareholder value in 1997 and subsequent years.

Accounting Policy Changes

Effective in 1996, the Corporation retroactively adopted new recommendations of the Canadian Institute of Chartered Accountants (CICA) for the presentation and disclosure of financial instruments, as described in Note 2 to the consolidated financial statements.

The CICA is reviewing potential changes to accounting standards covering foreign exchange translation. Currently, generally accepted accounting principles (GAAP) in Canada require the deferral and amortization of gains and losses on long-term debt over the remaining term of the debt. These emerging standards may require immediate recognition in income of foreign exchange adjustments from the revaluation of long-term debt, similar to US GAAP. An effective date for implementation of the proposed foreign exchange policy has not been established.

The CICA is also considering revisions to the treatment of post-retirement and post-employment benefits to adopt the accrual method similar to US GAAP. While no implementation date has been set for this proposed policy, the effects on income and retained earnings would be similar to those described under Note 16 to the consolidated financial statements.

Management Report

The consolidated financial statements contained in this annual report have been prepared by management in accordance with generally accepted accounting principles and the integrity and objectivity of the data in these financial statements are management's responsibility. Management is also responsible for all other information in the annual report and for ensuring that this information is consistent, where appropriate, with the information and data contained in the financial statements.

In support of its responsibility, management maintains a system of internal control to provide reasonable assurance as to the reliability of financial information and the safeguarding of assets. The Corporation has an internal audit department whose functions include reviewing internal controls and their application, on an ongoing basis.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control and exercises this responsibility through the Audit Committee of the Board, which is composed of directors who are not employees of the Corporation. The Audit Committee meets with management, the internal auditors and the external auditors at least four times each year.

The external auditors, Price Waterhouse, conduct an independent audit, in accordance with generally accepted auditing standards, and express their opinion on the financial statements. Their audit includes a review and evaluation of the Corporation's system of internal control and appropriate tests and procedures to provide reasonable assurance that, in all material respects, the financial statements are presented fairly. The external auditors have full and free access to the Audit Committee of the Board and meet with it on a regular basis.

M. Robert Peterson
Senior Vice President, Finance
and Chief Financial Officer

R. Lamar Durrett
President and
Chief Executive Officer

Auditors' Report

To the Shareholders of Air Canada:
We have audited the consolidated statement of financial position of Air Canada as at December 31, 1996 and 1995 and the consolidated statements of operations and deficit and changes in cash position for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 Corporation as at December 31, 1996 and 1995 and the results of its operations and the changes in its cash position for the years then ended in accordance with generally accepted accounting principles.

Price Waterhouse

Chartered Accountants
Montréal, Québec
February 20, 1997

Consolidated Statement of Operations and Deficit

(in millions except per share figures)

Year ended December 31	1996	1995
Operating revenues		
Passenger	$ 3,980	$ 3,581
Cargo	347	323
Other	553	603
	4,880	4,507
Operating expenses		
Salaries and wages	1,152	1,086
Benefits	179	166
Aircraft fuel	640	527
Depreciation, amortization and obsolescence	258	216
Commissions	395	359
Food, beverages and supplies	201	182
Aircraft maintenance, materials and supplies	210	184
Airport user fees	200	183
Aircraft rent	319	292
Customer maintenance materials	84	97
Other (note 1j)	1,027	940
	4,665	4,232
Operating income	215	275
Non-operating income (expense)		
Interest income	50	60
Interest expense	(239)	(285)
Interest capitalized	32	24
Amortization of deferred foreign exchange on long-term debt	(46)	(69)
Gain on sale of investment in Continental (note 5)	129	57
Gain on sale of assets	4	17
Other	8	3
	(62)	(193)
Income before income taxes	153	82
Income tax provision (note 11)	(56)	(40)
Recovery of prior years income taxes previously not recorded	52	20
Income for the year	149	62
Deficit, beginning of year	(392)	(444)
Charge relating to convertible debentures (note 2)	(14)	(10)
Deficit, end of year	$ (257)	$ (392)
Earnings per share		
Basic	$ 0.86	$ 0.36
Fully Diluted	$ 0.82	$ 0.36

See accompanying notes.

Consolidated Statement of Financial Position

(in millions)

December 31	1996	1995
Assets		
Current		
Cash and short-term investments (note 1d)	**$ 455**	$ 775
Accounts receivable	**390**	408
Spare parts, materials and supplies	**197**	176
Prepaid expenses	**20**	23
	1,062	1,382
Property and equipment (note 3)	**2,819**	2,751
Deferred charges (note 4)	**1,060**	905
Investments and other assets (note 5)	**445**	359
	$ 5,386	$ 5,397
Liabilities		
Current		
Accounts payable and accrued liabilities	**$ 615**	$ 591
Advance ticket sales	**270**	215
Current portion of long-term debt	**226**	710
	1,111	1,516
Long-term and subordinated perpetual debt (note 6)	**2,847**	2,642
Other long-term liabilities	**122**	114
Deferred credits (note 8)	**321**	292
	4,401	4,564
Shareholders' Equity		
Convertible debentures (note 2)	**186**	171
Share capital (note 10)	**1,056**	1,054
Deficit	**(257)**	(392)
	985	833
	$ 5,386	$ 5,397

See accompanying notes.

On behalf of the Board:

R. Lamar Durrett
President and Chief Executive Officer

John F. Fraser, O.C.
Chairman of the Board

Consolidated Statement of Changes in Cash Position

(in millions except per share figures)

Year ended December 31	1996	1995
Cash provided by (used for)		
Operating		
Income for the year	**$ 149**	$ 62
Adjustments to reconcile to net cash provided by operations		
Depreciation, amortization and obsolescence	**258**	216
Gain on sale of assets	**(4)**	(17)
Gain on sale of investment in Continental (note 5)	**(129)**	(57)
Deferred income taxes	**(45)**	(3)
Deferred pension expense	**(24)**	(21)
Amortization of deferred foreign exchange on long-term debt	**46**	69
Amortization of deferred gains	**(24)**	(30)
Decrease in accounts receivable	**18**	16
Increase in spare parts, materials and supplies	**(32)**	(24)
Increase (decrease) in accounts payable and accrued liabilities	**24**	(11)
Increase in advance ticket sales	**55**	13
Scheduled lease payments in excess of aircraft rent expense	**(206)**	(85)
Other	**(22)**	(69)
	64	59
Financing		
Issue of common shares	**2**	5
Issue of equity units (note 9)	**–**	480
Long-term borrowings	**645**	–
Reduction of long-term debt	**(848)**	(91)
Other	**(17)**	(14)
	(218)	380
Investing		
Proceeds from sale and leaseback of assets	**336**	4
Proceeds from sale of assets	**176**	95
Additions to property and equipment (net of recovered progress payments)	**(607)**	(326)
Investments and advances	**(71)**	(36)
	(166)	(263)
Increase (decrease) in cash position	**(320)**	176
Cash position, beginning of year	**775**	599
Cash position, end of year	**$ 455**	$ 775
Cash flow per share from operations		
Basic and fully diluted	**$ 0.41**	$ 0.41

See accompanying notes.

