'86

REVIEW

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WARDAIR INTERNATIONAL LTD. ANNUAL REPORT 1986

ANNUAL MEETING

The 34th Annual Meeting of Shareholders
will be held at 1:00 p.m. (M.D.T.) on
May 21, 1987 at the
ManuLife Place
The King Edward Room
Third Floor
10180-101 St.
Edmonton, Alberta

'86

REVIEW

FINANCIAL HIGHLIGHTS

YEAR ENDED DECEMBER 31, 1986	(thousands of dollars) 1986	1985
REVENUE	**$491,105**	$473,856
Operating costs before depreciation and amortization	**416,166**	402,735
Depreciation and amortization	**25,666**	20,454
Earnings from operations	**49,273**	50,667
Interest expense	**15,826**	23,511
Amortization of deferred foreign exchange losses	**2,963**	2,850
Gain on asset disposals	**(39,122)**	–
Earnings before income taxes	**69,606**	24,306
Deferred income taxes	**23,552**	13,280
Net earnings for the year	**$ 46,054**	$ 11,026
Per share amounts		
Earnings before gain on asset disposals (net of tax)	**$ 4.33**	$3.07
Net earnings for the year	**$12.84**	$3.07
Operating margin	**10.0%**	10.7%

CONTENTS


Wardair
Canada
DC-10
McDONNELL DOUGLAS
A300

CHAIRMAN'S MESSAGE

During the period since airline deregulation was introduced in the U.S. in 1978, it has been interesting to follow the saga of takeover, mergers, consolidations, Chapter 11 bankruptcies and the rise and fall of airlines in the U.S. ■■ Financial analysts, and for that matter all of us, have been endeavouring to read the U.S. experience into the Canadian context of aviation regulatory reform. ■■ While it would seem that consolidations within the U.S. airline industry are far from over, there appear to be few willing sellers left in the Canadian airline industry. Since deregulation formally began in Canada approximately two years ago, the Canadian airline industry has been consolidated to the extent there are now two large domestic and international scheduled airlines, plus Wardair, two major charter carriers, and a minimal number of independent feeder airlines. Economies of scale have never proven to contribute significantly to profitability in the airline industry but a comprehensive route structure convenient to the travelling public can favourably influence a carrier's market share and accounts for many of the airline consolidations. ■■ Regardless of what other airlines are or have been doing, Wardair has been a strong proponent of airline deregulation for a number of years, and during that period while operating as a charter airline, we were consciously shaping our operation in order to meet future challenges as a scheduled carrier, once deregulation became a reality. ■■ In today's competitive environment, a commercial air carrier cannot fund itself to prosper and grow on charter-type revenues (i.e. revenues derived from only one source, the leisure travel market). Accordingly, we continue to restructure our services to attract revenues from every market: leisure travel, business travel, travel for any reason, plus the carriage of mail and goods. In order to achieve this end,

CHAIRMAN'S MESSAGE

we are converting to scheduled routes those charter routes presently eligible for conversion under deregulation. We are also restructuring our fleet to replace 300 and 456 seat aircraft currently operating with low flight frequency on charter routes, with a mix of three Boeing 747-100 aircraft, each with 456 seats, for operation on high demand routes, plus twelve Airbus A310-300 aircraft each designed for high frequency operations on scheduled and chartered routes. ■■ The ideal commercial aircraft is the one which will provide low seat-mile costs with a relatively small number of seats, maintain low long-haul seat mile costs on short routes, and have the range to operate long, as well as short, flight legs. The latest generation twin powered aircraft comes closer to meeting the ideal aircraft criteria than any type currently flying today. Of the aircraft types available, we selected the Airbus A310-300 as the aircraft best suited for our route structure. The A310 meets our requirements by providing 196 seats at excellent seat-mile costs on long routes (e.g. Vancouver non-stop to London, England or to Frankfurt, Germany), as well as service on intermediate routes (Toronto to Edmonton), or on short routes (Halifax to Toronto) with a minimal seat-mile cost penalty. ■■ It is incumbent upon airline management to keep its fleet as close as possible to the leading edge of technology in commercial aircraft development in order to achieve the lowest operating costs for competitive purposes, and to provide the passenger with the highest level of comfort, convenience, and on-time service. The selection and disposal of aircraft has been a vital economic factor in our survival as a charter airline and is no less important now with a major fleet reorganization underway. The current market value of our fleet exceeds the debt remaining on those aircraft, and we look to this source for partial funding of the purchase of the new Airbus fleet. The future sale of

CHAIRMAN'S MESSAGE

aircraft is an important source of cash which will assist the Company to upgrade its fleet on a periodic basis and to maintain its long-term fuel-efficient competitive advantage. ■■ In September, 1988, upon delivery of the 12th and final Airbus aircraft currently on order, total available seats within the fleet will have increased approximately 26 percent over year end capacity, and we will have sufficient aircraft to expand our scheduled route network across Canada. We are anxious to create a route network adequate to serve a much larger portion of the public's travel needs than at present, and we are committed to a fleet of the most efficient and passenger-acceptable vehicles currently available, to do the job. ■■ Some traditional charter routes presently served will continue to be served on a charter basis, pending the removal of regulatory obstacles to further scheduled operations. Two classes of service will be provided on aircraft serving scheduled routes and on many charter routes. The new Airbus A310 fleet will continue our tradition of providing the traveller with twin aisle wide-bodied comfort in aircraft configured by the manufacturer to the Company's specifications. ■■ We are committed to providing the travelling public, both Canadian and international originating, with a high quality, useful commercial air transportation service, thereby ensuring the continued presence of a third major air carrier in Canada – Wardair.

Maxwell W. Ward

Maxwell W. Ward
Chairman and Chief Executive Officer.