Notes to Consolidated Financial Statements

(currencies in millions)

1. Significant Accounting Policies

Nature of Operations

Air Canada is a Canadian-based international air carrier providing scheduled and charter air transportation for passengers and cargo. The Corporation's airline route network, together with its regional airline subsidiaries, offer air transportation services over routes authorized by the Government of Canada and the foreign governments concerned. Those routes serve 97 communities in North America and 28 cities in Europe, the Middle East, Asia and the Caribbean. With Air Canada's alliance partners, scheduled and charter air transportation is provided to over 525 destinations in more than 110 countries. Air transportation and related revenues represent over 94% of consolidated operating revenues.

The Corporation provides aircraft and engine maintenance, and computer, ground handling, and other services to airlines and other customers.

a) Principles of Consolidation

The consolidated financial statements are expressed in Canadian dollars and are prepared in accordance with accounting principles generally accepted in Canada. They include the accounts of Air Canada as well as regional airlines (AirBC Ltd., Air Ontario Inc., Air Alliance Inc., Air Nova Inc., and Northwest Territorial Airways Ltd.), a computerized reservation system, Galileo Canada Distribution Systems Inc., and a tour operator, Air Canada Vacations (Touram Inc.), all of which are wholly-owned operating subsidiaries.

The excess of the acquisition costs of investment in subsidiaries over the Corporation's proportionate share of the underlying value of the net assets at the date of acquisition represents goodwill, and is amortized over periods not exceeding 20 years (note 5). The value of goodwill, and any impairment of that value, is assessed by reference to cash flows, operating income and estimation of fair value.

In 1995, the Corporation acquired the 15% minority interest in AirBC Ltd. for consideration of $18 of which $15 is goodwill and sold its 100% interest in Dynamex Express Inc. for consideration of cash and promissory notes of $10.

Investments in companies in which Air Canada does not have significant influence over management are carried at cost.

b) Use of Estimates

The preparation of financial statements requires management to make estimates and assumptions based on information available as of the date of the financial statements. Actual results could differ from those estimates.

c) 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. Gains or losses are included in income of the year, except gains or losses relating to long-term debt which are deferred and amortized over the remaining term of the debt. Non-monetary assets and liabilities and items recorded in income arising from transactions denominated in foreign currencies are translated at rates of exchange in effect at the date of the transaction.

In 1988, the Corporation acquired zero coupon bond investments to fund the foreign currency exchange loss on certain Swiss franc and Japanese yen debt. Accordingly, deferred foreign exchange losses equalling the amount of future interest on these investments have been segregated and are being amortized to income at amounts equal to the interest earned on the bonds. The maturity dates of the investments closely match the repayment dates of the related debt.

1. Significant Accounting Policies (Cont'd)

d) Cash and Short-Term Investments

Cash and short-term investments include short-term investments of $505 (1995 $808). All short-term investments may be liquidated promptly and have maturities of less than one year.

e) Spare Parts, Materials and Supplies

Spare parts, materials and supplies are valued at average cost. 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.

f) Air Transportation Revenue

Airline passenger and cargo sales are recognized as operating revenues when the transportation is provided. The value of unused transportation is included in current liabilities.

g) Post-Employment Benefits

Pension expense, based on management's assumptions, consists of the actuarially computed costs of the pension benefits in respect of current year's service; imputed interest on plan assets and pension obligations; and straight-line amortization of experience gains or losses, assumption changes and plan amendments over the expected average remaining service life of the employee group.

Costs associated with post-employment health care and life insurance benefits are recognized as incurred.

h) Depreciation and Amortization

Operating property and equipment are depreciated or amortized to estimated residual values based on the straight-line method over their estimated service lives.

	Estimated Residual Values		Period of Amortization
	Aircraft	Engines/Rotable Inventory	
Air Canada			
Boeing 747-133/233B	15%	10%	16 years
Boeing 767-233	15%	15%	20 years
A320-211	15%	15%	20 years
DC-9-32	15%	10%	10 years
Subsidiaries			
Various	15-20%	15-20%	12-20 years

Significant aircraft reconfiguration costs are amortized over 3 years. Aircraft introduction costs are amortized over 4 years. Betterments to aircraft on operating leases are amortized over the term of the lease.

i) Maintenance and Repairs

Maintenance and repair costs are charged to operating expenses as incurred. Significant modification costs are capitalized and amortized over the remaining service lives of the assets.

1. Significant Accounting Policies (Cont'd)

j) Other Operating Expenses

Included in other operating expenses are expenses related to building rent and maintenance, advertising and promotion, computer reservation service charges, professional fees and services, terminal handling, crew meals and hotels, computer network and information technology costs, insurance costs and other expenses.

k) Aeroplan

The incremental cost of providing travel awards under the Corporation's frequent flyer program is charged to expense when reward levels are reached. Mileage credits sold to participating partners and the resulting revenue is included in other revenue during the period in which the credits are sold.

l) 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.

m) Financial Instruments

The Corporation manages its foreign exchange exposure on long-term debt and aircraft lease payments through the use of options and forward contracts. Resulting gains and losses are accrued as exchange rates change to offset gains and losses resulting from the underlying hedged transactions. Premiums and discounts are amortized over the term of the contracts.

The Corporation also enters into interest rate swap agreements to reduce the impact of changes in rates for its floating interest rate debt. Net receipts or payments under the Corporation's swap agreements are accrued as adjustments to interest expense. Premiums and discounts are amortized over the term of the contracts.

The Corporation enters into fuel contracts to manage its exposure to jet fuel price volatility. Resulting gains and losses are recorded as adjustments to fuel expense as fuel is purchased. Premiums and discounts are recorded over the term of the contracts.

n) Gains on Sale and Leaseback of Assets

Gains on sale and leaseback of assets are deferred and amortized to income over the terms of the leases as a reduction in rental expense.

o) Comparative Figures

Certain comparative figures have been reclassified to conform with the financial statement presentation adopted in the current year.

2. Change in Accounting for Financial Instruments

Effective in 1996, the Corporation retroactively adopted new recommendations of the Canadian Institute of Chartered Accountants on presentation and disclosure of financial instruments.

A portion of convertible debentures (note 9), representing the present value of interest payments on the convertible debentures to April 2000, has been reclassified to long-term debt. This amount will decline to nil over the period to April 2000, offset by an increase in convertible debentures classified as Shareholders' Equity. Interest expense related to convertible debentures remaining in Shareholders' Equity is presented as a direct charge to Deficit. This change results in an increase in net income for the year of $14 (1995 $10) with no effect on Deficit. Issue costs, previously included in deferred charges, have been applied against the equity portion of convertible debentures.

3. Property and Equipment

	1996	1995
Cost:		
Flight equipment	**$ 2,942**	$ 2,759
Other property and equipment	**1,176**	1,110
	4,118	3,869
Accumulated depreciation and amortization:		
Flight equipment	**1,034**	927
Other property and equipment	**724**	667
	1,758	1,594
	2,360	2,275
Progress payments	**459**	476
Property and equipment at net book value	**$ 2,819**	$ 2,751

Flight equipment includes aircraft retired from active service with a net book value of $7 (1995 nil).

Interest capitalized during the year amounted to $32 using an average interest rate of 8.0% (1995 $24 at 8.0%).

4. Deferred Charges

	1996	1995
Employer pension plan funding in excess of pension expense	**$ 384**	$ 360
Foreign currency exchange on long-term debt	**184**	290
Scheduled lease payments in excess of aircraft rent expense	**394**	165
Financing costs	**58**	64
Aircraft introduction costs	**22**	15
Other	**18**	11
Deferred charges	**$ 1,060**	$ 905

5. Investments and Other Assets

	1996	1995
Investments in companies accounted for on the cost basis	**$ 162**	$ 174
Security and other deposits	**154**	66
Notes receivable	**64**	49
Goodwill, net of amortization	**45**	46
Partnership interests in international computer reservation systems	**15**	16
Other	**5**	8
Investments and other assets	**$ 445**	$ 359

Investments in companies accounted for on the cost basis include the Corporation's investment in Continental Airlines, Inc. Class B common shares of $36 (1995 $63) and mandatorily redeemable preferred shares of $63 (1995 $52). In 1996, the Corporation sold 2.2 million Class B common shares for proceeds of $156 resulting in a gain over cost of $129. In 1995, the Corporation sold Class A and B common share purchase warrants for proceeds of $67 resulting in a gain over cost of $57. The carrying value of mandatorily redeemable preferred shares approximates fair value and includes dividends accrued in 1996 of $7 (1995 $5). Subsequent to December 31, 1996, the Corporation sold the remaining Class B common shares for proceeds of $207, resulting in a gain over cost of $171.

5. Investments and Other Assets (Cont'd)

Also included in investments in companies accounted for on the cost basis are portfolio investments of \$61 (1995 \$58) with an estimated market value of \$80 (1995 \$71) and the Corporation's 1.02% investment in the common shares of GPA Group plc. which is carried at a nominal amount.

Notes receivable bear interest at a weighted average rate of 13.6% and mature 1998 through 2010. The carrying value of notes receivable approximates fair value.

Other non-operating income includes the Corporation's share of earnings of partnership interests totalling \$5 (1995 \$5).

6. Long-Term and Subordinated Perpetual Debt

	Final Maturity	Interest Rate (%)	1996	1995
U.S. dollar debt (a)	1997-2008	6.0 – 8.7	**\$ 1,272**	\$ 1,566
Canadian dollar debt	1997-2004	8.3 – 12.1	**220**	248
Swiss franc debt (b)	2002	5.1	**190**	335
Deutsche mark debt (c)	2001	7.1	**223**	–
Japanese yen notes (d)	2007	5.8	**177**	198
			2,082	2,347
Subordinated perpetual debt (note 7)			**931**	931
Long-term debt portion of convertible debentures (notes 2 and 9)			**60**	74
			3,073	3,352
Current portion of long-term debt			**(226)**	(710)
Long-term and subordinated perpetual debt			**\$ 2,847**	\$ 2,642

All debt is unsecured by the assets of the Corporation with the exception of subsidiaries' debt totalling \$220 (1995 \$248) which is secured by certain of their assets.

Principal repayment requirements for the next five years are as follows:

1997	1998	1999	2000	2001
\$ 226	\$ 104	\$ 154	\$ 228	\$ 354

a) As at December 31, 1996, U.S. dollar debt totalled U.S. \$938, of which U.S. \$738 is at floating interest rates based on U.S. dollar LIBOR. Approximately 10% of the 1997 interest rate exposure on the floating rate U.S. dollar debt is hedged by short-term interest rate contracts. Of the U.S. dollar debt:

- a U.S. \$300 borrowing has a final maturity in 2005 and may be repaid at par any time until the year 2000 and on any interest payment date thereafter. The Corporation has repurchased but not cancelled U.S. \$10 of this borrowing.
- a U.S. \$245 borrowing has a final maturity in 2006 and may be repaid at par in whole or in part on any interest payment date, with an indemnity.
- a U.S. \$86 borrowing has a final maturity in 2008 and may be repaid at par in whole or in part any time prior to maturity, with an indemnity.
- a U.S. \$207 borrowing has a final maturity in 2002 and may be repaid at par and U.S. \$177 may be redrawn subject to a reducing revolving availability period.
- a U.S. \$100 borrowing which may be repaid at par and redrawn until final maturity in June 1997.

6. Long-Term and Subordinated Perpetual Debt (Cont'd)

The following hedge with a credit worthy counterparty is related to the long-term debt above:

a swap where the Corporation owes a fixed rate of interest on a notional amount of U.S. $100. This swap is completely offset until 1997 by an equal and offsetting swap where the Corporation owes a floating rate of interest. The counterparty has the right to cancel the first swap in October 1997. If it does not exercise its cancellation option, then the swap will continue to be compounded until settlement no later than October 2000.

b) Swiss franc debt is comprised of 200 Swiss francs maturing in 2002 and may be called by the Corporation at a premium until 1997 and at par thereafter. The Corporation has repurchased but not cancelled 14 Swiss francs of this debt.

c) Deutsche mark debt is comprised of 250 Deutsche mark bonds maturing in 2001. The Corporation has entered into interest rate swap agreements, with credit worthy counterparties, to convert Deutsche mark fixed interest rate into floating interest rates on Deutsehe mark 250 until May 2001. The effective average interest rate of the debt for 1996 was 4.4%. In January 1997, the Corporation entered into interest rate cross-currency swap agreements to convert the Deutsche mark floating rate debt into Canadian dollar floating rate debt until maturity in May 2001.

d) The interest rate on the 15,000 Japanese yen notes will be reset in 2002 based on an interest rate index. These notes may be called by the Corporation at a premium until 1997 and at par thereafter.

7. **Subordinated Perpetual Debt**

	1996	1995
60,000 Japanese yen at 5.30% until 1999 Callable in 1999 and every fifth year thereafter at par (a)	**$ 710**	$ 793
300 Swiss francs at 6.25% Callable in 2001 and every fifth year thereafter at 102% of par	**307**	355
200 Swiss francs at 5.75% Callable at 101.5% of par in 1999 and every fifth year thereafter at 102% of par	**204**	237
200 Deutsche marks at 6.25% until 1997 Callable in 1997 and every third year thereafter at par (b)	**178**	190
Subordinated perpetual debt, at year-end foreign exchange rates	**$ 1,399**	$ 1,575
Less foreign exchange	**(468)**	(644)
Subordinated perpetual debt	**$ 931**	$ 931

The maturity of this subordinated perpetual debt is only upon the liquidation, if ever, of the Corporation. Principal and interest payments on the debt are unsecured and are subordinated to the prior payment in full of all indebtedness for borrowed money, excluding convertible debentures (note 9). The effects of foreign exchange fluctuations since issuance have not been recorded in income since it is not probable that circumstances will arise requiring redemption of the debt and since, under present circumstances, it is not probable that the Corporation will call the debt. As at December 31, 1996 the foreign exchange fluctuation related to 60,000 Japanese yen is $212 (1995 $295), 500 Swiss francs is $175 (1995 $256), and 200 Deutsche marks is $81 (1995 $93).

7. Subordinated Perpetual Debt (Cont'd)

a) The interest rate on the yen subordinated perpetual debt is 5.30% until 1999 and will be reset for each subsequent five-year reset period based upon a capped spread over the Japanese long-term prime lending rate. The Corporation has entered into interest rate swaps effectively fixing the next interest reset for one third of the principal at interest rates less than currently being paid.

b) The interest rate on the Deutsche mark subordinated perpetual bonds is 6.25% until 1997 and will be reset for each subsequent three-year reset period based upon an interest rate index. The Corporation has entered into interest rate swaps effectively fixing the next interest reset for one half of the principal at interest rates less than currently being paid.