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PRESIDENT'S REPORT

I am pleased to report our 1986 net earnings from operations exceeded forecast in spite of the slow start during the first half-year. Demand for our scheduled domestic seats in the third quarter was beyond our expectations, no doubt reflecting the strong attraction of Expo 86 as well as demonstrating a basic consumer need for low cost travel within Canada. ■■ Even though our domestic economy fares were priced below the fares offered by existing carriers, the margins were sufficient to substantially improve the Company's profits. I am convinced our decision to expand our operations through the addition of domestic scheduled services will have a stabilizing influence on earnings in the years ahead. ■■ Net income for the year ended December 31, 1986 increased to $46.1 million compared to $11.0 million in 1985 and $9.7 million, before extraordinary items, in 1984. Included in 1986 earnings is $33.2 million net of tax from the sale of one of our 747-200 aircraft late in the year. ■■ 1986 earnings per share totalled $12.84, or $4.33 excluding the gain on asset disposals. This compares to $3.07 for 1985 and $2.70, before extraordinary items, in 1984. The Company paid a dividend of $.10 per share in 1986. Return on equity and return on capital employed in the business were the best of the top four airlines in Canada. These figures reflect the importance your management places on achieving a sound economic performance. ■■ Although our 1986 results were largely due to the success of our domestic scheduled operations, we know much needs to be done in order to bring the range and standard of our service to the level demanded by the Canadian travelling public. We must identify, understand and meet the needs of the business traveller if we hope to attract and retain our share of that market to Wardair. ■■ After nearly twenty-five

PRESIDENT'S REPORT

years of serving the leisure traveller via our international charter operation, we have acquired a sound understanding of, and a good reputation in, the holiday market. Clearly, this knowledge will be important since the vast majority of scheduled passengers today travel on discount fares, undoubtedly reflecting a very high component of leisure-oriented travel. We will be able to use our vacation market experience to ensure success in our efforts to attract this travel sector to our flights. ■■ In order to sell the higher yielding fares, however, with their varying levels of flexibility, we are taking steps to introduce additional features to convenient, on-time flights:

- ease of booking, ticketing and pre-selection of seating.
- airport facilities which permit quick and convenient check-in, deplaning and baggage reclaim whenever required by the traveller.
- sufficient flight frequency to meet the fundamental requirements of the average passenger.
- a superior level of in-flight service and amenities, including sufficient hang-up and overhead stowage to meet carry-on needs.

■■ Passengers paying full fare expect travel flexibility and comfort. They will not remain loyal customers of an airline that neglects these basic expectations. Our plan is to incorporate all of these features as quickly as possible. ■■ We have recently completed a review of current reservations, marketing and passenger handling systems to determine the most time and cost effective alternative open to us. Our study has indicated we should abandon futher development of our USAS system because we will not be able to complete the work required in the time available without incurring a substantial cost penalty. We have contracted with CCS Automation Systems, Inc. to provide their "state of the art" reservation system to Wardair.

PRESIDENT'S REPORT

Implementation of this system will begin immediately with the first stage being available before the delivery of our first aircraft in November, 1987.

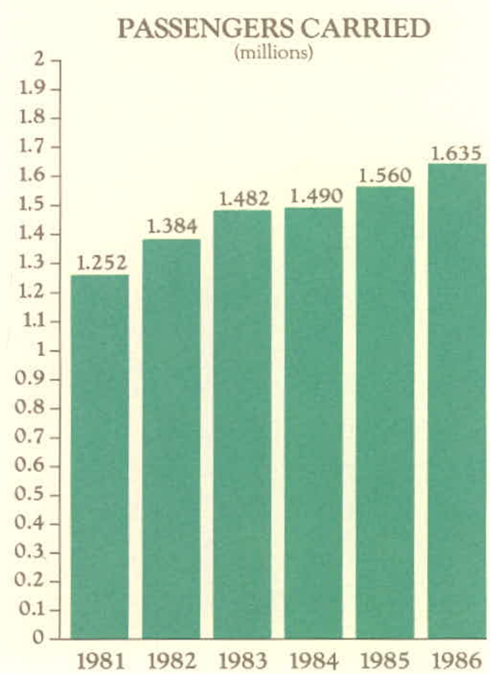
■■ An airline is only as good as its support structure. Over the past few years Wardair has been building a sales, marketing and passenger handling capability which anticipated our conversion to scheduled airline operations. We elected to build our own maintenance facility rather than contract out and acquired the necessary aircraft handling equipment at all major points on our route system. The experience gained in these areas of operation has prepared our management for the changes ahead.

■■ One of our prime concerns is the present airport facilities at Toronto's L.B. Pearson International Airport. The terminal facilities are presently operating at one and one-half times their rated capacity and are unable to cope with any further expansion. In an effort to provide for the future, Wardair has combined with Bramalea Limited, one of Canada's largest commercial real estate developers, to prepare a design, construction and operating proposal for the Minister of Transport respecting Terminal 3 at Toronto. This proposed new terminal will not be available for use until 1990 at the earliest, therefore some intermediate solution will have to be adopted in order to attract a greater number of passengers to our flights. ■■ On behalf of the shareholders, Directors and management of the Company, I would like to express my thanks to all of our employees for their loyalty, commitment and personal effort in the execution of their duties during 1986.

George D. Curley
President and Chief Operating Officer.

REVIEW OF OPERATIONS

During 1986, Wardair carried a record 1,635,400 passengers, which represented an increase of about 4.8% over 1985. Revenue passenger miles exceeded 4 billion. Passenger revenues were $387,954,000, approximately 3.5% above the 1985 level. ■■ A new element of Wardair service to the travelling public was introduced during 1986 with the launch of scheduled services within Canada, and the development of our scheduled operation to the U.K., introduced late in 1985. We believe the potential to reach business travellers offers an exciting new opportunity to Wardair that will have a significant impact on our operations in the years ahead. ■■ Technology and automation continue to offer opportunities for Wardair to more effectively reach our passengers. Our ability to sell to a broad base of travellers was enhanced in 1986 with the expansion of our computerized reservations network and our participation in the Bank Settlement Plans in Canada and the U.K., allowing travel agents to write tickets on behalf of Wardair. The decision to adopt the CCS Automation Systems, Inc. SHARES reservation system will allow us to expand the distribution of information about Wardair products. This system will also enable Wardair to implement competitive passenger handling services such as advance seat selection and automated check-in.



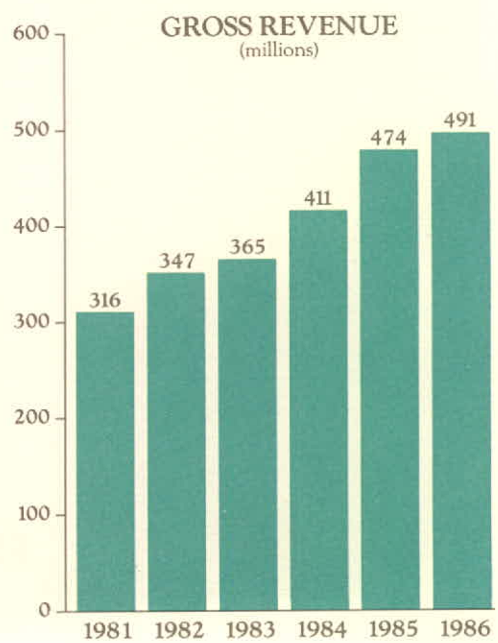
REVIEW OF OPERATIONS

BUSINESS TRAVEL

In 1986 Wardair realized improvements in its potential to capture a share of the business travel market. The launch of scheduled services in the Canadian domestic and U.K. markets, the implementation of a standard airline computer system, the introduction of a Corporate Sales Division, and the launch of a business-oriented Big Seat™ class were all designed to give Wardair the ability to generate higher-yielding fares and consequently higher revenues. ■■ While continuing to maintain and expand Wardair's presence in the leisure market, we have expanded and diversified our product offering to meet the needs of business travellers. Canadian scheduled domestic routes represented 28.9% of total seats offered by Wardair in 1986. Scheduled domestic service is now maintained year 'round, and offers competitive point-to-point fares from most of Canada's major business centres. This zone contributed 23.9% of total passenger revenues in 1986. Average yields per revenue passenger mile increased significantly. The introduction of domestic scheduled services coincided with the heavy vacation travel demand created by Expo 86. As a result, although higher-priced economy bookings represented 24% of total seats sold, we believe that a proportion of these bookings were made by vacationers. Increased awareness of Wardair's domestic business service and a return to traditional travel patterns should result in a more consistent balance of bookings. ■■ In 1985 Wardair also began scheduled service between Canada and the United Kingdom, with regular flights to and from London and Manchester. Wardair's reputation, superior levels of service and competitive pricing allowed us to compete with other major carriers in this market for the higher-yielding economy fare based traffic. ■■ The introduction of Wardair's Big Seat class was a response to the demands of business travellers for

REVIEW OF OPERATIONS

more spacious seating in which to work or relax in a separate, quieter environment. Big Seat class seats are wider, offering more legroom and greater cushioned comfort than Wardair's standard seat. The entire Big Seat class cabin is designated a no-smoking area – another Wardair innovation which has been positively received by air travellers. We are confident that the addition of Big Seat class offers the potential to generate improved revenue yield. ■■ To ensure that business travellers understand Wardair's level of service, an extensive multi-media advertising campaign was launched in 1986, and will be continued and expanded in 1987. The messages of schedule, service and price were communicated on radio, television and in print. ■■ In December, 1986 a Corporate Sales Division was established to support the efforts of our existing sales force by contacting potential corporate clients directly. The addition of this Division will allow us to reach corporate travellers wherever their business travel arrangements are made – at retail travel agencies and in corporate travel departments across Canada. ■■ In May we were linked to the Reservec™ System, providing over 3000 travel agents across Canada, and other airlines, with direct access to Wardair information and booking capability. Late in 1986 the network was further expanded through British Caledonian Airways Limited to reach over 1000 British travel agents specializing in business travel.

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REVIEW OF OPERATIONS

LEISURE TRAVEL

With Fall/Winter sales generating load factors (sales to capacity) of over 80% to most sunspot destinations, Wardair Holidays achieved impressive results from its aggressive marketing stance. Other tour operator contracts contributed $21 million to sales.

■■ Support from leisure travellers continued on Canadian routes. This, coupled with the popularity of Expo 86, resulted in an increase in yield per revenue passenger mile flown.

■■ Demand for flights to the U.K. was affected by world events. Despite travellers' fears and competitive pressure, Wardair increased bookings by 1.4%. Provincial points in Britain showed summer sales increases of 22%, offsetting weakness to London, where capacity was down 15% and sales were off 19%. ■■ Wardair flights to Paris produced excellent results, with capacity up 27%, sales up 33% and revenue up 26%. Strong competition kept fares low, causing yield to fall 12%. ■■ Passengers on the Frankfurt service increased 7% despite constant capacity. Western Canadian overseas traffic declined, primarily due to the popularity of Expo 86 while Eastern Canadian sales to Frankfurt increased 9%. ■■ Wardair carried 223,900 passengers to Hawaii in 1986 (45% of all Canadian traffic, according to the Hawaii Visitors Bureau), although a number of economic factors resulted in an 19% decrease in Wardair's passenger traffic. Active first-quarter competition forced fares to the low levels of the early 1980s, causing a severe impact on yield and revenues. ■■ Yields in the Florida market improved despite strong competition on the route. ■■ Lower capacity to Mexico and Caribbean destinations resulted in decreased passengers and revenue. As capacity increased in Fall 1986, results improved, with seasonal sales up 30%.


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REVIEW OF OPERATIONS

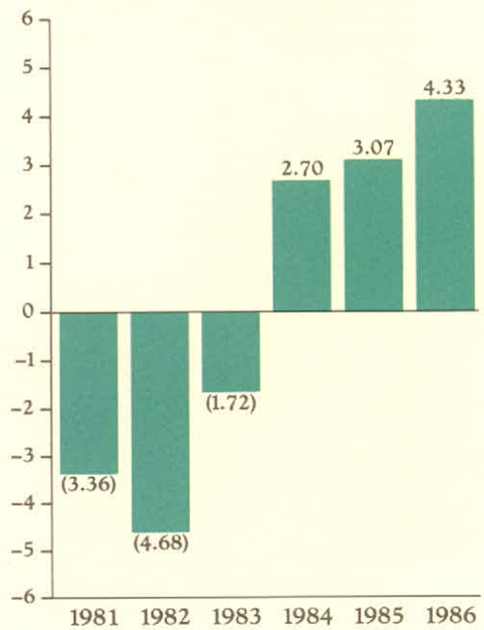
REDROCK REINSURANCE LIMITED (BERMUDA)

Redrock Reinsurance Limited, a wholly-owned subsidiary of Wardair Canada Inc., had another profitable year in 1986. Managed by Insurance Managers Ltd., of Hamilton, Bermuda, Redrock reinsures certain lines of travel related insurance issued by primary underwriters, such as passenger cancellation, baggage liability, medical and accident coverages.