8. Deferred Credits

	1996	1995
Gain on sale and leaseback of assets	**$ 164**	$ 173
Aircraft rent expense in excess of scheduled lease payments	**110**	65
Income taxes	**34**	33
Other	**13**	21
Deferred credits	**$ 321**	$ 292

9. Convertible Debentures

In 1995, the Corporation concluded a public offering of 178,572 units for net proceeds of $480. Each unit consisted of 200 Class A non-voting shares at a price of $7.00 per share (note 10) and a $1,400.00 principal amount 8% convertible unsecured subordinated debenture maturing April 2005. The units were split and commenced trading separately June 1, 1995.

The convertible debentures are convertible at the holder's option at anytime up to and including the close of business on the business day immediately preceding maturity in April 2005 at a conversion price of $8.00 per Class A non-voting common share being a rate of 12.5 Class A non-voting common shares per $100 principal amount of convertible debentures.

The convertible debentures are redeemable, for cash or Class A non-voting common shares, at the option of the Corporation beginning April 1998 and thereafter until April 2000 at par plus accrued and unpaid interest provided that the weighted average closing price of the Class A non-voting shares on the Montreal Exchange and on the Toronto Stock Exchange exceeds 125% of the conversion price. From April 2000, the convertible debentnres will be redeemable at the option of the Corporation either for cash or for Class A non-voting shares based upon 95% of the weighted average closing price of the Class A non-voting shares in a specified time period prior to redemption.

A portion of convertible debentures, $60 (1995 $74) representing the present value of interest payments on convertible debentures to April 2000, is classified as long-term debt. This amount will decline to nil over the period to April 2000, offset by an increase in convertible debentures classified as Shareholders' Equity.

10. Share Capital

The authorized capital of the Corporation consists of an unlimited number of common shares, Class A non-voting common shares, Class A preferred shares issuable in series and Class B preferred shares issuable in series. The Corporation's Articles of Continuance under provisions of the Canada Business Corporations Act include limits on individual and aggregate non-resident public ownership of common shares of 10 per cent and 25 per cent respectively, including associates of such shareholders.

The issued capital consists of common shares and Class A non-voting common shares, and the changes during 1995 and 1996 in the outstanding number of shares and their aggregate stated value during those years are as follows:

	Common Shares		Class A Non-Voting Shares	
	Number	Amount	Number	Amount
December 31, 1994	118,468,973	$ 809	–	$ –
Share purchase options exercised	106,348	–	–	–
Share Appreciation Rights Plan	792,742	5	–	–
Share purchase warrants exercised	7,550	–	–	–
Public offering (note 9)	–	–	35,714,400	240
December 31, 1995	119,375,613	$ 814	35,714,400	$ 240
Share purchase options exercised	47,692	–	64,427	–
Share Appreciation Rights Plan	379,437	2	–	–
December 31, 1996	119,802,742	$ 816	35,778,827	$ 240

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

	Options Outstanding Common Shares	Option Price Per Common Share	Options Outstanding Class A Non-Voting Shares	Option Price Per Class A Non-Voting Share
1988	195,025	$ 8.00	–	–
1990	1,013	$ 9.75	–	–
1991	3,128	$ 9.125	–	–
1992	2,889	$ 5.55	–	–
1993	119,962	$ 2.79	84,300	$2.79
1994	184,819	$6.42-$6.70	282,285	$6.42-$6.70
1995	186,512	$5.05-$7.89	400,068	$7.89
1996	479,362	$4.73-$4.94	566,173	$4.17-$4.64
	1,172,710		1,332,826	

The options granted in 1988 are exercisable in the amount of 33⅓% of the shares per year on a cumulative basis. All other options are exercisable on the basis of 25% of the options per year on a cumulative basis, beginning after one year and expiring after ten years.

On May 10, 1995, the Board of Directors approved a resolution providing for an amendment to the Corporation's share option plan pursuant to which the holders of common share options were offered an opportunity to convert such options to Class A non-voting common share options on a one-for-one basis with the same vesting schedule and subject to the same terms and conditions governing the common share options.

10. Share Capital (Cont'd)

On February 19, 1993, the Board of Directors approved a Share Appreciation Plan, effective May 1, 1993, which authorized the granting of Share Appreciation Rights (SARs) to employees affected by a salary reduction. During the year, appreciation on SARs was converted to 379,437 common shares. As at December 31, 1996, there are no SARs outstanding and there will be no further appreciation which is paid by common shares.

11. Income Taxes

Income taxes differ from the amount which would be obtained based on the combined basic Canadian federal and provincial income tax rate. The difference results from the following items:

	1996	1995
Provision (recovery) based on combined federal and provincial tax rates	**$ 62**	$ 33
Non-taxable portion of capital gains	**(11)**	(2)
Large corporations tax	**6**	7
Other	**(1)**	2
	$ 56	$ 40
Current	**$ 55**	$ 27
Deferred	**1**	13
Income tax provision	**$ 56**	$ 40

As at December 31, 1996, accumulated unrecognized income tax benefits amount to $20.

12. Commitments

The Corporation has commitments to purchase four Airbus A340 and thirty-four Airbus A319 aircraft for U.S. $1,168 which are payable as follows:

	U.S.
1997	$ 890
1998	$ 278

The Corporation has received a financing commitment of a maximum of U.S. $1,322 for these purchase commitments.

Other commitments for property, ground equipment and spare parts, amount to approximately $149.

Future minimum lease payments under operating leases of aircraft and other property total $3,034 and are payable as follows:

	Operating Leases of Aircraft	Operating Leases of Other Property
1997	$ 357	$ 55
1998	345	46
1999	333	37
2000	318	29
2001	314	22
Remaining years	948	230
	$ 2,615	$ 419

12. Commitments (Cont'd)

Operating lease commitments include currency swaps to convert a significant portion of U.S. dollar lease rentals into Canadian dollar lease rentals for five Canadair Jet operating leases until lease terminations in 2007. These currency swaps, with a credit worthy counterparty, were put in place at the time the leases were concluded and have a fair value at December 31, 1996 of $10 (1995 $4) in favour of the counterparty, taking into account foreign exchange rates in effect at that time.

13. Pension Plans

The Corporation and its subsidiaries maintain several defined benefit pension plans. Based on the latest actuarial reports prepared as at December 31, 1994 using management's assumptions, the estimated present value of the accrued pension benefits as at December 31, 1996 amounted to $3,670 and the net assets available to provide these benefits were $4,065 calculated on a four year moving average market value basis.

14. Financial Instruments and Risk Management

The Corporation manages 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 the purpose of hedging existing commitments or obligations, not for generating trading profits.

Credit Exposure of Derivatives

The Corporation's theoretical risk in the derivative financial instruments described below is the cost of replacing the contracts at current market rates in the event of default by any of the counterparties. However, the Corporation does not anticipate such default as it only transacts with credit worthy counterparties, and the relative market positions with each counterparty are monitored to ensure an adequate diversification of risk.