CONTRACT SERVICES

As in previous years, Wardair expanded its outside contract activities in 1986. Facilities and services were provided to production companies for the filming of major motion pictures and television commercials. Passenger handling functions were performed at various locations in Wardair's system for several international carriers. The Company also provided hangarage and maintenance services for numerous international and domestic operators at its hangar facility at Toronto's Lester B. Pearson International Airport. Contracted work included the storage of aircraft, line and repair maintenance functions, equipment rentals, and the installation of hush kits on DC8 aircraft for several operators. Other contractual arrangements in 1986 included the provision of computer equipment and services to several tour operators.

EARNINGS (loss) PER SHARE
before extraordinary items and gain on asset disposals



REVIEW OF OPERATIONS

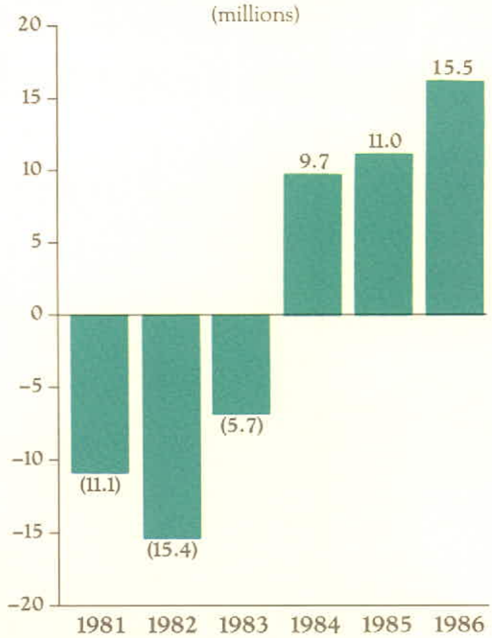
CARGO

Our 1986 Cargo operation produced a healthy increase in revenues for the fourth consecutive year. Pacific, North Atlantic and Domestic routes all experienced a doubling of volume over 1985 levels. ■■ These increases can be largely attributed to the introduction of scheduled services to the United Kingdom and within Canada. Another contributing factor to Wardair's 1986 success in cargo operations was a greater public and industry awareness of the company's cargo carrying capability. In addition, with sales agents from the Far East/ Pacific Rim to Europe, and interline agreements in place throughout the world, the Company was able to offer cargo service virtually around the globe in 1986. ■■ With the anticipation of a further relaxation in some government regulations, as well as the operation for a full twelve months of our scheduled services, further increases in cargo revenue are anticipated.

INFLIGHT SALES

Revenue and profit from inflight sales increased significantly in 1986. This growth is a result of streamlined sales procedures on board the aircraft and growing passenger demand for duty free merchandise. ■■ In October 1986, Wardair was awarded the prestigious Frontier Marketing Award as the world's best airline duty free operator at the Tax Free World Exhibition.

EARNINGS (loss)
before extraordinary items and gain on asset disposals
(millions)



REVIEW OF OPERATIONS

EMPLOYEE RELATIONS

The highly competitive airline industry presents the Company and its employees with an endless supply of challenges. ■■ Because our employees' response to these challenges has a key impact on customer satisfaction, their performance affects financial returns and future growth. ■■ Consistent with this belief, we introduced a system-wide Employee Profit Sharing Plan in 1986 which provides incentives for employees to apply their experience, talents and efforts to improve the Company's economic results. The plan provides for distribution of a share of the Company's profits to be distributed equally to all regular full-time eligible employees, and additional amounts to eligible part-time employees. We believe that our Employee Profit Sharing Plan is making employees highly aware of our corporate objectives and financial results. ■■ In 1986, the Company achieved collective bargaining agreements with unions representing passenger services employees and flight crew members. Collective agreements covering flight attendants, mechanics, crew schedulers, commissary/catering staff and reservations staff expire in 1987. ■■ Following a recent survey of work environments, the Financial Post included Wardair International Ltd. in its selection of the "100 Best Companies to Work For in Canada". It is our desire to maintain this distinction for both our Canadian and offshore employees.

1986 EMPLOYEE PROFIT SHARING CALCULATION

The following chart details the calculation of the Company's contribution to the Plan reflecting specific figures on page twenty-four of the audited financial statements:

	(thousands of dollars)
Earnings from operations	$49,273
Add Back:	
Employee Profit Sharing	2,908
Deduct: Interest Expense	15,826
Net earnings from operations	$36,355
The Company contribution equals 8% of net earnings	$ 2,908

CONSOLIDATED STATEMENT OF EARNINGS

YEAR ENDED DECEMBER 31, 1986	(thousands of dollars) 1986	1985
REVENUE	$491,105	$473,856
Expenses		
Operating	294,406	300,706
Marketing and administration	118,852	102,029
Depreciation	24,625	17,893
Amortization of deferred charges	1,041	2,561
Employee profit sharing	2,908	–
	441,832	423,189
Earnings from operations	49,273	50,667
Interest expense (note 6)	15,826	23,511
Amortization of deferred foreign exchange losses	2,963	2,850
Gain on asset disposals (note 2)	(39,122)	–
	(20,333)	26,361
Earnings before income taxes	69,606	24,306
Deferred income taxes (note 7)	23,552	13,280
Net earnings for the year	$ 46,054	$ 11,026
Earnings per share	$12.84	$3.07

CONSOLIDATED STATEMENT OF RETAINED EARNINGS

YEAR ENDED DECEMBER 31, 1986	(thousands of dollars) 1986	1985
Retained earnings at beginning of year	$ 28,875	$ 17,849
Net earnings for the year	46,054	11,026
	74,929	28,875
Dividends	359	–
Retained earnings at end of year	$ 74,570	$ 28,875

CONSOLIDATED BALANCE SHEET

AS AT DECEMBER 31, 1986	(thousands of dollars) 1986	1985
ASSETS		
Current assets		
Cash and short-term investments (note 3)	**$ 62,195**	$ 50,840
Accounts receivable	**13,907**	7,438
Inventories	**19,395**	16,533
Prepaid expenses	**5,544**	3,783
	101,041	78,594
Property and equipment (note 4)	**347,855**	246,704
Other assets and deferred charges (note 5)	**7,546**	14,743
	$456,442	$340,041
LIABILITIES		
Current liabilities		
Bank indebtedness (note 6)	**$ 5,230**	$ 8,359
Accounts payable and accrued liabilities	**46,151**	38,128
Passenger prepayments	**38,250**	47,638
Principal due within one year on long-term debt	**34,182**	28,891
	123,813	123,016
Long-term debt (note 6)	**207,588**	161,298
Deferred income taxes	**48,512**	24,893
SHAREHOLDERS' EQUITY		
Share capital		
Authorized		
80,000,000 Common shares		
Issued		
3,587,570 Common shares	**1,959**	1,959
Retained earnings	**74,570**	28,875
	76,529	30,834
	$456,442	$340,041

Approved by the board:

Director

Director

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

YEAR ENDED DECEMBER 31, 1986	(thousands of dollars) 1986	1985
Funds provided by (used for):		
Operations		
Net earnings for the year	$ 46,054	$ 11,026
Items not involving funds		
Depreciation	24,625	17,893
Amortization	4,004	5,411
Deferred income taxes	23,552	13,280
Gain on asset disposals	(39,122)	–
Cash flow from operations	59,113	47,610
Change in non-cash working capital	(3,054)	(7,857)
	56,059	39,753
Financing		
Long-term borrowing	132,730	162,813
Repayment of long-term debt	(79,220)	(202,854)
	53,510	(40,041)
Investing		
Proceeds from sale of aircraft	76,373	–
Property and equipment	(156,252)	(13,335)
Reservations system development	(2,788)	(2,455)
Other	(2,671)	(1,142)
	(85,338)	(16,932)
Dividends	(359)	–
Increase (decrease) in funds	23,872	(17,220)
Funds (deficiency) at beginning of year	(5,157)	12,063
Funds (deficiency) at end of year	$ 18,715	$ (5,157)
Funds are comprised of:		
Cash and short-term investments	$ 62,195	$ 50,840
Bank indebtedness	(5,230)	(8,359)
Passenger prepayments	(38,250)	(47,638)
	$ 18,715	$ (5,157)

AUDITORS' REPORT

TO THE SHAREHOLDERS OF
WARDAIR INTERNATIONAL LTD.

We have examined the consolidated balance sheet of Wardair International Ltd. as at December 31, 1986 and the consolidated statements of earnings, retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the Company as at December 31, 1986 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Thorne Ernst & Whinney

Toronto, Canada
March 31, 1987

Chartered Accountants
Member of EW Ernst & Whinney International

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

YEAR ENDED DECEMBER 31, 1986

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries, all of which are wholly-owned.

(b) Foreign exchange

The operations of foreign subsidiaries are considered to be integrated with those of the Company. Accordingly, all foreign currency amounts are translated into Canadian dollars on the following basis:

Property and equipment, related depreciation, and other non-monetary items, at the rates of exchange in effect at the dates of acquisition;

Monetary assets and liabilities, at the rate in effect at the balance sheet date or the hedged rate; and

Revenues and expenses, other than charges for depreciation and amortization of non-monetary assets, at average rates of exchange or hedged rates in effect during the period.

Foreign exchange gains and losses are reflected in earnings in the year in which they arise except those relating to monetary items with an initial fixed life exceeding one year which are amortized over the remaining life of the item.

(c) Inventories

Inventories are valued at the lower of cost and replacement cost less a provision for obsolescence.

(d) Property and equipment and overhaul costs

Property and equipment is stated at cost. Significant expenditures for modifications are capitalized. Upon retirement or disposal of equipment, the related cost and accumulated depreciation are removed from the accounts and the gain or loss is reflected in earnings.

Depreciation is computed substantially by the straight-line method as follows:

New aircraft and related equipment – effective January 1, 1985, the estimated useful life was revised from sixteen to nineteen years with a 15% residual. The undepreciated balance at that date is depreciated over the remaining useful life.

A 747-100 acquired in 1986 will be placed in service in 1987, at which time this aircraft will be depreciated over its remaining estimated useful life of 8 years with a 15% residual.

Three Airbus A300's were acquired in 1986 under conditional sales contracts, providing the vendor with the option to terminate the sale by specified dates at fixed prices. The equipment is being depreciated over the term to these specified dates with residuals equal to the fixed prices.

Other property and equipment – at various rates over the estimated useful life of the asset.

Major airframe overhaul costs are capitalized in the year incurred and amortized over the period to the next scheduled overhaul. Aircraft engine overhaul costs are expensed in the year incurred.

(e) Deferred charges

Deferred charges, other than deferred foreign exchange gains and losses, are amortized on the straight-line method over various periods up to ten years.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

YEAR ENDED DECEMBER 31, 1986

(f) Air fare revenues and direct costs

The Company recognizes air fare revenues and related direct costs at the departure date of each flight.

(g) Income taxes

Provision is not made for income taxes which would be payable on the transfer to Canada of earnings considered to be permanently invested in foreign subsidiaries.

Investment tax credits are accounted for by the cost reduction method whereby the tax credits reduce the cost of assets acquired.

(h) Pensions

Adjustments arising from actuarial revaluations are recognized in earnings while the costs of pension plan amendments are deferred and amortized over the lives of the work force. Actuarial pension liabilities, determined as at December 31, 1985, are fully funded.

2. GAIN ON ASSET DISPOSALS

	(thousands of dollars)
Gain on sale of aircraft net of unamortized foreign exchange and financing costs on related debt retired	$ 44,421
Reservations system development costs	(5,299)
	$ 39,122

3. CASH AND SHORT-TERM INVESTMENTS

Short-term investments include $23,444,000 set aside as segregated securities to meet passenger prepayment obligations.

4. PROPERTY AND EQUIPMENT

(thousands of dollars)	1986	1985
Flight equipment	$442,856	$342,245
Land, buildings and ground equipment	60,330	56,951
	503,186	399,196
Less accumulated depreciation	155,331	152,492
	$347,855	$246,704

5. OTHER ASSETS AND DEFERRED CHARGES

(thousands of dollars)	1986	1985
Loan receivable	$ 1,484	$ –
Foreign exchange losses on long-term monetary items	2,280	8,454
Pension plan amendment	1,309	1,383
Other	2,473	1,917
Reservations system development costs (see note 2)	–	2,989
	$ 7,546	$ 14,743

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

YEAR ENDED DECEMBER 31, 1986

6. LONG-TERM DEBT AND BANK INDEBTEDNESS

	(thousands of dollars) 1986	1985
Syndicated term loan, due 1992	**$ 88,957**	$140,966
Hangar loan, due 1995	**23,300**	25,000
Term loan, due 1993	**23,194**	–
Conditional sales contract	**–**	16,219
Conditional sales contracts, due 1989	**104,235**	–
Other long-term debt	**2,084**	8,004
	241,770	190,189
Less principal due within one year	**34,182**	28,891
	$207,588	$161,298

(a) Syndicated term loan

The syndicated term loan is secured by first charges on all assets of the Company subject to the priority on the assets pledged to secure the conditional sales contracts and the term, hangar and working capital loans.