Interest Rate Risk Management

The Corporation has entered into interest rate swap agreements in order to manage the interest rate exposure associated with certain long-term debt obligations. The notional amounts of the swaps do not represent amounts exchanged between parties and are not a measure of the Corporation's exposure resulting from the use of swaps. The amounts exchanged are based on interest rates applied to the notional amounts. The fair value of interest rate swap agreements as at December 31, 1996 was $39 (1995 $56) in favour of counterparties, taking into account interest rates in effect at the time.

Foreign Exchange Risk Management

The Corporation has entered into certain foreign exchange contracts, with maturities of less than one year, to manage risks associated with foreign currency exchange rates. As at December 31, 1996 the aggregate face amount of such contracts was approximately $703 (1995 $31). The related realized and unrealized gains and losses for such contracts were not material for either year presented.

14. Financial Instruments and Risk Management (Cont'd)

Fuel Price Risk Management

The Corporation enters into contracts with certain financial intermediaries, not exceeding two years, to manage its exposure to jet fuel price volatility. Gains and losses resulting from fuel hedging transactions are recognized as a component of fuel expense. As at December 31, 1996 the Corporation had effectively hedged approximately 35% of its projected 1997 fuel requirements and approximately 8% of its projected 1998 fuel requirements. As at December 31, 1996 the fair value of fuel contracts was $31 (1995 $2) in favour of the Corporation.

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 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 and subordinated perpetual debt, including current portion of long-term debt, is based on rates currently available to the Corporation for debt with similar terms and maturities. The fair value of long-term and subordinated perpetual debt as at December 31, 1996 was $3,363 (1995 $3,764) compared with carrying values, net of deferred foreign currency exchange, of $2,889 (1995 $3,062).

15. Contingencies

Various lawsuits and claims are pending by and against the Corporation. It is the opinion of management supported by counsel that final determination of these claims will not have a material adverse effect on the financial position or the results of the Corporation.

Under aircraft lease agreements, the Corporation may be required to provide residual value support not exceeding $117. Independent appraisals as at December 31, 1996 have indicated it is unlikely the Corporation will be required to provide this support. The Corporation retains a residual value interest in these leased aircraft through purchase options.

In 1990 and 1989, the Corporation concluded agreements with a substantial U.S. financial institution where, upon payment by the Corporation, the financial institution assumed liability for scheduled payments relating to certain long-term obligations in amounts of $98 in 1990 and $107 in 1989 and interest thereon. These obligations (which amount to $81 and $89 respectively at December 31, 1996) are extinguished for financial reporting purposes and have been removed from the Corporation's statement of financial position. Until the assumed liabilities have been fully discharged by the financial institution, the Corporation remains contingently liable for such obligations in the remote event that the counterparty fails to perform.

16. United States Generally Accepted Accounting Principles

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in Canada (Canadian GAAP) which conform in all material respects with generally accepted accounting principles in the United States (U.S. GAAP) except as set forth below.

	1996	1995
Income Adjustments		
Income for the year in accordance with Canadian GAAP	$ 149	$ 62
Convertible debentures (1)	(14)	(10)
Unrealized foreign exchange gain on translation of:		
Long-term debt with principal repayment requirements (2)	105	94
Subordinated perpetual debt (3)	176	–
Pension costs (4)	20	30
Post-retirement benefit costs other than pension (5)	(12)	(17)
Post-employment benefit costs (5)	–	4
Income tax provision (6)	125	–
Current year income adjustments	400	101
Income for the year before U.S. GAAP accounting change	549	163
Cumulative effect of U.S. GAAP accounting change for subordinated perpetual debt, net of income tax (3)	(448)	–
Income for the year in accordance with U.S. GAAP	$ 101	$ 163
Income per common share before U.S. GAAP accounting change (7)	$ 3.04	$ 1.04
Income per common share in accordance with U.S. GAAP (7)	$ 0.65	$ 1.04
Pro forma income per common share in accordance with U.S. GAAP (8)	$ 3.04	$ 0.96
Financial Position Adjustments		
Cash and short-term investments:		
Balance under Canadian GAAP	$ 455	$ 775
Reclassification of short-term investments with maturities greater than three months (9)	(8)	(355)
Balance under U.S. GAAP	$ 447	$ 420
Short-term investments:		
Balance under Canadian GAAP	$ –	$ –
Reclassification of short-term investments with maturities greater than three months (9)	8	355
Balance under U.S. GAAP	$ 8	$ 355
Investments and other assets:		
Balance under Canadian GAAP	$ 445	$ 359
Adjustment for available-for-sale securities (10)	171	183
Adjustment for tax effect of available-for-sale securities (10)	(52)	–
Deferred income taxes (6)	321	–
Reclassification of deferred income taxes from deferred charges	(34)	–
Balance under U.S. GAAP	$ 851	$ 542

16. United States Generally Accepted Accounting Principles (Cont'd)

	1996	1995
Deferred charges:		
Balance under Canadian GAAP	**$ 1,060**	$ 905
Adjustment for foreign currency exchange on long-term debt (2)	**(184)**	(290)
Adjustment for pension costs (5)	**99**	39
Balance under U.S. GAAP	**$ 975**	$ 654
Long-term and subordinated perpetual debt:		
Balance under Canadian GAAP	**$ 2,847**	$ 2,642
Reclassification of convertible debentures (1)	**186**	171
Foreign exchange on subordinated perpetual debt (3)	**468**	–
Balance under U.S. GAAP	**$ 3,501**	$ 2,813
Other long-term liabilities:		
Balance under Canadian GAAP	**$ 122**	$ 114
Adjustment for pension costs (5)	**89**	49
Adjustment for post-retirement benefit costs (5)	**248**	236
Balance under U.S. GAAP	**$ 459**	$ 399
Deferred credits:		
Balance under Canadian GAAP	**$ 321**	$ 292
Adjustment for tax effect of available-for-sale securities (10)	**–**	56
Reclassification of deferred income taxes to investments and other assets	**(34)**	–
Balance under U.S. GAAP	**$ 287**	$ 348
Shareholders' equity:		
Balance under Canadian GAAP	**$ 985**	$ 831
Reclassification of convertible debentures	**(186)**	(171)
Charge relating to convertible debentures	**14**	10
Current year income adjustments	**400**	101
Cumulative effect of U.S. GAAP accounting change for subordinated perpetual debt	**(448)**	–
Current year adjustment for available-for-sale securities	**(8)**	127
Cumulative prior year adjustments for:		
Foreign currency exchange	**(290)**	(384)
Pension costs	**(9)**	(39)
Post-retirement costs	**(236)**	(219)
Post-employment costs	**–**	(4)
Available-for-sale securities	**127**	–
Balance under U.S. GAAP	**$ 349**	$ 252

16. United States Generally Accepted Accounting Principles (Cont'd)

(1) Under Canadian GAAP, convertible securities are split for accounting purposes between long-term debt and shareholders' equity with interest expense related to the equity portion recorded as a charge to deficit. Under U.S. GAAP, convertible debentures are recorded as long-term debt with interest expense charged to earnings.

(2) Under Canadian GAAP, unrealized exchange gains and losses arising on the translation, at exchange rates prevailing on the balance sheet date, of long-term debt repayable in a foreign currency are deferred and amortized over the remaining life of the related debt. Under U.S. GAAP, such exchange gains and losses are included in income.

(3) For US GAAP, the Corporation has changed the method of accounting for subordinated perpetual debt. Previously this debt was translated at historic rates of exchange. Under the new policy this debt is translated at current exchange rates with resulting gains and losses being recognized in income in the period in which they occurred.