The loan agreement provides the Company with the right to borrow in Canadian dollars, United States dollars and to a limited extent in pounds sterling. As at December 31, 1986, the loan is payable in United States dollars.

The interest rate, which at December 31, 1986 is 7.9%, varies according to the currency in which the loan is denominated and the Company's debt to equity ratio. The Company may fix the interest rate on a limited portion of the loan.

(b) Hangar loan

This loan is secured by a mortgage on the office and hangar facilities and related leasehold interest in land and a fixed charge upon one aircraft engine.

The loan bears interest at 9.2% at December 31, 1986. The Company has the option of fixing the interest rate on the loan for periods up to five years based on commercial mortgage rates.

(c) Term loan

The term loan is secured by a charge on one McDonnell Douglas DC-10 Series 30 aircraft together with certain engines and auxiliary equipment.

The loan agreement provides the Company with the right to borrow in Canadian dollars, United States dollars and pounds sterling. As at December 31, 1986, the loan is payable in United States dollars.

The interest rate, which at December 31, 1986 is 7.1%, varies according to the currency in which the loan is denominated and the Company's debt to equity ratio.

(d) Conditional sales contracts

These contracts, providing the vendor with the right to terminate the sale of each aircraft upon

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

YEAR ENDED DECEMBER 31, 1986

six months written notice prior to the final payment date, are payable in United States dollars, non-interest bearing and each secured by an Airbus A300 aircraft.

One of the A300 aircraft will be returned to the vendor in August, 1987. The vendor has the right to require the return of the remaining A300 aircraft in 1989.

(e) Other long-term debt

Other long term debt due between 1989 and 2005 is secured by various charges on the assets of the Company with interest at fixed and floating rates which at December 31, 1986 have a weighted average of 10.7%.

(f) Additional information

The Company has a working capital line which is secured by specific flight equipment and certain accounts receivable. As at December 31, 1986, the Company has not drawn on this line of credit. Bank indebtedness as at December 31, 1986, is represented by outstanding cheques.

The various debt agreements contain restrictions and covenants, the most significant of which are:

(i) limitations on additional indebtedness;
(ii) requirement that the appraised value of pledged aircraft and engines be not less than 135% of the outstanding debt;
(iii) requirement to maintain shareholders' equity of at least $20,000,000; and
(iv) restriction on payment of annual dividends to not more than 25% of net earnings of the preceding year.

Principal due on long-term debt in the years 1987 to 1991 is approximately $34,182,000; $31,294,000; $70,972,000; $21,349,000 and $21,353,000, respectively.

Interest expense on long-term debt amounts to $15,595,000 (1985, $23,096,000).

7. INCOME TAXES

Total income tax expense varies from the amounts that would be computed by applying the Canadian federal and provincial tax rates to income before income taxes for the following reasons:

	(thousands of dollars)	
	1986	1985
Canadian federal and provincial tax rates	**49.0%**	48.8%
Tax based upon earnings before income taxes	**$34,107**	$ 11,865
Increase (decrease) results from:		
Non-taxable portion of capital gains	**(11,107)**	–
Non-deductible foreign exchange losses	**288**	778
Non-deductible expenses	**397**	793
Other	**(133)**	(156)
	$23,552	$ 13,280

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

YEAR ENDED DECEMBER 31, 1986

8. COMMITMENTS

(a) Forward exchange contracts

The Company has entered into forward contracts to buy United States dollars in order to hedge certain of the Company's United States dollar liabilities.

(b) Leases

The Company has obligations under long-term operating leases for computer equipment, offices and airport facilities. The aggregate minimum rentals under these leases in each of the years 1987 to 1991 are $5,843,000, $4,991,000, $4,795,000, $4,595,000 and $3,397,000, respectively, and an aggregate of $5,722,000 thereafter to the year 2000.

9. SEGMENTED INFORMATION

The Company considers its international travel and airline operations to be the dominant segment of its business.

Revenue from sales originating in foreign countries approximated $59,000,000 in 1986 (1985, $52,400,000).

10. CONTINGENT LIABILITY

A province has claimed damages of approximately $14 million relating to an income tax matter of 1984 settled with the Federal Government. Wardair rejects the claim and has retained counsel to defend the action. Based on the advice of counsel, Wardair believes that the Company does not have a liability with respect to this matter. The liability, if any, would be recorded as a prior period adjustment.

11. SUBSEQUENT EVENTS

(a) The Company has entered into agreements for the purchase of twelve Airbus A310-300 aircraft, engines and spare parts. Three aircraft are scheduled for delivery in 1987 and nine in 1988. The estimated cost of the aircraft and engines will total approximately $880,000,000 of which $39,000,000 has been paid as a non-refundable deposit.

(b) A Boeing 747-200 and related equipment was sold in March, 1987 resulting in a $29.9 million gain after income taxes.

(c) Banking proposals have been submitted to the Company to provide term financing of $660,000,000 for the aircraft acquisitions.

(d) Wardair Inc., a company which will replace Wardair International Ltd. as the parent company of the Wardair group, intends to:

(i) raise equity capital by the issue of its Class A subordinate voting shares, and invest these proceeds in Wardair International Ltd. to partially fund the acquisition of aircraft, and

(ii) acquire the outstanding common shares of Wardair International Ltd. by exchanging two of its Class B voting shares for each common share of the Company.

MANAGEMENT REPORT

Management is responsible for the preparation and presentation of the accompanying consolidated financial statements and other information in the Annual Report. The preparation of the financial statements requires the use of estimates based on careful judgements and the selection of appropriate generally accepted accounting principles. Financial information presented elsewhere in this Annual Report is consistent with that in the financial statements.

To assure the integrity and objectivity of the financial statements, management has established systems of internal control which provide reliable accounting records and properly safeguard Company assets. The financial statements have been audited by our independent auditors, Thorne Ernst & Whinney whose report outlines the scope of their examination and their opinion on the financial statements.

The Board of Directors appoints an audit committee from among its members to oversee the responsibility of management for financial reporting and to meet with management and the external auditors in order to gain assurance that management is carrying out its responsibilities. This committee reviews the financial statements and report of the external auditors and reports its findings to the Board of Directors for its consideration when approving the financial statements for issuance to shareholders.

T.S. Currie,
Vice President, Finance

G.D. Curley,
President and Chief Operating Officer

FIVE YEAR SUMMARY

	(thousands of dollars)	1986
FINANCIAL	Revenue	$491,105
	Operating costs	441,832
	Earnings from operations	49,273
	Interest expense	15,826
	Amortization of foreign exchange losses	2,963
	Fuel surtax (recovery)	–
	Gain on asset disposals	(39,122)
	Earnings (loss) before taxes	69,606
	Provision for income taxes	
	Current	–
	Deferred	23,552
		23,552
	Earnings (loss) before extraordinary items	46,054
	Extraordinary gain (loss)	–
	Net earnings (loss)	$ 46,054
	Dividends	
	Common	$ 359
	Total dividends	$ 359
	Long-term debt	$241,770
	Deferred income taxes	48,512
	Shareholders' equity (deficiency)	76,529
	Capital employed	$366,811
	Depreciation and amortization	$ 28,629
	Cash flow from operations	$ 59,113
	Additions to property and equipment	$156,252
	Decrease (increase) in long term debt	$ 53,510
	Operating margin	10.0%
	Per share data (in dollars)	
	Earnings (loss) before extraordinary items	$ 12.84
	Net earnings (loss)	$ 12.84
	Dividends	$ 0.10
OPERATING	Passengers carried (thousands)	1,635
	Revenue passenger miles (millions)	4,140
	Aircraft miles (thousands)	15,242
	Aircraft hours	32,567
PERSONNEL	Average number of employees	2,664
	Employee wages and benefits (thousands)	$ 81,466
SHARE INFORMATION	Common shares issued	3,587,570
	Shares held by Canadian residents	98.36%
	Total number of shareholders	1,604

1985	1984	1983	1982
$473,856	$410,879	$364,543	$346,531
423,189	361,308	336,075	334,560
50,667	49,571	28,468	11,971
23,511	25,663	20,705	25,604
2,850	3,350	3,293	4,308
–	(3,960)	1,056	(4,530)
–	–	–	–
24,306	24,518	3,414	(13,411)
–	3,537	–	–
13,280	11,293	9,162	1,970
13,280	14,830	9,162	1,970
11,026	9,688	(5,748)	(15,381)
–	40,784	–	(597)
$ 11,026	$ 50,472	$ (5,748)	$ (15,978)
–	–	–	–
–	–	–	–
$190,189	$218,241	$225,823	$239,212
24,893	11,614	62,586	53,424
30,834	19,808	(30,664)	(24,916)
$245,916	$249,663	$257,745	$267,720
$ 23,304	$ 24,494	$ 27,561	$ 25,655
$ 47,610	$ 45,475	$ 30,975	$ 12,509
$ 13,335	$ 5,582	$ 3,301	$ 11,188
$ 40,041	$ 19,291	$ 15,842	$ 18,787
10.7%	12.1%	7.8%	3.5%
$ 3.07	$ 2.70	$ (1.72)	$ (4.68)
$ 3.07	$ 14.07	$ (1.72)	$ (4.86)
–	–	–	–
1,560	1,490	1,482	1,384
4,215	4,036	3,851	3,844
14,314	12,823	12,365	13,682
30,048	26,949	26,198	29,183
2,159	2,081	1,992	2,234
$ 71,754	$ 63,551	$ 60,206	$ 60,620
3,587,570	3,587,570	3,587,570	3,287,570
97.77%	99.43%	99.55%	99.53%
1,639	1,662	1,538	1,552

WARDAIR INTERNATIONAL LTD.

BOARD OF DIRECTORS

MAXWELL W. WARD
Chairman and
Chief Executive Officer,
Wardair International Ltd.

G. D. CURLEY*
President and
Chief Operating Officer,
Wardair International Ltd.

T. L. SPALDING*
Consultant,
Spalding Associates

M. D. WARD
Vice President,
Wardair International Ltd.

K. M. WARD
Vice President,
Customer Services,
Wardair International Ltd.

J. N. HYLAND*
Corporate Director

L. R. DUNCAN*
Partner,
Duncan Collins

M. J. BROWN
President,
Ventures West Management Inc.

*member of audit committee

OFFICERS AND SENIOR MANAGEMENT

MAXWELL W. WARD
Chairman and Chief Executive Officer

G. D. CURLEY
President and Chief Operating Officer

B. WALKER
Senior Vice President, Sales and Marketing

M. D. WARD
Vice President

L. W. CARDIN
Vice President, Management Information Systems

T. S. CURRIE
Vice President, Finance

J. V. ROUSSEL
Managing Director, Europe

K. M. WARD
Vice President, Customer Services

I. C. WILKIE
Vice President, Corporate and Legal Affairs,
and Secretary-Treasurer

A. K. WILLARD
Vice President, Human Resources

D. W. ROUSE
Executive Assistant to the Chairman,
and Assistant Secretary

B. R. CORBETT
Director, Industrial Relations

R. N. DRISCOLL
Director, Tax Planning, and Assistant Secretary

E. R. LYSYK
Director, Corporate Security and Safety

L. B. MENZIES
Director, Strategic Planning

J. E. MURRAY
Director, Internal Audit

J. W. ORMISTON
Director, Financial Planning

J. L. SHAFFER
Director, Customer Relations
and Consumer Affairs

W. C. THOMPSON,
Director, Financial Operations

G. L. TIBBLES
Director, Corporate Administration
and Insurance, and Assistant Secretary

M. J. WATSON
Director, Computer and Systems Services

WHOLLY-OWNED SUBSIDIARIES

WARDAIR CANADA INC.