(4) The determination of net pension costs in accordance with Canadian and U.S. GAAP differs with respect to the valuation of assets at January 1, 1987, the basis used to determine the benefit obligation and the expected return on plan assets, and the amortization of changes in assumptions and experience gains and losses. Under U.S. GAAP changes in assumptions and experience gains and losses may remain unamortized until they exceed ten per cent of the projected benefit obligation or market related value of plan assets. For Canadian GAAP all changes in assumptions and experience gains and losses are amortized.

(5) Under Canadian GAAP, the cost of providing post-retirement and post-employment benefits other than pensions can either be charged against income as funding payments are made or provided for on an accrual basis. As allowed by Canadian GAAP, the Corporation is accounting for post-retirement and post-employment benefit costs other than pensions on a cash basis. Under U.S. GAAP, post-retirement and post-employment benefits other than pensions are charged against income on an accrual basis.

(6) Under Canadian GAAP the income tax provision is calculated using the deferred credit method and previously unrecognized income tax benefits are recognized as realized. Under U.S. GAAP the income tax provision is calculated using the liability method and a valuation allowance is provided against any deferred tax asset if it is more likely than not that a portion of the asset will not be realized.

(7) Under U.S. GAAP, the calculation of income (loss) per share is based on common share equivalents of 186,971,785 (1995 176,327,258).

(8) Under U.S. GAAP, pro forma income (loss) per common share amounts are presented as if accounting changes were applied retroactively and is based on pro forma income of $549 (1995 $170).

(9) Under Canadian GAAP short-term investments with maturities less than one year are included in cash and short-term investments. Under U.S. GAAP short-term investments with maturities greater than three months are recorded as short-term investments and as a result the statement of changes in cash position would be adjusted to reflect cash provided by investing activities of $347 (1995 cash used of $190).

(10) Under Canadian GAAP portfolio investments are accounted for using the cost method. Under U.S. GAAP portfolio investments classified as available-for-sale securities are carried at market values with unrealized gains or losses reflected as a component of shareholders' equity. The reconciliation for 1995 has been restated to reflect this GAAP difference.

Nine Year Comparative Review

	1996	1995
Financial Data – consolidated ($ millions)		
Operating revenues:		
Passenger	3,980	3,581
Cargo	347	323
Other	553	603
	4,880	4,507
Operating expenses:		
Salaries, wages and benefits	1,331	1,252
Aircraft fuel [1]	640	527
Depreciation, amortization and obsolescence	258	216
Aircraft rent	319	292
Other	2,117	1,945
	4,665	4,232
Operating income (loss) before the undernoted item	215	275
Staff reduction and retirement costs	–	–
Operating income (loss)	215	275
Non-operating income (expense):		
Net interest expense	(157)	(201)
Amortization of deferred foreign exchange	(46)	(69)
Gain (loss) on sale of assets	4	17
Gain on sale of investment in Continental	129	57
Gemini Group asset realization	–	–
Provision for investments and writedown of goodwill	–	–
Other	8	3
Total non-operating income (expense)	(62)	(193)
Income (loss) before income taxes and minority interest	153	82
(Provision for) recovery of income taxes	(4)	(20)
Minority interest	–	–
Income (loss) from continuing operations	149	62
enRoute Card discontinued operations	–	–
Income (loss) for the year	149	62
Cash provided by (used for):		
Operating	64	59
Financing	(218)	380
Investing	(166)	(263)
Increase (decrease) in cash position	(320)	176
Cash position, end of year	455	775
Operating margin before provision for staff reduction and retirement costs	4.4%	6.1%
EBITDAR [1][2]	792	783
EBITDAR margin	16.2%	17.4%
Current ratio	0.96	0.91
Total assets	5,386	5,397
Long-term debt (including current portion)	2,142	2,421
Subordinated perpetual debt	931	931
Shareholders' equity	985	833
Long-term debt to debt plus fixed capital [3]	53%	58%
Earnings (loss) per share [4]	$ 0.82	$ 0.36
Cash flow from operations per share [4]	$ 0.41	$ 0.41
Book value per share	$ 6.33	$ 5.37
Average common shares outstanding (millions) [4]	189.1	168.7
Return on equity	16.9%	10.1%

[1] Includes a fuel excise tax rebate in 1993 of $46 million (consolidated).
[2] Operating income before depreciation, amortization, obsolescence and aircraft rent; a measure of earning performance.
[3] Long-term debt divided by the sum of long-term debt, subordinated perpetual debt and shareholders' equity.
[4] Fully diluted.

1994	1993	1992	1991	1990	1989	1988
3,172	2,849	2,813	2,815	3,103	2,884	2,602
334	335	342	354	413	398	503
518	414	346	316	383	336	299
4,024	3,598	3,501	3,485	3,899	3,618	3,404
1,167	1,122	1,188	1,199	1,230	1,131	1,096
474	397	472	515	637	539	494
206	219	206	190	170	150	148
230	214	164	156	136	120	63
1,703	1,569	1,616	1,589	1,676	1,559	1,499
3,780	3,521	3,646	3,649	3,849	3,499	3,300
244	77	(145)	(164)	50	119	104
–	(76)	(52)	(36)	(61)	(16)	(6)
244	1	(197)	(200)	(11)	103	98
(185)	(191)	(190)	(126)	(49)	(52)	(87)
(67)	(34)	(17)	(5)	(6)	(3)	(7)
67	33	(29)	(5)	22	220	79
–	–	–	–	–	–	–
66	–	–	–	–	–	–
–	(111)	(15)	(17)	(11)	(57)	–
32	(14)	–	(1)	12	27	32
(87)	(317)	(251)	(154)	(32)	135	17
157	(316)	(448)	(354)	(43)	238	115
(25)	(9)	(4)	142	18	(85)	(29)
(3)	(1)	(2)	1	(1)	–	1
129	(326)	(454)	(211)	(26)	153	87
–	–	–	(7)	(48)	(4)	2
129	(326)	(454)	(218)	(74)	149	89
44	(34)	(243)	(221)	60	149	6
(359)	335	246	742	402	427	133
69	126	287	(829)	(583)	(375)	(6)
(246)	427	290	(308)	(121)	201	133
599	845	418	128	436	557	356
6.1%	2.1%	(4.1)%	(4.7)%	1.3%	3.3%	3.1%
680	510	225	182	356	389	315
16.9%	14.2%	6.4%	5.2%	9.1%	10.8%	9.3%
1.34	1.36	1.09	1.15	1.47	1.79	1.56
4,997	5,039	4,810	4,921	4,579	4,121	3,437
2,464	2,640	2,492	2,183	1,384	973	1,100
931	931	883	834	834	834	336
365	230	316	770	988	1,062	913
66%	69%	68%	58%	43%	34%	47%
$ 0.97	$ (4.23)	$ (6.13)	$ (2.94)	$ (1.01)	$ 1.99	$ 1.64
$ 0.37	$ (0.44)	$ (3.28)	$ (2.99)	$ 0.80	$ 1.99	$ 0.12
$ 3.08	$ 1.96	$ 4.27	$ 10.40	$ 13.35	$ 14.55	$ 12.70
143.5	80.7	75.9	75.1	74.9	74.8	48.5
46.7%	(237.6)%	(86.2)%	(25.0)%	(7.0)%	15.4%	13.5%