MAXWELL W. WARD
Chairman and Chief Executive Officer

G. D. CURLEY
President and Chief Operating Officer

B. WALKER
Senior Vice President,
Sales and Marketing

M. D. WARD
Vice President

T. S. CURRIE
Vice President, Finance

C. D. McNIVEN
Vice President, Maintenance and Engineering

D. V. NICHOLSON
Vice President, Flight Operations

W. R. O'HARA
Vice President, Cargo Sales

K. M. WARD
Vice President, Customer Services

I. C. WILKIE
Vice President, Corporate and Legal Affairs,
and Secretary-Treasurer

P. W. BOLTON
Director, Cabin Services

M. J. BRALEY
Director, Marketing Communications

B. GAERTNER
Director, Marketing Services

C. F. C. GIBSON
Director, Inflight Sales

J. V. GORDON
Director, Passenger Services

A. H. GRAHAM
Director, Operations Control

A. W. JACKMAN
Director, Crew Scheduling

M. KLIPPENSTEIN
Director, Reservations Sales

M. J. KOZAK
Director, Catering Services

J. H. MILLS
Director, Quality Control

T. F. NORD
Director, Engineering and
Maintenance Production

J. F. WOODHALL
Director, Maintenance and Contract Sales

WHOLLY-OWNED SUBSIDIARIES

WARDAIR HOLIDAYS INC.

MAXWELL W. WARD
Chairman and Chief Executive Officer

G. D. CURLEY
President and Chief Operating Officer

B. WALKER
Senior Vice President, Sales and Marketing

M. D. WARD
Vice President

T. S. CURRIE
Vice President, Finance

K. M. WARD
Vice President, Customer Services

I. C. WILKIE
Vice President, Corporate and Legal Affairs, and Secretary-Treasurer

S. A. TAGGART
General Manager

WARDAIR HAWAII, LIMITED

MAXWELL W. WARD
President

G. D. CURLEY
Vice President

M. D. WARD
Vice President

I. C. WILKIE
Vice President, and Secretary-Treasurer

P. B. GARD
General Manager

WARDAIR KAUAI, LIMITED**

MAXWELL W. WARD
President

G. D. CURLEY
Vice President

I. C. WILKIE
Vice President, and Secretary-Treasurer

P. J. REID
General Manager

WARDAIR (U.K.) LIMITED

MAXWELL W. WARD
Director

G. D. CURLEY
Director

A. I. MAYER
Director

J. V. ROUSSEL
Director

I. C. WILKIE
Director

WARDAIR HOLIDAYS (DEUTSCHLAND) GmbH

K. UHLMANN
Managing Director

WARDAIR (france) S.A.R.L.

K. UHLMANN
Managing Director

REDROCK REINSURANCE LIMITED* (BERMUDA)

R. D. SPURLING
Director and President

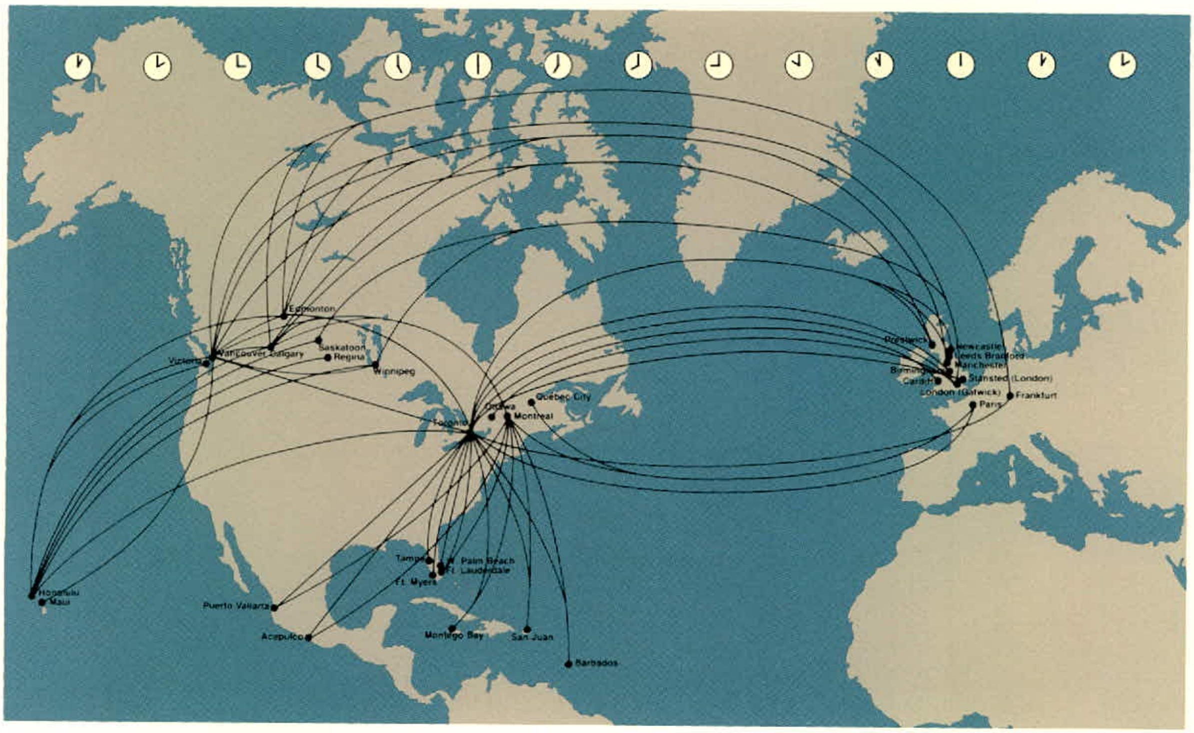
S. W. KEMPE
Director

G. D. CURLEY
Director

F. C. WHITE
Director

*Wholly-owned subsidiary of Wardair Canada Inc.
**Wholly-owned subsidiary of Wardair Hawaii, Limited

WARDAIR WORLDWIDE



CORPORATE INFORMATION

HEAD OFFICE:
325 ManuLife Place,
10180 101 Street, Edmonton, Alberta, T5J 3S4

PRINCIPAL OPERATING OFFICE:
Lester B. Pearson International Airport,
3111 Convair Drive, Mississauga, Ontario,
L5P 1C2

SHARES LISTED:
The Toronto Stock Exchange

AUDITORS:
Thorne Ernst & Whinney
Toronto, Ontario

REGISTRAR AND TRANSFER AGENT:
Montreal Trust Company
Edmonton, Toronto, Vancouver, Calgary and Montreal

PRINCIPAL BANKER:
Toronto-Dominion Bank

OTHER OFFICES

VANCOUVER

CALGARY

MONTREAL

LONDON

MANCHESTER

PRESTWICK

FRANKFURT

PARIS

HONOLULU

TAMPA

BARBADOS