Nine Year Comparative Review (cont'd)	1996	1995
Operating statistics – not consolidated		
Passenger – scheduled and charter:		
Revenue passengers carried (millions) [1]	**12.6**	10.8
Revenue passenger miles (millions) [1]	**19,199**	16,747
Available seat miles (millions)	**29,431**	26,578
Passenger load factor [1]	**65.2%**	63.0%
Yield per revenue passenger mile (cents) [1]	**17.6**	18.0
Yield per available seat mile (cents)	**11.5**	11.4
Cargo – scheduled and charter:		
Revenue ton miles (millions)	**783**	707
Yield per revenue ton mile (cents)	**41.6**	43.3
All operations:		
Operating expense per available seat mile (cents) [2]	**13.4**	13.4
Operating expense (net of non-ASM producing revenue) per available seat mile (cents) [2][3]	**10.8**	10.5
Average number of employees (thousands)	**19.9**	19.6
Available seat miles per employee (thousands)	**1,481**	1,359
Revenue per employee ($ thousands)	**209**	194
Average aircraft utilization (hours per day) [4]	**10.7**	10.6
Average aircraft flight length (miles)	**957**	958
Fuel price per litre (cents) [5]	**26.3**	23.5
Fuel litres (millions)	**2,080**	1,910
Operating statistics – consolidated		
Revenue passenger miles (millions) [1]	**20,463**	17,905
Available seat miles (millions)	**31,988**	28,968
Passenger load factor [1]	**64.0%**	61.8%
Yield per revenue passenger mile (cents) [1]	**19.4**	20.0

Quarterly Financial and Operating Data

(unaudited)	1996				
	Year	Q4	Q3	Q2	Q1
Financial data – consolidated ($ millions)					
Operating revenues	**4,880**	1,205	1,391	1,212	1,072
Operating income (loss)	**215**	10	208	37	(40)
Income (loss) for the period [6]	**149**	(18)	149	110	(92)
Cash flow from operations [6]	**64**	(151)	152	130	(67)
Operating statistics – not consolidated					
Revenue passenger miles (millions) [1,7]	**19,199**	4,327	5,926	4,828	4,118
Domestic	**6,599**	1,565	1,894	1,704	1,436
International	**12,600**	2,762	4,032	3,124	2,682
Available seat miles (millions) [7]	**29,431**	7,053	8,409	7,345	6,624
Domestic	**10,309**	2,531	2,920	2,559	2,299
International	**19,122**	4,522	5,489	4,786	4,325
Passenger load factor [1]	**65.2%**	61.4%	70.5%	65.7%	62.2%
Domestic	**64.0%**	61.8%	64.8%	66.6%	62.5%
International	**65.9%**	61.1%	73.4%	65.3%	62.0%
Yield per revenue passenger mile (cents) [1]	**17.6**	18.8	17.0	17.4	17.3

(1) Excludes frequent flyer redemptions.
(2) Excludes a fuel excise tax rebate in 1993 of $45 million (not consolidated).
(3) Represents the net cost of the passenger transportation business, after deducting the revenue impact of non-ASM producing businesses.
(4) Excludes maintenance down-time.
(5) If fuel excise tax rebate were included, fuel price per litre would be 21.5 cents in 1993.
(6) 1995 restated.
(7) 1996 Q3 restated.

1994	1993	1992	1991	1990	1989	1988
9.9	9.5	9.9	9.9	11.8	12.0	11.9
14,995	13,768	14,391	13,658	16,577	16,278	15,553
23,730	21,157	21,628	19,953	23,233	23,348	21,778
63.2%	65.1%	66.5%	68.4%	71.4%	69.7%	71.4%
17.7	17.1	16.3	17.3	16.7	16.3	15.7
11.2	11.1	10.8	11.9	11.9	11.4	11.2
633	586	532	549	645	595	605
43.5	47.6	53.1	53.1	53.2	53.5	56.6
13.2	14.0	14.2	15.6	14.8	13.4	13.3
10.5	11.3	11.7	12.9	12.1	10.9	10.7
18.4	18.2	19.4	20.6	23.1	23.2	22.6
1,288	1,166	1,112	969	1,005	1,005	962
178	161	148	141	148	139	134
10.3	9.6	9.6	9.8	9.5	9.3	9.7
946	907	925	898	900	850	814
23.8	24.4	24.6	26.6	28.9	24.3	23.6
1,707	1,529	1,609	1,627	1,965	1,991	1,905
16,143	14,820	15,519	14,642	17,271	16,868	15,938
25,991	23,341	23,886	22,031	24,630	24,562	22,525
62.1%	63.5%	65.0%	66.5%	70.1%	68.7%	70.8%
19.6	19.2	18.1	19.2	18.0	17.1	16.3

		1995		
Year	Q4	Q3	Q2	Q1
4,507	1,086	1,315	1,090	1,016
275	46	190	46	(7)
62	(12)	182	(20)	(88)
59	(20)	144	(37)	(28)
16,747	3,830	5,466	3,999	3,452
6,250	1,468	1,953	1,587	1,242
10,497	2,362	3,513	2,412	2,210
26,578	6,492	7,784	6,316	5,986
10,180	2,447	2,877	2,604	2,252
16,398	4,045	4,907	3,712	3,734
63.0%	59.0%	70.2%	63.3%	57.7%
61.4%	60.0%	67.9%	60.9%	55.1%
64.0%	58.4%	71.6%	65.0%	59.2%
18.0	18.7	17.1	18.5	18.2

Board of Directors

1 **Hon. W. David Angus, Q.C.**
Partner
Stikeman, Elliott
Montréal, Québec

2 **J.V. Raymond Cyr, O.C.**
Chairman of the Board
Telesat Canada and TMI Communications Inc.
Montréal, Québec

3 **R. Lamar Durrett**
President and Chief Executive Officer
Air Canada
Montréal, Québec

4 **John F. Fraser, O.C.**
Chairman of the Board
Air Canada
Winnipeg, Manitoba

5 **David A. Ganong**
President
Ganong Bros. Limited
St. Stephen, New Brunswick

6 **William James**
President and Chief Executive Officer
Inmet Mining Corporation
Toronto, Ontario

7 **Fernand Lalonde, Q.C.**
Counsel
Leduc Leblanc
Westmount, Québec

8 **Hon. Edward C. Lumley, P.C.**
Vice Chairman
Nesbitt Burns Inc.
South Lancaster, Ontario

9 **Gordon F. MacFarlane**
Director
BC TELECOM Inc.
Surrey, British Columbia

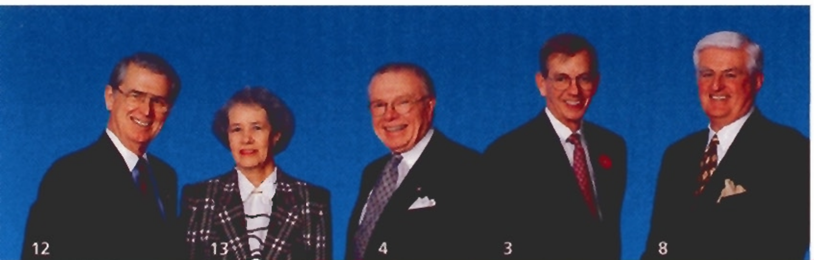
10 **David E. Mitchell, O.C.**
Chairman of the Board
Alberta Energy Company Ltd
Calgary, Alberta

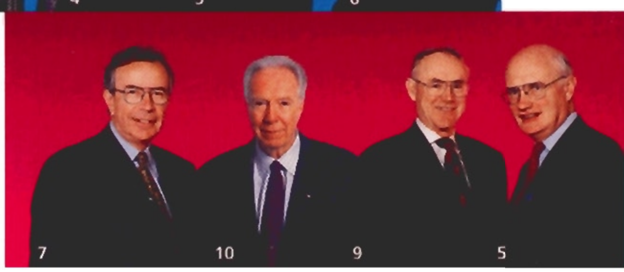
11 **Paul D. Mitchell**
President and Chief Executive Officer
McNeil Consumer Products Company
Waterloo, Ontario

12 **Claude I. Taylor, O.C.**
Chairman Emeritus
Air Canada
Montreal, Québec

13 **Louise Brais Vaillancourt, C.M**
Corporate Director
Outremont, Québec

Note:
Hollis L. Harris retired as a Director August 1, 1996.





Investor and Shareholder Information

Price Range and Trading Volume of Air Canada Common Shares

1996	High	Low	Volume
1st Quarter	$5.25	$4.55	28,141,298
2nd Quarter	$5.65	$4.72	35,741,858
3rd Quarter	$5.35	$4.11	28,229,493
4th Quarter	$6.60	$4.85	34,501,485

The above table sets forth the price ranges and combined trading volumes of the common shares of Air Canada on the Montréal, Toronto, Winnipeg, Alberta, and Vancouver Stock Exchanges

Price Range and Trading Volume of Air Canada Class "A" Shares

1996	High	Low	Volume
1st Quarter	$4.55	$4.05	6,252,863
2nd Quarter	$5.10	$4.20	5,453,400
3rd Quarter	$4.85	$3.65	6,730,352
4th Quarter	$5.80	$4.35	8,826,798

The above table sets forth the price ranges and combined trading volumes of the Class A Non-Voting shares of Air Canada on the Montréal and Toronto Stock Exchanges

Price Range and Trading Volume of Air Canada Class "A" Shares on the NASDAQ Market

1996	High	Low	Volume
1st Quarter	$3.21	$3.11	273,931
2nd Quarter	$3.81	$3.09	517,054
3rd Quarter	$3.50	$2.75	456,870
4th Quarter	$4.13	$3.35	511,633

The above table sets forth the price* ranges and combined trading volumes of the Class A Non-Voting shares of Air Canada on the NASDAQ National Market.

*Prices are quoted in U.S. Dollars.

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Stock Exchange Listings
Montréal, Toronto, Winnipeg, Alberta, Vancouver Stock Exchanges and the NASDAQ Stock Market.

Transfer Agents and Registrar
The R-M Trust Company, Halifax, Montréal, Toronto, Winnipeg, Regina, Calgary and Vancouver.

Chase Mellon Shareholder Services, L.L.C.
New Jersey.

Duplicate Communication
Some registered holders of Air Canada shares might receive more than one copy of shareholder information mailings such as this Annual Report. While every effort is made to avoid duplication, if securities are registered in different names and/or addresses, multiple copies are forwarded. Shareholders receiving more than one copy are requested to write to the Assistant Secretary and Shareholder Relations Director.

Restraints on Air Canada Shares
The Air Canada Public Participation Act and Air Canada's Articles of Continuance limit ownership of the airline's voting shares by all non-residents of Canada to a maximum of 25 per cent. The Canada Transportation Act, (CTA) requires inter alia that at least 75 per cent of the voting shares of Air Canada be owned or controlled by Canadians, as defined in section 55 of the CTA. In addition, no person or group of associated persons may own more than ten per cent of the airline's voting shares.

For Further Information

Shareholder Relations
Assistant Secretary and Shareholder Relations Director
Telephone: (514) 422-5787
Canada/USA
1 800 282-SHARE
Faxcom: (514) 422-5789

Investor Relations
Manager,
Investor Relations
Telephone: (514) 422-5724
Faxcom: (514) 422-5739

Air Canada complies with the guidelines adopted by the Toronto Stock Exchange. A report on governance matters is included in the February 20, 1997 Management Proxy Circular.

Glossary of Terms

Operating Margin
Operating income (loss) as a percentage of total operating revenues.

Current Ratio
Current assets divided by current liabilities.

Return on Equity
The rate of return on average convertible debentures and shareholders' equity.

Revenue Passenger Miles
Total number of revenue passengers carried* multiplied by the miles they are carried.

Available Seat Miles
A measure of passenger capacity calculated by multiplying the total number of seats available for revenue traffic by the miles flown.

Passenger Load Factor
A measure of passenger capacity utilization derived by expressing revenue passenger miles* as a percentage of available seat miles.

Revenue Ton Miles
Total number of cargo tons carried multiplied by the miles they are carried.

Yield
Average revenue per revenue passenger mile* or revenue ton mile.

*Excludes frequent flyer redemptions.

Officers of the Company

1 **R. Lamar Durrett**
President and Chief Executive Officer

2 **Jean-Jacques Bourgeault**
Senior Executive Vice President

3 **Robert A. Milton**
Executive Vice President and Chief Operating Officer

4 **Geoffrey Elliot**
Senior Vice President, Corporate Affairs and Government Relations

5 **M. Robert Peterson**
Senior Vice President, Finance and Chief Financial Officer

6 **Douglas D. Port**
Senior Vice President, Europe

7 **John M. Baker**
Vice President and General Counsel

8 **Paul E. Brotto**
Vice President, Finance & Treasurer

9 **Rupert Duchesne**
Vice President, Marketing

10 **Lise Fournel**
Vice President, Information Technology and Chief Information Officer

11 **Paul R. Garratt**
Vice President, Human Resources

12 **Paul Létourneau, Q.C.**
Secretary of the Company

13 **G. Ross MacCormack**
Vice President, Corporate Strategy

14 **B. Wayne MacLellan**
Vice President, Flight Operations

15 **Eileen McCoy**
Vice President, Airports

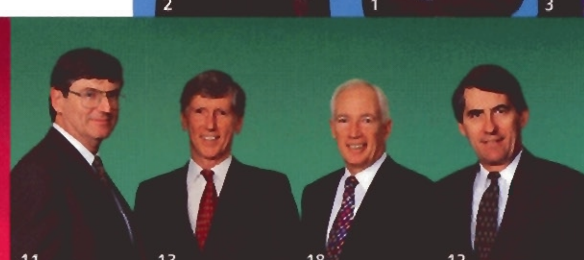
16 **Chris W. Nassenstein**
Vice President, Technical Operations

17 **Marc Rosenberg**
Vice President, Sales and Product Distribution

18 **H. Alan Thompson**
President and Chief Executive Officer – AirBC

Note:
The following officers left the Corporation to pursue other business interests:
Egon Koch,
Vice President, Europe
Terry F. Nord,
Senior Vice President, Operations and Chief Technical Officer
Donna L. Price,
Vice President, Airports

L. Cameron DesBois, Q.C., Vice President and General Counsel, retired in 1996.
Donald E. Ingham, Treasurer, elected to take early retirement effective February 20, 1997.



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